UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC. — CASE NO. 96-61376
Chapter 11
Debtors — Substantively Consolidated

RICHARD C. BREEDEN, as Trustee for
THE BENNETT FUNDING GROUP, INC.
and THE PROCESSING CENTER, INC.

Plaintiff

vs. — ADV. PRO. NO. 97-70049A

SPHERE DRAKE INSURANCE PLC, SPHERE DRAKE UNDERWRITING MANAGEMENT (BERMUDA) LIMITED, TRIANGLE INSURANCE MANAGEMENT LIMITED, LLOYD THOMPSON LIMITED, THE BENNETT FUNDING CORPORATION, BRIGHTON SECURITIES CORP., HALPERT AND COMPANY, WEINER ABRAMS & COMPANY INC., BANKERS FINANCIAL CORP., INTERNATIONAL FINANCE BANK, AMERICAN TRAFFIC SAFETY SERVICE ASSOCIATION, INC., SUMMIT FINANCIAL SECURITIES INC., HEFREN TILLOTSON, INC., HORIZON SECURITIES, SAGE-RUTTY & COMPANY, MID-STATE ADVISORS, ANDREW ANDREAS SPECIAL NEEDS TRUST, RICHARD H. REYNOLDS PROFIT SHARING PLAN, INC., SOUTHEASTERN PAPER PROFIT SHARING PLAN, FIRST FEDERAL SAVINGS BANK OF LAGRANGE, GREATER DELAWARE VALLEY SAVINGS BANK, MERCHANTS NATIONAL BANK OF WINONA, FARMERS STATE BANK, THE COMMERCIAL BANK, FIRST NORTHERN BANK & TRUST, LAFAYETTE SAVINGS BANK, DOLLAR CAPITAL CORPORATION, and JOHN DOES 1 through 10,000

Defendants

APPEARANCES:

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW, ORDER AND RECOMMENDATION

The Debtors, a network of financial service companies formerly controlled by the Bennett family of Syracuse, New York, collapsed amidst accusations of massive criminal securities fraud in March 1996. Since that time, numerous adversary proceedings have been commenced in this Court which have sought damages from the Debtors, certain of their officers, and the third-party professionals who allegedly abetted the fraud.

Among the defendants in this last category are Sphere Drake Insurance PLC, Sphere Drake Underwriting Management (Bermuda) Limited (together, "Sphere Drake"), Triangle Insurance Management Limited ("Triangle"), and Lloyd Thompson Limited ("Lloyd Thompson")-- collectively, the "Defendants"-- who are accused of assisting the fraud by providing misleading certificates of insurance to the investors in one of the Bennett companies. In his Second Amended Adversary Complaint, filed on July 29, 1998 ("Complaint"), Chapter 11 Trustee Richard C. Breeden ("Trustee") accordingly seeks to recover over $400 million in compensatory damages from these Defendants on various tort theories. In addition, cross claims against the Defendants have been asserted by certain other defendants in this adversary proceeding, among whom are Brighton Securities Corporation ("Brighton"); Halpert and Company ("Halpert"); Merchants National Bank of Winona ("Winona"); The Commercial Bank; and Dollar Capital Corporation ("Dollar") (collectively, the "Cross Claimants"). For the most part, these cross claims substantially echo the allegations and legal theories raised by Trustee's causes of action.

Lloyd Thompson and Triangle have attacked the legal sufficiency of these claims with motions brought under Rules 7009 and 7012 of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P."), which incorporate by reference the terms of Rules 9 and 12 of the Federal Rules of Civil Procedure ("Fed R.Civ.P."), principally on the grounds that the Trustee and Cross Claimants either lack standing to sue or have failed to allege the Defendants' fraud with the requisite particularity. On similar grounds, Sphere Drake has moved to dismiss certain of the cross claims asserted against it, although it does not move to dismiss any of the Trustee's claims.

The Court heard argument on the motions to dismiss at its motion calendar of February 11, 1999, at the close of which the matters were submitted for decision, all parties having previously submitted memoranda of law.

JURISDICTIONAL STATEMENT

While the issue of jurisdiction has not been addressed by any party to this motion, the tort claims asserted by the Trustee apparently seek vindication on behalf of the estate of pre-petition rights which would exist independently of this bankruptcy proceeding. According to the analysis set forth in 28 U.S.C. § 157(a), these are thus "non-core" matters which are "related to" the Debtors' Chapter 11 case. *See Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld LLP*, 201 B.R. 635, 639 (S.D.N.Y. 1996). Pursuant to 28 U.S.C. § 157(c)(1), this Court has limited jurisdiction to hear a motion brought on these claims and to submit proposed findings of fact and conclusions of law to the District Court. *See Aarismaa v. Jordan (In re Aarismaa)*, 233 B.R. 233, 237 (N.D.N.Y. 1999). As discussed at greater length below, the Court finds that to the extent that the cross claims and the Trustee's claims sound in contract or in a declaration of contract rights, it has core subject matter jurisdiction to hear and decide them pursuant to 28 U.S.C. §§ 1334 and 157(a), (b)(1), and (2)(A). However, the Court concludes that it lacks jurisdiction to hear or determine any of the cross claims which sound in tort or in a declaration of tort rights.

FACTUAL STATEMENT

Because Fed.R.Civ.P. 12(b) tests the legal sufficiency of a claim, and not its factual merit, a court deciding a motion brought under this rule is limited to a consideration of those facts which appear on the face of the complaint, along with any court documents of which it may take judicial notice. *See Ryder Energy Distribution Corp. v. Merrill Lynch Commodities, Inc.,* 748 F.2d 774, 779 (2d Cir. 1984). As a result, the following statement of facts is accordingly drawn from the pleadings of the Trustee and the Cross Claimants, except as otherwise noted. While these allegations will be construed as true for the limited purpose of this motion, they do not constitute findings of fact by the Court and will not be binding on the parties in subsequent proceedings. *See ABF Capital Management v. Askin Capital Management, L.P.,* 957 F. Supp. 1308, 1314 (S.D.N.Y. 1997).

1. The Debtors

The debtors in this Chapter 11 case are eight interrelated companies whose bankruptcy estates were substantively consolidated by an Order of the Court on July 25, 1997. The Trustee's adversary complaint was filed on behalf of two of these debtor entities: The Bennett Funding Group, Inc. ("BFG"), whose principal business consisted of originating and assigning equipment lease contracts to investors, and The Processing Center, Inc. ("TPC"), which would service the leases generated by BFG. It appears, however, that the causes of action which are presently at issue relate to BFG only.

Although BFG had been a legitimate, reputable finance company for the first decade of its existence, the nature of its business underwent a fundamental change in or about 1988. Under the direction of Patrick Bennett, its Chief Financial Officer, BFG began to assign leases which, unbeknownst to the investors who paid for them, had already been assigned to other persons. This deception was made possible, in part, by the intricacies of BFG's lease servicing program, under which TPC would continue to make collections from the lessees on behalf of the investors who had purchased the future lease payments. While each multiple-pledged lease would provide a short-term benefit to BFG, this fraud had the long-term effect of deepening BFG's insolvency since each investor would eventually demand to be paid back in an amount greater than his or her original investment. However, Patrick Bennett was able to escape the immediate consequences of this deception by resorting to the classic expedient of the "Ponzi" scheme-- in effect, paying off these old investors not with the fruits of their investment, but rather with funds misappropriated from new investors. This device could succeed only as long as BFG was able to attract an ever-growing circle of investors, which in turn drove Patrick Bennett to apply his fraud on an increasingly widening scale.

As a result of these practices, by the middle 1990s, BFG had grown into what the Trustee has elsewhere described as "the largest Ponzi scheme ever carried out against individual investors and financial institutions in U.S. history." *Breeden v. Bennett (In re The Bennett Funding Group, Inc.)*, 220 B.R. 743, 747 (Bankr. N.D.N.Y. 1997). The most immediate victims of this fraud were, of course, the thousands of BFG investors and creditors who were left holding millions of dollars in unpaid obligations when the bubble finally burst in early 1996. The Ponzi scheme also inflicted serious damage on BFG itself, whose business reputation was all but destroyed by the exposure of the fraud. Moreover, by masking the true state of BFG's finances, the Ponzi scheme allowed BFG to continue in the lease financing business long after it had stopped being profitable, thus artificially deepening its insolvency prior to bankruptcy. Additionally, the Ponzi scheme created a financial screen behind which Patrick Bennett was able to secretly divert tens of millions of dollars of BFG funds to his personal use. These embezzled funds were then used by Patrick Bennett to purchase, *inter alia*, interests in various unsuccessful gambling and entertainment ventures.

While the Trustee's complaint states that Patrick Bennett was "aided and abetted by others" in his orchestration of this fraud, it does not specify whether these "others" included his parents, Edmund and Kathleen Bennett, who were the sole shareholders of BFG.[1] However, in several other adversary proceedings that are currently pending in this case, the Trustee has affirmatively alleged that the Bennett parents were aware that certain leases had been double-pledged, and further characterizes them as "knowing participants" in the Ponzi scheme. *See* First

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[1] Although the complaint in this adversary proceeding contains no discussion of BFG's ownership, the Court takes judicial notice of BFG's List of Equity Security Holders, filed by the Trustee on August 1, 1996, which lists Edmund and Kathleen Bennett as the sole shareholders as of the petition date.

Amended Complaint in *Breeden v. Patrick R. Bennett et al.*, Adv. No. 96-70154 at ¶¶ 63-66; Complaint in *Breeden v. OnBank & Trust Co. et al.*, Adv. No. 98-70629 at ¶ 20.

The complaint's only other allegation about the inner workings of BFG is a statement that, at all relevant times, Patrick Bennett "was not the sole director and/or officer of BFG." (¶ 81) The identities and functions of these other officers and directors are not stated in the complaint. It is also not stated whether these other officers knew of the fraud, or whether they could have done anything to prevent it.

2. Sphere Drake

The ability of BFG to draw new victims into its Ponzi scheme depended in large part on BFG's ability to market its securities as conservative, low-risk investments. To this end, Patrick Bennett sought to obtain financial guarantees that would give the Bennett leases the appearance-- though not the effect-- of being insured. Beginning in 1990, Patrick Bennett obtained insurance for various Bennett investments from Assicurazioni Generali S.p.A. ("Generali"), whose relationship with BFG was terminated by 1994.[2] At that time, Generali was replaced by Sphere Drake, a British corporation and one the world's leading reinsurance companies, as well as

[2] The Trustee has asserted tort and contract claims against Generali which are identical in many respects to the causes of action asserted against the Defendants in the present motion. *See Breeden v. Generali U.S. Branch (In re The Bennett Funding Group, Inc.)*, Adv.No. 96-70195A (Bankr. N.D.N.Y. December 19, 1997) ("*Generali I")*; *In re The Bennett Funding Group, Inc.*, No. 96-61376 (Bankr. N.D.N.Y. March 18, 1999) (*"Generali II")*; *In re The Bennett Funding Group, Inc.*, No. 96-61376 (Bankr. N.D.N.Y. April 9, 1999) (*"Generali III"*). None of the Defendants in the present adversary proceeding were parties to any of the *Generali* decisions; as such, the doctrine of res judicata does not preclude any of their arguments.

Sphere Drake Underwriting, its Bermuda affiliate. Also in the summer of 1994, Patrick Bennett created a "captive" Bermuda insurance company known as Bennett Insurance Co., Ltd. ("BIC"), the name of which was later changed to Capital Insurance. In October 1994, BIC issued its Master Commercial Lines Policy #0001 to BFG, which purported to insure BFG against shortfalls in its lease collections. BIC, in turn, was reinsured by Sphere Drake. Because BIC had only minimal capital reserves, Sphere Drake functioned for all practical purposes as BFG's primary insurer, and further agreed to a "claims paying agent agreement" pursuant to which claims could be made to it directly in place of BIC. Among other provisions, this agreement contained a choice of law clause which provided that any dispute arising under it would be governed according to the laws of Bermuda.

While it thus might have appeared that the investments sold by BFG had the backing of a large and reputable reinsurance company, a number of hidden clauses in the insurance contracts combined to make Sphere Drake's reinsurance almost wholly illusory. Among these was a "double trigger" clause which set out two conditions that must be met before BIC (and, by extension, Sphere) would become obligated to pay BFG: there would have to be a shortfall in the payments made by the equipment lessees to BFG, <u>and</u> BFG would have to default on its own obligations to its investors. This was significant because, in a typical Ponzi scheme, the Ponzi operator never misses a payment to his investors until the moment when the entire scheme collapses. As a result, in this case, the double trigger ensured that no insurable event would take place prior to BFG's bankruptcy, no matter how badly the leases performed. Secondly, a "fraudulent acts" clause required BFG to reimburse its insurers for any payments made on account of its own fraud. Thirdly, under a "hold harmless" agreement that was added to the claims paying agent agreement in 1995, BFG was obligated to reimburse Sphere Drake for any and all claims paid out under BIC's reinsurance policy. Because BFG was itself the named insured under the BIC policies, the resulting payment obligations were entirely circular: in the event of an insured shortfall, BFG would make a claim against BIC, which would look for payment to Sphere Drake, which would in turn have a right of reimbursement against BFG. This last agreement was kept secret from many of BFG's key officers, including William Crowley, its Chief Accounting Officer.

Sphere Drake was aware of the unconventional nature of this insurance mechanism. In particular, the fraudulent acts clause was the subject of considerable discussion by high-ranking Sphere Drake officials, including Eric Keen, the Vice President of Underwriting at Sphere Drake Underwriting. Keen expressed his belief that this clause was unenforceable, and worried that the inclusion of the clause suggested that illegal activity was occurring at BFG. In spite of these concerns, however, Keen authorized the inclusion of the fraudulent acts language.

Needless to say, the true nature of this insurance was kept hidden from the purchasers of Bennett investments. On November 2, 1994, Sphere Drake drafted a "Confirmation of Reinsurance," which stated that it had issued reinsurance to BIC. Copies of this were distributed to investors along with putative "Certificates of Insurance" issued by BIC. Although the investors who received these Certificates were led to believe that they were the actual beneficiaries of these policies, in all but a few instances, the named loss payee under the policy was TPC. The Certificates did not contain industry-standard language stating that they conveyed no legal rights; nevertheless, they were highly effective in attracting investors to BFG.

In his Complaint, the Trustee asserts five separate causes of action against Sphere Drake.

These causes of action assert claims for breach of contract, based on Sphere Drake's failure to make payment under the claims paying agent agreement to TPC (Count I); a declaratory judgment that TPC and/or the estate have a superior interest in any proceeds of the insurance policies (Count II); damages for aiding and abetting the fraud of Patrick Bennett (Count V); damages for aiding and abetting Patrick Bennett's breach of fiduciary duties to BFG (Count VI); and damages for a negligent audit of BFG (Count VII). Sphere Drake has not moved to dismiss these causes of action.

3. Lloyd Thompson and Triangle

Lloyd Thompson is a British corporation which brokered the transactions between BFG, BIC, and Sphere Drake. During the course of the negotiations, Lloyd Thompson drafted or reviewed all the contract provisions discussed above, and at one point represented to Sphere Drake that, on account of the hold harmless agreement, the insurance program was a mere "cosmetic exercise" with no real risk to the insurer. It is not alleged that Lloyd Thompson assumed any of the risk (real or imagined) of this insurance program for itself, nor is it alleged that Lloyd Thompson received anything other than a regular brokerage commission for its work.

Triangle is a Bermuda corporation, 49% of which was owned by Lloyd Thompson at the time of its association with BFG. During this period, Triangle served as manager for BIC, in the course of which it prepared and issued the Certificates of Insurance to the investors. In addition, various BFG documents were maintained by Janice Witkowski ("Witkowski"), an employee of Triangle. These documents are alleged to have contained evidence of BFG's double-pledging of leases, and thus of its Ponzi scheme. As with Lloyd Thompson, however, it is not alleged that Triangle received any compensation for its work other than a standard professional fee.

Lloyd Thompson and Triangle have been joined as defendants to Counts II, V, and VI of the Trustee's Complaint, which seek a declaratory judgment and damages for aiding and abetting Patrick Bennett's torts. Lloyd Thompson and Triangle have moved to dismiss these causes of action for failure to state a claim on which relief may be granted, and alternately have moved to dismiss Counts V and VI of the Complaint for failure to plead fraud with particularity.

4. Halpert and Dollar

In their cross claims (which are in all relevant respects identical to one another), Halpert and Dollar allege that they are listed as loss payees on certain policies issued by BIC to BFG. Count I of these cross claims alleges a breach of contract by Sphere Drake and Triangle on account of their failure to make payment to Halpert and Dollar under the claims paying agent agreement. Count II asserts a fraud cause of action against all three Defendants and incorporates by reference the relevant factual allegations of the Trustee's Second Amended Complaint. Count III is styled as a "negligence" claim against Sphere Drake (but not Triangle or Lloyd Thompson) which, in substance, alleges that Sphere Drake breached a duty to BFG's investors by failing to discover and/or expose Patrick Bennett's fraud.

Sphere and Triangle have moved to dismiss Count I of these cross claims on the grounds that Bermuda law (which the Defendants argue to be applicable in this case) does not grant a contract right of action to intended third party beneficiaries such as Halpert and Dollar. In addition, all three Defendants have moved to dismiss Count II, against which they raise substantially the same arguments as are raised against the Trustee's fraud claims. Sphere Drake has not, however, moved to dismiss Halpert and Dollar's negligence cross claims.

5. The Commercial Bank

The Commercial Bank alleges that it entered into certain unspecified transactions with BFG, pursuant to which it was listed as the loss payee on a policy insured by BIC and reinsured by Sphere Drake. The Commercial Bank's First and Second Cross Claims, which appear to seek declaratory relief against Sphere Drake, request a judgment to the effect that The Commercial Bank (and not the Trustee) has the sole legal and equitable interest in the proceeds of the insurance policies of which it is listed as loss payee. The Third Cross Claim (entitled "Third Counterclaim, Third Cross-Claim Against Sphere Drake Defendants and First Cross-Claim Against Thompson and Triangle") seeks compensatory damages from all three Defendants under a fraud theory. Like Halpert and Dollar, The Commercial Bank adopts the Trustee's allegations concerning the Debtors' fraud. The Fourth and Fifth Cross Claims (listed as the "Second" and "Third" cross claims against Triangle and Lloyd Thompson) seek further declaratory judgment against all three Defendants. While the exact substance of this requested declaratory relief is somewhat unclear, The Commercial Bank appears to argue that it would have the exclusive right to any tort recoveries realized by the Trustee as the result of his fraud claims against the Defendants.

Lloyd Thompson and Sphere Drake (which does not seek dismissal of the contract-related claims) have each moved to dismiss The Commercial Bank's third cross claim as well as the two declaratory cross claims concerning the potential tort recoveries against the Defendants (Fourth and Fifth Cross Claims). However, in spite of its motion to dismiss the factually-indistinguishable fraud claims of Halpert and Dollar, Triangle has not moved to dismiss any of the claims asserted against it by The Commercial Bank.

6. Brighton

Brighton is a brokerage firm which appears to have been assigned an interest in certain Bennett leases on behalf of its customers. At least some of these investments were purportedly insured by Sphere Drake and BIC, which issued policies listing Brighton as the loss payee. Brighton has asserted four cross claims against the Defendants which seek, respectively, (1) compensatory damages from Sphere Drake for breach of contract; (2) declaratory judgment against Sphere Drake that Brighton and/or its customers have a perfected security interest in the insurance proceeds as well as the leases which they purport to insure; (3) declaratory judgment determining the liability of Sphere Drake in the event that Brighton or its customers are found liable to the Trustee in avoidance actions brought under § 547 or § 548 of the United States Bankruptcy Code, 11 U.S.C. §§ 101-1330 ("Code"); and (4) declaratory judgment against all three Defendants that Brighton and/or its customers have right to the insurance proceeds which is superior to that of the Trustee and all other parties. Lloyd Thompson and Triangle have moved to dismiss this final counterclaim on the grounds that it does not present a case or controversy, since neither of these Defendants presently claims an interest in the insurance proceeds. In its response to the motions of Lloyd Thompson and Triangle, filed on December 22, 1998, Brighton consented to the dismissal of this fourth cross claim with respect to Lloyd Thompson and Triangle only.

7. Winona

Winona alleges that it is a bank which acquired an interest in three Bennett lease contract portfolios that were purportedly insured by BIC and reinsured by Sphere Drake. Winona was listed as the loss payee on the Certificate of Insurance for two of these portfolios, while the Certificate of Insurance for the third portfolio was never delivered to it. Winona has asserted three cross claims against the Defendants, which seek damages for: (1) breach of contract, against Sphere Drake; (2) fraud and misrepresentation, against Sphere Drake, Lloyd Thompson, and Triangle; and (3) negligence, against Sphere Drake. Winona adopts all relevant factual allegations of the Trustee's complaint in support of its cross claims. Lloyd Thompson and Sphere Drake have each moved to dismiss Winona's second cross claim for failure to comply with Fed.R.Civ.P. 9(b). Triangle has not moved to dismiss the second cross claim, and Sphere Drake has not moved to dismiss the first or third cross claims.

DISCUSSION

1. The Trustee's Tort Claims

Lloyd Thompson and Triangle raise two alternate arguments in support of their motions to dismiss the Trustee's claims for aiding and abetting fraud.[3] In the first instance, these Defendants assert that the Trustee lacks standing to bring tort claims against them, either because those rights of action belong exclusively to the individual fraud victims (and not to the estate), or else because the Trustee's ability to recover is barred by the participation of BFG's insiders in the fraud. Alternately, the Defendants argue that Counts V and VI of the Complaint should be dismissed because of the Trustee's failure to plead fraud with the particularity required by Fed.R.Civ.P. 9(b).

a. Standing

The present motions mark the second occasion in which the Court has considered the Trustee's standing to bring fraud actions against the non-debtor parties who allegedly assisted in the BFG Ponzi scheme. In *Generali I*, the Trustee sought leave to file an amended complaint against Generali in which he asserted fraud claims substantially similar to those raised in Counts V and VI of the Complaint in the present adversary proceeding. Although Generali opposed that motion, arguing that the Trustee had no standing to assert the fraud claims, the Court subsequently granted the Trustee's motion. While Lloyd Thompson and Triangle were obviously not parties to that proceeding, and thus are unaffected by the doctrine of collateral estoppel, the Court finds that similar considerations mandate that it reject their challenge to the Trustee's

[3] Although similar tort claims have been asserted by the Trustee against Sphere Drake, Sphere Drake does not join in this portion of the motions to dismiss by Lloyd Thompson and Triangle.

standing in the present matter.

When considering a motion to dismiss which is based on a challenge to the plaintiff's standing, a federal court is "constrained . . . to accept as true all material allegations of the complaint, and [to] construe the complaint in favor of the complaining party." *Sullivan v. Syracuse Housing Authority*, 962 F.2d 1101, 1107 (2d Cir. 1992) (internal citations omitted). As with any other motion brought under Fed.R.Civ.P. 12(b), the court's analysis is limited to the facts which appear on the face of the complaint, along with "such other facts and circumstances as may be evident from the record." *Id*.

The constitutional and prudential requirements of standing reflect the principle that a litigant in federal court "must assert his own legal interests rather than those of third parties," and that a court will not entertain a claim unless the plaintiff has "suffered 'a distinct and palpable injury to himself' . . . that is likely to be redressed if the requested relief is granted." *Gladstone, Realtors v. Village of Bellwood*, 441 U.S. 91, 100, 99 S.Ct. 1601, 1608, 60 L.Ed.2d 66 (1979), *quoting Simon v. Eastern Kentucky Welfare Rights Organization*, 426 U.S. 26, 38, 96 S.Ct. 1917, 1924, 48 L.Ed.2d 450 (1976). This analysis often becomes greatly complicated where the plaintiff is a Chapter 11 trustee bringing suit in the name of a bankrupt corporation, and the present case is no exception. Noting that the Trustee stands in the shoes of BFG for purposes of this litigation, Lloyd Thompson and Triangle argue that the Trustee is attempting to assert rights of action which properly belong to BFG's defrauded investors, and not to BFG itself. The Trustee, however, argues that at least some of the harms alleged in his Complaint are harms that are "distinct" to BFG, for which the Trustee alone can obtain redress.

The substantive limits of a bankruptcy trustee's standing to bring claims against third parties were analyzed at some length by the Supreme Court in *Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416, 92 S.Ct. 1678, 32 L.Ed.2d 195 (1972). In *Caplin*, a case brought under Chapter X of the former Bankruptcy Act, the trustee sued Marine Midland, the debtor's indenture trustee, for its failure to prevent the debtor's willful breach of the indenture. In arguing that he had the right to pursue this cause of action on behalf of the defrauded bondholders, the trustee relied largely on public policy, asserting that as a practical matter, he was "in a far better position than debt investors" to investigate and litigate torts whose effects were dispersed among a broad group of creditors. *Id.* at 427, 92 S.Ct. at 1684.

The court disagreed, holding that the trustee lacked standing to bring any kind of action against the indenture trustee on behalf of the debenture holders. This ruling was based, in the first place, on the court's interpretation of the text of the Bankruptcy Act, which contained no express grant of authority allowing the trustee to collect money not owed to the estate. Instead, the court found an opposite intention in the legislative command that the trustee investigate potential causes of action "available to the estate," suggesting that the trustee's powers did not extend to rights of action that are not owned by the estate. *Id.* at 427, 92 S.Ct. at 1685. Secondly, the court noted that because of the debtor's own alleged role in the fraud, it would likely be barred from pursuing any claims against the indenture trustee in its own right by the common law doctrine of *in pari delicto*. *Id.* at 430, 92 S.Ct. at 1686. Finally, and perhaps most significantly, the court reasoned that allowing the trustee to sue in the name of the debenture holders would raise fundamental concerns of fairness (if not full-fledged due process problems) for both the defendant and the ostensible plaintiffs. As the court explained,

> . . . [A] suit by [the trustee] on behalf of debenture holders may be inconsistent with any independent actions that they might bring

> themselves. Petitioner and the SEC make very plain their position that a suit by the trustee in reorganization does not pre-empt suits by individual debenture holders. They maintain, however, that it would be unlikely that such suits would be brought since the debenture holders could reasonably expect that the trustee would vigorously prosecute the claims of all debt investors. But, independent actions are still likely because it is extremely doubtful that the trustee and all debenture holders would agree on the amount of damages to seek, or even on the theory on which to sue. Moreover, if the indenture trustee wins the suit brought by the trustee in reorganization, unless the debenture holders are bound by that victory, the proliferation of litigation that petitioner seeks to avoid would then ensue. Finally, a question would arise as to who was bound by any settlement.

Id. at 428, 92 S.Ct. at 1687.

While the statute under which *Caplin* was decided is of course no longer in force, its rationale has continued to be cited in cases brought under the Bankruptcy Code. *See Mixon v. Anderson (In re Ozark Restaurant Equipment Co., Inc.)*, 816 F.2d 1222, 1227 (8th Cir. 1987) (noting that the drafters of the Bankruptcy Code considered and rejected an amendment that would have overruled *Caplin*). More recently, *Caplin* has been clarified and extended in two decisions of the Second Circuit. The first of these, *Shearson Lehman Hutton, Inc. v. Wagoner,* 944 F.2d 114 (2d Cir. 1991), involved a lawsuit by the bankruptcy trustee against Shearson Lehman ("Shearson"), the debtor's securities broker, which was accused both of churning the debtor's trading accounts and of breaching its fiduciary duties by assisting the excessively speculative trades ordered by the debtor's sole shareholder. Shearson moved to dismiss for lack of standing, arguing that the trustee was improperly attempting to assert the rights of the creditor-investors who had entrusted their money to the debtor. After citing *Caplin* for the proposition that the bankruptcy trustee generally has no standing to bring actions against third parties on behalf of creditors, the court noted that the ultimate question of the trustee's standing would depend on "whether . . . there is any damage to the *corporation*, apart from that done to the third-party creditor noteholders." *Id.* at 118-119. This, in turn, would be determined by examining whether the claim in question could have been asserted by the debtor corporation against the third party prior to bankruptcy. *Id.* at 119.

Applying this analysis, the court concluded that the trustee had standing to assert his churning claim against Shearson. *Id.* By the same logic, however, the court found that the trustee could not assert a claim that Shearson had aided the debtor's principal in his fraud of the investors. In the first place, the court noted, this claim alleged damage suffered by the investors, not the corporation, and thus could not have been asserted by the corporation outside of bankruptcy. *Id.* at 120. Secondly, the court held that the trustee could not sue Shearson for aiding fraud for the simple reason that the debtor's "sole stockholder and decisionmaker . . . not only knew of the bad investments, but actively forwarded them." *Id.*

The Second Circuit had occasion to re-examine this second *Wagoner* rationale four years later in *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085 (2d Cir. 1995). *Hirsch* was decided against a factual backdrop that is in many respects similar to that alleged by the Trustee in the present case: the debtor, Colonial Realty ("Colonial"), was a once-legitimate investment company which, at the direction of its principals, was allegedly transformed into the vehicle for a Ponzi scheme. This fraud was allegedly instigated and orchestrated by non-debtor defendant Arthur Andersen & Co. ("Andersen"), which had performed various accounting and underwriting services for Colonial. As construed by the court, the trustee's complaint alleged essentially two different wrongs by Andersen: its provision of misleading information to the defrauded Ponzi investors, and its provision of deficient professional services to Colonial. *Id.* at 1092.

The *Hirsch* court concluded that the trustee lacked standing to pursue either of these tort claims. With respect to the misrepresentation allegations, the court found that applicable state law assigned a right of action to the defrauded investors exclusively. *Id*. at 1093. Thus, like the fraud claims in *Wagoner*, these claims could not be asserted by the trustee for the simple reason that they could never have been asserted by the bankrupt corporation. The court also observed that the malpractice claims were little more than an attempt to recast the losses suffered by investors as an injury to the corporation, as "any damage suffered . . . was ultimately passed on to the investors." *Id*. at 1094. However, the court noted that even if there had been a distinct harm to the debtor corporation, the second prong of the *Wagoner* test would deprive the trustee of standing on account of Colonial's "collaboration" with Andersen. *Id*.

The *Hirsch* decision never defines "collaboration" in this context, nor does it expressly state what degree of collaboration would suffice to destroy the trustee's standing. As the court's subsequent discussion makes clear, however, the standards are identical to those of the common law doctrine of *in pari delicto*, under which a plaintiff's rights of action may be limited by its own wrongdoing. *See Oppenheimer-Palmieri Fund, L.P. v. Peat Marwick Main & Co. (In re Crazy Eddie Securities Litigation)*, 802 F. Supp. 804, 817 (E.D.N.Y. 1992). Thus, the *Hirsch* decision cites with approval its prior opinion in *Kalb, Voorhis & Co. v. American Financial Corp*., 8 F.3d 130 (2d Cir. 1993), in which the Second Circuit, applying Texas and Ninth Circuit law, upheld a bankruptcy trustee's standing to bring a corporate veil-piercing action on the grounds that the debtor corporation was not *in pari delicto* with the third-party defendant. *Hirsch*, 72 F.3d at 1095, *citing Kalb*, 8 F.3d at 133.

Read together, *Caplin, Wagoner,* and *Hirsch* thus set out a two-step test which this Court must apply in order to determine whether the Trustee has standing to bring his fraud claims against Lloyd Thompson and Triangle. First, the relief sought must be of a type that a non-bankrupt corporation in BFG's position would *in general* be able to pursue. *See Wagoner*, 944 F.2d at 120. Secondly, the facts of the case must be such that the BFG *in particular* would not have been precluded by its own conduct from suing the Defendants prior to entering bankruptcy. *See Hirsch*, 72 F.3d at 1095.

Although the Trustee's Complaint attempts to draw a distinction between Patrick Bennett's fraud of BFG and his breach of fiduciary duties to BFG (a distinction which may be without significance, as the breach of fiduciary duties is apparently alleged to be the fraud itself), under either theory of action, there appear just four distinct harms which are alleged to have been suffered by BFG : (1) the financial losses suffered by the BFG investors, which has led in turn to massive fraud claims against BFG; (2) the damage to BFG's business reputation which resulted from the exposure of the fraud; (3) the looting of BFG assets under cover of the Ponzi scheme; and (4) the "deepening insolvency" of BFG.

Had the Trustee alleged only the first of these harms, his Complaint would likely be indistinguishable from the complaints dismissed in *Wagoner* and *Hirsch*. The ownership of a cause of action is determined with reference to state law, *see Mediators, Inc. v. Manney (In re Mediators*, *Inc.)*, 105 F.3d 822, 825 (2d Cir. 1997), and under New York law, the right to redress the first type of harm belongs to the defrauded creditors exclusively. *See Barnes v. Hirsch*, 215 A.D. 10, 11 (N.Y. App. Div. 1st Dept. 1925). Although there can be little question that the fraud claims asserted against BFG as a result of the Ponzi scheme represent a significant harm to BFG, this type of injury is completely derivative of whatever injuries had been suffered by the investor-creditors. Allowing the Trustee to go forward with a claim based on this theory while the investors pursue their own claims in state court would expose the Defendants to double liability for what are essentially the same harms and the same conduct, which would in turn give rise to the due process dilemmas identified by the court in *Caplin*. *See E.F. Hutton & Co., Inc. v. Hadley*, 901 F.2d 979, 987 (11th Cir. 1990) (holding that a bankruptcy trustee has no standing to litigate a cause of action which would be "duplicative" of claims belonging to creditors). While the exposure-to-liability allegation is carefully crafted to focus attention on the secondary harm to BFG, rather than on the primary harm to the investors, the Court is not bound by such formalities in its determination of the Trustee's standing. *See CEPA Consulting, Ltd. v. King Main Hurdman (In re Wedtech Securities Litigation)*, 138 B.R. 5, 7-8 (S.D.N.Y. 1992) (noting that, under *Wagoner*, "a party's own description of its claims . . . is not controlling."). Accordingly, the Trustee has no standing to sue the Defendants for the out-of-pocket losses suffered by the victims of the Ponzi scheme.

The last three alleged harms, by contrast, do present wrongs for which BFG (and BFG alone) may obtain redress. The loss of goodwill and business reputation, while in some sense a direct consequence of the fact that investors were defrauded, is nevertheless an injury that is distinct to BFG, rather than its creditors. *See Generali I*, slip op. at 13. Likewise, the looting carried out by Patrick Bennett (and made possible by the Ponzi scheme) unquestionably damaged BFG, but it did not directly harm the Ponzi scheme victims, except insofar as it left BFG with fewer assets to satisfy their claims. Even here, however, it is significant that both types of indirect damage were suffered proportionally by all of BFG's unsecured creditors, including those that did not participate in the Ponzi scheme, rather than by any discrete subgroup of creditors. In such a situation, the appropriate plaintiff is the bankruptcy trustee. *See Drabkin v.*

L&L Construction Associates (In re Latin Investment Corp.), 168 B.R. 1, 7 (Bankr. D.D.C. 1993). Likewise, if it can be proved that the Ponzi scheme created a prolonged artificial insolvency for BFG, the Trustee may be able to obtain redress against the parties responsible. *See Allard v. Arthur Andersen & Co.*, 924 F. Supp. 488, 494 (S.D.N.Y. 1996). Under this theory, the harm to BFG would have been that the Ponzi scheme prevented it from recognizing its own dire financial situation, when it might otherwise have minimized its losses by filing for bankruptcy in a more timely manner. *See also Bloor v. Dansker (In re Investors Funding Corp. of New York Securities Litigation)*, 523 F. Supp. 533, 541 (S.D.N.Y. 1980) (stating that "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it.").

Damage to business reputation, looting, and prolonged insolvency are thus among the harms for which a bankruptcy trustee may in general seek redress on behalf of a debtor corporation[4]. It next remains for the Court to consider the second prong of the *Hirsch/Wagoner* test, that is, whether BFG itself could have maintained a fraud claim against Lloyd Thompson and Triangle notwithstanding the defense of *in pari delicto*.

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[4] In its memorandum of law, Lloyd Thompson questions whether this result is consistent with the Second Circuit's decision in *Hirsch*, a copy of the complaint which was submitted along with Lloyd Thompson's memorandum. As Lloyd Thompson points out, that complaint alleged that defendant Arthur Andersen had harmed the debtor by its preparation of a misleading prospectus, which resulted in (among other harms) a prolonged existence for the insolvent debtor and, presumably, the loss of business goodwill. While the Second Circuit held that the trustee had no standing to assert claims predicated upon the distribution of a misleading prospectus, *see Hirsch*, 72 F.3d at 1094, a close reading of the complaint in that case reveals that the trustee relied exclusively on a theory of out-of-pocket damages to investors in asserting those claims. Because the issue of whether a bankruptcy trustee can obtain redress for intangible harms or prolonged existence was not raised in *Hirsch*, that decision does not control this part of the Court's analysis.

As the Court noted in *Generali I*, it is exceedingly difficult for a defendant to obtain a Fed.R.Civ.P. 12(b) dismissal on the basis of the fact-sensitive *in pari delicto* defense, though this is by no means impossible, as *Hirsch* and *Wagoner* themselves indicate. *See Generali I*, slip op. at 18. Analysis of this defense is greatly complicated by the fact that in the Second Circuit it has come to represent what are in essence two entirely separate doctrines. In common law actions for fraud, *in pari delicto* is in effect a proxy by which the defendant can rebut the plaintiff's claims of reasonable reliance. As discussed at greater length below, the defense can be met (subject to certain limited exceptions) merely by proving that the plaintiff was aware of or condoned the defendant's wrongdoing. In shareholder derivative suits and in cases brought under the securities acts and other regulatory laws, however, courts in the Second Circuit have applied a far more stringent version of the defense. *Id*. at 17. Under this "regulatory" variant of *in pari delicto*, the defendant must prove (in addition to plaintiff's own wrongdoing) that (1) the plaintiff's acts were at least as serious as those of the defendant; (2) the plaintiff acted knowingly; and (3) the application of the doctrine would not frustrate an important public purpose. *See Weitzman v. Stein*, 436 F. Supp. 895, 905 (S.D.N.Y. 1977). Although the Trustee implicitly argues that the regulatory version of *in pari delicto* is applicable to his claims against Triangle and Lloyd Thompson, the Court need not decide the issue of the proper standard for this defense at the present time, as the Trustee would survive the challenge to his standing even if the common law version of *in pari delicto* were applied.

In arguing that BFG would be precluded from maintaining a fraud action against Patrick Bennett's alleged abettors, Lloyd Thompson and Triangle note that the Trustee has previously alleged that Edmund and Kathleen Bennett each had actual knowledge of the Ponzi scheme. As a result, the Defendants argue, it would be absurd to imagine any court entertaining a suit by BFG against the aiders of the Ponzi scheme, since all of BFG's shareholders acquiesced in the fraud. Alternately, Defendants argue that even if the Bennett parents did not acquiesce in the fraud, the knowledge and culpability of Patrick Bennett should be imputed to the corporation under principles of agency, thus precluding any affirmative recovery arising out of the Ponzi scheme.

The Trustee has offered a number of responses to this argument. Most basically, the Trustee has questioned whether the *in pari delicto* doctrine is even applicable to this case, since the pre-petition management of BFG has been replaced with a trustee appointed pursuant to Code § 1104— a circumstance which, he argues, eliminates the doctrine's sole policy rationale. In addition, the Trustee argues that he should not be precluded from adopting a position on the Bennett parents' culpability that is at odds with his position in other pending adversary proceedings, particularly as the Court has not yet issued any decision involving the parents' guilt in or knowledge of the Ponzi scheme. Lastly, the Trustee asserts that under the "adverse interest" exception to the rules of agency, Patrick Bennett's fraud should not be imputed to BFG, since it was intended to harm rather than benefit the corporation.

The Trustee's first argument can be disposed of quickly. It is true that the notion that a bankruptcy trustee enjoys total immunity from *in pari delicto* has some support in other jurisdictions. *See, e.g., Latin Investment Corp.*, 168 B.R. at 7; *Scholes v. Lehmann*, 56 F.3d 750, 754 (7^{th} Cir. 1995) (noting that "the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated."). However, the Second Circuit appears to have implicitly rejected this exception to the general rule in *Hirsch* and *Wagoner*, each of which involved a debtor whose management had been supplanted by a Code § 1104 trustee. *See also Wedtech*, 138

B.R. at 8 (noting that a trustee works with a "clean slate" only with respect to avoidance actions). Nor do these cases allow for the argument (also advanced by the Trustee) that *in pari delicto* applies only where the debtor is a "shell" which is created for the sole purpose of committing a fraud. While the "shell" label is— arguably— an accurate description of the securities-trading debtor in *Wagoner* (although the exact details of that case are somewhat murky), it can hardly be applied to Colonial, the debtor in *Hirsch*, which had been a legitimate business organization for nearly two decades prior to becoming a vehicle for its principals' fraud. *See Hirsch*, 72 F.3d at 1088.

Turning to the merits of the potential *in pari delicto* defense, it is clear that if all shareholders of BFG had acquiesced in the fraud, the Trustee's rights of action against Lloyd Thompson and Triangle would be precluded. *See Wagoner*, 944 F.2d at 120, *Hirsch*, 72 F.3d at 1088; *see also Generali I*, slip. op. at 9 (under *Wagoner* and *Hirsch*, a trustee has no standing to sue a third party for defrauding the debtor where "the corporation's sole shareholder, or all of its shareholders, participated with the defendant in the alleged wrongdoing."). Apart from equitable considerations, this conclusion is mandated by the principle that if a fact is known to a sole shareholder or to all shareholders of a corporation, knowledge of that fact will be imputed to the corporation itself. *See Keen v. Keen*, 113 A.D.2d 964, 966, 493 N.Y.S.2d 636, 638 (N.Y. App. Div. 3d Dept. 1985). Thus, if the Bennett parents had actual knowledge of their son's wrongdoing, BFG would be precluded from recovering against Patrick Bennett or his confederates on a fraud theory, since any reliance by BFG on Patrick Bennett's representations would have been unreasonable as a matter of law.[5] *See Allard*, 924 F. Supp. at 495.

Lloyd Thompson and Triangle concede that the Trustee has not affirmatively alleged culpable knowledge or wrongdoing by the Bennett parents in his complaint. Nevertheless, they assert that having taken such a position in other adversary proceedings, the Trustee is bound to abide by it in all subsequent litigation. In so arguing, Lloyd Thompson and Triangle appear to rely on the doctrine of "judicial estoppel," under which a party is prohibited from advancing contradictory factual positions in separate legal proceedings. *See Village on Canon v. Bankers Trust Co.*, 1997 WL 47804 at *3 (S.D.N.Y. 1997). In the Second Circuit, however, this doctrine is available "only if the party against whom the estoppel is claimed actually obtained a judgment as a result of the inconsistent position." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Georgiadis*, 903 F.2d 109, 114 (2d Cir. 1990). Lloyd Thompson and Triangle have not cited to any decision of this Court (or any other court) in which a judgment was entered based on the Trustee's allegations that the Bennett parents knew of the Ponzi scheme. Until or unless such a judgment is obtained, the Trustee is free to advance inconsistent factual allegations in separate adversary proceedings. *See also* Fed.R.Civ.P. 8(e)(2) (providing that a litigant in federal court may "state as many separate claims and defenses as the party has regardless of consistency").

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[5] In his memorandum of law, the Trustee urges the Court to adopt an alternate version of the defense set out by a dictum in *Wechsler*, according to which *in pari delicto* will apply only where "*all* relevant shareholders *and decisionmakers* of the corporation were engaged in the fraud." *Wechsler*, 212 B.R. at 36 n.1 (emphasis in the original). The Court believes that this statement of the rule is far too narrow. In the first place, as noted above, the actual knowledge of all shareholders is sufficient to impute knowledge to the corporation, without regard to whether all officers also had actual knowledge. At the very least, it would be an incongruous result if a corporation were allowed to sue for a fraud perpetrated by all of its shareholders merely because of the fortuitous circumstance that one non-shareholding officer happened to have clean hands.

The existence of an innocent shareholder is thus a necessary, but not a sufficient, condition for the Trustee's standing. Even if one or both Bennett parents are shown to have been ignorant of the fraud, the actions of Patrick Bennett might alone be enough, under certain circumstances, to impute that knowledge to BFG. As explained by the New York Court of Appeals, "[t]he general rule is that knowledge acquired by an agent acting within the scope of his agency is imputed to his principal and the latter is bound by such knowledge although the information is never actually communicated to it. . . . Underlying this rule is the presumption that an agent has discharged his duty to disclose to his principal all the material facts coming to his knowledge with reference to the subject of his agency." *Center v. Hampton Affiliates, Inc.,* 66 N.Y.2d 782, 784, 488 N.E.2d 828, 497 N.Y.S.2d 898 (1985) (internal citations omitted).

This general rule is subject, however, to an "adverse interest" exception. This exception provides that "when an agent is engaged in a scheme to defraud his principal, either for his own benefit or that of a third person, the presumption that knowledge held by the agent was disclosed to the principal fails because he cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose." *Id.* at 784. The exception will not apply, however, unless the agent has "totally abandoned" the interests of the principal: accordingly, it "cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal." *Id*. at 785. The inquiry here is a purely factual one, which depends both on the subjective intent of the agent as well as the objective benefit received by the principal. *See Wedtech Corp. v. KMG Main Hurdman (In re Wedtech Corp.)*, 81 B.R. 240, 242 (S.D.N.Y. 1987).

Lastly, the adverse interest exception is itself subject to a counter-exception, the so-called "sole actor" rule. *See Mediators*, 105 F.3d at 827. Under this doctrine, if an individual agent so dominates the principal corporation that there is a practical unity between the two, the agent's knowledge will be imputed to the principal notwithstanding the agent's fraud, since "the party that should have been informed was the agent itself albeit in its capacity as principal." *Id.; see also Munroe v. Harriman*, 85 F.2d 493, 496 (2d Cir. 1936). Although the sole actor rule is most frequently invoked in situations where one individual is both the sole shareholder and sole officer of a corporation (and thus the "sole actor" in a literal sense), it has on occasion also been found to apply to multi-officer and multi-shareholder corporations, in which a single officer is influential enough as to bend all other officers and shareholders to his will. *See, e.g., Harriman*, 85 F.2d at 496 (director found to be sole actor for bank). The critical inquiry here is whether any other officer or shareholder could have served as a check on the wrongdoing agent, such that disclosure to the corporation would have made any difference; as a result, it has been held that the sole actor counter-exception may be rebutted by proving the existence of an innocent outside director with the power to stop the fraud. *See Wechsler,* 212 B.R. at 46.

Although it is clear from the complaint that Patrick Bennett was a key figure in the day-to-day operation of BFG, it is nowhere alleged that he had the type of total domination that would qualify him as the sole actor for the corporation. Likewise, it remains an open question of fact whether the Ponzi fraud was carried out at all for the benefit of BFG, or whether Patrick Bennett had instead fully abandoned the interests of BFG and his parents when he engaged in his wrongdoing. The upshot of this analysis is that while it may be very difficult for the Trustee to prove the facts necessary to sustain his standing, the Court cannot conclude on the present record that such a proof will be impossible. As noted, a motion brought under Fed.R.Civ.P. 12(b) tests only the legal sufficiency of a claim, not its evidentiary weight or likelihood of success. *See Ryder Energy Distribution*, 748 F.2d at 779 (a court "should not be swayed into granting [a 12(b)(6)] motion because the possibility of ultimate recovery is remote.").

It is apparent, of course, that the Trustee's standing will depend on proof of a number of specific facts which are not affirmatively alleged in his pleadings, such as the innocence of one or both Bennett parents and the existence of an officer or shareholder with the ability to prevent the fraud of Patrick Bennett. While as a general matter, standing "cannot be inferred argumentatively from the pleadings, . . . but rather must affirmatively appear in the record," *see FW/PBS, Inc. v. City of Dallas*, 493 U.S. 215, 231, 110 S.Ct. 596, 608, 107 L.Ed.2d 603 (1990) (internal citations omitted), a court must presume on a motion to dismiss that "general allegations embrace those specific facts that are necessary to support the claim." *See Lujan v. Defenders of Wildlife*, 504 U.S. 555, 561, 112 S.Ct. 2130, 2137, 119 L.Ed.2d 351 (1992). Because the Trustee has alleged a distinct injury to BFG in general terms, all necessary supporting allegations accordingly will be treated as implied in his Complaint. As a result, the Court concludes that the Trustee has adequately stated a basis for his standing to pursue the fraud claims.

b. Fed.R.Civ.P. 9(b)

Lloyd Thompson and Triangle have alternately sought to dismiss the Trustee's fraud causes of action on the basis of Fed.R.Civ.P. 9(b), which requires that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." This rule is generally construed with reference to the three main policy goals that it was designed to further, which are: (1) to provide a defendant with fair notice of a plaintiff's claim, (2) to protect a defendant from wrongful damage to his reputation, and (3) to discourage strike suits. *See DiVittorio v. Equidyne Extractive Industries, Inc.*, 822 F.2d 1242, 1245 (2d Cir. 1987).

As a preliminary matter, the parties dispute the proper Fed.R.Civ.P. 9(b) pleading standard to be applied to the Trustee's claims. *Compare Hassett v. Zimmerman (In re O.P.M. Leasing Services, Inc.)*, 32 B.R. 199, 203 (Bankr. S.D.N.Y. 1983) (holding that "greater liberality should be afforded in the pleading of fraud in a bankruptcy case"); *Zucker v. Sasaki*, 963 F. Supp. 301, 308 (more stringent Fed.R.Civ.P. 9(b) standard applies to allegations of securities fraud). While the Court has adopted the relaxed standard in similar matters arising in this case, *see, e.g., In re The Bennett Funding Group,* 220 B.R. at 753, this issue need not be revisited at the present time, since the Trustee's fraud claims would survive the Fed.R.Civ.P. 9(b) motion even under the more stringent version of the rule proposed by the Defendants.

Under any version of the rule, the Trustee's basic obligation is to plead the "circumstances" constituting the Defendants' role in the fraud in detail. In practice, "[t]his means the who, what, when, where and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990). This requirement must be met with respect to each element of the Trustee's cause of action. Under New York law, there are three elements included in the tort of aiding and abetting a fraud, each of which must accordingly be pleaded with particularity in order for the Trustee's Complaint to survive a Fed.R.Civ.P. 9(b) challenge. These elements are: (1) the existence of the primary fraud; (2) the actual (and not merely constructive) knowledge of the defendant; and (3) "substantial assistance" rendered to the primary fraud by the defendant. *See Kolbeck v. LIT America, Inc.,* 939 F. Supp. 240, 246-247 (S.D.N.Y. 1996), *aff'd without published opinion*, 152 F.3d 918 (2d Cir. 1998); *ABF Capital Management*, 957 F. Supp. at 1328.

Lloyd Thompson and Triangle apparently do not dispute that the Trustee has stated the first of these elements with particularity. *See In re The Bennett Funding Group,* 220 B.R. at 753 (holding that substantially similar allegations of Patrick Bennett's wrongdoing were pleaded with particularity for purposes of Fed.R.Civ.P. 9(b)). These Defendants instead direct their arguments at the second and third elements of the Trustee's proof, asserting that in both cases, the Complaint is defective in that it alleges neither a plausible motive to participate in the fraud nor any non-routine service performed by either Lloyd Thompson or Triangle.

Although Fed.R.Civ.P. 9(b) provides that allegations of intent and knowledge "may be averred generally," courts in the Second Circuit have imposed a higher pleading standard for allegations of scienter in securities fraud cases.[6] *See Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1994) (holding that conclusory allegation of knowledge in support of securities fraud claim failed to comply with Fed.R.Civ.P. 9(b)). In general, where the plaintiff's cause of action requires that the defendant have acted knowingly (as is the case here), these cases have held that the plaintiff's Fed.R.Civ.P. 9(b) may be met by either of two means. First, the plaintiff may plead scienter by alleging a motive and an opportunity for the defendant to have participated in the fraud. *Id.* at 1130. Alternately, the plaintiff satisfies this burden by pleading specific factual circumstances which indicate that the defendant acted with conscious knowledge. *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987). The Court finds that,

[6] While the Court applies the stringent securities fraud standard for purposes of this discussion only, it reaches no conclusion as to whether this standard (as opposed to any more relaxed standard) is in fact applicable to the Trustee's pleadings.

at the very least, the Trustee's Complaint has adequately pleaded scienter under the second of these methods.

While the concept of "circumstances indicating conscious knowledge" does not easily lend itself to definition, most courts agree that such circumstances are present where a defendant engages in unusual or nonstandard business practices. *See Actio v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) (unusual stock-trading activity may be indicative of conscious knowledge of fraud); *Beck*, 820 F.2d at 50 (failure to notify authorities of asset sale indicated conscious fraud). The Trustee's Complaint, of course, alleges that the reinsurance mechanism brokered by Lloyd Thompson and Triangle contained numerous features which rendered the entire transaction unusual, including the double trigger, the hold harmless clause, and the fraudulent acts provision. In addition, other alleged facts may, if proved, raise more direct inferences of scienter. These include the "cosmetic exercise" letter drafted by an employee of Lloyd Thompson and Witkowski's possession of documents which allegedly revealed the double-pledging of leases, evidence from which a fact-finder might reasonably conclude that the Defendants obtained actual knowledge of the Ponzi scheme.

In response, Lloyd Thompson and Triangle argue that the financial arrangements cited above are not objectively unusual within the reinsurance industry; that, if considered in its proper context, the "cosmetic exercise" statement does not indicate any consciousness of fraud; and that Witkowski never in fact learned of the double pledging. While these arguments may eventually prove persuasive, they are ultimately directed at the truth of the Trustee's factual allegations. As such, they have no place in a motion brought to dismiss based on the pleadings. In ruling on such a motion, a court considers only whether the plaintiff has given the defendant fair notice of the claims that will be leveled against it, which the Trustee has plainly done here. A court does not, however, actually weigh evidence in such a motion or dismiss a claim simply because the particularized details of the fraud are disputed. *See In re Time Warner Securities Litigation*, 9 F.3d at 259, 269-71 (2d Cir. 1993).

The same considerations apply to the third prong of the Trustee's cause of action, that of substantial assistance. As Lloyd Thompson and Triangle correctly note, substantial assistance has been found lacking as a matter of law where the defendants have done nothing more than provide ordinary, routine professional services. *See DePinto v. Ashley Scott, Inc.,* 222 A.D.2d 288, 289, 635 N.Y.S.2d 215 (N.Y. App. Div. 1st Dept. 1995); *W.L. Bane v. Sigmundr Exploration Co.*, 848 F.2d 579, 582 (5th Cir. 1988). Yet it is hardly clear from the Complaint that the transactions which Lloyd Thompson and Triangle facilitated were ordinary or routine; indeed, the Trustee has alleged precisely the opposite of this, and (as discussed above) he has done so with considerable particularity. This evidence of irregular business activity, if proved, would satisfy the "substantial assistance" prong of the Trustee's proof. *See ABF Capital Management*, 957 F.Supp. at 1330 (participation by a broker in a fraudulent, non-routine financing scheme constituted substantial assistance).

Thus, even under the most stringent version of Fed.R.Civ.P. 9(b), the Trustee has pleaded facts necessary to sustain his cause of action with the requisite particularity. Accordingly, the Court recommends that the District Court deny Lloyd Thompson and Triangle's motions to dismiss the fraud claims of the Trustee.

2. The Cross Claims and the Trustee's Contract Claim

For ease of discussion, the remaining claims which are at issue in this motion may be divided into three classes. These are: (1) claims seeking compensatory damages for fraud (Halpert's Second Cross Claim, Dollar's Second Cross Claim, Commercial Bank's Third Cross Claim, and Winona's Second Cross Claim); (2) claims seeking a declaratory judgment related to the ownership of fraud claims (Commercial Bank's Fourth and Fifth Cross Claims); (3) claims seeking a declaratory judgment concerning the ownership of contract claims (Brighton's Third Cross Claim and Count II of the Trustee's Complaint); and (4) claims seeking compensatory damages for breach of contract (Halpert's First Cross Claim, Dollar's First Cross Claim).

a. Fraud claims seeking compensatory damages

Each of the Cross Claimants which has asserted a compensatory fraud claim against the Defendants has adopted the theories and allegations of the Trustee; conversely, in their motions to dismiss these claims, Sphere, Lloyd Thompson, and Triangle have incorporated the arguments raised in Lloyd Thompson and Triangle's motions to dismiss the Trustee's fraud claims. As such, no party appears to have separately discussed the threshold issue of whether this Court has jurisdiction to hear or decide such claims, insofar as they have been asserted by a group of non-debtor third parties rather than by the Trustee. Nevertheless, since such a determination is a prerequisite to the Court's exercise of its judicial power, the issue of jurisdiction will be considered *sua sponte*. *See Boyer v. Balanoff (In re Boyer)*, 93 B.R. 313, 314 (Bankr. N.D.N.Y. 1988).

Pursuant to Title 28 of the United States Code, the jurisdiction of a bankruptcy court is limited to proceedings "arising under" the Code or else "arising in or related to" a bankruptcy case. 28 U.S.C. §§ 157(b), 1334(b); *see also Celotex Corp. v. Edwards*, 514 U.S. 300, 307, 115 S.Ct. 1493, 1498, 131 L.Ed.2d 403 (1995). A matter is considered to "arise under" the Code when it is "at the core of the jurisdiction of the bankruptcy courts, and depend[s] upon the application or construction of bankruptcy law as expressed in title 11." *In re Gucci*, 193 B.R. 417, 418 (Bankr. S.D.N.Y. 1996). An exhaustive, though non-exclusive, list of such "core" matters is set out by 28 U.S.C. §157(b)(2). Alternately, a matter is regarded as "related to" a bankruptcy case if its outcome affects the debtor's rights or the administration of a bankruptcy estate. *See Pacor, Inc. v. Higgins,* 743 F.2d 984, 994 (3d Cir. 1984); *Publicker Industries, Inc. v. United States (In re Cuyahoga Equipment Corp.)*, 980 F.2d 110, 114 (2d Cir. 1992). In any event, however, "bankruptcy courts have no jurisdiction over proceedings that have no effect on the debtor." *Celotex*, 514 U.S. at 308 n.6.

The tort claims presently under discussion essentially present claims by a group of non-debtors that has sued another group of non-debtors under a theory of liability that is not based in bankruptcy law. There has been no showing that the outcome of these tort proceedings will have any impact whatsoever on the bankruptcy estate. This is to be distinguished, on the one hand, from the Trustee's own tort causes of action, which do have financial consequences for the estate (and thus fall under the "related to" jurisdiction), as well as, on the other hand, the contract claims asserted by Trustee and the Cross Claimants, which expressly or implicitly seek to determine rights in property also claimed by the estate. *See Peterson v. 610 W. 142 Owners Corp. (in re 610 W. 142 Owners Corp.)*, 219 B.R. 363, 371 (Bankr. S.D.N.Y. 1998) (holding that matters which seek to determine the extent of a debtor's rights under an insurance policy are core matters); *see also MacArthur v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d. 89, 93 (2d Cir. 1988) (holding that a claim by a non-creditor against the debtor's insurer was subject to the bankruptcy court's core jurisdiction where the contract rights of the creditor were "inseparable" from the rights of the debtor) . Because the Cross Claimants have failed to allege facts demonstrating that their tort claims against the Defendants either arise under bankruptcy law, arise in this bankruptcy case, or are related to this bankruptcy case, those claims will be dismissed for lack of subject matter jurisdiction.

b. Declaratory fraud claims

The analysis is slightly more complicated for The Commercial Bank's Fourth and Fifth Cross Claims, which appear to seek some sort of declaratory relief in connection with certain fraud claims. Read in the light most favorable to The Commercial Bank, these counts appear to make two general legal claims: first, that under the Trustee's allegations, tort damages may be recovered only by the loss payees, and not by the Trustee; and secondly, that The Commercial Bank, as a loss payee, has a right to compensatory tort damages from the Defendants.

Though raised in a claim for declaratory judgement rather than in a motion to dismiss, The Commercial Bank's first argument is substantively indistinguishable from that portion of the Defendants' 12(b) motion which sought to dismiss the Trustee's fraud claims on the grounds that he had alleged no distinct harm to BFG. The analysis above applies here as well: as noted, the Trustee's complaint alleges harm to the corporation as well as to its creditors. In the event that all of the Trustee's allegations were proved at trial, he would be entitled to recover compensatory damages apart from any damages that would be owed to loss payees such as The Commercial Bank. The second form of relief requested, on the other hand, appears to be inseparable and indistinguishable from The Commercial Bank's Third Counterclaim, which sought compensatory tort damages from the Defendants. For the same reasons as stated above, the Court concludes that it has no jurisdiction to hear or consider that request. As a result, The Commercial Bank's Fourth and Fifth Counterclaims will be dismissed.

c. Declaratory contract claim

Brighton's Third Cross Claim seeks, in effect, a determination that any contract liability imposed on any of the Defendants should be paid over to the loss payees of each policy rather than to the Trustee; conversely, Count II of the Trustee's Complaint seeks a declaration that the Trustee has the superior interest in these proceeds, presumably to the exclusion of parties such as Brighton. Joined as defendants to both of these claims are Sphere Drake, Lloyd Thompson, and Triangle. While Sphere Drake, as the reinsurer and potential payor of these claims, is undoubtedly a proper defendant to this declaratory judgment action, Lloyd Thompson and Triangle are not. As Brighton itself appears to recognize, neither Lloyd Thompson nor Triangle claim an interest in the insurance proceeds, and neither is obligated to make payment under the relevant insurance contracts. As a result, the Court will dismiss these two claims with respect to Lloyd Thompson and Triangle for failure to present a justiciable case or controversy.

d. Breach of contract claims

Lastly, the Court considers the First Cross Claims of Halpert and Dollar, which seek compensatory damages from Sphere Drake and Triangle under the claims paying agreement, which they are alleged to have breached by their failure to make payment on the claims presented to them by Halpert and Dollar. The Court's core jurisdiction over these claims is present by virtue of the fact that the Trustee has also asserted ownership of this cause of action, thus necessitating that both competing contract claims be litigated in the same forum. *See 610 W. 142 Owners Corp.*, 219 B.R. at 371.

The cause of action which these Cross Claimants have asserted against Triangle does not merit considerable discussion. According to the allegations of the Trustee's Complaint, which are incorporated by reference into the cross claims of Halpert and Dollar, the role of Triangle was limited to its management of BIC. Nothing in the Trustee's Complaint or in the cross claims alleges that Triangle was itself obligated to serve as BIC's reinsurer, or that it was under any kind of obligation to make payments to the loss payees in the event of a default by BIC. Accordingly, Triangle is entitled to a judgment of dismissal on the First Cross Claims of Halpert and Dollar.

Sphere Drake, which allegedly did serve as the reinsurer for BIC, presents a considerably more difficult case. Relying on the choice of law clause in the claims paying agent agreement, Sphere argues that any contract claims arising out of the insurance contract must be governed by the laws of Bermuda, under which third party beneficiaries such as Dollar and Halpert have no direct rights of action on the contract. This argument thus raises two issues, one of choice of law, and the other of substantive contract law. By necessity, the Court begins with the first of these issues.

Under general American law, choice of law clauses in contracts are generally enforced, unless the party resisting enforcement makes a "strong showing" that enforcement would be unreasonable. *See M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15, 92 S.Ct. 1907, 1916, 32 L.Ed.2d 513 (1972). Halpert and Dollar suggest two reasons why this Court should nevertheless refuse to apply Bermuda law to the contract claims at hand. First, it is argued, enforcement under these circumstances would serve to further a fraud, a recognized exception to the deference usually given to contractual choice of law provisions. *See id*. at 13-14. Second, Halpert and Dollar note that New York common law generally recognizes third-party beneficiary rights of action, and that the choice of law provision, as applied here, should be rejected as violative of New York's judicially-expressed public policy.

The Court finds neither of these arguments persuasive. While fraud will on occasion invalidate a choice of law provision, the circumstances under which this relief will be granted are extremely narrow. *See Roby v. Corporation of Lloyd's*, 996 F.2d 1353, 1363 (2d Cir. 1993). In particular, the fraud exception will apply only where the objecting party can show that its inclusion in the contract was itself fraudulent, and did not reflect the true intention of the contracting parties– an allegation that does not appear in the pleadings of Halpert, Dollar, or the Trustee. *Id.* As concerns Halpert and Dollar's public policy argument, the decision in *Roby* additionally held that such considerations will only become decisive where enforcement of the choice of law clause would lead to a waiver of any remedy by the plaintiff. *Id.* at 1365. In the present case, it is clear that Halpert and Dollar have numerous other avenues available to obtain compensation for their losses, including (but not limited to) the fraud causes of action against the Defendants which are pleaded as their First Cross Claim, which they are still free to pursue in other fora. Thus, even assuming *arguendo* that New York's recognition of third party beneficiary rights rises to the level of a public policy strong enough to overcome concerns for international comity, Halpert and Dollar have alleged no circumstance that would justify the invalidation of the choice of law clause in the claims paying agent agreement.

To aid the Court in its construction of the law of Bermuda, the parties to this dispute have submitted the affidavits of two Bermuda-based attorneys, Saul Morton Froomkin, Q.C., and Richard Alphonso Hector, Q.C. These affidavits appear to be in agreement on most of the relevant points of British and Bermuda law: thus, it is apparently undisputed by the parties that Bermuda law does not generally recognize the rights of a third party beneficiary to sue on a contract; that one statutory exception to this doctrine is provided by The Third Party (Rights Against Insurers) Act 1963, which allows the third party beneficiaries of insurance contracts to maintain direct actions against the insurers; and that this statute does not, however, apply to reinsurance contracts.

In fact, the only disputed issue arising under Bermuda law appears to be the question of whether, by virtue of the claims paying agent agreement, Sphere Drake would be regarded as the direct insurer of the BFG leases, rather than as the reinsurer of BIC. The affidavits do not identify what standards a Bermuda court would apply in deciding this issue, nor do they state which facts would be relevant to its decision. The Court thus cannot conclude on the record before it that Halpert and Dollar "can prove no set of facts in support of [their] claim which would entitle [them] to relief," *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 102, 2 L.Ed.2d 80 (1957). Accordingly, the First Cross Claim of Halpert and Dollar will not be dismissed with respect to Sphere Drake.

Based on the foregoing, it is hereby

ORDERED that Sphere Drake's motion to dismiss is GRANTED with respect to the Second Cross Claim of Halpert; the Second Cross Claim of Dollar; the Third, Forth and Fifth Cross Claims of The Commercial Bank; and the Second Cross Claim of Winona; and is hereby DENIED with respect to the First Cross Claim of Halpert and the First Cross Claim of Dollar; and it is further

ORDERED that Lloyd Thompson's motion to dismiss is GRANTED with respect to Count II of the Trustee's Second Amended Adversary Complaint; the Second Cross Claim of Halpert,; the Second Cross Claim of Dollar; the Third, Fourth and Fifth Cross Claims of The Commercial Bank; the Second Cross Claim of Winona; and the Third Cross Claim of Brighton; and it is further

ORDERED that Triangle's motion to dismiss is hereby GRANTED with respect to Count II of the Trustee's Second Amended Adversary Complaint; the First and Second Cross Claims of Halpert,; the First and Second Cross Claims of Dollar; and the Third Cross Claim of Brighton; and it is further

RECOMMENDED that the District Court DENY the motions to dismiss filed by Lloyd Thompson and Triangle with respect to Counts V and VI of the Trustee's Second Amended Adversary Complaint.

Dated at Utica, New York

this 6th day of August 1999

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge