

## Avoiding Rough Seas in the Distressed-Debt and Bankruptcy Morass

As unsecured creditors face reduced recoveries in the recent wave of bankruptcies, they are increasingly targeting the bankrupt's financial advisors, investment banks, and accounting firms with lawsuits to attempt to mitigate their losses.

Two recent District Court cases highlight the exposure professionals may face when providing professional services to distressed companies and also clarify one particular defense available to such professionals. The U.S. District Court for the Eastern District of Pennsylvania refused to dismiss fraud claims brought by bankrupt American Business Financial Services, Inc.'s noteholders against the company's auditors BDO Seidman, LLP. There, the District Court concluded that the noteholders had sufficiently alleged that the accounting firm failed to maintain its independence and ignored 'red flags' signaling trouble.<sup>1</sup> On the other hand, the U.S. District Court for the District of Delaware dismissed the Oakwood Homes' Corp.'s Chapter 11 liquidation trustee's damage claims against their financial advisor Credit Suisse First Boston, holding that the doctrine of *in pari delicto* protected the financial advisor from liability to the company where the company retained final decision-making authority.<sup>2</sup>

### **American Business Financial Services, Inc. Noteholder Litigation**

American Business Financial Services, Inc. ("ABFS"), a major home lender, filed for Chapter 11 in 2005, owing various noteholders (the "Noteholders") hundreds of millions of dollars. With little recovery in the bankruptcy, the Noteholders initiated a class action lawsuit against deep pocketed BDO Seidman, LLP ("BDO") alleging fraud under Section 10(b) of the Securities Exchange Act. Specifically, the Noteholders alleged that BDO issued unqualified opinions on ABFS's financial statements and missed 'red flags' regarding the company's financial position. BDO's motion to dismiss was denied, paving the way for discovery in advance of eventual summary judgment motions or trial.

ABFS's primary business was the origination, purchase, and securitization of home mortgages and business loans. Initially, ABFS would bundle home mortgages and business loans, securitize their value, and receive cash from institutional lenders for them. Starting in about June 2003, however, investment banks refused to participate in the securitization process and ABFS turned to the general public to finance its mortgage and loan services. Placing advertisements in newspapers to attract buyers, ABFS issued notes valuing hundreds of millions of dollars. During the purchase process, the Noteholders relied on ABFS's 2002 and 2003 registration statements and prospectuses, which contained BDO-provided financial statements.

The Noteholders allege, *inter alia*, that BDO did not meet various of the generally accepted auditing standards including the requirements to exercise due professional care and professional skepticism; to neither assume that management is dishonest nor to assume unquestioned honesty; to conduct the audit accepting fraud as a possibility notwithstanding past experience with the client; to be intellectually honest and recognized as independent from the client; and to investigate contradictions between management representations and audit evidence.

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<sup>1</sup> Malack v. BDO Seidman, LLP (In re American Business Financial Services, Inc. Noteholders Litig.), 2008 U.S. Dist. LEXIS 61450, Case. No. 08-0784 (E.D. Pa. August 11, 2008).

<sup>2</sup> OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.), 39 B.R. 357 (D. Del. June 9, 2008).

The Court found that the Noteholders' complaint pleaded with sufficient particularity these aspects of fraud: allegedly, BDO (i) failed to sufficiently investigate areas of concern the previous auditor had highlighted when it resigned mid-audit; (ii) failed to properly heed strong comment letters from the Securities and Exchange Commission and subpoenas from the United States Attorney's office; (iii) failed to consider the domination of ABFS by a small group of individuals; and (iv) failed to properly question and investigate ABFS's negative operations cash flows since 1996, poor liquidity, dependence on debt financing, unsegregated escrow and operating accounts, inflated earnings expectations, and miscalculations in one of its securitizations.

The Court, reviewing the scienter requirements for auditors alleged to have committed securities fraud, noted that violations of Rule 10b-5 are not restricted to issuing companies themselves, but can be committed by secondary actors like BDO. To show sufficient scienter, the Court summarized that the Noteholders "must demonstrate that [BDO] 'possessed a mental state embracing intent to deceive, manipulate or defraud, or at a minimum, highly unreasonable conduct, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care ....'"<sup>3</sup> Considering the specific pleadings, the allegation that BDO failed to recognize and heed the red flags, and the allegation that BDO was not independent as an auditor because of the lucrative relationship with ABFS, the Court concluded that the pleaded failures in the BDO audit process "were sufficiently egregious to infer scienter."<sup>4</sup>

The Court's ruling allows the Noteholder litigation to move forward: "[u]pon consideration of [the Noteholders'] allegations of numerous, significant and specific auditing violations and repeated decision not to investigate multiple red flags, [the Court] den[ies BDO's] motion to dismiss...."<sup>5</sup> Significantly, BDO must now shoulder the costs and burdens of discovery and will have to defend itself either at summary judgment or at trial. This case is an important and recent example of the creditor's search for a deep pocket.

### **Oakwood Homes Bankruptcy**

Oakwood Homes Corporation ("Oakwood") designed, manufactured, and marketed modular homes and provided financing to its buyers. Credit Suisse First Boston ("Credit Suisse") served as Oakwood's securities underwriter starting in 1994 and underwrote more than \$7.5 billion in Oakwood securities by bundling mortgages for sale to private and institutional investors. Credit Suisse was closely involved with Oakwood's capitalization plans and financing maneuvers. As such, Credit Suisse was aware of the tough outlook for Oakwood, and internal Credit Suisse memoranda commented that Oakwood would not likely meet forecasted profitability levels. Nevertheless, after Oakwood's previous lender declined to renew its lending facilities, Credit Suisse provided Oakwood with liquidity and, in exchange for the funding, received a warrant to purchase just under 20% of Oakwood's common stock. Oakwood's financial problems deepened, and in November 2002 it filed for Chapter 11 bankruptcy protection.

In April 2004, the Delaware Bankruptcy Court confirmed Oakwood's reorganization plan, which empowered a Liquidation Trust ("OHC Trust") to pursue claims against third parties on behalf of Oakwood's creditors. Thereafter, the OHC Trust initiated a lawsuit against Credit Suisse to recover damages arising from Credit Suisse's pre-bankruptcy securitization services and its alleged breach of fiduciary duty resulting from Credit Suisse's role as a closely involved financial advisor.

In its defense, Credit Suisse invoked the doctrine of *in pari delicto*, a doctrine similar to, but not the same as, the common-law prohibition against providing relief to those with "unclean hands." *In pari delicto potior est conditio defendentis* translates into "a plaintiff who has participated in the wrongdoing may not recover damages resulting from the wrongdoing." That is, a party's own wrongful conduct should

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<sup>3</sup> In re ABFS Noteholders Litig., 2008 U.S. Dist. LEXIS 61450 at \*22 (quoting In re IKON Office Solutions, Inc. Sec. Litig., 277 F.3d 658 (3d Cir. 2002)).

<sup>4</sup> Id. at \*26.

<sup>5</sup> Id. at \*27.

prevent it from recovering damages. Most often, professionals sued by a bankrupt company or its successor trustee invoke the doctrine. A trustee, or in this case a liquidation trust, standing in the shoes of the bankrupt company, assumes the burden of the company's wrongdoing. Professionals invoke *in pari delicto* to assure that the debtor's pre-bankruptcy wrongdoings attach to any successor and hinder its ability to recover from these targets.

The OHC Trust argued that Credit Suisse, having assumed the role of an Oakwood insider through its close relationship with Oakwood, should not be protected by this doctrine. The Court found, however, that "the insider exception makes little sense without some showing of control or domination by the alleged insider over the debtor."<sup>6</sup> Notwithstanding significant contacts between Credit Suisse and Oakwood, the Court determined that the evidence was insufficient to justify the application of the insider exception.

Credit Suisse had served as financial advisor to the debtor company, monitoring its operations and helping to guide its management, but the Court found that the board made the final decisions and retained ultimate control. Thus, Oakwood's board and management – not Credit Suisse – bore the responsibility for the development and implementation of the corporate strategy that eventually led to the company's bankruptcy. Though Credit Suisse was closely involved with Oakwood's finances and suggested business ideas, Oakwood itself retained control over its own financial decisions. Because Oakwood's leadership was responsible for its ill-fated corporate strategy, the Court held that the *in pari delicto* doctrine applied.

The Oakwood case is important because it clearly imputes the debtor company's pre-bankruptcy control over financial decisions onto the trustee: Credit Suisse successfully argued that Oakwood's management had authorized and controlled all of the debtor company's financial strategies and transactions and, therefore, notwithstanding Credit Suisse's close involvement, cannot recover damages from Credit Suisse for its role in formulating and contributing to those financial decisions.

Although the OHC Trust disapproved of Oakwood's corporate strategy in retrospect, it could not foist responsibility for the setting of that strategy upon Credit Suisse. Financial advisors operating at arms' length are unlikely to become corporate insiders liable to post-bankruptcy litigation. Professionals who advise corporate entities can find solace in the companies' retention of control and final decision-making authority.

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If you have any questions concerning the foregoing or would like additional information, please contact James W. Giddens, Jeffrey S. Margolin, Anson B. Frelinghuysen, or the attorney with whom you regularly work.

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<sup>6</sup> In re Oakwood Homes, 389 B.R. at 367.

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