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.