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Making Lemons Out of Lemonade: Employing Counsel to Pursue Estate Assets Through Vicariously or Directly Liable 3rd Parties

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In Pari Delicto Doctrine

By Richard P. Ormond

What is it?

In pari delicto (*potior/melior est conditio possidentis*), Latin for "in equal fault (better is the condition of the possessor)"[1] is a legal term used to indicate that two persons or entities are equally at fault, whether the malfeasance in question is a crime or tort.

The defense of *in pari delicto*, which literally means "in equal fault," is rooted in the common law principle that a plaintiff's recovery may be barred by his or her own wrongful conduct. See Pinter v. Dahl, 486 U.S. 622, 632 (1988).

In essence, that since both parties are equally at fault, the court will not involve itself in resolving one side's claim over the other, and whoever possesses whatever is in dispute may continue to do so in the absence of a superior claim. The doctrine is similar to the defense of unclean hands, both of which are equitable defenses.

Note: Comparative fault and contributory negligence are not the same as *in pari delicto*, though all of these doctrines have similar policy rationales.

Interestingly, the same principle can be applied when neither party is at fault if they have equal right to the disputed property, in which case the maxim of law becomes in *aequali jure* (*melior est conditio possidentis*).

How is it typically invoked?

The phrase is most commonly used by courts when relief is being denied to both parties in a civil action because of wrongdoing by both parties.

This is the general standard applied by the California State Courts: The *in pari delicto* rule should not be applied where the public cannot be protected because the transaction has been completed, where no serious moral turpitude is involved, where the defendant is the one guilty of the greatest moral fault, and where applying the rule will permit the defendant to be unjustly enriched at the expense of the plaintiff.

How do courts analyze it?

The Seventh Circuit held that a receiver can bring fraudulent transfer claims against third parties in *Scholes v. Lehmann*, 56 F.3d 750, 754-55 (7th Cir.1995) where the court held that a Receiver for corporations owned by a Ponzi scheme principal had standing to assert fraudulent conveyance claims to recover amounts transferred by the corporations. The court determined that the receiver was acting on behalf of the corporations and not the Ponzi scheme investors because the corporations were legal entities separate from the principal and were injured by the transfers.

In this seminal case, Scholes was appointed receiver for "bad guy" Michael Douglas (not the actor) and corporations controlled by him that had participated in a Ponzi scheme. *Id.* at 752. Scholes brought fraudulent transfer claims against third parties who had received transfers from the corporate entities. *Id.* at 753. The court held that because the corporate entities were harmed when assets were diverted

through the fraudulent transfer, the receiver, as the holder of claims belonging to the corporations, had standing to assert these claims. *Id.* at 754-55.[1][1]

In *Scholes*, the third parties argued that principles of *in pari delicto* should bar the claims of these corporations because they had been participants in the wrongdoing. *Id.* The court rejected this argument stating that "[t]he defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated." *Id.* at 754.

Who is held up or restricted by it?

With the increasing number of exposed Ponzi schemes, bankruptcy trustees and state court receivers are suing more and more third parties, under either the Bankruptcy Code or state law, for their participation or purported contributions to the fraudulent scheme.

Because trustees and receivers stand in the shoes of the defunct entity in asserting claims against third parties, defendants often argue that the *in pari delicto* doctrine should operate to bar the trustee's or receiver's claims where the failed entity is equally responsible for the claim.

However, a defendant's success in asserting the defense may depend on the type of claim at issue and whether the defendant is being sued by a trustee or a state court receiver.

In controlling cases such as *O'Melveny v. FDIC,* 969 F.2d 744 (1991), the United States Court of Appeals for the Ninth Circuit has specifically stated that

"[T]he equities between a party asserting an equitable defense and a bank are at such variance with the equities between the party and a receiver of the bank that equitable defenses good against the bank should not be available against the Receiver. To hold otherwise would be to elevate form over substance - something courts sitting in equity traditionally will not do." O'Melveny, supra, at751.

As explained in *O'Melveny,* the cases of *Schacht v. Brown*, 711 F.2d 1343 (7th Cir. 1983), cert. denied, 464 U.S. 1002 (1983) and *Cenco, Inc. v. Seidman & Seidman,* 686 F.2d 449 (7th Cir. 1982), cert. denied, 459 U.S. 880 (1982), turn on whether a corporate plaintiff (or, as here, its receiver) is estopped from recovering for the defendant's breach of duty because of the fraud of insiders. The holdings in *Schacht* (followed by this Circuit in *Kempe v. Monitor Intermediaries, Inc.*, 785 F.2d 1443, 1444 (9th Cir. 1986) and *Cenco* determine that there can be no attribution, and therefore no estoppel, when the insiders, rather than the corporation, benefit from the wrongdoing. *O'Melveny, supra*, at 750, citing *Schacht, supra* at 1348 and *Cenco, supra* at 454-56.

In *O'Melveny*, the Ninth Circuit explicitly recognized that receivers may pursue claims against third party co-conspirators, even when individuals in the receivership estate or officers and/or directors acting on behalf of receivership entities may have been active participants in the wrongdoing. *O'Melveny, supra*, at 750. The knowledge of wrongdoing by officers of the entity will not preclude the assertion of claims by the receiver for those entities and as a fiduciary for the benefit of unsecured creditors of those entities. *Id.*

Finally, as stated by the Ninth Circuit in *O'Melveny,*

> *"*Indeed, under *Schacht*, even if the corporation were somehow to benefit from the wrongdoing of insiders, the insiders' conduct is still not attributable to the corporation if a recovery by the plaintiff would serve the objectives of tort liability by properly compensating the victims of the wrongdoing and deterring future wrongdoing."

Id. At 750-751; *accord*, *Cenc, supra*, at 455; *see also, Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp. 901 (D.D.C. 1990).

Who benefits?

Under certain circumstances *in pari delicto* may bar an action by a trustee against third parties who participated in, or received benefits from, the debtor corporation's Ponzi scheme. The defense has been used to bar such actions as negligence claims and claims of breach of fiduciary duty. It is often invoked by professionals that were engaged by the perpetrators such as accountants and lawyers. In some instances, because of this defense and because of the fraud implications—it may be more sound to seek recompense under a theory of aiding and abetting rather than negligence or fraud. But, insurance coverage under an E&O policy or professional negligence policy may not cover an aiding and abetting claim.

Some state courts hold that *in pari delicto* does not apply to state court receivers. These courts reason that "[w]hile a party may itself be denied a right or defense on account of its misdeeds, there is little reason to impose the same punishment on a trustee, receiver or similar innocent entity that steps into the party's shoes pursuant to court order or operation of law."

What are the Restrictions to the Doctrine?

The United States Supreme Court has substantially restricted the *in pari delicto* doctrine's applicability in certain types of federal litigation – most notably, private antitrust and securities lawsuits. See Perma Life Mufflers, Inc. v. Intl. Parts Corp., 392 U.S. 134, 138 (1968) (*overruled on other grounds in* Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984)) ("[T]he doctrine of in pari delicto, with its complex scope, contents, and effects, is not to be recognized as a defense to an antitrust action."); Pinter, 486 U.S. at 632 ("[T]he views expressed in Perma Life apply with full force to implied causes of action under the federal securities laws.") (Quoting Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985)). The Court has reasoned that the policies weighing in favor of preserving private rights of action under these federal laws "far outweigh" any inequities that might result should a culpable plaintiff recover a windfall. See Perma Life, 392 U.S. at 139; Bateman, 472 U.S. at 315-16.

Notwithstanding the Supreme Court's broad, sweeping statements, both the Supreme Court and the Ninth Circuit have recognized one narrow exception where the *in pari delicto* defense may defeat a federal securities or antitrust case: (1) where the plaintiff bears "at least substantially equal responsibility" for the violations he seeks to redress, and (2) the preclusion of suit would not significantly interfere with the effective enforcement of the laws and protection of the public. See Bateman, 472 U.S. at 308; Pinter, 486 U.S. at 633. This analysis frequently is referred to as the "complete involvement" test. See Regents of the University of Calif. v. American Broadcasting Cos., Inc., 747 F.2d 511, 519 (9th Cir. 1984) ("This circuit has determined that 'complete involvement' does constitute a defense to a treble damages claim in an antitrust action.") (Quoting THI-Hawaii v. First Commerce Fin. Corp., 627 F.2d 991, 995 (9th Cir. 1980)); Javelin Corp. v. Uniroyal, Inc., 546 F.2d 276, 279

(9th Cir. 1977) ("To satisfy this test, the jury must necessarily find that the degree of participation on the plaintiff must be equal to that of any defendant and a substantial factor in the formation of the conspiracy.").

What are other exceptions to the Doctrine?

The *in pari delicto* doctrine contains two other exceptions. First, "[k]nowledge will not be imputed to the corporation on the basis of an assertion that its agents, though motivated by personal interests did not benefit the corporation, where under the facts, there is no actual benefit to the corporation." (See Opposition at 20, quoting 8B Am.Jur2d Corporations § 1681 (1995)). Second, the *in pari delicto* defense will not apply to a corporation where an employee acts "completely and directly adverse to the interests of" the company. (Id. quoting Smith, 175 F. Supp. 2d at 1200.)

Pitfalls

Peregrine Funding, Inc. v. Sheppard Mullin Richter & Hampton LLP 133 Cal.App.4th 658, 35 Cal.Rptr.3d 31 (see attachment)

In the context of an unclean hands defense, a bankruptcy trustee stands in the shoes of the debtor and may not use his status as an innocent successor to insulate the debtor from the consequences of its wrongdoing.

Case Study Example by the Presenters

1. Case Study
    a. Example of being invoked
    b. Creative work around that benefits fiduciaries
    c. Class action option
        i. Who makes up the class?
        ii. Venue?
        iii. Certification?
2. Insurance considerations (example/hypo)
3. Class Management
4. Attorney compensation
5. Attorney management
6. Settlement/mediation options
7. Awards
    a. Types of awards
    b. Class distributions
    c. Attorney compensation
8. Pitfalls
9. Questions

133 Cal.App.4th 658, 35 Cal.Rptr.3d 31, 05 Cal. Daily Op. Serv. 9172, 2005 Daily Journal D.A.R. 12,510
(Cite as: 133 Cal.App.4th 658, 35 Cal.Rptr.3d 31)

Court of Appeal, First District, Division 3, California.
PEREGRINE FUNDING, INC., et al., Plaintiffs and Respondents,
v.
SHEPPARD MULLIN RICHTER & HAMPTON LLP, Defendant and Appellant.

No. A104481.
Oct. 19, 2005.
Rehearing Denied Nov. 10, 2005.

Background: Investors who lost millions in an investment scheme and a bankruptcy trustee representing entities that were used to perpetrate the scheme sued a law firm, claiming its negligence and affirmative misconduct helped the perpetrators of the scheme avoid detection and prosecution by securities regulators. The Superior Court of Alameda County, No. RG03087483,Ronald Sabraw, J., denied law firm's special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute, and firm filed an interlocutory appeal.

Holdings: The Court of Appeal, McGuinness, P.J., held that:
(1) attorney's opposition to SEC actions was protected activity under anti-SLAPP statute;
(2) unclean hands doctrine barred action by bankruptcy trustee, and
(3) investors' action was barred by statute of limitations.

Reversed in part, affirmed in part, and remanded.

West Headnotes

[1] Pleading 302 ⚿360

302 Pleading
302XVI Motions
302k351 Striking Out Pleading or Defense
302k360 k. Application and proceedings thereon. Most Cited Cases

Consideration of a special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute involves a two-step process: (1) the court decides whether the defendant has made a threshold showing that the challenged cause of action is one arising from protected activity in furtherance of the defendant's right of petition or free speech in connection with a public issue, and (2) if the court finds such a showing has been made, it then determines whether the plaintiff has demonstrated a probability of prevailing on the claim. West's Ann.Cal.C.C.P. § 425.16.

[2] Pleading 302 ⚿358

302 Pleading
302XVI Motions
302k351 Striking Out Pleading or Defense
302k358 k. Frivolous pleading. Most Cited Cases

A cause of action subject to special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute does not arise from protected

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activity simply because it is filed after protected activity took place, and neither does the fact that a cause of action arguably may have been triggered by protected activity necessarily entail that it arises from such activity. West's Ann.Cal.C.C.P. § 425.16.

[3] Pleading 302 ⚿358

302 Pleading
302XVI Motions
302k351 Striking Out Pleading or Defense
302k358 k. Frivolous pleading. Most Cited Cases

A defendant's act underlying the plaintiff's cause of action must itself have been an act in furtherance of the right of petition or free speech, in order to support a special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute. West's Ann.Cal.C.C.P. § 425.16.

[4] Appeal and Error 30 ⚿842(7)

30 Appeal and Error
30XVI Review
30XVI(A) Scope, Standards, and Extent, in General
30k838 Questions Considered
30k842 Review Dependent on Whether Questions Are of Law or of Fact
30k842(7) k. Review of evidence. Most Cited Cases

On appeal from an order concerning a special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute, Court of Appeal independently determines whether defendant's evidence demonstrates that the cause of action against him arose from protected activity. West's Ann.Cal.C.C.P. § 425.16.

[5] Pleading 302 ⚿358

302 Pleading
302XVI Motions
302k351 Striking Out Pleading or Defense
302k358 k. Frivolous pleading. Most Cited Cases

The special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute's definitional focus is not the form of the plaintiff's cause of action but, rather, the defendant's activity that gives rise to his or her asserted liability, and whether that activity constitutes protected speech or petitioning. West's Ann.Cal.C.C.P. § 425.16.

[6] Pleading 302 ⚿358

302 Pleading
302XVI Motions
302k351 Striking Out Pleading or Defense
302k358 k. Frivolous pleading. Most Cited Cases

In action by investors against attorney who represented parties sued by investors for fraud, certain claims by investors were subject to special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute, as involving protected petitioning activity, including attorney's opposition to the SEC's efforts to obtain restraining orders and to appoint a **receiver** for a corporate plaintiff in the action; that conduct necessarily involved written or oral statements made before a judicial

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proceeding, and was not merely incidental or collateral to plaintiffs' claims against attorney. West's Ann.Cal.C.C.P. § 425.16(e)(1, 4).

See Weil & Brown, Cal. Practice Guide: Civil Procedure Before Trial (The Rutter Group 2004) ¶ 7:221 (CACIVP Ch. 7-C).

[7] Pleading 302 ⚿358

302 Pleading
302XVI Motions
302k351 Striking Out Pleading or Defense
302k358 k. Frivolous pleading. Most Cited Cases

Where a cause of action alleges both protected and unprotected activity, the cause of action will be subject to special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute unless the protected conduct is merely incidental to the unprotected conduct. West's Ann.Cal.C.C.P. § 425.16.

[8] Pleading 302 ⚿360

302 Pleading
302XVI Motions
302k351 Striking Out Pleading or Defense
302k360 k. Application and proceedings thereon. Most Cited Cases

In order to establish a probability of prevailing for purposes of special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute, the plaintiff must demonstrate that the complaint is both legally sufficient and supported by a sufficient prima facie showing of facts to sustain a favorable judgment if the evidence submitted by the plaintiff is credited. West's Ann.Cal.C.C.P. § 425.16(b)(1).

[9] Pleading 302 ⚿360

302 Pleading
302XVI Motions
302k351 Striking Out Pleading or Defense
302k360 k. Application and proceedings thereon. Most Cited Cases

In deciding the question of potential merit of a suit subject to a special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute, the trial court considers the pleadings and evidentiary submissions of both the plaintiff and the defendant, and though the court does not weigh the credibility or comparative probative strength of competing evidence, it should grant the motion if, as a matter of law, the defendant's evidence supporting the motion defeats the plaintiff's attempt to establish evidentiary support for the claim. West's Ann.Cal.C.C.P. § 425.16(b)(2).

[10] Appeal and Error 30 ⚿893(1)

30 Appeal and Error
30XVI Review
30XVI(F) Trial De Novo
30k892 Trial De Novo
30k893 Cases Triable in Appellate Court
30k893(1) k. In general. Most Cited Cases

On appeal from an order concerning a special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute, Court of Appeal reviews de novo the trial court's determination regarding the plaintiff's probability of pre-

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vailing. West's Ann.Cal.C.C.P. § 425.16.

[11] Pleading 302 ⚿358

302 Pleading
302XVI Motions
302k351 Striking Out Pleading or Defense
302k358 k. Frivolous pleading. Most Cited Cases

Pleading 302 ⚿360

302 Pleading
302XVI Motions
302k351 Striking Out Pleading or Defense
302k360 k. Application and proceedings thereon. Most Cited Cases

Generally, a defendant may defeat a cause of action by showing the plaintiff cannot establish an element of its cause of action or by showing there is a complete defense to the cause of action, and there is nothing in the language of the special motion to strike complaint under anti-SLAPP (strategic lawsuit against public participation) statute or the case law construing it that suggests one of these avenues is closed to defendants seeking protection from a SLAPP suit, but a defendant that advances an affirmative defense to such claims properly bears the burden of proof on the defense. West's Ann.Cal.C.C.P. § 425.16.

[12] Bankruptcy 51 ⚿2154.1

51 Bankruptcy
51II Courts; Proceedings in General
51II(B) Actions and Proceedings in General
51k2154 Rights of Action by or on Behalf of Trustee or Debtor
51k2154.1 k. In general; standing. Most Cited Cases

A bankruptcy trustee has no standing to sue third parties on behalf of the estate's creditors, but may assert only claims held by the bankrupt entity itself, even when creditors have expressly assigned their claims to the trustee.

[13] Corporations and Business Organizations 101 ⚿2401(5)

101 Corporations and Business Organizations
101IX Corporate Powers and Liabilities
101IX(B) Representation of Corporation by Corporate Principals
101k2396 Knowledge of or Notice to Corporate Principal as Affecting Corporation
101k2401 Knowledge of or Notice to Particular Corporate Principals
101k2401(5) k. Officers in general. Most Cited Cases
(Formerly 101k428(3))

Knowledge of an officer of a corporation within the scope of his duties is imputed to the corporation.

[14] Corporations and Business Organizations 101 ⚿2401(5)

101 Corporations and Business Organizations
101IX Corporate Powers and Liabilities
101IX(B) Representation of Corporation by Corporate Principals
101k2396 Knowledge of or Notice to Corporate Principal as Affecting Corporation

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101k2401 Knowledge of or Notice to Particular Corporate Principals

101k2401(5) k. Officers in general. Most Cited Cases

(Formerly 101k428(3))

An officer's knowledge is not imputed to the corporation when he has no authority to bind the corporation relative to the fact or matter within his knowledge.

[15] Corporations and Business Organizations 101 ⚿2405

101 Corporations and Business Organizations

101IX Corporate Powers and Liabilities

101IX(B) Representation of Corporation by Corporate Principals

101k2396 Knowledge of or Notice to Corporate Principal as Affecting Corporation

101k2405 k. Knowledge or notice of principal's own fraud. Most Cited Cases

(Formerly 101k428(12))

A corporation is not chargeable with the knowledge of an officer who collaborates with outsiders to defraud the corporation.

[16] Bankruptcy 51 ⚿2154.1

51 Bankruptcy

51II Courts; Proceedings in General

51II(B) Actions and Proceedings in General

51k2154 Rights of Action by or on Behalf of Trustee or Debtor

51k2154.1 k. In general; standing. Most Cited Cases

Equity 150 ⚿65(3)

150 Equity

150I Jurisdiction, Principles, and Maxims

150I(C) Principles and Maxims of Equity

150k65 He Who Comes Into Equity Must Come with Clean Hands

150k65(3) k. Conduct with respect to different transactions. Most Cited Cases

Unclean hands doctrine barred trustee of bankrupt investment corporation from joining with investors in maintaining action against attorney for aiding owner of corporation in defrauding its investors; owner's misconduct was imputed to corporation without regard to the trustee's succession, and attorney's alleged misconduct was directly related to transactions underlying investors' causes of action against the attorney, alleging that his professional advice and tactics enabled owner and corporation to perpetuate their fraud on investors, which is precisely the sort of unfairness the unclean hands doctrine seeks to address.

See 11 Witkin, Summary of Cal. Law (9th ed. 1988) Equity, § 9.

[17] Bankruptcy 51 ⚿2154.1

51 Bankruptcy

51II Courts; Proceedings in General

51II(B) Actions and Proceedings in General

51k2154 Rights of Action by or on Behalf of Trustee or Debtor

51k2154.1 k. In general; standing. Most Cited Cases

Bankruptcy 51 ⚿2553

51 Bankruptcy

51V The Estate

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51V(C) Property of Estate in General
51V(C)2 Particular Items and Interests
51k2552 Rights of Action; Contract Rights Generally
51k2553 k. In general. Most Cited Cases

A bankruptcy trustee succeeds to claims held by the debtor as of the commencement of bankruptcy, and thus courts analyze defenses to claims asserted by a trustee as they existed at the commencement of bankruptcy, and later events may not be taken into account. 11 U.S.C.A. § 541.

[18] Bankruptcy 51 ⚿2154.1

51 Bankruptcy
51II Courts; Proceedings in General
51II(B) Actions and Proceedings in General
51k2154 Rights of Action by or on Behalf of Trustee or Debtor
51k2154.1 k. In general; standing. Most Cited Cases

Equity 150 ⚿65(1)

150 Equity
150I Jurisdiction, Principles, and Maxims
150I(C) Principles and Maxims of Equity
150k65 He Who Comes Into Equity Must Come with Clean Hands
150k65(1) k. In general. Most Cited Cases

In the context of an unclean hands defense, a bankruptcy trustee stands in the shoes of the debtor and may not use his status as an innocent successor to insulate the debtor from the consequences of its wrongdoing.

[19] Equity 150 ⚿65(3)

150 Equity
150I Jurisdiction, Principles, and Maxims
150I(C) Principles and Maxims of Equity
150k65 He Who Comes Into Equity Must Come with Clean Hands
150k65(3) k. Conduct with respect to different transactions. Most Cited Cases

The misconduct which brings the clean hands doctrine into operation must relate directly to the transaction concerning which the complaint is made, i.e., it must pertain to the very subject matter involved and affect the equitable relations between the litigants.

[20] Equity 150 ⚿65(3)

150 Equity
150I Jurisdiction, Principles, and Maxims
150I(C) Principles and Maxims of Equity
150k65 He Who Comes Into Equity Must Come with Clean Hands
150k65(3) k. Conduct with respect to different transactions. Most Cited Cases

In asserting an unclean hands defense, the issue is not whether the alleged misconduct directly relates to plaintiff's causes of action against defendant, but whether the unclean conduct relates directly to the transaction concerning which the complaint is made, i.e., to the subject matter involved, not whether it is part of the basis upon which liability is being asserted.

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[21] Equity 150 ⚿65(1)

150 Equity
150I Jurisdiction, Principles, and Maxims
150I(C) Principles and Maxims of Equity
150k65 He Who Comes Into Equity Must Come with Clean Hands
150k65(1) k. In general. Most Cited Cases

Although the unclean hands defense generally rests on questions of fact, this does not mean the defense can never prevail at the pleading stage or on a motion to strike; where a plaintiff's own pleadings contain admissions that establish the basis of an unclean hands defense, the defense may be applied without a further evidentiary hearing.

[22] Limitation of Actions 241 ⚿100(12)

241 Limitation of Actions
241II Computation of Period of Limitation
241II(F) Ignorance, Mistake, Trust, Fraud, and Concealment or Discovery of Cause of Action
241k98 Fraud as Ground for Relief
241k100 Discovery of Fraud
241k100(12) k. What constitutes discovery of fraud. Most Cited Cases

In action by defrauded investors against attorney for owner of investment company who allegedly aided company and owner in the fraud, limitations period began when investors learned of the fraud, not when they allegedly realized attorney owed a professional duty to them when they reviewed certain documents and found that attorney possessed details about individual investors' financial contributions to the investment funds, which was ancillary to the allegations of misconduct in the complaint. West's Ann.Cal.C.C.P. § 340.6(a).

[23] Limitation of Actions 241 ⚿95(11)

241 Limitation of Actions
241II Computation of Period of Limitation
241II(F) Ignorance, Mistake, Trust, Fraud, and Concealment or Discovery of Cause of Action
241k95 Ignorance of Cause of Action
241k95(10) Professional Negligence or **Malpractice**
241k95(11) k. Attorneys. Most Cited Cases

The one-year limitations period for attorney **malpractice** is triggered by the client's discovery of the facts constituting the wrongful act or omission, not by his discovery that such facts constitute professional negligence, i.e., by discovery that a particular legal theory is applicable based on the known facts; it is irrelevant that the plaintiff is ignorant of his legal remedy or the legal theories underlying his cause of action. West's Ann.Cal.C.C.P. § 340.6(a).

[24] Limitation of Actions 241 ⚿179(1)

241 Limitation of Actions
241V Pleading, Evidence, Trial, and Review
241k176 Pleading in Anticipation of Defense
241k179 Matters Avoiding Bar of Statute
241k179(1) k. In general. Most Cited Cases

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In action by defrauded investors against attorney for owner of investment company who allegedly aided company and owner in the fraud, equitable estoppel against asserting limitations period was not properly pleaded by allegations that attorney breached fiduciary duties owed to them, took evasive actions to stonewall and delay the proceedings, breached ethical duties to produce documents, and continued to withhold documents; complaint did not identify any specific conduct by attorney that was an alleged basis for estoppel, and did not plead facts indicating that such conduct actually and reasonably induced the investors to forbear filing suit within the limitations period.

[25] Limitation of Actions 241 ⚿13

241 Limitation of Actions
241I Statutes of Limitation
241I(A) Nature, Validity, and Construction in General
241k13 k. Estoppel to rely on limitation. Most Cited Cases

Equitable estoppel precluding limitation of actions defense comes into play only after the limitations period has run, and addresses itself to the circumstances in which a party will be estopped from asserting the statute of limitations as a defense to an admittedly untimely action because his conduct has induced another into forbearing suit within the applicable limitations period; its application is wholly independent of the limitations period itself and takes its life, not from the language of the statute, but from the equitable principle that no one will be permitted to profit from his own wrongdoing in a court of justice. West's Ann.Cal.Evid.Code § 623.

[26] Limitation of Actions 241 ⚿13

241 Limitation of Actions
241I Statutes of Limitation
241I(A) Nature, Validity, and Construction in General
241k13 k. Estoppel to rely on limitation. Most Cited Cases

When a defendant's conduct has deliberately induced a plaintiff to delay filing suit, the defendant will be estopped from availing himself of this delay as a defense. West's Ann.Cal.Evid.Code § 623.

****35** Rogers Joseph O'Donnell & Phillips, Pamela Phillips, Sean M. SeLegue and John S. Throckmorton, San Francisco, for Defendant and Appellant.

Bartko, Zankel, Tarrant & Miller, John J. Bartko, Robert H. Bunzel and Howard L. Pearlman, San Francisco, for Plaintiff and Respondent.

McGUINESS, P.J.

***665** This case is one of several arising from the collapse of a large Ponzi scheme.[FN1] Plaintiffs—investors who lost millions in the scheme and a bankruptcy trustee representing entities that were used to perpetrate the scheme—have sued the law firm Sheppard Mullin Richter & Hampton LLP (Sheppard), claiming its negligence and affirmative misconduct helped the perpetrators of the scheme avoid detection and prosecution by securities regulators. Sheppard filed a special motion to strike the complaint under Code of Civil Procedure section 425.16, subdivision (b)(1),[FN2] which provides a means for early dismissal of unmeritorious claims that target the defendant's constitutionally protected speech or petitioning activity. After the trial court denied its motion, the firm filed this

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interlocutory appeal. We conclude the ***666** motion to strike should have been granted in part because plaintiffs' claims are partially based on protected activity and some plaintiffs did not establish the requisite likelihood of prevailing. Specifically, we conclude the bankruptcy trustee's claims on behalf of one entity are barred by the doctrine of unclean hands and the investors' claims are barred by the applicable statute of limitations. Accordingly, we reverse and direct the trial court to enter an order granting the motion to strike as to these plaintiffs.

> FN1. "A Ponzi scheme is a fraudulent investment scheme where '[m]oney from the new investors is used directly to repay or pay interest to old investors, [usually] without any operation or revenue-producing activity other than the continual raising of new funds. This scheme takes its name from Charles Ponzi, who in the late 1920s was convicted for fraudulent schemes he conducted in Boston.' [Citation.]" (*People v. Williams* (2004) 118 Cal.App.4th 735, 739, fn. 2, 13 Cal.Rptr.3d 569.)

> FN2. All statutory references are to the Code of Civil Procedure unless otherwise stated.

BACKGROUND

While it lasted, the Ponzi scheme alleged in this case was disguised as a successful mortgage lending business. (See *Union Bank of California v. Superior Court* (2005) 130 Cal.App.4th 378, 384–385, 29 Cal.Rptr.3d 894 [describing the factual allegations of disgruntled investors in a related case arising from the scheme].) According to the first amended complaint,[FN3] James Hillman and Michael Fanghella established PinnFund USA, Inc. (PinnFund) in the late 1990's as a company to originate, purchase and sell sub-prime mortgage loans, with Fanghella serving as its chief executive officer. Hillman created three businesses—Allied Capital Partners, ****36** Grafton Partners and Six Sigma LLC (collectively, the Funding Entities)—to solicit funds for investment in PinnFund mortgages. These Funding Entities were all managed by Peregrine Funding, Inc. (Peregrine), a corporation owned and controlled by Hillman and his wife. Although contracts between PinnFund and the Funding Entities required all investor funds to be placed in a trust account and used for the sole purpose of funding loans, Hillman and Fanghella looted the account to pay fictional returns to earlier investors and to enrich themselves and other "insider confederates" with millions of dollars in phony commissions and fees. The scheme allegedly bilked investors of over $300 million and resulted in federal criminal charges against Fanghella and Hillman.

> FN3. All references to the complaint are to the first amended complaint.

Attorney William Manierre represented Hillman, Peregrine and two of the Funding Entities beginning in 1995, and he continued to represent them after he joined the Sheppard firm in October 1997. In February 1999, Sheppard prepared two opinion letters for Hillman that plaintiffs claim contain negligent or reckless legal advice. In what the complaint refers to as the "IAA Comfort Letter," Sheppard concluded Peregrine was not required to register as an investment advisor under applicable California or federal laws. Plaintiffs allege this advice was wrong and Sheppard issued it knowing the letter

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was intended to be used for the sole purpose of soliciting investors, in that its securities registration analysis apparently endorsed the legitimacy of the ***667** enterprise. In the "ICA Comfort Letter," and an October 2000 update to this letter, Sheppard advised Hillman that the Funding Entities were not required to register as investment companies under federal securities law so long as they had fewer than 100 investors. Aware that Hillman sought to increase the number of PinnFund investors yet still evade registration laws, Sheppard advised that the law's 100–investor limitation could be circumvented by the creation of a super accredited investment entity. Thereafter, Hillman created a third company (Six Sigma LLC) for this purpose, allowing the scheme to raise—and lose—additional investment funds.

But the scheme began to collapse in September 2000 when a large investor withdrew its $22 million in capital. Two months later, the Securities and Exchange Commission (SEC) commenced an investigation, and in February 2001 the SEC served subpoenas on Hillman, PinnFund, Peregrine and the Funding Entities. The complaint alleges that in February and March 2001, Sheppard counseled Hillman and the Funding Entities about whether to cooperate with the government's demands, and on behalf of these clients refused to produce subpoenaed documents and witnesses.

On March 21, 2001, the SEC filed suit against Hillman, Fanghella, PinnFund and the Funding Entities for violation of federal securities laws. During this time, the complaint alleges Sheppard continued to represent the Funding Entities and Peregrine but acted to their detriment in serving the needs of its co-client Hillman. Specifically, Sheppard opposed provisional relief sought by the government and fought the appointment of a **receiver**. In addition, "Sheppard advised government lawyers in late March 2001 that Hillman would not testify, and if the government insisted that he testify, Sheppard 'would put the Funding Entities into bankruptcy' in order to derail or disrupt the SEC action." To this end, Sheppard consulted with bankruptcy counsel in March 2001. On April 2, 2001, after the SEC obtained a temporary restraining order freezing the assets of Hillman and the Funding Entities, and shortly after the SEC began deposing Hillman, the Funding Entities filed a voluntary petition for bankruptcy and Sheppard filed a notice withdrawing as their counsel. The ****37** firm continued to represent Hillman through the duration of the SEC action, however, and was his counsel of record in the federal criminal case that was later brought against him.

Plaintiff Richard M. Kipperman was appointed the bankruptcy trustee of Peregrine and the Funding Entities in September 2001. Although Kipperman asked the firm to turn over all documents and files pertaining to its representation of these clients, the complaint alleges Sheppard provided only a small portion of the materials requested "in willful concealment of its misconduct."

***668** Plaintiffs [FN4] filed a complaint against Sheppard on March 19, 2003, and an amended complaint on May 12, 2003. The complaint asserts two causes of action—professional **malpractice** and aiding and abetting a breach of fiduciary duty—based on Sheppard's registration analysis and advice in 1997 through early 2001 and its allegedly conflicted representation of ad-

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verse parties in the 2001 SEC action. Plaintiffs claim Sheppard's advice in the IAA and ICA comfort letters was a substantial factor in causing investor losses because it enabled Hillman to evade registration requirements that would have alerted regulators and investors to the perpetrators' illegal activities. Plaintiffs also claim they were damaged by Sheppard's representation of Hillman in the SEC action in that the firm: (1) blocked the SEC's investigation and delayed provisional relief; and (2) assisted Hillman's exit from the Ponzi scheme by helping him implement a so-called dividend reinvestment program that recycled investor returns instead of distributing them to investors.

> FN4. Plaintiffs are: bankruptcy trustee Kipperman, asserting claims on behalf of Peregrine and the Funding Entities, and investors Tom Frame, Bruce Miller and Ronald G. VandenBerghe, asserting claims on behalf of themselves and a putative class of bilked investors.

In response, Sheppard filed a special motion to strike the complaint as a SLAPP suit, pursuant to section 425.16.[FN5] Sheppard argued the suit fell under section 425.16 because both of plaintiffs' claims arose from the firm's protected speech and "litigation activity" on behalf of its clients, and plaintiffs could not establish the requisite likelihood of success because the investors' claims were barred by the statute of limitations and the trustee's claims were barred by standing rules and the equitable doctrine of unclean hands.[FN6] The trial court denied the motion, however, concluding section 425.16 was not triggered because plaintiffs' claims did not arise from any acts by Sheppard in furtherance of its right of petition or free speech in connection with a public issue. While noting this finding did not require it to reach the second prong of a section 425.16 analysis, the trial court's order proceeded to observe that plaintiffs had stated and substantiated legally sufficient claims against Sheppard and the court could not conclude, on the record presented, that the claims were barred by any of the defenses asserted by Sheppard.

> FN5. Sheppard also filed a demurrer and motions to strike the complaint under section 436 and Civil Code section 1714.10. The trial court overruled the demurrer and denied the motions to strike; however, only its ruling on the special motion to strike was immediately appealable. (§§ 425.16, subd. (j), 904.1, subd. (a)(13).)

> FN6. Sheppard raised these same challenges—to the trustee's standing and clean hands and to timeliness of the investors' claims—in its demurrer.

***669 DISCUSSION**

I. Section 425.16 Applies to Claims Partially Based on Protected Activity

Section 425.16 provides for the early dismissal of certain unmeritorious claims ****38** by means of a special motion to strike. (See *Mann v. Quality Old Time Service, Inc.* (2004) 120 Cal.App.4th 90, 102, 15 Cal.Rptr.3d 215 [purpose of the statute is to encourage participation in matters of public significance by allowing prompt dismissal of unmeritorious claims concerning a defendant's constitutionally protected speech or petitioning activity].) In this regard, the statute states: "A cause of action against a person arising from any act of that person in fur-

therance of the person's right of petition or free speech under the United States or California Constitution in connection with a public issue shall be subject to a special motion to strike, unless the court determines that the plaintiff has established that there is a probability that the plaintiff will prevail on the claim." (§ 425.16, subd. (b)(1).)

[1] Consideration of a section 425.16 motion to strike involves a two-step process. "First, the court decides whether the defendant has made a threshold showing that the challenged cause of action is one arising from protected activity. The moving defendant's burden is to demonstrate that the act or acts of which the plaintiff complains were taken 'in furtherance of the [defendant]' s right of petition or free speech under the United States or California Constitution in connection with a public issue,' as defined in the statute. (§ 425.16, subd. (b)(1).) If the court finds such a showing has been made, it then determines whether the plaintiff has demonstrated a probability of prevailing on the claim." (*Equilon Enterprises v. Consumer Cause, Inc.* (2002) 29 Cal.4th 53, 67, 124 Cal.Rptr.2d 507, 52 P.3d 685.)

[2][3] A defendant who files a special motion to strike bears the initial burden of demonstrating that the challenged cause of action arises from protected activity. (*Brill Media Co. v. TCW Group, Inc.* (2005) 132 Cal.App.4th 324, 329, 33 Cal.Rptr.3d 371; see also *Equilon Enterprises v. Consumer Cause, Inc., supra*, 29 Cal.4th at p. 66, 124 Cal.Rptr.2d 507, 52 P.3d 685.) However, as our Supreme Court has observed, "the 'arising from' requirement is not always easily met. [Citations.]" (*Equilon Enterprises v. Consumer Cause, Inc., supra*, 29 Cal.4th at p. 66, 124 Cal.Rptr.2d 507, 52 P.3d 685.) A cause of action does not "arise from" protected activity simply because it is filed after protected activity took place. (*City of Cotati v. Cashman* (2002) 29 Cal.4th 69, 76–77, 124 Cal.Rptr.2d 519, 52 P.3d 695.) Nor does the fact "[t]hat a cause of action arguably may have been triggered by protected activity" necessarily entail that it arises from such activity. (*Id.* at p. 78, 124 Cal.Rptr.2d 519, 52 P.3d 695.) The trial court must instead focus on the substance of the plaintiff's ***670** lawsuit in analyzing the first prong of a special motion to strike. (*Scott v. Metabolife Internat, Inc.* (2004) 115 Cal.App.4th 404, 413–414, 9 Cal.Rptr.3d 242; see *City of Cotati v. Cashman, supra*, 29 Cal.4th at p. 78, 124 Cal.Rptr.2d 519, 52 P.3d 695.) In performing this analysis, the Supreme Court has stressed, "the critical point is whether the plaintiff's cause of action itself was *based on* an act in furtherance of the defendant's right of petition or free speech. [Citations.]" (*City of Cotati v. Cashman, supra*, 29 Cal.4th at p. 78, 124 Cal.Rptr.2d 519, 52 P.3d 695.) In other words, "the defendant's act underlying the plaintiff's cause of action must *itself* have been an act in furtherance of the right of petition or free speech. [Citation.]" (*Ibid.*)

[4] "In deciding whether the 'arising from' requirement is met, a court considers 'the pleadings, and supporting and opposing affidavits stating the facts upon which the liability or defense is based.' (§ 425.16, subd. (b).)" ****39**(*City of Cotati v. Cashman, supra*, 29 Cal.4th at p. 79, 124 Cal.Rptr.2d 519, 52 P.3d 695.) On appeal, we independently determine whether this material demonstrates that the cause of action arises from protected activity. (*Jespersen v. Zubiate–Beauchamp* (2003) 114 Cal.App.4th 624, 629, 7 Cal.Rptr.3d 715.)

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Here, plaintiffs allege essentially two phases of misconduct by Sheppard. First, in the February 1999 and October 2000 "comfort" letters, Sheppard counseled Hillman and Peregrine on strategies to avoid federal and state registration requirements. Plaintiffs complain this advice assisted Hillman in recruiting investors and enabled the scheme to escape the notice of securities regulators for a period of time. As Sheppard essentially concedes on appeal, allegations of wrongdoing pertaining to these advice letters do not concern any petitioning activity by Sheppard on its own behalf or on behalf of a client. [FN7] The letters were not writings made before a judicial proceeding, or in connection with an issue under review by a court. (§ 425.16, subd. (e)(1), (2).) Rather, plaintiffs' allegations concerning these letters describe garden variety transactional **malpractice**, which typically does not trigger the protections of section 425.16. (See, e.g., *Moore v. Shaw* (2004) 116 Cal.App.4th 182, 195–197, 10 Cal.Rptr.3d 154 [attorney's conduct in drafting a termination of trust agreement was not protected activity under section 425.16].)

> FN7. An attorney who is sued for statements made on behalf of a client in a judicial proceeding, or in connection with an issue under review by a court, has standing to bring a motion under section 425.16. (*Jespersen v. Zubiate–Beauchamp, supra*, 114 Cal.App.4th at p. 629, 7 Cal.Rptr.3d 715; see *Briggs v. Eden Council for Hope & Opportunity* (1999) 19 Cal.4th 1106, 1116, 81 Cal.Rptr.2d 471, 969 P.2d 564 [statute does not require that protected statements be made on the speaker's own behalf].)

The second type of wrongdoing alleged in the complaint, regarding Sheppard's representation of clients in the SEC action, is more problematic. The thrust of plaintiffs' argument is that Sheppard breached a duty owed to them by serving Hillman's needs to the detriment of co-clients Peregrine and ***671** the Funding Entities. Investors were harmed along with these entities, plaintiffs allege, because Sheppard's stalling and stonewalling tactics delayed the progress of the SEC's investigation and lawsuit and enabled the scheme's perpetrators to solicit—and steal—more money from investors.

[5] While we agree with the trial court that the essence, or gravamen, of plaintiffs' claims is that Sheppard breached duties of care and loyalty owed to them, this conclusion does not obviate the need to examine the specific acts of wrongdoing plaintiffs allege regarding Sheppard's conduct in the SEC proceeding. As the Supreme Court has explained, "[t]he anti-SLAPP statute's definitional focus is not the form of the plaintiff's cause of action but, rather, the defendant's *activity* that gives rise to his or her asserted liability—and whether that activity constitutes protected speech or petitioning." (*Navellier v. Sletten* (2002) 29 Cal.4th 82, 92, 124 Cal.Rptr.2d 530, 52 P.3d 703.) Because conduct that is alleged to be a breach of duty—e.g., in *Navellier*, the breach of contractual obligations—may also fall within the class of constitutionally protected speech or petitioning activity, a court considering a special motion to strike must examine the allegedly wrongful conduct itself, without particular heed to the form of action within which it has been framed. (*Id.* at pp. 92–93, 124 Cal.Rptr.2d 530, 52 P.3d 703; see also *Jarrow Formulas, Inc. v. LaMarche* (2003) 31 Cal.4th 728, 734–735, 3 Cal.Rptr.3d 636, 74 P.3d 737 [section 425.16 encompasses

any cause of action arising from protected activity, ****40** and the statute does not categorically exempt any particular type of action].)

[6] Plaintiffs complain of some conduct that is not in the nature of speech or petitioning activity. For example, plaintiffs submitted a declaration from law professor Stephen McG. Bundy opining that Sheppard violated ethical rules by failing to disclose potential conflicts of interest or obtain informed consent from all clients to its joint representation of Hillman, Peregrine and the Funding Entities.[FN8] Likewise, the entity-plaintiffs' complaint that Sheppard abandoned them by withdrawing from the representation, and then improperly failed to turn over all client documents when they were requested by the bankruptcy trustee, does not appear to target speech or petitioning activity. But plaintiffs also challenge some of Sheppard's actions in connection with the SEC suit that fall squarely in the category of petitioning activity. For example, plaintiffs complain Sheppard opposed the SEC's efforts to obtain restraining orders and to appoint a **receiver**. These actions necessarily involved "written or oral statement[s] ... made before a ... judicial proceeding" (§ 425.16, subd. (e)(1)). Plaintiffs further allege Sheppard ***672** stopped Hillman's deposition, refusing to allow him to testify further, and threatened to put Peregrine and the Funding Entities into bankruptcy if the SEC persisted in seeking Hillman's testimony. They also complain that Sheppard orchestrated the bankruptcies of the entity-plaintiffs and then, after it withdrew from their representation, selectively responded to a discovery request by withholding documents that would have been harmful to Hillman and themselves. While these acts may not have been communicative per se, they appear to constitute "conduct in furtherance of the exercise of the constitutional right of petition" (§ 425.16, subd. (e)(4)) in that they were litigation tactics the firm employed to benefit its client Hillman's position in an ongoing lawsuit. (Cf. *ComputerXpress, Inc. v. Jackson* (2001) 93 Cal.App.4th 993, 1009, 113 Cal.Rptr.2d 625 [letter of complaint sent to solicit an SEC investigation was a statement in an "official proceeding" for purposes of section 425.16].)

> FN8. Bundy also states that Sheppard wire-transferred $6 million of Hillman's assets into its own account, depleting the assets potentially available for Peregrine and the Funding Entities to use in satisfying claims.

[7] Considering the variety of wrongful acts alleged, the causes of action at issue in this case are mixed in that they are based on both protected and unprotected activity. Several appellate decisions have considered whether section 425.16 applies to such mixed causes of action, and the issue is currently under review by the Supreme Court. (*Kids Against Pollution v. California Dental Association,* review granted Sept. 17, 2003, S117156.) The apparently unanimous conclusion of published appellate cases is that "where a cause of action alleges both protected and unprotected activity, the cause of action will be subject to section 425.16 unless the protected conduct is 'merely incidental' to the unprotected conduct." (*Mann v. Quality Old Time Service, Inc., supra,* 120 Cal.App.4th at p. 103, 15 Cal.Rptr.3d 215; see also *Huntingdon Life Sciences, Inc. v. Stop Huntingdon Animal Cruelty USA, Inc.* (2005) 129 Cal.App.4th 1228, 1245, 29 Cal.Rptr.3d 521; *Martinez v. Metabolife In-*

ternat., Inc. (2003) 113 Cal.App.4th 181, 188, 6 Cal.Rptr.3d 494.) As one court explained, "if the allegations of protected activity are only incidental to a cause of action based essentially on nonprotected activity, the mere mention of the protected activity does not subject the cause of action to an anti-SLAPP motion. [Citation.]"****41** *(Scott v. Metabolife Internat., Inc., supra,* 115 Cal.App.4th at p. 414, 9 Cal.Rptr.3d 242.) But if the allegations concerning protected activity are more than "merely incidental" or "collateral," the cause of action is subject to a motion to strike. (See, e.g., *Mann v. Quality Old Time Service, Inc., supra,* 120 Cal.App.4th at pp. 103–105, 15 Cal.Rptr.3d 215; see also *Fox Searchlight Pictures, Inc. v. Paladino* (2001) 89 Cal.App.4th 294, 308, 106 Cal.Rptr.2d 906 [stating "a plaintiff cannot frustrate the purposes of the SLAPP statute through a pleading tactic of combining allegations of protected and nonprotected activity under the label of one 'cause of action' "].)

Some of the same cases that apply the "merely incidental" test to determine whether section 425.16 applies also assert "it is the principal thrust or ***673** gravamen of the plaintiff's cause of action that determines whether the anti-SLAPP statute applies." *(Scott v. Metabolife Internat., Inc., supra,* 115 Cal.App.4th at p. 414, 9 Cal.Rptr.3d 242; *Martinez v. Metabolife Internat., Inc., supra,* 113 Cal.App.4th at p. 188, 6 Cal.Rptr.3d 494.) [FN9] Plaintiffs rely on this formulation of the test to argue the fundamental basis or gravamen of their claims rests in Sheppard's breaches of duty and not its petitioning activity. But the fact is that some of the alleged *actions* constituting these breaches of duty involved petitioning activity the firm undertook on behalf of its client Hillman. Although the overarching thrust of plaintiffs' claims may be that Sheppard's conduct helped advance the Ponzi scheme—to their detriment—some of the specific conduct complained of involves positions the firm took in court, or in anticipation of litigation with the SEC. We cannot conclude these allegations of classic petitioning activity are merely incidental or collateral to plaintiff's claims against Sheppard. The complaint alleges plaintiffs suffered substantial losses due to Sheppard's conduct in delaying resolution of the SEC investigation and lawsuit and its legal strategies opposing early provisional relief.

FN9. Although the *Metabolife* cases cite *City of Cotati v. Cashman, supra,* 29 Cal.4th at p. 79, 124 Cal.Rptr.2d 519, 52 P.3d 695, for this observation, the Supreme Court's opinion in *Cotati* did not articulate this test, or any other test for mixed causes of action. Rather, the court referred to the "gravamen" of the plaintiff's cause of action as a way of explaining that application of section 425.16 in the case before it depended on an analysis of the substance of the plaintiff's declaratory relief action and not on the existence of a prior lawsuit that may have "triggered" its filing. (*City of Cotati v. Cashman, supra,* 29 Cal.4th at pp. 79–80, 124 Cal.Rptr.2d 519, 52 P.3d 695.)

These allegations of loss resulting from protected activity distinguish this case from other cases finding certain claims against lawyers were not subject to a motion to strike under section 425.16. For example, in *Jespersen v. Zubiate–Beauchamp, supra,* 114 Cal.App.4th at pp. 630–632, 7 Cal.Rptr.3d

715, Division Four of the Second Appellate District concluded a legal **malpractice** action did not arise from protected activity because the plaintiffs did not complain of any specific act of speech or petitioning by their attorneys; rather, the attorneys were sued for their negligent *failure* to act in furtherance of their clients' right of petition. Although the attorneys had filed a declaration in court admitting their **malpractice**, this declaration was merely evidence of their misconduct and was not the basis of the plaintiffs' claims. (*Id.* at pp. 631–632, 7 Cal.Rptr.3d 715; see also *Gallimore v. State Farm Fire & Casualty Ins. Co.* (2002) 102 Cal.App.4th 1388, 1399, 126 Cal.Rptr.2d 560 [section 425.16 does not apply when defendant's protected communicative acts are merely evidence supporting plaintiff's ****42** claim and do not constitute the alleged wrongful acts themselves].) Here, in contrast, plaintiffs claim they were injured by specific communications Sheppard made in the SEC action opposing temporary restraining orders and opposing the appointment of a **receiver**.

Last year, the same appellate division that decided *Jespersen* concluded a breach of loyalty claim against an attorney did not arise from protected ***674** activity under section 425.16. (*Benasra v. Mitchell, Silberberg & Knupp* (2004) 123 Cal.App.4th 1179, 20 Cal.Rptr.3d 621.) The plaintiffs in *Benasra* argued the defendant firm breached a duty of loyalty owed to them as current and former clients because it represented an opponent in an arbitration proceeding against them. (*Id.* at pp. 1182–1183, 20 Cal.Rptr.3d 621.) Although the trial court granted a special motion to strike, concluding the suit was based on the firm's statements and writings made in or in connection with arbitration and judicial proceedings (*id.* at pp. 1183–1184, 20 Cal.Rptr.3d 621), the Court of Appeal reversed (*id.* at p. 1190, 20 Cal.Rptr.3d 621). In so doing, the court relied on its holding in *American Airlines, Inc. v. Sheppard, Mullin, Richter & Hampton* (2002) 96 Cal.App.4th 1017, 117 Cal.Rptr.2d 685, that an attorney's breach of the duty of loyalty occurs as soon as the attorney agrees to represent a new client with conflicting interests, and actual disclosure of client confidences during litigation is not required as a basis of this tort. (*Benasra v. Mitchell, Silberberg & Knupp*, *supra*, 123 Cal.App.4th at pp. 1187–1189, 20 Cal.Rptr.3d 621.) Focusing on this moment when an actionable breach of the duty of loyalty occurs, the court reasoned that the *Benasra* plaintiffs' **malpractice** claim did not arise out of the firm's representation of an adverse party in arbitration, but rather from the earlier breach of loyalty that occurred when the law firm allied itself with the adverse party. (*Id.* at pp. 1186–1189, 20 Cal.Rptr.3d 621.)

We question the *Benasra* decision's focus on the theoretical time that a breach of duty occurs, as opposed to the specific allegations of wrongdoing in the operative complaint. We also question the decision's exclusive focus on the issue of breach of duty. Section 425.16, subdivision (b)(1) states that the statute applies to a "cause of action" arising from a defendant's protected activity, and establishing a cause of action requires proof of causation and damages in addition to liability. Where, as here, a cause of action alleges the plaintiff was damaged by specific acts of the defendant that constitute protected activity under the statute, it defeats the letter and spirit of section 425.16 to hold it inapplicable because the liability element of the plaintiff's claim may be proven without reference to the protected activity. The Legis-

lature has commanded that section 425.16 be "construed broadly," consistent with its remedial purpose. (§ 425.16, subd. (a).) Moreover, our interpretation finds support in the language of section 425.16 itself, which provides that the statute applies to a cause of action "arising from *any act* " of the defendant in furtherance of the right to petition or free speech. (§ 425.16, subd. (b)(1), italics added; cf. *City of Cotati v. Cashman, supra*, 29 Cal.4th at pp. 75–76, 124 Cal.Rptr.2d 519, 52 P.3d 695 [relying on this language and legislative intent that the statute be construed broadly in concluding a special motion to strike does not require proof of the plaintiff's intent to chill protected speech or petitioning].)

***675** Because we conclude both of plaintiffs' claims are based in significant part on Sheppard's protected petitioning activity in the SEC litigation, the burden shifts to plaintiffs under section 425.16 to make a prima facie showing their claims have merit.

****43 II. No Likelihood of Prevailing on Claims Barred by Defenses**

[8] In order to establish a probability of prevailing for purposes of section 425.16, subdivision (b)(1), "the plaintiff need only have ' "stated and substantiated a legally sufficient claim." ' [Citation.] 'Put another way, the plaintiff "must demonstrate that the complaint is both legally sufficient and supported by a sufficient prima facie showing of facts to sustain a favorable judgment if the evidence submitted by the plaintiff is credited." ' [Citation.]" (*Navellier v. Sletten, supra*, 29 Cal.4th at pp. 88–89, 124 Cal.Rptr.2d 530, 52 P.3d 703.) The plaintiff's burden on what the Supreme Court has referred to as the "minimal merit" prong of section 425.16, subdivision (b)(1) (*Navellier v. Sletten, supra*, 29 Cal.4th at p. 95, fn. 11, 124 Cal.Rptr.2d 530, 52 P.3d 703) has been likened to that in opposing a motion for nonsuit or a motion for summary judgment. (*1–800 Contacts, Inc. v. Steinberg* (2003) 107 Cal.App.4th 568, 584–585, 132 Cal.Rptr.2d 789.) [FN10] "A plaintiff is not required 'to *prove* the specified claim to the trial court'; rather, so as to not deprive the plaintiff of a jury trial, the appropriate inquiry is whether the plaintiff has stated and substantiated a legally sufficient claim. [Citation.]" (*Mann v. Quality Old Time Service, Inc., supra*, 120 Cal.App.4th at p. 105, 15 Cal.Rptr.3d 215.)

FN10. But see *Tuchscher Development Enterprises, Inc. v. San Diego Unified Port Dist.* (2003) 106 Cal.App.4th 1219, 1239–1240, 132 Cal.Rptr.2d 57 (*Tuchscher*), which points out that, unlike a motion for summary judgment, a special motion to strike under section 425.16 does not impose an initial burden of production on the moving defendant. The defendant's only burden is to establish that claims against it fall within the ambit of the statute, and the defendant does not have the overall burden of showing the plaintiff cannot prevail on the claims. (*Tuchscher, supra*, 106 Cal.App.4th at pp. 1239, 132 Cal.Rptr.2d 57.)

[9][10] "In deciding the question of potential merit, the trial court considers the pleadings and evidentiary submissions of both the plaintiff and the defendant (§ 425.16, subd. (b)(2)); though the court does not *weigh* the credibility or comparative probative strength of competing evidence, it

should grant the motion if, as a matter of law, the defendant's evidence supporting the motion defeats the plaintiff's attempt to establish evidentiary support for the claim. [Citation.]" (*Wilson v. Parker, Covert & Chidester* (2002) 28 Cal.4th 811, 821, 123 Cal.Rptr.2d 19, 50 P.3d 733; see also *Schroeder v. Irvine City Council* (2002) 97 Cal.App.4th 174, 184, 118 Cal.Rptr.2d 330.) As with the first prong of an analysis under section 425.16, we review de novo the trial court's determination regarding the plaintiff's probability of prevailing. (*Schroeder v. Irvine City Council, supra*, 97 Cal.App.4th at p. 184, 118 Cal.Rptr.2d 330; see also *1–800 Contacts, Inc. v. Steinberg, supra*, 107 Cal.App.4th at p. 585, 132 Cal.Rptr.2d 789.)

[11] ***676** In its motion to strike and on appeal, Sheppard does not challenge plaintiffs' ability to state or support any substantive element of their claims. Rather, Sheppard contends the bankruptcy trustee lacks standing and the claims of certain plaintiffs are barred by the defenses of unclean hands and the statute of limitations. In response, plaintiffs argue their burden is simply to present a prima facie case, and they have no obligation to disprove Sheppard's affirmative defenses. But plaintiffs' one-sided focus on the sufficiency of their prima facie showing ignores the other side of the equation, i.e., that the motion should be granted if the defendant presents evidence that defeats the plaintiff's claim as a matter of law. ****44**(*Wilson v. Parker, Covert & Chidester, supra*, 28 Cal.4th at p. 821, 123 Cal.Rptr.2d 19, 50 P.3d 733.) Generally, a defendant may defeat a cause of action by showing the plaintiff cannot establish an element of its cause of action *or* by showing there is a complete defense to the cause of action, and there is nothing in the language of section 425.16 or the case law construing it that suggests one of these avenues is closed to defendants seeking protection from a SLAPP suit. (See *Traditional Cat Assn., Inc. v. Gilbreath* (2004) 118 Cal.App.4th 392, 398–399, 13 Cal.Rptr.3d 353 [noting the anti-SLAPP statute contemplates consideration of the merits of the plaintiff's case "as well as all available defenses to it" including state law defenses such as the statute of limitations].) [FN11]

FN11. Several published cases have considered the validity of defenses in determining whether the plaintiff has shown a probability of prevailing in the context of section 425.16. (See, e.g., *Mann v. Quality Old Time Service, Inc., supra*, 120 Cal.App.4th at pp. 107–109, 15 Cal.Rptr.3d 215 [evaluating privilege defenses]; *Traditional Cat Assn., Inc. v. Gilbreath, supra*, 118 Cal.App.4th at pp. 398–399, 404–405, 13 Cal.Rptr.3d 353 [finding plaintiffs' claim barred by statute of limitations]; *Yu v. Signet Bank/Virginia* (2002) 103 Cal.App.4th 298, 322–323, 126 Cal.Rptr.2d 516 [evaluating unclean hands defense]; *Kashian v. Harriman* (2002) 98 Cal.App.4th 892, 925, 120 Cal.Rptr.2d 576 [concluding a cause of action was time-barred]; see also *Huntingdon Life Sciences, Inc. v. Stop Huntingdon Animal Cruelty USA, Inc., supra*, 129 Cal.App.4th at p. 1260, 29 Cal.Rptr.3d 521 [concluding one plaintiff lacked standing to pursue certain claims].)

However, the defendant also generally bears the burden of proving its affirmative defenses. (Evid.Code, § 500; *Sargent*

Fletcher, Inc. v. Able Corp. (2003) 110 Cal.App.4th 1658, 1667, 3 Cal.Rptr.3d 279.) Thus, although section 425.16 places on the plaintiff the burden of substantiating its claims, a defendant that advances an affirmative defense to such claims properly bears the burden of proof on the defense. (See, e.g., *Mann v. Quality Old Time Service, Inc., supra*, 120 Cal.App.4th at p. 109, 15 Cal.Rptr.3d 215 [noting, in the context of a section 425.16 analysis, that defendants had failed to carry their burden of establishing their allegedly defamatory statements were protected under the conditional privilege of Civil Code section 47, subdivision c].)

A. Trustee's Claims for Peregrine Are Equitably Barred

Sheppard argues claims by the bankruptcy trustee are barred as a matter of law because: (1) the trustee lacks standing to sue for investors' ***677** losses, and the complaint alleges no independent injury to the bankrupt entities; and (2) the defense of unclean hands bars the trustee from asserting claims on behalf of Peregrine. Although some cases have considered the bankrupt entity's unclean hands (generally referred to in federal decisions as the ***in pari delicto*** doctrine) as an element of standing (see, e.g., *Apostolou v. Fisher* (N.D.Ill.1995) 188 B.R. 958, 972), they are analytically distinct concepts. (See *Official Com. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.* (3d Cir.2001) 267 F.3d 340, 346 (*Lafferty*) ["Whether a party has standing to bring claims and whether a party's claims are barred by an equitable defense [such as ***in pari delicto***] are two separate questions, to be addressed on their own terms"].) We therefore consider them separately.

1. Standing

[12] A bankruptcy trustee has no standing to sue third parties on behalf of the estate's creditors, but may assert only claims held by the bankrupt entity itself. (*Caplin v. Marine Midland Grace Trust Co.* (1972) 406 U.S. 416, 428–434, 92 S.Ct. 1678, 32 L.Ed.2d 195; ****45***Shearson Lehman Hutton, Inc. v. Wagoner* (2d Cir.1991) 944 F.2d 114, 118–119 (*Shearson Lehman*); see also *Stodd v. Goldberger* (1977) 73 Cal.App.3d 827, 833–834, 141 Cal.Rptr. 67.) This is true even when creditors have expressly assigned their claims to the trustee. (*Williams v. California 1st Bank* (9th Cir.1988) 859 F.2d 664 [trustee lacked standing to pursue claims assigned by defrauded Ponzi scheme investors].) The crucial inquiry, then, is "whether in the case at hand there is any damage to the *corporation,* apart from that done to the third-party creditor noteholders." (*Shearson Lehman, supra*, 944 F.2d at pp. 118–119; see also *Lafferty, supra*, 267 F.3d at pp. 348–349; *In re Folks* (Bankr.9th Cir.1997) 211 B.R. 378, 385–387.)

The complaint in this case merely sets forth two causes of action against Sheppard and does not parse out which claims—and for which alleged damages—the trustee is asserting on behalf of Peregrine and the Funding Entities and which claims the individual investors are asserting. Plaintiffs have made no attempt to remedy this vagueness below or on appeal, and we can find no clear statement in their briefing that identifies the losses plaintiffs claim these corporate entities suffered, separate and apart from losses to investors, as a result of Sheppard's alleged misconduct. Keeping in mind plaintiffs' minimal burden at this stage of the proceedings, however (see *Navellier v. Sletten, supra*, 29 Cal.4th at p. 95, fn. 11, 124 Cal.Rptr.2d 530, 52 P.3d 703), we conclude a

separate claim on behalf of Peregrine and the Funding Entities is fairly implied from the complaint. Although the complaint is primarily focused on describing Sheppard's conduct in furtherance of the Ponzi scheme, and asserting that this conduct was a substantial factor in causing enormous investor losses, the complaint also alleges Sheppard " 'put the Funding Entities into bankruptcy' " to serve the conflicting goals of Hillman and, as a result, caused the ***678** companies to lose "investment contributions" and other "assets" and to incur attorney fees and expenses and "delay damages." While hardly a model of clarity, these allegations indicate the trustee is asserting claims the corporate entities have as clients of Sheppard, and such claims belong to the entities alone.[FN12]

> FN12. The trial court remarked on a similar ambiguity in ruling on a demurrer to plaintiffs' complaint in a related action against Union Bank of California. (Upon plaintiffs' unopposed request, we take judicial notice of this order.) The court sustained a demurrer challenging the trustee's standing with leave to amend and encouraged plaintiffs to clarify which claims are being asserted by the trustee and which by investors, noting "the trustee and the individual investors cannot ultimately pursue the same claims."

This conclusion does not end our standing analysis, however. When it is alleged that a debtor corporation was used as a tool in perpetrating a Ponzi scheme, federal bankruptcy courts have questioned whether any injury to the corporation is "merely illusory" because it passed directly to the sole shareholders and wrongdoers. (E.g., *Lafferty, supra*, 267 F.3d at pp. 352–353; *Feltman v. Prudential Bache Securities* (S.D.Fla.1990) 122 B.R. 466, 473–474 (*Feltman*).) The answer to this question depends upon whether the debtor's corporate form is to be respected, or conversely whether circumstances permit a piercing of the corporate veil. (*Lafferty, supra*, 267 F.3d at pp. 352–354.) For example, in a case in which it was alleged the debtor corporations were sham entities with no corporate identity apart from their sole shareholder, a bankruptcy court concluded: "As the corporations were essentially only conduits for stolen money, any injury to the debtors ... must be substantially coterminous with the injury to the ****46** defrauded creditors. Everything [the shareholder] stole from the debtor corporations, the debtors had stolen from the creditors. Thus, any alleged injury to the debtors is as illusory as was their corporate identity." (*Feltman, supra*, 122 B.R. at pp. 473–474, fn. omitted.) Several cases have distinguished *Feltman*, however, where the complaint does not allege the debtor was a sham corporation or a mere alter ego of its shareholders. (See, e.g., *Lafferty, supra*, 267 F.3d at pp. 353–354; *In re Plaza Mortgage & Finance Corp.* (Bankr.N.D.Ga.1995) 187 B.R. 37, 40–41; *In re Latin Investment Corp.* (Bankr.D.D.C.1993) 168 B.R. 1, 7.)

The complaint does not specifically describe Peregrine and the Funding Entities as "sham" or "fictional" corporations, and we are reluctant to read such allegations into the complaint, as Sheppard would have us do, given the harsh consequences that would result. Although the complaint states Fanghella and Hillman used the Funding Entities as "devices to swindle the investors" and later describes them as "mere pass-throughs for the investors to fund"

PinnFund mortgage loans, it does not allege corporate formalities were ignored, or that Peregrine or the Funding Entities were mere alter egos of the perpetrators of the Ponzi scheme. According to the complaint these companies were created "and operated ... to generate and collect investment ***679** dollars" for PinnFund mortgages. It is unclear from the complaint and the record whether some of the invested money was legitimately used to fund mortgages; thus, we cannot conclude at this stage of the proceedings that Peregrine and the Funding Entities were " 'created for the sole purpose of defrauding creditors.' " (*In re Latin Investment Corp., supra*, 168 B.R. at p. 7.)

2. Unclean Hands

Having determined Sheppard's challenge to standing does not defeat the trustee's claims as a matter of law, we next consider the argument that the trustee's claims on behalf of Peregrine are barred by the equitable defense of unclean hands.[FN13] This issue requires us to address three questions: (1) whether Hillman and Fanghella's misconduct in running a Ponzi scheme can be imputed to the corporate entity Peregrine (see *Casey v. United States Bank Nat. Assn.* (2005) 127 Cal.App.4th 1138, 1143, 26 Cal.Rptr.3d 401 [application of unclean hands doctrine depends upon whether wrongdoing of officers may be imputed to the corporation]); (2) whether Peregrine's misconduct can be imputed to the bankruptcy trustee (see *Lafferty, supra*, 267 F.3d at pp. 356–357; *In re Hedged–Investments Associates, Inc.* (10th Cir.1996) 84 F.3d 1281, 1284–1286); and (3) whether the misconduct is sufficiently related to the causes of action asserted in this case (see *Kendall–Jackson Winery, Ltd. v. Superior Court* (1999) 76 Cal.App.4th 970, 979, 90 Cal.Rptr.2d 743).

FN13. In this appeal, Sheppard asserts the unclean hands defense *only* against claims the trustee has brought on behalf of Peregrine. As such, we do not decide whether the defense bars the trustee's claims on behalf of the bankrupt Funding Entities.

[13][14][15][16] The first question is not complicated. It is settled California law that "[k]nowledge of an officer of a corporation within the scope of his duties is imputed to the corporation. *(Sanders v. Magill* [(1937)] 9 Cal.2d 145, 153 [70 P.2d 159].)" *(United California Bank v. Maltzman* (1974) 44 Cal.App.3d 41, 51–52, 118 Cal.Rptr. 299.) "On the other hand, an officer's knowledge is not imputed to the corporation when he has no authority to bind the corporation relative to the fact or matter within his knowledge. [Citations.]" ****47** *(Meyer v. Glenmoor Homes, Inc.* (1966) 246 Cal.App.2d 242, 264, 54 Cal.Rptr. 786.) Nor is a corporation chargeable with the knowledge of an officer who collaborates with outsiders to defraud the corporation. *(Ibid.;* see also *F.D.I.C. v. O'Melveny & Myers* (9th Cir.1992) 969 F.2d 744, 750 *(O'Melveny*).) The complaint alleges that Peregrine was owned entirely by Hillman and his wife and was "controlled by" Hillman. Because Hillman, one of the primary architects of the Ponzi scheme, was also the owner and sole person in control of Peregrine, his fraud is properly imputed to Peregrine. (See *Lafferty, supra*, 267 F.3d at pp. 359–360 [imputing fraudulent conduct of officers to debtor corporation they owned and controlled]; cf. *Casey v. United States Bank Nat. Assn., supra*, 127 Cal.App.4th at p. 1143, 26 Cal.Rptr.3d 401 [concluding ***680** officers' wrongful conduct could not be imputed to debtor corporation on demurrer

where complaint did not allege who owned or controlled the corporation and it could not be determined whether all relevant decisionmakers of the company participated in the fraud].)

[17][18] Our answer to the second question is also straightforward. A bankruptcy trustee succeeds to claims held by the debtor "as of the commencement" of bankruptcy. (11 U.S.C. § 541(a)(1).) Section 541 of the Bankruptcy Code thus requires that courts analyze defenses to claims asserted by a trustee as they existed at the commencement of bankruptcy, and later events (such as the ouster of a wrongdoer) may not be taken into account. (*Lafferty, supra*, 267 F.3d at pp. 356–357; *In re Hedged–Investments Associates, Inc., supra*, 84 F.3d at p. 1285; see also *Bank of Marin v. England* (1966) 385 U.S. 99, 101, 87 S.Ct. 274, 17 L.Ed.2d 197 ["The trustee succeeds only to such rights as the bankrupt possessed; and the trustee is subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition"].) In the context of an unclean hands defense, this means a bankruptcy trustee stands in the shoes of the debtor and may not use his status as an innocent successor to insulate the debtor from the consequences of its wrongdoing. (*Lafferty, supra*, 267 F.3d at pp. 357–358; *In re Hedged–Investments Associates, Inc., supra*, 84 F.3d at p. 1285; see also *Hirsch v. Arthur Andersen & Co.* (2d Cir.1995) 72 F.3d 1085, 1094–1095 [finding trustee precluded from asserting professional **malpractice** claims because of the debtor's collaboration in promoting a Ponzi scheme].) Peregrine's unclean conduct—i.e., its participation in the scheme that defrauded investors of millions—must therefore be considered without regard to the trustee's succession.[FN14]

FN14. Cases cited by plaintiffs that have declined to apply the ***in pari delicto*** doctrine to claims asserted in a receivership (see, e.g., *O'Melveny, supra*, 969 F.2d at pp. 751–752) are distinguishable because, unlike a **receiver**, a bankruptcy trustee's standing is based on, and subject to the limits of, 11 U.S.C. § 541. (See *Lafferty, supra*, 267 F.3d at p. 358; *Apostolou v. Fisher, supra*, 188 B.R. at pp. 973–974.)

[19][20] We also believe Sheppard has the better argument as to the third question. It has long been held that the misconduct asserted in an unclean hands defense must be sufficiently related to the matter currently before the court. Thus the court held in *Fibreboard Paper Products Corp. v. East Bay Union of Machinists* (1964) 227 Cal.App.2d 675, 728, 39 Cal.Rptr. 64 (*Fibreboard*) that "[t]he misconduct which brings the clean hands doctrine into operation must relate directly to the transaction concerning which the complaint is made, i.e., it must pertain to the very subject matter involved and affect the ****48** equitable relations between the litigants." (See also *Yu v. Signet Bank/Virginia, supra*, 103 Cal.App.4th at p. 323, 126 Cal.Rptr.2d 516; *Kendall–Jackson Winery, Ltd. v. Superior Court, supra*, 76 Cal.App.4th at p. 979, 90 Cal.Rptr.2d 743.) Plaintiffs argue the ***681** unclean hands defense does not apply because Peregrine's alleged misconduct "does not *directly relate* to plaintiffs' causes of action against Sheppard Mullin for its breaches of the duties of care and loyalty." This overly narrow formulation is not supported by case law. The question is whether the unclean conduct relates directly "to the

transaction concerning which the complaint is made," i.e., to the "*subject matter* involved" (*Fibreboard, supra*, 227 Cal.App.2d at p. 728, 39 Cal.Rptr. 64, italics added), and not whether it is part of the basis upon which liability is being asserted. (*Unilogic, Inc. v. Burroughs Corp.* (1992) 10 Cal.App.4th 612, 621, 12 Cal.Rptr.2d 741 ["the doctrine does apply 'if the inequitable conduct occurred in a transaction directly related to the matter before the court and affects the equitable relationship between the litigants' "]; see also *Kendall–Jackson Winery, Ltd. v. Superior Court, supra*, 76 Cal.App.4th at p. 985, 90 Cal.Rptr.2d 743 ["any evidence of a plaintiff's unclean hands in relation to the transaction before the court or which affects the equitable relations between the litigants in the matter before the court should be available to enable the court to effect a fair result in the litigation"].)

In this case, Peregrine and Hillman's orchestration of the Ponzi scheme that defrauded investors is intimately related to the professional **malpractice** claims before the court. These claims are based entirely on the assertion that Sheppard's professional advice and tactics enabled Hillman and Peregrine to perpetuate their fraud on investors. Moreover, Peregrine's participation in the fraud affects the equities between itself and Sheppard. For Peregrine—the company plaintiffs allege was controlled by Hillman and used by him to operate the Ponzi scheme—to now complain of Sheppard's role in enabling it to commit the fraud is unfair, and it is precisely this sort of unfairness the unclean hands doctrine seeks to address. (See *Kendall–Jackson Winery, Ltd. v. Superior Court, supra*, 76 Cal.App.4th at p. 985, 90 Cal.Rptr.2d 743 [explaining the doctrine "is an equitable rationale for refusing a plaintiff relief where principles of fairness dictate that the plaintiff should not recover, regardless of the merits of his claim"].)

[21] We agree with Sheppard that Peregrine's claims present a classic case for the unclean hands defense. Although plaintiffs are correct that application of this defense generally rests on questions of fact (see *Kendall–Jackson Winery, Ltd. v. Superior Court, supra*, 76 Cal.App.4th at p. 978, 90 Cal.Rptr.2d 743), this does not mean the defense can never prevail at the pleading stage or on a motion to strike. Where, as here, a plaintiff's own pleadings contain admissions that establish the basis of an unclean hands defense, the defense may be applied without a further evidentiary hearing. (See, e.g., *In re Dublin Securities, Inc.* (6th Cir.1997) 133 F.3d 377, 380 [bankruptcy trustee's claims were barred by ***in pari delicto*** doctrine on a motion to dismiss because complaint admitted the debtor's actions were instrumental in committing a fraud on investors]; *Lafferty, supra*, 267 F.3d at pp. 346, 360 [affirming order that granted motion to dismiss based on ***in pari delicto*** doctrine].) Because ***682** Sheppard established the trustee's claims on behalf of Peregrine are barred by the unclean hands doctrine, plaintiffs did not establish a likelihood of prevailing on them, and these claims should have been stricken pursuant to section 425.16, subdivision (b).

****49 B. Investors' Claims Are Time–Barred**

Sheppard next argues the investors cannot establish a likelihood of prevailing for purposes of section 425.16 because their claims are barred by the statute of limitations. Both parties agree that section 340.6 provides the applicable limitations period. This statute requires that an action against an at-

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torney for professional **malpractice** must be filed "within one year after the plaintiff discovers, or through the use of reasonable diligence should have discovered, the facts constituting the wrongful act or omission, or four years from the date of the wrongful act or omission, whichever occurs first." (§ 340.6, subd. (a).) The four-year period is not at issue in this case; rather, the debate concerns whether the investors had sufficient knowledge more than one year before the complaint was filed to put them on inquiry notice that they had potential claims against Sheppard. (See *Jolly v. Eli Lilly & Co.* (1988) 44 Cal.3d 1103, 1110, 245 Cal.Rptr. 658, 751 P.2d 923 [statute of limitations begins to run when a plaintiff suspects or should suspect "that someone has done something wrong to [him or] her"].)

The evidence shows, and plaintiffs do not dispute, that the investors were injured by Hillman's fraudulent scheme in 2001 and also knew in 2001 that attorneys from Sheppard were representing Hillman. Plaintiffs admit they realized they were damaged by the Ponzi scheme in March 2001, when the SEC filed suit against the companies and Hillman and Fanghella. Indeed, several investors met with their current attorney within weeks after the news was reported, and it appears from the evidence that the three named investor-plaintiffs in this action filed a putative class action suit against Hillman sometime in 2001. By 2001, when the fraudulent nature of the business was exposed, press articles identified attorneys from Sheppard as representing Hillman. Sheppard also produced evidence showing at least one investor knew in the late 1990's of Sheppard's advice to Hillman about the funds. Investor Thomas Frame testified in deposition that in 1998 he believed all the Funding Entities were represented by William Manierre, an attorney he had previously worked with and whom he knew Hillman had previously used. From his discussions with Hillman, Frame knew in 1999 that Hillman was consulting with Manierre about how to find "an exemption" to the 99–investor limit of securities registration laws. Plaintiffs now claim Manierre's advice on this subject contributed to their injuries because it enabled Peregrine and the Funding Entities to operate without appropriate regulatory oversight.

***683** The evidence produced in connection with the motion to strike also demonstrates that by the end of 2001—more than one year before March 19, 2003, when they filed this action—the investors knew or should have known about the wrongful acts by Sheppard alleged in the complaint. In April 2001, the press reported that Hillman had transferred $6 million to his attorneys at Sheppard in violation of a court order freezing his assets. Also in April 2001, Charles La Bella, the **receiver** appointed for PinnFund, filed an initial report documenting several of Sheppard's actions plaintiffs now point to as wrongful. In addition to describing Hillman's transfer of $6 million to Sheppard on March 26, 2001, the **receiver** reported that three days later "without notice to the Court, the **Receiver** or the other parties, Sheppard Mullin withdrew as counsel for the Funding Entities." Sheppard did not notify the court of its withdrawal until it appeared at a hearing on April 2, 2001. Later that day, according to the **receiver**, Sheppard ****50** gave notice that the Funding Entities had initiated an involuntary bankruptcy proceeding for PinnFund in the United States District Court for the Southern District of California. The Funding Entities then filed their own voluntary petitions for bankruptcy still later on April 2,

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2001, in the Northern District of California. The **receiver** closed his initial report by remarking that his attention had been "diverted" by the asset transfer to Sheppard and by "Hillman's tactic of using his three Funding Entities to attempt to place PinnFund into involuntary bankruptcy, only to place the same entities into bankruptcy hours later."

The **receiver's** second report, from May 23, 2001, expanded on the difficulties caused by these bankruptcies and lay the blame largely at Sheppard's feet. The **receiver** stated that, since his appointment, he had engaged in a "significant and on going dialogue" with the defrauded investors. These investors agreed to cooperate with each other and with the **receiver**. They collectively expressed the view that a bankruptcy of PinnFund would not be in the best interest of investors and would not be pursued. Likewise, the **receiver** explained why he had independently determined it was not prudent to pursue a bankruptcy yet. Hillman's unilateral tactic of placing the companies into bankruptcy frustrated these decisions and, according to the **receiver**, "served to hamstring the administration of the receivership." The **receiver** was highly critical of Sheppard in this report, arguing the firm's actions in orchestrating the bankruptcies "stretched the limits of good faith" and "seem[ed] to be nothing short of a continuation of the original fraud on the investors." The **receiver** explained that the way the bankruptcies were filed enabled Hillman to remain empowered to protect his personal interests. At the same time, the necessity of working through bankruptcy made it difficult or impossible for the **receiver** to perform the tasks for which he was appointed and caused the receivership to incur great expense, wasting resources that otherwise would have been returned to investors and creditors.

***684** The **receiver's** May 2001 report also accused Sheppard of trying to interfere with the receivership itself. First, the report noted Hillman's attorneys from Sheppard had "strongly opposed" the appointment of a **receiver**, and of LaBella in particular. The **receiver** asserted that a Sheppard attorney made materially false statements to the court in an attempt to oppose LaBella's appointment. Later, Sheppard attorneys refused to provide information the **receiver** requested about Hillman's assets.

Much of the conduct complained of in these reports is described in the complaint and forms the basis of plaintiffs' claims against Sheppard. Although it does not appear that the investors were served with the **receiver's** first two reports, their attorney was served with his "third report" (a title that would have given them notice of the existence of two prior reports). Moreover, these reports were filed in a public proceeding, and plaintiffs do not deny having notice of their contents. Indeed, the investors do not deny that they knew or should have known of Sheppard's wrongdoing more than one year before they filed suit. But they argue their claims against Sheppard are timely because they did not "discover[ ] facts establishing Sheppard Mullin's duty to them" until August 2002.

[22] In May 2002, the investors reached a global settlement with the bankruptcy trustee and **receiver** of their claims against the corporate entities. As part of the settlement, these parties established a "litigation committee" to pursue potential claims against third parties. On May 14, 2002, the trustee sent a letter asking Sheppard****51** to turn

over all files and documents regarding the firm's representation of the Funding Entities. In response, Sheppard produced over 1,000 pages of documents to the trustee on June 14, 2002, and the trustee forwarded them to counsel for the investors on August 26, 2002. Plaintiffs claim they did not realize Sheppard owed a professional duty to them until they reviewed these documents and found that Sheppard possessed details about individual investors' financial contributions to the funds. Plaintiffs thus assert, "the investors did not learn the facts of an attorney-client relationship until they obtained" Sheppard's files.

[23] Plaintiffs' attempt to cast this history as the belated discovery of an essential fact is belied by their own complaint. The complaint alleges, "Sheppard's conduct *implies* an attorney-client relationship with the investors." (Italics added.) Specifically, the complaint asserts a duty should be implied because, in light of the small number of investors, the scope of Sheppard's engagement, and the fact that "the transactions and advice devised by Sheppard were intended to and did affect the Plaintiff Investors ***685** directly," it was reasonably foreseeable that Sheppard's actions would cause the investors injury. That Sheppard may have owed an implied duty of care to the investors based on the foreseeability of harm to them is a *legal theory*, not an essential fact necessary to establishing liability. It is well settled that the one-year limitations period of section 340.6 " 'is triggered by the client's discovery of "the facts constituting the wrongful act or omission," not by his discovery that such facts constitute professional negligence, i.e., by discovery that a particular legal theory is applicable based on the known facts. "It is irrelevant that the plaintiff is ignorant of his legal remedy or the legal theories underlying his cause of action." ' *(Worton v. Worton* (1991) 234 Cal.App.3d 1638, 1650, 286 Cal.Rptr. 410.)" *(Village Nurseries v. Greenbaum* (2002) 101 Cal.App.4th 26, 42–43, 123 Cal.Rptr.2d 555; see also *McGee v. Weinberg* (1979) 97 Cal.App.3d 798, 803, 159 Cal.Rptr. 86 ["The statute of limitations is not tolled by belated discovery of *legal theories*, as distinguished from belated discovery of *facts* "].)

Based on the evidence presented on the motion to strike, the investors knew or should have known all the facts alleged in the complaint concerning Sheppard's wrongful conduct more than a year before they filed their complaint on March 19, 2003. The only fact they discovered *after* March 19, 2002 is that Sheppard had in its possession 14 pages of information about individual investors' contributions to the funds. But this "fact" is ancillary to the allegations of misconduct in the complaint; it is merely evidence the investors cite to support the theory that Sheppard owed them implied duties of care and loyalty. The investors' claims against Sheppard are untimely because they had sufficient knowledge, or access to knowledge, to put them on notice in 2001 that Sheppard had done something wrong to them. *(Jolly v. Eli Lilly & Co., supra*, 44 Cal.3d at p. 1110, 245 Cal.Rptr. 658, 751 P.2d 923; see also *McGee v. Weinberg, supra*, 97 Cal.App.3d at p. 803, 159 Cal.Rptr. 86 ["The test is whether the plaintiff has information of circumstances sufficient to put a reasonable person on inquiry, or has the opportunity to obtain knowledge from sources open to his or her investigation"].) Their ignorance of specific information contained in Sheppard's files, which were not even requested until May 2002, did not toll the running of the statute.

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"A plaintiff need not be aware of the specific 'facts' necessary to establish the claim; that is a process contemplated by pretrial discovery. Once the plaintiff has a suspicion of ****52** wrongdoing, and therefore an incentive to sue, she must decide whether to file suit or sit on her rights. So long as a suspicion exists, it is clear that the plaintiff must go find the facts; she cannot wait for the facts to find her." (*Jolly v. Eli Lilly & Co., supra,* 44 Cal.3d at p. 1111, 245 Cal.Rptr. 658, 751 P.2d 923.)

[24] Finally, the investors argue Sheppard is equitably estopped from invoking the statute of limitations because it breached fiduciary duties owed to them, ***686** "took evasive actions to stonewall and delay these proceedings," [FN15] breached ethical duties to produce documents, "and continues to this day to withhold documents."

> FN15. Plaintiffs' brief does not clarify which "proceedings" are referred to, nor does it identify any particular "evasive" stonewall[ing]" or "delay [ing]" tactics Sheppard allegedly employed to cause them to delay filing suit.

[25][26] " '[Equitable estoppel] ... comes into play only after the limitations period has run and addresses itself to the circumstances in which a party will be estopped from asserting the statute of limitations as a defense to an admittedly untimely action because his conduct has induced another into forbearing suit within the applicable limitations period. Its application is wholly independent of the limitations period itself and takes its life, not from the language of the statute, but from the equitable principle that no man will be permitted to profit from his own wrongdoing in a court of justice.' " (*Battuello v. Battuello* (1998) 64 Cal.App.4th 842, 847–848, 75 Cal.Rptr.2d 548.) The general doctrine of equitable estoppel has been codified in Evidence Code section 623: "Whenever a party has, by his own statement or conduct, intentionally and deliberately led another to believe a particular thing true and to act upon such belief, he is not, in any litigation arising out of such statement or conduct, permitted to contradict it." Thus, when a defendant's conduct has deliberately induced the plaintiff to delay filing suit, the defendant will be estopped from availing himself of this delay as a defense. (*Lantzy v. Centex Homes* (2003) 31 Cal.4th 363, 384, 2 Cal.Rptr.3d 655, 73 P.3d 517; see also *Leasequip, Inc. v. Dapeer* (2002) 103 Cal.App.4th 394, 403–404, 126 Cal.Rptr.2d 782 [listing elements required to establish equitable estoppel].)

The most glaring problem with plaintiffs' argument is that plaintiffs have failed to plead the elements of equitable estoppel. The complaint does not identify any specific conduct by Sheppard that is an alleged basis for estoppel, nor does it plead facts indicating that this conduct "*actually and reasonably induced* " the investors to forbear filing suit within the limitations period. (*Lantzy v. Centex Homes, supra,* 31 Cal.4th at p. 385, 2 Cal.Rptr.3d 655, 73 P.3d 517.) Nor, given the facts of this case, do we believe plaintiffs could amend the complaint to plead a viable estoppel claim. (See *id.* at pp. 385–388, 2 Cal.Rptr.3d 655, 73 P.3d 517 [concluding trial court properly dismissed claims on demurrer where plaintiffs failed to plead facts that would equitably estop defendants from asserting statute of limitations defense and there appeared no reasonable possibility the deficiency could be cured by amendment].)

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For example, the court held an attorney was equitably estopped from asserting a statute of limitations defense in ***687***Leasequip, Inc. v. Dapeer, supra*, 103 Cal.App.4th at pp. 403–405, 126 Cal.Rptr.2d 782. The plaintiff, Leasequip, was prevented from filing a timely legal **malpractice** action against its attorney because, during the statutory period, its corporate powers were suspended. (*Id.* at p. 404, 126 Cal.Rptr.2d 782.) However, Leasequip's status****53** as a suspended corporation resulted directly from the attorney's erroneous advice that compliance with corporate formalities was not necessary and would not affect the company's legal claims. (*Ibid.*) Applying the doctrine of equitable estoppel, the Court of Appeal concluded the attorney could not claim that the statute of limitations had expired on Leasequip's claim against him when reliance upon his erroneous legal advice was the very thing that led to the statute expiring. (*Id.* at p. 405, 126 Cal.Rptr.2d 782.)

The facts alleged in this case are very different. The investors have not identified any specific conduct by Sheppard that they claim induced them to delay filing suit. Plaintiffs have criticized Sheppard's litigation tactics in defending Hillman against the SEC's civil charges, but, as discussed, this information became available to the investors long before they filed this action, and plaintiffs have not explained why such tactics would have reasonably induced them to delay filing suit against Sheppard. If anything, one would expect information about Sheppard's questionable legal tactics would have caused the investors to sue Sheppard sooner rather than later. Nor does Sheppard's allegedly belated production of documents to the trustee justify application of the equitable estoppel doctrine. As plaintiffs' legal ethics expert stated in his declaration, the California Rules of Professional Conduct require a firm that withdraws from representation to release all client papers promptly *at the request of the client.* Sheppard did produce such documents promptly, sending approximately 1,000 pages of material to the bankruptcy trustee 30 days after he requested them on behalf of the firm's former clients Peregrine and the Funding Entities. Plaintiffs have not argued, nor is there evidence to show, that they made any prior unsuccessful request for these files. Finally, an estoppel cannot be based on a plaintiff's bare assertion that the defendant is continuing to withhold relevant documents in its possession, or else statutes of limitations would be eviscerated in every case involving a discovery dispute. Moreover, it is not apparent—and plaintiffs have not explained—how any improper withholding of documents by Sheppard in its June 2002 production actually and reasonably induced the investors to delay filing suit. (See *Lantzy v. Centex Homes, supra*, 31 Cal.4th at p. 385, 2 Cal.Rptr.3d 655, 73 P.3d 517.)

Accordingly, the investors' claims are barred by section 340.6, and plaintiffs did not establish a likelihood of prevailing on these claims for purposes of the motion to strike.

***688 DISPOSITION**

The order denying Sheppard's special motion to strike is reversed in part. On remand, the trial court is directed to enter an order granting the motion to strike as to all claims asserted by the investor-plaintiffs and all claims asserted by the bankruptcy trustee on behalf of Peregrine. The order denying Sheppard's motion to strike is affirmed as to the remaining claims, which are those asserted by the bankruptcy trustee on behalf of the Funding Entities. Each side shall bear its

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own costs on appeal.

We concur: CORRIGAN and PARRILLI, JJ.

Cal.App. 1 Dist.,2005.
Peregrine Funding, Inc. v. Sheppard Mullin Richter & Hampton LLP
133 Cal.App.4th 658, 35 Cal.Rptr.3d 31, 05 Cal. Daily Op. Serv. 9172, 2005 Daily Journal D.A.R. 12,510

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In the
United States Court of Appeals
For the Seventh Circuit

No. 10-3770

RONALD R. PETERSON, as Chapter 7 Trustee for the estates of Lancelot Investors Fund, L.P., *et al.*,

Plaintiff-Appellant,

v.

MCGLADREY & PULLEN, LLP, *et al.*,

Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 10 C 274—**Elaine E. Bucklo**, *Judge*.

ARGUED SEPTEMBER 8, 2011—DECIDED APRIL 3, 2012

Before EASTERBROOK, *Chief Judge*, and BAUER and SYKES, *Circuit Judges*.

EASTERBROOK, *Chief Judge*. In 2002 Gregory Bell established five mutual funds, known as the Lancelot or Colossus group. We call them "the Funds." They raised about $2.5 billion, which they reinvested in busi-

nesses such as Thousand Lakes, LLC, that claimed to act as commercial factors. (For simplicity we use Thousand Lakes as the only exemplar.) The Funds told their investors that Thousand Lakes loaned money to operating businesses on the security of their inventories.

Most of the firms to which the Funds routed money were controlled by Thomas Petters. He was running a Ponzi scheme. There was no inventory. Thousand Lakes did not finance any business transactions. Instead Petters used new investments in Thousand Lakes to pay older debts, siphoning off some of the money for his own use. Ponzi schemes must grow in order to survive, and there always comes a time when growth cannot be sustained. When Petters was caught in September 2008, the Funds collapsed; about 60% of the money had vanished. The Funds entered bankruptcy, and Ronald Peterson was appointed as Trustee to marshal and distribute what assets remained.

Peterson filed this action under Illinois law against the Funds' auditor, McGladrey & Pullen, LLP, and some affiliated entities. The complaint contends that McGladrey was negligent in failing to discover that Thousand Lakes lacked customers. The Funds told their investors that the venture was low risk because Thousand Lakes had established lockboxes to which payments would be made when the operating businesses sold any of their inventory. Peterson's complaint alleges that McGladrey did not detect that the money entering these lockboxes came from Thousand Lakes itself, not from customers of the phony businesses

whose inventory Thousand Lakes supposedly financed. The Trustee maintains that an auditor must perform spot checks that will find such deceptions. (To be more precise, one part of an auditor's job is to determine whether the client's financial controls are sufficient to catch deceits practiced against it; otherwise the auditor cannot be sure that the client's financial statements accurately represent its condition. Auditors must do some independent verification to learn whether the client's controls are working.)

The district court dismissed the complaint without deciding whether the auditor had done its task competently. 2010 U.S. Dist. LEXIS 117018 (N.D. Ill. Nov. 3, 2010). The judge invoked the doctrine of *in pari delicto*—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. Illinois applies this doctrine to suits by clients against their auditors, because a participant in a fraud cannot claim to be a victim of its own fraud. See *First National Bank of Sullivan v. Brumleve & Dabbs*, 183 Ill. App. 3d 987 (1989); *Holland v. Arthur Andersen & Co.*, 127 Ill. App. 3d 854 (1984); *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 454–55 (7th Cir. 1982) (Illinois law). The Funds knew what Bell knew, for he was the head of their management company and investment adviser. See *Prime Eagle Group Ltd. v. Steel Dynamics, Inc.*, 614 F.3d 375 (7th Cir. 2010) (discussing imputation of knowledge in corporate law). So if Bell was in on Petters's scam, then the Funds have no claim against McGladrey for failing to detect and warn the Funds about something that Bell, and thus the Funds, already understood. See *Community*

College District No. 508 v. Coopers & Lybrand, 208 Ill. 2d 259 (2003). Trustee Peterson stepped into the shoes of the Funds under 11 U.S.C. §541(a) to collect property of the estate—here, the estate's chose in action against its auditor. The Trustee's claims are subject to the same defenses that McGladrey could have asserted had the Funds themselves filed suit. (Which is to say, this is not an avoiding action to recoup any transfer from the Funds to McGladrey, an action in which a bankruptcy trustee can take the part of any hypothetical lien claimant, see 11 U.S.C. §544; nor is it an action on behalf of investors. Cf. *Grede v. Bank of New York Mellon*, 598 F.3d 899 (7th Cir. 2010). This makes it unnecessary to consider limits that Illinois law places on investors' efforts to make direct claims against auditors.)

The district court concluded that Bell was in the know about the Ponzi scheme. The Trustee alleges that Bell joined forces with Petters in February 2008. In October 2009 Bell pleaded guilty to wire fraud. Petters stood trial and was convicted of multiple federal crimes. Because Bell is criminally culpable for fraud, the district court concluded that the Funds lack a claim against their auditor.

The crime to which Bell pleaded guilty occurred in 2008. The Trustee's complaint alleges that Bell began to conspire with Petters in February 2008—and that, until then, Bell honestly (though carelessly and perhaps even recklessly) believed that Thousand Lakes was a real commercial factor and that the Funds' investments had been successful. The Trustee does not seek damages

on account of anything the auditor did or omitted in 2008; the suit relates to McGladrey's audit of the Funds' financial statements in 2006 and 2007. The Trustee's theory is that, if McGladrey had done what it was supposed to do, the Ponzi scheme would have been exposed earlier, and the Funds would not have thrown so much money down the drain in 2007 and 2008. The district court apparently supposed that, if Bell was criminally culpable in 2008, then surely he knew about the Ponzi scheme earlier. But this is not something a court can assume at the complaint stage of litigation. The court must accept the complaint's allegations—and the Trustee expressly alleges that, until February 2008, Bell did *not* know that Petters had built a house of cards.

McGladrey observes that the Trustee is trying to have things both ways. In a separate suit against Bell, the Trustee alleges that Bell committed fraud during 2006 and 2007. McGladrey contends that the district court was entitled to take the same view of matters in the Trustee's suit against it. But there's no rule against inconsistent pleadings in different suits, or for that matter a single suit. "A party may state as many separate claims or defenses as it has, regardless of consistency." Fed. R. Civ. P. 8(d)(3). What's more, "[a] party may set out 2 or more statements of a claim or defense alternatively or hypothetically, either in a single count or defense or in separate ones. If a party makes alternative statements, the pleading is sufficient if any one of them is sufficient." Fed. R. Civ. P. 8(d)(2). So if we understand the Trustee to be alleging that Bell both did, and did not, know of Petters's fraud in 2006 and 2007, the pleading

is sufficient if *either* allegation is sufficient. An allegation that Bell was negligent but not criminally culpable in 2006 and 2007 makes the claim against McGladrey sufficient; the complaint therefore cannot be dismissed on the ground the district court gave. (If the Trustee had prevailed against Bell on a theory that his fraud began in 2006, then the doctrine of judicial estoppel would block the Trustee from arguing an inconsistent position against McGladrey. See *New Hampshire v. Maine*, 532 U.S. 742, 749–51 (2001); *Astor Chauffeured Limousine Co. v. Runnfeldt Investment Corp.*, 910 F.2d 1540, 1547-48 (7th Cir. 1990). But the suit against Bell is pending; the requirements of judicial estoppel are unmet.)

Trustee Peterson asks for relief broader than a remand to determine what Bell knew, and when he knew it. The Trustee asks us to knock out the *pari delicto* defense altogether, so that the culpability of a corporate manager never would bar recovery against a negligent auditor. *Holland* shows that Illinois would allow the defense if a receiver for the Funds were suing under state law, but the Trustee contends that federal law prevents its application once a firm enters bankruptcy and a trustee is appointed. The National Association of Bankruptcy Trustees has filed a brief as *amicus curiae* supporting this position. Illinois has limited the defense on public-policy grounds in some circumstances as a matter of its domestic law. See *McRaith v. BDO Seidman, LLP*, 391 Ill. App. 3d 565 (2009) (*in pari delicto* does not apply to insurance liquidator's claims against auditors); *Albers v. Continental Illinois Bank & Trust Co.*, 296 Ill. App. 596 (1938) (*in pari delicto* inapplicable to bank receiver).

But the Trustee and the Association pitch their argument on federal bankruptcy law. They use *McRaith* and *Albers* to support the proposition that McGladrey can be liable if Bell was negligent but did not commit fraud, but that's different from the question whether federal law supersedes state law when the state would allow a *pari delicto* defense.

Section 541(a) provides that an estate in bankruptcy includes all of the debtor's "property", a word that comprises legal claims such as the one against McGladrey. "Property" normally is defined by state law—and in Illinois a claim for damages is limited by defenses such as *in pari delicto*. The Trustee and the Association want us to hold that a bankruptcy estate includes rights of recovery, stripped of their defenses. If *in pari delicto* is out, presumably the statute of limitations would be out too, or maybe even the defense of accord and satisfaction. As the Trustee and the Association see things, "public policy" favors greater recoveries for estates in bankruptcy, so that more money is available for distribution and so that wrongdoing by a corporation's "gatekeepers" (the accountants as well as Bell) may be deterred more effectively.

This is not a new argument. It was advanced and rejected in *Butner v. United States*, 440 U.S. 48 (1979). The Court held that state law defines the "property" that enters the bankruptcy estate, unless a provision in the Bankruptcy Code displaces state law. *Butner* did not deal with §541 or the *pari delicto* defense, but its principle is general. See, e.g., *Raleigh v. Illinois Department of*

Revenue, 530 U.S. 15, 20 (2000) ("The 'basic federal rule' in bankruptcy is that state law governs the substance of claims, *Butner*, *supra*, at 57, Congress having 'generally left the determination of property rights in the assets of a bankrupt's estate to state law,' 440 U. S., at 54"). Bankruptcy is a means of administering claims that are defined by tort, contract, and other generally applicable bodies of law. Congress has modified these claims in some respects, and changed some distribution priorities, but unless the Code makes such an alteration the job of the bankruptcy court is to gather all of the debtor's assets, as state law defines those assets, and distribute them according to the creditors' rights under state law. In the main, bankruptcy law is designed to provide a single forum for resolving competing claims to assets defined by other bodies of law.

Neither the Trustee nor the Association identifies any provision of the Code that overrides state-law limits on the legal claims created by state law against the debtor's auditors. "Public policy" is not a ground on which the federal judiciary may create such a limit—not unless the Supreme Court first overrules *Butner*, *Raleigh*, and similar decisions. We therefore agree with the conclusion of every other court of appeals that has addressed this subject and hold that a person sued by a trustee in bankruptcy may assert the defense of *in pari delicto*, if the jurisdiction whose law creates the claim permits such a defense outside of bankruptcy. See *Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1152 (11th Cir. 2006); *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267

F.3d 340, 357 (3d Cir. 2001); *In re Hedged-Investments Associates, Inc.*, 84 F.3d 1281, 1285 (10th Cir. 1996).

According to the Trustee, *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995), commits this court to a contrary position. Like today's case, *Scholes* arises from a Ponzi scheme. The Securities and Exchange Commission appointed a receiver to marshal the assets of one participant in the scheme. The receiver sought to recover some payments as fraudulent conveyances—for one aspect of a Ponzi scheme is handsome but unearned payments to early investors, who then drum up pigeons with promises of hefty and risk-free profits. Some recipients of these payments invoked an equitable defense, observing that the principal fault lay with the scheme's mastermind, to which we replied that, although recovery would indeed have been inequitable while the crook was running the show, recovery of fraudulent transfers is entirely appropriate once the crook is gone and the recovery will benefit duped investors. We added: "Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated."

That sentence is dictum; *Scholes* did not entail a *pari delicto* defense. It has nothing to do with §541 of the Bankruptcy Code; *Scholes* was not a bankruptcy proceeding. And it does not stand for the proposition that federal law overrides state-law defenses; *Scholes* was decided under Illinois law, which, as we have observed, puts the *pari delicto* defense out of bounds in some situations. The state statute involved in *Scholes*

was replaced in 1990 when Illinois enacted the Uniform Fraudulent Transfer Act, 740 ILCS 160. More importantly, the law of fraudulent conveyances—both in Illinois and under the Bankruptcy Code, see 11 U.S.C. §§ 547–50—is one of those bodies that does supersede private-law definitions of legal entitlements. The recipient of a fraudulent or preferential transfer usually has a right to the money as a matter of contract, but when the transfer injures other creditors it can be recouped for their benefit. *Scholes* should not be generalized beyond the law of fraudulent conveyances and preferential transfers. *Scholes* did not mention *Cenco*, which applied Illinois law to block a corporation's action against an auditor when the fraud that the auditor failed to catch had been engineered by the client's managers. By the time suit began in *Cenco*, the fraudsters were long gone, but that did not clear the way for collection from the deep pockets of an auditor that had been taken in by the client's former managers.

Two other arguments in this case require only brief attention.

First, the Trustee contends that the *pari delicto* defense is inapplicable, as a matter of Illinois law, because Bell was acting adversely to the interest of the Funds. The district court sensibly concluded that *Cenco* dooms this argument. *Cenco* predicted that Illinois would hold that fraud by corporate managers is imputed to the corporation where "managers are not stealing from the company—that is, from its current stockholders—but instead are turning the company into an engine of

theft against outsiders". *Cenco*, 686 F.2d at 454. Thirty years have passed, and no court in Illinois has disagreed with this understanding. Bell was not stealing from the Funds, whether or not he was using them to snooker people who had money to invest.

Second, McGladrey defends its judgment by pointing to a clause in the engagement contract exculpating the auditor if the client (*i.e.*, the Funds) makes material misrepresentations. The Trustee asks us to ignore this clause, calling it vague. There's no "vague clause" exception to contract law, however, and anyway this clause is not vague. "Material" is one of those protean legal terms that cannot be reduced to an algorithm. If McGladrey can show that material misrepresentations made by its own client affected the performance of its duties, it receives the benefit of this clause. But it supplies a defense; its negation is not an element of a plaintiff's claim for relief. Complaints need not anticipate and plead around defenses. *Gomez v. Toledo*, 446 U.S. 635 (1980). If the complaint itself demonstrated that the Funds made material misrepresentations to McGladrey, then the Trustee could have pleaded himself out of court. The complaint does not contain any fatal admissions, however. At oral argument, counsel for McGladrey maintained that, according to the complaint, Bell told the auditor that Thousand Lakes had a lockbox mechanism for collecting money when the businesses sold their inventory. This is a "misrepresentation," however, only if Bell knew it to be false; otherwise he was just passing along what others had said, and one function of an auditor is to check whether the client is

being bilked by the likes of Petters. The state of Bell's knowledge cannot be determined at the complaint stage of this litigation.

The judgment of the district court is vacated, and the case is remanded for proceedings consistent with this opinion.

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- Commercial/Business Litigation
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- Corporate and Partnership Disputes
- Alternatives to Bankruptcy and
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Presentations and Publications

- Moderator, "Note Purchasers," West Coast High Yield Real Estate Finance Summit, May 14, 2014, Santa Monica, CA
- Panelist, "Receivership/Bankruptcy Update," 2013 Trigild Lender Conference, October 17, 2013, San Diego, CA
- Panelist, "Love Your Laterals: Exploring the Role of Marketing in Law Firm Lateral Recruiting and Integration," LMA Bay Area Chapter Event, August 15, 2013, San Francisco, CA
- "Alternatives to Bankruptcy," TMA Western Regional Conference, July 18, 2013, Dana Point, CA
- Panelist, "When Receiverships and Bankruptcy Code Collide," California Receivers Forum Annual Insolvency Conference, May 17, 2013, San Diego, CA
- "Opportunities in Distress," CRE Finance Council Distressed Debt Summit, May 13-14, 2013, Santa Monica, CA
- Moderator, "Current Issues in Loan Administration," Spring 2013 Trigild Lender Conference, April 23, 2013, Dallas, TX

- Commentary, "5 Tips for Doing Real Estate Deals in Bankruptcy Court," *Law360*, March 29, 2013

- Panelist, "A Spoonful of Sugar: Receivers in Restructurings, Liquidations and Regulatory Actions," LACBA Remedies Section Meeting, March 21, 2013, Los Angeles, CA
- "Substandard Housing - Health & Safety Codes," Loyola V Complex Case Symposium, January 19, 2013, Irvine, CA
- Panelist, "Intersection of Bankruptcy and Receivership Law," 12th Annual Trigild Lender Conference, October 17-19, 2012, San Diego, CA
- "Consider a Receiver for Your Restructuring and Turnaround," *Law360*, October 18, 2012
- "Receivership Law and Pre-Foreclosure Strategies," American College of Mortgage Attorneys Annual Conference, Kohler, WI, October 11-13, 2012
- Panelist, "Identifying Promising Investment Opportunities," Investment Trends Summit, Santa Barbara, CA, September 12-14, 2012
- Commentary, "Receivership Roles Becoming More Specialized," *GlobeSt.com*, August 17, 2012
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- "Six Questions for Buchalter Nemer's Richard Ormond," *GlobeSt.com*, August 18, 2011
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- "The Effective Use of Receivership with Distressed Hospitality Property Assets," San Francisco, CA, July 22, 2010
- "Shelter From the Storm: Dealing with Distressed Loans and Assets," CCIM Los Angeles, CA July 20, 2010
- "Commercial Property Receiverships," Los Angeles, CA June 23, 2010
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- "Fundamentals of Intellectual Property Management," 2009-10 National Institutes of Health Commercialization Assistance Program, Marina Del Ray, CA, November 17-18, 2009

- "How To Maximize Value With Distressed Loans: Myths, Magic and Money-Making," ULI Urban Land Expo, November 6, 2009, San Francisco, CA
- "Decoding CMBS: Who? What? Where? Why? How? A Primer for Borrowers and Buyers," NAIOP CRE Breakfast Series, October 7, 2009, Newport Beach, CA
- "Receiverships 101," Realshare Distressed Assets Conference, September 15, 2009, Dallas, TX
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Representing this diverse group of clients includes extensive experience with class action litigation, partnership disputes, breaches of contract and related litigation, licensing agreements, intellectual property disputes, entity formation, contract formation and negotiation, loan structuring, commercial and residential loan default workouts, construction defect litigation, receiverships, and negotiating and structuring real property leases, acquisitions, sales, financing, and development.

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- *Watts v. Farmers Ins. Exchange* (2002) 98 Cal.App.4th 1246

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- Co-Author, "Slamming the Door on Legal Malpractice In Criminal Matters," *Los Angeles Lawyer*, Vol. 24, No. 11, February 2002
- "Recognizing and Preserving Native American Treaty Usufructs in The Supreme Court: The Mille Lacs Case," *Public Lands & Resources Law Review*, Westlaw Citation 21 PUBLRLR 169, July 2000

Mike has been named a Super Lawyer "Rising Star" by his peers and *Los Angeles Magazine* and is a licensed real estate broker in the State of California, President Emeritus of the Venice Neighborhood Council, and Chair of the Westside Regional Alliance of Councils (WRAC), a coalition of all 13 Los Angeles Neighborhood and Community Councils on the Westside of Los Angeles. Mike also serves on the Board of Directors of the Venice Chamber of Commerce, Venice Arts, and the Venice Canals Foundation.

Mike earned his J.D. at Northwestern School of Law of Lewis and Clark College, and his B.A. *magna cum laude* at the University of Southern California.

Areas of Practice

Litigation
Restaurant, Food and Beverage
Apparel & Consumer Products

Bar Admissions

California

Court Admissions

U.S. District Court for the Central District of California
U.S. Court of Appeals for the Ninth Circuit

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Suzanne M. Henry is Special Counsel in the Firm's Litigation Practice Group in Los Angeles. Suzanne is an experienced civil litigator with extensive experience in a wide variety of complex business litigation, ranging from trade secret, real estate, and shareholder disputes, to insurance coverage disputes, class action suits and environmental actions. Ms. Henry also assists clients in evaluating their potential insurance coverage in connection with litigation.

Suzanne practices in state and federal courts across the country and has co-authored an amicus brief in support of a certiorari petition to the United Stated Supreme Court.

Suzanne earned her J.D. at the University of San Diego School of Law where she was the founding Contents Editor of the *San Diego International Law Journal*. She is a member of the American Bar Association, the Beverly Hills Bar Association, and the Women Lawyers Association of Los Angeles.

Areas of Practice

Litigation
Land Use
Environmental Litigation
Insurance Coverage
Real Estate Litigation

Bar Admissions

California

Court Admissions

Supreme Court of the United States
U.S. Court of Federal Claims
U.S. Court of Appeals for the Third Circuit
U.S. Court of Appeals for the Ninth Circuit
U.S. District Court for the Northern District of Texas
U.S. District Court for the Central District of California