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SUPERIOR COURT OF ARIZONA

COUNTY OF MARICOPA

Peter S. Davis, as Receiver of DenSco Investment Corporation, an Arizona corporation, Plaintiff, v. Clark Hill PLC, a Michigan limited liability company; David G. Beauchamp and Jane Doe Beauchamp, husband and wife, Defendants.	No. CV2017-013832 **DEFENDANTS' RESPONSE TO PLAINTIFF'S MOTION FOR PARTIAL SUMMARY JUDGMENT ON DEFENDANTS' AFFIRMATIVE DEFENSE OF *IN PARI DELICTO*** **AND** **DEFENDANTS' CROSS-MOTION FOR SUMMARY JUDGMENT** (Assigned to the Honorable Daniel Martin)

Defendants Clark Hill PLC and David Beauchamp respond to the Receiver's Motion for Partial Summary Judgment on Defendants' Affirmative Defense of *In Pari Delicto* (the "Motion") and Cross-Move for Summary Judgment Dismissing Plaintiff's Complaint as barred by the doctrine of *In Pari Delicto*. While binding Arizona case law is admittedly sparse, (a) the Court retains the authority, as a court of equity, to impose the doctrine of *in pari delicto* to bar wrongdoers from pursuing damages they themselves caused, notwithstanding either Arizona's Constitution or its comparative fault statute, (b) a receiver, who steps into the shoes of the wrongdoer, is not shielded from equitable defenses, and (c) Defendants' status as legal counsel with fiduciary duties to their client does not preclude *in pari delicto*, particularly where the client had no innocent actors. Given DenSco's wrongful and illegal conduct as expressly acknowledged by the Receiver, summary judgment is appropriate.

I. INTRODUCTION

The equitable defense of *in pari delicto* is a widely recognized doctrine whereby a court, sitting in equity, can determine that a plaintiff's right to present its case to the fact finder is barred by the plaintiff's own wrongful or illegal conduct. Over the past year, the Receiver for DenSco has made various allegations in support of his theory that Clark Hill and David Beauchamp, in their role as securities counsel for DenSco, violated the standard of care and aided and abetted Denny Chittick's breaches of his fiduciary duties to DenSco. Conversely, the Receiver has spilt little ink addressing DenSco's wrongful conduct, which includes, but is not limited to: (a) secretly, repeatedly, and intentionally deviating from DenSco's promises to its investors by handing more than half of DenSco's loan portfolio *directly to a con-man*, (b) urging investors to provide DenSco with more money without making full disclosure of DenSco's deepening financial issues, and (c) looting the company for the benefit of Chittick. The Receiver has acknowledged these wrongful actions in filings with this Court, and used them to successfully pursue claims against Chittick's estate and certain DenSco investors.

Contrary to the Motion, however, the Receiver cannot absolve himself of DenSco's fraudulent and wrongful conduct.

Defendants fervently deny that their actions fell short of the standard of care. Defendants likewise deny the accusation that David Beauchamp carelessly risked his career and reputation by advising DenSco that it could hide its wrongful conduct, thereby by violating fundamental security disclosure rules—rules DenSco understood and had followed for years. There can be little question, however, that DenSco's actions were wrongful (not merely negligent), thus placing DenSco *in pari delicto*, and barring DenSco from pursuing Defendants for damages predicated on DenSco's own bad acts. And because the Receiver stands in DenSco's shoes, and is therefore subject to the defenses available against DenSco, including *in pari delicto*, the Receiver is likewise barred from bringing his claims against Defendants as a matter of law.

II. BRIEF SUMMARY OF RELEVANT FACTS

A. DenSco's makes representations to investors, raises money to lend to borrowers.

Denny Chittick was the sole owner, president, and employee of DenSco. (DSOF ¶ 1) Chittick started DenSco in 2001, after a successful career culminating as the Chief Information Officer for Insight Enterprises, Inc. (DSOF ¶ 2) After leaving Insight, Chittick learned the hard money lending business by apprenticing with other local lenders, one of whom, Scott Gould, consulted with DenSco for several years after its formation. (DSOF ¶¶ 8-9) As Mr. Gould testified, DenSco understood the importance of making disclosures to investors, maintaining a diverse borrower base, conducting proper due diligence on its collateral, and ensuring first position lien priority through using proper lending procedures, including lending purchase money to the fiduciary trustee, rather than the borrower. (DSOF ¶¶ 11-13)

DenSco's business model was simple. It borrowed money from investors, which it then pooled and lent out at higher interest rates to borrowers who typically bought residential real estate at trustee's sales. (DSOF ¶¶ 3-4) Yomtov Menaged (and his related entities), was one such borrower.

DenSco made certain representations to its investors, most of whom were Chittick's family, friends, and neighbors. Many of those representations were included in Private Offering Memoranda ("POM") that DenSco provided to its investors every other year. (DSOF ¶ 5) Those representations included, among other things, that DenSco intended to minimize risk by (1) not lending more than 10-15% of its portfolio to any one borrower and (2) ensuring that its loans would be secured by a first position deed of trust on the property the borrower purchased. (DSOF ¶ 5)

B. DenSco mismanages its lending process, hands Menaged half its portfolio, is defrauded by Menaged *twice* as a result.

It is common sense and common business practice for lenders to fund the purchase of homes by sending the funds directly to a trustee or escrow company—someone with a fiduciary responsibility to ensure that the money is used for its intended purpose. (DSOF ¶¶ 13-18, 22) Chittick knew this. DenSco's own loan documents provide that DenSco will deliver its funds directly to the trustee conducting the trustee sale. (DSOF ¶ 7) Yet notwithstanding its loan documents and prudent business practice, DenSco chose to fund its loans directly to its borrowers, including Yomtov Menaged and his entities. (DSOF ¶) That decision would prove predictably disastrous.

1. <u>DenSco learns Menaged is double-liening DenSco's collateral, jeopardizing its lien priority; DenSco reacts by handing Menaged half its loan portfolio.</u>

In September 2012, a competing hard money lender, Active Funding Group ("AFG"), informed DenSco that multiple properties purchased by Menaged were subject to deeds of trusts in favor of both AFG *and* DenSco. (DSOF ¶¶19-21) In other words, Menaged appeared to have borrowed money for the same property twice, from two different lenders. This issue, referred to as double-liening, consequently jeopardized DenSco's desired first position security

interest in those properties. DenSco was nonchalant upon hearing about this serious breach. Then, rather than investigate Menaged's business practices, DenSco instead embarked on a year-long lending spree to Menaged. DenSco's lending to Menaged increased from $4.65 million in loans outstanding at the end of 2012, *to more than $28 million outstanding* at the end of 2013, at which point Menaged held more than 50% of DenSco's funds, well in excess of the represented maximum 15% threshold. (DSOF ¶ 23) DenSco did not share this information with its attorney, David Beauchamp (and there is no evidence to suggest otherwise).

2. DenSco learns the double-liening issue was ongoing and widespread, arose as a direct result of DenSco's lending practices, yet keeps lending directly to Menaged for several more years.

In late 2013, Chittick learned that Menaged had continued his practice of borrowing money from two lenders to purchase one home, double-liening the collateral, and putting DenSco in second position. (DSOF ¶ 24). Menaged blamed the problem on his "cousin", who purportedly pocketed the funds DenSco had provided directly to Menaged, while the competing lender's funds, which had been sent directly to the trustee, were used to actually purchase the property. (*Id.*) After Chittick's death, it was revealed that no cousin ever existed. (*Id.*) The Receiver refers to this as the First Fraud and calculates that it cost DenSco more than $14.3 million. (*Id.*) The First Fraud covered DenSco's loans to Menaged from 2012 through late 2013. (*Id.*) The reality, however, is that the First Fraud was made possible only because of DenSco's reckless lending practices. Had DenSco provided funds to the trustee, there could have been no funds for the "cousin" to steal.

Even after Menaged revealed the First Fraud to Chittick in November 2013, Chittick refused to seek counsel from Defendants. Instead, Chittick waited until after a competing group of hard money lenders threatened to sue him to provide any details to Beauchamp at all. (DSOF ¶¶ 25-31) Even then, Chittick (a) failed to provide his lawyer with Menaged's history of double liening and generally poor borrowing history, choosing instead to portray Menaged as a solid borrower who had been duped by a family member and (b) failed to consult with his lawyer before entering into, and funding, a joint venture with Menaged to deal with the lien priority issues created by the First Fraud.

(DSOF ¶¶ 31-34) Only in January 2014, after vouching for Menaged in the midst of pursing an agreed upon course of action with Menaged, and under threat from competing lenders, did DenSco enlisted Clark Hill to draft a forbearance agreement. (DSOF ¶¶35-36) The forbearance agreement, among other things, would document the joint venture Menaged and Chittick had already entered into (and partially performed). (*Id.*)

Yet despite the prior double-liening issues, DenSco *continued to lend money directly to Menaged*. (DSOF ¶ 57) Menaged, in turn, continued to take advantage of this lending practice, except now, Menaged never purchased any properties at all. Instead, after DenSco wired funds to Menaged's account, Menaged pretended to obtain a cashier's check to purchase property at a trustee's sale, then fabricated a trustee's sales receipts, tricking DenSco into believing that Menaged had purchased investment property. In reality, Menaged again simply pocketed the money. Menaged churned through more than $700 million in loans this way, ultimately costing DenSco more than $28.3 million. (*Id.*) The Receiver refers to this as the Second Fraud.[1]

The Second Fraud started as early as January 2014. (*Id.*) DenSco, however, was remarkably cavalier about raising money from its investors in contravention of its disclosure obligations, DenSco's mounting losses, and Menaged's role in causing those losses. (DSOF ¶¶ 38-48) By way of example only: (i) on February 11, 2014, Chittick wrote to Menaged, acknowledging that he would need to disclose DenSco's issues with Menaged in order to raise funds from investors; (ii) on May 28, 2014, Chittick commented to Menaged after Menaged's bank had reserved the right to revoke access to Menaged's account "at any time due to potential fraud," that the bank had done so because "they heard about us"; and (iii) on June 27, 2014, Chittick and Menaged joked about whether an investor who was meeting with Chittick would be looking "for the [updated POM]! HaHa." (DSOF ¶¶ 43, 45, 59)

[1] The Receiver has since filed suit in Maricopa County Superior Court against US Bank and Chase Bank for aiding and abetting Menaged's Second Fraud. *See* CV2019-011499. The case is pending before this Court.

As the years went on, however, and the Second Fraud crashed down around him, Chittick took his own life. Yet even as the reality of DenSco's irreversible losses dawned on Chittick, DenSco continued to raise money from its investors without disclosure. For example, on August 21, 2015, Chittick expressed frustration that DenSco's $30 million balance with Menaged has not gone down and admitted he "can't get new investors [because] I can't give them the documentation that is necessary" and that "**I am in so many violations with my current investors it's nuts**." (DSOF ¶ 46) (emphasis added). Yet knowledge of those violations, lack of documentation, and lack of disclosure did not stop DenSco. Chittick told Menaged that he had nevertheless "tried raising more money" from his friends and family and hoped he could squeeze more money out of the "Utah guys." (*Id.*) Unfortunately for DenSco's investors, DenSco was successful in doing so. In 2016 alone, well after Chittick understood the jig was up, DenSco raised more than $1.7 million. (DSOF ¶ 49)

C. Receiver pursues Chittick estate and investor "winners" based on DenSco's fraud.

The above is just a small sampling illustrative of DenSco's repeated wrongful conduct. The Court, however, can also consider the Receiver's own conclusions and admissions with respect to DenSco's wrongful and illegal conduct.

For one, on December 9, 2016, the Receiver filed a notice of claim against the estate of Denny Chittick. (DSOF ¶¶ 50-51) In that notice, the Receiver asserted that Chittick was guilty of common law fraud, misrepresentation, and breach of fiduciary duty because Chittick, and thus DenSco, among other things: (i) failed to institute or follow proper management and control of DenSco's business operations in part, by directly funding loans to Menaged, (ii) continued "to accept monies for investors into DenSco," then lending that money out to Menaged, "*despite his actual knowledge of the fraud by Menaged*", (iii) prepared false and inaccurate financial records, thereby artificially increasing DenSco's tax liability and misleading its accountant, who was also an investor, and (iv) allowed Chittick to loot millions

of dollars from DenSco starting as early as January 2014, after rendering it insolvent through his improper lending practices. (*Id.*) Chittick's fraud had allegedly cost DenSco $43,947,819.61. (*Id.* at ¶ 53)

Further, on August 8, 2017, in a letter written to Judge Sanders who is presiding over the DenSco receivership, the Receiver's counsel concluded that "DenSco…also was operating as a Ponzi investment scheme *while intentionally misleading its investors*, as to its financial solvency." (DSOF ¶ 54).

Based on that solvency analysis, the Receiver concluded that DenSco was running a Ponzi scheme as of December 31, 2012, and pursued all the "net winners" of that scheme, demanding that they return the "profits you received from [DenSco's] *fraudulent scheme*" as of December 31, 2012, "regardless of whether you knew or had reason to know that the scheme was *illegal*." (DSOF ¶ 55) (emphasis added). As the Receiver's counsel explained, "proof of the existence of a Ponzi scheme *showed that there was actual intent to defraud*…" (*Id*) (emphasis added). Further, the Receiver's demand for the return of funds from net winners was directly premised on the assertion that there was "clear and satisfactory evidence of an 'actual intent to hinder, delay or defraud any creditor of the debtor'…," that "one can infer an intent to defraud future undertakers from the mere fact that an individual was running a Ponzi scheme," and that "the orchestrator of the scheme [Chittick] must know all along, from the very nature of his activities, that investors at the end of the line will lose their money." (*Id.*)

In short, DenSco ignored its promises to its investors by inexplicably investing most of its portfolio in Menaged, managed those investments in such a reckless manner that it violated DenSco's promises regarding lien priority and allowed Menaged to perpetrate the First Fraud, nevertheless continued making loans to Menaged in such a reckless manner that it allowed Menaged to perpetrate the Second Fraud, lied to its accountant and the IRS to hide the extent of its business losses, and continued to raise money from its investors in the face of those losses, all of which is expressly acknowledged by the Receiver.

III. ARGUMENT

Arizona recognizes the equitable doctrine of *in pari delicto*, which "dictates that when a participant in illegal, fraudulent, or inequitable conduct seeks to recover from another participant in that conduct, the parties are deemed *in pari delicto*, and the law will aid neither, but rather, will leave them where it finds them." *In re Bill Johnson's Restaurants, Inc.*, 255 F. Supp. 3d 927, 934 (D. Ariz. 2017), *quoting Smith ex rel. Estates of Boston Chicken, Inc. v. Arthur Andersen L.L.P.*, 175 F.Supp.2d 1180, 1198 (D. Ariz. 2001) (applying defense to breach of fiduciary duty claim); *Brand v. Elledge*, 89 Ariz. 200, 360 P.2d 213, 217 (1961) (approving use of *in pari delicto* doctrine in case involving illegal contract, and stating that "a court of law will not lend its aid to either of the parties to *an illegal or fraudulent transaction*") (emphasis added). Stated another way, the *in pari delicto* doctrine is an affirmative defense that precludes a plaintiff who participated in the wrongdoing from recovering damages from that wrongdoing. *Grayson Consulting, Inc. v. Wachovia Sec., Inc. (In re Derivium Capital, LLC)*, 716 F.3d 355, 367 (4th Cir. 2013); *Parmalat Capital Fin. Ltd. v. Bank of Am. Corp.*, 412 Fed. Appx. 325, 327 (2nd Cir. 2011) ("*In pari delicto* prevents a party from suing others for a wrong in which the party itself participated"). Yet that is precisely what DenSco proposes to do here: recover for damages that resulted from DenSco's fraudulent and illegal wrongdoing. The facts, as acknowledged by the Receiver, are plain.

A. Receiver's claims are barred by *in pari delicto*.

The Receiver asserts, among other things, that Defendants breached duties and fell below the standard of care with respect to advice regarding disclosures to investors. (DSOF ¶ 58) The inaccuracy of that accusation is not at issue here, but it cannot reasonably be disputed that DenSco understood its disclosure obligations. DenSco's consultant, Scott Gould, who himself had run afoul of disclosure laws, made sure that DenSco understood the importance of disclosure. (DSOF ¶ 11) DenSco itself had made disclosures to its accredited investors through its POMs every two years from 2003 to 2011. (*Id.* at ¶ 5) And DenSco's

principal, Chittick, acknowledged to Menaged the need to disclose material information to his investors when he winkingly told Menaged in January 2014 that "I've not taken any new investors, so if I do, I have to disclose a lot to them, which is all about you", joked with Menaged that he hoped he would not run across investors looking for an updated written disclosure, and later acknowledged trying to raise money despite known securities violations. (DSOF ¶¶ 43, 46, 59) That Chittick attempted to salvage his own investment in DenSco's sinking ship starting in 2014, while continuing to raise money from investors, further underscores that he understood the wrongfulness of his lack of disclosure.

Further, there is nothing to suggest that Chittick and DenSco were unaware of the promises they made to investors through the POMs and otherwise. Yet DenSco *chose* to ignore those promises when it disregarded Menaged's double-liening in 2012, then handed more than half of DenSco's money to Menaged over the next year. There is no suggestion that Defendants were somehow knowledgeable or complicit in this remarkable breach of trust. In fact, DenSco did not bring these issues to Defendants' attention until *after* other lenders threatened to sue it, and *after* DenSco and Menaged had already put in place a joint venture to "solve" the issue. (DSOF ¶¶28-30) While the Receiver asserts that Defendants negligently advised DenSco about its proposed workout, failed to investigate Menaged, and failed to force DenSco to change its business practices (DSOF ¶ 58), the facts demonstrate that DenSco had hitched its wagon to Menaged long ago, without any consideration for legal advice. *This* is the "actual fraud" and illegal conduct born out of "intentional" misrepresentations to investors (including DenSco's intentionally misleading representations to its accountant) in the face of DenSco's "*actual knowledge of the fraud by Menaged*" that the Receiver himself has acknowledged. (DSOF ¶¶ 50-55) Ultimately, DenSco's losses, which it incurred through its continued lending to Menaged, were losses born by investors who were the target of that illegal conduct.

Similarly the Receiver asserts that Defendants should have provided better advice regarding DenSco's lending procedures. (DSOF ¶ 58) But yet again, it cannot reasonably be questioned that DenSco understood the proper way to lend money, and secure a first position lien, after a decade in the industry, and *in the face of a crippling First Fraud made possible as a direct result of DenSco's carelessness*. As the Receiver himself acknowledges, Chittick was guilty of common law fraud, misrepresentation, and breach of fiduciary duty *because* he failed to institute or follow proper management and control of DenSco's business operations in part. (DSOF ¶ 51).[2] These actions rise above mere negligence to wrongful tortious conduct on DenSco's behalf, and thus, fall directly within the ambit of *in pari delicto*. *See e.g., Kirschner v. KPMG LLP*, 938 N.E.2d 941, 957 (N.Y. 2010).

Thus, based on the facts regarding DenSco's wrongful and illegal conduct, as expressly acknowledged by the Receiver, DenSco, and thus, the Receiver, is barred by the equitable doctrine of *in pari delicto* from pursuing claims against Defendants.

B. The Receiver is not immune from the *in pari delicto* defense

The Receiver argues that receivers, as a matter of law, are not subject to the equitable *in pari delicto* defense, because the Receiver is not the bad actor, but was instead thrust into his role through court appointment for the benefit of creditors. Mot. At 8 citing *FDIC v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir. 1995). The case law on this issue is admittedly not settled and there is no law binding on Arizona courts.[3] The policy considerations, however, favor maintaining the defense.

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[2] Whether the actions are ascribed to Chittick or DenSco is irrelevant. Under the "sole actor" rule, where all relevant shareholders or decision makers were involved in the wrongful conduct, that decision maker's actions are imputed to the company. *See Smith ex rel. Estates of Boston Chicken, Inc. v. Arthur Andersen L.L.P.*, 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001); *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 354 (3rd Cir. 2001) (sole shareholder's conduct as sole actor of corporation imputed to corporation).

[3] As set forth above, however, Arizona courts have recognized the defense.

It is axiomatic that the Receiver stands in the shoes of DenSco upon his appointment. *See Gravel Resources of Ariz. v. Hills,* 217 Ariz. 33, 38, 170 P.3d 282, 287 (App. 2007) (receiver "stands in the shoes of the entity it represents"). And where the Receiver stands in the shoes of the corporation, "the Receiver's rights as a plaintiff are subject to the same claims *and defenses* as the received entity he represents, and not third-party beneficiaries." *Wuliger v. Manufacturers Life Ins. Co.*, 567 F.3d 787, 798–99 (6th Cir. 2009). Consequently, and contrary to *O'Melveny*, the Receiver, as DenSco's successor in interest, is likewise subject to equitable defenses such as *in pari delicto* and unclean hands. *Id.* at 799; *see also Myatt v. RHBT Fin. Corp*., 635 S.E.2d 545, 548 (S.C. Ct. App. 2006) ("in the absence of a fraudulent conveyance case, the receiver of a corporation used to perpetrate fraud *may not seek recovery against an alleged third-party co-conspirator in the fraud*") (emphasis added) (applying South Carolina law).

As the 7th Circuit reasoned in *Knauer v. Jonathon Roberts Financial Group, Inc.*, while the receiver may in some sense be separated from the corporation's (or its actors') past crimes, the extent of the separation is an equitable one, and where the defendant invoking *in pari delicto* did not benefit from the bad actor's actions, the defense continues to apply. 348 F.3d 230 (7th Cir. 2003); *see also Hays v. Pearlman*, 2010 WL 4510956, at *1 (D.S.C. Nov. 2, 2010) (where receiver bringing claims for legal malpractice and breach of fiduciary duty against attorney, claims barred by *in pari delicto* where the receiver sought tort damages and attorney had not derived any alleged benefit from client's Ponzi scheme). Here, likewise, Defendants did not benefit from DenSco's illegal conduct, and there is no reason to now deprive them of an equitable defense (or this court of the ability to consider the defense) merely because DenSco's conduct resulted in the appointment of a receiver.

While this may seem harsh for DenSco's investors, they are not without recourse. For one, *in pari delicto* would not prevent the Receiver from seeking recovery from Chittick, for breach of fiduciary duties he owed to DenSco, as the Receiver has already done. Creditors,

such as the investors, would also be free to bring their own tort claims. *See Stewart v. Wilmington Trust SP Services, Inc.*, 112 A.3d 271 (Del. 2015) ("*in pari delicto* only acts to bar claims that in fact belong to the corporation, so *it would not preclude a stockholder or creditor who suffered a direct harm from bringing a direct claim to redress it*") (emphasis added). There is simply "no cogent reason" for treating a Receiver different from "equally innocent stockholders or policyholders" who would be subject to the defense. *Id*. at 312–13. This Court should reject "the suggestion that because the Receiver is innocent of wrongdoing when [he] 'steps into the shoes' of the liquidated entities, [he] cannot be subject to the defenses to which the entities themselves would be subject" because doing so would "eviscerate *in pari delicto*." *Id*. Because the Receiver remains subject to the *in pari delicto* defense, his claims against Defendants remain subject to the Court's equitable authority to apply the doctrine.

C. Arizona's comparative fault statute did not abrogate the *in pari delicto* defense.

The Receiver asserts (at 4-6), that Arizona's comparative fault statute, A.R.S. § 12-2506, has displaced the common law doctrine of *in pari delicto*. Not so. Notably, the Receiver cites neither case law nor legislative history to support the conclusion that the statute curtails this Court's equitable powers. Statutes that purport to abrogate common law, however, must be narrowly construed. *See Hayes v. Cont'l Ins. Co.*, 178 Ariz. 264, 273, 872 P.2d 668, 677 (1994) ("we will not interpret a law to deny, preempt, or abrogate common-law damage actions unless the statute's text or history shows an explicit legislative intent to reach so severe a result").

Critically, the Receiver confuses and conflates *in pari delicto* with the comparative fault and negligence doctrines included in § 12-2506, in arguing that *in pari delicto* is also subject to the statute's limitations. Comparative fault, however, is a doctrine of tort law that compares the fault of each party (and non-parties) for a single injury. Contributory negligence is a subset of that doctrine whereby a claimant has, through their own negligence, contributed to the harm

claimant suffered, and is thus barred from relief. *In pari delicto*, on the other hand, rests on the policy consideration that courts should not lend assistance to those whose wrongful conduct is the primary cause of their own injuries. *Stewart v. Wilmington Trust SP Servcs.*, 112 A.3d 271 (Del. 2015). There is a substantial difference between one who acted negligently and one who engaged in deliberately fraudulent conduct to such an extent that use of the court system should be barred. *See Merrimack Coll. v. KPMG LLP*, 480 Mass. 614, 624, 108 N.E.3d 430, 441 (2018) ("*in pari delicto* is separate and distinct from comparative negligence"; comparative negligence considers plaintiff's relative fault only when apportioning damages and does not necessarily preclude recovery, whereas *in pari delicto* serves as a complete bar for plaintiff engaged in intentional wrongdoing, if applicable)

Further, while the issue of a comparative statute displacing the equitable doctrine of *in pari delicto* is an issue of first impression in Arizona, cases from other jurisdictions have routinely held that comparable comparative fault statutes do not displace the *in pari delicto* defense, recognizing that they are distinct legal concepts. For example, in *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 957 (N.Y. 2010), the court rejected an argument that New York's statute addressing contributory negligence and assumption of risk abolished *in pari delicto*, concluding that "there is no reason to suppose that the statute did away with common-law defenses based on intentional conduct, such as *in pari delicto* . . . ." (emphasis in original). Specifically, the court determined that *in pari delicto* barred claims asserted in the names of two corporations (in one case, by shareholders suing derivatively; in the other case, by a bankruptcy litigation trustee) against the corporations' outside advisors for failing to prevent fraudulent schemes perpetrated by corporate officers acting on behalf of the corporations. In each case, the misconduct of the corporate officers was found to be imputable to the corporation as a matter of law.

Similarly, in *In re ICP Strategic Credit Income Fund Ltd.*, 568 B.R. 596, 612 (S.D.N.Y. 2017), *aff'd sub nom. In re ICP Strategic Income Fund, Ltd.*, 730 F. App'x 78 (2nd Cir. 2018),

the court applied New York law and held that *in pari delicto* barred a claim for aiding and abetting breach of fiduciary duty against a law firm defendant, notwithstanding New York's comparative fault regime. *See also In re Scott Acquisition Corp*., 364 B.R. 562, 567 (Bankr. D. Del. 2007) (applying Florida law to conclude, in dicta, that even if plaintiff's legal malpractice claim sounded in negligence rather than intentional tort, and thus fell within Florida's comparative fault statute, the statute would still not displace the *in pari delicto* defense).

Various courts in other jurisdictions have likewise recognized the differences between *in pari delicto* and comparative fault/contributory negligence, and allowed defendants to proceed with that affirmative defense notwithstanding the presence of comparative fault statutes. *See Inge v. McClelland*, 725 F. App'x 634, 639 (10th Cir. 2018) (New Mexico's wrongful conduct doctrine, which the court characterized as "analogous to" *in pari delicto*, was not precluded by the comparative fault framework); *Christians v. Grant Thornton, LLP*, 733 N.W.2d 803, 814 (Minn. Ct. App. 2007) (comparative fault and *in pari delicto* "are conceptually distinguishable and do not require simultaneous resolution"); *Peterson v. Eide Bailly, LLP*, 10 C 8038, 2016 WL 1358527, at *6 (N.D. Ill. Apr. 5, 2016) ("the comparative responsibility issue is not relevant to the *in pari delicto* defense" because "the court is not considering a damage issue here, but rather whether Bell's misconduct outweighs any responsibility that may be attributed to Edi Bailly's alleged negligence).

Ultimately, recovery under the doctrine of *in pari delicto* is denied, not because the plaintiff contributed to his injury, but because the common law public policy is to deny access to judicial relief to those injured largely as a result of their own serious wrongdoing. In other words, to the extent *in pari delicto* applies, there is no claim for the fact finder to apply comparative fault to. *In pari delicto* is conceptually distinct from comparative fault. Consequently, it has not been displaced by Arizona's comparative fault statutes.

D. Applying the *in pari delicto* doctrine would not violate Article 18, Section 5 of the Arizona Constitution

The Receiver argues (at 6-7), that the Arizona Constitution bars application of the *in pari delicto* defense. The Receiver, however, has not cited a single Arizona case construing Article 18, Section 5 of the Constitution in that manner. For good reason. The provision states only that: "The defense of *contributory negligence* or of *assumption of risk* shall, in all cases whatsoever, be a question of fact and shall, at all times, be left to the jury." Ariz. Const. art. XVIII, § 5. The plain language, which expressly governs only "contributory negligence" and "assumption of risk", does not apply to *in pari delicto*. *Soto v. Superior Court In & For Cty. of Maricopa (State ex rel. Romley)*, 190 Ariz. 450, 454–55, 949 P.2d 539, 543–44 (App. 1997) ("if the language [of the constitutional provision] is clear and unambiguous, we generally must follow the text of the provision as written. We only look beyond the plain language if the provision is not clear on its face."). Once again, the Receiver is mixing apples and oranges, because, as explained above, the defense of *in pari delicto* is not the same as the "defense of contributory negligence or of assumption of risk," which is all that the constitutional provision addresses.

Arizona courts have recognized that the comparative fault statutory regime changed the application of contributory negligence; it is no longer a bar to recovery, but is instead a prerequisite to the exercise of comparative negligence. *Hall v. A.N.R. Freight Sys., Inc*., 149 Ariz. 130, 136, 717 P.2d 434, 440 (1986). However, no Arizona court has held that comparative fault has displaced *in pari delicto*, which is not concerned with apportioning fault, but instead, with acting as a gate keeper to preclude misuse of the courts by wrongdoers. In any event, Defendants are not requesting that the Court assess DenSco's negligence, but recognize that it participated in causing its damages through its "wrongful" conduct.

Likewise, assumption of risk is a distinct legal concept. "The essential idea was that the plaintiff assumed the risk whenever she expressly agreed to by contract or otherwise, and also

when she impliedly did so by words or conduct." *Phelps v. Firebird Raceway, Inc*., 210 Ariz. 403, 405, 111 P.3d 1003, 1005 (2005). That doctrine, which does not assess wrongfulness, has no application to *in pari delicto* at all. The Constitution does not save the Receiver's claims.

E. *In pari delicto* is available to legal counsel and other fiduciary defendants.

Citing *Stewart v. Wilmington*, the Receiver lastly argues that Defendants, as professional advisors with fiduciary duties, are barred from invoking *in pari delicto*. Motion at 10 citing *Stewart*, 126 A.3d 1115. First, that decision is limited to the invocation of *in pari delicto* where a receiver sues "the corporation's own fiduciaries for breach of their fiduciary duties." Mot. at 10. It does not apply to claims against professionals sounding in negligence[4] and as set forth below, numerous courts across the country have applied *in pari delicto* to bar legal malpractice claims brought by plaintiff wrongdoers.

Second, the *Stewart* rationale has not been adopted in Arizona, and there is good reason for this Court to refrain from doing so. *In re National Century Financial Enterprises* is instructive. 783 F.Supp.2d 1003, 1024-25 (S.D. Ohio 2011). There, the debtor sued Credit Suisse, alleging that the financial services provider had looted funds from debtor's subsidiaries in a scheme to defraud debtor, and argued that Credit Suisse could not invoke the *in pari delicto* defense because it had a fiduciary duty to debtor. The court refused to bar the defense, *where there were no innocent shareholders or board members who had been duped by the fiduciary*. 783 F.Supp.2d 1003, 1024-25. Instead, the court reasoned, in cases of "'full corporate complicity,' there would be 'a good cause' for applying *in pari delicto* to defeat claims arising out of intentional auditor misconduct." *Id.* at 1024 (citing *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PriceWaterhouseCoopers, LLP*, 605 Pa. 269, 274, 989 A.2d 313, 315 (2010). However, when a principal fully participates in the wrongdoing, it has 'exposed itself' to a 'just, judicial determination' that it should be left

[4] The Receiver's cause of action against Defendants asserts claims sounding in negligence as well as breach of fiduciary duty. Complaint at ¶¶ 100-101.

in the condition in which the court finds it." *Id.* This is because, as the court noted, the purported fiduciary duty exception is grounded in the policy that a third party fiduciary, such as an attorney, is in the best position to communicate information to an innocent principle. *Id.* at 1025. Where there is no innocent principal, such as in this case, where Chittick was the sole actor for DenSco, there is no reason to limit application of the *in pari delicto* doctrine. *Id. see also Kirchner*, 938 N.E. 2d at 950 (when plaintiff is the primary wrongdoer, *in pari delicto* "should not be weakened by exceptions," even if outside professional's actions were willful); *Tamposi v. Denby*, 974 F. Supp. 2d 51, 58 (D. Mass. 2013) (*in pari delicto* valid defense to legal malpractice claim); *Tillman v. Shofner*, 90 P.3d 582, 584 (Ok.App. 2004) (claim against attorney for malpractice barred by *in pari delicto* where claim arose out of client's participation in conspiracy with attorney); *Whiteheart v. Waller*, 199 N.C. App. 281, 282, 681 S.E.2d 419, 420 (2009) (claim against attorney for malpractice barred by *in pari delicto* where client aware his complaint was predicated on inaccurate facts). Here, where the Receiver himself acknowledges that DenSco and Chittick committed fraud, there is no innocent corporate actor, and the fiduciary duty exception, to the extent Arizona would even adopt such law, is inapplicable.

IV. CONCLUSION

Pursuant to the argument and facts set forth above and in the Defendants' Supporting Statement of Facts, Defendants respectfully request that the Court dismiss Plaintiff's Count 1 for Breach of the Standard of Care and Count 2 for Aiding and Abetting Breach of Fiduciary Duty on the grounds that DenSco was *in pari delicto* with the Defendants. Alternatively, Defendants request that the Court deny the Receiver's Motion such that the defense is preserved in the event the Court, through subsequent summary judgment briefing, or a jury, assesses DenSco's wrongdoing to a degree that invokes the defense and bars the claims.

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