Item # 36

ADDITIONAL MATERIAL

10:00 a.m. Regular Meeting

OCTOBER 17, 2017

SUBMITTED AT THE REQUEST OF

FINANCE and ADMINISTRATIVE SERVICES DEPARTMENT

Finance and Administrative Services Department
PURCHASING DIVISION
115 S. Andrews Avenue, Room 212 • Fort Lauderdale, Florida 33301 • 954-357-6066 • FAX 954-357-8535

MEMORANDUM

DATE: October 12, 2017

TO: Board of County Commissioners

THRU: Kevin B. Kelleher, Deputy CFO/Deputy Director
Finance and Administrative Services Department

Digitally signed by STEPHEN FARMER
Date: 2017.10.13 14:45:44 -04'00'

FROM: Brenda J. Billingsley, Director
Purchasing Division

BRENDA BILLINGSLEY

Digitally signed by BRENDA BILLINGSLEY
DN: dc=cty, dc=broward, dc=bc, ou=Organization, ou=BCC, ou=PU, ou=Users, cn=BRENDA BILLINGSLEY
Date: 2017.10.12 16:34:36 -04'00'

SUBJECT: October 17, 2017 - Commission Meeting - Agenda Item No. 36
Motion to Approve Agreement between Broward County; Broward County Property Appraiser; Broward County Sheriff; Broward County Supervisor of Elections; Housing Finance Authority of Broward County, Florida; Health Facilities Authority of Broward County, Florida and RSM US LLP for Request for Proposals (RFP) No. R2112554P2, External Audit Services

Attached please find Cone of Silence communication dated October 12, 2017 submitted by Joseph M. Goldstein, Shutts & Bowen, LLP, on behalf of S. Davis & Associates, P.A. regarding the subject procurement.

BJB/lg

c: Bertha Henry, County Administrator
George Tablack, CPA, Chief Financial Officer
Robert Melton, County Auditor
Andrew Meyers, County Attorney

JOSEPH M. GOLDSTEIN
PARTNER
Shutts & Bowen LLP
200 East Broward Boulevard
Suite 2100
Fort Lauderdale, Florida 33301
DIRECT (954) 847-3837
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EMAIL jgoldstein@shutts.com

October 12, 2017

BY EMAIL

Andrew J. Meyers (ameyers@broward.org)
County Attorney
Broward County, Florida
115 South Andrews Avenue, Room 423
Fort Lauderdale, FL 33301

Brenda J. Billingsley, Director (BBillingsley@broward.org)
Purchasing Division, Finance and Administrative Services Department
Broward County, Florida
115 South Andrews Avenue, Room 212
Fort Lauderdale, FL 33301

Re: Renewed Request for a Finding of Non-Responsibility Regarding RSM US LLP as to Solicitation No.: R2112554P2 for External Audit Services

Dear Mr. Meyers and Ms. Billingsley:

We represent S. Davis & Associates, P.A. regarding Solicitation No.: R2112554P2 for External Audit Services and request that you provide this letter and its attachments to the Board of County Commissioners. Now that the bid protest process is complete, we renew our request that the Commission rescind the award and find RSM US LLP to be non-responsible.

The Commission has an independent, obligation to consider the responsibility of RSM.

Independent and de novo from the Evaluation Committee or Hearing Office, under the Solicitation, it is the obligation of the Commission to determine the responsibility of the purported awardee RSM. RFP, at Standard Instructions, § B (2nd paragraph). Upon the discovery of the "new significant information" discussed below, neither Purchasing, the Evaluation Committee, nor the Hearing Officer ever addressed the following issues that all relate to RSM's responsibility:

- The fact that RSM failed to disclose litigation that was clearly "material" under the plain language of the Solicitation.

- The fact that when RSM was caught it tried to minimize the import of this “material” litigation by pointing to motions to dismiss that it had filed in both actions but withheld the fact that one of those motions to dismiss was a nullity because RSM had already withdrawn it.

- The fact RSM misrepresented its litigation history to the County.

These facts require the Commission find RSM nonresponsible.

<u>S. Davis and Associates is highly qualified and will save nearly $600,000.00.</u>

Rejecting RSM as non-responsible will preserve the integrity of the procurement process while simultaneously ensuring the County receives exceptional (and honest) auditing services at a significant savings. S. Davis and Associates was ranked a close second to RSM (476.85 v. 445.05 or a 6.7% difference), but with an associated cost savings over the 5 year term of the contract of $594,150.00 or 16%. Please see the attached letter from Mr. Norman Thabit, CPA, former Broward County Commission Auditor, recounting the auditing experience of S. Davis with the County providing all of the services that are combined in this contract. **(Exhibit 1)**. The services listed by Mr. Thabit represent those that S. Davis and Associates itself opined on; however, the firm did work on the general fund and other funds. Moreover, S. Davis and Associates’ proposed CBE subcontractor was responsible for the entire audit of the County as a manager with her previous audit firm.

<u>RSM failed to disclose two instances of “material” litigation, which goes to responsibility.</u>

Since the Board’s initial review of the proposed award, “significant new information” regarding RSM’s responsibility has been discovered. Following the Board’s initial consideration of the procurement, RSM failed to disclose two pending litigation matters that involved allegations of fraud, negligence, and professional malpractice, among other allegations, against RSM. (1) RS Investments, Ltd., et al. v. RSM US LLP, in Cook County, Illinois (**Exhibit 2**); and (2) MVC Capital, Inc. v. RSM US LLP, in Westchester County, New York (**Exhibit 3**).

While Purchasing did not make any determination of whether these lawsuits were “material” or not, Ms. Billingsley did believe that they constituted sufficient “significant new information” to reconvene the Evaluation Committee. While this information did not cause the Evaluation Committee to reconsider its previous actions, the Evaluation Committee’s findings are only recommendations and the Commission may reconsider its initial decision based on this new information. *Cf.* Broward Code of Ordinances, § 18.7.j (indeed such may even qualify to permit a Commissioner from the losing side to move to rescind. *Id.* at § 18.7.j.1.)

<u>When caught with its failure to disclose, RSM gave an irrelevant and incomplete explanation to for its failure.</u>

Further, not only did RSM fail to disclose material litigation, when caught in this misrepresentation during the bid protest, RSM again omitted material information that must be brought to the attention of the Commissioners as to RSM's responsibility. When RSM responded to the protest on June 29, 2017, it (through its counsel) stated "RSM has filed a Motion to Dismiss based on MVC's lack of privity with RSM. [A c]op[y] of [the] Motion to Dismiss [is] attached for your review." **Exhibit 4**, June 29, 2017 Letter from Counsel to Carolyn Messersmith, with attachments, at pp. 1, 129-145.[1] Clearly, this statement was meant to give Purchasing and the Evaluation Committee the impression that MVC's complaint would (or at least could) be dismissed for failure to state a claim. However, at the time RSM made its untruthful statement to Purchasing about the MVC motion to dismiss, RSM had already withdrawn its motion to dismiss at a court hearing. **Exhibit 5**, RSM Stipulation with Exhibit B noting the withdrawal of the motion to dismiss as notated by the Court. In other words, on June 29, 2017 RSM advised the County that it would (or at least could) prevail on a motion to dismiss, it knew that motion to dismiss had been withdrawn on April 6, 2017. Thus, RSM's initial failure to disclose the material litigation was compounded by its failure to accurately describe the status of one of the matters. Such conduct establishes that RSM is not a firm that has the integrity to be the County's auditor. Therefore, the Commission should rescind its prior vote and then find RSM non-responsible for failing to disclose "material" litigation and for failing to accurately describe the status of the withdrawn motion to dismiss to Purchasing when asked about the pending lawsuits.[2]

<u>The Board should reconsider its decision and find RSM nonresponsible.</u>

We respectfully request that you bring this matter to the attention of the Commissioners at the Board's next meeting. Further, to the extent that the County determines that RSM's failures to disclose material litigation against the company are a misrepresentation, then the County's Procurement Code, Section 21.49, requires that the matter be referred to the County Attorney's Office for further consideration and referral to the State Attorney's Office for criminal prosecution.

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[1] Pagination as per Bates numbers in lower right corner.

[2] The other matter, the RS Investments, Ltd. complaint that had been pending was dismissed with prejudice following the Evaluation Committee's second meeting.

Sincerely,

SHUTTS & BOWEN LLP

Joseph M. Goldstein

Joseph M. Goldstein
Andrew E. Schwartz

Daphne Jones, Assistant County Attorney (djones@broward.org)
Glenn Miller, Assistant County Attorney (gmiller@broward.org)

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Exhibit 1

AX

NUMBER OF PAGES INCLUDING COVER PAGE 2

Shaun Davis/Tanya
954-927-5927

FROM:	Norman W. Thabit
FAX:	954-584-9866
PHONE:	954-581-0258
EMAIL:	NThabitcpa@bellsouth.net

NTS:

September 24, 2017

To Whom It May Concern:

S. Davis & Associates, P.A. (SDA) served Broward County as auditors for 15 years from fiscal years ended September 30, 1995 to 2009. I worked with them, overseeing the audits as Commission Auditor, through my retirement in June 2003.

SDA began performing portions of the County's audits under a prime contractor who signed all of the audit opinions. Due to SDA's excellent work and with my support and the support of the Commission, the firm "graduated" to performing audits from top to bottom on their own, thus signing the opinions of the following from fiscal year ended September 30, 2000 forward:

1) Clerk of Courts
2) Supervisor of Elections
3) Property Appraiser
4) Housing Finance Authority - operating entity financial statements
5) Housing Finance Authority – bond program audits
6) Health Facilities Authority
7) Single Audit

In addition, they prepared the County-required special reports.

It is my pleasure to provide this letter of reference for SDA. They have served Broward County well and I am sure they will continue to do so.

Sincerely,

N. W. Thabit

Norman Thabit, CPA

Exhibit 2

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT; LAW DIVISION

RS INVESTMENTS LIMITED, ET AL.,

Plaintiffs,

v.

RSM US LLP, RSM CAYMAN LTD., AND SIMON LESSER,

Defendants.

Case No. :

COMPLAINT AT LAW

1. Plaintiffs (as defined below) lost over $79 million as a direct result of being fraudulently induced by the above-captioned Defendants to make multiple investments in a hedge fund known as Lancelot Investors Fund, Ltd. ("Lancelot Offshore" or the "Fund"). Plaintiffs made each of their investments in the Fund in reliance upon the Fund's financial statements, which contained material misrepresentations and omissions. The Fund's financial statements were audited by Defendants (or their predecessors in interest), and were addressed to Plaintiffs as shareholders of Lancelot Offshore.

2. The Fund told investors that it used investor money to make loans to a company controlled by Thomas Petters ("Petters") that was supposedly engaged in purchase order finance transactions whereby it sold high-end electronic goods to Costco Wholesale ("Costco"). In fact, the underlying sales to Costco were completely fictitious, and instead the Fund invested substantially all of its assets in worthless promissory notes issued by a Petters entity in connection with a $3.65 billion Ponzi scheme orchestrated by Petters. This was hidden from and

never affirmatively or otherwise known to Plaintiffs and presumably other investors given the voluminous associated civil litigation concerning the Fund.

3. Defendants were the auditors of Lancelot Offshore and its affiliates, the Lancelot Onshore Funds (as hereinafter defined), from which Lancelot Offshore purchased worthless promissory notes issued by a Petters entity. Auditing standards require auditors to conduct audits with "professional skepticism," with an awareness that fraud may have occurred. It was Defendants' undeniable duty as certified public accountants and auditors to obtain reasonable assurance based on appropriate audit evidence that the financial statements were free of such fraud. It is inconceivable that Defendants received such reasonable assurance because the underlying purchases and sales of goods on which the Fund's business was predicated were completely fictitious. Even a modest amount of professional care would have revealed that the "transactions" with Petters and his affiliates were not real. The most rudimentary warning signs all were lit, as alleged herein, and were consistently ignored by Defendants.

4. Defendants had repeated opportunities over the course of at least five years to discover and reveal the fraud to the Fund's management. They had a duty to obtain and skeptically review independent third party confirmations. Instead of fulfilling their professional obligations, Defendants did worse than nothing. Defendants were engaged at least as early as 2002, and issued unqualified audit reports ("Audit Opinions") for the years ending January 5, 2004, 2005, 2006, 2007 and 2008. Each of those Audit Opinions was addressed by Defendants to shareholders of the Fund including Plaintiffs. Each of these Audit Opinions had the eminently foreseeable effect of assuring Plaintiffs that they were invested in a legitimate business as portrayed in the Fund's audited financial statements. Defendants' Audit Opinions for the years ending January 5, 2006, 2007 and 2008 are annexed hereto as **Exhibits A, B, and C**, respectively.

5. As detailed below, in performing their audits of the Fund, Defendants breached their duty to Plaintiffs by violating the auditing standards identified herein, including without limitation (a) failing to investigate the issuer and the guarantor of the promissory notes which at all relevant times constituted all or virtually all non-cash assets; (b) failing to exercise professional skepticism and instead blindly accepting that the issuer of the notes purchased and sold high-end electronic goods; (c) failing to confirm with Costco the existence of the purchase orders supposedly underlying the notes purchased by the Fund; (d) failing to check, inspect, or confirm the inventory at the issuer's warehouses; (e) failing to exercise professional skepticism and instead blindly accepting that Costco deposited money directly into a lock-box controlled by the Fund; (f) failing to investigate the reputation for truth and honesty of Petters and other individuals who were responsible for all or virtually all of the Fund's business, and thus failing to detect that these individuals had criminal records related to their respective prior business dealings and character for truth and honesty; (g) ignoring multiple red flags; and (h) failing to ascertain and require disclosure of the fact that some promissory notes had been delinquent when extended, and insist on establishment of a bad debt reserve.

6. Based on Defendants' unqualified Audit Opinions, Plaintiffs in fact: (a) made investments in the Fund; (b) kept their invested monies in place; and (c) invested additional money in the Fund in each of 2004, 2005, 2006, 2007 and 2008. While Plaintiffs continually performed their own diligence as detailed below, they had no reason to question, doubt or challenge the Fund's financial statements and operations. Assurance from the auditors also meant that there was no reason to challenge or doubt the existence of certain structures or invoices, or the presence of security with respect to the underlying goods that supposedly were being sold to Costco.

7. Defendants somehow managed to miss the massive Ponzi scheme perpetrated by their audit client's principal customer and key business partner who was responsible for all or virtually all of Lancelot Offshore's business. This abject failure given the duties of Defendants and facts involved presents a textbook definition of recklessness. As auditors, Defendants keenly could anticipate and appreciate the risks of their negligence, malfeasance, misfeasance, and even willful blindness. But for Defendants' reckless and irresponsible conduct, Plaintiffs would never have invested in the Fund in the first place (nor continue to invest over the next four years), and thus would never have been exposed to losses aggregating in excess of $79 million.

8. Until today, Plaintiffs were members of a putative class action commenced by Tradex Global Master Fund SPC Ltd. and related funds ("Tradex") on behalf of themselves and as representatives of a class consisting of all persons and entities including Plaintiffs and their predecessors in interest that invested in, purchased or retained shares in the Fund from the inception of the Fund to the present, which action is now pending in this Court, Case No. 10-CH-13264 (the "Tradex Class Action").

9. Plaintiffs allege the following upon information and belief, except for allegations pertaining directly to Plaintiffs. Plaintiffs' information and belief is based upon a continuing investigation conducted by and on behalf of Plaintiffs into the facts and circumstances alleged herein including, without limitation, review and analysis of: (i) documents the Defendants named herein drafted, audited, reviewed and/or authorized; (ii) documents relating to the Fund on which Defendants relied in the performance of their audit services; (iii) public statements, press releases and other publications concerning Lancelot Offshore and the Defendants; (iv) applicable accounting principles and auditing standards and duties; (v) documents and court filings relating to the bankruptcy and liquidation of Lancelot Offshore and its domestic affiliates; (vi) press releases, civil complaints, criminal indictments and trial testimony relating to Petters,

Petters Company, Inc. ("PCI"), Petters Group Worldwide LLC and their subsidiaries and affiliates, and the Fund's principal, Gregory M. Bell ("Bell"); and (vii) other public records.

SUMMARY OF ACTION

10. As particularized below, Plaintiffs, through a series of material misrepresentations and omissions by the Defendants, which Plaintiffs reviewed, understood to be true and reliable, and relied upon justifiably (including because the representations involved unqualified audit opinions signed by certified public accountants after allegedly following generally accepted auditing standards), were fraudulently induced to purchase shares in Lancelot Offshore, and then were defrauded into not only remaining invested in the Fund, but also making additional investments therein.

11. In or about 2002, Bell created a number of Petters feeder funds including Lancelot Offshore and the Lancelot Onshore Funds (as hereinafter defined). Between November 2004 and July 2008, Plaintiffs and/or their predecessors in interest (collectively, the "Lancelot Investors") invested tens of millions of dollars in the Fund. Plaintiffs are the beneficial owners of 37,484.94 shares in Lancelot Offshore, which represent claims aggregating $79,047,685.80 (based on last reported NAV in 2008). As a result of Defendants' actions and omissions, Plaintiffs are entitled to judgment against Defendants for compensatory and consequential damages including lost profits in an amount in excess of $79 million, exclusive of pre-judgment interest and any other relief at law or in equity to which Plaintiffs may prove themselves entitled.

12. Plaintiffs' losses include damages separate and distinct from Lancelot Offshore. Those separate and distinct losses are directly attributable to the Defendants' failure to properly audit the Fund, and not to any losses that the Fund itself suffered. Had Defendants performed their audit services in accordance with generally accepted auditing standards ("GAAS"), as they were required to do, Plaintiffs would never have invested in the Fund initially. Had Defendants

fulfilled their duty in performance of their audits at any time between 2004 and 2008, Plaintiffs would not have allowed their investments to remain with the Fund, left gains reported over the years invested with the Fund, or periodically in years after their initial investment made entirely new investments in the Fund. Plaintiffs therefore would not have suffered any losses, irrespective of any losses that the Fund itself may have suffered as a result of its already existing investments in the Ponzi scheme. Moreover, once Plaintiffs made their initial investments, they would not have invested further monies in the Fund had Defendants not continuously issued unqualified or "clean" Audit Opinions.

13. Lancelot Offshore purchased commercial notes ("SPV Notes") that were supposed to be secured by merchandise owned by Thousand Lakes, LLC ("Thousand Lakes"), a special purpose vehicle ("SPV") owned by PCI, which was set up specifically by Petters to sell SPV Notes to the hedge funds formed by Bell. Thousand Lakes was supposed to use the loan proceeds to purchase high-definition flat screen television sets and other expensive electronic consumer products from either of two vendors, Enchanted Family Buying Company ("Enchanted") or Nationwide International Resources, Inc. ("NIR"), to fulfill existing purchase orders from Costco with respect to loans made by the Fund, and to other discount retailers such as Sam's Club and BJ's Wholesale Club with respect to loans made by other so-called feeder funds.

14. Such sales were completely fictitious. No merchandise was ever purchased by Thousand Lakes. Instead, Petters and his affiliates, including Enchanted, NIR and their principals, used investor money to run a $3.65 billion Ponzi scheme. A Ponzi scheme typically involves some form of fraudulent investment operation where the operator pays returns to existing investors from new capital raised from new investors, rather than from profit earned through legitimate activities. This is what Petters did to Lancelot Offshore and other feeder

from PCI, not from retailers, an obvious red flag that the Fund's auditors should have uncovered and identified.

17. The Defendants, however, allowed through their conduct unqualified or "clean" Audit Opinions to be disseminated to the Lancelot Investors. Those Audit Opinions unqualifiedly represented that the Fund's financial statements, including footnotes, presented fairly in conformity with accounting principles generally accepted in the United States the Fund's balance sheets, statements of operations, cash flows, and changes in shareholders' capital. This conclusion was reached each year and disseminated after the auditors, ostensibly, applied auditing standards generally accepted in the United States.

18. It is undeniable that the audit reports and the content of each of them were addressed to Plaintiffs.

19. Federal agents uncovered the Petters Ponzi scheme in September 2008. They confirmed the Ponzi scheme by using the basic audit practice of confirmation - that is, taking the simple step of asking the retailers to confirm that they purchased high-end electronic goods from the SPV. The retailers uniformly denied that any such purchases had ever occurred. This basic step led the investigators to uncover the Petters fraud in a short amount of time. Exhibit D (FBI Affidavit), at ¶9.

20. Any competent auditor likewise would have easily uncovered this massive fraud by, *inter alia*, showing the purchase orders and invoices to the retailers, physically visiting the warehouses where the alleged merchandise was supposed to be stored, reviewing bank records of its audit client to determine that the "lock-box" arrangement was not being maintained as represented to investors, investigating the issuer and/or guarantor of the SPV Notes (which at all relevant times constituted at least 80% of the Fund's stated assets), observing that the purported invoices did not comply with procedures posted by retailers online (thus easily accessible to the

auditors), checking public records to assure that UCC filings had in fact been made to perfect the Fund's security interest in accounts receivable due from retailers, or even attempting to shop for the goods allegedly sold to the retailer for re-sale to customers, whether on-line or in-store. Any of these steps would constitute the simplest, even obvious, step in any of the audits performed by the Defendants. Despite the fact that Defendants performed multiple audits of the Fund over the years, there is no evidence available to Plaintiffs that Defendants ever took these basic steps, and to Plaintiffs' knowledge no such evidence has been disclosed publicly in response to the multiple lawsuits filed against Defendants concerning the Fund, or otherwise.

21. As demonstrated by recordings of FBI-monitored conversations, Petters and his co-conspirators knew that the basic auditing step of observing inventory or seeking written third party confirmation was a weakness of their scheme and discussed it among themselves, at one point admitting that "the scheme would implode" as soon as "investors send auditors out to visit warehouses where the merchandise is located." Ex. D (FBI Affidavit) at ¶12.

22. Had the Defendants taken the basic auditing steps that Petters and his co-conspirators feared - and done so competently consistent with their duties as certified public accountants and auditors - the Petters Ponzi scheme would have been exposed before Plaintiffs made their first investment of $1,250,000 in November 2004. At the very least, had the Defendants taken these basic auditing steps, the fraud would have been exposed in the succeeding years before Plaintiffs vastly increased their investments, thereby saving Plaintiffs from significant losses.

23. On or about July 8, 2009, the United States Securities and Exchange Commission ("SEC") filed a complaint against Petters, Bell and the Fund's investment advisor, Lancelot Investment Management L.L.C. ("LIM" or "Lancelot Management"), in the United States District Court for the District of Minnesota, Case No. 09-cv-1750, seeking injunctive and other relief (the "SEC Complaint"). The SEC Complaint and its factual allegations concerning the

Ponzi scheme perpetrated by Petters and those involved with him is attached hereto as **Exhibit H** and incorporated herein. Petters and his co-conspirators were indicted and convicted of mail fraud, wire fraud, money laundering and conspiracy in connection with their operation of a multi-billion-dollar Ponzi scheme.

24. The Lancelot Investors reasonably relied on the unqualified representations in the Audit Opinions. These statements were considered repeatedly by the Lancelot Investors' responsible employees and accepted as fairly presented as signed by Defendants, consistent with Defendants' duties as auditors. The Audit Opinions helped to assure, and over succeeding years repeatedly assured, the Lancelot Investors that the Fund was a legitimate business able to generate steady and positive returns on its purported investments.

25. The investments made by Lancelot Offshore actually were a sham. The monies invested by the Lancelot Investors were not used to fund legitimate business transactions as Defendants' clean Audit Opinions represented, but instead were transmitted into a Ponzi scheme and diverted by Petters, a convicted felon pre-dating the Ponzi scheme, and Petters's cohorts, several of whom had criminal records that pre-dated the Fund's first investment in Thousand Lakes. Those pre-existing convictions should have been a red flag to any auditor, and should have been identified and investigated. As a result, the underlying Ponzi scheme would then have been become evident.

26. Thus, Defendants' representations to Plaintiffs were blatant falsehoods. All of the Audit Opinions grossly overstated and mischaracterized the assets, financial results and shareholders' capital of Lancelot Offshore.

27. In this regard, Defendants' false statements were specifically designed to, and did, induce investors to transfer monies to the Fund, which were then promptly diverted to a multi-year Ponzi scheme.

28. Plaintiffs have suffered direct loss and injury as a result of Defendants' misrepresentations and omissions. All told, Plaintiffs lost tens of millions of dollars in Lancelot Offshore as a direct result of Defendants' false statements and omissions.

29. Plaintiffs' claims against Defendants are also direct claims based on the doctrine of *in pari delicto* and the holdings of the United States Court of Appeals for the Seventh Circuit in *Peterson v. McGladrey & Pullen LLP,* 676 F.3d 594 (7th Cir. 2012) and *Peterson v. McGladrey LLP*, 792 F.3d 785 (7th Cir. 2015). In its second opinion, the Seventh Circuit ruled that the Fund's bankruptcy trustee did not have standing to assert claims against the Fund's auditors, but observed that: "The Trustee stepped into the shoes of the Funds, not the shoes of the investors. People who put up money have their own claims." The Seventh Circuit opined that, "a claim [by investors] against McGladrey may offer some recompense, if the auditor was indeed negligent or willfully blind." 792 F.3d at 788. In conclusion the Court held: "Proceedings on the investors' claims have been stayed pending resolution of the Trustee's suit [against McGladrey]. It is time to bring the investors' claims to the fore." *Id.* at 789 (emphasis added). Thus, the Seventh Circuit held that claims against the Fund's auditors belong to investors like Plaintiffs, and not the Fund itself. In this action, Plaintiffs are asserting those very claims against Defendants that the Seventh Circuit has recognized as claims that rightfully belong to investors like Plaintiffs.

30. The claims asserted herein are not precluded by the so-called "reflective loss" doctrine under Cayman Islands law because, *inter alia*, the Fund did not have a good claim which would have served to remedy the loss of the Fund's shareholders, and Plaintiffs' claims herein are for losses which are distinct and separate from those suffered by the Fund.

JURISDICTION, APPLICABLE LAW AND VENUE

31. Jurisdiction is proper in this Court because several of the Defendants are or were citizens or residents of Illinois; within the relevant time period transacted substantial business

within Cook County, Illinois; and otherwise in a legally effective manner subjected themselves to the laws of Illinois including through the actions and omissions giving rise to the claims asserted herein.

32. For purposes of illustration and not limitation, the claims asserted herein are subject to Illinois law because the offices, employees, and books and records of the Fund's manager were located in Cook County, the Audit Team (as hereinafter defined) was located in Cook County, the Audit Team conducted its negligent, reckless and irresponsible audit work in Cook County, Defendants made false statements in Cook County, Defendants committed torts in Cook County, the financial statements giving rise to liability were audited and distributed from the Defendants' offices in Cook County, the claims giving rise to liability herein occurred in Cook County, the Fund's governing documents recited that Illinois law applied and the Defendants' engagement letters provided that Illinois law applied.

33. The Defendants' engagement letters provided that: "Any claim arising out of services rendered pursuant to this agreement shall be resolved in accordance with the laws of Illinois." *See, e.g.*, Engagement Letters, attached as **Exhibit I** at p. 3.

34. In addition, the Subscription Agreement annexed as Exhibit A to the Fund's CIMs provided that: "This Subscription Agreement is governed by the laws of the State of Illinois, United States. The parties hereto consent to the jurisdiction of the courts in the State of Illinois, United States with respect to any proceeding or claim arising hereunder or in respect of the Fund." *See* Subscription Agreement, attached as **Exhibit J** at p. A-9.

35. Under 735 ILCS 5/2-101, 735 ILCS 5/2-102(a) and 815 ILCS 505-10a(b), venue is properly laid in this Court because a substantial part of Defendants' conduct giving rise to the claims asserted herein occurred in Cook County. Among other things: (i) one or more of the Defendants had an office in Cook County where business regarding Lancelot Offshore was

conducted; (ii) the Fund's manager's office and records were located in Cook County, and Defendants performed their audits of Lancelot Offshore's financial statements primarily in Cook County; and (iii) Audit Opinions regarding Lancelot Offshore were disseminated from Defendants' offices in Cook County.

PARTIES

Plaintiffs

36. Plaintiffs RS Investments Limited ("RSIL"), Corrado Investments Limited ("Corrado"), Eden Rock Finance Master Limited ("ERFML"), Eden Rock Asset Based Lending Master Ltd. ("ERABLM"), Eden Rock Unleveraged Finance Master Limited ("ERUFML") and Solid Rock Special Situations 2 Ltd. ("Solid Rock") (collectively, unless otherwise indicated, "Plaintiffs") are foreign corporations validly organized and existing under the laws of their respective jurisdictions, and maintain no principal office or other place for the conduct of their business within the United States.

Plaintiffs' Investments in the Fund

37. Through a series of transactions, Plaintiffs are the beneficial owners of 37,484.94 shares in Lancelot Offshore, which represent claims aggregating $79,047,685.80 (based on last reported NAV in 2008), as follows: RSIL is the beneficial owner of 13,561.64 shares, which represent claims aggregating $28,598,593.40; Corrado is the beneficial owner of 10,601.64 shares, which represent claims aggregating $22,356,595.87; ERUFML is the beneficial owner of 6,406.70 shares, which represent claims aggregating $13,510,355.84; ERABLM is the beneficial owner of 5,944.53 shares, which represent claims aggregating $12,535,739.17; and Solid Rock is the beneficial owner of 970.42 shares, which represent claims aggregating $2,046,401.53. In some instances, predecessors in interest transferred their shares in the Fund to Plaintiffs. All such transfers included the assignment of all of the transferors'

claims, rights and interests, including litigation claims, to Plaintiffs. Nothing pertaining to the shares or the Fund itself prohibited such transfers.

The Defendants, their Predecessors in Interest and Members of the Audit Team

38. Altschuler, Melvoin & Glasser, LLP ("AM&G) was a limited liability partnership with principal offices in Chicago, Illinois.

39. Altschuler, Melvoin & Glasser, Cayman ("AM&G Cayman") was located in the Cayman Islands. AM&G Cayman issued Audit Opinions for the Fund for the years ending January 5, 2004, January 5, 2005, January 5, 2006, and January 5, 2007. AM&G Cayman was a subsidiary of and/or affiliated with AM&G. As described below, the audit services relating to the AM&G Cayman Audit Opinions for the Fund were performed primarily by the partners and employees of AM&G. The AM&G Cayman Audit Opinions for the Fund were prepared and signed by an employee of AM&G using AM&G Cayman's letterhead.

40. McGladrey & Pullen LLP ("M&P") was an Iowa limited liability partnership with offices located in Bloomington, Minnesota. M&P had approximately 100 offices in the United States, including an office in Cook County. In November 2006, M&P purchased the assets of AM&G. *See* November 2006 Press Release, attached as **Exhibit K**. In its November 2006 Press Release, M&P assured that: "Clients will continue to receive world-class service and benefit from the strategic business advice of a global professional services firm." *Id.* In connection with its acquisition of AM&G, the partners and employees of AM&G became partners and employees at M&P. In addition, clients of AM&G became clients of M&P. M&P assumed the office space where AM&G was located in Chicago, Illinois, which is where the audit workpapers relating to the Fund were maintained. Thus, M&P owned and controlled AM&G and was its alter ego. Furthermore, as described more fully below, the audit services relating to the Fund were

performed by partners and employees of AM&G, who later became partners and employees of M&P.

41. McGladrey & Pullen, Cayman ("M&P Cayman") was located in the Cayman Islands. M&P Cayman issued an Audit Opinion for the Fund for the year ending January 5, 2008. M&P Cayman was a subsidiary of and/or affiliated with M&P. Thus, according to one M&P Cayman press release: "McGladrey & Pullen Cayman, Certified Public Accountants, specialize in accounting and audit services and are an affiliate office of McGladrey & Pullen, LLP, the fifth largest accounting firm in the United States." As described below, the audit services relating to the M&P Cayman Audit Opinion for the Fund were performed by the partners and employees of M&P. In addition, the M&P Cayman Audit Opinion for the Fund was prepared and signed by an employee of M&P using M&P Cayman's letterhead.

42. In or about May 2012, M&P officially changed its legal name to McGladrey LLP. In or about July 2012, McGladrey LLP changed its headquarters from Bloomington, Minnesota to Chicago. In or about October 2015, McGladrey LLP changed its legal name to RSM US LLP ("RSM").

43. Defendant RSM is a limited liability partnership organized under the laws of Illinois, and according to its website maintains its "corporate headquarters" at One South Wacker, Chicago, Illinois. RSM is the successor in interest to M&P and AM&G.

44. Defendant RSM Cayman Ltd. ("RSM Cayman") is a corporation formed under the laws of the Cayman Islands, and maintains its principal place of business at 2nd Floor, Harbour Place, South Church Street, P.O. Box 10311, Grand Cayman KY1-1003, Cayman Islands.

45. On or about August 10, 2011, RSM Cayman disclosed that: "The partners of McGladrey and Pullen, Cayman recently announced the formation of the new firm, RSM Cayman Ltd., trading as RSM Cayman and the successor firm to McGladrey & Pullen, Cayman."

See August 10, 2011 Cayman Compass article attached as **Exhibit L**. RSM Cayman is the successor in interest to M&P Cayman and AM&G Cayman. *See* RSM Cayman materials attached as **Exhibit M**.

46. The vast majority of the audit work for the Fund was performed by AM&G and, later, M&P, rather than their respective Cayman affiliates. These services were performed from the offices where the Audit Team (as defined below) worked in Chicago, Illinois. Moreover, the invoices for the audit work performed for the Fund (including any work by AM&G Cayman and M&P Cayman) were sent to Bell by AM&G and M&P, and paid by the Fund to AM&G, and later, M&P. Thus, the fees for whatever services were performed by the Cayman Island entities were paid to the United States entities.

47. The partner at AM&G Cayman, and later M&P Cayman, who was assigned to the Lancelot engagement, Alex Bodden ("Bodden"), played a nominal role in the audits of the Fund. For the most part, Bodden merely reviewed a package of financial statements and other documents prepared by the Audit Team in Illinois and then authorized the Audit Team to sign the Audit Opinions on behalf of AM&G Cayman (for the 2004 through 2006 Audit Opinions) and M&P Cayman (for the 2007 Audit Opinion) using AM&G Cayman and M&P Cayman letterhead.

48. Based on the foregoing, the Audit Opinions constitute statements made not only by AM&G Cayman and M&P Cayman, but also statements made by AM&G and M&P.

49. Defendant Simon Lesser ("Lesser") is an Illinois resident and was a partner of M&P and AM&G. Lesser was the partner in charge of the audits for the Fund.

50. Unless otherwise indicated, AM&G Cayman, AM&G, M&P Cayman, M&P, its or their successors in interest, and Lesser are collectively referred to herein as the "Auditors."

51. The principal individuals involved in the Defendants' audits of the Fund were Lesser, Harold Katz ("Katz") and Kenneth Carlton Ackerman ("Ackerman"). Lesser, Katz and Ackerman were initially employed by AM&G and later joined M&P in the fall of 2006, although they continued to work in the same offices in Chicago, Illinois. Unless otherwise indicated, Lesser, Katz and Ackerman, and the members of their staff that worked on the Fund's engagements, are hereinafter referred to as the "Audit Team." Lesser was the Partner in charge of the Audit Team.

52. On April 29, 2015, Lesser was disciplined by the SEC for failing to exercise the requisite level of care when conducting audits of certain hedge funds unrelated to Lancelot Offshore. Lesser consented or admitted to the material terms of the SEC Order attached hereto as **Exhibit N**. Lesser failed in connection with the subjects at issue in that proceeding to ensure that M&P's audits for each fiscal year were conducted in conformity with GAAS. The audit clients at issue were an interrelated grouping of foreign and domestic hedge funds and feeder funds, not unlike the Lancelot entities at issue in this action. Lesser failed to act with adequate professional skepticism in accordance with GAAS; failed to supervise the audit; failed to obtain and maintain adequate evidential matter; failed to adequately document his firm's audit work; Lesser was responsible for the issuance of clean audit reports where he failed to assure GAAS compliance; and he engaged in improper professional conduct for those and additional reasons on behalf of his and the other defendants' audit clients in the engagement at issue. *Id.*

53. The SEC further contended that Lesser did not obtain sufficient audit evidence or prepare audit documentation explaining adequately why he considered the financial statements to be fairly presented under accounting principles generally accepted in the United States absent such related party disclosures. Likewise, Lesser failed to obtain sufficient evidence in connection with his audits of the Fund. The SEC's action against Lesser cited his lack of due

professional care and reliance on inadequate evidence in support of the issued clean Audit Opinions. Those failures or failures comparable to them are evident in this action, including as alleged herein. Without admitting or denying the SEC's findings, Lesser agreed to a $75,000 civil penalty and a minimum three-year suspension from appearing or practicing before the SEC as an accountant.

54. "Lesser [was] denied the privilege of appearing before the [SEC] as an accountant," subject to an option after three (3) years from the date of the Order to reapply under severe restrictions. Ex. N, p. 11. Those restrictions in a future case where a public company's financial statements are filed with the SEC include that Lesser's work will be reviewed by the company's independent audit committee, or in some other manner acceptable to the SEC. *Id.* The restrictions also include, in the case of Lesser's practice as an independent accountant, the registration with the Public Company Accounting Oversight Board ("PCAOB") by Lesser or any firm with which he practices in accordance with the federal Sarbanes-Oxley act of 2002; inspection of Lesser or inspection of the firm with which he practices by the PCAOB, including a finding of an absence of criticisms or potential defects in the quality control system relating to Lesser's work and an absence of any indication that Lesser will not receive appropriate supervision. *Id.* Before any future application would be considered, Lesser also was ordered, for purposes of illustration, to resolve any disciplinary issues with the PCAOB, including compliance with all terms and conditions of any sanctions imposed; and that Lesser will have resolved any disciplinary issues with any boards of accountancy and otherwise presents with a valid CPA license. *Id.* The SEC in addition to those conditions retained the option to consider other matters related to Lesser's "character, integrity, professional conduct, or qualifications to appear or practice before the [SEC]." *Id.*

55. In or about November 2007, Katz became the Vice President of Finance of Lancelot Management. Thereafter, beginning in or about February 2008, Katz began assisting Bell in covering up the delinquency of the SPV Notes by implementing sham "round-trip" flows of cash described below to make it appear as though Thousand Lakes was making payments on time. Katz pled guilty to one count of conspiracy to commit wire fraud and was sentenced to prison in September 2010.

MATERIALLY INVOLVED NON-PARTIES

Petters, PCI and the "Vendors"

56. Petters is an individual who resided in Wayzata, Minnesota. Petters owned and controlled PCI, which owned Thousand Lakes. At times, Petters was a guarantor of the SPV Notes.

57. Larry Reynolds ("Reynolds") owned and controlled NIR.

58. Michael Catain ("Catain") owned and controlled Enchanted.

Bell, Lancelot Offshore and its Affiliates

59. Lancelot Offshore was a corporation organized under the laws of the Cayman Islands, which commenced operations effective October 6, 2002, and which had its principal place of business at 1033 Skokie Boulevard, Suite 620, Northbrook, Illinois.

60. Lancelot Offshore's domestic affiliates, Lancelot Investors Fund, L.P. and Lancelot Investors Fund II, L.P. (together, the "Lancelot Onshore Funds"), were limited partnerships organized under the laws of Delaware, and had their principal place of business at 1033 Skokie Boulevard, Suite 620, Northbrook, Illinois.

61. Lancelot Management was a Delaware limited liability company, which had its principal place of business at 1033 Skokie Boulevard, Suite 620, Northbrook, Illinois. Lancelot

Management was appointed by Lancelot Offshore and the Lancelot Onshore Funds to conduct all investment management operations for Lancelot Offshore and the Lancelot Onshore Funds.

62. Bell was an Illinois resident, and was the sole principal of Lancelot Management. Bell managed and had discretionary authority over the assets of Lancelot Offshore and the Lancelot Onshore Funds. Bell was also a director of Lancelot Offshore for all, or part of, the relevant period.

FRAUDS PERPETRATED BY NON-PARTIES

The Petters Ponzi Scheme

63. On December 2, 2009, Petters was convicted by a jury sitting in federal court in St. Paul, Minnesota of ten counts of wire fraud, three counts of mail fraud, one count of conspiracy to commit mail and wire fraud, one count of conspiracy to commit money laundering and five counts of money laundering. On December 3, 2009, the United States Attorney's Office for the District of Minnesota announced that: "According to the indictment and evidence presented at trial, Petters, aided and abetted by others, defrauded and obtained billions of dollars in money and property by inducing investors to provide PCI funds to purchase merchandise that was to be resold to retailers at a profit. However, no such purchases were made. Instead, the defendants and co-conspirators diverted the funds provided them for other purposes, such as making lulling payments to investors, paying off those who assisted in their fraud scheme, funding businesses owned or controlled by the defendants, and financing Thomas Petters's extravagant lifestyle." *See* December 3, 2009 Press Release attached as **Exhibit O**.

64. That announcement further disclosed that Petters co-conspirator Deanna Coleman agreed to work with law enforcement and wore a recording device to tape conversations with Petters and others. "Petters was heard admitting that purchase orders were 'fake' and claiming 'divine intervention' was the only explanation for how he and his co-conspirators 'could of [sic]

got away with this for so long.' … Petters's scam was an ordinary Ponzi scheme. Often potential investors were provided fabricated documents that listed goods purportedly purchased by PCI from various vendors and then sold to retailers. In some instances, investors also were provided false records indicating that PCI had wired its own funds to vendors, thus giving the appearance that PCI had money invested in the deals too. In addition, investors frequently received false PCI financial statements showing the company was owed billions of dollars from retailers. To induce investors further, Petters often signed promissory notes and provided his personal guarantee for the funds received. Those who invested, however, were not paid through profits from actual transactions. Rather, they were paid with money obtained from subsequent investors and, sometimes, even their own money. … PCI conducted some legitimate business initially but engaged in fraud from its first day. … To further his scheme, Petters recruited purported vendors to assist him. In 2001, he asked business associates Larry Reynolds and Michael Catain to launder billions of dollars of investor funds through their business accounts and back to Petters and PCI. Reynolds operated [NIR], and previously he had conducted deals involving shoes and clothing with retailers, including Petters. In 2001, Petters asked Reynolds to allow him to wire millions of dollars through Reynolds's bank accounts and, in exchange, agreed to pay Reynolds a fraction of a percent of the funds as a 'commission.' Petters made a similar agreement with Catain. As a result, in early 2002, Catain created a sham company, [Enchanted], and opened a business bank account. He then directed funds from Petters through that business account and back to Petters and PCI, less a commission. [Enchanted] did no real business. In fact, its headquarters was above Catain's car wash, just a few miles from Petters's headquarters. Between January 2003 and September 2008, approximately $12 billion flowed through the NIR account into the PCI account. During that same time period, roughly the same amount flowed through the [Enchanted] account into PCI. Although each company was purportedly a vendor, selling hundreds of millions of dollars in merchandise to PCI, bank records revealed no vendor income from those transactions. Instead, money flowed only from the two companies to PCI." *See* Ex. O.

65. In April 2010, Petters was sentenced to 50 years in prison for operating a $3.65 billion Ponzi scheme.

66. Enchanted and NIR were the "vendors" who were supposedly selling electronic merchandise to Thousand Lakes, but instead were working with Petters to operate a massive Ponzi scheme.

67. On September 14, 2010, the United States Attorney's Office for the District of Minnesota announced that Reynolds "was sentenced today ... to 130 months in federal prison on one count of conspiracy to commit money laundering. Reynolds was charged on October 16, 2008, and pleaded guilty on October 23, 2008." *See* September 14, 2010 press release attached as **Exhibit P**.

68. That announcement further disclosed that: "In his plea agreement, Reynolds admitted that from 2002 through September of 2008, he conspired with others to launder the proceeds of Petters' fraud scheme. Reynolds owned [NIR], which was nothing more than a shell corporation. He deposited funds into the NIR bank account on behalf of [PCI], a company formed by Tom Petters to further his fraudulent activities. The funds deposited into the NIR account were provided by PCI investors, who were falsely advised that the money would be used for the purchase of consumer electronics, which, in turn, would be sold by PCI to big-box retail stores for a profit. In reality, however, Reynolds wired almost all of the funds back to PCI, where they were used to further the fraud scheme and support the lavish lifestyle of Tom Petters." *See* Ex. P.

69. On September 13, 2010, the United States Attorney's Office for the District of Minnesota announced that Catain "was sentenced earlier today ... to 90 months in federal prison on one count of conspiracy to commit money laundering. Catain was charged on October 3, 2008, and pled guilty on October 8, 2008." *See* Catain September 13, 2010 press release attached as **Exhibit Q**.

70. That announcement further disclosed that: "In his plea agreement, Catain admitted that from 2002 through September of 2008, he conspired with others to launder the proceeds of that fraud scheme. To that end, Catain started a business called [Enchanted], which was nothing more than a shell corporation. He then began depositing funds into the [Enchanted] bank account on behalf of [PCI], a company formed by Tom Petters to further his fraudulent activities. The funds deposited into the [Enchanted] account were provided by PCI investors, who were falsely advised that the money would be used for the purchase of consumer electronics, which, in turn, would be sold by PCI to big-box retail stores for a profit. In reality, however, the funds were simply wired back to PCI and then used to further the fraud scheme and support the lavish lifestyle of Tom Petters." *See* Ex. Q.

Bell Imprisoned for Covering Up Delinquency of SPV Notes and Other Misdeeds

71. Beginning in or about December 2007, Bell began covering up the fact that the SPV Notes were not being paid when due, but Bell testified he still believed representations by Petters that the retailers would eventually pay. Beginning in or about February 2008, Bell conspired with Katz (who had been a member of the Audit Team but by then was working for LIM), and others to cover up the continuing delinquency of the SPV Notes. Presumably to cover up his own failures as part of the Audit Team, Katz implemented the "round-trips" that, beginning in or about February 2008, were used to perpetuate the cover-up.

72. On September 30, 2010, the United States Attorney's Office for the District of Minnesota announced that Bell "was sentenced today … to 72 months in prison on one count of wire fraud. Bell was charged on September 17, 2009, and pleaded guilty on October 7, 2009." *See* September 30, 2010 press release attached as ***Exhibit R***.

73. That announcement further disclosed that: "In his plea agreement, Bell admitted obtaining more than $200 million from people investing in [PCI] from February 26 through September 24, 2008. Bell's hedge fund, Lancelot Investment Management, had all of its money invested in PCI promissory notes. Bell admitted that after PCI fell behind in paying the notes held by Lancelot, he devised a plan to make it appear to Lancelot investors that PCI was paying off its notes when due. That plan entailed Lancelot providing funds to PCI that were then used to make payments back to Lancelot. From February 26, 2008, to September 24, 2008, Bell made 86 sham 'round-trip' banking transactions that gave investors and potential investors the false impression PCI was paying its promissory notes in a timely manner. The 'round-trip' transactions were preceded by telephone calls or e-mails between Lancelot personnel and PCI personnel about the amounts of money involved. In each of these 'round-trip' transactions, money was wired from Lancelot to PCI and then immediately wired back to Lancelot. When the money came back to Lancelot, it was represented as being payment by PCI on the promissory notes held by Lancelot. The effect of the round-trip transactions was to make it appear to investors that PCI was paying its obligations when due, when in fact, by 2008, PCI was no longer financially able to make payment on its notes." *See* Ex. R.

<u>THE DEFENDANTS' ACTIONABLE NEGLIGENCE AND FRAUD</u>

<u>Background</u>

74. At all relevant times, the Fund reported that it was doing over $1 billion in business per annum with Thousand Lakes, and the Fund's loans to Thousand Lakes were in the hundreds

of millions of dollars at any given time. In fact, assets were stated at over $1 billion as of the last Audit Opinion for the year ending January 5, 2008.

75. Lancelot Offshore was created in 2002 as a "feeder fund" for Petters and his organizations, who were purportedly engaged in "purchase order inventory financing."

76. Initially, Petters personally guaranteed the SPV Notes. However, in December 2007, Plaintiffs learned from Bell that Petters was no longer a personal guarantor, supposedly because by then the trade had been running for a few years and Lancelot Offshore was comfortable with the SPV's credit risk without the personal guarantee. This coincides with the time when Bell agreed to extend the maturities of the SPV Notes by 90 days, including SPV Notes which were then delinquent, although those facts were hidden from Plaintiffs and not disclosed affirmatively in the Audit Opinion dated January 5, 2008.

77. In theory, one of the Lancelot Onshore Funds would make loans to Thousand Lakes in exchange for a promissory note and collateral; such notes would then be purchased by and assigned to Lancelot Offshore; Thousand Lakes would use the loan proceeds to purchase electronic merchandise from U.S. suppliers after receiving a purchase order from Costco; Petters would arrange to warehouse the merchandise and ship it to Costco; Costco would pay Thousand Lakes for the merchandise; and Thousand Lakes would repay the loans to Lancelot Offshore with earned interest.

78. However, as detailed above, none of this actually happened. There were no purchases and resales of consumer electronics. The vendors were mere shell companies acting in concert with Petters; and no retailers participated in the purported business. Instead, the entire operation was a vast Ponzi scheme involving billions of dollars.

79. Defendants at all relevant times served as the Fund's auditors, as well as the auditors for the Lancelot Onshore Funds.

80. The scheme was uncovered in September 2008, by a federal investigatory task force assembled in the District of Minnesota. As described in the FBI Affidavit (Ex. D at ¶6):

> The primary method of effectuating the fraud scheme involves PETTERS, his employees, and his associates creating fictitious documents and then providing these documents to current and potential investors as evidence that PCI is buying and selling substantial goods and merchandise which PCI will then resell. In many instances, funds from investors are sent directly to the purported supplier of the merchandise, NIR or ENCHANTED. In turn, NIR or ENCHANTED direct the funds to PCI (less a commission) without any merchandise. PETTERS and other persons then fraudulently pledge the non-existent goods and merchandise as security for the investments.

81. As part of the federal investigation, FBI agents took the phony purchase orders and invoices directly to retailers to obtain confirmation of their legitimacy, and were immediately informed that they were fabrications. Ex. D at ¶9.

82. In fact, before learning of the Petters Ponzi scheme in September 2008, Bell warned the Auditors that Petters might be a fraud. Then and before then, the Auditors should have taken steps to assure that the assets, income and other data reported in the Fund's financial statements and accompanying notes were not simply fabrications.

83. The Auditors also failed to uncover and disclose to management material facts related to the Fund, including that Petters and others intimately involved in the Ponzi scheme had a prior criminal history. For example, Petters had been charged in Minnesota with two counts of theft by check, pled guilty to one such count and served one year in prison. Reynolds, the owner of NIR, one of the companies that was supposedly selling millions of dollars in consumer electronics to Petters, was charged with mail fraud, wire fraud, money laundering, obstruction of justice, and conspiracy to commit fraud. Reynolds has a decades' long criminal history and has served time in prison on multiple occasions. Reynolds, according to the trial testimony of Bell during the Petters criminal trial in November 2009, was in the federal witness protection

program while the Petters Ponzi scheme was being perpetrated, a fact germane to Reynolds which Bell on information and belief did not learn until sometime after Petters was indicted. Frank Vennes, Jr. ("Vennes"), one of the primary liaisons between Petters and unsuspecting investors, was previously convicted on federal charges of money laundering, illegal firearm sales and cocaine distribution in 1987, and served a lengthy prison sentence at the Sandstone Federal Correctional Institution.

84. The Auditors should have investigated Petters and these other key individuals, especially where they were responsible for all or virtually all of the Fund's business and Petters had personally guaranteed the SPV Notes.

85. During the first few years of the Fund, there was very little disclosure from management regarding the identities of the parties who were involved in the financing and purchase orders, and Plaintiffs did not learn the identities of the supposed suppliers until after the fraud came to light. The Fund's failure to disclose the identities of these parties did not arouse Plaintiffs' suspicions because the Fund asserted plausible commercial concerns in not disclosing the identity of retailers or vendors. Plaintiffs therefore reasonably relied on independent sources of information like the Audit Opinions signed by a reputable independent audit firm in performing investor diligence and making specific investment decisions as to the Fund.

The Fund's CIMs and Defendants' Knowledge Thereof

86. The Fund, LIM and Bell provided CIMs dated October 2002, December 2003 and March 2006 to Plaintiffs "for the purpose of enabling the recipient to evaluate an investment in the Fund." *See, e.g.*, December 2003 CIM, Ex. F, at p. i. The CIMs were reviewed by the Auditors, as were similar Confidential Information Memoranda for the Lancelot Onshore Funds.

87. As set forth in the December 2003 CIM: "The principal investment objective of the Fund is to seek consistent and reliable investment returns while minimizing the risk of permanent impairment to capital." Ex. F at p. 6. As described in the December 2003 CIM:

> It is anticipated that the Notes sold by Lancelot U.S.A. to the Fund, will evidence Loans made to one or more independently controlled special purpose vehicles (the "SPVs") which engage in the business of acquiring goods and selling such goods to major retailers ("Retailers"). Each SPV will use the proceeds from the Notes to finance the acquisition of those goods (the "Underlying Goods"), which such SPV sells to a Retailer. *Id.*

88. The December 2003 CIM outlined the "protections" and "monitoring" efforts that were allegedly in place for the benefit of the investors. Defendants should have discovered that the statements in the CIM were erroneous. *Id.* at 6-7. To the extent such errors impacted the fairness of presentation of the Fund's financial statements, Defendant's Audit Opinions should have been qualified or adverse. According to the Memorandum:

(A) "The Fund will purchase Notes only in circumstances where the SPV has a pre-existing, binding agreement with a Retailer to sell the Underlying Goods to such Retailer on a future date (a "Purchase Order")." *Id.* at 7.

(B) "As a result of such Purchase Orders, the Funds will assume little or no inventory risk with respect to the Underlying Goods." *Id.* at 6.

(C) "In general, a Note purchased by the Fund will finance up to 80% of the purchase price of the Underlying Goods purchased by the SPV in a particular transaction," with the SPV to fund the remaining 20%. *Id.* at 6-7.

(D) "With respect to each Note purchased by the Fund, the Fund will require collateral generally equal to 150% of the value of the Note." *Id.* at 7.

(E) "The Fund will have a security interest in the Underlying Goods which will be protected through the use of a proof of encumbrance filing under Article 9 of the Uniform Commercial Code." *Id.*

(F) "In addition to its security interest in the Underlying Goods, each Note purchased by the Fund will be guaranteed by the SPV's principals and/or affiliates of the SPV." *Id.*

(G) "In addition, in general the Fund will have a 'lock-box' arrangement with the SPV, pursuant to which the Fund will have control over the SPV's bank account into which the Retailer will pay the purchase price for the Underlying Goods, which is designed to protect the Fund from the SPV using such proceeds for any other purpose prior to satisfying the SPV's obligations under the Note." *Id.*

(H) "After a Note is purchased, an affiliate of the Fund or Investment Manager will monitor the SPV and the Retailer during the duration of the Note. In particular, the SPV will be monitored to confirm that the SPV satisfies its obligations under the Purchase Order including, without limitation, the delivery of the Underlying Goods to the Retailer, and the payment by the Retailer to the SPV of the purchase price of the Underlying Goods, all in accordance with the requirements set forth in the Purchase Order." *Id.*

89. Because of the fraudulent nature of the Fund's transactions, the non-existence of merchandise securing the SPV Notes, and the fabricated documents associated with the collateral underlying the SPV Notes, the representations contained in the CIMs were materially false and misleading. Specifically:

(A) The representation that Lancelot Offshore would "purchase Notes only in circumstances where the SPV has a pre-existing, binding agreement with a Retailer to sell the Underlying Goods to such Retailer" was materially false and misleading. In fact, there were no "pre-existing, binding agreement[s]" with retailers and no "Underlying Goods" were ever sold to retailers.

(B) The representation that the Fund would "assume little or no inventory risk with respect to the Underlying Goods" was materially false and misleading. Because there were no "Underlying Goods" purchased by retailers, the Fund was 100% at risk for the monies provided to Petters.

(C) The representations that Lancelot Offshore would "require collateral generally equal to 150% of the value of the Note;" that the Fund would have a "security interest in the Underlying Goods" were materially false and misleading. None of the Fund's transactions were secured by collateral, let alone collateral equal to "150% of the value" of each SPV Note. Because there were no "Underlying Goods," moreover, the Fund never had a security interest to protect it in the event of default.

(D) The representation regarding the Fund's supposed "lock-box" arrangements with SPVs were materially false and misleading. In fact, the "lock-box" arrangements touted in the CIMs as a mechanism for "protect[ing] the Fund" from improper use of the Fund's proceeds never existed. There were never any payments by retailers into the so-called lock-box, with all deposits into the lock-box coming from Petters in furtherance of his Ponzi scheme.

(E) The representations regarding the "monitor[ing]" purportedly performed by "an affiliate of the Fund or Investment Manager" were materially false and misleading. In fact, no "monitoring" was performed by anyone associated with the Fund or LIM, despite the millions of dollars in fees paid by the Fund precisely for this purpose. This included failure by the Auditors to verify these representations while performing their audits.

90. The Auditors reviewed the CIMs as part of their annual audits, were familiar with the contents thereof, and knew or should have known as a result of performing their audits that the representations contained in the CIMs were materially false.

<u>The Auditors Owed a Duty to Plaintiffs</u>

91. As the Auditors knew, hedge funds such as Plaintiffs are reluctant, if not unwilling, to invest millions of dollars in any venture - much less a non-public entity such as Lancelot Offshore - that does not have an independent auditor and audited financial statements. In fact, the Plaintiffs have only made investments in entities that have an independent auditor and audited financial statements. AM&G and AM&G Cayman were retained as the Fund's outside auditors in or about 2002.

92. In its capacity as an independent auditor, AM&G Cayman issued Audit Opinions for the Fund for the years ending January 5, 2004, January 5, 2005, January 5, 2006 and January 5, 2007. Given their years of experience auditing hedge funds and interacting with hedge fund investors, Lesser, AM&G and AM&G Cayman knew that the Lancelot Investors would be sent, and would be relying upon, these Audit Opinions in making decisions about purchasing and holding shares in the Fund.

93. Lesser, in fact, held himself out for years as having particular expertise as an auditor of and for funds such as Lancelot Offshore. He additionally emphasized his leadership and accomplishments as an auditor in the financial services area. Defendants encouraged Lesser to do so, in substantial part for pecuniary gain and without regard to Lesser's self-promoted expertise and other professional *bona fides*, and without among other things adequate or meaningful regular monitoring or other activities to confirm and otherwise ensure that Lesser's actual work continually met the sophistication and high standard that Lesser promised to clients.

94. Each Audit Opinion involving the Funds was specifically addressed and sent to the "Shareholders of Lancelot Investors Fund, Ltd.," which at all times as of and after November 2004 included Plaintiffs among a small group of the Fund's investors known to Defendants. Moreover, based on their years of experience with hedge funds such as Lancelot Offshore, Lesser, AM&G and AM&G Cayman knew that a hedge fund will and in fact did provide its audit opinions to persons considering investments in the fund for such persons to evaluate the financial performance, business and results of the fund, and to gain comfort with the character and integrity of its management.

95. The AM&G Cayman Audit Opinions represented without qualification that AM&G Cayman had conducted its audits "in accordance with auditing standards generally accepted in the United States of America." According to AM&G Cayman, "[w]e believe that our audit provides a reasonable basis for our opinion." AM&G Cayman also represented in its Audit Opinions that the Fund's "financial statements present fairly, in all material respects, the financial position" of the Fund as of January 5, 2004, January 5, 2005, January 5, 2006 and January 5, 2007, respectively, "the results of its operations, changes in shareholders' capital and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America."

96. M&P and M&P Cayman assumed the role of the Fund's outside auditors after acquiring the assets of AM&G and AM&G Cayman, respectively. In its capacity as independent auditors, M&P Cayman issued an Audit Opinion for the Fund on March 28, 2008 for the year ended January 5, 2008.

97. As with Lesser, AM&G and AM&G Cayman, M&P and M&P Cayman also knew that the Lancelot Investors would be sent, and would be relying upon, the January 5, 2008 Audit Opinion in making decisions about purchasing and holding shares in the Fund.

98. Moreover, as with the earlier Audit Opinions issued by AM&G Cayman, the Audit Opinion issued by M&P Cayman was specifically addressed and sent to the "Shareholders of Lancelot Investors Fund, Ltd.," which at all times as of and after November 2004 included Plaintiffs among a small group of the Fund's investors known to Defendants.

99. M&P and M&P Cayman also knew based on their years of experience with hedge funds such as Lancelot Offshore that a hedge fund will and in fact did provide its audit opinions to persons considering investments in the fund for such persons to evaluate the financial performance, business and results of the fund, and to gain comfort in the character and integrity of its management.

100. The M&P Cayman Audit Opinion represented without qualification that M&P Cayman had conducted its audit "in accordance with auditing standards generally accepted in the United States of America." According to M&P Cayman, "[w]e believe that our audit provides a reasonable basis for our opinion." M&P Cayman also represented in its Audit Opinion that the Fund's "financial statements present fairly, in all material respects, the financial position" of the Fund as of January 5, 2008, "the results of its operations, changes in shareholders' capital and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America."

101. The Audit Opinions were sent both to existing investors in the Fund and to individuals and entities evaluating whether to invest in the Fund. In this regard, the Audit Opinions were highly relevant sources of indispensable independent information about the Fund for both existing and prospective investors such as Plaintiffs, without which Plaintiffs would not have invested in the Fund, and it was reasonably foreseeable by the Auditors that the Lancelot Investors would invest millions of dollars in the Fund and retain their investments in the Fund in reliance on the Audit Opinions.

102. As described above, these facts were well known to the Auditors, who undoubtedly knew a primary intent of the Fund, LIM and Bell was to influence prospective and existing investors in the Fund. Indeed, prior to making their investments in the Fund, the Audit Opinions were provided to representatives of the Lancelot Investors, were maintained in the Lancelot Investors' files, and were relied upon by the Lancelot Investors in deciding to purchase shares in the Fund.

103. After the Lancelot Investors made their investments in the Fund, the Auditors sent the Audit Opinions directly to representatives of the Lancelot Investors. By virtue of these and other communications with the Lancelot Investors, the Auditors were clearly aware that the Audit Opinions would be used to influence the actions of the Lancelot Investors in deciding whether to purchase shares in the Fund. The Lancelot Investors continued making investments in the Fund based upon the Defendants' "clean" Audit Opinions.

104. The Fund specifically retained the Auditors to add an aura of legitimacy to the Fund's operations, and thereby induce wealthy individuals and hedge funds such as Plaintiffs to invest.

105. The Fund intended that the Lancelot Investors rely upon the Audit Opinions, and the Auditors knew that the Fund so intended for the Lancelot Investors to rely on the Audit Opinions for investment purposes.

106. The Auditors were in the business of supplying audit opinions to investors for input for their investment decisions. In transmitting the Audit Opinions to the Fund's shareholders, the Auditors were acting at the direction of or on behalf of their client to benefit or influence third parties, including the Fund's shareholders, among which were Plaintiffs.

107. The Auditors knew that the Lancelot Investors would rely upon the Audit Opinions, and that the Lancelot Investors did rely on the Auditors' representations in the Audit Opinions in deciding to invest in and continue to invest in the Fund.

108. The Auditors knew that their Audit Opinions would be used and were used by the Lancelot Investors for the purpose of making investment decisions.

109. By directly addressing their Audit Opinions to the Lancelot Investors, the Auditors confirmed their understanding that the Lancelot Investors were relying on and benefitting from that information prepared and disseminated by the Auditors.

110. In fact, as was well known to Defendants, a principal reason for the Fund to hire Defendants (or anyone else) to audit its financial statements was to influence investors and potential investors such as Plaintiffs.

111. Based on the foregoing, the Auditors owed a duty to the Lancelot Investors, which the Auditors breached in the manner described herein.

Audit Standards and Violations Thereof

Standards

112. The independent accountant or auditor serves as guardian of the credibility of a company's financial statements for the benefit of investors, lenders and other identified stakeholders such as, in the case of Lancelot Offshore, its shareholders. The auditor's role is to provide reasonable assurance that financial statements and accompanying footnotes are presented fairly under Generally Accepted Accounting Principles ("GAAP"). The unqualified audit opinion indicates that the information furnished by management and included in the audited financial statements can be relied upon, which in the case of Plaintiffs and these Defendants included the Plaintiffs as prospective and actual investors.

113. The auditor can only issue an unqualified opinion after gathering, testing and assessing appropriate audit evidence supporting the reported information and otherwise following GAAS, including familiarity with the subject matter, experience with the audit client, and the professional judgment and skepticism required from an auditor. The auditor's compliance with GAAS among other requirements must be properly documented in the audit workpapers. In determining whether the financial statements and footnotes are presented fairly, the auditor must also be expert on GAAP. As detailed herein, the Defendants failed to satisfy their audit responsibilities.

114. Each of the Audit Opinions represented that: "In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Lancelot Investors Fund, Ltd. as of January 5, [for the relevant year – 2004 to 2008], and the results of its operations, changes in shareholders' capital and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America."

115. This conclusion by the auditor is required for an unqualified or "clean" audit opinion to be issued. Accordingly, the auditor must be knowledgeable as to GAAP in assessing whether the financial statements are presented fairly. GAAP is determined primarily by the Financial Accounting Standards Board ("FASB") and addresses the requirements for individual components comprising financial statements. Overall, GAAP stipulates how every balance sheet item shall be recorded and valued and how and when revenues and expenses flow through the income statement. For example, relevant to Lancelot Offshore, these standards address when and how to record notes receivable and interest income.

116. In assessing whether the financial statements are in conformity with GAAP, the auditor must follow GAAS, which are adopted by the Auditing Standards Board, a committee of

the American Institute of Certified Public Accountants ("AICPA"). GAAS addresses "foundations standards" as well as those applicable to specific items. The standards are designated with the prefix "AU" for auditing standards.

117. The language in some of the AU standards was changed for audit periods beginning after December 15, 2006, so both the old and current standards apply to the Audit Opinions that are the subject of this action, but the substance of each version is essentially the same and imposed fundamentally the same duties on the Auditors. The current AU standards applied to the last Audit Opinion issued by Defendants for the year ending January 5, 2008. The previous version of the AU standards applied to the Audit Opinions issued by Defendants for the years ending January 5, 2006 and 2007.

118. For example, the previous version of AU 150, "Generally Accepted Auditing Standards," paragraph 2, imposed the following foundations standards: "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors; due professional care is to be exercised in the performance of the audit and preparation of the report; a sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed; and sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit."

119. The current version of AU 150 (paragraph 2) imposes the following foundations standards: "The auditor must maintain independence in mental attitude in all matters relating to the audit. The auditor must exercise due professional care in the performance of the audit and the preparation of the report. The auditor must adequately plan the work and must properly supervise any assistants. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the

financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit."

120. If an auditor is unable to complete the steps noted above, depending on the circumstances, the result could be a disclaimer of an opinion, as follows per AU 508, "Reports on Audited Financial Statements," paragraph 10: "A disclaimer of opinion states that the auditor does not express an opinion on the financial statements."

121. It is not, however, acceptable for an auditor to disclaim an opinion on the financial statements when evidence suggests that there is (are) a material misstatement(s). In those circumstances, the auditor must issue a qualified or adverse opinion, depending on the magnitude and pervasive nature of the misstatement. AU 508 (paragraph 10) dictates the wording of each: "A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles."

122. The nature and role of audit evidence is not captured in a comprehensive checklist. An auditor must apply professional judgment in the identification and interpretation of appropriate audit evidence. As required by AU 150 (paragraph 2): "The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit." The previous version of AU 150, paragraph 2, also referenced the importance of audit evidence, as follows: "Sufficient competent

evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit."

123. Further indication of the role of judgment relates to an auditor's assessment of audit risk. Audit risk reflects the risk that the auditor determines that the financial statements are presented fairly, when they are not. The use of judgment in examining audit evidence is further expressed in the current version of AU 230, "Due Professional Care in the Performance of Work," paragraph 10: "While exercising due professional care, the auditor must plan and perform the audit to obtain sufficient appropriate audit evidence so that audit risk will be limited to a low level that is, in his or her professional judgment, appropriate for expressing an opinion on the financial statements. The high, but not absolute, level of assurance that is intended to be obtained by the auditor is expressed in the auditor's report as obtaining reasonable assurance about whether the financial statements are free of material misstatement (whether caused by error or fraud)." (Emphasis added). The previous version of AU 230 was substantively equivalent to the current version. It required the auditor to exercise due professional care in performing the audit, including evaluating the competence and sufficiency of audit evidence.

Violations With Respect to Concentration Risk

124. The Auditors were aware, contemporaneously with their audits, of the degree to which Petters's tentacles reached into virtually all aspects of the Fund's structure and operations (the "Petters Effect"). They knew that Petters was in control of the SPV, Thousand Lakes, and its alleged purchase and sale activities. They knew that Thousand Lakes represented all or virtually all of the Fund's business, revenues, income and assets. They knew that Petters was the conduit to the vendors as well as to Costco, the sole retailer to which Thousand Lakes was supposedly selling merchandise. In addition, they knew that Petters guaranteed the debt of the SPV to the Fund.

125. Under this scenario, Petters could have (and did) have his hands on and control of all aspects of document, inventory and cash flows for the Fund. He was in a position to fabricate documents reflecting the purchase of inventory by the SPV from the vendors, the transfer of inventory to the warehouse(s), the purchase orders from Costco, which were allegedly a necessary prerequisite to the SPV's purchase of inventory, the shipment of goods to Costco, and the source of collections by the SPV. Further, according to Petters, contact by others could threaten his relationship with Costco.

126. In light of the interrelated and comprehensive roles that Petters played in the scheme, the risk of the financial statements being false and misleading was indeed high. The current and previous versions of AU, Section 312, "Audit Risk and Materiality in Conducting an Audit," paragraph 1 state: "This section provides guidance on the auditor's consideration of audit risk and materiality when performing an audit of financial statements in accordance with generally accepted auditing standards. Audit risk and materiality affect the application of generally accepted auditing standards, especially the standards of fieldwork and reporting, and are reflected in the auditor's standard report. Audit risk and materiality, among other matters, need to be considered together in designing the nature, timing, and extent of audit procedures and in evaluating the results of those procedures."

127. The current version of AU 312, paragraph 11, elaborates on the statements in paragraph 1: "The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: (a) Determining the extent and nature of risk assessment procedures; (b) Identifying and assessing the risks of material misstatement; (c) Determining the nature, timing, and extent of further audit procedures; (d) Evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with generally accepted accounting principles." The previous version of AU 312 was

structured differently from the current version, but required that the audit be performed in substantively the same manner.

128. Because the Auditors were aware of the concentration of influence and control exercised by Petters, they should have factored the above requirements into their risk assessment procedures. Absent other indicia mitigating such risks, it would be necessary to increase the underlying tests and evidentiary support necessary for the Auditors to conclude that the Fund's financial statements were free of material misstatements.

129. The Petters Effect reflected a concentration of decision-making authority impacting the Fund in one person and/or entities controlled by him. If the Auditors incorrectly assumed a lesser role by Petters, they could well have decided that the risks of material misstatements in the financial statements were lowered. The level of risk, however, would still not be reduced to "low." Among other factors, the concentration of Notes Receivable from one SPV would indicate that there was significant risk that the financial statements (including, but not limited to Notes Receivable and Interest Income) contained material misstatements. There is a correlation between assessed risk and the sufficiency of audit evidence necessary to support a clean opinion, *i.e.*, the greater the risk, the higher the threshold for required evidentiary support.

Violations With Respect to Audit Evidence

130. The current version of AU 326, "Audit Evidence," at paragraph 13 provides: "In forming the audit opinion, the auditor does not examine all the information available (evidence) because conclusions ordinarily can be reached by using sampling approaches and other means of selecting items for testing. Also, the auditor may find it necessary to rely on audit evidence that is persuasive rather than conclusive; however, to obtain reasonable assurance, the auditor must not be satisfied with audit evidence that is less than persuasive. The auditor should use professional judgment and should exercise professional skepticism in evaluating the quantity and

quality of audit evidence, and thus its sufficiency and appropriateness, to support the audit opinion." The previous version of AU 326 was organized and structured differently than the current version. The contents and requirements were substantively equivalent to the current version. Without regard to its organization and structure, this is the same failing Lesser, including while he was associated with the other Defendants, exhibited in the Alpha Titans matter that is the subject of the SEC Order annexed as Ex. N.

131. Management is responsible for the fair presentation of financial statements that reflect the nature and operations of the entity. Current AU 326, at paragraph 14. The auditor is responsible for verifying that the assertions made by management regarding the financial statements are supported by independent evidence. The current version of AU 326, at paragraph 15 provides that auditors must verify, *inter alia*, that: "Transactions and events that have been recorded have occurred and pertain to the entity. ... Amounts and other data relating to recorded transactions and events have been recorded appropriately. ... Assets, liabilities, and equity interests exist. ... The entity holds or controls the rights to assets, and liabilities are the obligations of the entity."

132. Although organized and presented differently, both the current and prior versions of AU 326 note the responsibility of management to make assertions regarding elements of the financial statements. The auditor is charged with applying professional judgment in evaluating the underlying evidence and its consistency with the assertions made by management.

133. In the case at hand, the alleged flow of cash and goods previously described was ultimately shown to have been a façade. Had Auditors sufficiently investigated, as they were required to do, they would have discovered that the transactions and events did not occur as indicated, and, accordingly, the Fund's financial statements were not presented fairly. For example, the assets did not exist and, therefore, the Fund could not hold nor control them.

134. The Auditors did not follow any of the above auditing standards. Based on the information available at the time of each audit, it is clear that the Auditors did not gather sufficient evidentiary support for a clean opinion. Lesser, including while he was associated with the other Defendants, exhibited the same basic failings, including as to audit planning, audit supervision, and obtaining sufficient audit evidence in the Alpha Titans matter that is the subject of the SEC Order annexed as Ex. N. Accordingly, if the Auditors were unable to retrieve necessary evidence (*e.g.*, from Costco), at the very least, a disclaimer would have been appropriate, but no such disclaimer was ever issued. However, in light of the issues that the Auditors should have discovered, the impact on the Fund's financial statements was so great as to not support a qualified opinion, and an adverse opinion would have been necessary.

135. The Auditors could not have obtained "competent evidential matter" and reached the conclusion that there was adequate support for the recorded transactions. *See also, e.g.*, Ex. N (SEC Order). For example, AU 330, "The Confirmation Process," requires that an auditor obtain third-party confirmations of balances due from customers. These confirmations are to be returned directly to the auditor. Further, in light of the importance of the value of inventory serving as collateral for the SPV Notes, the Auditors should have taken steps to verify its existence and sufficiency. This is clear from the current version of AU 326, paragraph 1, which states that: "The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit." The subsection of AU 326 that addresses "Audit Procedures for Obtaining Audit Evidence" (paragraph 21) provides that: "The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit

procedures in the form of tests of controls, when relevant or necessary, and substantive procedures." The previous version of AU 326 was consistent with the above as to the role of audit evidence and risk assessment in the performance of the audit. Lesser, including while he was associated with the other Defendants, exhibited the same basic failing as to evidential matter in the Alpha Titans matter that is the subject of the SEC Order annexed as Ex. N.

136. Even a modest amount of professional care would have revealed that the "transactions" with Petters and his affiliates were not real. As with other subjects in this action, Lesser, including while he was associated with the other Defendants, exhibited the absence of due professional care in the Alpha Titans matter that is the subject of the SEC Order annexed as Ex. N. Similarly, an analysis of the internal control system would have revealed to the Auditors that the existence and flow of documents suggested by the asserted business activities were fabricated.

<u>False Statements With Respect to Notes Receivable and Income</u>

137. The Audit Opinions applied to the footnotes as well as to the financial statements. Note 1 to the audited financial statements for the year ending January 5, 2008 (Ex. C) purported to describe the "Nature of [the Fund's] Activities and Significant Accounting Policies" as follows:

> The Company purchases and is assigned Notes, whereby the Company assumes the rights of the original owner of such Notes. The Notes are purchased by and assigned to the Company from Lancelot Investors Fund, L.P., a Delaware limited partnership (the "Partnership") and also may be purchased from other entities from time to time. The Company's investment manager ("Manager") is also the General Partner of the Partnership. Any proposed purchase by the Company of a Note from the Partnership is subject to review, evaluation and approval or rejection by the Loan Acquisition Officer of the Company, which approval or rejection is made at the sole discretion of the Loan Acquisition Officer, who is unrelated to the Partnership and the Manager. The Notes purchased from the Partnership and assigned to the Company evidence loans made to one or more independently controlled special purpose vehicles ("SPV").

> During the fiscal year, the Notes purchased from the Partnership were issued primarily by a single SPV [Thousand Lakes], which is based in the United States. This SPV is engaged in the business of acquiring goods and selling such goods to major U.S. based retailers. This SPV uses the proceeds from such Notes to finance the acquisition of goods, which the SPV sells to the retailer. The Notes pay a fixed interest rate, and the Company earns revenue from the Notes through the collection of such interest payments.

138. Note 4 addressed Concentration of Credit Risk: "During the year ended January 5, 2008, the Company purchased and was assigned Notes from the Partnership. The Partnership acquired Notes primarily from one SPV issuer [Thousand Lakes] (the "Primary Issuer"). <u>The Company is economically dependent on its ability to purchase Notes ... that are issued by one or more SPV issuers</u> at rates and terms acceptable to the Company. <u>The Company is exposed to credit risk in that the Primary Issuer may fail to make interest and principal payments on the Notes</u> at the contractually agreed date following default by a retailer." *Id.* (emphasis added). The above notes are consistent, with minor wording differences, with those included with the audited financial statements for years ending January 5, 2006 and January 5, 2007. Ex. A & B.

139. The audited financial statements as of and for the fiscal year ending January 5, 2008 reported Notes Receivable (from Thousand Lakes) in the amount of $1,055,945,983, representing 92.6% of reported Total Assets in the amount of $1,139,842,696, and Interest Income (from the SPV Notes) in the amount of $160,879,234, representing 99.8% of reported Total Income in the amount of $161,277,138. Ex. C. The audited financial statements for years ending January 5, 2006 and January 5, 2007 also reflected the dominance of Petters-related Notes Receivable and Interest Income as compared to Total Assets and Total Income, respectively. Ex. A & B.

140. Taken together, Notes 1 and 4 and the financial metrics in the preceding paragraph demonstrate that the Auditors should have gathered and analyzed sufficient independent

evidence to conclude that the Petters-related Notes Receivable were valid and collectible, which clearly they failed to do. Note 1 to the above financial statements also includes the following regarding Notes Receivable: "Notes receivable are stated at cost (generally equal to the principal amount of the Notes), plus accrued interest, which was $63,302,186 as of January 5, 2008. Income is recognized on the accrual basis over the term of the Notes, which generally range from 180 to 270 days. Interest income accrues at predetermined rates on Notes outstanding at year-end." Ex. C.

141. Under GAAP, the above statements in Note 1 would only be appropriate if the assessment by management of the collectibility of the Notes Receivable led to the conclusion that they were fully collectible. FASB Statement Number 5, "Contingencies," addresses this issue as follows, paragraph 1: "For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a 'gain contingency') or loss (hereinafter a 'loss contingency') to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. ... (paragraph 3) When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range....(paragraph 4) Examples of loss contingencies include: Collectibility of receivables. ...(paragraph 8) An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if both of the following conditions are met: Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in

this condition that it must be probable that one or more future events will occur confirming the fact of the loss. The amount of loss can be reasonably estimated …(paragraph 9) Disclosure of the nature of an accrual made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading. … (paragraph 10) If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made." (Emphasis added). Based on the above GAAP requirements, Note 1 indicating that the Notes Receivable were carried at cost (generally equal to the principal amount of the notes) would be in compliance with GAAP if there were only a remote chance that a portion (or all) of the notes would be uncollectible. The same blindness to these issues was exhibited by Lesser, including while he was associated with the other Defendants, in the context of related party transactions, disclosure, and audit scrutiny in the Alpha Titans matter that is the subject of the SEC Order annexed as Ex. N.

Violations With Respect to Inventory Underlying the Notes Receivable

142. In addition to the confirmation process, an audit of the Notes Receivable would have to include independent evidence that the SPV purchased inventory from the vendors, that the inventory existed, and was of sufficient value to provide the required collateral coverage. The necessary audit procedures would include confirmation from the vendors of amounts purchased. The Auditors would need evidence that the inventory existed and belonged to the SPV. The SPV's assertions to that effect would need to be tested at a minimum for accuracy.

Further, without independent knowledge of the operations and financial condition of the vendors, the Auditors would need independent verification of the existence, ownership, quantities and valuation of the inventory.

143. According to both the current and prior versions of AU 331, "Inventories", paragraph 1: "Observation of inventories is a generally accepted auditing procedure. The independent auditor who issues an opinion when he has not employed them must bear in mind that he has the burden of justifying the opinion expressed."

144. This requirement typically relates to the client's inventory. However, for the reasons noted above, evidence regarding the existence, ownership, quantities and valuation of the SPV's inventory was critical in the audit of the Fund's Notes Receivable.

145. Had the Auditors observed the inventory, they would have discovered that the claim in the CIM regarding value of collateral was fraudulent. As there was <u>no</u> inventory belonging to the SPV, there could not be any attribution of value to it.

<u>Other Violations</u>

146. The Auditors could not have carried out their professional duties and responsibilities under GAAS and arrived at the conclusion that the Fund's financial statements were prepared in compliance with GAAP. This blindness by the Auditors rises to the level of willfulness, particularly but not solely because Lesser, including while he was associated with the other Defendants, acted and failed to act similarly in the Alpha Titans matter that is the subject matter of the SEC Order annexed at Ex. N.

147. The representations contained in the Fund's audited financial statements were materially false and misleading. First, they materially misreported the Fund's: (i) notes receivable; (ii) shareholders' capital; (iii) interest income and net income; and (iv) investments.

148. The audited financial statements also represented that the Fund had the following assets, shareholders' capital and net income for the years:

Year Ending	Assets	Shareholders' Capital	Net Income
January 5, 2006	$509,442,601	$448,141,485	$42,219,715
January 5, 2007	$901,266,612	$709,437,383	$68,452,692
January 5, 2008	$1,139,842,696	$945,237,360	$98,643,198

149. The reported figures associated with these line items were inflated by virtually the entire amount. The financial statements, however, were each accompanied by a clean Audit Opinion.

150. Second, the representations in the Audit Opinions that the Fund's "financial statements present fairly, in all material respects, the financial position" of Lancelot Offshore, and "the results of its operations, changes in shareholders' capital and its cash flows" for the reporting period in question, were materially false and misleading. In fact, the Fund's audited financial statements were not fairly presented and violated GAAP in numerous material respects.

151. Third, the representations in the Audit Opinions that the Auditors conducted their audits in accordance with applicable auditing standards were materially false and misleading. In performing audits of financial statements, certified public accountants are required to follow GAAS in arriving at their opinion that the financial statements are fairly stated in accordance with GAAP. As quoted above, when performing an independent audit of a client's financial statements, a certified public accountant is obligated under both the current and previous versions of AU 150, paragraph 2, with slight variation in wording, to follow the following standards, among others: maintain independence; exercise due professional care; adequately plan the work and properly supervise any assistants; obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements; and obtain sufficient appropriate audit evidence by performing audit

procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

152. The Auditors failed in numerous respects to follow these standards mandated by GAAS including their inexcusable failure to: (i) assure that the Fund was a legitimate business enterprise and not involved in a massive, long-running Ponzi scheme; (ii) investigate the collectability of the SPV Notes; (iii) obtain original source material to assure that the Fund's transactions were not based on forged documents; and (iv) make inquiry about the key individuals involved in the Fund's transactions. For these and other reasons, the Auditors' representations about their purported compliance with GAAS were materially false and misleading. Lesser's and the other Defendants' similar failings also led to the issuance of clean audit reports without assuring GAAS compliance in the Alpha Titans matter that is the subject of the SEC Order annexed at Ex. N.

153. Fourth, the notes to the audited financial statements falsely depicted the nature of the Fund's business and operations. For example, contrary to the representations in the notes, the Fund did not seek to "provide its shareholders with consistent and reliable returns while minimizing the risk of impairment to capital." *See, e.g.*, Ex. A. Rather, the Fund's sole "business" was in effect to funnel monies solicited from the Lancelot Investors to several convicted felons who were operating a vast Ponzi scheme.

154. Moreover, the notes also represented that: "This SPV is engaged in the business of acquiring goods and selling such goods to major U.S. based retailers. This SPV uses the proceeds from such Notes to finance the acquisition of goods, which the SPV sells to the retailer." *See, e.g.*, Ex. A.

155. The Auditors knew or should have known, with any basic auditing diligence, that these statements were false. The Auditors never obtained or examined any evidence from the

companies the SPV was alleged to have purchased high-end electronics from or sold them to, as there was no such evidence. As described above and in the SEC Complaint (Ex. H), "there were no real transactions;" "no goods were ever delivered to any Retailers;" and "no Retailers ever engaged in any transactions" with any SPVs. Consequently, the audited financial statements repeatedly mischaracterized the Fund as a legitimate business enterprise, when, in fact, it was nothing more than an empty shell using investor monies for the benefit of Petters and his cohorts.

Failure to Detect Fraud

156. AU 110, "Responsibilities and Functions of the Independent Auditor," paragraph 1, provides that: "The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles. ... The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." (emphasis added).

157. AU 316, "Consideration of Fraud in a Financial Statement Audit," establishes standards and provides guidance to auditors in fulfilling their responsibility under AU 110, as such responsibility relates to fraud. AU 316 provides in relevant part: "Due professional care requires the auditor to exercise professional skepticism. ... Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism

requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest. … Prior to or in conjunction with the information-gathering procedures described in … this section, members of the audit team should discuss the potential for material misstatement due to fraud. The discussion should include: An exchange of ideas or 'brainstorming' among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated; An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud. … The discussion [among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud] should occur with an attitude that includes a questioning mind as described in paragraph .16 and, for this purpose, setting aside any prior beliefs the audit team members may have that management is honest and has integrity. … Finally, the discussion should include how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud." (emphasis added) (citations and footnotes omitted). The Auditors failed to fulfill their responsibilities under AU 316 to engage in brainstorming to determine whether a material misstatement due to fraud could be present in the Fund's financial statements.

Failure to Detect Illegal Acts

158. When reviewing the CIMs that included statements regarding investor protections, the Auditors should have assessed whether such statements were consistent with the audit

evidence gathered. There were statements in the CIMs that were false and misleading. The Defendants should have determined their impact (if any) on the audited financial statements. AU 317, "Illegal Acts by Clients" would be relevant to this assessment by the auditor. When the auditors read the company's CIMs, they should have discovered: (a) False statements about the cash flows through the "collateral accounts" maintained at Wells Fargo Bank N.A.; (b) False statements that its independent accountants completed quarterly examinations of the Fund's transaction procedures; and (c) False statements regarding the existence and amount of collateral for Notes Receivable.

159. Given that these false statements were made in documents that the client used in connection with the sale of securities, the Auditors should have known that it was possible that the client was engaged in illegal acts. That possibility should have caused the Auditors to follow the guidance below that is set forth in AU 317, "Audit Procedures in Response to Possible Illegal Acts." Paragraph 10: When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of management at a level above those involved, if possible. If management does not provide satisfactory information that there has been no illegal act, the auditor should - a. Consult with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. Arrangements for such consultation with client's legal counsel should be made by the client. b. Apply additional procedures, if necessary, to obtain further understanding of the nature of the acts. Paragraph 11: The additional audit procedures considered necessary, if any, might include procedures such as the following: a. <u>Examine supporting documents, such as invoices, canceled checks, and agreements and compare</u>

with accounting records. b. Confirm significant information concerning the matter with the other party to the transaction or with intermediaries, such as banks or lawyers. c. Determine whether the transaction has been properly authorized. d. Consider whether other similar transactions or events may have occurred, and apply procedures to identify them. The Auditor's Response to Detected Illegal Acts: Paragraph 12: When the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit. Effect on the Auditor's Report: Paragraph 18: If the auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor should express a qualified opinion or an adverse opinion on the financial statements taken as a whole, depending on the materiality of the effect on the financial statements. Paragraph 19: If the auditor is precluded by the client from obtaining sufficient appropriate audit evidence to evaluate whether an illegal act that could be material to the financial statements has, or is likely to have, occurred, the auditor generally should disclaim an opinion on the financial statements. Paragraph 20: If the client refuses to accept the auditor's report as modified for the circumstances described in paragraphs 18 and 19, the auditor should withdraw from the engagement and indicate the reasons for withdrawal in writing to those charged with governance." (emphasis added). The Auditors failed to perform any of the above steps in issuing their clean Audit Opinions for years ending on January 5, 2006, January 5, 2007 and January 5, 2008.

The Auditors' Knowledge or Gross Recklessness

160. Internally, the Auditors designated the Fund to be a "high risk" client. Moreover, according to internal documents, the Auditors understood the possibility that source documents

in connection with the Petters "transactions" (such as purchase orders and bills of sale) could be forgeries.

161. Nevertheless, the "work" performed by the Audit Team was so perfunctory, careless, and rife with erroneous accounting judgments, that the Auditors either knew - or were reckless in not knowing - that the audited financial statements were materially false and misleading. Among other things, the Audit Team:

(A) Failed to perform any substantive analysis as to the true value of the SPV Notes, which represented virtually all of the Fund's non-cash assets, and instead merely offered clean Audit Opinions on financial statements that reported the value of the SPV Notes at cost (generally equal to the principal amount of the notes), plus accrued interest;

(B) Failed to adequately review wire transfers to determine who was actually paying the SPV Notes that represented virtually all of the Fund's non-cash assets, did not obtain other evidence as to the source of such payments and/or failed to indicate that, due to the Auditor's inadequate (if any) effort to obtain sufficient evidence regarding the source of the payments, they would issue an adverse opinion;

(C) Did not perform adequate due diligence on Thousand Lakes, visit the offices of Thousand Lakes or investigate the solvency of Thousand Lakes, the principal counter-party in the fraudulent Petters transactions and the issuer of the SPV Notes;

(D) Never confirmed transactions with the supposed retailer - Costco - that was purportedly purchasing hundreds of millions of dollars of merchandise underlying the Petters transactions;

(E) Failed to perform adequate due diligence on the "vendors" supposedly selling merchandise to retailers in connection with the bogus Petters transactions;

(F) Failed to determine whether the supposed sellers of merchandise to Thousand Lakes were affiliated with Petters;

(G) Never determined where the merchandise in connection with the bogus Petters transactions was warehoused;

(H) Never visited any warehouses where any of the purported merchandise was stored;

(I) Never determined whether the inventory underlying the fraudulent Petters transactions even existed;

(J) Failed to insist upon independent evidence, such as shipping documentation, to confirm that merchandise was actually being delivered to Costco;

(K) Failed to perform adequate due diligence on Petters or his affiliated entities, even though Petters guaranteed the SPV Notes;

(L) Did not consider it unusual that a bad debt reserve was never created for the notes issued by Thousand Lakes and other SPVs; and

(M) Failed to contact the law firm that prepared the Fund's UCC filings to ascertain the procedures it was following in connection with those filings, or check public records to assure that UCC filings had in fact been made to perfect the Fund's security interest in notes receivable.

162. The Audit Team also ignored multiple red flags that would lead any reasonable auditor exercising the required professional skepticism to inquire further to obtain the requisite level of comfort. The red flags to which the Auditors knew, or to which they paid no attention, include the following: (i) beginning in 2007, the Fund began extending the terms of the SPV Notes by 90 days to as long as 270 days, including SPV Notes that were then delinquent, signaling a level of financial stress and instability that, at the very least, should have triggered

further investigation; (ii) while the money to satisfy the loan obligations underlying the SPV Notes was represented to investors in the CIMs to come from Costco and other retailer purchasers of merchandise and placed in a "lock-box" account, the money was instead coming from Petters himself, clearly indicating the existence of a massive Ponzi scheme; (iii) a bad debt reserve was never created on the Fund's balance sheet, despite the fact that the Fund's "investments" were supposedly secured by hundreds of millions of dollars in electronic merchandise that was easily subject to damage and obsolescence; (iv) Thousand Lakes repeatedly failed to provide Lancelot with monthly financial statements as required by the parties' master loan agreement, a fact the Audit Team was well aware of; (v) Petters and several of his co-conspirators were convicted felons who had served time in prison in connection with various fraudulent schemes and criminal activities that pre-dated the Fund's first investment in Thousand Lakes; (vi) the Fund did not have programs or controls in place to guard against fraudulent activities, even though the Auditors were specifically informed by Bell that source documents associated with the Petters transactions could be forgeries; and (vii) the Fund and its affiliates were purportedly making billions of dollars of "investments" exclusively with Petters, a concentration risk that warranted extraordinary diligence, attention and oversight that Defendants never performed.

163. The Auditors in effect in each of the years during which Plaintiffs invested, remained invested, and increased their investments in the Fund accepted full payment of their audit and any related fees knowing that they did nothing or next to nothing to earn those fees. As the years progressed, the Auditors' misfeasance and malfeasance compounded, constituting for that reason and the others alleged herein willful blindness, at the very least. The Auditors knew that they were not paid to do nothing, but for all intents and purposes that is what they did, because if they had made any reasonable effort to obtain appropriate audit evidence as they were

required to do, then they would have uncovered the fraud before Plaintiffs made their first investment in the Fund.

164. Although the Audit Team was auditing Lancelot, not Thousand Lakes or Petters, the SPV Notes due from Thousand Lakes represented virtually all of the Fund's non-cash assets. Therefore, the Auditors had a duty to investigate whether the Fund's SPV Notes were being reported fairly on the financial statements, which of necessity entails investigation and analysis of Thousand Lakes, the issuer of the SPV Notes, and Petters, the guarantor thereof. Moreover, the supposed relationships between Thousand Lakes and Costco, and between Thousand Lakes and the vendors and warehouses, were critical because the SPV Notes were worthless without the collateral because an SPV such as Thousand Lakes had no ability - independent of its purported Costco sales revenue - to repay the SPV Notes.

165. This was not a structure involving hundreds of retailers. Throughout the relevant time period ending with the last Audit Opinion for the year ending January 5, 2008, Thousand Lakes was purporting to sell merchandise to just one retailer – Costco. Subsequently, in an effort to cover up the delinquency of the SPV Notes, Bell caused some SPV Notes supposedly representing underlying goods sold to Costco to be exchanged for SPV Notes supposedly representing underlying goods sold to Sam's Club and BJ's Wholesale Club.

166. In fact, the Audit Team knew fraud could be present but negligently, if not willfully, turned a blind eye to numerous red flags, including warnings from Bell, or it just did nothing. On or about January 5, 2004, Lesser asked Bell whether source documents could be easily forged, and Bell told him that it would be difficult for someone to forge documents, "but it could be done." On or about January 5, 2004, the Audit Team reported (in its workpapers) that the potential fraud risk was that "Documents supporting [the] transactions (including purchase orders, wire transfer requests, promissory notes, UCC filings, etc.) may be forged." In

connection with its 2006 audit work, the Audit Team acknowledged (in its workpapers) the need to "test the underlying collateral." In connection with its 2007 audit work, the Audit Team noted (in its workpapers) that Lancelot had "limited internal control know-how," that it was "required to have collateral for the full amount of the note[s]," and that the overall audit risk was "High."

167. In the government's criminal trial against Petters, Bell testified that Petters would not allow any auditors or any other parties to contact Costco - for reasons that are now obvious. Plaintiffs did not know of this prohibition until after the Petters Ponzi scheme came to light, and reasonably relied on the fact that the Auditors were contacting Costco and other third parties to independently verify the information contained in the Fund's financial statements, as all auditors are required to do under GAAS. When confronted with the fact that they were not permitted to contact Costco (which at all relevant times was the party purportedly behind virtually all of the Fund's stated non-cash assets), the Auditors should have withdrawn from the audit of the Fund and/or should have disclaimed an opinion on the fair presentation of the financial statements, instead of issuing a "clean" opinion.

168. At the very least, this was a huge "red flag," and so the Auditors should have undertaken additional due diligence and investigatory work. At a minimum, the Auditors should have insisted on inspecting the inventory in Thousand Lakes's warehouses, where it was supposedly being stored for some months before delivery to Costco. Thus, such an inspection would not have impinged the relationship Petters supposedly had with Costco. The Auditors also should have investigated Petters, especially because the Fund relied on Petters for virtually all of its business and he was a personal guarantor of the SPV Notes until in or about late 2007. Lesser, including while he was associated with the other Defendants, engaged in comparable failures to plan, obtain sufficient appropriate evidence, and exercise required professional care in the Alpha Titans matter that is the subject of the SEC Order annexed as Ex. N.

169. In fact, Petters admitted that "[i]f investors send auditors out to visit warehouses where the merchandise is located, ... the scheme would implode." Moreover, because of the concentration risk with Petters and his personal guarantee, the Auditors should have sought independent verification of his *bona fides* and financial wherewithal even without the red flag of being prohibited from contacting Costco.

170. In his Plea Agreement dated September 23, 2009, Bell admitted that: "Beginning in late 2007, PCI became delinquent in paying the notes held by Lancelot. The delinquent payments from PCI were not reported to the Lancelot investors by Bell. Instead, on December 18, 2007, Bell executed an agreement with Thomas Petters that extended the repayment term of all the PCI notes held by Lancelot from 180 to 270 days. The effects of this extension were that those notes that had been delinquent on a 180-day maturity schedule were no longer delinquent, and that the day on which any other note would have to be acknowledged as delinquent was pushed back by 90 days."

171. The audited financial statements and footnotes for the year ending January 5, 2007 disclosed that: "Income is recognized on the accrual basis over the term of the Notes, which range from 90 to 180 days." Ex. B. The notes for the year ending on January 5, 2008 disclosed that: "Income is recognized on the accrual basis over the term of the Notes, which generally range from 180 to 270 days." Ex. C. No explanation was provided for this 90-day extension, and the fact that an extension had been granted was not even disclosed. Nor did the Auditors ascertain and require disclosure of the fact that some of the SPV Notes had been delinquent when extended and insist on establishment of a bad debt reserve, a clear audit failure. By spring 2008, the SPV Notes were again delinquent.

172. As a result of their foregoing improper professional conduct and audit failures, the Auditors breached their duty to the Lancelot Investors.

173. Moreover, based on the foregoing, it is clear that Defendants' clean Audit Opinions, indicating that the financial statements were presented fairly, were false and misleading and were made not just negligently, but also knowingly and/or recklessly. As demonstrated by the foregoing facts and circumstances, Defendants had a culpable state of mind.

Proximate Causation and Injury

174. Plaintiffs performed extensive diligence before making their first investment in the Fund, continued to monitor their investments, and conducted ongoing diligence prior to each subsequent investment in the Fund. Such diligence included, *inter alia*, review of the CIMs, the Fund's audited financial statements and other documents, and meetings, emails and telephone conferences with the Fund's management to discuss issues relating to Plaintiffs' investments in the Fund, as well as the Fund's assets, revenues, income, business prospects, risks and other relevant issues.

175. In November 2004, Plaintiffs made their first investment in the Fund in the amount of $1,250,000 in reliance on the Audit Opinion for the year ending January 5, 2004. If the Auditors had issued an adverse Audit Opinion regarding the financial statements due to their not being fairly presented under GAAP, Plaintiffs would not even have made that investment in the Fund, and thus would have been spared any loss.

176. After the Lancelot Investors invested in the Fund, the Auditors transmitted the Audit Opinions directly to them. Plaintiffs carefully reviewed the Audit Opinions, which were an integral part of Plaintiffs' continuing diligence with respect to their investments in the Fund. For example, after reviewing each year's Audit Opinions, Plaintiffs regularly posed follow-up questions to management of the Fund.

177. In or about February 2005, before increasing their investments in the Fund by tens of millions of dollars, Plaintiffs requested the Fund's audited financial statements so that

Plaintiffs could complete their diligence with respect to potential additional investments in the Fund. Assured by the "clean" opinion proffered by Defendants, Plaintiffs substantially increased their exposure to the Fund.

178. The Lancelot Investors reasonably relied on the Audit Opinions in making their initial investments in the Fund, making additional investments in the Fund and refraining from submitting a complete redemption of their investments in the Fund. Plaintiffs would have submitted a complete redemption of their investments in the Fund if the audited financial statements had disclosed the current state of affairs or if the Auditors had failed to deliver a "clean" opinion, which they should have if they had performed their audits properly.

179. The omissions and misrepresentations in the Audit Opinions described above directly and proximately caused the tens of millions of dollars in losses sustained by the Lancelot Investors. In this regard, every dollar invested by the Lancelot Investors was done so in express reliance on Defendants' false and misleading Audit Opinions and was promptly diverted into a vast Ponzi scheme.

180. For example, between May 1, 2006 and May 1, 2007, after receiving the Audit Opinions for the years ending January 5, 2006 and 2007 and in reliance thereon, ERFML made five (5) investments in the Fund in the aggregate amount of $44,500,000, acquiring 25,384.9474 shares in the Fund. Thus, there is a direct causal relationship between Defendants' fraudulent statements and the losses sustained by Plaintiffs.

181. Defendants could have readily foreseen the losses the Lancelot Investors sustained. Among other things, Defendants knew, or could have easily discovered, that: (i) the Fund had no internal controls or procedures in place to prevent fraudulent activities like those perpetrated here; (ii) source documents associated with the Petters "transactions," such as purchase orders and bills of sale, could be forgeries, a fact that Bell expressly communicated to the Auditors; and

(iii) the "lock-box" arrangement described in the CIMs, which was specifically designed to deter fraud and misconduct, was not being used. In fact, Bell testified that he was not aware of the Ponzi scheme until September 2008, and before then he had warned the Auditors of the possibility of fraud. Thus, the fact that the Lancelot Investors could - and ultimately did - lose the monies they transmitted to Lancelot Offshore in reliance on Defendants' false and misleading statements was eminently foreseeable, and discoverable or ascertainable with any meaningful effort by Defendants in fulfillment of their duties.

182. In addition, the injuries sustained by the Lancelot Investors were distinct and separate from any injuries purportedly sustained by the Fund. In this regard, Plaintiffs' losses as alleged herein were not caused by general corporate mismanagement, waste or a diminution in the value of their shares or the assets of the Fund. Rather, the Lancelot Investors' losses were sustained when each was fraudulently induced to invest monies based on Defendants' false and misleading statements about the Fund and its purported "investments," which the Lancelot Investors relied on in making their decisions.

183. These false statements convinced the Lancelot Investors that the Fund was a legitimate business enterprise engaging in routine financing transactions when, in fact, Lancelot Offshore was merely a vehicle for channeling millions of dollars into a multi-billion dollar Ponzi scheme. This misconduct was directed specifically to the Lancelot Investors - not the Fund itself - and caused immediate and distinct losses to the Lancelot Investors, separate and independent from any losses sustained by the Fund.

184. Furthermore, the Lancelot Investors sustained injuries that were separate and distinct from other shareholders in the Fund. Specifically, prior to September 2008 when the Petters Ponzi scheme was exposed, a number of other investors in the Fund were able to fully redeem all their shares in the Fund and recover the monies they had invested. Thus, unlike the

Lancelot Investors, these other Fund shareholders did not sustain losses in connection with Defendants' false and misleading communications. Consequently, not only did Defendants' misconduct have a separate and disparate impact on the Lancelot Investors vis-à-vis the Fund, it had a separate and disparate impact on the Lancelot Investors vis-à-vis other Fund shareholders.

185. Plaintiffs would not have maintained or increased their investment in shares of the Fund had the Auditors not issued unqualified Audit Opinions in 2004, 2005, 2006, 2007 and 2008 that, based on their audits purportedly conducted in accordance with the auditing standards generally accepted in the United States, the Fund's financial statements presented fairly in all material respects, the Fund's financial position, the results of its operations, changes in shareholders' capital and its cash flows for the year then ended in conformity with GAAP.

186. Had the audited financial statements accurately described the performance and operations of the Fund, the Lancelot Investors would have redeemed or otherwise sought the return of their significant investments in the Fund. Indeed, had the audited financial statements accurately described the performance and operations of the Fund, the Lancelot Investors would not have invested in the Fund at all, and would thus have been spared any loss.

Stay of Investor Lawsuits

187. On October 20, 2008, Lancelot Offshore and related funds filed Chapter 7 bankruptcy petitions, and Ronald R. Peterson was appointed Chapter 7 trustee (the "Lancelot Trustee"). The Lancelot Trustee sought stays of various investor lawsuits, including the Tradex Class Action. The Tradex Class Action in which Plaintiffs had been participating was stayed by order dated August 24, 2010.

188. Moreover, because the Lancelot Trustee took the position that the claims against the Auditors were property of Lancelot Offshore's estate, and because the Bankruptcy Court overseeing Lancelot Offshore's bankruptcy case agreed in its Memorandum Opinion dated

July 17, 2009, the automatic stay imposed pursuant to 11 U.S.C. § 362 prohibited all investor lawsuits. Investor lawsuits were stayed while the Lancelot Trustee attempted to prosecute claims for accounting malpractice against M&P.

189. Those claims were rejected by the Seventh Circuit under the doctrine of *in pari delicto* in separate opinions issued in 2012 and 2015. In its July 7, 2015 opinion, the Seventh Circuit opined: "The Trustee stepped into the shoes of the Funds, not the shoes of the investors. People who put up money have their own claims. Claims against Bell may not be worth much (he's in prison), and securities law claims against the Funds for misstatements in the offering documents aren't worth much either (they're bankrupt), but a claim against McGladrey may offer some recompense, if the auditor was indeed negligent or willfully blind. (citations omitted). Proceedings on the investors' claims have been stayed pending resolution of the Trustee's suit. It is time to bring the investors' claims to the fore."

190. By motion dated July 31, 2015, Tradex sought to lift the stay on investor lawsuits, and that motion was granted by order dated September 15, 2015. By filing this complaint, Plaintiffs have determined to no longer participate in the Tradex Class Action, and instead have elected to independently assert their own claims. While they were members of the putative class, Plaintiffs received $13,793.05, representing Plaintiff's share of a settlement between the putative class and Swiss Financial Services, Inc., Lancelot Offshore's administrator.

191. On or about February 16, 2016, an amended complaint was filed in the Tradex Class Action. Thereafter, on or about March 4, 2016, M&P and AM&G filed motions to dismiss the amended complaint in the Tradex Class Action. The motions are currently under advisement.

192. Because, *inter alia*, the claims of Plaintiffs and other members of the putative class were timely asserted in or about 2009 in the Tradex Class Action and investor lawsuits were stayed by the Bankruptcy Court in July 2009, the claims asserted herein are timely.

193. Moreover, Northwater MarketNeutral Trust and NewQuant Offshore Limited I, both of whom transferred their shares and all rights relating thereto to Plaintiff Corrado in or about December 2011, were among the plaintiffs in a separate action filed in March 2009 in this Court, Case No. 2009-L-003364, against M&P Cayman that was subsequently stayed by the Bankruptcy Court overseeing Lancelot Offshore's bankruptcy case.

194. Furthermore, pursuant to 735 ILCS 5/13-216, the statute of limitations and the statute of repose imposed under 735 ILCS 5/13-214.2(a) and 735 ILCS 5/13-214.2(b), respectively, were tolled while the Bankruptcy Court's injunction and the automatic stay were in effect.

Mitigation of Damages

195. Plaintiffs took reasonable steps to mitigate their damages by, *inter alia*, participating until recently in the Tradex Class Action (where Plaintiffs received a recovery of less than $14,000), filing damage claims against Lancelot Offshore's bankruptcy estate and filing victim loss claims in the action styled *United States v. Gregory Malcolm Bell*, in the United States District Court for the District of Minnesota, Docket No. 09 CR 00269-001(RHK). Due to Defendants' actions in opposing the Lancelot Trustee's recovery efforts, the claims against Lancelot Offshore's bankruptcy estate have not yielded any recovery for Plaintiffs. Nor have Plaintiffs received any recovery on account of their victim loss claims.

Defendants' Fees

196. The Auditors reaped substantial fees for providing years of "services" to investors in a Fund which "invested" all or virtually all of its capital in a long-standing Ponzi scheme.

CAUSES OF ACTION

COUNT I:

For Common Law Fraud and Fraudulent Inducement (Against all Defendants)

197. Plaintiffs repeat and reallege each and every allegation contained in the preceding paragraphs as if fully set forth herein.

198. The Audit Opinions were specifically addressed and directed to the shareholders of the Fund, including the Lancelot Investors.

199. Defendants, as the self-proclaimed "independent" auditors of the Fund, made false statements to the Lancelot Investors as shareholders of the Fund with respect to, *inter alia*, the Fund's notes receivable, interest income, net income, investments and shareholders' capital, and omitted material facts, with the intent to cause the Lancelot Investors falsely to believe that the Fund's financial statements fairly represented the financial condition of the Fund and that the Auditors had taken proper auditing steps prior to issuing unqualified Audit Opinions on the Fund's financial statements for the years ended January 5, 2004 through 2008.

200. Defendants expected and intended the shareholders of the Fund, including the Lancelot Investors, to rely on the thoroughness, accuracy, integrity, independence and overall professional caliber of their audits.

201. Defendants knew that potential shareholders, like the Lancelot Investors, would rely on the thoroughness, accuracy, integrity, independence and overall professional caliber of their audits when they purchased shares of the Fund, maintained those shares, and invested in additional shares.

202. Defendants were aware that a primary intent of the Fund, LIM and Bell was for the Auditors' professional services to benefit or influence the Lancelot Investors in making their decisions to purchase and retain shares in the Fund.

203. Defendants were manifestly aware of the uses to which the Audit Opinions were to be put and intended that they be so used, and had a duty to communicate to Plaintiffs accurate information regarding the Fund and its financial condition.

204. The Lancelot Investors were a foreseeable and limited class of persons for whom the Audit Opinions were intended, either directly or indirectly. In this regard, Defendants possessed, or had access to, lists and other information that identified all shareholders in the Fund and regularly communicated by telephone and email with existing and prospective investors in the Fund.

205. The Lancelot Investors reviewed and relied on the Audit Opinions, and in so doing, purchased, continued to purchase, and retained shares in the Fund.

206. At the time the subject misrepresentations and omissions were made, the Defendants knew the misrepresentations to be false and misleading or were reckless in not knowing that they were false and misleading, and intended to deceive the Lancelot Investors.

207. Had the Lancelot Investors known of the material facts that the audited financial statements misrepresented and omitted the Lancelot Investors would not have made their initial purchases of shares in the Fund.

208. Had the Lancelot Investors known, after their initial purchases, of the material facts that the audited financial statements misrepresented and concealed, the Lancelot Investors would have refrained from making further purchases of shares in the Fund, and would have immediately sought to redeem all of their shares in the Fund.

209. Plaintiffs, as a result of the purchases and retention of shares in the Fund, and by reason of the fact that the financial statements audited by Defendants included false and misleading misrepresentations and omissions have sustained damages in an amount in excess of $79 million.

210. By reason of the foregoing, the Defendants are jointly and severally liable to Plaintiffs.

211. As detailed above, Defendants' fraudulent acts were willful and wanton, and Plaintiffs are entitled to punitive damages.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs respectfully pray that the Court grant the following relief:

A. That Plaintiffs be awarded damages in an amount in excess of $79 million, plus pre-judgment interest;

B. That Plaintiffs be awarded their costs, disbursements and attorneys' fees to the fullest extent permitted by law;

C. That Plaintiffs be awarded punitive damages to the fullest extent permitted by law; and

D. That the Court order such further or additional relief as it deems just, proper and equitable.

COUNT II:

For Negligent Misrepresentation
(Against all Defendants)

212. Plaintiffs repeat and reallege each and every allegation contained in the preceding paragraphs as if fully set forth herein.

213. As set forth above, the financial statements audited and disseminated by Defendants contained false representations and omissions of fact.

214. Defendants supplied the Audit Opinions during the course of their business, profession, employment, and in transactions in which they had a pecuniary interest.

215. Defendants were manifestly aware of the uses to which the Audit Opinions were to be put and intended that they be so used, and had a duty to communicate to Plaintiffs accurate information regarding the Fund and its financial condition.

216. The Lancelot Investors were a foreseeable and limited class of persons for whom the Audit Opinions were intended, either directly or indirectly. In this regard, Defendants possessed, or had access to, lists and other information that identified all shareholders in the Fund and regularly communicated by telephone and email with existing and prospective investors in the Fund.

217. The representations in the financial statements audited by Defendants were made for the purpose of inducing the Lancelot Investors to rely on, and act upon such reliance, by among other things making investments and additional investments in the Fund.

218. The Lancelot Investors, in justifiable reliance on the Audit Opinions, purchased and continued to purchase shares in the Fund.

219. Had Plaintiffs known, after their initial purchases, the material facts that were misrepresented and concealed in the financial statements audited by Defendants, Plaintiffs would have immediately sought to redeem all of their shares in the Fund, and would have refrained from making further purchases of shares in the Fund.

220. As alleged in greater detail above, the Defendants did not exercise due care when auditing the financial statements containing the preceding representations and omissions.

221. Plaintiffs, as a result of the purchases and retention of shares in the Fund, and by reason of Defendants' false and negligent representations and omissions, have sustained damages in an amount in excess of $79 million.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs respectfully pray that the Court grant the following relief:

A. That Plaintiffs be awarded damages in an amount in excess of $79 million, plus pre-judgment interest;

B. That Plaintiffs be awarded their costs, disbursements and attorneys' fees to the fullest extent permitted by law;

C. That Plaintiffs be awarded punitive damages to the fullest extent permitted by law; and

D. That the Court order such further or additional relief as it deems just, proper and equitable.

COUNT III:

For Professional Malpractice
(Against all Defendants)

222. Plaintiffs repeat and reallege each and every allegation contained in the preceding paragraphs as if fully set forth herein.

223. In performing audits of the Fund's financial statements, Defendants, who held themselves out as qualified certified public accountants in their Audit Opinions, were required and reasonably expected by the Lancelot Investors, as shareholders of the Fund, to (1) determine in conducting their audits whether GAAP was appropriately applied, and (2) follow GAAS in arriving at their opinions that financial statements are fairly presented in accordance with GAAP.

224. When performing an independent audit of a client's financial statements, Defendants, as professional certified public accountants, were obligated to follow the standards identified herein.

225. In performing their audits of the Fund, Defendants breached their duty to the Lancelot Investors by violating the preceding auditing standards identified herein, including without limitation (a) failing to investigate the issuer and the guarantor of the SPV Notes (which at all relevant times constituted virtually all of the Fund's stated non-cash assets); (b) ignoring multiple red flags; (c) failing to exercise professional skepticism and instead blindly accepting that Thousand Lakes purchased and sold high-end electronic goods; (d) failing to confirm with Costco the existence of the purchase orders supposedly underlying the SPV Notes purchased by the Fund; (e) failing to inspect the inventory at Thousand Lakes's warehouses; (f) failing to exercise professional skepticism and instead blindly accepting that Costco deposited money directly into an SPV lock-box to which neither Petters nor PCI had access as represented in the CIMs, and/or being oblivious to the fact that the supposed lock-box was not working in the manner represented to investors in the CIMs; and (g) failing to investigate Petters and other individuals who were critical to the Fund's business, especially where they were responsible for all or virtually all of the Fund's business.

226. Defendants acted negligently and recklessly in connection with the audits at issue in this action.

227. As the direct and proximate cause of Defendants' breach of their duties and their negligent and reckless conduct, Plaintiffs have sustained damages in an amount in excess of $79 million.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs respectfully pray that the Court grant the following relief:

A. That Plaintiffs be awarded damages in an amount in excess of $79 million, plus pre-judgment interest;

B. That Plaintiffs be awarded their costs, disbursements and attorneys' fees to the fullest extent permitted by law;

C. That Plaintiffs be awarded punitive damages to the fullest extent permitted by law; and

D. That the Court order such further or additional relief as it deems just, proper and equitable.

Dated: November 21, 2016

PLAINTIFFS

By: ______________________________
One of Their Attorneys

Nicholas F. Kajon
Eric M. Robinson
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Exhibit 3

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF WESTCHESTER

MVC CAPITAL, INC., Plaintiff, -against- RSM US LLP, Defendant.	Index No.: **SUMMONS** **DEMAND FOR TRIAL BY JURY** **VENUE:** Plaintiff designates Westchester County as the place of trial. Venue is based upon the County in which Plaintiff resides.

TO THE ABOVE NAMED DEFENDANT:

YOU ARE HEREBY SUMMONED to answer the Complaint in this action, and to serve a copy of your Answer, or, if the Complaint is not served with this summons, to serve a Notice of Appearance, on the Plaintiff's Attorneys within twenty (20) days after the service of this summons, exclusive of the day of service (or within thirty (30) days after the service is complete if this summons is not personally delivered to you within the State of New York); and in case of your failure to appear or answer, judgment will be taken against you by default for the relief demanded in the Complaint.

Dated: December 23, 2016

LOWEY DANNENBERG COHEN & HART, P.C.

By: Richard W. Cohen

Richard W. Cohen
Uriel Rabinovitz
One North Broadway, Suite 509
White Plains, NY 10601-2310
Tel. No.: (914) 997-0500

DEFENDANT:

RSM US LLP
f/k/a McGladrey LLP
c/o Corporation Service Company
80 State Street
Albany, NY 12207-2543

{2687 / CMP / 00138706.DOCX v7}

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF WESTCHESTER

MVC CAPITAL, INC., Plaintiff, -against- RSM US LLP, Defendant.	Index No.: Date Filed: December 23, 2016 **COMPLAINT** **DEMAND FOR TRIAL BY JURY**

Plaintiff MVC Capital, Inc. ("MVC" or "Plaintiff"), by its attorneys, Lowey Dannenberg Cohen & Hart, P.C., for its Complaint against Defendant RSM US LLP f/k/a McGladrey, LLP ("McGladrey" or "Defendant"), alleges as follows:

INTRODUCTION

1. In 2014, Plaintiff lent $6 million to G3K Displays, Inc. (f/k/a Projuban, LLC) (the "Borrower") based upon the integrity of its 2013 financial statements, which showed the Borrower was solvent and had a growing and highly profitable business.

2. Plaintiff made it a condition precedent to the loan that Borrower have its 2013 financial statements audited by a reputable national accounting firm to confirm their reliability.

3. Borrower hired Defendant to conduct the audit, and informed Defendant that it did so to satisfy Plaintiff's condition precedent.

4. On April 3, 2014, Defendant issued an unqualified audit report on the Borrower's 2013 financial statements, whose (i) statement of operations reported 2013 net income of more than $5 million on over $33 million of sales, and (ii) balance sheet reported a net book value over $4 million, and accounts receivable of more than $17 million at December 31, 2013.

5. The financial statements disclosed that two customers, Foot Locker, Inc. ("Footlocker") and Adidas Group ("Adidas"), accounted for 85% of the Borrower's revenues and 87% of the Borrower's accounts receivable.

6. In reliance upon Defendant's April 3, 2014 audit report, on April 14, 2014, Plaintiff lent $6 million to Borrower.

7. On April 24, 2014, Plaintiff learned from one of Borrower's employees that the Borrower's financial statements were fraudulent, the Borrower's revenues and December 31, 2013 accounts receivable from Foot Locker and Adidas were negligible, Borrower was insolvent, and Plaintiff's $6 million loan was lost and unrecoverable.

8. Defendant issued its unqualified April 3, 2014 audit report without having confirmed with authorized representatives of Foot Locker or Adidas the validity of more than $15 million of accounts receivable supposedly owed by them that were included in Borrower's December 31, 2013 balance sheet.

9. Unlike with an audit of a client with a large and diversified customer base comprising hundreds or thousands of accounts receivable, the principal task for Defendant in auditing Borrower's December 31, 2013 financial statements was to verify the revenue earned and confirm the validity of the receivables Borrower claimed were due from just these two customers.

10. Defendants knew its audit report was a condition precedent to Plaintiff's loan of $6 million and communicated directly with Plaintiff in the course of its audit.

11. Defendant's negligent misrepresentation of the Borrower's financial statements foreseeably and proximately caused Plaintiff to lose $6 million.

PARTIES

12. Plaintiff MVC is a publicly traded-business development company (NYSE: "MVC"), headquartered at 287 Bowman Ave, Purchase, New York, and registered to do business in New York. Plaintiff is an externally managed, non-diversified closed-end management investment company, which provides equity and debt investment capital to fund growth, acquisitions and recapitalizations of small and mid-market companies, in a variety of industries.

13. Defendant McGladrey provides audit, tax and consulting services focused on middle market companies, and employs more than 8,000 employees in 80 offices nationwide. In 2015, Defendant rebranded itself as "RSM US LLP."

JURISDICTION AND VENUE

14. McGladrey has done business in the State of New York continuously since 1922, and has been registered to do business in the State of New York continuously since at least 1995. McGladrey maintains an office at 1185 Avenue of the Americas, New York, NY 10036. McGladrey's website states "The New York Practice is part of the Tri-State Operating Unit which services clients in Connecticut, New York and Northern New Jersey. Clients throughout New York State and Northern New Jersey are served primarily from our New York City offices. The 600+ employees of the Tri State Operating Unit of RSM assist more than 1,000 businesses and more than 5,000 individuals in the area." *See* rmus.com/locations/new-york.html.

15. MVC's headquarters and principal place of business are in Purchase, New York, in Westchester County.

FACTS

16. In September 2013, Glenwood Capital, an investment bank, introduced MVC to Borrower as a lending opportunity.

17. Borrower claimed to be a fast growing and profitable designer, installer and marketer of made-to-order retail product display fixtures for large chain shoe retailers. Borrower's owners were CEO Steven Kaitz ("Kaitz"), Latchmee Mahato ("Mahato") and Jonathan Wheeler ("Wheeler").

18. After reviewing Borrower's unaudited financial statements, MVC tentatively offered to lend $10 million to Borrower in installments, with a first installment of $6 million.

19. However, as a condition precedent to its investment, MVC required comfort concerning the reliability of Borrower's financial statements from a reputable national accounting firm.

20. In response, Borrower hired McGladrey to report on Borrower's financial statements.

21. On December 16, 2013, Gina Zamarelli, the Chief Financial Officer of Borrower, emailed Adrienne Anderson of McGladrey, with copies to Shivani Khurana and Puneet Sanan of MVC and two representatives of Glenwood Capital, stating:

> Adrienne, it looks like MVC will be requiring McGladrey to perform a review of some kind for 9/30/13 … I am proposing we have a [4:30] conference call with MVC.

Ms. Anderson emailed all parties in response: "Works for me."

22. Following further discussions, MVC informed Borrower that MVC would require an audit of Borrower's financial statements for the year ended December 31, 2013 (the "Audit") as a condition precedent to making the $6 million loan.

23. Borrower informed McGladrey of MVC's heightened requirement, and McGladrey agreed to perform the Audit, with the knowledge and understanding that it was asked to do so in order to provide MVC with comfort that Borrower's financial condition and operating results were consistent with its December 31, 2013 financial statements.

24. McGladrey and MVC communicated with one another orally and in writing during McGladrey's Audit engagement.

25. On March 6, 2014, Adrienne Anderson of McGladrey sent a draft of the audit report to MVC's Shivani Khurana via email.

26. On April 3, 2014, McGladrey completed its Audit and tendered the April 3, 2014 audit report to Borrower, which immediately forwarded it, together with the Borrower's audited December 31, 2013 financial statements, to MVC.

27. Defendant's April 3, 2014 audit report on Borrower's December 31, 2013 financial statements was unqualified.

28. Borrower's December 31, 2013 financial statements reported total assets at December 31, 2013 of $20.3 million, including accounts receivable of $17.7 million, net sales of $33.5 million, and net income of $5.2 million for the year ended December 31, 2013.

29. Borrower's December 31, 2013 Accounts Receivable represented 87% of Borrower reported current assets and 80% of its reported total assets, making the Accounts Receivable far and away the most important factor of the reliability of Borrower's financial statements, Borrower's solvency, and Borrower's viability as a going concern.

30. In Note 7 to Borrowers 2013 amended financial statements, titled "Major Customers," Borrower reported that Foot Locker and Adidas accounted for 85% of Borrower's net sales in 2013 and 87% of its Accounts Receivable at December 31, 2013.

31. Accordingly, the reliability of Borrower's December 31, 2013 financial statements, its solvency, and its viability as a going concern depended upon the validity of the Accounts Receivable Borrower claimed were due from Foot Locker and Adidas.

32. McGladrey understood this.

33. McGladrey's unqualified audit report on Borrower's December 31, 2013 financial statements stated:

> **Auditor's Responsibility**
>
> Our responsibility is to express an opinion on these combined financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free from material misstatement.
>
> An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the combined financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the combined financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the combined financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control....
>
> We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.
>
> **Opinion**
>
> In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of Projuban, LLC d/b/a G3 Display and its combined affiliate as of December 31, 2013, and the results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

34. McGladrey negligently performed its auditing duties, failing to perform the Audit in accordance with U.S. Generally Accepted Auditing Standards ("GAAS"). McGladrey failed to exercise professional standards of care necessary to opine that Borrower's December 31, 2013 financial statements presented fairly Borrower's financial position and the results of its operations, in particular by failing to properly verify reported revenues and accounts receivable from Foot Locker and Adidas.

35. McGladrey knew that Borrower, a first time client, was a high-risk audit client, whose viability as a going concern was dependent upon the authenticity of the accounts receivable from Foot Locker and Adidas. Verification of just those two accounts receivable and testing of the related revenues should have been McGladrey's primary audit objective, and McGladrey should have performed that task with a high degree of professional skepticism, requiring the auditor to obtain sufficient appropriate reliable evidence of these two accounts to support its April 3, 2014 audit report.

36. If McGladrey had performed the Audit competently, it would not have been able to verify the Borrower's receivables and revenues from Foot Locker and Adidas and would not have issued an unqualified audit report.

37. Without McGladrey's unqualified April 3, 2014 audit report, Plaintiff would not have lent $6 million to Borrower.

38. McGladrey knew that Plaintiff was Borrower's prospective lender, that the loan was dependent upon its delivery of an unqualified audit report on Borrower's December 31, 2013 financial statements, and knew that Plaintiff was relying upon those financial statements and McGladrey's unqualified report thereon as a material condition precedent to making the $6 million loan.

39. McGladrey communicated not only with the Borrower in the course of its Audit, but also with Plaintiff.

40. Rather than operate as a competent independent auditor should have under the circumstances, McGladrey took instruction from Borrower concerning how to confirm its accounts receivable.

41. Borrower reported $9,728,582 of accounts receivable were owed by Foot Locker at December 31, 2013, in footnote 7 of its McGladrey-audited financial statements.

42. Borrower told McGladrey to confirm receivables from Foot Locker with Robert Rainier, whose email address Borrower gave McGladrey. In violation of GAAS, McGladrey followed Borrower's instruction and emailed the address provided by Borrower on February 26, 2014, seeking confirmation of the validity of invoices purportedly owed by Foot Locker to Borrower at December 31, 2013.

43. By return email to McGladrey on February 28, 2014, Rainier (or someone purporting to be Rainier) wrote "I can now confirm that the invoices attached are outstanding and our accounting team is in the process of approving them to be paid." The return email identified Rainier as "Divisional VP – Franchise Development," not an employee in Foot Locker's treasury or accounting department.

44. Most of the invoices confirmed by Foot Locker through Rainier's February 28, 2014 email were fabrications and therefore were not outstanding receivables as of December 31, 2013.

45. In fact, as of December 31, 2013, there were only $296,500 of receivables outstanding from Foot Locker to Borrower, or only 3% of the $9.7 million Borrower reported

were owed by Foot Locker in Borrower's McGladrey-audited December 31, 2013 financial statements.

46. Rainier (or the email recipient purporting to be Rainier) was unauthorized by Foot Locker to confirm Foot Locker's trade debt obligations.

47. McGladrey did not confirm Rainier's authority to confirm debts of Foot Locker.

48. No reasonable person, much less an independent auditor, would accept that a supposed "Divisional Vice President of Franchise Development" would have authority to verify Foot Locker's trade debts, or accept an email from such a person as adequate confirmation of the validity of a majority of an audit client's $17 million of reported receivables.

49. If McGladrey had simply communicated with Foot Locker's payables department, it would have learned that the receivables could not be confirmed.

50. Borrower reported $5,669,767 of accounts receivable were owed by Adidas at December 31, 2013, in footnote 7 of its McGladrey-audited financial statements.

51. McGladrey's confirmation regarding the Adidas accounts receivable came from Borrower's insiders, who gave McGladrey emails supposedly confirming the amounts from "Vicki LoBue," whose emails claimed she was an "accounts payable D-H" at Adidas.

52. The domain name on the LoBue emails was "adidas-us.com" not Adidas' corporate email domain name of "adidas-group.com."

53. In fact, as of December 31, 2013, there were actually no receivables outstanding from Adidas to Borrower.

54. Vicki LoBue (or the email recipient purporting to be Vicki LoBue) was unauthorized by Adidas to confirm its trade debt obligations.

55. McGladrey did not confirm "Vicki LoBue's" authority to confirm debts of Adidas.

56. No reasonable person, much less an independent auditor, would accept that a supposed "accounts payable D-H" —whatever that means—would have authority to verify millions of dollars of Adidas' trade debts, or accept an email from such a person as adequate confirmation of the validity of more than 35% of an audit client's receivables.

57. If McGladrey had simply communicated with Adidas' payables department, it would have learned that the receivables did not exist.

58. In January 2015, Kaitz, Mahato and Wheeler were criminally indicted by a Grand Jury for the Southern District of New York for securities and wire fraud. Kaitz pled guilty to bank fraud and was sentenced to 40 months in jail. Mahato plead guilty to conspiracy to commit wire fraud and bank fraud and received a 24-month jail sentence. Wheeler pled guilty to fraud and received a 21-month sentence.

FIRST CAUSE OF ACTION
(Negligent Misrepresentation)

59. Plaintiff realleges each of the foregoing paragraphs of the Complaint as though fully set forth herein.

60. McGladrey understood that Plaintiff would rely on the integrity of Borrower's December 31, 2013 financial statements in deciding whether to lend Borrower $6 million.

61. Plaintiff expressly conditioned its willingness to lend to Borrower on McGladrey's Audit of Borrower's December 31, 2013 financial statements.

62. McGladrey understood the purpose of its retention by Borrower to audit its financial statements was to satisfy Plaintiff's condition precedent to making the $6 million loan.

63. McGladrey understood and expected that Plaintiff would rely on its April 3, 2014

audit report in deciding whether to lend Borrower $6 million.

64. To that end, McGladrey communicated directly with Plaintiff in the course of performing the Audit.

65. Plaintiff justifiably and reasonably relied on Defendant's April 3, 2014 audit report in lending $6 million to Borrower.

66. McGladrey's Audit was grossly negligent, certifying as reliable Borrower's financial statements that materially misrepresented its financial condition and results of operations, and which portrayed Borrower as solvent, and successful going concern, when in fact it was insolvent and had only nominal operations.

67. McGladrey negligently performed its auditing duties, failing to comply with GAAS and to exercise professional standards of care to verify revenues and confirm accounts receivable reported by Borrower, a first-time audit client, most notably those from Foot Locker and Adidas.

68. If McGladrey had followed GAAS and exercised due care in performing the Audit of Borrower, it would not have issued the unqualified April 3, 2014 audit report, and MVC would not have lent $6 million to Borrower.

69. As a direct, foreseeable, and immediate consequence of McGladrey's negligent Audit, MVC has incurred a loss of $6 million, plus foreseeable expenses and losses associated with such loss, with the precise amount to be proven at trial.

70. Plaintiff demands a trial by jury.

WHEREFORE, Plaintiff requests that judgment be entered against Defendant awarding damages of $6 million plus reasonable costs and expenses incurred in this action, including but not limited to, interest, attorney's fees and experts fees.

Dated: December 23, 2016
White Plains, New York

LOWEY DANNENBERG COHEN & HART, P.C.

By: Richard W. Cohen

Richard W. Cohen
Uriel Rabinovitz
One North Broadway, Suite 509
White Plains, New York 10601-2310
(914) 997-0500

Counsel for Plaintiff MVC Capital, Inc.

Exhibit 4

BECKER & POLIAKOFF

Mark J. Stempler, Esq.
Shareholder
Board Certified Construction Lawyer
LEED Green Associate
Phone: (561) 820-2884 Fax: (561) 832-8987
mstempler@bplegal.com

625 N. Flagler Drive, 7th Floor
West Palm Beach, Florida 33401

June 29, 2017

Via E-Mail: cmessersmith@broward.org

Carolyn Messersmith, Purchasing Agent
Broward County Purchasing Division
115 S. Andrews Avenue, Room 212
Fort Lauderdale, FL 33301

Re: RFP R2112554P2 - External Audit Services - Response to 6/26/17 Request

Dear Ms. Messersmith:

The undersigned law firm represents RSM US LLP ("RSM") in regard to the above captioned Request for Proposals (the "RFP"). Please accept this correspondence in response to your request to RSM on June 26, 2017. In that request, you specifically sought additional information regarding two lawsuits filed against RSM, cited in the Protest filed by S. Davis & Associates, P.A.

The first legal matter referenced in your request was filed by RS Investments Limited, et al., in the Circuit Court of Cook County, Illinois. In that case, which concerns allegations that go back ten years or more, Plaintiffs are foreign investment funds which allege that they lost money through investments in Lancelot Cayman, an entity established primarily to fund loans to an entity controlled by Thomas Petters. It was later revealed that Petters – not Lancelot Cayman - was perpetrating a massive Ponzi scheme. RSM had no relationship with Petters and the Plaintiffs freely admit that the auditor defendants were unaware of the Ponzi scheme. RSM is vigorously defending this action and has filed its Motion to Dismiss which is fully briefed and pending before the court. Copies of the briefing documents are attached for your review.

The second lawsuit referenced in your request was filed by MVC Capital, Inc. in Westchester County, New York. The Plaintiff is a business development company which primarily invests in small to midsize companies. The Plaintiff invested $6M in G3K Displays, Inc. ("G3K") Unbeknownst to the Plaintiff and RSM, G3K and its principals perpetrated an extensive fraud, fooling numerous parties into believing it had much more revenue than it claimed. Three G3K principals and a former G3K customer's employee each admitted to their role in the fraud, and were convicted of various crimes. MVC likely cannot recover its investment from G3K or its principals. MVC's relationship with RSM is attenuated - it had no direct relationship with RSM, thus RSM has filed a Motion to Dismiss based on MVC's lack of privity with RSM. Copies of Motion to Dismiss are attached for your review.

RSM denies any liability or wrongdoing and is vigorously defending these claims. Further, these cases do not have any bearing on the service to be performed for Broward County. Neither case involves auditing services for a governmental agency. Neither case involves anyone from the government auditing division of RSM. Neither case involves any RSM personnel that will be providing services for Broward County. For these reasons, and those stated below, RSM believes these cases are immaterial to its response to this RFP.

We hope that you can appreciate that due to the ongoing nature of the litigation, RSM is not able to provide additional details beyond what is in the public record. If additional documents that have been filed with the courts are needed from either of the cases, please let us know and we will seek to provide them.

RSM has never been named in a lawsuit regarding the auditing of a government agency locally, or nationally. In addition, none of the proposed RSM personnel for this RFP have ever been involved in any litigation related to the audits of government agencies. As described more fully in the RFP Response, RSM currently serves or has served dozens of public governmental agencies in Florida, including other large counties like Broward County.

RSM is a national audit, tax and consulting services firm. It operates in more than 80 cities in nearly 30 states across this country, and employs approximately 8,000 people. RSM has been in business for more than 90 years. Like any large national professional services firms, RSM is subject to various forms of litigation, like these two cases, in the standard course of business. For this reason, RSM maintains significant insurance coverage to insulate itself from the potential impacts of litigation. RSM does not consider these lawsuits to be material to its financial condition as a whole and does not expect that they will in any way impact its ability to perform the services contemplated in its proposal for Broward County or its clients generally.

Thank you for your consideration of the foregoing. As the recommended awardee, RSM stands ready, willing and able to perform Broward County's auditing services. RSM is a responsible proposer and is fully capable and qualified in all respects to perform the contract requirements with the integrity and reliability which will assure good faith performance. If you have any additional questions, or need additional information, please do not hesitate to contact the undersigned.

Sincerely,

Mark J. Stempler

Mark J. Stempler
For the Firm

MJS2/lb
cc: Brenda Billingsley (via e-mail w/ enclosures: bbillingsley@broward.org)
Glenn Marcos (via e-mail w/ enclosures: gmarcos@broward.org)
Glenn Miller (via e-mail w/ enclosures: gmiller@broward.org)
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ACTIVE: E24387/384583:9890161_1

Firm #59917

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION

RS INVESTMENTS LTD.; CORRADO INVESTMENTS LTD.; EDEN ROCK FINANCE MASTER LTD.; EDEN ROCK ASSET BASED LENDING MASTER LTD.; EDEN ROCK UNLEVERAGED FINANCE MASTER LTD.; SOLID ROCK SPECIAL SITUATIONS 2 LTD.,	)	
Plaintiffs,	)	Case No. 16-L-11459
v.	)	Judge Raymond W. Mitchell
RSM US LLP; RSM CAYMAN LTD.; and SIMON LESSER,	)	
Defendants.	)	

NOTICE OF FILING

To: See Attached Certificate of Service

PLEASE TAKE NOTICE that on **February 27, 2017**, we caused to be filed with the Clerk of the Circuit Court of Cook County, Law Division, **(1) RSM US LLP and Simon Lesser's Motion to Dismiss Plaintiffs' Complaint**, **(2) Memorandum In Support of RSM US LLP and Simon Lesser's Motion to Dismiss Plaintiffs' Complaint,** and **(3) Affidavit of Aristotelis Alexandros Galatopoulos**, copies of which are attached hereto and hereby served upon you.

Dated: February 27, 2017

Respectfully submitted,

By: ______________________________

Robert Palmersheim
Anand Mathew
HONIGMAN MILLER SCHWARTZ & COHN LLP
One South Wacker Drive, 28th Floor
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Firm No. 59917

Joseph M. Terry (admitted *pro hac vice*)
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(202) 434-5000

Attorneys for Defendants RSM US LLP and Simon Lesser

CERTIFICATE OF SERVICE

I, Anand Mathew, an attorney, hereby certify that I caused a copy of the foregoing **Notice of Filing** to be served by First Class U.S. Mail, postage prepaid, and e-mail, on the individuals listed below this 27th day of February, 2017:

Nicholas F. Kajon (nfk@stevenslee.com)
Eric M. Robinson (emr@stevenslee.com)
Constantine Pourakis (cp@stevenslee.com)
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Counsel for Plaintiffs

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SUGAR FELSENTHAL GRAIS & HAMMER LLP
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Chicago, Illinois 60602

Counsel for Plaintiffs

Anand Mathew

Firm #59917

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION

FILED
17 FEB 27 PM 3:46
DOROTHY BROWN
CLERK OF CIRCUIT COURT
LAW DIVISION

RS INVESTMENTS LTD.; CORRADO INVESTMENTS LTD.; EDEN ROCK FINANCE MASTER LTD.; EDEN ROCK ASSET BASED LENDING MASTER LTD.; EDEN ROCK UNLEVERAGED FINANCE MASTER LTD.; SOLID ROCK SPECIAL SITUATIONS 2 LTD., Plaintiffs, v. RSM US LLP; RSM CAYMAN LTD.; and SIMON LESSER, Defendants.	)	Case No. 16-L-11459 Judge Raymond W. Mitchell

<u>RSM US LLP AND SIMON LESSER'S MOTION TO DISMISS THE COMPLAINT</u>

Pursuant to 735 ILCS 5/2-619.1, and for the reasons set forth in the accompanying memorandum, Defendants RSM US LLP and Simon Lesser (collectively, "the McGladrey US Defendants") hereby move the Court to dismiss Plaintiffs' Complaint under 735 ILCS 5/2-615 and 735 ILCS 5/2-619(a)(9) for the following reasons:

(1) Pursuant to 735 ILCS 5/2-619(a)(9), Plaintiffs' action is barred because they lack standing to assert claims based on losses suffered by Lancelot Investors Fund, Ltd. ("Lancelot Cayman"). Cayman law governs whether Plaintiffs have standing and bars shareholders from bringing a direct cause of action against a third-party for losses that are reflective of an injury suffered by the company, as Plaintiffs seek to do here. In addition, the U.S. Bankruptcy Court for the Northern District of Illinois has already held that these very claims are the property of Lancelot Cayman, not its shareholders.

(2) Pursuant to 735 ILCS 5/2-615, Plaintiffs fail to state a claim for negligent misrepresentation or professional negligence because the McGladrey US Defendants did not owe Plaintiffs a legal duty, whether under the laws of Illinois or the Cayman Islands.

(3) Pursuant to 735 ILCS 5/2-615, Plaintiffs fail to state a claim for common law fraud/fraudulent inducement, whether under the laws of Illinois or the Cayman Islands, because they fail to plead that the McGladrey US Defendants acted with the requisite intent.

WHEREFORE, the McGladrey US Defendants respectfully request that this Court dismiss Plaintiffs' Complaint with prejudice and grant such other and further relief as justice may require.

Dated: February 27, 2017

Respectfully submitted,

By: ______________________________

Robert Palmersheim
Anand Mathew
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Firm No. 59917

Joseph M. Terry (admitted *pro hac vice*)
ARDC # 6320157; Cook County #59788
Jessica L. Pahl (admitted *pro hac vice*)
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(202) 434-5000

Attorneys for Defendants RSM US LLP and Simon Lesser

CERTIFICATE OF SERVICE

I, Anand Mathew, an attorney, hereby certify that I caused a copy of the foregoing **RSM US LLP and Simon Lesser's Motion to Dismiss Plaintiffs' Complaint,** to be served by First Class U.S. Mail, postage prepaid, and e-mail, on the individuals listed below this 27th day of February 2017:

Nicholas F. Kajon (nfk@stevenslee.com)
Eric M. Robinson (emr@stevenslee.com)
Constantine Pourakis (cp@stevenslee.com)
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Counsel for Plaintiffs

Anand Mathew

Firm #59917

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION

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RS INVESTMENTS LTD.; CORRADO INVESTMENTS LTD.; EDEN ROCK FINANCE MASTER LTD.; EDEN ROCK ASSET BASED LENDING MASTER LTD.; EDEN ROCK UNLEVERAGED FINANCE MASTER LTD.; SOLID ROCK SPECIAL SITUATIONS 2 LTD.,	)	Case No. 16-L-11459
	)	Judge Raymond W. Mitchell
Plaintiffs,	)	
v.	)	
RSM US LLP; RSM CAYMAN LTD.; and SIMON LESSER,	)	
Defendants.	)	

MEMORANDUM IN SUPPORT OF RSM US LLP
<u>AND SIMON LESSER'S MOTION TO DISMISS THE COMPLAINT</u>

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INTRODUCTION

This is a lawsuit brought both by certain shareholders who invested in Lancelot Investors Fund, Ltd. ("Lancelot Cayman") prior to its collapse and others who purchased those shares after the collapse for the purpose of pursuing litigation against third parties including the Defendants.

Plaintiffs seek to recover their proportionate share of investment losses that Lancelot Cayman suffered directly, and Plaintiffs suffered only derivatively, when it was revealed that Lancelot Cayman had invested nearly all of its cash in a Ponzi scheme orchestrated by Thomas Petters. Plaintiffs fault Lancelot Cayman's outside auditor, McGladrey & Pullen, Cayman ("McGladrey Cayman") for failing to uncover the Petters Ponzi scheme and bring claims against RSM Cayman Ltd. ("RSM Cayman"), the alleged successor to McGladrey Cayman. Plaintiffs sue RSM US LLP f/k/a McGladrey LLP ("RSM") and Simon Lesser (collectively, the "McGladrey US Defendants") for the assistance they allegedly provided in connection with the audits.

The McGladrey US Defendants now move to dismiss the Complaint pursuant to Sections 2-619 and 2-615, on the grounds that Plaintiffs lack standing to assert these claims and that the facts alleged fail, as a matter of law, to establish two critical elements of a cause of action for negligence and fraud: duty and an intent to deceive.

First, Plaintiffs lack standing because their losses are merely derivative or reflective of Lancelot Cayman's losses. As such, under the Cayman Island doctrine of "reflective loss" applicable here, Plaintiffs have no standing to assert their claims individually. Indeed, the bankruptcy court for the Northern District of Illinois, in analyzing a related legal issue, already concluded that claims against the auditors belong to Lancelot Cayman, not its shareholders. Dismissal is required under 735 ILCS 5/2-619(a)(9).

Second, because no relationship existed between Plaintiffs and the McGladrey US Defendants that gave rise to a duty, Plaintiffs' claims for negligent misrepresentation and professional malpractice fail under 735 ILCS 5/2-615. The McGladrey US Defendants were not retained by Plaintiffs and never spoke with them about the audits. Nothing in the allegations suggest that there existed the type of relationship necessary to impose a duty to non-clients such as Plaintiffs.

Third, Plaintiffs fail to allege facts sufficient to establish the core element of a fraud claim: an intent to deceive. They freely admit that the McGladrey US Defendants were unaware of the Petters Ponzi scheme and therefore cannot establish the requisite intent, their allegations of negligence by hindsight and missed "red flags" notwithstanding. The fraud claim therefore must be dismissed under 735 ILCS 5/2-615.

BACKGROUND

With one exception,[1] Plaintiffs are foreign investment funds organized under the laws of undisclosed jurisdictions that either invested in Lancelot Cayman at unspecified times between November 2004 and July 2008 or, at some point after October 2008, purchased the shares—and with them the purported claims—of undisclosed parties who were Lancelot Cayman shareholders prior to the revelation of the Petters Ponzi scheme. Compl. ¶¶ 11, 26–37.

Lancelot Cayman was a fund established primarily to fund loans made to an entity controlled by Thomas Petters ("Petters SPV"). Compl. ¶¶ 75, 77. To do so, one of Lancelot Cayman's domestic affiliates would make loans to the Petters SPV in exchange for a promissory note; Lancelot Cayman, in turn, would purchase the promissory note and the right to repayment. *Id.* ¶ 77. Petters claimed to use the loan proceeds to purchase merchandise from two vendors and resell it to retailers such as Costco. *Id.* ¶ 13. Once the merchandise was purportedly resold, the

[1] It is unclear whether Plaintiff ERFML is the beneficial owner of any Lancelot Cayman shares as Paragraph 37 does not include ERFML in its list of beneficial owners. Compl. ¶¶ 36–37.

Petters SPV would then repay Lancelot Cayman for the amount of the loan along with accrued interest. *Id.*

In September 2008, after one of Petters's co-conspirators went to the FBI, it was publicly revealed that Petters was operating a Ponzi scheme and had not, in fact, used the loan proceeds to purchase merchandise. *Id.* ¶ 19 & Ex. D ¶ 7. Instead, Petters and his co-conspirators used the proceeds to repay earlier investors, to enrich themselves, and to support their other business ventures. *Id.* ¶ 63. To avoid detection, the conspirators created bogus transaction documents including "phony purchase orders and invoices" and also had third parties pose as the vendors from which Petters purportedly purchased inventory. *Id.* ¶¶ 64, 66, 80–81. The Complaint does not allege that Lancelot Cayman itself was a Ponzi scheme, but rather that Lancelot Cayman was fleeced by Petters. *See, e.g.*, *id.* ¶¶ 12, 14, 15, 25, 27. After the fraud was revealed, Lancelot Cayman went into bankruptcy and liquidation proceedings. *Id.* ¶ 187.

The McGladrey US Defendants did not serve as the auditor for any Petters entity. Nor did the McGladrey US Defendants have any direct contractual relationship with Plaintiffs. It was McGladrey Cayman—RSM Cayman's alleged predecessor—that acted as the outside auditor for Lancelot Cayman. There are no allegations that McGladrey Cayman or any of the McGladrey US Defendants spoke with any of the Plaintiffs specifically. Indeed, there is no allegation that any of the Plaintiffs or their alleged predecessors in interest had any direct contact whatsoever with any of the Defendants prior to their investments in Lancelot Cayman. Although the Complaint alleges that McGladrey Cayman sent the audit opinions directly to Lancelot Cayman's shareholders after they had invested (an allegation that the McGladrey US Defendants deny but accept as true solely for purposes of this motion to dismiss), the Complaint does not allege that any of the McGladrey US Defendants were even aware of any of the Plaintiffs' existence prior to their initial investments, were ever informed that Plaintiffs intended to rely on the audit reports in deciding whether to invest in Lancelot Cayman, or ever vouched for the quality of the audits. *Id.* ¶¶ 103, 176.

Prior to filing this suit, Plaintiffs, or their alleged predecessors-in-interest, were named plaintiffs and/or purportedly members of the putative class of plaintiffs in two other Illinois suits against McGladrey Cayman and/or the McGladrey US Defendants, styled *Northwater Five-Year Market-Neutral Fund Ltd. et al. v. McGladrey & Pullen, Cayman*, Case No. 2015-L-11102 (Cook Cnty., Ill.) ("*Northwater*") and *Tradex Global Master Fund SPC Ltd. et ano., on behalf of themselves and all others similarly situated v. McGladrey & Pullen, Cayman et al.*, Case No. 10-CH-13264 (Cook Cnty., Ill.) ("*Tradex*"), which asserted claims on behalf of Lancelot Cayman's shareholders similar to those asserted here. Compl. ¶¶ 8, 193. More than six years ago, Lancelot Cayman's bankruptcy trustee sought to stay both the *Tradex* and *Northwater* suits, contending that the shareholders' claims against the Lancelot Cayman's auditors were actually property of Lancelot Cayman's bankruptcy estate. Compl. ¶ 188. In granting the trustee's request, the court overseeing Lancelot Cayman's bankruptcy found that the claims "***belong to the bankruptcy estate [of Lancelot Cayman]***." Order & Prelim. Injunc., *In re Lancelot Investors Fund, LP et al.*, Case No. 09-ap-00413 (Bankr. N.D. Ill. filed Aug. 24, 2010) (attached hereto as Exhibit 1) (emphasis added).

The cases remained stayed for five years while Lancelot Cayman's bankruptcy trustee litigated against McGladrey Cayman and the McGladrey US Defendants, ultimately losing those claims on summary judgment based on the defense of *in pari delicto*. *Peterson v. McGladrey LLP*, 792 F.3d 785 (7th Cir. 2015). Following the conclusion of the trustee suit, the stays of the *Tradex* and *Northwater* actions, as well as two other shareholder suits filed in Minnesota, were lifted. McGladrey Cayman and/or the McGladrey US Defendants filed motions to dismiss in all cases.

Dismissal was granted in two of those cases, with the court finding that the auditor owed no duty to the Lancelot plaintiff shareholders under either Illinois or Minnesota law. *See McKinley Lancelot One, LLC, McKinley Associates, Inc. et al. v. McGladrey & Pullen, LLP*, No. 27-cv-09-16412 and *Belmont Strategic Income Fund, LP v. McGladrey & Pullen, LLP*, No. 27-cv-15-16851 (Minn. Dist. Ct. May 25, 2016), *available at* 2016 WL 4958223 ("*McKinley* Op.") (attached hereto as Exhibit 2). And, just recently, Judge McGrath dismissed the *Northwater* action on *forum non conveniens* grounds, and stated at oral argument that she otherwise would have dismissed on standing grounds.[2] In the *Tradex* class action, Judge Atkins allowed the case to proceed, but in so ruling placed a heavy emphasis on allegations that are notably not present here. The remainder of that ruling is currently the subject of a motion for reconsideration based upon Cayman law.

STANDARD OF REVIEW

"A motion to dismiss under sections 2-615 and 2-619 admits well-pleaded facts, but . . . conclusions of law and conclusory factual allegations not supported by allegations of specific facts are not deemed admitted." *Patrick Eng'g, Inc. v. City of Naperville*, 2012 IL 113148, ¶ 31 (internal quotation marks omitted). "If, after the legal and factual conclusions have been disregarded, the complaint does not allege sufficient facts to state a cause of action, the motion to dismiss must be granted." *Weis v. State Farm Mut. Auto. Ins.*, 333 Ill. App. 3d 402, 406 (2d Dist. 2002) (affirming section 2-615 dismissal of fraud claims).

Claims for fraud must satisfy a "high standard of specificity." *Chatham Surgicore, Ltd. v. Health Care Serv. Corp.*, 356 Ill. App. 3d 795, 803 (1st Dist. 2005). Plaintiffs must set forth "specific allegations of facts from which fraud is the necessary or probable inference." *Bd. of*

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[2] Plaintiff Corrado's alleged predecessors-in-interest filed motions for voluntary dismissal in the *Northwater* action, which were granted just two days before the court ruled on the motion to dismiss, and thereby escaped judgment in that case.

Educ. v. A, C, & S, Inc., 131 Ill. 2d 428, 457 (1989). This standard is even more stringent than the heightened pleading requirements for fraud under the federal rules. *Id.* (referring to Federal Rule of Civil Procedure 9(b) as "more lenient").

ARGUMENT

I. THE COMPLAINT MUST BE DISMISSED PURSUANT TO 735 ILCS 5/2-619(a)(9) FOR LACK OF STANDING

Plaintiffs seek to recover their alleged investment losses arising out of Lancelot Cayman's investment in the Petters Ponzi scheme. That effort is barred by the controlling Cayman Island doctrine of "reflective loss." Under that doctrine, where a shareholder's alleged losses could be recouped through a successful action by the corporation itself—here an action by Lancelot Cayman against McGladrey Cayman, the McGladrey US Defendants, and/or other third parties allegedly responsible for Lancelot Cayman's Ponzi-scheme related losses—any suit by the shareholders themselves is deemed to be reflective of the corporation's losses and thus barred.

A. Cayman Law Bars Claims Seeking To Recover Reflective Losses

The question of whether Lancelot Cayman's shareholders have standing to sue individually or whether the claim must be pursued by the company is a threshold choice-of-law issue that implicates the internal affairs doctrine. *Bagdon v. Bridgestone/Firestone, Inc.*, 916 F.2d 379, 382–83 (7th Cir. 1990). Illinois follows the widely accepted rule that the law of the place of incorporation of Lancelot Cayman governs that issue. *E.g.*, *Housman v. Albright*, 368 Ill. App. 3d 214, 218 (5th Dist. 2006) ("To determine whether the plaintiffs have standing to sue . . . . Illinois courts apply the law of the state of incorporation."); *Lipman v. Batterson*, 316 Ill. App. 3d 1211, 1215 (1st Dist. 2000). Because Lancelot Cayman is a Cayman company, Compl. ¶ 59, Cayman law governs. Mem. Op. & Order, *Tradex Global Master Fund SPC Ltd. v. Lancelot Inv. Mgmt, LLC*, Case No. 2010-CH-13264, op. at 5 (filed Jan. 12, 2016) (attached hereto as Exhibit 3)

(“*Tradex* Op.”).

Cayman law strictly forbids shareholders from bringing claims against third parties for losses that are derivative of an injury suffered by the company, following the English common law doctrine of “reflective loss.” Affidavit of Aristotelis Alexandros Galatopoulos (Feb. 24, 2017) ¶¶ 13–26 (“Galatopoulos Aff.”).[3] The reflective loss doctrine holds that a shareholder has no right to sue directly “to make good a diminution in the value of the shareholder’s shareholding where that merely reflects the loss suffered by the company.” Galatopoulos Aff. ¶ 19 n.5 (quoting Lord Bingham in *Johnson v. Gore Wood & Co.* [2002] 2 AC 1). As Lord Bingham explained in *Johnson*:

> A claim will not lie by a shareholder to make good a loss which would be made good if the company’s assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss . . . .

Put another way, Plaintiffs have no standing to assert a claim for damages that merely reflects losses suffered in the first instance by Lancelot Cayman and that Lancelot Cayman’s trustee could have recovered had it succeeded in a suit against McGladrey Cayman, the McGladrey US Defendants and/or any other third parties “responsible for the loss.” This is true even if there is a successful defense to the company’s claim. *See* Galatopoulos Aff. ¶ 20 (“‘It is not simply the case that . . . [if] there is some defence to the company’s claim, the shareholder can pursue his claim.’” (quoting judgment of Arden, LJ, *Day v. Cook* [2001] EWCA (Civ) 592)). But as explained below, that is precisely what Plaintiffs seek to do.

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[3] The McGladrey US Defendants stand ready to provide copies of the foreign cases cited in the Galatopoulos affidavit, if the Court so desires.

B. Plaintiffs' Own Allegations Establish that They Impermissibly Seek To Recover Reflective Losses

The allegations of the Complaint make clear that Plaintiffs impermissibly seek to recover losses that reflect Lancelot Cayman's losses. Because suits brought by Lancelot Cayman against McGladrey Cayman, the McGladrey US Defendants and/or other third parties could have made good the same losses sought by Plaintiffs here, *Johnson* and Cayman law forbid Plaintiffs from bringing individual claims.

Lancelot Cayman's bankruptcy trustee already brought suit against McGladrey Cayman and the McGladrey US Defendants in 2009 seeking to recover all of the losses Lancelot Cayman suffered in connection with its investments in the Petters Ponzi scheme. The trustee likewise brought suit against various other parties—including Lancelot Cayman's management, its third-party administrator, its lawyers, and the third-party auditor of the Petters SPV.[4] Over the years of litigation that followed, the trustee settled some of those cases, lost some based on the *in pari delicto* defense, and continues to litigate others. If the trustee had prevailed (or prevails) in any of those cases and recovered the full amount of Lancelot Cayman's investment losses in the Petters Ponzi scheme, those recoveries would have been distributed to Lancelot Cayman's shareholders, including Plaintiffs, and eliminated the losses Plaintiffs seek to recover here. *See* Compl. ¶ 195 (noting that Plaintiffs had filed claims against Lancelot Cayman's bankruptcy estate to recover their alleged losses). It is under precisely these circumstances—where the "loss . . . would be made good if the company's assets were replenished through action against the party responsible

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[4] *See Peterson v. McGladrey & Pullen LLP et al.*, Case No. 10-c-00274 (N.D. Ill.); *Peterson v. Bell et al.*, Case No. 09-1252 (N.D. Ill.); *Peterson v. Katten Muchin Rosenman LLP*, Case No. 12-cv-3393 (N.D. Ill.); *Peterson v. Winston & Strawn LLP*, Case No. 11-c-02601 (N.D. Ill.); *Peterson v. Swiss Financial Services (Bahamas) Ltd.*, Case No. 09-ap-01283 (Bankr. N.D. Ill.); *Peterson v. Eide Bailly LLP*, Case No. 10-c-8038 (N.D. Ill.).

for the loss," Galatopoulos Aff. ¶¶ 15, 19 n.5—that the doctrine of reflective loss bars the shareholder claim.

Indeed, the bankruptcy court for the Northern District of Illinois has already found that the claims belong to Lancelot Cayman. The bankruptcy court examined the complaint in the *Tradex* class action brought on behalf of Lancelot Cayman's shareholders, and held that allowing the shareholders' claims to proceed would "***improperly permit creditors to litigate claims that belong to the bankruptcy estate***." Ex. 1, *In re Lancelot Investors Fund, LP*, Case No. 09-ap-00413 (emphasis added). In so ruling, the bankruptcy court reaffirmed its prior holding in a related investor suit that claims against the McGladrey US Defendants are "***general claims that rightfully belong to the bankruptcy estate***." *Id.* (emphasis added) (quoting *In re Lancelot Inv'rs Fund, LP*, 408 B.R. 167, 172 (Bankr. N.D. Ill. 2009)). As the court explained in that decision:

> The alleged professional negligence and misrepresentations were suffered by many creditors, not just [the individual Lancelot investor]. The financial information [the individual Lancelot investor] relied upon was distributed to all investors, not individually to [the individual Lancelot investor]. This puts [the individual Lancelot investor] in the same shoes as other investors who relied upon the financial reports. This is apparent based on the multitude of other lawsuits filed by other creditors of the estate against McGladrey alleging claims sounding in misrepresentation and professional negligence. All parties that invested in the [Lancelot Funds], including [the individual Lancelot investor], lost their investments because of Petters' alleged fraudulent conduct which may have been facilitated by McGladrey's alleged negligence and misrepresentations regarding the [Lancelot Funds'] financial condition. [The individual Lancelot investor's] claims are no different than those claims.

In re Lancelot Inv'rs Fund, 408 B.R. at 172. Although the question at issue in the bankruptcy court was a matter of federal bankruptcy, rather than Cayman, law, the court's reasoning compels the same answer here: the claims asserted by Plaintiffs are not theirs to bring.

C. The Outcome of the Lancelot Cayman Trustee's Suits Does Not Impact the Reflective Loss Analysis

Plaintiffs do not—and cannot—deny that, had the bankruptcy trustee prevailed in his suits against the auditors and other third parties, Plaintiffs would have no remaining damages in this case. That fact alone is dispositive as to the reflective loss doctrine, regardless of the ultimate outcome of those suits.

First, the fact that McGladrey Cayman and the McGladrey US Defendants defeated the trustee's claim based on *in pari delicto* on summary judgment after years of litigating on the merits does not displace the reflective loss doctrine. Cayman law does not and would not recognize an *in pari delicto* exception to the reflective loss doctrine. *See* Galatopoulos Aff. ¶ 20.[5] Indeed, in *Barings plc (in liquidation) v. Coopers & Lybrand* [2002] 2 BCLC 364, the company's shareholder alleged that the auditors failed to discover the illegal acts of the company's manager. Galatopoulos Aff. ¶ 23. The auditors, however, had a "complete defence" to the company's claim very similar to *in pari delicto*, namely a "claim in deceit based on the directors' representation letter" that had been provided to the auditors. *Id.* ¶ 24. Justice Lombe-Evans nevertheless held that this "complete defence" to the company's claim did not "permit [the shareholder] to sue for reflective loss." *Id.* ¶ 25 (quoting paragraph 138 of the judgment); *see also, e.g.*, *Day v. Cook* [2002 1 BCLC 1] ("It is

[5] Courts in the United States likewise reject such an exception. *ABF Capital Management v. Askin Capital Management, LP*, 957 F. Supp. 1308, 1332–33 (S.D.N.Y. 1997) (holding that "[s]tanding is a constitutional requirement" and the "application of *in pari delicto* to bar the trustee can neither confer constitutional standing upon Plaintiffs nor transform the nature of its alleged injury from a derivative one into a direct and personal one"); *Primavera Familienstriftung v. Askin*, 1996 WL 494904, at *12 (S.D.N.Y. Aug. 30, 1996) ("At the outset, it is necessary to address the Bankruptcy Court's finding that the Funds' trustee was barred from asserting certain claims by the doctrine of *in pari delicto.* Although Primavera asserts that that finding confers standing on it to pursue certain derivative claims, that is not so."); *In re Optimal U.S. Litig.*, 813 F. Supp. 2d 383, 397 (S.D.N.Y. 2011) (rejecting the "notion that a corporation's unclean hands—potentially barring derivative claims—will yet allow the corporation's *shareholders* to sue directly")

not simply the case [under the reflective loss doctrine] that double recovery will not be allowed so that, for instance, if the company's claim is not pursued or there is some defence to the company's claim, the shareholder can pursue his claim. The company's claim, if it exists, will always trump that of the shareholder. Accordingly the court has no discretion. The claim cannot be entertained." (cited at Galatopoulos Aff. ¶ 20.).[6]

Second, several of the cases brought by the trustee against other third parties allegedly responsible for the loss were not dismissed based on *in pari delicto*. Rather, the trustee settled certain claims, including his claim against Lancelot Cayman's management and continues to litigate others. *See, e.g.*, Settlement Agreement (attached hereto as Exhibit 4). Cayman cases specifically recognize that the reflective loss doctrine applies in full in such cases, regardless of the amount of the settlement. *See, e.g.*, Galatopoulos Aff. ¶ 22 ("The reflective loss principle . . . 'includes the case where the company has settled for less than it might . . . .'" (quoting *Giles v. Rhind* [2002] EWCA Civ 1428); *Johnson v. Gore Wood & Co.* [2000] UKHL 65 (holding that the reflective loss doctrine applies "even if the company . . . has declined or failed to make good that loss"); *see also Greenpond South, LLC v. G.E. Capital Corp.*, 886 N.W.2d 649, 658 (Minn. Ct. App. 2016) (holding, under Minnesota law, that a claim by a Petters investor was derivative where

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[6] Contrary to Plaintiffs' suggestion, Compl. ¶ 29, the Seventh Circuit decision in *Peterson v. McGladrey LLP*, 792 F.3d 785 (7th Cir. 2015), which affirmed the dismissal of the trustee's claims against McGladrey Cayman and the McGladrey US Defendants did not create some kind of *in pari delicto* exception to standing. The Seventh Circuit did not address or otherwise consider Cayman law or the reflective loss doctrine and never reviewed any complaint filed by a shareholder. The Seventh Circuit's *dicta* regarding shareholder claims was simply an observation that its *in pari delicto* ruling against the trustee did not similarly bar investor claims and that, in some circumstances, non-clients can bring claims against auditors. The Seventh Circuit never purported to hold that Plaintiffs here (in a case outside the Seventh Circuit's jurisdiction) actually had standing to pursue claims.

the Petters's bankruptcy trustee had filed suit against the same alleged wrongdoer and settled that case).[7]

As these authorities make clear, the reflective loss doctrine is not an outcome-based inquiry. It is indisputable that Lancelot Cayman possessed and pursued claims against various third parties to recover all of the monies it, and reflectively its shareholders, lost in the Petters Ponzi scheme. If successful, those suits would have satisfied Plaintiffs alleged losses here. Nothing else is required for application of the reflective loss doctrine here. Plaintiffs' claims must be dismissed.

II. THE COMPLAINT MUST BE DISMISSED PURSUANT TO 735 ILCS 5/2-615 FOR FAILURE TO STATE A CAUSE OF ACTION

The Complaint also fails for the separate and independent reason that Plaintiffs—who were not clients of the McGladrey US Defendants—have no viable cause of action for negligence or fraud.

Although the threshold standing issue is governed by the law of Lancelot Cayman's state of incorporation, Illinois's process of dépeçage requires a separate choice-of-law analysis for the merits of Plaintiffs' claims. *Townsend v. Sears, Roebuck & Co.*, 227 Ill. 2d 147, 161 (2007). That choice-of-law analysis is guided by Restatement (Second) of Conflicts of Law § 148 (1971) and requires application of the law of the jurisdiction with the "most significant relationship" to the alleged tort and the parties. *See, e.g.*, *Barbara's Sales, Inc. v. Intel Corp.*, 227 Ill. 2d 45, 61, 66

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[7] In *Tradex*, Judge Atkins erroneously found that the reflective loss doctrine did not bar the shareholders' claims, concluding that Lancelot Cayman could not "make good" the loss given its management's involvement in the underlying fraud. Ex. 3 (*Tradex* Op. at 7). But, as McGladrey Cayman and the McGladrey US Defendants highlighted in their pending motion for reconsideration, that fails to take into account the trustee's suit against Lancelot Cayman's management (of which Judge Atkins was previously unaware) and also is directly contrary to the holding in *Barings* and other authorities binding under Cayman law.

(2007); *Townsend*, 227 Ill. 2d at 163–64 & n.4. Although Plaintiffs curiously fail to identify the jurisdictions in which they are incorporated, making a full choice-of-law analysis impossible, the Complaint implicates two jurisdictions on its face:

(1) Illinois, where Mr. Lesser resides, where McGladrey has its principal place of business, and where the Complaint alleges that the "vast majority" of the audit work was performed, *id.* ¶¶ 32, 46, 47, 59;

(2) the Cayman Islands, where Lancelot Cayman, RSM Cayman, and McGladrey Cayman are located and registered, and where final approval of the audit opinion was given, *id.* ¶¶ 41, 44.

At this stage, however, a choice of law analysis is unnecessary because the Complaint fails to state a claim regardless of whether it is evaluated under Illinois or Cayman law.

A. Plaintiffs Fail To State a Cause of Action for Negligent Misrepresentation or Professional Malpractice

1. The McGladrey US Defendants Owed Plaintiffs No Duty under Illinois Law

The Illinois legislature enacted a statute strictly limiting the circumstances in which an auditor is liable to a non-client, like Plaintiffs here. Under the Illinois Public Accounting Act, 225 ILCS 450/30.1(2) (West 2016) ("IPAA"), a claim for negligent misrepresentation or professional malpractice may be brought by a non-client only where the complaint alleges that the auditor "was aware that a ***primary intent*** of the client was for the professional services to benefit or influence the ***particular person*** bringing the action," *id.* (emphases added). Although Plaintiffs pay lip service to this standard by parroting the language of the statute, Compl. ¶ 202, they allege no facts sufficient to support such a contention. Rather, the Complaint alleges only that the McGladrey US Defendants "undoubtedly knew" and that it was "reasonably foreseeable" that potential and existing shareholders like them generally would rely on the audit reports and invest in Lancelot Cayman. *Id.* ¶¶ 101, 102, 204. That is wholly insufficient under the IPAA.

In enacting the IPAA, Illinois repudiated the standard followed in some other jurisdictions that would make auditors liable to all those who might foreseeably rely on their audits. *E.g.*, *Kopka v. Kamensky & Rubenstein*, 354 Ill. App. 3d 930, 938 (1st Dist. 2004) (rejecting assertion that the accountant "owed a duty of due care to all persons who would foreseeably rely on its statements, as this is not the law in Illinois"); *Builders Bank v. Barry Finkel & Assocs.*, 339 Ill. App. 3d 1, 7 (1st Dist. 2003) (same). Illinois courts have made abundantly clear that it is insufficient to allege merely that the auditor knew that its audit reports were being provided to investors or other third parties. *See, e.g.*, *Brumley v. Touche, Ross & Co.*, 123 Ill. App. 3d 636, 637 (2d Dist. 1984) (affirming dismissal pre-IPAA despite allegations that the auditor "knew and foresaw that its audit report would be circulated by [the company] in carrying on its business, including its submission to potential investors in the company"); *Bank of Am., N.A. v. Knight*, 725 F.3d 815, 816 (7th Cir. 2013) (holding that the IPAA "would be ineffectual if knowledge that clients show financial statements to third parties were enough"). Similarly, an auditor's awareness that its audit reports were being provided to a particular type or class of persons, such as shareholders, is insufficient to satisfy the IPAA's "particular person" requirement. *See, e.g.*, *Gordon v. Buntrock*, No. 99 CH 18378, 2001 WL 35832322 (Ill. Cir. Ct., Cook Cty. June 1, 2001) (allegations "concerning [auditor's] knowledge of shareholders in general is insufficient to satisfy the more particular requirements of [the IPAA]"); *see also Builders Bank*, 339 Ill. App. 3d at 9–10 ("[T]here is no ambiguity in the requirement of the statute that the third party be 'the particular person bringing the action.'"). Critical under the IPAA is some evidence that the auditor either provided "independent verification" of the contents of the audit to the plaintiff or else took some other "affirmative action" towards the plaintiff. *Bank of Am. v. Knight*, 875 F. Supp. 2d 837, 846 (N.D. Ill. 2012).

The strenuous requirements of the IPAA are highlighted in *Tricontinental Indus., Ltd. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824 (7th Cir. 2007). There, the Seventh Circuit found that the plaintiffs did ***not*** satisfy the IPAA despite the Complaint's allegations that the auditor:

- knew "that Plaintiffs were negotiating to sell significant assets to [the audit client]";
- knew that the plaintiffs "received and were relying on . . . [the auditor's] unqualified audit report, and that [the audit client] intended that Plaintiffs rely on the . . . audit report"; and
- "participated in the negotiations" between the plaintiff and the audit client.

Id. at 838–39 n.9. Likewise, in *Bank of America, N.A. v. Knight*, the court dismissed the claim despite allegations that (1) the audit engagement letter expressly acknowledged that the audit reports would "be distributed to lenders" like plaintiff; and (2) the audit workpapers included copies of the plaintiffs' loan agreement, which required the audit client to provide the plaintiff with the audit report. 875 F. Supp. 837, 846–47 (N.D. Ill. 2012) (internal quotation marks omitted).

In response to the high hurdle imposed by the IPAA, Plaintiffs offer only the allegations that the audit reports were generally addressed to "Shareholders of Lancelot Investors, Ltd.," whose identities the McGladrey US Defendants allegedly knew and which, at certain undisclosed points, included certain of the Plaintiffs; that the McGladrey US Defendants sent the audit reports directly to Plaintiffs (an allegation that the McGladrey US Defendants deny and accept as true only for purposes of this motion); and that the McGladrey US Defendants had conversations with certain, undisclosed shareholders about certain, undisclosed matters at undisclosed times. *E.g.*, Compl. ¶¶ 103, 109, 204, 216.

These thin allegations are wholly insufficient under the authority cited above and stand in sharp contrast to the type of allegations that Illinois courts have found to be sufficient under the IPAA. For example, in *Chestnut Corp. v. Pestine, Brinati, Gamer, Ltd.*, the court allowed the claim to proceed only because the plaintiffs specifically told the auditor defendant that they were contemplating an investment in the audit client and the auditor told the plaintiffs directly "that the audit was accurately performed according to generally accepted auditing standards" and gave them "work papers in support of the information in the [audit]." 281 Ill. App. 3d 719, 721 (1st Dist. 1996). Similarly, in *Builders Bank*, the plaintiff was permitted to proceed where the auditor was told that its client was applying for a loan from the plaintiff, went with his client and "personally met with plaintiff's president," and personally "reviewed the[] [financial] statements with plaintiff's president and senior vice-president." 339 Ill. App. 3d at 4. And in *Tradex*, the Court found that the IPAA was satisfied only because the plaintiffs pleaded that they had a specific conversation with Mr. Lesser about the audits. Ex. 3 (*Tradex* Op. at 10–11).

Here, of course, there are no allegations that the McGladrey US Defendants spoke with any of the Plaintiffs at all, let alone any allegations that the McGladrey US Defendants were told that Plaintiffs were relying on the audits to make investment decisions, that they discussed the specifics of the audits with the McGladrey US Defendants, or that the McGladrey US Defendants affirmed the accuracy of the audited financial statements. The McGladrey US Defendants owed no duty to Plaintiffs simply by virtue that some of them were shareholders in Lancelot Cayman and the audit reports were generally addressed and sent to the shareholders.

Indeed, one court has already found that claims nearly identical to those here and brought by the limited partners of Lancelot Cayman's domestic affiliate failed under Illinois law because the auditor owed the limited partners no legal duty. Ex. 2, *McKinley* Op. at 8–9 (rejecting plaintiffs' allegations that the audit reports were addressed to the limited partners as insufficient under both Illinois and Minnesota law). The same result should obtain here.

2. The McGladrey US Defendants Owed Plaintiffs No Duty under Cayman Law

Plaintiffs' claims likewise fail under Cayman law where there is "***no reported case*** in which shareholders individually or as a body have succeeded in recovering damages" for a breach of the duty of care owed by auditors. Galatopoulos Aff. ¶ 60 (quoting the decision of Lord Justice Moore-Bick in *MAN Nutzfahrzeuge AG v. Freightliner Ltd* [2005] EWHC 2347 (emphasis added)). The absence of any such successful claim reflects Cayman's stringent requirement that the plaintiff establish the existence of a special relationship with the auditor, in which the auditor knew its work would be relied upon by the "claimant for the purpose of a particular transaction or class of transaction," Galatopoulos Aff. ¶ 61 (citing *Barings plc (In liquidation) v Coopers & Lybrand* [2002] 2 BCLC 364); as well as the general recognition that "[n]o duty is owed directly to the individual shareholders," *id.* ¶ 65 (quoting the opinion of Lord Phillips in *Stone & Rolls Ltd (in liquidation) v Moore Stephens (a firm)* [2009] 1 AC 1391); *see also id.* ¶ 62.

Indeed, Plaintiffs' claims here are precluded by the holding in the seminal case of *Caparo Industries Plc. v. Dickman* [1990] 2 AC 605. In *Caparo*, the plaintiffs sued the corporation's outside auditor, alleging—just like Plaintiffs here—that they initially purchased shares based upon audit reports that failed to detect management fraud and subsequently continued to purchase shares also in reliance on the audit reports. The opinion of Lord Bridge held that the auditor owed no duty to plaintiffs and explaining that "auditors of a public company's accounts owe no duty of care to members of the public at large who rely upon the accounts [i.e., the audit reports] in deciding to buy shares of the company." Galatopoulos Aff. ¶ 54. Similarly, applying *Caparo*, Lord Moore-Bick stated that auditors do not owe current shareholders an individual duty of care, explaining in *MAN Nutzfahrzeuge* that "***[t]he duty of care owed by auditors . . . is not owed to shareholders as individuals*** . . . . The damage from which the auditors must take care to protect shareholders is a diminution in the value of their interest in the company . . . . It follows that neither individual shareholders, nor for that matter the shareholders as a body, can bring an action in their own names to recover that loss" because the cause of action belongs instead to the company itself. *Id.* ¶ 60 (emphasis added).

Caparo mandates dismissal of the negligent misrepresentation and accounting malpractice claims here. Neither of the McGladrey US Defendants were retained by Plaintiffs; McGladrey Cayman was retained by Lancelot Cayman. Just as in *Caparo*, Plaintiffs claim they made an initial investment in 2004 and then made additional investments between November 2004 and July 2008 (though they do not specify which Plaintiffs made which investments or at which times). Compl. ¶¶ 11, 175–80. Plaintiffs allege nothing to suggest that they fall outside of the category of general investing members of the public to whom the auditor owes no duty under Cayman law. The Complaint offers no factual allegations that the McGladrey US Defendants knew of Plaintiffs' existence prior to their initial investments or that the McGladrey US Defendants knew Plaintiffs would rely on the audits in making any particular investment decisions. Although the Complaint alleges that the audit opinions were addressed and sent to "Shareholders of Lancelot Investors Fund, Ltd.," which at some point included certain of the Plaintiffs, *e.g.*, Compl. ¶¶ 103, 109, the audit reports in *Caparo* were presented at the company's annual shareholders' meeting and Lord Bridge nevertheless found there was no duty, *see* Galatopoulos Aff. ¶¶ 53–55. Plaintiffs therefore cannot state a cause of action for negligent misrepresentation or malpractice under Cayman law.

B. Plaintiffs Fail To State a Cause of Action for Fraud/Fraudulent Inducement

Plaintiffs freely admit that the McGladrey US Defendants did not know about the Petters fraud, and instead fault the McGladrey US Defendants for "manag[ing] to miss the massive Ponzi scheme." Compl. ¶ 7; *see also id.* ¶¶ 4, 133. In light of that concession, the fraud claim fails because there is no way for Plaintiffs to establish that the McGladrey US Defendants intentionally made false statements or intended to deceive Plaintiffs. Although allegations of reckless conduct, in appropriate circumstances, can serve as a ***proxy*** for allegations of actual knowledge, those allegations cannot save a fraud claim when the plaintiff admits the defendant was unaware of the fraud. *See, e.g.*, *Park v. Sohn*, 89 Ill. 2d 453, 459 (1982) (affirming dismissal of fraud claim where "there was no evidence that the defendants made any representation to the plaintiffs that they knew to be false, nor was there any evidence that they knowingly concealed defects from the plaintiffs"); *In re Adv. Battery Tech., Inc.*, 781 F.3d 638, 644 (2d Cir. 2015) (holding that, under a theory of recklessness, the auditor's conduct must "approximate an actual intent to aid in the fraud"); Galatopoulos Aff. ¶ 29 (quoting *Derry v. Peek* for the proposition that "recklessness" is tantamount to making a statement "without belief in its truth"). Allegations that the McGladrey US Defendants "should have known" or should have discovered the Ponzi scheme sound only in negligence. In any event, Plaintiffs' allegations would be insufficient to support their fraud claim even if they did not directly allege that the McGladrey US Defendants were unaware of the Ponzi scheme.

1. Fraud Claims Must Allege Requisite Knowledge and Intent to Deceive

Illinois and the Cayman Islands follow the universal rule that a plaintiff asserting fraud must adequately allege facts establishing that the defendant acted with knowledge of falsity and an intent to deceive. *See, e.g.*, *Park*, 89 Ill. 2d at 459; *Fox v. Heimann*, 375 Ill. App. 3d 35, 47 (1st Dist. 2007) ("The defendants' knowledge of the falsity of the statement, or a deliberate concealment with the intent to deceive, is an essential element of common law fraud."); *Jackson v. S. Holland Dodge, Inc.*, 197 Ill. 2d 39, 52 (2001) (affirming dismissal of consumer fraud claim because there were "no specific factual allegations that . . . Chrysler directly participated in a scheme with the dealership to misrepresent the facts to the plaintiff" despite the "conclusory allegations of 'actual knowledge'"); Galatopoulos Aff. ¶ 39; *see also, e.g.*, *id.* ¶¶ 35, 37.

Allegations that an auditor violated professional auditing standards (GAAP and GAAS) are insufficient to establish the scienter necessary for a fraud claim. *Navistar Int'l Corp. v. Deloitte & Touche LLP*, 2012 WL 4043283, at *12 (Ill. Cir. Ct., Cook Cty. July 25, 2012) ("[A]llegations of GAAP and GAAS violations alone generally are not enough to satisfy the pleading requirements for *scienter*. . . . GAAP and GAAS violations provide no specific facts upon which a court can infer the state of mind of the accountant." (internal quotation marks omitted)). It is similarly insufficient to label conduct as "reckless." Rather, the recklessness sufficient to support a fraud claim must be such an "extreme departure" from the standard of care as to "approximate an intent to aid in the fraud." *E.g.*, Ex. 3 (*Tradex* Op. at 13); *In re Bally Total Fitness Sec. Litig.*, 2006 U.S. Dist. LEXIS 93986, at *16, *40 (N.D. Ill. July 12, 2006). For allegations that the defendant overlooked "red flags" to support a fraud claim, the red flags "must be closer to 'smoking guns' than mere warning signs." *E.g.*, *In re Bally*, 2006 U.S. Dist. LEXIS 93986, at *40; *see also* Galatopoulos Aff. ¶¶ 34–38.

2. Plaintiffs Concede that the McGladrey US Defendants Were Unaware of the Ponzi Scheme and Allege No Facts to Support the Inference that the McGladrey US Defendants Intended to Deceive Plaintiffs

The Complaint correctly alleges that the McGladrey US Defendants had no knowledge of the Petters Ponzi scheme before it was publicly revealed. Compl. ¶¶ 4, 7, 133. That concession is dispositive because Plaintiffs therefore cannot establish that the McGladrey US Defendants knew that any statements in the audit opinions were false or that they had any intent to deceive plaintiffs. But even if there was any ambiguity regarding the McGladrey US Defendants' awareness of the scheme, Plaintiffs' allegations of recklessness are nevertheless insufficient to establish the "necessary or probable" inference that the McGladrey US Defendants were aware of Petters's fraud.

Plaintiffs' allegations of recklessness fall into one of two categories: (1) that the McGladrey US Defendants ***would have*** learned certain facts had they performed audit procedures on Petters, a non-client, and (2) that the McGladrey US Defendants missed certain "red flags" that, in hindsight, should have alerted them to the fraud. *See, e.g.*, Compl. ¶¶ 161–62. These are, at best, allegations that the McGladrey US Defendants did a poor job performing the audit work (which the McGladrey US Defendants strenuously deny), but none establishes the "necessary or probable" inference that the McGladrey US Defendants knew of the Ponzi scheme and intended to deceive Plaintiffs.

First, Plaintiffs allege that the McGladrey US Defendants would have learned of the fraud had they contacted the retailers or visited warehouses. Compl. ¶¶ 5, 161, 163. But allegations of auditing failures support a claim for negligence, not fraud. *See, e.g.*, *Navistar*, 2012 WL 4043283, at *12. In any event, as Plaintiffs acknowledge, "the Audit team was auditing Lancelot, not [the Petters SPV] or Petters." Compl. ¶ 164. The merchandise was never owned by Lancelot Cayman; it was the Petters SPV that supposedly purchased merchandise from vendors and resold it to retailers. *Id.* ¶ 77. Plaintiffs fail to identify a single legal or professional standard that would require an auditor to conduct due diligence on a non-client or to conduct audit procedures on assets that were not on the books and records of its client, let alone allege any facts that suggest the failure to take such steps constitutes fraud.[8]

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[8] Similarly, the allegation that the McGladrey US Defendants failed to uncover the criminal backgrounds of Petters and his associates, Compl. ¶¶ 25, 83, is nothing more than an assertion of negligence. In that same regard, there is no allegation that the McGladrey US Defendants were aware of the fraudulent round-trip transactions in 2008 or that money was being put into the Petters SPV "lock-box" bank account by Petters himself, rather than the retailers. *Id.* ¶¶ 71, 73, 77, 88(G). And Plaintiffs offer no reason why the McGladrey US Defendants would have examined bank records of a bank account belonging to a non-client like the Petters SPV. Indeed, the Complaint makes clear that the McGladrey US Defendants were ***not*** aware that the money was coming in from Petters. *See id.* ¶ 16 (alleging that the auditors "should have" uncovered this fact).

Courts, in similar contexts, have dismissed fraud claims resting upon allegations that auditors should have performed procedures on the non-client perpetrator of the fraud:

> But most critically, the Auditors were never engaged to audit Madoff's businesses or to issue an opinion on the financial statements of [Madoff]. The Auditors' only role is that they audited the financial statements of the [feeder funds]. The notion that a firm hired to audit the financial statements of one client ([the feeder funds]) must conduct audit procedures on a third party that is not an audit client ([Madoff]) on whose financial statements the audit firm expresses no opinion has no basis.

In re Tremont Sec. Law, State Law, & Ins. Litig., 703 F. Supp. 2d 362, 371 (S.D.N.Y. 2010); *accord, e.g.*, *Meridian Horizon Fund, LP v. KPMG (Cayman)*, 487 F. App'x 636, 640–41 (2d Cir. 2012) (summary order) ("The Auditors were responsible for auditing the Tremont funds, not [Madoff]. Many of the purported 'red flags' that plaintiffs contend should have put the Auditors on notice of the Madoff fraud . . . were risks inherent to [Madoff], not the [the audit client].").

Second, none of the "red flags" that the McGladrey US Defendants allegedly missed can be seriously considered sufficient to give rise to a fraud claim. Specifically, Plaintiffs allege that the McGladrey US Defendants "knew, or paid no attention" to the fact that: (i) the maturity dates of the loans to the Petters SPV were extended from 180 days to 270 days in 2007 after certain loans became delinquent; (ii) a bad debt reserve was never created even though the merchandise being purchased was allegedly "easily subject to damage and obsolescence"; (iii) the Petters SPV did not provide Lancelot Cayman with monthly financial statements; and (iv) Lancelot Cayman and its affiliates were heavily concentrated in Petters. Compl. ¶ 162. These too are, at most, allegations of negligence—crafted in hindsight—not fraud. Countless businesses concentrate their investments, waive contractual requirements, forgive delinquencies, or change loan terms without having any involvement in fraud whatsoever. None are "smoking guns" that clearly revealed the existence of the Petters fraud. Indeed, the Complaint alleges that even Gregory Bell—Lancelot

Cayman's manager and director—had no awareness of the Ponzi scheme until it was publicly revealed. *Id.* ¶¶ 71, 181.

Similarly, the Complaint's allegation that "the Auditors understood the possibility that source documents in connection with the Petters 'transactions' . . . could be forgeries," *id.* ¶ 160, does not raise the "necessary or probable inference" that the McGladrey US Defendants knew of the Ponzi scheme. Understanding the theoretical risk does not mean that the McGladrey US Defendants knew that the Petters documents were, in fact, forged, or that any indicia of forgery existed. To hold otherwise would mean that a plaintiff could successfully accuse an auditor of fraud merely by alleging that the auditor considered the ever-present risk of forged documents in the ordinary course of conducting a fraud-risk assessment during an audit.[9]

Numerous courts confronting lawsuits arising from the Petters and Madoff Ponzi schemes have rejected fraud claims on motions to dismiss when, as here, the allegations of missed "red flags" established nothing more than that the auditors should have known of the Ponzi scheme (a contention that sounds in negligence, not fraud). *See, e.g., Meridian*, 487 F. App'x at 640 (affirming dismissal of fraud claims on motion to dismiss arising out of the Madoff Ponzi scheme based on "red flags" as "impermissible allegations of fraud by hindsight" (internal quotation marks omitted)); *In re Tremont*, 703 F. Supp. 2d at 371 (dismissing fraud claims on motion to dismiss for lack of scienter despite allegations of "red flags" surrounding the Madoff Ponzi scheme and holding that "alleging a shoddy audit in violation of GAAS does not establish the intent to defraud required to maintain a claim for securities fraud"); *see also DeLollis v. Friedberg, Smith & Co.*,

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[9] Equally off the mark is Plaintiffs' irrelevant reference to Mr. Lesser's work on the Alpha Titans' matter. As Plaintiffs' themselves admit, that fund was "unrelated" to Lancelot Cayman and the Petters Ponzi scheme and, in any event, all of the work post-dated the audit work for Lancelot Cayman. Compl. ¶ 52 & Ex. N.

600 F. App'x 792, 796 (2d Cir. 2015) (affirming dismissal on motion to dismiss of negligence and malpractice claims against auditor who failed to detect the Madoff Ponzi scheme and noting that "[n]umerous actions brought against auditors and investment advisors by victims of Madoff's fraud have been dismissed despite the presence of 'red flags,' which in hindsight arguably should have called attention to Madoff's illegal conduct"); *In re Palm Beach Fin. Partners, L.P.*, 488 B.R. 758, 773 (Bankr. S.D. Fla. 2013) (granting motion to dismiss aiding and abetting fraud claim because allegations did not indicate the defendant "had actual knowledge of Petters' fraud" and instead "merely suggest[ed] that [the defendants] should have known of Petters' fraud").

Although Judge Atkins allowed the fraud claim in *Tradex* to proceed past the motion to dismiss stage, that decision has no application here as it was based primarily on allegations distinct from those in this matter. Specifically, Judge Atkins placed a strong emphasis on the Tradex plaintiffs' allegation that the McGladrey Defendants had expressly agreed to confirm the transactions directly with Costco. Ex. 3 (*Tradex* Op. at 14). That allegation is false and Plaintiffs here make no such allegation, nor could they do so in good faith. Nevertheless the allegation was made in *Tradex* and Judge Atkins, as he must, relied upon it. This case is further distinguishable from *Tradex* because here, unlike in *Tradex*, Plaintiffs expressly (and rightfully) concede that the McGladrey Defendants were unaware of the Ponzi scheme. For the reasons stated above, that concession requires dismissal of the fraud claim. In any event, Judge Atkins's ruling was erroneous as a matter of law, including without limitation, because it focused on allegations of "red flags" about which the Tradex plaintiffs (and the plaintiffs here) admit the McGladrey US Defendants were unaware, such as Petters's prior criminal history, *see* Compl. ¶ 25, and alleged audit failures. In allowing the fraud claim to proceed, Judge Atkins's decision went contrary to decisions of courts around the country that hold that allegations of audit failures or missing "red flags" is insufficient to state a claim for fraud. *See supra* pp. 23–24 (citing cases). That is most certainly the case where, as here, the Plaintiffs concede that the McGladrey US Defendants lacked any knowledge of the fraud.

At most, Plaintiffs' allegations suggest that Petters's fraud went innocently undetected by the McGladrey US Defendants, just as it went undetected for years by other third-party professionals, the authorities, and Plaintiffs themselves. Courts repeatedly have dismissed fraud claims in such situations. *See, e.g.*, *Meridian*, 487 F. App'x at 641 ("[T]he more compelling inference as to why Madoff's fraud went undetected for two decades was his proficiency in covering up his scheme . . . ."); *In re Tremont*, 703 F. Supp. 2d at 371 (same); *SEC v. Cohmad Sec. Corp.*, No. 09 Civ. 5680, 2010 U.S. Dist. LEXIS 8597, at *6 (S.D.N.Y. Feb. 2, 2010) (rejecting fraud claims because allegations suggested that "Madoff fooled the defendants as he did individual investors, financial institutions, and regulators"). That same result is required here.

CONCLUSION

For the foregoing reasons, the Complaint should be dismissed with prejudice.

Respectfully submitted,

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Dated: February 27, 2017

CERTIFICATE OF SERVICE

I, Anand Mathew, an attorney, hereby certify that I caused a copy of the foregoing **Memorandum in Support of RSM US LLP and Simon Lesser's Motion To Dismiss Plaintiffs' Complaint,** to be served by First Class U.S. Mail, postage prepaid, and e-mail, on the individuals listed below this 27th day of February, 2017:

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EXHIBIT

1

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

In re:	)	Chapter 7
	)	
Lancelot Investors Fund, L.P., et al.	)	Case No. 08 B 28225, et al.
	)	(Jointly Administered)
Debtor.	)	
______________________________	)	
	)	
Ronald R. Peterson, as Chapter 7 Trustee for Lancelot Investors Fund, L.P., et al.,	)	
	)	
Plaintiff,	)	
	)	
v.	)	Adv. No. 09 A 413
	)	
Ellerbrock Family Trust, LLC, et al.,		)
	)	
Defendants.	)	Judge Jacqueline P. Cox

ORDER AND PRELIMINARY INJUNCTION (Docket No. 91)

On March 10, 2010 Tradex Global Master Fund SPC Ltd., the ABL Segregated Portfolio 3, and Tradex Global Master Fund SPC Ltd., the Original Segregated Portfolio 3 (the "Tradex Plaintiffs") filed their third class action complaint against entities that Chapter 7 Trustee Ronald R. Peterson has targeted. The Plaintiffs have filed, amended and dismissed a federal class action complaint; they now seek to recover in state court ("Tradex State Class Action") against Lancelot Investment Managment, L.L.C. ("LIM"), Gregory Bell ("Bell"), Swiss Financial Services (Bahamas), Ltd., and Swiss Financial Services, Inc. (together, "Swiss Financial"), McGladrey & Pullen LLP and McGladrey & Pullen, Cayman (together "M&P"), Altschuler, Melvoin & Glasser, Cayman and Altschuler, Melvoin & Glasser, LLP (together "AM&G"), and Simon Lesser ("Lesser", and with M&P and AM&G, "McGladrey") (collectively, the "Tradex Defendants"). The Tradex Plaintiffs generally allege that the Tradex Defendants made material misrepresentations and omissions that induced them and others to invest millions of dollars in Lancelot Investors Fund, Ltd. (the "Offshore Fund") money that was lost when that fund filed for bankruptcy protection after the fraud of Thomas Petters ("Petters") and his co-conspirators was discovered.

Ronald R. Peterson, Debtors' Bankruptcy Trustee ("Trustee") argues that the Tradex Plaintiffs seek to litigate their claims despite this court's prior order that common investor claims against a target of the Trustee's investigation should be enjoined. On July 17, 2009 this court enjoined a group of Lancelot investors known as the McKinley Plaintiffs from pursuing a complaint against McGladrey for professional negligence because such claims were "general claims that rightfully belong to the bankruptcy estate." (July 17, 2009 Mem. Op. At 6-7, Dkt. 54. 09 ap 413).

Before October 30, 2008, the date on which the underlying bankruptcy proceeding was filed, Bell controlled the Debtors through his management companies. He was authorized to make investment and management decisions on behalf of the Debtors through those entities.

The Debtors were commercial lenders to a special purpose vehicle, Thousand Lakes, which was controlled by Thomas Petters and the Petters Entities.[1] Bell and the management companies caused the Debtors to purchase from Thousand Lakes numerous notes that were purportedly secured by goods owned by the Petters Entities. The notes were ostensibly issued to finance Thousand Lakes' purchase of goods to fulfill existing purchase orders from discount retailers such as Costco, Sam's Club, Boscov's and B.J.'s. Instead, the transactions were part of a multi-billion dollar Ponzi scheme orchestrated by Petters and his co-conspirators.

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[1]The Debtors consist of nineteen related entities that were engaged in the operation of related hedge funds or special purpose vehicles and consist of: SWC Services, LLC; Lien Acquisition, LLC; AGM, LLC; AGM II, LLC; KD1, LLC; KD2, LLC; KD3, LLC; KD4, LLC; KD5, LLC; KD6, LLC; KD7, LLC; KD8, LLC; RWB Services, LLC; Surge Capital II, LLC; Colossus Capital Fund, L.P.; Colossus Capital Fund, Ltd.; Lancelot Investors Fund, L.P.; Lancelot Investors Fund II, L.P.; and Lancelot Investors Fund, Ltd. (Chap. 7 Vol. Pet., Case No. 1:08-bk-28225, Dkt. No. 1 (Oct. 20, 2008)).

Petters was convicted of mail and wire fraud, conspiracy to commit mail or wire fraud, money laundering conspiracy and money laundering. Petters and his co-conspirators created fictitious invoices, purchase orders and other documents and used the money they received from investors to make disbursements and other payments to earlier investors and to enrich themselves. The goods in which the Debtors purportedly held a security interest did not exist making the notes held by the Debtors worthless.

McGladrey & Pullen LLP provide auditing and financial services that consisted of auditing the Funds' financial statements and issuing opinions as to the accuracy of the Funds' financial condition. Lesser was the McGladrey partner in charge of the audits of the Offshore Fund. AM&G is M&P's predecessor.

Swiss Financial served as administrator for the Funds and performed various accounting, administrative and shareholder services. Swiss Financial agreed to calculate the Funds' New Asset Value on a monthly basis and provide monthly and year-end statements that accurately and fairly represent the Funds' financial condition.

Upon consideration of the Third Amended Complaint For Injunctive Relief ("Third Amended Complaint") of the Trustee; the Motion of Trustee Ronald R. Peterson for Preliminary Injunction Staying The Tradex State Class Action ("Motion"); the Memorandum of Law in Support of the Trustee's Motion; the Tradex Plaintiffs' Response in opposition; the Trustee's Reply; the hearing conducted before this court regarding the Motion held on August 5, 2010; due notice of the motion having been given; the relief requested in the Motion being in the interest of the Debtors' estates, their creditors, the public and other parties in interest and authorized pursuant to section 105(a) of Title 11 of the United States Code (the "Bankruptcy Code"), Rule 65 of the Federal Rules of Civil Procedure (the "Civil Rules"), and Rule 7065 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"), the Motion is GRANTED.

The continued prosecution by Tradex Global Master Fund SPC Ltd., the ABL Segregated Portfolio 3, and Tradex Global Master Fund SPC Ltd., the Original Segregated Portfolio 3

("Tradex Plaintiffs") of their currently pending state court class action against (a) Gregory Bell; (b) Lancelot Investment Management, LLC, one of the Debtors' management entities; (c) Swiss Financial Services, Inc. and Swiss Financial Services (Bahamas) Ltd., the administrators of Lancelot Investors Fund, Ltd., Lancelot Investors Fund, L.P., and Lancelot Investors Fund, II. L.P.; (d) and certain of the Debtors' auditors, McGladrey & Pullen LLP and McGladrey & Pullen, Cayman, Altschuler, Melvoin & Glasser, Cayman and Altschuler, Melvoin & Glasser LLP, and Simon Lesser, would (a) improperly permit creditors to litigate claims that belong to the bankruptcy estate as to the AM&G and M&P entities and (b) affect the amount of property in the bankruptcy estate and the allocation of property among creditors.

LIKELIHOOD OF SUCCESS

The Trustee has a likelihood of success on the merits. The criminal conviction of Petters lends credence to the Trustee's efforts as the burden of proof for criminal matters is beyond a reasonable doubt which is higher than the burdens of proof for civil matters, clear and convincing evidence and a preponderance of the evidence.

PUBLIC INTEREST

The Trustee's efforts are in the public interest as he is attempting to orderly administer the Debtors' bankruptcy estates and to make *pro rata* distributions to their creditors.

LIMITED OBJECTION TO INJUNCTION

The Tradex Plaintiffs do not generally oppose the imposition of the requested injunction. They ask that its imposition be limited to allow them to litigate a motion to dismiss regarding the issue of whether their claims are general or direct in state court. However, the Tradex Plaintiffs do not assert any authority in support of their position that the limited imposition of injunctive relief as suggested is proper. It is therefore waived. Their counsel admitted at the August 5, 2010 hearing that they can not litigate their claims until the Trustee concludes his litigation. Transcript of August 5, 2010 Hearing on Motion for Preliminary Injunction, 09 ap 413, p. 24 ("Transcript").

ELEMENT OF IRREPARABLE HARM

The Tradex Plaintiffs argued at the hearing of this Motion that the Trustee would be entitled to injunctive relief under section 105 of the Code if he can demonstrate potential harm to the estate or some potential adverse impact to the claims he is pursuing. Transcript, p. 18. That is not the law. The Seventh Circuit ruled in *Fisher v. Apostolou* that a trustee does not have to show harm to obtain an injunction enjoining related litigation: "In other words, the court does not need to demonstrate an inadequate remedy at law or irreparable harm." *Fisher v. Apostolou,* 155 F.3d 876, 882 (7th Cir. 1998) (quoting *In re L&S Industries, Inc.,* 989 F.2d 929, 932 (7th Cir. 1993).

RELATEDNESS OF CLAIMS

Even if the claims that the Tradex Plaintiffs seek to proceed on in state court are determined to be direct such that a bankruptcy trustee can not pursue them, they are related to Trustee Peterson's lawsuits herein to marshal property of the estate to and to make *pro rata* distributions to the Debtors' creditors as the Tradex Plaintiffs would seek satisfaction from the same assets and insurance proceeds as the Trustee who does so on behalf of all creditors.

EXTENSION OF NOVEMBER 12, 2009 AGREEMENT

The Tradex Plaintiffs ask that the court require Trustee Peterson to resume his November 12, 2009 agreement that allowed the Tradex Plaintiffs to pursue its claims then pending in federal district court. The Trustee asserts that he entered into that agreement only because the judge presiding over that matter insisted on proceeding. This court does not have the authority to require the Trustee to resume that agreement and declines to do so.

INTERFERENCE WITH BANKRUPTCY COURT JURISDICTION

The court rejects the Tradex Plaintffs' assertion that allowing the state court to resolve the nature and scope of the claims in this bankruptcy case would benefit the parties. Such a resolution could impermissibly interfere with this court's responsibility regarding this matter and prejudice the Trustee who is not a party in the state court case. The Tradex Plaintiffs' attempt to resolve an issue central to the bankruptcy process outside of bankruptcy court supports the trustee's request herein for injunctive relief.

ALTER EGO CLAIMS

The Trustee has legitimately identified AM&G as a target of his investigation in arguing that it is a potential defendant. The court notes that the Trustee has commenced proceedings against M&P, whom the Tradex Plaintiffs claim is an "alter ego" of AM&G. *See* Amended Complaint for Injunctive Relief, 09 ap 413, Dkt. 99, Exh. #4, ¶18. To the extent that M&P is liable for the conduct of AM&G as its alter ego, claims asserted by the Tradex Plaintiffs against AM&G are claims that belong to the Trustee.

The Seventh Circuit has ruled that creditors with individual claims closely related to a trustee's claims "must wait their turn behind the trustee, who has the responsibility to recover assets for the estate on behalf of the creditors as a whole". *Fisher*, 155 F.3d at 881. The Tradex Plaintiffs' claims are closely related to the Trustee's claims. The Tradex Plaintiffs have not shown that they are pursing wholly separate causes of action based on unrelated facts and circumstances.

IT IS HEREBY ORDERED THAT:

1. The motion is GRANTED.

2. Prosecution of the following state court action is preliminarily enjoined and restrained until the bankruptcy case is closed:

> Tradex Global Master Fund SPC Ltd., the ABL Segregated Portfolio 3, and Tradex Global Master Fund SPC Ltd., the Original Segregated Portfolio 3 v. Lancelot Investment Management, L.L.C., Gregory Bell, Swiss Financial Services (Bahamas), Ltd., Swiss Financial Services, Inc., McGladrey & Pullen, LLP, McGladrey & Pullen, Cayman, Altschuler, Melvoin & Glasser, Cayman, Altschuler, Melvoin & Glasser, LLP and Simon Lesser, No. 2010-CH-13264, Circuit Court of Cook County, Ill.

3. Pursuant to Rule 7065 of the Bankruptcy Rules, the Trustee is excused from the requirement to post security under Rule 65(c) of the Civil Rules.

4. The trustee is authorized and empowered to take such actions as may be necessary to implement and to effectuate this Order.

5. This court shall retain jurisdiction to hear and to determine all matters involved in the implementation of this Order.

Dated: August 24, 2010

ENTERED: Jacqueline P. Cox

J.P. Cox

Jacqueline P. Cox
United States Bankruptcy Judge

EXHIBIT

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STATE OF MINNESOTA	DISTRICT COURT
COUNTY OF HENNEPIN	FOURTH JUDICIAL DISTRICT

McKinley Lancelot One, LLC, McKinley Associates, Inc., Scott Turban Family Trust, Scott Turban, Gene Turban, and Paul Dimond,

Court File No. 27-cv-09-16412

Plaintiffs,

ORDER AND MEMORANDUM

v.

McGladrey & Pullen, LLP,

Defendant.

AND

STATE OF MINNESOTA	DISTRICT COURT
COUNTY OF HENNEPIN	FOURTH JUDICIAL DISTRICT

Belmont Strategic Income Fund, LP,

Court File No. 27-cv-15-16851

Plaintiff,

ORDER AND MEMORANDUM

v.

McGladrey & Pullen, LLP,

Defendant.

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Hennepin County, MN

THIS MATTER came before the undersigned for a hearing on February 18, 2016, on Defendant McGladrey & Pullen LLP's motion to dismiss the Complaint pursuant to Rule 12.02(e). After the hearing, the parties made additional submissions. The last submissions was filed on February 26, 2016, whereupon the matter was submitted.

Vincent D. Louwagie, Esq., Hugh P. Lambert, Esq., and Morgan Embleton, Esq., appeared on behalf of Plaintiffs McKinley Lancelot One, LLC, McKinley Associates, Inc., Scott Turban Family Trust, Scott Turban, Gene Turban, and Paul Dimond.

Michael A. Rosow, Esq., Jeffrey R. Ansel, Esq., and Robert R. Weinstine, Esq., appeared on behalf of Plaintiff Belmont Strategic Income Fund, LP.

Paul C. Peterson, Esq., Jessica L. Pahl, Esq., and Paul C. Peterson, Esq., appeared on behalf of Defendant McGladrey & Pullen, LLP.

FACTUAL SUMMARY

While the background of this case and its procedural path to this moment is complex and tortuous, the facts related to the basis for this Order are few and straightforward.

Plaintiffs were investors and limited partners in three funds: Lancelot I, Lancelot II, and Colosssus ("the Funds"). The Funds made asset-based loans and other investments. The McKinley plaintiffs' investments in the Funds totaled approximately $11 million.[1] The McKinley Complaint does not allege when each of the McKinley plaintiffs made their individual investments. Plaintiff Belmont Strategic Income Fund LLP ("Belmont") invested $5.55 million in Lancelot II in May 2008. Belmont invested an additional $1.5 million and $3.0 million in July 2008 and September 2008. Unfortunately for Plaintiffs, almost all of the Funds' "assets" were

[1] The Court is referring to the Plaintiffs in District Court File No. 27-CV-09-16412 as the McKinley plaintiffs and the Complaint in that matter as the McKinley Complaint.

tied up in what is now known as the Petters' Ponzi scheme which was uncovered in late September 2008. After the Petters fraud was uncovered, the general manager of the Funds informed its limited partners and investors that their investments were virtually worthless.

Defendant McGladrey & Pullen, LLP ("McGladrey") is a national public accounting firm. McGladrey or its predecessors audited the financial statements of the Funds since their inception. Each year, McGladrey issued unqualified opinion letters for the Funds. McGladrey represented each time that the financial statements presented fairly the financial position of the Funds in conformity with generally accepted accounting standards.

In their Complaint, under count one for professional negligence, the McKinley plaintiffs allege: "McGladrey's audit reports were specifically addressed and directed to the partners of [the Funds], including Plaintiffs. Defendant expected and intended the limited partner investors in [the Funds] to rely on its audits."[2] Under count two for negligent misrepresentation, the McKinley plaintiffs allege: "[t]he misrepresentations made by McGladrey, were for Plaintiffs' guidance in deciding to invest and reinvest in [the Funds]."[3] Plaintiffs further allege that any reasonable investigation during the audits of the Funds would have revealed that the purchase orders and invoices which Petters prepared and gave to potential investment funds were phony.

In its Complaint, Belmont alleges that the manager of Lancelot II provided it with McGladrey's 2006 and 2007 audit reports before Belmont invested in this fund. It also makes almost the identical allegation that the McKinley plaintiffs make: "McGladrey's audit reports were specifically addressed and directed to the partners of [the Funds], including Plaintiffs. Defendant expected and intended the limited partner investors in [the Funds] including Plaintiffs, to rely on the thoroughness, accuracy, integrity, independence, and overall professional caliber of

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[2] Compl. at ¶ 37.
[3] Compl. at ¶ 44.

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its audits."[4] In count two, Belmont alleges that McGladrey owed Plaintiffs a duty to exercise reasonable care in the performance of its audits of the Funds' financial statements and "negligently and carelessly discharged the aforesaid duty by supplying false information in the audit reports to Plaintiffs in connection with their investments in [the Funds]."[5]

PROCEDURAL POSTURE

As mentioned above, the procedural history of this case is complicated and involves the bankruptcy proceedings of the Funds in the U.S. District Court for the Northern District of Illinois; a preliminary injunction by the bankruptcy court enjoining the Plaintiffs from pursuing any action against McGladrey; the Lancelot trustee's action for malpractice against McGladrey in federal court in Illinois; two trips to the U.S. Court of Appeals for the Seventh Circuit for that Case; the dissolution of the preliminary injunction against these Plaintiffs; and now, this motion by McGladrey to dismiss both Complaints for failing to state a claim upon which relief can be granted.

McGladrey's motion is made on several grounds. First, McGladrey argues that the Plaintiffs lack standing because their claims are, as a matter of Delaware law, derivative claims, and therefore can only be brought by the trustee of the bankrupt funds in which Plaintiffs were investors.[6] Second, McGladrey argues that the Plaintiffs' claims fail because under either Minnesota or Illinois law McGladrey owed no duty to Plaintiffs because Plaintiffs were not part of a limited group of third-parties known by McGladrey to have been intended to reply upon McGladrey's work.

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[4] Compl. at ¶ 39.
[5] Compl. at ¶ 47.
[6] The trustee did pursue claims against McGladrey in federal court in Illinois and lost. These were the claims of the Funds, not of the individual investors. The Seventh Circuit upheld the district court's conclusion that the complicity of the fund's manager in the Petters' fraud subjected the fund, and therefore the trustee, to the affirmative defense of in pari dilecto, and therefore barred any recovery by the trustee. *See Peterson v. McGladrey LLP*, 792 F.3d 785 (7th Cir. 2015).

The Plaintiffs disagree with McGladrey on every point of law, including whether or not their claims are direct or derivative, what state law applies to deciding the question of whether the Plaintiffs' claims are direct or derivative, whether a conflicts of law exists as to accountants' liability to third parties, and what Minnesota and Illinois case authorities hold on such liability.

CONCLUSIONS OF LAW

A. Choice of Law

The parties agree that as to which state's law to apply, two are implicated: (1) Minnesota, which is the forum state, where McGladrey's headquarters were located at the time of the audits at issue, and the location of the Petters' Ponzi scheme; and (2) Illinois, which is where the Lancelot funds were based, where McGladrey is now located, and where the audits were performed. But a court need not engage in a choice of law analysis and may apply the law of the forum where there is no outcome determinative conflict between the states' laws.[7] The court concludes that Minnesota, like many other states, follows the Restatement (Second) of Torts § 552 in determining the extent of an auditor's duty to persons such as the plaintiffs here; and that there is little, if any, significant difference between the Restatement and the law in Illinois governing the liability of auditors to third persons.[8] Both Minnesota[9] and Illinois reject the strict privity requirement announced *Ultramares Corp. v. Touche*[10] and the foreseeability test applied in a small minority of jurisdictions in favor of a compromise approach. Accordingly, the court applies Minnesota law on this issue.

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[7] *Milbank Mut. Ins. V. U.S. Fid & Guar. Co.*, 332 N.W.2d 160, 163 n.4 (Minn. 1983).
[8] *Compare NorAm Inv. Servs., Inc v Stirtz Bernards Boyden Surdel & Larter, P.A.*, 611 N.W.2d 372, 375 (Minn. App. 2000) and *Builders Bank v. Barry Finkel & Assocs.*, 790 N.E.2d 30, 37 (Ill. App. 2003); *see also Bank of Am., N.A. v. Knight*, 875 F. Supp. 2d 837, 847 (N.D. Ill 2012), aff'd 725 F. 3d 815 (7th Cir. 2013).
[9] *See Bonhiver v. Graff*, 248 N.W.2d 291, 301 (Minn. 1976).
[10] 174 N.E. 441 (N.Y. 1931).

B. Standard of Review

On a motion to dismiss pursuant to Rule 12.02(e), the court must accept as true all well-pled allegations of fact.[11] A "claim is sufficient against a motion to dismiss for failure to state a claim if it is possible on any evidence which might be produced, consistent with the pleader's theory, to grant the relief demanded."[12] A claim of negligent misrepresentation is a species of fraud and must be pled with particularity as required by the Minnesota Rules of Civil Procedure, Rule 9.02.[13]

C. Analysis of Negligent Misrepresentation Claim

Minnesota law, applying the Restatement (Second) of Torts § 552, provides that an auditor's liability for negligent misrepresentation to persons to whom it supplies false information is limited to losses suffered by the person or one of a limited group of persons for whose benefit and guidance the auditor intends to supply the information or knows that the recipient intends to supply it.[14] As stated above, the law in Illinois is almost identical: In Illinois, an accountant owes a duty to parties who relied on his report or opinion if the accountant was "acting at the direction of or on behalf of his client to benefit or influence [the] third party."[15]

To understand the scope of liability for auditors created by the Restatement (Second) of Torts § 552 and courts applying the Restatement, it is important to contrast it with what is described as the "foreseeability" rule. Under the "foreseeability" rule, auditors are subject to liability to third parties much like any other tortfeasor. That is, auditors may be held liable to any third party for negligent misrepresentation if it is reasonably foreseeable that such third party

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[11] *Walsh v. U.S. Bank, N.A.*, 851 N.W.2d 598, 606 (Minn. 2014).
[12] *Id.* at 603.
[13] *See, e.g., Gen. Ins. of Am. v. Lebowsky*, 252 N.W.2d 252, 255 (Minn. 1977).
[14] *See, e.g., NorAm Inv.*, 611 N.W. 2d at 375.
[15] *Chestnut Corp., v Pestine, Braniti, Gamer, Ltd.*, 667 N.WE.2d 543, 457 (Ill. App. 3d. 1996) (quoting *Brumley v. Touche, Ross & Co.*,463 N.E.2d 195 (Ill. App. 3d 1996) and explaining that the Illinois Public Accounting Act states the general rule set out in *Brumley*, and creates a legislative exception to the general rule)

might obtain and rely on the audit report.[16] The foreseeability test has received substantial criticism from commentators.[17] One court, in rejecting the foreseeability approach, explained the appeal of the rule in the Restatement (Second) of Torts § 552:

> The rule expressed [in the Restatement] attempts to define a narrow class and circumscribed class of persons to whom or for whom representations are made. In this way, it recognizes commercial realities by avoiding both unlimited and uncertain liability for economic losses in cases of professional mistake and exoneration of the auditor in situations where it clearly intended to undertake the responsibility of influencing particular business transactions involving third persons.[18]

Another court examining the Restatement rule concluded similarly:

> [T]he Restatement approach does not allow recovery for every reasonably foreseeable consumer of financial information. Rather, the Restatement approach steers a middle course by allowing only a prescribed group of third parties to recover for pecuniary losses attributable to inaccurate financial statements.[19]

The comments to the Restatement make it clear that § 552 requires that an accountants' liability does not extend to the general class of people who "might reasonably be expected sooner or later to have access to the information and foreseeably take some action in reliance upon it."[20]

The court concludes that both Plaintiffs have not pled sufficient facts which, consistent with their theory, if proved, would provide them with relief because both Plaintiffs have pled facts that are only consistent with the "foreseeability theory" of accountant liability. Under Minnesota law, Plaintiffs are required to plead facts that, if

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[16] *Scottish Rite Heritable Trust, Plc and SHT Holdings (US), Inc. v. Peat Marwick Main & Co*., 84 F.3d 606, 611 (5th Cir. 1996) (and cases cited therein); *see also Bily v. Arthur Young & Co.*, 834 P.2d 745, 757, 769 (1992) (rejecting the foreseeability approach, noting its few adherents, and substantial criticism from commentators); *Petrillo v. Bachenberg*, 655 A.2d 1354, 1360 (1995) (noting that New Jersey has statutorily changed its foreseeability rule for accountants to a more restrictive test).
[17] *See Bily*, 834 P.2d at 769.
[18] *Id.*
[19] *Scottish Rite Heritable Trust*, 81 F.3d at 612.
[20] Restatement (Second) of Torts Restatement (Second) of Torts § 552, cmt h.

proved, would establish that they are one of a limited group of persons who were relying on the audit for a particular transaction.[21] Similarly, in Illinois, Plaintiffs are required to plead facts that, if proved, will show that the purpose and intent of the accountant-client relationship was to benefit or influence the third-party plaintiff.[22]

The Minnesota Court of Appeals has rejected the very theory set forth in Plaintiffs' Complaints, i.e, that it is sufficient to allege that the audit reports were addressed generally to the partners of the funds.[23] In that unpublished butt well-reasoned case, the plaintiff/shareholders argued that because the accountant there had directed audit reports to plaintiff/shareholders, consented to having its reports included in the company's SEC filings, and attended meetings with shareholders and answered their questions, they fell within a limited group of people expected to gain access to the financial information.[24] In that unpublished, but detailed and persuasive decision, the Court of Appeals stated: But accountants are not liable if they "merely know[] of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon an [audit], on the part of anyone to whom it may be repeated."[25]

The complaints here allege even fewer facts than those alleged in *Loop* upon which to base a finding that the McKinley plaintiffs and Belmont are part of a limited group to whom a duty was owed. The McKinley Complaint does not even allege when it invested in the Funds or if it received a copy of the audit reports. Belmont alleges it received a copy of the 2006 and 2007 audit reports before it invested, but of course, any unknown number of investors in the Funds may also have received the McGladrey audit reports before they invested in the Funds. In

[21] *See, e.g., NorAm Inv. Servs.*, 611 N.W.2d at 375.
[22] *Chestnut Corp*., 667 N.E.2d at 546 (citing *Brumley II*, 487 N.W. 2d 641 (1985)).
[23] *See Loop Corp v. McIlroy*, 2004 WL 2221619, *4-5 (Oct. 5, 2004) (citing *NorAm*, 622 N.W.2d at 375)).
[24] *Id.* at *4.
[25] *Id*. (quoting *NorAm*, 611 N.W.2d at 375).

sum, both Complaints allege nothing more than that an unidentifiable group of investors may have possibly relied upon the audit reports. Numerous courts have rejected such generalized allegations as Plaintiffs make here. [26]

D. <u>Analysis of Professional Negligence Claim</u>

In Minnesota, in order to state a valid claim for professional negligence, a nonclient plaintiff is required to plead that they were an intended third-party beneficiary and that the client's sole purpose in retaining the professional is to benefit the nonclient directly.[27] The "Goldberger" rule creates a high bar for professional negligence claims. In fact, as McGladrey points out, no Minnesota appellate court has ever allowed a non-audit client to bring such a claim.[28]

Despite Plaintiffs' protestations that they have pled valid claims for professional malpractice, they have not. There is no allegation to support a conclusion that they were an intended third-party beneficiary of the contract between the Funds and McGladrey or that the Funds' sole purpose in engaging McGladrey was to benefit Plaintiffs directly.

Similarly, in Illinois, plaintiffs must satisfy the strict test of the Illinois Public Accounting Act ("IPPA"), which provides that an accountant is liable to a nonclient third party only when the "accountant was aware that the primary intent of the client was for the professional services to benefit or influence the particular person bringing the action."[29] Again, Plaintiffs have not alleged facts to state a valid claim under the IPAA.

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[26] *See, e.g., Grant Thornton LLP v. Prospect High Income Fund*, 314 S.W.2d 913, 921 (Tex. 2010); *Box Office Entm't, LLC v. Brian Gordon, CPA, P.A.*, No. 05-210100CIV, 2007 WL 1362898, at *5 (S.D. Fla., May 9, 2007); *Machata v. Seidman & Seidman*, 664 So. 2d 114, 115 (Fla. Dist. App. 1994).

[27] See *Goldberger v. Kaplan, Strangis & Kaplan, P.A.*, 534 N.W.2d 734, 738 (Minn. App. 1995) rev'd on other grounds, 601 N.W. 179 (Minn. 1999).

[28] *See N.Am. Specialty Ins. V. Wipfli, LLP*, No. 12-1531 (JRT/JJK), 2013 WL 3871438, at *2, *4 (D. Minnn. July 26, 2013) and *Assoc. Comm. Fin., Inc. v. Brady Martz & Assocs.*, No. 04-5555 (PJS/JJG), 2006 WL 3406762, at *1 (D. Minn. Nov. 7, 2006).

[29] *See* 225 Ill. Comp. Stat. 450/30.1 (West 2015).

E. Request for Leave to Amend the Complaints

Plaintiffs argue that if the court determines there is some "technical defect" in their pleadings, they should be allowed leave to amend the complaint to cure these defects. They argue further that several of the authorities McGladrey relies upon were issued after this case was decided and that there is a "great deal" of information now available about the Petters' Ponzi scheme. Plaintiffs seem to be suggesting that existing discovery will provide them with the specific facts needed to cure their complaints. However, to the Court's knowledge, no discovery has occurred specifically related to the allegations in this case that are at issue here. And, more importantly, Plaintiffs argue themselves that the question "[whether] McGladrey knew that the funds intended to use the financial statements to influence the Plaintiffs' investment decisions....can be determined only through discovery." [30] Consistent with its conclusions above, the Court finds that discovery of such knowledge by McGladrey would still not establish the Plaintiffs as anything more than members of an ever-present group of people whom the Funds may have provided McGladrey's audit papers. Finally, the Court notes that negligent misrepresentation is a species of fraud and must be pled with particularity, and the Minnesota Supreme Court has held that plaintiffs cannot expect discovery to provide factual support for conclusory allegations where particularity is required.[31] Accordingly, the court denies Plaintiffs' request for leave to amend their Complaint.

CONCLUSION

For the reasons set forth above, the court grants Defendant McGladrey's motion to dismiss. Because the court concludes that Plaintiffs have not stated claims upon which relief can

[30] Plaintiffs' Memorandum in Opposition, dated January 25, 2016, at 30.
[31] *Elwood v. County of Rice* 423 N.W. 671, 676 (Minn. 1988).

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be granted, the Court does not reach the alternative basis for McGladrey's motion – namely, that Plaintiffs lack standing to assert claims based on losses suffered by the Funds. Having granted McGladrey's motion to dismiss, the Court hereby orders that the Complaint in both matters be dismissed with prejudice with costs and disbursements awarded in favor of Defendant.

Let judgment be entered accordingly.

Dated: May 25, 2016

Bridget A. Sullivan
Judge of District Court

EXHIBIT

3

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

TRADEX GLOBAL MASTER FUND SPC LTD, THE ABL SEGREGATED PORTFOLIO 3; and TRADEX GLOBAL MASTER FUND SPC LTD., THE ORIGINAL SEGREGATED PORTFOLIO 3, on behalf of themselves and all others similarly situated,	)	
Plaintiffs,	)	No. 10 CH 13264
v.	)	Calendar 16
LANCELOT INVESTMENT MANAGEMENT, LLC., GREGORY BELL; McGLANDRY & PULLEN, LLP; McGLADREY & PULLEN, CAYMAN; ALTSCHULER, MELVOIN & GLASSER, CAYMAN; ALTSCHULER MELVOIN & GLASSER, LLP; and SIMON LESSER,	)	Judge David B. Atkins
Defendants.	)	

MEMORANDUM OPINION AND ORDER

THIS CAUSE COMING ON TO BE HEARD on defendants McGlandrey & Pullen, LLP, McGlandrey & Pullen, Cayman, and Simon Lesser's Motion to Dismiss pursuant to 735 ILCS 5/2-619.1, and Altschuler, Melvoin & Glasser, LLP's motion to dismiss pursuant to 735 ILCS 5/2-619.1, and the court having considered the briefs submitted, and the court being fully advised in the premises,

IT IS HEREBY ORDERED that defendants' motions to dismiss are denied.

Background

In this class action lawsuit, plaintiffs Tradex Global Maser Fund Spc Ltd., The ABL Segregated Portfolio 3 ("Tradex ABL"), and Tradex Global Master Fund SPC Ltd., The Original Segregated Portfolio 3 ("Tradex OSP")(collectively "Tradex"), on behalf of themselves and others similarly situated, and allege that defendants Lancelot Investment Management, L.L.C., ("Lancelot"), Gregory Bell ("Bell"), McGladrey & Pullen, LLP ("M&P"), McGladrey & Pullen, Cayman ("M&P Cayman"), Altschuler, Melvin & Glasser, L.L.P. ("AM&G"), Altschuler, Melvin & Glasser Cayman ("AM&G Cayman"), and Simon Lesser ("Lesser")(collectively, M&P, M&P Cayman, AM&G, AM&G Cayman, and Lesser may be referred to hereinafter as "the auditors"), are liable for fraud and negligent misrepresentation.

The above causes of action arise out of a ponzi scheme perpetrated by Thomas Petters ("Petters"). Plaintiffs are each a segregated portfolio of Tradex Global Master Fund SPC, Ltd., which is a British Virgin Islands Business Company Limited by Shares and registered as a Segregated Portfolio Company under the laws of the British Virgin Islands. (Am. Compl. ¶ 11) Plaintiffs entered into various transactions through its custodian bank with Lancelot Investors Fund, Ltd. ("Lachelot Offshore" or "The Fund") during the summer of 2008. (*Id.* at ¶ 12) The Fund, which was created in 2002 allegedly as a "feeder fund" for Petters, was purportedly created to engage in "purchase order inventory financing." (*Id.* at ¶ 23) This essentially means that The Fund would issue a loan to a domestic affiliate ("Lancelot Onshore") in return for a promissory note and collateral. (*Id.*) The Fund would then use the loan proceeds to purchase electronic merchandise from U.S. suppliers through a special purposes vehicle ("SPV") and ship it to a retailer such as Sam's Club or Costco Wholesale, which would then pay the SPV for the merchandise. The SPV would then pay the loan owed to Lancelot Onshore, which would then repay the loan from Lancelot Offshore with earned interest. However, in September of 2008 the FBI uncovered that none of this activity was actually occurring and that Petters was in fact operating a ponzi scheme. (*Id.* at ¶ 26) In December 2009 Petters was convicted of 20 counts of wire fraud, mail fraud, money laundering and conspiracy. (*Id.*)

Before the scheme was uncovered, Lancelot sought to attract investors to The Fund. To attract prospective investors Lancelot prepared an "Offering Memoranda" describing the purported activities of The Fund and outlining the purported protections and monitoring efforts defendants supposedly employed on behalf of investors. (*Id.* at ¶ 30) The Offering Memorandum was reviewed and/or approved by management for Lancelot as well as Bell, who was the sole principal of Lancelot. (*Id.* at ¶¶ 14, 28) Plaintiffs allege that due to the fraudulent nature of The Fund's transactions, the representations contained in the Offering Memorandum were materially false and misleading. (*Id.* at ¶ 31)

In 2003, Lancelot retained AM&G and AM&G Cayman as outside auditors for The Fund. (*Id.* at ¶ 33) AM&G Cayman issued audit opinions for The Fund dated February 2005, January 2006, and March 30, 2007. (*Id.*) M&P and M&P Cayman assumed the role of The Fund's outside auditors after AM&G and AM&G Cayman. (*Id.* at ¶ 35) In this capacity, M&P Cayman issued an audit opinion for The Fund on January 5, 2008. (*Id.*) Plaintiffs allege that the auditors failed in several respects to follow generally accepted accounting standards and guidelines, resulting in materially false and misleading audit reports that were later relied on by plaintiffs when investing in Lancelot. Plaintiffs allege that the work performed by the auditors was so perfunctory, careless, and rife with erroneous accounting judgments that the auditors either knew or were reckless in not knowing that the audit opinions were materially false and misleading.

Plaintiffs allege that in or around 2008 and prior to their investments in The Fund, representatives of Tradex spoke with defendant Lesser, who at the time was a partner at M&P and had previously served as a partner at AM&G, regarding the audit opinions. (*Id.* at ¶ 37)

Plaintiffs allege that Lesser told them that AM&G and M&P did serve as auditors in 2005, 2006, 2007 and 2008.

Plaintiffs initially filed suit in federal court. However, after defendants in the federal action moved to dismiss for lack of subject-matter jurisdiction plaintiffs voluntarily dismissed the federal action and filed the present lawsuit. Plaintiffs filed their initial class-action complaint on March 30, 2010. Shortly thereafter, the federal bankruptcy court overseeing Lancelot Cayman's bankruptcy proceeding stayed this action pursuant to a request from the Lancelot Cayman's bankruptcy trustee. This lawsuit remained stayed for five years while Lancelot Cayman's bankruptcy estate litigated against M&P. The District Court dismissed the trustee's lawsuit against M&P under the doctrine of *in pari delicto*, which rests on the idea that when the plaintiff is as culpable as the defendant, if not more so, the law will let the losses rest where they fell. *Peterson v. McGlandrey LLP*, 792 F.3d 785, 787 (7th Cir. 2015). Applying this doctrine, the district court found, without considering whether M&P failed to perform its duty, that The Fund's misconduct was at least equal in gravity to any alleged misconduct by M&P and therefore the doctrine applied. *Id.* The Seventh Circuit affirmed the District Court. *Id.* at 789. In affirming, the Seventh Circuit noted that while claims against Bell may not be worth much because he is in prison and claims against Lancelot may not be worth much because it is bankrupt, a claim against M&P may offer some compensation for the investors if the auditor was indeed negligent or willfully blind. *Id.* at 788. In so holding, the Seventh Circuit effectively lifted the stay on this lawsuit, stating that "[i]t is time to bring the investor's claims to the fore." *Id.* at 789.

In late 2015 plaintiffs reinstated this action. On February 16, 2016 plaintiffs filed an amended complaint. On March 4, 2016 M&P, M&P Cayman, and Lesser ("the M&P defendants") filed their present motions to dismiss pursuant to 735 ILCS 5/2-619.1. On that same date AM&G filed its motion to dismiss. Both motions were fully briefed and the court heard oral argument on July 27, 2016. The court then took the motions under advisement for consideration of the issues and to prepare a written order.

Legal Standard

The Illinois Code of Civil Procedure ("Code") permits a litigant to combine a motion to dismiss pursuant to 735 ILCS 5/2-615 and 735 ILCS 5/2-619 in a single motion. 735 ILCS 5/2-619.1; *Jenkins v. Concorde Acceptance Corp.*, 345 Ill. App. 3d 669, 674 (1st Dist. 2003). However, a combined motion must be in parts. 735 ILCS 5/2-619.1. Each part shall be limited to either section 2-615 or section 2-619 and each part must clearly show the grounds for relief under the section upon which it is based. *Id.*; *Storm & Assocs., Ltd. v. Cuculich*, 298 Ill. App. 3d 1040, 1046 (1st Dist. 1998) ("Meticulous practice dictates that the movants clearly state the section of the Code under which a motion to dismiss is brought."). Defendants' motions comport with these requirements.

Discussion

The M&P defendants initially argue that this action should be dismissed pursuant to 2-619(a)(9) due to a lack of standing. Because standing is a necessary element for all of plaintiffs' claims and a potentially dispositive issue, the court will consider this issue first. AM&G's motion to dismiss joins M&P's arguments regarding standing, therefore their motions will be considered jointly in this regard.

735 ILCS 5/2-619

A section 2-619 motion is designed to provide a summary disposition of issues of law or easily proven issues of fact. *Melko v. Dionisio,* 219 Ill. App. 3d 1048, 1057 (2d Dist.1991). Such a motion admits all well-pled facts alleged in the complaint and reasonable inferences to be drawn from those facts. *Ciono v. Gerhart*, 201 Ill. App. 3d 853, 856 (3d Dist. 1990). Where evidentiary material is submitted which contradicts well-pled allegations of fact in the complaint, the trial court should not dismiss a complaint pursuant to section 2-619. *Melko*, 219 Ill. App. 3d at 1057.

For plaintiffs to have standing in this action their claims must be direct and not derivative of The Fund itself. The reason for this is because the Bankruptcy Trustee is the proper representative of the claims for the The Fund. Accordingly, this action was stayed to allow the bankruptcy trustee to pursue the claims of The Fund and those claims have already been litigated. Plaintiffs, as investors, only have standing to pursue claims for directly suffered harm, not harm due to their position as investors of the company. Thus, the issue of standing may be determined by analyzing whether the plaintiffs' claims are direct or derivative.

Preliminarily, the court must determine from which jurisdiction's law to apply to the issue of whether the claims are direct or derivative. Defendants argue that the law of the Cayman Islands governs this issue because that is the place of incorporation of Lancelot Cayman. Under Illinois law, the issue of whether a claim is direct or derivative is a claim pertaining to how the internal affairs of a corporation are managed. *Bagdon v. Bridgestone/Firestone, Inc.*, 916 F.2d 379, 382 (7th Cir. 1990). Thus, Illinois applies the "internal affairs doctrine" to determine the choice of law on this issue. *Id.* "The internal affairs doctrine is a conflict of laws principle that prescribes that matters relating to a corporation's internal governance should be controlled exclusively by the state of incorporation." *Newell Co. v. Petersen*, 325 Ill. App. 3d 661, 687 (2d Dist. 2001). Thus, to determine whether plaintiffs must bring their claim as a derivative action or a direct action is governed by the jurisdiction of incorporation. *Lipman v. Batterson*, 316 Ill. App. 3d 1211, 1215 (1st Dist. 2000)("The issue of whether plaintiffs properly should have brought their claims in a derivative action instead of a direct class action is determined by application of the substantive law of Delaware since ISC is incorporated in that state."); *see also Housman v. Albright*, 368 Ill. App. 3d 214, 218 (5th Dist. 2006)("To determine whether the plaintiffs have standing to sue, we must first determine whether Illinois law or Delaware law applies. Waterfront is a Delaware corporation, and Illinois courts apply the law of the state of incorporation.").

Plaintiffs argue that Illinois law should be applied to this issue. First, plaintiffs point out that Lancelot Offshore's Officer Memo provides that subscription agreements, such as the ones entered into by plaintiffs, are to be governed by the State of Illinois. (Opp. to M&P's Mot., Ex. A) However, defendant auditors were not parties to the subscription agreement and cannot be bound by its terms. Additionally, plaintiffs' claims do not pertain to substantive rights arising out of the subscription agreement. Instead, plaintiffs' claims against the auditors arise out of activity done by the auditors, who were third parties to the subscription agreement. Additionally, plaintiffs plead claims of negligent misrepresentation and fraud, not breach of contract arising out of a breach of the subscription agreement. Finally, the Illinois Court of Appeals has previously held that the internal affairs doctrine is a fundamental public policy as it relates to governing the inner workings of a corporation and controls over a choice of law provision in a contract. *Newell Co.*, 325 Ill. App. 3d at 387-88; *see also Bagdon*, 916 F.2d at 383 (where the Seventh Circuit reasoned in *dicta* that if the plaintiff had raised a choice of law question issue based on a choice-of-law provision in a contract, that the Court "would incline to think that the choice-of-law clause governs the validity and effect of the contract *and does not affect corporate law on subjects outside that pact.*") (emphasis added). Thus, the subscription agreement's choice of law provision does not govern whether plaintiffs' claims against the auditors are direct or derivative.

Second, plaintiffs argue that section 196 of the Restatement (Second) of Conflicts of Laws dictates that the court apply Illinois law. Section 196 states that in an action pertaining to the validity of a contract for the rendition of services and the rights created thereby are determined, that courts use the local law of the state where the contract that requires that the services or a major portion of the services, be rendered. Plaintiffs argue that because the audits by defendants occurred in Illinois that Illinois should control. However, as defendants point out, section 196 applies to issues of contract validity, which is not at issue here. Thus, section 196 is not applicable to the issue of whether plaintiffs' claims are direct or derivative. Therefore, the court will follow the rule provided in *Lipman*[1] and *Housman* that the issue of whether the claims are direct or derivative are governed by the jurisdiction of incorporation. Therefore, Cayman Island law applies to this specific issue[2].

The Cayman Islands are a British Oversees Territory. (Aff. of Galatopoulos ¶ 5) Consequently, the Cayman's legal system is a common law system founded on the English system. (*Id.*) Where there is no applicable Cayman Island case law, the Cayman Islands Court will generally follow English appellate authorities to the extent they are not inconsistent with Cayman Islands statute or authority. (*Id.*) There is no dispute among the parties that the Cayman Island courts follow the English common law doctrine of "reflective loss" to determine whether a claim is direct or derivative. (*Id.* at ¶ 11; Aff of Harlowe ¶ 28) The issue is therefore whether the damages complained of by plaintiffs are merely reflective of the losses of the company as a whole as opposed to losses by its individual investors.

Generally, the rule against reflective loss states that a claim cannot lie with a shareholder where the loss complained of is merely reflective of the losses to the company itself. As Lord Bigham explained in the leading English case of *Johnson v. Gore-Wood*, "[n]o action lies at the

[1] Plaintiffs attempt to distinguish *Lipman* by pointing out that *Lipman* dealt with claims directly against a corporation while the claims here are against third-party auditors. However, this is a distinction without a difference. The issue is whether the injuries in this action were suffered by the plaintiffs directly, or derivatively through injury to the corporation. *See Lipman*, 316 Ill. App. 3d at 1215 ("In a derivative suit, the shareholder sues on behalf of the corporation for harm done to it whereas, in a direct action, the shareholder brings suit individually or on behalf of the class of shareholders for injuries done to them in their individual capacities."). Whether the defendant is the corporation itself or a third party makes no difference for the purposes of a choice of law analysis.

[2] The court's application of Cayman Island law as to this discrete issue should in no way be construed as a finding that Cayman Island law governs any of plaintiffs' substantive causes of action in this matter.

suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. A claim will not lie by a shareholder to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss." *Johnson v. Gore Wood & Co.* [2000] UKHL 65. Defendants argue that the loss complained of by plaintiffs is merely reflective of the loss by the corporation Lancelot. Defendants point out that plaintiffs did not invest with Petters, but rather that they purchased shares of Lancelot Cayman. Lancelot Cayman made short-term loans to one of its domestic affiliates, which in turn made loans to the SPVs owned by Petters ("the Petters SPVs"). Defendants argue that because Lancelot Cayman was only forced into Bankruptcy after Petter's fraud was revealed and his SPVs defaulted on their loan obligations that the losses realized by the shareholders are reflective of the losses to Lancelot Cayman.

The court disagrees. When considering the rule against reflective loss, the court must consider the following guidance as to the application of the rule:

> On the one hand the court must respect the principle of company autonomy, ensure that the company's creditors are not prejudiced by the action of individual shareholders and ensure that a party does not recover compensation for a loss which another party has suffered. On the other, the court must be astute to ensure that the party who has in fact suffered loss is not arbitrarily denied fair compensation. The problem can be resolved only by close scrutiny of the pleadings at the strike-out stage and all the proven facts at the trial stage: the object is to ascertain whether the loss claimed appears to be or is one which would be made good if the company had enforced its full rights against the party responsible, and whether the loss claimed is "merely a reflection of the loss suffered by the company." In some cases the answer will be clear, as where the shareholder claims the loss of dividend or a diminution in the value of a shareholding attributable solely to depletion of the company's assets, or a loss unrelated to the business of the company. In other cases, inevitably, a finer judgment will be called for. At the strike-out stage any reasonable doubt must be resolved in favour of the claimant.

Johnson v. Gore Wood & Co., [2000] UKHL 65.

Defendants' argument ignores two important elements fundamental to the amended complaint. First, the complaint alleges that Lancelot only existed to funnel monies solicited from its investors into the ponzi scheme operated by Petters. (Am. Compl. ¶ 44) The complaint alleges Lancelot's Offering Memorandum made materially false representations regarding monitoring and protections employed by Lancelot as well as concealing material facts regarding the prior criminal history of Petters in order to induce investors to invest in Lancelot. (*Id.* at ¶¶ 27-32) Plaintiffs also allege that Bell, the director of Lancelot, was himself complicit in the ponzi scheme. The amended complaint alleges that Bell admitted in his plea agreement with the SEC that he and others acting at his direction made material misrepresentations and concealed material information about Lancelot Funds' investment with Petters company from investors and potential investors. Thus, plaintiffs' allegations are not merely that Lancelot suffered losses once Petter's fraud was revealed, but that Lancelot was complicit in the fraud in the first place. This, of course, was the basis for the federal court's dismissal of the Bankruptcy Trustee's action against AM&G pursuant to the doctrine of *in pari delicto*:

> The district court concluded that the Funds' misconduct...was at least equal in gravity to McGladrey's, if not a greater fault...What's more, the court concluded, the Funds' representations and McGladrey's errors (if any) led to the same loss: investors' money went down a rabbit hole. Either truth by the Funds (leading to smaller investments), or McGladrey's discovery of Petters's scam, would have protected the investors from loss during 2006 and 2007, when the Funds were growing rapidly.

Peterson, 792 F.3d at 788. Accordingly, construing the complaint in the light most favorable to plaintiffs, the party responsible for the loss to Lancelot is not M&P or AM&G, but Lancelot itself. Plaintiffs would not be able to be compensated for their loss "if the company had enforced its full rights against the party responsible," *Johnson v. Gore Wood & Co.*, [2000] UKHL 65, because the party responsible was the corporation itself.

The second important element of the complaint is the nature of the loss alleged by plaintiffs. Defendants mischaracterize the complaint when they argue that plaintiffs merely seek to recover their *pro rata* losses as shareholders. To the contrary, nowhere in the complaint does it state that plaintiffs seek to recover their *pro rata* losses as shareholders. Nor does the complaint allege that the nature of plaintiffs' losses is merely those of The Fund. Instead, the complaint alleges that plaintiffs' losses are the result of defendants fraudulently inducing them into investing in a ponzi scheme. Paragraph 56 of the amended complaint is instructive. It alleges that:

> In addition, the injuries sustained by members of the class were distinct and separate from any injuries purportedly sustained by the Fund. In this regard, Plaintiffs' losses as alleged herein were not caused by general corporate mismanagement, waste, or a diminution in their value of their Shares. Rather, Plaintiffs' losses — and the losses of other members of the Class — were sustained when each was fraudulently induced to part with monies based on Defendants' false and misleading disseminations about the Fund and its purported "investments," which Class members relied on in making their decisions. These disseminations were purportedly designed to convince Class members that Lancelot was a legitimate business enterprise engaging in routine financing transactions when, in fact, Lancelot was merely a vehicle for channeling millions of dollars into a multi-billion dollar Ponzi scheme. This misconduct was directed specifically to Lancelot investors — not the Fund itself — and caused immediate and distinct losses to those investors, separate and independent from any losses sustained by the Fund.

(Am. Compl. ¶ 56)

Plaintiffs allege that they invested in Lancelot in "express reliance" on defendants' allegedly false and misleading documents, proximately causing defendant's injuries. (*Id.* at ¶ 54) Thus, plaintiffs do not seek to recover their *pro rata* losses as shareholders. Instead, the complaint seeks to recover the actual monies initially invested in Lancelot by plaintiffs, not merely the *pro rata* shares of their stock. Had the bankruptcy trustee been successful in prosecuting Lancelot's claim against the auditors, it may have mitigated plaintiffs' damages, but would not necessarily have fully compensated them. Additionally, plaintiffs seek punitive damages for defendants' conduct, which also goes beyond the *pro rata* shares value of their shares. (Am. Compl. at 38)

Thus, plaintiffs' alleged damages are not merely reflective of the losses to The Fund. Consequently, plaintiffs' claims that they were fraudulently induced into investing into Lancelott are direct, nor derivative, and they have standing to bring their claims.

It is also important to note that the above finding is consistent with the Seventh Circuit's reasoning in affirming the dismissal of the bankruptcy turstee's claims against the auditors in the bankruptcy action under the *pari delicto* doctrine. In affirming the dismissal, the Seventh Circuit recognized that dismissing one party's claims because that party is a wrongdoer arguably excuses the other party from performing its duties. *Peterson*, 792 F.3d at 788. This would potentially leave a gap in the law where the investors are left unprotected. *Id.* However, the Seventh Circuit reasoned, "that's not the outcome of applying the *pari delicto* doctrine to the Trustee's suit. The Trustee stepped into the shoes of the Funds, not the shoes of the investors. People who put up money have their own claims." *Id.* To hold that plaintiffs lack standing because their claims belong to the Fund would be to fall into the gap that the Seventh Circuit explicitly sought to avoid. It would also inequitably foreclose any possibility of plaintiffs substantively pursuing their claims against the auditors because then no one would have that ability.

735 ILCS 5/2-615

Illinois is a fact-pleading jurisdiction. *Weiss v. Waterhouse Securities, Inc.,* 208 Ill. 2d 439, 451 (2004). A motion to strike or dismiss pursuant to 735 ILCS 5/2-615 challenges only the legal sufficiency of a pleading. *Jarvis v. South Oak Dodge, Inc.,* 201 Ill. 2d 81, 85 (2002). The central inquiry is whether the allegations, when considered in the light most favorable to the plaintiff, are sufficient to state a cause of action upon which relief may be granted. *Jarvis*, 201 Ill. 2d at 86. The court may only consider the allegations of the pleading and the attached exhibits. *Haddick v. Valor Ins.*, 198 Ill. 2d 409, 413-14 (2001). A pleading should not be dismissed unless it appears there is no set of provable facts that would entitle plaintiff to recovery. *Id.* Where there is a conflict between an attached exhibit and the allegations of a pleading, the exhibits control. *Bajwa v. Metro. Life Ins. Co.*, 208 Ill. 2d 414, 431-432 (2004).

Plaintiffs' amended complaint contains two counts. The first count is for common law fraud and fraudulent inducement. The second count is for negligent misrepresentation.

Preliminarily, the court recognizes that the laws of three potential jurisdictions are implicated by plaintiff's allegations. To determine whether the court must apply a law other than that of the forum for claims based on "false representations" Illinois courts use section 148 of the Restatement (Sections) of Conflicts of Laws. *Barbara's Sales, Inc. v. Intel Corp.*, 227 Ill. 2d 45, 61 (2007). Accordingly, Illinois courts look to the jurisdiction that retained the most significant relationship to the occurrence of the parties to determine the rights and liabilities of the particular issues presented in the lawsuit. *Id.* Although the parties have not filed a choice of law motion, the court recognizes that three potential jurisdictions are implicated. Those jurisdictions are Illinois, where Lancelot Cayman's management is alleged to have operated and where the plaintiffs allege that the majority of the audit work for The Fund was performed, the British Virgin Islands ("BVI"), where plaintiffs are registered and organized as offshore investment vehicles, and the Cayman Islands, where Lancelot Cayman, AM&G Cayman, and M&P Cayman are located and registered. Defendants[3] argue that at this stage a choice of law analysis is unnecessary because the amended complaint fails to state a claim regardless of which jurisdiction it is evaluated under. The court disagrees that plaintiffs' claims fail no matter what choice of law the court applies because, as discussed below, dismissal is not warranted under Illinois law. Because the parties have not yet filed a choice of law motion for plaintiffs' substantive claims the court cannot find that dismissal of either of plaintiffs' causes of action are warranted because they would be permitted to proceed in at least one of the possible jurisdictions implicated.

Negligent Misrepresentation

Defendants argue that plaintiffs have not stated a claim for negligent misrepresentation under Illinois law because they have not met the requirements pleading this claim as provided for under the Illinois Public Accounting Act ("IPPA"). The IPPA provides that a claim for negligent misrepresentation may only be brought against an auditor by a non-client where the auditor "was aware that a primary intent of the client was for the professional services to benefit or influence the particular person bringing the action." 225 ILCS 450/30.1(2).

The amended complaint alleges that the auditors "knew a primary intent of the Lancelot Defendants was to influence prospective and existing investors in The Fund." (Am. Compl. ¶ 37) Plaintiffs support this conclusion by alleging that the audit reports were "specifically addressed and sent to the 'Shareholders of Lancelot Investors Fund, Ltd.'" (*Id.* at ¶ 33, 35) and that the auditors knew "based on their years of experience" with hedge funds that Lancelot Cayman would provide the reports to potential investors. (*Id.* at ¶ 33) Plaintiffs also allege that the audit opinions represented, without qualification, that the audits where conducted "in accordance with auditing standards generally accepted in the United States of America" and that AM&G Cayman believed "that [its] audit provide[d] a reasonable basis for [its] opinion." (*Id.* at ¶ 34) Plaintiffs also allege that they spoke with Lesser regarding the audit opinions and that Lesser informed them that, among other things, the M&P had been involved as auditors since The Fund's inception but that the firm name for 2005 was his predecessor firm, which was AM&G, and that The Fund/its partners were communicative during M&P's last audit procedure. (*Id.* at ¶ 37)

[3] Although this argument is put forth by M&P, M&P Cayman, and Lesser, AM&G has joined this part of M&P's motion to dismiss

However, as defendants point out, the complaint alleges that plaintiffs did not invest in The Fund until after all the audit opinions were issued and there is no allegation that the auditors knew that Lancelot intended for the audits to influence the plaintiffs in particular. Under Illinois law, it is not enough that the auditors knew that their client would generally show the audit reports to third parties. *Bank of Am., N.A. v. Knight*, 725 F.3d 815, 817 (7th Cir. 2013)("The statute would be ineffectual if knowledge that clients show financial statements to third parties were enough to demonstrate that the client's 'primary intent' was to benefit a particular lender."); *see also Builders Bank v. Barry Finkel & Assocs.*, 339 Ill. App. 3d 1, 9-10 (1st Dist. 2003)("[T]here is no ambiguity in the requirement of the statute that the third party be 'the particular person bringing the action.'). Hence, defendants argue that plaintiffs have not pleaded that the "primary intent" of Lancelot was that plaintiffs were the particular persons Lancelot intended to influence with the audit opinions.

Plaintiffs argue that case law shows similar situations to the present one where other plaintiffs were deemed to have pleaded the particular person requirement. For instance *Freeman, Freeman, and Salzman P.C. v. Lipper* the plaintiffs were investors in a limited partnership that was audited by PricewaterhouseCoopers ("PWC"). *Freeman, Freeman, and Salzman P.C. v. Lipper*, 349 Ill. App. 3d 677, 681 (2004). In alleging a claim of negligent misrepresentation by PWC, the complaint:

> [A]lleged that PWC is in the business of supplying audit opinions to investors for guidance with their investment decisions; PWC knew that plaintiffs would rely upon PWC's audit opinions, the funds' audited financial statements and the related schedules; and that plaintiffs did rely on PWC's representations in the audit opinions, the audited financial statements and related schedules in deciding to invest in and continue to reinvest in Lipper Convertibles and the Fixed Income Fund.

Id. at 682. Ultimately the Court of Appeals held that the complaint sufficiently alleged that PWC knew that the primary intent of their client was to influence the plaintiffs. *Id.* at 682-83. Defendants point out that the complaint also alleged that PWC provided the audit reports directly to the plaintiff, did tax work for the specific plaintiff using the allegedly false audited financial figures, directly communicated with the plaintiffs regarding the contents of the audits, and knew that plaintiffs specifically relied on and benefited from the information contained therein. *Id.* at 681-83. While some of those elements are missing here, plaintiffs do allege that they talked with Lesser about a month before they invested at which time Lesser confirmed that M&P had been involved as auditors since The Fund's inception but that the firm name for 2005 was his predecessor firm, which was AM&G, and that The Fund/its partners were communicative during M&P's last audit procedure. (*Id.* at ¶ 37)

Similarly, in *Brumley v. Touche, Ross & Co.*, 139 Ill. App. 3d 831 (2d Dist. 1985)("*Brumley II*") the plaintiff alleged that they specifically told the auditor that he was interested in acquiring stock and that the audit reports had been submitted to plaintiff for the purpose of influencing his stock purchase option and the auditor confirmed to plaintiff on three occasions that the audit reports were accurate. *Id.* at 833. Conversely, an earlier pleading in *Brumley* was dismissed where plaintiff had only alleged that the auditor "knew and foresaw that its audit report" would be distributed to "potential investors, such as plaintiff, who would rely upon the audit report" but did not allege that the auditor knew that "the report was to be used by [the auditor's client] to influence plaintiff's purchase decision." *Brumley v. Touche, Ross & Co.*, 123 Ill. App. 3d 636, 637, 642 (2d Dist. 1984)("*Brumley I*")[4]. The *Brumley* cases are specifically instructive because the complaint in *Brumley* alleged that the auditor "confirmed to plaintiff" on three occasions that the audit reports were accurate after the audit reports were issued but before plaintiffs invested. *Brumley II*, 139 Ill. App. 3d at 833. Here, plaintiffs allege that Lesser confirmed to Tradex that his auditing firms conducted the audits for the fund for 2005, 2006, and 2007. (Am. Compl. ¶ 37) Plaintiffs also allege that by virtue of this conversation that Lesser was aware that the audit opinions would be used to influence the actions of plaintiffs. (*Id.*) On the basis of these allegations, it is reasonable to infer that Lesser knew that M&P and AM&G's audit opinions were being used to influence Tradex in particular. By confirming that the firms conducted these audits, it is also reasonable to infer that Lesser was adopting the representations in the audit opinions that the audits were conducted in accordance with auditing standards generally accepted in the USA and that the audits formed a reasonable basis for the auditing firms' opinions. (*Id.* at ¶ 34) Therefore, plaintiffs have sufficiently pleaded the "primary intent" element of a claim for negligent misrepresentation. Thus, the court should not dismiss this count for failure to state a claim of negligent misrepresentation. Accordingly, the motion to dismiss is denied as to count I.

Common Law Fraud and Fraudulent Inducement

In order to state a claim for fraud under the laws of Illinois, the BVI, or the Cayman Islands, plaintiffs must allege facts indicating that the defendants acted with knowledge of falsity and an intent to deceive. *Fox v. Heimann*, 375 Ill. App. 3d 35, 47 (1st Dist. 2007); *Park v. Sohn*, 89 Ill. 2d 453, 459 (1982)(scienter is an "essential element of actionable fraud"). (*See* also Aff. of di Iorio ¶¶. 21-30; Aff. of Harlowe ¶¶ 15-16) Complaints alleging fraud must contain specific allegations of facts from which fraud is the necessary or probable inference. *Board of Education v. A, C & S, Inc.*, 131 Ill. 2d 428, 457 (1989).

Plaintiffs conceded that they do not plead that the auditors had actual knowledge as to the falsity of their statements, but instead that they satisfy the scienter element by pleading that the auditors did not follow proper accounting practices and thereby recklessly ignored certain "red flags" available to the auditors at the time of the audit. *Wafra Leasing Corp. 1999-A-1 v. Prime Capital Corp.*, 247 F. Supp. 2d 987, 998 (N.D. Ill. 2002)(noting that alleged violations of accounting are relevant to proving scienter "when the complaint also identifies 'red flags,' or specific, highly suspicious facts and circumstances available to the auditor at the time of the audit, and alleges that these facts were ignored, either deliberately or recklessly"). "In the context of outside auditors, recklessness means that the accounting firm practices amounted to no audit at all, or to an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *Id.* (internal quote marks omitted).

[4] The *Brumley* cases were decided prior to the enactment of the IPAA, but courts have recognized that the IPAA codifies the holdings of those cases. *Tricontinental Indus. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824, 836 (7th Cir. 2007).

Plaintiffs allege that the auditors failed to follow generally accepted accounting standards and guidelines in that the auditors did not assure that The Fund was a legitimate business enterprise, obtain original source material to assure that The Fund's transactions were not based on forged documents, or make inquiries about key individuals involved in The Fund's transactions to assure they were not convicted felons that had been incarcerated for fraud. (Am. Compl. ¶ 42) Plaintiffs also allege that the auditors internally designated The Fund as a "high risk" client and understood that it was possible that the sources of documents in connection with the Petters transactions could be forgeries. (*Id.* at ¶ 47) The complaint asserts that in spite of this, the auditors did not:

1. Perform due diligence on Thousand Lakes – one of one of the Petters SPVs and allegedly The Fund's principal counter-party in the Petters transactions;

2. Review any wire transfers to determine who was paying the notes held by Lancelot Onshore;

3. Confirm any transactions with the retailers purportedly purchasing the merchandise in the underlying Petters transactions, despite specifically agreeing to do so in some instances;

4. Visit any warehouses where any of the purported merchandise was stored or otherwise determine where the merchandise was warehoused;

5. Determine whether or not the inventory underlying the Petters transactions existed;

6. Request or review shipping documentation to confirm whether merchandise was actually delivered to a retailer;

7. Conduct due diligence on Petters or his affiliated entities;

8. Perform due diligence on the purported guarantors of the notes issued by Thousand Lakes and other SPVs;

9. Contact the law firm that prepared the Fund's UCC filings to ascertain the procedures it was following in connection with those filings;

10. Perform any substantive analysis as to the true value of the notes held by The Fund, instead merely reporting the value of the notes at cost plus accrued interest; and

11. Make necessary disclosures in the audit opinions concerning the risks and characteristics of the notes as required by applicable accounting standards.

(*Id.*) Plaintiffs also allege that the auditors ignored several "red flags" in relation to the Petters transactions, which included:

1. That The Fund extended the terms of the Petters notes to as long as 270 days, which plaintiffs argue signaled a level of financial stress and instability that should have triggered further investigation;

2. That while the money to satisfy the loan obligations underlying the Lancelot notes was supposed to come from retailers such as Costco and placed in a "lock-box" account, that the money was instead coming from Petters, which plaintiffs argue indicated the existence of a ponzi scheme;

3. That a bad debt reserve was never created on The Fund's balance sheet even though The Fund's investments were supposed to be secured by tens of millions of dollars in electronic merchandise that would have been subject to damage and obsolescence;

4. That Thousand Lakes repeatedly failed to provide Lancelot with monthly financial statements as required by the parties' master loan agreement and that the auditors were aware of this;

5. That Petters and several of his conspirators were convicted felons who had served time in prison in connection with various fraudulent schemes and criminal activities;

6. That neither The Fund nor the Onshore Funds had programs or controls in place to guard against fraudulent activities, even though the auditors were informed by "the Bell Defendants"[5] that source documents associated with the Petters transactions could be forgeries; and

7. That The Fund and the Onshore Funds were purportedly making billions of dollars of investments exclusively with Petters, a concentration risk that warranted diligence, attention, and oversight that the defendants, including the auditors, never performed.

(*Id.* at ¶ 48)

Defendants argue that plaintiff's allegations are merely impermissible "allegations of fraud by hindsight." *See Meridian Horizon Fund, LP v. KPMG (Cayman)*, 487 Fed. Appx. 636, 640 (2d Cir. 2012). In order to support a cause of action for fraud against an auditor, the allegations must support an inference that the auditor's activity was "an extreme departure from the standards of ordinary care." *Id.* "Such recklessness must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company." *Id.* The court disagrees that the above allegations are merely allegations of "fraud by hindsight." Plaintiffs argue that the auditor's ignoring of the above "red flags" basically amounts to there being no real audit at all. Because this matter is still at the pleading stage, defendants have not yet had to answer the above allegations or otherwise explain their auditing procedure in this case. However, if the above allegations, particularly those listed in paragraph 47, are true, without more, they support an

[5] Although paragraph 48 specifically refers to "the Bell Defendants," this term is undefined in the complaint. Presumably, this is a scrivener's error and ought to read "the Lancelot Defendants," which the complaint specifies as a collective of Bell and Lancelot Investment Management, L.L.C.

inference the auditors did not seriously look at Lancelot to determine its financial stability. This is especially concerning in relation to the "red flags" listed in paragraph 48.

Defendants argue that most of the claims of plaintiffs are based on failure to look into the Petters SPVs which were third-parties to their client. Defendants compare this case to other fraud cases that were dismissed against auditors in relation to the Ponzi scheme perpetrated by Bernie Madoff. *E.g.*, *Meridian Horizon Fund, LP v. KPMG (Cayman)*, 487 Fed. Appx. 636, 640-41 (2d Cir. 2012); *In re Tremont Security Law, State Law & Ins. Litigation*, 703 F. Supp. 2d 362, 371 (S.D.N.Y. 2010). In both of these cases, causes of action for fraud were dismissed against auditors of feeder funds that invested with Madoff because the plaintiffs' allegations of scienter were merely allegations of fraud by hindsight and thus not actionable fraud. *Meridian Horizon Fund*, 487 Fed. Appx. at 640-41; *Tremont Security Law*, 703 F. Supp. 2d at 371. In both those cases, the courts considered allegations of red flags that plaintiffs allege should have tipped the auditors off to the Ponzi scheme but disregarded it because the red flags related to Madoff and his business, not the feeder funds themselves. *Meridian Horizon Fund*, 487 Fed. Appx. at 640-41 ("Many of the purported 'red flags' that plaintiffs contend should have put the Auditors on notice of the Madoff fraud, such as the lack of an independent third-party custodian, and BLMIS's dual role as both investment manager and administrator, were risks inherent to BLMIS, not the Tremont entities."); *Tremont Security Law*, 703 F. Supp. 2d at 371 ("But most critically, the Auditors were never engaged to audit Madoff's businesses or to issue an opinion on the financial statements of BMIS. The Auditors' only role is that they audited the financial statements of the Rye Funds and the Market Neutral Fund. The notion that a firm hired to audit the financial statements of one client (the Rye Funds and the Market Neutral Fund) must conduct audit procedures on a third party that is not an audit client (BMIS) on whose financial statements the audit firm expresses no opinion has no basis.").

However, the red flags in this case are more egregious, and much closer to possible smoking guns, than the red flags in the Madoff cases. First, Madoff was not a convicted felon at the time he was running his ponzi scheme. Here, Petters had previously served jail time for fraud. Second, one of the red flags alleged here is that the auditors were informed that source documents associated with the Petters transactions could be forgeries and yet The Fund allegedly did not have any controls in place to guard against fraudulent activities. Third, the auditors were allegedly aware that Thousand Lakes repeatedly failed to provide monthly financial statements to The Fund, in violation of the parties' master loan agreement. Finally, plaintiffs allege that The Fund dealt exclusively with Petters's SPVs, significantly concentrating the risk and making it more reasonable to infer that the auditors should have taken a closer look at Petters. *Contra, Tremont Security Law*, 703 F. Supp. 2d at 366 (where one of the two feeder funds only invested 27% of the fund with Madoff). This is especially alarming in light of Petters's criminal record and the alleged warning to the auditors that source documents may be forged.

Additionally, while the plaintiffs in the Madoff cases did not allege that the auditors had any explicit responsibility to audit Madoff's businesses, here plaintiffs allege that that auditors specifically agreed to confirm transactions with the retailers purportedly purchasing the merchandise in the underlying Petters transactions but failed to do so. This allegation, if true, is a strong indication that no real audit occurred. Finally, in *Meridian Horizon Fund* the investment risks were plainly disclosed in the feeder funds offering materials. *Meridian*

Horizon Fund, 487 Fed. Appx. at 641. Here, plaintiffs allege that the investment risks were never disclosed. (Am. Compl. ¶ 47(p))

When considered along with the other steps that the auditors allegedly did not engage in, as well as all of the red flags alleged (without regard to any potentially mitigating factors or other audit procedures that may later be alleged by the defendants), it supports the necessary and probable inference that the auditors' work could be considered an extreme departure from the ordinary standards of care such that essentially no audit occurred. Therefore, the motion to dismiss should be denied as to count II.

AM&G's Motion to Dismiss

AM&G joins M&P and Lesser's motion to dismiss. To the extent that AM&G joins that motion, it is denied for the same reasons already discussed. AM&G, however, raises two additional bases for its dismissal as a defendant. Both bases for dismissal are raised pursuant to section 2-615 of the Code of Civil Procedure.

First, AM&G argues that it should be dismissed as a defendant in this action because it never made any statements and therefore cannot be held liable for fraud or negligent misrepresentation. *See Board of Education*, 131 Ill. 2d at 452 (noting that a false statement is an essential element of both fraud and negligent misrepresentation). AM&G argues that it was AM&G Cayman that made the alleged false statements in this case, not AM&G. AM&G points out that the complaint alleges that AM&G Cayman issued the audit reports relevant in this matter (Am. Compl. ¶¶ 18, 20, 33) and that the complaint does not point to any relevant statements made by AM&G or any of its agents.

However, as plaintiffs point out, the complaint does allege that the actual work within the audit reports issued by AM&G Cayman was performed, at least in part, by AM&G employees. (*Id.* at ¶¶ 18, 45) The complaint also alleges that the partner at AM&G Cayman who approved the audit reports played a nominal role in the audits themselves and merely reviewed a package of financial statements and then authorized AM&G's audit team to sign the audit opinions on behalf of AM&G Cayman using AM&G Cayman letterhead. (*Id.* at ¶ 46) Construing these facts in the light most favorable to plaintiff, the information in the audit opinions may be credited towards AM&G because AM&G employees actually wrote the contents of the audit reports. AM&G cites no authority indicating an auditor may avoid liability for audit work primarily done by that auditor simply by handing the audit off to a foreign alter-ego at the last minute for that foreign alter-ego to officially sign off on it. Therefore, this is not a basis for dismissal.

AM&G's second argument is that they cannot be held liable for negligent misrepresentation because no one from AM&G was aware that the primary intent of the audits was to benefit or influence plaintiffs. As discussed previously, Lesser's conversation with plaintiffs satisfies the primary intent element of a negligent misrepresentation count. However, AM&G points out that Lesser was an employee of M&P, not AM&G, at the time he made the alleged statements. Therefore, AM&G argues, neither his alleged statement to plaintiff, nor his knowledge of the audit's intent to influence plaintiff, cannot be imputed upon AM&G. The court disagrees. The complaint alleges that M&P purchased the assets of AM&G in 2006. (*Id.* at ¶ 19) The complaint further alleges:

> In connection with that transaction, the partners and employees of AM&G became the partners and employees at M&P. In addition, clients of AM&G became clients of M&P. Moreover, M&P assumed the office space where AM&G was located in Chicago, Illinois, which is where the audit workpapers relating to the Fund were maintained. Thus, M&P owns and controls AM&G and is its alter ego.

(*Id.*) Construing these facts in the light most favorable to plaintiff, the above sufficiently alleges that M&P was AM&G's alter-ego. M&P assumed AM&G's employees, clients, and workspace after M&P purchased AM&G's assets. There is no indication at this time that AM&G functioned in any meaningfully separate capacity after the merger. Thus, for the purposes of the present motion, it is reasonable to infer that AM&G learned of the Fund's intent to influence plaintiffs with the audit opinions to the extent that M&P gained knowledge through the conversation Lesser had with plaintiffs. Accordingly, this is not a basis for dismissal.

WHEREFORE, defendants' motions to dismiss are denied. Defendants must answer the complaint no later than February 15, 2017. Due to plaintiff counsel's presence out of state, the parties shall confer with the court to schedule a new case management conference at such a date after the pleadings are due.

ENTERED:

Judge David B. Atkins

The Court.

EXHIBIT

4

SETTLEMENT AGREEMENT

This settlement agreement (this "Agreement") is entered into as of June 3, 2015 by and among: (a) Gregory Bell ("Bell"); (b) the Gregory Bell Revocable Trust (the "Bell Trust"); (c) Lancelot Investment Management, LLC ("Lancelot Management"); (d) Inna Goldman ("Goldman"); (e) the Inna Goldman Revocable Trust (the "Goldman Trust" and together with Bell, the Bell Trust, Lancelot Management and Goldman, the "Receivership Parties"); (f) Ronald R. Peterson, not individually but in his capacity as the court appointed receiver for the assets of the Receivership Parties (the "Receiver"); (g) Ronald R. Peterson, not individually but in his capacity as the Chapter 7 case trustee for the Debtors (as hereinafter defined) (the "Trustee" and together with the Receiver, "Peterson"); (h) the United States Securities and Exchange Commission (the "SEC") and the United States Department of Justice (the "DOJ" and together with the SEC, the "United States"); (i) David Bell ("David"); (j) Rebecca Bell ("Rebecca" and together with David, the "Bell Children"); (k) 12H Wellington LLC ("Wellington"); (l) Spruce Family Partnership L.P. ("Spruce"); (m) Blue Sky Investment Holdings LLC ("Blue Sky"); (n) Asia Trust, Ltd. ("Asia Trust"); and (o) Blue Sky Trust ("Blue Sky Trust" and together with Wellington, Spruce, Blue Sky and Asia Trust, the "Affiliated Entities" and the Affiliated Entities, together with the Receivership Parties and the Bell Children, the "Bell Parties"). Each of the foregoing is sometimes referred to individually herein as a "Party" hereto and, together, the "Parties" hereto.

RECITALS

WHEREAS, Bell was the founder and, indirectly through Lancelot Investment Management, Inc., Lancelot Holdings, LP, BRG Services LLC, Lancelot Investment Management LP, and Colossus Capital Management, LP (collectively, the "Management Entities") the principal manager of five hedge funds known as Lancelot Investors Fund, L.P., Lancelot Investors Fund II, L.P., Lancelot Investors Fund, Ltd., Colossus Capital Fund, L.P., and Colossus Capital Fund, Ltd. (collectively, the "Funds");

WHEREAS, Bell and Goldman are husband and wife and the Bell Children are Bell and Goldman's children;

WHEREAS, together Bell and Goldman owned 100% of the Management Entities and received, over the course of the Funds' operation, certain management fees;

WHEREAS, prior to October 22, 2008, a majority of the Funds' investments were in notes issued by Thousand Lakes, LLC and/or Petters Company, Inc., two entities affiliated with Thomas J. Petters (Thousand Lakes, LLC, Petters Company, Inc. and Thomas J. Petters are collectively referred to herein as "Petters") which purported to be engaged in the business of diverting consumer electronics;

WHEREAS, in September 2008, it was revealed that Petters' purported diverting business was in fact a massive Ponzi scheme, which revelation resulted in over $750 million in cash losses by investors in the Funds (collectively, these investors are referred to as "Net Losers");

WHEREAS, on October 22, 2008, the Funds and certain affiliated entities filed for Chapter 7 bankruptcy relief in the United States Bankruptcy Court for the Northern District of Illinois (the "Bankruptcy Court") in cases jointly administered under case no. 08-28225 (collectively, the "Bankruptcy Cases");

WHEREAS, thereafter the Trustee was appointed permanent Chapter 7 case trustee for the Funds and their affiliated Debtors, by the Office of the United States Trustee;

WHEREAS, on September 17, 2009, after the revelation of the Ponzi scheme and the bankruptcy of the Funds, the United States Department of Justice filed a felony Information against Bell in the United States District Court for the District of Minnesota (the "District Court") on a charge of wire fraud (case no. 09-269), based on his having participated in certain "round trip" transactions with Petters beginning on February 26, 2008, which had the effect of hiding from investors in the Funds the fact that Petters was having liquidity problems;

WHEREAS, on July 8, 2009, the United States Securities and Exchange Commission also brought a civil action (the "Receivership Case") against Bell and Lancelot Management in the District Court, which among other things named the other Receivership Parties and Asia Trust and Blue Sky Trust as relief defendants (case no. 09-1750) seeking return of approximately $41.7MM of management and incentive fees and interest;

WHEREAS, Bell pled guilty to and was convicted of the charge of wire fraud, and a money judgment was entered against him in the amount of $208,896,307 (the "Judgment"), which also is the subject of a separate repayment agreement between Bell and the United States Department of Justice;

WHEREAS, on November 3, 2010, the United States Securities and Exchange Commission instituted an administrative proceeding (the "SEC Administrative Proceeding") against Bell which barred him from association with any investment adviser (In the Matter of Gregory M. Bell, Investment Advisers Act Release No. 3102, 2010 SEC LEXIS 3689 (Nov. 3, 2010);

WHEREAS, on December 7, 2009, the Trustee brought suit against Bell, among others, asserting negligence, gross negligence, breach of fiduciary duty, unjust enrichment and the avoidability of certain transfers in the Bankruptcy Court in case no. 09-01252 (the "Trustee's Suit");

WHEREAS, on October 11, 2010, the District Court appointed the Receiver as the receiver for the Receivership Parties' assets;

WHEREAS, on August 30, 2011, for purposes of administration, an ancillary proceeding to the Receivership Case was filed in the United States District Court for the Northern District of Illinois (the "Illinois District Court") as case no. 11-06032 (the "Illinois Receivership Case").

WHEREAS, certain of the Receivership Parties have raised issues relating to which of the Receivership Parties' assets are proceeds of the management and incentive fees attributable to Petters' Ponzi scheme and/or the wire fraud to which Bell pled guilty;

WHEREAS, on July 22, 2013, in the Receivership Action, Bell signed a "Consent of Gregory M. Bell," in which he agreed to a final judgment including disgorgement of $41,702,834 ("Consent Agreement")—an amount Bell had previously declared as ordinary income from management and incentive fees;

WHEREAS, on December 16, 2013, Bell signed a "Notice of Intent to Collect Payment," reflecting his agreement to repay the forfeiture money judgment ("Repayment Agreement") entered on September 24, 2010, in the United States Federal Court for the District of Minnesota;

WHEREAS the Receiver now desires to marshal the Receivership Parties assets for distribution to the Net Losers; and

WHEREAS, the Parties each have consulted with their respective counsel in connection with the matters subject hereto;

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the Parties hereby agree as follows:

1. **Recitals Incorporated.** The recitals and prefatory phrases and paragraphs set forth above are hereby incorporated in full, and made a part of, this Settlement Agreement.

2. **Definitions.**

a. "Affidavits" has the meaning set forth in Section 4(a)(viii) hereof.

b. "Agreement" has the meaning set forth in the preamble hereto.

c. "Affiliated Entities" has the meaning set forth in the preamble hereto.

d. "Applewood Mortgage" has the meaning set forth in Section 3(a)(iv) hereof.

e. "Applicable Law" shall mean all applicable laws, statutes, treaties, rules, codes, ordinances, regulations, certificates, orders, interpretations, licenses and permits of any Governmental Authority and judgments, decrees, injunctions, writs, orders or like action of any court, arbitrator or other administrative, judicial or quasi-judicial tribunal or agency of competent jurisdiction

f. "Asia Trust" has the meaning set forth in the preamble hereto.

g. "Bankruptcy Cases" has the meaning set forth in the sixth "whereas" clause hereto.

h. "Bankruptcy Court" has the meaning set forth in the sixth "whereas" clause above.

i. "Bell" has the meaning set forth in the preamble hereto.

j. "Bell Assets" has the meaning set forth in Section 3(c) hereof.

k. "Bell Children" has the meaning set forth in the preamble hereto.

l. "Bell Parties" has the meaning set forth in the preamble hereto.

m. "Bell Trust" has the meaning set forth in the preamble hereto.

n. "Blue Sky" has the meaning set forth in the preamble hereto.

o. "Blue Sky Trust" has the meaning set forth in the preamble hereto.

p. "Consent Agreement" has the meaning set forth in the fifteenth "whereas" clause above.

q. "David" has the meaning set forth in the preamble hereto.

r. "David Bell Assets" has the meaning set forth in Section 3(e) hereof.

s. "Debtors" shall mean collectively the Funds and SWC Services, LLC, Lien Acquisition, LLC, AGM, LLC, AGM II, LLC, KD1, LLC, KD2, LLC, KD3, LLC, KD4, LLC, KD5, LLC, KD6, LLC, KD7, LLC, KD8, LLC, RWB Services LLC, and Surge Capital, LLC, all of whose Chapter 7 cases are being jointly administered by the Bankruptcy Court under case no. 08-28225.

t. "District Court" has the meaning set forth in the eighth "whereas" clause above.

u. "DOJ" has the meaning set forth in the preamble hereto.

v. "Effective Date" has the meaning set forth in Section 5(c) hereof.

w. "Final and Non-Appealable" shall mean that the order had been entered after notice and a hearing, the order is final for purposes of 28 U.S.C. §§158 and 1291, the order is no longer subject to appeal or *certiorari* proceedings and no appeal or *certiorari* proceedings is pending.

x. "Funds" has the meaning set forth in the first "whereas" clause above.

y. "Freeze Orders" shall mean collectively that certain "Temporary Restraining Order and Order Imposing Asset Freeze and Other Ancillary Relief" entered by the District Court on the docket of the Receivership Case at docket no. 18, that certain "Agreed Order of Preliminary Injunction Asset Freeze and Other Ancillary Relief" entered by the District Court on the docket of the Receivership Case at docket no. 45, that certain "Agreed Order of Asset Freeze and Other Ancillary Relief" entered by the District Court on the docket of the Receivership Case at docket no. 46, and that certain "Order of Asset Freeze and Other Ancillary Relief as to Relief Defendants Asia Trust, Ltd. and Blue Sky Trust" entered on the docket of the Receivership Case at docket no. 52.

z. "Goldman" has the meaning set forth in the preamble hereto.

aa. "Goldman Assets" has the meaning set forth in Section 3(b) hereof.

bb. "Goldman Trust" has the meaning set forth in the preamble hereto.

cc. "Governmental Authority" shall mean, with respect to the United States, any federal, state, county, municipal or other governmental authority or judicial or regulatory agency, board, body, commission, instrumentality, court or quasi-governmental authority from time to time, and, in the case of any foreign governmental authority, all similar entities to the foregoing having jurisdiction over any Person that is a Party to this Agreement, any property of any of them or any of the transactions contemplated by this Agreement.

dd. "Illinois District Court" has the meaning set forth in the thirteenth "whereas" clause above.

ee. "Illinois Receivership Proceeding" has the meaning set forth in the thirteenth "whereas" clause above.

ff. "Joint Assets" has the meaning set forth in Section 3(d) hereof.

gg. "Judgment" has the meaning set forth in the ninth "whereas" clause above.

hh. "Lancelot Management" has the meaning set forth in the preamble hereto.

ii. "Lexus" has the meaning set forth in Section 3(a)(vi).

jj. "Management Entities" has the meaning set forth in the first "whereas" clause above.

kk. "Marshalling Account" has the meaning set forth in Section 3(a)(i) hereof.

ll. "Net Losers" has the meaning set forth in the fifth "whereas" clause above.

mm. "Notice of Compliance" has the meaning set forth in Section 5(b) hereof.

nn. "Oakton Mortgage" has the meaning set forth in Section 3(a)(iii) hereof.

oo. "Party" and "Parties" have the meanings set forth in the preamble hereto.

pp. "Person" shall mean any individual, corporation, partnership, joint venture, association, joint stock company, trust, unincorporated organization, Governmental Authority or any other entity.

qq. "Personal Property" has the meaning set forth in Section 3(c)(ii) hereof.

rr. "Peterson" has the meaning set forth in the preamble hereto.

ss. "Petters" has the meaning set forth in the forth "whereas" clause above.

tt. "Rebecca" has the meaning set forth in the preamble hereto.

uu. "Rebecca Bell Assets" has the meaning set forth in Section 3(f) hereof.

vv. "Receiver" has the meaning set forth in the preamble hereto.

ww. "Receiver Accounts" has the meaning set forth in Section 3(a)(i) hereof.

xx. "Receiver Assets" has the meaning set forth in Section 3(a) hereof.

yy. "Receivership Case" has the meaning set forth in the tenth "whereas" clause above.

zz. "Receivership Parties" has the meaning set forth in the preamble hereto.

aaa. "Repayment Agreement" has the meaning set forth in the seventeenth "whereas" clause above.

bbb. "SEC" has the meaning set forth in the preamble hereto.

ccc. "Spruce" has the meaning set forth in the preamble hereto.

ddd. "Spruce Street Home" has the meaning set forth in Section 3(a)(ii) hereof.

eee. "Tax Refunds" has the meaning set forth in Section 4(a)(ii) hereof.

fff. "Trustee" has the meaning set forth in the preamble hereto.

ggg. "Trustee's Suit" has the meaning set forth in the eleventh "whereas" clause above.

hhh. "United States" has the meaning set forth in the preamble hereto.

iii. "Wellington" has the meaning set forth in the preamble hereto.

jjj. "Wellington Assets" has the meaning set forth in Section 3(g) hereof.

3. **Allocation of Assets.** The Parties agree that upon the Effective Date, the assets of the Bell Parties shall be allocated as follows:

a. The Receiver shall receive, for distribution to the Net Losers as and to the extent authorized by the District Court, the funds and other assets set forth below (collectively, the "Receiver Assets"):

i. All funds and assets in the following accounts, which total approximately $ 28 million: Merrill Lynch acct. no. 69F-946633 (Goldman f/b/o Rebecca), Merrill Lynch acct. no. 69F-946634 (Goldman f/b/o David), JP Morgan Chase acct. no. Q55183-00-0 (Spruce), PrivateBank acct. no. 2322123 (Receiver) (the "Marshalling Account"), PrivateBank acct. no. 0002173396 (Blue Sky), and the $4,248,563.93 held in the Bank of America internal account associated with ref. no. U071009000856 (collectively, the "Receiver Accounts").

ii. The real property commonly known as 1947 Spruce Street, Highland Park, Illinois 60635 (the "Spruce Street Home").

iii. The mortgage in favor of Lancelot Investment Management LLC dated 9/13/06 and recorded 9/19/06 as document no. 0626222060 on the property commonly known as 5001 Oakton #404, Skokie, IL, ID no. 10-28-201-034-1015 (the "Oakton Mortgage").

iv. The mortgage in favor of Goldman dated 11/10/05 and recorded 5/20/08 as document no. 6348049 on the property commonly known as 3175 Applewood, Highland Park, IL, ID no. 16-16-103-011-0000 (the "Applewood Mortgage").

v. The Overpayment of taxes remaining on 2013 Federal Income Tax Return.

vi. All shares, membership interests, partnership interests or other incidences of ownership, including approximately $1.9MM in frozen distributions held by Helix Funds in the following entities and all proceeds thereof: Spruce Family Partnership, Helix Rainbow Lake LLC, RC Westwood Estate Investors LLC, RC Pheasant Lake Estate LLC, and RC Arc Investors LLC. Upon the Effective Date, the Receiver shall change the taxpayer identification numbers for each of these entities so that they are no longer recorded as related to Inna Goldman.

vii. The 2002 Lexus SL 430 titled in the name of Bell (the "Lexus").

viii. All claims totaling $160,896,244 to deferred compensation, management fees, and/or incentive fees related to any of the Funds or Management Entities.

ix. Any and all investments in the Funds by Gregory Bell, Gregory Bell IRA and Gregory Bell SEP-IRA valued $1,819,305 pre-petition .

b. Goldman shall retain, free and clear of all claims of the Receiver (collectively, the "Goldman Assets"):

i. All funds and assets in the following accounts: Synergy Non-Affiliated Employers Retirement acct. no. Plan ID401363, American Funds IRA acct. no. 63667407, Vanguard IRA acct. no. 09879926811, and Vanguard IRA acct. no. 88027040942;

ii. 2004 Lexus GX 470.

iii. Funds from Account Nos. xxxxxxxx4624 and Account No. xxxxxxxx0904 at Bank of America, which were previously transferred into Goldman's Fifth Third Bank Account (ending in 8890) by order of the Receivership Court [Dkt. No. 145 at 5].

iv. One-hundred percent of the ownership interests in Wellington, which, in turn, shall retain, free and clear of all claims of the Receiver (collectively, the "Wellington Assets"):

1. All funds and assets in the following account: Bank of America acct. no. 291006076627.

2. The real property commonly known as 445 Wellington, Unit 12H, Chicago, Illinois 60657.

v. All personal property housed at the Spruce Street Home (the "Personal Property").

c. Bell shall retain, free and clear of all claims of the Receiver (collectively, the "Bell Assets"):

i. All funds and assets in the following accounts: Vanguard IRA acct. no. 88027041462 and Vanguard IRA acct. no. 88032279355.

d. Bell and Goldman jointly shall retain, free and clear of all claims of the Receiver (collectively, the "Joint Assets") :

i. All funds and assets in the following accounts: Vanguard acct. no. 9898839785 (Bell and Goldman JTWROS) and JP Morgan Chase acct. no. 01110020839221 (Bell and Goldman JTWROS).

4. **Cooperation with Marshalling of Assets.**

a. As promptly as practicable after the Effective Date, and in no event more than 10 business days thereafter, the Bell Parties shall take all steps reasonably requested by the Receiver to:

i. Transfer all funds and other assets held in the Receiver Accounts to the Marshalling Account.

ii. File tax returns (or amended tax returns) with the Internal Revenue Service for the tax year 2013 requesting the payment of the overpayments/refunds due into the Marshalling Account, with $300,000 held and to be returned after 3 years audit period limitation to cover potential liabilities on capital gains on assets turned over to the Receiver and provide the Receiver with copies of such returns. Nothing in this provision or in this Agreement suggests that the IRS will or will not pay overpayments or refunds due to any party.

iii. Sign and deliver to the Receiver the quitclaim deed for the Spruce Street Home attached hereto as Exhibit A.

iv. Sign and deliver to the Receiver the [stock powers] attached hereto as Exhibits B, C, __ and __.

v. Sign and deliver to the Receiver the assignments of the Applewood Mortgage and the Oakton Mortgage attached hereto as Exhibits D and E.

vi. Sign and deliver to the Receiver title to the Lexus within 30 days of settlement.

vii. On the date of the closing of the sale of the house by the Receiver (provided the Receiver provides two-weeks advance notice of any closing), vacate the Spruce Street Home, including removing the Personal Property and delivering possession thereof to the Receiver.

b. Each of Bell and Goldman shall deliver to the Receiver affidavits (the "Affidavits") in the form attached hereto as Exhibit F attesting that neither owns or controls, directly or indirectly, assets with a value in excess of $25000 except those assets described in Section 3 hereof.

c. As promptly as practicable, but in no event more than 5 business days after the last of the receipt by the Receiver of (a) all funds due to the Marshalling Account under Sections 4(a)(i) and 4(a)(ii), (b) the deliveries required Sections 4(a)(iii), 4(a)(iv), 4(a)(v) and 4(a)(vi), (c) the delivery of a quit claim deed of the Spruce Street Home as set forth in Section 4(a)(vii), and (d) the delivery to the Receiver of the Affidavits as set forth in Section 4(b) hereof, the Receiver (x) shall file the Notice of Compliance with the District Court, and (y) file a notice of dismissal of the Trustee's Suit with the Bankruptcy Court.

5. **Effectiveness.**

a. As promptly as practicable upon the execution of this Agreement by all Parties hereto, the Receiver and the Trustee shall provide to counsel for Goldman drafts of motions seeking approval of this Agreement ("Approval Motions") from the District Court, the Illinois District Court, and the Bankruptcy Court seeking approval of this Agreement.

b. As promptly as practicable, counsel for Goldman shall review the draft Approval Motions, make only necessary changes, and return the draft Approval Motions to the Receiver and the Trustee. Counsel for Goldman shall not unnecessarily withhold approval on the Approval Motions.

c. As promptly as practicable after counsel for Goldman has reviewed and approved the Approval Motions, the Receiver and Trustee shall file the Approval Motions with the District Court, the Illinois District Court, and the Bankruptcy Court seeking approval of this Agreement.

d. Without limiting the generality of the foregoing, the motion filed with the District Court will also request that the Freeze Orders be vacated upon the filing, by the Receiver, of a "Notice of Compliance" (the "Notice of Compliance") certifying that all obligations of the Bell Parties under this Agreement have been complied with.

e. The "Effective Date" of this Agreement shall be the date on which the last of the following occurs: (a) a District Court order approving this Agreement shall have become Final and Non-Appealable; (b) an Illinois District Court order approving this Agreement shall have become Final and Non-Appealable; and (c) a Bankruptcy Court order approving this settlement shall have become Final and Non-Appealable.

f. The Parties may jointly waive the requirement that the aforementioned orders by Final and Non-Appealable.

6. **Waivers and Releases of Claims.**

a. Subject to and conditioned upon the occurrence of (i) the Effective Date and (ii) the issuance of a Final and Non-Appealable order from the District Court lifting the asset freeze, the Receiver shall require, as a condition of any Net Loser receiving a distribution from the Receiver Assets, that any such Net Loser first sign a release and waiver of any and all claims they may have against either Goldman or Bell.

b. Subject to and conditioned upon the occurrence of (i) the Effective Date, and (ii) the satisfaction of all the conditions for the filing of a Notice of Compliance set forth in Section 4(b), each of the Parties except for the DOJ, and each of their officers, agents, professionals, employees, attorneys, other legal representatives, affiliates, predecessors, successors and assigns, and each of them (collectively, the "Releasors"), shall be conclusively deemed to have unconditionally, absolutely, and irrevocably released all other Parties and their officers, agents, professionals, employees, attorneys, other legal representatives, affiliates, predecessors, heirs, agents, successors and assigns, and each of them (collectively, the "Releasees") with respect to any and all actions, causes of action, suits, debts, accounts, promises, warranties, damages and consequential damages, demands, agreements, costs, expenses, claims or demands whatsoever, of any kind or nature, whether known or unknown, liquidated or unliquidated, disputed or undisputed, contingent, inchoate, or matured, in law or in equity, arising in connection with or relating to the Bankruptcy Cases, the Receivership Case, the Illinois Receivership Proceeding, the Trustee's Suit, the SEC Administrative Proceeding, or the Debtors, including any claims, surcharges or causes of action under chapter 5 of the Bankruptcy Code, which each of the Releasors have or ever had against the Releasees on or at any time prior to the date of this Agreement; provided, however, that for avoidance of doubt, nothing herein shall be deemed to release the Judgment which is the subject of the Repayment Agreement; and provided further that nothing contained in this Section 6 shall be deemed or construed to be a release, waiver or discharge of the terms and conditions of this Agreement.

c. The DOJ covenants and agrees that, notwithstanding the survival of the Judgment and the Repayment Agreement, it waives any right to, and covenants not to seek recovery from, the Goldman Assets, the Bell Assets, or the Joint Assets as partial satisfaction of the Judgment.

d. Notwithstanding anything to the contrary in the foregoing, the SEC remains able to enforce its permanent injunction in the Receivership Case and the injunctive relief it obtained in the Order in the SEC Administrative Proceeding.

7. **Stay of Claims**. The Parties agree that the Trustee and Receiver shall seek a stay ("Stay") from the District Court and the Illinois District Court of any and all claims against Goldman, Bell, the Goldman Assets, the Bell Assets, or the Joint Assets arising out of the events described in the Recitals.

a. The Trustee and Receiver shall seek the Stay as promptly as possible after the Effective Date. Counsel for Goldman shall provide requested assistance in obtaining the Stay.

b. The Stay is to remain in place, as long as Bell remains compliant with the Repayment Agreement, until the Repayment Agreement is fully satisfied.

c. Notwithstanding the foregoing, the stay shall not limit the SEC's ability to enforce the injunctive relief it has obtained in the Receivership Case or the SEC Administrative Proceeding.

d. Nothwithstanding the foregoing, and except as provided in Section 6c above, the stay shall not limit the DOJ's ability to amend the Repayment Agreement or to enforce the Judgment.

8. **Jurisdiction and Governing Law.** The Parties agree that the District Court shall retain jurisdiction to the fullest extent possible over the interpretation and enforcement of this Agreement, and over any dispute between them in any way related to this Agreement. The Parties further agree that this Agreement shall be construed and governed by the laws of the State of Illinois, irrespective of its choice of law rules.

9. **Entire Agreement.** This Agreement constitutes the entire agreement of the Parties as to the subject matter hereof (except, as between Bell and the DOJ, for the Repayment Agreement) and is the final and complete expression of their intent. The undersigned

acknowledge that there are no communications or understandings, oral or written, contrary, different, or which in any way restrict this Agreement. The undersigned further acknowledge that all prior agreements, communications, and understandings within the scope of the subject matter of this Agreement are, upon execution of this Agreement, superseded, null and void. This Agreement can only be changed, modified or discharged if consented to in writing executed by the Parties hereto and, if applicable, approved by order of the District Court.

10. **Counterparts.** This Agreement may be executed in one or more counterparts, via facsimile or electronic means; each counterpart to be considered an original portion of this Agreement.

11. **Enforcement**. Notwithstanding anything herein to the contrary, to the extent that an action is brought to enforce any provision of this Agreement, the prevailing party in that action shall be entitled to an award of its reasonable attorneys' fees and costs of maintaining the action, except that notwithstanding the foregoing, no attorney's fees or costs shall be imposed against the SEC or DOJ.

12. **Advice of Counsel.** The Parties acknowledge that each Party has had the opportunity to make an investigation of the facts pertaining to this Agreement and all matters pertaining thereto, as it deems necessary. The Parties further acknowledge: (a) each Party is represented by experienced counsel; (b) each Party has read this Agreement and understands its contents; and (c) each Party is entering into this Agreement voluntarily and without duress, and with a full understanding of its terms. The Parties agree that no Party shall later seek to overturn or invalidate any aspect of this Agreement on grounds of unconscionability, oppression or any similar reason.

13. **No Admissions.** Nothing contained in this Agreement shall be deemed to be an admission, by any Party, of any fact, matter, claim or defense previously in dispute. Each Party is aware that it may hereafter discover claims or facts in addition to or different from those it now knows or believes to be true. Nevertheless, it is the intention of the Parties to fully, finally, and forever settle and release any and all controversies among themselves, and all claims relative thereto, that do now exist or heretofore have existed between them as and to the extent expressly provided herein. In furtherance of such intention, the releases given herein shall be and remain in effect as full and complete releases of all such matters, notwithstanding the discovery or existence of any additional or different claims or facts relative thereto.

14. **Covenant of Further Assurances.** The Parties covenant and agree that, from and after the execution and delivery of this Agreement, they shall, execute, deliver and file any and all documents and instruments as are reasonably necessary or requested by the other Party to obtain approval of or implement the terms of this Agreement, and shall not take any action to directly or indirectly oppose the approval of this Agreement.

15. **Representations and Warranties.** Each Party hereto, severally, hereby represents and warrants as of the Effective Date that, subject to the approval of this Agreement by the District Court, the Illinois District Court, and the Bankruptcy Court:

a. it has all requisite power and authority and legal right to execute, deliver, and perform its obligations under this Agreement, to consummate the transactions contemplated hereby, and to carry out and perform its obligations under this Agreement;

b. its execution, delivery, and performance of this Agreement (i) has been duly authorized by all necessary action, (ii) does not violate any Applicable Law, (iii) does not require the consent or approval of, the giving notice to, or the registration with, or the taking of any other action with respect to, any Governmental Authority or any third Person (except such as shall have been duly obtained or given and are in full force and effect), and (iv) does not contravene or constitute a default under its organizational documents or any indenture, mortgage, contract or agreement to which it is party or by which it is bound, or any judgment or order binding on it;

c. with the exception of the Receivership Case, the Illinois Receivership Proceeding, the Bankruptcy Cases, the Trustee's Suit, and the SEC Administrative Proceeding, no action or proceeding has been instituted by it, and it is not aware of (i) any action or proceeding that has been instituted by any other Person, or (ii) any action, proceeding or action by any Governmental Authority that is threatened, or (iii) any order, judgment or decree that has been issued or proposed to be issued, at the Effective Date to set aside, restrain, enjoin or prevent the completion and consummation of the transactions contemplated by this Agreement; and

d. this Agreement constitutes the legal, valid and binding obligations of such Party and is enforceable in accordance with its terms, except as such enforceability may be limited by applicable bankruptcy, insolvency, reorganization, moratorium or similar laws affecting the rights of creditors generally and by general principles of equity.

16. **Notices.** Any and all notices required or permitted under this Agreement and any and all correspondence shall be in writing and shall be personally delivered or mailed by registered or certified mail, return receipt requested, or by overnight delivery to the Parties at the addresses designated with their respective signatures below, unless and until a different address has been designated by written notice to the other Parties.

[Signature pages follow.]

IN WITNESS WHEREOF, the Parties hereto, each by persons duly authorized, have caused the Settlement Agreement to be executed as of the day and year first written above.

GREGORY BELL

By:______________________________

Notice address:

Vincent P. (Trace) Schmeltz III
Barnes & Thornburg LLP
One North Wacker Drive
Suite 4400
Chicago, Illinois 60606
Attn: Vincent P. (Trace) Schmeltz III
Email: tschmeltz@btlaw.com [***for all Bell-related entities/individuals***]

THE GREGORY BELL REVOCABLE TRUST

By:______________________________
Its:______________________________

Notice address:

____
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____
____
Attn:
Email:

RONALD R. PETERSON, NOT INDIVIDUALLY BUT IN HIS CAPACITY AS THE CHAPTER 7 CASE TRUSTEE FOR THE DEBTORS

By: Ron Peterson

Notice address:

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Attn:
Email:

RONALD R. PETERSON, NOT INDIVIDUALLY BUT IN HIS CAPACITY AS THE COURT APPOINTED RECEIVER FOR THE ASSETS OF THE RECEIVERSHIP PARTIES

By: Ron Peterson

Notice address:

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Attn:
Email:

LANCELOT INVESTMENT MANAGEMENT, LLC

By:______________________________
Its:______________________________

Notice address:

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Attn:
Email:

INNA GOLDMAN

By:______________________________

Notice address:

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Attn:
Email:

THE INNA GOLDMAN REVOCABLE TRUST

By:______________________________
Its:______________________________

Notice address:

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Attn:
Email:

12H WELLINGTON LLC

By:______________________________
Its:______________________________

Notice address:

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Attn:
Email:

SPRUCE FAMILY PARTNERSHIP L.P.

SPRUCE INVESTMENT MANAGEMENT LLC

By:___Leonid Goldman____________________
Its:___President________________________

Notice address:

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Attn:
Email:

BLUE SKY INVESTMENT HOLDINGS LLC

By:_______________________________
Its:_______________________________

Notice address:

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Attn:
Email:

UNITED STATES DEPARTMENT OF JUSTICE

By: James S. Alexander
Its: Assistant U.S. Attorney

Notice address:

600 U.S. Courthouse
300 South Fourth Street
Minneapolis, MN 55415
____
Attn:
Email: jim.alexander@usdoj.gov

BLUE SKY TRUST

By:_______________________________
Its:_______________________________

Notice address:

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Attn:
Email:

SECURITIES AND EXCHANGE COMMISSION

By:____________________
John E. Birkenheier
Its: Supervisory Trial Counsel

Notice address:

175 W. Jackson Blvd., Suite 900
Chicago, Illinois 60604
Attn: John E. Birkenheier
Email: birkenheierj@sec.gov

IN WITNESS WHEREOF, the Parties hereto, each by persons duly authorized, have caused the Settlement Agreement to be executed as of the day and year first written above.

GREGORY BELL

By: G Bell

Notice address:

Vincent P. (Trace) Schmeltz III
Barnes & Thornburg LLP
One North Wacker Drive
Suite 4400
Chicago, Illinois 60606
Attn: Vincent P. (Trace) Schmeltz III
Email: tschmeltz@btlaw.com [*for all Bell-related entities/individuals*]

THE GREGORY BELL REVOCABLE TRUST

By: G Bell
Its: GRANTOR

Notice address:

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____
Attn:
Email:

RONALD R. PETERSON, NOT INDIVIDUALLY BUT IN HIS CAPACITY AS THE CHAPTER 7 CASE TRUSTEE FOR THE DEBTORS

By: __________

Notice address:

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Attn:
Email:

RONALD R. PETERSON, NOT INDIVIDUALLY BUT IN HIS CAPACITY AS THE COURT APPOINTED RECEIVER FOR THE ASSETS OF THE RECEIVERSHIP PARTIES

By: __________

Notice address:

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Attn:
Email:

LANCELOT INVESTMENT MANAGEMENT, LLC

By: [signature]
Its: MANAGER

Notice address:

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Attn:
Email:

INNA GOLDMAN

By: Inna Goldman

Notice address:

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Attn:
Email:

THE INNA GOLDMAN REVOCABLE TRUST

By: Inna Goldman
Its: GRANTOR

Notice address:

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Attn:
Email:

12H WELLINGTON LLC

By: Inna Goldman
Its: MANAGER

Notice address:

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Attn:
Email:

SPRUCE FAMILY PARTNERSHIP L.P.

SPRUCE INVESTMENT MANAGEMENT LLC

By: Leonid Goldman *Leo Goldman*
Its: President

Notice address:

Attn:
Email:

BLUE SKY INVESTMENT HOLDINGS LLC

By: *G Bell*
Its: *GRANTOR*

Notice address:

Attn:
Email:

UNITED STATES DEPARTMENT OF JUSTICE

By:
Its:

Notice address:

Attn:
Email:

BLUE SKY TRUST

By: *G Bell*
Its: *GRANTOR*

Notice address:

Attn:
Email:

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

RS INVESTMENTS LIMITED, ET AL.,

Plaintiffs,

v.

Case No.: 2016LO11459

RSM US LLP, RSM CAYMAN LTD, AND SIMON LESSER,

Defendants.

AFFIDAVIT OF ARISTOTELIS ALEXANDROS GALATOPOULOS

I, ARISTOTELIS ALEXANDROS GALATOPOULOS, of Ugland House, South Church Street, George Town, Grand Cayman, Cayman Islands MAKE OATH and SAY as follows:

1 I am a Partner and the Head of the Litigation Department of the Cayman Islands office of Maples and Calder, attorneys-at-law practising at the above address.

2 I make this Affidavit in connection with the Complaint dated 21 November 2016 filed in the Circuit Court of Cook County, Illinois (the "Complaint"), against RSM US LLP, RSM Cayman Ltd and Simon Lesser.

3 I graduated from Cambridge University in 1988 with a BA Honours degree in Law. I qualified as a solicitor of the Supreme Court of England and Wales in 1991. Between 1991 and late 2001 I practised as a solicitor in the City of London with Clifford Chance (now Clifford Chance LLP). I joined Maples and Calder in October 2001 and was admitted as a Cayman Islands attorney in January 2002. I have been a Partner of Maples and Calder since 1 December 2003.

4 I am a litigation specialist and I act for a wide variety of clients in relation to disputes in the investment funds and financial services sectors. Much of my work is also bankruptcy related. I have acted for a number of auditors in audit negligence cases.

5 Maples and Calder is one of the largest law firms based in the Cayman Islands, having over 300 lawyers and 500 support staff based in offices in George Town, Grand Cayman as well as Dublin, London, Hong Kong, Singapore, Dubai and the British Virgin Islands. In addition to advising on all aspects of Cayman Islands law, Maples and Calder and its affiliates provides registered offices and related administrative and legal services to a significant number of Cayman Islands companies and limited partnerships.

An overview of the Cayman Islands

6 The Cayman Islands are a British Overseas Territory. The legal system is a common law system founded on the English system. Specific sources of Cayman Islands law are Cayman Islands legislation, English legislative provisions extended to the Cayman Islands by United Kingdom Orders in Council, Cayman Islands case law and case law from England and other common law jurisdictions.

7 The doctrine of judicial precedent applies in the Cayman Islands as it applies in England. The ultimate court of appeal is the Judicial Committee of the Privy Council, whose decisions are binding on the Cayman Islands Court of Appeal and the Cayman Islands Grand Court. Decisions of the Cayman Islands Court of Appeal are similarly binding on the Grand Court. Where there is no applicable Cayman Islands case law, the Cayman Islands Court will generally follow English appellate authorities to the extent they are not inconsistent with Cayman Islands statute or authority and do not relate to English statutory provisions that have no equivalent in the Cayman Islands. Such authorities are persuasive but not binding on the Cayman Islands Court. Similarly, decisions of the appellate courts of other Commonwealth jurisdictions are also of persuasive, but not binding, authority.

Scope of Instructions

8 I have been requested by the law firm of Williams & Connolly LLP, which represents RSM US LLP and Simon Lesser, to set forth the relevant law of the Cayman Islands. I have reviewed the Complaint. I have not been provided with any other pleadings or documents relating to these proceedings. I express no opinion as to whether Cayman Islands law would apply to the claims made by the Plaintiffs in these proceedings.

The Plaintiffs' Claims

9 The following causes of action are asserted by the Plaintiffs:

(a) Common law fraud and fraudulent inducement;

(b) Negligent misrepresentation; and

(c) Professional malpractice.

10 Various forms of relief are sought, including damages and punitive damages.

11 The claims are predicated on a set of factual allegations that may be summarised as follows:

(a) The Plaintiffs are the beneficial owners of shares in a Cayman fund known as Lancelot Investors Fund, Ltd (which is referred to in the Complaint as "Lancelot Offshore" or the "Fund" and I will use the former definition in this affidavit);

(b) The Defendants were, at all material times, outside auditors for Lancelot Offshore and their annual audit reports, for the years ended 5 January 2004 to 5 January 2008, were addressed to the Plaintiffs;

(c) The Plaintiffs have relied on some of these reports and/or the Defendants' services generally in connection with the purchase and/or retention of shares in Lancelot Offshore;

(d) As a result the Plaintiffs lost their investments in Lancelot Offshore, when that fund was exposed as a victim of the Petters fraud.

12 Lancelot Offshore is currently in insolvent liquidation in the Cayman Islands and is in Chapter 7 bankruptcy in the United States.

Fundamental Propositions of Cayman Islands Company Law

13 The distinction between the personal rights of a shareholder in a Cayman Islands company, and the rights of the company itself, is fundamental in Cayman Islands law. Where a shareholder seeks to enforce a right that is vested in the company itself (as opposed to a

personal right of his own) he can only do so (if at all) by way of a derivative action.[1] This is because only the company may sue for damage that has been done to it.

14 The fact that a company is in liquidation means that a derivative claim cannot be brought by a shareholder, but does not mean that the company's rights now vest in the shareholders. Those rights remain vested in the company, but can now only be enforced by the liquidator on the company's behalf.[2]

15 Even if a shareholder is able to show that a wrong has been done to him, he cannot recover the loss he has suffered, in circumstances where that loss is a reflection of the loss that the company itself has suffered. In other words, if the company were to enforce its rights against the wrongdoer, and the result of that enforcement would be that the shareholder's loss would be made good, then the loss is reflective and the Cayman Islands courts will not allow the shareholder to proceed even if the shareholder has a separate and distinct cause of action. Of course if the shareholder cannot actually show that a wrong has been done to him – either

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1 *Renova v Gilbertson* [2009] CILR 268 and *Nedgroup Trust (Jersey) Limited v Renova Industries Limited* [2014] (2) CILR N-6.

2 See *Fargro Limited v Godfroy and Others* [1986] 1 WLR 1134, where in the context of a deadlocked company, the Court held as follows: *"...one starts from the position that as regards a claim such as is made in the present action which, putting it very compendiously, is that the defendants ...have diverted assets and opportunity belonging to the company to their own use, the proper plaintiff is the fourth defendant, the company. It is such because it is the company which has suffered the loss. Now if that company had not been in liquidation, it is conceded that the pleas contained in paragraph 8 and paragraph 28 of the statement of claim would have laid a proper foundation for a minority shareholders' action, because it would have been impossible for the plaintiff to have got the company to have taken any action against its other shareholder or indeed the other defendants. That is quite clearly because if the matter had been put to the board of the company the board would have been equally split. There would therefore have been no resolution to bring such an action. And if the matter had been carried to the shareholders in general meeting exactly the same result would have followed. Therefore, as a practical matter, it would have been totally impossible for the plaintiff to set the company in motion to bring the action and it is under those circumstances that a minority shareholders' action will lie. But once the company goes into liquidation the situation is completely changed, because one no longer has a board, or indeed a shareholders' meeting, which is in any sense in control of the activities of the company of any description, let alone its litigation. Here, what has happened is that the liquidator is now the person in whom that right is vested. Now, that being the case, the plaintiff can take a variety of courses. The plaintiff can ask the liquidator to bring the action in the name of the company. Doubtless, as in virtually all cases, the liquidator will require an indemnity from the persons who wish to set the company in motion against all the costs, including, of course, the costs of the defendant, which he may have to incur in bringing that action. The liquidator may ask for unreasonable terms or, on the other hand, the liquidator may be unwilling to bring the action, and under those circumstances it is always possible for the shareholders who wish the action to be brought to go to the court asking for an order either that the liquidator bring the action in the name of the company or, more usually, that they are given the right to bring the action in the name of the company, of course, against the usual type of indemnity, which will, if there is any difficulty about the matter, be settled by the court."* *Fargro* was applied by the Cayman Islands Grand Court in *In the Matter of The Sphinx Group of Companies* [2014] (2) CILR 131.

because the wrongdoer owes him no duty of care or because another element of the claim cannot be made out – then the shareholder will fail in any event.

16 The "no reflective loss" principle is well illustrated by the case of *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*.[3] The claimant minority shareholders in that case brought a derivative action in respect of damage suffered by the company as a result of fraud; the claimants also brought a personal claim for damages against the defendants. They alleged that the fraud had caused a reduction in the company's net profits, which in turn had adversely affected the value of the company's shares. The Court of Appeal viewed the personal claim as "misconceived".[4]

17 The decision in *Prudential Assurance Co Ltd v Newman Industries (No 2)* has been followed in England and has also been referred to and approved by the Cayman Islands Court of Appeal in *Svanstrom v Jonasson* [1997] CILR 192.

18 In *Renova Resources Private Equity Limited v Gilbertson* [2009] CILR 268 the Grand Court of the Cayman Islands applied the principle that a plaintiff bringing in a derivative action may not recover reflective loss.

19 The leading English authority on reflective loss, *Johnson v Gore Wood & Co* [2002] 2 AC 1, was also considered in *Renova Resources Private Equity Limited v Gilbertson*. *Johnson v Gore Wood & Co* is a decision of the English House of Lords, and the doctrine of reflective loss was considered by all five Law Lords. The speeches of Lord Bingham[5] and Lord Millett[6] are particularly instructive.

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3 [1982] Ch 204.

4 *"[A shareholder] cannot ... recover damages merely because the company in which he is interested has suffered damage. He cannot recover a sum equal to the diminution in the market value of his shares, or equal to the likely diminution in dividend, because such a "loss" is merely a reflection of the loss suffered by the company. The shareholder does not suffer any personal loss. His only loss is through the company, in the diminution in the value of the net assets of the company, in which he has (say) a 3% shareholding. The [claimant's] shares are merely a right of participation in the company on the terms of the articles of association. The shares themselves, his right of participation, are not directly affected by the wrongdoing. The [claimant] still holds all the shares as his own unencumbered property. The deceit practiced upon the [claimant] does not affect the shares; it merely enables the defendant to rob the company."*

5 Lord Bingham set out the following three principles: *(1) Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. A claim will not lie by a shareholder*

20 In a number of subsequent English decisions, the reflective loss principle has been held to apply even where the Court found that there was no risk of the shareholder and the company obtaining recovery in respect of the same loss, including because of a successful defence to the claims made by the company. For example, in *Day v Cook* [2002] 1 BCLC 1 at paragraph 38, Arden LJ explained that:

> *"It is not simply the case that double recovery will not be allowed so that, for instance, if the company's claim is not pursued or there is some defence to*

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to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss...(2) Where a company suffers loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it (if the shareholder has a cause of action to do so), even though the loss is a diminution in the value of the shareholding. ... (3) Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it, but neither may recover loss caused to the other by breach of the duty caused to that other."

[6] *"A company is a legal entity separate and distinct from its shareholders. It has its own assets and liabilities and its own creditors. The company's property belongs to the company and not to its shareholders. If a company has a cause of action, this represents a legal chose in action which represents part of its assets. Accordingly, where a company suffers loss as a result of an actionable wrong done to it, the cause of action is vested in the company and the company alone can sue. No action lies at the suit of a shareholder suing as such, though exceptionally he may be permitted to bring a derivative action in right of the company and recover damages on its behalf: see Prudential Assurance Co Ltd v Newman Industries (No 2) [1982] 1 All ER 354 at 357, [1982] Ch 204 at 210. Correspondingly, of course, a company's shares are the property of the shareholder and not of the company, and if he suffers loss as a result of an actionable wrong done to him, then prima facie he alone can sue and the company cannot. On the other hand, although a share is an identifiable piece of property which belongs to the shareholder and has an ascertainable value, it also represents a proportionate part of the company's net assets and if these are depleted the diminution in its assets will be reflected in the diminution in value of the shares. ...This causes no difficulty where the company has a cause of action and the shareholder has none, or where the shareholder has a cause of action and the company has none...Where the company suffers loss as a result of a wrong to the shareholder but has no cause of action in respect of its loss, the shareholder can sue and recover damages for his own loss, whether of a capital or income nature, measured by the diminution in the value of his shareholding. He must, of course, show that he has an independent cause of action of his own and that he has suffered personal loss caused by the defendant's actionable wrong. Since the company itself has no cause of action in respect of its loss, its assets are not depleted by the recovery of damages by the shareholder. The position is, however, different where the company suffers loss caused by the breach of a duty owed both to the company and to the shareholder. In such a case the shareholder's loss, in so far as this is measured by the diminution in value of his shareholding or the loss of dividends, merely reflects the loss suffered by the company in respect of which the company has its own cause of action. If the shareholder is allowed to recover in respect of such loss, then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders. Neither course can be permitted. This is a matter of principle; there is no discretion involved. Justice to the defendant requires the exclusion of one claim or the other; protection of the interests of the company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder."*

the company's claim, the shareholder can pursue his claim. The company's claim, if it exists, will always trump that of the shareholder.

Accordingly the court has no discretion. The claim cannot be entertained."

21 That case was decided after *Johnson v Gore Wood* and the Court relied on and applied that decision in its judgment.

22 I also note the decision of *Giles v Rhind* [2002] EWCA Civ 1428 which has been approved in a number of subsequent cases,[7] which includes the following statement:

> *"[The reflective loss principle] is not rooted simply in the avoidance of double recovery in fact; it extends to heads of loss which the company could have claimed but has chosen not to and therefore includes the case where the company has settled for less than it might...;"*

23 In *Barings plc (In liquidation) v Coopers & Lybrand* [2002] 2 BCLC 364 which I discuss further below in relation to the Plaintiffs' negligence claims, a bank traded in securities and futures through a subsidiary (BSL), which incorporated a subsidiary in Singapore (BFS) to trade on behalf of BSL and the bank's other subsidiaries and other clients. The manager of BFS used a secret account to carry out unauthorised trading and incurred huge losses. The auditors of BFS at the relevant times did not detect the manager's activities.

24 The bank and BSL issued proceedings against the auditors alleging that the manager's activities remained undetected because of the auditors' negligence. The auditors filed a defence and counterclaim which alleged they had been deceived into signing the audit by a directors' representation letter from BFS that there had been no irregularities with management or employees and that there were no errors in the financial statements. The auditors also applied to strike out two of the claims on the grounds that those claims ought properly be brought by BFS, not the bank and BSL, and the claims were reflective of BFS's claims. The bank and BSL submitted that the rule preventing reflective loss did not apply because if the claims were brought by BFS then the auditors would have a "complete defence" by reason of a claim in deceit based on the directors' representation letter.

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[7] Including the English Court of Appeal decisions in *Gardner v Parker* [2004] 2 BCLC 554 and *Webster v Sanderson* [2009] 2 BCLC 542.

25 Evans-Lomb J, after a detailed review of the decisions in *Johnson v Gore Wood* and *Day v Cook*, came to the conclusion that the fact that the third party may have one or more defences to a claim against it by the company was not sufficient to oust the reflective loss principle. The Court indicated, without reaching a final conclusion, that in determining whether this limit on the reflective loss principle applies, a distinction had to be drawn between "cases where was no claim at all and those where the claim existed but was subject to a defence." The Court held that the "complete defence" based on deceit did not "permit...BSL, as a shareholder of BFS, to sue for reflective loss." (see paragraphs 128 and 137 of the judgment).

26 More recently, in *Malhotra v Malhotra* [2015] 1 BCLC 428 (at paragraph 54) the English High Court described an exception to the reflective loss principle as being:

> *"Where the company itself has no cause of action (eg because it was not a party to the relevant contract; or was not owed a duty of care in tort; or did not exist at the time of the wrongful conduct but was incorporated subsequently)...".*

27 I turn now to consider the various causes of action that are pleaded against the Defendants.

Count 1: Common Law Fraud and Fraudulent Inducement

<u>Overview</u>

28 Common law fraud is known as deceit under Cayman Islands law. The tort can be stated as follows: where a false representation is made which the party making it knows to be untrue, or is reckless, in the sense that he makes the representation without caring whether it is true or false, with the intent, or which from the mode in which it is made is calculated to induce another to act on the faith of it in such a way as that he may incur damage, and that damage is actually incurred.

29 In the case of *Derry v Peek* (1889) 14 App Cas 337 it was held that negligence was insufficient to establish the tort of deceit. Lord Herschell summarised the principles relating to deceit as follows:

"Having now drawn attention, I believe, to all the cases having a material bearing upon the question under consideration, I proceed to state briefly the conclusions to which I have been led. I think the authorities establish the following propositions: First, in order to sustain an action of deceit, there must be proof of fraud, and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states. To prevent a false statement being fraudulent, there must, I think, always be an honest belief in its truth. And this probably covers the whole ground, for one who knowingly alleges that which is false, has obviously no such honest belief. Thirdly, if fraud be proved, the motive of the person guilty of it is immaterial. It matters not that there was no intention to cheat or injure the person to whom the statement was made."

30 Lord Herschell continued:

"In my opinion making a false statement through want of care falls far short of, and is a very different thing from, fraud, and the same may be said of a false representation honestly believed though on insufficient grounds."[8]

31 Honest belief in the truth of a statement on the part of the representor will negative the necessary requirement of knowledge even if extravagant or ill-founded and however much it might objectively be taken to mean something else.[9]

32 I address each of the elements of the tort in turn below.

<u>False representation of fact</u>

33 The first element of the cause of action in deceit which the Plaintiffs would need to establish is that the Defendants made some false representation of fact to the Plaintiffs.[10] It is not

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8 The dictum of Lord Herschell was applied in *Bodden v Ferryman Invs. and O'Brien* [1992-3] CILR N-8.

9 *Gross v Lewis Hillman* [1970] Ch 445.

enough simply to allege that there was a false representation by the Defendants. A false representation must have been either made by the Defendants to the Plaintiffs directly (or to a class to which they belong), or made to a third party with the intention that it be passed to the Plaintiffs.[11] If the Plaintiffs cannot show the communication of a false representation to them, this claim would fail.

Knowledge or recklessness of false representation

34 In order to establish this element of the claim, the Plaintiffs would have to plead (and ultimately prove) sufficient particularised facts from which it could be inferred that at the time they issued their audit reports, the Defendants either knew or were reckless as to whether the reports contained false representations, or had no honest belief in the truth of the reports.[12]

35 In this context, recklessness means the making of a representation without caring whether it is true or false. It is not simply tantamount to negligence. On the contrary, it is akin to the making of a representation without any belief in its truth. In *Derry v Peek (1889)* 14 App Cas 337 (at page 374) Lord Herschell stated:

> *"...fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a false statement under such circumstances can have no real belief in the truth of what he states."*

36 In *AIC Ltd v ITS Testing Services (UK) Ltd* [2006] EWCA Civ 1601 Rix LJ described this element of the cause of action in the following terms (at paragraphs 256):

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10 The elements of deceit are set out in the recent decision of the English Court of Appeal in *Eco3 Capital Ltd v Ludsin Overseas Ltd* [2013] EWCA Civ 413 at paragraph 77.

11 *Renault UK Ltd v Fleetpro Technical Services Ltd* [2007] EWHC 2541 (QB) at paragraph 118.

12 See *Derry v Peek (1889) 14 App Cas 377.*

> *"As for the element of dishonesty, the leading cases are replete with statements of its vital importance and of warnings against watering down this ingredient into something akin to negligence, however gross."*

37 The Court cited the following passage from *Armstrong v Strain* [1951] 1 TLR 856 at 871 per Devlin J with approval:

> *"A man may be said to know a fact when once he has been told it and pigeon-holed it somewhere in his brain where it is more or less accessible in case of need. In another sense of the word a man knows a fact only when he is fully conscious of it. For an action of deceit there must be knowledge in the narrower sense; and conscious knowledge of falsity must always amount to wickedness and dishonesty. When judges say, therefore, that wickedness and dishonesty must be present, they are not requiring a new ingredient for the tort of deceit so much as describing the sort of knowledge which is necessary."*

38 Accordingly, there is a fundamental distinction between the mental element required to establish a claim in negligence i.e. a want of due care (however gross), and that required to establish a claim in deceit i.e. dishonesty in the sense described above. In order to determine that the Plaintiffs could succeed in a claim for deceit against the Defendants, the Court would need to be satisfied that the Defendants' alleged failures in preparing the audit reports pleaded in the Amended Complaint fall into the latter category and not the former.

Intention that false representation will be relied upon

39 The Plaintiffs would need to establish that the Defendants intended, when auditing the accounts of Lancelot Offshore, that the Plaintiffs would rely on their audit reports in deciding whether to invest in the fund: *Peek v Gurney* (1873) LR 6HL 377. If such intent cannot be shown, the claim will fail.[13] Auditors do not owe individual shareholders or investors any duty of care in negligence in relation to the content of their audit reports in the absence of some special relationship. It follows therefore in my view that, in the context of a deceit claim, it

[13] An intention to deceive the plaintiff will be found to exist where this element of the cause of action and the second element referred to above are present: see *Eco3 Capital Ltd* at paragraph 78 per Jackson LJ. "Intention to deceive" is not a separate element of the claim.

cannot be established that an auditor had the requisite intention to deceive a party which alleges that it has relied on the content of the auditor's report in making an investment decision simply by alleging in general terms that the auditor must have appreciated that the report would be shared with investors and shareholders and would be relied upon by them in making investment decisions. What is required is a clear factual basis from which the Court can conclude that the auditor intended the plaintiff to act upon a false representation in the audit report and thereby intended to deceive the plaintiff.

40 *Peek v Gurney* also clearly establishes that liability for a fraudulent misrepresentation extends only so far as the specific transaction to which that representation was directed. In that case promoters of a company issued a fraudulent prospectus. They were held not liable to persons who purchased their shares in the market, because their intention had been to influence investors to subscribe for shares, not to influence dealings in the shares after that.

Reliance

41 The final element of the cause of action is that the plaintiff has acted in reliance upon the false representation. The false representation must have substantially contributed to deceiving the plaintiff.[14]

Proving Fraud

42 More convincing evidence will be required to establish fraud than other types of allegation.[15]

43 Clear guidance has been provided by the House of Lords in *Three Rivers District Council v Governor and Company of the Bank of England*[16] on the proper pleading and proof of fraud claims. Lord Milllet said as follows:[17]

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14 *Edgington v Fitzmaurice* (1885) 29 Ch 459 (CA) at 483 per Bowen LJ.

15 *Hornal v Neuberger Products Ltd* [1957] 1 QB 247, per Denning LJ at 258: *"The more serious the allegation the higher the degree of probability that is required."*

16 Followed by the Grand Court of the Cayman Islands in *Kernohan v H.E. The Governor, Bridger, Acting Commissioner of Police and H.M. Attorney General* [2011] (2) CILR 7.

17 [2003] 2 AC 1, at paragraph 184.

"It is well established that fraud or dishonesty must be distinctly alleged and as distinctly proved; that it must be sufficiently particularised; and that it is not sufficiently particularised if the facts pleaded are consistent with innocence: see Kerr on Fraud and Mistake 7th ed (1952), p 644; Davy v Garrett (1878) 7 Ch D 473, 489; Bullivant v Attorney General for Victoria [1901] AC 196; Armitage v Nurse [1998] Ch 241, 256. This means that a plaintiff who alleges dishonesty must plead the facts, matters and circumstances relied on to show that the defendant was dishonest and not merely negligent, and that facts, matters and circumstances which are consistent with negligence do not do so. It is important to appreciate that there are two principles in play. The first is a matter of pleading. The function of pleadings is to give the party opposite sufficient notice of the case which is being made against him. If the pleader means "dishonestly" or "fraudulently", it may not be enough to say "wilfully" or "recklessly". Such language is equivocal. A similar requirement applies, in my opinion, in a case like the present, but the requirement is satisfied by the present pleadings. It is perfectly clear that the depositors are alleging an intentional tort. The second principle, which is quite distinct, is that an allegation of fraud or dishonesty must be sufficiently particularised, and that particulars of facts which are consistent with honesty are not sufficient. This is only partly a matter of pleading. It is also a matter of substance. As I have said, the defendant is entitled to know the case he has to meet. But since dishonesty is usually a matter of inference from primary facts, this involves knowing not only that he is alleged to have acted dishonestly, but also the primary facts which will be relied upon at trial to justify the inference. At trial the court will not normally allow proof of primary facts which have not been pleaded, and will not do so in a case of fraud. It is not open to the court to infer dishonesty from facts which have not been pleaded, or from facts which have been pleaded but are consistent with honesty. There must be some fact which tilts the balance and justifies an inference of dishonesty, and this fact must be both pleaded and proved."

44 As a matter of Cayman Islands law, an allegation of fraud must be distinctly alleged and distinctly proved and more convincing evidence is required to establish fraud than other

types of allegation. In addition, the guidance in *The Supreme Court Practice 1999* paragraph 18/8/16 in relation to Order 18, rule 8 of the Grand Court Rules provides that "*any charge of fraud or misrepresentation must be pleaded with the utmost particularity.*"

45 In *McLaughlin v American Home Assurance Co*[18] the Cayman Islands Grand Court applied the principle that the cogency of the evidence required to prove allegations of fraud is greater than to prove other types of allegations in civil cases. Similarly, in *Johnson v Johnson*[19] the Grand Court referred with approval to the longstanding common law principle that an allegation of fraud must be distinctly alleged and distinctly proved and that it is not sufficient to leave fraud to be inferred from the facts.

Fraudulent inducement

46 Fraudulent inducement, in these circumstances, would also be considered a claim for deceit as a matter of Cayman Islands law as it is one of the necessary elements of the tort of deceit. As set out above, the tort requires that a false representation be made by the representor with the intention that it be acted upon by the claimant.[20] The intention element requires not only that the representor actually intended that the claimant would rely on the representations but also that the representor appreciated that in the absence of unseen intervention the claimant would actually do so.[21]

Counts 2 and 3: Negligent Misrepresentation and Professional Malpractice

47 Cayman Islands law does not recognise a separate cause of action of professional malpractice. The legal elements of a claim in negligence against a professional, such as an auditor, are the same as against any other party.

48 I therefore deal with counts 2 and 3 in the Complaint together.

49 There are four requirements of the tort of negligence: the existence of a duty of care; breach of that duty by the defendant; a causal connection between the defendant's conduct and the

18 [1994-1995] CILR Note 18a.

19 [1988-89] CILR 413.

20 *Peek v Gurney* (1873) LR 6HL 377 at 411-413.

21 *Shinhan Bank ltd v Sea Containers ltd* [2000] 2 Lloyd's rep 406.

damage caused; and that the particular kind of damage caused to the particular claimant was not so unforeseeable as to be too remote. It is trite law that the breach of the duty of care may result from a misrepresentation made by the defendant to the plaintiff.

50 The English courts have considered a number of tests that can be applied in order to determine whether the relationship between plaintiff and defendant is such that a duty of care exists. The three main contenders are the "threefold test", the "assumption of responsibility test" and the "incremental approach". In *BCCI (Overseas) Ltd v Price Waterhouse (No 2)*[22] Sir Brian Neill commented that it might be useful to consider a set of facts by applying all three tests, and that the tests could be considered as mutually supportive. The tests can be briefly explained as follows: the threefold test considers (1) whether it is foreseeable that if the defendant is negligent the plaintiff is likely to suffer damage; (2) whether there is a sufficiently proximate relationship between the parties; and (3) whether it is just and reasonable to impose the liability. The assumption of responsibility test was considered by the House of Lords in *Henderson v Merrett Syndicates Ltd.*[23] Lord Goff said:

> *"...if a person assumes responsibility to another in respect of certain services, there is no reason why he should not be liable in damages in respect of economic loss which flows from the negligent performance of those services."*[24]

51 The three stage test was introduced by the House of Lords in *Caparo Industries v Dickman*[25] in circumstances where their Lordships felt that the assumption of responsibility test did not necessarily help to identify the key factors in any particular case. It involves consideration not only of foreseeability, and proximity, but also fairness justice and reasonableness.

52 The facts in *Caparo* were these. The plaintiffs, a public limited company, which had taken over F Plc, brought proceedings against the directors of F Plc, alleging fraudulent misrepresentation, and against the auditors of F Plc alleging that they were negligent in carrying out the audit and in making their report. The plaintiffs alleged that they had been

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22 [1998] PNLR 564.

23 [1995] 2 AC 145.

24 Cited by the Cayman Islands Grand Court in *In the Matter of Omni Securities Limited* (No. 3) [1998] CILR 275.

25 [1990] 2 A.C.605.

induced to purchase shares in F Plc in reliance on the accounts and that the auditors owed both existing shareholders and potential investors a duty of care in respect of the accounts. The Court of Appeal had held that although there was no relationship between an auditor and a potential investor sufficiently proximate to give rise to a duty of care at common law, there was such a relationship with individual shareholders. The auditors appealed to the House of Lords.

53 The auditors' appeal was successful. Some passages from the judgments are helpful. Lord Bridge of Harwich, having reviewed the authorities, observed as follows:

> *"The salient feature of all these cases is that the defendant giving advice or information was fully aware of the nature of the transaction which the plaintiff had in contemplation, knew that the advice or information would be communicated to him directly or indirectly and knew that it was very likely that the plaintiff would rely on that advice or information in deciding whether or not to engage in the transaction in contemplation. In these circumstances the defendant could clearly be expected, subject always to the effect of any disclaimer of responsibility, specifically to anticipate that the plaintiff would rely on the advice or information given by the defendant for the very purpose for which he did in the event rely on it. ... The situation is entirely different where a statement is put into more or less general circulation and may foreseeably be relied on by strangers to the maker of the statement for any more of a variety of different purposes which the maker of the statement has no specific reason to anticipate. To hold the maker of the statement to be under a duty of care in respect of the accuracy of the statement to all and sundry for any purpose for which they may choose to rely on it is not only to subject him, in the classic words of Cardozo C.J. to "liability in an indeterminate amount for an indeterminate time to an indeterminate class:" see Ultramares Corporation v Touche (1931) 174 NE 441, 444; it is also to confer on the world at large a quite unwarranted entitlement to appropriate for their own purposes the benefit of the expert knowledge or professional expertise attributed to the maker of the statement."*

54 Lord Bridge went on to say:

"These considerations amply justify the conclusion that auditors of a public company's accounts owe no duty of care to members of the public at large who rely upon the accounts in deciding to buy shares in the company. If a duty of care were owed so widely, it is difficult to see any reason why it should not equally extend to all who rely on the accounts in relation to other dealings with a company as lenders or merchants extending credit to the company. A claim that such a duty was owed by auditors to a bank lending to a company was emphatically and convincingly rejected by Millett J in Al Saudi Banque v Clarke Pixley [1990] Ch 313. The only support for an unlimited duty of care owed by auditors for the accuracy of their accounts to all who may foreseeably rely on them is to be found in some jurisdictions in the United States of America where there are striking differences in the law in different states. In this jurisdiction I have no doubt that the creation of such an unlimited duty would be a legislative step which it would be for Parliament, not the courts, to take."

55 Finally, having reviewed an auditor's statutory duty (under sections 236, 237 and 384 of the English Companies Act 1985, which have since been repealed and replaced by sections 495, 498, 485 and 489 of the Companies Act 2006) to investigate and form an opinion on the company's records and report to the members, Lord Bridge said:

"No doubt these provisions establish a relationship between the auditors and the shareholders of a company on which the shareholder is entitled to rely for the protection of his interest. But the crucial question concerns the extent of the shareholder's interest which the auditor has a duty to protect. The shareholders of a company have a collective interest in the company's proper management and in so far as a negligent failure of the auditor to report accurately on the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book and to ensure that errors in management are corrected, the shareholders ought to be entitled to a remedy. But in practice no problem arises in this regard since the interest of the shareholders in the proper management of the company's affairs is indistinguishable from the interest of

the company itself and any loss suffered by the shareholders, e.g. by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of the company, will be recouped by a claim against the auditors in the name of the company, not by individual shareholders. I find it difficult to visualise a situation arising in the real world in which the individual shareholder could claim to have sustained a loss in respect of his existing shareholding referable to the negligence of the auditor which could not be recouped by the company."

In other words, we are back to the issue of reflective loss.

56 There are also some relevant and helpful passages in the speech of Lord Oliver of Aylmerton. At page 638 of the report, he says as follows:

> *"What can be deduced from the Hedley Byrne*[26] *case, therefore, is that the necessary relationship between the maker of a statement or giver or advice ("the adviser") and the recipient who acts in reliance upon it ("the advisee") may typically be held to exist where (1) the advice is required for a purpose, whether particularly specified or generally described, which is made known, either actually or inferentially, to the adviser at the time when the advice is given; (2) the adviser knows, either actually or inferentially, that his advice will be communicated to the advisee, either specifically or as a member of an ascertainable class, in order that it should be used by the advisee for that purpose; (3) it is known either actually or inferentially, that the advice so communicated is likely to be acted upon by the advisee for that purpose without independent enquiry, and (4) it is so acted upon by the advisee to his detriment. That is not, of course, to suggest that these conditions are either conclusive or exclusive, but merely that the actual decision in the case does not warrant any broader propositions."*

[26] A case of negligent misrepresentation, and the first occasion on which the courts extended the tort of negligence to cover pure economic loss not resulting from physical damage.

57 Lord Oliver quoted with approval the following passage from Richmond P's judgment in the New Zealand decision in *Scott Group Limited v McFarlane*:[27]

> *"The question in any given case is whether the nature of the relationship is such that one party can fairly be held to have assumed a responsibility to the other as regards the reliability of the advice or information. I do not think that such a relationship should be found to exist unless, at least, the maker of the statement was, or ought to have been, aware that his advice or information would in fact be made available to and be relied on by a particular person or class of persons for the purposes of a particular transaction or type of transaction. I would especially emphasise that to my mind it does not seem reasonable to attribute an assumption of responsibility unless the maker of the statement ought in all the circumstances, both in preparing himself for what he said, and in saying it, to have directed his mind, and to have been able to direct his mind, to some particular and specific purpose for which he was aware that his advice or information would be relied on. In many situations that purpose will be obvious. But the annual accounts of a company can be relied on in all sorts of ways and for many purposes. It would be going too far to treat accountants as assuming a responsibility towards all persons dealing with the company or its members, in reliance on to some greater or lesser degree on the accuracy of the accounts, merely because it was reasonably foreseeable, in a general way, that a transaction of the kind in which the plaintiff happened to become involved might indeed take place. The relationship between the parties would, I think, be too general and not sufficiently "special" to come within the principles underlying the decision in Hedley Byrne. As I have said, I believe it to be essential to the existence of a "special relationship" that the maker of the statement was or should have been aware that his advice was required for use in a specific type of contemplated transaction. This requirement has not always required emphasis in the course of judicial discussion as to the nature of a special relationship. Probably this is because in most cases the purpose for which the*

27 [1978] NZLR 553.

information was required was, on the facts, quite obvious. But certainly this particular point was made very clear indeed in Denning LJ's judgment in Candler v Crane, Christmas & Co. I would think that it must almost inevitably follow, once the maker of the statement is aware of a specific purpose for which his information will be used, that he will also have in direct contemplation a specific person or class of persons, even though unidentified by name."

58 Lord Oliver's approval of the above passage was expressed in the following terms:

> *"For my part, however, I can see nothing in the statutory duties of a company's auditor to suggest that they were intended by Parliament to protect the interests of investors in the market and I see no reason in policy or in principle why it should be either desirable or appropriate that the ambit of the special relationship required to give rise to liability in cases such as the present should be extended beyond those limits which are deducible from the cases of Hedley Byrne and Smith v Eric S Bush. Those limits appear to me to be correctly and admirably stated in the passages from the judgment of Richmond P in the Scott Group case to which I have already referred. In particular, I see no reason why any special relationship should be held to arise simply from the circumstances that the affairs of the company are such as to render it susceptible to the attention of predators in the market who may be interested in acquiring all or the majority of the shares rather than merely a parcel of shares by way of addition to a portfolio."*

59 *Caparo Industries* has been followed by the Cayman Islands Grand Court in *Banque Commerciale (Cayman) Limited (In Liquidation) v Coopers & Lybrand and Coopers & Lybrand International* [1990-91] CILR 1, and in *Re Omni Securities* (no. 3) [1998] CILR 275.

60 A more recent review of the position of auditors is to be found in the decision of Moore-Bick LJ in *Man Nutzfahrzeuge Ag & Ors v Freightliner Ltd.*[28] The following passages from the judgment are informative:

[28] [2005] EWHC 2347.

"Auditors are appointed by a company to investigate and form an opinion on the adequacy of its accounting records and returns and to report to the shareholders whether in their opinion the accounts give a true and fair view of its financial position: see per Lord Bingham LJ in Caparo Industries Plc v Dickman [1989] QB 653, 680-681 cited with approval by Lord Bridge at [1990] 2 AC 605, 625. In the words of Lord Oliver in the same case:

"It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinize the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided."

The auditors' primary duty, therefore, is owed to the company pursuant to the contract under which they are engaged, but it is now accepted that they also owe a duty of care under the general law to the shareholders as a body who can be expected to exercise their rights and powers in a general meeting on the basis of the audited accounts: see Caparo v Dickman per Lord Bridge at page 626C-E, Lord Oliver at page 654C and Lord Jauncey at page 662A-B. ... The duty of care owed by auditors to the shareholders is unusual in a number of respects. It is not owed to shareholders as individuals, but to the shareholders as a body, and is a duty which has as its object the protection of their interest in the proper management of the company. The damage from which the auditors must take care to protect the shareholders is a diminution in the value of their interest in the company, that is, in the value of their shares, but as Lord Bridge pointed out at page 626D-E, the interest of the shareholders in the proper management of the company is indistinguishable from the interest of the company itself and therefore any loss falling within the scope of this duty that is suffered by the shareholders will be recouped by a *claim against the auditors in the name of the company. It follows that neither individual shareholders, nor for that matter the shareholders as a body, can bring an action in their own names to recover that loss. This was one of the points made by the House of Lords in Johnson v Gore Wood & Co [2002] 2 AC 1 and may explain why there appears to be no reported case in which shareholders individually or as a body have succeeded in recovering damages for a breach of this duty."*

61 In *Barings plc (In liquidation) v Coopers & Lybrand* [2002] 2 BCLC 364, in a claim against a firm of auditors in relation to fraudulent trading activities, the Court described the applicable legal principles as follows:

> *"...[I]n the case of a claim in tort against an auditor the claimant must plead and prove, in addition to a relationship between the auditor and the claimant capable of giving rise to a duty of care, and that the loss flowing from the auditor's breach of that duty was caused by the auditor's negligent report, and was foreseeable, that, at the time he undertook those services, the auditor had in contemplation that they would be relied on by the claimant for the purpose of a particular transaction or class of transaction that was likely to result and that the claimant, in fact, relied on the auditor's report when embarking on such transaction which resulted in the loss for which compensation is claimed."*

62 In *Anthony v Wright* [1995] BCLC 236, the Court stated:

> *"The law is well established that auditors do not, in respect of their audits, owe a duty of care to anyone other than the company itself save in exceptional circumstances where a special duty has been treated as assumed to a third party. Thus in principle no duty is owed to shareholders or prospective shareholders in respect of investment decisions made regarding the purchase or sale of shares in the company, nor to existing or future creditors who may relay on the audited accounts and leaving debts outstanding or making loans to the company. A special relationship is required and, in particular, intention, actual or inferred on the part of the auditors, that the third party shall rely and*

reliance by the third party on the audit before a claim in negligence against the auditor can be maintained."

63 The mere fact that a party is an existing or prospective shareholder in a company is not sufficient to give rise to such a special relationship. As Richmond P stated in the *Scott Group Limited v McFarlane* decision referred to at paragraph [52] above:

> *"...the annual accounts of a company can be relied on in all sorts of ways and for many purposes. It would be going too far to treat accountants as assuming a responsibility towards all persons dealing with the company or its members, in reliance to some greater or lesser degree on the accuracy of the accounts, merely because it is reasonably foreseeable, in a general way, that a transaction of the kind which the plaintiff happened to become involved might take place."*

64 In order to establish a special relationship, it is necessary to show that the auditors knew and intended, at the time of issuing their audit report, that the report would be communicated to and relied upon by the plaintiff either individually or as a member of a defined class for a particular purpose in connection with the particular transaction(s) alleged to have caused the plaintiff loss.[29]

65 It is instructive to look at a decision of the House of Lords in *Moore Stephens (a firm) v Stone & Rolls Limited (in liquidation).*[30] This was a strike out application, which was principally concerned with the doctrine of ex turpi causa (illegality). Two of the five Law Lords dissented, however the following passages from the judgment of Lord Phillips of Worth Matravers illustrate and confirm the principles I have set out above:

> *"The duties of an auditor are founded in contract and the extent of the duties undertaken by contract must be interpreted in the light of the relevant statutory provisions and the relevant accounting standards. The duties are duties of reasonable care in carrying out the audit of the company's accounts. They are owed to the company in the interests of its shareholders. No duty is owed*

29 *Caparo Industries v Dickman* [1990] 2 AC 605 at page 638 per Lord Bridge; *Man Nutzfahrzeuge v Freightliner Ltd* [2005] EWHC 2347 per Moore-Bick LJ at paragraph 339.

30 [2009] UKHL 39.

directly to the individual shareholders. This is because the shareholders' interests are protected by the duty owed to the company. ... The exercise of an auditor's duties to a company will, in some situations, have the effect of preserving the assets of the company. Such preservation will, whenever there is a risk that the company's assets may prove inadequate to meet its liabilities, protect not merely the interests of the shareholders but those of the creditors. It is arguable that the scope of the duty undertaken by the auditors of a company should extend to protecting the interest that the creditors have in the preservation of the assets of the company. So to hold would involve departing from or at least extending, the reasoning of this House in Caparo. Such an extension would not, however, assist S&R in this case. To recover damages in this case S&R would have to establish that the scope of the duty undertaken by [the auditors] extended to taking reasonable care to ensure that the company was not used as a vehicle for fraud and that this duty was owed for the benefit of those that the company might defraud. I see no prospect that such a duty could be established."

66 The recent case of *Jetivia SA v Bilta (UK) Limited*[31] has, to some extent, cast doubt on the decision in *Stone & Rolls*, however *Jetivia v Bilta* was concerned with the liability of the directors of a company in a fraudulent transaction and whether they could attribute their own knowledge of wrongdoing to their own company in order to found a reliance on the ex turpi causa defence against the company. *Stone & Rolls* is still relevant and of value in present circumstances as it relates to the question of auditors' negligence.

67 It will be apparent from the passages quoted above that in general only the company will have a claim against its auditors. That claim is likely to lie primarily in contract, under the terms of the auditors' engagement by the company, but will also lie in tort, pursuant to the duty of care owed by the auditors to the company. The shareholders themselves will generally be unable to sue because the loss they suffer will be merely reflective of that suffered by the company. Moreover, even if the auditors could reasonably foresee that reliance might be placed on the accounts by others, that in itself is not sufficient to give rise to a duty of care. What will be required is a special relationship (in other words knowledge

31 [2015] UKSC 23.

on the part of the auditors that the accounts would be relied on for the specific transaction for which they were in fact relied on[32]), a loss that is not merely reflective of the company's, and circumstances such that it would be fair, just and reasonable for a duty of care to be imposed.

Under penalties as provided by law pursuant to Section 1-109 of the Illinois Code of Civil Procedure, the undersigned certifies that the statements set forth in this instrument are true and correct, except as to matters therein stated to be on information and belief and as to such matters the undersigned certifies as aforesaid that he verily believes the same to be true.

SWORN to at George Town,	)	
Cayman Islands	)	
this 24th day of February 2017	)	
	)	
BEFORE ME:		ARISTOTELIS ALEXANDROS GALATOPOULOS

Chandra Solomon
Notary Public in and for the Cayman Islands
(My commission expires on 31st January 2018)

[32] See the dicta of Moore-Bick LJ in *Man Nutzfahrzeuge & Ors v Freightliner Ltd* [2005] EWHC 2347: *"In my view Mr Fenwick was right in saying that when a claim is made by a third party against a company's auditors based on an alleged duty of care in relation to the statutory accounts, close attention must be paid to the particular statement on which the claimant seeks to rely, the circumstances in which and purpose for which that statement was made and the type of loss which the claimant is seeking to recover. The auditors will only be held to have incurred such a duty if it can be shown that they knew and intended that their statement as to the company's accounts would be communicated to and relied on by a particular person or class of persons for a particular purpose in connection with a particular transaction."*

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

RS INVESTMENTS LIMITED, ET AL.,

Plaintiffs,

v.

Case No.: 2016LO11459

RSM US LLP, RSM CAYMAN LTD, AND SIMON LESSER,

Defendants.

FILED 2017 MAY -8

THIRD AFFIDAVIT OF ARISTOTELIS ALEXANDROS GALATOPOULOS

I, ARISTOTELIS ALEXANDROS GALATOPOULOS, of Ugland House, South Church Street, George Town, Grand Cayman, Cayman Islands MAKE OATH and SAY as follows:

1 I am the same Aristotelis Alexandros Galatopoulos who has sworn two previous affidavits in these proceedings dated 24 February 2017 and 26 April 2017. I am a Partner and the Head of the Litigation Department of the Cayman Islands office of Maples and Calder, attorneys-at-law practising at the above address.

2 I have been requested by the law firm Williams & Connolly LLP, which represents Defendants RSM US LLP and Simon Lesser, to review the affidavit of William Helfrecht dated 12 April 2017 filed in these proceedings on behalf of the Plaintiffs and to comment on Mr Helfrecht's affidavit from a Cayman Islands law perspective.

3 I note the statement at paragraph 12 of Mr Helfrecht's affidavit that "*...the courts will be flexible in applying limits to the reflective loss doctrine so long as a limitation is consistent with the guiding principles and policy concerns...*". I agree with Mr Helfrecht that, like all common law principles, the reflective loss doctrine may evolve over time and its boundaries may be developed by the courts. Nevertheless, in my view, the current boundaries of the principle are clear, and have been considered and applied by the English and Cayman

Islands courts on numerous occasions since the House of Lords decision in *Johnson v Gore Wood* [2002] 2 AC 1, which is the leading authority on reflective loss.[1]

4 Insofar as Mr Helfrecht is suggesting that there is some flexibility in the application of the doctrine, I note in Lord Millett's speech in *Johnson v Gore Wood* (at p.62) he said:

> "*The position is, however, different where the company suffers loss caused by the breach of a duty owed both to the company and to the shareholder. In such a case the shareholder's loss, in so far as this is measured by the £ diminution in value of his shareholding or the loss of dividends, merely reflects the loss suffered by the company in respect of which the company has its own cause of action. If the shareholder is allowed to recover in respect of such loss, then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders. Neither course can be permitted. This is a matter of principle; there is no discretion involved. Justice to the defendant requires the exclusion of one claim or the other; protection of the interests of the company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder. These principles have been established in a number of cases, though they have not always been faithfully observed.*" [emphasis added]

5 This passage has been cited with approval in a number of subsequent decisions including *Bank Mellat v HM Treasury (No 3)* [2017] 2 All ER 139, *Gardner v Parker* [2003] All ER (D) 249 and *Giles v Rhind* [2003] 1 BCLC 1.

6 In *Day v Cook* [2002] 1 BCLC 1, before the passage in the judgment of Arden LJ to which Mr Helfrecht refers at paragraph 6 of his affidavit, Her Ladyship cited the passage above from Lord Millet's speech and went on to state (at [38] to [40]):

> "*It will thus be seen from the speeches in Johnson v Gore Wood & Co ... that where there is a breach of duty to both the shareholder and the company and the loss which*

[1] Including in cases where the court found that there was no risk of the shareholder and the company obtaining recovery in respect of the same loss because of a successful defence to the company's claims, as I discuss at paragraphs 20 to 25 of my first affidavit.

the shareholder suffers is merely a reflection of the company's loss there is now a clear rule that the shareholder cannot recover. ...

Accordingly the court has no discretion. The claim cannot be entertained.

...Thus the position in English law differs from the position (as I understand it to be) in the majority of states in the USA, where the courts exercise limited discretion to allow direct recovery by shareholders of closely-held corporations..."

7 I also note Mr Helfrecht's statement at paragraph 13 of his affidavit that the question of whether the reflective loss principle applies requires a "*sufficiently developed factual matrix*". To the extent that Mr Helfrecht is suggesting that the court cannot or should not consider the application of the reflective loss principle at a very early stage of the proceedings, I do not agree.

8 There are two main ways in which a Cayman Islands court has the power to dispose of a claim at an early stage:[2]

8.1 The court may strike out a claim and enter judgment for the defendant on a number of grounds, including that the claim discloses no reasonable cause of action.[3] Such an application is normally made at an early stage of the proceedings, and commonly before completion of the exchange of pleadings between the parties.[4]

8.2 The court may give judgment against a plaintiff or a defendant without a full trial when that party has no reasonable prospect of success,[5] or in the case of an application by a defendant when the plaintiff has no prospect of recovering more than nominal damages.[6] Again, such an application is normally made at an early stage of the proceedings, and commonly before completion of the exchange of pleadings.

---

[2] Although these powers can be used at any stage of the proceedings.

[3] *Grand Court Rules*, Order 18, rule 19(1)(a). The English court has a similar power pursuant to the English *Civil Procedure Rules*, Part 3, rule 3.4(2)(a).

[4] Which in commercial litigation in the Cayman Islands is generally the first stage of the proceedings and takes place before document discovery and the exchange of evidence.

[5] *MBI Dive Corporation Incorporated v Condoco Grand Cayman Resort Limited* [2004] CILR 254.

[6] *Grand Court Rules*, Order 14, rule 1(1) and rule 12(1). The English court has a similar power pursuant to the English *Civil Procedure Rules*, Part 24, rule 24.2.

9 In *Giles v Rhind* [2003] 1 BCLC 1[7] it was acknowledged that an early disposition of a claim can occur on the basis of reflective loss. The Court of Appeal approved the following summary of the principles as formulated by the first instance Judge in that case[8] (and cited in a number of subsequent decisions including the first instance decision in *Gardner v Parker* [2003] All ER (D) 346 and *Webster v Sanderson* [2009] 2 BCLC 542):

> "*...the relevant principles are... as follows...:*
>
> *(1) a loss claimed by a shareholder which is merely reflective of a loss suffered by the company – i.e. a loss which would be made good if the company had enforced in full its rights against the defendant wrongdoer – is not recoverable by the shareholder save in a case where, by reason of the wrong done to it, the company is unable to pursue its claim against the wrongdoer;*
>
> <u>*(2) where there is no reasonable doubt that that is the case, the court can properly act, in advance of trial, to strike out the offending heads of claim;*</u>
>
> ..." [emphasis added]

10 Below are examples of decisions of the English courts where a claim has been disposed of or otherwise found to be unsustainable at a preliminary stage of the proceedings due to the application of the rule against reflective loss include:

10.1 *Barclay Pharmaceuticals Ltd and others v Waypharm LP and others* [2014] 2 All ER (Comm) 82, where the claim was struck out.

10.2 *Rawnsley and another v Weatherall Green & Smith North Ltd* [2010] 1 BCLC 658, where the claim was struck out.

10.3 *Gaetano Limited v Obertor Limited* [2009] EWHC 2653, where the claim was struck out.

10.4 *Kazakhstan Kagazy plc and others v Zhunus and others* [2013] All ER (D) 238, where the court held there was no good arguable case for a claim to proceed based on the

[7] Referred to at paragraph 22 of my First Affidavit and at paragraphs 8 to 12 of Mr Helfrecht's affidavit.

[8] *Giles v Rhind* [2001] 2 BCLC 582

rule against reflective loss, in the context of an application to discharge a freezing injunction.

11 Therefore, at an early stage of the proceedings the court can, if it is satisfied on the material then before it[9] that the claim is barred by the rule against reflective loss, strike out the claim without the matter proceeding to trial.

12 Finally I note Mr Helfrecht's comments on auditor liability to shareholders for negligent misstatement.[10] I generally agree with Mr Helfrecht's summary of the law, and in particular I agree with the summary at paragraphs 26 (a), (b) and (c). I also agree with Mr Helfrecht's statement at paragraph 26(d) that "*the requirement for a special relationship is aimed at removing the spectre of indeterminate liability*". However, I am not aware of the approach of the Canadian court in the decision of *Canadian Imperial Bank of Commerce v Deloitte & Touche*, 2016 ONCA 922 referred to by Mr Helfrecht having yet been adopted or approved by the Cayman Islands or English courts.

Under penalties as provided by law pursuant to Section 1-109 of the Illinois Code of Civil Procedure, the undersigned certifies that the statements set forth in this instrument are true and correct, except as to matters therein stated to be on information and belief and as to such matters the undersigned certifies as aforesaid that he verily believes the same to be true.

SWORN to at George Town,)
Cayman Islands)
this 8th day of May 2017)
)

ARISTOTELIS ALEXANDROS GALATOPOULOS

BEFORE ME:

Chandra Solomon
Notary Public in and for the Cayman Islands
(My commission expires on 31st January 2018)

[9] Which, in a case where the defendant applies to strike out the claim before filing a Defence, would be only the plaintiff's Statement of Claim.

[10] At paragraphs 16 to 25 of the affidavit.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF WESTCHESTER

MVC CAPITAL, INC.,

Plaintiff,

-against-

RSM US LLP,

Defendant.

Index No. 69544/2016

DEFENDANT RSM US LLP'S MEMORANDUM OF LAW IN SUPPORT OF ITS MOTION TO DISMISS

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March 21, 2017

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Defendant RSM US LLP ("Defendant" or "RSM") respectfully submits this memorandum of law in support of its motion for an order dismissing the complaint with prejudice pursuant to CPLR § 3211(a)(7) for failure to state a claim, and pursuant to CPLR § 3211(a)(1) on the basis of documentary evidence, on the grounds that Plaintiff MVC Capital, Inc. ("Plaintiff" or "MVC") fails to properly plead the elements of a claim for negligent misrepresentation against an auditor or accountant.

PRELIMINARY STATEMENT

The Plaintiff in this case is attempting to recover its loan losses from a party with whom it had no relationship: its borrower's auditor, RSM. Plaintiff lent money to former advertising and display company, G3K Displays, Inc. (formerly known as Projuban, LLC) ("G3K"). Unbeknownst to the Plaintiff and RSM, G3K and its principals perpetrated an extensive fraud, fooling a variety of parties into believing that it was a successful, financially secure company, when the company was, in fact, essentially worthless. Three G3K principals, a former G3K employee and a former G3K customer's employee each admitted to their role in the fraud, and are or were incarcerated. The responsibility for this criminal fraud lies with the individuals who perpetrated it. MVC cannot attempt to pin blame on fellow victim, RSM, a party with whom MVC had no contractual relationship.

New York is among the American jurisdictions which require third parties seeking to assert claims against auditors to meet the high standard of "near privity" with the auditor. MVC fails to meet this well-established standard under New York law.

STATEMENT OF FACTS

Defendant RSM US LLP, formerly known as McGladrey LLP ("RSM"), is a national audit, tax, and consulting services firm. (Affirmation of Ian Jay, dated March 21, 2017 ("Jay Aff."), Exhibit A) (the "Complaint") ¶ 13. Plaintiff MVC is a publicly-traded business development company, which invests in small and mid-market companies through the provision of equity and debt investment capital. Complaint ¶ 12. G3K was a company which claimed to be a designer, installer, and marketer of retail product displays for large chain retailers. Complaint ¶ 17. Prior to its dissolution, G3K was owned by three individuals, Steven Kaitz, Latchmee Mahato, and Jonathan Wheeler. *Id.*

In 2013, G3K -- not MVC -- hired RSM to report on G3K's financial statements. Complaint ¶ 20. The audit engagement letter was signed by G3K and RSM and MVC is not referenced anywhere in the letter. Jay Aff., Exhibit B. The engagement letter specifically states that the final audit report will be directed to the members of G3K's operating company, not to MVC, *id.* at 5, and requires G3K to obtain permission before utilizing the report as part of a securities offering. *Id.* at 3.

The Complaint cites only limited, sporadic contact with MVC by RSM. The first communication cited is a December 13, 2013 email from the CFO of G3K to a representative of RSM, copying two MVC employees, advising RSM that "it looks like MVC will be requiring McGladrey to perform a review of some kind for 9/30/13" and proposing a conference call. Complaint ¶ 21. A review is a very different type of engagement than the audit ultimately performed and the reference to the potential "review" being "as of 9/30/13" indicates that G3K and MVC were contemplating work on an interim financial period, not an audit as of fiscal year-end, which is the engagement that RSM actually performed. Additionally, the Complaint fails to allege whether the conference call referenced in the email actually occurred, and if so, who participated and what was discussed.

The only other communication cited in the Complaint other than unspecified "oral and written" communications (Complaint ¶ 25), is a March 6, 2014 email from RSM transmitting a draft of the audited financial statements, copying a group of people including one MVC employee. The email appears to be directed to the audit firm of BDO, the firm actually retained directly by MVC, and reads as follows:

> Dear Michael [Kuczborski, of BDO],
>
> I have attached the 2012 and 2013 audit draft reports. As mentioned this morning, final release final [*sic*] is pending a couple of administrative items which we hope to wrap up at the beginning of the next week. We do not anticipate any changes to the numbers as presented in the drafts attached.
>
> *We will be able to accommodate the request to review the 2012 and 2013 audit workpapers locally in our Blue Bell, PA office. Please just provide me with a tentative date so that I can start coordinating. I will also send over the required access letter which we will need to be executed by BDO prior to allowing the workpapers to be reviewed.*
>
> Please don't hesitate to reach out if you need anything else.

Jay Aff., Exhibit C (emphasis supplied). This email indicates that MVC was not content to rely on RSM's audit opinion, but rather wanted its own independent review of the sufficiency of the financial statement information and underlying evidential matter, performed by its own directly contracted audit firm.

RSM provided its final audit report only to its client, G3K. Complaint ¶ 26. The Plaintiff alleges that G3K then provided the report to MVC, but makes no assertion that RSM was included in that communication or was aware it occurred. Complaint ¶ 26.

Shortly after MVC made its loan, the magnitude of the fraud committed by the G3K principals became clear and a federal criminal investigation ensued, culminating in plea bargains and jail time. Each of the G3K principals was indicted, pled guilty to criminal fraud charges, and sentenced to significant federal prison terms. Complaint ¶ 58.[1] In announcing the sentencing,

[1] Steven Kaitz was sentenced to 40 months in prison; Latchmee Mahato was sentenced to 24 months in prison; and Jonathan Wheeler was sentenced to 21 months in prison. Complaint ¶ 58. In addition, Zachary Kaitz (a graphic designer employed by G3K who created the false documentation of nonexistent receivables) and Kathleen Smith (a

federal prosecutors specifically noted that the G3K principals "took elaborate steps to […] prevent G3K's lenders *and outside auditors* from discovering the fraud." United States Department of Justice, United States Attorney's Office for the Southern District of New York, *Four Executives Sentenced In Manhattan Federal Court for Their Roles In Multimillion-Dollar Corporate Accounting Fraud* (Sept. 9, 2015) (emphasis supplied).[2]

ARGUMENT

In reviewing this motion to dismiss, this Court must accept the facts alleged in the Complaint to be true and accord the Plaintiff the benefit of favorable inferences. *Jacobs v. Macy's E., Inc.*, 262 A.D.2d 607, 608 (2d Dep't 1999). However, the Court need not accept as true bare legal conclusions or allegations of fact that are not credible. *Breytman v. Olinville Realty, LLC*, 54 A.D.3d 703, 704 (2d Dep't 2008).

I. NEW YORK LAW REGARDING ACCOUNTANT LIABILITY BARS MVC'S CLAIM AGAINST RSM.

For nearly a century, the law in New York has been clear and explicit: in actions seeking to hold accountants liable for alleged misstatements, the only parties which may pursue claims are those who actually engaged the accountant, and third-parties meeting the high standard of being in near-privity with the auditor. New York courts have recognized, time and again, that permitting third parties who may have seen an audit report to maintain claims against the accountant who prepare it would effectively cripple the auditors' ability to do business in New York, and the clients' ability to obtain high-quality audit services. This policy is effectively designed to ensure that only in certain, very specific situations can a third party meet this standard. A review of the precedential cases in this area shows that MVC does not do so here.

former employee of Foot Locker who participated in a kickback scheme involving the false confirmation of nonexistent receivables) were each sentenced to four months in prison.

[2] Available at https://www.justice.gov/usao-sdny/pr/four-executives-sentenced-manhattan-federal-court-their-roles-multimillion-dollar.

New York's strict near-privity policy has its origins in the landmark Court of Appeals decision, *Ultramares Corp. v. Touche*, 255 N.Y. 170 (1931). Writing for the Court, Chief Judge Cardozo commented on the "assault upon the citadel of privity", and searched for the "antidote . . . to the overuse of the doctrine of liability for negligent misstatement." *Id*. at 185. Judge Cardozo's "antidote" was to limit auditor liability for negligent misrepresentation to those parties either in privity of contract with the auditor or those with such a close relationship with the auditor as to approach a relationship equivalent to privity. Otherwise, Chief Judge Cardozo feared auditor liability for an "indeterminate amount" to an "indeterminate class" for failure to uncover fraudulent behavior masked by the audit client's deceptive practices. *Id*. at 179. That is to say, without a clear limitation on potential liability, an auditor might be held answerable to anyone who might happen to view an audit report or audited financial statements and later claim reliance, an untenable situation which would expose an accountant to limitless liability and make the practice of accounting in New York a practical impossibility.

In the years since *Ultramares*, which has been cited hundreds of times by the courts of this state, this principle has become the foundation of New York law regarding accountant and auditor liability. Numerous authorities have commented on the strict nature of New York's policy. *See, e.g.*, 76 N.Y. JUR. 2D *Malpractice* § 10 (noting that, under *Ultramares*, "failure to allege a relationship between the parties even approaching one of the practical equivalent of privity prevents recovery under *any* negligence theory") (emphasis supplied); 16 AM. JUR. 2D *Proof of Facts* § 641 (noting that under *Ultramares*, New York law does not recognize a cause of action against an accountant, even for gross negligence, unless the claim rises to the level of actual fraud, which MVC does not allege here); Kenneth Davis, *Accountants' Liability for Negligently Certifying Financial Reports: The Legacy of Ultramares v. Touche*, 64 N.Y. ST. B.J.

30 (1992) (noting that New York's standard for accountant liability is particularly strict in comparison to those of other jurisdictions).

Courts in New York, including the Court of Appeals, have consistently affirmed, and indeed expanded, the strong limitation on accountant liability articulated in *Ultramares*. *See, e.g.*, *Sec. Pac. Bus. Credit, Inc. v. Peat Marwick Main & Co.*, 586 N.Y.2d 695, 703 (1992) (applying "sufficiently approaching privity" standard); *Ossining Union Free Sch. Dist. v. Anderson LaRocca Anderson*, 73 N.Y.2d 417, 424-25 (1989) (extending *Ultramares* rule to actions against architectural firm, and noting that the "imposition of such broad liability [for non-contractual parties] is unwise as a matter of policy"); *Sykes v. RFD Third Ave. 1 Assocs., LLC*, 15 N.Y.3d 370, 372-73 (2010) (extending *Ultramares* rule to actions against engineering firm).

As the policy has crystalized over the decades, a clear test has emerged. Today, under New York law, a party seeking to assert a claim of negligent misrepresentation against an accountant for statements made in a financial report, where that party is not a client of the accountant, must plead three discrete elements. The party must demonstrate that (i) the accountant was aware that the financial report would be used for a particular purpose; (ii) the accountant must have intended that the financial report would be used by a specific, known party or parties; and (iii) there was affirmative conduct on the part of the accountant, linking them to that party or parties and demonstrating the accountant's awareness that the party or parties would be relying on the financial statements. *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 551, *amended*, 66 N.Y.2d 812 (1985). The third prong, in particular, is the lynchpin protecting what the Court of Appeals has described as the "citadel of privity" protecting auditors from liability to entities which are neither signatories to the engagement agreement nor mentioned therein. *Ultramares*, 255 N.Y. at 445 (1931). Taken together, the complaint must allege that the totality of a plaintiff's relationship with the accountant was such that it approaches contractual privity between the plaintiff and the accountant. *Sec. Pac. Bus. Credit*, 79 N.Y.2d at 702-703. Here, MVC has failed to properly plead even a single element of the *Credit Alliance* test, and its claim against RSM for negligent misrepresentation must necessarily be dismissed.

This strong policy against holding auditors liable to third parties was demonstrated in a recent case with facts remarkably similar to those alleged by MVC. Indeed, almost identical allegations were rejected by the Second Department in *Signature Bank v. Holtz Rubenstein Reminick, LLP*, 109 A.D.3d 465 (2d Dep't 2013).

Signature Bank was an action brought by a plaintiff who had lent money to a borrower, allegedly based on audited financial statements; the borrower declared bankruptcy shortly after receiving the loan proceeds, and the lender brought suit against the auditor. The trial court initially held that the lender had adequately satisfied the third prong of *Credit Alliance*, based on the allegation that the auditor "knew" that the lender was relying on the audit reports as part of its lending decision. Knowledge and linking conduct were present, according to the trial court, because (1) an executive affiliated with the borrower supposedly informed the auditor of this, and (2) the lender had "several conversations" with the auditor concerning the borrower's financial viability. *Signature Bank v. Holtz Rubenstein Reminick LLP*, Index No. 15936/2011, 2012 WL 11980647, at *2 (Sup. Ct. Nassau Co. Aug. 14, 2012). Notably, the Second Department reversed, holding that the lender's allegations referred to by the trial court (which are almost identical to those made by MVC in the instant matter) failed to satisfy the *Credit Alliance* test, and directed the trial court to dismiss the negligent misrepresentation claim. *Signature Bank*, 109 A.D.3d at 466-67; *see also*, *Westpac Banking Corp. v. Deschamps*, 66 N.Y.2d 16 (1985) (holding that an auditor may not be liable to a lender even where the auditor knew that its reports would be used by potential lenders and that plaintiff was one of the likely potential lenders). As discussed below, the same outcome is required here.

II. THE ALLEGATIONS IN MVC'S COMPLAINT FAIL TO MEET THE HIGH THRESHOLD FOR THIRD PARTY CLAIMS AGAINST AN ACCOUNTANT.

A. Plaintiff has Failed to Plead that RSM was Aware that its Financial Reports Would be Used As a Basis for MVC's Lending Decision.

The first prong of the *Credit Alliance* test requires the complaint to plead that the report in question was prepared with a particular purpose in mind. *Credit Alliance*, 65 N.Y.2d at 551. Here, MVC would be required to plead that RSM was aware that its audit report would be used as the basis for MVC's decision whether or not to lend to G3K, and that RSM prepared its audit report with that intent in mind. Nothing in the Complaint rises to that level as a matter of law. Two allegations possibly relevant to this first element are an email from a G3K executive to an RSM employee stating that "it looks like MVC will be requiring McGladrey to perform a review of some kind for 9/30/13" and proposing a conference call, Complaint ¶ 21, and the conclusory statement that G3K "informed McGladrey of MVC's heightened requirement." Complaint ¶ 23.

A request for "some sort of review" is substantively different than a formal audit. Indeed, the American Institute of CPAs explicitly distinguishes between an "review" and an "audit", noting that a "review" is intended only to provide a "basic level of assurance on the accuracy of financial statements", while an "audit" is intended to provide "a high level of comfort on the accuracy of financial statements" and involves a formal "opinion on whether the financial statements are presented fairly, in all material respects". American Institute of CPAs, *Guide to Financial Statement Services: Compilation, Review and Audit, available at* https://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/DownloadableDocuments/financial-statement-services-guide.pdf. Furthermore, the reference to "9/30/13" is for a different time period than what RSM actually audited, namely the year ending December 31, 2013. There thus is no indication that there was any agreement as to the scope of work to be performed, nor is there any indication that the proposed conference call ever took place. None of these allegations demonstrate that RSM prepared its audit report with the specific intent that the report would be utilized and relied upon by MVC. MVC's bald assertion that RSM had "the knowledge and understanding that it was asked to [provide an audit report] in order to provide MVC with comfort", Complaint ¶ 23, is a bare legal conclusion, which is not presumed to be true even on a motion to dismiss. *Breytman v. Olinville Realty, LLC*, 54 A.D.3d 703, 704 (2d Dep't 2008).

The only other allegations potentially relevant to RSM's supposed awareness of MVC's desire to use the audit report to assist in its loan decision are vague and inconclusive. MVC alleges that MVC and RSM "communicated" regarding unspecified subjects during the course of the audit, and that RSM "sent a draft" of the audit report to a group which included an individual purportedly employed by MVC. Notably, the draft was specifically directed toward an individual at BDO, another auditing firm, and the cover email explicitly referenced BDO's review of the audit workpapers for the benefit of MVC. Jay Aff., Exhibit C. This communication is evidence that RSM did *not* know that MVC would rely directly on its audit report, but rather expected MVC to engage in its own independent review, using auditors MVC itself had engaged, before determining whether or not to lend money to G3K.

All other allegations relate to *G3K's* use of the audit report, and in particular G3K's relationship with MVC. This simply does not meet New York's near-privity requirement. As discussed above, the Second Circuit rejected a finding of near privity on nearly identical facts. *See Signature Bank*, 109 A.D.3d at 466-67; *see also State St. Trust Co. v. Ernst*, 278 N.Y. 104, 111 (1938) ("in the absence of a contractual relationship or its equivalent, accountants cannot be held liable for ordinary negligence in preparing a certified balance sheet *even though they are aware that the balance sheet will be used to obtain credit*") (emphasis supplied).

B. Plaintiff has Failed to Plead that RSM was Aware that MVC Would Rely on its Financial Reports and Intended for MVC to Do So.

The second prong of the *Credit Alliance* test requires a plaintiff to demonstrate that the accountant intended a specific party or parties to rely on its report. *Credit Alliance*, 65 N.Y.2d at 551. Plaintiff fails to plead, other than in a conclusory and unsupported fashion, that RSM knew that MVC specifically would receive and rely on the final audit reports. Without such specificity, the second prong of the *Credit Alliance* test is not met. *Westpac*, 66 N.Y.2d 16; *see also Sykes*, 15 N.Y.3d at 373.

Westpac involved an action brought by a lender, Westpac, against an auditor, Seidman & Seidman, which prepared financial statements for a company; these statements were allegedly relied upon by Westpac in determining whether to extend credit to the company. Following Westpac's extension of a bridge loan, significant fraud emerged, the company's planned public offering (the proceeds of which were intended to repay the bridge loan) was cancelled, and the loan became uncollectible. In its complaint, Westpac alleged that the auditor knew not only that the company was in the process of obtaining additional financing from third-party lenders, but knew that Westpac was the largest existing lender and thus the most likely to extend additional credit. The Court of Appeals nonetheless held that this was insufficient to satisfy the particularity requirement of the *Credit Alliance* test, and ordered the action dismissed. Despite the auditor's potential knowledge of Westpac's interest, the Court noted the lack of any "allegation of any word or action on the part of [Seidman & Seidman] directed to Westpac, or anything contained in [Seidman & Seidman's] retainer agreement with [the borrower] which provided the necessary link" between Westpac and the auditor. Again, MVC's allegations do not meet the mark, including because MVC is not a party to the engagement letter, it is not referenced in the engagement letter, and there is no indication that RSM had knowledge that its final audit report was shared with MVC, much less that RSM intended to have it shared and relied upon by MVC. This, too, requires dismissal of MVC's Complaint.

C. Plaintiff has Failed to Plead that RSM Acted In a Way Demonstrating RSM's Awareness of MVC's Reliance on the Financial Reports As a Basis for MVC's Decision to Lend to G3K.

MVC's complaint also fails to adequately plead the third prong of the *Credit Alliance* test. This prong, which as noted above is perhaps the most critical and the most difficult to satisfy, requires MVC to establish a *direct* relationship with RSM, based upon the auditor's affirmative conduct, evincing RSM's understanding that MVC will be relying on its audited financial reports. *Credit Alliance*, 65 N.Y.2d at 551; *see also Signature Bank*, 109 A.D.3d at 466-67 (2d Dep't 2013); *LaSalle Nat'l Bank v. Ernst & Young LLP*, 285 A.D.3d 101, 108 (1st Dep't 2001); *Parrott v. Coopers & Lybrand, LLP*, 263 A.D.2d 316, 321 (1st Dep't 2000), *aff'd*, 95 N.Y.2d 479 (2000). Without this affirmative linking conduct, the alleged relationship between RSM and MVC is too attenuated for RSM to be held liable for G3K's extensive fraud. As discussed in Section I, *supra*, this prong is both the most important, and the most difficult to satisfy, and unsurprisingly MVC fails to do so here.

Only four paragraphs in MVC's complaint allege any direct contact between RSM and MVC. *See* Complaint ¶¶ 21, 24, 25, 64. All other contact alleged in the complaint is indirect, and places G3K as the middle-man providing information separately to MVC and RSM. Taken together, such unspecific, minimal and sporadic communications between the parties fail to allege "linking conduct" sufficient to establish near privity. As the Second Department held in *Signature Bank*, "Here, the allegations supporting the cause of action to recover damages for negligent misrepresentation do not satisfy the third *Credit Alliance* prong.… [T]he complaint failed to allege some conduct of the defendant 'linking' it to the plaintiff which evinced the defendant's understanding of the plaintiff's reliance. [Citations omitted]. Accordingly, the Supreme Court should have granted the subject branch of the defendant's motion." *Signature Bank*, 109 A.D.3d at 466-67. The Second Department came to this conclusion notwithstanding the trial court noting that the plaintiff/lender, Signature Bank, had alleged that the audit firm knew, through the Chief Executive Officer of the audit firm's lendee/audit client, that "plaintiff [Signature Bank] relied on the 2008 audit report to determine whether to extend credit." *Signature Bank*, 2012 WL 11980647 at *2. Signature Bank further alleged "that it had several communications with [the auditor] concerning the [lendee] company's financial viability." As is the case here, however, such communications are insufficient to establish the necessary "linking" conduct to satisfy the third prong of *Credit Alliance*. *Signature Bank*, 109 A.D.3d at 466-67. *See also LaSalle Nat'l Bank*, 285 A.D.3d at 108 (finding minimal or sporadic communications to be insufficient to satisfy prong three of the *Credit Alliance* test); *Westpac*, 66 N.Y.2d at 19 (1985) (noting plaintiff lender's absence from the engagement agreement between borrower and auditor in dismissing negligent misrepresentation action).

The lack of substantive communications between the parties is also important. *See Parrott*, 263 A.D.2d at 321 ("The factors utilized in demonstrating the requisite relationship depend not only on the number of contacts but also on the substantive nature of the contacts."); *see also CRT Invs., Ltd. v. BDO Seidman, LLP*, 85 A.D.3d 470 (1st Dep't 2011) (internal citations omitted) (holding that "minimal or nonexistent" contact between accountant and plaintiff is insufficient to support recovery, even where plaintiff, unlike MVC, was actually entitled to receive a copy of the audited financial statements).

Based on the allegations of the Complaint, RSM took no action demonstrating its awareness of MVC's reliance on its audit report. Indeed, considering BDO's involvement, RSM could have reasonably concluded that MVC was relying not on RSM's report, but on BDO's independent review in coming to its decision to extend credit to G3K. Without any further linking conduct, none of which is alleged, MVC cannot satisfy the *Credit Alliance* factors. This is particularly true in light of MVC's admissions in other cases that it relied in great part upon its own due diligence in making its lending decision to G3K.

CONCLUSION

For the foregoing reasons, Defendant RSM US LLP respectfully requests that the single claim against it in the Complaint be dismissed with prejudice.

Dated: New York, New York
March 21, 2017

ARNOLD & PORTER
KAYE SCHOLER LLP

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Exhibit 5

BROWARD COUNTY BOARD OF COUNTY COMMISSIONERS

S. DAVIS & ASSOCIATES, P.A.

Petitioner, Re: External Audit Services
Solicitation No. R2112554P2

v.

BROWARD COUNTY BOARD
OF COUNTY COMMISSIONERS,

Respondent.

_________________________________/

STIPULATION FOR APPEAL

Broward County (the "County"), S. Davis & Associates, P.A. ("Davis") and RSM US LLP ("RSM") stipulate as follows:

1. RSM stipulates that the words spoken by Robert Feldman, Partner at RSM, at the reconvened evaluation committee meeting on July 19, 2017 are correctly transcribed on the transcription attached as Joint Exhibit 14 to the appeal.

2. RSM also states the following as updates on the two pending litigation cases cited by Davis, per Davis's request, since the reconvened evaluation committee:

a. In the RS Investments case, the Court granted RSM's Motion to Dismiss with prejudice on August 31, 2017. A copy of the Order is attached as Exhibit A.

b. In the MVC case, upon request from the Court RSM withdrew its Motion to Dismiss without prejudice on April 6, 2017, pending additional discovery on the issue of privity. A copy of the withdrawal is attached as Exhibit B.

3. Davis stipulates that in exchange for this stipulation, it will not seek testimony from Robert Feldmann or anyone with or employed by RSM at the Final Hearing for this Appeal.

4. This stipulation is made for the purpose of facilitating the final hearing. RSM reserves the right to dispute the relevancy of or weight given to the information contained herein.

Dated this 22nd day of SEPTEMBER, 2017.

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Intervenor Becker & Poliakoff, P.A. 625 N. Flagler Drive, 7th Floor West Palm Beach, Florida 33401 By: [signature] Mark J. Stempler, Attorney for RSM US LLP	

ACTIVE: 10128815_1

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION

RS Investments Limited, Corrado Investments Limited, Eden Rock Finance Master Limited, Eden Rock Asset Based Lending Master Ltd., Eden Rock Unleveraged Finance Master Limited and Solid Rock Special Situations 2 Ltd.,	)	No. 16 L 11459
Plaintiffs,	)	Calendar S
vs.	)	Judge Raymond W. Mitchell
RSM US LLP, RSM Cayman Ltd., and Simon Lesser,	)	
Defendants.	)	

ORDER

This matter is before the Court on Defendants RSM US LLP and Simon Lesser's motion to dismiss Plaintiffs RS Investments Limited, Corrado Investments Limited, Eden Rock Finance Master Limited, Eden Rock Asset Based Lending Master Ltd., Eden Rock Unleveraged Finance Master Limited and Solid Rock Special Situations 2 Ltd.'s complaint and Defendant RSM Cayman Ltd.'s motion to dismiss Plaintiffs' complaint pursuant to 735 ILCS 5/2-615 and 735 ILCS 5/2-619.

I.

Plaintiffs are various investment funds that invested in Lancelot Investors Fund, LTD, which collapsed after heavily investing in companies that were part of a Ponzi scheme. After the scheme was revealed, Lancelot went into bankruptcy and liquidation proceedings. Plaintiffs allege that Defendants RSM US LLP and RSM Cayman Ltd. served as auditors of Lancelot and Defendant Simon Lesser was the responsible audit partner. Plaintiffs further allege that Defendants provided Plaintiffs with "clean" audit opinions from 2004 through 2008, and in reliance on those opinions, Plaintiffs invested more than $79 million dollars in Lancelot and consequently lost that money. Plaintiffs filed a three-count complaint alleging fraud, negligent misrepresentation, and professional malpractice. Defendants now move to dismiss Plaintiffs' complaint in its entirety.

II.

A section 2-619 motion to dismiss admits the legal sufficiency of the complaint. 735 ILCS 5/2-619. The purpose of a section 2-619 motion to dismiss is to dispose of issues of law and easily proved issues of fact at the outset of the litigation. *Henry v. Gallagher*, 383 Ill. App. 3d 901, 903 (1st Dist. 2008). Although a section 2-619 motion to dismiss admits the legal sufficiency of a complaint, it raises defects, defenses, or some other affirmative matter appearing on the face of the complaint or established by external submissions, which defeat the plaintiff's claim. *Ball v. County of Cook*, 385 Ill. App. 3d 103, 107 (1st Dist. 2008).

Unlike a section 2-619 motion, a section 2-615 motion attacks the sufficiency of a complaint and raises the question of whether a complaint states a cause of action upon which relief can be granted. *Fox v. Seiden*, 382 Ill. App. 3d 288, 294 (1st Dist. 2008). All well-pleaded facts must be taken as true and any inferences should be drawn in favor of the non-movant. 735 ILCS 5/2-615; *Hammond v. S.I. Boo, LLC*, 386 Ill. App. 3d 906, 908 (1st Dist. 2008). Plaintiffs are not required to prove their case at the pleading stage; they are merely required to allege sufficient facts to state all elements which are necessary to constitute each cause of action in their complaint. *Visvardis v. Eric P. Ferleger, P.C.*, 375 Ill. App. 3d 719, 724 (1st Dist. 2007). A 2-615 motion to dismiss should not be granted unless no set of facts could be proved that would entitle the plaintiff to relief. *Beacham v. Walker*, 231 Ill. 2d 51, 58 (2008).

All Defendants move to dismiss on the basis that Plaintiffs, as shareholders of Lancelot, lack standing to sue directly for the company's losses. For issues related to corporate governance, Illinois courts apply the law of the place of incorporation. *See Spillyards v. Abboud*, 278 Ill. App. 3d 663, 667 (1st Dist. 1996). Plaintiff contends that Defendants' engagement letters and the Lancelot's offering memorandum contain choice of law provisions that choose Illinois law to govern claims arising from services rendered under those agreements. But the choice-of-law provisions govern only the validity and effect of those agreements; they do not reach issues of corporate governance. *See, e.g., Bagdon v. Bridgestone/Firestone, Inc.*, 916 F.2d 379, 383 (7th Cir. 1990). The issue of whether Plaintiffs may properly assert claims in a direct action rather than a derivative action is therefore determined by application of Cayman substantive law because Lancelot is a Cayman company. *See Lipman v. Batterson*, 316 Ill. App. 3d 1211, 1215 (1st Dist. 2000).

Under Illinois law, the laws of foreign countries must be established as any other fact. *Bangaly v. Baggiani*, 2014 IL App (1st) 123760, ¶ 145. In cases where any dispute exists regarding the application of foreign law, expert testimony regarding the meaning of the applicable law is essential. *Atwood Vacuum Machine Co. v. Continental Casualty Co.*, 107 Ill. App. 2d 248 (1st Dist. 1969). Regarding the application of Cayman law, Defendants submitted affidavits of Aristotelis Alexandros Galatopoulos and Plaintiffs submitted an affidavit of William Helfrecht. Helfrecht acknowledges that the law of Cayman's reflective loss doctrine is "generally represented accurately" in Galatopoulos's affidavit. Plaintiffs argue that Galatopoulos' affidavit is inadmissible because it contains conclusions of law. But Illinois courts can rely upon expert testimony by way of affidavit to establish and assist in the interpretation of foreign law. *See, e.g., Bangaly*, 2014 IL App (1st) 123760, ¶165.

Cayman law adopts the English common law doctrine of "reflective loss." *Svanstrom v. Jonasson* [1997] CILR 192. The leading case on reflective loss is *Johnson v. Gore Wood & Co*, an English case decided by the House of Lords. [2002] 2 AC 1. In delivering the principal judgment of the court, Lord Bingham summarized the reflective loss doctrine as follows:

> Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. A claim will not lie by a shareholder to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss.

Id. In other words, where a third party has wrongly caused a company's losses, a shareholder cannot maintain a direct action against the third party if the shareholder's loss would be made good by a successful action by the company against the third party. The rationale for the decision in *Johnson* was that the loss suffered by the shareholder is linked to and inseparable from general losses of the relevant company.

Plaintiff argues that its claims fall within two notable situations in which the reflective loss doctrine has no application. Lord Bingham summarized the first situation:

> Where a company suffers loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it (if the shareholder has a cause of action to do so), even though the loss is a diminution in the value of the shareholding.

Id. Here, however, Lancelot had a cause of action against Defendants. Indeed, the company's trustee in bankruptcy brought those claims against Defendants in federal court. *See Peterson v. McGladrey LLP*, 792 F.3d 785 (7th Cir. 2015). While the Seventh Circuit dismissed those claims under the doctrine of *in pari delicto*, dismissal of a company's claims subject to a successful defense does not permit a shareholder to then pursue otherwise reflective claims. "The principal applies even where the facts preclude double recovery, for example where the company has compromised its claim or chosen not to pursue it or where there is a defence to the company's claim which is not available with regard to the shareholder's claim." Victor Joffe and James Mather, *The Vanishing Exception*, 158 NLJ 1677 (2008); *Day v. Cook*, [2002] 1 BCLC 1, ¶38. Because Lancelot had claims to recover its losses, this first situation is not present.

Lord Bingham summarized the second situation:

> Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it, but neither may recover loss caused to the other by breach of the duty caused to that other.

Johnson v. Gore Wood & Co. [2002] 2 AC 1. Plaintiffs' losses, however, were not separate and distinct from Lancelot's loss. Where a company suffers loss caused by the breach of a duty owed both to the company and to the shareholder, "the shareholder's loss, in so far as this is measured by the diminution in value of his shareholding or the loss of dividends, merely reflects the loss suffered by the company in respect of which the company has its own cause of action." *Id.* Here, the professional negligence and misrepresentation claims allege breaches of duties owed to both Lancelot and its shareholders, and Plaintiffs' losses are measured solely by the diminution in the value of their shares. Moreover, Plaintiffs' fraud claim is not separate and distinct because the financial information Plaintiffs allegedly relied upon was distributed to all shareholders. In reaching the same conclusion, another court explained why individual shareholders' claims were not separate and distinct:

> The alleged professional negligence and misrepresentations were suffered by many creditors, not just McKinley. The financial information McKinley relied upon was distributed to all investors, not individually to McKinley. This puts McKinley in the same shoes as other investors who relied upon the financial reports. This is apparent based on the multitude of other lawsuits filed by other creditors of the

> estate against McGladrey alleging claims sounding in misrepresentation and professional negligence. All parties that invested in the Debtors, including McKinley, lost their investments because of Petters' alleged fraudulent conduct which may have been facilitated by McGladrey's alleged negligence and misrepresentations regarding the Debtors' financial condition. McKinley's claims are no different than those claims.

Peterson v. Ellerbrock Family Trust, LLC (In re Lancelot Investors Fund, L.P.), 408 B.R. 167, 172 (Bankr. N.D. Ill. 2009). Because Plaintiffs' claims are not separate and distinct, this second situation is not present here.

Plaintiffs argue that this Court should defer to the Seventh Circuit's decision in *Peterson v. McGladrey & Pullen*:

> Corporate and securities law rely on both managers and accountants to protect investors' interests. There would be a major gap in those bodies of law if, when one turns out to be a scamp, then the other is excused from performing his own duties, and investors are left unprotected. But that's not the outcome of applying the *pari delicto* doctrine to the Trustee's suit. The Trustee stepped into the shoes of the Funds, not the shoes of the investors. People who put up money have their own claims.
>
> . . . a claim [by investors] against McGladrey may offer some recompense, if the auditor was indeed negligent or willfully blind.
>
> . . . Proceedings on the investors' claims have been stayed pending resolution of the Trustee's suit. It is time to bring the investors' claims to the fore.

792 F.3d 785, 788–89 (2015). This language, however, is not inconsistent with the analysis here. If Plaintiffs' claims *were* separate and distinct from the injury suffered by the company, the *in pari delicto* doctrine would not bar Plaintiffs' claims. Plaintiffs would indeed have their own claims and now would be the time to bring those claims. But the *McGladrey* court did not discuss the merits of, or defenses to, Plaintiffs' claims—the Seventh Circuit did not analyze whether Plaintiffs' claims were separate and distinct from the injury suffered by the company or whether Cayman's reflective loss doctrine otherwise applied. In this regard, the *McGladrey* court did not rule that Plaintiffs have standing to bring their

claims. None of Plaintiffs' arguments forecloses the application of the reflective loss doctrine in this case.[1]

III.

Based on the foregoing, it is hereby ORDERED:

(1) RSM US LLP's motion to dismiss is GRANTED. Plaintiffs RS Investments Limited, Corrado Investments Limited, Eden Rock Finance Master Limited, Eden Rock Asset Based Lending Master Ltd., Eden Rock Unleveraged Finance Master Limited and Solid Rock Special Situations 2 Ltd.'s complaint is dismissed with prejudice.

(2) All future dates are stricken.

(3) This is a final order that disposes of the case in its entirety.

Judge Raymond W. Mitchell

ENTERED,

AUG 31 2017

Circuit Court -- 1992

Judge Raymond W. Mitchell, No. 1992

[1] Because Plaintiffs lack standing to assert their claims, the Court does not reach the section 2-615 bases for dismissal.

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motion withdrawn without prejudice

4/6/17

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JUSTICE

SUPREME COURT

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF WESTCHESTER

MVC CAPITAL, INC.,

Plaintiff,

-against-

RSM US LLP,

Defendant.

Index No. 69544/2016

NOTICE OF MOTION TO DISMISS

PLEASE TAKE NOTICE that, upon the annexed affirmation of Ian Jay, dated March 21, 2017, the Memorandum of Law in Support of Defendant RSM US LLP's Motion to Dismiss the Complaint, and all prior proceedings heretofore had herein, Defendant RSM US LLP will move this Court, at the courthouse at 111 Dr. Martin Luther King Jr. Drive, White Plains, New York 10601, on **May 26, 2017, at 9:30 a.m.**, or as soon thereafter as counsel may be heard, for an order dismissing the complaint with prejudice pursuant to CPLR § 3211(a)(7) for failure to state a claim, and pursuant to CPLR § 3211(a)(1) on the basis of documentary evidence, and for such other and further relief as this Court deems just and proper.

PLEASE TAKE FURTHER NOTICE, that pursuant to stipulation amongst the parties, answering papers, if any, shall be served on or before **May 4, 2017.**

Oral argument is respectfully requested.