

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:

REFCO INC., *et al.*,

Debtors.

§ Chapter 11
§ Case No. 05-60006 (RDD)
§ Jointly Administered
§

Final Report of Examiner

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I. INTRODUCTION

A. OVERVIEW OF THE FINAL REPORT

This is the Final Report of the Examiner (the “Report”). The Report documents the findings and conclusions of Joshua R. Hochberg, the duly-appointed examiner (the “Examiner”) in the bankruptcy cases (the “Bankruptcy Cases”) of Refco Inc. and its affiliated debtors (collectively, “Refco” or the “Debtors”).

Part I explains the structure and content of this Report, provides an overview of the Debtors and their Bankruptcy Cases, and summarizes the Examiner’s findings on potential causes of action held by the Debtors’ estates.

Part II of this Report discusses the procedural aspects of the Examination. This Part details the Examiner’s appointment, the scope of the Examination, and various factors affecting the Examination. Part II also discusses the Examiner’s investigative efforts, coordination with governmental agencies and other interested third-parties, and other factors that aided or limited the Examiner’s investigative efforts.

Part III of this Report provides a history of the Debtors and describes the “Round Trip Loan” transactions which were used to conceal certain related-party receivables and, when disclosed, precipitated Refco’s bankruptcy.

Part IV of the Report details the role of the auditing professionals that were subjects of the Examination, Arthur Andersen LLP and Grant Thornton LLP. Part IV also analyzes each auditing professional’s relationship to the Debtors, and reaches conclusions as to the potential liability of each of the auditing professionals.

Part V of the Report details the role of the two accounting professionals (tax accountants) that were subjects of the Examination, Ernst & Young LLP, and Levine Jacobs & Company,

L.L.C. Part V also analyzes each accounting professional's relationship to the Debtors, and reaches conclusions as to the potential liability of each of the accounting professionals.

Part VI of the Report details the role of the principal legal professionals that were subjects of the Examination, Mayer, Brown, Rowe & Maw LLP and Weil, Gotshal & Manges LLP. Part VI also analyzes each legal professional's relationship to the Debtors, and reaches conclusions as to the potential liability of each of the legal professionals.

Part VII of the Report analyzes the circumstances surrounding the declaration and payment of the \$82.2 million dividend made by Refco in connection with its IPO, and the likelihood of recovering the dividend or related damages for the benefit of the bankruptcy estates.

Part VIII of the Report briefly discusses certain professionals that were subjects of the Examination, but for whom a detailed discussion in this Report was determined not to be necessary.

Part IX discusses certain considerations regarding determination of the solvency of the Debtors, recovery of preferential transfers, calculation of damages, and application of the *Wagoner* rule.

The Report also contains exhibits and appendices. Exhibit 1 is a glossary of key terms used in the Report. Exhibits 2 and 3 list the parties whose documents were reviewed, and the witnesses interviewed by the Examiner and his counsel. Appendices A through C contain discussions of the law applicable to the potential causes of action identified in the Examiner's investigation and conclusions, with appropriate citations to authority, which are provided to assist in the evaluation and analysis of the potential claims and defenses discussed herein.

Appendix D is a compilation of copies of certain of the documents referred to and relied on in the Report.

B. SUMMARY OF THE MATTER UNDER INVESTIGATION

Phillip R. Bennett (“Bennett”), Robert C. Trosten (“Trosten”), and Tone N. Grant (“Grant”) are individuals under indictment for orchestrating and participating in a massive fraudulent scheme designed to manipulate the financial statements of various Refco companies that were publicly reported and supplied to lending institutions and to regulators.¹ These Refco companies’ financial statements were prepared on a consolidated basis under Refco Group Ltd., LLC (“RGL”). The financial information of Refco Group Holdings, Inc. (“RGHI”), a holding company owned principally by Bennett, was not consolidated with Refco and was not public. In August 2005, Refco made an Initial Public Offering (“IPO”) of its stock and was subsequently listed on the New York Stock Exchange. Shortly thereafter, in October 2005, revelations concerning the fraudulent manipulation of Refco’s financial statements precipitated Refco’s bankruptcy and losses of hundreds of millions of dollars by creditors and equity holders.

The roots of the scheme that was used to conceal losses and money owed to Refco by RGHI began at least in 1997 or 1998. At that time, Refco suffered millions of dollars in losses as certain of its customers could not make good on their own trading losses. There is evidence that Bennett and others caused these bad debts to be “sold” or transferred from Refco entities to the unconsolidated parent company, RGHI. As a result, the bad debts would not have to be recognized as losses on the books of a Refco company. The “sale” price of the bad debt transferred directly or indirectly to RGHI was treated as a receivable, due from RGHI, on the books of Refco (the “RGHI Receivable”). Over time, the amount of the RGHI Receivable

¹ See Indictment, *United States v. Bennett, et al.*, 05-CR-1192 (S.D.N.Y. Jan. 16, 2007) (“Superseding Indictment”).

fluctuated as interest accrued, other bad debts were transferred to RGHI, and certain professionals' fees and computer expenses were also transferred out of the consolidated reporting Refco companies. To hide the RGHI Receivable, as each reporting period came to a close, Bennett and others caused the consolidated reporting Refco companies to manipulate their books through a series of transactions commonly referred to as "Round Trip Loans." The loans made it appear that the RGHI Receivable was due from unrelated third parties rather than from RGHI. This concealment of the true nature of the RGHI Receivable also provided comfort to outsiders that the receivable was collectible. The mechanics of the typical Round Trip Loans is described below.

- The Round Trip Loans were two short term loans of several weeks duration that spanned the end of Refco's fiscal year-end or quarterly financial reporting periods. The first loan was made by a Refco entity to a third party at a certain interest rate for a certain period of time. The second one was made by that same third party to RGHI for the same period of time, but at a higher interest rate. The repayment of the loan by RGHI to the third party was guaranteed by RGL and the third party was also indemnified by RGL against any loss or expense for entering into the Round Trip Loan.
- The funds or credit advanced for the loan to the third party were deposited into the third party's account with RCM. Those funds were then transferred at the third party's request from the third party's account at RCM to RGHI's account at RCM. The effect of these transactions was to reduce RGHI's receivable balance owed to RCM by the amount of the Round Trip Loan, and to substitute a receivable in that amount from the third party. In most cases, these were bookkeeping entries and no cash actually "moved." After the end of the applicable reporting period, the process was reversed and unwound.

These Round Trip Loans were sham transactions with no economic substance which were entered into solely to "dress up" Refco's consolidated financial statements. The loans involved no risk to the third party because they included secret guarantees by Refco that were not reflected on Refco's books. The guarantees obligated Refco to pay back RGHI's obligation in case RGHI defaulted. The loans were also falsely reported to be "repo" transactions when, in fact, unlike a true repo, there was no security on deposit at Refco to act as collateral for the loan. The effect of

the loans was to expose Refco to risk and to cause Refco to pay interest, with no resulting economic benefit to Refco.

Bennett and others caused Refco to engage in these schemes at every annual reporting period from at least 1998 through 2005. Starting in 2000, attorneys at Mayer Brown prepared the loan documentation and the guarantee and otherwise assisted with the loan process for virtually every Round Trip Loan. At the end of each financial reporting period, first Arthur Andersen and later Grant Thornton audited RGL's books and issued unqualified audit opinions that did not disclose the Round Trip Loans or the full extent of the related-party RGHI Receivable.

The scheme to conceal the large related-party receivable went undetected during the course of a leveraged buyout transaction in August 2004. It was also undetected when certain senior subordinated notes issued by Refco were registered with the SEC in April 2005 in a public exchange offering, and during the IPO in August 2005. After the IPO a new Refco employee discovered the irregularities on the books and brought them to the attention of RGL's Audit Committee. Shortly thereafter, on October 17, 2005 ("Petition Date"), Refco and 23 of its affiliated companies filed for protection under chapter 11 of Title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (as amended and supplemented, the "Bankruptcy Code") in the United States Bankruptcy Court for the Southern District of New York ("Court"). On March 22, 2006, the Court approved the appointment of the Examiner in these cases, and McKenna Long & Aldridge LLP ("MLA") was retained as the Examiner's counsel.

C. SCOPE OF THE EXAMINATION

As explained in more detail in Section II.A., below, the scope of the Examination included the investigation of, and reporting on, potential claims which might be brought by the Debtors' estates against any of Refco's prepetition professionals, and any causes of action that

might be brought to recover the \$82.2 million dividend paid in connection with the IPO, or damages arising from its payment.² The Examination included consideration of how the fraud was perpetrated through the use of Round Trip Loans in order to understand whether or not the professionals were negligent or complicit. The Examiner evaluated potential liability with respect to the following entities and subject matters:

- Arthur Andersen LLP (“AA”) was Refco’s outside auditor from at least the late 1980s to 2002.
- Grant Thornton LLP (“GT”) was Refco’s outside auditor from approximately October 2002 until the filing of the Refco Bankruptcy Cases in October 2005.
- Ernst & Young LLP (“E&Y”) provided various services to Refco entities, including tax accounting and consulting services, from 1991 until 2004.
- Levine Jacobs & Company, L.L.C. (“Levine Jacobs”) provided tax accounting services to various Refco entities from 2004 to 2005.
- Mayer, Brown, Rowe & Maw LLP (“Mayer Brown”) served as the main outside counsel for Refco and its related entities from approximately 1994 until the filing of the Refco Bankruptcy Cases.
- Weil, Gotshal & Manges LLP (“Weil”) represented various Thomas H. Lee entities in connection with the LBO in 2004 and thereafter represented both Thomas H. Lee and various Refco entities (and certain members of Refco’s Board of Directors) in connection with various matters including Refco’s IPO.
- Payment of Dividend. An approximately \$82.2 million dollar dividend to pre-IPO shareholders was paid in connection with Refco’s IPO.

² The Examiner evaluated potential claims of the Refco Debtors as a whole, without distinguishing transactions and claims among the various Refco entities. Although some issues discussed herein are relevant to claims held by RCM, such claims are not separately considered or discussed herein because they were excluded from the scope of the Examination. (Docket # 1487).

D. SUMMARY OF CONCLUSIONS

This Report is the work product of the Examiner and his counsel. The information and statements contained herein, representing the Examiner's conclusions and opinions, should not be taken as admissions or findings for or against any person or entity.³

The Examiner concludes that the Debtors' estates could state claims for relief, sufficient to withstand a motion to dismiss, against certain of Refco's prepetition professionals who contributed to, or failed to prevent, the harm suffered by Refco, including:

- Claims for professional negligence against GT, E&Y, and Mayer Brown.
- Claims for aiding and abetting fraud and breaches of fiduciary duty against Mayer Brown and, although it is a close question, E&Y.
- Claims for avoidance and recovery of preferential transfers against Refco's professionals who received payments on or within the 90-days prior to the Petition Date.

As to Weil, although it is a close question, the Examiner concludes that there are facts that could support an allegation that Weil failed to adhere to the standard of care applicable to its representation of Refco.

Additional claims might be asserted against certain of the directors responsible for the declaration of the \$82.2 million dividend and those who received the dividend, including:

- Claims for breaches of fiduciary duties and violation of Delaware General Corporate Law against Bennett.
- Claims for avoidance and recovery of fraudulent conveyances and/or preferential transfers, and damages, against Bennett/RGHI and Thomas H. Lee entities as the recipients of the \$82.2 million dividend.

³ The Report includes discussions of facts that may be helpful to understanding the conclusions reached herein, but relate to non-professionals and topics that were not subjects of the Examination. The Examiner does not reach any conclusions concerning persons or entities other than those specifically identified in the Report; and, nothing in the Report should be interpreted as meaning the Examiner reached any conclusions as to the liability of, among others, the Round Trip Loan Participants, Thomas H. Lee entities, and the underwriters, because these persons and entities were beyond the scope of the Examination.

The Examiner believes further investigation is warranted to determine whether evidence exists to support other claims, including:

- Claims for aiding and abetting fraud and breaches of fiduciary duty against AA and GT.
- Claims for damages arising out of the declaration of the \$82.2 million dividend against certain other members of Refco's Board of Directors.

Several significant factual and legal defenses are potentially available to all parties against whom claims may be asserted. Among the most significant potential defenses are the "*Wagoner*" rule and, in some cases, the statute of limitations.

II. PROCESS OF THE EXAMINATION

A. ESTABLISHING THE SCOPE OF THE EXAMINATION

Following Court approval of his appointment by the Office of the United States Trustee ("U.S. Trustee"), the Examiner's initial efforts were directed toward familiarizing himself with the background of the cases and the investigations in progress by other parties, including governmental agencies. Prior to commencing his investigation, as directed by the Court in an Order entered on March 16, 2005 ("Examiner Appointment Order") (Docket # 1487), the Examiner developed a work plan and budget in consultation with the Debtors and the Official Committee of Unsecured Creditors appointed in the Bankruptcy Cases ("Creditors Committee"). This process of developing a work plan culminated in a hearing on June 21, 2006, at which the Court indicated that it was appropriate for the Examiner to focus on investigating possible claims against professionals, as outlined by the Examiner in an alternative work plan and budget filed under seal with the Court. The Court also requested that the Examiner investigate possible claims arising out of the dividend paid to the pre-IPO shareholders of Refco in connection with the IPO. Thus, the scope of the Examination was determined to include the investigation and reporting on causes of action which might be brought by the Refco estates against Refco's

prepetition professionals, including causes of action arising out of or related to the LBO, the IPO, and related transactions and services, and causes of action that might be brought against any subjects arising out of the payment of the \$82.2 million dividend in connection with the IPO. The Court directed the Examiner to file his final report by April 16, 2007. The Court did not require the filing of any interim reports. Immediately after the June 21 hearing, the Examiner commenced the investigation.

B. FACTORS THAT INFLUENCED THE EXAMINATION

1. Factors that Aided the Examination

- a. The Court's availability to set hearings and *in camera* conferences and deliver prompt rulings on contested matters, and otherwise, was most helpful in moving the investigation forward.
- b. The Court directed the Examiner to establish protocols and to coordinate and avoid interference with investigations being conducted by the Securities and Exchange Commission ("SEC"), the United States Attorney's Office for the Southern District of New York ("USAO"), the Commodities Futures Trading Commission ("CFTC"), and other governmental agencies. The Examiner established protocols with the SEC, USAO and CFTC, which resulted in a minimum of interference with the ongoing governmental investigations while allowing the Examination to proceed. Specifically, the Examiner coordinated his efforts with the Assistant United States Attorneys handling the Bennett and related investigations to minimize interference with the criminal investigations. The protocols with the investigatory agencies were intended to facilitate the sharing of information to the extent that such sharing would benefit the Debtors' estates. As explained below, the deference afforded to the USAO's criminal investigation limited the Examiner's ability to interview certain witnesses deemed central to the USAO's criminal proceedings, and to access certain documents.

c. The Examiner coordinated with the SEC throughout his investigation. Based on the Examiner's role as a court-appointed fiduciary, the SEC granted the Examiner's "access request," a formal mechanism through which the Examiner gained access to documents produced to the SEC by third parties. Thereafter, the SEC was particularly cooperative in providing the Examiner access to these documents. The SEC also made itself readily available to the Examiner for consultations regarding coordination as part of the Examiner's efforts to avoid interference with governmental investigations.

d. The Examiner also received a high degree of cooperation from the U.S. Trustee, particularly with regard to clarifying provisions of the Debtors' Joint Chapter 11 Plan that impacted the Examiner and his investigation.

e. Cooperation from several of the major parties in interest was helpful to the Examiner throughout the course of the Examination. The Examiner received cooperation from, and consulted frequently with, among others, the Debtors, their restructuring personnel, and their counsel; the RCM Trustee and his counsel; and the Creditors Committee (and later the Litigation Trustee), its counsel and its conflicts counsel. The Debtors and their counsel, and the RCM Trustee and his counsel, among others, provided the Examiner access to a tremendous volume of documents, including privileged documents. Sharing of these documents was provided by way of access to Debtors' counsel's intranet site on which electronic images of the documents had been loaded. Similarly, the Creditors Committee's counsel was helpful in arranging for access to documents which had been produced to it by third parties. The Examiner arranged for counsel to the Litigation Trustee to attend each interview with the consent of the parties being interviewed, which resulted in efficiencies and cost savings for the estates.

f. Prior to the Examiner's appointment, the Debtors and the Creditors Committee retained consultants in the Bankruptcy Cases (Goldin Associates, LLC, AP Services, LLC and FTI Consulting, Inc. for the Debtors; Houlihan Lokey Howard & Zukin Capital, Inc. and FTI Consulting, Inc. for the Creditors Committee). Based on the Court's admonition against retaining additional consultants unless absolutely necessary, the Examiner determined that his investigation could proceed without the retention of more consultants whose expertise would overlap that of the Debtors' and Creditors Committee's consultants. While retention of his own consultants would have enabled a more in-depth and extensive expert review of certain financial and accounting issues, the Examiner was able to obtain sufficient information with the cooperation of the existing consultants to conduct the investigation.

2. Limitations on the Examination

a. The period from the June 21, 2006 hearing, at which authorization to proceed was received, to the filing of this Report spanned less than ten months calendar time and was a short time period within which to complete and report on the Examination. The Examiner and his counsel engaged in an extensive review of over one million pages of documents, conducted extensive legal research, and conducted numerous witness interviews, culminating in an analysis applying the complex set of facts discovered against existing law, and the writing of this Report. With the volume of documents in existence, large number of witnesses to be interviewed, and the complexity of the underlying transactions to be investigated, the Examiner believes he would have benefited from additional time, but understood that the Court intended for the Report to be completed six months before the two-year anniversary of the Petition Date. The Examiner believes that his efforts, together with the efforts of his professionals, resulted in the review of most of the key documents, and interviews of the most knowledgeable witnesses, available to the Examiner.

b. The Examiner, as did the Creditors Committee, provided advance notice to the USAO of proposed interviews to allow the USAO an opportunity to object if the USAO believed an interview would compromise its criminal investigation. As noted above, out of deference to ongoing governmental investigations, the Examiner was unable to interview certain witnesses believed to have valuable knowledge of the facts underlying the fraudulent schemes. Because of the ongoing criminal investigation, it is also likely that some participants would have refused to be interviewed or to testify. The witnesses unavailable to the Examiner included high-level Refco officers and directors, key GT principals and employees, and a few of the third-party participants in some, but not all, of the Round Trip Loan transactions. The Examiner was also unable to review certain reports provided to the USAO by Latham & Watkins regarding the internal investigation performed at the request of Refco's Audit Committee immediately prior to the bankruptcy filings.

c. The Examiner received a large volume of documents during the course of the investigation. The Examiner did not review every document provided to him due to the volume of documents, the timing of their receipt, and the limited time within which to conduct the Examination. The vast majority of these documents were loaded into a searchable computer database. Based on the OCR (optical character recognition) search methodology employed, the Examiner is confident that the most significant and relevant documents were reviewed to adequately inform this Report.

d. The Court requested that the Examiner not retain additional consultants unless absolutely necessary, but instead utilize consultants previously retained by the Debtors and the Creditors Committee. The Examiner honored this request and did not employ additional consultants.

C. PROCEDURAL ASPECTS OF THE EXAMINATION

1. Staffing the Examination

The Examiner organized the investigation by assembling teams at MLA to assist him in discharging his duties. The Examiner staffed the investigation with a core group of thirteen lawyers, and one non-lawyer professional who has specialized knowledge in securities and derivatives matters. These professionals were divided into an administrative team, five investigatory teams, and a bankruptcy/legal research/report writing team, with each team consisting generally of one partner and one associate. Each of the five investigatory teams was assigned to investigate certain subjects within the scope of the Examination, as follows: (1) GT and AA, Refco's prepetition outside auditors; (2) E&Y, Levine Jacobs and other accountants; (3) Mayer Brown; (4) attorneys Weil and McDermott Will & Emery LLP ("McDermott Will"); and (5) the \$82.2 million dividend paid at the time of the IPO. In addition, the report writing team was charged with the responsibility of working with the Examiner in coordinating and developing the report of the Examiner with input of information from the various investigative teams.

The teams were occasionally and temporarily augmented as necessary to deal with spikes in activity in the investigative process. Additionally, several lawyers with specialized knowledge in areas (such as securities and tax law) were consulted as appropriate; associates were brought in to assist with various legal research needs; and paralegals were utilized to assist with many of the necessary tasks, including the assembly and review of documents, the review, preparation and service of fee applications and reports to the Fee Review Committee, subject to review by a partner of the firm, and reviewing the Court docket in the Bankruptcy Cases on a periodic basis to alert the Examiner and his counsel to pleadings that might bear on the Examiner's investigation or his status as a party in interest in the Refco cases.

The Examiner was in overall control of the investigation, coordinated activities of the various teams, interacted with the USAO and other parties in interest, and, in consultation with his legal advisors, made the final decisions with respect to any conclusions and the content of this Report. An administrative team assisted the Examiner in coordinating the investigation and carrying out the directives of the Examiner with respect to positions taken by the Examiner in Court proceedings or in meetings with other parties in interest. The administrative team also utilized a non-lawyer technology expert with expertise in litigation support databases and related matters, who was responsible for establishing and overseeing the third party database for documents reviewed and used by the investigative teams, and coordinating with other parties regarding the use of their electronic databases.

2. Coordinating the Examination

The Examiner, from time to time, required periodic reports from each investigative team with respect to the activities of the team. This ensured that the investigation and the activities of the investigative teams were adequately coordinated and that unnecessary duplication was avoided. Further, weekly conference calls were conducted with the leaders of each investigative team and the Examiner to review the progress of the investigation, the planned work for the coming weeks, and to resolve any problems or issues that may have arisen.

The investigation was organized so as to be completed in three stages: (1) document review and research; (2) interviews and depositions; and (3) conclusions and drafting of the Report. Of course, given practicalities in the timing of receipt of certain documents and the availability of witnesses, there was necessarily some overlap of the stages.

3. Monitoring and Participating in the Bankruptcy Cases

The Examiner's administrative team monitored and participated, as appropriate, in the Debtors' Bankruptcy Cases. The Examiner filed several motions in the cases, including motions

to seal certain filings that contained information that may have been prejudicial to the investigation and prosecution of estate causes of action had the information been disclosed prematurely. The pleadings filed by the Examiner under seal included his initial assessment of the case, proposed work plan and budget and filings related to the established fee application process. The Examiner also provided input to the Debtors and Creditors Committee regarding the Debtors' Chapter 11 Plan's provisions regarding the continuation of the Examiner's duties after confirmation of the Plan. On March 9, 2007, the Examiner filed a motion⁴ for authority to file this Report under seal, on a temporary basis, to establish procedures for removing the temporary seal, and to resolve assertions of confidentiality and privilege regarding information provided to the Examiner and used in this Report.

4. Obtaining and Reviewing the Documents

The Examiner received a very large volume of documents from numerous sources throughout the course of the investigation, including: the Debtors and their counsel, with the consent of the RCM Trustee and his counsel pursuant to a common interest agreement among the Debtors, the RCM Trustee and the Examiner; counsel to the Creditors Committee, and conflicts counsel to the Creditors Committee, who each provided documents previously produced to them from third parties; the SEC, which provided documents previously produced to it from third parties pursuant to subpoenas; and other third parties, pursuant to agreements or stipulations with the Examiner, and pursuant to Court orders and/or Bankruptcy Rule 2004 subpoenas. In addition, the Examiner entered into separate common interest agreements with (a) the Debtors and the RCM Trustee, and (b) the Creditors Committee, to facilitate the production and sharing

⁴ Docket # 4596.

of documents. Exhibit 2 to the Report lists the parties who produced documents referred to in this Report.

5. Witness Interviews

The Examiner and his investigative teams interviewed thirty-three fact witnesses. The interviews were taken on a consensual basis or pursuant to Bankruptcy Rule 2004 subpoenas. The interviews were not conducted under oath. Some of the interviews were transcribed. The Examiner did not conduct interviews of every possible witness. He selected the most appropriate available persons based on factors including time, resources and the desire to avoid interviewing witnesses with substantially overlapping knowledge. Counsel for the Litigation Trustee attended the interviews. Exhibit 3 lists all witnesses interviewed by the Examiner and his counsel.

III. HISTORY OF REFCO AND ITS AFFILIATES

A. BRIEF HISTORY OF THE REFCO DEBTORS

Refco Inc. and its subsidiaries were a commodities and futures trading brokerage conglomerate that provided execution and clearing services for exchange-traded derivatives, and also provided prime brokerage services in the fixed income and foreign exchange markets. Refco employed over 2,000 employees for its operations in fourteen countries, supervising and managing over 200,000 customer accounts.

The Refco Debtors' primary line of business was their futures trading business, consisting of the execution and clearance of trades of exchange-traded derivatives. Hedge funds, investment companies and similar customers used Refco to trade commodities and financial products, among other things. Some of Refco's business activities were subject to the regulations of the CFTC as well as the regulations of the Chicago Mercantile Exchange ("CME") and other applicable commodities exchanges on which the Debtors traded.

Refco, largely through its subsidiary, Refco Capital Markets Ltd. (“RCM”), a Bermuda company, also operated various unregulated businesses. For example, RCM invested and traded in over-the-counter derivatives and other financial products, primarily on behalf of wealthy individuals and related companies. The Debtors, through Refco Securities Ltd. (“RSL”), also operated as a regulated securities dealer subject to the regulation of the SEC in addition to the regulations of the exchanges on which RSL conducted business. RSL never filed for relief under the Bankruptcy Code, and substantially completed a winding down of its securities business during the pendency of the Bankruptcy Cases.

For much of the time period in question, Refco was wholly or partially owned by RGHI, a company that is not one of the Debtors in the Bankruptcy Cases.⁵

In early 1999, plans were made for an Austrian Bank called BAWAG P.S.K. Bank für Arbeit Und Wirtschaft Und Österreichische Postsparkasse Aktiengesellschaft (“BAWAG”) to purchase a 10% interest in RGL for \$95 million. Prior to this purchase, RGL and all of its subsidiaries (except Refco, Inc.) were converted to LLCs. BAWAG’s purchase of 10% of RGL closed in 1999. At the same time, BAWAG loaned \$85 million to RGHI, which, in turn, loaned the \$85 million plus an additional \$10 million to a newly-created entity called Refco Group Holdings, LLC (“RGHL”), which used the money to purchase a 10% interest in RGL.⁶ After the above transactions, RGL (now an LLC) was owned as follows: BAWAG — 10%; RGHI — 80%; and RGHL — 10%.⁷

⁵ The ownership of RGHI changed over time. Initially, RGHI was owned by three individuals — Thomas Dittmer (51%), Bennett (24.5%), and Grant (24.5%). Later, Dittmer and Grant were bought out.

⁶ The loan from BAWAG to RGHI included an option by BAWAG to purchase an additional 10% interest in RGL.

⁷ RGHL was 90% owned by RGHI and 10% owned by two RGHI shareholders, Bennett and Grant.

Within the fourteen month period prior to the filing of these Bankruptcy Cases, the Debtors conducted first (i) a leveraged buy-out transaction on August 5, 2004 (“LBO”), which included issuance of certain senior subordinated notes which were subsequently registered with the SEC in a public exchange; and then (ii) an IPO on August 16, 2005.

In the LBO, THL Refco Acquisition Partners, an affiliate of Thomas H. Lee Partners, L.P., and its affiliates and co-investors (collectively, “THL”), in exchange for a \$507 million cash payment, acquired a portion of New Refco Group Ltd., LLC (“New Refco”), thereby acquiring an approximate 57% equity interest in RGL. Through the LBO, Bennett exchanged his existing \$382.5 million equity position in RGL for an approximate 42.8% equity interest in New Refco. In addition, other Refco managers invested in New Refco. Additional funding for the LBO included a fully-drawn \$800 million term loan pursuant to a credit agreement dated as of August 5, 2004 between Refco Finance Holdings LLC (which became RGL), as borrower, and Bank of America, N.A., as administrative agent, with a number of RGL’s affiliates guaranteeing the debt. At the closing of the LBO, RGL distributed \$550 million in cash, and all of the equity interests in an RGL affiliate (which owned substantially all of the asset management business of Refco) to RGHI (owned at that time by Grant and Bennett). As part of the LBO, Refco Finance Holdings LLC and Refco Finance Inc. co-issued \$600 million of senior subordinated notes by way of a Rule 144A Exchange Offer, known as the 9% Senior Subordinated Notes due August 1, 2012 (“Senior Subordinated Notes”). The Senior Subordinated Notes were guaranteed, jointly and severally, on a senior unsecured basis, by many of RGL’s non-regulated domestic subsidiaries.

RGL was the company through which Refco's business was conducted. New Refco became the parent of, and owned all of the outstanding membership interests in, RGL upon completion of the LBO, after which the companies were structured as follows:

- Bennett owned 100% of RGHI;
- New Refco was owned by THL (57%) and RGHI (43%);
- New Refco owned 100% of RGL;
- RGL was the company through which all of Refco's operations were conducted.

Refco Inc. was formed in connection with the IPO, and issued the stock sold in the IPO.

In connection with its August 2005 IPO, 30,475,000 shares of Refco Inc. were sold. Refco sold 12,500,000 shares, and existing shareholders sold 14,000,000 shares, of common stock at a price of \$22.00 per share. An additional 3,975,000 shares were sold by Refco pursuant to the exercise of the IPO's underwriters' over-allotment purchase option. Proceeds from the sale of Refco's shares were used to redeem \$210 million aggregate principal amount of the outstanding Senior Subordinated Notes, and for general corporate purposes. The proceeds from the over-allotment sale were used, on August 18, 2005, to pay an aggregate dividend of \$82,203,000 to its pre-IPO shareholders, mostly THL and RGHI (owned by Bennett).

Approximately two months after consummation of the IPO, on October 10, 2005, Refco issued a press release disclosing the existence of a previously undisclosed \$430 million receivable from RGHI. This receivable had previously been recorded on the Debtors' financial statements as a receivable from an unaffiliated third party. The true nature of this receivable had been concealed through the use of the fraudulent Round Trip Loan scheme designed to present a false financial picture at various points in Refco's history, including at the times of the LBO and IPO. The October 10 press release also stated that due to the material nature of the discovery of

this undisclosed receivable, Refco's previously-issued financial statements could no longer be relied upon.

Immediately prior to the bankruptcy filings, the undisclosed receivable was investigated internally by Refco's Audit Committee, which hired the law firm of Latham & Watkins LLP and financial consultant FTI Consulting Inc. to aid in the investigation. Subsequent to the discovery, the Board of Directors demanded immediate repayment of the receivable from RGHI/Bennett,⁸ including interest. This payment was made by RGHI on October 10, 2005 using money obtained from BAWAG.⁹ The public disclosure that Refco's previously issued financial statements could not be relied upon, together with related events, precipitated an immediate and extraordinary crisis at Refco, which ultimately led to the Debtors seeking relief under the Bankruptcy Code.

In the one week between the disclosure and the bankruptcy filings, Refco's customers engaged in a "run on the bank" resulting in a decline in customer deposits at Refco LLC, from approximately \$7.5 billion on October 10, to approximately \$5.7 billion by October 17. Refco's publicly-traded stock declined in value from an October 7, 2005 closing price of \$28.56 (up from its IPO price of \$22.00 per share) to an October 18, 2005 closing price of \$0.65 per share. While Refco's regulated affiliates had maintained sufficient capital to satisfy the barrage of customer demands for withdrawals of their deposits, Refco's unregulated business, principally RCM, did not maintain sufficient cash on hand to satisfy customer withdrawal requests during this "run on

⁸ The Board suspended Bennett from his duties at Refco pending conclusion of the investigation. Thereafter, on or about October 11, 2005, Bennett was arrested and is currently under indictment in the United States District Court for the Southern District of New York. In subsequent superseding indictments, Trosten and Grant were also indicted.

⁹ BAWAG sued the Debtors in the Bankruptcy Cases to recover the loan. The Creditors Committee, with Court approval, counterclaimed on behalf of the Debtors. Ultimately, settlements were reached among BAWAG, the Debtors, the Creditors Committee, the USAO, THL, and other parties, providing for the payment by BAWAG of guaranteed amounts totaling \$867 million to the Debtors, the USAO, and others, together with additional contingent payments and BAWAG's release of \$480 million of claims it had asserted against the Debtors. As part of the settlements, BAWAG made significant admissions concerning its role in the fraudulent transactions.

the bank” period. This lack of cash reserves, coupled with the high level of customer withdrawal demands, resulted in the declaration by the Board of Directors of a temporary moratorium on customer withdrawals as of October 13, 2005.

On October 17, 2005, the Debtors filed petitions for relief under the Bankruptcy Code.¹⁰ Other than RCM, for which a chapter 11 trustee was subsequently appointed, all of the Debtors operated as debtors-in-possession pursuant to §§ 1107(a) and 1108 of the Bankruptcy Code during the pendency of their Bankruptcy Cases and until the Effective Date of the confirmed Joint Chapter 11 Plan in the Bankruptcy Cases — December 26, 2006. The Creditors Committee was duly appointed, and retained counsel, and conflicts counsel, to represent interests of creditors in the Bankruptcy Cases.

In the first months of the Bankruptcy Cases, the Debtors effectuated the liquidation of substantially all of their valuable, non-contingent business assets which effectively resulted in the cessation of the Debtors’ operations as going concerns. On December 9, 2005, the U.S. Trustee filed a motion for the appointment of a chapter 11 trustee in these Bankruptcy Cases. The motion was predicated on the alleged fraud and malfeasance of certain controlling members of the Debtors’ prepetition management. The Court conditionally denied the motion for appointment of a chapter 11 trustee subject to the Debtors meeting certain conditions, which were met. Thereafter, the U.S. Trustee, on January 27, 2006, filed a motion for the appointment of an examiner, which was approved by the Court on March 16, 2006.

On December 15, 2006, the Court entered an order confirming the Modified Joint Chapter 11 Plan of Refco Inc. and Certain of Its Direct and Indirect Subsidiaries. On the

¹⁰ On November 25, 2005, Refco, LLC filed a petition for relief under Chapter 7 of the Bankruptcy Code. On June 5, 2006 three additional affiliated companies also filed petitions for relief under the Bankruptcy Code.

Effective Date of the Plan, a Litigation Trustee, to pursue claims of the estates, and a Plan Administrator, to wind down the affairs of the estates, were named pursuant to provisions of the Plan. The Plan also provided for the Examiner to continue with his investigation and file his report pursuant to the Examiner Appointment Order.

B. ROUND TRIP LOANS AND SIMILAR TRANSACTIONS

1. Overview

Beginning in no later than February 1998, Refco's senior management used several forms of purported short-term loans that straddled the end of Refco's financial reporting periods to mask substantial portions of the RGHI Receivable. In this section of the Report, the Examiner describes those loans, and explains their impact on the RGHI Receivable.

The RGHI Receivable was composed of the debit balances in three Refco accounts:

(i) the account of RGHI at RCM; (ii) the account of RGHI at Refco Capital Corporation (later, Refco Capital LLC) ("RCC"); and (iii) the account of Refco Global Finance ("RGF") at RCM (RGF was a subsidiary of RCM in which a portion of the RGHI Receivable — the so-called "Asian receivable" — was "parked"). As of January 1998, the total RGHI Receivable was over \$376 million.¹¹ It ballooned to over \$1 billion by January 2004.¹²

Between 1998 and 1999, transactions similar to what later became known as Round Trip Loans (or RTLs) were used to mask the RGHI Receivable. These did not involve any loan documentation. These transactions will be referred to as "Wire Transfer Loans" or "WTLs." Like the RTLs, the WTLs involved purported "loans" from a third party to RGHI in late

¹¹ See FTI Consulting Schedule 3, at App. D-1.

¹² *Id.*

February, which RGHI would subsequently repay in early March after the close of Refco's fiscal year. The third party WTL participants were paid interest for their funds by RCM.

Between February 2000 and September 2005, the RTLs with unaffiliated third parties ("RTL Participants") were used to conceal the RGHI Receivable. The RTLs were initially done at the end of Refco's financial reporting year (end of February), but later the transactions became more frequent, occurring at quarter and calendar year end as well. Based on the loan documents, the total principal amount of these loans was \$6,250,000,000. Further, based on the loan documents, the total cost to Refco in net interest paid to the RTL Participants was \$1,227,042.82.

Another type of short term loan used to mask the RGHI Receivable was also done at the end of Refco's financial reporting year for the years 2000 through 2005 between Refco and BAWAG (the "BAWAG Loans"). The BAWAG Loans were substantially funded by RCM, with BAWAG providing some additional funds for which it was paid interest by RCM. The total principal amount of these loans was \$1,650,000,000, and their cost to Refco was \$347,042.97.

2. Impact of Loans on RGHI Receivable

The proceeds of the short-term loans were used to reduce the total outstanding balance of the RGHI Receivable. These proceeds were credited to one or more of the accounts that had a debit balance representing a portion of the then-existing RGHI Receivable. The effect of such credits was to reduce the debit balance. After the end of the financial reporting period, the proceeds of these loans that had been temporarily credited to the various accounts evidencing the RGHI Receivable were returned, thereby reinstating the receivable in its prior amount, and increasing it by the amount of the interest charged on those loans.

Set forth below is a table showing the effect on the then-existing RGHI Receivable of these short term loans that straddled the end of Refco's financial reporting periods starting with February 1998, and continuing through September 2005.

For substantially all of the periods (with the notable exception of July-August 2004 when the LBO closed), the total amount of the short-term RTLs, WTLs, and BAWAG Loans tracked the net reduction in the RGHI Receivable shown at the end of a reporting period, and the increase in the receivable when they were reversed generally equaled or exceeded the amounts of these short-term loans.¹³

**IMPACT OF SHORT TERM LOANS
ON RGHI RECEIVABLE**

<u>Year /Month Accounting Period End Date¹⁴</u>	<u>Total Loans (RTLs, WTLs, BAWAG)¹⁵</u>	<u>Net Reduction in Receivable¹⁶</u>	<u>Month End Combined RGHI Receivable Balance</u>
January 31, 1998			\$376,678,786
February 28, 1998	\$175,000,000	\$165,095,248	\$211,583,538
March 31, 1998			\$387,708,499
January 31, 1999			\$409,398,142
February 28, 1999	\$265,000,000	\$275,462,834	\$133,935,308
March 31, 1999			\$455,135,660
January 31, 2000			308,951,450
February 29, 2000	\$610,000,000	\$325,299,510	(16,348,060)
March 31, 2000			596,676,711

¹³ These accounts were also used for other purposes. As a result, there is a substantial, but not a direct, dollar-for-dollar correlation between the short term loans, the reduction in the RGHI Receivable when they were made, and its increase when they were unwound.

¹⁴ This column identifies the end date for the month end accounting period. It is generally, but not always, the last day of the month.

¹⁵ The total loan amount for each period is a total of all RTLs, WTLs, and BAWAG Loans made during that period.

¹⁶ Net reduction in receivable is calculated using balances reflected on account statements for accounts held by RGHI at RCM and RCC, and by RGF at RCM. The net reduction is the cumulative difference between the closing balance as of the last day of the prior monthly accounting period and the closing balance on the last day of the subsequent monthly accounting period. See FTI Consulting Schedule 3, at App. D-1.

**IMPACT OF SHORT TERM LOANS
ON RGHI RECEIVABLE**

<u>Year /Month Accounting Period End Date¹⁴</u>	<u>Total Loans (RTLs, WTLs, BAWAG)¹⁵</u>	<u>Net Reduction in Receivable¹⁶</u>	<u>Month End Combined RGHI Receivable Balance</u>
January 31, 2001			656,856,470
February 28, 2001	\$750,000,000	\$656,765,194	91,276
March 31, 2001			709,888,962
January 31, 2002			852,871,155
February 28, 2002	\$925,000,000	\$857,508,816	(4,637,661)
March 31, 2002			849,144,785
January 31, 2003			\$981,676,171
February 28, 2003	\$900,000,000	\$971,967,903	\$9,708,268
March 31, 2003			\$943,939,524
January 31, 2004			\$1,018,169,785
February 27, 2004	\$970,000,000	\$1,081,847,495	(\$63,677,710)
March 31, 2004			\$918,410,130
April 30, 2004			\$927,869,697
May 31, 2004	\$700,000,000	\$975,513,269	(\$47,643,590)
June 30, 2004			\$1,020,630,338
July 30, 2004			\$1,047,734,097
August 31, 2004 ¹⁷	\$485,000,000	\$1,047,734,094	\$3
September 30, 2004			\$509,921,688

¹⁷ This is the month in which the LBO was consummated, and the RGHI Receivable was partially reduced by proceeds from the LBO paid to RGHI.

**IMPACT OF SHORT TERM LOANS
ON RGHI RECEIVABLE**

<u>Year /Month Accounting Period End Date¹⁴</u>	<u>Total Loans (RTLs, WTLs, BAWAG)¹⁵</u>	<u>Net Reduction in Receivable¹⁶</u>	<u>Month End Combined RGHI Receivable Balance</u>
October 29, 2004			\$507,896,761
November 30, 2004	\$545,000,000	\$505,060,909	\$2,835,852
December 2004 ¹⁸	\$550,000,000	\$547,641,494	\$2,358,506
January 2005			526,621,060
February 28, 2005	\$595,000,000	\$526,727,143	(106,083)
March 31, 2005			560,900,215
April 29, 2005			626,425,628
May 31, 2005	\$450,000,000	\$629,849,370	(3,423,742)
June 30, 2005			488,348,647
July 29, 2005			496,620,598
August 31, 2005	\$420,000,000	\$495,177,116	1,443,482
September 30, 2005			(8,076)
October 11, 2005			418,701,276

3. The 1998 and 1999 Wire Transfer Loans

The WTLs engaged in by Refco and RGHI in 1998 and 1999 involved purported “loans” from third parties to RGHI in late February, which RGHI purportedly “repaid” in early March after the close of Refco’s fiscal year. These transactions were not booked as loans, but, rather,

¹⁸ This RTL was made at calendar year end rather than at the end of a Refco financial reporting period. Because there was a RTL in the previous month of November 2004, the Net Reduction in the RGHI Receivable for this December RTL is calculated with reference to the month end balance of the combined RGHI Receivable at the end of October 2004.

were described as short term “repos” with “repo termination dates” in early March. No loan documentation was prepared for the WTLs. The WTLs were an early method of manipulating the RGHI Receivable.

The first of the WTLs occurred on February 26 and 27, 1998, just days before the close of Refco’s 1998 fiscal year. As a result of a series of four WTLs, RGHI’s account at RCC was credited by a total of \$175 million. On February 26, 1998, Tradewinds Debt Strategies Fund transferred \$50 million from its RCM account to RGHI’s account at RCC, and MLC Emerging Markets HSE-Cox (“MLC”)¹⁹ transferred \$50 million from its RCM account to RGHI’s account at RCC. On February 27, 1998, Tradewinds Emerging Debt Fund transferred \$25 million from its RCM account to RGHI’s account at RCC, and MLC transferred another \$50 million from the same account to RGHI’s account at RCC. On March 3, 1998, each of these transactions was reversed, with interest.²⁰

The second set of the WTLs occurred in February 1999, and as a result of these WTLs, RGHI’s accounts at RCC and RCM were credited by a total of \$265 million. Both the 1998 and 1999 WTLs involved funding by RCM. That is, for each wire transfer made by the entities involved in the 1998 and 1999 WTLs, RCM made corresponding short term loans in the same principal amounts to those entities.

On February 23, 1999, MLC made four separate transfers (three via wire transfer and one via journal entry) totaling \$125 million from its account at RCM to RGHI’s accounts at RCC and

¹⁹ There were several MLC-related entities involved in the WTLs. For ease of reference, they are collectively called “MLC.”

²⁰ The information pertaining to these transactions is derived from flowcharts and RCM account information for each of the WTL Participants provided to the Examiner by FTI Consulting.

RCM. On the same day, \$125 million was credited to MLC's account at RCM in a transaction described as a "US Dollar Term Loan."

On February 24, 1999, three similar transactions took place: (i) the Bulgarian-Russian Investment Bank ("BriBank") wire transferred \$50 million from its account at RCM to RGHI's account at RCC, and RCM credited BriBank's account with \$50 million by means of a short term loan; (ii) GlobeInvest Corp., an entity related to BriBank ("GlobeInvest"), wire transferred \$40 million from its account at RCM to RGHI's account at RCC, and RCM credited BriBank's account with \$40 million by means of a short term loan; and (iii) EMF, Ltd. wire transferred \$50 million from its account at RCM to RGHI's account at RCC, and RCM credited EMF's account with \$50 million by means of a short term loan. On March 3, 1999, each of these transactions was reversed, with interest.

Set forth below is a table outlining each known WTL transaction as well as the identity of each WTL Participant, the dates and amount of the transactions.

<u>WIRE TRANSFER LOAN TRANSACTIONS</u>			
<u>Start Date</u>	<u>End Date</u>	<u>WTL Participant</u>	<u>Amount</u>
02/26/1998	03/03/1998	Tradewinds Debt Strategies Fund	\$50,000,000
02/27/1998	03/03/1998	Tradewinds Emerging Debt Fund	\$25,000,000
02/26/1998	03/03/1998	MLC	\$50,000,000
02/27/1998	03/03/1998	MLC	\$50,000,000
TOTAL 1998			\$175,000,000
02/24/1999	03/03/1999	EMF, Ltd.	\$50,000,000
02/24/1999	03/03/1999	BriBank	\$50,000,000
02/24/1999	03/03/1999	GlobeInvest Corp.	\$40,000,000
02/23/1999	03/03/1999	MLC	\$9,600,000
02/23/1999	03/03/1999	MLC	\$2,772,000
02/23/1999	03/03/1999	MLC	\$4,253,000
02/23/1999	03/03/1999	MLC	\$108,375,000
TOTAL 1999			\$265,000,000

4. The 2000 - 2005 Round Trip Loans

Refco engaged in RTL transactions from February 2000 through August 2005. The RTLs had two primary costs to Refco. First, Refco paid a total of \$1,227,042.48 in interest to the RTL Participants to engage in these loan transactions. Second, each of the RTLs exposed RGL to potential claims because RGL guaranteed RGHI's full repayment to each RTL Participant and agreed to indemnify the RTL Participant for any claims arising out of the transactions.

These Round Trip Loan transactions generally followed a pattern. First, RCM would "loan" between \$50 million and \$720 million to a RTL Participant at a fixed rate of interest (typically LIBOR). The loan would be "funded" by means of a credit to an account at RCM in the name of the RTL Participant.

Simultaneously with the RCM loan to the RTL Participant, a loan in the same amount would be made by the RTL Participant to RGHI at an interest rate that was between 15 and 100 basis points higher than the interest rate charged by RCM to the RTL Participant. The loan to RGHI would be "funded" by transferring the credit in the RTL Participant's account at RCM to RGHI's account at RCM.

Since the RGHI account at RCM had a debit balance representing the RGHI Receivable (or portion thereof), the crediting of the purported loan funds from the RTL Participant's account at RCM to that RGHI account had the effect of reducing the RGHI Receivable in a like amount. At times, entries would also be made to further transfer funds from the RGHI account at RCM to an RCC or RGF account.

The net effect of these transactions was that at the end of the reporting period it appeared on Refco's books that RCM was owed money from the RTL Participant, and the amount that had been owed by RGHI was reduced in an amount equal to the Round Trip Loan or eliminated.

A few days after the close of the reporting period, the transactions would be unwound. The amount RGHI “borrowed” from the RTL Participant would be “repaid” by a transfer from RGHI’s account at RCM to the Round Trip Loan Participant’s account at RCM, plus interest, thereby causing a debit in the RGHI account in that amount and a corresponding increase in the RGHI Receivable.

Then, an amount would be deducted from the RTL Participant’s account to “repay” its loan from RCM, with interest. Because the interest rate on the Round Trip Loan Participant’s loan to RGHI was 15 to 100 basis points higher than the rate of the RTL Participant’s loan from RCM, the RTL Participant would “earn” a profit equal to the difference between the two interest payments. The net profit made by the RTL Participants on each transaction ranged from \$1,500 to nearly \$200,000, depending on the amount “loaned,” the interest spread, and the duration of the loans.

Although characterized as “loans,” generally no funds moved in these transactions except for the profits paid to the Round Trip Loan Participants. Rather, the funds moved on a book basis by making adjustments to the RCM accounts of the Round Trip Loan Participants and RGHI.

The repayment of RGHI’s loans to each RTL Participant was guaranteed by RGL, thereby insuring that the RTL Participant had the funds to repay its loan to RCM (RCM was a subsidiary of RGL). RGL also agreed to indemnify each RTL Participant for any claims arising out of either loan transaction.

Other than the amounts, dates, and interest rates, the documentation for each RTL transaction was generally the same and consisted of the following six documents:

- RCM Loan: short term loan from RCM to the RTL Participant;

- RCM Note: promissory note made by the RTL Participant payable to RCM in the same amount reflected in the RCM Loan;
- RGHI Loan: short term loan from the RTL Participant to RGHI;
- RGHI Note: promissory note made by RGHI payable to the RTL Participant in the same amount reflected in the RGHI Loan;
- Guaranty: guaranty from RGL guaranteeing RGHI's repayment of the RGHI Loan; and
- Indemnity: indemnity from RGL indemnifying the RTL Participant from any claims arising from either the RCM or RGHI Loans.

The RTL Participants were all entities who had preexisting business relationships with Refco. For many of them, Refco served as their prime broker. Although many of them held various investment accounts at RCM, they generally opted to run the RTL transactions through small accounts at RCM that did not contain any investor or customer money, and in many cases, the accounts appear to have been opened solely for the purpose of doing RTLs.

Different Refco individuals — Nick Mascio (“Mascio”), Peter McCarthy (“McCarthy”), and David Weaver (“Weaver”) — approached different RTL Participants to engage in the transactions, although it appears that Santo Maggio (“Maggio”) of Refco oversaw most of these transactions.

The loans from each RTL Participant to RGHI were always signed by Bennett. The RGL guaranty and indemnity were also signed by Bennett in all instances except one. The loan from RCM to each RTL Participant was signed in one instance by Bennett, in several instances by Weaver, and in the remaining instances by Maggio.

The RTL Participants all denied having any knowledge that the transactions were used to manipulate Refco's balance sheets; but, as explained below, some did suspect that the transactions were being used for “balance sheet clean-up” or “to dress up Refco's balance sheet.” Most of the RTL Participants indicated that the main reason they agreed to participate in the

RTLs was because they felt that the structure of the transaction effectively eliminated any risk that they would not be repaid the amounts they loaned to RGHI and therefore, the transaction was simply a “risk free” way to make a relatively small profit.

The RTL Participants said that they did not know who first designed the RTL transactions. As discussed in more detail below, some of the early RTL Participants did request the addition of certain provisions to the RTL documentation — provisions mainly designed to eliminate any risk that they would not be repaid on their loan to RGHI and therefore be left without the funds to repay their loan to RCM. In later years, however, there was little negotiation and few changes made to the standard RTL transaction documents. All of the Round Trip Loan Participants stated that they did not know whether there were other Round Trip Loan Participants or who they were.

Set forth below is a chart outlining each of the Refco RTL transactions from February 2000 to September 2005, the identity of the RTL Participant, and the dates and amount of the transaction. As the chart illustrates, in the early years, Refco engaged in RTLs with multiple parties for each year-end reporting period. Starting in 2003, however, Refco engaged in RTLs only with Liberty Corner Capital Strategies, and started doing the transactions multiple times per year.

ROUND TRIP LOAN TRANSACTIONS

<u>Start Date</u>	<u>End Date</u>	<u>RTL Participant</u>	<u>Amount</u>
02/25/2000	03/09/2000	CIM Ventures, Inc.	\$150,000,000
02/25/2000	03/03/2000	EMF Core Fund, Ltd.	\$50,000,000
02/25/2000	03/03/2000	CS Land Management, LLC	\$110,000,000
TOTAL 2000			\$310,000,000
02/23/2001	03/06/2001	CIM Ventures, Inc.	\$250,000,000
02/26/2001	03/02/2001	Delta Flyer Fund, LLC	\$200,000,000
TOTAL 2001			\$450,000,000
02/25/2002	03/04/2002	Liberty Corner Capital Strategies, LLC	\$325,000,000
02/25/2002	03/04/2002	Delta Flyer Fund, LLC	\$175,000,000
02/25/2002	03/04/2002	Beckenham Trading Company, Inc.	\$125,000,000
TOTAL 2002			\$625,000,000
02/21/2003	03/04/2003	Liberty Corner Capital Strategies, LLC	\$500,000,000

<u>Start Date</u>	<u>End Date</u>	<u>RTL Participant</u>	<u>Amount</u>
02/21/2003	03/04/2003	Delta Flyer Fund, LLC	\$150,000,000
TOTAL 2003			\$650,000,000
02/20/2004	03/04/2004	Liberty Corner Capital Strategies, LLC	\$720,000,000
05/27/2004	06/07/2004	Liberty Corner Capital Strategies, LLC	\$700,000,000
08/25/2004	09/07/2004	Liberty Corner Capital Strategies, LLC	\$485,000,000
11/26/2004	12/03/2004	Liberty Corner Capital Strategies, LLC	\$545,000,000
12/30/2004	1/05/2005	Liberty Corner Capital Strategies, LLC	\$550,000,000
TOTAL 2004			\$3,000,000,000
02/23/2005	03/08/2005	Liberty Corner Capital Strategies, LLC	\$345,000,000
05/25/2005	06/06/2005	Liberty Corner Capital Strategies, LLC	\$450,000,000
08/26/2005	09/06/2005	Liberty Corner Capital Strategies, LLC	\$420,000,000
TOTAL 2005			\$1,215,000,000

5. The Individual Round Trip Loan Participants

a. CIM Ventures

CIM Ventures, Inc. (“CIM Ventures”) is a subsidiary of Ingram Micro, Inc. (“Ingram Micro”), a worldwide distributor of information technology products based in Santa Ana, California. CIM Ventures engaged in RTLs in February 2000 and February 2001 for \$150,000,000 and \$250,000,000 respectively. CIM Ventures made a total net profit of \$19,583.33 on the two RTLs.

The Examiner’s counsel conducted voluntary interviews of two Ingram Micro employees who were involved in the RTLs with Refco — James Ricketts, Ingram Micro’s corporate treasurer (“Ricketts”), and Thomas Madden, Ingram Micro’s former CFO (“Madden”). In addition, Ingram Micro’s outside counsel and general counsel made a presentation to the Examiner’s counsel and the Creditors Committee’s counsel in a meeting in December 2006 regarding the results of their own investigation into the RTLs engaged in by CIM Ventures.

The CIM Ventures RTL transactions were conducted through an account at RCM held by CIM Ventures created in late 1999 to provide short-term financing to Ingram Micro’s overseas subsidiaries. Prior to engaging in the RTLs, CIM Ventures had entered into a deal for Refco to provide such financing that closed in mid-December 1999, in which Refco was represented by

Joseph Collins (“Collins”) and Robert Monk (“Monk”) of Mayer Brown. The primary Refco contacts in that transaction were Maggio and Weaver, and Ricketts was the primary CIM Ventures contact.

Ricketts stated that the topic of doing a RTL first arose on February 1, 2000, when Weaver contacted him to broach the subject. Ricketts’ contemporaneous handwritten notes from his conversation with Weaver show that they discussed a “back-to-back loan arrangement,” with one loan at LIBOR with RCM, a second loan at LIBOR plus 15 basis points with “Refco Holdings,” and the term of the loan going from February 25 to March 9.²¹ Ricketts’ notes also indicate that the contemplated documentation for the RTL transaction were “notes,” an “indemnification letter,” and “a right of offset letter.”

On February 4, 2000, a few days after the initial call between Ricketts and Weaver, Monk sent Ricketts drafts of a loan agreement between RCM and CIM Ventures, a loan agreement between CIM Ventures and RGHI, and an indemnity letter from RGHI.²² The loan amount was \$150,000,000. It appears that at this stage, the RTL transaction documents did not contain the guaranty and the indemnity was from RGHI, not RGL.

After receiving the initial drafts from Mayer Brown, Ricketts had a number of questions and changes he wanted made in the RTL transaction documents. First, Ricketts wanted provisions added to the loan agreements in which RCM and RGHI would represent that they were and would remain in compliance with any applicable anti-money laundering regulations

²¹ IM-SEC 008435; *see also* IM-SEC 007448.

²² IM-SEC 007529-64.

during the term of the loans.²³ Ricketts also raised some questions about the relationship between RGHI and RGL. On February 8, 2000, Weaver sent Ricketts an e-mail in which he explained that “[RGHI] is outside the org chart and represents [t]he shareholders of RGL. [RGHI] is an affiliate of RGL. Both companies have the same shareholders.”²⁴ It also appears that at some point Ricketts asked Mayer Brown to add the guaranty to the RTL transaction documents.

Monk incorporated Ricketts’ proposed changes into the transaction documents and sent a revised draft to Ricketts for review on February 11, 2000.²⁵ This revised set of documents included: (1) a guaranty by RGL; (2) the indemnity now made by RGL instead of RGHI; (3) anti-money laundering language added to both loan agreements; and (4) additional changes to the language of the indemnity letter that was proposed by Ricketts and others at Ingram Micro.²⁶

The February 11, 2000 drafts forwarded by Monk did not differ in substance from the final RTL documents that were ultimately executed by the parties as of February 25, 2000.²⁷ The Examiner’s review of the documents produced by all of the subsequent RTL Participants indicates that subsequent RTLs (whether with CIM Ventures or other RTL Participants) basically used the same template that was agreed to by CIM Ventures and Refco in February 2000.

²³ IM-SEC 007566-68. Ricketts stated that he wanted this language included in the agreements because Ingram Micro conducted significant business in Caribbean and Latin American countries, many of which have strict anti-money laundering regulations.

²⁴ IM-SEC 007565.

²⁵ IM-SEC 007581-619.

²⁶ Compare IM-SEC 007616-17 with IM-SEC 007563-64.

²⁷ IM-SEC 007326-65, at App. D-2; MB02325109.

A few days prior to execution on February 21, 2000, CIM Ventures' Board of Directors approved the transaction because it concluded that "it is in the best interest of the Company and its shareholders to enter into a back-to-back loan arrangement with [RCM and RGHI]."²⁸

Ricketts stated that it was his understanding from the outset that the entire transaction would be done on a book basis, with no cash moving, except for the net profit on the interest spread. On February 22, 2000, Ricketts sent Monk a letter summarizing and detailing the mechanics of the transaction²⁹ — information Ricketts stated he obtained from either Weaver or Maggio at Refco. The transaction was run through CIM Ventures' RCM account, which Ricketts stated was opened at the time of Refco's investment in CIM Ventures in late 1999. Ricketts further stated that CIM Ventures used this account for a variety of other unrelated short-term cash investments in addition to the RTLs with Refco.

Pursuant to the agreements, the RTL was reversed on March 9, 2000. On that date, Ricketts sent an e-mail to Weaver requesting that the transaction be reversed pursuant to the two loan agreements, that the \$8,125 net profit on the transaction be transferred to CIM Ventures' bank account in the Cayman Islands, and the two promissory notes be signed and marked as cancelled and returned to the respective makers.³⁰ On March 9, 2000, Monk transmitted the original promissory note which CIM Ventures had signed in connection with the RTL, which he (Monk) endorsed as "paid in full" as the authorized agent of RCM.³¹

In late 2000, Refco renewed its investment in CIM for a second year. Shortly after the CIM transaction was renewed, Ricketts was again approached by Weaver to do another RTL.

²⁸ IM-SEC 001107.

²⁹ IM-SEC 007368.

³⁰ IM-SEC 007310-11.

³¹ See IM-SEC 007313-14.

Once again, Monk handled the drafting of the documents, substituting new dates and a new loan amount of \$250,000,000.

Monk discussed the 2001 documents with CIM Ventures' outside counsel, at whose suggestion clauses were added to the loan agreements to provide that if repayment of one of the loans was accelerated due to a default, the lender under the other loan could also accelerate payment.³²

The 2001 loan documents were executed on February 16, 2001,³³ with the loans commencing on February 23, 2001.³⁴ On February 16th, Ricketts sent a letter to Collins at Mayer Brown, confirming all the details and mechanics of the transaction.³⁵ On February 23, 2001, Ricketts sent Refco written authorization to transfer the \$250,000,000 RCM had deposited in CIM Ventures' account to RGHI's account.³⁶ The transaction was unwound on March 6, 2001, with the \$11,458.33 net profit being transferred to the bank account identified by Ricketts in his February 16 letter to Mayer Brown, and the RCM Note being returned to Ingram Micro marked as "paid in full."³⁷

On April 2, 2001, Ingram Micro received an audit confirmation request from Refco's outside auditor at the time, AA.³⁸ The confirmation request asked Ingram Micro to confirm the details of CIM's account at RCM. Attached to the confirmation request letter was the February

³² IM-SEC 001349.

³³ IM-SEC 006330.

³⁴ IM-SEC 006289, 6296-329; MB 02339880-81, MB 02339869-70. The Examiner could not locate a signed copy of the RGHI Note for this transaction.

³⁵ IM-SEC 006330.

³⁶ IM-SEC 006293.

³⁷ IM-SEC 006288-89.

³⁸ IM-SEC 006049-52.

2001 CIM account statement, showing the deposit of the \$250,000,000 RTL amount. Ricketts signed the confirmation and noted no exceptions.

Ricketts denied knowing what Refco's business purpose was for the RTLs. Ricketts acknowledged that he knew that Refco's financial reporting year ended on February 28, but he stated that the fact that the terms of the RTLs straddled Refco's fiscal year-end did not raise any concerns with him or anyone at CIM Ventures or Ingram Micro, nor did he suspect that Refco was using the transactions to manipulate its financial statements.

Ricketts stated that Ingram Micro's purpose in doing the RTLs was primarily to bring in additional income for CIM to offset some of CIM's operating expenses in the Cayman Islands. Ricketts acknowledged that the \$8,125 and \$11,458 profit CIM made on the two transactions was not substantial or significant when viewed in comparison to CIM's overall finances. Ricketts stated that Ingram Micro also engaged in the transactions because it wanted to grow its business relationship with Refco.

In January 2002, Ingram Micro no longer needed a minority partner in CIM Ventures because of tax law changes. As such, Ingram Micro bought out Refco's interest in CIM Ventures. This buyout closed on January 31, 2002. CIM Ventures still exists today as a wholly-owned subsidiary of Ingram Micro.

While Ingram Micro and Refco were working on buying out Refco's investment in CIM Ventures, Weaver contacted Ricketts on January 7, 2002 to do another RTL.³⁹ Weaver proposed a RTL for the same amount as 2001 (\$250,000,000), but now with a 25 basis point spread and a one-week term starting on February 25, 2002, and ending on March 4, 2002. The 10 basis point

³⁹ IM-SEC 005415-16.

increase was to account for the shorter term so that the net profit to CIM Ventures would be approximately the same as 2001.⁴⁰

Ricketts wanted to do the transaction again and sought approval for the 2002 RTL from Ingram Micro's general counsel, and Madden, Ingram Micro's then-new CFO. Ricketts provided the following description of the transaction to them:

Rec'd this today from Refco asking us to do the back-to-back loan/investment out of CIM again at the end of February. This would be the third time for the transaction. As you may recall, CIM would borrow \$250 million from REFCO Capital Markets LTD (Bermuda company) at LIBOR and then lend these same funds to REFCO Group Holdings, Inc. with a mark-up (they are ok with a 25bp spread). REFCO Group Ltd, LLC provides a guarantee to CIM backing the repayment of the loan by REFCO Group Holdings. REFCO Capital Markets agrees to a right of offset if REFCO Group Holdings does not repay CIM. No cash would move under the transaction (all done on a book basis) except for the payment of our spread to the Royal Bank of Canada account. REFCO would also sign an indemnity letter relative to money laundering regulations. All legal costs would be paid by REFCO.⁴¹

The evidence shows that both Ingram Micro's general counsel and Madden initially approved the transaction.⁴² Upon receiving approval, Ricketts proceeded to mark up the 2001 RTL documents to reflect the new dates and interest rate and sent his markups to Collins.⁴³

On January 30, 2002, Madden stated that he had second thoughts about proceeding with the 2002 RTL based on the then recent news of the Enron scandal.⁴⁴ In response, Ricketts noted that he had already told Refco that they would do the transaction and that Refco had already

⁴⁰ IM-SEC 005415-16.

⁴¹ *Id.*

⁴² IM-SEC 005415, 5462.

⁴³ IM-SEC 005462, 006247-83. The proposed revisions were sent to Collins because Monk left Mayer Brown on February 16, 2001, around the time the 2001 RTL transaction documents were executed. IM-SEC 006366.

⁴⁴ IM-SEC 006204-05.

engaged outside counsel to draft the documents.⁴⁵ Ricketts also explained that, given the CIM buy-out was set to close the next day (January 31), “optically the Refco folks may feel like we misled them so as to get the CIM minority share redemption completed without challenge tomorrow,” and “I would hate to create bad blood over a small transaction like this. I’d rather tell them of our concerns and indicate that we cannot continue the practice next year.”⁴⁶

The points raised by Ricketts did not convince Madden to proceed with the transaction.

In response, Madden wrote:

Jim[:] [I] wouldn’t take the chance at this point. [W]e don’t know what the new disclosures will be, but it looks like a total revamp. [A]lso, given the environment, [I] wouldn’t feel comfortable with this unless we briefed [the CEO] and the board in advance, which ([I’m] sure they’d want an outside legal opinion), *[sic]* given the environment and amounts involved, [I] just wouldn’t take the risk or go to the trouble. . . . *[I’d] think [Refco] should really be reviewing this area anyways.*⁴⁷

When asked about his January 30 e-mails to Ricketts and his overall reaction to the 2002 RTL, Madden stated that his only concern with the transaction from the very beginning was that it was “too complicated,” which Madden explained meant that he simply thought the amount of the loan was too large for the amount of profit CIM would be making on the transaction. Madden stated that the other reasons he set forth in his e-mails to Ricketts were all secondary to his primary concern regarding the “complexity” of the transaction, and that he mainly provided those additional reasons to Ricketts because, as a new CFO, he wanted to be “polite.” Madden denied that the Enron scandal, the use of an offshore entity in the Cayman Islands, or possible new SEC disclosure rules played any significant role in his decision to back out of the 2002

⁴⁵ IM-SEC 006204.

⁴⁶ *Id.*

⁴⁷ *Id.* (emphasis supplied).

RTL. Madden did not recall what he meant when he said that Refco “should really be reviewing this area anyways.”

Ricketts ultimately accepted Madden’s decision.⁴⁸ He sent Weaver and Maggio an e-mail in the late evening on January 30 informing them that Ingram Micro would not be engaging in the 2002 RTL in which he stated the following:

Dave/Sandy: As you know, the Enron debacle is putting pressure in the SEC to increase the level of financial disclosure by large companies like IM. Don’t know how closely you have been following this, but our accounting types (inside and outside) and attorneys have been monitoring the situation very closely, and they advised me late this evening (now 10:30pm) that we should avoid doing any large transactions thru offshore tax havens (in our case the Caymans) until the picture becomes clearer on new financial disclosure rules. I spoke with Tom Madden, our worldwide CFO, in Europe and briefed him again on the details of our planned late-February transaction, and we jointly concluded that we should put a hold on the transaction. Please understand that we both recognize and appreciate the warm, partnership relationship we’ve had with Refco over the past two years, and we would not be taking this step unless we felt strongly that the disclosures risks were too high. Also, do not interpret this change of mind on our part as a statement about our trust in Refco. That is not the issue here. Refco has always acted in a responsible and professional manner in its dealings with CIM⁴⁹

Neither Weaver nor Maggio had any response to Ricketts’ e-mail,⁵⁰ and both Ricketts and Madden stated that neither Weaver nor Maggio raised the topic with them at any time after January 30, 2002. The redemption of Refco shares in CIM went forward without incident the next day. After the investment in CIM was redeemed, Ingram Micro did not have any further business dealings with Refco.

⁴⁸ IM-SEC 005502.

⁴⁹ IM-SEC 001409, at App. D-3.

⁵⁰ IM-SEC 001412.

b. CS Land

CS Land Management LLC (“CS Land”) is a company related to Coast Asset Management, L.P. (“Coast”) based in Santa Monica, California. CS Land engaged in a RTL with Refco from February 25, 2000, to March 3, 2000, for \$110,000,000,⁵¹ and CS Land made a net profit of \$3,208.33 on the transaction.

Although CS Land produced executed copies of the documents, Christopher Petitt (“Petitt”), Coast’s former chief operating officer who apparently signed the RTL transaction documents on behalf of CS Land, had no recollection of the transaction.⁵²

The documents produced by Coast indicate that Coast’s relationship with Refco began as early as 1996;⁵³ and by at least 1998, Coast was a party to a Global Master Repurchase Agreement with Refco.⁵⁴ Coast’s business relationship with Refco continued until at least 2003.⁵⁵ Coast’s primary contact at Refco was Mascio, but Maggio and Richard Gill (“Gill”) of Refco also appear to have been involved in the relationship.⁵⁶

The earliest reference to the RTL transaction is in a February 23, 2000 e-mail exchange between Petitt and Mascio, in which Petitt inquired whether the “transaction will have a legal opinion regarding enforceability, encumbency and all that good stuff?”⁵⁷ Mascio forwarded Petitt’s inquiry to Maggio, who responded:

⁵¹ C 05557, 05560, 05564-606, 05614-15.

⁵² Based on a representation by Coast’s counsel that Petitt had no recollection of the transaction, the Examiner did not interview Petitt.

⁵³ C 05548-49.

⁵⁴ REFCO-E-002543224, 002541776; C 05501-22, 05526-45.

⁵⁵ C 05441-68, 5384-440, 5469-500.

⁵⁶ REFCO-E-002543224, 002541776, 002635410, 002635710.

⁵⁷ C 00465.

No legal opinio[n] is attached unless they are asking if Refco has the right under its charter to enter in [t]hese transactions. Between you and I there is enough paperwork to protect them if anything should happen to us during the week of the trade.⁵⁸

On February 24, 2000, there was an e-mail exchange between Mascio and Maggio, in which Mascio stated:

Coast wants to know who we have done this trade with before because it looks like the documents have been used before. If they know that the docs have been used before maybe they would feel more comfortable with not getting the enforceability letter.⁵⁹

In response, Maggio confirmed that the documents had been used before and stated that:

I have been doing this for the past several years. *The purpose is to [n]et down my offshore company balances as to not show so much passive income.*⁶⁰

Mascio forwarded Maggio's explanation to Petitt, who responded by asking whether "your lawyer has spoken to ours?"⁶¹ Mascio responded that he believed the lawyers had spoken and asked Petitt to confirm with his counsel so Mascio could start working on the transaction documents. Mascio also asked Petitt, "What counterparty will I face?"⁶² At some point after this e-mail, CS Land was identified as the counterparty in the transaction and that information was conveyed to Monk, who used that entity to create the initial drafts of the CS Land RTL documents.

⁵⁸ C 00465. Based on a review of Mayer Brown's billing records, it appears that Maggio contacted Collins to discuss the issue raised by Petitt. On February 23, 2000, Collins has a time entry that reads: "[Telephone conference with] [Maggio] re need for enforceability opinion." MBRM-EX 00052902.

⁵⁹ C 00470.

⁶⁰ *Id.* (emphasis added).

⁶¹ *Id.*

⁶² *Id.*

On February 24, 2000, Monk sent drafts of RTL documents to CS Land and its outside counsel for review and execution.⁶³ No changes were made to the documents, except outside counsel requested that a New York choice-of-law clause be added to the indemnity letter.⁶⁴ The CS Land RTL documents were executed as of February 25, 2000.⁶⁵ Petitt signed the documents on behalf of CS Land. Monk sent Petitt a full set of the executed RTL documents on February 28, 2000.⁶⁶ The RTL transaction was conducted through an account opened by Maggio at RCM on behalf of CS Land on February 25, 2000.⁶⁷

The RTL was reversed on March 3, 2000. Also on March 3, Monk sent Petitt a copy of the CS Land Note payable to RCM that Monk had endorsed as “Paid in full – March 3, 2000.”⁶⁸

c. EMF/Delta Flyer

Three entities affiliated with EMF Financial Products, LLC (“EMF Financial”) – EMF, Ltd., EMF Core Fund Limited (“EMF Core Fund”), and Delta Flyer Fund, LLC (“Delta Flyer”) (collectively, the “EMF/Delta Entities”) engaged in RTLs with Refco. EMF Financial is a hedge fund manager that was set up in 1998. Eric Flanagan (“Flanagan”) is the President of EMF Financial, H. Whitney Tindale (“Tindale”) is the chief financial officer,⁶⁹ and Vincent Messina (“Messina”) is the chief technology officer. All three had involvement in the EMF/Delta Entities RTL transactions.

⁶³ C 05620-21.

⁶⁴ C 05617-19.

⁶⁵ C 05557, 05560, 05564-606, 05614-15.

⁶⁶ C 05561.

⁶⁷ REFCO-E-013811073, REFCO-E-009758808.

⁶⁸ C 05558-59.

⁶⁹ Prior to joining EMF Financial, Tindale worked at Coast. Tindale left Coast in the spring of 1999. The documents relating to the CS Land RTL do not show that Tindale had any involvement with Refco or RTLs while he was employed at Coast.

EMF, Ltd. and EMF Core Fund⁷⁰ were government arbitrage funds managed by EMF Financial. As discussed herein, EMF, Ltd. did a WTL in 1999 for \$50,000,000. EMF Core Fund did a RTL in 2000 for \$50,000,000. Delta Flyer was a small venture capital fund (less than \$500,000 initially invested) started by Flanagan in 1999 in which Flanagan and some of his personal friends pooled some money primarily to make investments in Internet start-up companies. Although Delta Flyer was not an EMF Financial-managed hedge fund, it had a close relationship with EMF Financial given that Flanagan and Messina were both investors in the fund, and Tindale provided financial administration to Delta Flyer. Delta Flyer did three RTLS with Refco: (i) 2001 for \$200,000,000;⁷¹ (ii) 2002 for \$175,000,000; and (iii) 2003 for \$150,000,000. The EMF/Delta Entities made a net profit of \$77,562.00 for engaging in the one WTL and four RTLS.⁷²

Refco served as the prime broker for the EMF Financial hedge funds. This relationship began in October 1998, when the first EMF Financial hedge fund was launched and continued until Refco's bankruptcy.

In 2000, Refco engaged in a RTL transaction with EMF Core Fund for \$50,000,000.⁷³ The loans were made on February 25, 2000, and were unwound on March 3, 2000. The documents were drafted by Monk,⁷⁴ and Weaver was the Refco person involved in this

⁷⁰ EMF Core was liquidated on December 31, 2005. EMFEXMR 001269.

⁷¹ DFF00169-200, 202-05, 07.

⁷² DFF00083, EMFEXMR 000331.

⁷³ EMFFP03831-66, MB02046176, MB02046212-15, MB02046317.

⁷⁴ MB02046009.

transaction.⁷⁵ Flanagan received the documents on February 24, 2000,⁷⁶ and he signed and returned them to Monk the next day.⁷⁷

Other than a different loan amount (\$50 million versus \$150 million) and a shorter loan term (7 days versus 13 days), the documentation for the EMF Core Fund RTL was the same as the documentation used for the 2000 CIM Ventures RTL. In fact, the EMF Core Fund RTL documents included all of the provisions that CIM Ventures requested be added to the transaction documents (*e.g.*, anti-money laundering provisions).⁷⁸

Based on an interview with Tindale, the Delta Flyer loan came about as follows: Sometime in early February, McCarthy of Refco contacted EMF to inquire whether they would be interesting in doing another RTL in 2001. Tindale also stated that Flanagan had a close relationship with McCarthy, who was an investor in Delta Flyer. Tindale discussed the transaction with Flanagan, who informed him that they had done the transaction in the prior year through EMF Core Fund, and that EMF's prior CFO had reviewed the 2000 RTL documentation and did not see any problems in proceeding with the transaction. Because Tindale was not employed by EMF at the time of the 2000 RTL and was not familiar with the 2000 RTL, Weaver faxed copies of the 2000 RTL documentation to Tindale for his review.⁷⁹

Upon reviewing the documents, Tindale did not think the transaction was unusual, but he expressed concerns to Flanagan and Messina about doing the transaction through one of the EMF funds because the EMF funds were primarily used for leveraged government bond trades.

⁷⁵ MB02046009, MB02046123.

⁷⁶ MB02046009.

⁷⁷ MB02046011, MB02046165.

⁷⁸ The EMF Core Fund RTL documents, however, did not contain the New York choice-of-law clause that was added to the indemnity for the CS Land 2000 RTL at the request of CS Land's counsel.

⁷⁹ EMFFP03831-66.

Because the RTL was not a government bond transaction, Tindale, Flanagan, and Messina all agreed to do the transaction in Delta Flyer instead.

Tindale stated that he was aware that Refco's financial reporting year ended on February 28 and that McCarthy told him that Refco needed to do the transaction as "part of their year-end capital planning." Tindale interpreted this to mean that either Refco was using the transactions to "manage their balance sheets"/"do a balance sheet cleanup" or Refco was doing a "tax trade" — *i.e.*, a transaction designed to reduce tax liability.

Tindale stated that he had seen transactions similar to the RTLs done for tax purposes in similar amounts (hundreds of millions to billions of dollars) in order to move income from an onshore entity to a related offshore entity to avoid taxes. Tindale stated that at the time he suspected the RTL was likely a "tax trade" because it involved onshore and offshore Refco entities. Tindale also stated that at the time of the transaction he thought that RGHI was a subsidiary of RGL.

The 2001 RTL documents were drafted by Paul Koury ("Koury") of Mayer Brown.⁸⁰ Tindale stated that his primary concern with the transaction documents was to make sure that Delta Flyer got a guaranty from the parent company to insure that the transaction was risk-free. Tindale had the 2001 RTL documents reviewed by his attorneys because he wanted to be sure that the transaction was appropriate from a tax perspective, given that he understood the transaction involved loans from on-shore and off-shore entities. After review by counsel, Tindale was satisfied that the tax issues had been addressed.

The 2001 RTL documents were similar to those used in the 2000 RTL with EMF Core Fund, except that the term of the loan was shorter (February 26, 2001 to March 2, 2001 — four

⁸⁰ EMFFP03907, EMFFP03870.

days), the interest rate on the RGHI Loan was much higher (LIBOR plus 100 basis points), and the guaranty and indemnity were both signed on behalf of RGL by Trosten, instead of Bennett — the only instance where this occurred.⁸¹ Flanagan executed the documents on behalf of Delta Flyer. The transaction was executed in an account set up for Delta Flyer at RCM,⁸² and the profit on the transaction was wired to a Delta Flyer bank account. Tindale stated that the Delta Flyer RCM account was opened shortly before the 2001 RTL, and that the account was not used for any other purpose.

Tindale acknowledged that Delta Flyer did not have the funds to cover the transaction — *i.e.*, if RCM had not loaned Delta Flyer the money first, Delta Flyer would not have had sufficient funds to make a \$200,000,000 loan to RGHI. Tindale understood that no cash was moving in the transactions other than the net interest profit.

In February 2002, McCarthy again contacted Delta Flyer to inquire whether Delta Flyer would be interested in doing the RTL transaction again. Delta agreed to do the transaction again.

The 2002 Delta Flyer RTL was for \$175,000,000, and the term of the loans was from February 25, 2002, to March 4, 2002.⁸³ The structure and terms of the transaction were the same as the prior year's RTL, except that the documents now included specified interest rates instead of interest rates based on LIBOR (1.8375% for the RCM Loan, and 2.8375% for the RGHI Loan). Koury again drafted the documents.⁸⁴ Weaver signed on behalf of RCM, Bennett signed the RGHI loan on behalf of RGHI and the guaranty and indemnity on behalf of RGL, and

⁸¹ The RGHI Loan and Note were still signed by Bennett.

⁸² DFF00044, DFFF00040.

⁸³ EMFFP03991-4041.

⁸⁴ EMFFP04003-06.

Messina executed the documents on behalf of Delta Flyer. Koury sent the final executed documents to Tindale on February 26, 2002.⁸⁵

The transaction was once again done in Delta Flyer's account at RCM, and Flanagan and Tindale requested that Refco wire the net profit on the transaction to a Delta Flyer account at Fleet Bank.⁸⁶

In 2003, McCarthy again approached Delta Flyer to determine whether it would agree to do another RTL transaction through Delta Flyer in February-March 2003. Koury, working with Weaver, again drafted the documents starting in mid-February 2003.⁸⁷ The 2003 RTL was for \$150,000,000, and the term of the loans was from February 21, 2003, to March 4, 2003.⁸⁸ The transaction documents for the 2003 RTL were the same as the previous year's, except that Maggio signed on behalf of RCM instead of Weaver and the interest rates were different (1.31% on the RCM Loan, and 2.06% on the RGHI Loan). Koury sent final executed copies of the transaction documents to Tindale on March 13, 2003.⁸⁹ The transaction again was run through Delta Flyer's account at RCM, and Delta Flyer netted \$18,638.88 on the 2003 transaction.⁹⁰

In early February 2004, McCarthy again approached Delta Flyer about doing another RTL with Refco, but the offer was rejected because Delta Flyer was in the process of being dissolved. Tindale stated that he was never presented with transaction documents for a RTL in 2004, although it appears that Mayer Brown had taken steps to draft such documentation.⁹¹ EMF

⁸⁵ REFCO-HC-0533324.

⁸⁶ DFF00277, EMFFP03990.

⁸⁷ MBRM-EX 00092678-713.

⁸⁸ DFF00220-55.

⁸⁹ DFF00220.

⁹⁰ EMFEXMR 000331.

⁹¹ MB 00068-100.

Financial continued to do business with Refco until Refco's bankruptcy. Refco did not approach Delta Flyer or EMF Financial to do any RTLs after Delta Flyer declined to do the 2004 RTL. Delta Flyer was dissolved in 2005.

d. Beckenham Trading Company

Beckenham Trading Company, Inc. ("Beckenham Trading") engaged in a single RTL with Refco in 2002 for \$125,000,000 and made a net profit of \$24,305.55 on the transaction.⁹²

The Examiner's counsel interviewed Andrew Krieger ("Krieger") who stated that Beckenham Trading was one of several investment funds started by him in the late 1980s and early 1990s. Krieger's entities specialized in futures and foreign currency trading as well as trading in other highly speculative markets. Starting in the late 1990s, Refco served as the prime broker for Krieger's entities, and Krieger continued to do business with Refco until Refco's bankruptcy. Beckenham Trading did not contain any customer funds, but rather was used as a "beta testing entity" in which Krieger would experiment with new trading strategies and allow new traders to gain experience without placing customer money at risk. Peter Molyneaux ("Molyneaux"), who is now deceased, handled back office duties for Beckenham Trading and the other Krieger entities.

Beckenham Trading produced 213 pages of documents that were reviewed by the Examiner's counsel, along with information relating to Beckenham Trading among documents produced by Mayer Brown and Refco.

All of the documents reviewed by the Examiner's counsel indicate that Molyneaux was the point person at Beckenham Trading for the transaction, and that Krieger did not have any significant role. This was confirmed by Krieger's statements during his interview.

⁹² BTC 000057-92; REFCO-0005-118759.

Beckenham Trading produced fully executed copies of the 2002 RTL transaction documents that appear to have been signed by Krieger.⁹³ The terms of the Beckenham Trading RTL are identical to those set forth in other RTL transactions, except that the applicable interest rates for the Beckenham Trading RTL were not based on LIBOR, but instead were specified in the transaction documents themselves (1.8375% for the RCM Loan and 2.8375% for the RGHI Loan). The transaction was run through a Beckenham Trading account at RCM, which does not appear to have been used for any purpose other than the 2002 RTL. The transaction documents were prepared by Koury, who then forwarded the documents to Molyneaux for review and execution.⁹⁴ Krieger noted that Molyneaux had a good relationship with Maggio. Krieger did not know Koury and stated he had no dealings with him.

Krieger stated he had no recollection of signing the Beckenham Trading RTL documents, but did acknowledge that he did sign documents on occasion without reading them. Krieger stated that he would have heard if \$125 million were either deposited or withdrawn from the Beckenham Trading account, but that he did not recall ever hearing anything about such a transaction taking place.

e. Liberty Corner

Liberty Corner Capital Strategies, LLC (“Liberty Corner”) was a hedge fund manager located in Summit, New Jersey, that engaged in ten RTLs with Refco between February 2002 and August 2005. Liberty Corner was wholly owned by William T. Pigott (“Pigott”), the primary person involved in each of the Liberty Corner RTL transactions. Refco paid Liberty

⁹³ BTC 000057-92. Krieger was not certain that the signatures on the agreement were actually his.

⁹⁴ BTC 000057.

Corner a little over \$1.1 million to engage in these transactions. The profit on the transactions went to Liberty Corner or to Pigott personally.

The Examiner's counsel conducted targeted searches of the approximately 1.6 million pages of documents Liberty Corner produced to governmental agencies and the Creditors Committee. The Examiner also found information relating to the Liberty Corner RTLS among documents produced by Mayer Brown and Refco.

The Examiner's counsel conducted voluntary interviews of Pigott, as well as two other Liberty Corner employees: a portfolio manager at Liberty Corner who received some e-mails regarding the transactions but stated she had limited involvement in the RTLS; and a back-office employee who signed requests received from Refco's auditor (GT) confirming Liberty Corner's account at RCM, where the RTLS took place.

Liberty Corner managed a number of hedge funds that primarily traded in government treasury bills. Refco served as Liberty Corner's prime broker. Liberty Corner's business relationship with Refco continued up to Refco's bankruptcy. The hedge funds that Liberty Corner managed were closed down in early 2006, and since that time Liberty Corner has been dormant.⁹⁵

In February 2001, Refco explored doing a RTL with one of the hedge funds managed by Liberty Corner — Liberty Corner Patriot Master Fund, Ltd. ("LCPMF"). Work on this RTL appears to have begun on February 16, 2001, when Weaver faxed Pigott's contact information to Collins.⁹⁶ Handwritten notes on this fax identify the basic terms of the proposed transaction —

⁹⁵ Pigott indicated that he knew Flanagan and EMF Financial, but had no business dealings with them. Pigott also stated that Liberty Corner managed an account for Coast and that he worked with Petitt at Coast. Pigott stated that he had no knowledge that either EMF Financial/Delta Flyer or Coast/CS Land had been involved in RTLS with Refco.

⁹⁶ MB02035219.

namely, a \$200,000,000 RTL with LCPMF from February 26, 2001, to March 2, 2001, with a 15 basis point profit to LCPMF. Mayer Brown's files contain unexecuted drafts of a 2001 RTL transaction with LCPMF.⁹⁷ On February 21, 2001, Collins sent drafts of the transaction documents to Weaver and Mascio.⁹⁸ Weaver then sent drafts of these documents to Liberty Corner on February 22, 2001.⁹⁹

The RTL with LCPMF did not occur. No one at Liberty Corner recalled the proposed 2001 RTL, nor did they know why the transaction with LCPMF did not proceed. Mayer Brown's files contain copies of the 2001 LCPMF RTL documents with handwritten mark-ups by Collins in which he changed all references from LCPMF to Delta Flyer.¹⁰⁰ The amount and term of the loan remained the same, and Refco ultimately went through with the transaction with Delta Flyer in 2001.

Liberty Corner and Refco engaged in ten RTLS starting in February 2002. The amounts ranged from \$325,000,000 to \$720,000,000. In 2002 and 2003, Liberty Corner did only one RTL transaction in February-March of each year,¹⁰¹ but starting in 2004, the frequency of the RTLS increased, with RTLS occurring quarterly, up to September 6, 2005 — the end date for the last Liberty Corner RTL.¹⁰² The net interest spread on each Liberty Corner RTL was 75 basis points, except for 2002, when the interest spread was 100 basis points.

⁹⁷ MB 00476, MB00003905-36.

⁹⁸ MB00003937.

⁹⁹ LC-SEC-EM 001388360.

¹⁰⁰ MB02035673-706.

¹⁰¹ 2002 RTL: LC-USAO 000001-36. 2003 RTL: LC-USAO 000037-72.

¹⁰² February 2004 RTL: LC-USAO 000073-105. May 2004 RTL: LC-USAO 000139-56, MB02293240-54 (Liberty Corner did not produce a copy of the RCM Loan agreement). August 2004 RTL: LC-USAO 000157-87. November 2004 RTL: LC-USAO 000188-218. December 2004 RTL: LC-USAO 000221-51. February 2005 RTL: LC-USAO 000272-309 (executed copies of the RCM Loan agreement or the RCM Note could not be located). May 2005 RTL: REFCO-0002-000147-49, REFCO-0002-000118-30, REFCO-0002-000132-44, REFCO-HC-0533922,

(footnote continued on next page)

Pigott recalled that sometime in early February 2002 he was approached by McCarthy and Maggio regarding the RTL. Maggio directed Pigott to contact Koury. Pigott recalled having a conference call with Koury during which he was provided additional information about the transaction.

Mayer Brown's earliest drafts of the 2002 RTL documents (created on February 12, 2002) had LCPMF, not Liberty Corner, as the counter-party.¹⁰³ At some point after February 12, 2002, Liberty Corner was substituted for LCPMF. Pigott stated that he requested the RTLs be done with Liberty Corner, a management company, as the counter-party, rather than one of the funds managed by Liberty Corner, because the RTL was not the type of transaction normally executed in the funds. Pigott stated that the funds primarily did treasury bill arbitrage transactions, and he did not believe the RTL would be consistent with the type of transaction that he marketed to investors that he would be doing in the Liberty Corner-managed funds. Furthermore, Pigott was concerned that if anything went wrong with the transaction (*i.e.*, RGHI did not repay its loan and the RGL guaranty was unenforceable), he did not want to place investor money located in one of the Liberty Corner-managed funds at risk.

Koury e-mailed copies of the proposed 2002 RTL transaction documents to Pigott on February 14, 2002.¹⁰⁴ Pigott then forwarded these documents to his counsel for review.¹⁰⁵ Pigott

(footnote continued from previous page)

REFCO-HC-0533908 (Liberty Corner did not produce copies of the May 2005 RTL transaction documents). August 2005 RTL: LC-USA0 000310-26, LC-USA0 000341-53, REF002-000098 (Liberty Corner did not produce a copy of the RGHI Note for this transaction). Although in some cases Liberty Corner did not produce executed copies of documents, the Examiner was able to obtain executed copies from Refco's and Mayer Brown's documents.

¹⁰³ MB02048044-87.

¹⁰⁴ LC-SEC-EM 001610388-89.

¹⁰⁵ *Id.*

stated that his only concern about any of the RTLs was whether he would be able to get his money back in case RGHI defaulted on its loan.

Pigott stated that he understood RGL to be the parent of RGHI, so he believed he was getting a guaranty from RGHI's parent. According to Pigott, the presence of the guaranty from RGL was the primary reason he engaged in the transaction because Pigott felt secure that, if RGHI defaulted on its obligation to Liberty Corner, he would still be able to collect from RGL, whom he viewed to be the Refco parent company with the financial capability of covering RGHI's loan obligation. Pigott indicated that his counsel had reviewed the documents and had advised him that he had sufficient protection in case of an RGHI default.

Pigott stated that other than the RTL transactions, Liberty Corner had never engaged in transactions involving amounts in the hundreds of millions of dollars, and that Liberty Corner only had a capitalization of a few hundred thousand dollars. Pigott also explained that, other than the RTLs, Liberty Corner only engaged in transactions involving the purchases of securities and that the RTLs were the only non-collateralized cash transactions that Liberty Corner did. Pigott stated that at no time prior to the Refco bankruptcy did he have any knowledge or understanding that Refco was using the RTLs for anything other than a legitimate business purpose.

Pigott stated that the RTL transactions were run through Liberty Corner's account at RCM, which Pigott indicated he used on occasion to make trades on his own behalf. Pigott stated that the profit on each of the Liberty Corner RTLs was wired from the Liberty Corner RCM account to either a Liberty Corner bank account or Pigott's own personal bank account.¹⁰⁶

¹⁰⁶ 2002 RTL: LC-USA0 000357, REFCO-0009-025570-71. 2003 RTL: REFCO-0009-025587-90. February 2004 RTL: REFCO-E-001599522-23, REFCO-0009-025593-94. May 2004 RTL: REFCO-0009-028804-05, REFCO-E-001052706. August 2004 RTL: REFCO-0009-28800-01, REFCO-0009-028797-98. November 2004

(footnote continued on next page)

Once the parties agreed on the documents for the 2002 RTL, that same format was used for the subsequent RTLs between Liberty Corner and Refco.

Mayer Brown documents indicate that Koury drafted most of the Liberty Corner RTL documents.¹⁰⁷ Both Weaver and Maggio were involved in the 2002 RTL,¹⁰⁸ but Maggio appears to have been the key Refco contact on the Liberty Corner RTLs from 2003 forward.¹⁰⁹ In each year, Bennett signed the Liberty Corner RTL documents on behalf of RGL and RGHI, and Pigott signed on behalf of Liberty Corner. Maggio signed on behalf of RCM for all of the Liberty Corner RTLs except for the 2002, when Weaver signed for RCM.

For the August 2004 RTL, the original transaction documents were drafted with a loan amount of \$475,000,000 and a term starting on August 26, 2004, but handwritten amendments on the transaction documents increased the loan amount to \$485,000,000 and changed the start date to August 25, 2004.¹¹⁰ Similarly, the original RTL transaction documents for the February 2005 RTL were drafted with a loan amount of \$335,000,000, but Koury drafted amendments that changed the loan amount to \$345,000,000.¹¹¹ Pigott stated that the changes to the August 2004 and February 2005 RTLs were all made at Refco's request.

Liberty Corner received annual requests from GT asking for confirmation of the February/March RTL transactions that took place in Liberty Corner's account at RCM. The

(footnote continued from previous page)

RTL: REFCO-0009-028792-93, REFCO-0009-028788-90. December 2004 RTL: REFCO-0009-028788-91, LC-SEC-EM 001492774, LC-USAO 000373. February 2005 RTL: REFCO-0009-025615-16, REFCO-0009-025613-14, LC-USAO 000374. May 2005 RTL: REFCO-0009-025621-22, REFCO-0009-028775-76, LC-USAO 376-77. August 2005: LC-USAO 000378-79.

¹⁰⁷ MBRM-EX 00052003-04, 00052014, 00052024, 00052026-29.

¹⁰⁸ MBRM-EX 00052004.

¹⁰⁹ MBRM-EX 0052014, 00052024, 00052026-29.

¹¹⁰ LC-USAO 000157-87.

¹¹¹ LC-USAO 000272-75. MBRM-EX 00052029.

individual who signed the requests stated that, when he received the requests, he only confirmed that the transaction actually took place and that the date and amount as reflected on the attached statements were correct.¹¹²

6. The BAWAG Loans

From February 2000 through February 2005, Refco engaged in yearly transactions with BAWAG that Refco used to temporarily pay down the RGHI Receivable at the end of Refco's fiscal year. The BAWAG Loans involved transfers of amounts from BAWAG to RGHI in late February, with those transactions subsequently being reversed in early March. BAWAG made \$347,042.97 by engaging in these transactions.

The BAWAG Loans to RGHI were done primarily through wire transfers. The BAWAG Loans were not papered with any loan agreements, promissory notes, indemnities, or guarantees.

Each BAWAG Loan involved two separate and concurrent transfers from BAWAG to RGHI — one larger transfer ranging from \$175,000,000 to \$225,000,000, and a smaller transfer in the \$40,000,000 to \$75,000,000 range.

Funding for the larger portion of the loan came from RCM, generally through wire transfers into an account that RCM held at BAWAG, where it appeared to be a deposit. Once RCM transferred funds into its BAWAG account, BAWAG used those funds as security to loan a like amount to RGHI by depositing that amount into an account that RGHI held at BAWAG.¹¹³ Those funds would then be wire transferred to RGHI's account at either RCM or RCC, and the

¹¹² 2002 RTL: LC-USA0 000361-64. 2003 RTL: GT SEC 0015053-54 (unsigned). February 2004 RTL: GT SEC 0010499-501. February 2005 RTL: GT SEC 0001942-43.

¹¹³ BAWAG 001213. Starting in 2003 (at BAWAG'S request), RCM provided written authorization to BAWAG to take the "deposited" funds if RGHI failed to repay the full amount of the loan. BAWAG 000810, 000883, 000890, 001227.

credit to the benefit of RGHI resulting from such deposit would be applied against the debit evidencing the then-existing RGHI Receivable.

The smaller portion of the loan was funded directly by BAWAG. BAWAG would simply deposit funds for the smaller portion of the loan into the account that RGHI held at BAWAG, and then those funds would also be wire transferred to RGHI's account at either RCM or RCC.

In early March of each year, the BAWAG loans were unwound. An amount equal to the principal of the smaller portion of the loan, plus interest, would be transferred from the RGHI account at either RCM or RCC into which the funds had been deposited, with the account being debited, thereby reinstating the RGHI Receivable in its prior amount, and increasing it by the amount of the interest charged on those loans.

Repayment of the larger portion of the loan to RGHI varied somewhat (*e.g.*, some years it was repaid via wire transfers, in other years through journal entries), but followed the same pattern, in that an amount equal to the principal of the larger portion of the loan would be transferred from the RGHI account at either RCM or RCC into which the funds had been deposited, with the account being debited, thereby reinstating the RGHI Receivable in its prior amount. There was no interest on this loan.

The BAWAG Loans appear to have been first proposed by Maggio in January 2000. Maggio was one of the key Refco people involved in these transactions, although Trosten and Bennett were also involved.¹¹⁴ There is little doubt that BAWAG had clear knowledge of the

¹¹⁴ BAWAG 000722-23, 000859-90, 000893, 001041, 001056.

true purpose of the transactions, as numerous documents produced by BAWAG describe the transactions as a BAWAG “cleanup” of the Refco inter-company receivable.¹¹⁵

Set forth below are the dates and amounts for each of the BAWAG Loans:

<u>BAWAG LOAN TRANSACTIONS</u> ¹¹⁶			
<u>Start Date</u>	<u>End Date</u>	<u>Participant</u>	<u>Amount</u>
02/24/2000	03/02/2000	BAWAG	\$225,000,000
			\$75,000,000
TOTAL 2000			\$300,000,000
02/26/2001	03/05/2001	BAWAG	\$225,000,000
			\$75,000,000
TOTAL 2001			\$300,000,000
02/25/2002	03/04/2002	BAWAG	\$210,000,000
			\$90,000,000
TOTAL 2002			\$300,000,000
02/25/2003	03/05/2003	BAWAG	\$175,000,000
			\$75,000,000
TOTAL 2003			\$250,000,000
02/25/2004	03/04/2004	BAWAG	\$210,000,000
			\$40,000,000
TOTAL 2004			\$250,000,000
02/23/2005	03/08/2005	BAWAG	\$175,000,000
			\$75,000,000
TOTAL 2005			\$250,000,000

¹¹⁵ BAWAG 001305 (“I/C cleanup provided for by BAWAG”); *see also* BAWAG 000892, 001225-26, 001264, 001273, 001281, 001284 (all describing the transaction as a “clean up”).

¹¹⁶ 2000: BAWAG 001062-64, 001183-85. 2001: BAWAG 000612, 001011-14, 001019, 001024, 001028-35, 001164-71, 001173, 001177, 001272, 001180-82. 2002: BAWAG 000520, 000893, 000953-56, 000989, 001140-42, 001145-52, 001161-63, 001198-200. 2003: BAWAG 000479, 000880, 000883, 000892, 000895, 000905-07, 000915-19, 000928-32, 001124, 001126, 001129, 001131, 001133-39, 0001201-03, 001305. 2004: BAWAG 000799-804, 000811, 000816-18, 000824, 000841-42, 000848-53, 000861-66, 001090-92, 001114-16, 001204-06, 001264. 2005: BAWAG 000706-11, 000747, 000753-61, 000779-80, 000785, 000788-791, 000794-97, 001069-71, 001207-09, 001213, 001218, 001233.

IV. REFCO'S AUDITORS

A. INTRODUCTION AND SUMMARY OF THE EXAMINER'S INVESTIGATION OF THE ROLE OF THE AUDITING PROFESSIONALS

AA performed annual audits of Refco from at least the late 1980s through the audit of Refco's fiscal year 2002. Thereafter, GT became Refco's auditor. The Examiner has combined his review of the AA and GT engagements because Mark Ramler ("Ramler") was the lead partner on the engagement at both firms.

1. Preliminary Comments Concerning Arthur Andersen

The Examiner had access to and reviewed AA's audit workpapers from the Refco engagement for the audit years 1995 through 2002, as well as e-mails and desk files for the Refco audit team members, including Ramler. In early December 2006, counsel to the Examiner approached AA's counsel seeking production of documents — specifically, detailed billing records, audit manuals, reviews by concurring or professional standards partners in connection with AA's audits of Refco, and personnel files of certain former AA employees who worked on Refco audits. The Examiner also sought interviews of selected former AA employees and an examination of AA through a designee. The Examiner attempted to negotiate terms by which this discovery could be obtained relatively quickly and without the need to consume judicial resources. Specifically, the Examiner asked that AA acknowledge by stipulation the Examiner's authority to issue subpoenas rather than requiring the Examiner to seek a ruling from the Court through motion practice pursuant to Bankruptcy Rule 2004.¹¹⁷ However, AA declined to

¹¹⁷ After first requesting these documents from AA, counsel to the Examiner promptly sent AA's counsel a proposed stipulation permitting the Examiner to issue subpoenas to AA pursuant to Rule 2004. AA's counsel was aware that this stipulation was intended to eliminate the need for the Examiner and AA to litigate the Examiner's authority to issue subpoenas, which courts have routinely upheld. AA's counsel also knew that any objections to the subpoenas themselves were expressly reserved until after service of those subpoenas, except for an objection to the Examiner's authority to issue the subpoenas.

stipulate to the Examiner's authority to issue subpoenas.¹¹⁸ The Examiner filed a Rule 2004 motion, which was granted in full.

The Examiner then issued a subpoena to AA for documents. After numerous meet-and-confer efforts, the Examiner's counsel was finally able to review (but was prohibited from copying) records reflecting performance evaluations of AA personnel assigned to the Refco audits. The Examiner only obtained some of the relevant portions of AA's internal guidance on the performance of audits as this Report was nearing completion.

2. Preliminary Comments Concerning Grant Thornton

The Examiner's investigation of GT's audits and reviews of Refco was based entirely on documents. The Examiner had access to documents that GT had previously produced to various government agencies and the Creditors Committee. These documents included GT's workpapers from its annual audits and quarterly reviews of Refco, the desk files of Ramler and other GT employees, and e-mails and attachments. The Examiner also obtained documents directly from GT using subpoenas issued pursuant to Bankruptcy Rule 2004. In all, the Examiner had access to over 400,000 pages of documents produced by GT. Pursuant to the protocol with the USAO, the Examiner did not interview Ramler or any employees of GT, or Refco employees who dealt with Ramler.

The Examiner sought and issued subpoenas to GT pursuant to Bankruptcy Rule 2004. After extensive negotiations, the Examiner eventually obtained many of the subpoenaed documents. In mid-November 2006, counsel to the Examiner first approached GT's counsel to

¹¹⁸ AA's counsel indicated that AA was unable to so stipulate because it objected to standard language in the proposed stipulation by which it would have acknowledged the jurisdiction of the Court over matters pertaining to subpoenas issued by the Examiner and language permitting the Examiner to bring a motion to compel if AA failed to comply with the subpoenas. AA's counsel even indicated that AA objected to the language in the proposed stipulation that would permit the Examiner to issue multiple "subpoenas" rather than "a subpoena." AA's counsel ultimately declined to stipulate that the Examiner had authority to issue subpoenas.

seek production of documents relevant to the Examiner’s inquiry but to which the Examiner did not then have access. More specifically, the Examiner’s counsel requested that GT produce GT’s detailed billing records concerning the Refco audits, GT’s audit manuals, reviews by concurring or professional standards partners in connection with GT’s audits of Refco, personnel files of certain GT employees involved with the Refco audits, and tax preparation documents reflecting the tax work GT had performed for Bennett as part of a separate GT engagement.

As an alternative to producing the documents voluntarily, the Examiner asked GT to stipulate to the Examiner’s authority to issue subpoenas pursuant to Rule 2004.¹¹⁹ GT declined to stipulate, and the Examiner filed a Rule 2004 motion. Just before the motion was heard by the Court, GT and the Examiner reached an agreement on a proposed order, and the Examiner’s motion was granted.

In response to the Examiner’s subpoena, GT interposed a number of objections that served mainly, in the Examiner’s opinion, to delay its production of materials.¹²⁰ Most of those objections were resolved through negotiation between counsel, and GT has since produced documents to the Examiner on a rolling basis. However, GT’s responses to the Examiner’s requests delayed substantially GT’s production of documents and limited their usefulness to the Examination.

¹¹⁹ The stipulation proposed by the Examiner expressly reserved any objection GT wished to raise as to the terms of any subpoena with the exception of an objection to the Examiner’s authority to issue subpoenas.

¹²⁰ For instance, GT objected to the Examiner’s request for detailed billing records as “not relevant” and “unrelated to the Chapter 11 Debtors’ estates” even though GT had filed proofs of claims against the Debtors’ estates based, in part, on uncollected fees for professional services. Likewise, GT’s counsel asserted relevancy objections against the Examiner’s requests for basic information such as audit manuals and personnel files of individuals involved in the Refco audits.

3. Summary of the Examiner's Findings and Conclusions

The Examiner concludes that both auditing firms, AA and GT, failed to meet the standard of care required of professional auditors. However, the three-year statute of limitations for professional malpractice (which is a form of negligence) likely bars this claim against AA unless further evidence is developed that AA engaged in fraudulent concealment.

Due principally to limitations on the Examiner's investigation, the Examiner is unable to reach a conclusion as to whether there is sufficient evidence to support a claim for aiding and abetting a breach of fiduciary duty and/or aiding and abetting fraud against AA or GT. These claims require proof of actual knowledge. While circumstantial evidence suggests that the auditors may have had actual knowledge of the fraud, further investigation is warranted.

a. Overview of the Failings of Both Sets of Auditors

AA had been Refco's auditor for many years when, in 2002, Ramler brought the engagement with him from AA to GT. For the years in question in this Report, Ramler was the engagement partner at both firms for the Refco audits. Other audit personnel assigned to the Refco engagement changed frequently. Therefore, the Examiner fully reviewed AA's role both to assess potential liability of AA and because the knowledge obtained by Ramler during the course of the AA audits is relevant to evaluating the adequacy of GT's audits under Ramler's direction. In short, many of the audit procedures (or lack thereof) were carried over from AA to GT.

Specifically, Ramler knew that: (i) RGHI was not audited by AA or by GT; (ii) RGHI's financial results were not included in RGL's consolidated financial statements; and (iii) there was a high risk of material misstatement arising from related party transactions between Refco

and RGHI. For a number of reasons, both AA and GT assessed as “high” the risk that Refco’s management could override controls in order to falsify Refco’s financial results.¹²¹

The auditors were further aware that RGHI owed large sums to Refco from schedules provided by the company.¹²² Beginning with AA’s audit of Refco’s February 28, 1998 financial statements, Ramler informed Bennett and Trosten that those borrowings could no longer increase and needed to be repaid by RGHI over a five-to-seven year period.

Both AA and GT knew of the existence of related-party accounts held by RGHI at RCC and RCM that reflected receivables due Refco from RGHI.¹²³ However, the auditors took virtually no steps to perform procedures designed to obtain competent evidential matter concerning the nature, substance and amount of the high risk, related-party transactions in order to satisfy themselves that related party transactions were adequately disclosed in the financial statements.¹²⁴

¹²¹ Part of the risk involved the fact that Bennett intended to sell Refco. Ramler knew, as early as May 1998, that Bennett desired to sell a significant portion of RGHI’s interest in Refco over the next three to ten years. Ramler was also aware, during the audit of Refco’s February 28, 2005 financial statements, of the impending IPO and attendant risk that management may override controls in order to improve Refco’s financial results.

¹²² In fiscal year 1998, the schedule was entitled, “Restricted Schedule of Loans to Stockholders and Unconsolidated affiliates.” The auditors also obtained such a schedule in earlier years, although it was referred to by other titles such as “Affiliate Receivable/Payable” or “Receivable/Payable Non Consolidated Affiliates.”

¹²³ AA’s workpapers contained a Customer Payables/Receivables schedule for RCM as of February 28, 1998 indicating that RGHI, through its customer account no. 004521-0000, owed \$97.4 million to RCM as of that date. Similarly, the auditors were aware during their audit of Refco’s February 28, 2000 financial statements that RGHI continued to engage in related party transactions through its customer account at RCM (which had, by then, been redesignated as account no. 10002657). Likewise, GT knew at the time of the audit of Refco’s February 28, 2003 financial statements that \$71 million of the \$105 million in related party loans disclosed in the footnotes to RGL’s financial statements was contained within RGHI’s customer account at RCC (account no. 1690-001).

¹²⁴ Such steps are required in order to comply with Generally Accepted Auditing Standards (“GAAS”). For further discussion of GAAS requirements, *see* Section IV.B, below. For example, the auditors did not verify that RGHI was actually making payments by examining bank statements. Furthermore, the actual steps taken were clearly ineffectual. For example, from 1998 to 2001, AA issued confirmation requests to RGHI asking it to confirm the balance of the amount it owed to Refco. That practice, however, was discontinued during the 2002 audit, when Ramler and audit manager, Dara Moore Schneider, decided that such confirmations were of little utility because they were being sent to a related party. Thereafter, nothing appears to have been done to test the validity of related party transactions between RGHI and Refco, and this lack of diligence and skepticism appears to have carried over to the audits performed by GT for fiscal years 2003, 2004 and 2005.

Significantly, during the 2003 audit (the first year in which GT had the engagement), GT auditor Yonah Dahan e-mailed a list of document requests to Frank Mutterer at RCC indicating that GT needed a list of payments made during the year by RGHI on the \$71 million balance in its customer account at RCC and that GT would need to trace some of those payments to Refco's bank statements. There is no evidence, however, that such procedure was ever actually performed. Indeed, if it had been, GT likely would have discovered the fraud. Both AA and GT could have conducted a simple tracing of payments to bank statements for any of the years in question but did not. In addition, given the auditors' consistently high assessment of the audit risk arising from related-party transactions and the possibility that management could override controls, the auditors should have obtained and scrutinized the customer statements for RGHI's accounts at RCM and RCC, which would have revealed key aspects of the fraud, but did not do so.

It appears efforts were made by Bennett, Trosten, and others at Refco, to deceive the auditors. Therefore, the auditors would likely attempt to defend a professional malpractice claim by pointing to the misrepresentations of Refco management. For example, management letters were routinely provided to the auditors representing that all related party transactions and relationships had been properly recorded or disclosed. Similarly, the balances in RGHI's customer accounts at RCM and RCC were manipulated at the end of each accounting period so as to hide the true magnitude of the amounts RGHI owed Refco. However, an auditor exercising professional skepticism "neither assumes that management is dishonest nor assumes unquestioned honesty."¹²⁵ Indeed, if management assurances were sufficient in and of themselves, there would be little point in engaging auditors in the first place.

¹²⁵ AU § 230.09, SAS 82.

Furthermore, the auditors were in possession of a series of “red flags” that should have alerted a properly skeptical auditor to the fraud, or at least caused it to seek additional evidential matter that would have led to its discovery.¹²⁶ For example, GT was aware that, in each year that it audited (2003, 2004, and 2005) and in each quarter that Refco was required to obtain quarterly reviews (May 2004 to August 2005), Refco extended several hundred million dollars in uncollateralized loans to Liberty Corner that were “repaid” shortly after the end of each of Refco’s accounting periods. GT knew that Refco accounted for these uncollateralized loans as “reverse repo” transactions despite the fact that, by GT’s own definition, such a transaction was required to be collateralized.

The Examiner concludes that both AA and GT failed to adequately test high-risk related party transactions, failed to approach their audits with the appropriate degree of skepticism, and failed to adequately consider and evaluate the potential for fraud within Refco, a company controlled by a few individuals who could override controls and who intended to sell the company. The Examiner is unable to reach a definitive conclusion as to whether AA or GT knowingly aided and abetted the breach of a fiduciary duty.

B. OVERVIEW OF THE PROFESSIONAL STANDARDS GOVERNING AUDITING PROFESSIONALS

AA and GT’s potential professional liability depends on whether they planned and performed their respective audits in accordance with generally accepted auditing standards

¹²⁶ For example, during its 2000 audit, AA attached to its confirmation request to RGHI a copy of the February 2000 customer statement for RGHI’s account at RCM (no. 10002657). On its face, that statement disclosed that, as of the beginning of the month of February 2000, RGHI owed RCM approximately \$350 million. That two-page statement also disclosed that on February 25, 2000 (just three days before Refco’s fiscal year end), \$357 million worth of credits were booked to the account and effectively eliminated the amount owed to Refco by RGHI. AA failed to take notice of this despite the otherwise relatively small activity in the account and the fact that, when Ramler emphasized the need to pay down the RGHI Receivable in May 1998, Bennett indicated that RGHI would do so *if* RGL’s earnings were \$50 million or greater so that it could pay a dividend to RGHI, which in turn could be used to

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(“GAAS”), as well as common law and legal precedents applying those standards.¹²⁷ The American Institute of Certified Public Accountants (“AICPA”) issues pronouncements called Statements on Auditing Standards (“SAS”), which amplify, modify, and interpret the ten general, fieldwork, and reporting standards.¹²⁸ The SAS have been codified in a volume of professional standards, referred to as auditing interpretations, which are cited to using the prefix “AU.” In conducting an audit, the auditor has a responsibility to consider the SAS, and justify any departure from them.

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pay down the receivable. A properly skeptical auditor would have questioned how RGHI suddenly obtained \$350 million and taken steps to find competent evidence sufficient to support the answer given by management.

¹²⁷ See *United States v. Arthur Young & Co.*, 465 U.S. 805, 811 (1984).

¹²⁸ The ten standards are as follows:

- A. General Standards
 - 1. Training and proficiency. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
 - 2. Independence. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
 - 3. Due care. Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.
- B. Fieldwork Standards
 - 4. Planning and supervision. The work is to be adequately planned, and assistants, if any, are to be properly supervised.
 - 5. Internal control. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
 - 6. Evidential matter. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.
- C. Reporting Standards
 - 7. GAAP. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
 - 8. Consistency. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
 - 9. Disclosure. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
 - 10. Reporting obligation. The report shall contain either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons should be stated. In all cases where an auditor’s name is associated with financial statements, the report shall contain
 - a. A clear-cut indication of the auditor’s work, if any.
 - b. The degree of responsibility the auditor is taking.

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In evaluating AA's and GT's respective audits, the Examiner has focused on the auditors' performance of their duties in those areas in which the fraud at Refco occurred. The relevant standards are discussed below after a brief discussion on the goal of an audit.

1. The Goal of an Audit

The goal of an audit of financial statements by an independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, the financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.¹²⁹ To achieve this objective, the auditor "has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."¹³⁰

2. Due Professional Care and Professional Skepticism in the Performance of Work

An independent auditor is required to plan and perform his or her work with due professional care.¹³¹ Due professional care requires the auditor to exercise professional skepticism, which is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should use the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence.¹³²

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AU § 150.02. An "AU" is described in the text of the Report, above.

¹²⁹ AU § 110.01.

¹³⁰ AU § 110.02.

¹³¹ AU § 230.02.

¹³² AU § 230.07. This paragraph was added by SAS 82, which is effective for audits of financial statements for periods ending on or after December 15, 1997.

“Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit process, professional skepticism should be exercised throughout the audit process.”¹³³ In exercising professional skepticism, the auditor “neither assumes that management is dishonest nor assumes unquestioned honesty”¹³⁴ and “should not be satisfied with less than persuasive evidence because of a belief that management is honest.”¹³⁵ Thus, management’s representations “are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.”¹³⁶

3. Audit Documentation

AU § 339, “Working Papers,” makes clear that the information contained in working papers constitutes the principal record of the work that the auditor has done and the conclusions reached concerning significant matters. The working papers ordinarily should contain documentation showing that:

- The work has been adequately planned and supervised;
- A sufficient understanding of internal control has been obtained to plan the audit and determine the nature, extent and timing of the tests performed; and
- The audit evidence obtained, the auditing procedures applied, and the testing performed have provided sufficient competent evidential matter to afford a reasonable basis for an opinion.

Effective for audits of periods beginning after May 15, 2002, AU § 339 became known as “Audit Documentation.”

¹³³ AU § 230.08, SAS 82.

¹³⁴ AU § 230.09, SAS 82.

¹³⁵ *Id.*

4. Auditing Related Party Transactions

AU § 334 sets forth the requirements for auditing related party transactions. The auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. In addition, the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form.¹³⁷ Arm's length transactions with outside parties are usually subjected to less detailed scrutiny than intercompany transactions or transactions with officers and employees, where the same degree of disinterested dealing cannot be assumed.¹³⁸ "During the course of the audit, the auditor should be aware of the possible existence of related party transactions that could affect the financial statements and common ownership or management control relationships for which Financial Accounting Standards Board ("FASB") requires disclosure even though there are no transactions."¹³⁹

The auditor's procedures for examining related party transactions should provide reasonable assurance that identified related party transactions do not contain misstatements that, when aggregated with misstatements in other balances or classes of transactions, could be material to the financial statements taken as a whole.¹⁴⁰ As in examining other material account

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¹³⁶ AU § 333.02, SAS 19.

¹³⁷ AU § 334.02.

¹³⁸ AU § 150.05, SAS 43 (effective November 1972).

¹³⁹ AU § 334.04.

¹⁴⁰ AU § 9334.17: Related Parties – Auditing Interpretations of Section 334. "Interpretations" are recommendations, issued under the authority of the AICPA Accounting Standards Board, on how to apply the SAS in specific circumstances. For example, AU § 9334 provides guidance on how to apply the requirements of AU § 334. Interpretations are not auditing standards; however, auditors should be aware of and consider them and be prepared

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balances, the auditor needs to consider the audit risk posed by related party transactions and then design and apply appropriate substantive tests to evaluate management's assertions.¹⁴¹

Notably, the risk associated with management's assertions about related party transactions is often assessed as higher than for many other types of transactions because of the possibility that the parties to the transaction are motivated by reasons other than those that exist for most business transactions. "The higher the auditor's assessment of risk regarding related party transactions, the more extensive or effective the audit tests should be. For example, the auditor's tests regarding valuation of a receivable from an entity under common control might be more extensive than for a trade receivable of the same size because the common parent may be motivated to obscure the substance of the transaction."¹⁴²

To identify material transactions with known related parties, AU § 334 requires the auditor to employ, among others, the following procedures:

f. Consider whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing accounting, management or other services at no charge or a major stockholder absorbing corporate expenses.

g. Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.

* * *

i. Review invoices from law firms that have performed regular or special services for the company for indications of the existence of related party transactions.¹⁴³

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to explain how they complied with the relevant SAS requirements addressed by such guidance. AU § 150.05, as amended by SAS 95 in December 2001. GT's internal guidance appears to be consistent with AU § 9334.

¹⁴¹ *Id.*

¹⁴² AU § 9334.19.

¹⁴³ AU § 334.08.

Further, if the auditor assigns a high degree of risk to related party transactions, he or she might respond by, among other things, engaging in discussions with tax preparers regarding their knowledge of related parties.¹⁴⁴

After identifying related party transactions, the auditor should apply the procedures he or she considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. Such procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management.¹⁴⁵

For each material related party transaction (or aggregation of similar transactions) or common ownership or management control relationship for which FASB Statement No. 57 requires disclosure, the auditor should consider whether he or she has obtained sufficient competent evidential matter to understand the relationship of the parties and, for related party transactions, the effects of the transaction on the financial statements. He should then evaluate all the information available concerning the related party transaction or control relationship and satisfy himself on the basis of his professional judgment that it is adequately disclosed in the financial statements.¹⁴⁶

¹⁴⁴ Accounting and Auditing for Related Parties and Related Party Transactions, A Toolkit for Accountants and Auditors, prepared by the staff of the AICPA, December 2001. This Toolkit was not intended by staff to “break any new ground,” but rather to “provide accountants and auditors with an overview of selected authoritative accounting and auditing literature, SEC requirements and nonauthoritative best practice guidance concerning related parties and related party transactions.” *Id.* The Toolkit is an “other auditing publication” as defined in SAS 95 and it has no authoritative status. Nonetheless, other auditing publications are intended to help auditors understand and apply the SAS. Had the auditors consulted Refco’s tax preparers, they would likely have learned facts that ultimately would have led to the disclosure of the fraud.

¹⁴⁵ AU § 334.09.

¹⁴⁶ AU § 334.11.

5. Consideration of Fraud in a Financial Statement Audit

Although the Enron scandal and the Sarbanes-Oxley Act of 2002 increased the level of scrutiny on corporate fraud and led to a heightening of the applicable auditing standards, the requirement that an auditor assess the risk of material misstatement due to fraud is not new. AU § 316, “Consideration of Fraud in a Financial Statement Audit” based on SAS 82, was issued in 1997. As described in further detail later in this Report, Refco began to manipulate significantly the RGHI Receivable in fiscal-year 1998, and, consequently, the Examiner focused on AA’s performance of its audits for fiscal-years 1998 through 2002. During each of those years, AA was required to comply with the requirements of SAS 82.

SAS 99 was issued in October 2002 and replaced SAS 82 for audit periods ending on or after December 15, 2002. SAS 99, however, did not change the auditor’s underlying responsibility to obtain reasonable assurance as to whether the financial statements were free of material misstatement, whether caused by error or fraud. But, SAS 99 did provide some additional performance requirements in fulfilling that responsibility as it relates to fraud, such as the requirement that the audit team discuss where and how the financial statements may be susceptible to misstatement caused by fraud.

a. SAS 82 Requirements

SAS 82 required an auditor to specifically assess the risk of material misstatement due to fraud and provided categories of fraud risk factors to be considered in the auditor’s assessment.¹⁴⁷ In doing so, the auditor must exercise professional skepticism. Some examples demonstrating the application of professional skepticism in response to the auditor’s assessment of the risk of material misstatement due to fraud include: (a) increased sensitivity in the

¹⁴⁷ SAS 82, ¶ 1.

selection of the nature and extent of documentation to be examined in support of material transactions; and (b) increased recognition of the need to corroborate management explanations or representations concerning material matters — such as further analytical procedures, examination of documentation, or discussion with others within or outside the entity.¹⁴⁸

Specific responses to the auditor's assessment of the risk of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified and the account balances, classes of transactions, and assertions they may affect. If these factors or conditions indicate a particular risk applicable to specific account balances or types of transactions, audit procedures addressing these specific areas should be considered that will, in the auditor's judgment, limit audit risk to an appropriate level in light of the risk factors or conditions identified. The following are specific examples of responses:

- Perform a detailed review of the entity's quarter-end or year-end adjusting entries and investigate any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year end, investigate (a) the possibility of related parties and (b) the sources of financial resources supporting the transactions.¹⁴⁹

b. SAS 99 Requirements

SAS 99 applies to audits of financial statements for periods ending on or after December 15, 2002. It stresses the importance of exercising professional skepticism¹⁵⁰ and requires discussion or "brainstorming" among audit engagement personnel regarding the risks of material misstatement due to fraud. The discussion among the audit team members should emphasize the

¹⁴⁸ SAS 82, ¶27.

¹⁴⁹ SAS 82, ¶29.

¹⁵⁰ SAS 99, ¶13.

need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating evidence throughout the audit.¹⁵¹

SAS 99 warns practitioners that management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively. By its nature, management override of controls can occur in unpredictable ways. Accordingly, in addition to overall procedures that address specifically identified risks of material misstatement due to fraud, the following procedures should be performed to further address the risk of management override of controls:

- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.¹⁵²
- Reviewing accounting estimates for biases that could result in material misstatement due to fraud.¹⁵³
- Evaluating the business rationale for significant unusual transactions.¹⁵⁴

C. BACKGROUND OF REFCO'S AUDITOR ENGAGEMENTS

1. The Audits Performed by AA

From 1998 to 2002, AA only audited and issued reports for the following Refco entities: RCM, RCC, Refco, Inc. (later Refco LLC), RGL (on a consolidated basis), and other foreign subsidiaries. According to statements made during interviews of former AA personnel, RCM and RCC were audited to comply with loan covenants of lenders and to provide “sufficient coverage” to support the issuance of an audit opinion on the consolidated financial statements of

¹⁵¹ SAS 99, ¶¶ 14-16.

¹⁵² SAS 99, ¶ 58.

¹⁵³ SAS 99, ¶ 63.

¹⁵⁴ SAS 99, ¶ 66.

RGL. It appears that, by auditing the above-specified Refco subsidiaries, AA did obtain sufficient coverage for the consolidated financial statements of RGL under its own guidelines.

The Examiner was provided access to and reviewed AA's audit workpapers from the Refco engagement for the audit years 1995 through 2002, totaling approximately 35,000 pages. The review emphasized records from 1998 forward. The Examiner reviewed approximately 6,000 pages of e-mails and desk files for the Refco audit team members, including Ramler.

From at least 1992 though the end of AA's tenure as Refco's auditors in 2002, Ramler served as the engagement partner, with various other individuals performing in the roles of audit manager, audit senior, and staff auditors (Associates and Experienced Associates).¹⁵⁵ The Examiner interviewed the audit managers for the Refco audits of 1999 through 2002, Melissa Kesh¹⁵⁶ and Dara Moore Schneider.¹⁵⁷ The Examiner also interviewed lower level audit staff identified in the workpapers as performing the audit confirmation processing and testing of relevant financial statements.¹⁵⁸ Given the time that has passed since the involvement of these witnesses in the Refco audits, their recollections were limited. However, each represented to the Examiner that the AA workpapers documented the procedures performed for each audit, and were intended as stand-alone support for the audit opinions. This is consistent with AU § 339,

¹⁵⁵ GT SEC 0130512 at 0130518, at App. D-4 (GT "Evaluation of Proposed Client" form completed by Ramler noting that "I was an engagement partner on the client at Andersen for 10 years").

¹⁵⁶ Kesh was also the audit senior for the fiscal year 1998 audit.

¹⁵⁷ Schneider, a former AA audit manager assigned to the Refco engagement, explained that in order to obtain coverage sufficient to form an "adequate assurance" to support the audit opinion, AA needed to audit 90 percent of the audit client's assets and revenues. Schneider further explained that the 90 percent test was AA policy, and, in Refco's case, meant that AA needed to audit 90 percent of RGL's consolidated assets and revenues. Schneider Interview, February 8, 2007.

¹⁵⁸ These persons were: William Denehy (year 2001 and 2002 Experienced Associate); Jason Blumkin (year 2001 Experienced Senior); Brian Falahee (2001 Experienced Associate); Amy Lynn Murphy (2002 Experienced Associate).

providing that the working papers for an audit constitute the principal record of the work the auditor has done and the conclusions reached concerning significant matters.

Based upon a review of the available audit workpapers and the interviews of two former managers assigned to the Refco audits of 1999 through 2002, the annual engagement followed a fairly regular practice. The Refco entities' fiscal year ended in February; thus planning for audits usually began each year in the fall prior to the fiscal year end under audit. In the November or December prior to Refco's fiscal year end, the AA audit staff would meet to set staffing for the upcoming audit and review the prior year's audit workpapers. Ramler, and whoever served as the audit manager in that particular year, would hold one or more pre-audit meetings with Refco management to inquire about any new developments during the year, discuss issues noted in the closing meeting of the prior year, and plan the audit timeline. The field work for the audits was generally performed in late March or early April, with a usual completion deadline of May 19 to May 21 that was driven by the debt covenants that RGL, RCM, and RCC held with various lenders.

AA's engagement included providing an auditor's report expressing an opinion on the RGL consolidated financial statements and on the stand-alone financial statements of the Refco subsidiaries audited by AA.¹⁵⁹ AA's engagement required it to examine, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assess the accounting principles used and significant estimates made by management, and evaluate the overall financial statement presentation.¹⁶⁰ For this purpose, AA's engagement required Refco to make available all financial records and related information and personnel with information of

¹⁵⁹ See, e.g., AAREF 00010141 (AA 2001 Audit Engagement Letter).

¹⁶⁰ See *id.*

relevance to the audits.¹⁶¹ The scope of its audit engagement included obtaining an understanding of Refco's internal controls for audit planning and determining the nature, timing, and extent of audit procedures.¹⁶² While AA was not engaged to provide assurances on the internal controls or to identify deficiencies in the controls,¹⁶³ GAAS required AA to obtain reasonable assurance that the financial statements were free of material misstatement, whether by error or fraud.¹⁶⁴

For each of Refco's fiscal years 1998 through 2002, AA issued an "unqualified opinion," meaning that AA opined that Refco's financial statements presented fairly, in all material respects, the financial position of Refco as of the particular balance sheet date under audit, and the results of Refco's operations and cash flows for the year then ended were in conformity with GAAP.¹⁶⁵ Each of AA's audit reports also represented that:

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.¹⁶⁶

As explained in detail below, however, the Examiner concludes that AA failed to conduct its audits of Refco in accordance with GAAS because, among other things, it failed to:

¹⁶¹ See *id.*

¹⁶² See *id.*

¹⁶³ See *id.*

¹⁶⁴ SAS 1 at AU § 110.02.

¹⁶⁵ See, e.g., AAREF 00004978, Report of Independent Public Accountants, May 19, 1999.

¹⁶⁶ *Id.*

(1) adequately test related party transactions to which it had assigned a high degree of risk; (2) maintain a properly skeptical attitude; (3) obtain sufficient evidentiary matter to support its opinions; and (4) adequately consider and evaluate the potential for fraud knowing that Refco was controlled by a few individuals who intended to sell their interests in Refco and who could override controls in order to maximize the apparent value of Refco.

Following AA's audit in fiscal year 2002, and at a time when AA had effectively disbanded, Ramler left AA, accepting a position with GT in August 2002.¹⁶⁷ Refco followed, moving its audit engagement to GT through Ramler. In addition to assessing AA's potential liability for professional malpractice, a significant focus of the Examiner's investigation of AA's audits of Refco was on the activities of Ramler as the engagement partner. The audit methods used by AA and GT were very similar, and Ramler was the apparent link between the two engagements. No other former AA personnel having experience on the Refco audits were identified as moving with Ramler to GT. Ramler was knowledgeable of Refco's business and the relationships between its various entities, and carried that knowledge with him to GT. Notably, while at AA, Ramler claimed to have had such a close relationship with Refco that he believed its management did not engage in any transactions without his thoughts and advice and stated that Bennett and other senior Refco management called him on an almost daily basis to discuss transactions and business issues.¹⁶⁸ When he joined GT, he explained: "I was the audit partner on the Refco engagement while at Andersen. The client is very loyal to its professional service advisers (*sic*) and has agreed to follow me to [GT]. My relationship and knowledge of

¹⁶⁷ On August 31, 2002, AA relinquished, or consented to revocation of, its firm permits in all states where it was licensed to practice public accountancy with state regulators. AA continues to exist as a legal entity, but all former partners have resigned from the firm.

¹⁶⁸ Ramler's personnel file contains this claim. AA allowed the Examiner to review, at AA's office, this and other personnel files for those who worked on the Refco engagement but did not permit the Examiner to copy them.

Refco dates back to the late 1980s.”¹⁶⁹ Thus, the activities of AA, under Ramler’s supervision, in conducting the fiscal year 1998 through 2002 Refco audits are highly relevant to assessing the manner in which GT, also under Ramler’s supervision, continued the engagement through fiscal year 2005.

AA was paid \$1,835,000 in professional fees for its financial statement audit services to Refco from fiscal years 1998 to 2002.¹⁷⁰

2. The Audits and Reviews Performed by GT

After AA ceased functioning as an auditing firm, Ramler joined the New York office of GT as a partner in August 2002. Ramler proposed Refco to GT as a prospective client in late 2002, and GT accepted the Refco engagement in March 2003. As explained above, Ramler was well aware of the risks inherent in auditing Refco from his time as the partner in charge of the Refco engagement at AA, and GT categorized Refco as a “high-risk client.”¹⁷¹ GT assessed Refco as a high-risk client in part because it engaged in significant and complex related party transactions,¹⁷² lacked an internal audit function,¹⁷³ and was dominated by a limited number of

¹⁶⁹ See, e.g., GT SEC 0130512 at 130515, at App. D-4 (GT “Evaluation of Proposed Client” form completed by Ramler).

¹⁷⁰ From Professional Fee Summary provided by Refco.

¹⁷¹ GT SEC 0031551 [REDACTED]

* See also GT E EX 000004, a spreadsheet from 2005 listing Refco among “High Risk Clients as Identified by RPPS in Annual Office Visit.” RPPS is an acronym used by GT for its “Regional Partner in Charge of Professional Standards.” The risks associated with the Refco engagement were apparently well-known throughout GT: the engagement was once described as having “mucho issues/risks.” GT E EX 000942 (June 7, 2005 e-mail re: “ARM” from Maria Manasses at GT to Linda McAninch and Jennifer Carney at GT).

* All redactions in the Report are made pursuant to Order of the Court (Docket No. 5516).

¹⁷² GT SEC 0031029 (“Inherent Risk Indicators-General” for audit of Refco Group Ltd., LLC and Subsidiaries, dated April 3, 2003).

¹⁷³ Id.

senior executives and managers¹⁷⁴ who had an interest in maximizing the apparent financial health of the company.¹⁷⁵

GT conducted financial statement audits for Refco's fiscal years ending February 28, 2003, February 29, 2004, and February 28, 2005. At first, GT's audits included RGL as well as separate audits of the stand-alone financial statements of RCC and RCM. GT never conducted audits of RGF, a third Refco subsidiary involved in the Round Trip Loans, and no longer separately audited RCC when it audited the February 28, 2005 financial statements of Refco. GT also conducted audits or reviews of Refco entities that were apparently not involved in the financial statement manipulations, including Refco Securities LLC, Refco LLC, RefcoFund Holdings, and multiple foreign Refco subsidiaries.

In May 2004, Refco engaged PricewaterhouseCoopers LLP ("PwC") to assist with Refco's SEC and external reporting function.¹⁷⁶ Beginning around the time of the LBO, PwC began to assist with Refco's internal bookkeeping and its filings under the Securities Exchange Act of 1933.

In anticipation of the LBO, GT performed additional services during 2004, such as a re-audit of Refco's financial statements for the fiscal year ended February 28, 2002¹⁷⁷ and a review

¹⁷⁴ GT SEC 0028264 ("Refco Group Ltd., LLC & Subsidiaries (or New Refco Group, Ltd., LLC) Planning Meeting – Inherent Risk Discussion February 28, 2005").

¹⁷⁵ GT SEC 0004084 at 4085, at App. D-5 (Memorandum dated 4/11/05 re: Refco Group Ltd., LLC – Discussion and Risk of Misstatement Due to Fraud to The Files from Ramler).

¹⁷⁶ GT SEC 0004084 at 4088, at App. D-5.

¹⁷⁷ GT E SEC 20001312.0001- 0007 (Engagement letter dated June 8, 2004 from Richard C. Flowers at GT to Trosten).

of Refco's financial statements for the quarters ended May 31, 2003 and May 31, 2004. After the LBO, GT continued to conduct quarterly reviews of Refco in addition to the annual audits.¹⁷⁸

In November 2004, Refco filed its initial Form S-4, which became effective on April 8, 2005, to publicly register the Senior Subordinated Notes. On April 8, 2005, Refco also filed a Form S-1 in connection with the IPO. In connection with these public filings, GT conducted reviews of Refco's financial statements for the quarters ended August and November of 2003 and 2004.¹⁷⁹

As a result of the LBO, a Board of Directors was established consisting of representatives of THL and Refco management. In January 2005, three independent directors joined the Board of Directors and also formed Refco's Audit Committee.

Apparently in anticipation of Refco's filing of its annual report (Form 10-Q) with the SEC, in June 2005, Refco engaged GT to conduct reviews of its May 31, 2005, August 31, 2005, and November 30, 2005 quarterly financial statements.¹⁸⁰ GT reviewed the May and August financial statements, but Refco filed for bankruptcy before the November review could be performed.

According to its engagement letters with Refco, GT's audits were to be conducted in accordance with auditing standards generally acceptable in the United States. The audits were to

¹⁷⁸ GT understood that, in connection with the LBO, \$500 million in cash was paid as a dividend to RGHI and concluded that the foregoing events made Refco a highly leveraged company. GT SEC 0004084-85, at App. D-5 (Memorandum dated 4/11/05 re: Refco Group Ltd., LLC – Discussion and Risk of Misstatement Due to Fraud to The Files from Ramler).

¹⁷⁹ Because the LBO occurred during this quarter, the review covered the period from June 1, 2004 through August 5, 2004 and the "successor period" after the LBO from August 6, 2004 through August 31, 2004.

¹⁸⁰ These quarterly reviews apparently were conducted pursuant to GT's March 21, 2005 engagement letter with Refco for the February 28, 2005 audit, GT SEC 0028162, which permitted Refco's audit committee and shareholders to appoint GT to conduct such reviews subject to the terms of the March 21 engagement letter in the event no separate engagement letter was issued. GT prepared a separate engagement letter for these quarterly audits, but it was never executed. GT E SEC 20000980.

involve GT's examining, "on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant judgments and estimates made by management, as well as evaluating the overall financial statement presentation."¹⁸¹ GT was responsible for "obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed."¹⁸² GT disclaimed responsibility for identifying deficiencies in internal control, guaranteeing the accuracy of financial statements, or detecting illegal acts within Refco.¹⁸³ However, GT committed to "communicate significant deficiencies or material weaknesses in internal control" coming to its attention during the audit.¹⁸⁴

The objective of GT's engagement was the completion of the audit and rendering of an opinion on Refco's financial statements, but GT noted the possibility that "due to unexpected circumstances we may determine that we are unable to complete the audit engagement or that we . . . cannot form an opinion. In those circumstances, we may decline to express an opinion or . . . to issue a report."¹⁸⁵ The engagement letter permitted GT to resign from the engagement "if . . . the circumstances require."¹⁸⁶ As explained in an internal GT memorandum concerning the audit of the financial reporting period ended February 28, 2005, GT "audited the consolidated

¹⁸¹ See, e.g., GT SEC 0113599 (Engagement letter dated March 14, 2003 for audits of consolidated financial statements of Refco Group Ltd. LLC and Subsidiaries as of February 28, 2003 from Ramler to Trosten).

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

statement of income, changes in members' equity and cash flows" of Refco during the audit period.¹⁸⁷

GT issued unqualified audit opinion letters on Refco's financial statements for the fiscal years ended February 28, 2003, February 29, 2004, and February 28, 2005. Further, an unqualified audit opinion by GT concerning the February 28, 2003 and February 29, 2004 financial statements was included within Refco's Offering Circular in connection with the registration of the Senior Subordinated Notes following the LBO.¹⁸⁸ Although GT appears to have in fact conducted a re-audit of Refco's February 28, 2002 financial statements, its audit report in the Offering Circular asserts that no such audit was conducted.¹⁸⁹

GT's unqualified opinion letters for the fiscal years ended in 2003, 2004, and 2005 were included in Refco's fiscal year 2005 Annual Report on Forms 10-K and 10-KA and stated:

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on

¹⁸⁷ GT SEC 0027911 (Memorandum dated May 13, 2005 to New Refco Group Audit Files from GT auditor Joe London re: Refco Group Ltd. LLC Summary of Significant Matters).

¹⁸⁸ WGM-L 0014497 at 0014681-14727 (July 22, 2004 Confidential Offering Circular of Refco for \$600,000,000 in 9% Senior Subordinated Notes).

¹⁸⁹ Although the February 28, 2002 financial information included with the LBO offering memorandum was designated "unaudited" and GT disclaimed having performed such an audit in its opinion letter, it did, in fact, review AA's 2002 audit workpapers and conduct audit procedures on Refco's 2002 financial information. It also billed Refco \$750,000 for this re-audit. GT SEC 0078297 (October 18, 2004 invoice for professional fees from GT to Trosten at Refco). It is unclear why GT claimed in the offering memorandum that such an audit was not conducted, and the Examiner was unable to interview GT and/or Refco personnel in order to find out why this statement was made.

a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.¹⁹⁰

The Examiner concludes that GT failed to plan, perform, and document its audits in a manner sufficient to provide a reasonable assurance that the financial statements were free of material misstatement — even though the fraud was perpetrated largely through related party transactions that GT had assessed as creating a high risk of misstatement.

GT's professional relationship with Refco continued until the time the fraud was revealed. Shortly after Refco collapsed, GT released the following statement: "While our professional consideration is still underway, it appears to be a purposeful deception that required participation by senior management, hidden well enough to also evade numerous other detailed financial inspections performed by many of the most well-respected financial institutions in the country."¹⁹¹ While it does appear that attempts were made to hide the fraud, the Examiner concludes that an auditor employing the requisite degree of professional skepticism in its review of RGHI's customer statements for its accounts at RCC and RCM would have detected the fraud.

GT has filed claims against Refco's estates asserting, among other claims, indemnification under the engagement letters it had entered into with Refco.¹⁹² Specifically, GT's proofs of claim seek indemnity and contribution from Refco for legal fees incurred in responding to actions against it as Refco's auditor. GT also reserved the right to argue that any

¹⁹⁰ Refco Group Ltd., LLC Form 10-K for the fiscal year ended February 28, 2005 at pages F-2 and F-3, filed with the SEC dated July 1, 2005, and available at: <http://www.sec.gov/Archives/edgar/data/1305464/000104746905018583/a2159496z10-k.htm>.

¹⁹¹ Ben White and Terrence O'Hara, "Crisis at Refco Raises Questions About Accounting," The Washington Post, October 15, 2005 at D01.

¹⁹² See, e.g., Proof of Claim of Grant Thornton LLP, No. 11536 (July 17, 2006), filed in *In re Refco Capital Markets, Ltd.*, No. 05-60018.

claims asserted against it by Refco are subject to the rights of setoff and recoupment. The only engagement letters that contained any indemnification language were those for the audits of Refco's February 28, 2003 and February 29, 2004 financial statements.¹⁹³ Engagement letters for subsequent reviews and audits did not contain this language, possibly because in May 2004 GT realized that SEC independence rules did not permit such indemnification language to be included in engagement letters of auditors for registrants.¹⁹⁴ In fact, at one point GT intended to rescind its original engagement letters from the 2003 and 2004 annual audits and prepared letters to that effect, but it does not appear that such letters were ever executed.¹⁹⁵

GT was paid \$9,279,568 in professional fees for its financial statement audit and review services to Refco.¹⁹⁶ Some of these payments may be preferences under the Bankruptcy Code.¹⁹⁷

D. THE AUDITORS FAILED TO CONDUCT AUDITS OF REFCO'S FINANCIAL STATEMENTS IN ACCORDANCE WITH GAAS

1. AA's Failure to Properly Audit Refco's Related Party Transactions

Throughout the audit periods memorialized by the documents available to the Examiner, RGHI was the unconsolidated parent of RGL and the various audited and unaudited subsidiaries. From at least the beginning of Ramler's involvement in the Refco engagement from the late

¹⁹³ See, e.g., GT SEC 0078275 at 78276 (March 9, 2004 Engagement Letter for February 29, 2004 financial statements audit of Refco): "The Company shall indemnify and hold us harmless from any liability, damages, fees, expenses and costs (including defense costs) arising from or relating to misrepresentations by management."

¹⁹⁴ GT E SEC 20001297 (e-mail string dated May 24-25, 2004 between Linda McAninch, partner at GT, and Ramler re: Refco Engagement Letters).

¹⁹⁵ See, e.g., GT E SEC 20007608 (unexecuted draft engagement letter from GT to Refco dated June 7, 2004): "Due to the change in the terms and conditions associated with the proposed offering as indicated in the Scope of Services section, this engagement letter replaces the previously issued engagement letters dated March 14, 2003 and March 9, 2004 for the period of time and for the services included in the Scope of Services paragraphs solely with respect to any indemnification provisions or other clauses that are not permitted by the U.S. Securities and Exchange Commission."

¹⁹⁶ From Professional Fee Summary provided by Refco.

¹⁹⁷ See Section IX.B., below.

1980s, AA was aware of the relationship of RGHI to the other Refco entities, the regularity of transactions between them, and the substantial amounts owed by RGHI to Refco subsidiaries.¹⁹⁸

a. AA's Knowledge of the RGHI Related Party Receivable

As discussed herein, the fraud was perpetrated in large part by manipulation of customer accounts held by RGHI at RCC and RCM beginning in 1998. These manipulations hid only a portion of the amounts owed to RGL by RGHI in each year audited by AA. Each year Refco provided AA an inaccurate “Schedule of Loans to Shareholders and Unconsolidated Affiliates.” These schedules disclosed some, but not all, of the related party receivables due RGL:

Audit / Review Period		RGHI @ RCM	RGHI @ RCC	RGF@RCM	
					Total
1998	Actual Balance 1/31/98	96,865,728	128,120,110	151,692,948	376,678,786
	As Reported 2/28/98				125,403,000
1999	Actual Balance 1/31/99	104,375,137	148,130,941	156,892,064	409,398,142
	As Reported 2/28/99				170,000,000
2000	Actual Balance 1/31/00	354,380,648	15,064,012	(60,493,210)	308,951,450
	As Reported 2/29/00				228,389,000
2001	Actual Balance 1/31/01	133,730,287	315,283,602	207,842,581	656,856,470
	As Reported 2/28/01				205,000,000
2002	Actual Balance 1/31/02	142,683,966	461,110,624	249,076,565	852,871,155
	As Reported 2/28/02				179,427,000

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¹⁹⁸ AAREF 00033405 (1995 Schedule of Loans from Affiliates); GT SEC 0130512 at 521, at App. D-4 (Ramler's explanation of related party transactions for GT "Evaluation of Proposed Client" Form). In seeking approval of the Refco engagement moving to GT, Ramler stated on the new engagement form that the receivable balances then existing on the RGL financial statements pre-dated his involvement with the Refco audits by AA to at least the 1980s. *See id.* ("Evaluation of Proposed Client" form). The Examiner did not have access to audit materials from the AA audits of Refco conducted in the 1980s, or to Refco financial reports or data from that period. Thus, while Ramler confirmed the existence of those balances in the 1980s, the particular amounts of the receivable balances in those years are unknown.

¹⁹⁹ The "Actual Balance" amounts for each year reflect the balances from the customer account statements of RGHI at RCM (no. 10002657) and RCC (no. 1690-001), and of RGF at RCM (no. 10001295), as of January 31 each year, prior to the annual manipulations of the balances for these accounts in February. *See* FTI Consulting Schedule 3, at App. D-1. The "As Reported" amounts are taken from the Schedule of Loans to Shareholders and Unconsolidated Affiliates contained in the workpapers for each AA audit year and tie to the related party transaction disclosures in

(footnote continued on next page)

Beginning at least as early as 1998, AA raised concerns over the amount of debt owed by RGHI and the need for management to adopt a plan to pay down the debt. For example, in 1998 an audit status memorandum was prepared to document in the workpapers issues related to the 1998 audit discussed with Refco management. It shows that AA believed there was essentially no equity in RGL “because the intercompany receivable balance would reduce equity if there was no intent and no ability to pay it down.”²⁰⁰ Refco management responded that “if [RGL’s] earnings were \$50 million or greater they would pay down the receivable balance by dividend money to [RGHI] and then having RGHI pay down the intercompany balance.”²⁰¹ AA resolved to review the status of the pay down plan the following year.²⁰²

But in fiscal year 1999, AA observed no change in the overall status of the related party receivables.²⁰³ Refco was advised of AA’s concern over the high risks posed by related party receivables and the need for RGHI to actively reduce the balance through a 1999 Ramler memorandum to Bennett.²⁰⁴ In that memorandum, Ramler set forth the balance of the related party receivables, then purportedly \$227 million, and pointed out that “[a] key consideration in reporting amounts due from stockholders and their affiliates as assets is if such shareholders

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RGL’s audited financial statements for those years. *See* AAREF 00015843, at App. D-6 (1998 Schedule of Loans to Shareholders and Unconsolidated Affiliates); AAREF 00004999, at App. D-6 (1999 Schedule of Loans to Shareholders and Unconsolidated Affiliates); AAREF 00005557, at App. D-6 (2000 Schedule of Loans to Shareholders and Unconsolidated Affiliates); AAREF 00010202, at App. D-6 (2001 Schedule of Loans to Shareholders and Unconsolidated Affiliates); AAREF 00012494, at App. D-6 (2002 Schedule of Loans to Shareholders and Unconsolidated Affiliates). According to these schedules, in addition to RGHI, Refco had engaged in loan transactions with approximately eight other stockholders and unconsolidated affiliates, including Refco Advisors, Refco Paris, Strategic Opportunities Fund, T. Dittmer Trading, Wells, Ltd., and Westminster Inc.

²⁰⁰ AAREF 00020226 (May 12, 1998 Audit Status Memorandum to fiscal year 1998 audit workpapers).

²⁰¹ *Id.*

²⁰² *See id.*

²⁰³ *See* AAREF 00003035 at 3038 (Agenda for January 7, 1999 Audit Planning Meeting with Refco management).

²⁰⁴ *See* AAREF 00011967, at App. D-7 (May 10, 1999 Memorandum from Ramler to Bennett and Jim Friedlieb).

intend to pay back amounts owed in the relatively near future. Without a clear indication of intent, such amounts owed would likely be reported as a debit in stockholder's equity or an effective deemed distribution of equity capital.”²⁰⁵ It was AA's view that “shareholder management has to clearly and formally demonstrate their intent to pay down [the receivables] in a reasonable timeframe [five to eight years].”²⁰⁶ Ramler further recommended that interest on the receivables be payable currently rather than be allowed to accrue.²⁰⁷

At the sign-off meeting for the 1999 audit, management and AA discussed Ramler's memorandum and the priority of paying down affiliate receivables.²⁰⁸ Refco committed to a minimum \$25 million annual pay down, and AA committed to review the balances again the following year.²⁰⁹ Yet, for fiscal year 2000, there was no reference to discussion of the affiliate receivables during the audit period beyond Bennett's representation that there had been no additions to the balance and the attachment of Ramler's 1999 memorandum to the planning meeting report for the fiscal year 2000 audit.²¹⁰

b. AA's Recognition of the High Risk of Misstatement Attendant to Related Party Transactions

AA provided standard tools to its auditors for assessing audit risk, some of which were used to determine whether the engagement would be retained year to year. From at least 1998

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ *See id.*

²⁰⁸ See AAREF 00003029 at 3032, at App. D-8 (May 19, 1999 Audit Sign Off Meeting Memorandum). AA also discussed the receivables with Bennett and Trosten at a 1999 audit pre-closing meeting days prior to the closing meeting. AAREF 00003022 (May 6, 1999 Audit Pre-Closing Meeting Memorandum). It was at this meeting that AA first proposed a plan for Refco to pay down the debt over five years, explaining that “Refco needs to have the intent and ability to pay down the receivable or else it is deemed a dividend,” and Refco management first committed to paying the receivable balance down by \$25 million per year through a dividend. *Id.* at 00003024.

²⁰⁹ *See id.*

through 2002, AA auditors, as part of the pre-audit procedures, completed the “Smart Tool” electronic form provided by AA.²¹¹ The completed Smart Tool forms maintained in the workpapers for the 1998 through 2000 audits show that AA identified as “significant” or “very significant” audit risk areas that ultimately were the very means used to commit the fraud at Refco. Yet, AA failed to design audit procedures addressing these risks to reduce them to an acceptable level.

For example, for the audit of fiscal year 1999, the Smart Tool form for the Refco audit shows that in assessing “Accounting and Financial Reporting Risk” that may lead to the risk of financial statement misstatements, the auditors considered the “Transactions with related parties,” one of three risk factors under “Complex/risky transactions,” as “Very Significant.”²¹² Under the misstatement risk from “Complex/risky accounts,” the auditors rated both “Collectability of receivables” and “Investment audited by others or unaudited” as “Significant.”²¹³

The Smart Tool forms also show that AA considered the risk presented by the fact that Refco’s parent, RGHI, was not audited.²¹⁴ This risk factor carried a specific warning that “There may be significant risks due to the fact the entity’s parent is audited by other auditors or unaudited,” and required that a resolution of this risk be documented.²¹⁵ For the 1999 audit, the

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²¹⁰ See AAREF 00007740 at 7741, 7745 (November 2, 1999 Audit Closing and Planning Memorandum to fiscal year 2000 audit workpapers).

²¹¹ See, e.g., AAREF 00020019 (Fiscal Year 1998 Smart Tool form); AAREF 00002635 (Fiscal Year 1999 Smart Tool form); AAREF 00011972 (Fiscal Year 2000 Smart Tool form); AAREF 00012138 (Fiscal Year 2002 Smart Tool form).

²¹² AAREF 00002635 at 2645 (Fiscal Year 1999 Audit Smart Tool form).

²¹³ *Id.*

²¹⁴ See *id.* at 2655.

²¹⁵ *Id.*

auditors resolved it simply by noting on the form, “As the majority of balances in Refco Group Holdings, Inc. are intercompany accounts, which have been tested through the audit of the Group or are guaranteed by shareholders of the Company, there is limited risk.”²¹⁶ As discussed later in this Report, however, related party transactions were not audited in conformance with GAAS, especially considering AA’s determination that related party transactions created a very significant risk.

For the audit of fiscal year 2000, the auditors repeated the same notation for resolving the risk from an unconsolidated parent as that quoted above.²¹⁷ The balance of Smart Tool risk factor assessments likewise mirrored those of 1999.²¹⁸ But once again, the Examiner could find no procedures or tasks memorialized in the workpapers for the 2000 audit specifically geared to ameliorating these risks through the design and implementation of appropriate audit procedures.

In 2002, the auditors employed a new audit tool, “The Business Audit,” in addition to using the Smart Tool.²¹⁹ The Business Audit Tool provided a checklist of review items for a completed audit, including questions related to whether other audit tools were used, such as the Smart Tool and fraud risk forms, to which the auditor was to respond “yes” or “no,” explaining any “no” answers.²²⁰ Specifically as to related parties, the Business Audit tool asked “Were procedures performed (including inquiry) to obtain evidence regarding the identification and disclosure of related parties and the effect of material related party transactions on the financial

²¹⁶ *Id.*

²¹⁷ See AAREF 00011972 at 979 (Fiscal Year 2000 Audit Smart Tool form).

²¹⁸ *See id.*

²¹⁹ AAREF 00012114.

²²⁰ *See generally id.*

statements?"²²¹ The Refco auditors responded, "yes."²²² Yet the Examiner could not identify any procedures in the 2002 audit workpapers directed to determining the effect of material related party transactions on the financial statements, or any other procedure directed to related party identification and disclosure, different than those that were ineffective in past years.

c. AA's Failure to Comply with GAAS with Respect to Auditing the Transactions with RGHI

The Examiner could not determine what, if any, specific planning for or testing of related party transactions AA undertook because there was no written audit plan contained in the audit workpapers for any of the audit years 1998 through 2002. Witnesses confirmed that there was no formal audit plan during the 1998 to 2002 audit years.²²³ And, despite repeated requests by the Examiner, AA failed to identify any.²²⁴

Moreover, although AA repeatedly expressed concern over related party loans in 1998 and 1999, and obtained a commitment from Refco management to retire the debt by at least \$25 million per year, the Examiner did not identify any verification by AA that the loans were actually being paid down. Nor did the Examiner locate any evidence that AA verified by review of source documentation either the loans themselves or any accrued interest charges. Rather,

²²¹ *Id.* at 12119.

²²² *Id.*

²²³ The Examiner interviewed several former AA employees assigned to the Refco audits of 1998 through 2002, and none could recall the preparation or even existence of any formal audit plan for the Refco audits of those years. Rather, the witnesses represented that the audit team informally, mostly verbally, kept track of being "on plan" for the audit and that "experienced people knew what had to be done to gain comfort." Kesh Interview, January 30, 2007.

²²⁴ The only evidence of audit plans of any type located in AA's workpapers predate 1998. For example, the Examiner found that for the 1996 audit, AA prepared a "Work Program" for the RCC audit. *See* AAREF 00025711-7114 (Liabilities); AAREF 00025545-546 (Financial Reporting Cycle). AA also prepared "audit Planning Memos" for the audits of RGL, AAREF 00034360 (1995 Audit Planning Memo); AAREF 00027144 (1997 Audit Planning Memo), RCC, AAREF 00034352 (1995); AAREF 00025331 (1996); AAREF 00027136 (1997), and RGF, AAREF 00035795 (1995); AAREF 00023726 (1996). Audit procedures were also generally described in an "audit planning memorandum" dated April 9, 1997 specific to the audit of RCM. *See* AAREF 00027151.

beginning with the year 2000 audit, it appears AA simply accepted at face value the “Schedule of Loans to Shareholders and Unconsolidated Affiliates” provided by Refco for each of years 2000, 2001 and 2002 showing a \$16 million credit from a subordinated debt owed by Refco to RGHI and a \$10 million “Capital Infusion” credit (\$26 million total) deducted from the overall affiliate loan net total balance as being in compliance with management’s agreement to reduce the loan balance by at least \$25 million per year.²²⁵

If AA had tested the loan balances as scheduled in comparison to the year-end transactions between the affiliates, it would have learned that, while ostensibly reducing its related party debt, RGHI was actually *receiving* substantial credits²²⁶ from the same related parties to whom the schedules stated it was indebted. For example, the “Schedule of Loans to Shareholders and Unconsolidated Affiliates” for year 2001 lists a loan from RGF to RGHI of \$66.4 million.²²⁷ But on February 23, 2001, only days before the end of the fiscal year, RGF transferred \$250 million from its account at RCM to the credit of RGHI.²²⁸ This transaction was documented on the RGF statement of its RCM account maintained in the AA workpapers as support for amounts “Due from Affiliates.”²²⁹ Similarly, the 2002 “Schedule of Loans to Shareholders and Unconsolidated Affiliates” referenced a loan from RGF to RGHI with a year-end balance of \$65.4 million.²³⁰ But on February 25, 2002, again only days before the end of the fiscal year, RGF made a \$625 million wire transfer “TO RGHI” from its account at RCM.²³¹

²²⁵ See, *supra*, n. 208.

²²⁶ The Examiner was unable to determine that any cash was transferred in any years except for certain wire transfers in 1998 and 1999, and possibly 2000.

²²⁷ See AAREF 00010202 (2001 Schedule of Loans to Stockholders and Unconsolidated Affiliates).

²²⁸ See AAREF 00009159 at 9162 (February 2001 customer statement for RGF’s account at RCM (no. 13 006)).

²²⁹ See *id.*

²³⁰ See AAREF 00012494 (2002 Schedule of Loans to Stockholders and Unconsolidated Affiliates).

Though AA was provided both the schedules of loans and the RGF account statements reflecting these transfers, it apparently never questioned the large round-dollar amount transfers from one unconsolidated, unaudited related party to another near the end of a fiscal year.²³²

The Examiner has determined that rather than obtaining and reviewing loan documentation and other source documents,²³³ the extent of AA's review of related party receivables — aside from simply accepting the balances as reflected on the various Refco-provided financial statements — was apparently to send a confirmation request to related parties seeking to have the related party confirm the balance of its customer account, or confirm its loan balances and accrued interest.

As a regular part of the audit process, AA was provided with a list of RCC, RCM and Refco, Inc. customer account balances. Using forms to determine a level of materiality of individual account balances in relation to the total amount of all account balances, *i.e.*, the level at which a customer account balance error could materially affect the total customer payable or receivable balance on a given entity's financial statement, AA determined what minimum and above account balances would be confirmed with the individual customer as part of the audit

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²³¹ See AAREF 00013257 at 13259 (February 2002 customer statement for RGF's account at RCM (no. 13 001)).

²³² In the years prior to the 1998 audit, AA also audited RGF. In the 1996 audit of RGF, while auditing the loans reflected on RGF's financial statements, AA found that related party "loans [were] properly recorded on RGF's and its affiliates' books and records and the proper disclosures [were] made in the financial statements." AAREF 00023726 at 728 (RGF Audit Planning Memo for fiscal year 1996). But for the audit years 1998 through 2002, AA issued no audited financial statements for RGF. Nor does it appear that AA reviewed any RGF financial statements. Rather, AA limited its review of RGF "to be determined based on materiality of individual account balances" at year end. AAREF 00002665 at 2671 (1999 PBC list). For the 1998 to 2002 audit years, the only RGF materials AA maintained in the work files were the RGF statements of its account at RCM.

²³³ For the 1998 audit, Kesh prepared a memorandum to the workpaper file detailing the loan procedures of RCC. The memorandum explains that RCC required a promissory note for *all* loans to affiliates. AAREF 00018577 at 579.

process.²³⁴ AA then prepared a letter for the client's signature requesting the customer to review an attached account statement, or account balances printed directly on the letter request, to confirm the ending account balance was properly stated, sign the request, and return it to the auditor.²³⁵ AA mailed the confirmation requests, and received and logged the responses.²³⁶ Further review would only be done if the customer disputed the account balance referenced on the request.

From 1998 to 2001, AA not only sent these confirmation requests to third-party customers, but also to any related parties having accounts with RCM, RCC or Refco, Inc. For RGHI, AA simply sent confirmation requests annually asking it to confirm its RCM account balances.²³⁷ Similarly, AA sent confirmation requests to RGHI annually asking it to confirm its unsecured loan balances with RCC.²³⁸

This *de minimis* procedure involving a confirmation request to a related party ceased in 2002 when Ramler and manager Schneider determined it was a useless exercise. Schneider explained to the Examiner during her interview that the practice of sending a confirmation to a related party was not worth doing because it did not provide the level of assurance that would be obtained when confirming a balance due from an *unrelated* party. According to Schneider, it made little sense having Phil Silverman ("Silverman"), the Controller of RCC, send an audit confirmation to himself as Controller of RGHI.²³⁹ Schneider discussed the lack of effectiveness

²³⁴ See AAREF 00005802 at 5803 (Note to Refco, Inc. Customer Equity Report); AAREF 00011779 at 780 (April 30, 2001 Memorandum to fiscal year 2001 audit workpaper on Confirmation Issues).

²³⁵ See, e.g., *id.*; AAREF 00002663.

²³⁶ See, e.g., *id.*; AAREF 00002663.

²³⁷ See AAREF 00006387 at 6388 (April 20, 2000 Confirmation Request Letter from RCM to RGHI).

²³⁸ See AAREF 00007369 (April 13, 2000 Confirmation Request Letter from RCC to RGHI).

²³⁹ Schneider Interview, February 8, 2007.

of such a confirmation process with Ramler, and he agreed there was no reason to continue to send confirmation requests to RGHI.²⁴⁰

AA apparently did not perform any alternative procedures that would have provided adequate assurance that related party transactions were accurately presented in Refco's financial statements, despite the tacit acknowledgement that the confirmation procedures on which AA had previously relied were essentially worthless.

In each of the 1998 through 2002 RGL consolidated financial statements, the footnotes referencing related party transactions reflected the total affiliate receivable and payable balances as provided by Refco. The footnotes identify these balances as occurring "in the normal course of [RGL's] business,"²⁴¹ ostensibly including those with RGHI. The Examiner could find no basis for this statement. There is no indication in the workpapers that AA ever examined any of the transactions making up these balances in order to determine their business purpose. In fact, when clearing the initial engagement with GT, Ramler stated that RGHI was the parent of Refco with no operations, and its loans with subsidiaries pre-dated even his involvement with the Refco audits beginning in the late 1980s.²⁴² Former audit personnel interviewed by the Examiner's counsel confirmed that the review of these balances went no further than verifying that an affiliate receivable of one consolidated entity was offset by a payable on the books of another related party.²⁴³

²⁴⁰ See *id.*

²⁴¹ See, e.g., AAREF 0004976 at 4986 (Fiscal Year 1999 RGL Consolidated Financial Statement, Footnote 7 – Related Party Transactions).

²⁴² See GT SEC 0130512 at 521, at App. D-4 (Ramler's explanation of related party transactions for GT "Evaluation of Proposed Client" Form).

²⁴³ See, e.g., AAREF 00012317 (May 30, 2002 Memorandum to 2002 Audit File explaining related party information was tied to financial statements of each related party).

Moreover, although AA knew that a portion of the related party loan balance referenced in the footnotes of RGL's financial statements arose from RGHI's customer account balances with RCM and RCC, there is no evidence that the auditors reviewed those accounts or the statements used for confirmations beyond confirming the end balances. Had AA simply requested and analyzed the monthly statements for these accounts, as a reasonably skeptical auditor would have done before concluding that the related party loans arose in the "normal course of business," it likely would have discovered the fraudulent manipulation.²⁴⁴

For example, the audit year 1999 RCM account confirmation request sent to RGHI included an account statement showing a swing in the RGHI account balance during the final month of Refco's fiscal year from an \$82 million *debit* balance to a \$25 million *credit* balance.²⁴⁵ The account statement accompanying the RCM account confirmation request to RGHI for the 2000 audit year showed four separate large round-dollar cash transfers to RGHI's account, totaling \$357 million, only days before the fiscal year end, taking RGHI's account from a \$334 million *debit* balance to a \$19 million *credit* balance.²⁴⁶ Nothing in these account statements or AA's workpapers supports the assertion that these year-end transactions with RGHI were "in the normal course of business" as represented by the footnotes on related party transactions contained in the RGL financial statements.²⁴⁷

²⁴⁴ AU § 334 *et seq.*

²⁴⁵ See AAREF 00000569 at 575, at App. D-9 (April 7, 1999 Confirmation Request Letter from RCM to RGHI and attached February 1999 RGHI Statement of Account at RCM).

²⁴⁶ See AAREF 00006387 at 6388 (April 14, 2000 Confirmation Request Letter from RCM to RGHI).

²⁴⁷ See, e.g., AAREF 0004976 at 4986 (Fiscal Year 1999 RGL Consolidated Financial Statement, Footnote 7 – Related Party Transactions).

d. AA's Failure to Discover the Manipulation of the Niederhoffer Losses Through Proper Testing of Related Party Transactions with RGHI

As a result of the 1997 collapse of the Asian markets, Refco incurred losses which were hidden. As part of its business, Refco extended credit to customers who engaged in securities, commodities, and futures trades. One of those customers was a money manager named Victor Niederhoffer (“Niederhoffer”), who lost more than \$90 million on investments placed through Refco, Inc. when the Asian markets collapsed in 1997, and Refco was required to meet the margin call on Niederhoffer’s investments.

To hide these losses, Refco purportedly assigned to Wells, Ltd. (a subsidiary of RGHI) \$71 million of the amounts lost by Niederhoffer.²⁴⁸ AA apparently was unaware of this assignment agreement and the full extent of the losses incurred by Refco, Inc. in covering Niederhoffer’s margin calls. Further, AA was apparently unaware that Refco, Inc. moved \$71 million of that loss off its books and increased the receivable due from RGHI by a like amount.

During the course of its audit of Refco’s fiscal year ended February 28, 1998, AA was well aware that Niederhoffer had most likely suffered large losses in his accounts held at Refco due to the collapse of the Asian markets, and that Refco “might be on the hook for millions.”²⁴⁹ AA apparently accepted management’s representations that the Niederhoffer losses were much less than they really were.²⁵⁰

²⁴⁸ Assignment Agreement dated October 28, 1997 between Refco, Inc. and Wells Ltd., at App. D-10.

²⁴⁹ AA’s workpapers for the audit of Refco’s fiscal year ended February 28, 1998 included a press article describing Niederhoffer’s losses and indicating that Refco might be liable for his losses. *See* AAREF 00020014-15, Wall Street Journal Article found in AA’s workpapers entitled, *The Market Calms Down: Niederhoffer is Sunk by Market Maelstrom*.

²⁵⁰ During the audit for the 1998 fiscal year, AA accepted the debit balances (*i.e.*, the purported amounts due from Niederhoffer to Refco, Inc.) as \$27.6 million. Indeed, from the 1998 audit period forward, the audit workpapers consistently show that AA tracked the Niederhoffer Funds’ balances as presented by the Refco Inc. financial statements and recommendations for bad debt reserves on the accounts provided by Refco’s management, with no

(footnote continued on next page)

While AA did apparently send out audit confirmation letters to confirm the balance of the losses — *i.e.*, the amounts that Refco books disclosed were incurred in covering losses on Niederhoffer's behalf, those confirmations were of little utility because AA knew from press articles that Refco had taken over the accounts.²⁵¹ In other words, AA, in essence, sent confirmation requests to Refco itself.

More fundamentally, AA failed to verify the full amount of the Niederhoffer losses borne by Refco, Inc., or that a substantial portion of such losses had been shifted from Refco, Inc. to RGHI, even though compliance with GAAS in the auditing of related party transactions with RGHI could have uncovered the fraudulent entries.²⁵²

RGHI, as the parent of Refco, was a known related party that supposedly transacted business in the ordinary course with Refco subsidiaries such as RCM and RCC. Thus, in order to obtain a reasonable assurance of the nature, substance and amount of Refco's related party

(footnote continued from previous page)

meaningful testing of the balances referenced at any time. *See, e.g.*, AAREF 00020226 (May 12, 1998 Audit Status Meeting Agenda recommending a \$13.5 million reserve for Niederhoffer). This tracking continued through the 1998, 1999 and 2000 audit years.

More specifically, during the 1999 fiscal year audit, the Refco, Inc. financial statements showed the Niederhoffer balance as lower than the prior year, \$26.1 million, but there is no indication AA verified the basis for the reduction, [AAREF 00001742 (fiscal year 1999 Refco, Inc. A/R Allowance Analysis)] even though AA required that Refco increase the reserve against the Niederhoffer accounts to \$20 million. *See* AAREF 00003022 at 3025 (May 6, 1999 Pre-closing Meeting Memo). For the fiscal year 2000 audit, AA recommended fully reserving the \$26.1 million Niederhoffer balance. *See* AAREF 00007247 at 7248 (notes to fiscal year 2000 Refco, Inc. listing of Significant Customer Debit Balances). Then, during the 2001 fiscal year audit, AA noted that \$8.7 million of the Niederhoffer balance was unsecured and reserved in the Refco, Inc. financial statements, with the balance of \$18 million being carried on the financial statements of RGL. *See* AAREF 00009683 at 9684 (notes to fiscal year 2001 Refco, Inc. listing of Significant Customer Debit Balances). The \$8.8 million remaining with Refco, Inc. was then written off in fiscal year 2002. *See* GT SEC 0129191 (April 26, 2002 Audit Status Meeting Agenda). Thus, although AA dutifully reserved against the amount Refco represented was due from Niederhoffer, it failed to discover the true amount of the losses Refco had to cover on Niederhoffer's behalf because it failed to properly audit related party transactions between RGHI and Refco, Inc.

²⁵¹ *See* AAREF 00020014-15, Wall Street Journal Article found in AA's workpapers entitled, *The Market Calms Down: Niederhoffer is Sunk by Market Maelstrom* ("Refco, Inc. ... has taken effective control of what remains of the portfolio").

²⁵² *See* AU § 334, *et seq.*; SAS 82 ¶ 29.

transactions with RGHI, AA should have obtained and reviewed the account statements for RGHI's customer account at RCM (in 1997, account no. 004521-00000, but changed subsequently to no. 10002657). If it had done so, AA would have noticed that those statements reflected a \$71 million debit (*i.e.*, an increase in the amount owed to RCM by RGHI) to "RECORD REC'BLE FR WELLS 10/29/[97]."²⁵³ Because AA also knew that Wells Ltd. was a related party,²⁵⁴ it most likely would have questioned why the receivable due to RCM from RGHI was being increased in order to book an amount due to Refco from Wells Ltd. In addition, a properly skeptical auditor, employing a questioning mind and making a critical evaluation of audit evidence, would have requested documentation supporting this transaction.²⁵⁵ If AA had done so, it very likely would have discovered that Refco, Inc. shifted its losses relating to Niederhoffer off its books and onto those of an unconsolidated related party. AA's failure to obtain and review the statements for RGHI's customer account at RCM is evidence of its negligence.

e. AA's Failure to Detect and/or Act upon "Red Flags" Regarding Refco Related Party Transactions

(i) *The Initial Manipulation of RGHI's Account Balance at RCM*

One of the first manipulations of the RGHI Receivable during the relevant years occurred on February 26 and 27, 1998, just days before the close of RGL's 1998 fiscal year. On those dates, RGHI's account at RCC was credited by \$175 million in a series of four WTLs booked by

²⁵³ Customer statement for RGHI account no. 004521-00000 at RCM for October 1997.

²⁵⁴ See AAREF 00015841 at 15843, at App. D-6 (1998 Schedule of Loans to Stockholders and Unconsolidated Affiliates).

²⁵⁵ AU § 334, *et seq.*; SAS 82 ¶ 29.

RCM as “repos”²⁵⁶ through the accounts of three RCM customers. AA apparently failed to review the customer statement for the RGHI account at RCC, and there is nothing in the work papers analyzing this massive influx of cash just days before year end. If it had done so, it would have noticed the source of the funds and likely would have discovered, from other documents AA had already obtained, that Refco had moved the funds of four RCM customers into RGHI’s account at RCC.

Specifically, Tradewinds Debt Strategies Fund transferred \$50 million from its RCM account (no. 004177-00000) to RGHI’s account (no. 1690-001) at RCC.²⁵⁷ The transfer was booked by RCM as a “repo” but identified as a “US DOLLAR LOAN” dated February 26, 1998 with a repo termination date of March 3, 1998 — just after the close of the 1998 fiscal year.²⁵⁸ Tradewinds Emerging Debt Fund transferred \$25 million from its RCM account (no. 004233-00000) to RGHI’s account (no. 1690-001) at RCC.²⁵⁹ The transfer was booked by RCM as a repo, but identified as a “US DOLLAR LOAN” dated February 27, 1998 with a repo termination date of March 3, 1998.²⁶⁰ Similarly, MLC transferred \$50 million from its RCM account (no. 004292-10403) to RGHI’s account (no. 1690-001) at RCC on February 26, 1998, and then

²⁵⁶ Repo and reverse repo transactions were a significant portion of Refco’s assets. “Repo” is an abbreviation of “repurchase.” Repo and reverse repo transactions are both securities sale and repurchase agreements executed between two parties. In both transactions, the party selling the security receives cash against the value of the security and promises to buy the security back from the purchaser at some point in the future. Typically, the party providing the cash (*i.e.*, the purchaser) will take possession of the securities involved in the transaction as collateral for its temporary outlay of cash to the seller. In essence, the transactions are loans collateralized by securities.

²⁵⁷ Compare February 1998 customer statement for Tradewinds Debt Strategies Fund’s account at RCM (no. 004177-00000) with February 1998 customer statement for RGHI’s account at RCC (no. 1690-001).

²⁵⁸ See AAREF 00019260 at 264 (February 1998 RCM EQ division Forward Repo/Reverse Repo Report).

²⁵⁹ Compare February 1998 customer statement for Tradewinds Emerging Debt Fund’s account at RCM (no. 004233-00000) with the February 1998 customer statement for RGHI’s customer account at RCC (no. 1690-001).

²⁶⁰ See, *supra*, n.258.

another \$50 million from the same account to RGHI's RCC account on February 27, 1998.²⁶¹

Both transfers were booked by RCM as "repos," but each was identified as a "US DOLLAR LOAN" with a repo termination date of March 3, 1998.²⁶²

The result of these transfers was to take RGHI's RCM account balance from a \$130 million *debit* balance to a \$43 million *credit* balance. During the 1998 fiscal year audit, AA confirmed loan account balances for RCC customers, including that for RGHI's account number 1690-002 with a \$4.99 million debit balance.²⁶³ But AA apparently took no steps to confirm the \$43 million *credit* balance of RHGI's RCM account number 1690-001. Moreover, AA reviewed the "Forward Repo/Reverse Repo Report" for RCM, which included the "repos" used to make the transfers to RGHI's RCC account.²⁶⁴ During the same audit, AA was reviewing and documenting the plans for MLC to receive \$100 million in preferred stock from RCM International, detailed in a memorandum to the working papers by audit senior Kesh on April 22, 1998.²⁶⁵ Still, the workpapers do not reflect that AA questioned at all the \$100 million in "US DOLLAR LOANS" taken out from RCM by MLC days before fiscal year end and having a termination date only three days after the close of the fiscal year, even though the memorandum reflects that as part of the preferred stock arrangement, MLC was to receive a \$50 million dollar (versus \$100 million) credit facility from RGL or one of its affiliates.²⁶⁶

²⁶¹ Compare February 1998 customer statement for MLC's account at RCM (no. 004292-10403) with the February 1998 customer statement for RGHI's account at RCC (no. 690-001).

²⁶² AAREF 00019260 at 265.

²⁶³ See AAREF 00018667 (April 4, 1998 Confirmation Request Letter from RCC to RGHI).

²⁶⁴ AAREF 00019260 (February 1998 RCM EQ division Forward Repo/Reverse Repo Report).

²⁶⁵ See AAREF 00016535 at 536 (April 22, 1998 \$100 million Preferred Security Memorandum to fiscal year 1998 audit workpapers).

²⁶⁶ *Id.*

(ii) Additional MLC Funds Transfer to RGHI

For the 1999 audit, AA sent a confirmation request to RGHI concerning its account at RCM.²⁶⁷ The account statement accompanying the request shows a beginning *debit* balance of \$82 million and an ending *credit* balance of \$25 million.²⁶⁸ The huge swing in balance within the month of February 1999 was the result of a \$108 million cash transfer on February 23, 1999 from an entity called “MLC,” listed as a “TRANSFER FR MLC TO RGHI.”²⁶⁹

The transaction was mirrored in MLC’s statement accompanying the confirmation request sent to MLC as part of the 1999 audit for its account at RCM.²⁷⁰ MLC’s statement listed a “TRANSFER FR MLC TO RGHI” of \$108 million on February 23, 1999, taking MLC’s RCM account from a \$5,303 *credit* balance to a \$108 million *debit* balance. In addition, MLC’s February 1999 RCM account statement listed additional transfers to RGHI, but to RGHI’s account at RCC. Listed on the MLC statement are three transfers on February 23, 1999 described as “WIRE TO RCC A/C RGHI,” the first for \$9.6 million, the second for \$2.772 million, and a third for \$4.253 million.²⁷¹ In sum, the MLC account statement reflects MLC transferring \$125 million from its RCM account for the credit of RGHI, taking the account from a \$5,303 *credit* balance to a \$125 million *debit* balance.²⁷²

To mask the transactions, the statement also lists a February 23, 1999 “credit” to MLC for a “PHYSICAL SETTLEMENT” of \$125 million, reducing the ending balance of MLC’s

²⁶⁷ See AAREF 00000569, at App. D-9 (April 7, 1999 Confirmation Request Letter from RCM to RGHI with February 1999 RGHI Account Statement).

²⁶⁸ See *id.* at 576.

²⁶⁹ See *id.* at 575.

²⁷⁰ See AAREF 00004724 (April 7, 1999 Confirmation Request Letter from RCM to MLC with February 1999 MLC Account Statement).

²⁷¹ See *id.* at 4727.

²⁷² See *id.*

RCM account for February 1999 back to a \$5,303 *credit* cash balance.²⁷³ The statement details this “credit” as a “US Dollar Term Loan” for \$125 million dated February 23, 1999.²⁷⁴ The “loan” is secured by “inventory” of 1 million shares of preferred convertible stock in RCM International valued, per the account statement, at \$100 per share for a total stated value of \$100 million.²⁷⁵ The “inventory” section of the MLC account statement also lists the \$125 million short term loan as a “debit,” resulting in a \$25 million “net” inventory debit balance,²⁷⁶ and a \$25.1 million *debit* balance as the February 28, 1999 “total account value.”²⁷⁷

AA was aware of MLC’s inventory of preferred RCM International stock. Audit senior Kesh prepared a memorandum to the 1998 audit work file on RCM’s investment in MLC.²⁷⁸ AA then reviewed RCM’s investment in MLC during the 1999 audit, including a review of MLC’s financial statements.²⁷⁹ Furthermore, AA was aware of and addressed the debit balance of MLC’s account with RCM.²⁸⁰ As part of its audit, AA tested RCM accounts with debit balances and assessed them for collectability.²⁸¹ For the 1999 fiscal year audit, AA prepared a “Debit Balance Testing Memo,” listing “issues [with] debit balances.”²⁸² But for the MLC debit balance, the extent of AA’s test for collectability of the MLC’s accounts, or any review of MLC accounts with RCM at all, was to note: “Accounts returned to credit balance a few days after

²⁷³ See *id.*

²⁷⁴ See *id.* at 4728.

²⁷⁵ See *id.*

²⁷⁶ See *id.*

²⁷⁷ See *id.* at 4729.

²⁷⁸ See AAREF 00016535 at 536 (April 22, 1998 \$100 million Preferred Security Memorandum to fiscal year 1998 audit workpapers).

²⁷⁹ See AAREF 00002516 (April 9, 1999 Letter request for investment confirmation from RGL to MLC).

²⁸⁰ See AAREF 00000505 at 509 (fiscal year 1999 audit Debit Testing memo to audit workpapers).

²⁸¹ See *id.*

year end when Refco repaid the \$100 million preferred securities. On an overall basis, MLC maintained a credit balance.”²⁸³ The Examiner found no evidence that AA analyzed the MLC account beyond confirmation of the debit balance and review of the post year-end balance. Despite MLC’s status as a related party by virtue of RCM’s investment, and the complete lack of any role by RGHI in the MLC investment transaction, AA apparently made no inquiry into the \$125 million transfer to various RGHI accounts days before year end 1999 funded by moneys RCM loaned to MLC. The complete lack of any questions regarding this series of related party transactions shows AA failed to exercise appropriate skepticism.²⁸⁴

(iii) BriBank Funds Transfer to RGHI

The 1999 audit confirmation requests in AA’s workpapers reflected a further wire transfer to RGHI of \$50 million from BriBank.²⁸⁵ The account statement accompanying the account confirmation request to BriBank for its account with RCM listed the \$50 million “WIRE TRANSFER TO RGHI” from BriBank’s account on February 24, 1999.²⁸⁶ At the time, BriBank’s account had a \$9.7 million *debit* cash balance.²⁸⁷ The wire transfer took BriBank’s RCM account to a \$59.7 million *debit* balance, but this was then offset through a \$50 million short term *loan* by RCM to BriBank on the same day, February 24, 1999, bringing BriBank’s account back to a \$9.7 million *debit* cash balance.²⁸⁸

(footnote continued from previous page)

²⁸² *See id.*

²⁸³ *See id.*

²⁸⁴ AU §§ 334.04, 334.8; SAS 82 ¶ 29.

²⁸⁵ *See* AAREF 00601 (April 7, 1999 Confirmation Request Letter from RCM to BriBank with February 1999 BriBank Account Statement).

²⁸⁶ *See id.* at 604.

²⁸⁷ *See id.*

²⁸⁸ *See id.*

BriBank was the subject of an inquiry by AA in 1999. As with MLC, BriBank was singled out during AA's debit testing process as a customer with a debit balance of questionable collectability.²⁸⁹ AA was concerned about BriBank's ability to pay down its \$9.9 million *debit* balance with RCM. More specifically, AA notes show that it learned from Refco management that BriBank was on a \$200,000 per month installment plan (which matches the installment payment the account statement shows for February 1999), with plans for installments and collateral deposits to pay off the debit balance by December 1999.²⁹⁰ But given AA's concern over the collectability of BriBank's \$9.9 million debit balance, one would expect a reasonable auditor to note and ask why BriBank was given an unsecured \$50 million loan and wired those funds to RGHI immediately prior to the end of Refco's fiscal year.²⁹¹ However, there is no evidence AA recognized either the total amount of debt or the unexplained wire transfer to affiliate RGHI.

(iv) EMF Funds Transfer to RGHI

The 1999 audit confirmation requests in AA's workpapers also reflected a wire transfer to RGHI of \$50 million from EMF, Ltd.²⁹² The account statement accompanying the account confirmation request to EMF for its RCM account lists a \$50 million "WIRE TRANSFER TO RGHI" from EMF's account on February 24, 1999.²⁹³ At the time, EMF's account had a \$2.5

²⁸⁹ See AAREF 00003029 at 3030, at App. D-8 (May 19, 1999 Sign-off Meeting Memorandum to workpapers); AAREF 00000505 at 507 (fiscal year 1999 audit Debit Testing memo to audit workpapers).

²⁹⁰ See AAREF 00000505 at 507 (fiscal year 1999 audit Debit Testing memo to audit workpapers).

²⁹¹ The Examiner discovered through a review of later AA e-mail correspondence that in approximately 1998-99, Refco obtained an ownership interest in BriBank by absorbing BriBank's losses in the Russian currency markets. See REFCO-E-002405482 (January 8, 2004 Refco internal e-mail). Thus, BriBank was a related party, but it appears that AA was not aware of that fact during the 1999 fiscal year audit.

²⁹² See AAREF 00004553 at 4579 (April 7, 1999 Confirmation Request Letter from RCM to EMF with February 1999 EMF Account Statement).

²⁹³ See *id.*

million *credit* cash balance.²⁹⁴ The wire transfer took EMF's account to a \$47.5 million *debit* balance, but this was then offset by a \$50 million short term *loan* by RCM to EMF on the same day, February 24, 1999, bringing EMF's account back to a \$2.5 million *credit* cash balance.²⁹⁵

As with BriBank, EMF was singled out by AA during the 1999 fiscal year audit as a customer with a debit balance having questionable collectability.²⁹⁶ Yet AA apparently did not question its \$50 million transfer to RGHI days before the close of fiscal year 1999, or even wonder why Refco would extend an additional \$50 million loan to EMF.²⁹⁷ Instead, AA only noted that EMF's account balance was returned to a credit balance by May 17, 1999, after the close of the 1999 fiscal year.²⁹⁸

(v) Major Changes to RGHI Account Balances

For the 2000 audit, as in prior years, AA confirmed the balance for RGHI's account at RCM (no. 10002657). The statement of account identified four separate large round-dollar cash transfers on February 25, 2000 to RGHI's account at RCM, totaling \$357 million, and taking RGHI's account from a \$334 million *debit* balance on February 1, 2000 to a \$19 million *credit* balance on February 28, 2000.²⁹⁹ The account statement lists three of these transfers as "FUNDS RECEIVED" in amounts of \$50 million, \$110 million and \$150 million on February 25, 2000,

²⁹⁴ See *id.*

²⁹⁵ See *id.*

²⁹⁶ See AAREF 00000505 at 508 (fiscal year 1999 audit Debit Testing memo to audit workpapers).

²⁹⁷ See *id.*

²⁹⁸ See *id.*

²⁹⁹ See AAREF 00006387 at 6388-6389 (April 14, 2000 Confirmation Request Letter from RCM to RGHI with February 2000 RGHI Account Statement).

and the fourth as “REC FDS FOR REFCO GLOBAL HOLDINGS” in the amount of \$47 million the same day.³⁰⁰

There is no evidence AA questioned the source of funds or the drastic change in the account balance only days before the close of the fiscal year.³⁰¹ Had AA questioned the source of funds, it would likely have found that the three transfers labeled as “FUNDS RECEIVED” were transfers from the accounts of three other RCM customers, with EMF transferring \$50 million from its RCM account (no. 10003358);³⁰² CS Land transferring \$110 million from an account opened *on that day* (no. 10008225) using money loaned to it by RCM for this purpose;³⁰³ and CIM Ventures transferring \$150 million from its RCM account (no. 006800-10101).³⁰⁴ The fourth transfer for \$47 million was from RGHI’s account number 1690-001 at RCC, which had just received \$300 million from BAWAG.³⁰⁵

³⁰⁰ See *id.* at 6388.

³⁰¹ Similarly, the MLC transfer to RGHI in February 1999 detailed above showed the transaction brought RGHI’s RCM customer account balance from a February 1999 beginning debit balance of \$82 million to an ending credit balance of \$25 million. See AAREF 0000569 at 575 (April 7, 1999 Confirmation Request Letter from RCM to RGHI with February 1999 RGHI Account Statement).

³⁰² The February 25, 2000 Cash Disbursements Journal for RCM shows the \$50 million, \$110 million, and \$150 million payments being taken from the three customers’ accounts with the description “WIRE TFR TO REFCO GROUP H.” That same document shows those funds being credited to RGHI’s account at RCM (no. 10002657) as “FUNDS RECEIVED.” See also AA review of the Margin Call Summary Report for RCM’s EQ Division, AAREF 00005997 at 5999, listing EMF account 10003358 as having an equity debit balance of \$49,999,884.

³⁰³ See, *supra*, n.302. See also AA review of the Margin Call Summary Report for RCM’s EQ Division, AAREF 00005997 at 5999, listing CS Land account 10008225 as having an equity debit balance of \$110 million.

³⁰⁴ See, *supra*, n.302. See also AA review of the Customer Receivables for RCM’s EQ Division, including a Time Deposit Directory report listing CIM Ventures account 006800 as having a US Dollar Loan of \$150 million dated February 25, 2000 with a termination date of March 9, 2000. See AAREF 00006093 at 6096.

³⁰⁵ February 2000 customer statement for RGHI’s account at RCC (no. 1690-001).

(vi) Unusual Relationship Between the RGHI Receivable Balance and Interest on that Balance

(a) RGHI Interest Accrual Issues

For the year 2000 audit, AA sent a request to RGHI seeking confirmation of its unsecured loan balances with RCC.³⁰⁶ The request detailed RGHI's customer account number 1690-001 as having a principal balance of \$44.3 million and an accrued interest charge of \$9.6 million.³⁰⁷ The Examiner could find no evidence in the workpapers that AA analyzed this loan, reviewed the loan documentation,³⁰⁸ tested the interest accrual, or questioned why the reported accrued interest of \$9.6 million on the \$44.3 million principal balance equates to a 22% annual interest rate.³⁰⁹

Had AA tested the interest accrual, or reviewed the account statements for the RGHI account at RCC, it likely would have discovered the fraud. Account statements the Examiner reviewed demonstrated that in January 2000, RGHI had a \$255 million account *debit* balance until January 25, 2000, when a series of four \$60 million wire transfer credits reduced the debit balance.³¹⁰ Thereafter, on February 24, 2000, through four journal entries to the RGHI account at RCC, the four \$60 million transfers were "reversed" as part of a series of transactions whereby \$47 million was wired out to another RGHI account, and \$300 million was wired into the account from BAWAG.³¹¹

³⁰⁶ See AAREF 00007369 (April 13, 2000 Confirmation Request Letter from RCC to RGHI).

³⁰⁷ See *id.*

³⁰⁸ See, *supra*, 1998 Kesh memorandum, n.233.

³⁰⁹ The 1998 Kesh memorandum also reported that the interest charged related parties ranged from the prime rate to three points above prime. See *id.*

³¹⁰ January 2000 Customer Statement for RGHI's account at RCC (no. 1690-001).

³¹¹ February 2000 Customer Statement for RGHI's account at RCC (no. 1690-001).

(b) Issues Revealed by AA Analyses

During the 2001 audit, AA performed a variation analysis comparing the interest income and expense booked by RCC in the fiscal years 2000 and 2001 tied to related party loans.³¹² The comparison revealed that from fiscal 2000 to fiscal 2001, RCC's interest income increased 44.4% from \$48.8 million to \$70.1 million.³¹³ RCC's interest expense also increased significantly, from \$43.6 million in fiscal 2000 to \$55.5 million in fiscal 2001, a 27.3% increase.³¹⁴ But between the two years, the comparison showed that total loan balances remained flat, with loans receivable for fiscal 2000 being \$656.8 million compared to \$675.9 million in 2001 (a 2.9% increase), and loans payable actually falling from \$624.7 million in fiscal 2000 to \$620.2 million for fiscal 2001 (a 0.7% reduction).³¹⁵ AA apparently sought an explanation for the large interest revenue and expense increases year to year while loans receivable and payable remained flat, discussing the findings with Silverman.³¹⁶ But AA apparently did no more with its questions than note Silverman's response, "These [loan] balances fluctuate through out the year. The balance was much higher throughout the year, resulting in increases in interest income and expense for the year."³¹⁷ Had AA properly discharged its duty of skepticism³¹⁸ and sought to verify the validity of Silverman's representation, it may have discovered the fraud by reviewing the loan accounts and finding the large, round-dollar reductions in loan balances just before each fiscal year end.

³¹² See AAREF 00009117 at 9119 (fiscal year 2001 Interest Income and Expense Variation Analysis).

³¹³ See *id.*

³¹⁴ See *id.*

³¹⁵ See *id.*

³¹⁶ See *id.* at 9118.

³¹⁷ See *id.*

³¹⁸ See AU §§ 230.8, 333.02, 334.04, 334.08.

f. AA's Awareness of and Failure to Properly Audit Related Party Transactions with BAWAG in Accordance with GAAS

A January 7, 1999 agenda for a meeting between AA and Refco management shows that Refco advised AA that BAWAG planned to invest in RGL, purchasing a ten percent share of RGL for \$85 million.³¹⁹ AA understood that the transaction would include a \$95 million loan from BAWAG to RGL “in anticipation of BAWAG buying another 10% by February 15, 2000.”³²⁰ AA followed up on the status of the BAWAG investment in a pre-closing meeting on May 6, 1999, noting in a memorandum to the file the following discussions with management during the meeting: “On May 14, 1999, BAWAG is expected to convert its \$95 million loan to RGL to an equity interest,” with the original \$85 million investment to “be extended to five years on the same day as the equity investment is made on May 14, 1999.”³²¹

The memorandum for the closing meeting makes no mention of any discussion regarding the BAWAG investment, or the status of the anticipated May 14, 1999 conversion of the BAWAG \$95 million loan to equity.³²² It appears that AA did not inquire and had no knowledge as to whether the additional 10% interest was ever purchased. Moreover, former managers Kesh and Schneider denied any knowledge that BAWAG had purchased an additional, undisclosed interest in Refco.

³¹⁹ AAREF 00003035 at 3039 (Agenda for January 7, 1999 Audit Status Meeting with Refco management).

³²⁰ See *id.* See also AAREF 00005096 at 5098-99 (April 22, 1999 Kesh Memorandum to File detailing the “BAWAG Loan Transaction”).

³²¹ See AAREF 00003022 at 3024 (notes from May 6, 1999 pre-closing meeting with Refco management).

³²² See AAREF 00003029, at App. D-8 (May 19, 1999 memorandum of notes to fiscal year 1999 audit workpapers on audit closing meeting with Refco management).

(i) AA's Knowledge of the Annual BAWAG Year-End Receivable

In addition to its knowledge of BAWAG's investment in RGL, and its related party status, AA also knew that BAWAG had large unsecured receivables owed to RCM. AA's workpapers for the fiscal year 2001 audit related to debit testing for RCM show that AA observed the unsecured \$225 million debit balance of BAWAG's account.³²³ AA apparently took no further action other than noting that BAWAG had a 10% ownership interest in Refco and that "Refco" was "required to post margin because BAWAG is a regulated entity."³²⁴

During the fiscal year 2002 audit, AA again reviewed RCM's significant unsecured customer debit balances.³²⁵ AA noted a \$210 million unsecured debit balance for BAWAG's account with RCM.³²⁶ AA again apparently took no action concerning the unsecured debit balance because "the referenced accounts are related parties, reducing the risk of loss through default."³²⁷

(ii) AA's Failure to Comply with GAAS with Respect to Auditing the Related Party Transactions with BAWAG

The Examiner could not determine what, if any, specific planning for or testing of related party transactions AA undertook because there was no written audit plan for any of the audit years 1998 through 2002 contained in the audit workpapers.

Although AA recognized BAWAG was a related party, it failed to exercise any professional skepticism regarding BAWAG's transactions with Refco related parties. Indeed,

³²³ AAREF 00010576 at 577 (fiscal year 2001 Debit Testing workpapers for RCM EQ division).

³²⁴ *See id.*

³²⁵ *See* AAREF 00013519 (fiscal year 2002 RCM Unsecured Debits Report).

³²⁶ *See id.*

³²⁷ *See id.*

even knowing that BAWAG had invested in RGL *after* management's expression of an exit strategy to sell Refco, there was no effort by AA to obtain competent evidentiary matter from which to determine the nature, purpose and amount of BAWAG's investment. Rather, and contrary to the professional guidance,³²⁸ it appears AA simply accepted management's representations regarding the significant debit balances BAWAG incurred with RCM just days before the close of the 2001 and 2002 fiscal years.³²⁹

In each of the 2001 and 2002 RGL financial statements on which AA issued an unqualified opinion, the footnotes disclosed related party transactions as occurring "in the normal course of [RGL's] business."³³⁰ AA knew that BAWAG was a related party — even justifying there being no reserve on its \$210 million unsecured debit balance for the fiscal year 2002 audit *because* it was a *known* related party.³³¹

Yet, despite this recognition of BAWAG's related party status, the BAWAG receivable was not included in the related party transactions footnote disclosures for either of the 2001 or 2002 RGL Consolidated Financial Statements. The BAWAG receivable should have been disclosed.

(iii) AA's Failure to Detect and/or Act Upon "Red Flags" Regarding the Related Party Transactions with BAWAG

Despite its knowledge of BAWAG's ownership interest and related party status, AA failed to obtain and evaluate competent evidence of the nature and purpose of the related party

³²⁸ See Professional Standards section IV.B.4, *supra*.

³²⁹ See AAREF 00010576 at 577 (fiscal year 2001 RCM Debit Testing Memo); AAREF 00013519 (fiscal year 2002 RCM Unsecured Debits Report).

³³⁰ See AAREF 00010176 at 188 (Fiscal Year 2001 RGL "Browncover" Consolidated Financial Statement, Footnote 8 – Related Party Transactions); AAREF 00013715 at 725 (Fiscal Year 2002 RGL Consolidated Financial Statement, Footnote 9 – Related Party Transactions).

³³¹ See, *supra*, footnote 326.

transactions resulting in BAWAG’s debit balances at RCM in 2001 and 2002. Rather, for the 2001 fiscal year audit, AA’s debit testing documentation reflects that AA apparently accepted an explanation by Refco management that “Refco” was “required to post margin because BAWAG is a regulated entity.”³³² The AA audit manager reviewed the work papers at her interview and advised that she assumed that this was necessary in order for RCM to trade with BAWAG.³³³ She further claimed that the \$225 million was not “unsecured” because it was a deposit by Refco with a right to have it returned.³³⁴

The Examiner could find no basis for a requirement that RCM post margin with BAWAG, and certainly none that would require posting margin to BAWAG’s trading account at RCM. The memorandum for the 1999 fiscal year audit planning meeting with management explains that the BAWAG investment and relationship with Refco was in part fueled by a business effort to have BAWAG’s banking and investment customers served by Refco, but doing so through BAWAG given Refco’s lack of name recognition and experience with BAWAG’s customers.³³⁵ Refco management advised at that meeting that it planned to place personnel at BAWAG; AA noted: “Customers will be customers of the bank, Refco will be the executioner. Customers don’t want to deal with Refco because not enough credit, but will deal with BAWAG.”³³⁶ By the post-1999 audit closing meeting on November 2, 1999, Refco management made AA aware that RCM’s fiscal year 2000 results year-to-date were “disappointing; expecting

³³² See AAREF 00010576 (fiscal year 2001 RCM Debit Testing Memo).

³³³ Schneider interview, February 8, 2007.

³³⁴ See *id.*

³³⁵ See AAREF 00003035 at 3039 (Agenda for January 7, 1999 Audit Planning Meeting with Refco management).

³³⁶ See *id.*

to leverage off of BAWAG relationship and increase accounts in October 99.”³³⁷ Thus, the explanation received by AA during the 2001 audit — that Refco had to post margins for that year in order to trade with BAWAG — does not make sense; no such requirement was in place in 1999.

Despite AA’s knowledge of BAWAG’s related party status for the 2001 fiscal year audit, the Examiner could find no indication in AA’s workpapers that AA reviewed the customer statements for BAWAG’s account at RCM. If AA had done so, it would have seen that BAWAG was generally making small foreign currency trades, compared to which the \$225 million debit immediately prior to the close of the 2001 fiscal year stood out starkly both in the amount and because it was in U.S. dollars.³³⁸ Further, the account statement showed the debit balance to be the result of a single transaction having nothing to do with RCM “posting margin” for trades it made with BAWAG.³³⁹

During the fiscal year 2002 audit, AA again failed to exercise the required skepticism regarding BAWAG’s significant \$210 million debit balance with RCM. AA once again identified BAWAG’s RCM debit balance as a material unsecured balance, but characterized it as having a low risk of default due simply to BAWAG’s status as a related party.³⁴⁰ As in 2001, the Examiner’s review showed that if AA had examined BAWAG’s RCM account statement, it would have seen that this balance was the result of a single transaction again occurring immediately before RCM’s fiscal year end.³⁴¹ That should have led to questions by AA as to

³³⁷ See AAREF 00007740 at 7742 (November 2, 1999 Audit Closing and Planning Memorandum to fiscal year 2000 audit workpapers).

³³⁸ February 2001 Customer Statement for BAWAG’s account no. 3905 at RCM.

³³⁹ See *id.*

³⁴⁰ See AAREF 00013519 (fiscal year 2002 RCM Unsecured Debits Report).

³⁴¹ February 2002 Customer Statement for BAWAG’s account no. 3905 at RCM.

why such transactions occurred in consecutive years just days before the fiscal year end, and could very likely have led to a detection of related party fraud.

2. GT's Failure to Properly Audit Refco's Related Party Transactions

GT knew that Refco engaged in substantial and complex related party transactions and knew the risk associated with such transactions, but failed to conduct its audits of those transactions in accordance with GAAS. GT was also keenly aware of the risks posed to Refco by its own management, particularly in management's ability to override controls (which GT had identified as deficient at Refco in the first place), but failed to perform GAAS-compliant audit steps to detect possible of such management-driven fraud. In addition, GT received numerous "red flags" pointing to the Round Trip Loan fraud in conducting its audits of Refco but failed to recognize and follow up on those flags as one would have expected a sufficiently skeptical auditor to do. Instead, GT appears to have relied much too heavily on its perception of the "integrity" of Refco's management.

a. GT Failed to Audit Refco's Related Party Transactions in Accordance with GAAS

Despite being aware of the existence of related party transactions and assessing them as a high risk factor, GT failed to comply with GAAS in auditing such transactions.

(i) GT Was Aware that Refco Engaged in Significant Related Party Transactions

Ramler had become familiar with issues concerning Refco's related party transactions during his years at AA, and brought this knowledge with him to GT. When he proposed Refco to GT as a client and completed GT's new client evaluation form, Ramler indicated that Refco

engaged in significant related party transactions and that certain such related parties were either not audited or were audited by other firms.³⁴²

At that time, Ramler further noted that RGHI, which was the corporate parent of RGL, was a shell entity with no operations other than its relationship with RGL and that it owed RGL approximately \$170 million as of February 28, 2002.³⁴³ Although Ramler acknowledged that these receivables pre-dated his association with Refco, he stated that he had no indication that they were the result of losses that should have been recognized by RGL.³⁴⁴

As part of the new client evaluation process, Ramler outlined and provided updated information about the agreements that AA had reached with Bennett concerning the related party balances in 1999 — *i.e.*, that the balances owed by RGHI to Refco would no longer increase, the balances would be paid down over a period of seven years, and during fiscal year 2003, at least another \$50 million would be paid off.³⁴⁵ Thus, from the outset of GT's involvement with Refco, Ramler had gone on record regarding the existence of material related party receivables and the need for RGHI to repay these receivables so that they did not have to be written off against its equity in RGL. GT was also cognizant of the fact that related party transactions with RGHI created a high degree of risk of material misstatement.³⁴⁶

³⁴² Ramler noted several risk factors applicable to the proposed Refco engagement by checking boxes on the GT "Evaluation of Proposed Client" form. Boxes are checked next to the statements on the form indicating that the proposed client had "associated entities that are not audited or are being audited by firms outside GT" and engaged in "significant related party transactions." GT SEC 00130512 at 519-20, at App. D-4.

³⁴³ GT SEC 0130512 at 521, at App. D-4 (Ramler's explanation of related party transactions for GT "Evaluation of Proposed Client" Form).

³⁴⁴ *See id.*

³⁴⁵ *Id.*

³⁴⁶ The 1999 agreements between Refco and AA concerning these balances are discussed above in Section IV.D.1.a. Briefly, in 1999, Ramler informed Bennett that it was important for accounting purposes that shareholders demonstrate actual intent to repay outstanding receivables to Refco in the "relatively near future" — five to eight years. AAREF 00011967, at App. D-7. Refco apparently agreed to repay \$25 million per year. AAREF 00003030 at 00003032. When he proposed Refco to GT as a client in late 2002 or early 2003, Ramler outlined action steps for

(footnote continued on next page)

Finally, GT, like AA, was aware that BAWAG was a related party.³⁴⁷ GT was also aware that Refco engaged in substantial transactions with BAWAG.³⁴⁸

As discussed in the Round Trip Loan section of this Report, RGHI's debt to Refco was, in reality, substantially greater than what was presented to GT at the end of each financial reporting period. The fraud at Refco was accomplished by manipulating the amount RGHI owed to Refco shortly before the end of the financial reporting period (first annually at the end of February, then quarterly beginning in May 2004) and then unwinding the fraudulent entries shortly after the close of the financial reporting period. Although GT apparently never looked at the statements for RGHI's significant customer accounts at Refco, those statements reflect the

(footnote continued from previous page)

GT to take in the 2003 audit related to the inter-company receivable, including: "Obtaining written rep from the shareholder/ CEO of their intent as of a date certain to pay down these balances. To the best of our ability document our understanding of the financial resources and ability to pay these balances down in 3 to 4 years. Document our agreement, that if they fail to adhere to the payments, the remaining balance will be written-off through equity." GT SEC 0130512 at 521, at App. D-4. As explained further below, GT apparently obtained repayment assurance from Bennett in connection with the 2003 financial statements audit. GT SEC 0032255.

³⁴⁷ GT SEC 0130530 at 130531 ("New Client Background Investigation" report by GT's National Professional Standards Investigative Research Group dated October 31, 2002 concerning RGL and Subsidiaries, Bennett, Trosten, and Grant): "since May 1999, a 10 percent stake in Refco Group has been held by [BAWAG]."

³⁴⁸ GT SEC 0031573 (Paper Explorer File for audit period ended 2/28/03, "Refco Group Ltd. LLC and Subsidiaries, Developing the Audit Plan"). For instance, GT's 2005 audit workpapers contained the following summary of related party loans outstanding as of the end of the prior four fiscal years:

	2004	2003	2002	2001
BAWAG	210,223,000	175,223,000	210,223,000	225,223,000
RGHI	- 0 -	105,322,000	179,000,000	205,000,000
Total:	210,223,000	280,545,000	389,223,000	430,223,000

GT SEC 0029090 (page from workpapers for audit of New Refco Group, Ltd. February 28, 2005 financial statements).

following balances immediately before and as of the close of the audited financial statement periods (credit balances appear in parentheses):³⁴⁹

Period	Statement Ending	RGHI @ RCM (no. 10002657)		Total
		Ending Balance	RGHI @ RCC (no. 1690-001)	
2003	1/31/2003	147,454,498	555,548,961	703,003,459
	2/28/2003	70,094	71,813,726	71,883,820
2004	1/30/2004	0	701,420,345	701,420,345
	2/27/2004	0	(5,251,847)	(5,251,847)
Q1 2005	4/30/2004	0	602,192,916	602,192,916
	5/31/2004	0	80,317	80,317
Q2 2005	7/30/2004	408,314	711,869,064	712,277,378
	8/31/2004	3	0	3
Q3 2005	10/29/2004	507,896,761	0	507,896,761
	11/30/2004	2,835,852	0	2,835,852
Q4 2005	1/31/2005	526,621,060	0	526,621,060
	2/28/2005	(106,083)	0	(106,083)
Q1 2006	4/29/2005	626,425,628	0	626,425,628
	5/31/2005	(3,423,742)	0	(3,423,742)
Q2 2006	7/29/2005	496,620,598	0	496,620,598
	8/31/2005	1,443,482	0	1,443,482

(ii) GT Knew that Related Party Transactions Presented High Risks of Misstatement

Related party transactions are not like typical business transactions because they cannot be assumed to have been conducted at arm's length.³⁵⁰ Related party transactions have

³⁴⁹ The figures that appear in this chart were taken from the customer statements for RGHI's account at RCM (account no. 10002657) and at RCC (account no. 1690-001).

³⁵⁰ AU § 150.05 (based on SAS 43, issued November 1972). GT's internal guidance was consistent with the standards interpretation. See GT EX 003460 [REDACTED]

historically been associated with major business frauds. While related party transactions, if properly disclosed, do not require different accounting than transactions with non-related parties, they do pose financial statement risks, such as misstatement motivated by a desire to give the appearance of certain business results.³⁵¹ Consequently, related party transactions generally merit more scrutiny than transactions with unaffiliated entities, and particular care is warranted when related parties are not audited or are audited by a different accounting firm.³⁵² Moreover, the auditor must understand the business purpose of the transaction before the audit can be completed.³⁵³

Beginning in at least 2004, the risks associated with related party transactions were made ever more apparent to GT in connection with an SEC enforcement action in which GT was a respondent. On August 5, 2004, the SEC announced that it had settled an administrative proceeding against GT arising from GT's 1998 audit of MCA Financial Corporation ("MCA").³⁵⁴ The matter had been pending since at least January 5, 2004, when the SEC instituted the administrative proceeding.³⁵⁵

The MCA-related enforcement action alleged that GT permitted its audit client to conceal material related party transactions, of which GT's auditors were allegedly aware, in connection with the client's SEC filings and public debt offerings. Among other allegations, the SEC noted that "despite their knowledge of millions of dollars of undisclosed related party transactions, [the

³⁵¹ AU §§ 334.04, 9334.17, 9334.19.

³⁵² See *id.* See also AU §§ 334.08; 334.09. GT's internal guidance was consistent with these standards. See GT EX 003460 at 3461, 3465 [REDACTED].

³⁵³ AU § 334.09.

³⁵⁴ *In the Matter of Grant Thornton LLP, et al.*, Administrative Proceeding No. 3-11377, Exchange Act Release No. 50148, Accounting and Auditing Enforcement Release No. 2076 (August 5, 2004) (available at <http://www.sec.gov/litigation/admin/34-50148.pdf>).

³⁵⁵ *Id.*

auditors] did not design audit procedures to test the total amount of undisclosed related party [transactions].”³⁵⁶ The SEC alleged that GT had engaged in improper professional conduct in auditing MCA because it did not adequately plan the 1998 MCA audit, did not act with sufficient skepticism in conducting the audit, and did not obtain enough evidence to support its conclusions.³⁵⁷ In order to settle the administrative proceeding, GT agreed to pay a fine and to provide enhanced fraud detection training to its audit staff. In addition, the SEC censured GT pursuant to SEC Rule 102(e).³⁵⁸

In light of this SEC proceeding, GT had an additional reason to have conducted its ongoing audits of Refco with an enhanced awareness of the need to plan audits adequately, the professional requirement of skepticism, the importance of gathering sufficient evidential matter to support audit conclusions, and the risks associated with related party transactions. Further, GT’s 2005 audits were conducted after GT had promised the SEC that it would enhance its fraud detection training of audit staff as part of the settlement for the pending enforcement action.

The Examiner finds no evidence that the Consent Decree and the obligations it imposed on GT led to audit procedures directed to discovering the type of related-party fraud that was occurring at Refco.

GT was aware of certain Refco-specific risks concerning related-party transactions. GT knew that there was a very large receivable from RGHI to Refco, that the receivable had existed for a very long time, and that it was unsecured.³⁵⁹ Issues concerning related party receivables

³⁵⁶ *Id.* at ¶ 93.

³⁵⁷ *See id.* at ¶ 120.

³⁵⁸ *See id.* at ¶ 25.

³⁵⁹ *See, e.g.*, GT SEC 0031027-30. An “Inherent Risk Indicators” assessment showing risk of “significant and/or complex related party transactions” as “high.” *Id.* at 31029.

were apparently also discussed at an audit planning meeting attended by the GT Refco audit team prior to the 2003 financial statements audit.³⁶⁰

(iii) GT Had Procedures for Conducting Audits Involving Related Parties

The GT personnel working on the Refco engagement had an obligation to follow professional standards in their audit procedures and develop audit procedures tailored specifically to the Refco engagement. The professional standards for auditing related party transactions call for reasonably necessary procedures to obtain competent evidential matter sufficient to provide the auditor with an understanding of the purpose, nature and extent of the transactions and their effect on the financial statements.³⁶¹ That same guidance requires auditors not to merely accept management representations concerning the purpose, nature, and extent of related party transactions.³⁶² Rather, auditors should substantiate management representations concerning related party transactions.³⁶³

Further, RGH and BAWAG were not merely related parties - they were related parties that were not audited by GT. Auditors should be particularly skeptical of transactions with such entities.³⁶⁴ When auditing transactions with related parties that GT did not audit, GT auditors

³⁶⁰ In connection with the 2003 audit, GT prepared a power point briefing titled “Refco Planning Meeting.” One of the slides for that briefing identified several “Audit Issues.” The audit issues identified in advance of the 2003 audit included unsecured debits, related party receivables, and “overall F/S [financial statement] disclosures.” GT SEC 0129858 at 0129863.

³⁶¹ AU §§ 344.02, 344.04, 344.08, 334.09, 9334.17, 9334.19; GT’s internal guidance was consistent with these standards. *See* GT EX 003460 at 3465 [REDACTED].

³⁶² *See, e.g.*, AU § 334.09.

³⁶³ AU §§ 334.09, 9334.19.

³⁶⁴ AU §§ 334.09, 334.11, 9334.17. GT’s internal audit guidance was consistent with these standards. *See* GT EX 003460 at 003465-66 [REDACTED].

were obligated to consider adding additional procedures with respect to the related party in an effort to gain some independent verification of the nature of those transactions.³⁶⁵

As a carry-over from his audits of Refco while at AA, Ramler continued to focus on the need for RGHI to repay its debt to Refco. In connection with the audit of the 2003 financial statements, on April 28, 2003, Ramler obtained a letter from Bennett concerning Bennett's intent to pay down the RGHI Receivable.³⁶⁶ In that letter, Bennett noted that the RGHI shareholders intended to reduce the amount of the receivable, then totaling \$105 million, by at least \$35 million per year, resulting in full repayment by February 28, 2006.³⁶⁷ GT does not appear to have made any meaningful effort to determine that payments were actually made.

(iv) GT's Failure to Properly Audit Related Party Transactions

In spite of the identified risks and its own audit procedures, GT failed to conduct appropriate audit procedures of related party transactions.

(a) GT's Audit of the Related Party Receivable from RGHI Was Ineffective and Failed to Incorporate Appropriate Audit Procedures

The related party receivable at Refco consisted primarily of receivables from RGHI to several different consolidating Refco entities.³⁶⁸ Although Refco management attempted to deceive GT as to the true magnitude of the RGHI Receivable, GT, like AA before it, failed to

³⁶⁵ AU §§ 334.09, 334.11, 9334.17. GT's internal guidance reflect an understanding of and adopts these requirements. See GT EX 003460 at 3465-66 [REDACTED]

³⁶⁶ GT SEC 0032255 (letter dated April 28, 2003 from Bennett to Ramler re: Related Party Transactions). Such letter was of questionable utility given that Ramler knew Bennett had previously promised to pay down the related party receivables and the balance of RGHI's loan from RCC had been identified as increasing from approximately \$41 million to \$71 million during fiscal year 2003.

³⁶⁷ *Id.*

perform procedures adequate to assess its true amount. Instead, GT appears to have simply accepted its client's false representation as to the true amount of that receivable.

During the 2003 audit, for example, GT was told by Bennett that the RGHI Receivable was \$105 million.³⁶⁹ Yet, apart from ensuring that it was consistent with other summary-level internal Refco documentation, GT apparently performed no testing to verify the accuracy of this representation. During its 2004 and 2005 audits, GT likewise failed to obtain evidence sufficient to provide a reasonable assurance that related party transactions were properly reflected in the financial statements.

(b) GT Failed to Follow its Own Procedures Specific to Auditing Related Party Transactions

In its workpapers for the 2003 audit, GT noted that it had considered transactions entered into with related parties not audited by GT, and that material balances with RGHI and BAWAG were audited and documented.³⁷⁰ However, the Examiner was unable to locate any documentation in the workpapers indicating that GT did anything more than accept management's representation as to what the balances were, ensure that information was

(footnote continued from previous page)

³⁶⁸ For instance, while at AA, Ramler obtained a “Schedule of Loans to Stockholders and Unconsolidated Affiliates,” which reflected a total related party loan balance as of February 28, 2002 of \$179.4 million. *See* AAREF 00012494. Over \$100 million of that amount was owed by RGHI.

³⁶⁹ *See* GT SEC 0032255 (letter from Bennett to Ramler re: Related Party Transactions, dated April 28, 2003).

³⁷⁰ In a “Paper Explorer File” titled “Refco Group Ltd., LLC and Subsidiaries / Developing the Audit Plan” for the February 28, 2003 audit [GT SEC 0031573], GT adopted the following step:

3. Related Parties

* * *

(b) Consider the implications of transactions with related parties that we do not audit.

GT has considered transactions entered into with related parties not audited by GT. Balances that are material with RGHI and BAWAG, the entities were audited and appropriate documentation was obtained.

internally consistent (in the case of the RGHI Receivable),³⁷¹ and confirm the balance with the customer (in the case of the BAWAG receivable).³⁷²

Documents relating to audit and review planning in later periods reflect that GT contemplated steps to scrutinize related party transactions, particularly those involving entities not audited by GT, but did not implement any of these steps.³⁷³ GT's adopted audit procedures which acknowledged that related party transactions should be reviewed for whether they occur in the ordinary course of business or are unusual or have not been accorded appropriate accounting treatment.³⁷⁴

One way in which GT planned to review certain related party transactions was to tie them back to the books of the related party. For example, in conducting its audit of RCC in 2003, GT told Refco that it needed to see certain loan receivables to RCC on the books of the affiliate owing the money.³⁷⁵ When making this inquiry, GT specifically requested the information about the loan from RCC to RGHI purporting to have a balance of \$71,813,725.99, including:

(a) source documents to verify the loan principal, interest rates and payment schedule; and (b) a detailed schedule of payments made during the year, indicating that GT would trace some

³⁷¹ See GT SEC 0031852-54, at App. D-6 (workpaper documents showing a Refco-generated “Schedule of Loans to Stockholders and Unconsolidated Affiliates” tied to a list of “Customer Divisional Loans Receivable” from RCC). For instance, the cited workpaper reflects that the amount of the RGHI Receivable at RCC was “traced to Refco Capital explorer file workpapers,” but does not reflect any attempt at independent verification such as review of RGHI’s account statement.

³⁷² See GT SEC 0014361-461 (April 8, 2003 customer confirmation request letter from Refco to BAWAG appending statement for BAWAG’s account at RCM dated February 28, 2003).

³⁷³ See, e.g., GT SEC 0107113 (Refco LLC, 2/28/04 Audit Program): “Consider the implications of transactions with related parties that we do not audit.”

³⁷⁴ See GT SEC 00135423 (GT audit program “activity log” for “Borrowings” from audit of RCC 2/28/03 financial statements).

³⁷⁵ See GT E SEC 20010934, at App. D-11, e-mail from GT auditor Yonah Dahan to Frank Mutterer at Refco transmitting a list of items GT needed for the RCC audit.

payments into Refco's bank statements.³⁷⁶ In other words, GT requested documentation to verify the existence and terms of the loan and ensure that RGHI was actually making payments that were reflected in RCC's bank statements. In apparent violation of GT's own practices and GAAS, there is no indication that these critical procedures were ever carried out. If they had been, GT would likely have either uncovered the fraud or, if Refco failed to provide the requested information, would have had to consider seriously whether to issue a qualified audit opinion or withdraw from the engagement in 2003 without issuing an audit opinion.

(c) GT Failed to Audit RCC's Transactions with RGHI in Accordance with GAAS

The primary component of the reported \$105 million related party loan balance, as of February 28, 2003, was a \$71 million debit balance in RGHI's account at RCC (no. 1690-001). Knowing this, GT should have followed the professional audit standards requiring it to obtain sufficient competent evidentiary matter to satisfy itself as to the purpose, nature, and extent of the transactions leading to RGHI's loan balance, such as reviewing loan documents and payments.³⁷⁷ Although GT obtained a Refco-provided summary sheet indicating that the RGHI account balance was a debit of \$71,813,725.99 in principal and approximately \$8.7 million in accrued interest,³⁷⁸ GT's workpapers do not indicate that it reviewed the customer statement for RGHI's account.

The customer statement for RGHI's account at RCC for the month of February 2003 indicate that:

- Until February 21, 2003 (*i.e.*, just seven days before Refco's fiscal year-end), RGHI owed Refco more than \$720 million.

³⁷⁶ See GT E SEC 20010934.0007.0010, at App. D-11.

³⁷⁷ AU § 334.09.

³⁷⁸ See GT SEC 0031853 (schedule of "Customer Divisional Loans Receivable" at RCC as of 2/28/2003).

- On February 21, 2003, RGHI's account at RCC received a cash transfer "from margins" for \$308 million, reducing the amount that RGHI owed RCC.
- On February 25, 2003, the same day BAWAG transferred \$175 million from its own account at RCM, RGHI received a \$175 million credit from a "WT From Wachovia NY Int'l" (the bank used by BAWAG in New York).³⁷⁹

Given the high degree of risk GT knew was associated with related party transactions at Refco, GT should have examined the customer statement for the RGHI account at RCC for the month of March 2003. Had GT done so, it would have learned that the above-described entries were reversed shortly after Refco's year end, and the amount RGHI owed to RCC ballooned from \$71.8 million on February 28, 2003 back up to \$630 million by March 4, 2003.³⁸⁰

Moreover, the 2003 receivable balance in RGHI's RCC account of \$71.8 million represented an approximately \$30 million increase over the prior year.³⁸¹ Although GT inquired as to the reason for the increase and was told by Trosten that it represented "additional loans,"³⁸² GT apparently never questioned why, or the implications of, the fact that during a time when RGHI was supposed to be paying down the debit balance, RCC was extending RGHI additional credit.

GT apparently also did not obtain or review any loan documents concerning the RGHI Receivable at RCC, despite Ramler's assertion at the time he brought Refco to GT as a new client, that the receivable represented "actual borrowing of funds."³⁸³ Nor did GT perform any

³⁷⁹ See REFCO-0009-001274 and 0009-001280 (Customer Ledger Report for RGHI's customer account at RCC). Prior to November 1999, the account number was 004521-00000. In December 1999, the account number was changed to 1690-0001.

³⁸⁰ REFCO-0009-001280.

³⁸¹ Compare GT SEC 0031852, at App. D-6 (Schedule of Loans to Stockholders and Unconsolidated Affiliates as of 2/28/2003) with AAREF 00012494 (fiscal year 2002 Schedule of Loans to Stockholders and Unconsolidated Affiliates). See App. D-6.

³⁸² See GT SEC 00135303 (schedule of "Loans Receivable" at RCC dated February 28, 2003).

³⁸³ See GT SEC 0130512 at 130521, at App. D-4 (portion of "Evaluation of Proposed Client" form completed by Ramler).

assessment of the interest income represented by Refco to have accrued on the RGHI Receivable, although GT did report in the notes to the financial statements of RGL and RCC that interest on related party loans was generally charged at prevailing market rates.³⁸⁴ Both of these procedures were called for under GT's audit plan for Refco, but there is no evidence that they were ever performed.

After the 2003 audit, GT apparently failed to perform any procedures whatsoever to monitor or test the RGHI Receivable at RCC. The Schedule of Loans to Stockholders and Unconsolidated Affiliates that was obtained and reviewed in every audit since 1996, first by AA and then by GT, was not contained in GT's workpapers after 2003. By the time of the audit of Refco's financial statements ending February 29, 2004, Refco was representing to GT that the related party loan balance outstanding in the prior year (\$105 million) had been repaid in full. GT appears to have done nothing to question this representation and allowed it to be repeated in the footnotes to the consolidated financial statements of RGL for the period ended February 29, 2004.³⁸⁵

For audit years 2004 and 2005, GT neither requested nor received evidence sufficient to obtain a reasonable assurance that RGHI no longer engaged in related party transactions with RCC. Although Ramler knew, from his audits of Refco while at AA and from GT's 2003 audit, that RGHI maintained a customer account at RCC, GT apparently failed to obtain and examine the customer statement for RGHI's account at RCC. Had GT done so, it would have learned that Refco management's representation that the debt had been repaid was false. Although as of February 29, 2004 Refco's management had again fraudulently manipulated the balance of the

³⁸⁴ See, e.g., GT SEC 0130611 (Note I, Related Party Transactions, in Consolidated Financial Statements of Refco Group Ltd. LLC and Subsidiaries, February 29, 2004).

³⁸⁵ See *id.*

RGHI account at RCC to levels far below the true receivable (this time leaving a credit balance of approximately \$5.2 million), even a cursory review of the customer account statement would have revealed a debit balance (*i.e.*, amount owed to RCC) of almost \$700 million until just days before and after Refco's fiscal year end.³⁸⁶

Instead, by taking Refco management at its word that the related party debit balance had been repaid in full and that all related party transactions and relationships had been properly recorded or disclosed,³⁸⁷ GT failed to detect the accounting fraud and issued an unqualified audit opinion. GT's Refco audit team repeated this failure in its audit of Refco's 2005 financial statements.

(d) GT Failed to Audit RCM's Transactions with RGHI in Accordance with GAAS

Refco management apparently also deceived GT as to the true amount of RGHI's balances at RCM. In fact, as reflected in the table of RGHI accounts in Section (i) above, the information presented to GT by Refco's management at the time of its audits and quarterly reviews did not show RGHI's account at RCM to have substantial balances. However, Ramler knew that in the past RGHI owed substantial sums of money to Refco through its account at RCM.³⁸⁸ Even though the balances in RGHI's account would have appeared small to GT at the end of various financial statement reporting periods, GT still should have performed additional procedures on this related party account to ensure it was being properly recorded on Refco's

³⁸⁶ See REFCO-0009-001370, 0009-001378, at App. D-12 (Customer Ledger Report for RGHI's customer account at RCC).

³⁸⁷ See GT SEC 00134839-41 (RCC's Management Representation Letter to GT dated April 27, 2004). Management representations, however, are "not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit." AU § 333.02 (Reliance on Management Representations).

books.³⁸⁹ As independent auditors, GT's knowledge of the significant risk attendant to Refco's related party relationships obligated it to review accounting records for "large, unusual or non-recurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period."³⁹⁰ GT was further charged with obtaining "sufficient competent evidential matter to understand the relationship of the parties and, for related party transactions, the effects of the transaction on the financial statements."³⁹¹

As with the RCC account, one relatively simple procedure would have been to review a copy of the customer statement for RGHI's account at RCM. The account statement for February 2003 indicated that:

- The debit balance in the account as of February 1, 2003 was \$147.4 million,³⁹² and
- On February 7, 2003, an adjustment was made to credit the account for \$147.5 million, leaving a small debit balance on February 28, 2003 of \$70,094.³⁹³

Similarly, it does not appear from GT's workpapers that GT obtained any information at all about RGHI's account at RCM during its November 30, 2004 review. Had GT done so, it would have discovered the balance in RGHI's account at RCM as of November 30, 2004 to be a

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³⁸⁸ Compare AAREF 00005557 (Schedule of Loans to Stockholders and Unconsolidated Affiliates February 29, 2000), referencing payable due RGHI from RCM of \$277,000, with AAREF 00006387 at 6389 (AA Confirmation Request to RGHI for account 10002657 for net credit balance of \$276,670).

³⁸⁹ AU § 334.04 ("the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships for which FASB Statement No. 57 requires disclosure even though there are no transactions.").

³⁹⁰ AU § 334.08(g).

³⁹¹ AU § 334.11.

³⁹² See REFCO-0009-000240-41 (Statement of Account for RGHI's customer account at RCM for February 2003).

³⁹³ See *id.*

relatively small debit balance of \$2,835,851.51.³⁹⁴ A scanning of the customer statement for this related party account from the financial reporting period under review (*i.e.*, November 2004) through the time of the audit fieldwork (which occurred in January 2005), however, would have shown:

- As of November 1, 2004, RGHI's account at RCM had a net debit balance of approximately \$508 million;³⁹⁵
- On November 26, 2004 (just four days prior to the close of the quarter ended November 30, 2004), RGHI's account at RCM was credited by \$545 million, reducing the net balance to \$2,835,851.51;³⁹⁶ and
- On January 4, 2005, \$550 million was transferred out of RGHI's account at RCM, resulting in a debit balance in the account by January 31, 2005 of \$526,621,059.54.³⁹⁷

Thus, the fraudulent manipulations of the RGHI debit balance at RCM would have been plainly evident from a simple scanning of RGHI's account statement at RCM. Moreover, had GT's auditors exercised proper professional skepticism by employing an inquisitive mind and making a critical evaluation of audit evidence, it could have recognized the link between the \$545 million credit applied to RGHI's account at RCM on November 26, 2004 and the \$545 million debit arising in Liberty Corner's account at RCM on that same day. Recognition of that connection likely would have led GT to discover the fraudulent use of the transactions between RGHI and Liberty Corner.

In summary, GT failed to follow its own audit procedures to verify the amount, nature and substance of related party transactions with RGHI. GT's workpapers do not indicate that it

³⁹⁴ See REFCO-0009-000282-290, at App. D-13 (Customer Statement for RGHI's account at RCM for November 2004).

³⁹⁵ See *id.*

³⁹⁶ See *id.*

³⁹⁷ See Customer Statement for RGHI's account at RCM for January 2005.

obtained or reviewed loan documents evidencing the amount owed by RGHI. The workpapers also do not indicate that GT reviewed the customer statements for RGHI's accounts at RCC or RCM. There is also no indication that GT sought evidence corroborating the repayment of the RGHI Receivable even though Ramler had made the repayment an audit priority in every year since 1998. Had GT taken these simple steps, it likely would have discovered the fraud at Refco. Instead, GT ignored its own consistently high assessment of the risks attendant to related party transactions and relied primarily on the representations of management personnel within Refco. Thus, GT's performance of its audits fell well short of the appropriate standard of care.³⁹⁸

(e) GT's Auditing of Related-Party Transactions with BAWAG Was Similarly Deficient

GT knew that BAWAG was a related party, that it was not audited by GT, and that it had a customer account at RCM. A review of a BAWAG customer account statement available to GT reveals that, for the most part, the account was used for executing foreign currency trades in relatively small amounts.³⁹⁹

In addition to flagging related party receivables and other transactions as a high risk area, GT had identified unsecured debit balances as a risk area for Refco.⁴⁰⁰ During each audit it conducted of Refco, GT obtained information concerning BAWAG's account at RCM and each time GT noted a large debit balance in BAWAG's account as of the end of Refco's fiscal year.

These debit balances represented funds funneled from BAWAG to RGHI to effect fraudulent round trip loan transactions. As described above, GT had adopted certain procedures applicable to related party receivables and other related party transactions. Although those

³⁹⁸ AU § 334.09

³⁹⁹ See GT SEC 0014362-14461 (February 28, 2003 statement for BAWAG's customer account at RCM).

procedures called for an assessment of the transaction to verify its business purpose and other audit measures,⁴⁰¹ GT failed to perform any of those steps with respect to the recurring BAWAG debit balances.

Instead, GT simply sent confirmation requests to BAWAG. For example, in April 2003, GT sent an account confirmation letter to BAWAG concerning BAWAG's account number 3905 at RCM.⁴⁰² The account confirmation sent by GT included a complete account statement listing all transactions during February 2003, a summary of activity during the month, and the opening and closing balances of the account.⁴⁰³ The account balance at the beginning of February was a debit of \$723,500; by the end of that month the account had a debit balance of \$179,503,130.12.⁴⁰⁴ Most of the debit portion of the balance arose in the last few days of February 2003 when BAWAG transferred \$175,000,000 out of its account.⁴⁰⁵ The account statement does not indicate where the funds were transferred, but clearly indicates that the funds were transferred out of the account.⁴⁰⁶ Both the amount and the nature of this transaction stand out starkly from the other transactions in the account, which are primarily foreign currency trades covering a range of values below \$10,000,000.⁴⁰⁷ Yet, there is no indication in the audit

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⁴⁰⁰ See GT SEC 0129863 (March 11, 2003 PowerPoint briefing titled "Refco Planning Meeting," apparently prepared in connection with audits of Refco's financial statements dated February 28, 2003).

⁴⁰¹ See GT SEC 0065938 ("Trading" section of GT "Audit Program" for February 28, 2003 audit of RCM financial statements); *see also* GT EX 003460-79 (GT internal guidance concerning audits of related party transactions).

⁴⁰² See GT SEC 0014361-461 (April 8, 2003 customer confirmation request letter from Refco to BAWAG appending statement for BAWAG's customer account at RCM as of February 28, 2003).

⁴⁰³ *See id.*

⁴⁰⁴ See GT SEC 0014362.

⁴⁰⁵ See GT SEC 0014445.

⁴⁰⁶ The line item for this transaction reflects a "DR" (debit) of the \$175,000,000 on 2/25/03. The description of the transaction is "Vostro transfer," indicating a transfer to the account of another bank.

⁴⁰⁷ See GT SEC 0014361-461.

workpapers that GT inquired as to where the cash had gone, or how the debit balance was secured, or why the transaction had occurred, despite the large amount of this extension of credit to a related party. GT merely confirmed the account ending balance with BAWAG and moved on.

In the audit of Refco's February 29, 2004 financial statements, GT again reviewed a significant debit balance in BAWAG's account at RCM. The information Refco provided GT to review was not as detailed as in the prior year and did not include a full account statement. But, GT was given information sufficient to show that, as of February 29, 2004, BAWAG's account at RCM contained a debit balance of \$209,789,475.00. GT sent a confirmation request to BAWAG and BAWAG confirmed the balance.⁴⁰⁸

Unlike in 2003, GT's procedures in 2004 included a credit risk analysis on BAWAG's debit balance at RCM. The debit balance again appeared to GT as essentially an unsecured cash loan, but GT apparently was reassured that there was no credit risk based on the fact that BAWAG was a 10% shareholder of RGL and "is the largest bank in Vienna." In addition, by the time of the audit fieldwork (during April 2004), BAWAG's account showed a credit balance of \$5.8 million.⁴⁰⁹ Thus, GT apparently determined that the amount due from BAWAG was not a credit risk. However, GT failed to independently determine the purpose, nature, and extent of this extension of credit to a related party. Just as in 2003, there is no evidence that GT questioned the business purpose of this transaction or asked where the money had gone. It simply confirmed the balance and conducted a cursory assessment of the account's credit risk.

⁴⁰⁸ See GT SEC 0011208-09 (April 12, 2004 letter from Refco to BAWAG requesting confirmation of account; "Daily Account Equity Statement" for BAWAG's customer account no. 3905 at RCM); GT SEC 0012902 (confirmation request from Refco to BAWAG signed and dated by BAWAG as of April 20, 2004).

⁴⁰⁹ See GT SEC 0003375 at 3378 ("Refco Capital Markets Ltd. Credit Risk - Customer Cash Debit Balances 2/29/04" workpaper. The document reflects the net value of BAWAG's account as of 4/21/04).

In the audit of the February 28, 2005 financial statements, GT again noted a large debit balance in the account of BAWAG at RCM. The level of detail available to GT concerning this balance was similar to that in the prior year and did not include a detailed RCM account statement for BAWAG. However, GT had information showing a cash transfer of \$175,000,000 out of BAWAG's RCM account, resulting in a debit account balance of \$176,023,989.52.⁴¹⁰ Again, the workpapers do not indicate that GT questioned this transaction. Instead it appears that GT simply assessed the credit risk posed by the transaction and determined that, because the debit balance had largely been repaid by the time of the audit fieldwork, the account posed no credit risk.⁴¹¹

In connection with the audit of Refco's February 28, 2005 financial statements, Refco provided GT with a schedule of related party loans as of each prior fiscal year end from 2001 to 2004.⁴¹² That schedule showed that BAWAG owed Refco at least \$175 million, and usually more than \$210 million, at the end of each of Refco's fiscal years from 2001 to 2004. Yet, even though these receivables were paid off every year shortly after year-end and, in at least one case, GT knew that they were incurred shortly *before* year-end, GT failed to exercise proper professional skepticism and appears never to have questioned this pattern as called for by

⁴¹⁰ See GT SEC 0007273 ("Daily Account Equity Statement" for BAWAG's customer account no. 3905 at RCM as of 2/28/05).

⁴¹¹ See GT E SEC 20004482.0004-0007 ("Refco Capital Markets, Ltd. Credit Risk - Customer Cash Debit Balances 2/29/2005" [sic] workpaper, showing BAWAG's net account balance as of 4/22/05 as \$1,171,784, and noting that that balance was "collectible"). By the time of GT's audit of Refco's February 28, 2005 financial statements, BAWAG was no longer a 10% owner of Refco. Apparently as a result of this change in ownership following the LBO, Refco's 2005 financial statements included in its 10-K do not identify the \$175 million debit balance as an amount due from a related party, as was reflected in prior SEC filings such as Refco's S-4. However, even though BAWAG was no longer a related party, Refco's historical relationship with BAWAG and the similarity between this transaction and those occurring in prior years should have triggered additional skepticism of this transaction on the part of GT.

⁴¹² See GT SEC 0029090.

professional audit standards.⁴¹³ Had GT investigated these transactions to determine the purpose, nature, extent, and effect on Refco's financial statements, GT would likely have discovered this aspect of the fraud.

The BAWAG unsecured debit balances from 2003 and 2004 are not mentioned in the GT-audited financial statements of RGL. However, such balances are disclosed in the consolidated financial statements of RGL appended to Refco's S-4 filing. Note L (Related Party Transactions) to Refco's S-4 filing provides: "As of February 29, 2004 and February 28, 2003, the Group had a deposit with a third party financial institution, who was a member, of \$210 million and \$175 million, respectively. These balances were included in 'Receivables from customers' and liquidated shortly after year-end."⁴¹⁴ The representation concerning how the balances were recorded on Refco's books and that they had been repaid shortly after year end was included at Ramler's suggestion.⁴¹⁵

The related party transactions with BAWAG were components of the fraudulent Round Trip Loan scheme that resulted in Refco's collapse. Although GT was aware of the related party receivables due from BAWAG, it apparently never sought source documentation to determine their nature or business purpose. GT also never questioned the annual pattern of these cyclical loan transactions. Instead, as had been Ramler's practice previously at AA, GT did nothing more

⁴¹³ See, e.g., AU § 334.08(g) (advising particular attention accorded to end of period transaction).

⁴¹⁴ See WGM-L 0014681-14727 at 14701.

⁴¹⁵ See GT E SEC 20000669, e-mail from Ramler to Mutterer (Refco) and Henri Steenkamp (PwC) re: "Refco financial statements - 06.24.04 draft comments" dated June 26, 2004. Ramler's suggested addition to the financial statements notes — that the loans were "repaid shortly after each year-end" — suggests recognition of the pattern used in the Round Trip Loan accounting fraud at Refco.

In addition, there is an open question as to why these debit balances were not originally included as separate line item related party receivables disclosed in the notes to Refco's financial statements for the financial period ended February 29, 2004. GT SEC 0027609-23. Handwritten annotations on a copy of Refco's audited financial statements from February 28, 2003 suggest that, at some point in time, GT contemplated adding the BAWAG debit

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than confirm the year-end balance and ask if it had been repaid after year end. GT's audits of these transactions with BAWAG did not employ procedures dictated by GAAS and its own audit protocols.⁴¹⁶

(v) *GT Apparently Failed to Detect Management's Manipulation of Income and Expense Through the Use of Related Party Transactions*

From February 1999 through August 2005, Refco appears to have inflated its revenues and shifted certain expenses to RGHI. As discussed further below, the auditors were aware of the high risk that management had the incentive and the ability to override controls in order to falsify the financial statements and should have uncovered at least some of the fraudulent transactions used to manipulate Refco's revenues and expenses.

(a) *The Auditing Guidance Cautioned Auditors to Watch for This Kind of Fraud*

As discussed in the Overview of Professional Standards Governing Auditors, SAS 82 described in detail how an auditor must address the possibility of fraud.⁴¹⁷ It further stressed the importance of professional skepticism and provided examples of how such skepticism may be demonstrated, including: (a) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions; and (b) increased recognition of the need to corroborate management explanations or representations concerning material

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balance to the 2004 financial statement notes. See GT SEC 0063789 at 0063798 (noting "Need to add Shareholder a/c balance \$200 million").

⁴¹⁶ See generally, AU §§ 334, et seq.

⁴¹⁷ SAS 82, ¶ 1.

matters — such as further analytical procedures, examination of documentation, or discussion with others within or outside the entity.⁴¹⁸

In further emphasizing the importance of skepticism, SAS 99 noted that the auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present regardless of any past experience with the entity and regardless of the auditor's belief about the integrity of management. In exercising skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest.⁴¹⁹

(b) The Auditors Were Well Aware of the Risks that Refco's Management Could Override Controls

As discussed previously, Ramler was aware as early as 1998 of Bennett's plan to sell a substantial portion of Refco, when during the 1998 audit closing meeting Bennett expressed the desire to increase earnings and maintain RGL's book value.⁴²⁰ Bennett informed AA that Refco intended to restructure Refco over the next 3-10 years as the shareholders would eventually want to liquidate their positions.⁴²¹ Through the review of workpapers, it is clear that AA considered this exit strategy as a potential area of audit fraud risk. Specifically, when preparing the AA standard audit form for assessing fraud risks for the 1998 audit, the auditors wrote as the initial assessment: "Management indicated that there would be plans over the next 3 – 10 years for the shareholders to sell Refco to a third party. Therefore, there is the risk that profits could be inflated to attract a higher selling price."⁴²² Yet, the risk was considered "low", "as a strong

⁴¹⁸ SAS 82, ¶27.

⁴¹⁹ SAS 99, ¶13.

⁴²⁰ See AAREF 00020226 at 227 (May 12, 1999 Audit Status Meeting memorandum to audit workpapers).

⁴²¹ See *id.*

⁴²² AAREF 00020042 (Fraud Risk Assessment Sheet, Part II, section A.).

separation of duties exist and no fraud or material misstatements have been noted in prior years.”⁴²³ This assessment is concluded by noting: “No modification of the audit plan is required.”⁴²⁴

Further, as part of its “Smart Tool” analysis of the audit risk at Refco, AA recognized that the risk of misstatement due to “Domination of management by a single person or small group,” was “Significant” due to the potential for improper journal entries.⁴²⁵ Domination by a small group or one person allows for management override of the accounting controls.⁴²⁶

Ramler was also aware, at the time of the audit of Refco’s February 28, 2005 financial statements, of the impending IPO and the attendant risk that management may override controls and overstate income.⁴²⁷ Further, Ramler knew that there was a risk that erroneous entries could be made to the general ledger to improve Refco’s financial results.⁴²⁸

(c) *GT Apparently Failed to Detect the Income and Expense Manipulations Because It Failed to Review the Customer Statements for RGHI’s Accounts at RCM and RCC*

To address the above-described risks, Ramler indicated in the April 11, 2005 Memorandum to the File that GT would review the detail of journal entries made to the general

⁴²³ *Id.*

⁴²⁴ *Id.*

⁴²⁵ See, e.g., *supra*, n.211.

⁴²⁶ Interview of Dara Schneider, February 8, 2007.

⁴²⁷ See Ramler’s April 11, 2005 Memorandum to the Files, GT SEC 0004084, at App. D-5, in which Ramler stated “the risk of fraud has to be seriously considered with the LBO and the potential IPO. The IPO price will be based on a multiple of proforma earnings so there is a considerable gain to shareholders in overstating earnings in presenting the most favorable financial picture.” Ramler was also aware that Refco had become a highly leveraged company after the LBO.

⁴²⁸ *See id.*

ledger for Refco, LLC, Refco Capital Markets and Refco Securities.⁴²⁹ It appears, however, that GT never actually did so.⁴³⁰

If GT had audited related party transactions between RGHI and RCM by obtaining and reviewing the customer statements for RGHI's accounts at RCM and RCC during the course of its 2005 audit, it would have learned that income had been manipulated as follows: (1) on November 17, 2004, RGHI engaged in 50 US Treasury note transactions and lost \$7.8 million in the process, while RCM gained a like amount;⁴³¹ and (2) on February 11, 2005, RGL recognized \$12 million in interest income and increased the receivable due from RGHI by a \$12 million “INT ADJUSTMENT.”⁴³² It also would have learned that the debit balance owed by RGHI, as of February 1, 2005, was \$526 million, but had been “reduced” to a credit balance due to RGHI of \$106,083 as of the last day of Refco’s fiscal year, by a massive influx of funds just days before year end from the Round Trip Loan transactions with BAWAG (\$250 million) and Liberty Corner (\$345 million).⁴³³

Similarly, a review of the customer statements in earlier years would have revealed not only that the true amount of the RGHI Receivable was being hidden, but that RGHI’s customer

⁴²⁹ See *id.*

⁴³⁰ GT’s workpapers for the 2003 audit indicate that GT “did not observe any unusual entries at the end of the year.” GT SEC 0031621 (Concluding Procedures for Refco Group Ltd. LLC and Subsidiaries Period Ended 2/28/03 Paper Explorer File). GT cross-referenced as support for this observation the “eliminating entries at workpapers 2000.” Workpapers 2000, however, pertain solely to the intercompany eliminating entries used in arriving at the consolidated financial statements of RGL. See GT SEC 0032653-32669, “Refco Group 2003 Workpapers” relating to Refco Group Consolidation and Elimination Entries.

⁴³¹ According to the customer statement for RGHI’s account at RCM, RGHI engaged in 25 transactions on November 17, 2004 in which it *purchased* \$50 million of US Treasury notes in 25 separate transactions totaling \$1.25 billion. See REFCO-0009-000284-287, at App. D-13. That same day, RGHI engaged in 25 *sales* of those same US Treasury notes for \$49.68 million each. *Id.* The resulting loss to RGHI and gain to RCM was \$7.8 million ($[\$50,000,000 - \$49,688,500] \times 25$). *Id.* Thus, RGHI “lost” \$311,500 on each of the 25 purchases and sales of the US Treasury notes in which it engaged on November 17, 2004.

⁴³² REFCO-0009-000302.

⁴³³ See REFCO-0009-000300-304.

accounts at RCC and RCM were being used to manipulate income and expense. For example, a review of the 2004 customer statements for RGHI's account at RCC would have revealed that, on March 19, 2004, the RGHI Receivable was increased by \$7.9 million.⁴³⁴ This entry should then have warranted further review because, with the exception of the fraudulent entries made at the end of each accounting period, it was the largest entry in the account during fiscal year 2004. Further examination would likely have revealed that the entry was used to shift to RGHI \$7.9 million in consulting fees incurred by Refco.

While these items would have stood out had the auditors examined the customer account statements, they would have paled in comparison to the size of the debit balance due from RGHI and the amounts of funds hitting the account just prior to year end in order to reduce greatly or eliminate the debit balance. Thus, even if the income and expense manipulations were not noticed initially by the auditors, they would eventually have discovered them once they had digested the Round Trip Loan fraud evident from the customer statements.

Another way GT could have detected the fraud was to vary the timing of its testing of the RGHI Receivable balance.⁴³⁵ Had GT tested the RGHI Receivable balance at times other than the end of the fiscal year, or the end of the quarter, it would likely have learned of the fraud as early as the audit of fiscal 2003 because Refco did not manipulate the balance of the RGHI Receivable at the end of each and every month.

⁴³⁴ See REFSCO-0009-001387 (Customer Ledger Report for RGHI's account at RCC).

⁴³⁵ See, e.g., SAS 99, ¶ 50 (the auditor should incorporate an element of unpredictability in the auditing testing from year to year, such as adjusting the timing of the testing of a particular account from that which is otherwise expected).

b. GT Apparently Overlooked Significant Red Flags Revealing that Refco Was Misusing “Repo” Transactions to Commit Fraud

During its audits and reviews of Refco, GT encountered numerous red flags indicative of the continuing accounting fraud at Refco. A significant number of these red flags arose in the context of GT’s review of repo, reverse repo, and time deposit financing transactions at RCM. In apparent violation of GAAS, GT failed to investigate these matters further and issued audit reports with unqualified opinions.

(i) Repo and Reverse Repo Transactions and Time Deposits

Repo and reverse repo transactions were a significant portion of Refco’s assets. “Repo” is an abbreviation of “repurchase.” Repo and reverse repo transactions are both securities sale and repurchase agreements executed between two parties. In both transactions, the party selling the security receives cash against the value of the security and promises to buy the security back from the purchaser at some point in the future. Typically, the party providing the cash (*i.e.*, the purchaser) will take possession of the securities involved in the transaction as collateral for its temporary outlay of cash to the seller. In essence, the transactions are loans collateralized by securities.⁴³⁶

⁴³⁶ See also Financial Accounting Standards Board, FASB Interpretation No. 41, “Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements” (Dec. 1994) at n. 1 and 2 (“FIN 41”):

Footnote 1: For purposes of this Interpretation, a repurchase agreement (repo) refers to a transaction that is accounted for as a collateralized borrowing in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. The “payable” under a repurchase agreement refers to the amount of the seller-borrower’s obligation recognized for the future repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a “reverse repo.”

Footnote 2: For purposes of this Interpretation, a reverse repurchase agreement (reverse repo) refers to a transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them

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Whether a particular transaction involving the sale and repurchase of securities is called a “repo” or a “reverse repo” depends entirely on the perspective of the party to the transaction. GT’s audit workpapers describe repos as transactions involving the purchase of securities under an agreement to resell and reverse repos as transactions involving the sale of securities under agreement to repurchase.⁴³⁷ In fact, the terms are ambiguous (as are GT’s definitions from its workpapers) unless the party from whose perspective the transaction is being described is identified. Indeed, as used in Refco’s books and records, the transactions in question characterized as “reverse repos” were made to appear as if Refco were the purchaser of securities from the counterparty, because they resulted in a debit balance for the account of the purchaser⁴³⁸ and were generally treated as “time deposits” by Refco. A “time deposit,” as used by Refco, is simply a loan extended to a customer for purposes of trading.⁴³⁹ These loans are secured by the customer’s security positions.⁴⁴⁰ The so-called “reverse repo” transactions in RCM’s customer accounts were also characterized as time deposits by Refco and were reviewed as time deposits

(footnote continued from previous page)

to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances. The “receivable” under a reverse repurchase agreement refers to the amount due from the seller-borrower for the repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a “repo.”

⁴³⁷ See GT SEC 0003351 (memorandum re: “Repo’s and Reverse Repo’s confirmation sampling” to Refco Capital Markets Ltd. 2/29/04 Audit File from GT auditor Juan Cruz, dated April 12, 2004).

⁴³⁸ This accounting is, to a certain extent, consistent with the definition of a reverse repo in FIN 41 in that the purported transactions gave rise to receivables to Refco from the counterparty. Of course, the transactions still lacked collateral.

⁴³⁹ See GT SEC 0003373 (Memo re: Refco Capital Markets Ltd. Credit Risk Analysis — Debit Balances, Repo / Reverse Repo & Time Deposits, 2/29/04).

⁴⁴⁰ See *id.*

by GT.⁴⁴¹ To a large degree, at least in characterizing the transactions described below, Refco appears to have used the terms interchangeably. However, as explained below, these transactions were not actually time deposits or reverse repos — that is merely how they were described in Refco's books and records.

(ii) Risk Assessment Concerning Reverse Repo Transactions and Time Deposits

Because repos, reverse repos, and time deposits all involve agreements with third parties who may fail to honor the terms of those agreements, such transactions present a credit risk.⁴⁴² In addition, there is a risk that the audit client will (either intentionally or unintentionally) provide inaccurate information about repos, reverse repos, or other balances owed to or by third parties. GT's review of these transactions also occurred against the background of its general assessment of Refco as a high risk client due to its lack of an effective internal audit function,⁴⁴³ involvement in significant and complex related party transactions,⁴⁴⁴ and domination by a limited number of individuals such as Bennett, Maggio, and the controllers of each division.⁴⁴⁵ As a result, GT was aware of serious financial statement risks associated with Refco's reverse repo and time deposit transactions.

⁴⁴¹ See, e.g., GT SEC 0003361-0003382 (materials from GT's 2004 Audit of RCM showing Liberty Corner transaction for \$720,000,000 in "Reverse Repo / Repo sampling analysis" and reviewing it as a "Time Deposit" on a "Credit Risk Analysis" workpaper).

⁴⁴² See, e.g., *id.*

⁴⁴³ See GT SEC 0031029 ("Inherent Risk Indicators-General" dated April 3, 2003 for audit of Refco Group Ltd., LLC and Subsidiaries).

⁴⁴⁴ See *id.*

⁴⁴⁵ See GT SEC 0028264.

(iii) Audit Procedures Relevant to Testing Repo and Reverse Repo Transactions and Time Deposits

GT adopted procedures for verifying the existence and amount of repo and reverse repo transactions and time deposits at Refco. To accomplish this, GT sent account confirmations to repo and reverse repo transaction and time deposit counterparties. These account confirmations included either an account statement or a summary of that account statement and asked the account holder to confirm the accuracy of the account statement.⁴⁴⁶ To identify customers with which to confirm balances, GT obtained a Refco-produced report called the “Repo Risk Analysis Report” or “RPT551.” GT then prepared a summary of this report, and selected customer account balances for confirmation that exceeded a materiality threshold GT calculated from year to year.⁴⁴⁷

Professional audit standards advise auditors to be particularly diligent when confirming transactions that are large, unusual, or complex, and that such transactions, particularly when occurring at year end, are associated with a particularly high level of risk.⁴⁴⁸ Consequently, auditors are counseled to confirm the terms of such transactions and not merely their amount.⁴⁴⁹

In addition to the confirmation process, GT adopted procedures to assess the credit risk of repo and reverse repo transactions and time deposits.⁴⁵⁰ This process primarily involved assessing whether customer debit balances arising from repo or reverse repo transactions or time deposits were secured by adequate collateral. As GT knew, it was the policy of Refco to take

⁴⁴⁶ See, e.g., GT SEC 0016260 (April 16, 2003 confirmation request from Refco to Liberty Corner).

⁴⁴⁷ See, e.g., GT E SEC 20004419 (March 31, 2005 Memorandum to RCM audit file concerning Repos and Reverse Repos confirmation sampling).

⁴⁴⁸ AU §§ 334.8(g); 9334.18. GT’s internal guidance was consistent with these standards. See GT EX 003403.

⁴⁴⁹ See AU § 334.8(g).

⁴⁵⁰ See, e.g., GT SEC 0003373-82 (Memo re: Refco Capital Markets Ltd. Credit Risk Analysis — Debit Balances, Repo / Reverse Repo & Time Deposits, 2/29/04).

possession of securities purchased (presumably, purchased by Refco) under an agreement to resell,⁴⁵¹ which is how the purported “reverse repo” transactions or “time deposits” would have appeared to GT. In addition, GT knew that “time deposits” were supposed to be secured by a customer’s security positions.⁴⁵²

Refco’s internal records concerning repo and reverse repo transactions, primarily the Repo Risk Analysis Report used to identify customers for confirmation, contained information about the collateral used to secure the transaction and provided the primary basis for GT’s analysis of credit risk. In certain audit periods, GT also reviewed RPTR03, another internal Refco report indicating whether the repo balances had been repaid.⁴⁵³ Finally, during certain audit periods, GT also conducted a review of the credit files of customers with significant debit balances arising from repos or reverse repos. The purpose of the credit file review was apparently to provide additional assurance and due diligence concerning credit risks posed by customer debit balances.⁴⁵⁴

(iv) Review of Repo and Reverse Repo Transactions and Time Deposits

The use of transactions presented in Refco’s books and records as “reverse repo” and time deposit transactions in customer accounts at RCM was a major part of the accounting fraud perpetrated by Refco’s management. The Round Trip Loans with Refco customers during the

⁴⁵¹ See, e.g., Refco Group Ltd., LLC Form 10-K for the fiscal year ended February 28, 2005 at page F-12, filed with the SEC dated July 1, 2005, available at <http://www.sec.gov/Archives/edgar/data/1305464/000104746905018583/a2159496z10-k.htm>, noting that “It is the Group’s policy to take possession of securities purchased under agreements to resell.”

⁴⁵² See GT SEC 0005928 (Memorandum concerning Credit Risk Analysis – Debit Balances, Repo/Reverse Repo & Time Deposits from February 28, 2005 audit of Refco Capital Markets, Ltd.).

⁴⁵³ See, e.g., GT SEC 0018853-59 (workpapers from 5/31/05 review of RCM relating to Customer Debit Balances, Time Deposits, and Repos).

⁴⁵⁴ See GT SEC 0056453 (workpaper from 2/28/05 audit of RCM relating to Credit File Testwork).

periods audited by GT, such as Liberty Corner, Delta Flyer, Beckenham Trading, and others, were accomplished at RCM by recording the cash loan as a reverse repo or time deposit in the Round Trip Loan Participant's customer account.

In reality, however, these were *not* "reverse repo" transactions or "time deposits." The hallmark of both transactions, according to Refco's accounting policies, is collateralization by the counterparty's security positions.⁴⁵⁵ The transactions at issue, as explained below, consistently lacked collateral. Nonetheless, GT appears to have accepted Refco management's characterization of these transactions in its books and records as reverse repos and time deposits and failed to perform appropriate audit steps. GT never questioned management's characterization of these transactions in the face of contradicting evidence. GT encountered significant clues of the Round Trip Loan accounting fraud in its review of reverse repo transactions and time deposits at RCM.

(a) Purported Reverse Repo Transactions /Time Deposits Reviewed in Audit of February 28, 2003 Financial Statements

During its 2003 year-end audit of RCM, GT noted large, period-end, round-dollar so-called "reverse repo" transactions between RCM and two customers, Liberty Corner and Delta Flyer as follows:

Customer Name	Trade Date	Maturity Date	Amount
Liberty Corner	2/21/03	3/4/03	\$500,000,000.00
Delta Flyer	2/21/03	3/4/03	\$150,000,000.00

⁴⁵⁵ See, e.g., n.440 and n.451, *supra*.

As the “trade date” and “maturity date” indicate, these transactions were both timed to span the end of Refco’s fiscal year (February 28, 2003) and to be essentially reversed after the close of Refco’s fiscal year.

On April 16, 2003, GT sent confirmation requests to Liberty Corner⁴⁵⁶ and Delta Flyer.⁴⁵⁷ Those confirmations requests included a copy of the Repo Risk Analysis Report for the account showing the trade and maturity date, collateral amount, accrued interest, and amount of reverse repo. The confirmation requests were signed by the recipients and returned to GT, indicating that the statements were accurate. Although GT performed additional credit risk testing on other RCM customer accounts, the Liberty Corner and Delta Flyer accounts were not selected in 2003 for additional testing, perhaps because they had been repaid by the time of audit fieldwork. In any event, GT did not inquire into the circumstances of these transactions.

*(b) Purported Reverse Repo / Time Deposit Reviewed
in Audit of February 29, 2004 Financial
Statements*

During its audit of RCM for the following fiscal year, ended February 29, 2004, GT again noted at least one large, period-end, round-dollar transaction characterized as a reverse repo.⁴⁵⁸ That transaction was with Liberty Corner on February 20, 2004 in the amount of \$720 million.

As with the previous year, GT sent a request to Liberty Corner to confirm this account balance. The confirmation request included a page from the Liberty Corner account statement showing just the trade date and the amount of the so-called “reverse repo” or “time deposit.”⁴⁵⁹ Liberty Corner signed and returned the confirmation request. This year, however, GT took the

⁴⁵⁶ See GT SEC 0016260-61.

⁴⁵⁷ See GT SEC 0016280-81.

⁴⁵⁸ See GT SEC 0003607 (Repo Risk Analysis Report (RPT551) for Liberty Corner as of 2/27/04).

⁴⁵⁹ See GT SEC 0061712-14. On the account statement, the transaction was called a time deposit.

additional step of reviewing the potential credit risk of this transaction. GT noted that the entire amount of Liberty Corner's debit balance - \$720,000,000 - was at risk, meaning that no collateral secured it.⁴⁶⁰ However, apparently because by the time GT reviewed the account the balance had been repaid, GT did not identify the account as a credit risk.⁴⁶¹ GT apparently either did not recognize or ignored the fact that reverse repo transactions and time deposits *should* be secured by collateral.

**(c) *Purported Reverse Repos / Time Deposits*
Reviewed in Re-Audit of February 28, 2002
*Financial Statements***

Shortly after completing its audit of Refco's February 28, 2004 financial statements, GT conducted a re-audit of Refco's February 28, 2002 financial statements. GT reviewed AA's workpapers in connection with the re-audit and generally reviewed the same information that had been available to AA. GT noted that the following reverse repo transactions or time deposits occurred at the end of the audit period:⁴⁶²

Customer Name	Trade Date	Maturity Date	Amount
Liberty Corner	2/25/02	3/4/02	\$325,000,000.00
Delta Flyer	2/25/02	3/4/02	\$175,000,000.00
Beckenham	2/25/02	3/4/02	\$125,000,000.00

⁴⁶⁰ See GT SEC 0003380-82 (workpaper from 2/28/04 audit of Refco Capital Markets titled "Credit Risk Analysis – Time Deposits, reflecting a net debit exposure as of 2/27/04 in Liberty Corner's account of \$720 million).

⁴⁶¹ *Id.*

⁴⁶² See GT SEC 0017198 (Funding Product Accrued Interest Report (RPT610) reflecting, in succession, the receivables from Liberty Corner, Delta Flyer, and Beckenham).

GT reviewed summary account statements for these three customers, reflecting the debit balances shown above.⁴⁶³ Those account statements showed GT that these debit balances had been extended without collateral.⁴⁶⁴ GT again saw records of large, round-dollar, reporting period end reverse repo transactions or time deposits. Still, it appears that for the re-audit GT did little more with this information than had been done previously in that it merely requested confirmation of the balances as of February 28, 2002.⁴⁶⁵

(d) Purported Reverse Repos / Time Deposits Included in Review of November 30, 2004 Financial Statements

During its review of the November 2004 financial statements of RCM, GT was presented with evidence relating to reverse repos that should have prompted it to ask serious questions of its client.⁴⁶⁶ As with prior audit periods, GT received information about repos and reverse repos pending as of the date of the financial statements being reviewed. Once again, GT saw evidence

⁴⁶³ See GT SEC 0017514-5 (Liberty Corner); GT SEC 0072645-6 (Beckenham Trading); GT SEC 0072639 – 40 (Delta Flyer).

⁴⁶⁴ For instance, the customer account statements referenced in n.463, *supra*, reflect no securities or other assets securing the debit balances.

⁴⁶⁵ See GT SEC 0003861 – 63 (memorandum dated August 12, 2004 re: “Repo’s and Reverse Repo’s confirmation sampling” to Refco Capital Markets 2/28/02 Audit File from GT Auditor Jennifer Zhang).

⁴⁶⁶ GT’s interim reviews of Refco’s financial statements were not audits. These reviews were to be conducted in accordance with standards set forth by the United States Public Company Accounting Oversight Board (“PCAOB”). The objective of the interim review was to “provide a basis for communicating whether we are aware of any material modifications that should be made to the interim financial information for it to conform with [GAAP].” The reviews were to consist “principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters.” The procedures to be performed in connection with the reviews were “substantially less” than those in an audit, and were not intended to result in issuance of an opinion on the financial statements. GT SEC 0143033. GT, however, noted in its workpapers for the audit of fiscal year ended February 28, 2005 that its review procedures had tended to be more substantive than analytical in order to better address the risk of material misstatement. See GTE SEC 20003221.0003. Even though these reviews were not audits, they presented GT with red flags that should have prompted further action, which in turn could have led to discovery of the fraud.

of large, period-end, round-dollar transactions purported to be reverse repo transactions or time deposits occurring in customer accounts at RCM, as follows:⁴⁶⁷

Customer Name	Trade Date	Maturity Date	Amount
Liberty Corner	11/26/04	12/3/04	\$545,000,000.00
Refco Group Holdings, Inc.	11/26/04	12/3/04	\$545,000,000.00

Because this information arose in the context of a review, rather than an audit, GT did not seek to confirm the accounts with the customers. However, GT did conduct a credit risk analysis as it had in prior audit and review periods. As before, GT knew that the purported reverse repo with Liberty Corner was unsecured.⁴⁶⁸ When GT inquired about this transaction, it was apparently told by RCM's Richard Outridge that "there had been a reporting error on recording of the \$545 million" and that the "amount had been adjusted."⁴⁶⁹ That representation by Refco was apparently sufficient to prevent any further inquiry by GT into this transaction. GT, again, did not question the characterization of the unsecured transaction as a reverse repo or time deposit.

Significantly, however, RGHI had also entered into a purported reverse repo transaction or time deposit with RCM for exactly the same amount and covering exactly the same dates as Liberty Corner.⁴⁷⁰ In performing its review of Refco's November 2004 financial statements, GT

⁴⁶⁷ See GT SEC 0002001, at App. D-14 (page from Funding Product Accrued Interest Report (RPT610) showing \$545 million receivables from Liberty Corner and RGHI).

⁴⁶⁸ See GT SEC 0075018 (workpaper spreadsheet titled "Refco Capital Markets Ltd., LLC Reverse Repo / Repo Customer Analysis – Summary of Repo Analysis Report (RPT551)").

⁴⁶⁹ See GT SEC 0075031, at App. D-15 (workpaper spreadsheet document titled "Refco Capital Markets LTD Credit Risk Analysis – Time Deposits").

⁴⁷⁰ See GT SEC 0002001, at App. D-14.

even obtained a copy of Refco’s “Accrued Interest Report” (or “RPT610”) that displayed these two similar transactions *on two consecutive lines*.⁴⁷¹ The only apparent difference between the transactions on this form is the interest rate: Liberty Corner was being charged 2.00%, while RGHI was being charged 2.75%. GT should have noted the striking similarities between these two transactions, which transactions are practically direct evidence of the fraud that occurred in November 2004 involving a \$545 million loan from Liberty Corner to RGHI used to pay down RGHI’s receivable in its RCM account.⁴⁷² Moreover, it does not appear that GT questioned why Refco entered into a \$545 million reverse repo with an affiliated party or scrutinized the circumstances of that transaction. Significantly, it also does not appear that GT questioned why — if RGHI had indeed paid down its debt to Refco as GT had been told — Refco appeared to be extending additional unsecured loans or advances to RGHI in such massive amounts. Finally, it does not appear that GT followed up on this red flag to review RGHI’s account at RCM, which would have revealed not only the true amount of RGHI’s debt to Refco, but also the fraud used by Refco management to conceal it.

(e) *Pattern of Purported Reverse Repos / Time Deposits Reviewed in Financial Statement Audits and Reviews*

In every audit and review that it conducted of Refco, GT received information that RCM was engaging in large period-end, unsecured credit transactions, purported “reverse repo” transactions or time “deposits,” with Liberty Corner as follows:

⁴⁷¹ See *id.*

⁴⁷² See, *supra*, Section IV.D.2.a(iv)(d).

Audit / Review Period	Trade Date	Maturity Date	Amount
February 28, 2002	2/25/02	3/4/02	\$325,000,000.00 ⁴⁷³
February 28, 2003	2/21/03	3/4/03	\$500,000,000.00 ⁴⁷⁴
February 29, 2004	2/20/04	3/04/04	\$720,000,000.00 ⁴⁷⁵
May 31, 2004	[see footnote 476]	[see footnote 476]	\$700,000,000.00 ⁴⁷⁶
August 31, 2004	8/25/04	9/7/04	\$485,000,000.00 ⁴⁷⁷
November 30, 2004	11/26/04	12/3/04	\$545,000,000.00 ⁴⁷⁸
February 28, 2005	2/23/05	3/8/05	\$345,000,000.00 ⁴⁷⁹
May 31, 2005	5/24/05	6/6/05	\$450,000,000.00 ⁴⁸⁰
August 31, 2005	8/26/05	9/6/05	\$420,000,000.00 ⁴⁸¹

⁴⁷³ GT SEC 0072637 (Funding Product Accrued Interest Report (RPT610) for 2/28/02).

⁴⁷⁴ GT SEC 0016260-61 (April 16, 2003 confirmation request to Liberty Corner and Repo Risk Analysis Report (RPT551) for 2/28/03).

⁴⁷⁵ GT SEC 0003607 (Repo Risk Analysis Report (RPT551) for 2/27/04).

⁴⁷⁶ GT SEC 0077662, at App. D-16 (“Credit Risk Analysis - Time Deposits” workpaper in Refco Capital Markets Ltd. 5/31/04 review file). GT’s workpapers for the May 2004 review do not appear to contain direct evidence of the “trade” or “maturity” dates of the transaction with Liberty Corner (such as that found in RPT551 or RPT610). However, in reviewing the credit risk associated with the debit balance, GT was told by Richard Outridge, CFO of RCM, that “Liberty Capital repaid their balance in full subsequent to 5/31/04. The \$700 million was repaid in June of 2004.” *Id.*

⁴⁷⁷ GT SEC 0019333 (Repo Risk Analysis Report (RPT551) for 8/31/04).

⁴⁷⁸ GT SEC 0002001, at App. D-14 (Funding Product Accrued Interest Report (RPT610) for 11/30/04).

⁴⁷⁹ GT SEC 0001944 (Repo Risk Analysis Report (RPT551) for 2/28/05).

⁴⁸⁰ GT SEC 0000887 (Funding Product Accrued Interest Report (RPT610) for 5/31/05).

⁴⁸¹ GT SEC 0073514 (Funding Product Accrued Interest Report (RPT610) for 8/31/05).

GT also noted similar transactions with other customers, including Delta Flyer, Beckenham Trading, and RGHI. In each case, GT apparently understood that the transactions, represented by management as reverse repo transactions, were in fact unsecured loans of hundreds of millions of dollars rather than collateralized reverse repo transactions. Yet, in each case, GT declined to investigate further based on the information — often merely a representation from management — that the unsecured balance had been repaid.⁴⁸² Moreover, despite being engaged for years as Refco’s auditors, GT apparently never noted the pattern and questioned why Refco entered into these uncollateralized transactions with Liberty Corner at the end of each and every reporting period. Nor did GT apparently ever question why Refco was characterizing these transactions as reverse repos or time deposits when they were not collateralized.

(v) *Customer Credit File Review*

In addition to the procedures described above concerning testing of credit risk, during its audit of Refco’s February 2005 financial statements, GT tested credit files of certain customers. Liberty Corner’s account was selected for testing and GT obtained the customer credit file for Liberty Corner from RCM’s credit department. GT noted that Liberty Corner’s “customer credit file does not mention any opening of accounts at RCM.”⁴⁸³ GT took additional steps to

⁴⁸² For instance, in connection with the \$700 million receivable in Liberty Corner’s RCM account as of May 31, 2004, GT noted that “P/D/W Rich Outridge, Liberty Capital repaid their balance in full subsequent to 5/31/04. The \$700 million was repaid in June 2004.” GT SEC 0077662, at App. D-16. Again during the 2005 fiscal year-end audit, when Liberty Corner’s account showed a debit balance of \$345 million, GT noted that “Per discussion with Richard Outridge, CFO, as of 4/22/05 the total equity balance is zero. All monies due to Refco were subsequently paid back.” GT SEC 0005940 at 5943, at App. D-17.

⁴⁸³ GT SEC 0056453-54 (“Credit File Testwork” workpaper from 2/28/05 audit of RCM).

determine that “Liberty Corner Capital opened up an account with Refco Securities,” and, based on this conclusion, declined to investigate the matter further.⁴⁸⁴

Yet, there is no indication in the audit workpapers that GT itself reviewed Liberty Corner’s credit file with Refco Securities or otherwise determined whether Liberty Corner could repay hundreds of millions of dollars in unsecured loans. In fact, an additional indication of the irregularity of these loans is that Liberty Corner was not worthy of credit in the amount of hundreds of millions of dollars. Liberty Corner was owned entirely by an individual (Terrence Pigott), had assets of only a few hundred thousand dollars, and was not regularly engaged in the business of securities trading.⁴⁸⁵

In summary, GT failed to note the significance in the recurring pattern of purported reverse repo transactions or time deposits with customers. GT also failed to exercise appropriate professional skepticism with regard to Refco management’s explanation for these transactions, particularly since GT knew that Refco management posed significant financial statement risks and these types of transactions merited additional skepticism and scrutiny under its own internal guidelines. GT also seems to have never questioned why Refco was recording transactions that essentially amounted to unsecured loans as “time deposits” or “reverse repos” in its books and records. Finally, and perhaps most significantly, GT appears to have simply overlooked an obvious red flag in the form of the November 2004 near-identical reverse repo transactions with Liberty Corner and RGHI. GT’s treatment of that transaction and the others described above did

⁴⁸⁴ *Id.*

⁴⁸⁵ Pigott Transcript, pp. 7, 53, 55.

not exhibit the crucial “questioning mind and critical assessment of audit evidence” required of an auditor.⁴⁸⁶

c. GT Generally Exhibited a Lack of Skepticism and Relied too Heavily on “Management’s Integrity”

Despite having identified significant risk areas in the Refco engagement, in some instances GT appears to have ignored or dismissed those risks. For instance, GT understood that Bennett could materially impact the accuracy of financial statements by, for example, withdrawing funds from the company. Rather than performing audit steps designed to detect top-level accounting fraud of the very sort that was occurring, GT dismissed the possibility that Bennett would engage in such conduct, noting that “based on conversations with Robert Trosten, Joe Mazurek Chief Credit Officer, and in-house legal counsel, it is extremely unlikely that Phil [Bennett] would do anything like this.”⁴⁸⁷ GT went on further to note that “it has been Mark Ramler’s experience that Phil [Bennett] is not going to put the firm’s capital at risk if good business sense dictates not to.”⁴⁸⁸

It therefore appears that GT dismissed a critical risk factor of which it was well aware - and that played a key role in the ongoing accounting fraud. GT appears not to have performed any audit procedures designed to mitigate this perceived risk. GT’s reasons for dismissing this perceived risk are not evident beyond the personal feelings of the audit partner and the representations of Refco’s insiders. Criticizing GT’s apparent reliance on such evidence, which included the opinion of Trosten, one of Bennett’s co-defendants in the criminal case, is not

⁴⁸⁶ AU § 230.07; SAS 99.

⁴⁸⁷ GT SEC 0032688, at App. D-18; GT SEC 0069068 (identical pages from “Developing the Audit Plan” portions of GT Audit Programs for Refco Group Ltd. LLC and Subsidiaries and Refco Capital Markets Ltd. and Subsidiaries, dated 2/28/2002).

⁴⁸⁸ *Id.*

purely the benefit of hindsight. As noted above, Ramler had previously identified Refco's control by a small group of insiders as a significant control risk, including during his time auditing Refco while with AA. Ramler's reliance on that same group of insiders to dispel concerns about Bennett indicates a lack of skepticism and care in the face of a known risk.

Similarly, a preliminary audit planning step for RGL was to "inquire of the audit committee or its chairman regarding . . . awareness of fraud or suspected fraud."⁴⁸⁹ Because Refco did not have an audit committee at that time, Ramler could not make this inquiry. Instead, he apparently spoke with Trosten and Bennett, who, not surprisingly, assured GT that they were unaware of any fraud. Furthermore, they assured GT that any fraud would likely be committed by their customers or independent brokers. GT should have exercised more diligence and skepticism than inquiring concerning potential fraud with the same company insiders who presented a risk of fraud.

E. EVIDENCE SUGGESTING GT'S ACTUAL KNOWLEDGE OF FRAUD

There are some documents suggesting that Ramler may have had some knowledge of the relationship among the purported reverse repo transactions, the BAWAG debit balances, and the fraud occurring at Refco. One such document, in which Ramler suggested that the financial disclosure statements reflect that the BAWAG debit balances were "repaid shortly after each year end" is discussed above. In addition, an undated note — apparently handwritten by Ramler and located in his desk file — contained the words "\$450,000 million" and "contract loan," with a line drawn between "\$450,000 million" and the words "Liberty Corner Capital Strategy Fund LLC."⁴⁹⁰ Next to the name of Liberty Corner appear the words "nature transaction," and below

⁴⁸⁹ GT SEC 0031571 ("Preliminary Audit Planning" Paper Explorer File for Refco Group Ltd. LLC and Subsidiaries period ending 2/28/03).

⁴⁹⁰ GT SEC 0130713, at App. D-19.

it are the words “clean-up of interco accounts.”⁴⁹¹ During the quarter ended May 31, 2005, Refco did in fact extend to Liberty Corner a \$450 million “loan” characterized on its books as a “reverse repo.”

Ramler’s reference to “clean-up of interco accounts” is particularly noteworthy because this is essentially the same phrase used in documents produced by BAWAG in connection with its providing Refco with period-end Round Trip Loans.⁴⁹² It is also significant because Refco used the \$450 million Liberty Corner loan to “clean up” its intercompany accounts. That is a connection Ramler would not likely draw unless he had actual knowledge of what was happening.

As discussed above, GT noted repeatedly that Refco extended unsecured credit to certain customers in massive amounts, and observed that Refco recorded these transactions as “reverse repos” or “time deposits” in its books and records. Yet, GT was aware that true reverse repo transactions and time deposits were, by definition, collateralized by a customer’s security positions. Whether GT *actually* recognized that Refco was mischaracterizing the nature of these transactions in its books and records requires additional investigation, including depositions of Ramler, other GT personnel, and Refco employees. If GT did in fact realize that Refco was mischaracterizing these transactions, it could be subject to liability for aiding and abetting Refco’s fraud.

Finally, records of internal communications within GT’s management reflect a keen concern about the risks posed by the Refco engagement in general and Refco management in particular. Specifically, GT appears to have been concerned as late as December 2004 that

⁴⁹¹ *Id.*

⁴⁹² BAWAG 001305 (“Year-End Planning - Schedule of Events”).

Refco did not have adequate controls in place, had poor financial oversight, and was moving too quickly towards an IPO for GT's comfort. GT appears further to have had concerns about its own liability risks arising from the Refco engagement.⁴⁹³ This, too, requires further investigation through the questioning of GT personnel.

F. CONCLUSIONS: ANALYSIS OF POTENTIAL CLAIMS AGAINST THE AUDITING PROFESSIONALS

1. Negligence and Professional Malpractice

Under New York law, “a professional’s failure to perform his job in accordance with the standards required of one in his field states a claim in tort or malpractice,” a form of negligence.⁴⁹⁴ When an auditor negligently performs its duties, its client has a cause of action against the auditor.⁴⁹⁵ Under the Bankruptcy Code, this claim is the property of the estate to assert.⁴⁹⁶ To establish a claim for professional malpractice by the auditors, the estate must show that: (1) the auditors owed a duty to the audit client; (2) the auditors breached that duty; (3) there is a “a reasonably close causal connection” between the breach of duty and the injury; and (4) “actual loss, harm, or damage.”⁴⁹⁷

⁴⁹³ Notes of a conversation between Ramler and an unidentified member of GT’s Professional Standards Group that appear to date from December 2004 suggest that the risks of the Refco engagement were well-understood by GT and other professionals. The note appears to relate to Refco’s response to comments from the SEC. *See* GT EX 001976, at App. D-20 (handwritten notes on page of Diary and Work Record for December 21, 2004). The note states “Atty called — also this AM — Refco makes Firm uncomfortable . . . issue is sig. def. . . . Issue is no CFO. Probably had weak one before. We might not want to participate in IPO once this S-4 is done.” The note goes on to state, apparently concerning Refco and its push to go public, “They are moving very fast - too fast for comfort . . . what to do - we would be sued.” Because the Examiner did not interview any GT employees, the meaning of this note is unclear. The tone and apparent subject matter of the note, however, strongly suggest urgent concern within GT about the risks posed by Refco’s lack of controls and desire to quickly conduct an IPO.

⁴⁹⁴ *Bloor v. Dansker (In re Investors Funding Corp. of New York Sec. Litig.)*, 566 F. Supp. 193, 201 (S.D.N.Y. 1983). *See also* App. A, Sec. III.A.

⁴⁹⁵ *See* App. A, Sec. III.A.

⁴⁹⁶ *Id.*

⁴⁹⁷ *Sharp Int’l Corp. v. KPMG LLP (In re Sharp Int’l Corp.)*, 319 B.R. 782, 790 (Bankr. E.D.N.Y. 2005) (finding claim for professional malpractice by the auditor withstands motion to dismiss based on alleged breaches of

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An auditor owes its client a duty to “use the skill and due professional care and to exercise good faith and to observe generally accepted auditing standards and professional guidelines, with the appropriate reasonable, honest judgment that a reasonably prudent and skillful auditor would use under the same or similar circumstances.”⁴⁹⁸ An established means for auditors to fulfill this duty is to conduct their audits in accordance with GAAS, the standards of practice for auditors.⁴⁹⁹ While proof of a departure from the standards does not necessarily establish negligence *per se*, it does require the auditor to substantiate any departure from the standards.⁵⁰⁰

a. AA and GT Owed a Duty to Refco

As audit professionals engaged by Refco to perform audits in compliance with GAAS, AA and GT had legal duties to conduct the audits of Refco financial statements by undertaking “to use skill and due professional care and to exercise good faith and to observe generally accepted auditing standards and professional guidelines, with the appropriate reasonable, honest judgment that a reasonably skillful and prudent auditor would use under the same or similar circumstances.”⁵⁰¹ The engagement letters for each obligated them to conduct their audits of Refco in accordance with auditing standards generally acceptable in the United States (US GAAS). The audits were to involve examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and

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professional standards in conducting audit). *Integrated Waste Servs., Inc. v. Akzo Nobel Salt, Inc.*, 113 F.3d 296, 299 (2d Cir. 1997).

⁴⁹⁸ *Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F. Supp. 531, 538 (S.D.N.Y. 1990).

⁴⁹⁹ *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 811 (1984).

⁵⁰⁰ See App. A, Sec. III.B.1.

⁵⁰¹ *Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F. Supp. 531, 538 (S.D.N.Y. 1990).

significant judgments and estimates made by management, as well as evaluating the overall financial statement presentation.⁵⁰² Each was responsible for obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed.⁵⁰³ Each committed to communicating significant deficiencies or material weaknesses in internal control coming to their attention during the audits.⁵⁰⁴

b. AA and GT Breached Their Duty of Professional Care

As an initial matter, based on the documents, the Examiner concludes that there is sufficient evidence to state a claim that AA and GT breached their respective duties of professional care by failing to conduct audits of Refco entities, namely RGL, RCM, and RCC, in accordance with GAAS. With respect to GT, the Examiner notes particularly its failure to conduct its review of related party transactions in compliance with GAAS during the fiscal year 2005 audit, despite entering into a consent decree with the SEC involving similar problems in auditing related party transactions. The documentary evidence supports a claim that both AA and GT failed to: (1) exercise due professional care in the planning and performance of the audits and the preparation of auditor's reports;⁵⁰⁵ (2) obtain sufficient competent evidential matter through inspection, observation, inquiries, and confirmations to afford a reasonable basis for opinions regarding the financial statements under the audits;⁵⁰⁶ and (3) satisfy themselves that

⁵⁰² See, e.g., AAREF 00010141 (AA 2001 Audit Engagement Letter); GT SEC 0113599 (Engagement letter dated March 14, 2003 for audits of consolidated financial statements of Refco Group Ltd. LLC and Subsidiaries as of February 28, 2003 from Ramler to Trosten).

⁵⁰³ See *id.*

⁵⁰⁴ *Id.*

⁵⁰⁵ AU §§ 410, 431, 500; *Bankr. Servs., Inc. v. Ernst & Young (In re CBI Holding Co., Inc.)*, 247 B.R. 341, 363 (Bankr. S.D.N.Y. 2000), *rev'd in part on other grounds*, 311 B.R. 350 (S.D.N.Y. 2004), *vacated on other grounds*, 318 B.R. 761 (S.D.N.Y. 2004).

⁵⁰⁶ AU § 326; *In re CBI Holding Co., Inc.*, 247 B.R. at 363.

financial statement disclosures of related parties were reasonably adequate with respect, at least, to the nature and extent of related party transactions.⁵⁰⁷

The failure to comply with GAAS is evidenced by the auditors' specific acts, or failures to act, in breach of the duty to Refco to adequately plan for the audit and testing of related party transactions year after year. Although they identified significant risks associated with related party transactions and management incentives to override accounting controls, the auditors did virtually nothing to address them. Moreover, when GT did devise procedures to address the known risks from related party transactions, it failed to follow them.

The documentary evidence supports a claim that AA and GT breached their respective duty of professional care to Refco by failing to exercise the professional skepticism expected of a reasonable auditor throughout the audit process, most glaringly in relation to known risks of related party transactions. In exercising professional skepticism, the auditor "neither assumes that management is dishonest nor assumes unquestioned honesty"⁵⁰⁸ and "should not be satisfied with less than persuasive evidence because of a belief that management is honest."⁵⁰⁹ As detailed through the Examiner's Report, both AA and GT essentially accepted without question management's representations regarding the nature and extent of related party transactions, despite having identified related party transactions as a very significant audit risk.

GAAS required the auditors to obtain competent evidential matter to support the financial statements on which each opined. But the Examiner found that with respect to the audit of related party transactions, the auditors gathered little to no evidence aside from the financial statements provided by Refco along with representations by management, while ignoring "red

⁵⁰⁷ AU § 334.11.

⁵⁰⁸ AU § 230.09; SAS 82.

flags” pointing to the fraud. Instead, the auditors were obligated to adequately verify, corroborate, or confirm management’s representations.⁵¹⁰

AA’s and GT’s failure to conduct audits of Refco in conformance with professional auditing standards and in seeming disregard of the impact of related party transactions are the same departures from auditing standards courts have recognized as breaching an auditor’s professional duty of care, including, without limitation, the failure to: (1) exercise the requisite skepticism throughout the auditing process;⁵¹¹ (2) gather competent evidential matter to support Refco’s financial statements;⁵¹² (3) adequately verify Refco’s accounts receivable;⁵¹³ (4) adequately verify, corroborate, or confirm representations of Refco’s management.⁵¹⁴

c. Statute of Limitations for Professional Negligence

The statute of limitations for professional auditor malpractice in New York is three years, and generally begins to run when the auditor delivers the negligently prepared audit report to the client.⁵¹⁵ Under the “continuous representation doctrine,” the limitations period is extended on a malpractice claim against an auditor through the entire period of consecutive audits the auditor

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⁵⁰⁹ *Id.*

⁵¹⁰ AU § 334.09; *Sharp Int’l Corp. v. KPMG LLP (In re Sharp Int’l Corp.)*, 278 B.R. 28, 33 (Bankr. E.D.N.Y. 2002) (allegation auditor failed to adequately verify, corroborate, or confirm management representations on alleged growth of accounts receivable one of several alleged departures from professional standards defeating motion to dismiss).

⁵¹¹ See *In re CBI Holding Co., Inc.*, 247 B.R. at 363.

⁵¹² See *id.*; *In re Sharp Int’l Corp.*, 278 B.R. at 34-35.

⁵¹³ See *In re Sharp Int’l Corp.*, 278 B.R. at 34-35.

⁵¹⁴ See *id.*

⁵¹⁵ See App. A, Sec. III.D.

performed if it is found that the consecutive audits constitute continuous service; a question of fact for the fact finder.⁵¹⁶

d. Examiner's Conclusion Concerning Negligence

Based on the Examiner's review of the relevant professional and legal standards, their application under common law, and GT's failure to conduct its audits and reviews of Refco's financial statements in accordance with established professional auditing standards as detailed by this Report, the Examiner concludes, subject to applicable defenses, that a cause of action against GT for professional malpractice would withstand a motion to dismiss. GT delivered its audit reports within the three years prior to the petition date. Accordingly, a claim for professional malpractice against GT as to any audit reports it prepared is not barred by the statute of limitations until the later of three years from June, 2005 or two years from the date the statute of limitations is tolled under Section 108 of the Bankruptcy Code.

AA delivered its last audit report in May 2002, over three years before the filing of Refco's Petitions. A professional malpractice claim therefore may be barred by the applicable statute of limitations.⁵¹⁷

2. Aiding and Abetting Breach of Fiduciary Duty/Fraud

Under New York law, a corporation may sue a third party for aiding and abetting officers' and directors' breaches of fiduciary duty or aiding and abetting fraud.⁵¹⁸ The elements of these two claims are very similar. A claim for aiding and abetting breach of fiduciary duty

⁵¹⁶ *Id.*

⁵¹⁷ "Fraudulent concealment" can act to extend the statute of limitations such that it is tolled while facts that the auditor was under an affirmative obligation to disclose are concealed from the client. *See App. A, Sec. III.D.* However, whether New York law continues to recognize fraudulent concealment as a means of tolling the statute of limitations for malpractice claims against auditors is an open question. Moreover, to invoke fraudulent concealment requires alleging facts sufficient to show that the auditor deliberately concealed facts underlying the claim.

⁵¹⁸ *See App. A, Sec. IV.A.* and cases cited therein.

requires a showing of: (1) the existence of a breach by a fiduciary of a duty owed to the plaintiff; (2) knowing inducement or participation in the breach by the defendant; and (3) damages suffered by the plaintiff.⁵¹⁹ The elements of a claim for aiding and abetting fraud are: (1) existence of a fraud; (2) the defendant's knowledge of the fraud; (3) provision by the defendant of substantial assistance to advance the fraud's commission; and (4) damages suffered by the plaintiff.⁵²⁰ Under the Bankruptcy Code, these claims are property of the estate.⁵²¹

a. The Requirement of “Actual Knowledge”

Both aiding and abetting breach of fiduciary duty and aiding and abetting fraud require proof of “actual knowledge” under New York law.⁵²² To allege actual knowledge, a plaintiff must plead “specific facts that would give rise to an inference that [the auditor] actually knew of [the debtor’s] allegedly fraudulent activities.”⁵²³ Most often, this is accomplished by the use of the auditor’s internal documents showing the auditor recognized the particular breach of fiduciary duty, or the fraud.⁵²⁴ Allegations an auditor “should have known,” or had access to the client’s records revealing the breach or fraud, do not satisfy the actual knowledge requirement.⁵²⁵

⁵¹⁹ See *id.*

⁵²⁰ See *id.*

⁵²¹ See *id.*

⁵²² See *Kolbeck v. Lit America, Inc.*, 939 F. Supp. 240, 245-249 (S.D.N.Y. 1996) (discussing and harmonizing extensive case law substantiating the requirement of actual knowledge versus reckless disregard or willful blindness, and granting motion to dismiss aiding and abetting claim for failure to specifically allege facts demonstrating actual knowledge). *But see Cromer Fin. Ltd. v. Berger*, No. 00 Civ.2284 DLC, 2003 WL 21436164, *9 (S.D.N.Y. June 23, 2003) (“[T]here is no reason to believe that New York law would not accept willful blindness as a substitute for actual knowledge in connection with aiding and abetting claims.”).

⁵²³ *Vtech Holdings Ltd. v. Pricewaterhouse Coopers LLP*, 348 F. Supp. 2d 255, 269 (S.D.N.Y. 2004).

⁵²⁴ *Ryan v. Hunton & Williams*, 99-CV-5938, 2000 U.S. Dist. LEXIS 13750, *29 (E.D.N.Y. Sept. 20, 2000).

⁵²⁵ See *Kolbeck*, 939 F. Supp. at 247 (actual knowledge requirement is logically consistent with other elements of tort, such as substantial assistance or failure to act).

(i) Further Investigation Is Warranted into the Actual Knowledge Held by GT of the Breach of Fiduciary Duty and Fraud

Documents reviewed by the Examiner suggest that Ramler may have had some knowledge of the relationship among the reverse repo transactions, the BAWAG debit balances, and the fraud occurring at Refco, including, without limitation, documents showing:

- Requests by Refco in the 2003 audit to provide documents demonstrating the payment of related party receivables that were apparently never obtained, and never again requested;
- GT's knowledge that BAWAG balances were repaid each year shortly after fiscal year end;
- Hand written notes from Ramler detailing a Liberty Corner transaction and tying it to inter-company account "clean-up,"
- GT reviewing and accepting as "reverse repos" transactions that were not reverse repos, and that did not fit GT's or Refco's own definitions of "reverse repos;" and
- GT's internally expressed significant concerns with its own potential auditor liability as Refco moved toward its IPO.

Pursuant to the protocol with the USAO, the Examiner did not interview certain former Refco employees and officers, Ramler, or other GT personnel involved in the Refco audits. While the Examiner believes it is premature to conclude at this point that actual knowledge of the fraud may be sufficiently alleged as to GT, the Examiner is of the opinion that further investigation is warranted.

(ii) Further Investigation Is Warranted into the Actual Knowledge of the Breach of Fiduciary Duty and Fraud Held by AA

As explained below, the relevant statute of limitations for *monetary* damage claims against AA for aiding and abetting a breach of fiduciary duty has run, barring such claim. A claim for aiding and abetting breach of fiduciary duty seeking *equitable* remedies is not barred

by the statute of limitations. Such a claim could result in restitution. However, questions remain as to AA's actual knowledge of the fraud.

Beyond the duration, seriousness and nature of the fraud, and AA's repeated failure to act upon "red flags" displaying aspects of the fraud, the Examiner did not find evidence showing AA's actual knowledge of the fraud. Ramler and other key witnesses could not be interviewed. Further investigation involving witnesses relevant to GT should also include inquiry into the actual knowledge of AA.

b. The Requirement of Participation or Substantial Assistance

To state a claim for aiding and abetting the breach of a fiduciary duty, a plaintiff must allege facts showing the auditor participated in the fraud, while a claim of aiding and abetting a fraud requires factual allegations that the auditor provided substantial assistance to the fraud.⁵²⁶ The elements of either claim may be satisfied by alleging facts showing the auditor affirmatively acted to assist or helped conceal the known breach of fiduciary duty or fraud.⁵²⁷

⁵²⁶ See App. A, Sec. IV.C.

⁵²⁷ See *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC*, 446 F. Supp. 2d 163, 201 (S.D.N.Y. 2006) (citing *Diduck v. Kaszycki & Sons Contractors, Inc.*, 974 F.2d 270, 284 (2d Cir. 1992)). See also *Ross v. Patrusky, Mintz & Semel*, No. 90 Civ. 1356 (SWK), 1997 WL 214957, *3, *14 (S.D.N.Y. Apr. 29, 1997) (auditor's internal memoranda noting deficiencies in the client's statements and showing the auditor issued an unqualified audit shortly thereafter established auditor knowingly concealed management's illegal acts).

Alternatively, the participation element (for breach of fiduciary duty) or substantial assistance element (for fraud) may be satisfied by alleging facts showing the auditor knew of the conduct and failed to act. *Montreal Pension*, 446 F. Supp. 2d at 201; see also, *Ross*, 1997 WL 214957 at *15 (pleading that an auditor concealed adverse information about the client, permitted management to breach its fiduciary duty, while agreeing to conceal management's wrongdoing states a claim for aiding and abetting fraud sufficient to defeat a motion to dismiss). But, alleging facts showing a failure to act requires additional allegations showing a fiduciary duty between the auditor and the plaintiff directly, *Kolbeck v. LIT Am., Inc.*, 939 F. Supp. 240, 247 (S.D.N.Y. 1996); see also App. A, Sec. IV, versus that between the violator and the plaintiff. New York law is arguably unsettled as to whether an auditor is a fiduciary to its client, although most recent authority does not recognize an auditor-client fiduciary relationship. Thus, whether a failure to act can support an aiding and abetting claim against AA and/or GT may depend upon whether they are found to be fiduciaries of Refco. See App. A, Sec. IV.C. (The Requirement of Substantial Assistance).

If AA or GT had actual knowledge of the Refco fraud, their issuance of unqualified audit opinions may be sufficient to support a claim for aiding and abetting the breach of fiduciary duty or fraud.⁵²⁸

c. The Statutes of Limitations for Aiding and Abetting Claims

(i) Aiding and Abetting Breach of Fiduciary Duty

The statute of limitations for bringing a claim for aiding and abetting a breach of fiduciary duty is dependant on the relief sought, with a three year limitations period applying to claims for damages and a six year limitations period for claims seeking equitable remedies.⁵²⁹ As with a claim for professional malpractice, the doctrine of continuing representation applies to claims for breaches of fiduciary duty and may toll the statute of limitations for claims against auditors performing consecutive audits.⁵³⁰

(ii) Aiding and Abetting Fraud

The statute of limitations for a claim against an auditor for aiding and abetting fraud is the greater of (1) six years from the date the cause of action accrued or (2) two years from the date the client discovered or should have reasonably discovered the fraud.⁵³¹ Whether a plaintiff should have discovered the fraud is a mixed question of law and fact. The test of discovery is objective — a determination of when the circumstances were such that a person of ordinary intelligence would recognize they have been defrauded.⁵³²

⁵²⁸ See *Ross*, 1997 WL 214957, at *3, *14.

⁵²⁹ See App. A, Sec. IV.E.

⁵³⁰ See *Williamson v. PricewaterhouseCoopers LLP*, 817 N.Y.S.2d 61, 64 (N.Y. App. Div. 2006); *Transp. Workers Union of Am. Local 100 AFL-CIO v. Schwartz*, 821 N.Y.S.2d 53, 56 (N.Y. App. Div. 2006).

⁵³¹ See App. A, Sec. IV.

⁵³² See *Armstrong v. McAlpin*, 699 F.2d 79, 88 (2d Cir. 1983); *Schmidt v. McKay*, 555 F.2d 30, 37 (2d Cir. 1977) (“[A]lthough a plaintiff may not shut his eyes to facts which call for investigation, mere suspicion will not suffice as a ground for imputing knowledge of the fraud.”).

d. The Examiner's Conclusion Regarding a Claim for Aiding and Abetting Breach of Fiduciary Duty

Because AA delivered its last audit report in May 2002, over three years before the Petition Date, a claim for aiding and abetting breach of a fiduciary duty for *monetary* damages is barred by the applicable statute of limitations. However, claims for *equitable* remedies including restitution remain timely under a six year statute of limitations. Moreover, should a fact finder determine that AA's consecutive audit engagements from fiscal 1998 through fiscal year 2002 were continuous representation of Refco, the statute of limitations will be tolled for the 1998 and later audits until the final audit report delivery date in or about May 2002.

A claim for aiding and abetting breach of fiduciary duty remains timely with respect to GT's audits for fiscal years 2003 through 2005 both for *monetary* damages and *equitable* remedies.

e. The Examiner's Conclusion Regarding a Claim for Aiding and Abetting Fraud

Based upon the applicable legal standards, the materials available for review, and the limitations imposed upon the Examiner's investigation of GT's audits of Refco, the Examiner cannot fully assess the viability of an aiding and abetting claim against GT. It is the Examiner's opinion that further investigation is warranted to determine whether evidence exists to support factual allegations of actual knowledge of the fraud by GT and/or AA and to determine the viability of an action against the auditors for aiding and abetting the fraud.

V. REFCO'S TAX ACCOUNTANTS

A. ERNST & YOUNG LLP

1. Introduction and Overview of Investigation

E&Y prepared tax returns for Refco and RGHI from approximately 1991 through the 2002 tax year. E&Y also provided Refco with tax advice during and after that time. The

Examiner concludes that E&Y gained substantial knowledge that Refco engaged in financial statement manipulation during the course of its engagement.

a. Document Review

The Examiner had access to and selectively searched approximately 37,000 pages of documents that E&Y produced to the SEC and to the Creditors Committee. E&Y, through its counsel, informed the Examiner that E&Y had additional documents in its possession pertaining to E&Y's work for Refco. E&Y produced some of these documents directly to the Examiner and gave the Examiner an index of the remaining documents. E&Y asked the Examiner to review the index and agreed to produce to the Examiner specific items on the index if the Examiner requested them. The Examiner did request a small number of items from the index, which E&Y promptly produced.

b. Interviews

The Examiner interviewed two current E&Y tax partners — Kurt Neidhardt (“Neidhardt”) and Michael Meisler (“Meisler”) — and one former E&Y tax partner — Steven Cappel (“Cappel”). Neidhardt has been with E&Y for 22 years and is now the head of E&Y’s Financial Services tax practice. Neidhardt was the lead partner for the Refco engagement, had the most contact with Refco, and worked consistently on all facets of the Refco engagement from 1993 until E&Y’s decision to resign from the Refco engagement in late 2003. Cappel is a former E&Y tax partner who handled the day-to-day management of the Refco engagement from about 2000 until mid-2002. Meisler is a partner in E&Y’s New York Financial Services office who assumed responsibility for the day-to-day management of the Refco engagement in mid-2002. These persons were the three E&Y personnel who clearly had the most significant involvement with E&Y’s Refco engagement. E&Y’s counsel cooperated with the Examiner and agreed to make the aforementioned witnesses available consensually and represented the witnesses in their

interviews.⁵³³ E&Y’s counsel declined the Examiner’s request to have the interviews transcribed. The interviews were not taken under oath. The Litigation Trustee’s counsel participated in each of the interviews with E&Y’s consent.

Counsel for the Examiner found all three witnesses to be reasonably forthcoming and generally cooperative. The witnesses generally made an effort to answer questions rather than simply claiming memory lapse. There were some exceptions, however. For example, when Neidhardt was presented with several documents that showed that he had concerns about the Refco engagement, Neidhardt offered little explanation of the documents or his thought process in connection with them.

2. Background Facts

a. History of E&Y’s Engagement with Refco

E&Y began working for Refco around 1991. E&Y understood that its client was RGHI and all of the subsidiaries below it, including RGL and Refco, Inc. Initially, Refco retained E&Y simply to review tax returns and answer tax questions. In 1993 or 1994, E&Y began preparing tax returns and later helped with IRS tax audits as well as audits by state and local tax authorities. E&Y prepared tax returns for RGL and its subsidiaries and affiliates, including RGHI, through the tax year 2002.⁵³⁴

In addition, E&Y provided tax consulting and advice on an “as needed basis” with respect to various transactions involving Refco, including corporate restructurings among the various Refco entities, proposed sales and acquisitions of Refco interests, and potential third-party investments involving Refco. As discussed in more detail below, the most significant

⁵³³ The Examiner determined that additional interviews of other E&Y personnel were unlikely to yield information different from that which had been obtained from Neidhardt, Meisler and Cappel.

⁵³⁴ January 16, 2007 interview of Kurt Neidhardt (“Neidhardt interview”).

transactions/issues on which E&Y worked include: (i) RGHI's 1997 conversion to an S corporation and the myriad tax ramifications flowing there from (including efforts to avoid "busting" the S election or triggering Built-in-Gain tax); (ii) planning beginning in 1997 to take advantage of the Niederhoffer Loss; (iii) BAWAG's 1999 acquisition of a 10% interest in RGL; (iv) the 2001 conversion of RGL subsidiary Refco, Inc. from a C corporation to an LLC; (v) structuring and analyzing the tax consequences of plans for profits-only interests in RGL for certain Refco executives; (vi) 2001/2002 proposed acquisition by BAWAG of a controlling interest in RGL while minimizing or avoiding tax consequences to RGHI; and (vii) 2002 proposed BAWAG investment of hundreds of millions of dollars in RGL in three installments in exchange for BAWAG's right to "participate" in the proceeds of a sale of Refco.

Beginning in at least 1995, Neidhardt was the engagement partner for Refco and Refco was considered "his client." From about 1995 to 2000, Neidhardt handled the day-to-day responsibility for the client.⁵³⁵ In 2000, Cappel assumed day-to-day responsibility. Cappel stopped working on the Refco engagement in mid-2002,⁵³⁶ and, thereafter, Meisler assumed day-to-day responsibility for the client. Throughout this time period, Neidhardt remained involved as a senior advisor and handled IRS audits of the client.⁵³⁷

Silverman and later Trosten were Neidhardt's principal contacts at Refco, although Neidhardt had periodic meetings with Bennett. Cappel and Meisler dealt almost exclusively with Trosten.

Neidhardt decided in November or December 2003 that E&Y should resign from its engagement with Refco. Following this decision, E&Y did not prepare Refco's 2003 tax returns

⁵³⁵ Neidhardt interview.

⁵³⁶ February 26, 2007 interview of Steven Cappel ("Cappel interview"). Cappel left E&Y in October 2003. *Id.*

and Neidhardt says that E&Y stopped providing Refco with tax advice. Nevertheless, E&Y appears to have continued to work for Refco on at least tax audits through as late as December 2004, several months after the LBO.

Records indicate that Refco paid E&Y \$4,993,887⁵³⁸ between December 28, 2000 and June 21, 2005. In addition, Neidhardt stated that Refco paid E&Y approximately \$750,000 in fees for tax return preparation and tax consulting work in 2000.

b. Genesis of the RGHI Receivable

The genesis of the RGHI Receivable appears to be as follows: In the mid to late 1990s, and especially in 1997, certain Refco customers sustained trading losses. These customers had been trading on margin (*i.e.*, RGL or its subsidiaries had extended these customers credit to trade),⁵³⁹ and when the customers lost tens of millions of dollars in trading, they were unable to fully repay RGL the credit that RGL had extended. RGL was forced to settle the customers' positions with the trading exchanges (*i.e.*, pay the full amount owed by the customers to the trading exchanges) and RGL was left with receivables owed to it by the trading customers who had sustained the trading losses. Rather than "writing off" the entirety of these losses on the books of RGL at the time the customer was unable to meet its margin call,⁵⁴⁰ RGL "sold"⁵⁴¹

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⁵³⁷ Neidhardt interview.

⁵³⁸ This amount was discerned from checks and wire transfers. However, the Examiner has not been able to determine whether all checks and wire transfers from Refco to E&Y were payments of professional fees.

⁵³⁹ To be precise, the RGHI Receivable actually reflected amounts owed by RGHI or one of its subsidiaries (*e.g.*, Wells, Ltd.) to RGL or one of its subsidiaries (*e.g.*, RCM). For the sake of simplicity, the above description refers to amounts owed by RGHI to RGL.

⁵⁴⁰ According to Neidhardt, in some cases, a portion of the loss may have been written off on RGL's books at the time of the loss. For example, according to Neidhardt, approximately \$30 million of the Niederhoffer Loss was written off in 1997. Neidhardt interview.

⁵⁴¹ The Examiner has reviewed only one document evidencing a "sale" of a receivable from subsidiary to parent — an assignment agreement dated October 28, 1997 that purports to assign Refco, Inc.'s claims against Niederhoffer to Wells, Ltd. *See* App. D-10. Although E&Y repeatedly described these transactions as "sales" of receivables, E&Y

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these customer receivables to RGHI “for face value” even though the receivables were worth perhaps pennies on the dollar. E&Y’s understanding was that in most cases, instead of paying cash for the receivables it “purchased,” RGHI “paid” RGL for the customer receivables with notes.⁵⁴² Thus, after the “sale” of the receivables by RGL to RGHI, the books of RGL showed a receivable owed by RGHI to RGL (*i.e.*, the RGHI Receivable) in the full (or nearly full) amount of the receivable that had been owed by the customer to RGL, and ***RGL’s books did not show a loss*** stemming from the trading customer’s bad receivable. Neidhardt explained in documents that RGHI would “then write it [the losses] off on its [RGHI’s] books.”⁵⁴³

The receivable that arose in this manner, however, lacked the traditional indicia of a bona fide debt. The Examiner found no evidence that this inter-company debt was evidenced by a written instrument, such as a note or written guarantee, as would be expected with a legitimate debt of this magnitude. There is no evidence of any agreed upon terms of repayment for the inter-company debt, nor any evidence that RGHI made payments — periodic or otherwise — to pay down the debt during the time period E&Y was engaged. Indeed, the evidence shows that RGHI lacked the intention and the financial ability to repay this debt unless and until all or part of Refco was sold.⁵⁴⁴ Although interest accrued on the RGHI Receivable, RGHI apparently

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also described the transactions as “guarantees” by RGHI of its subsidiaries’ losses. Neidhardt interview. The Examiner found no documents evidencing a written guarantee of this nature. *See* EY-REF-023416 (Dec. 30, 1998 Neidhardt e-mail, suggesting that “guarantee” was unwritten).

⁵⁴² *See* EY-REF-005815, at App. D-21 (Oct. 6, 1998 Neidhardt e-mail). RGHI may have paid Refco, Inc. cash for a portion of the Niederhoffer receivable. The cash for this payment, however, apparently was loaned to RGHI by RCM. Neidhardt interview; *see also* EY-REF 000153 (Nov. 6, 1997 memo of Neidhardt discussing Niederhoffer Loss and containing handwritten note saying, “Did RCM advance funds.”); EY-REF 000095.

⁵⁴³ EY-REF-005815, at App. D-21 (Oct. 6, 1998). Neidhardt confirmed in his interview that “its” referred to RGHI’s books.

⁵⁴⁴ *See* EY-REF-004941, at App. D-22.

made no cash interest payments. Instead, accrued interest was simply added to the growing RGHI Receivable balance.⁵⁴⁵

Although the RGHI Receivable initially was comprised of customer bad debts sold or transferred from RGL to RGHI, over time other items were added to the RGHI Receivable, including, among other things, certain expenses of RGL that were paid for by RGL in the first instance but then transferred to RGHI and added to the receivable balance.⁵⁴⁶

c. E&Y's Knowledge of Inter-Company Receivable Comprised of Bad Debts Sold or Transferred by RGL to RGHI

As of October 8, 1998, Neidhardt was aware of an inter-company receivable of approximately \$200 million. Neidhardt said that his knowledge of the inter-company receivable was derived from Refco's audited financial statements.⁵⁴⁷ Documents indicate that Neidhardt understood that the receivable had come into existence before 1997 as a result of RGHI buying "bad debt receivables" for full face value, and that the receivable had been sitting on the books of RGL accruing interest "for years" while a corresponding payable grew on RGHI's books.⁵⁴⁸

⁵⁴⁵ There is some evidence that Neidhardt believes that RGHI made cash interest payments. *See* EY-REF-004428, at App. D-23 (June 25, 2002 e-mail of Neidhardt: "Re the \$750m payable that RGHI has to the operating company RGL- Each year RGHI receives a distribution of earnings for its pro rata share (these earnings would include accrued interest income on their payable). RGHI uses this cash to pay down the interest on their payable so that the receivable on RGL's books is a performing asset from RGL's standpoint. I had not known that the cash was ploughed back in."). The Examiner found no evidence to corroborate the statement in Neidhardt's e-mail and found substantial evidence to the contrary.

⁵⁴⁶ *See, e.g.*, EY-REF-004463-64.

⁵⁴⁷ Neidhardt interview.

⁵⁴⁸ EY-REF-024453, at App. D-24 (Oct. 8, 1998); EY-REF-004969 (Aug. 13, 1999); EY-REF-005815, at App. D-21 (Oct. 6, 1998) ("The S Corp and the partnership used to be a 20 sub consolidated C corporation which filed a consolidated return. First the entire thing converted to an S Corp. Then most of the Qsubs converted to wholly owned LLC status and then became one big partnership when a new investor was admitted. Back when they were all part of the same consolidated return if Sub 1 (now part of the partnership) had a bad receivable then Parent (now part of the S Corp) would buy it for full face value and then write it off on its books. The Parent always gave a note to the sub and these amounts have sat on the subs books accruing interest for years while an equal payable grows on the Parent's books.").

Neidhardt said that he was unsure regarding the specific components of the RGHI Receivable.⁵⁴⁹ However, E&Y knew by as early as November 6, 1997 that at least one Refco entity — Refco, Inc. — had “sold” a receivable (comprised of bad debts stemming from trading losses suffered by a customer called Niederhoffer)⁵⁵⁰ to RGHI for approximately \$70 million.⁵⁵¹ In addition, numerous E&Y documents discuss the “Wells losses,” which appear to pertain to losses of approximately \$50 million on Russian securities involving Wells, Ltd., a wholly-owned subsidiary of RGHI, and RCM.⁵⁵² Documents indicate that E&Y understood these losses to have formed part of the RGHI Receivable.⁵⁵³

In sum, although E&Y knew the source of some of the bad debts that made up the RGHI Receivable, it is not clear that E&Y fully understood and could identify all of the precise components of the RGHI Receivable.⁵⁵⁴

d. Niederhoffer Loss

One component of the RGHI Receivable with which E&Y was very familiar was the so-called “Niederhoffer Loss” or “N Loss.” In October of 1997, Niederhoffer — a Refco, Inc. customer comprised of several hedge funds that had been trading on margin — sustained huge losses in its trading accounts and was unable to repay Refco, Inc. approximately \$97 million it

⁵⁴⁹ Neidhardt interview.

⁵⁵⁰ Neidhardt was asked in his interview whether the \$200 million receivable balance of which he was aware included the Niederhoffer Loss. Neidhardt said he was not sure but that it might not. Neidhardt interview.

⁵⁵¹ EY-REF 000153 (Nov. 6, 1997). *See also* EY-REF 000063 (Nov. 13, 1997).

⁵⁵² *See, e.g.*, EY-REF 002118-20, at App. D-25 (Feb. 25, 1999 Neidhardt memo to file regarding Wells Losses); *see also* EY-REF-023387-93.

⁵⁵³ *See, e.g.*, EY-REF 002118-20, at App. D-25 (Feb. 25, 1999 Neidhardt memo to file regarding Wells Losses); *see also* EY-REF-023387-93.

⁵⁵⁴ As of January 28, 1997, E&Y knew about at least \$59.5 million in bad debt deductions claimed by Refco entities on amended 1994 federal tax returns, the bulk of which was attributable to losses sustained by Trade and Marine Investments, Ltd. (“Trade & Marine”). *See* EY-REF 002978. It is not clear from E&Y’s documents whether these losses were a part of the RGHI Receivable.

had borrowed from Refco, Inc. Shortly after the losses were sustained, RGHI's wholly-owned subsidiary, Wells, Ltd., purchased from Refco, Inc. approximately \$71 million of the \$97 million debt that Niederhoffer owed Refco, Inc.⁵⁵⁵ Neidhardt said that the remainder of the loss was recognized at the time.⁵⁵⁶ The remaining \$71 million debt from Niederhoffer was "sold" to RGHI at "face value" — *i.e.*, \$71 million — a price that vastly exceeded fair market value.⁵⁵⁷

According to Neidhardt, the transfer of the N Loss receivable to RGHI had no effect for tax purposes, although it is not clear what he meant by this statement. Neidhardt explained that the loss could be carried forward unless the debt was deemed uncollectible/worthless. Neidhardt also explained that until the N Loss was completely worthless, or until part was impaired and a loss was taken on the books, it could not be deducted. Neidhardt also stated that if this loss became worthless at RGHI, the deduction would revert back to a loss on Refco, Inc.'s books.⁵⁵⁸

⁵⁵⁵ Neidhardt interview. The only document evidencing this "sale" appears to be an "Assignment Agreement" dated October 28, 1997 purporting to assign and sell Refco, Inc.'s claims against Niederhoffer to Wells, Ltd. *See* App. D-10.

⁵⁵⁶ Neidhardt interview.

⁵⁵⁷ Refco and E&Y fully understood that the fair market value of the Niederhoffer receivable that Refco, Inc. sold to RGHI was substantially less than the "face value" of the receivable. Neidhardt interview. Some of E&Y's records say that, for tax purposes, E&Y treated the lower fair market value of the Niederhoffer receivable as the value of the asset and the remainder that RGHI "paid" as a capital contribution. *See* EY-REF 000192 (Dec. 8, 1997 memo to Neidhardt stating that N Loss receivable was treated this way). *See also* EY-REF-023634 (Mar. 21, 2002 memo to Refco tax files, at footnote 1, stating that all of the bad debts comprising the RGHI Receivable were treated this way). It is not clear whether these records are accurate, and Neidhardt was not sure whether the sales of receivables were treated in this manner. Neidhardt interview.

As Neidhardt explained the tax treatment of the N Loss further during his interview, he cast doubt on whether E&Y treated a portion of the amount "paid" by RGHI as a capital contribution. Neidhardt said that E&Y treated the amount in excess of fair market value "not as equity" (*i.e.*, not as a capital contribution) so it was permissible for RGHI to accrue interest income on the receivable. Neidhardt also said that even if it was a promised capital contribution, it might be permissible to accrue interest on the obligation. Neidhardt interview. Cappel did not know one way or the other whether it would be permissible to accrue interest on a promised capital contribution of this sort. Cappel interview.

⁵⁵⁸ Neidhardt interview. *See also* REFCO-HC-0299683. Neidhardt stated that § 267(f) of the tax code provides that when a "legal sale" (an actual sale) occurs between related parties in which a receivable is sold at face value by a sub to the parent, the tax loss must be deferred until the receivable is worthless. In the case of Refco, when the receivable became worthless at the parent (RGHI), it would be reflected as a loss at Refco, Inc. Neidhardt further said that if no legal sale occurred, the movement of the receivable from sub to the parent would be considered a

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According to Neidhardt, Refco told E&Y every year that the debt was not worthless for various reasons, including a pending lawsuit filed by Niederhoffer in which Niederhoffer claimed he might be able to recover some funds and pay back Refco.⁵⁵⁹

Neidhardt stated in his interview that he does not know why the N Loss receivable was moved to RGHI. He stated, however, that the movement of the receivable by Refco was not done for purposes of obtaining favorable tax treatment. Documents suggest that at one time, a stated objective was to move the N Loss to RGHI's tax return.⁵⁶⁰

e. E&Y's Early Understanding of Refco's Objective of Selling the Company as a Whole

E&Y understood since before RGHI's conversion to an S corporation on January 1, 1997 that the goal of Refco's owners was to sell the entire S corporation. Indeed, all of E&Y's tax planning advice was apparently based upon Refco's representation that no sales of separate entities would occur since the goal was to sell the entire S corporation in the future.⁵⁶¹ E&Y understood that the RGHI Receivable would probably get paid upon a sale of the entire company.⁵⁶²

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capital contribution by the parent to the sub in the amount of the sale price of the receivable in excess of fair market value. Neidhardt interview.

⁵⁵⁹ Neidhardt interview.

⁵⁶⁰ EY-REF 000153 (Nov. 6, 1997); EY-REF 002622 (objective in 1997 was to include the N Loss "in the [RGHI tax] return."). E&Y did a significant amount of work with respect to the N Loss. *See, e.g.*, EY-REF 000063; EY-REF 000199; EY-REF 000081; EY-REF-007021 (memoranda and materials dealing with N Loss tax planning).

⁵⁶¹ *See, e.g.*, EY-REF 001199 (May 27, 1999 Neidhardt memo to file, noting that "the goal was to sell the entire S Corp. in the future"); EY-REF 000420 (May 5, 1999 Neidhardt memo, at p.2, stating: "This is why we anticipated selling the entire RGHI entity as opposed to individual pieces or asset sales when we adopted S [corporation] status [on Jan. 1, 1997].").

⁵⁶² EY-REF 002123 (handwritten notes on Jan. 4, 1999 Neidhardt e-mail stating, "Will RCM get paid? Yes. probably upon sale of the company or right around then.").

f. BAWAG's Acquisition in 1999 of a 10% Interest in RGL

E&Y provided tax advice in connection with structuring the 1999 BAWAG purchase of an interest in RGL. In particular, E&Y advised Refco on how to avoid the IRS viewing BAWAG's acquisition of a 10% interest in RGL as a "disguised sale" of part of RGHI's interest in RGL, which would trigger RGHI's liability for so-called Built-in-Gain taxes.⁵⁶³ In addition, E&Y advised Refco to insert into the RGL limited liability company agreement provisions that would reduce tax liability on interest income associated with the RGHI Receivable.⁵⁶⁴ Finally, E&Y provided verbal and written comments and suggestions to Mayer Brown regarding deal documents that Mayer Brown drafted.⁵⁶⁵ An E&Y memo to the file shows that E&Y disagreed with representations contained in Mayer Brown's draft deal documents that stated that there were no undisclosed liabilities on the audited RGL financial statements and that all tax returns had been filed and withholding taxes had been paid.⁵⁶⁶ Neidhardt stated in his interview that E&Y

⁵⁶³ See, e.g., EY-REF-007711 (May 5, 1999 memo discussing disguised sale issue). The conversion of RGHI from a C corporation to an S corporation on January 1, 1997 began a 10-year period during which any gain realized by RGHI from a disposition of all or part of its interest in RGL would be subject to a corporate-level tax at the level of RGHI — but only to the extent of any appreciation in value of RGHI's interest in RGL between the time of RGHI's acquisition of the asset and January 1, 1997 (so-called "Built-in-Gain" or "BIG"). A sale of RGHI's interest or any part thereof before January 1, 2007, therefore, could cause RGHI to recognize and pay corporation-level tax on a ratable portion of any Built-in-Gain. While the documents reviewed did not indicate whether a calculation was ever done to determine whether there was BIG in RGHI's interest in RGL, E&Y was very concerned about any BIG that would be taxable to RGHI in any proposed sale of RGHI's interest in RGL.

⁵⁶⁴ See EY-REF-005897.

⁵⁶⁵ See, e.g., EY-REF-005701 (Jan. 28, 1999 letter conveying comments to LLC agreement); EY-REF-024389 (notes of Feb. 5, 1999 conference call with Mayer Brown). See also EY-REF-024274; EY-REF-006050; EY-REF 001129.

⁵⁶⁶ See EY-REF-005863, at App. D-26 (Feb. 9, 1999 Neidhardt memo to file stating: ***I communicated to Steve Rossi today that we did not agree with the representations in the loan, pledge, and purchase agreements which stated that there were no undisclosed liabilities on the audited RGL financial statements and that all tax returns and withholding taxes had been filed/paid. I also told him that if asked by Mayer Brown or BAWAG we would need to express our views.*** This approach was confirmed by Paul Bader and Elliott Tannenbaum. On February 10th, Jim Barry of Mayer Brown asked it [sic] I was okay with Section 2.16 of the agreement regarding taxes. Richard Stern and Jake Blank were on the call. I told Jim that we were not making any representations regarding that Section and that I had discussed the above with Rossi. ***I also told him that there may very well be material tax issues and that he should discuss these with the client and with Joe Collins who is already aware of some of them. I did not have permission to give details of the exposures.*** Steve Rossi then instructed me to refer Jim to him if he

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only disagreed with the representations regarding tax liability issues, not representations regarding financial statement issues. However, this memo could also be interpreted as reflecting E&Y's disagreement with the representation that there were no undisclosed liabilities on the audited RGL financial statements, notwithstanding Neidhardt's statement to the contrary. The representation regarding undisclosed liabilities in Section 2.12 of the Purchase Agreement was arguably false because the financial statements did not disclose the extent of the related-party receivables.

g. Issues in 2000 and 2001 over Allocation of Refco Expenses

E&Y knew that Refco had a practice of allocating vaguely described expenses — often dealing with computer expenses — to RGHI, but having RGL actually pay the expense and then adding those expenses to the RGHI Receivable. Refco justified this practice by pointing to a RGHI Board of Directors resolution that authorized RGHI to guarantee and be responsible for certain historical and continuing expenses incurred ostensibly for the benefit of RGHI.⁵⁶⁷ Refco also justified this practice by claiming that these expenses were “erroneously” paid by RGL, but were reclassified upon discovery of the error, resulting in these expenses being added to the RGHI Receivable.⁵⁶⁸ E&Y apparently accepted Refco’s explanation.

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should inquire again and that Steve would give him a full description of the issues.”) (emphasis added). *See* EY-REF-005624-25; EY-REF-007743-66.

⁵⁶⁷ *See* EY-REF-004463-64 (Oct. 10, 2000 letter from Trosten attaching May 12, 1999 Board Resolution).

⁵⁶⁸ *See id.* *See also* EY-REF-006430 (Sept. 28, 2000); EY-REF-006428; EY-REF-006429; EY-REF-024088; EY-REF-024472; EY-REF-006416 (computer expense); EY-REF-006414 (explanation of booking accounting of expenses); EY-REF-005202; EY-REF 001748.

h. E&Y Learns of an Inter-Company Receivable in an Amount Hundreds of Millions of Dollars in Excess of the Amount Reflected in Refco's Audited Financial Statements

While working on Refco's tax returns in approximately September 2001, Cappel discovered that the receivable owed by RGHI to RGL was much larger than what appeared on RGL's audited financial statements. Cappel explained that he learned of this by looking at Schedule L of a 2000 RGL draft tax return (which contains a calendar year-end balance sheet) and comparing it to an audited RGL financial statement dated February 28, 2001. He noticed that one classification of RGL's assets (receivables owed to RGL) reflected on the Schedule L calendar year-end balance sheet was about \$500 million greater than the balance reflected on the audited financial statement.⁵⁶⁹

Sometime after noticing the difference between the fiscal year-end asset receivable balance and the calendar year-end asset receivable balance, Cappel believes that he requested monthly tax trial balances to ensure that he had the correct year-end numbers. He believes E&Y received the monthly tax trial balances, and they correctly tied into the calendar year-end balance.⁵⁷⁰

Neidhardt says that he did not learn about the large receivable in the \$700 to \$900 million range until Cappel informed him.⁵⁷¹ Neidhardt was surprised when he learned about the large receivable and until he learned of it, he had thought that the receivable was in the \$200 million

⁵⁶⁹ In his interview, Neidhardt said that he thought Cappel had discovered the large receivable balance when Cappel was examining mid-year trial balances in connection with the proposed BAWAG transaction. Neidhardt does not know the date of this, but thought it was prior to September 2001. Neidhardt interview.

⁵⁷⁰ Cappel interview.

⁵⁷¹ Neidhardt discussed a \$700 million RGHI liability with Trosten on January 3, 2000. See EY-REF-004958 (Jan. 3, 2000 Neidhardt memo documenting discussion with Trosten). However, when shown the document memorializing this conversation, Neidhardt said it did not reflect his knowledge of a receivable in the amount of \$700 million but rather it was just a "hypothetical" that Trosten was throwing around. Neidhardt said that Trosten

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range based on what the financial statements reported. Neidhardt said that after learning about the receivable, he spoke to Trosten and conveyed his surprise that the receivable was larger than what the financial statements disclosed. According to Neidhardt, Trosten said, "You knew about it. You saw the interest income and expense."⁵⁷²

Neidhardt said that E&Y tried to track the source of the large receivable but was unable to do so because Refco never provided E&Y detailed information regarding the receivable buildup. He also said that there were significant other receivables and interest expenses from Refco's day-to-day activities on Refco's books. Neidhardt never made detailed inquiry concerning the collectability of the RGHI Receivable.⁵⁷³

Although there are indications in the documents that E&Y understood the receivable to be in an amount anywhere from \$720 million to over \$1 billion,⁵⁷⁴ it appears that E&Y ultimately determined that the receivable was \$750 million as of spring 2002.⁵⁷⁵

i. E&Y's Knowledge that the RGHI Receivable Was a Sham Calculated to Improve the Financial Appearance of RGL

As recounted in their interviews, E&Y personnel had different understandings about the purpose of the RGHI Receivable. Neidhardt stated that he viewed the assumption of the

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threw around hypotheticals with regularity so he did not think anything of this particular hypothetical. Neidhardt interview.

⁵⁷² Neidhardt interview.

⁵⁷³ Neidhardt interview.

⁵⁷⁴ For example, e-mails in August 2001, EY-REF-004941-44, at App. D-22, speak of a "hypothetical" scenario involving a "\$900 receivable" owed by "S Corp" (presumably RGHI) to "LLC" (presumably RGL). *See also* EY-REF-025950 dated Aug. 8, 2001 ("S Corp owes \$900 to LLC"); Nov. 7, 2001 e-mail from Cappel to Stern mentioning that \$900 million "utilized to pay down the RGHI payable to RGL." EY-REF-025655; EY-REF-004922 dated 9/13/01 ("Please assume that RGHI has nothing in it but a liability to RGL of \$1,072 mm."). Cappel, however, said that these documents reflected hypotheticals that Trosten posited and did not reflect Cappel's understanding of the precise amount of the RGHI Receivable. Cappel interview.

⁵⁷⁵ A draft memo dated February 28, 2002, EY-REF-023764-70, refers to the RGHI receivable as \$750 million.

receivable by RGHI as the “guaranteeing” of a subsidiary’s losses by the parent company.

Meisler thought that the purpose of the receivable was to ensure that only RGHI, not BAWAG, would be responsible for historical losses suffered by RGL prior to BAWAG’s admission in 1999 as an owner of RGL. Cappel said he never learned of the purpose of the receivable.

Notwithstanding the foregoing, there is evidence that E&Y understood that the purpose of the RGHI Receivable was to improve the financial appearance of RGL. In an e-mail dated August 8, 2001, Cappel observed that a write-off of the RGHI Receivable would have a deleterious effect on RGL’s earnings, which were protected by RGHI.⁵⁷⁶ In the same e-mail, Cappel stated that RGHI was basically insolvent, did not have the cash to pay down the receivable, nor did it have the inclination to do so.⁵⁷⁷ This e-mail supports the conclusion that, as of August 2001, E&Y knew that the RGHI Receivable was being maintained, not because it was a legitimate debt or that RGHI had intentions of paying it off, but rather because elimination of the receivable would destroy RGL’s appearance of profitability.⁵⁷⁸ When asked during his

⁵⁷⁶ See EY-REF-004941, at App. D-22 (Aug. 9, 2001 e-mail of Cappel) (“[A]re you suggesting that they simply liquidate S Corp immediately, while it is, basically, insolvent? I think that would create an issue because the write down of the receivable in LLC would kill LLC’s earnings, which are carefully protected and buffered by the S Corp.”).

⁵⁷⁷ See EY-REF-004941, at App. D-22 (Aug. 9, 2001 e-mail of Cappel) (“But Refco doesn’t want to be left with S Corp, which would be nothing but a big liability. **They also do not have the cash, absent a sale, to pay down that \$900; nor do they have the inclination to do so if they get the cash.** They’re simply hoping for a buyer who will solve all their problems, and fulfill all their dreams.”) (emphasis added); *id.* (“it [RGHI] is basically insolvent”). See also EY-REF-004969 (Aug. 13, 1999 e-mail of Neidhardt) (“THERE ARE SIGNIFICANT LIABILITIES WITHIN RGL AND RGHI. RGL PRESENTLY HAS A \$200M RECEIVABLE FROM RGHI. RGHI HAS VERY LITTLE OF VALUE OTHER THAN ITS INVESTMENT IN RGL.”) (emphasis in original); EY-REF-005809 (undated handwritten notes of Neidhardt reading, “receivables from RGHI ---> who knows how good.”). Neidhardt indicated in his interview and in correspondence that he believed that RGHI’s shareholders could pay off the RGHI Receivable by borrowing the necessary funds. See EY-REF-024453, at App. D-24; EY-REF 001998 (undated handwritten notes of Neidhardt regarding a proposed acquisition of RGL by BAWAG reading, “This proves that RGHI has ability to satisfy the receivable because it was able to have someone assume the receivable to acquire a piece of the company. RGL is valuable based on what Bawag is willing to put in.”). In addition, E&Y received from Refco yearly written representations that the RGHI Receivable was a valid, enforceable legal obligation. See, e.g., EY-REF-018800 (July 17, 2002); EY-REF-004566 (Nov. 7, 2002).

⁵⁷⁸ Another e-mail arguably could support a similar conclusion. In an e-mail dated October 10, 1998, before E&Y discovered the true amount of the receivable, Neidhardt appears to explain that it is possible (though unlikely) that

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interview what he meant by the statements in his August 8, 2001 e-mail, Cappel said he did not know what he meant and emphasized that he thought that the e-mail merely reflected a set of hypothetical facts posited by Trosten.

In sum, there is evidence supporting the conclusion that E&Y knew that the RGHI Receivable was not a bona fide debt, but rather was a sham, based on the following:

- E&Y apparently never saw a written agreement evidencing the debt, never knew the terms and conditions of the debt or its repayment schedule,⁵⁷⁹ and never knew of any valuable consideration for the debt (and, indeed, knew that the consideration was worth little, and questioned whether or not it was worthless);
- E&Y never received a requested confirmation directly from Refco's counsel that the debt was valid (discussed *infra*);
- During the E&Y engagement, RGHI appears to have never made a payment, periodic or otherwise, to service or pay down the debt (except for the sham Round Trip Loans);
- RGHI did not make interest payments in cash and instead simply added accrued interest to the outstanding receivable balance;
- RGHI never expressed an intention to repay the debt and instead indicated that it did not intend to repay the debt unless the entire company was sold;
- RGHI was unable to repay the debt and was "basically insolvent;"
- RGL and its subsidiaries might have been insolvent absent the receivable balance on their books;
- E&Y knew that a purpose of the receivable was to improve the appearance of RGL's earnings by transferring losses to RGHI; and

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the entities below RGHI to which RGHI owes the receivable would be insolvent without the receivable as an asset. Neidhardt states: "RGHI has a large (\$200m) payable to its first tier sub RGL on its books. RGL's audited financial statements show this receivable and interest is accrued on it. The receivable was generated by the Parent promising to pay full face value for receivables and other instruments which the sub had owned and which became worthless or devalued in exchange for those instruments. The bulk of those receivables have been written off for tax purposes in prior years. ***It is unlikely but unclear whether the entities below RGHI would be insolvent without this receivable on a fair market value basis.*** RGHI does not have significant assets with which to pay off this receivable other than its ownership of the entities below. The shareholders of RGHI could likely fund the amount." EY-REF-024453, at App. D-24 (emphasis added).

⁵⁷⁹ Neidhardt interview.

- E&Y knew that a purpose of the receivable was to inflate the net worth of RGL by moving losses that should have been taken by RGL.

j. E&Y Learns of at Least Part of the Round Trip Loan Transactions

Shortly after he confirmed the existence of a large receivable in the \$700 million range in September 2001, Cappel asked Trosten why there was a difference between the February and December totals for inter-company receivables. Trosten explained to Cappel that Refco utilized the Round Trip Loan transactions at fiscal year end and, for that reason, the inter-company receivable balances did not appear on RGL's financial statements. Trosten explained that the transactions were undertaken simply to "clean up" the balance sheet at each fiscal year end.⁵⁸⁰

Neidhardt said that he learned about the Round Trip Loans at the same time he learned of the large receivable of \$700 to \$900 million (approximately September 2001). He learned about the Round Trip Loans from either Cappel or Meisler, but not from anyone at Refco. Neidhardt was surprised when he learned about the Round Trip Loans. Neidhardt viewed this as a legal transaction that only had implications if it was not disclosed.⁵⁸¹

Meisler said that he thought that Refco's auditors knew about the RGHI Receivable and its year end pay down and he assumed that the auditors did not report them on the audited financial statements for good reasons that the auditors must have determined. Cappel had a similar view about the auditors' lack of disclosure of the RGHI Receivable and Round Trip Loans on the audited financials. Meisler and Cappel were both of the view that it was not

⁵⁸⁰ Cappel interview.

⁵⁸¹ Neidhardt interview.

E&Y's job to second guess the decisions of a Big Five accounting firm such as Arthur Andersen.⁵⁸²

E&Y says it does not believe it had a duty to disclose its knowledge of the Round Trip Loans. E&Y claimed it never had discussions with Refco's auditors or law firms about either the Round Trip Loans or the RGHI Receivable.⁵⁸³

The evidence is mixed as to whether E&Y knew the details of all portions of the Round Trip Loans. E&Y admits that by no later than February 28, 2002, it knew in general terms about the second part of the Round Trip Loan scheme — namely, RGHI borrowing funds from a third party to pay down the RGHI Receivable in late February, and the subsequent reversal of the transaction in early March.⁵⁸⁴ The Examiner found no evidence that E&Y knew the identities of the third parties lending funds to RGHI (other than BAWAG) or that the third parties (other than BAWAG) were not financial institutions.⁵⁸⁵

The Examiner found no direct evidence that E&Y was aware of the first part of the Round Trip Loan scheme — namely, that RCM loaned funds to a third party who in turn loaned the funds to RGHI. Neidhardt, Meisler and Cappel each denied knowledge of this part of the Round Trip Loan scheme.

The Examiner found some documents suggesting that E&Y was aware of the first part of the Round Trip Loans. For example, several documents refer to "circular flows of cash" in the

⁵⁸² January 17, 2007 interview of Michael Meisler ("Meisler interview"); Cappel interview.

⁵⁸³ Neidhardt interview; Cappel interview; Meisler interview.

⁵⁸⁴ See, e.g., EY-REF-025104, at App. D-27, and subsequent drafts, all describing the second part of the Round Trip Loan scheme. See also EY-REF-004768 (undated but describing Round Trip Loan scheme in general terms) and EY-REF-004841 (Feb. 27, 2002 e-mail referring to "debt pay down and borrowback").

⁵⁸⁵ The Examiner did not find any E&Y documents identifying any of the Round Trip Loan Participants. Cappel and Meisler said they had no idea who the Round Trip Loan Participants were. Cappel interview; Meisler interview. Neidhardt said he thought the Round Trip Loan lender was BAWAG only. Neidhardt interview.

context of discussions of pay down of the receivable at fiscal year end.⁵⁸⁶ These documents could be interpreted as reflecting E&Y's knowledge of a circular flow of cash from RCM to a third party lender to RGHI to RGL (the parent of RCM), and a reversal of the transaction. However, this interpretation would be contrary to the explanation offered by Neidhardt, who said that "circular flow of cash" is a term of art that simply means that cash goes somewhere and then comes back, such that the transaction may be ignored for tax purposes.⁵⁸⁷

In addition, the Examiner reviewed handwritten notes of Cappel dated March 4, 2002, which contain the phrases "borrowed cash from RGL," "third party customer," and "Niederhoffer."⁵⁸⁸ These notes could be interpreted as reflecting knowledge of the third party customer borrowing funds from RGL to in turn loan to RGHI as part of the Round Trip Loan scheme designed to hide the RGHI Receivable, which was partly composed of the Niederhoffer Loss. In his interview, Cappel could not explain the context for these statements. He did not think, however, that these notes could or should be interpreted as meaning that a third party borrowed money from RGL and denied that these notes could indicate that Cappel had knowledge that RGL or RCM loaned money to the third party as part of the first leg of the Round Trip Loans. Although he admitted that he was speculating about the meaning of his own notes, Cappel said he thought that "borrowed cash from RGL" more likely referred to the first

⁵⁸⁶ See EY-REF 001834 (Nov. 11, 2002 Neidhardt e-mail stating: "Finally, I explained that to have this treatment we would need to treat any 'paydowns' of the receivable at 2/28 as circular flows of cash. Rob confirmed that the funds are down at RGL for less than a few days and that there is no written instrument, agreement, or anything that would treat the flow of funds back up to RGHI as a debt obligation. As a result pull out the ruling but I believe that we probably have a pretty good tax return position to treat this as 'no basis debt.' It truly is a circular flow of funds in substance."). See also EY-REF-000153 (Nov. 6, 1997 memo re N Loss, handwritten note stating "Did RCM advance funds. Circular flow of cash". The context of the memo suggests that this refers to RCM advancing funds to RGHI to pay cash to Refco, Inc. for the Niederhoffer receivable — a "circular flow of cash" that more closely resembles the Round Trip Loans' flow of funds); but see EY-REF-004207 (appearing to describe "circular flow of cash" as follows: "interest expense accrues . . . cash distributed . . . interest paid down . . . debt to RGL increases.").

⁵⁸⁷ Neidhardt interview.

⁵⁸⁸ EY-REF-004815.

step of the unwinding of the Round Trip Loans (*i.e.*, “borrowing” really meant reinstating of the loan receivable from RGL to RGHI).⁵⁸⁹

The Examiner found no direct evidence that E&Y was aware that RGL guaranteed RGHI’s obligation to the third party lender and agreed to indemnify the third party lender in connection with the Round Trip Loans. Neidhardt, Cappel, and Meisler each denied knowledge of this aspect of the transaction.⁵⁹⁰

k. 2001-2002 Work on Devising a Tax Advantageous Transaction to Sell Part or All of Refco

In the mid-2001 through mid-20002 time frame, E&Y performed a substantial amount of work for Refco in connection with proposals to sell all or part of Refco to BAWAG or another third party. During the second half of 2001, Trosten began asking E&Y — particularly Cappel — to devise tax advantageous strategies for a potential sale or partial sale of Refco.⁵⁹¹ According to Cappel, Trosten’s goal, which Cappel believed was wholly unrealistic, was to find a way to effect a tax free sale of all or part of Refco. In that effort, Trosten routinely called Cappel and presented “hypothetical” sets of facts which Trosten asked Cappel to assume in devising a deal structure. These “hypotheticals” typically assumed the existence of a receivable owed by RGHI to RGL in the amount of \$720 million to over \$1 billion.⁵⁹²

⁵⁸⁹ Cappel interview.

⁵⁹⁰ Although the Examiner found a document referring to “Refco’s guarantees and pay down of receivable at year-end,” EY-REF 000334, at App. D-28, Neidhardt said that “Refco’s guarantees” referred to his view that the RGHI Receivable reflected RGHI’s commitment to guarantee the losses of its subsidiary RGL. Neidhardt interview.

⁵⁹¹ The subject of a sale of a controlling interest in Refco had come up previously. *See, e.g.*, EY-REF 001941 (Aug. 20, 1999 memo regarding potential sale of 51% of RGHI); EY-REF-004961 (Sept. 1, 1999 Lowry e-mail considering tax consequences of the inter-company receivables in a proposed sale).

⁵⁹² *See* EY-REF-002590 E&Y memo dated Aug. 8, 2001 (“S Corp owes \$900 to LLC”); EY-REF-025655 Nov. 7, 2001 Cappel e-mail mentioning that \$900 million “utilized to pay down the RGHI payable to RGL”; EY-REF-004922 Sept. 13, 2001 Cappel e-mail (“Please assume that RGHI has nothing in it but a liability to RGL of \$1,072 mm.”).

E&Y had three principal concerns in structuring any transaction. E&Y's first concern was to establish, if possible, a high tax basis in RGHI's interest in RGL in order to minimize RGHI's gain on sale that would be taxed.⁵⁹³ Second, E&Y was very concerned about any Built-in-Gain that would be taxable to RGHI in any proposed sale of RGHI's interest in RGL (or in any structure that, although not denominated a sale, the IRS determined was a "disguised sale" and recharacterized as a sale for tax purposes).⁵⁹⁴ Third, E&Y was concerned with avoiding any partial sale of RGHI, which would terminate RGHI's S election.⁵⁹⁵

E&Y proposed several alternative structures for a transaction in an effort to minimize the tax consequences to RGHI of a deal with BAWAG. The principal structure E&Y suggested contemplated RGL distributing the RGHI Receivable to RGHI in partial redemption of RGHI's interest in RGL followed by BAWAG contributing a total of approximately \$750 million in cash, notes or subscription receivables in two or three installments in exchange for an additional 40.8% member interest in RGL.⁵⁹⁶

By spring of 2002, it appears that Refco was forging ahead with a deal with BAWAG, but may have been generally taking into account E&Y's advice regarding tax structuring in certain respects.⁵⁹⁷ For example, on February 14, 2002, Refco sent E&Y a draft agreement prepared by Mayer Brown that, as drafted, contemplated an actual sale to BAWAG of RGHI

⁵⁹³ See EY-REF-025628; EY-REF-025543.

⁵⁹⁴ See, e.g., EY-REF-004904.

⁵⁹⁵ See, e.g., EY-REF 000335 (Mar. 14, 2002 Neidhardt e-mail).

⁵⁹⁶ See, e.g., EY-REF-004904 (Oct. 11, 2001 Stern memo to file); EY-REF-025204 (Apr. 25, 2002 Meisler e-mail). Other drafts of this and a related memo include: EY-REF-026284 (Sept. 24, 2001); EY-REF-004858 (Feb. 18, 2002); EY-REF-023774 (Feb. 21, 2002); EY-REF-010198 (Feb. 25, 2002); EY-REF-023764 (Feb. 28, 2002); EY-REF-023680 (March 8, 2002); EY-REF-024969 (March 11, 2002); EY-REF-023670 (March 12, 2002); EY-REF-001890 (March 13, 2002); EY-REF-025273 (March 14, 2002); EY-REF-025740 (March 20, 2002); EY-REF-001906 (March 22, 2002); EY-REF 001947 (Apr. 8, 2002).

⁵⁹⁷ See, e.g., EY-REF 000293 (May 8, 2002 Neidhardt letter providing advice regarding structure of BAWAG transaction).

stock — a structure that would not be advantageous from a tax standpoint.⁵⁹⁸ E&Y appears to have told Refco about this, and Refco ultimately followed E&Y's advice and formulated the transaction using the so-called Proceeds Participation Agreement.⁵⁹⁹

I. Proceeds Participation Agreement

In July 2002, RGL and DFI (an affiliate of BAWAG) entered into a Proceeds Participation Agreement (“PPA”) pursuant to which DFI was to make three payments to RGL in exchange for the right to participate in the proceeds of a future sale of RGL. The payments were originally scheduled to be made on February 28, 2003, February 28, 2004 and February 28, 2005. However, the February 28, 2004 payment was accelerated to November 2003.

On June 6, 2002, Trosten spoke to Neidhardt about the PPA. Trosten said that Refco viewed the transaction as essentially an “option” to acquire an interest in RGL — a non-event or “a nothing” for tax purposes — and would not need to be disclosed or dealt with in the tax returns.⁶⁰⁰ On December 30, 2002, Refco finally allowed E&Y to view a copy of the PPA, although Refco would not allow E&Y to make a copy of it.⁶⁰¹ E&Y reviewed it and felt that the PPA resulted in an acquisition of an ownership interest in RGL by BAWAG and needed to be

⁵⁹⁸ EY-REF 000296 (Feb. 11, 2002 Mayer Brown Draft Purchase Agreement). E&Y insists that it did not communicate with Mayer Brown regarding this draft. Cappel interview.

⁵⁹⁹ EY-REF 000296 (Feb. 11, 2002 Mayer Brown Draft Purchase Agreement); EY-REF 000292 (May 21, 2002 Neidhardt e-mail stating that he has advised Trosten against documenting the BAWAG deal as a “sale transaction” and indicating that Trosten said he understood Neidhardt’s advice and would try to modify the deal documents accordingly); EY-REF-005212 (June 6, 2002 Neidhardt e-mail noting that Refco did follow E&Y’s advice on the BAWAG deal in that “they did significantly change their deal from originally having RGHI sell shares to B[AWAG] which would have been a disaster and they did make sure cash comes directly to RGL for additional shares”).

⁶⁰⁰ EY-REF-005212 (June 6, 2002 Neidhardt e-mail).

⁶⁰¹ EY-REF-022655 (Dec. 30, 2002 Neidhardt e-mail); Neidhardt interview.

treated that way for purposes of the 2003 tax returns.⁶⁰² E&Y decided to resign from the Refco account, however, before preparing Refco's 2003 tax returns.

m. Amendment of Refco, Inc.'s 1997 Tax Return

E&Y claims that in September 2002, during an IRS audit of tax years including 1997, E&Y learned for the first time from Refco that the N Loss was completely uncollectible from Niederhoffer because there had been a settlement and release in 1997 between Niederhoffer and Refco, Inc. pertaining to the losses. Thus, E&Y had to amend the 1997 tax returns. E&Y does not recall whether it amended subsequent returns. This discovery that the N Loss should have been deducted in full in 1997 coincided with the IRS's disallowance of certain other deductions as a result of the IRS's audit of Refco's 1997 tax returns. Thus, the amendment of the 1997 return to deduct the full N Loss had the benefit of allowing Refco to replace the other deductions that had been disallowed by the IRS as a part of its audit of the 1997 returns.⁶⁰³

Documents indicate that E&Y was planning to amend the 1997 Refco, Inc. tax return much sooner than September 2002, and that E&Y was aware of a settlement with Niederhoffer well before the September 2002 IRS tax audit.⁶⁰⁴

n. E&Y's Concerns Over the Refco Engagement and E&Y's Own Potential Liability

Beginning in as early as 1997 and continuing throughout E&Y's engagement with Refco, E&Y expressed significant concerns internally at E&Y regarding positions taken by Refco,

⁶⁰² Neidhardt interview; Meisler interview.

⁶⁰³ Neidhardt interview; Cappel interview

⁶⁰⁴ See, e.g., EY-REF-007004 (Aug. 7, 2000 e-mail of Neidhardt stating, “[Refco,] Inc intends to amend its 1997 tax return for the entire \$97m which will create a \$97m net operating loss (“NOL”) on that return.”); EY-REF-004946 (Aug. 8, 2001 e-mail of Cappel stating, in the context of discussing tax basis of RGL in connection with a proposed sale: “If the 1997 tax return for R, Inc. is amended to take a substantially larger deduction in that year . . .”); EY-REF-009112-13 (handwritten notes of Cappel dated Dec. 3, 2001 reading: “Niederhoffer Bad Debt . . . Client signed waiver following day settling debt for total assets of various Niederhoffer Funds”).

disclosure of information by Refco to its auditors and others, the potential for fraud by Refco, and potential E&Y liability arising out of E&Y's involvement with Refco. Throughout this time period, E&Y did little or nothing to address these significant concerns and simply continued to work for Refco.

For example, in November 1997, Neidhardt was concerned about Refco's handling of the N Loss, which Neidhardt thought was "unusual."⁶⁰⁵ Documents also suggest that Neidhardt had serious concerns over the auditor's accounting treatment of the obligation from RGHI to RGL arising out of the N Loss as a receivable rather than as equity.⁶⁰⁶ A memo reflects that, in light of Neidhardt's concerns, on November 11, 1997, Neidhardt met with Jerry Goldman, who was the head of E&Y's Financial Services Department, to discuss AA's accounting treatment of the N Loss as a sale for face value and whether E&Y could be viewed as somehow being "an accessory to some type of fraud." Goldman informed Neidhardt that so long as E&Y never gave Refco any accounting advice and prepared Refco's tax returns correctly, E&Y should not have a concern from a firm risk standpoint.⁶⁰⁷ Following this meeting, Neidhardt still had questions regarding the N Loss receivables — in particular whether they were "real receivables" that could be "sold" to RGHI.⁶⁰⁸ Neidhardt's concerns regarding whether the receivable should be

⁶⁰⁵ Neidhardt interview.

⁶⁰⁶ EY-REF-005815, at App. D-21 (Oct. 6, 1998).

⁶⁰⁷ Neidhardt wrote a note to memorialize his conversation with Goldman. It read: "Discussed with J. Goldman entire Refco Inc situation from a firm risk standpoint re Arthur Andersen's treatment of N loss as a sale for face and whether we could be viewed as somehow being an accessory to some type of fraud. JG felt that as long as we never give them any accounting advice and our tax returns are prepared correctly we should not have a concern." EY-REF 000080, at App. D-29. Counsel for the Examiner asked Neidhardt in his interview what he meant by "some type of fraud," but Neidhardt said he did not recall to what this statement referred. Neidhardt interview.

⁶⁰⁸ EY-REF 000081 (referencing a memo that would address "whether these are real receivables which can be sold").

characterized as debt or equity remained as of October of 1998.⁶⁰⁹ Despite these continuing serious concerns, Neidhardt did not speak to Refco's auditors or take any other measures to address these concerns.⁶¹⁰

Neidhardt's concerns over the Refco engagement remained. In January of 2001, documents indicate that Neidhardt felt a new engagement letter was warranted. The new engagement letter contemplated having Refco provide E&Y with additional information and representations to E&Y in connection with the preparation of Refco's tax returns.⁶¹¹ As a result of this new engagement letter, in connection with preparing Refco's tax returns, in the years 2001 through 2003, E&Y sent a letter to Refco management asking Refco to provide, *inter alia*: (a) a representation "per [Refco's] legal counsel" that the inter-company payable from RGHI to RGL was a legally enforceable obligation; (b) a schedule of any expenses that RGL allocated to RGHI per a "5/12/99 Certification and Assumption by RGHI;" and (c) an analysis of inter-company accounts.⁶¹² E&Y **never** received a representation directly from Refco's legal counsel that the inter-company payable was a legally enforceable obligation. E&Y did receive a representation from Trosten to that effect, which E&Y says is all that it requested. E&Y

⁶⁰⁹ EY-REF-005815, at App. D-21 (Oct. 6, 1998) ("I probably need to make sure this is real indebtedness and not equity? However, the audited financials from Andersen treat the amount as a receivable on the balance sheet of Sub1.").

Other documents from December 1998 support the conclusion that E&Y was seriously concerned over Refco's accounting treatment with respect to certain receivables arising from bad debts. In a December 15, 1998 fax, Steve Rossi of Refco appears to ask for accounting advice from Neidhardt. Notes attached to this document suggest that Neidhardt consulted with Michael Frank, a lawyer in E&Y's General Counsel's office; Mike Kelley, the number two person in the Financial Services Department; Jerry Goldman, the head of the Financial Services Department; and Ron Friedman of the Tax Quality Department. The notes state, "Ron Friedman - Thinks we need to get them to tell Andersen." *See* EY-REF 000563-66. Neidhardt stated in his interview that these notes merely meant that E&Y should tell Refco to consult with its auditing firm regarding accounting questions, not that E&Y felt there was anything in particular that Refco should tell AA.

⁶¹⁰ Neidhardt interview.

⁶¹¹ EY-REF-007990; EY-REF-006256.

⁶¹² *See, e.g.*, EY-REF-018800-08; EY-REF-006227-28.

accepted that representation without demanding anything further.⁶¹³ In addition, the Examiner found no evidence that E&Y received a “schedule of expenses” or “analysis of inter-company accounts,” and E&Y apparently took no action and continued to prepare Refco’s tax returns despite management having ignored E&Y’s requests.⁶¹⁴

Neidhardt was also concerned over the lack of disclosure of the RGHI Receivable and Round Trip Loans in Refco’s financial statements. In March 2002, Neidhardt discussed this issue with Tom McGrath, who was the head of the audit side of E&Y’s New York office. At the time, E&Y was helping to structure a transaction with BAWAG in a tax advantageous manner. McGrath felt that there was nothing to be concerned about with respect to E&Y’s tax work on the BAWAG transaction.⁶¹⁵ Neidhardt discussed this issue with Bennett but did not inquire further into the Round Trip Loan transactions and took no action as a result of this discussion. Significantly, E&Y did not discuss this issue with Refco’s auditors (nor even request permission to speak with Refco’s auditors) and did not discontinue its work on Refco’s tax returns.⁶¹⁶

On July 8, 2002, Neidhardt met with Mike Kelley to discuss mounting concerns with the Refco engagement. Kelley, who is now retired, was in 2002 the number two partner in E&Y’s tax department and was someone with whom Neidhardt would consult on important and difficult

⁶¹³ Neidhardt interview; *see, e.g.*, EY-REF-004566-67; EY-REF-006192-93.

⁶¹⁴ Neidhardt interview; Cappel interview.

⁶¹⁵ Neidhardt wrote a note dated March 7, 2002, memorializing his discussion with McGrath. It read: “Discussed financial statement issues with Tom McGrath re Refco’s guarantees and pay down of receivable at year-end. He did not see an issue with our tax work on this Bawag transaction. ***Sanity check.***” EY-REF-000334 (emphasis added). During his interview, Neidhardt offered little explanation regarding this note but stated that the “guarantees” to which he refers in this note are RGHI’s guarantees of the losses of RGHI’s subs. Neidhardt interview.

⁶¹⁶ *See also* EY-REF 000288 (undated handwritten notes of Neidhardt that include the following: “\$235M . . . \$750M . . . What is?” [suggesting that Neidhardt questioned the difference between the actual inter-company receivable and the inter-company receivable reflected on the 2000 audited financials] followed by the statements “Does AA know?” and “is running [illegible] around good acctg?”).

issues.⁶¹⁷ During the meeting, Neidhardt explained that E&Y had relatively recently learned that RGHI (which E&Y knew was unaudited) owed RGL a payable of \$750 million, that RGL's audited financial statements reflected an inter-company receivable of only around \$225 million, and that RGHI would borrow money to reduce this receivable balance just before fiscal year end and reinstate it just after so that only \$225 million would be reflected on RGL's audited financial statement. Kelley's view was that these transactions were really financial statement disclosure issues rather than tax return issues. Still, Kelley asked Neidhardt if he was aware of any lies by Refco to E&Y (Neidhardt was not) and recommended a background check on Bennett and Grant, which was done. The background checks revealed nothing suspicious.⁶¹⁸ Despite these concerns, E&Y did not push for any contact with Refco's auditors and did not discontinue its tax work.

On January 16, 2003, Neidhardt met with Kelley again to discuss concerns over Refco. During the meeting, Neidhardt again described the history of the RGHI Receivable and how it was used to book losses above the audited entity. Neidhardt also described a proposed transaction (*i.e.*, apparently the PPA) that would be "hidden" from the IRS (in that it would not

⁶¹⁷ Neidhardt interview.

⁶¹⁸ Neidhardt documented the July 8, 2002 meeting over 3 months later in an October 17, 2002 e-mail to file. EY-REF 000287, at App. D-30. (Neidhardt stated in his interview that it was his routine practice to type up his notes on meetings and other matters periodically at some point in time after the fact.) In the e-mail, Neidhardt says, "**I had some concern around the fact that we had recently learned that RGHI (unaudited holding company) had a \$750m payable to RGL (audited operating company).** We had not known this because RGL's financials had historically shown only about \$225 of intercompany receivable. We had recently learned that RGHI would borrow money at year end and pay down the receivable followed by a distribution back from RGL which would then pay off the loan." (Emphasis added). Neidhardt seems to indicate that his concern was not over the unusual nature of the transaction, but rather that perhaps BAWAG did not know about it (Bennett assured Neidhardt that BAWAG was aware). The e-mail also alludes to Neidhardt's concern over the IRS becoming aware of unspecified issues involving the Bermuda company "where the bigger issues reside." (Neidhardt explained in his interview that the issue was that the IRS might take the position that RCM should be filing a U.S. tax return). Apparently as a result of these concerns, Neidhardt and Kelley "**concluded that there was no need to contact legal at this time** but that [they] should have Larry Bastocky run an investigation on both Phil Bennet and the other shareholder Tone Grant to see if there was any evidence that they may not be acting truthfully eg some prior problem. [They] did this and Larry came back with a clean bill of health on both these people." (Emphasis added).

be disclosed on the tax return) involving DFI, in which DFI would pay down the receivable at fiscal year end in a manner that would hide the inter-company nature of the receivable and improve the balance sheet without disclosing why the balance sheet improved. Kelley thought E&Y had nothing to be concerned about from a non-tax standpoint so long as they got the tax returns correct. Kelley and Neidhardt were in agreement on this analysis and agreed that E&Y would continue to do tax work for Refco.⁶¹⁹ Again, E&Y did not request further information from Refco or its auditors.

o. E&Y's Decision to Resign

Neidhardt said that E&Y resigned from the Refco engagement in November or December of 2003, but that he had started thinking about resigning in late spring or early fall of 2003.⁶²⁰ Neidhardt explained that E&Y resigned from the engagement for three main reasons, each of which reflected a concern over the credibility and reliability of Refco and its records. These

⁶¹⁹ EY-REF-022645, at App. D-31. The e-mail, dated June 4, 2003 (*nearly 5 months after the meeting*) reads: "Met with Mike Kelley on January 16 to discuss Refco again. Gave Mike the background of the entire saga including Trade and Marine and Niederhoffer. Discussed how they have booked roughly \$500m of losses at RGHI (above the audited entity) based on the fact that RGHI guarantees the losses of the subs and how this has created a large receivable from RGHI to RGL. Went through how the DFI transaction would bring in new money which would effectively eliminate these receivables right at year end on the audited financial statements so that the balance sheet would improve by replacing intercompany receivables with new outside money. This would not be disclosed on the tax return if we technically got comfortable that DFI's investment was not a partnership interest. In addition, it would correspond with their book treatment which might not disclose how and why the balance sheet improved. We discussed whether this gave us any cause for concern from a nontax standpoint. Mike believed that it was our responsibility to get the tax return right and accurate and that there were very good tax reasons for taking the positions we were taking and that we should be appropriately aggressive from a tax standpoint. This was true because there were significant tax issues around a disguised sale if we highlighted this transaction. I agreed with this conclusion and we agreed that we could continue doing tax work on this client. **Redacted**" (Redaction and emphasis in original).

⁶²⁰ Although Neidhardt said that E&Y resigned from the Refco engagement, Levine Jacobs stated that Refco told Levine Jacobs that Refco had fired E&Y. *See* Levine Jacobs section of Report. The Examiner has not seen an actual resignation letter, so the exact date and circumstances of E&Y's "resignation" are not known.

reasons were memorialized in a memo that Neidhardt prepared on or about November 10, 2005 at the request of counsel, long after the decision to resign.⁶²¹

First, Neidhardt says he was concerned over Refco's "error" regarding when the Niederhoffer Loss was settled, which necessitated an "embarrassing" amended return. Neidhardt explained that in September 2002 during an IRS tax audit, he learned from Trosten that the loss was uncollectible from Niederhoffer because there had been a settlement and release of Niederhoffer in 1997. Because the loss was entirely uncollectible in 1997, the entire loss should have been deducted in 1997. Neidhardt said he was embarrassed that he had to amend the 1997 return to reflect the entire N Loss.⁶²²

Second, Neidhardt says he was upset by the way Trosten had handled certain "compensatory options." These options (ostensibly unrelated to the RGHI Receivable and Round Trip Loans) concerned certain options Refco had granted to Trosten. Neidhardt had advised against taking these options for tax purposes, but Neidhardt believes that Trosten ignored his advice, which could have affected certain returns in 2001 or 2002. Simply put, Neidhardt does not believe Trosten was being straight forward with him.⁶²³ Meisler confirmed this account, saying that Neidhardt told him "I just don't trust these guys."⁶²⁴

Finally, Neidhardt was concerned over Refco's lack of disclosure and secrecy over a so-called "BAWAG option" or PPA. Neidhardt did not fully understand the BAWAG option and was not sure whether this transaction actually was an option or, instead, was an actual sale of an interest in Refco (for purposes of tax return preparation).

⁶²¹ EY-REF 003278-79, at App. D-32 (Nov. 10, 2005 Neidhardt memo). Neidhardt noted that the first reference in the memo to 2003 should be 2002.

⁶²² Neidhardt interview; EY-REF 003278-79, at App. D-32.

⁶²³ Neidhardt interview; EY-REF 003278-79, at App. D-32.

In November 2003, Neidhardt met personally with Bennett to discuss these concerns and requested a meeting with Refco's then auditor, GT. This was the first time Neidhardt had ever requested a meeting with Refco's auditors. E&Y says it resigned after Bennett refused to allow E&Y to meet with GT.⁶²⁵

The Examiner found some evidence to corroborate Neidhardt's explanation regarding E&Y's decision to resign. For example, some documents indicate Refco was highly secretive about the N Loss settlement and release and that discovery of the N Loss release was the final basis for amending the 1997 tax returns.⁶²⁶ Likewise, some documents appear to confirm Neidhardt's statement that Refco was secretive about the PPA.⁶²⁷

Despite the evidence corroborating parts of Neidhardt's explanation, the Examiner was surprised that Neidhardt did not state that the RGHI Receivable and Round Trip Loans at least partially motivated E&Y to resign.⁶²⁸ The Examiner found ample evidence to support the conclusion that E&Y's decision to resign was also motivated in large part by its concerns over its

(footnote continued from previous page)

⁶²⁴ Meisler interview.

⁶²⁵ Neidhardt interview; EY-REF 003278, at App. D-32 (Nov. 10, 2005 Neidhardt memo).

⁶²⁶ See, e.g., EY-REF-004276-77 (handwritten notes of Meisler dated Nov. 4, 2002 saying, "existence of settlements is a change in facts warranting amending return to get to right answer"); EY-REF-006190 (Nov. 22, 2002 e-mail of Neidhardt proposing explanation for amended return); EY-REF-022679 and EY-REF-022699 (documents reflecting Refco's secrecy regarding confidential N Loss settlement).

⁶²⁷ See, e.g., EY-REF-022655-57 (confirming that Neidhardt was not allowed to copy the BAWAG Agreement); EY-REF-005212-13 (stating that E&Y will need to look at the deal documents further before filing 2003 return).

⁶²⁸ It should be noted, however, that Meisler indicated that Neidhardt was concerned about the receivable. More particularly, Meisler understood that Neidhardt wanted to ensure that the auditors knew about the receivable (although it is unclear whether Meisler was referring to the large RGHI Receivable owed to RGL or the portion of the receivable attributable to the N loss, which is discussed in the resignation memo). Neidhardt wanted to have a meeting with Refco's outside auditors. When asked during the interview, however, Meisler stated that he (Meisler) had no reason to think the auditors did not already know about the receivable. Meisler interview.

own potential liability for aiding and abetting a fraud as a result of its knowledge of the RGHI Receivable, the Round Trip Loans, and their financial statement implications.⁶²⁹

Moreover, the Examiner found evidence that is inconsistent with parts of E&Y's explanation of its decision to resign. In particular, there is evidence that suggests that E&Y learned of the Niederhoffer settlement and a "waiver" (though E&Y says not the release) sooner than September 2002.⁶³⁰ In addition, although Neidhardt said he was disturbed by Trosten's handling of certain "compensatory options," there appear to be no contemporaneous documents among those the Examiner reviewed that deal with this issue that Neidhardt says he found troubling.⁶³¹

p. Services After Decision to Resign

Following E&Y's decision to resign in late 2003, E&Y finished up work on open tax matters (basically IRS audits) from prior years (*i.e.*, 2002 and prior) but, according to Neidhardt, did not perform any new work for Refco.⁶³² E&Y did help on a New York sales tax issue and wrapped up a New York state and city audit examination, and there is evidence that this work may have continued through at least December 2004.⁶³³ Neidhardt never spoke with Refco's

⁶²⁹ See, e.g., EY-REF 000287, at App. D-30; EY-REF-022645, at App. D-31; EY-REF-004199-200; EY-REF 000334, at App. D-28.

⁶³⁰ See, e.g., EY-REF-007004; EY-REF-004946; EY-REF-009112-13.

⁶³¹ It appears that E&Y was concerned over its relationship with Refco long after it says it decided to resign, as indicated by an e-mail exchange in October of 2005. On October 7, 2005, Rory Alex, an E&Y accountant who does not appear to have worked on the Refco engagement previously, wrote Neidhardt and Meisler: "We have an opportunity to work for Refco Group Ltd. at 200 Liberty Street, NY, NY DUNS # 130878804 and wanted to see if they were related to your entity REFCO OVERSEAS LTD. There is a time sensitive nature to our retention, your prompt reply is much appreciated." In response to this e-mail, Neidhardt wrote to Meisler on October 8, 2005: "I left him [Rory Alex] a message too.we need to be very careful here.I left him all my numbers..anything [sic] we tell him must be strictly confidential.I may have Nancy Altobello shut him down.find out the nature of the work and tell him you will get back to him." EY-REF-004199-200.

⁶³² Neidhardt interview; EY-REF 003278-79, at App. D-32 (Nov. 10, 2005 Neidhardt memo).

⁶³³ See, e.g., EY-REF-031908 (E&Y spreadsheet that appears to contain metadata suggesting that it was created or accessed on December 15, 2004).

subsequent tax accountants, Levine Jacobs. Although E&Y had begun work on the 2003 tax returns, it ceased working on them and Levine Jacobs ultimately prepared the 2003 returns. E&Y says it may have transferred some of its work papers to Levine Jacobs, and one of E&Y's accountants (Yoav Citron) may have communicated with Levine Jacobs regarding ministerial matters, but there is nothing to suggest that E&Y told Levine Jacobs (or anyone else) about its decision to resign or its concerns with Refco.⁶³⁴

q. Communications (or Lack Thereof) with Other Refco Professionals

Neidhardt, Cappel, and Meisler each said that he did not communicate with other professionals — including AA, GT, KPMG, PwC, or Mayer Brown — regarding the RGHI Receivable or Round Trip Loans.⁶³⁵ E&Y maintains that an accountant has a duty of confidentiality under both CPA rules and federal statutes and regulations prohibiting the disclosure of client tax information absent client consent. E&Y maintains that these rules apply to both preparation of tax returns as well as provision of tax advice. E&Y also maintains that these rules prohibited E&Y from speaking with auditing firms working on Refco matters. E&Y claims that it never obtained information directly from Refco's auditors and that all information was obtained through Refco. E&Y never asked Refco for permission to speak with Refco's auditors until just before E&Y decided to resign.⁶³⁶

r. E&Y's Tax Treatment of Receivable and Round Trip Loans

E&Y maintains that the large RGHI Receivable really made no difference from a tax standpoint. E&Y treated the RGHI Receivable as a bona fide debt and explained that its main

⁶³⁴ Neidhardt interview; Meisler interview.

⁶³⁵ However, there is evidence from which it could be inferred that E&Y communicated with Mayer Brown regarding the RGHI Receivable. *See* Mayer Brown Section of this Report.

⁶³⁶ Neidhardt interview; Meisler interview; Cappel interview.

tax effect was interest income and expense. That is, RGHI deducted interest expense associated with the RGHI Receivable on its tax returns and RGL reported as income on its tax returns interest income accrued by RGL associated with the RGHI Receivable. However, E&Y also said that prior to BAWAG's acquisition of a 10% interest in RGL in 1999, the existence of the RGHI Receivable made no difference from a tax perspective because the interest income and interest expense amounts all flowed through to RGHI (which wholly owned RGL) and offset each other. After BAWAG's entry, the only concern from a tax perspective, according to E&Y, was to ensure the proper allocation of the RGHI Receivable and associated interest income and expense between BAWAG and RGHI. E&Y did not make any adjustments to the allocation Refco instructed E&Y to use, however, because Refco did not give E&Y anything to suggest that the allocations did not already properly line up with RGHI.⁶³⁷

The three E&Y witnesses all claimed that they viewed the Round Trip Loans as non-events for tax purposes. Because they considered these transactions as "circular flows of cash" during the tax year, they concluded that the loans had no impact on the final trial balance numbers and therefore had no effect from a tax standpoint. Accordingly, E&Y ignored the Round Trip Loans for purposes of preparing tax returns.⁶³⁸ At his interview, Neidhardt did not take a meaningful position on how the Round Trip Loans should be treated if the entire transaction was a sham and without any business purpose. He said that the interest on the books

⁶³⁷ Neidhardt interview; Meisler interview. *See* EY-REF 001831-32, ¶ 3 (memo analyzing the investment interest expense/investment interest income offset in relation to the receivable).

⁶³⁸ Neidhardt interview; Meisler interview.

was real and only two weeks of interest was directly attributable to the Round Trip Loan transactions.⁶³⁹

3. Conclusions: Analysis of Potential Claims Against E&Y

As discussed below, the Examiner concludes that, based on the evidence reviewed to date and summarized above, and subject to overcoming the potential defenses available to E&Y, there is sufficient evidence to (a) state a claim upon which relief may be granted for professional malpractice; and (b) state a claim upon which relief may be granted for aiding and abetting a fraud and/or breach of fiduciary duty. The Examiner concludes that the Refco estate could not state a claim upon which relief may be granted for fraud, negligent misrepresentation, and breach of fiduciary duty.

a. Professional Malpractice

The Examiner concludes that there is evidence sufficient to state a claim upon which relief may be granted for professional malpractice. The legal standards for professional malpractice related to accountants are discussed in substantial detail in Appendix A. Briefly, the elements of a professional malpractice claim are (1) a duty, (2) breach of duty, (3) “a reasonably close causal connection” between the breach of duty and injury, and (4) “actual loss, harm, or damage.”⁶⁴⁰

A tax accountant owes his client a duty to perform within the standards of practice of his profession.⁶⁴¹ An accountant’s good faith compliance with generally accepted accounting

⁶³⁹ Neidhardt also stated in his interview that there would be tax implications if Refco were insolvent. Neidhardt interview.

⁶⁴⁰ See *Integrated Waste Servs., Inc. v. Akzo Nobel Salt, Inc.*, 113 F.3d 296, 299 (2d Cir. 1997). In addition, a tax accountant’s conduct “does not give rise to a malpractice claim unless that conduct is alleged to have negatively impacted on the professional service rendered.” *Block v. Razorfish, Inc.*, 121 F. Supp. 2d 401, 403 (S.D.N.Y. 2000).

⁶⁴¹ See, e.g., *Carroll v. LeBoeuf, Lamb, Green & MacRae, LLP*, 392 F. Supp. 2d 621, 625 (S.D.N.Y. 2005).

principles discharges the accountant's obligation to act with reasonable care.⁶⁴² Although a tax accountant is not under a duty to verify the accuracy of all information furnished by its client, a tax accountant nevertheless has a duty to undertake a sufficient inquiry to satisfy itself that the information provided and positions taken by the taxpayer are reasonable.⁶⁴³ Indeed, a tax accountant preparing tax returns "cannot ignore the implications of information furnished to the preparer or actually known by the preparer . . . [and] must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete."⁶⁴⁴ Where it is apparent that information provided by a taxpayer is incorrect or incomplete, it is negligent for a tax preparer not to seek additional information.⁶⁴⁵

In this case, Refco's estate could allege that E&Y was negligent because it failed to make an adequate inquiry with its client to determine whether information furnished and positions taken by the client were reasonable. Specifically, E&Y failed to make an adequate inquiry to satisfy its duty with respect to the following:

- Bad Debts - E&Y did not take sufficient steps to determine whether the bad debts that had been sold to RGHI were, in fact, completely worthless.

⁶⁴² *In re Sharp Int'l. Corp.*, 278 B.R. 28 (Bankr. E.D.N.Y. 2002).

⁶⁴³ See *Carroll*, 392 F. Supp. 2d at 626 (rejecting accounting firm's contention that it had no duty to look beyond the materials it was provided by client); *Schneider v. United States*, 257 F. Supp. 2d 1154, 1161 (S.D. Ind. 2003) (holding that tax preparer generally may rely in good faith without verification of information provided by taxpayer, but must make reasonable inquiries if the information provided appears to be incorrect). See also Rule 201(D) of the AICPA Code of Professional Conduct (accountants shall "[o]btain sufficient relevant data to afford a reasonable basis for conclusions and recommendations in relation to any professional services rendered.").

⁶⁴⁴ Treas. Reg. § 1.6694-1(e)(1). A tax preparer may be liable under 26 U.S.C. § 6694(a) for civil penalties if the preparer "negligently fails to inquire into information given him by the taxpayer and use of such information results in filing of a return that violates a rule or regulation." *Sansom v. United States*, 703 F. Supp. 1505, 1510 (N.D. Fla. 1988). See also *Brockhouse v. United States*, 749 F.2d 1248, 1252-53 (7th Cir. 1984) (finding tax preparer (1) negligent in failing to inquire about whether any interest payments paid by corporation were paid to taxpayer, and (2) liable for civil penalties under 26 U.S.C. § 6694(a) where tax preparer relied solely on information supplied by taxpayer indicating that taxpayer had not received any interest income on loans made to corporation, but tax preparer knew that taxpayer had made loans to corporation and that the corporation had made interest payments).

⁶⁴⁵ *Brockhouse*, 749 F.2d at 1252.

- RGHI Receivable - E&Y did not take sufficient steps to determine whether the RGHI Receivable was a bona fide debt upon which interest could accrue. Despite harboring doubts over whether the RGHI Receivable could properly be characterized as a debt, E&Y never inquired further with the client or requested permission from the client to speak with Refco's auditors (until Neidhardt's belated November 2003 request to meet with GT). In addition, although E&Y asked for representations from Refco's legal counsel that the inter-company payable from RGHI to RGL was a legally enforceable obligation, E&Y never received a direct representation and, instead of following up, relied on the representation of Refco management. E&Y also never asked for or received written agreements documenting these huge debts. Finally, despite suspecting, if not knowing, that RGHI was insolvent and unable to repay the RGHI Receivable, E&Y failed to inquire further regarding the collectability of the debt.
- Interest Income - E&Y never inquired to determine whether interest on the RGHI Receivable was ever paid in cash or whether the accrued interest was simply added to the receivable balance.
- Expense Allocation Manipulation - E&Y asked Refco for a schedule of any expenses that RGL allocated to RGHI per a "5/12/99 Certification and Assumption by RGHI," but never received one and never followed up.
- Analysis of Inter-Company Accounts - E&Y requested an analysis of inter-company accounts, but never received one and never followed up.
- Round Trip Loans - E&Y never inquired to determine whether the Round Trip Loans were sham transactions devoid of a legitimate business purpose.

Had E&Y conducted a sufficient inquiry, it would have determined that the information provided and positions taken by Refco were not reasonable, would not have reported the inaccurate information on Refco's tax returns, and would have thereby prevented the dissemination of the unreasonable and inaccurate information in the tax returns. However, as a direct and proximate result of E&Y's failure to sufficiently inquire regarding the aforementioned information, incorrect information was disseminated, contributing to the fraud that ultimately caused Refco's bankruptcy.⁶⁴⁶

⁶⁴⁶ E&Y may argue that it was under no duty to inquire regarding the reasonableness of information provided by the taxpayer since its engagement letters disclaimed responsibility for any inaccuracies in information provided by Refco. *See, e.g.*, EY-REF-006258-66; EY-REF 001717-20; EY-REF-010131-35; EY-REF-006207-09. The

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In conclusion, the Examiner notes that he did not retain an expert tax accountant to determine independently whether E&Y acted in a reasonable manner and complied with generally accepted standards governing the conduct of tax accountants. The Examiner used experts retained by others in order to avoid added expense to Refco's estate. The Examiner did not view the retention of an expert as absolutely necessary for purposes of reaching the conclusions expressed herein. The Examiner notes, however, that an expert tax accountant, who may be necessary to prove a claim of professional malpractice,⁶⁴⁷ may determine that there were other ways in which E&Y was negligent that are not discussed in this Report.⁶⁴⁸

b. Aiding and Abetting Fraud/Aiding and Abetting a Breach of Fiduciary Duty

The Examiner concludes that, based on the evidence reviewed to date and summarized above, there is sufficient evidence to state a claim upon which relief may be granted for aiding and abetting a fraud and/or breach of fiduciary duty. As discussed in greater detail in Appendix A, the elements of a claim for aiding and abetting fraud are (1) existence of fraud, (2) the

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Examiner concludes, however, that these contractual disclaimers likely would not trump the standard of care imposed on E&Y by law in these circumstances.

E&Y may also argue that, assuming it had a duty to inquire further, the alleged failure to undertake the aforementioned inquiries did not proximately cause damages to Refco. In this regard, E&Y may argue that damages that proximately flow from a tax preparer's negligence are limited to overpayment of taxes by the taxpayer or penalties assessed by the IRS against the taxpayer for underpayment of taxes or erroneous tax returns. Here, E&Y may argue that the negligence alleged did not result in the overpayment of taxes by Refco (or penalties assessed against Refco) because Refco's predecessor-in-interest for whom E&Y prepared tax returns — RGL — was treated as a partnership for tax purposes; thus, its partners paid taxes, not RGL. E&Y may argue that, for this reason, Refco suffered no damages as a proximate result of E&Y's alleged negligence and, therefore, has no claim against E&Y.

⁶⁴⁷ Unless the fact-finder has a sufficient basis for judging the adequacy of the accountant's conduct, "expert testimony will be necessary to establish that the [accountant] breached a standard of professional care and skill." *Board of Trustees of the Teamsters Local 918 Pension Fund v. Freeburg & Freeburg, C.P.A.*, No. 98CV4895(SJ), 1999 WL 803895, at *6 (E.D.N.Y. Sept. 28, 1999).

⁶⁴⁸ In its engagement letters, E&Y purported to limit its liability for damages arising out of its services provided to Refco to an amount no greater than the fees it received. *See, e.g.*, EY-REF-006207. New York law generally enforces contractual limitations of liability with respect to negligence, but does not enforce them with respect to

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defendant's knowledge of the fraud, (3) provision by the defendant of substantial assistance to advance the fraud's commission, and (4) damages.⁶⁴⁹ The elements of a claim for aiding and abetting a breach of fiduciary duty are (1) a breach by a fiduciary of obligations owed to the plaintiff, (2) knowing inducement or participation in the breach by the defendant, and (3) damages.⁶⁵⁰ The substantial assistance and participation elements may be satisfied by showing that the defendant "affirmatively assists, helps conceal, or by virtue of failing to act when required to do so," allows the wrongdoing to proceed.⁶⁵¹

The Examiner assumes for purposes of this analysis that a fraud and breach of fiduciary duty by one or more of the officers of Refco can be established. The Examiner addresses the knowledge and participation elements in turn below.

(i) Knowledge

The Examiner concludes that there is sufficient evidence to permit Refco's estate to allege that E&Y had actual knowledge of a fraud and breach of fiduciary duty. As detailed above, there is considerable evidence that:

- as early as September of 2001, E&Y understood the RGHI Receivable to be approximately \$720 million to \$900 million, while E&Y knew that Refco's February 28, 2001 audited financial statements disclosed an inter-company receivable balance of only approximately \$219 million;
- E&Y knew that the RGHI Receivable consisted, at least in part, of bad debts of Refco customers that were "sold" or assigned to RGHI for a price that vastly exceeded fair market value;

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gross negligence or intentional misconduct. *See, e.g., Am. Tissue, Inc. v. Donaldson, Lufkin & Jenrette Sec. Corp.*, 351 F. Supp. 2d 79, 99 (S.D.N.Y. 2004).

⁶⁴⁹ *Wright v. BankAmerica Corp.*, 219 F.3d 79, 91 (2d Cir. 2000).

⁶⁵⁰ *Sharp Int'l Corp. v. State St. Bank & Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43, 49-50 (2d Cir. 2005).

⁶⁵¹ *See* App. A, IV.C.

- as early as February 28, 2002, E&Y knew in general terms about the second part of the Round Trip Loan scheme — namely, RGHI borrowing funds from a third party to pay down the RGHI Receivable in late February and that portion of the transaction being reversed in early March;
- by no later than September, 2002, E&Y knew that the entire Niederhoffer Loss was uncollectible because the debt had been settled and released in 1997;
- E&Y knew that RGHI lacked the ability to pay off the RGHI Receivable;
- E&Y knew that Bennett's objective was to sell the entire company and that RGHI did not intend to pay off the RGHI Receivable unless and until the company was sold;
- E&Y knew that at least one purpose of the RGHI Receivable was to make RGL appear more financially sound by transferring RGL losses and expenses to RGHI (or, stated differently, Refco's officers were intentionally manipulating Refco's balance sheet for the purpose of bolstering the financial appearance of the company); and
- E&Y knew that at least one purpose of the Round Trip Loans was to improve Refco's balance sheet on its financial statements by concealing the fact that the RGHI Receivable was a related-party transaction and was uncollectible.

Indeed, E&Y *admits* that it knew the first four items above.

Although the Examiner has found less supporting evidence, the Examiner concludes that there is sufficient evidence to afford a good faith basis to allege:

- E&Y knew about the first part of the Round Trip Loan scheme — namely, that RCM loaned funds to a third party who in turn loaned the funds to RGHI.

It should be noted, however, that the Examiner concludes that a court would not necessarily require Refco's estate to prove that E&Y had actual knowledge of every last detail of the Round Trip Loans in order to establish liability. Indeed, the Examiner concludes that a lack of knowledge of the details of the original source of funds described in the last bullet point above likely would not be fatal to a claim for aiding and abetting given that E&Y knew that one purpose of the Round Trip Loans was to improve Refco's balance sheet and its financial statement.

(ii) Substantial Assistance/Participation

(a) Substantial Assistance or Helping to Conceal

With respect to the substantial assistance/participation element, although it is a close call, the Examiner concludes that there is sufficient evidence to afford a good faith basis to allege that E&Y “substantially assisted” or “helped conceal” the fraud and breach of fiduciary duty.

(1) Preparing Tax Returns that Reported Inaccurate or False Interest Income Associated with a Sham Receivable

First, E&Y “substantially assisted” the fraud/breach of fiduciary duty of Refco’s officers by preparing and filing tax returns that E&Y knew were inaccurate or false; and that E&Y must have known that Refco was likely to present to lenders, potential investors, underwriters, and other third parties in connection with Bennett’s continuous efforts to get financing and to sell the company. That is, E&Y knew that the RGL tax returns reflected interest income associated with the RGHI Receivable that E&Y knew was entirely or partially inaccurate.

There is evidence suggesting that E&Y knew that the entire RGHI Receivable was a sham transaction⁶⁵² and was not a bona fide debt on which interest income could properly accrue for tax purposes.⁶⁵³ For example, E&Y expressed doubts from as early as 1997 whether RGL’s

⁶⁵² See *In re Richard*, 2005-05XX, 2005 WL 3670919, at *6 (N.Y. Sup. Ct. Nov. 17, 2005). For tax purposes, a “sham transaction” is considered to be a transaction that “has no business purpose or economic effect other than the creation of tax deductions” or the creation of “income tax losses.” *United States v. Atkins*, 869 F.2d 135, 139-140 (2d Cir. 1989) (internal quotations omitted).

⁶⁵³ A “bona fide debt” is defined as “a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.” 26 C.F.R. § 1.166-1(c); see also *Hynard v. Internal Revenue Service*, 233 F. Supp. 2d 502, 507 (S.D.N.Y. 2002) (holding that a “debtor-creditor relationship contemplates that the taxpayer has made a loan,” and that the “inquiry is whether the parties actually intended and regarded the transaction as a loan”). In determining whether a debtor-creditor relationship exists as part of the bona fide debt analysis, courts must determine whether the taxpayer-creditor had a reasonable expectation of repayment, and often consider whether intent existed to repay funds transferred by a taxpayer to another entity. *Meier v. Commissioner of Internal Revenue*, 2003 WL 1700083 (U.S.Tax Ct.), 85 T.C.M. (CCH) 1097 (2003); *Haynard*, 233 F. Supp. 2d at 507. Significantly, “[a]dvances between a parent corporation and a subsidiary or other affiliate are subject to particular scrutiny ‘because the control element suggests the opportunity to contrive a fictional debt.’” *In*

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customers' bad debts that RGL had assigned or sold to RGHI could accurately be accounted for as a receivable balance/debt obligation. In addition, E&Y claims it never knew the business purpose of the receivable but admits that it was not motivated by tax considerations — which supports the inference that E&Y knew the debt was created for an improper purpose. Moreover, E&Y suspected or knew that RGHI was insolvent, had no assets other than its ownership of RGL, lacked the ability to pay the receivable, and had no intention of paying the receivable absent a sale of the company facilitated by a fraudulent scheme to deceptively bolster the financial appearance of the company. Despite its suspicions or knowledge that RGHI was insolvent, E&Y did virtually nothing to confirm the validity of the debt or RGHI's ability to pay it. Moreover, at least during part of its engagement, E&Y understood that RGHI was not making cash payments to RGL for the interest payments on the debt but rather was simply adding the interest payments to the receivable balance. Based on the foregoing, there is sufficient evidence for Refco's estate to claim that E&Y knew that the RGHI Receivable was a sham transaction that allowed RGHI to deduct interest expense, gave a misleading view of Refco's assets and income, and was an uncollectible debt.

Assuming that the RGHI Receivable was created for an improper purpose and was uncollectible, it was inaccurate and false to include on RGL's tax returns interest income associated with these receivable balances. Inclusion of the interest income had the effect of inflating the net income reported on RGL's tax returns. By preparing these inaccurate returns, which E&Y must have known Refco would show to third parties such as banks and investors,

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re Uneco, 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting *Cuyuna Realty Co. v. United States*, 382 F.2d 298, 300-01 (Ct. Cl. 1967)).

E&Y substantially assisted the Refco officers' fraudulent scheme of deceptively portraying the financial health of the company.

There is also evidence that E&Y knew by no later than September 2002 that at least the portion of the RGHI Receivable balance attributable to the Niederhoffer Loss was erroneously treated as a receivable and could not properly accrue interest income. Specifically, by as early as November 2000 and by no later than September 2002, E&Y knew that the entire Niederhoffer Loss was uncollectible because it had been settled and released in 1997. The fact that the claim against Niederhoffer was settled and released in 1997 meant that the entire N Loss should have been recognized as a loss and "written off" in 1997, and the tax deduction for this loss should have been taken in 1997 rather than the receivable being sold or transferred to RGHI and added to the RGHI Receivable. Upon learning that the N Loss had been settled in 1997, E&Y should have amended the 1997 Refco, Inc. tax return and each subsequent year's tax return to reflect the absence of a receivable, in an amount corresponding to the N Loss, from RGHI to Refco, Inc. and the corresponding absence of interest income associated with this improper receivable balance.⁶⁵⁴ Although E&Y claims it did amend the 1997 tax return, it does not know whether it amended subsequent returns,⁶⁵⁵ and the Examiner did not review any evidence indicating that E&Y did amend subsequent returns. If it did not amend subsequent returns (and inform those who might have reviewed the inaccurate unamended returns about the amended returns), E&Y

⁶⁵⁴ See 26 C.F.R. § 1.451-1(a) (stating that "[i]f a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due."); 26 C.F.R. § 1.461-1(a)(3) (stating that "[i]f a taxpayer ascertains that a liability was improperly taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file an amended return and pay any additional tax due").

⁶⁵⁵ Neidhardt interview; Cappel interview.

contributed to the perpetuation of the fraudulent and deceptive overstatement of Refco's income — a portion of which was attributable to interest income.⁶⁵⁶

Moreover, Refco's estate could allege that E&Y's failure to amend the returns once E&Y learned of the LBO and a possible future IPO was even more glaring and damaging to the estate.⁶⁵⁷ E&Y clearly knew that in connection with an LBO or IPO, third parties — such as investors, underwriters, and banks — likely would rely upon the inaccurate tax returns E&Y had prepared. Although E&Y says it decided to resign from its engagement with Refco in late 2003, E&Y committed to continue working on open IRS audits and did, in fact, continue working for Refco throughout 2004 and perhaps later.⁶⁵⁸ E&Y should have amended the tax returns at least while it continued to work for Refco.

(2) *Preparing Tax Returns that E&Y Knew Contained Erroneous Information Regarding RGL's Net Worth*

Similarly, there is sufficient evidence for Refco's estate to claim that E&Y "substantially assisted" the fraud/breach of fiduciary duty of Refco's officers by preparing and filing tax returns that E&Y knew contained false and inflated information regarding RGL's net worth. E&Y knew that the RGL tax return balance sheets (Schedule L) included as assets the receivable balances from RGHI that reflected losses that the books of RGL should have recognized. Thus, these Schedules showed an erroneous and inflated net worth for RGL. Again, E&Y must have known that Refco would present these inaccurate tax returns to lenders, potential investors, underwriters, and other third parties in connection with Bennett's plan to sell the company.

⁶⁵⁶ See, e.g., EY-REF-015045-56, at p. 49.

⁶⁵⁷ Bennett mentioned to Neidhardt the possibility of a future IPO in March 2002. See EY-REF 000335.

⁶⁵⁸ The IRS audit period for tax years 1997 through 1999 did not expire until September 2004 at the earliest. See EY-REF-023376.

(3) *E&Y's Possible Responses to Allegations That It Substantially Assisted or Helped Conceal the Fraud/Breach of Fiduciary Duty*

E&Y may assert significant counter-arguments to the foregoing theories of liability.

Most significantly, E&Y may argue that it cannot be viewed as having helped conceal the fraud since, E&Y may claim, it did disclose the existence of large inter-company receivable balances on Schedule L of the tax returns that it prepared. Indeed, Cappel himself says he discovered the huge inter-company receivable balance simply by looking at Schedule L on the tax returns that E&Y prepared.⁶⁵⁹ E&Y may argue that anyone else who had bothered to look (including banks, investors, underwriters, or other Refco professionals) could have seen these large inter-company receivable balances as well.

In addition, E&Y may argue that Refco could have proceeded and sometimes did proceed with transactions absent E&Y's tax advice and E&Y's preparation of tax returns. In other words, E&Y may argue that its tax work was not necessary to Refco's undertaking of the actions that constituted the fraud. E&Y may further argue that even if Refco followed E&Y's tax advice, E&Y merely saved RGL and/or RGHI money (by lowering tax liability), but did not facilitate any particular fraudulent transaction.

On balance, however, the Examiner concludes that the foregoing counter-arguments likely would not preclude Refco's estate from stating a claim because these arguments, even if accepted, do not negate the allegation that E&Y substantially assisted the fraud. Accordingly, while it is a close call, the Examiner concludes that the Refco estate could state a claim upon which relief may be granted.

⁶⁵⁹ See, e.g., EY-REF-029227-494, at p. 370-466.

(b) Failing to Act When Required to Do So

A defendant also may be found to have participated in a fraud or breach of fiduciary duty “by failing to act when required to do so,” thereby allowing the wrongdoing to proceed.⁶⁶⁰ The Examiner concludes that Refco’s estate could allege that E&Y was duty-bound to report the wrongdoing of which it was aware to BAWAG after it acquired a minority ownership interest in RGL in 1999, and to THL after it acquired a majority ownership interest in RGL in 2004; and, that by failing to do so, E&Y allowed the wrongdoing to proceed. While the general rule is that a tax accountant is not a fiduciary with respect to its client, and therefore has no duty to report wrongdoing, the Examiner concludes that Refco’s estate could credibly argue that E&Y had a duty to report wrongdoing to other owners of E&Y’s client, including BAWAG⁶⁶¹ and THL.⁶⁶² Indeed, Neidhardt himself recognized this duty, as evidenced by his repeated expressions of concern over whether BAWAG was fully aware of the RGHI Receivable and its periodic pay

⁶⁶⁰ *Pension Comm. of the Univ. of Montreal Pension Plan*, 2006 U.S. Dist. LEXIS 49954 at *101.

⁶⁶¹ Admittedly, it has since been learned that BAWAG was a co-conspirator with Bennett in connection with the fraud. However, the Examiner assumes that E&Y did not know at the time it learned of wrongdoing at Refco that BAWAG was actually assisting with the scheme.

⁶⁶² See, e.g., *White v. Guarante*, 43 N.Y.2d 356, 361-62, 372 N.E.2d 315, 318-19, 401 N.Y.S.2d 474, 477-78 (1977). In *White*, the court held that (1) a negligence claim could be brought by limited partners against accountants retained by a limited partnership to perform auditing and tax preparation services for failing to notify limited partners that general partners were improperly withdrawing funds from the partnership’s capital account, and (2) where the services of an accountant were not extended to a “faceless or unresolved class of persons,” but rather to a known group, marked by a definable limit, it is proper to apply a duty of care to those not in explicit privity with an accountant where the accountant was aware that a party would rely on or make use of the tax returns prepared by the accountant. The court reasoned that the accountant must have been aware that the limited partners would rely on or make use of the audit and tax returns. *Id.* at 361-62, 372 N.E.2d at 318-19, 401 N.Y.S.2d at 477-78. Although subsequent case law has somewhat narrowed the principle that a relationship approaching privity between an accountant and a third party can give rise to a duty of care owed by the accountant to the third party, *White* still remains good law. Compare, e.g., *Sanitoy, Inc. v. Shapiro*, 705 F. Supp. 152, 155 (S.D.N.Y. 1989) (distinguishing the relationship of a buyer and seller from a relationship approaching privity between an accountant and limited partners in *White*); with *Goldner v. Kemper Ins. Co.*, 125 A.D.2d 954, 954, 510 N.Y.S.2d 44, 45 (1986) (holding that although the facts of *White* were inapposite to the case before the court, privity may extend to those not in privity so long as those not in privity can qualify as members of a limited class who were expected to rely on the information provided those in privity).

down/reinstatement.⁶⁶³ Here, a court may conclude that E&Y was duty-bound to disclose the fraud to BAWAG and THL,⁶⁶⁴ but failed to do so and therefore allowed the fraud to continue. E&Y may assert significant counter-arguments to the foregoing theory. First, E&Y may argue that, rather than being duty-bound to report client wrongdoing to third parties such as BAWAG and THL, E&Y was prohibited from disclosing to anyone information it learned in the course of serving as Refco's tax preparation firm. According to E&Y, 26 U.S.C. § 7216(a) imposes criminal penalties upon a tax preparer if it discloses confidential client tax information without client consent.⁶⁶⁵

⁶⁶³ See, e.g., EY-REF 000335; EY-REF 000287, at App. D-30.

⁶⁶⁴ Although E&Y says it decided to resign from the Refco engagement in late 2003, there is evidence that E&Y continued to perform work for Refco throughout 2004 and therefore any disclosure duty it had arguably continued. See, e.g., EY-REF-031908.

⁶⁶⁵ 26 U.S.C. § 7216(a):

Any person who is engaged in the business of preparing, or providing services in connection with the preparation of, returns of the tax imposed by chapter 1, or any person who for compensation prepares any such return for any other person, and who knowingly or recklessly (1) discloses any information furnished to him for, or in connection with, the preparation of any such return, or (2) uses any such information for any purpose other than to prepare, or assist in preparing, any such return, shall be guilty of a misdemeanor, and, upon conviction thereof, shall be fined not more than \$1,000, or imprisoned not more than 1 year, or both, together with the costs of prosecution.

26 C.F.R. § 301.7216-1 also provides, in part:

any tax return preparer...who on or after January 1, 1972, discloses or uses any tax return information (as described in paragraph (b)(3) of this section) other than for the specific purpose of preparing, assisting in preparing, or obtaining or providing services in connection with the preparation of, any tax return of the taxpayer by or for whom the information was made available to a tax return preparer, shall be guilty of a misdemeanor, and, upon conviction thereof, shall be fined not more than \$1,000, or imprisoned not more than 1 year, or both, together with the costs of prosecution.

In addition, New York's rules governing the professional conduct of accountants provide that “[u]nprofessional conduct shall also include revealing of personally identifiable facts, data or information obtained in a professional capacity without the prior consent of the client.” 8 N.Y.C.R.R. § 29.10(c). To the extent that this rule applies here, E&Y could and should have sought permission from Refco to disclose information to third parties and resigned if permission was not granted.

The Examiner concludes that this argument likely would not defeat the Refco estate's claim at the Rule 12(b)(6) stage. The scope of the duty established by 26 U.S.C. § 7216(a) is not well defined, and because the statute imposes criminal penalties, the Examiner believes that a court would strictly construe the statute and narrowly limit the duty of non-disclosure to "information furnished by a taxpayer for, or in connection with, the *preparation of a tax return.*"⁶⁶⁶ The Examiner concludes that a reasonable argument exists that E&Y acquired knowledge of the wrongdoing from information that Refco provided, not in connection with the preparation of a tax return, but rather in connection with the provision of general transactional tax advice. In addition, the narrow duty of 26 U.S.C. § 7216(a) may not have prohibited E&Y's disclosure of wrongdoing to partial owners and controlling owners of E&Y's client such as BAWAG and THL.

Moreover, it is not clear that 26 U.S.C. § 7216(a) would prohibit E&Y from communicating with other professionals who were representing Refco on the very same matters that E&Y worked on for Refco. For instance, in spring 2002, both E&Y and Mayer Brown were working for Refco in connection with efforts to sell a portion of Refco (and may have been communicating directly on such matter). In this context, where two professionals are effectively jointly representing Refco, it is not clear that 26 U.S.C. § 7216(a) would prohibit communication between the two.

Even if E&Y's view of 26 U.S.C. § 7216(a) were correct, nothing prohibited E&Y from seeking consent from Refco to speak with third parties regarding Refco's tax information. Yet, E&Y never sought permission to speak to any third party until it requested a direct meeting with Refco's auditors in November 2003. Moreover, if Refco withheld the requested consent, E&Y

⁶⁶⁶ 26 U.S.C. § 7216(a) (emphasis added).

was free (and perhaps duty-bound) to resign from the engagement rather than continue to hide the fraud of which it was aware. Simply put, the Examiner is not persuaded that a court will agree with E&Y's position that it had no choice but to sit on its hands and remain silent for years about the ongoing fraud of which it was aware.

c. Statute of Limitations Considerations

The statute of limitations for professional malpractice in New York is three years. The date for the start of the running of the statute depends on the type of services provided.⁶⁶⁷ The statute of limitations for bringing a claim for aiding and abetting a breach of fiduciary duty is dependant on the relief sought, with a three year limitations period applying to claims for damages and a six year limitations period for claims seeking equitable remedies.⁶⁶⁸ The statute of limitations for a claim against an accountant for aiding and abetting fraud is the greater of (1) six years from the date the cause of action accrued or (2) two years from the date the client discovered or should have reasonably discovered the fraud.⁶⁶⁹ The limitations period may be extended on each of these claims against an accountant under the doctrines of continuous representation and fraudulent concealment, both of which involve questions of fact for the fact finder.⁶⁷⁰

⁶⁶⁷ See App. A, Sec. III.D; *Bastys v. Rothschild*, 2000 WL 1810107, *50 (S.D.N.Y. 2000). See *Ackerman v. Price Waterhouse*, 84 N.Y.2d 535, 541 (N.Y. 1994) ("claim accrues upon the client's receipt of the accountant's work product"); *Gould v. Berk & Michaels, P.C.*, 1990 WL 41706 (S.D.N.Y. 1990) (where claim involves purchase of investment in limited partnership or other tax shelter, injury occurs at time of purchase and commences the running of the limitations period).

⁶⁶⁸ See App. A, Sec. IV.E. Professional fees may be recoverable as equitable damages. See *id.*

⁶⁶⁹ See *id.* Whether a plaintiff should have discovered the fraud is a mixed question of law and fact. The test of discovery is objective – a determination of when the circumstances were such that a person of ordinary intelligence would recognize they have been defrauded. See *Armstrong v. McAlpin*, 699 F.2d 79, 88 (2d Cir. 1983); *Schmidt v. McKay*, 555 F.2d 30, 37 (2d Cir. 1977) ("[A]lthough a plaintiff may not shut his eyes to facts which call for investigation, mere suspicion will not suffice as a ground for imputing knowledge of the fraud.").

⁶⁷⁰ See App. A, Sec. IV.E. See *Williamson v. PricewaterhouseCoopers LLP*, 817 N.Y.S.2d 61, 64 (N.Y. App. Div. 2006); *Transp. Workers Union of Am. Local 100 AFL-CIO v. Schwartz*, 821 N.Y.S.2d 53, 56 (N.Y. App. Div. 2006).

E&Y delivered a variety of tax services to Refco, including preparation of tax returns and consultation services. The last tax return prepared by E&Y was prepared in 2003 for the 2002 calendar year. E&Y appears to have continued to provide various tax related services through the end of 2004.⁶⁷¹ Many of E&Y's acts and omissions which form the factual bases for the claims discussed above, such as the failure to amend various tax returns known by E&Y to contain false information, appear to have occurred within two years prior to the Petition Date. Accordingly, Refco's estate may argue that the claims discussed above are not barred by the respective statutes of limitation until the later of the running of the applicable limitations period as outlined above, the date of the services complained of or two years from the date the statute of limitations is tolled under Section 108 of the Bankruptcy Code.

d. Fraud, Negligent Misrepresentation, or Breach of Fiduciary Duty

The Examiner concludes that there is insufficient evidence to allow the Refco estate to state a claim upon which relief could be granted for fraud, negligent misrepresentation, or breach of fiduciary duty.

B. LEVINE, JACOBS & COMPANY, L.L.C.

1. Introduction and Background

Levine Jacobs is a small accounting firm that prepared the 2003 state and federal tax returns for RGL and RGHI.⁶⁷² In 2005, Levine Jacobs prepared the 2004 state and federal tax returns for RGHI, but was not engaged to prepare the 2004 tax returns for RGL.⁶⁷³ Levine

⁶⁷¹ As noted above, E&Y stated that it resigned from its representation of Refco in late 2003; however, it appears that E&Y continued to provide various services through at least December 2004.

⁶⁷² See LJC 04000.

⁶⁷³ See LJC 03247.

Jacobs conducted no audit work for Refco and no work with respect to Refco's financial statements.

2. Additional Factual Background

a. The Examiner's Investigation of Levine, Jacobs & Company, L.L.C.

The Examiner reviewed and analyzed all of the documents Levine Jacobs produced to government agencies, which consisted of over 25,000 pages. The Examiner also conducted interviews of the key Levine Jacobs partners who worked on the Refco engagement, namely, Richard Hoffman, Timothy Shore, and Robert Blackwell. The witnesses fully cooperated with the Examiner in scheduling the interviews without the need for subpoenas. During the interviews, the Levine Jacobs witnesses provided full, forthcoming answers to questions in a group setting in the presence of their attorney.⁶⁷⁴ Counsel for the Examiner found these witnesses to be credible. Through both the documents and interviews, the Examiner believes that he gained access to the necessary information to reach his conclusions regarding Levine Jacobs.

The Examiner found no documents that show Levine Jacobs had actual knowledge of the following: (1) RGHI owed RGL a large receivable comprised of bad debts that had been transferred from RGL to RGHI; (2) the RGHI Receivable was paid down at fiscal year end or quarterly to avoid its disclosure on audited financial statements; (3) RCM loaned funds to third parties, who, in turn, loaned funds to RGHI, who then paid down the receivable; or (4) these loan transactions later were reversed. The Examiner also did not find evidence that Levine Jacobs should have discovered the Round Trip Loan scheme, although the Examiner located a few

⁶⁷⁴ Levine Jacobs consented to the transcription of the interviews. The interviews were not taken under oath. For purposes of this Report, the transcript will be referred to as the 2/6/07 Levine Jacobs Interview Transcript.

documents that possibly should have caused Levine Jacobs to question Refco about certain transactions. Likewise, the Examiner did not locate evidence that Levine Jacobs either willfully ignored documents that arguably could have raised questions, or intentionally did not confront Refco about such evidence. The witness interviews, during which numerous documents were discussed, confirmed the Examiner's findings.

b. Background of Levine Jacobs and the Refco Engagement

Levine Jacobs is a small, full service accounting firm with approximately twenty-five employees based in Livingston, New Jersey. It maintains a general tax practice, and has several specialty areas, including one niche comprising 2-3% of its total practice involving the preparation of tax returns for large companies that otherwise would employ a large accounting firm.⁶⁷⁵

In 2004, RGL⁶⁷⁶ engaged Levine Jacobs to prepare 2003 federal and state tax returns for RGHI; RGL; Refco Group Holdings, LLC; Refco Europe Ltd., LLC; Refco Futures Holdings, Inc.; and Refco Securities, LLC.⁶⁷⁷ Most of Refco's other subsidiaries were rolled into the tax returns of the foregoing entities, and were considered disregarded entities for tax return purposes.⁶⁷⁸ In 2004, Levine Jacobs also assisted Refco on an Illinois sales tax audit and a

⁶⁷⁵ See 2/6/07 Levine Jacobs Interview Transcript at 17:7-20:21; 36:20-23.

⁶⁷⁶ Levine Jacobs understood that it was hired because Refco fired E&Y due to (1) cost concerns, and (2) E&Y's purported lack of diligence in timely filing returns. *Id.* at 42:8-43:5; 61:17-62:4. See LJC 04000.

⁶⁷⁷ Levine Jacobs' former associate, Zahava Meister, who married Trosten, first introduced Trosten and Refco to Levine Jacobs. As a result of this introduction, Levine Jacobs began preparing Trosten's individual tax returns in 2000 (which it still did as of the time of the interviews). See 2/6/07 Levine Jacobs Interview Transcript at 37:9-17; 46:21-47:6. Prior to the Refco tax return engagement beginning in 2004, Levine Jacobs also maintained other connections with Refco, including Levine Jacobs' preparation of the 2002 tax return for RJP Services, LLC, a company with ties to Refco that leased a corporate jet. *Id.* at 46:8-20. In addition, in 2002 Refco contacted Levine Jacobs about preparing a valuation of RGL as of November 30, 2001 for purposes of establishing a non-qualified deferred compensation plan. Levine Jacobs explained that it lacked capability to perform this work and, therefore, recommended another small accounting firm to Refco for this matter. *Id.* at 44:3-21; see also LJC 03196.

⁶⁷⁸ See 2/6/07 Levine Jacobs Interview Transcript at 58:17-59:17.

similar audit for the city of Chicago.⁶⁷⁹ Levine Jacobs filed the federal returns in approximately September 2004.⁶⁸⁰

When Levine Jacobs started its tax preparation work in 2004, E&Y provided Levine Jacobs with Fast-Tax locator numbers⁶⁸¹ at Refco's request so that Levine Jacobs could review information related to the Refco returns.⁶⁸² Levine Jacobs could view Refco's prior returns through 2001 using the Fast-Tax locator numbers.⁶⁸³ However, Levine Jacobs could not view anything else with the Fast-Tax locator numbers, including E&Y's work papers.⁶⁸⁴ Other than the Fast-Tax locator numbers, E&Y only provided apportionment calculations and net operating loss calculations to Levine Jacobs.⁶⁸⁵ Levine Jacobs did not have any substantive conversations with E&Y personnel related to Refco or Refco's tax returns.⁶⁸⁶ In fact, Levine Jacobs' standard practice when taking over accounting work and obtaining tax related information was to speak with the client rather than a prior accounting firm.⁶⁸⁷

In 2005, Levine Jacobs' engagement continued. RGHI retained Levine Jacobs to prepare 2004 federal and state tax returns for RGHI and Refco Securities, LLC.⁶⁸⁸ However, PwC was retained to prepare RGL's 2004 federal return.⁶⁸⁹ Nonetheless, until the formal engagement

⁶⁷⁹ *Id.* at 60:3-14.

⁶⁸⁰ *Id.* at 61:2-7.

⁶⁸¹ Fast-Tax is a complex web-based program that a number of accounting firms use to assist in the preparation of tax returns. A locator number allows a tax preparer to access tax return information. *Id.* at 62:25-63:2.

⁶⁸² See 2/6/07 Levine Jacobs Interview Transcript at 62:12-63:17.

⁶⁸³ *Id.* at 63:18-64:4.

⁶⁸⁴ *Id.* at 63:18-64:7.

⁶⁸⁵ *Id.* at 65:3-66:3.

⁶⁸⁶ *Id.* at 66:4-67:1

⁶⁸⁷ *Id.* at 66:14-67:1; 69:23-70:2.

⁶⁸⁸ See LJC 03247; 2/6/07 Levine Jacobs Interview Transcript at 70:18-24; 73:6-15.

⁶⁸⁹ *Id.* at 70:25-71:12.

letter with Levine Jacobs was executed in July 2005, Levine Jacobs performed substantial work on the RGL federal return during the first half of 2005 anticipating that it would be engaged to complete the return.⁶⁹⁰ Ultimately, at the request of Refco, Levine Jacobs transferred its work to PwC.⁶⁹¹ Refco paid Levine Jacobs for the work it performed on the RGL return.⁶⁹² As for the other returns Levine Jacobs was retained to prepare, Levine Jacobs filed the federal returns in approximately September 2005.⁶⁹³

Throughout this engagement, Levine Jacobs performed no auditing work, did not prepare or edit any financial statements, and, with the exception of the Illinois and Chicago sales tax audits, simply prepared tax returns and provided limited tax consulting advice regarding transactions.⁶⁹⁴ In addition, during the course of the engagement, Levine Jacobs never spoke with any of the other professionals providing services to Refco, with the exception of very limited communications with E&Y and/or PwC related solely to the transfer of Fast-Tax locator numbers or the transfer of other tax materials.⁶⁹⁵ Levine Jacobs did not have conversations with E&Y or PwC related to anything of substance concerning Refco.⁶⁹⁶ Over the course of Levine

⁶⁹⁰ *Id.* at 71:4-72:7.

⁶⁹¹ *Id.* at 71:4-12; 72:22-73:1.

⁶⁹² *Id.* at 73:2-5.

⁶⁹³ *Id.* at 77:10-13. Levine Jacobs filed the state tax returns shortly after Refco filed for bankruptcy. *Id.* at 77:10-17.

⁶⁹⁴ Levine Jacobs' engagement letters contained no limitations of liability or indemnification provision. However, the 2005 engagement letter, signed by Bennett, stated that Refco would provide information relating to the returns and Levine Jacobs would "not verify or audit this information." *See* LJC 03247.

⁶⁹⁵ *See* LJC 03247; 2/6/07 Levine Jacobs Interview Transcript at 84:17-85:8; 85:14-88:4. As to contacts with Refco personnel, during Levine Jacobs' two year engagement, Levine Jacobs' primary contact at Refco was Silverman. *Id.* at 49:16-21. In addition to Silverman, however, Levine Jacobs worked with Trosten and Sean Galvin on certain occasions. *Id.* at 49:16-25; 50:13-51:3. Levine Jacobs also had limited conversations with Bennett, including two meetings and two or three phone conversations. *Id.* at 51:4-53:5.

⁶⁹⁶ 2/6/07 Levine Jacobs Interview Transcript at 62:12-63:17; 66:4-13; 86:7-89:4.

Jacobs' two year engagement with Refco, Levine Jacobs estimates that it generated approximately \$300,000 in fees.⁶⁹⁷

c. Levine Jacobs' Tax Return Preparation Work

For purposes of preparing the tax returns, Levine Jacobs' work depended heavily on tax trial balances prepared by Refco for various Refco entities. Levine Jacobs summarized the information on the tax trial balances into its own spreadsheets, and used the information contained on these spreadsheets to complete the tax returns.⁶⁹⁸ Levine Jacobs rarely made adjustments to the tax trial balances. Occasionally for tax return "presentation" purposes, Levine Jacobs would present and classify multiple related trial balance entries as a single tax return line item.⁶⁹⁹

The tax trial balances contained numerous entries, including asset line items for "Due from Affiliates" and "Loans Receivable." Similarly, the liabilities section of the tax trial balances contained line items for "Due to Affiliates" and "Loans Payable." Tax trial balances for

⁶⁹⁷ *Id.* at 82:20-23. Providing further corroboration, a Levine Jacobs "Summary of Tax & Fee Wire Transfers" shows fee payments to Levine Jacobs from Refco, exclusive of funds transferred to Levine Jacobs to pay Refco taxes, from February 20, 2004 through January 4, 2005 (approximately one half of the engagement) of \$157,850. *See* LJC 7409 - LJC 7410.

⁶⁹⁸ *See* 2/6/07 Levine Jacobs Interview Transcript at 92:2-95:4.

⁶⁹⁹ *Id.* at 99:4-100:14. In addition, in rare circumstances, Levine Jacobs would make substantive adjustments to a trial balance line item for purposes of reporting it on a tax return. For example, it made adjustments to certain items Refco initially classified as bad debt expenses on tax trial balances. More specifically, Levine Jacobs explained that before taking a bad debt expense deduction, Levine Jacobs wanted to ensure that the debt was uncollectible. On occasion, Levine Jacobs would ask whether a particular bad debt expense referenced on a trial balance was uncollectible. Refco then would inform Levine Jacobs if the item constituted a bad debt for tax purposes. At times, Refco chose to not treat certain bad debt expenses on the trial balances as bad debts on tax returns. *Id.* at 100:15-102:24; 144:1-145:13.

For these bad debt expenses, the Examiner did not find evidence that Levine Jacobs made adjustments to bad debts related to the receivable scheme. In one particular spreadsheet prepared by Levine Jacobs, Levine Jacobs questioned whether it should classify a RGHI bad debt expense of \$19.9 million as a true bad debt expense for tax purposes. *See* LJ0000007358 - LJ0000007359. Levine Jacobs approached Refco about this entry, and asked whether this expense should be recognized as a bad debt under IRS rules. Silverman decided this item did not constitute a bad debt for tax purposes, and, therefore, Levine Jacobs did not reference this expense for tax purposes. *See* 2/6/07 Levine Jacobs Interview Transcript at 110:4-112:6; 144:1-145:13. No other documents located by the

(footnote continued on next page)

RGHI and RGL showed extremely large monthly fluctuations in these various line items.⁷⁰⁰ However, Levine Jacobs witnesses stated that they focused on, and only saw, the tax balance column (in addition to columns for the line item number, line item description, preliminary balance amount, and tax adjustment amount) and did not see the monthly balances on the computer screen.⁷⁰¹ Levine Jacobs witnesses indicated that Levine Jacobs generally did not concern itself with the balances in other columns, and would not be concerned with any fluctuations, even if they had noticed them, because the tax return focused on end-of-tax-period final numbers and not balance sheet items.⁷⁰² Moreover, Levine Jacobs explained that the calendar year end numbers accounted for these other monthly entries. Accordingly, Levine Jacobs saw no need to consider the large fluctuations.⁷⁰³

As with the fluctuations in the line items for amounts due to and from affiliates, the trial balances also contained various interest receivable and payable line items, which often showed numbers in the tens of millions of dollars. Levine Jacobs witnesses said that they did not view it as unusual for certain Refco entities to have large interest expenses or interest income (or fluctuations in those amounts) considering the nature of Refco's business. Levine Jacobs understood that certain Refco entities regularly would pay interest on customer account balances,

(footnote continued from previous page)

Examiner show that Levine Jacobs believed this particular bad debt expense, or any other bad debt expense, was part of the uncollectible receivable owed by RGHI to RGL.

⁷⁰⁰ See LJ0000007878; LJ0000009800.

⁷⁰¹ See 2/6/07 Levine Jacobs Interview Transcript at 117:2-124:12. When Levine Jacobs received tax trial balances from Refco, it received them in an Excel spreadsheet format with only these 4-5 columns viewable on the computer screen. The spreadsheets often had numerous additional columns, including monthly balances or monthly transaction activity entries. However, Levine Jacobs witnesses stated they did not view these additional columns because they were hidden. Although Levine Jacobs easily could open these hidden cells, the witnesses said they rarely did. *Id.*

⁷⁰² *Id.* at 117:2-124:12; 129:15-130:7; 157:4-160:9; 162:7-21.

⁷⁰³ *Id.*

receive interest from customers resulting from margin trades, or execute transactions involving financial instruments that generated interest income or expense.⁷⁰⁴

Although Levine Jacobs frequently communicated with Refco to obtain clarification of particular tax balance entries, Levine Jacobs did not question the accuracy of any figures contained in trial balances.⁷⁰⁵ Similarly, it did not confirm the accuracy of the figures by auditing or examining Refco's books. Due to Refco's size, Levine Jacobs presumed that Refco's own accounting staff and auditors performed competent work, and assumed Refco provided accurate numbers.⁷⁰⁶

During the interviews, Levine Jacobs personnel explained that ultimately Refco maintained responsibility for the tax treatment of certain items. Levine Jacobs simply explained the tax rules to Refco.⁷⁰⁷ Before filing any of the returns, Levine Jacobs would circulate the returns to Silverman at Refco for comments. Levine Jacobs would not file any of the returns until Refco approved them.⁷⁰⁸

d. The RGHI Receivable and Round Trip Loans

Levine Jacobs denied having knowledge of the RGHI Receivable. Although Levine Jacobs knew that trial balances contained line items for "due to/from affiliates" or "loans payable/receivable," Levine Jacobs did not know the specifics of the transactions comprising

⁷⁰⁴ *Id.* at 128:12-15; 146:22-149:8; 179:20-180:3.

⁷⁰⁵ *Id.* at 104:10-23.

⁷⁰⁶ *Id.* at 104:10-105:8.

⁷⁰⁷ *Id.* at 104:3-19.

⁷⁰⁸ *Id.* at 96:1-8.

these entries, did not know who any of the affiliates were, and did not know who was involved with any affiliate loans.⁷⁰⁹

Levine Jacobs explained that it did not need additional details from Refco for these line items, because they would not affect the income on the tax returns. Levine Jacobs witnesses stated they believed that these items represented balance sheet items that had no bearing on taxes.⁷¹⁰ Moreover, as discussed above, Levine Jacobs only was concerned with tax year end numbers, not monthly balances. Indeed, Levine Jacobs stated that it did not even see the large fluctuations in the due to affiliates and due from affiliates categories or the monthly interest fluctuations, because the monthly columns did not appear on their computer screens when a user opened the tax trial balance document.⁷¹¹

None of the previously-referenced large numbers or fluctuations prompted Levine Jacobs to inquire further.⁷¹² Levine Jacobs also denies having any understanding of the purpose of the due to/from affiliate transactions, or that these entries reflected in part uncollectible bad debts that were transferred from RGL to RGHI.⁷¹³

Levine Jacobs also denied it knew that the RGHI Receivable was paid down at fiscal year end (or quarter end).⁷¹⁴ Levine Jacobs further denied having knowledge of the Round Trip Loan scheme, and denied knowing that RCM loaned funds to third parties to lend to RGHI to pay down the receivable.⁷¹⁵ Levine Jacobs witnesses also stated that the pay-down of the RGHI

⁷⁰⁹ *Id.* at 126:18-127:16; 133:5-134:21; 135:7-136:6.

⁷¹⁰ *Id.* at 129:15-130:7.

⁷¹¹ *Id.* at 117:2-124:12; 129:15-130:7; 157:4-160:9; 162:7-21.

⁷¹² *Id.* at 130:14-131:7.

⁷¹³ *Id.* at 131:12-132:1.

⁷¹⁴ *Id.* at 139:7-140:16.

⁷¹⁵ *Id.* at 182:8-183:7; 184:22-185:4.

Receivable and Round Trip Loans should not affect tax liability and, therefore, were irrelevant for tax preparation purposes.⁷¹⁶

The documents reviewed by the Examiner do not contradict Levine Jacobs' denial of actual knowledge of the RGHI Receivable and the Round Trip Loans. The Examiner found no internal communications among Levine Jacobs personnel or external communications between Levine Jacobs and Refco in which the RGHI Receivable or Round Trip Loans were discussed, or any documents suggesting that Levine Jacobs might have known about the RGHI Receivable and the purpose behind it.

Several documents, however, including tax trial balances, could have raised red flags for Levine Jacobs. While not sufficient by themselves to establish constructive knowledge, the documents discussed below contained entries that could have aroused concerns and could have led to inquiries revealing aspects of the receivable scheme.

(i) Tax Trial Balances

First, the tax trial balances, if fully reviewed, would have shown that an extremely large loan receivable existed at times. Had Levine Jacobs fully opened the trial balances, which it claims not to have done, it would have seen the enormous fluctuations in the amounts due to/from affiliates and the interest receivable/payable line items. These trial balances constitute some evidence of the existence of a large receivable owing from RGHI to RGL and interest income/expense generated by the receivable.

(ii) Spreadsheet Concerning Gain on Sale

Second, the Examiner located a spreadsheet concerning the gain on the sale of RGHI's interest in RGL as part of the LBO. The spreadsheet, which relates to a tax basis calculation,

⁷¹⁶ *Id.* at 138:2-25.

specifically mentions certain sources of the bad debts giving rise to the RGHI Receivable.⁷¹⁷

According to Levine Jacobs, Silverman prepared the spreadsheet (and other similar versions) in September 2005 as a result of a Levine Jacobs inquiry for more information about a single number on a year 2004 tax trial balance reflecting the gain on sale.⁷¹⁸ Levine Jacobs explained that the spreadsheet shows the amount that was paid to all other persons and entities from sale proceeds, and, accounting for RGHI's basis in RGL, the net gain on the sale of RGHI's interest in RGL.⁷¹⁹

Because this document references the Asian receivable and Niederhoffer (and a guaranteed payment by RGHI for the benefit of RGL presumably related to the uncollectible Niederhoffer balance), Levine Jacobs might have been prompted to ask what certain entries represented. Levine Jacobs denies knowing that one of the bad debts precipitating the receivable scheme resulted from Niederhoffer, and denies knowing about the Asian receivables.⁷²⁰ It also says it did not ask Refco any questions about these entries.⁷²¹

The spreadsheet also references a payment to BAWAG of \$757 million. Levine Jacobs says it asked Refco why BAWAG received more money than any other person or entity because BAWAG was only a minority owner.⁷²² According to Levine Jacobs, after Silverman spoke with Bennett, Silverman told Levine Jacobs that BAWAG received this amount because BAWAG

⁷¹⁷ See LJ0000008268. This spreadsheet contains entries for "additional basis for other payments by RGHI for benefit of Refco Group Ltd." and references additional payments made by RGHI, including entries for "BAWAG (paid from Chase A/C) [\$757 million]," "Asian Receivables [\$395.6 million]," "Funds sent to RGL Re: Niederhoffer (RGHI Guarantee f/b/o RGL) [\$44 million]," and "Due from Affiliates — ROL (RGHI Guarantee f/b/o RGL) [\$1.4 million]." *Id.* at LJ0000008271.

⁷¹⁸ See 2/6/07 Levine Jacobs Interview Transcript at 186:9-187:6.

⁷¹⁹ *Id.* at 188:24-189:17.

⁷²⁰ *Id.* at 136:7-137:25.

⁷²¹ *Id.* at 191:8-15.

⁷²² *Id.* at 191:13-15.

was the largest minority owner in RGL, was holding up the THL sale, and, therefore, demanded a premium.⁷²³

Levine Jacobs stated that despite the various entries related to the Asian receivables, Niederhoffer, BAWAG, and others, it ultimately was concerned only with the final number for tax purposes — the net gain on the sale of RGHI's interest in RGL.⁷²⁴ As with the trial balances, arguably Levine Jacobs should have inquired further to better understand the Niederhoffer Loss and the Asian receivables, especially since Levine Jacobs had requested that Refco prepare this spreadsheet.

(iii) E-mails Concerning \$462 Million Expense

Finally, the Examiner located an e-mail dated July 23, 2004 from Blackwell to Silverman asking for additional information related to a \$462 million expense.⁷²⁵ Despite follow-up e-mails from Levine Jacobs dated August 13, 2004 and August 18, 2004, Refco never provided any clarification of the \$462 million expense.⁷²⁶ Levine Jacobs explained during the interview that it simply posed the question about the expense to Refco due to the large size of the particular expense. Receiving no response, Levine Jacobs left the item categorized as an "accrued

⁷²³ *Id.* at 191:19-25.

⁷²⁴ *Id.* at 192:15-193:15; 194:7-15.

⁷²⁵ The e-mail states in part:

There is also accrued expenses [for RGHI] for \$462,816,396 which seems large compared to the other liability items and I was wondering if I can break this down further . . . These items will surely [sic] create a question if I am not more specific as to what they really are. Can you clarify these items for me?

See LJ0000017125.

⁷²⁶ *See* LJ0000017126, LJ0000017641.

expense" for tax purposes.⁷²⁷ Levine Jacobs says it made no assumption as to what this accrued expense would have included.⁷²⁸

Had Levine Jacobs pursued this issue further, it might have learned information that could have revealed the existence of a large receivable or large accrued interest amounts. Again, (1) since Levine Jacobs raised questions about this large expense, it should have pursued the matter further when Refco failed to respond, and (2) Levine Jacobs raised questions about this expense but did not do the same with often larger numbers referenced in the tax trial balances.

Notwithstanding the foregoing documents, the limited scope and duration of the engagement, and Levine Jacobs' inexperience preparing tax returns for businesses the size of Refco's, may further support Levine Jacobs' explanations concerning the lack of inquiry and failure to obtain additional information. The Examiner concludes there is insufficient evidence to show that Levine Jacobs knew or should have known of the receivable scheme or aided and abetted members of Refco's management who participated in that scheme.⁷²⁹ Similarly, the Examiner found no evidence suggesting that Levine Jacobs knowingly ignored signs that Refco engaged in the receivable scheme or Round Trip Loans.

3. Conclusions: Analysis of Potential Claims Against Levine Jacobs

Based on the evidence reviewed and the resources made available to him, the Examiner concludes that there is not sufficient evidence to state a claim that Levine Jacobs committed malpractice by negligently preparing tax returns. The legal standards for professional negligence

⁷²⁷ See 2/6/07 Levine Jacobs Interview Transcript at 179:11-19.

⁷²⁸ *Id.* at 180:15-24.

⁷²⁹ By contrast, E&Y was Refco's tax accounting firm for many years. E&Y had actual knowledge of the RGHI Receivable and the fact that Refco was manipulating its financial statements to hide the RGHI Receivable and to remove bad debts from Refco. E&Y also played an active role in advising Refco how to structure certain financial transactions. *See* Section V.A.

related to accountants are discussed in substantial detail in Appendix A. The evidence available to the Examiner does not establish that Levine Jacobs failed to follow generally accepted professional accounting standards when preparing the returns.

Similarly, the Examiner did not find evidence establishing that Levine Jacobs had actual knowledge of the fraudulent scheme. Having carefully considered the evidence available, the Examiner also concludes that the Refco estate likely could not state a claim against Levine Jacobs for aiding and abetting fraud and breach of fiduciary duty, fraud, negligent misrepresentation, or breach of fiduciary duty.

VI. REFCO'S ATTORNEYS

A. MAYER, BROWN, ROWE & MAW LLP

1. Introduction

Mayer Brown began representing Refco in early 1994, when Collins moved to Mayer Brown from his prior law firm and brought Refco with him as a client. Thereafter, and until the LBO was consummated in early August 2004, Mayer Brown was Refco's primary law firm, and Collins was Refco's primary outside attorney. Mayer Brown performed a substantial amount of work for Refco, billing Refco approximately \$5 million annually.⁷³⁰

a. Document Review

The Examiner was given access to over a million of pages of documents pertaining to Mayer Brown's representation of Refco. These documents included:

- Documents provided by Mayer Brown to the SEC and to counsel for the Creditors Committee.

⁷³⁰ The Examiner received a summary of payments made by Refco to certain professionals for the period beginning January 1, 1998 and ending October 7, 2005 for payments made by check, and for the period beginning January 1, 2000 and ending October 7, 2005 for payments made by wire transfer. This summary reflected that Mayer Brown received a total of \$23,979,915 during that time frame.

- Documents provided to counsel for the Litigation Trustee for sharing with and review by the Examiner.⁷³¹
- Documents from the files of the Refco Debtors that were compiled by the Debtors' counsel and placed in a database to which the Examiner was given access.
- Documents produced by various Round Trip Loan Participants to the SEC, to counsel for the Creditors Committee, or directly to the Examiner.
- Documents produced to the Examiner by THL and Weil Gotshal.
- Other documents produced to counsel for the Creditors Committee to which the Examiner was given access.

The Examiner focused his investigation and his document review on the following particular areas:

- Mayer Brown's involvement in the Round Trip Loans.
- Mayer Brown's involvement in transactions between Refco and BAWAG, whereby BAWAG and related parties acquired debt and equity interests in Refco for which they were paid out of the proceeds of the LBO.
- Mayer Brown's involvement in other transactions which might bear upon Mayer Brown's knowledge of the existence and size of the RGHI Receivable and the purpose and intent of the Round Trip Loans to mask that receivable.
- Mayer Brown's involvement in the LBO transaction and the registration of the Senior Subordinated Notes.
- Mayer Brown's involvement in Refco's IPO.

b. Witness Interviews

The Examiner interviewed several current or former Mayer Brown attorneys who performed legal services for Refco:

- Joseph Collins ("Collins") — current partner who was responsible for Mayer Brown's representation of Refco. Collins was Mayer Brown's primary contact with Refco, and had been throughout Mayer Brown's representation of Refco.

⁷³¹ Mayer Brown last produced documents on or about March 7, 2007, several weeks after the last Mayer Brown interview.

The approximately \$3-5 million annually billed to Refco constituted about half of the billings for which Collins was responsible as billing partner. As billing partner, he was responsible for and did review the detailed billings for services rendered to Refco on a monthly basis. Accordingly, Collins was aware of the work that everyone at Mayer Brown performed for Refco.⁷³²

- Robert Monk (“Monk”) — a former associate located in Chicago who left Mayer Brown in about February 2001, and was involved in several Round Trip Loans that took place in February 2000 and February 2001.
- Andrea Henneman (“Henneman”) — a former associate located in New York who was identified in an e-mail sent by Monk as he left Mayer Brown in February 2001 as the person who would be taking his place in a then-pending Round Trip Loan transaction, and who performed legal services in connection with several other Refco transactions prior to her departure from Mayer Brown in about April 2001.
- Paul Koury (“Koury”) — a former associate who was involved in a substantial number of Round Trip Loan transactions that took place from a time after Monk left through May 2005, and who also performed legal services in connection with several other Refco transactions prior to his departure in May 2005.
- Ross Pazzol (“Pazzol”) — a current “of counsel” attorney with Mayer Brown who was identified in an e-mail sent by Koury as he left Mayer Brown in May 2005 as one of the persons who could be contacted in connection with a then-pending Round Trip Loan transaction, and who also performed legal services in connection with several other Refco transactions.
- Peter Schultz (“Schultz”) — a current associate who was also identified in the e-mail sent by Koury as he left Mayer Brown in May 2005 as one of the persons who could be contacted in connection with a then-pending Round Trip Loan transaction, and who also performed legal services in connection with several other Refco transactions.

Each of these persons voluntarily appeared for an interview conducted by the Examiner or his counsel. Mayer Brown cooperated with the Examiner in facilitating these interviews. The witnesses were represented by individual counsel, and counsel for Mayer Brown was also

⁷³² Collins also stated in his interview that he usually sent to Refco on a monthly basis a “summary” bill that summarized the detailed daily entries of attorneys and paraprofessionals who worked on Refco matters into short narratives. Collins stated that he was responsible for the preparation of such summary monthly bills, and he either prepared them himself by dictating the summaries, or had them prepared by his assistant. He reviewed the summary bills before they were sent to Refco.

present. The witnesses and Mayer Brown objected to the presence of a court reporter, and, therefore, the interviews were not transcribed.

Although the witnesses were able to provide general background information, the witnesses all said that they had little or no recollection of the specific events about which the Examiner questioned them. In virtually every case, the witnesses claimed that their recollections were not refreshed by being shown documents they had created or previously seen. Therefore, they offered very little additional evidence concerning these events, and the Examiner has based his conclusions largely on the documents. As a result, facts described herein are derived substantially from Mayer Brown time records and documents that were created or amassed by Mayer Brown or others with whom Mayer Brown interacted.

2. Factual Conclusions

The Examiner concludes that there is significant evidence that Mayer Brown:

- assisted Refco by drafting and negotiating documents in connection with the Round Trip Loan transactions, which Mayer Brown knew or should have known were fraudulent and undertaken for the purpose of manipulating Refco's financial statements;
- failed to disclose material matters in connection with the LBO, the IPO, and related transactions; and
- failed to disclose its knowledge of the RGHI Receivable and Round Trip Loan scheme to persons at Refco independent of Bennett — including, after the LBO, THL personnel and, after January 2005, Refco's independent outside directors.

a. Evidence that Mayer Brown Knew that the Round Trip Loans Were Used to Manipulate Refco's Financial Statements

The Examiner concludes that there is evidence showing that Mayer Brown knew that the Round Trip Loans were a scheme to avoid disclosure of the RGHI Receivable on Refco's audited financial statements in order to fraudulently bolster Refco's financial appearance to lenders and investors. The Examiner has not located direct evidence that Mayer Brown knew

that the Round Trip Loans were used to manipulate Refco's financial statements. Mayer Brown attorneys deny any such knowledge and claim to have virtually no recollection of the Round Trip Loan transactions.⁷³³ However, as explained below, the circumstantial evidence, taken as a whole, is sufficient to support the conclusion that Mayer Brown had such knowledge.

Specifically, the evidence establishes the following:

- Over a five year period Mayer Brown drafted virtually all of the Round Trip Loan documents with respect to seventeen transactions.
- Mayer Brown negotiated terms with Round Trip Loan Participants or their attorneys.
- Mayer Brown knew that the Round Trip Loans involved the lending of typically hundreds of millions of dollars by Refco, for a period of only several days, through the Round Trip Loan Participants to RGHI, an entity that was controlled by Bennett and controlled Refco.
- Mayer Brown knew that these massive loans were risk free to the Round Trip Loan Participants, and was not aware of any business purpose for the transactions.
- Mayer Brown drafted guarantees and indemnifications made by RGL in favor of the Round Trip Loan Participants, guaranteeing RGHI's repayment obligations, and Mayer Brown knew that Bennett signed virtually all of the guarantees and indemnities on behalf of RGL and the loan documents on behalf of RGHI.
- Mayer Brown knew the nature of the Round Trip Loan transactions from both the deal documents and correspondence from the Round Trip Loan Participants.
- Mayer Brown knew that, prior to the LBO, Refco was required to submit audited financial statements to lenders on a yearly basis and, after the LBO, on a quarterly basis to lenders and the SEC.
- Mayer Brown performed legal services in connection with loans whose covenants were violated by the Round Trip Loans.
- Mayer Brown knew that the Round Trip Loans straddled Refco's financial reporting periods and occurred only at those times (with one exception).

⁷³³ Mayer Brown distinguished Round Trip Loans from back-to-back loans, the latter involving only the loans and transactions and not financial statement manipulation.

- Mayer Brown knew no later than early June 2002 that RGHI owed an intercompany debt to RGL of at least \$350 million.

In addition, although Mayer Brown denies it, there is sufficient evidence to allege that Mayer Brown knew the full extent of the RGHI Receivable, as evidenced by:

- correspondence of Bennett and Trosten;
- work on tax issues in connection with the 1999 BAWAG transaction;
- work on the PPA agreement; and
- work in connection with other transactions pertaining to Refco “bad debts,” including the Asian receivables, Niederhoffer Loss, Wells, the \$43 million arbitration award, and Trade & Marine.

Finally, Mayer Brown understood that Refco’s senior executives had incentives to manipulate Refco’s financial statements. This evidence is addressed below.

(i) Mayer Brown’s Repeated Substantive Involvement in the Round Trip Loan Transactions

Seventeen times over a five year period from 2000 to 2005, Mayer Brown attorneys Collins, and Monk or Koury, were involved in every facet of the Round Trip Loan transactions.⁷³⁴ Mayer Brown negotiated the terms of and drafted virtually all of the Round Trip

⁷³⁴ As discussed in Section III.B., there also were transactions in February-March 1998 and February-March 1999 (the “WTLs”). Mayer Brown was involved in the resolution of claims that Refco had against entities involved in the WTLs, described as follows:

- a. MLC — Beginning in about December 1997, Collins and Henneman were involved in a transaction whereby preferred stock in a Refco-related entity was sold to MLC in several installments. *See* the following Mayer Brown time record(s): MBRM-EX 00051934, 38-40, 42, 49, 51. *See* the document(s) with the following beginning document number(s) or number range(s): MBRM-EX 00123008-53; REFCO-HC-0036764-86; MBRM-EX 00007153.
- b. Tradewinds entities — Beginning in about August 1998, Mayer Brown began engaging in discussions with Tradewinds as to claims of Refco: *See* the following Mayer Brown time record(s): MBRM-EX 00051944, 46, 48-56, 66. *See* the document(s) with the following beginning document number(s) or number range(s): MB00041957-58; MBRM-EX 00037178-79; MB00032438-39; MBRM-EX 00007244-50; MB02010668-69.
- c. Bribank and GlobeInvest — Between August 1998 through January 1999, Mayer Brown dealt with resolving Refco’s claims against Bribank and GlobeInvest through Refco’s acquisition of stock in Bribank. *See* the following Mayer Brown time records: MBRM-EX 00051945-48, 50-56. *See* the document(s) with the following beginning document number(s) or number range(s): MB00031784; MB00031785-86; MB00031788-89;

(footnote continued on next page)

Loan documents; transmitted those documents to Refco and the Round Trip Loan Participants; and retained custody of and distributed the executed copies of those Round Trip Loans. At least in the first few years, Mayer Brown implemented changes to the documentation requested by Round Trip Loan Participants and marked the notes to RCM as satisfied on the maturity of the Round Trip Loans.

The first Round Trip Loan transactions that Mayer Brown worked on were in February and March 2000. Specifically, Collins and Monk documented and participated in three Round Trip Loan Transactions involving a total of \$310 million. Mayer Brown's involvement appears to have begun on February 1, 2000, when Weaver of Refco discussed with Collins a transaction involving "back-to-back" loans — the first one from RCM to CIM Ventures, and the second from CIM Ventures to RGHI.⁷³⁵ Collins' notes dated February 1, 2000, indicate that he was advised by Weaver of the following facts regarding the loans: (i) there would be loans from RCM to CIM Ventures and from CIM Ventures to RGHI; (ii) the principal amount of the loans would be \$150 million; (iii) there would be a right of offset; (iv) there would be a 15 basis point spread between the two loans; (v) the term of the loans would be one month from February 15 to March 15; and (vi) there would be an indemnity letter.⁷³⁶

During the next few weeks, Collins and Monk prepared, edited, and reviewed Round Trip Loan transaction documents pertaining to CIM Ventures, including loan documents, a guarantee

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MB00031791-92; MB00031793; MBRM-EX 00037174; MB00031797-99; MB00031849-50; MB00031808-09; MB00031853-54.

d. EMF, Ltd — in October 1998, Collins and Mayer Brown dealt with issues related to EMF, Ltd, consulting with Refco on "EMF Fund restructuring" and "EMF Fund management fee." *See* the following Mayer Brown time record(s): MBRM-EX 00051952.

⁷³⁵ *See* the following Mayer Brown time record(s): MBRM-EX 00052900.

by RGL of RGHI's repayment obligation to CIM Ventures, and an indemnification agreement by RGL in favor of CIM Ventures. Monk had a number of conversations with Weaver and with Ricketts of CIM Ventures, and sent copies of the documents to Ricketts for review and execution.⁷³⁷ Monk sent execution copies of documents to Refco and RGHI, and upon receiving the executed documents from Refco and RGHI, Monk was in possession of RCM loan documents, RGHI loan documents, and an RGL guarantee (of RGHI's obligation) and indemnity in favor of CIM Ventures — all signed by Bennett on behalf of RCM, RGHI, and RGL.⁷³⁸

(footnote continued from previous page)

⁷³⁶ See MB02328934, at App. D-33. The Examiner did not locate this document until after Collins' interview and was unable to question him about it.

⁷³⁷ See the following Mayer Brown time record(s): MBRM-EX 00052900-02, 947. See the document(s) with the following beginning document number(s) or number range(s): IM-SEC-007529-64; MBRM-EX 00106122-23; IM-SEC-007581-619; MB0235172; MB02328658-59.

⁷³⁸ See March 9, 2000 letter from Monk to Ricketts transmitting executed originals of the RTL agreements, the indemnification and the guaranty: MB02327415; IM-SEC 007327-65, at App. D-2.

As to other RTLs where Mayer Brown was in possession of, and circulated, executed copies of documents, including documents signed by Bennett on behalf of RGHI and RGL, see the document(s) with the following beginning document number(s) or number range(s):

- a. CIM 2000 - RCM Agreement: MB02325075-91; RCM Note: MB02325074; RGHI Agreement: MB02325092-108; RGHI Note: MB02325109; Indemnity: MB02325186-87; Guaranty: MB02325188-89; Cover Correspondence: MB02327415.
- b. EMF Core 2000 - RCM Agreement: MB02046178-94; RCM Note: MB02046176; RGHI Agreement: MB02046195-211; RGHI Note: MB02046177; Indemnity: MB02046212-13; Guaranty: MB02046214-15; Cover Correspondence: MB02046165-75.
- c. CS Land 2000 - RCM Agreement: MB02046219-35; RCM Note: MB02046018; RGHI Agreement: MB02046236-52; RGHI Note: MB02046217; Indemnity: MB02046253-54; Guaranty: MB02046255-56; Cover Correspondence: MB02046013-14.
- d. CIM 2001 - RCM Agreement: MB02035285-301; RCM Note: MB02035283; RGHI Agreement: MB02035302-18; RGHI Note: MB02339726; Indemnity: MB02339880-81; Guaranty: MB02339866-70; Cover Correspondence: MB02035282, MB02035284.
- e. LC 2003 - RCM Agreement: MB02293285-99; RCM Note: MB02293301; RGHI Agreement: MB02293270-84; RGHI Note: MB02293300; Indemnity: MB02293239; Guaranty: MB02293237-38; Cover Correspondence: MB00135.
- f. Delta Flyer 2003 - RCM Agreement: MB02293337-51; RCM Note: MB02293352; RGHI Agreement: MB02293353-67; RGHI Note: MB02293312; Indemnity: MB02293328; Guaranty: MB02293326-27; Cover Correspondence: MB00034.

Mayer Brown also drafted Round Trip Loan documents for CS Land and EMF Core Fund in February 2000, performing essentially the same work it did with respect to the CIM Ventures deal documents.⁷³⁹ In addition, Collins talked with Maggio of Refco and Monk regarding an issue of enforceability that had been raised by CS Land.⁷⁴⁰

CIM Ventures sent executed copies of the Round Trip Loan documents to Monk with a transmittal letter that provided a succinct description of how the \$150 million Round Trip Loan would flow from RCM to CIM Ventures to RGHI, and back, with a positive interest spread being paid to CIM Ventures for engaging in the transaction. In pertinent part, Ricketts advised Monk as follows:

It is planned that RCM will deposit the loan proceeds in CIM's account (No. 6800-10101) at RCM on February 25, 2000. CIM will then fax a letter to RCM instructing them to move the funds to RGHI with a 15 basis point uplift in the interest rate. RCM then will withdraw the funds from CIM's account and deposit them in RGHI's account, thereby completing the back-to-back loan transaction. The steps will be reversed on March 9, 2000. RCM will then transfer the CIM spread on the transaction to its Royal Bank of Canada account in the Cayman Islands.⁷⁴¹

This e-mail indicated that no later than February 2000, Mayer Brown understood the nature of the Round Trip Loan transactions. This e-mail also indicated to Mayer Brown that RCM would be the source of the interest spread to CIM Ventures. Mayer Brown claims, however, that it had no idea what RGHI used the loan proceeds for and that it did not know that RGHI used the funds to pay down its debt to Refco.

⁷³⁹ See the following Mayer Brown time record(s): MBRM-EX 00052902, 48-50. See documents with the following beginning document numbers or number ranges: MB02332749-50; MBRM-EX 00106360-61; MB02332815; MB02332803; MB02046013-14; MB02046020-21; EMFFP03831-66, MB02046176-215, C 05556-616.

⁷⁴⁰ See the following Mayer Brown time record(s): MBRM-EX 00052902. See documents with the following beginning document numbers or number ranges: C 00465; C 00468; C 00378.

⁷⁴¹ See MB02325177, at App. D-34.

After the February/March 2000 Round Trip Loans matured, Monk wrote to each of the Round Trip Loan Participants, transmitting to them the original promissory notes which they had signed in connection with their loans from RCM. Monk also played an active role in the transactions when he endorsed the notes as “paid in full” as the authorized agent of RCM.⁷⁴²

Mayer Brown handled Round Trip Loan transactions *an additional 14 times over the next four years*, with each transaction following the same basic format described above.⁷⁴³ Each time, Mayer Brown drafted (and sometimes negotiated) deal documents, including loan agreements, guarantees, and indemnifications. Every time, Bennett signed the loan documents on behalf of his company, RGHI, and Bennett also signed the guarantees and indemnities on behalf of RGL — except for one time when Collins apparently modified the documents for Trosten to sign the guarantee and indemnity rather than Bennett.⁷⁴⁴ Weaver or Maggio signed the RCM loan documents.

Mayer Brown also continued to communicate with the Round Trip Loan participants and their lawyers.⁷⁴⁵ For example, on February 19, 2001, CIM Ventures sent Collins a letter almost identical to one it had sent the previous year, again explaining precisely how the Round Trip Loans would work, including that RCM would pay the interest spread directly to CIM Ventures. This letter read:

⁷⁴² See the following Mayer Brown time record(s): MBRM-EX 00052902. See documents with the following beginning document numbers or number ranges: MB02046017-18; MB02046175-76; MB02327415; MB02325109; IM-SEC 007313-14.

⁷⁴³ The document numbers of these RTLs, as well as all other RTLs, are set forth in the section of this Report that describes the RTLs. See Section III.B.

⁷⁴⁴ See MB02035648-49, at App. D-35; MB02035650-51, at App. D-36.

⁷⁴⁵ See the following Mayer Brown time record(s): MBRM-EX 00052904-06; MBRM-EX 00052094; MBRM-EX 00051990-91. See the document(s) with the following beginning document number(s) or number range(s): MBRM-EX 00006540; IM-SEC-000877-951; IM-SEC-006369-70; IM-SEC-003894-97.

It is planned that RCM will deposit the loan proceeds in CIM's account (No. 6800-10101) at RCM on February 23, 2001. CIM will then fax a letter to RCM instructing them to move the funds to RGHI with a 15 basis point uplift in the interest rate. RCM will then withdraw the funds from CIM's account and deposit the funds to RGHI's account, thereby completing the back-to-back loan transaction. The steps will be reversed on March 6, 2001. RCM will transfer the CIM spread on the transaction to CIM's Royal Bank of Canada account (Acct. No. 2003895) in the Cayman Islands. The account details, are the same as used for the back-to-back loan done in 2000.⁷⁴⁶

The Round Trip Loan Participants changed over time, with some participants backing out, necessitating redrafts and renegotiations of the documents.⁷⁴⁷ The dollar values of the Round Trip Loans also increased in amount, soaring to as much as \$720 million for one Round Trip Loan in February/March 2004.⁷⁴⁸ As detailed completely in the chart in Section III.B.,

⁷⁴⁶ See MB02339720, at App. D-37. Prior to this letter, Monk had advised Ricketts that he was leaving Mayer Brown, IM-SEC-006366; MB02339994; MB02339995, and had provided instructions for the handling of the matter in a voice message, which Collins acknowledged in his interview bore his (Collins') handwriting. MB02339251. Consistent with these instructions, when the RTL was unwound in early March, 2001, the original executed note for the loan from RCM to CIM Ventures marked "Paid in full," was sent to Ricketts, with a copy to Collins. IM-SEC-006288; MB02339722.

⁷⁴⁷ See, e.g., the following documents that bear handwritten changes acknowledged by Collins to be in his handwriting: MB02035673-89; MB02035690-706, at App. D-38. See also the guaranty and indemnity discussed above. MB02035648-49, at App. D-35, and MB02035650-51, at App. D-36. See also a handwritten note that appears to be in Collins' handwriting, dated February 12, 2002, which reflects a conversation with Weaver in which Weaver conveyed the following information to Collins about the February 2002 RTLs: (i) there would be two loans - one to Delta Flyer for \$175 million and one to Liberty Corner for \$325 million; (ii) RCM would lend, and RGHI would borrow; (iii) the terms of the loans would be from February 25, 2002 through March 4, 2002; (iv) there would be an interest spread of 1% (or 100 basis points) between the two loans; and (v) there would be a "Group Guarantee" and a right of offset. MB02037574.

⁷⁴⁸ For the RTLs in February 2001, 2002 and 2003, see the following Mayer Brown time records and documents:

a. February 2001 - see the following Mayer Brown time record(s): MBRM-EX 00051990-91; MBRM-EX 00049285. See the document(s) with the following beginning document number(s) or number range(s): MB00458-59; EMFP03831-66; DFF00200-08; MB02035673-706, at App. D-38; EMFP03907-08; EMFP03870; MB02035652.

b. February 2002 - see the following Mayer Brown time record(s): MBRM-EX 00049291; MBRM-EX 00052003-04; MBRM-EX 00052907; MBRM-EX 00052110. See the document(s) with the following beginning document number(s) or number range(s): MB00003632-34; REFCO-E-010474556; MBRM-EX 00134498-500; LC-SEC-EM-001610388-89; EMFP04003-7; EMFP03991; IM-SEC-005405-07; IM-SEC-005462; IM-SEC-006247-87; MB00040743-97; MB00045479-95; IM-SEC 001409, at App. D-3.

c. February 2003 - see the following Mayer Brown time record(s): MBRM-EX 00052013; MBRM-EX 00049294; MBRM-EX 00052014; MBRM-EX 00052114. See the document(s) with the following beginning

(footnote continued on next page)

supra, these loan transactions involved six different Round Trip Loan Participants spanning five years ranging in amounts from \$50 million to \$720 million. In addition, the frequency of the Round Trip Loan transactions increased. The Round Trip Loans always straddled the end of **every** financial reporting period and **never** occurred at any other time with the exception of the December 2004 Round Trip Loan. The loans took place every February/March through 2004, and then increased in frequency to every quarter-end beginning May/June 2004 when Refco began having to report quarterly, including immediately before and after the closing of the LBO and after the filing of the S-1 for the IPO with the SEC.⁷⁴⁹ The last Round Trip Loan transaction

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document number(s) or number range(s): WEAVER-00025-28; WEAVER-00040-54; EMFFP03945-56; DFF00220-55; LC-USAO-000037-72; MBRM-EX 00135916.

In February/March 2004, two Round Trip Loan Transactions were planned in the total amount \$700 million (Liberty Corner for \$500 million, and Delta Flyer for \$200 million). Delta Flyer declined to engage in another Round Trip Loan transaction, and the final amount of the Liberty Corner Round Trip Loan transaction was \$720 million. This transaction was particularly significant because Delta Flyer's decision not to participate required several iterations of document drafts in which differing loan numbers were used (\$500 million, to \$700 million, to \$720 million), resulting in a very substantial purported loan to one customer. At the same time, as discussed below, Mayer Brown was representing Refco in connection with the beginnings of the THL acquisition transaction that later became the LBO. *See* the following Mayer Brown time record(s): MBRM-EX 00052024. *See* the document(s) with the following beginning document number(s) or number range(s): MBRM-EX 00093269-335; MBRM-EX 00093370-437; LC-SEC-EM 000016857; LC-SEC-EM-000013143.

⁷⁴⁹ For the RTLs starting in May 2004, and continuing through May 2005, *see* the following Mayer Brown time records and documents:

- a. May 2004 - *See* the following Mayer Brown time record(s): MBRM-EX 00052026. *See* the document(s) with the following beginning document number(s) or number range(s): MBRM-EX 00093617-51; LC-SEC EM-000156943-44; REFCO-HC-0533886; LC-SEC-EM-000061640-41; LC-SEC-EM-000053095-96; LC-USAO-000139-56; MB02293240-54.
- b. August 2004 - *See* the following Mayer Brown time record(s): MBRM-EX 00052027. *See* the document(s) with the following beginning document number(s) or number range(s): REFCO-HC-0533697; MB00237-68; REFCO-E-002996175; LC-USAO 000157-87.
- c. November 2004 - *See* the following Mayer Brown time record(s): MBRM-EX 00052028. *See* the document(s) with the following beginning document number(s) or number range(s): REFCO-E-2994699; LC-USAO 000188-218.
- d. December 2004 - *See* the following Mayer Brown time record(s): MBRM-EX 00052029. *See* the document(s) with the following beginning document number(s) or number range(s): REFCO-HC-0533792; MB00302-34; REFCO-HC-0533823, at App. D-39; LC-USAO-000221-51.

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in the amount of \$420 million was completed in August/September 2005, only days after Refco had completed its IPO.⁷⁵⁰

In his interview, Collins claimed that he did not know Koury was continuing to prepare documents for Round Trip Loan transactions. The Examiner concludes that there is evidence tending to establish that Collins knew that Koury was preparing such documents; the Round Trip Loan transactions were described in summary fashion in the monthly billing statements Collins prepared and/or reviewed, and sent to Refco.⁷⁵¹

In light of the extensive involvement of the Mayer Brown attorneys in drafting deal documents involving vast sums of money seventeen times over a period of five years, it is highly unlikely that those attorneys would have so little recollection regarding these transactions. The Examiner has serious questions about the credibility of at least one attorney who claimed to have virtually no recollection of these transactions.

(ii) Mayer Brown's Knowledge of Refco's Accounting Periods and the Need for Audited Financial Statements

Mayer Brown knew that the Round Trip Loans straddled a several week period at the end of one Refco financial reporting period and the beginning of the next financial reporting period

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e. February 2005 - *See* the following Mayer Brown time record(s): MBRM-EX 00052029. *See* the document(s) with the following beginning document number(s) or number range(s): REFCO-HC-0533833; MB00335-68; REFCO-HC-0533828; MB00402-05; LC-USAO-000269-309.

f. May 2005 - Koury apparently did not bill any time for this RTL. *See* the document(s) with the following beginning document number(s) or number range(s): REFCO-HC-0533829; MBRM-EX 00052119; REFCO-HC-0533882-83, at App. D-39; MB00369-401; REFCO-0002-000118-30, 000132-44, 000147-49; REFCO-HC-0533908, 0533922.

⁷⁵⁰ *See* documents with the following beginning document numbers or number ranges: REFCO-HC-0533888; LC-SEC-000380; REFCO-0002-000085-113. It appears that for this RTL, Maggio at Refco made use of the loan documents that Koury had prepared for the May/June 2005 RTL, merely changing the dates and the amounts of the RTLS.

— both the February fiscal year end accounting periods, and, when Refco became a “public” reporting company, the fiscal quarter end accounting periods. Mayer Brown also knew that Refco required audited financial statements for use in connection with its business operations, and that these financial statements would, among other things, be provided to, and relied upon by, Refco’s lenders in connection with loans and lines of credit totaling hundreds of millions of dollars.

For example, Collins and Mayer Brown received multiple requests for letters to be sent to Refco’s auditors in connection with an examination of Refco’s financial statements at the end of February, for the year then ended, and, after Refco’s LBO, for accounting reviews at the end of each financial reporting quarter.⁷⁵² In addition, throughout the course of its representation of Refco, Mayer Brown prepared responses to various requests it received for audit letter responses from Refco.⁷⁵³ Collins sometimes spoke to Bennett, Trosten and other Refco representatives in connection with preparing audit letter responses, and, on at least two occasions, reviewed and

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⁷⁵¹ See documents with the following beginning document numbers or number ranges: REFCO-E-008057891-908; REFCO-E-008209041-55, at App. D-40; REFCO-E-001351682-700; REFCO-E-008165527-40; REFCO-E-001311424-38.

⁷⁵² See documents with the following beginning document numbers or number ranges, which provide a representative view of Mayer Brown’s and Collins’ knowledge of Refco’s financial reporting periods: REFCO-E-017238614; REFCO-E-017238136-37; REFCO-E-008643170; REFCO-E-008642677; REFCO-E-002414297; REFCO-0008-177233; REFCO-E-009640529; REFCO-E-002162864; REFCO-E-002242865; REFCO-E-001817868; REFCO-E-002227418; REFCO-E-002040574-75; REFCO-E-001997821; REFCO-E-017263582.

⁷⁵³ See the following Mayer Brown time record(s) which provide a representative view of Mayer Brown’s and Collins’ involvement in the preparation of audit responses: MBRM-EX 00048952, 9058, 9064, 9068, 9078, 9095, 9101-108, 9259, 9272-273, 9276, 9286, 9292; MBRM-EX 00050236; MBRM-EX 000512006; MBRM-EX 00163247, 254-55. See also the document(s) with the following beginning document number(s) or number ranges(s): GT-SEC-0113629; MB00007740; MB00014954; MB00016456; MB00016461; MB00017014; MB00032014; MB00032336; MB00032362; MB00043780; MB02030339; MBRM-EX 00003762; MBRM-EX 00036245; MBRM-EX 00036247; MBRM-EX 00036249; MBRM-EX 00036499; MBRM-EX 00036506; MBRM-EX 00036521; MBRM-EX 00036524; REFCO-0008-218157; REFCO-E-001817868; REFCO-E-001997821; REFCO-E-002216213.

commented upon one or more footnotes to be placed in Refco's financial statements.⁷⁵⁴ In addition, Mayer Brown occasionally reviewed or referred to Refco's audited financial statements and sent copies of those statements to others.⁷⁵⁵

Mayer Brown also knew that Refco needed audited financial statements to satisfy the financial covenants contained in the senior note and loan agreements entered into by Refco to obtain hundreds of millions of dollar of financing. Mayer Brown represented Refco in those financings;⁷⁵⁶ and maintained execution copies of the operative documents pertaining to those financings.⁷⁵⁷ The operative documents, which Mayer Brown drafted, contained provisions requiring Refco to furnish the lenders with audited financial statements within a certain period after the close of its fiscal year.⁷⁵⁸

(iii) Mayer Brown's Knowledge that the Round Trip Loans Had No Apparent Business Purpose and May Have Violated Loan Covenants

The Mayer Brown witnesses stated in their interviews that they did not know the business purpose for the Round Trip Loan transactions, did not think at the time of the transactions about

⁷⁵⁴ See the following Mayer Brown time record(s): MBRM-EX 00049095; MBRM-EX 00049321.

⁷⁵⁵ See the following Mayer Brown time record(s): MBRM-EX 00049321. See the document(s) with the following beginning document number(s) or number range(s): REFCO-HC-0037397; MB00014981.

⁷⁵⁶ See the following Mayer Brown time record(s): MBRM-EX 00049111-12, 115-117, 119; MBRM-EX 00050354-56, 58-62, 65-69. See the document(s) with the following beginning document number(s) or number range(s): MB00034613; MB00041745; MBRM-EX 00018499; MBRM-EX 00110678.

⁷⁵⁷ See, e.g., RGL Composite Conformed Copy of Note Agreements, dated December 18, 1996, Relating to \$68,000,000 7.18% Series A Senior Notes Due December 18, 2004 and \$14,000,000 7.42% Series B Senior Notes Due December 18, 2006, MB02002976-3060; Composite Execution Copy of RGL Note Agreement, dated as of November 30, 1999, Relating to \$70,000,000 8.85% Senior Notes due November 30, 2007, MB02002821-2930; Composite Conformed Copy of Note Agreement, dated as of October 15, 2002 Relating to \$100,000,000 5.99% Series A Senior Notes Due October 15, 2007 and \$122,500,000 6.60% Series B Senior Notes Due October 15, 2009, MB02002603-2718; Composite Execution Copy RGL Note Agreement, dated as of June 29, 2000, Relating to \$111,000,000 9.18% Senior Notes Due June 29, 2005, MB02002443-2601, at App. D-41; Execution Copy of RGL \$339,500,000 Revolving Credit Agreement, dated as of June 23, 2003, MB02003172-3295, at App. D-42.

⁷⁵⁸ *Id.* These requirements are generally set forth in the section of the Note or Loan Agreements titled "Reports and Rights of Inspection," or, as to the \$339,500,000 Revolving Credit Agreement, dated as of June 23, 2003, Section 5.01 titled "Financial Statements."

what their business purpose might be, did not ask anyone at Refco about the business purpose of these transactions, and did not believe they had a responsibility to do so. In their interviews, none of the witnesses could articulate an apparent business purpose for the Round Trip Loans.⁷⁵⁹

The fact is that the Round Trip Loans had no legitimate business purpose, as the features of the transactions indicate. These were uncollateralized short-term, back-to-back loans involving the lending of hundreds of millions of dollars by one Refco entity through a third party to another Refco entity, with guarantees and indemnities by RGL to eliminate any risk to the third party. Thus, the transactions appeared to lack any economic substance. Indeed, rather than having any apparent business purpose, the transactions appear suspicious on their face.

Other circumstantial evidence suggests that Mayer Brown understood that the Round Trip Loans lacked any economic substance or business purpose. For every Round Trip Loan transaction except one (the February 2001 Delta Flyer RTL), Bennett signed on behalf of RGL both guarantees of RGHI's obligations and indemnifications in favor of the Round Trip Loan Participants.⁷⁶⁰ In many instances, Mayer Brown had executed copies of the documents showing the dual role of Bennett in obligating RGHI to repay the loan and at the same time using a Refco entity to guarantee that obligation.

In addition, Mayer Brown was aware from its representation of Refco in connection with Refco's bank financings that the operative loan documents contained covenants prohibiting Refco from incurring additional indebtedness beyond certain limits and, in some cases,

⁷⁵⁹ Collins stated that although he had not thought about the potential purpose of the Round Trip Loans at any time prior to Refco's bankruptcy, thereafter he speculated that there could have been a number of legitimate business purposes for such transactions, including generating short term funds for some unspecified purpose or accomplishing some unspecified tax objective.

⁷⁶⁰ Trosten signed the RGL documents for the Delta Flyer February 2001 RTL. Collins apparently made the modifications to the guaranty and indemnity documents for this transaction. DF00202-03; DF00204-05; MB02035645; MB0203560; MB02035648-49, at App. D-35; MB02035650-51, at App. D-36.

specifically prohibiting Refco from becoming liable on a guarantee.⁷⁶¹ “Indebtedness,” as defined in the loan documents, included guaranteeing a third party’s debts. Despite its knowledge of these loan covenants, Mayer Brown prepared the guarantees for large amounts of money in violation of the loan covenants. Mayer Brown thereby assisted in transactions that violated loan covenants in financing documents it had drafted. Furthermore, Mayer Brown’s willingness to assist in structuring these transactions without inquiry as to purpose suggests that Mayer Brown believed and knew full well that the Round Trip Loan transactions and guarantees lacked any real economic substance and, hence, any legitimate business purpose.

(iv) Mayer Brown’s Knowledge that RGHI Owed a Large Receivable to RGL

All Mayer Brown witnesses, except Collins and Schultz, denied knowing that there was a receivable owing from RGHI to Refco. As discussed below, Schultz, while claiming no recollection of any such receivable, did acknowledge, when shown certain documents which he had drafted, that he must have known that RGHI owed debts of at least \$350 million.

While Collins did not deny knowing that there was a receivable in some amount owing from RGHI to Refco, he did deny knowing the size or extent of it, and further stated that he never asked Refco management about the size of the RGHI Receivable. As also discussed below, documents prepared by Mayer Brown in connection with the PPA reflect that Mayer Brown knew no later than June 11, 2002 that RGHI owed an intercompany debt to Refco in the amount of not less than \$350 million.

The Examiner looked at the four categories listed below to determine if there was evidence that Mayer Brown knew the full extent of the RGHI Receivable:

⁷⁶¹ See MB02002976, Sections 5.10, 5.14, 5.16; MB02002821, Sections 5.10, 5.14, 5.16; MB02002603, Sections 5.10, 5.14, 5.16; MB02002443, at App. D-41, Sections 5.10, 5.14, 5.16; MB02003172, Sections 6.01, 6.05,

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- correspondence of Bennett and Trosten;
- work on tax issues in connection with the 1999 BAWAG transaction;
- work on the PPA; and
- work in connection with other transactions pertaining to Refco “bad debts,” including the Asian receivables, Niederhoffer Loss, Wells, the \$43 million arbitration award, and Trade & Marine

The results of this review are summarized below.

(a) Correspondence of Bennett and Trosten

Some communications involving Bennett and Trosten support the inference that Mayer Brown knew more about the RGHI Receivable than Mayer Brown admits.

For example, a letter from Bennett on which Collins wrote some notes evidences Collins’ knowledge of the receivable. After the closing of the amended and restated BAWAG transaction in May 1999,⁷⁶² Collins and other attorneys at Mayer Brown were involved in communications and meetings with respect to attempts to obtain a position statement from the New York Federal Reserve Board office (“NYFRB”) as to the requirements of the federal Bank Holding Company Act. As this process continued, in a letter dated October 15, 1999, Bennett wrote to Collins to provide additional arguments to be used with the NYFRB to support the transaction, including the apparent net worth of RGHI.⁷⁶³ In arguing that RGHI has substantial value, Bennett stated, in part: “Given the fact that it is not an operating company, Refco Group Holdings capital (*i.e.*, net worth) is represented by the value of its investment in Refco Group Limited.” This statement is bracketed in handwriting, and in the margin immediately next to this statement in this Mayer

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at App. D-42; MB02056716, Sections 4.03, 4.07.

⁷⁶² See MB00000478-880.

⁷⁶³ MB02071243-58, at App. D-43.

Brown document is the comment “**Minus Loans to RGH.**” (emphasis added). This handwriting appears to be consistent with the handwriting which Collins acknowledged to be his own.⁷⁶⁴

There is also a time entry by Collins on October 19, 1999 reflecting that he “reviewed PRB materials on RGHI,” and on October 21, 1999 that he “[talked with] PRB re status of FRBNY review.”⁷⁶⁵ Attached to this document is an unaudited balance sheet for RGL as of May 31, 1999, and a copy of RGL’s consolidated and audited financial statements for the fiscal year ended February 28, 1999. The audited financial statements disclose, in Footnote 7, entitled “Related Party Transactions,” that at year end (*i.e.*, February 28, 1999), there were outstanding loans receivable from related parties of \$252 million.⁷⁶⁶

Several other letters from Trosten to E&Y also suggest that Mayer Brown knew about the receivable. Trosten indicated in several letters to E&Y that he had consulted “counsel” who had confirmed that the inter-company balances between RGHI and RGL were valid, legally enforceable debts.⁷⁶⁷

(b) *Work on Tax Issues in Connection with the 1999 BAWAG Transaction*

There is evidence that Mayer Brown may have learned details about the RGHI Receivable in connection with its work on the 1999 BAWAG transaction.

Mayer Brown did a significant amount of work to facilitate BAWAG’s acquisition of a 10% share of RGL in 1999. Collins’ involvement in this transaction began in December 1998,

⁷⁶⁴ The Examiner did not find this Mayer Brown-produced document until after Collins’ interview and, therefore, could not question him about this document.

⁷⁶⁵ See the following Mayer Brown time record(s): MBRM-EX 00052771.

⁷⁶⁶ As noted elsewhere in this Report, this number, while substantial, is actually much lower than the actual amount of the related party receivable owing from RGHI before and after the WTL transactions engaged in by Refco and RGHI at the end of February 1999.

⁷⁶⁷ See, *e.g.*, EY-REF-004566-67; EY-REF-006192-93.

when Collins first talked with Bennett regarding the outline of the transaction, and then worked on the transaction with other Mayer Brown attorneys.⁷⁶⁸ Collins and other attorneys at Mayer Brown recorded time to this matter on an almost daily basis through and after the closing of the restated and amended BAWAG transaction in May 1999.⁷⁶⁹ Refco was concerned about incurring unnecessary tax liability in connection with BAWAG's acquisition of an interest in RGL. Accordingly, as described below, a number of Mayer Brown time entries reflect that tax issues were a material concern with respect to the structuring of this BAWAG transaction.

Because of the significant tax issues involved, E&Y provided substantial assistance in structuring the transaction in such a way as to minimize tax consequences. Indeed, E&Y, like Mayer Brown, performed a substantial amount of work on this transaction during the first half of 1999.⁷⁷⁰

At the time that E&Y was working on the 1999 BAWAG transaction, E&Y: (i) knew that RGHI owed RGL a large receivable that was comprised of bad customer debts that had been transferred from RGL to RGHI rather than RGL taking the loss; (ii) had serious questions about AA's accounting for this receivable as an asset of RGL; (iii) had questions about whether RGL would be solvent without the receivable as an asset on its books; and (iv) knew that RGHI likely was unable to pay the debt.⁷⁷¹

Mayer Brown and E&Y were working on tax issues in connection with the BAWAG transaction at approximately the same time and often in response to work by the other. For example, in January, E&Y was working on tax issues in connection with the transaction. At

⁷⁶⁸ See the following Mayer Brown time record(s): MBRM-EX 00052735. See the document(s) with the following beginning document number(s) or number range(s): MB00028631; MB00028660.

⁷⁶⁹ See, generally, the following Mayer Brown time record(s): MBRM-EX 00052735-69.

⁷⁷⁰ See discussion in E&Y section of this Report.

about that time, Collins talked with Bennett regarding “tax structural issues” as to the BAWAG transaction;⁷⁷² and handwritten notes, apparently prepared by Collins, reflect that on January 14, 1999 he participated in a telephone call with Rossi, Neidhardt of E&Y, and several other persons, during which the subject of RCM’s tax status and potential tax exposure were discussed.⁷⁷³ Similarly, on January 19, 1999, Neidhardt wrote to Rossi at Refco regarding tax issues pertaining to the BAWAG transaction.⁷⁷⁴ On that same day, Collins talked to Mayer Brown attorney Barry regarding tax issues on LLC mergers. Three days later, Collins reviewed and revised a tax memorandum, and talked with Rossi regarding an E&Y memorandum on the LLC agreement.⁷⁷⁵

During this time period, E&Y communicated directly with Mayer Brown regarding the 1999 BAWAG transaction on several occasions. On January 28, 1999, Neidhardt sent a memorandum to Henneman providing comments on the Refco/BAWAG deal documents that Mayer Brown had drafted.⁷⁷⁶ On February 5, 1999, Neidhardt participated in a conference call with several other E&Y accountants and Mayer Brown lawyers. According to handwritten notes on the typed draft notes of this call, Collins, Henneman, and Barry also participated, although neither Collins nor Henneman recall participating.⁷⁷⁷ According to these notes, the participants discussed, among other things, the potential Refco parties to the BAWAG transaction, including

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⁷⁷¹ *Id.*

⁷⁷² See the following Mayer Brown time record(s): MBRM-EX 00052736.

⁷⁷³ MB02037615. This document was not produced by Mayer Brown until on or about March 7, 2007, several weeks after the Collins interview.

⁷⁷⁴ REFCO-0010-000537.

⁷⁷⁵ See the following Mayer Brown time record(s): MBRM-EX 00052737-38.

⁷⁷⁶ EY-REF-005698.

⁷⁷⁷ EY-REF-024389-93.

“Bermuda” — whose business is described in the notes of the call as “intercompany loans and receivables.”

On February 9, 1999, Neidhardt prepared a memorandum to the Refco files memorializing his communication with Rossi and telephone conversation with Barry. The memo said that Neidhardt had advised both Refco and Mayer Brown that E&Y did not agree with the representation in the BAWAG deal documents that there were no undisclosed liabilities on the audited RGL financial statements and that there were no undisclosed material tax issues. The memo also indicated that E&Y believed there might be material tax issues that should be discussed with Collins “who is already aware of some of them.”⁷⁷⁸

(c) Work in Connection with the Proceeds Participation Agreement

There is evidence that Mayer Brown learned details about at least part of the RGHI Receivable in connection with its work on the PPA transaction. Mayer Brown performed a substantial amount of work on a regular basis in connection with the PPA transaction, in which the RGHI Receivable was a critical factor in the structuring of the deal.⁷⁷⁹ E&Y likewise performed significant work on this transaction and the RGHI Receivable was central to E&Y’s analysis of the deal.

On or about February 11, 2002 (the day before Collins and Koury worked on Round Trip Loan documents for three Round Trip Loan Participants),⁷⁸⁰ Schultz prepared a memorandum pertaining to the potential sale of a portion of RGHI’s membership shares in RGL, attaching a

⁷⁷⁸ EY-REF-005863, at App. D-26.

⁷⁷⁹ See, generally, the following Mayer Brown time record(s): MBRM-EX 00052777-79; MBRM-EX 00163211-27.

⁷⁸⁰ See the following Mayer Brown time record(s): MBRM-EX 00052003.

draft of a purchase agreement.⁷⁸¹ In this memorandum, Schultz described a transaction whereby RGHI would sell 51% of its voting membership shares in RGL, and the purchaser would pay \$700 million (\$350 million to be paid by the assumption of liabilities of RGHI and the remainder by cash). At his interview, Schultz could not recall from whom he received this information, but did acknowledge preparing the memorandum, and did concede that he must have known that RGHI had liabilities of at least \$350 million. Moreover, as discussed below, based upon documents later drafted by Mayer Brown in connection with this transaction, it is clear that Mayer Brown knew, no later than June 11, 2002, that RGHI owed an inter-company debt to RGL of not less than \$350 million.⁷⁸²

The draft of the purchase agreement accompanying this memorandum reflects that a portion of the purchase price for 51% of the membership shares of RGL held by RGHI would consist of the “assumption of \$350,000,000 of the liabilities of Holdings [RGHI].”⁷⁸³ This draft agreement, which was the third version of the document, and contained some changes from an earlier version dated February 6, 2002, also contained an acknowledgement that the parties thereto (RGL, RGHI and an unnamed purchaser) agreed that the “Company’s [RGL’s] board of managers shall endeavor to sell ownership of the Company or its assets.”⁷⁸⁴ It appears also, therefore, that no later than February 6, 2002, Mayer Brown knew that the ultimate goal of the “managers” of RGL (Bennett and other senior executives) was to sell RGL.

Before Schultz had prepared the February 11 memorandum, Collins had discussed the terms for the purchase with Trosten and Bennett and had reviewed and revised prior drafts of the

⁷⁸¹ MB02376667, at App. D-44, MB00043814-45.

⁷⁸² MBRM-EX 00066153-57, at App. D-45.

⁷⁸³ MB00043814-45.

⁷⁸⁴ *Id.*

purchase agreement.⁷⁸⁵ One of the structures for the transaction that E&Y had developed and that Trosten was considering involved RGL distributing the approximately \$720 million receivable to RGHI in partial redemption of RGHI's interest in RGL, followed by BAWAG contributing an additional \$370 million in cash and a note for \$350 million (for a total of \$720 million) in exchange for an additional 40.8% member interest in RGL.⁷⁸⁶ Mayer Brown may have learned the full extent of the RGHI Receivable during these discussions concerning the structure of the deal.

E&Y worked on this transaction, and received and reviewed the purchase agreement drafted by Mayer Brown, expressed its concern to Trosten that the form of that agreement reflected an actual sale which might have adverse tax consequences, and advised Trosten to change the form of the agreement.⁷⁸⁷ Indeed, after Cappel of E&Y had apparently convinced Trosten that the proposed structure of the deal had some adverse tax implications, Cappel commented to others at E&Y that Trosten wanted them to draft language to correct the problem. Cappel says he told Trosten that E&Y would not do that, but that he (Cappel) wanted to give him "something he could conceivably provide to Mayer Brown for translation into the actual language."⁷⁸⁸

⁷⁸⁵ See the following Mayer Brown time record(s): MBRM-EX 00049351; MBRM-EX 00052778. Earlier, in November 1999 (a few months after the May 1999 BAWAG transaction) Collins had also discussed a "possible restructuring" with Bennett, reviewed a memo from Bennett on a proposed option, and drafted a memo regarding same. See the following Mayer Brown time record(s): MBRM-EX 00049348. The Bennett memo described a transaction whereby an option would be issued to acquire 51% of RGHI's shares for the "assumption of 51% of the liabilities of RGHI existing as of the exercise date," and an additional cash amount equal to 50% of the value of RGL as of the exercise date minus the amount of the liabilities assumed. See MB02071240-41. The Collins memo was titled "Refco/BAWAG; Next Chapter," and mentioned a newly created company to be owned by Bennett (40%), Grant (40%), and Chris Sugrue (20%). See MB02071239.

⁷⁸⁶ See EY-REF-004904.

⁷⁸⁷ See E&Y handwritten comments on Purchase Agreement drafted by Mayer Brown. EY-REF 000296-317.

⁷⁸⁸ EY-REF-023773. See also Neidhardt memo to Trosten, dated April 29, 2002, setting forth various alternatives for restructuring a new investment by BAWAG in RGL, and specifically referring to an RGHI debt balance with RGL of \$750 million. REFCO-0010-000540-53, at App. D-46.

Refco and Mayer Brown apparently heeded some of the admonitions of E&Y to change the structure of the deal, as it finally changed from a “Purchase Agreement” to a “Proceeds Participation Agreement” at or about the end of May 2002 — after a number of conversations between and among Collins, Schultz, Trosten, and Bennett.⁷⁸⁹

On June 11, 2002, Mayer Brown revised some of the documents pertaining to the PPA, including a “Letter Agreement” to be signed by RGL, RGHI, BOI, and the still unidentified purchaser, whereby the “Company” [RGL] agreed that “\$350 million of the Purchase Price for the Participation right shall be used or caused to be used for the retirement of intercompany debt of Refco Group Holdings, Inc.”⁷⁹⁰ Mayer Brown time records reflect that on this date, Collins, among other things, talked with Bennett regarding status and open issues, revised documents, and on the next day, talked with Bennett about a price adjustment and revised the purchase agreement in respect of credits to the purchase price.⁷⁹¹ It is possible, therefore, that Collins was the author of this inserted language. When the PPA closed on July 12, 2002, the final “Letter Agreement” between and among the parties contained virtually identical language.⁷⁹²

(d) Mayer Brown’s Involvement in Other Transactions Pertaining to Refco “Bad Debts” and/or the Intercompany Receivable

Mayer Brown provided legal services to Refco in connection with other transactions in which “bad debts” incurred by Refco were involved. In some of those cases, bad debts were assigned to RGHI or other related entities.

⁷⁸⁹ See the following Mayer Brown time record(s): MBRM-EX 00163217, 18.

⁷⁹⁰ MBRM-EX 00066153-57, at App. D-45.

⁷⁹¹ See the following Mayer Brown time record(s): MBRM-EX 00163222.

⁷⁹² MB02069381-87, Section 11.1, at App. D-47.

(1) *The Asian Debt Receivables*

According to the Superseding Indictment, in or about May 1997, a group of Refco customers to whom Refco had extended credit for the purpose of investing in Asian markets sustained large losses in connection with the Asian debt crisis. When those customers were unable to cover their losses, Refco paid the losses, using hundreds of millions of dollars of customer funds from within the unregulated segments of its business. By the end of May 1997, these losses totaled more than \$310 million.⁷⁹³

The Refco customers involved in this Asian market crisis included: Repco Holdings, Inc. (“Repco”); Devonshire Investment Management, Ltd., and Devonshire Strategic Holdings (collectively, “Devonshire”); and East Client Services Limited (“East Client”). Repco’s debt balance as of January 31, 1998 was approximately \$139 million, and the debt balance of East Client as of January 31, 1998 was approximately \$21.2 million.⁷⁹⁴

Mayer Brown attorneys were involved in the resolution of Refco’s claims against these entities. For example, between approximately April 21, 1998 and July 1, 1998, Collins, Henneman, and other attorneys at Mayer Brown worked on a deal whereby indebtedness owed by Devonshire as of February 28, 1998 would be converted into stock in Devonshire to be held by East Client, which was controlled by Refco.⁷⁹⁵ However, the amount of the debts then owed by Repco and East Client-Devonshire are not overtly stated in the various documents. Although

⁷⁹³ Superseding Indictment, ¶ 11.

⁷⁹⁴ FTI Consulting Schedule 4. By January 1998, Devonshire had either changed its name to or merged with East Client.

⁷⁹⁵ See the following Mayer Brown time record(s): MBRM-EX 00049259-61; MBRM-EX 00051939-42. See the document(s) with the following beginning document number(s) or number range(s): MB00031439-48; MBRM-EX 00006622-88; MB00031501-39; MBRM-EX 00142198-236; MBRM-EX 00142150; MBRM-EX 00006136; MBRM-EX 0006151.

this debt became part of the RGHI Receivable, the Examiner found no evidence that Mayer Brown knew that this loss became part of the receivable.

(2) *The “Niederhoffer” and “Wells” Debts*

At the end of October 1997, several months after the Asian market crisis, an individual named Victor Niederhoffer and several funds which he controlled lost more than \$90 million in a series of transactions on the CME.

Beginning on or about October 28, 1997, Refco entered into settlements with Niederhoffer that were documented and negotiated by Mayer Brown, primarily by Collins. Thereafter, various Mayer Brown attorneys, including litigators, continued to be involved in the so-called “N Transaction” for many months and years.⁷⁹⁶

Following Niederhoffer’s losses, Refco, with the assistance of E&Y and Mayer Brown, took immediate action to convert this loss into a receivable owed from a purportedly solvent entity (RGHI), both by entering into settlements with Niederhoffer to have his funds liquidate their assets and turn them over to Refco in return for a release of liability, and by contemporaneously assigning the “rights” to receive those asset payments and other unspecified “claims.”⁷⁹⁷

Mayer Brown worked on multiple drafts of this assignment. One version was between Refco, Inc. as Assignor, and RCM as Assignee, and purports to assign “. . . certain rights of the Assignor to Payments from the [Niederhoffer] Accounts in exchange for the transfer from the Assignee to the Assignor of an amount up to \$ _____ (to be paid to the Assignor in

⁷⁹⁶ See the following Mayer Brown time record(s): MBRM-EX 00052693-712.

⁷⁹⁷ See the following Mayer Brown time record(s): MBRM-EX 00049038-39. See the document(s) with the following beginning document number(s) or number range(s): MB02057884-87, at App. D-48; MB02065548; MB02057831-36.

immediately available funds on the date hereof) . . .”⁷⁹⁸ Another version contains the same description of what is being assigned, but specifies \$71 million as the amount to be transferred, and is between Refco, Inc. as Assignor and Wells Limited (a wholly-owned subsidiary of RGHI) as Assignee.⁷⁹⁹

After the initial flurry of activity to assign the Niederhoffer claims, Refco, with the assistance of Mayer Brown, dealt with investigations initiated by the various commodities regulators into the Niederhoffer Loss and how Refco was handling and accounting for that loss.⁸⁰⁰ In connection with these efforts, Collins reviewed Refco’s financial statements and revised footnotes to financial statements being delivered to the regulators.⁸⁰¹ He also reviewed tax issues, correspondence as to IRS claims, and a tax settlement.⁸⁰²

At the same time that Mayer Brown and Refco were dealing with the regulators, E&Y began to deal with tax issues related to the Niederhoffer Loss, including bad debt losses and write-offs that could be taken or attributed to these losses (including a determination of which Refco entities would be entitled to claim the losses). E&Y had serious concerns about AA’s accounting treatment for the Niederhoffer bad debt losses, and struggled with how they should be dealt with both from a tax and an accounting perspective.⁸⁰³ Moreover, as time went on, Mayer Brown became involved in these and related issues, including discussing with Bennett

⁷⁹⁸ See MBRM-EX 00043716-18.

⁷⁹⁹ See 10/28/1997 assignment by Refco, Inc. of its rights to payments from Niederhoffer accounts to Wells, Ltd, which Bennett signs on behalf of Wells. See App. D-10.

⁸⁰⁰ See the following Mayer Brown time record(s): MBRM-EX 00049039, 101, 319-323, 326; MBRM-EX 00052702. See the document(s) with the following beginning document number(s) or number range(s): MB02061666; MBRM-EX 00013530; MB02061322; MB02059721.

⁸⁰¹ See the following Mayer Brown time record(s): MBRM-EX 00049321-22.

⁸⁰² See the following Mayer Brown time record(s): MBRM-EX 00049319, 22.

⁸⁰³ See the following documents from or to E&Y pertaining to this transaction: EY-REF 000081; EY-REF 000150; EY-REF 000080, at App. D-29; EY-REF-009115; EY-REF 002346; REFCO-HC-0036140; REFCO-0010-004530.

and others at Refco the following subjects relating to the Niederhoffer Loss: (i) bad debt write off issues; (ii) bad debt analysis; (iii) background arguments for bad debt treatment; (iv) reviewing and revising a memorandum to be sent to E&Y; (v) treatment of receivables; and (vi) impact of accounting reclassifications.⁸⁰⁴

The close relationship between and among the Niederhoffer losses, E&Y, Mayer Brown, Refco, RGHI and Wells is illustrated by activity in early March 1999. Mayer Brown's March 8, 1999 time entries for the Niederhoffer matter reflect that Collins talked to an unidentified person with the initials "TS" regarding "bad debt analysis."⁸⁰⁵ On the same day, Neidhardt transmitted to Rossi several memoranda regarding the plan for RGHI to assume a bad receivable obligation from Wells to RCM.⁸⁰⁶ In that memorandum, Neidhardt stated: "RCM will not write this receivable off on its separate audited income statement on the theory that this receivable will be satisfied by the S corp [RGHI] at some point, perhaps upon a sale of the business." He advises that RGHI should legally assume the Wells liability to RCM, "thereby making Wells solvent."

Several days later, on March 12, 1999, Collins recorded time to the Niederhoffer matter for a telephone conversation with "SR" [Rossi] regarding background arguments for bad debt treatment.⁸⁰⁷ On March 15, 1999, Lowry at E&Y sent a letter to Silverman at Refco pertaining to the need for a form for Wells to change its status so that its gains and losses would be included in the "S Corp's" [RGHI's] tax return.⁸⁰⁸ The next day, on March 16, 1999, Collins recorded

⁸⁰⁴ See the following Mayer Brown time record(s): MBRM-EX 00049326-27, 29.

⁸⁰⁵ See the following Mayer Brown time record(s): MBRM-EX 00049327.

⁸⁰⁶ See EY-REF-023387-93.

⁸⁰⁷ See the following Mayer Brown time record(s): MBRM-EX 00049327.

⁸⁰⁸ EY-REF-005121.

time to the Niederhoffer matter for reviewing and revising a memorandum to be sent to E&Y.⁸⁰⁹ Because Mayer Brown and E&Y were working in tandem on these issues, it could be inferred that Mayer Brown was aware of the matters contained in the memoranda E&Y sent to Refco.

(3) *The \$43 Million Adverse Arbitration Award*

There is evidence that Mayer Brown knew of and participated in Refco's efforts to transfer losses from one Refco entity to another in connection with Mayer Brown's work on an adverse arbitration award.

At some point in 2001, an adverse arbitration award was entered against Refco subsidiary Refco, LLC. In an effort to avoid having to create a reserve for that award which would affect the earnings of Refco, LLC, Trosten sought to convince the CFTC to allow the charge for that award to be assumed by RGL. In December 2001, the CFTC rejected that position, advising Refco's then-auditors, AA, that GAAP would not allow a charge for that award to be assumed by the parent (RGL) without the consent of the claimants.⁸¹⁰

Refco sought Mayer Brown's assistance in persuading the CFTC that Refco's position was defensible. Collins had Koury research the issue, but Koury found no legal support for the position.⁸¹¹ Thereafter, in late December and early January, Collins and Koury sent various draft opinions to Bennett, Refco's General Counsel Dennis Klejna ("Klejna"), and Trosten regarding the ability of RGL to assume liabilities for arbitration awards so as to keep them from being charges to earnings of Refco, LLC. This process culminated in an opinion letter to be sent to the

⁸⁰⁹ See the following Mayer Brown time record(s): MBRM-EX 00049327.

⁸¹⁰ See AAREFLN-000196.

⁸¹¹ On the early morning of December 27, 2001, at 2:57 a.m. after a full day of research, Koury sent a draft opinion to Collins seeking to support RGL's assumption of liability pertaining to arbitration awards, commenting that he was disappointed in the quality of research he found to support such a position. See MB00045612. In his interview, Koury stated that he did not recall conducting such research or writing such memorandum.

CFTC stating, basically, that RGL could assume the liabilities without the consent of the claimant, but the claimant would retain a claim against Refco, LLC as well as RGL.⁸¹²

(4) *The "Trade & Marine" Bad Debt*

Mayer Brown may have also learned of Refco's transfer of losses from Refco to RGHI in connection with its work on the Trade & Marine losses. The evidence of Mayer Brown's knowledge is a couple of nondescript time entries that relate to Trade & Marine. Trade & Marine was a Refco customer that suffered losses resulting in bad debt losses for Refco in 1994 (\$38 million) and 1996 (\$18 million).⁸¹³ In December 1999, there was substantial activity involving E&Y, Refco, and Mayer Brown as to a continuing inquiry by the IRS as to the Trade & Marine bad debt deductions by RGHI.

On December 3, 1999, Neidhardt wrote to Bennett regarding an IRS request for substantiation of a bad debt deduction taken on RGHI's tax return for FYE February 28, 1994. He asked for information including: the balance owed by Trade & Marine on February 28, 1994; efforts Refco had made to collect; and why the receivable was determined to be worthless on February 28, 1994. He commented that it appeared RGHI purchased \$38 million of the Trade & Marine receivable for \$38 million in February 1994 immediately prior to writing it off. He asked Bennett to verify that fact, and whether there was any chance that the purchased receivable was not worthless, or was actually worth \$38 million. He also asked whether Refco could take the

⁸¹² See the document(s) with the following beginning document number(s) or number range(s): MB00045600-607, 625-26, 633-37.

⁸¹³ REFCO-0010-000454. On November 14, 1996, Bennett, in response to a request from Neidhardt for information as to these losses, twice proposed to have "Refco's counsel to supplement this background information with details of the account activity in question" and to "compile the background documentation which would then be available to the extent further review is needed." REFCO-0010-005587-88. Refco's main counsel at that time (1996) was Mayer Brown and Collins; however, the Examiner has not found documents indicating that Mayer Brown compiled such information at that time.

position that RGHI guaranteed the losses of the Refco subsidiary involved (Refco F/X, which later became RCM).⁸¹⁴

At nearly the same time that Neidhardt and Bennett were discussing the Trade & Marine situation, Collins had discussions with Trosten regarding the Trade & Marine debt and account.⁸¹⁵ The Examiner has not located any evidence other than these time entries to indicate that Mayer Brown was involved in providing such information. Thereafter, Trosten apparently provided some of the information Neidhardt had sought, because on December 22, 1999, Neidhardt wrote to Trosten advising that he received answers to several of his questions regarding the Trade & Marine bad debt (including the question of RGHI guaranteeing the losses of RCM), but that he needed more information before he met with the IRS agent inquiring into the matter.⁸¹⁶

(v) Mayer Brown Understood that Refco's Executives Had Incentives to Manipulate Refco's Financial Statements

Mayer Brown was aware of several facts that might provide incentive for Refco's management to manipulate Refco's financial appearance.

Beginning September 4, 2003, Collins began to provide services to Refco in connection with an effort by Bennett to sell equity interests in Refco that culminated in the LBO.⁸¹⁷ Mayer Brown also became aware in the October/December 2003 time-frame of Bennett's desire to

⁸¹⁴ REFCO-0010-005575-76.

⁸¹⁵ See the following Mayer Brown time record(s): MBRM-EX 00049275.

⁸¹⁶ REFCO-0010-005573-74. Although the Examiner has not located any additional direct evidence of Mayer Brown's further involvement with the Trade & Marine matter, there are several Collins time entries pertaining to an unidentified IRS audit, which could be the Trade & Marine audit. Specifically, in March 2003, Collins had conversations with several persons, including Bennett, pertaining to the "IRS audit request" and "issues for IRS audit." See the following Mayer Brown time record(s): MBRM-EX 00163234-35; MBRM-EX 00049107. In October 2003, Collins spoke with Trosten regarding settlement documents needed for the IRS audit. See the following Mayer Brown time record(s): MBRM-EX 00049081. Collins stated that the only IRS audit he recalled working on dealt with Refco principal Thomas Dittmer.

undertake an IPO when Collins began to have discussions with Credit Suisse First Boston (“CSFB”), began to embark on “Project Royce” [the THL transaction], and began to e-mail various people regarding due diligence materials and prepare drafts of a purchase agreement.⁸¹⁸

Mayer Brown was aware of a profits participation plan for certain key Refco executives, because it had drafted changes to the RGL LLC agreement which embodied the plan.⁸¹⁹ E&Y worked closely with Mayer Brown on this transaction. E&Y received and reviewed the agreement drafted by Mayer Brown and provided its comments to Mayer Brown.⁸²⁰

This plan was implemented on January 1, 2002, and provided certain Refco executives with profit-only equity interests in RGL. Under the plan, the senior executives of Refco would be compensated based upon the annual net profits of Refco, and would also receive a substantial bonus if Refco were sold for more than a certain price.

(footnote continued from previous page)

⁸¹⁷ See the following Mayer Brown time record(s): MBRM-EX 00163237.

⁸¹⁸ See, generally, the following Mayer Brown time record(s): MBRM-EX 00163238-40; MBRM-EX 00049849-50.

⁸¹⁹ The time records of Mayer Brown indicate that Collins and Mayer Brown became involved in the profits interest matter in early October 2001. At that time, Collins had several discussions with Trosten regarding profit based units and a related plan, reviewed an E&Y memorandum on a profits participation plan, and had discussions with other Mayer Brown attorneys regarding same. See the following Mayer Brown time record(s): MBRM-EX 00163195-96, 198-99. The memorandum referred to is likely a memorandum prepared by Cappel on May 16, 2001 and sent to Trosten, which, presumably, was forwarded by Trosten to Collins. In Cappel’s memorandum, he outlined a step plan for issuance of profits-only interests to certain RGL executives which were recommended to be implemented by RGL’s attorneys. EY-REF-023419-26. The draft LLC agreement attached to the memorandum contains a page describing members which differs from later versions and the execution versions of the LLC agreement, in that this version describes all Members (not just “Voting” and “Non-Voting”) and provides for the identification of the “Profits Membership Shares” held by particular persons. MB02071712-45.

On about September 9, 2003, Trosten provided signature pages for each of the profits members in response to a request from Meisler at E&Y. EY-REF-004335-42, at App. D-50. The Examiner located a copy of this same document, in the Mayer Brown provided documents, with a generic signature page to be signed by each profits member, and with specific pages for each of the profits members containing information pertaining to each of their specific profits interests. By way of example, this document describes Trosten’s profits interest as being 16.44736842 Profits Membership Shares, and Bennett’s interest as being 24.67105263 Profits Membership Shares. MB02072959-95, at App. D-49.

⁸²⁰ See Second Amended and Restated LLC agreement of RGL, revised by E&Y on December 3, 2001. MB02071665. See also the following Mayer Brown time records which reflect that Mayer Brown attorneys (Collins, Schultz, and Barry) participated in conference calls with E&Y regarding markups to the amended LLC agreement: MBRM-EX 00163200-201, 203.

The foregoing evidences Mayer Brown’s knowledge and appreciation that Bennett, Trosten, and other participants with profit interests had ample incentive to maximize the annual profits of Refco, and to maximize the purchase price of any sale of Refco.

b. Mayer Brown’s Involvement in the LBO and IPO

(i) Mayer Brown’s Involvement in the LBO and Related BAWAG Transaction

Mayer Brown represented Refco and RGHI in connection with the LBO and was deeply involved in the LBO and the related BAWAG transaction. It negotiated the agreement with THL, handled the Refco side of THL’s due diligence, and drafted the related BAWAG agreement. As explained in detail below, in the course of its work in connection with the LBO, Mayer Brown appears to have failed to disclose key information to THL, and misrepresented other material matters, all of which allowed the LBO, and later the IPO, to go forward.

(a) Mayer Brown’s Apparent Failure to Disclose Material Information to THL’s Attorneys During Due Diligence

Collins was integrally involved in the LBO due diligence process. He reviewed due diligence and corporate documents to be provided to THL and its counsel, Weil, met frequently with Weil attorneys, had numerous conferences with Bennett and Trosten, and had numerous conferences with other Mayer Brown attorneys.⁸²¹ Jay Tabor (“Tabor”), the attorney at Weil primarily responsible for conducting the due diligence on behalf THL, stated in his interview that

⁸²¹ See the following Mayer Brown time record(s): MBRM-EX 00048951-59; MBRM-EX 00049849-50, 52, 55, 58-63, 65-66, 68, 70, 72-74, 77, 80-82, 902-904, 913, 919, 927, 929-931. See the document(s) with the following beginning document number(s) or number range(s): MB02012622; MB02220533; MB02223353-62; MB02377755-59; MB02377769; MWE0003256; MWE0003404; PWC-407727; PWC-407767; PWC-407811; REFCO-0001-002287; REFCO-0005-072139; REFCO-0008-120749; REFCO-E-001404655; THL/SEC-00089509-45; THL-SEC-00001236; WGM-L-0016233.

Collins and Mayer Brown played a very substantial role in connection with the due diligence information provided by Refco prior to the LBO.⁸²²

In the course of this due diligence process, according to Tabor, Mayer Brown represented to Weil that there were no transactions or dealings between Refco and RGHI. Specifically, Weil asked Refco to confirm that there were no transactions between RGHI and Refco except for a \$16 million inter-company debt that was being paid as part of the deal.⁸²³ According to Tabor, Collins so confirmed. Tabor's notes from a telephone call with Collins read:

Joe [Collins] confirms that company [Refco] is not a payee of “debt” other than customer receivables arising in the ordinary course of business. Receivables on balance sheet from customers in ordinary course. Company has gone through with accountants.⁸²⁴

Scott Schoen of THL likewise said that THL received written and oral representations from Bennett and Mayer Brown that RGHI was not engaging in any undisclosed related-party transactions.⁸²⁵ The representations in the Equity Purchase and Merger Agreement, a document negotiated and reviewed by Mayer Brown, also stated that there were no undisclosed inter-company loans between Refco and RGHI, and specifically required that Refco not assume or

⁸²² Tabor Interview, 38-39, 71, 144, 149-50, 155-56, 244-45.

⁸²³ *Id.*, pp. 62-63, 82-83, 145, 250, 263-65. *See also* MB02377755-59 (Memorandum from Collins to Tabor, dated May 6, 2004, transmitting assignment of \$16 million inter-company subordinated debt, and not mentioning any other inter-company debt); MB02223353-62 (Memorandum from Collins to Tabor, dated May 11, 2004, transmitting \$16 million Subordinated Loan Agreement, and not mentioning any other inter-company debt); and MB02377769 (Memorandum from Collins to Tabor, dated May 6, 2004, stating that Mayer Brown had been “advised by Refco that there are no significant indemnification obligations that have not been disclosed already,” and not mentioning any of the indemnification agreements provided by RGL in connection with the Round Trip Loans).

⁸²⁴ *Id.*, pp. 145, 250; Tabor handwritten notes, WGM-L 0021769.

⁸²⁵ Schoen Attorney Proffer, p. 12.

guarantee any indebtedness in excess of \$5 million.⁸²⁶ Tabor stated that knowledge of any loans between Refco and one of its shareholders (*i.e.*, RGHI) was clearly material to THL's decision to proceed with the acquisition.⁸²⁷

At the same time that Mayer Brown was apparently making representations during the LBO due diligence that there were no undisclosed Refco-RGHI transactions, Koury was preparing documents for the \$700 million Round Trip Loan involving Refco, Liberty Corner, and RGHI.⁸²⁸ This \$700 million Round Trip Loan then went forward on another day during which Koury and Collins were furnishing due diligence materials to Weil, and was unwound on the day before the closing of the THL-Refco transaction.⁸²⁹

(b) Mayer Brown's Apparent Failure to Disclose the PPA and the Executives' Profits-Only Interests

As previously mentioned, in late 2001, Mayer Brown drafted a Refco executive compensation plan, which became effective January 1, 2002, that provided profits-only equity interests to certain key Refco executives. In addition, from and after April 2004, and during the same time-frame that Collins was involved in due diligence in connection with the LBO, Collins and Mayer Brown were also involved in a transaction which ultimately resulted in the acquisition by RGHI of the rights of BAWAG affiliate DF Capital under the PPA, to be paid for by using a part of the proceeds of the LBO distributed to RGHI. The topics that Collins discussed with Bennett and others in connection with this transaction included: debt financing and financials;

⁸²⁶ See Equity Merger and Purchase Agreement, Sec. 3.9(a) - accuracy of financial statement; Sec. 3.9(c) - absence of any undisclosed debts or obligations; Sec. 3.10 - absence of any undisclosed liabilities; Sec. 5.1(d) - covenant not to assume or guarantee any indebtedness exceeding \$5 million. WGM-L 0017759-823, at App. D-51.

⁸²⁷ Tabor Interview, 264-65.

⁸²⁸ See the following Mayer Brown time record(s): MBRM-EX 00052026. See the document(s) with the following beginning document number(s) or number range(s): MBRM-EX 00093617-51.

⁸²⁹ See the following Mayer Brown time record(s): MBRM-EX 00048955-56; MBRM-EX 00049868, 81. See the document(s) with the following beginning document number(s) or number range(s): MBRM-EX 00093617-51.

debt structure and disclosures; a stock purchase agreement between RGHI and DF Capital; the purchase price to be paid for the stock of DF Capital; cash payments due to certain individuals; redemption agreements; and the funds flow describing how the proceeds paid to RGHI under the LBO would be distributed to BAWAG and others, with a recognition that amounts already held by BAWAG would be applied to the purchase price.⁸³⁰

In the course of the LBO due diligence process, according to Tabor, Mayer Brown failed to disclose the existence of either the PPA or the profits-only interests, even though Weil had specifically requested all documents regarding the existence of all equity interests in Refco. Tabor confirmed in his interview that Weil asked for this information and that this information was material to THL's decision with respect to the LBO.⁸³¹ Tabor stated: "Anything that would lead me to believe there were other equity interests outstanding at Refco Group, Limited would have been one of the most important things that we would look at in our diligence process."⁸³²

⁸³⁰ See the following Mayer Brown time record(s): MBRM-EX 00048951-55, 57-59; MBRM-EX 00049854, 55, 60, 61, 68, 72, 74, 77, 902, 912-913, 916, 919, 925, 927, 929-31. See the document(s) with the following beginning document number(s) or number range(s): MB02030339; MWE0000541-52; MWE0002862; MWE0003404; MWE0003454-84; MWE0003962-84; MWE0007729; MWE0007730; MWE0007731; PWC-407767; PWC-407811; REFCO-0001-002287; REFCO-0008-117417-74, at App. D-52; REFCO-0008-118210; REFCO-0008-118235; REFCO-0008-120749; REFCO-E-001393560; REFCO-E-001393612; REFCO-E-001404655; REFCO-E-001415555; REFCO-E-001420209; REFCO-E-002517492; REFCO-E-008061444; REFCO-E-008061884; REFCO-E-008061934; REFCO-E-008071326; REFCO-E-008220347; REFCO-E-008221755, at App. D-53; REFCO-E-008221815; REFCO-E-008224842; REFCO-E-008225406; REFCO-E-008225542; REFCO-E-008226374; REFCO-E-008237525; THL/UCC-00012707; WGM-L-0016233.

⁸³¹ Tabor Interview, 122, 126, 203. See also MB02012622 (Memorandum from Collins to Tabor, dated May 6, 2004, stating, in part, "Refco Group does not sponsor a defined benefit plan, nor does it have any plans which permit employees to invest in its stock," and not mentioning the profits memberships in RGL of Refco's senior executives).

⁸³² *Id.*, p. 203. See also *id.* at 101-02.

Moreover, in July 2005, prior to the finalization of the IPO in August 2005, Mayer Brown, through several attorneys in its New York office, were representing Trosten at his testimony before the NASD in a securities arbitration case when he specifically described the profits interest that he had in Refco prior to the LBO and the amount he had been paid for that interest from the proceeds of the LBO. During the course of that testimony, Trosten stated that he had a profits participation interest in RGL, which meant that he would receive a percentage of net earnings of RGL as his income. He also stated that his interest included a "strike price" value of \$900 million, meaning that if RGL were sold for more than \$900 million, he would receive an additional payment. He stated that as a result of the LBO closing, he received approximately \$45 million. The Examiner found no evidence to indicate that Mayer Brown brought Trosten's testimony to the attention of THL, Weil or anyone else, including the SEC.

(footnote continued on next page)

In addition, the existence of the profits only interests and the PPA were not initially or completely disclosed to the SEC in connection with the IPO.

(c) *Mayer Brown’s Apparent Failure to Disclose that the \$500 Million “Cash” Payment Was Not All Cash*

Tabor stated that it had been represented to Weil and THL that Refco had \$500 million in cash that it wanted to get credit for as an increase in the purchase price in the LBO or take out of the company. THL declined to increase the purchase price and agreed that this cash could be taken out at closing, so long as it was isolated in a bank account and not used by the business between the signing of the contract and the closing.⁸³³

Documents transmitted and received by Mayer Brown in connection with the RGHI-DF Capital stock purchase agreement, which provided for the acquisition of DF Capital’s rights under the PPA, indicate that Collins and Mayer Brown knew that the purported “cash” balance that Refco was required to maintain in an account with BAWAG pursuant to Section 5.9 of the Equity Purchase and Merger Agreement actually contained only \$110 million in cash, and that the remaining amount of purported “cash” actually consisted of a “credit” resulting from an intentional overdraft in an account held by RGHI at BAWAG that would be repaid to BAWAG from the proceeds of the LBO.⁸³⁴ However, the Examiner found no evidence that Mayer Brown or anyone associated with Refco or BAWAG ever disclosed these facts to Weil or THL.

(footnote continued from previous page)

See Testimony of Trosten in the arbitration case of McElwreath v. Refco Securities, LLC and RGL, given on July 14, 2005, pp. 541-42, at App. D-54.

⁸³³ Tabor Interview, 84-85; 230-31.

⁸³⁴ *See the document(s) with the following beginning document number(s) or number range(s): REFCO-E-001393612; REFCO-E-001393560; REFCO-E-008221815; REFCO-E-008221755, at App. D-53; REFCO-E-008061444; REFCO-0008-117417-74, at App. D-52.*

(d) Misrepresentations or Omissions in the Offering Circular

After the signing of the LBO definitive agreement between THL and Refco in early June, Collins remained involved in the sale process, which was consummated in early August 2004. The transaction was funded in part by the sale of the Senior Subordinated Notes and by an \$800 million loan from a syndicate of banks and other financial institutions. In connection with that process, Collins continued to participate in conferences with various persons, including Bennett and Trosten and representatives from THL and Weil, worked on an amendment to the definitive agreement between THL and Refco, worked on the schedules for the purchase agreement, reviewed and revised various operative agreements, and reviewed, revised and reviewed revisions to the offering circular to be submitted in connection with the exchange of the privately purchased notes for publicly traded notes.⁸³⁵

While Collins was in the midst of this activity, on June 21, 2004, he sent Mayer Brown's summary billing statement for services rendered in May 2004 to Refco, which describes, in part, "revision to liberty loan documents," an apparent reference to the \$700 million Liberty Corner Round Trip Loan on May 27, 2004.⁸³⁶

The final Confidential Offering Circular in connection with the issuance of the Senior Subordinated Notes was completed on or about July 22, 2004 (the "Offering Circular"), and Mayer Brown was described therein as having represented RGL.⁸³⁷

⁸³⁵ See, e.g., the following Mayer Brown time record(s): MBRM-EX 00048957-59; MBRM-EX 00049902-04, 13, 19, 27, 29-31. See the document(s) with the following beginning document number(s) or number range(s): MWE0002862; MWE0003256; PWC-407767; PWC-407811; REFCO-E-001404655; REFCO-E-008220347; REFCO-E-008225542; WGM-L-0016233.

⁸³⁶ REFCO-E-008057891-903.

⁸³⁷ See WGM-L 0014497-730 in general, and p. 172 thereof for Mayer Brown listing as counsel. WGM-L 0014675.

The LBO closed on August 5, 2004.⁸³⁸ On that date, Mayer Brown issued a legal opinion to CSFB in which it acknowledged that it had acted as counsel for RGL in connection with the sale of the Senior Subordinated Notes and had acted as counsel for RGL in connection with the matters described in the Offering Circular under the caption “Business — Legal Proceedings — SEC Investigation.” In the legal opinion, Mayer Brown also acknowledged that it had examined various documents and participated in conferences with representatives of RGL and its accountants, and with representatives of CSFB and its counsel, at which times the contents of the Offering Circular and related matters were discussed. Mayer Brown advised that no facts had come to its attention that caused Mayer Brown to believe that the statements contained in the Offering Circular under that captioned matter as of the date of the opinion contained any untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements in the Offering Circular not misleading.⁸³⁹

The Offering Circular was false and misleading, however, because it did not, among other things, contain any disclosure of the Round Trip Loans. The Offering Circular stated that \$105 million owed from RGHI as of February 28, 2003 had been received by February 29, 2004. It did not disclose that at February 29, 2004, RGL had an outstanding guaranty (prepared by Mayer Brown) to a Round Trip Loan Participant for the \$720 million Round Trip Loan that would come due a week later. The Offering Circular did not disclose that the repayment of that \$720 million would result in an increase in Refco’s receivable from RGHI in like amount. There is legal authority to support the argument that Mayer Brown had a duty to advise Refco and

⁸³⁸ See Index to THL-Refco Acquisition Transaction. WGM-L 017745-57.

⁸³⁹ WGM-L 0016233-34. See also MB02012021-22 (draft of letter bearing handwritten notation “JPC: 7/19/04”).

Weil, who was also counsel in connection with the Offering Circular, of any inaccuracies in the Offering Circular.⁸⁴⁰

(ii) Mayer Brown's Involvement in the Notes Exchange Offer and the IPO

After the closing of the LBO, Refco began the process to register the Senior Subordinated Notes so that they could become publicly traded, and also began preparing a prospectus that would lead to an IPO. Mayer Brown had some involvement in both processes, and, along with Weil, was listed as counsel for Refco in the disclosure document pertaining to the IPO (the so-called “S-1”).⁸⁴¹

In October 2004, Collins talked with Klejna and Bennett regarding unspecified disclosure issues before the initial disclosure document pertaining to the notes registration (the so-called “S-4”) was filed with the SEC.⁸⁴²

Thereafter, the SEC provided comments to the initial S-4 and S-1 filings and Weil responded thereto on behalf of Refco and filed the amended S-4 and S-1. Mayer Brown received and presumably reviewed⁸⁴³ the SEC’s comments, Weil’s responses, the SEC’s replies, and the amended S-1s.⁸⁴⁴

⁸⁴⁰ See *Nat'l Enter. Corp. v. Dechert, Price & Rhoads*, 246 A.D.2d 481, 667 N.Y.S.2d 745, 746 (1998).

⁸⁴¹ Prospectus WGM-R 0010289-505, and WGM-R 0010432.

⁸⁴² See the following Mayer Brown time record(s): MBRM-EX 00163247.

⁸⁴³ See the following Mayer Brown time record(s): MBRM-EX 00163252.

⁸⁴⁴ See, e.g., the following representative e-mails sent by Barbra Broudy of Weil to an e-mail distribution list that included Collins, transmitting copies of, *inter alia*, Diligence and Drafting Agendas, drafts of the Refco S-1 and amendments thereto, SEC comments to the Refco S-4 and amendments to the S-4, SEC comments to the Refco S-1 and amendments to the S-1, and responses to the SEC comments: REFCO-E-008203166; REFCO-E-008201321; REFCO-E-008201043; REFCO-E-008199899; REFCO-E-008197514-15; REFCO-E-008197243; MB02181544-45; THL/SEC 00093865-66; REFCO-E-008157208; REFCO-E-008145345-46; REFCO-E-008142174; REFCO-E-008140390; WGM-R E175811-13; REFCO-E-008125998; REFCO-E-006854476; REFCO-E-006854081; REFCO-E-006853725; REFCO-E-006853395; REFCO-E-008108395; REFCO-E-006852354-55; REFCO-E-006869613; REFCO-E-006851371-72; REFCO-E-006850174-75; REFCO-E-006849007-08; REFCO-E-006848108-09; REFCO-E-008946896; REFCO-E-006847209-10; REFCO-E-006846783-84.

During this time frame, Collins talked with both Bennett and Grant regarding due diligence meetings and concerns, prepared for and attended a due diligence meeting pertaining to the Senior Subordinated Notes, and reviewed a note purchase agreement.⁸⁴⁵

Also during this time frame, at least through May 2005, Koury continued to prepare the documents for the Round Trip Loan transactions (\$485 million in August 2004;⁸⁴⁶ \$545 million in November 2004;⁸⁴⁷ \$550 million in December 2004;⁸⁴⁸ \$345 million in February 2005;⁸⁴⁹ and \$450 million in May 2005⁸⁵⁰) at times sending copies to Collins.⁸⁵¹ Collins also continued to send Mayer Brown's monthly summary bills to Refco, which, as to the months in which the Round Trip Loans were prepared by Koury, each generally described "preparation of Liberty loan documents," and one of which (for August 2004, and sent after the closing of the LBO) described "preparation of loan agreement, indemnification and guaranty for Liberty Corner."⁸⁵² Collins also continued to receive and respond to periodic requests for audit response letters —

⁸⁴⁵ See the following Mayer Brown time record(s): MBRM-EX 00049109.

⁸⁴⁶ See the following Mayer Brown time record(s): MBRM-EX 00052027. See the document(s) with the following beginning document number(s) or number range(s): MB00237-68; REFCO-E-002996175; REFCO-HC-0533697.

⁸⁴⁷ See the following Mayer Brown time record(s): MBRM-EX 00052028. See the document(s) with the following beginning document number(s) or number range(s): REFCO-E-2994699.

⁸⁴⁸ See the following Mayer Brown time record(s): MBRM-EX 00052029. See the document(s) with the following beginning document number(s) or number range(s): LC-USAO-000220-51; MB00302-34; REFCO-HC-0533792; REFCO-HC-0533823.

⁸⁴⁹ See the following Mayer Brown time record(s): MBRM-EX 00052029. See the document(s) with the following beginning document number(s) or number range(s): LC-USAO-000269-309; MB00335-68; REFCO-HC-0533833.

⁸⁵⁰ See the document(s) with the following beginning document number(s) or number range(s): MB00369-401; REFCO-HC-0533829; REFCO-HC-0533882-83, at App. D-39.

⁸⁵¹ See, e.g., REFCO-HC-0533882, at App. D-39.

⁸⁵² See the document(s) with the following beginning document number(s) or number range(s): REFCO-E-008057891-908; REFCO-E-008209041-55, at App. D-40; REFCO-E-001351682-700; REFCO-E-008165527-40; REFCO-E-001311424-38.

keyed to Refco's fiscal quarters that ended in the same months as the Round Trip Loan transactions.⁸⁵³

In early August 2005, Mayer Brown associate Ware worked on the auditor update for the S-1, completed and circulated the auditor update for the S-1, and prepared the auditor update for the "462(b)" [presumably in connection with the S-1].⁸⁵⁴ Collins then reviewed the "opinion," apparently meaning the opinion that had been prepared by Ware.⁸⁵⁵

The IPO was completed on August 16, 2005, after the final Prospectus dated August 10, 2005 was issued in which Mayer Brown and Weil each was described as having represented Refco, Inc. in connection therewith.

On August 16, 2005, Mayer Brown issued an opinion letter to CSFB in connection with the S-1 that made limited representations almost identical to those it had made on August 5, 2004 in connection with the Offering Circular.⁸⁵⁶ Even though the Prospectus was misleading in substantially the same manner as the prior Offering Circular, Mayer Brown apparently made no effort to correct those misrepresentations or inform Refco or Weil of them, although arguably having a duty to do so.⁸⁵⁷

⁸⁵³ See the following Mayer Brown time record(s): MBRM-EX 00049083, 108; MBRM-EX 00049903; MBRM-EX 00163246, 47, 53-55, 57, 59-60. See the document(s) with the following beginning document number(s) or number range(s): GT-SEC-0082110; MBRM-EX 00003762; MBRM-EX 00063243; REFCO-0008-218157; REFCO-E-002029320; REFCO-E-002216213; REFCO-E-008612971.

⁸⁵⁴ See the following Mayer Brown time record(s): MBRM-EX 00163259-60.

⁸⁵⁵ See the following Mayer Brown time record(s): MBRM-EX 00049938.

⁸⁵⁶ WGM-R-0011142-43. See also MB02221982-83 (draft of letter adding phrase "with the staff of the Securities and Exchange Commission" among other changes to prior draft).

⁸⁵⁷ See *Dechert*, 246 A.D.2d 481, 667 N.Y.S.2d 745.

Two days after the closing of the IPO, the form of the Round Trip Loan documents that were prepared by Koury for use with the May 2005 Round Trip Loan were used by Maggio to engage in a \$420 million Round Trip Loan transaction.⁸⁵⁸

Mayer Brown continued to represent Refco at least through October 6, 2005. On that date, Ware sent a Status Report regarding pending litigation to Klejna, and Collins sent an audit response letter to GT pertaining to the quarterly period ended August 31, 2005.⁸⁵⁹

3. Conclusions: Analysis of Potential Claims Against Mayer Brown

The Examiner concludes that there is sufficient evidence to allow the Refco estate to state a claim upon which relief may be granted for legal malpractice, aiding and abetting the breach of fiduciary duty, and aiding and abetting fraud. On March 22, 2007, counsel for Mayer Brown made a written submission to the Examiner on a confidential basis to set forth Mayer Brown's position on various areas of questioning during the interviews, along with three expert affidavits. The Examiner considered this submission in reaching his conclusions.

a. Legal Malpractice

As discussed in more depth in Appendix A, to establish a claim for legal malpractice in New York,⁸⁶⁰ the plaintiff must allege and prove that (1) the defendant failed to exercise the care, skill, and diligence commonly possessed and exercised by a member of the legal profession; (2) the defendant's negligence was a proximate cause of the loss sustained; (3) the plaintiff

⁸⁵⁸ See the document(s) with the following beginning document number(s) or number range(s): REFCO-HC-0533888; REFCO-0002-000085-113.

⁸⁵⁹ REFCO-E-002029320; REFCO-E-002216213.

⁸⁶⁰ While an attorney may face liability under a number of theories, New York courts typically view claims for breach of fiduciary duty and breach of contract as duplicative of legal malpractice claims. See, e.g., *Flutie Bros. LLC v. Hayes*, No. 04 Civ. 4187(DAB), 2006 WL 1379594, at *7-*8 (S.D.N.Y. May 18, 2006); *Amadasu v. Ngati*, No. 05CV2585(JFB)(LB), 2006 WL 842456, *9 (E.D.N.Y. Mar. 27, 2006); *InKine Pharm. Co. Inc. v. Coleman*, 759 N.Y.S.2d 62, 63 (N.Y. App. Div. 2003). For ease of reference, therefore, this claim will be described as "legal malpractice."

incurred actual damages as a result of the defendant's actions or inaction; and (4) that but for the defendant's negligence, the plaintiff would have prevailed in the underlying action or would not have sustained damages.⁸⁶¹

While the definition and scope of a lawyer's "professional duty" may vary from situation to situation, New York courts often look to the New York Code of Professional Responsibility (the "CPR") and the accompanying Cannons, Ethical Considerations, and Disciplinary Rules ("DRs") to articulate the standard of care for purposes of a legal malpractice claim. Violation of a Disciplinary Rule does not itself constitute malpractice *per se* or create a presumption of malpractice, but "conduct constituting a violation of a disciplinary rule may also constitute evidence of malpractice."⁸⁶²

As explained below, there is sufficient evidence to allege that Mayer Brown breached its duties established by common law and by New York DR7-102(a) and DR5-109.

(i) DR7-102(a)

New York DR7-102(a) prohibits a lawyer from assisting a client with conduct the lawyer knows or should have known to be fraudulent. It states, in pertinent part:

In the representation of a client, a lawyer shall not: . . . 3. Conceal or knowingly fail to disclose that which the lawyer is required to reveal . . . 5. Knowingly make a false statement of fact or law . . . 7. Counsel or assist the client in conduct that the lawyer knows to be illegal or fraudulent . . . 8. Knowingly engage in other illegal conduct or conduct contrary to a Disciplinary Rule.

⁸⁶¹ *Brady v. Bisogno & Meyerson*, 819 N.Y.S.2d 558, 559 (N.Y. App. Div. 2006).

⁸⁶² *Swift v. Choe*, 674 N.Y.S.2d 17, 21 (N.Y. App. Div. 1998); *accord William Kaufman Org., Ltd. v. Graham & James LLP*, 269 A.D.2d 171, 173 (N.Y. App. Div. 2000); *GD Searle & Co., Inc. v. Pennie & Edmonds LLP*, No. 602374/00, 2004 WL 3270190, *1 (N.Y. Sup. Ct. Jan. 14, 2004); *cf. Tilton v. Trezza*, No. 005818/2003, 2006 WL 1320738 (N.Y. Sup.), *5 (Mar. 27, 2006) (holding expert may testify about ethical standards in legal malpractice action but may not cite CPR).

Cases interpreting the word “knowingly” in the context of DR7-102(a) and other DRs make clear that the concept of “knowing” encompasses “should have known.”⁸⁶³

(a) Assisting with the Round Trip Loans

There is evidence that Mayer Brown committed malpractice by conduct that, if proven to be true, would violate DR7-102(a) — specifically, assisting Refco with the Round Trip Loan transactions, which Mayer Brown knew or should have known were fraudulent. Mayer Brown admits that:

- It represented Refco for a substantial period of time, ranging from early 1994, when Collins came to Mayer Brown and brought Refco with him as a client, through and including the time that Refco filed for bankruptcy in October 2005.
- Beginning no later than February 2000, and continuing until May 2005, Mayer Brown documented, and on a number of occasions performed other services in connection with, multi-million dollar Round Trip Loan transactions involving two Refco entities (RCM and RGL), the holding company owned by Bennett and others (RGHI), and third-party Round Trip Loan Participants.

In addition, there is sufficient evidence to allege that Mayer Brown knew that these Round Trip Loan transactions:

⁸⁶³ See, e.g., *In re Robert*, 10 A.D.3d 96, 779 N.Y.S.2d 236, 238 (2004) (respondent lawyer *knew or should have known* that a statement made by him was misleading, in violation of DR7-102(a)(4)); *In re Bunting*, 10 A.D.3d 146, 781 N.Y.S.2d 153 (2004) (respondent lawyer *knew or should have known* his testimony was false and misleading in violation of DR1-102(a)(4)). Ass’N OF THE BAR OF THE CITY OF N.Y., FORMAL OPINION 2002-1, available at <http://www.nycbar.org/Ethics/eth2002-1.html>. See also rationale of *Florida Bar v. Brown*, 790 So.2d 1081 (Fla. 2001):

Our legal system depends on attorneys who appropriately question requests by clients that should arouse suspicion, and an attorney must not permit his or her judgment to be influenced by the desire to please a client. . . . Moreover, Brown’s failure to fully consider the propriety or legality of Malone’s request resulted in the involvement of his law firm in this scheme, jeopardizing the firm and other attorneys.

By failing to consider the legality of Malone’s request, Brown assisted his client in conduct that Brown should have known was criminal or fraudulent, violating rule 4-1.2(d).

790 So.2d at 1088.

- were engaged in at the expense of RCM, which advanced the funds or credits for the Round Trip Loans to the Round Trip Loan Participants, and paid the interest to the Round Trip Loan Participants;
- involved no risk of loss by the Round Trip Loan Participants, and, indeed, essentially guaranteed the Round Trip Loan Participants a positive return on the transactions;
- created the risk of loss to RGL for the non-repayment by RGHI of the loans from the Round Trip Loan Participants to RGHI, and exposed RGL to a contingent liability of as much as \$720 million and the risk for any loss or expense suffered by the Round Trip Loan Participants for participating in the Round Trip Loans;
- were engaged in for the benefit of RGHI;
- straddled a several week period at the end of one Refco financial reporting period and the beginning of the next financial reporting period;
- had no apparent business purpose; and
- violated loan covenants.

Finally, although Collins and the other Mayer Brown witnesses denied knowing some or all of the following, the Examiner concludes that there is sufficient evidence to allege that Mayer Brown knew, should have known, or consciously avoided knowing, that:

- there was a substantial receivable owing from RGHI to Refco;
- the purpose of the Round Trip Loan transactions was to temporarily mask portions of the RGHI Receivable and replace those portions with what appeared to be legitimate receivables owing from unrelated third-parties;
- the effect of such masking of the RGHI Receivable would be to materially misstate Refco's financial condition on its audited financial statements; and
- those materially misstated audited financial statements would be presented to, and relied upon, by third parties.

(b) Failure to Disclose/False Statements in Connection with LBO, IPO, and Related Transactions

Mayer Brown also committed malpractice by conduct that, if proven to be true, would violate DR7-102(a) by failing to disclose material matters and by making affirmative statements

that it knew, or should have known, were untrue. There is sufficient evidence to allege that

Mayer Brown:

- engaged in the due diligence process with respect to the LBO and was responsible for providing due diligence materials to THL and Weil;
- was asked by THL and Weil to provide due diligence materials and information regarding the existence, or lack of existence, of any dealings between RGHI and Refco;
- failed to disclose to THL and Weil the existence of the multiple multi-million dollar Round Trip Loan transactions for which Mayer Brown had prepared, and was preparing, the documentation;
- was involved in the negotiation and preparation of the definitive agreement between Refco and THL;
- knew that the agreement contained false representations pertaining to, *inter alia*, disclosed liabilities, disclosed debts or obligations, and a covenant not to assume or guarantee any indebtedness in excess of \$5 million;
- continued to prepare documentation for multi-hundred million dollar Round Trip Loan transactions that were guaranteed by RGL after the signing of the definitive agreement between THL and Refco, after the closing of the LBO and the resulting change of ownership, during the course of the Senior Subordinated Notes registration transaction, and during the course of the due diligence period leading up to the closing of the IPO;
- failed, after inquiry, to disclose to THL and Weil the existence of “profits only” membership interests held by Bennett, Trosten, and other members of Refco’s senior management;
- failed to disclose to THL and Weil the testimony of Trosten, provided prior to the closing of the IPO, and known to Mayer Brown from the presence of two of its attorneys at that testimony, that he (Trosten) had a profits interest in Refco, as well as an interest in the proceeds of the sale of Refco over a “strike price” of \$900 million, and that he had received \$45 million from the proceeds of the LBO in partial payment for those interests;
- participated in the due diligence process for the registration of the Senior Subordinated Notes and the IPO, and reviewed the various drafts of the operative documents filed with the SEC and the comments thereto by the SEC and the responses thereto by Weil on behalf of Refco; and
- failed to disclose any of the matters described above to any of the independent directors of Refco, or anyone associated with THL.

(ii) DR5-109

New York DR5-109 provides, in relevant part:

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization.⁸⁶⁴

Mayer Brown continued to represent Refco in Round Trip Loan transactions at the time of the LBO and IPO. Mayer Brown did not bring the Round Trip Loans to the attention of anyone independent of Bennett — including, after the LBO, THL-related directors or independent directors. This may constitute a violation of DR5-109.

⁸⁶⁴ DR5-109 continues:

(b) . . . In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include, among others:

- (1) asking reconsideration of the matter;
- (2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and
- (3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.

(c) If, despite the lawyer's efforts in accordance with DR 5-109 (B), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in a substantial injury to the organization, the lawyer may resign in accordance with DR 2-110.

(iii) Conflict of Interest

Mayer Brown's conduct in representing parties that have conflicting interests — RGHI and (at least after the LBO) RGL — in contravention of DR5-105, is further evidence of Mayer Brown's malpractice. DR5-105 forbids a lawyer from representing a client if that representation will adversely affect the interests of another current client. The Rule states in part, “[A] lawyer may represent multiple clients if a disinterested lawyer would believe that the lawyer can competently represent the interest of each and if each consents to the representation after full disclosure of the implications of the simultaneous representation and the advantages and risks involved.”⁸⁶⁵ Subject only to the exception contained in DR5-105(c), the provisions of DR5-105(a) and (b) prohibit undertaking or continuing in multiple representation “if the exercise of independent professional judgment in behalf of a client will be or is likely to be adversely affected” or “if it would be likely to involve the lawyer in representing differing interests.” The New York Code defines differing interests as “every interest that will adversely affect either the judgment or the loyalty of a lawyer to a client, whether it be conflicting, inconsistent, diverse, or other interest.”⁸⁶⁶

Mayer Brown's continued representation of both RGL and RGHI in connection with the Round Trip Loans after the LBO constituted a conflict of interest. RGL's interest in the Round Trip Loans were directly at odds with those of RGHI. Indeed, the Round Trip Loans, which included a guarantee by RGL of RGHI's obligations and an indemnity in favor of the Round Trip Loan Participant, placed RGL at risk with no corresponding consideration flowing to RGL. Although RGL and RGHI may have been able to consent to this conflict following full

⁸⁶⁵ See DR5-105(c).

⁸⁶⁶ 22 N.Y.C.R.R. § 1200.1(a).

disclosure when Bennett controlled both RGL and RGHI, no such assumption is warranted after the LBO, since THL became the controlling owner of RGL while Bennett remained in control of RGHI. To the contrary, had Mayer Brown “full[y] disclos[ed] the implications of the simultaneous representation and the advantages and risks involved” to THL, as it was required to do, it seems unlikely that THL would have consented to the simultaneous representation that disadvantaged RGL. In any event, the Examiner found no evidence of a request for a waiver of any conflict of interest.

b. Aiding and Abetting Breach of Fiduciary Duty/Aiding and Abetting Fraud

The Examiner concludes that, based on the evidence reviewed to date and summarized above, Refco’s estate, more likely than not, could state a claim upon which relief may be granted for aiding and abetting a fraud and/or breach of fiduciary duty.⁸⁶⁷ The elements of these claims are discussed in greater detail in Appendix A.

In this case, the Examiner concludes there is sufficient evidence to allege that Mayer Brown aided and abetted a breach of fiduciary duty and fraud by:

- drafting and sometimes negotiating the transaction documents for the Round Trip Loans while knowing that the Round Trip Loans were part of a scheme to fraudulently bolster Refco’s financial appearance to lenders and investors by manipulating Refco’s financial statements;
- failing to disclose its knowledge of the RGHI Receivable and Round Trip Loan scheme to persons at Refco independent of Bennett — including, after the LBO, THL personnel and, after January 2005, Refco’s independent outside directors — even though Mayer Brown, as a fiduciary, was under a duty to disclose its knowledge;
- drafting loan documents that benefited RGHI, to the detriment of Refco, after the LBO;

⁸⁶⁷ The Examiner assumes for purposes of this analysis that a fraud and breach of fiduciary duty by one or more of the officers of Refco can be established.

- failing to disclose and making material misrepresentations to Weil, who was counsel to THL, during the LBO; and
- failing to disclose material information during the course of the IPO.

B. WEIL, GOTSHAL & MANGES LLP

1. Introduction and Overview of Investigation

Weil represented THL, but not Refco, in connection with the LBO which closed August 5, 2004. Weil undertook “legal” due diligence,⁸⁶⁸ drafted the Equity Purchase and Merger Agreement and associated LBO documents,⁸⁶⁹ and drafted documents in connection with the Senior Subordinated Notes and bank financing for the LBO.⁸⁷⁰ Weil was paid \$3,765,000 from the proceeds of the LBO.⁸⁷¹

After the LBO, Weil simultaneously represented THL, Refco, and certain members of Refco’s Board of Directors in connection with various matters. The Examiner evaluated these representations by Weil for potential claims by Refco’s estate against Weil. Specifically, the Examiner focused on Weil’s representation of Refco in connection with its filings with the SEC

⁸⁶⁸ WGM-L 0011186.

⁸⁶⁹ WGM-L 0017759, at App. D-51.

⁸⁷⁰ *E.g.*, WGM-L 0002711; WGM-L 0002735; WGM-L 0032319-60; WGM-L 0032368-405; WGM-L 0032445-83; WGM-L 0032484-519; WGM-L 0022421-23; WGM-L 0001800; WGM-L 0002012; WGM-L 0002187. In addition to its diligence, as THL decided to acquire a majority stake in Refco, Weil prepared the operative acquisition documents, beginning with THL’s letter of intent to purchase a majority stake in Refco, executed on or about April 19, 2004. WGM-L 0007925, at App. D-55. Weil also drafted the Equity Purchase and Merger Agreement, executed by THL and RGHI on or about June 8, 2004. WGM-L 0017759, at App. D-51. Finally, Weil drafted and negotiated on behalf of THL the documents associated with the closing of the LBO. WGM-L 0018313. In particular, Weil participated in the drafting and negotiation of the Credit Agreement and related agreements pursuant to which New Refco and its affiliates borrowed \$800 million. *E.g.*, WGM-L 0002711; WGM-L 0002735; WGM-L 0032319-60; WGM-L 0032368-405; WGM-L 0032445-83; WGM-L 0032484-519. Weil participated in the drafting of the Offering Circular for the Senior Subordinated Notes and coordinated activities with counsel for the notes’ underwriters. *E.g.*, WGM-L 0022421-23; WGM-L 0001880; WGM-L 0002012; WGM-L 0002187. For these post-LBO activities, there was a general commonality of interest between THL and Refco in selling the notes and securing the credit for New Refco, with THL acting as the “sponsor” for the financing. WGM-L 0007945; WGM-L 0009782; Interview of James Westra (“Westra Interview”), 157:4-158:16.

⁸⁷¹ WGM-L 0018907.

for approval of Refco's sale of registered notes in April 2005 and its initial public offering of stock in August 2005.

Weil's work for THL does not give rise to claims by the Refco estate against Weil. However, Weil's work for THL is relevant to an analysis of the Refco estate's possible claims against Weil arising out of Weil's work for Refco. Accordingly, the discussion below includes an overview of Weil's and other professionals' work for THL in connection with the LBO, in addition to a detailed discussion of Weil's engagement by Refco itself.

a. Document Review

The Examiner had access to a database of Refco documents maintained by the Debtors' counsel and documents produced to the SEC and to the Creditors Committee by various other individuals and entities mentioned in this Report. The Examiner conducted targeted searches that allowed him to review the most significant and relevant documents from these databases.

The Examiner also obtained a significant number of documents directly from Weil. Given that Weil had not previously produced its own documents to the SEC or to the Creditors Committee, Weil stated that it had not assembled these documents to be readily available for production. The Examiner obtained authorization from Refco for Weil to provide potentially privileged documents to the Examiner.⁸⁷² The Examiner and Weil also reached agreement on the protections that documents designated by Weil as confidential and highly confidential would be afforded.⁸⁷³ Although efforts were undertaken to avoid duplicative production of documents

⁸⁷² Pursuant to a November 1, 2006 letter to Weil from Skadden, as counsel for Refco, the Chapter 7 Trustee for Refco LLC, and the RCM Trustee, Weil was authorized to produce to the Examiner certain documents otherwise possibly protected from disclosure because of their privileged nature. Weil, however, did not produce privileged documents related solely to its representation of THL.

⁸⁷³ The Examiner and Weil entered into a letter agreement dated November 27, 2006, pursuant to which the terms of the April 26, 2006 Protective Order Governing the Production and Use of Confidential Material would apply to materials Weil voluntarily produced to the Examiner as if they were produced in response to a Rule 2004 Subpoena.

already in the Examiner's possession, the volume of responsive Weil materials was substantial⁸⁷⁴ and portions of Weil's files were not electronically searchable and retrievable, thus requiring Weil to manually review and produce a considerable number of hard copy documents in addition to the electronic document productions.

Weil was generally cooperative in providing the Examiner with access to documents. Nevertheless, the Examiner experienced significant delays in obtaining and reviewing documents from Weil's files as a result of the factors described above. Given these delays, and owing to the large volume of Weil documents, Weil continued to produce documents through the final stages of drafting this Report. As a result, not all documents produced to the Examiner are referred to in this Report.

b. Interviews

The Examiner interviewed the following Weil attorneys who had the most significant involvement with Weil's work relating to Refco:

- James Westra ("Westra") - Westra joined Weil in 2002 as a partner in Weil's Boston office and became co-head of Weil's private equity group in or around September 2005. Westra was the relationship partner for the THL and Refco engagements and had ultimate responsibility for Weil's work in connection with THL's acquisition of Refco. Westra had limited involvement in Weil's work on Refco's private note offering, registered note offering, and subsequent IPO, but he reviewed documents and was provided updates regarding those transactions.
- Jay Tabor ("Tabor") - Tabor has been a partner in Weil's Dallas office since 1999. He focuses his practice on mergers and acquisitions and private equity transactions. Tabor was responsible for the day-to-day management of Weil's work in connection with THL's acquisition of Refco. After the LBO closed, Tabor's involvement with the Refco engagement was primarily to manage Refco's corporate restructuring in preparation for the IPO and to consult with

⁸⁷⁴ Weil made available for the Examiner's review in New York approximately 150 boxes of hard copy documents. In addition, Weil identified over 150 timekeepers who billed time to Refco matters. From these, the Examiner prioritized his requests for documents to twenty-one custodians initially, and followed up with seven additional custodians once the production of responsive files from the initial list of custodians was completed.

other Weil teams regarding the LBO structuring and its description in SEC filings. Tabor reported to Westra in connection with his work on Refco.

- Alexander Lynch (“Lynch”) - Lynch has been a partner in Weil’s New York office since joining the firm in April 2004. He focuses his practice on equity capital markets transactions. Lynch became involved in the Refco transactions beginning in late 2004 and was responsible for Weil’s work in connection with Refco’s registered note offering and IPO.
- Barbra Broudy (“Broudy”) - Broudy joined Weil’s New York office as an associate upon graduating from law school in 2003. Broudy’s involvement with Refco began in spring 2004. She had significant involvement in the private note offering, the registered note offering, and the IPO. Broudy appears to have essentially coordinated Weil’s due diligence efforts in connection with the registered note offering and IPO. Broudy reported to Lynch.

Weil’s counsel cooperated with the Examiner and agreed to make the aforementioned witnesses available consensually. The interviews were transcribed but were not taken under oath. All four Weil witnesses appeared to counsel for the Examiner to be reasonably forthcoming and generally made an effort to answer questions, although there were a number of documents and subjects about which the witnesses had little or no recollection.

2. Overview of Weil’s Representation of Refco

After the LBO, and upon THL’s assumption of control over Refco, Refco engaged Weil to provide some legal services to Refco. Weil coordinated Refco’s filings with the SEC in connection with the approval of Refco’s sale of registered notes in April 2005 and its initial public offering of stock in August 2005.

According to relevant documents, preliminary planning for the IPO began immediately after the closing of the LBO in August 2004.⁸⁷⁵ Weil held an initial meeting to discuss the requirements of the IPO and to begin its legal work in connection with the IPO on or about

⁸⁷⁵ WGM-R E156852; WGM-R 0032286.

October 19, 2004.⁸⁷⁶ Weil's work in connection with the sale of Refco's registered notes was on a parallel track with Weil's work in connection with the IPO.⁸⁷⁷ Weil determined to complete its work and obtain SEC approval for the sale of registered notes, then file its papers and begin the process to obtain SEC approval for Refco's IPO prospectus immediately thereafter. In fact, Weil and Refco gained approval for its Form S-4 on or about April 8, 2005, which was the same day that Weil filed on behalf of Refco its first draft Form S-1 prospectus in connection with the IPO.

Weil did not serve as Refco's sole outside counsel for the period following the LBO. In particular, Mayer Brown continued to act as counsel to Refco in certain matters, including certain litigation matters,⁸⁷⁸ an investigation by the SEC,⁸⁷⁹ and Refco's acquisition of Cargill Investor Services in the summer of 2005.⁸⁸⁰

Weil provided other legal services to Refco in addition to its work in preparing the S-4 registration statement and the S-1 IPO prospectus. In fall 2004, THL asked Weil to assist Refco's General Counsel, Dennis Klejna, in addressing matters that would be necessary for the governance of a public company.⁸⁸¹ For example, Weil suggested procedures for managing board meetings and for coordinating the various committees of a board, prepared corporate governance policies, procedures, and documents for use by Refco in connection with its public

⁸⁷⁶ See WGM-R 0014031-64 (Organizational Materials for an Initial Public Offering for Refco dated October 19, 2004). Broudy explained in her interview that this was the "kickoff meeting" for the initial public offering. Interview of Barbra Broudy ("Broudy Interview"), 33:5-10.

⁸⁷⁷ Broudy Interview, 14:15-19.

⁸⁷⁸ Westra Interview, 201:12-18.

⁸⁷⁹ WGM-R E158182.

⁸⁸⁰ Westra Interview, 201:9-10.

⁸⁸¹ *Id.* At least by October 2004, THL was concerned that Klejna was not acting as a true general counsel for Refco. With his regulatory background, THL believed he did not have the experience necessary to address the issues related to the SEC filings and the demands of a public company generally. WGM-R E157000, at App. D-56.

filings,⁸⁸² and assisted Refco in the preparation of organizing documents for the various committees of Refco's board, including the audit committee and compensation committee.⁸⁸³ Weil also prepared the employment agreement for Refco's new CFO, Gerald Sherer, in December 2004.⁸⁸⁴

Following the IPO, Weil continued to represent Refco on matters relating to its status as a public company, providing advice on such matters as restrictions on the sale of Refco stock following the IPO and on rules for filing 8K, 10K, and 10Q reports with the SEC.⁸⁸⁵ This engagement continued at least through the public disclosure of Refco's round trip lending and receivables scheme in October 2005.

Simultaneously, Weil represented THL and the members of Refco's board who were affiliated with THL. At the time of the LBO, THL was permitted to appoint four members of Refco's management committee, and Weil retained its attorney-client relationship with those members of the board. Weil continued to represent THL and the THL-affiliated members of the Refco board throughout its representation of Refco. Despite the potential for conflict between Refco, THL, and members of Refco's board, the Examiner could not find and Weil could not identify any conflict waivers executed either by Refco or by THL in connection with Weil's simultaneous representation.⁸⁸⁶

In the matters in which Weil was not representing Refco directly, Weil provided oversight of Refco through its representation of THL and the THL-affiliated members of Refco's

⁸⁸² WGM-R 0013945-48.

⁸⁸³ WGM-R 0006996-007025; WGM-R 0007975-77.

⁸⁸⁴ WGM-R 0017387-90.

⁸⁸⁵ WGM-R 0017615-17; WGM-R E000226.

⁸⁸⁶ Westra Interview, 158:17-159:4.

board, at least until the IPO closed. For example, at one point in April 2005, in reviewing a news article discussing a dispute between Refco and another party, THL advised Weil to “make sure Refco was acting appropriately in light of the upcoming IPO.”⁸⁸⁷ In another example, Weil was asked to review on behalf of THL the diligence and transaction documents prepared by Mayer Brown on behalf of Refco in connection with Refco’s acquisition of Cargill.⁸⁸⁸ For those significant matters where Weil did not represent Refco directly, it appears likely that THL made Weil aware of the matters and that Weil advised THL in connection with Refco’s handling of the matters.

3. Background Regarding LBO and Related Matters

a. Division of Labor with Respect to LBO Diligence

Weil represented THL in connection with THL’s due diligence and in preparing the documents related to the LBO. Weil was engaged to conduct “legal” due diligence in connection with the Refco acquisition.⁸⁸⁹ THL engaged KPMG to conduct financial, accounting, and tax diligence. THL also engaged McKinsey, Marsh, Inc., Mercer Consulting, and Sandler O’Neill to conduct various kinds of diligence.⁸⁹⁰ In addition, it appears that THL satisfied itself with respect to many diligence inquiries without relying on Weil or its other professionals. THL did not ask Weil generally to coordinate all of the diligence conducted on THL’s behalf.⁸⁹¹ Accordingly, Weil was not privy to all of the information collected by THL or THL’s agents during the diligence period. Weil worked with KPMG on certain tax matters in order to structure

⁸⁸⁷ WGM-R 0017385-86.

⁸⁸⁸ WGM-R 0018178-80; WGM-L 0039385-469; WGM-L 0039470-648.

⁸⁸⁹ Interview of Jay Tabor (“Tabor Interview”), 27:20-28:8.

⁸⁹⁰ Tabor Interview, 35:22-36:6; WGM-L 0011557-73.

⁸⁹¹ Tabor Interview, 36:7-17.

the acquisition, and Weil was provided copies of draft reports prepared by KPMG in connection with its diligence on financial, accounting, and tax matters.⁸⁹²

b. Weil's Initial Diligence in Connection with the LBO

Weil began its principal diligence work for THL in connection with the LBO by reviewing documents provided by Refco's investment banker, CSFB, in February 2004.⁸⁹³ In its initial review of documents, Weil appears to have learned that the RGL limited liability company agreement permitted the issuance of "profits membership shares," and Weil apparently accepted a representation that no such shares were then issued.⁸⁹⁴ Weil also learned that Refco was a party to the PPA.⁸⁹⁵ Although Weil appears to have recognized the existence of the PPA, it does not appear to have obtained or requested a copy of it. Weil notes from February 2004 regarding the PPA contain the notation "(Get copy of?)."⁸⁹⁶ A generally contemporaneous list of "open

⁸⁹² WGM-L 0002207.

⁸⁹³ It is not clear what documents Weil initially requested or CSFB made available for review. Weil has a generic request list for conducting its legal due diligence, which it then customizes depending on the issues posed by the "target," *i.e.*, the company to be acquired. Westra Interview, 98:13-99:11; WGM-L 0011206-17. Among other things, Weil's generic request list includes items such as:

- the Target's LLC agreement, as amended;
- all agreements among the officers or directors of the company relating to indemnity, employment, or compensation;
- all loan agreements or other debt instruments, including any guaranties of indebtedness by other persons;
- agreements governing accounts receivable or other securitization transactions;
- agreements providing for payments or benefits upon consummation of the proposed transaction;
- all federal, state, local, or other tax returns and reports filed for the last three fiscal years;
- all lease agreements relating to real property; and
- a list of all pending or threatened litigation or administrative proceedings.

It is not clear whether Weil used this generic list in this instance.

⁸⁹⁴ WGM-L 0010412-13 (notes from due diligence summarizing basic information about Refco).

⁸⁹⁵ *Id.*

⁸⁹⁶ *Id.*

diligence items” prepared by Weil, dated February 26, 2004, noted the PPA as a “minor point to keep track of.”⁸⁹⁷

Following its initial review of documents, Weil asked for additional documents to review. By March 31, 2004, the following material information that Weil had requested — sometimes multiple times — had not been made available:

- “employment agreements or arrangements with key employees;”⁸⁹⁸
- documentation for all of Refco’s debt;⁸⁹⁹
- information relating to Refco’s current or previous owners: RGHI, Refco Group Holdings, LLC, and BOI, including corporate documentation for such entities;⁹⁰⁰
- any written or oral arrangements among the owners/members of Refco “especially, although not exclusively, in connection with the sale of any part of [Refco];”⁹⁰¹
- an executed LLC agreement for Refco;⁹⁰²
- any agreement with the former managers of Refco, including Thomas Dittmer, William Graham, and Edwin Cox,⁹⁰³ including the agreement pertaining to Dittmer’s “carrier” interest in Refco entitling him to a payout should Refco sell itself or issue shares in a public offering,⁹⁰⁴ and
- a copy of “an intercompany debt agreement for \$16 million.”⁹⁰⁵

In late March, THL directed Weil and KPMG to suspend their diligence activities, indicating its “disappointment” that Refco could not respond to their diligence requests.⁹⁰⁶ Weil

⁸⁹⁷ WGM-L 0011187.

⁸⁹⁸ WGM-L 0011186; WGM-L 0011015; WGM-L 0011020.

⁸⁹⁹ WGM-L 0011015; WGM-L 0011020.

⁹⁰⁰ WGM-L 0011015; WGM-L 0011020.

⁹⁰¹ WGM-L 0011015; WGM-L 0011020.

⁹⁰² WGM-L 0011015.

⁹⁰³ *Id.*

⁹⁰⁴ WGM-L 0012477-78 n.1.

⁹⁰⁵ WGM-L 0011020.

admitted that it had been “frustrated” by Refco’s inability or unwillingness to respond to its requests, and there were numerous open items on Weil’s diligence list.⁹⁰⁷

c. THL’s Letter of Intent and Weil’s Continuing Diligence

In early April 2004, despite the lingering gaps in its diligence, THL made a proposal for the purchase of an interest in Refco. On or about April 19, the parties executed a Letter of Intent in which THL set forth generally the terms under which it would buy its interest, subject, among other things, to addressing diligence items and executing a definitive purchase agreement.⁹⁰⁸

The diligence items included:

- information Weil had previously requested relating to RGHI and BOI, the intercompany debt agreement, and discussion of employee matters;⁹⁰⁹
- information relating to “analysis of receivables as of February 28, 2003, November 30, 2003 and February 29, 2004 quantifying amounts due from customers; brokers and dealers; shareholders loans; and other loans, etc;”⁹¹⁰ and
- Refco’s tax returns for the years since 1999.⁹¹¹

Following execution of the Letter of Intent, Collins of Mayer Brown provided a series of memos to Tabor in May 2004 addressing the outstanding requests and providing additional information.⁹¹² In his interview with counsel to the Examiner, Tabor stated that Collins told him that there were no agreements or arrangements between Refco and its senior executives, and that Collins and Bennett repeatedly told him that there were no “transactions” between RGHI and

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⁹⁰⁶ THL/SEC 00051785; KPMG-THL 0024323, at App. D-57.

⁹⁰⁷ Tabor Interview, 132:10-133:13.

⁹⁰⁸ WGM-L 0007925-44, at App. D-55.

⁹⁰⁹ WGM-L 0007942-43.

⁹¹⁰ WGM-L 0007944.

⁹¹¹ *Id.*

⁹¹² E.g., WGM-L 0023344-54.

Refco.⁹¹³ These representations were later incorporated into the representations and warranties included in the Equity Purchase and Merger Agreement.⁹¹⁴

As of May 13, 2004, Weil was still seeking the information it had previously sought related to RGHI and BOI.⁹¹⁵ Despite its request for information relating to BOI, Weil did not undertake to contact BOI, its parent, or its counsel directly to ask for information.⁹¹⁶ Instead, Weil concluded it was more efficient simply to deal with Refco and to use Refco and its counsel (Mayer Brown) as an intermediary for collecting all information it needed regarding BAWAG or BOI.⁹¹⁷

d. KPMG's Diligence and Report on Accounting, Financial, and Tax Information

Meanwhile, following execution of the Letter of Intent, KPMG attempted to complete its diligence on financial, accounting, and tax matters. Weil learned that GT, Refco's auditor, refused to release to KPMG significant audit work papers, which KPMG stated had limited its

⁹¹³ Tabor Interview, 62:7-63:20 (stating that Weil was told on multiple occasions by Collins, Bennett, through written representations in the purchase agreement, and in response to questionnaires that "there were no transactions, period" between Refco and RGHI); 265:20-24.

⁹¹⁴ In section 3.3 of the Equity Purchase and Merger Agreement, RGHI represented and warranted that Exhibit A to the Agreement set forth "a true, complete and correct list of all of the members of [Refco] immediately preceding the execution and delivery of this Agreement." Exhibit A listed RGHI and BAWAG, but not any of the executives who had held profits membership interests in Refco. Similarly, section 3.12 stated, "Except as set forth on Schedule 3.12, since March 1, 2003, no officer . . . of [Refco] has had, either directly or indirectly, a material interest in any contract or agreement to which [Refco] is a party . . . except for employment contracts entered into on an arm's length basis." WGM-L 0017777, at App. D-51. Schedule 3.12 did not list any such interests. *Id.* In fact, eight Refco executives were due to receive a total of \$106 million as part of that very Agreement.

In section 3.15(vi), Refco represented that it was not bound by any "agreement which contains restrictions with respect to payment of any distribution in respect of any of the Membership Interests," WGM-L 0017780, except as disclosed in the schedules. No such agreement was listed in the schedules. WGM-L 0017969-73. In fact, Refco had entered into the PPA to require the payment to DF Capital of a portion of the proceeds that would otherwise be paid to RGHI.

⁹¹⁵ REFCO-0005-072185-87. Weil continued to seek information related to the possible "carrier" interest held by Dittmer and any other rights that may vest upon Refco's sale. *Id.* The evidence suggests that a meeting was conducted that day that addressed these issues, though the Examiner could not locate documents reflecting the results of that discussion or any information that was passed to Weil relating to these issues. THL/SEC 00011257.

⁹¹⁶ Tabor Interview, 197:3-198:8.

ability to complete the tasks THL had asked it to address. In a draft report to THL provided to Weil, KPMG stated that it could not determine the specific nature and extent of audit procedures performed by GT because of its limited access to the work papers.⁹¹⁸ In particular, KPMG stated in its May 17, 2004 draft report that GT would not make available its work papers documenting its audit conclusions related to Refco's credit risk loss reserves and the adequacy of such reserves, even though GT considered Refco's credit risk relating to customer balances to be a "critical" audit area.⁹¹⁹ KPMG's report also reflected a discussion in which Trosten stated that Refco had incurred a loss of \$42 million from customers whose positions had suffered reversals as a result of the 1997 Asian financial crisis and that Refco continued in 2004, some seven years later, to hold a reserve of the full \$42 million for that loss.⁹²⁰

KPMG also observed that as of February 28, 2003, "receivables from members, affiliated parties, and related parties" amounted to \$105 million, but that this amount had been received as of February 29, 2004.⁹²¹ KPMG did not describe in more detail what fell within the \$105 million figure, and the Examiner did not locate any evidence indicating that KPMG, THL, or Weil investigated this figure. Similarly, the Examiner did not locate any evidence in which Weil or THL addressed the potential inconsistency between KPMG's statement as to the related party

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⁹¹⁷ *Id.*

⁹¹⁸ WGM-L 0010268-69.

⁹¹⁹ WGM-L 0010268.

⁹²⁰ WGM-L 0010233; WGM-L 0012451, at App. D-58. KPMG also shared with THL its belief that Trosten would not be an effective CFO of a public company, though it did not include this conclusion in its written report. Interview with John Berndsen ("Berndsen Interview"), 31:10-32:15. THL shared this view, and THL expressed this view to Weil. WGM-L 0025262, at App. D-59. Though it was not reflected in the documents between the parties as a condition for closing, THL demanded to Bennett that Trosten be replaced after THL acquired a controlling interest in the company. Tabor Interview, 189:24-191:4.

⁹²¹ WGM-L 0010252.

receivables and Tabor's recollection of Collins' statement that there were no "transactions" between RGHI and Refco.

KPMG's May 21, 2004 "final" draft report reflected its review of Refco's tax returns for the years 2000-2002.⁹²² The tax returns for 2002 (and for 2003, which apparently were not complete at the time of the LBO diligence) included K-1 returns that appear to reflect that eight of Refco's senior executives held equity positions in Refco for those tax years.⁹²³ John Berndsen of KPMG stated that KPMG reviewed Refco's recent tax returns, but also stated that KPMG was not charged with determining the ownership of Refco.⁹²⁴ Tabor stated Weil undertook to verify the ownership of equity interests in Refco, but though at least one tax partner was on Weil's LBO team, and though Weil had included tax returns among the items it sought for its legal due diligence, Tabor stated that he believed that no one at Weil had reviewed the tax returns before the Equity Purchase and Merger Agreement was signed or before the LBO closed.⁹²⁵ The Examiner did not locate any document reflecting Weil's review of Refco's tax returns or its attempt to reconcile the apparent inconsistency between the tax returns and Collins' and Refco's statements that the only owners of Refco were RGHI and BOI.

e. THL's Receipt of Inside Information from "Deep Throat"

On or about May 25, 2004, as Weil and Mayer Brown were exchanging drafts of the Equity Purchase and Merger Agreement and related schedules, THL received a call from an employee at Bear Stearns who was an acquaintance of THL senior partner Scott Schoen.⁹²⁶ The

⁹²² WGM-L 0012462, at App. D-58.

⁹²³ EY-REF 021336-96; LJC 07048-64.

⁹²⁴ Berndsen Interview, 133:18-23.

⁹²⁵ Tabor Interview, 49:14-50:17.

⁹²⁶ KPMG-THL 0024324, at App. D-57; Attorney Proffer of Testimony of Scott Schoen ("Schoen Attorney Proffer"), 2:23-3:3. The Examiner sought to interview the THL representative most knowledgeable about facts

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Bear Stearns employee (the “Source”) informed Schoen that his cousin had learned that THL was considering an investment in Refco. The Source reported that his cousin had worked at Refco in the 1990s and had told the Source that while he worked there Refco had been “sloughing off” trading losses into a foreign subsidiary, based in the United Kingdom, whose financial statements were not consolidated with Refco’s.⁹²⁷ Schoen asked the Source the name of his cousin and asked whether the cousin would be willing to speak with THL. The Source had not been given authority by his cousin to provide his name to THL, though the Source told Schoen he would ask his cousin.⁹²⁸ THL made Weil aware of this “tip.”⁹²⁹

THL also contacted KPMG about the tip, and Berndsen abruptly cut short a trip to Paris to return to Boston to respond to the issue.⁹³⁰ Based on Berndsen’s recollection, THL did not describe the details of the tip to KPMG, saying only that an insider (to whom KPMG referred to as “Deep Throat”) had expressed reservations about the possible investment in Refco.⁹³¹ THL nevertheless asked KPMG how “something like this” may have manifested itself, and further asked KPMG to provide a list of procedures it might perform to address the issue.⁹³² KPMG suggested that THL (1) obtain RGHI’s financial statements and tax returns and reconcile them to

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relating to THL’s receipt of Refco “inside information” in May 2004 regarding Refco’s transfer of trading losses to an unconsolidated foreign subsidiary. Weil and THL offered to make Scott Schoen available to the Examiner for an interview limited to this subject; however, pursuant to its protocol with the USAO, the Examiner did not interview Schoen. Instead, the Examiner received a proffer of information from Schoen’s attorney setting forth his knowledge of the facts surrounding THL’s receipt and handling of the Refco inside information.

⁹²⁷ *Id.* at 4:4-12. Schoen and THL learned the identity of the Source’s cousin and that he had indeed worked for Refco in the 1990s but not for the last few years. Schoen Attorney Proffer, 5:6-10. The Source’s cousin, a/k/a Deep Throat, refused to speak with THL about the information he had imparted, however.

⁹²⁸ *Id.* at 4:20-24.

⁹²⁹ Westra Interview, 68:6-16.

⁹³⁰ Berndsen interview, 46:16-23.

⁹³¹ *Id.* at 38:11-39:12.

⁹³² *Id.* at 41:3-9.

Refco's financial statements, seeking to "isolate and investigate all items not flowing through from [Refco]";⁹³³ and (2) obtain details of the nature of all inter-company financing arrangements, both on- and off-balance sheet, and understand the controls over inter-company trading and funding transactions on behalf of customers and management of customer/counterparty limits.⁹³⁴ In his interview with counsel for the Examiner, Berndsen stated that these procedures would be "likely fairly simple" to address promptly.⁹³⁵ The Examiner concludes that these procedures, if implemented, should have detected the fraud.

After receiving the list of proposed additional diligence procedures, Scott Jaeckel of THL e-mailed Berndsen to indicate THL "was told to look for a 'London Overseas Subsidiary' for possible FX trading losses," and asked whether that "made sense" to Berndsen.⁹³⁶ Berndsen responded by e-mail that KPMG had seen in its diligence certain financial statements for Refco Europe in 2002, "audited by [GT UK] and presented in accordance UK GAAP (sic). Presumably such includes London Overseas Subsidiary. They were also light on the disclosure."⁹³⁷ Berndsen followed with an e-mail noting that Refco Overseas Ltd. was consolidated into Refco Europe Ltd., that Refco Europe Ltd.'s assets as of February 29, 2004 were approximately \$58 million, and that Refco had not provided any information about the subsidiary. Berndsen also noted there were "incidents" in the United Kingdom in 2001.⁹³⁸ Berndsen offered to discuss the

⁹³³ KPMG-THL 0019714-16, at App. D-60.

⁹³⁴ *Id.* The Examiner could not locate a copy of the document that was sent to Weil containing KPMG's proposed procedures. However, lawyers at Weil received THL's response to KPMG's list (WGM-L 0047309), and there are other documents reflecting contemporaneous e-mail communications between THL, KPMG, and Weil that have been redacted for privilege. WGM-L E028945.

⁹³⁵ Berndsen Interview, 52:21-53:12.

⁹³⁶ WGM-L 0047309.

⁹³⁷ KPMG-THL 0018038.

⁹³⁸ THL/UCC 00070314.

matter further with THL.⁹³⁹ After receiving Berndsen's response, however, THL did not ask KPMG to undertake any of the KPMG additional diligence procedures.⁹⁴⁰ In his interview, Berndsen stated that he was unaware of what more THL did to follow up on the allegation.⁹⁴¹

Following a conference call in which Westra participated, Lee and Schoen, along with fellow THL senior partner David Harkins, decided to meet with Bennett to address the matter.⁹⁴² Bennett met with Lee, Schoen, and Harkins on June 1.⁹⁴³ Schoen reported on the meeting to other members of the THL deal team as well as Westra and Tabor on June 2, 2004, noting that the meeting "went very well" and that "Phil was very constructive."⁹⁴⁴ Schoen summarized the discussion regarding the allegations in a June 2 e-mail as follows:

He says Overseas Ltd. and Royce Paris were unconsolidated subs in the 1990's. In f/x, where they broker as principal (with the client behind them with margin), there were some losses in the 1990's (less than 10 million dollars) that they ran through those subs to offset European taxable income, rather than paying taxes thereon [sic] other earnings and generating foreign tax credits. [sic] Since 1999 for Overseas Ltd and 2000 for Paris, all have been fully consolidated in the LLC rather than owned as separate entities by the S Corp.⁹⁴⁵

Through his Weil attorney, Schoen stated to the Examiner that based on this meeting, he did not believe at the time anything illegal or inappropriate had been done.

⁹³⁹ *Id.*

⁹⁴⁰ Berndsen Interview, 66:6-11; KPMG-THL 024322, at App. D-57.

⁹⁴¹ *Id.* at 79:19-80:17.

⁹⁴² THL/UCC 00033266, at App. D-61.

⁹⁴³ Schoen Attorney Proffer, 9:11-13.

⁹⁴⁴ WGM-L 0025237, at App. D-62.

⁹⁴⁵ *Id.* The Examiner notes that THL referred to Refco as "Royce" throughout the LBO diligence period. The Examiner has assumed in reviewing these documents that the "S Corp" refers to RGHI, which was a corporation organized under subchapter-S of the Internal Revenue Code. In response to a question from counsel to the Examiner following up on his attorney proffer, Schoen, through his attorney (Weil), stated he could not now recall if Bennett had indicated in this meeting or whether THL otherwise learned whether Bennett had known about this practice at the time it occurred.

Schoen also indicated in his June 2, 2004 e-mail that Bennett would review the next day how “the owners of the S Corp have handled the tax liabilities stemming from Royce,” and that Bennett offered to “rep that both historically and going forward the S Corp has had and will have no brokerage accounts with any Royce entities, as further assurance that there are no trades where the losses are being passed away.”⁹⁴⁶ THL accepted Bennett’s explanation and decided to proceed with execution of the Equity Purchase and Merger Agreement. Though Weil did not play a direct role in addressing the issues raised by the Source’s information, as noted above, THL kept Weil informed about its activities in seeking out Bennett to attempt to resolve the issue.

f. Preparation for and the Closing of the LBO and Related Transactions

As the parties reached agreement on the operative documents in advance of execution of the Equity Purchase and Merger Agreement, THL also undertook to understand how RGHI and Bennett would allocate the proceeds of the LBO transaction.⁹⁴⁷ THL noted that Bennett had been unwilling to provide this information previously.⁹⁴⁸ Five days before the Equity Purchase and Merger Agreement was signed, THL met with Bennett to discuss this allocation of proceeds, and THL reported to Weil that Bennett provided a description of how the proceeds of the transaction would be allocated.⁹⁴⁹ Tabor explained in his interview that as lawyer for the deal, Weil was not concerned with the allocation of proceeds received by RGHI other than to address

⁹⁴⁶ *Id.*

⁹⁴⁷ THL/SEC 00002828.

⁹⁴⁸ *Id.*

⁹⁴⁹ WGM-L 0025241.

the issues specified in the Equity Purchase and Merger Agreement, and he could not recall whether he discussed the allocation issue with THL.⁹⁵⁰

THL and Weil had intended to complete their due diligence before execution of the Equity Purchase and Merger Agreement, given that THL would be largely bound to proceed with the deal once it signed.⁹⁵¹ However, in connection with the preparation of the offering circular for the Senior Subordinated Notes, counsel for the underwriters — Cravath Swaine & Moore and Davis Polk & Wardwell — sought to conduct additional diligence.⁹⁵² Over the course of this subsequent diligence period, Weil discovered that Refco had failed to keep THL and Weil informed as to certain pending litigation and matters pending before the SEC that Weil and THL believed should have been disclosed.⁹⁵³ THL raised the issue with Bennett on June 19 to demand “the kind of open communication and transparency that we need as partners,” and addressed these issues to Weil.⁹⁵⁴

The parties executed the Equity Purchase and Merger Agreement on June 8. Leading up to the closing of the LBO, Weil prepared memoranda describing the steps to be taken at closing and the flow of funds among the various parties to accomplish the tasks required by the contractual agreements. Among those steps was the purchase by Bennett of Grant’s interest in RGHI, a condition that THL had imposed on RGHI in connection with the Equity Purchase and Merger Agreement.⁹⁵⁵ Similarly, the acquisition of BOI’s interest in Refco was described in the

⁹⁵⁰ Tabor Interview, 99:1-14.

⁹⁵¹ Tabor Interview, 184:21-185:3.

⁹⁵² WGM-L E023715.

⁹⁵³ WGM-L 0025262, at App. D-59.

⁹⁵⁴ *Id.*

⁹⁵⁵ Tabor Interview, 95:16-96:1.

Equity Purchase and Merger Agreement and in the closing memoranda prepared by Weil.⁹⁵⁶ The flow of funds memorandum described the flow of funds from THL and the various debt sources — as explained in the Credit Agreement and in the Senior Subordinated Note Agreement — to RGHI and Refco.⁹⁵⁷ The flow of funds memorandum also described the payment of \$500 million from Refco to RGHI, reflecting \$500 million of “free cash” that Refco had identified in the diligence process and that was to be paid to RGHI as part of the transaction.⁹⁵⁸ Other than as described above, the funds flow memorandum did not describe how RGHI would apply the proceeds of the LBO. The LBO closed on August 5, 2004.

The first recipients of proceeds from RGHI were the eight senior executives who had profits participation interests in Refco, apparently unbeknownst to THL and Weil. Documents reviewed by the Examiner indicate that in 2002, these eight executives were awarded profits participation interests under the Refco LLC agreement.⁹⁵⁹ In June 2004, following execution of the Equity Purchase and Merger Agreement, *RGHI*, apparently on behalf of RGL, had proposed to redeem these profits participation interests by paying the executives a portion of the proceeds received by RGHI.⁹⁶⁰ The Examiner located letters for seven of the eight executives, though not one for Trosten. On the day of the closing of the LBO, after RGHI received its proceeds, it paid a total of \$106,368,980 to these eight executives, including \$48,019,300 to Trosten.⁹⁶¹ Bennett individually received \$25,322,810 as compensation for the redemption of his interest.⁹⁶² The

⁹⁵⁶ WGM-L 0017796-97.

⁹⁵⁷ WGM-R 0007270-90.

⁹⁵⁸ Equity Purchase and Merger Agreement, § 5.9, WGM-L 0017795.

⁹⁵⁹ JM001 0001, at App. D-63.

⁹⁶⁰ E.g., WGM-R 0009698-99.

⁹⁶¹ RGHI-UC 00832.

⁹⁶² *Id.*

June 2004 redemption agreements reflected that additional payments would be made to certain of the executives at the end of calendar years 2005 and 2006.⁹⁶³ The evidence suggests that Weil was not aware of these redemption agreements at the time.⁹⁶⁴ Tabor stated in his interview that he was not aware of the profits participation interests and had never received any documents relating to such interests, even though Mayer Brown expressly represented that all documents relating to the equity interests had been provided.⁹⁶⁵

Further, on the same day as the LBO, another transaction closed involving BAWAG and its affiliates, DF Capital and Desana Foundation. Under the PPA, DF Capital had made payments to Refco in 2003 totaling \$467 million.⁹⁶⁶ In return, DF Capital received the right to participate in the proceeds of a sale of Refco. Accordingly, on August 5, 2004, pursuant to documents negotiated by Mayer Brown, on behalf of Refco and RGHI, and McDermott Will, on behalf of BAWAG and its affiliates, RGHI redeemed DF Capital's interest in the PPA by paying to Desana Foundation \$566 million.⁹⁶⁷ Finally, RGHI repaid a note in the amount of \$85 million issued by RGHI to BAWAG on May 14, 1999, which was the amount paid in 1999 by BAWAG to RGHI for an option to purchase an additional ten percent interest in Refco.

As part of the Equity Purchase and Merger Agreement, and as described in Weil's flow of funds memorandum, Refco was to wire \$500 million to RGHI as a dividend before THL's acquisition closed. Refco was obligated to maintain \$500 million in escrow from June 8, 2004

⁹⁶³ E.g., WGM-R 0009698, at App. D-64.

⁹⁶⁴ Tabor Interview, 117:17-21.

⁹⁶⁵ Tabor Interview, 202:19-203:1.

⁹⁶⁶ MWE 0002927-47, at App. D-65.

⁹⁶⁷ RGHI-UC 00832. Thus, BAWAG and its affiliates received \$757 million for their equity or proceeds participation interest in the transaction, combining the \$566 million paid under the PPA with the \$191 million paid pursuant to the Equity Purchase and Merger Agreement.

through the LBO closing. In fact, \$390 million of the \$500 million was not held by Refco; rather BAWAG simply overdrafted one of RGHI's accounts for \$390 million and credited one of Refco's accounts by that amount.⁹⁶⁸ Thus, on paper it appeared that Refco had a receivable due from BAWAG. After the LBO, on September 30, 2004, Refco wrote off a \$500 million receivable due from BAWAG.⁹⁶⁹ In addition, the wire that was to take place at the LBO closing did not take place.⁹⁷⁰

As noted above, Weil was aware of the existence of the PPA in February 2004 as part of its diligence. However, the Examiner has not found any evidence to suggest that Weil obtained a copy of the PPA before the closing of the LBO or that Weil or THL was aware of these transactions relating to the PPA that took place on the same day as the LBO.

Finally, documents reviewed by the Examiner reveal that RGHI paid Dittmer \$64,577,605 out of the proceeds of the LBO.⁹⁷¹ Further, these documents also indicate that RGHI paid MLC, described as "Dittmer's entity," \$10 million out of the LBO proceeds.⁹⁷² Though evidence suggests that Weil understood that Bennett owed "personal obligations" to Dittmer to make payments upon closing of the LBO,⁹⁷³ the Examiner has found no documents to suggest that Weil knew of these payments to Dittmer or to MLC.

⁹⁶⁸ May 2004 Statement for Refco's BAWAG account no. 00151-111-955 and May 2004 statement for RGHI's BAWAG account no. 00153-114-510. (No Bates number; obtained by FTI from Refco's counsel).

⁹⁶⁹ Refco September 2004 Journal Entry Detail. (No Bates number; furnished by FTI).

⁹⁷⁰ MWE 002915-17.

⁹⁷¹ RGHI-UC 00832.

⁹⁷² *Id.*

⁹⁷³ WGM-L 0010152.

4. Refco Engagement of Weil in Connection with Securities Filings and IPO Diligence

After the LBO, Refco engaged Weil to serve as Refco's primary counsel in connection with preparation and filing of Refco's S-4 registration statement and Refco's S-1 prospectus. Weil also managed the closing of the IPO for Refco in August 2005.

a. Weil's Diligence on Behalf of Refco in Connection with the S-4 and S-1 Filings

On October 12, 2004, Weil filed the initial Form S-4 for the exchange offer for the Senior Subordinated Notes privately issued under Rule 144A (the "registered notes offering").⁹⁷⁴ The SEC review process for the Form S-4 was extensive, involving six amendments and lasting until April 2005. The SEC made over one hundred comments to the initial S-4 filing alone.⁹⁷⁵ On April 8, 2005, the date the Form S-4 became effective, Weil filed on behalf of Refco the initial Form S-1 for the IPO.⁹⁷⁶ The SEC review process for the Form S-1 lasted until August 10, 2005 and involved five amendments. During these review periods, the SEC inquired into several topics which, if thoroughly addressed, might have led Weil to discover aspects of Refco's fraud. In addition, Weil became aware of instances where Refco had previously withheld material information. In those instances, though, the Examiner could not locate information to suggest that Weil undertook to fully verify subsequent representations relating to these topics.

In preparing the SEC filings, Weil relied on the documents and diligence first compiled in connection with the Offering Circular prepared for the private offering of notes in advance of the LBO. Because the privately placed notes were not registered, SEC disclosure requirements did not apply to the Offering Circular; however, given that a subsequent registered notes offering

⁹⁷⁴ REFCO-0005-069396-69631.

⁹⁷⁵ REFCO-0008-219177-219196.

and IPO were contemplated from the outset, Weil, Mayer Brown, and the banking sponsors' counsel (Cravath, Swaine & Moore and Davis Polk & Wardwell) undertook to prepare the Offering Circular with the upcoming registered note offering and IPO in mind.

Weil's due diligence for the registered note offering and IPO was managed by Weil attorneys based in New York and borrowed heavily from the LBO due diligence conducted by Weil attorneys principally based in Dallas. Weil explained that its public offering diligence focused on obtaining material information required for SEC disclosures, whereas its LBO diligence was aimed primarily at identifying liabilities of the target company that would affect the negotiated purchase price.⁹⁷⁷ Importantly, though THL chose to close on the LBO despite the acknowledged existence of gaps in Weil's and KPMG's due diligence, it does not appear that Weil undertook to fill any of the gaps in its diligence prior to making public disclosures for the registered note offering and the IPO. Weil acknowledged the need for an LBO team member to be involved in its diligence for the IPO, but only to hand off certain documentation and information to the IPO team in order to avoid duplication of diligence efforts that had been undertaken during the LBO process.⁹⁷⁸ The IPO diligence team presumed that the LBO diligence had been adequate, and their "bring-down" diligence requests related solely to the period beginning August 5, 2004.⁹⁷⁹ Weil's IPO team requested from Refco relevant materials not previously made available in connection with the LBO, but it does not appear that Weil

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⁹⁷⁶ REFCO-E-001311044-1311263; WGM-R 0018744.

⁹⁷⁷ Lynch Interview, 23:2-24:18.

⁹⁷⁸ REFCO-E-002148719; Broudy Interview, 49:23-50:19.

⁹⁷⁹ REFCO-E-002148721; Broudy Interview, 17:17-18:4.

undertook to verify that all such materials had been provided, even after Weil learned that there were instances in which Refco had not provided materials previously requested.

In preparation for the registered notes offering and IPO, Weil requested from Refco information regarding organizational documents, accounting and auditing materials (including management letters), financing documents, shareholder matters (including related party transactions), taxation, and other regulatory matters. Because Weil had previously requested most of these materials during its LBO diligence, Weil's IPO request was for documents "since August 5, 2004" not previously received. In addition to requesting documents created after the LBO closed, Weil circulated Director and Officer ("D&O") Questionnaires designed to elicit material information required for disclosure under SEC rules. Weil also coordinated numerous due diligence conference calls among various members of the working group to review Refco's risk management policies, customer profile, businesses, litigation history, internal controls, and regulatory investigations. Weil reviewed corporate governance guidelines and checked to see that Refco's written charters, policies and codes complied with applicable regulatory standards.⁹⁸⁰ Weil assisted Refco in revising its corporate governance policies and procedures and provided guidance in Refco's dealings with its board members and the creation of its audit committee.⁹⁸¹

Lawyers at Weil stated in their interviews that their due diligence during the period of time when they worked on the registered notes offering and the IPO focused on uncovering and adequately describing matters required to be disclosed in the S-4 and S-1 filings. Weil stated that it deferred to the various accountants involved (in particular, GT and PwC) to review and

⁹⁸⁰ E.g., WGM-R E023353-55.

⁹⁸¹ E.g., WGM-R E166939-40; WGM-R E 023353-55.

verify Refco's financial disclosures, particularly with respect to intercompany and related party transactions.⁹⁸²

b. Weil's Handling of SEC Inquiries Regarding Credit Losses, Customer Receivables, and Receivables from Equity Members

In its review, the SEC commented on several risk factors and requested additional information relating to credit losses and customer receivables. In some instances, rather than provide explanations requested by the SEC, Refco simply changed the disclosure.

For example, the SEC requested in its first round of comments that Refco disclose the amount of any credit losses due to customer defaults.⁹⁸³ Refco's Amendment No. 1 to the Form S-4 did not address the SEC's request. Instead, it simply disclosed Refco's reserves against receivables.⁹⁸⁴ Alexander Lynch, who led the Weil team for the S-4 and S-1 filings, stated that Weil followed up with Refco to ascertain the amount of credit losses due to customer defaults. According to Lynch, William Sexton, Refco's COO, reviewed Refco's customer loss prevention procedures with Weil, PwC, and GT, and represented that the amount of credit losses due to customer defaults was insignificant.⁹⁸⁵ When questioned by counsel for the Examiner about why Refco did not provide the actual credit loss amount in the Form S-4 as requested by the SEC, Lynch explained that he understood the relevant number in measuring potential future customer losses to be Refco's reserve against receivables because that number reflected the company's view of the likely customer defaults.⁹⁸⁶ When Refco subsequently reported a \$15 million write-

⁹⁸² Lynch Interview, 98:11-99:19.

⁹⁸³ REFCO-0008-219182 (SEC Comment 27).

⁹⁸⁴ See Amendment No. 1 to Form S-4 (PwC 044715) at p. 22.

⁹⁸⁵ Notes and documents from Weil's files confirm that during due diligence meetings and presentations, considerable attention was devoted to the fact that Refco historically had suffered only minimal losses and write-offs on customer receivables. Lynch Interview, 206:14-207:11.

⁹⁸⁶ *Id.*, 207:21-208:10.

off of its reserve for customer receivables for the period ending February 28, 2005, as compared to none during the two previous years,⁹⁸⁷ however, there is no evidence that Weil followed up to obtain additional information regarding the write-off.⁹⁸⁸

The SEC also inquired specifically into Refco's disclosure of its receivables from equity members and related parties.⁹⁸⁹ The initial Form S-4 noted that receivables from equity members RGHI and BAWAG were included in "receivables from customers" on Refco's consolidated balance sheet and cash flow statement.⁹⁹⁰ In response to the SEC's request for a supplemental explanation as to why Refco deemed it appropriate to classify these related party receivables as receivables from customers, Refco added line items to the consolidated balance sheet and cash flow statement to separately disclose \$210,223,000 and \$280,545,000 as "receivables from equity members" for fiscal years 2004 and 2003, respectively.⁹⁹¹ No supplemental explanation was provided to the SEC relating to these receivables, however, and the Examiner has not located any evidence to suggest Weil inquired as to why Refco had initially classified the related party receivables as receivables from customers.

Note L to the consolidated financial statements included in the Form S-4 indicated that the RGHI receivables were received by February 29, 2004, and that the BAWAG receivables were liquidated shortly after each year-end.⁹⁹² Lynch stated that Weil discussed with Refco the

⁹⁸⁷ See Amendment No. 1 to Form S-1 (PwC 269323-517 at 269517) at Schedule 11.

⁹⁸⁸ Lynch stated that he did not recall any discussions regarding the write-off and, in his view, the \$15 million amount was low relative to the revenues of the company at the time. Lynch Interview, 214:20-23. However, KPMG reported that GT applied a materiality threshold of \$10 million in conducting its audit of Refco's consolidated financial statements. See WGM-L 0010228-79 at 10269, at App. D-66.

⁹⁸⁹ WGM-R 0011859-80 (SEC comment letter dated November 10, 2004) at 11876 (comment 97).

⁹⁹⁰ REFCO-0005-069396-69631 at 69581 (Note L).

⁹⁹¹ PwC 044689-951 at pp. F-3, F-6, and F-26.

⁹⁹² *Id.* at F-26.

fact that it received the RGHI and BAWAG receivables at the end of February 2004, but generally deferred to GT and PwC to confirm that such payments were, in fact, made and to keep track of whether the transactions were not ongoing.⁹⁹³ The Examiner did not locate any information to suggest that Weil itself requested any underlying documentation for the RGHI and BAWAG transactions disclosed in Note L.

c. Weil's Handling of SEC Inquiries Regarding Trosten's Resignation

In its first round of comments to Refco's Form S-4, the SEC requested a discussion of the actions that preceded and followed, and the facts that led up to, Trosten's resignation as Refco's CFO.⁹⁹⁴ Weil learned prior to the closing of the LBO in August 2004 that THL intended to replace Trosten as Refco's CFO.⁹⁹⁵ Weil understood that THL intended for Trosten to have a new role at Refco following the LBO, and that Trosten was informed of his new role by Bennett prior to August 2004.⁹⁹⁶ Trosten made an equity investment in Refco at the time of the LBO, along with other executives, seemingly accepting his demotion. On September 7, 2004, one month after the LBO closed, Trosten announced his resignation.⁹⁹⁷ Trosten's announcement was unexpected by the Weil attorneys involved in the LBO.⁹⁹⁸ Yet there is no indication that Weil

⁹⁹³ Lynch Interview, 211:21-212:9.

⁹⁹⁴ WGM-R 0011859-79 at 11871 (Comment 69).

⁹⁹⁵ See WGM-L0025262 (June 19, 2004 e-mail from Schoen to Tabor). Schoen informed Tabor that Bennett intended to have a conversation with Trosten about his "new role" at Refco after THL's acquisition. THL agreed that Bennett should have this discussion with Trosten before THL agreed to allow Trosten to purchase a "meaningful amount of equity" in Refco as part of the LBO.

⁹⁹⁶ *Id.*

⁹⁹⁷ WGM-R E156892.

⁹⁹⁸ E-mail messages among Weil attorneys involved in the LBO reflect their surprise at Trosten's sudden departure. Tabor comments that Trosten's resignation was "interesting" considering Trosten invested \$2.5 million in the company and "has no right to get his money back unless the company decides to buy him out." WGM-R E156950 (e-mails between Tabor and Angela Fontana dated Sept. 10, 2004). Fontana responds: "I have to tell you I was

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sought further explanation for Trosten's resignation either after learning about it on September 7, 2004, or in response to the SEC's request for additional details. Instead, Weil simply responded on behalf of Refco to the SEC's question with a short statement that Trosten's decision to resign was straightforward and there were no significant details surrounding the resignation.⁹⁹⁹

d. Weil's Handling of SEC Inquiries Regarding LBO Accounting and Transaction Steps Presentation

Two topics that led to numerous discussions among Weil, Refco, and the SEC throughout the review process were accounting for the LBO transactions and the use of the LBO proceeds. After Amendment No. 1 was filed, Weil prepared and submitted to the SEC a "transactions steps presentation," derived largely from the funds flow memorandum prepared by Tabor and the LBO team. Weil also coordinated several conference calls with the SEC to answer additional questions relating to the LBO accounting. As detailed below, Weil documents suggest that representatives from Refco, THL, PwC, GT, and KPMG participated either in conference calls with the SEC, or in conference calls led by Weil in preparation for the SEC calls.

Lynch stated in his interview that he understood the SEC's interest in the LBO to be focused primarily on accounting treatment under EITF 88-16 relating to basis calculations in the context of leveraged buyouts. Broudy's notes from SEC calls suggest that the SEC was interested in more than simply valuation and structure, however, and asked how much of the proceeds went to BAWAG and RGHI.¹⁰⁰⁰ Similarly, Lynch's notes reflect that, during a January 27, 2005 conference call, the SEC inquired into the use of the LBO proceeds and specifically

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surprised that he invested that much money when I knew he had been told about the CFO thing before he invested so I just assumed he had gotten comfortable with it. ***Who knows, maybe he just made enough money in the original buy-out and is rethinking life.***" *Id.* (Emphasis added).

⁹⁹⁹ REFCO-E-001711836, Response to SEC.

asked how much of the proceeds ultimately went to Grant and Bennett, and what RGHI did with its portion of the proceeds.¹⁰⁰¹ Clearly, the SEC was interested in knowing how the LBO proceeds had been used, and in greater detail than had been disclosed in Amendment No. 1 to the Form S-4.

In connection with these conversations, Weil's LBO team prepared and its IPO team circulated a presentation illustrating the LBO transaction steps and flow of funds.¹⁰⁰² An early draft of the transaction steps presentation reflects some emphasis on the fact that Refco had on its balance sheet \$500 million in cash, which would be distributed to RGHI in the LBO.¹⁰⁰³ The same draft also makes reference to the “mechanics” of how this payment would be made.¹⁰⁰⁴ These references were deleted from subsequent drafts of the transaction steps presentation, but the final version included a representation to the SEC on various pages and in an appendix that Refco distributed \$500 million to RGHI as a step in the LBO transaction.¹⁰⁰⁵ Lynch stated that he did not personally confirm that the funds flowed as represented to the SEC in the transaction steps presentation, but that he confirmed the accuracy of the representations by talking with Tabor and Adam Nelson — two members of Weil's LBO team.¹⁰⁰⁶ According to Tabor, Weil never undertook to confirm that the \$500 million was, in fact, transferred from Refco to RGHI prior to making its representations to the SEC.¹⁰⁰⁷ The funds flow memorandum (and, therefore,

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¹⁰⁰⁰ WGM-R 0006167.

¹⁰⁰¹ WGM-R 0014385.

¹⁰⁰² See Lynch Interview, 151:14-153:6; REFCO-E-001700984-996.

¹⁰⁰³ REFCO-E-001700987.

¹⁰⁰⁴ REFCO-E-001700992.

¹⁰⁰⁵ REFCO-E-001671200-12.

¹⁰⁰⁶ Lynch Interview, 159:13-16.

¹⁰⁰⁷ Tabor Interview, 235:24-236:4.

the transaction steps presentation) did not fully describe how RGHI used the proceeds of the LBO, despite the SEC's interest in knowing details regarding how the LBO proceeds would be used.

e. Weil Learns in Approximately March 2005 that Refco Had Provided False and Misleading Information During the LBO About the Existence of Profits Participation Interests

While not the subject of any specific SEC comment, in the course of its preparation of Refco's SEC filings, Weil became aware of the profits participation agreement between Refco and certain Refco executives and that RGHI made payments at the closing of the LBO to the executives to redeem their "profits participation interests." Lynch and Broudy both stated that Weil was not informed of any profit sharing arrangements prior to March 2005 (though their recollections vary as to when and how Weil discovered the existence of the profit sharing agreement). Weil previously requested on numerous occasions in connection with the LBO, the registered note offering, and the IPO, all information regarding Refco's agreements with and compensation to its executives.¹⁰⁰⁸

On January 10, 2005, Weil received Sexton's responses to his D&O Questionnaire for the Form S-1, which disclosed that he had filed a Schedule K-1 for the calendar years 2002 and 2003 and he had received in 2003 \$1,640,497 as "Proceeds from Sale of 'Profits Interest.'"¹⁰⁰⁹ The K-1 Schedules for Refco's 2002 and 2003 tax returns reflected that eight Refco executives held equity positions for those years. Weil thus would have discovered that eight Refco executives

¹⁰⁰⁸ For example, D&O Questionnaires completed in July 2004 in preparation for the Form S-4 asked for information pertaining to transactions with management. Each individual who completed these questionnaires responded that no such transactions existed. In December 2004, Weil circulated D&O Questionnaires in preparation for the Form S-1 and again asked for information regarding transactions with management. As discussed below, only two of the six individuals who completed these questionnaires ultimately disclosed in their written responses the profit sharing agreement.

¹⁰⁰⁹ WGM-R 0003352-3, at App. D-67 (Sheet 2 to W. Sexton D&O Questionnaire signed January 10, 2005).

held partnership interests in Refco in 2002 and 2003 if Weil had followed up on Sexton's disclosure regarding his K-1 by reviewing Refco's tax returns for those years.

Sexton's D&O Questionnaire response further disclosed that, pursuant to a June 18, 2004 letter agreement between Refco and Sexton, Refco agreed to acquire his "outstanding profits participation interest" for a total of \$9,043,850, of which \$7,060,870 was paid to Sexton upon the closing of the LBO, and the remaining amount would be accelerated in the event of a change of ownership or an IPO.¹⁰¹⁰ Although Broudy and Lynch both emphasized in their interviews the importance of the D&O Questionnaires to their due diligence, neither recalled reviewing Sexton's January 2005 D&O Questionnaire response disclosing his profit sharing arrangement.

According to Lynch and Broudy, Weil learned of the profit sharing agreement sometime around March 2005. Lynch stated that the profit sharing agreement was first brought to his attention in connection with Sexton's D&O Questionnaire.¹⁰¹¹ Lynch later admitted that he perhaps learned about the profit sharing arrangement for the first time through a March 17, 2005 e-mail from Scott Jaeckel of THL discussing SEC disclosure issues for the IPO.¹⁰¹² Broudy stated that she first learned of the profit sharing agreement through a phone call from Joseph Murphy, a senior Refco executive, in connection with his D&O Questionnaire.¹⁰¹³ Murphy explained that Sexton intended to disclose his profit sharing arrangement as part of a schedule to his D&O Questionnaire responses.¹⁰¹⁴ Weil requested and received copies of Murphy's and Sexton's nearly identical redemption letters, dated June 18, 2004.

¹⁰¹⁰ WGM-R 0003353, at App. D-67.

¹⁰¹¹ Lynch Interview, 162:1-4.

¹⁰¹² WGM-R 0014614; Lynch Interview, 163:16-164:8.

¹⁰¹³ Broudy Interview, 126:24-127:17.

¹⁰¹⁴ *Id.*

On April 5, 2005, Weil filed Amendment No. 5 to the Form S-4, which disclosed the profit sharing agreement for the first time. After updating the S-4 to disclose Murphy's and Sexton's redemption payments from the profit sharing agreement, Weil was informed by Refco that profit sharing redemption letters existed for Klejna and Maggio.¹⁰¹⁵ On April 6, 2005, Weil filed Amendment No. 6, revising the disclosure to include details for RGHI's redemption of Klejna's and Maggio's¹⁰¹⁶ profits participation interests.

In addition to the four executives named in the Amended Form S-4, the Examiner has located profits participation redemption letters for Bennett, Grady, and Mutterer.¹⁰¹⁷ Refco's tax returns suggest that Trosten was also party to the profit sharing agreement.¹⁰¹⁸ Weil apparently was not aware of their participation in the profit sharing agreement, however, and therefore never disclosed their redemption payments in Refco's SEC filings.

Weil thus discovered in March 2005 that several Refco executives had failed to disclose the profit sharing agreement, despite Weil's inquiries throughout the LBO and IPO processes, but that fact evidently did not prompt Weil to verify whether Bennett, Trosten, or any other Refco executives were parties to the profit sharing arrangement. Neither Lynch nor Broudy recalled specifically requesting a copy of the underlying profit sharing agreement, and neither knew whether a written profit sharing agreement even existed.¹⁰¹⁹ It does not appear that Weil

¹⁰¹⁵ *Id.* at 144:8-14.

¹⁰¹⁶ Maggio received another redemption letter from *Refco* dated July 25, 2005, purportedly revising his redemption agreement to provide for \$5,289,040 in additional compensation to be paid either in equal installments on December 31, 2005 and 2006, or upon completion of Refco's IPO. The Examiner did not locate any evidence to suggest that Weil was ever informed of the revision, and neither the S-4 nor the S-1 was updated with the new information. Broudy Interview, 154:19-20.

¹⁰¹⁷ REFCO-HC-0037863-64, at App. D-64 (Bennett); REFCO-HC-0021272-73, at App. D-64 (Grady); REFCO-HC-0021193-94, at App. D-64 (Mutterer).

¹⁰¹⁸ JM001 0001-02, at App. D-63 (January 8, 2003 Memo describing establishment of profits participation interests); EY-REF 021372-76 (2002 Return); LJC 07063 (2003 Return); PWC 395628-30 (2004 Return).

¹⁰¹⁹ Broudy Interview, 132:21-133:2; Lynch Interview, 168:14-169:9.

ever requested, received, or reviewed any documents through which Refco had granted the profits participation interest to its executives, and the Examiner has located no evidence that Weil sought an explanation of why RGHI — and not Refco — redeemed an interest pursuant to an agreement entered into by Refco.¹⁰²⁰ Moreover, despite Weil’s discovery that Bennett and other Refco executives had made material misrepresentations during the LBO process in failing to disclose the profit sharing agreement with Refco, the Examiner has located no evidence that Weil made any effort to determine whether other aspects of the LBO diligence had also been incorrect.

f. Weil Learns that Refco Is Resisting Disclosure Regarding Findings About Internal Control Deficiencies

Weil learned during the course of its IPO diligence that Refco had not disclosed during the LBO diligence certain documents that identified internal control deficiencies, and Refco continued to resist disclosure of these deficiencies in the S-1 statement.

During its IPO diligence period, Weil received copies of GT’s management letters reporting significant deficiencies in Refco’s controls over financial reporting. On March 21, 2005, Youngjoon Park, Refco’s assistant general counsel, faxed to Broudy a draft of the 2004 Management Letter with the note: “Management letter attached. This letter should NOT be circulated.”¹⁰²¹ Weil’s files contain copies of this fax with Broudy and Lynch’s handwritten notes, suggesting there was a conference call to discuss the letter.¹⁰²² The notes indicate that the company had received a management letter in 2003 that had not been disclosed during the LBO

¹⁰²⁰ Broudy Interview, 161:18-162:3.

¹⁰²¹ WGM-R 0005619 (emphasis in original).

¹⁰²² *Id.*

diligence process. Thus, Weil learned that Refco's management had been less than forthcoming in turning over material documents during the LBO process.¹⁰²³

Indeed, it appears that Weil may have learned that Refco attempted to mislead KPMG. In conducting its accounting diligence for the LBO, KPMG attempted to review management letters but was told that GT did not issue formal management letters as part of its Refco audit.¹⁰²⁴ Refco represented that there were no significant matters relating to internal controls that could have a material effect on Refco's consolidated financial condition.¹⁰²⁵

In the draft 2004 management letter provided to Weil, GT noted several internal control deficiencies relating to Refco's internal audit and accounting functions.¹⁰²⁶ After discussing the issues raised in the management letter with GT, Weil followed up with Refco, which responded that it was recruiting an Internal Audit Director and that Refco's board had established an Audit Committee to oversee Refco's accounting and financial reporting processes and the auditing of its financial statements. In addition, Refco stated that it was recruiting a Chief Accounting Officer to lead the financial reporting effort, along with Refco's CFO, Controller, and accounting staff, to identify risk areas and fill any gaps within the accounting function.¹⁰²⁷

¹⁰²³ Park was not hired until after LBO diligence was completed. Tabor Interview, 220:2-8.

¹⁰²⁴ WGM-L 0010269. KPMG stated in its May 17, 2004 draft diligence report that GT had made certain recommendations to Refco management in connection with its audit, however, and that the same recommendations had been made in prior years, though GT did not make available to KPMG its memoranda relating to the recommendations. *See also* WGM-L 003673-710 at 3706 (KPMG "final" draft report dated May 21,2004).

¹⁰²⁵ *See* WGM-L 0010269.

¹⁰²⁶ Specifically, GT indicated that Refco's engagement of PwC to fill current gaps in accounting and financial reporting was not a sufficient long-term solution. GT pointed out Refco's unsatisfactory audit support, noting that Refco had not been responsive in providing information necessary to complete the audit in a timely and efficient manner. GT further noted that, on occasions, audit requests were only partially completed, generally lacking the detail requested and required for timely completion of the audit. REFCO-E-001478369.

¹⁰²⁷ REFCO-E-001478369.

At some point in March 2005, GT informed THL, who in turn informed Weil, that it would be issuing a management letter for 2005, much like its 2004 management letter, and Weil obtained a copy of the draft 2005 letter.¹⁰²⁸

E-mail correspondence reflects that Weil and Refco resisted disclosing the significant deficiencies reported by GT, but ultimately acceded to the banking sponsors' insistence that the S-1 include a disclosure regarding the significant deficiencies.¹⁰²⁹

By July 22, 2005, a draft of the "significant deficiencies" insert for the S-1 had been circulated to GT for comment.¹⁰³⁰ Amendment No. 4 to the Form S-1, filed on July 25, 2005, disclosed that Refco's auditors reported two significant deficiencies in Refco's internal controls over financial reporting. According to the auditors, Refco needed to (1) increase finance department resources to prepare timely financial statements compliant with SEC reporting guidelines, and (2) establish formalized procedures for closing Refco's books. The Form S-1 was amended to disclose the identified deficiencies¹⁰³¹ and to state that Refco was in the process of hiring additional internal audit and finance personnel and developing formalized closing procedures.¹⁰³²

¹⁰²⁸ WGM-R 0000989.

¹⁰²⁹ REFCO-E-001702968-70.

¹⁰³⁰ REFCO-E-002064679.

¹⁰³¹ PwC 292443 (Amendment No. 4 to Form S-1 at p. 23).

¹⁰³² *See id.*

5. Conclusions: Analysis of Potential Claims Against Weil¹⁰³³

a. Legal Malpractice

As more fully addressed in Appendix A, the elements of a claim for legal malpractice are (1) a breach of a duty of care; (2) causation; and (3) damages. Although it is a close question, the Examiner concludes that there are facts that could support an allegation that Weil failed to adhere to the standard of care applicable to its representation of Refco in connection with the S-4 and S-1 filings. The Examiner assumes that if the other elements of a legal malpractice claim are proven, Refco's estate could prove damages. The evidence supporting a possible malpractice claim is highlighted below.

(i) Breach of Duty of Care

As explained below, there is evidence that Weil failed to adhere to the applicable standard of care by failing to examine properly and confirm the statements made in the S-4 registration statement and the S-1 prospectus. The standard of care applicable to an attorney representing a company filing public statements in connection with the sale of securities or an exchange offer was announced in the seminal *Escott v. BarChris Constr. Corp.* case,¹⁰³⁴ in which the court held that attorneys involved in preparing registration statements and other securities filings must not rely blindly on the statements of their clients, but instead should conduct "a check of matters easily verifiable" by reference to original written records.¹⁰³⁵ Arguably this

¹⁰³³ The Examiner received a confidential letter from Weil dated April 4, 2007 that addresses issues pertaining to potential claims against Weil. The Examiner has considered Weil's submission in reaching the conclusions set forth in this Report.

¹⁰³⁴ 283 F. Supp. 643 (S.D.N.Y. 1968) (securities investor suit setting forth applicable standard of care of issuers' counsel).

¹⁰³⁵ *Id.* at 690. Though *BarChris* itself involved a Section 11 action, similar standards appear to apply in common law malpractice cases. *See Nat'l Enter. Corp. v. Dechert, Price & Rhoads*, 667 N.Y.S.2d 745, 746 (1998) (affirming denial of law firm's summary judgment motion where firm had failed to advise client to disclose material fact in securities filings); *see also FDIC v. O'Melveny & Myers*, 969 F.2d 744, 748-49 (9th Cir. 1992), *rev'd and remanded on other grounds*, 512 U.S. 79 (1994), *prior opinion adopted in haec verba*, 61 F.3d 17 (9th Cir. 1995)

(footnote continued on next page)

standard of care required Weil to, at a minimum, (i) confirm statements of Refco's management by undertaking complete due diligence with respect to the S-4 and S-1 filings, including completing the LBO due diligence efforts that were not undertaken or had been initiated but were not completed, rather than simply limiting its diligence to the post-LBO time period; and (ii) upon learning that Refco had misled Weil regarding certain material matters, conduct further investigation with respect to at least those matters and perhaps others.

***(a) Weil Erroneously Assumed that the LBO
Diligence Was Adequate and Failed to Follow Up
on the “Deep Throat” Allegations***

Weil arguably breached its duty of care by failing to undertake complete due diligence with respect to the S-4 and S-1 filings. Although Weil undertook considerable diligence, its diligence placed undue reliance on its LBO diligence efforts, including efforts that had been begun but were not completed. Weil also failed to follow up on matters, such as the “Deep Throat” allegations, that THL had chosen not to pursue.

Weil’s principal error in its post-LBO diligence was in presuming that the LBO diligence had been adequate when Weil knew that, for a variety of reasons, it was inadequate and incomplete. As previously explained, due diligence for the registered note offering and IPO was managed by Weil attorneys based in New York and borrowed heavily from the LBO due diligence conducted by Weil attorneys principally based in Dallas.¹⁰³⁶ The IPO diligence team presumed that the LBO diligence had been adequate, and the IPO diligence team’s “bring-down”

(footnote continued from previous page)

(holding that client could state claim against law firm for firm’s alleged failure to undertake a reasonable, independent investigation to detect fraud in securities filings).

¹⁰³⁶ Weil also apparently relied on the documents and diligence first compiled by the banking sponsors’ counsel (Cravath, Swaine & Moore and Davis Polk & Wardwell) in connection with the Offering Circular prepared for the Senior Subordinated Notes private offering in advance of the LBO. WGM-L E023715.

diligence requests therefore related solely to the period beginning August 5, 2004.¹⁰³⁷ Weil acknowledged the need for an LBO team member to be involved in its diligence for the IPO, but only to hand off certain documentation and information to the IPO team in order to avoid duplication of diligence efforts that had been undertaken during the LBO process.¹⁰³⁸

The assumption by Weil's IPO diligence team that the LBO diligence was adequate was erroneous. Weil knew, based on its prior representation of THL in connection with the LBO, that there were major gaps in the LBO diligence because Refco had not furnished certain requested materials before THL called off the diligence efforts. In particular, Weil knew that it and THL had repeatedly requested the following information that Refco did not furnish:

- “employment agreements or arrangements with key employees;”¹⁰³⁹
- documentation for all of Refco’s debt;¹⁰⁴⁰
- corporate information and any written or oral arrangements among the owners/members of Refco “especially, although not exclusively, in connection with the sale of any part of [Refco];”¹⁰⁴¹ and
- information relating to “analysis of receivables as of February 28, 2003, November 30, 2003 and February 29, 2004 quantifying amounts due from customers; brokers and dealers; shareholders loans; and other loans, etc.”¹⁰⁴²

In addition, Weil was aware of the “Deep Throat” allegations and KPMG’s list of relatively simple additional diligence steps to investigate those allegations. THL chose to proceed with the LBO despite the gaps in diligence and the “Deep Throat” allegations, and THL therefore

¹⁰³⁷ REFCO-E-002148721; Broudy Interview, 17:17-18:4.

¹⁰³⁸ REFCO-E-002148719; Broudy Interview, 49:23-50:19.

¹⁰³⁹ WGM-L 0011186; WGM-L 0011015; WGM-L 0011020.

¹⁰⁴⁰ WGM-L 0011015; WGM-L 0011020.

¹⁰⁴¹ WGM-L 0011015; WGM-L 0011020.

¹⁰⁴² WGM-L 0007944.

apparently instructed Weil and KPMG not to pursue these diligence issues further with respect to the LBO.

Nevertheless, when *Refco* engaged Weil to prepare the S-4 and S-1 filings, Weil assumed a duty to *Refco* to conduct sufficient diligence to confirm the accuracy of representations in the SEC filings. Because Weil knew from its prior representation of THL in connection with the LBO that the LBO diligence was not completed, Weil arguably was duty-bound to fill in the information gaps of the prior LBO diligence. At a minimum, Weil could have obtained the documents previously requested but not furnished by *Refco* in connection with the LBO diligence. In addition, Weil could have investigated the “Deep Throat” allegations — perhaps by undertaking the relatively simple diligence steps that KPMG had suggested but which THL chose not to pursue.¹⁰⁴³ Although such information was relevant to the S-4 and S-1 filings, Weil failed to obtain it.¹⁰⁴⁴

(b) *Weil Failed to Investigate Further upon Learning that Refco Had Provided False and Misleading Information Regarding Senior Executives’ Profits Participation Interests in Refco*

By no later than March 2005, Weil learned that *Refco* had previously provided false and misleading information regarding the existence of *Refco* executives’ profits participation interests in *Refco*. As previously explained, in January 2005, in responding to another questionnaire in connection with the S-4, Sexton disclosed that he had received a payment in

¹⁰⁴³ Before ceasing further investigation of the “Deep Throat” allegations in favor of closing the LBO, THL learned, and informed Weil, that “Deep Throat’s” allegations of *Refco* “sloughing off” trading losses to a subsidiary were largely true, although Bennett stated that *Refco* no longer engaged in the practice. In response to THL’s inquiry relating to *Refco Europe*, Bennett offered to represent to THL that *RGHI* had not and would not trade on its own account with *Refco* as assurance that there were no trades where the losses were being “sloughed off.” WGM-L 0025237, at App. D-62.

¹⁰⁴⁴ Weil also failed to follow up on obtaining the PPA, which it had identified during the LBO diligence but had never obtained.

connection with the LBO. Weil may not have reviewed Sexton's questionnaire responses in a timely manner or at all. Broudy said that Murphy told her in March 2005 about Sexton's receipt of LBO funds. This revelation led to further questions by Weil, which eventually led to Weil's discovery that, contrary to Refco's prior representations, four Refco executives (Sexton, Murphy, Maggio, and Klejna) had profit participation interests in Refco, that RGHI — not Refco — had redeemed those interests, and that they had received LBO proceeds from RGHI in redemption of those interests. Weil says it asked Klejna whether there were any other executives who received payments out of the LBO proceeds, and Klejna told them "no."

Weil appears to have simply accepted Klejna's representation without further inquiry, despite the fact that during Weil's LBO diligence on behalf of THL, Refco's senior executives and Refco's then-counsel (Mayer Brown) informed Weil and THL that Refco had not issued any profits participation interests under its LLC agreement. Moreover, once it learned that four senior executives had profits participation interests, Weil apparently made no effort to determine whether the two highest executives in the company — Bennett and Trosten — also had profits interests.

Weil had ready access to information that could have led to its discovery of the other profits participation interests. Sexton's questionnaire response referred to money he received for his profits participation interests as noted on his 2002 and 2003 K-1's. Refco's tax returns for 2002 and 2003 disclosed the equity interests of all eight executives. Weil apparently had access to but did not review those portions of the tax returns. Further, Weil apparently did not ask anyone at Refco for the documents relating to the creation of the profits participation interests. Weil also did not ask to review the payments made by RGHI disbursing LBO proceeds.

Finally, despite Weil’s discovery that Refco executives had made material misrepresentations during the LBO process in failing to disclose the profit sharing agreement with Refco, the Examiner has located no evidence that Weil made any effort to determine whether other aspects of the LBO diligence had also been incorrect.

(c) *Weil Was on Notice that Refco Had Provided False and Misleading Information Regarding the Absence of “Transactions” Between Refco and RGHI and Should Have Investigated this Issue Further*

Weil, as part of its legal due diligence on behalf of THL, asked Refco to provide information relating to its owners — RGHI and BOI.¹⁰⁴⁵ Weil noted it was still seeking this information at least twice in March, again in early April, and again in May.¹⁰⁴⁶ According to Tabor, Mayer Brown and Refco’s management expressly told Weil during its LBO due diligence process that there were no “transactions” between Refco and RGHI other than those disclosed on the schedules for the Equity Purchase and Merger Agreement.

By March 2005, Weil was on notice that Refco’s representation that there were no “transactions” between Refco and RGHI was false. In March 2005, Weil learned that several Refco executives had profit interests in Refco and that RGHI — rather than Refco — redeemed those interests by using money paid to RGHI in the LBO. Weil was thus on notice that RGHI and Refco were involved in an undisclosed “transaction” that effectively disguised these executives’ equity interests in Refco by having a related party — RGHI — redeem those interests. This revelation also arguably put Weil on notice that RGHI had assumed an obligation of Refco — *i.e.*, redeeming the executives’ interests in Refco. The revelation of an undisclosed

¹⁰⁴⁵ WGM-L 0011015.

¹⁰⁴⁶ WGM-L 0013612; WGM-L 0011018; WGM-L 0011020; WGM-L 0012051.

“transaction” between Refco and RGHI could have prompted further inquiry by Weil and at least prompted Weil to seek an explanation of why RGHI — and not Refco — was redeeming an interest pursuant to an agreement entered into by Refco.

The above facts are evidence that could support an allegation that Weil did not perform appropriate due diligence in investigating the relationship between Refco and RGHI in preparing Refco’s S-4 and S-1 filings. Arguably, Weil had reason to require Bennett to describe with particularity the relationship between RGHI and Refco, and to support his description with documentation. Weil failed to do so.

(d) Weil Failed to Conduct Sufficient Inquiry with Respect to Trosten’s Resignation, Even Though the SEC Requested Further Explanation

Weil learned prior to the closing of the LBO in August 2004 that THL intended to replace Trosten as CFO, that Trosten would have a decreased role in Refco following the LBO, and that Trosten was to be informed of his new role prior to August 2004. Given that Trosten made a substantial equity investment in Refco at the time of the LBO along with other executives, and appeared to be willing to accept his demotion, Trosten’s resignation after the LBO was abrupt and unexpected. Yet there is no indication that Weil sought additional details upon learning of Trosten’s resignation, even in response to the SEC’s inquiry to seek further explanation for Trosten’s resignation. Instead, Weil simply responded to the SEC on behalf of Refco with a short statement that Trosten’s decision to resign was straightforward and there were no significant details surrounding the resignation.

Weil also learned during its IPO diligence process that Refco had previously entered into a profits participation arrangement with several of its executives pursuant to which they received payments in connection with the LBO. Weil understood that these agreements had existed for some period of time prior to the LBO (the four redemption letters Weil received were all dated

June 18, 2004), but were not disclosed until March 2005. The Examiner located no evidence that Weil asked Refco about Trosten's receipt of money out of the LBO.¹⁰⁴⁷ This payment should have been disclosed in its SEC filings on behalf of Refco.

(e) "Red Flags" Placed Weil on Notice that Refco's Diligence Responses Could Be Inadequate

Weil's assumption that the LBO diligence was adequate and its reliance on management's representations in connection with the S-4 and S-1 diligence stands in contrast to Weil's knowledge of "red flags" that could have caused it to doubt the adequacy of Refco's responses to various diligence requests. In addition to the incidents described above, Weil was also aware of the following:

- Refco Misled KPMG Regarding Internal Control Deficiencies. Refco represented to KPMG that there were no significant matters relating to internal controls that could have a material effect on Refco's consolidated financial statements.¹⁰⁴⁸ In the course of its IPO diligence, however, Weil learned that this representation was false. Weil learned in March or April 2005 that GT had apparently issued a "management letter" to Refco in 2003 detailing several internal control deficiencies. Refco did not disclose this "management letter" during the LBO diligence.¹⁰⁴⁹
- Refco's Failure to Keep Weil Informed Regarding Litigation. Over the course of the diligence period in connection with the offering circular for the Senior Subordinated Notes, Weil discovered that Refco had failed to keep THL and Weil

¹⁰⁴⁷ On July 14, 2005, Trosten testified in an arbitration proceeding (the "McElwreath arbitration") that he received \$45 million upon the closing of the LBO. *See* App. D-54. Mayer Brown represented Refco at the arbitration, and it is not clear from the information reviewed by the Examiner whether Weil observed or was aware of Trosten's testimony in the arbitration. It is clear that (1) Trosten's testimony in the McElwreath arbitration was several weeks before the S-1 was completed in August 2005; (2) Weil was aware of and even had some involvement with Mayer Brown in the McElwreath arbitration in connection with a subpoena to THL witnesses, WGM-L E091960-61, WGM-L 3091974, WGM-L 3091998; and (3) Westra could not affirmatively recall whether he learned of Trosten's \$45 million payment from THL personnel before or after the IPO closed. Westra Interview, 51:23-52:6.

¹⁰⁴⁸ *See* WGM-L 0010269.

¹⁰⁴⁹ WGM-R 0005619; WGM-R 0000996. *See generally* WGM-L 0010269; WGM-L 003673-710; REFCO-E-001478369.

informed as to certain pending litigation and matters pending before the SEC that Weil and THL believed should have been disclosed.¹⁰⁵⁰

- Refco’s “Non-Response” to SEC’s Inquiry Regarding Losses and Receivables. In its review of Refco’s SEC filings, the SEC commented on several risk factors and requested additional information relating to credit losses and customer receivables. Rather than provide explanations requested by the SEC or conduct appropriate inquiry, Refco simply changed the disclosure.

These “red flags” could have prompted Weil to question Refco’s responsiveness to other diligence requests.

(ii) Causation

Refco’s estate can argue that if Weil had (i) pressed Refco to produce all documents that had not been furnished in the LBO diligence, (ii) implemented the procedures suggested by KPMG following the “Deep Throat” allegations, especially in view of the fact that Weil had learned that misrepresentations had been made during the LBO, (iii) reviewed all documents pertaining to the Refco executives’ profit interests, including agreements and tax returns, (iv) pressed Refco for evidence of transactions and agreements between Refco and RGHI, including the transaction by which RGHI redeemed the executives’ Refco interests, and (v) obtained and analyzed the PPA, then Weil might have uncovered the relationship between Refco and RGHI and the fraudulent scheme. Had Weil discovered the fraud, it is likely that Refco would have delayed its entry into public capital markets. This would have allowed Refco to have better weathered the announcement of the RGHI Receivable and the related fraudulent activity and, potentially, avoided bankruptcy.

b. Aiding and Abetting

Based on the information the Examiner reviewed and as described above, the Examiner concludes there is not sufficient evidence to suggest that Weil had actual knowledge of any fraud

¹⁰⁵⁰ WGM-L 0025262, at App. D-59.

or breaches of fiduciary duties owed to Refco. Given the apparent absence of Weil's actual knowledge of the various fraudulent schemes established by Refco's executives, the Examiner concludes that Refco's estate likely could not state a claim against Weil for aiding and abetting either fraud or a breach of fiduciary duty.

VII. \$82.2 MILLION DIVIDEND IN CONNECTION WITH THE IPO

A. INTRODUCTION AND SUMMARY

1. Scope of Investigation

On August 18, 2005, Refco Inc. paid an aggregate dividend of \$82,203,000 to its pre-IPO shareholders. The Examiner investigated the events surrounding the declaration and payment of the dividend in order to determine whether the Refco estate could state claims to recover those payments or damages. The Examiner's counsel conducted numerous targeted searches of documents supplied by THL, KPMG, Refco, Murray, Devine & Company, Inc. ("Murray Devine"), GT, Weil, and others that resulted in a review of significant and relevant documents related to the dividend payment. In addition to the review of documents, the Examiner's counsel interviewed Daniel M. DiDomenico ("DiDomenico"), the Murray Devine Vice President who wrote and oversaw the August 10, 2005 solvency opinion which was used as support for the declaration of the dividend.

2. Summary of Facts

On August 10, 2005, the Refco Board of Directors resolved to declare and pay a dividend and established a Dividend Committee, comprised of Bennett and Schoen, to determine the aggregate and per share amount of the dividend, as well as the payment date. The dividend was to be paid from proceeds received by Refco from the exercise by the underwriters of their option to purchase additional shares ("optional securities") of common stock (the "underwriters' option"). On August 16, 2005, the IPO closing occurred with respect to both the 26,500,000

firm securities as well as the 3,975,000 optional securities. Each closed at a price of \$22.00 per share to investors. Allowing for \$1.32 per share in underwriting discounts and commissions, the exercise of the underwriters' option to purchase the optional securities generated \$82,203,000. On the same date, the Dividend Committee authorized payment of an aggregate dividend in the same amount, \$82,203,000, to shareholders of record as of August 10, 2005. On August 18, 2005, Refco paid the dividend.¹⁰⁵¹

B. SUMMARY OF FINDINGS AND CONCLUSIONS

Recovery of the dividend payments and damages is possible under a number of theories, each of which is discussed below. Broadly speaking, recovery may be pursued by characterizing the dividend as: (1) an improper distribution in violation of Delaware General Corporation Law ("DGCL");¹⁰⁵² (2) an improper distribution in violation of the directors' fiduciary duties of care and loyalty; (3) an avoidable fraudulent conveyance under the Bankruptcy Code and New York Debtor and Creditor Law; or (4) an avoidable preferential transfer under the Bankruptcy Code. The DGCL and fiduciary duty claims provide for recovery from the directors, while the fraudulent conveyance and preferential transfer claims provide for recovery from the recipients of the funds.

C. FACTUAL BACKGROUND RELEVANT TO DECLARATION OF THE DIVIDEND

1. Solvency Opinion

The first evidence of the dividend is found in Amendment No. 4 to the S-1 statement filed with the SEC on July 25, 2005. That same day, in an e-mail from Jaeckel of THL to Sherer of Refco and George Taylor of THL ("Taylor"), Jaeckel stated that he and Bennett had "decided

¹⁰⁵¹ See Refco Inc. SEC Form 8-K dated August 19, 2005.

¹⁰⁵² Delaware General Corporation Law applies because Refco was incorporated in Delaware.

to explore getting a solvency opinion related to the dividend as good form for our board of directors" and that he had asked Dennis Murray, President of Murray Devine, for a proposal.¹⁰⁵³

Documents reviewed by the Examiner's counsel show that work on the solvency opinion began shortly thereafter. A July 26, 2005 "Refco Solvency Information Request" from DiDomenico to Jaeckel requested that various pieces of information related to Refco be forwarded in order to facilitate Murray Devine's due diligence with respect to the solvency opinion.¹⁰⁵⁴ Among the requested information were copies of Refco's most recent Form S-1, financial projections and forecasts, and Refco's audited financial statements. In addition to the review of these documents and others, Murray Devine conducted interviews of company officials to determine the reasonableness of financial projections and to satisfy other queries related to contingent liabilities and the existence of pending litigation.

On August 5, 2005, Murray Devine submitted an engagement letter to provide valuation services in connection with the dividend.¹⁰⁵⁵ According to the engagement letter, Refco requested that Murray Devine render an opinion with respect to the solvency of Refco, on a consolidated basis, after giving effect to Refco's use of proceeds from the IPO to redeem \$210 million aggregate principal amount of the existing Senior Subordinated Notes, pay pre-IPO shareholders a dividend, and for other general corporate purposes. DiDomenico stated that though all of the procedures highlighted in the solvency opinion were performed, they were not necessarily performed in conjunction with the August 10, 2005 solvency opinion. He explained that Murray Devine had done previous valuations, as well as a 2004 solvency opinion, for Refco

¹⁰⁵³ THL SEC 00004833, E-mail from Jaeckel to Sherer and Taylor (July 25, 2005).

¹⁰⁵⁴ THL SEC 00035137-38, at App. D-68, Memorandum from DiDomenico to Jaeckel re "Refco Solvency Information Request" (July 26, 2005).

¹⁰⁵⁵ WGM-R 0004768-72, Letter from Murray Devine to Board of Directors of Refco, Inc. (August 5, 2005).

and, therefore, much of the work for the August 10, 2005 opinion had been completed in connection with those engagements. He described the August 10, 2005 solvency opinion as an “update” of the prior work. Murray Devine’s fee for professional services related to the engagement was \$50,000 plus \$250 in expenses.¹⁰⁵⁶

On August 10, 2005, Bennett and Sherer on behalf of Refco provided Murray Devine with a letter certifying that the management representations (*e.g.*, financial position, cash flows, balance sheets, and accounting practices), which Refco had made to Murray Devine for its solvency determination, were “true and correct in all material respects.”¹⁰⁵⁷ In the letter, Refco acknowledged its responsibility for the fair presentation of the financial statements and stated that based upon its own review of the IPO, dividend payment, operating results, and related debt of the company, nothing “would cause us to believe that the Company, on a consolidated basis, would not be solvent.” When interviewed, DiDomenico explained that he drafted the letter of representations. In what he described as typical practice, after Refco was given an opportunity to make changes, the representation letter was put on Refco letterhead. He could not recall what changes, if any, were made, but noted that all of the included representations were standard. DiDomenico further explained that when engaged to do a valuation or solvency analysis, Murray Devine regularly drafted representation letters to assure itself that all necessary representations were included. He added that without such representations, Murray Devine would not give an opinion.

¹⁰⁵⁶ REFCO-E-001487065, Murray Devine Invoice #05-0803 (August 16, 2005).

¹⁰⁵⁷ WGM-R 0011571-75, at App. D-69, Letter from Refco, Inc. to Murray Devine (August 10, 2005).

Murray Devine provided Refco with its solvency opinion letter dated as of August 10, 2005.¹⁰⁵⁸ In its solvency opinion letter, Murray Devine concluded that “after giving effect to the Transactions” [defined as the dividend, the reincorporation, and the IPO]:

- The aggregate value of the assets of the company at fair value and present fair saleable value exceeds its total liabilities (including contingent, subordinated, unmatured, and unliquidated liabilities) as they become absolute and matured in the normal course of business;
- The Company has the ability to pay its debts and liabilities (including contingent, subordinated, unmatured, and unliquidated liabilities) as they become absolute and matured in the normal course of business;
- The Company does not have an unreasonably small amount of capital with which to conduct business; and
- Immediately after giving effect to the Dividend, the excess of the aggregate value of the assets of the Company, at fair value and present fair saleable value, over the Company’s “liabilities (including contingent, subordinated, unmatured, and unliquidated liabilities), is equal to or exceeds the amount of the Stated Capital of the Company.”¹⁰⁵⁹

When interviewed, DiDomenico stated that he drafted the opinion and explained the process by which the opinion was created. According to DiDomenico, in forming the opinion, Murray Devine relied upon Refco’s audited consolidated financial statements, which had been provided by THL. DiDomenico stated that nothing in the provided information gave him cause for concern about Refco’s financial condition and that he neither was aware of Refco’s alleged practice of shifting debt nor of a \$430 million related party receivable that the company publicly disclosed on October 10, 2005, just two months after Murray Devine rendered its August 10, 2005 solvency opinion.¹⁰⁶⁰ DiDomenico was questioned regarding his review of receivables. In response, he stated that his analysis was premised upon Refco as a going concern and that, as a

¹⁰⁵⁸ WGM-R 0011556-65, at App. D-70, Letter from Murray Devine to the Board of Directors of Refco, Inc.

¹⁰⁵⁹ WGM-R 0011559-60, at App. D-70.

result, he did not look at individual items on the balance sheet and did not check the creditworthiness of receivables. DiDomenico stated that Murray Devine does not have the expertise to audit the receivables and that it relied upon Refco's auditors.

2. Declaration of Dividend

On August 10, 2005, the Refco Board of Directors resolved to declare and pay a dividend to pre-IPO shareholders.¹⁰⁶¹ According to the Board's resolution, it had "discussed" and "determined" that "after giving effect to the Reorganization, the Offering and the exercise of the Underwriters' Option, there will be sufficient surplus . . . to permit payment of the Dividend." The Board determined that the dividend would equal the "net proceeds received from the exercise, if any, by the underwriters in the Offering of their option . . . to purchase up to an additional 3,750,000 shares." The resolution was signed by each of the Refco Directors: Bennett, Leo R. Breitman, Nathan Gantcher, David V. Harkins, Jaeckel, Thomas H. Lee, Ronald L. O'Kelley, and Schoen. The Board of Directors created a Dividend Committee, comprised of Bennett and Schoen, to determine the aggregate and per share amount of the dividend, as well as its payment date.

On August 11, 2005, CSFB, as representative of the underwriters, confirmed with Refco that on August 16, 2005 the underwriters would exercise the over-allotment option in the amount of 3,975,000 additional shares of common stock.¹⁰⁶² Referencing the Board's August 10, 2005

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¹⁰⁶⁰ See Press Release, Refco News, Refco Announces Undisclosed Affiliate Transaction (October 10, 2005).

¹⁰⁶¹ GT SEC 0045148, Unanimous Written Consent of the Board of Directors of Refco, Inc.

¹⁰⁶² See MB 02067220, letter from Mathew D. Abrusci, Director and Counsel for CSFB, to Sherer. While the original Board resolution sets forth the number of shares attributable to the underwriters' option as 3,750,000, GT SEC 0045148, Abrusci's letter, MB 02067220, and the Dividend Committee's resolution, GT SEC 0045160, both state 3,975,000 as the number of over-allotment shares. The Examiner did not locate any documents explaining this inconsistency.

declaration of a dividend and the Board’s receipt of a “favorable opinion letter” from Murray Devine, the Dividend Committee ratified the precise terms of the dividend on August 16, 2005.¹⁰⁶³ Accordingly, the Dividend Committee resolved that “an aggregate dividend equal to the net proceeds of the \$82,203,000 received from the exercise of the Underwriters’ Option be paid”,¹⁰⁶⁴ to the pre-IPO shareholders on August 18, 2005.¹⁰⁶⁵

Distribution lists indicate that Bennett and his related entities received approximately \$34.6 million (42%); all THL related entities (not including co-investors) received approximately \$41.1 million (50%); THL co-investors received \$4 million (5%); Board members Leo R. Breitman, Nathan Gantcher, and Ronald L. O’Kelley (collectively “Outside Directors”) each received \$9,603 (.04%), and other Refco employees and managers received the remainder (2.6%).¹⁰⁶⁶ The Examiner’s counsel did not locate any information pertaining to whether the other Board members, Lee, Harkins, Jaeckel, and Schoen (collectively “THL Directors”), indirectly received a portion of the dividend.

3. October 10, 2005 Refco Press Release Disavowing Financial Statements

Subsequently, in a press release dated October 10, 2005, Refco announced that it had discovered a \$430 million receivable from an entity controlled by Bennett and that the receivable, “which may have been uncollectible,” was not shown on the company’s balance

¹⁰⁶³ See GT SEC 0045160-61, Unanimous Written Consent of the Dividend Committee of the Board of Directors of Refco Inc. “Whereas, the Board received a favorable opinion letter, dated as of the Record Date (a copy of which is attached), from Murray, Devine & Co., a third party valuation firm, which takes into account, among other things, the use of proceeds from the Offering as described in the prospectus and the payment of the Dividend . . . Therefore, Be it Resolved . . . that the Dividend shall be paid . . .”

¹⁰⁶⁴ *Id.*

¹⁰⁶⁵ See Refco Inc. SEC Form 8-K dated August 19, 2005.

¹⁰⁶⁶ See PwC 064848, at App. D-71, August 17, 2005 Schedule of greenshoe dividends to be paid to pre-existing shareholders; THL/SEC 00005263, at App. D-72, Refco Proceeds Summary spreadsheet.

sheet as a related party transaction. As a result, Refco announced that “its financial statements, as of, and for the periods ended, February 28, 2002, February 28, 2003, February 28, 2004, February 28, 2005, and May 31, 2005, taken as a whole, for each of Refco Inc., Refco Group Ltd., LLC and Refco Finance, Inc. should no longer be relied upon.”¹⁰⁶⁷

When interviewed, DiDomenico was shown the October 2005 Refco Press Release and was asked whether he was aware of Refco’s fraudulent reporting practices and whether financial statements provided to him by Refco gave him reason to question the accuracy or reliability of the data included therein. DiDomenico said that he was unaware of any fraudulent activity on behalf of the company or its officers and that had he learned of the fraud at the time, he would have recommended to his principals that no opinion be issued and that the engagement be terminated.

Although DiDomenico declined at his interview to opine regarding whether Refco was in fact solvent at the time of his valuation opinion, he did make clear that Refco’s goodwill value would have been substantially impaired by the fraudulent activity. He added that he had never encountered a situation in which he had been asked to value a company that had been the subject of pervasive fraud. He further stated that he was unsure of how to perform a solvency opinion based upon unreliable financial statements. DiDomenico observed that the methodology used in an opinion that would account for the bad receivable would likely require a liquidation analysis, rather than the going concern analysis that was used in Murray Devine’s opinion. He also noted that Murray Devine’s going concern analysis of Refco did not include an item by item valuation and did not examine inter-company debts. Moreover, Murray Devine’s going concern analysis

¹⁰⁶⁷ See Press Release, Refco News, Refco Announces Undisclosed Affiliate Transaction (October 10, 2005).

assigned goodwill value, whereas, according to DiDomenico, the more apt liquidation analysis typically would not reflect goodwill.

D. CONCLUSIONS CONCERNING THEORIES OF RECOVERY AGAINST DIRECTORS

Recovery against the directors is possible under theories that the dividend amounted to (1) an improper distribution in violation of the DGCL or (2) an improper distribution in violation of the directors' fiduciary duties of care and loyalty. Based upon the facts as reviewed above and elsewhere in this Report, the Examiner has concluded that under either theory, sufficient evidence exists to state a claim against Bennett for recovery of the entire dividend amount. There is some evidence that the THL Directors may have been negligent, potentially subjecting them to liability under the DGCL. Because the Examiner's investigation did not focus upon the actions or knowledge of the THL Directors, additional investigation would be necessary to evaluate whether a cause of action alleging either fraud or breach of fiduciary duty by those directors could succeed. With respect to the Outside Directors, the Examiner has not discovered evidence to suggest that these directors are liable.

1. Violation of Delaware Statute 8 Del. C. § 174(a)

Under the DGCL, dividends may be paid only: (1) out of surplus, defined as the excess of net assets over capital;¹⁰⁶⁸ or (2) if there is no surplus, out of the combined net profits from the fiscal year in which the dividend is declared and/or the preceding fiscal year.¹⁰⁶⁹ Directors present and voting in favor of a dividend payment are jointly and severally liable for a willful or negligent violation of the surplus requirement.¹⁰⁷⁰ However, a member of the board "shall be

¹⁰⁶⁸ "Net assets" is defined as the amount by which total assets exceed total liabilities. 8 Del. C. § 154.

¹⁰⁶⁹ 8 Del. C. § 170(a).

¹⁰⁷⁰ *Id.* "In case of any wilful or negligent violation . . . the directors under whose administration the same may happen shall be jointly and severally liable, at any time within 6 years after paying such unlawful dividend or after such unlawful stock purchase or redemption, to the corporation, and to its creditors in the event of its dissolution or

(footnote continued on next page)

fully protected [from liability] in relying in good faith" upon the records of the corporation or upon "such information, opinions, reports or statements presented to the corporation" regarding the "existence and amount of surplus."¹⁰⁷¹

A successful claim therefore depends on the ability to show (1) a violation of the surplus requirement, and (2) that the violation was willful or negligent. A dividend payment made while Refco was insolvent is a violation of the surplus requirement.¹⁰⁷² Although the Examiner did not perform a full solvency analysis, as explained in Section IX.A. the Examiner believes that it is likely that Refco was insolvent during 2004 and 2005. Presuming insolvency, it then must be shown that the violation was willful or negligent, *i.e.*, that the director knew, or was negligent in not knowing, that Refco was insolvent at the time the dividend was paid.¹⁰⁷³ If the director knew

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insolvency, to the full amount of the dividend unlawfully paid, or to the full amount unlawfully paid for the purchase or redemption of the corporation's stock, with interest from the time such liability accrued. Any director who may have been absent when the same was done, or who may have dissented from the act or resolution by which the same was done, may be exonerated from such liability by causing his or her dissent to be entered on the books containing the minutes of the proceedings of the directors at the time the same was done, or immediately after such director has notice of the same."

¹⁰⁷¹ 8 Del. C. § 172. "A member of the board of directors, or a member of any committee designated by the board of directors, shall be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of its officers or employees, or committees of the board of directors, or by any other person as to matters the director reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation, as to the value and amount of the assets, liabilities and/or net profits of the corporation or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid, or with which the corporation's stock might properly be purchased or redeemed."

¹⁰⁷² See *EBS Litig. LLC v. Barclays Global Investors*, 304 F.3d 302, 305 (3d Cir. 2002) ("If the dividend occurred when [the company] was insolvent, or rendered [the company] insolvent, it was illegal under Delaware law, and voidable in bankruptcy.").

¹⁰⁷³ See *Pereira v. Cogan* ("Pereira I"), 2001 WL 243537, at *1 (S.D.N.Y. March 8, 2001) (complaint that alleged that directors "knew or should have known" about the illegality of dividend payments was sufficient to survive motion to dismiss).

or should have known of the corporation’s insolvency, he or she is jointly and severally liable for the payments.¹⁰⁷⁴

Based on the facts contained in this Report, there is little doubt that Bennett authorized the dividend payment despite being aware of Refco’s inaccurate balance sheets and financial statements, which concealed the RGHI Receivable. Given the assumption that Refco was insolvent, Bennett violated the DGCL and is jointly and severally liable for the declaration and payment of the dividend.

As referenced above, the Examiner has not investigated THL and the directors appointed by THL to determine what information was made available to them in their capacities as Refco directors; nonetheless, there is information available that may support a claim under DGCL Section 174. First, unlike the Outside Directors who joined the board in January 2005, the THL Directors had been on the Refco board since the LBO in August 2004. Therefore, the THL Directors were in a position to analyze Refco’s true financial condition not only through the LBO due diligence process, but also through their fulfillment of their oversight duty as inside directors managing the company.

Second, Lee, Jaeckel, Schoen, and Harkins were made aware of allegations of previous questionable conduct related to Refco’s reporting of trading losses. Specifically, in May 2004, subsequent to the completion of its diligence efforts in connection with the LBO, THL was made aware that a former Refco insider alleged that “all was not well with Refco.”¹⁰⁷⁵ KPMG provided THL with possible additional due diligence procedures which would address concerns raised by the former insider that in order to avoid tax implications, trading losses had been run

¹⁰⁷⁴ Section 174 provides that “directors who are guilty of ‘wilful or negligent violation’ of the statutes” shall be jointly and severally liable. *Johnston v. Wolf*, 487 A.2d 1132, 1136 (Del. 1985).

¹⁰⁷⁵ KPMG-THL 0024324, at App. D-57, “Project Royce – Chronology” (undated).

through two overseas Refco entities that were not consolidated.¹⁰⁷⁶ Lee, Schoen, and Harkins met with Bennett for an explanation, rather than undertaking the procedures that likely would have discovered the fraud.¹⁰⁷⁷ THL moved ahead with the LBO and did not conduct the additional diligence. THL also did not implement these procedures during the subsequent IPO due diligence, by which time all four THL Directors were serving on the Refco board and THL was the controlling shareholder.

With respect to the Outside Directors, the Examiner has found no evidence supporting recovery from them of the dividend payment under Section 174. The Examiner has not discovered evidence suggesting that these directors knew or should have known either of the balance sheet issues or of Refco's insolvency.

In defense of the claim, directors can assert the protection of Section 172, which immunizes against liability directors who in good faith rely upon records of the corporation and other information regarding the existence of a surplus.¹⁰⁷⁸ Section 172 requires defendants to prove (1) that the material relied upon "actually determined a surplus existed," and (2) that "it was reasonable for them to rely on that determination."¹⁰⁷⁹ The August 10, 2005 Board resolution, which declared the dividend, referred to "discuss[ions]" regarding methods for valuing assets and noted that the Board had "determined" that "there will be a sufficient surplus .

¹⁰⁷⁶ KPMG-THL 0019714-715, at App. D-60, E-mail from Berndsen to Jaeckel (May 28, 2004) (attaching "possible questions for insider" and other diligence procedures to be addressed).

¹⁰⁷⁷ THL/UCC 00033266, at App. D-61, E-mail from Schoen to Lee, Westra, Harkins, Jaeckel, and Taylor (May 30, 2004) (outlining "consensus" as to how to approach Bennett regarding allegation); WGM-L0025237, E-mail from Schoen to Jaeckel, Taylor, Max Strasburg, Westra, and Tabor (June 2, 2004) (summarizing June 1, 2004 meeting with Bennett).

¹⁰⁷⁸ See *In re Sheffield Steel Corp.*, 320 B.R. 423, 451 (Bankr. N.D. Okla. 2004) (interpreting Delaware law and noting that Section 172 is an affirmative defense, which "immunizes directors from liability for declaring an otherwise illegal dividend . . .").

¹⁰⁷⁹ *Id.*

.. to permit the payment of a [d]ividend.”¹⁰⁸⁰ The Board also received a “favorable” solvency opinion from Murray Devine.

2. Breach of Fiduciary Duties of Care and Loyalty

A viable claim to recover the entire dividend amount based on breach of fiduciary duties exists against Bennett. Based on the evidence currently available, it is unlikely that a viable claim could be asserted against the THL Directors for breach of their fiduciary duties of care and loyalty. The Examiner has not located evidence that would support a claim against the Outside Directors.

In order to state a claim against directors for breach of fiduciary duty, a plaintiff must plead that (1) a fiduciary duty exists, and (2) a breach of that duty has occurred.¹⁰⁸¹ With regard to the existence of a fiduciary duty, it is settled under Delaware law that, at the point of insolvency, directors owe a fiduciary duty to, among others, the corporation’s creditors.¹⁰⁸² The duty of care essentially requires that directors engage in due diligence prior to decision making: a trial court will not find a breach of a director’s duty of care “unless directors individually and the board collectively have failed to inform themselves fully and in a deliberate manner before voting as a board upon a transaction . . .”¹⁰⁸³ The duty of loyalty mandates that the “best interest of the corporation and its shareholders takes precedence over any interest possessed by a

¹⁰⁸⁰ GT SEC 0045148, Unanimous Written Consent of the Board of Directors of Refco, Inc.

¹⁰⁸¹ See *Pereira I*, 2001 WL 243537, at *12.

¹⁰⁸² See *Prod. Res. Group, LLC v. NCT Group, Inc.*, 863 A.2d 772, 790-791 (Del. Ch. 2004) (The fact of insolvency expands the class of those eligible to press fiduciary duty claims to include creditors.). See also *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, Civ. A. No. 12150, 1991 WL 277613, *34 (Del. Ch. Dec. 30, 1991) (where a corporation is in the zone of insolvency, the board of directors owes its duty not only to the shareholders, but to the corporate enterprise, including the corporation’s creditors).

¹⁰⁸³ *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345, 368 (Del. 1994) (citations omitted).

director, officer or controlling shareholder and not shared by the stockholders generally.”¹⁰⁸⁴

However, self interest alone does not violate the duty of loyalty; there must be evidence of disloyalty, such as fraud upon the corporation or the board, or abdication of directorial duties.¹⁰⁸⁵

Primary examples of director self-interest are (1) when a director appears on both sides of a transaction, and (2) when a director receives a personal benefit from a transaction “not received by the shareholders generally.”¹⁰⁸⁶

A director’s determination of the existence of a surplus and decision to declare and pay a dividend is generally protected by the business judgment rule.¹⁰⁸⁷ Accordingly, in making such a determination, the Refco directors are afforded the presumption that they “acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company.”¹⁰⁸⁸ A claim for recovery of the dividend therefore will have to rebut this presumption if it is to be successful. To do so, it must be shown either that (1) the directors were grossly negligent in causing the payment of the dividend¹⁰⁸⁹ (thereby breaching their fiduciary duty of good faith, loyalty, or due care), or (2) the transaction was self-dealing (thereby breaching their duty of loyalty).¹⁰⁹⁰ If the presumption is rebutted, directors will have the burden of showing the

¹⁰⁸⁴ *Id.* (citations omitted).

¹⁰⁸⁵ *Cede*, 634 A.2d at 363 (citations omitted).

¹⁰⁸⁶ *Id.*

¹⁰⁸⁷ See *Gabelli & Co., Inc. v. Liggett Group Inc.*, 479 A.2d 276, 280 (Del. 1984).

¹⁰⁸⁸ *Smith v. Van Gorkom*, 488 A.2d 858, 872-873 (Del. 1985) (“A director’s duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders.”).

¹⁰⁸⁹ *Van Gorkom*, 488 A.2d at 873 (“[G]ross negligence is . . . the proper standard for determining whether a business judgment reached by a board of directors was an informed one.”).

¹⁰⁹⁰ See *Pereira v. Cogan* (“*Pereira II*”), 294 B.R. 449, 527 (S.D.N.Y. 2003).

“entire fairness” of the transaction. Directors found to have violated their fiduciary duty are jointly and severally liable for the dividend payment.¹⁰⁹¹

The analysis of claims against the Refco directors for breach of fiduciary duties falls along similar lines as the analysis under the DGCL, discussed above. Bennett’s determination that a surplus existed and his decision to authorize a dividend payment while knowing of Refco’s balance sheet inaccuracies and the undisclosed RGHI Receivable meet the standard of gross negligence and, therefore, do not satisfy a director’s duty of good faith, care, and loyalty.

Whether the THL Directors would be found to have violated their fiduciary duties turns on whether they were grossly negligent in not discovering the balance sheet inaccuracies. Section 172 of the DGCL, discussed above, codifies the duty of care, diligence, good faith, and reason necessary for the dividend to conform with applicable standards.¹⁰⁹² It is likely that to the extent the THL Directors are shielded by Section 172, they also have fulfilled their fiduciary duties.

E. CONCLUSIONS CONCERNING THEORIES OF RECOVERY AGAINST DIVIDEND RECIPIENTS

1. Violation of Federal and State Fraudulent Conveyance Laws

Recovery of the dividend payments may be pursued against the recipients of the dividend payments under two fraudulent conveyance provisions of the Bankruptcy Code: 11 U.S.C. §§ 544 and 548. Section 544 authorizes a trustee to “avoid any transfer of an interest of the

¹⁰⁹¹ See *In re Toy King Distrib., Inc.*, 256 B.R. 1, 168 (Bankr. M.D. Fla. 2000) (Where two or more directors jointly participate in a breach of fiduciary duty, the liability is joint and several.) (citations omitted). See also *Pereira II*, 294 B.R. at 535 (holding “all” directors liable for dividend payments made in violation of directors’ fiduciary duties).

¹⁰⁹² See *In re Sheffield Steel*, 320 B.R. at 449.

debtor in property . . . that is voidable under applicable law”¹⁰⁹³ Recovery pursuant to Section 544 requires there to be an unsecured creditor that had a claim under state law at the time the bankruptcy case was filed. The Examiner assumes for purposes of this Report that New York law likely will apply,¹⁰⁹⁴ and recovery could be sought pursuant to a theory that payment of the dividend constituted an actual fraudulent conveyance, or in the alternative, a constructive fraudulent conveyance, under the New York Uniform Fraudulent Conveyance Act, codified at, N.Y. Debt. & Cred. Law (hereinafter “DCL”) §§ 270-81. In most cases, “if a transfer is fraudulent under New York Debtor Creditor Law, it is also fraudulent under § 548 of the Bankruptcy Code.”¹⁰⁹⁵

a. Actual Fraudulent Conveyance

DCL § 276 governs actual fraudulent transfers and states: “[e]very conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in the law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.” The federal law, 11 U.S.C. § 548, is substantially similar to New York law, providing that a trustee may avoid a transfer when the transfer was made “with actual intent to hinder, delay, or defraud” present or future creditors.¹⁰⁹⁶ Factual allegations supporting claims of intentional fraudulent transfers are scrutinized pursuant to Fed. R. Civ. P. 9(b), “while taking into

¹⁰⁹³ 11 U.S.C. § 544(b). The term “applicable law” refers to non-bankruptcy state law. *See Hassett v. Far W. Fed. Sav. & Loan Ass’n (In re O.P.M. Leasing Servs., Inc.)*, 40 B.R. 380, 384 (Bankr. S.D.N.Y. 1984), *aff’d*, 44 B.R. 1023 (S.D.N.Y. 1984).

¹⁰⁹⁴ *See* App. A.

¹⁰⁹⁵ *Geron v. Shulman (In re Manshul Const. Corp.)*, 2000 WL 1228866, *43, n.7 (S.D.N.Y. Aug. 29, 2000).

¹⁰⁹⁶ 11 U.S.C. § 548(a)(1)(A).

account that the trustee is entitled to some leeway in the areas of scienter and particularity because he has no personal knowledge of the facts.”¹⁰⁹⁷

Other than as to Bennett, the Examiner has not discovered direct evidence of fraudulent intent on the part of the directors declaring the dividend. However, because direct proof of fraudulent intent is sometimes difficult to obtain, under both federal and New York law, a plaintiff may prove such intent through circumstantial evidence known as “badges of fraud.” The badges of fraud include (1) inadequacy of consideration received, (2) the closeness of the relationship between parties to the transfer, (3) that the transferor was rendered insolvent by the conveyance, (4) suspicious timing of the conveyance, (5) use of fictitious parties or secrecy, (6) the transferor’s knowledge of a creditor’s claim and subsequent inability to pay it, and (7) retention of control of the property by the transferor after the transfer.¹⁰⁹⁸ To satisfy “fair consideration,” the transferee in good faith must either convey property or discharge an antecedent debt of equivalent value to the property transferred.¹⁰⁹⁹ In addition to the direct evidence of Bennett’s fraudulent intent, several of these badges of fraud are present.

First, there was no consideration received in exchange for the payment. Nonetheless, given that a dividend payment rarely is paid in exchange for consideration, lack of consideration

¹⁰⁹⁷ *Sec. Investor Prot. Corp. v. Stratton Oakmont, Inc.*, 234 B.R. 293, 315 (Bankr. S.D.N.Y. 1999) (citations omitted).

¹⁰⁹⁸ See *Eclairer Advisor Ltd. v. Daewoo Eng’g & Constr. Co., Ltd.*, 375 F. Supp. 2d 257, 268-69 (S.D.N.Y. 2005) (citing *Bulkmatic Transp. Co. Inc. v. Pappas*, No. 99 Civ. 12070(RMB) (JCF), 2001 WL 882039 (S.D.N.Y. May 11, 2001)); *MFS/SUN Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp. 913, 935 (S.D.N.Y. 1995). See also *Salomon v. Kaiser (In re Kaiser)*, 722 F.2d 1574, 1582 (2d Cir. 1983).

¹⁰⁹⁹ DCL § 272: “Fair consideration is given for property, or obligation . . . [w]hen in exchange for such property, or obligation, as a fair equivalent therefore, and in good faith, property is conveyed or an antecedent debt is satisfied . . .”

in this context may not weigh heavily in favor of fraudulent intent.¹¹⁰⁰ Further, recipients of the dividend also could assert the less compelling argument that if the dividend was lawfully declared under Delaware law, a contract debt was created¹¹⁰¹ and therefore payment of the dividend was fair consideration for release of an antecedent debt. If the dividend was lawfully declared such that there was an antecedent debt, then the payment is still potentially recoverable as an avoidable preferential transfer under § 547 of the Bankruptcy Code.¹¹⁰² In one of the few cases to examine this issue, the court found that even if the declaration of a dividend had formed a contract, insolvency would have prohibited performance and would have rendered any dividends paid subject to recovery by the estate.¹¹⁰³

Second, with regard to the closeness of the relationship between the parties to the transaction, over ninety percent of the proceeds of the dividend payment went to either directors

¹¹⁰⁰ See *Lippe v. Bairnco Corp.*, 249 F. Supp. 2d 357, 384 (S.D.N.Y. 2003) (finding lack of consideration to be irrelevant as a badge of fraud in the context of a dividend payment reasoning “[o]f course, no consideration was paid for the dividends . . . but this is always the case in a dividends situation . . .”).

¹¹⁰¹ See *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1175 (Del. 1988). However, if the dividend is unlawful under Delaware law, it does not qualify as an “antecedent debt.” See *Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Blackstone Family Inv. P’ship (In re Color Tile, Inc.)*, 2000 WL 152129, *5 (D. Del. Feb. 9, 2000).

¹¹⁰² See App. B. A transfer can be avoided if it was made: (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt; (3) while the debtor was insolvent; (4) on or within ninety days before the bankruptcy petition date, or between ninety days and one year if the transfer was made to an insider; and (5) where the transferee received more than it would have in a liquidation under Chapter 7. Here, if the declaration of the dividend created a contractual debt obligation, the transferees could become creditors for purposes of that transaction, satisfying the first element. Because the debt was created on August 10, 2005 and satisfied through payment on August 18, 2005, it may be an antecedent debt in satisfaction of the second element. With respect to solvency, under 11 U.S.C. § 547(f), there is a presumption of insolvency for the ninety day period preceding the filing of the petition for bankruptcy. Because the dividend was declared and paid within ninety days of October 17, 2005, the date on which Refco filed for bankruptcy, the third and fourth elements are satisfied. With respect to the final element, in light of the relevant facts in this case, the recipients of the dividend received more than they would have received in a Chapter 7.

¹¹⁰³ See *Trace II*, 289 B.R. at 561. Moreover, when a transfer on account of an antecedent debt is made to an insider while the transferor is insolvent, the insider does not meet the “good faith” requirement of DCL § 272, and thus there is no fair consideration for the transfer. See *Farm Stores, Inc. v. School Feeding Corp.*, 477 N.Y.S.2d 374, 378 (N.Y. App. Div. 1984), *aff’d*, 479 N.E.2d 222 (N.Y. 1985). Good faith is not required, however, if the transfer is on account of an antecedent debt in an arms-length transaction with an outsider. *Sharp Int’l Corp. v. State St. Bank & Trust Co. (In re Sharp Int’l Corp.)*, 403 F.3d 43, 54 (2d Cir. 2005).

themselves or to entities related to the directors. Although the Examiner’s investigation did not trace the proceeds beyond the original recipients of the payment, Refco’s estate could argue that given the close nexus between the directors who approved the dividend payment and the individuals and entities who received it, the “closeness of the relationship” prong is met here.¹¹⁰⁴ In turn, the recipients might argue that given that all shareholders received a proportionate share of the dividend, no fraudulent intent can be inferred.¹¹⁰⁵

Section 548 of the Bankruptcy Code and Section 278 of DCL provide transferees with a defense to the avoidance of an actual fraudulent conveyance for property taken for fair value and in good faith.¹¹⁰⁶ First, as discussed above, no value was given in exchange for the dividend payment. Putting aside the issue of consideration, Bennett cannot argue that he received the dividend payment in good faith. With respect to the THL affiliates that received the payment, it may be that the THL Directors’ knowledge or lack of knowledge with respect to the fraud fairly can be imputed to the affiliates, and it is thus undetermined whether the affiliates have a viable good faith defense.

b. Constructive Fraudulent Conveyance

A claim for avoidance of a constructive fraudulent conveyance is governed by DCL § 273 in state law and Section 548(a)(1)(B) of the Bankruptcy Code. Unlike actual fraud, constructive fraud does not have a scienter requirement. In order to show constructive fraud

¹¹⁰⁴ See *State v. First Investors Corp.*, 592 N.Y.S.2d 561, 569 (N.Y. Sup. Ct. 1992) (finding actual intent to defraud where, among other factors, almost two-thirds of dividend went to two of the three directors).

¹¹⁰⁵ See *Lippe*, 249 F. Supp. 2d at 384 (noting that because there is always a close relationship between the company paying a dividend and the shareholders receiving the payment, such closeness is not necessarily a badge of fraud).

¹¹⁰⁶ 11 U.S.C. § 548(c) provides in part, “a transferee or obligee of [a fraudulent] transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred . . . to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.” DCL § 278 provides in relevant part, “Where a conveyance or obligation is fraudulent as to a creditor, such creditor

(footnote continued on next page)

under DCL § 273, a plaintiff must show: (1) the debtor transferred an interest in property; (2) the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer;¹¹⁰⁷ and (3) the debtor received less than a reasonably equivalent value in exchange for such transfer (“fair consideration”).¹¹⁰⁸ Lack of fair consideration creates a presumption of insolvency and shifts the burden to the transferees to prove solvency.¹¹⁰⁹

A claim under Section 548 of the Bankruptcy Code is similar to one under DCL § 273 except with respect to the burden of proving good faith. While New York law burdens the party seeking recovery with showing a lack of good faith on the part of the transferee, federal law burdens the transferee with showing the presence of good faith.¹¹¹⁰

Assuming that Refco was insolvent when it paid the dividend, the case for a constructive fraudulent conveyance claim will rely on evidence that shows that the dividend was paid without consideration from shareholders who did not receive it in good faith. Regardless of where the burden of showing good faith lies, the relevant factual analysis is the same as discussed with regard to actual fraudulent conveyance and yields the same outcome as outlined above. Accordingly, although recipients of the dividend could argue that payment of the dividend created an antecedent debt, likely it will be found that fair value was not given for the dividend.

(footnote continued from previous page)

... may, as against any person except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase . . . [h]ave the conveyance set aside . . .” (emphasis added).

¹¹⁰⁷ Other tests for insolvency under this statute include: (1) as a result of the transfer, the transferor is left with unreasonably small capital to conduct its business (§ 274); and (2) as a result of the transfer, the transferor intends or believes that it will incur debt beyond its ability to pay (§ 275). *A.J. Heel Stone, L.L.C. v. Evisu Int'l, S.R.L.*, No. 03 Civ. 1097(DAB), 2006 WL 1458292, at *3 (S.D.N.Y. May 25, 2006) (summarizing solvency tests found in DCL).

¹¹⁰⁸ See *Trace I*, 287 B.R. at 107 (citations omitted).

¹¹⁰⁹ See *In re The Cassandra Group*, 338 B.R. at 597.

¹¹¹⁰ See 11 U.S.C. § 548(c).

VIII. OTHER PROFESSIONALS

A. McDERMOTT WILL & EMERY LLP

The Examiner preliminarily considered investigating potential claims of Refco's estate against McDermott Will. The Examiner reviewed Refco's documents made available by the Debtors' counsel on its online database and documents made available by the Creditors Committee's counsel on its online database in connection with his preliminary evaluation of possible claims. However, after reviewing documents to determine the extent of McDermott Will's involvement with Refco, the Examiner determined that it was not appropriate to invest significant additional time to conduct a thorough investigation of potential claims against McDermott Will.

First, it appears that McDermott Will performed very little work for Refco. During the period 1998 through 1999, it appears that McDermott Will did some minor legal work for Refco. Schedules of Refco's accrued expenses show that Refco owed McDermott Will \$2,000.00 in October 1998 and \$10,000.00 in September 1999 for legal services rendered.¹¹¹¹ In addition, in response to audit letter requests from Refco, McDermott Will acknowledged representation of Refco in 1998 and 1999 but stated that it had not represented Refco in any matters that would need to be disclosed as part of the audits.¹¹¹² Based on the information known to the Examiner, McDermott Will appears to have engaged in only limited representation of Refco and to have received a minimal amount of attorneys' fees from Refco more than six years ago.

McDermott Will represented BAWAG in connection with transactions between BAWAG, Refco, and RGHI in 1999 and again during the years 2002-2004. McDermott Will

¹¹¹¹ REFCO-E-017238683 at Tab C, 1; REFCO-E-017254824 at Tab C, 2.

¹¹¹² REFCO-HC-0545086 at Tab C, 3; REFCO-HC-0545036 at Tab C, 4.

represented BOI in connection with the LBO. McDermott Will also represented BAWAG and its affiliates DF Capital, Desana Foundation, and Alinea Holding GmbH (“Alinea Holding”). McDermott Will provided general corporate representation and assisted BAWAG and its affiliates in connection with the drafting and closing of the PPA between Refco and DF Capital on July 12, 2002.¹¹¹³ McDermott Will also represented BAWAG, DF Capital, Alinea Holding, and Desana Foundation in connection with the acquisition of DF Capital’s stock.¹¹¹⁴ Pursuant to the series of agreements effecting this acquisition, McDermott Will was paid \$465,000 from the LBO proceeds in August 2004.¹¹¹⁵

Even if claims could otherwise be asserted by Refco’s estate against McDermott Will based on its representation of BAWAG in connection with these transactions, the Examiner concludes that Refco’s estate, through its settlement with BAWAG, has released McDermott Will in its capacity as BAWAG’s counsel. As part of Refco’s estate’s settlement with BAWAG, Refco agreed to:

forever release, acquit, and discharge the BAWAG Entities and the BAWAG Shareholders and any of their current officers and directors . . . , advisors, attorneys, and representatives . . . from and against any and all claims or actions belonging to Refco, their current officers and directors, or the Debtors’ bankruptcy estates, whether direct, derivative, or otherwise . . . , including, but not limited to . . . (ii) all claims that could have been asserted in the Adversary Proceeding or any other claim that could have been brought by or on behalf of Refco or the Committee¹¹¹⁶

Accordingly, the Examiner concluded that he would not conduct further investigation of possible claims against McDermott Will.

¹¹¹³ REFCO-E-002513986 at Tab C, 12; REFCO-0005-000843 at Tab C, 13; REFCO-0005-000893 at Tab C, 14.

¹¹¹⁴ REFCO-E-001391794 at Tab C, 17; REFCO-E-001392117 at Tab C, 18.

¹¹¹⁵ REFCO-0008-151662 at Tab C, 20.

B. KPMG LLP

1. Introduction

During the initial phase of this investigation, the Examiner's counsel reviewed documents to identify the scope of services that KPMG performed for Refco and its related entities. The purpose of this preliminary review was to determine the threshold issue of whether the likely value of any potential claims that Refco's estate could pursue against KPMG supported incurring fees and costs associated with conducting a thorough investigation of KPMG. In particular, the document review focused on whether (1) KPMG performed services for Refco that had a discernible nexus to the fraudulent activity in this case, and (2) whether KPMG had a relationship with Refco creating duties, the breach of which could give rise to a claim brought on behalf of Refco's estate against KPMG.

Based on that review, the Examiner has determined that with respect to this investigation, KPMG's Refco-related engagements fall into one or more of the following: (1) engagements with Refco to provide services outside the three-year statute of limitations period for professional malpractice claims;¹¹¹⁶ (2) engagements with Refco to provide services not relevant to the alleged fraudulent conduct at issue in this case; and (3) engagements with THL that do not create a duty to Refco and, therefore, likely do not give rise to causes of action on behalf of the estate.

In light of the results of the review by the Examiner's counsel, the Examiner concluded that further investigation of KPMG was unwarranted. Notwithstanding the above, the KPMG-related document review did reveal certain engagements that bear describing here.

(footnote continued from previous page)

¹¹¹⁶ Stipulation and Order of Settlement dated June 2, 2006, section 4(a), as approved by Order Approving and Clarifying Stipulation and Order of Settlement and Resolving Certain Objections [July 6, 2006; Docket # 2348].

¹¹¹⁷The statute of limitations for professional malpractice in New York is three years. N.Y. C.P.L.R. § 214(6).

2. Tax Related Engagements

It appears that KPMG performed tax consulting work concerning Refco in 2004 and 2005. Specifically, KPMG's services involved analysis of the tax implications of various corporate transactions and structures following the LBO and in conjunction with the IPO. It is unclear, however, whether THL or Refco was the client during this time period, for although RGL was billed for the work, and RCC paid the invoices, the client number on many of the invoices matches that used on KPMG's invoices to THL for due diligence work related to the LBO. It is also unclear whether the tax work done in conjunction with the IPO was a continuation of a prior engagement or whether KPMG had been engaged separately for the tax work. Despite the lack of clarity, because the substance of the engagement dealt with tax matters unrelated to the fraud at issue in this case, the Examiner has determined that further investigation is not necessary.

3. Engagements with Refco Entities

The following KPMG engagements with Refco entities fall outside of the three-year statute of limitations for professional malpractice claims and/or do not implicate the alleged fraudulent conduct at issue in this case:

- In December 1998 KPMG was engaged to become the “contract manager of the IT function at Refco and [to] take control of the day to day operations.”¹¹¹⁸
- At some point in either 1998 or early 1999, Refco engaged KPMG to complete an evaluation of preparedness for Y2K compliance.¹¹¹⁹

¹¹¹⁸ REFCO-HC-0324240, Memorandum from Refco Group Ltd, Executive Committee to Refco Employees and Associates (December 14, 1998).

¹¹¹⁹ No engagement letter for this project was found; however, an invoice from May 6, 1999 indicated that a Y2K Program Management Office had been established, as stated in KPMG's “amendment proposal letter dated February 12, 1999.” See REFCO-HC-0555520, Invoice from KPMG to Stephen F. Rossi, Senior Vice President-Group Administration, Refco Group, Ltd. (May 6, 1999).

- Several annual reports (found in the THL folders) produced by KPMG for Refco Investment Services Pte Ltd. (“RIS”) indicate that KPMG Singapore reviewed the financial statements of RIS for the fiscal years 1999, 2001, 2002, and 2003. [The report for fiscal year 2000 was not among them.] KPMG Singapore also served as independent auditor for Refco (Singapore) Pte Ltd.
- RGL “and subsidiaries” engaged KPMG for an “MLC Project” which involved a “Financial Statement Audit.”¹¹²⁰ The matter opened on July 1, 1999 and closed on May 3, 2000.
- RGL engaged KPMG to perform an “Investigation,” described by the Conflict and Independence Search Report as a “Forensic in the Audit.”¹¹²¹ The matter opened on July 1, 1999 and closed on April 5, 2000.
- RGL engaged KPMG for a matter related to “Now Financial LLC” involving a “Financial Statement Audit.”¹¹²² The matter opened on August 26, 1999 and closed on December 4, 1999.
- RGL “and subsidiaries” engaged KPMG for a “Special Project” related to a “Risk Assessment.”¹¹²³ The matter opened on November 29, 1999 and closed on May 3, 2000.

4. THL Engagements

THL engaged KPMG for various due diligence efforts related to the LBO. For a discussion of these matters, see Section VI.B. of this Report.

5. Conclusion

After a preliminary review of documents that identified KPMG engagements, the Examiner concluded that further investigation of KPMG was unwarranted for the reasons stated above.

¹¹²⁰ See KPMG-THL 0019223-228, KPMG Conflict and Independence Search Report regarding Refco Group (February 12, 2004).

¹¹²¹ *Id.*

¹¹²² *Id.*

¹¹²³ *Id.*

C. PRICEWATERHOUSECOOPERS, LLP

The Examiner included PricewaterhouseCoopers, LLP (“PwC”) as part of his initial investigation. Review of PwC’s activities also was significant to evaluating the roles of the other professionals, especially in relation to the LBO and IPO.

During the initial stages of the investigation, however, it came to the Examiner’s attention that the Examiner’s counsel, MLA, had one open matter on behalf of PwC being handled by MLA’s Denver, Colorado office related to a government contract. This other legal work did not relate to Refco, the Refco Examination, or the Refco Bankruptcy Cases. The MLA partner in charge of this file did not work on the Refco Examination. Nonetheless, the Examiner brought this issue to the attention of the Court, and consulted with counsel for the U.S. Trustee, counsel for the Debtors, counsel for the Creditors Committee, and counsel for the RCM Trustee. Based on those consultations, the Examiner decided to discontinue any investigation of possible claims against PwC. Upon disclosure to the Court of the Examiner’s recommendation, the Court did not direct the Examiner to continue his investigation.

IX. MISCELLANEOUS CONSIDERATIONS

A. ISSUES CONCERNING REFCO’S SOLVENCY OR INSOLVENCY

Some of the potential claims investigated by the Examiner and referred to in this Report are affected by whether Refco was solvent or insolvent at various points in time. The Court requested that the Examiner not retain additional consultants unless it was absolutely necessary to do so and, instead, to rely on the work done by consultants already retained by other parties in interest in the Bankruptcy Cases. The Examiner has done this. Therefore, the Examiner has not conducted a full-fledged solvency analysis but has utilized the solvency work done by the consultants referred to in this section of the Report, as well as other information reviewed by the Examiner and his counsel, to reach the Examiner’s conclusions on solvency. While it is not

entirely free from doubt, the Examiner believes, based upon his review, that a court would likely find Refco was insolvent, on a consolidated basis. Based on work done by others, some of which was preliminary in nature, the Examiner is assuming for purposes of this Report that Refco was insolvent at all points after the LBO which closed in early August of 2004 until the filing of the Bankruptcy Cases in October of 2005. The Examiner will summarize below what he did to gain comfort in this assumption.

There were at least four consultants who did some work relevant to the solvency issue. They are: (1) FTI Consulting, Inc. (“FTI”) retained by the Creditors Committee; (2) Houlihan Lokey Howard & Zukin Capital, Inc. (“Houlihan”) retained by the Creditors Committee; (3) Goldin Associates, LLC (“Goldin”) retained by the Debtors; and (4) Murray Devine retained by Refco’s board of directors in connection with the IPO dividend.

FTI Consulting

FTI was retained to express an opinion with respect to the solvency of Refco, on a consolidated basis, in connection with the Creditors Committee’s litigation against BAWAG. M. Freddie Reiss of FTI filed a declaration with the Court in support of the Creditors Committee’s request for temporary injunctive relief against BAWAG (the “Reiss Declaration”).

Specifically, Reiss concluded as follows:

1. As a result of a series of transactions (the “Leveraged Recapitalization”) involving THL Refco Acquisition Partners (“THL”), on August 5, 2004, RGL was left with unreasonably small capital.
2. As a result of the Leveraged Recapitalization, on August 5, 2004, RGL was insolvent or rendered insolvent.
3. Pursuant to RGL’s filed financial statements, RGL had approximately \$431,000,000.00 of tangible net book equity as of February 29, 2004, and negative \$1.2 billion of

tangible net book equity as of August 5, 2004 after the Leveraged Recapitalization.¹¹²⁴

Reiss defined insolvency as "...when the present saleable value of one's assets is less than the amount that will be required to pay one's probable liabilities on existing debts as they become absolute and matured."¹¹²⁵

Reiss essentially concluded that Refco, on a consolidated basis, was insolvent at the time of the LBO. Reiss concluded that, if proper disclosure had been made at the time of the LBO, the consequences that were eventually visited upon Refco in October of 2005, or consequences very close to them, would have occurred at the time of the LBO. As a result, Reiss concluded that Refco's good will was impaired and that the elimination of good will from Refco's balance sheet would render the company insolvent. He also concluded that certain other intangible assets on Refco's balance sheet would have been impaired.

Reiss further stated in his declaration as follows:

"It is my belief that if RGL had made the appropriate financial and non financial disclosure to the public regarding the true status of its operations and its financial statements as of August 5, 2004, RGL would have suffered similar financial distress that it suffered in the wake of the October 10, 2005 press release, and would as a result, have been rendered under capitalized and insolvent as of August 5, 2004. ...RGL's financial condition improved between the time of the Leveraged Recapitalization and the October 10, 2005 announcement...consequently, it stands to reason that if RGL was unable to survive the disclosures of this uncollectible receivable after the IPO...it certainly would not have been able to withstand the same announcement after the closing of the Leveraged Recapitalization when it had even higher leverage."¹¹²⁶

¹¹²⁴ See Pages 1-2 of the Reiss Declaration. (Emphasis in original).

¹¹²⁵ See Page 21 of Reiss Declaration.

¹¹²⁶ See Pages 15-16 of Reiss Declaration.

While the FTI solvency analysis was preliminary in nature and was used for the purpose of supporting temporary injunctive relief against BAWAG, the Examiner believes the approach taken by FTI is valid with respect to a solvency analysis at all times in 2004 and 2005.

Houlihan

Houlihan was retained by the conflicts counsel for the Creditors Committee to examine solvency issues in connection with the analysis of possible claims against underwriters, banks, or others arising out of the IPO process. Its work in that regard was preliminary in nature and focused on specific parts of Refco. Houlihan also performed, and filed with the Court as a part of the confirmation process, a liquidation analysis of Refco both on a consolidated and individual Refco entity basis.

The liquidation analysis prepared by Houlihan was helpful to the Examiner. It analyzed, for plan confirmation purposes, whether Refco, on both a consolidated and individual entity basis, was solvent or insolvent and concluded that Refco was insolvent. While the Examiner did not meet with Houlihan to discuss the liquidation analysis, he did have access to the analysis as filed with the Court and the Houlihan representative's testimony before the Court during the confirmation process.

Goldin

Goldin was retained by the Debtors and provided restructuring and financial consulting assistance. Prior to the parties arriving at a consensual plan that provided, for plan purposes, the equivalent of a substantive consolidation that rendered a full fledged solvency analysis unnecessary, Goldin did some preliminary work on solvency. The Examiner met with representatives of Goldin to discuss its work and considered its analysis and conclusions, which

were preliminary in nature but not inconsistent with the assumption of insolvency that the Examiner is making.

Murray Devine

In connection with the approximately \$82.2 million dividend authorized by Refco's board of directors and paid at the time of the IPO, Murray Devine was retained to provide a solvency opinion to the board of directors. Murray Devine provided such an opinion based upon an analysis it had previously conducted for Refco and an update of that analysis at the time of the IPO.¹¹²⁷

However, Murray Devine's conclusion of solvency was based in large part on Refco management representations and the audited financial statements which were false and rendered unreliable by Refco's public announcement in October of 2005 with respect to the undisclosed RGHI Receivable. At the interview of the Murray Devine person responsible for the solvency opinion, he stated that if he had known of those irregularities at the time of the solvency opinion he would have recommended to Murray Devine that it not issue an opinion and withdraw from the engagement. He also stated that if Murray Devine did go forward and perform a solvency opinion under those circumstances it would likely use a liquidation value approach as opposed to the going concern approach which was used in the Murray Devine solvency opinion.

Based on the foregoing, the Examiner does not believe that the Murray Devine solvency opinion in connection with the IPO dividend could be the basis for finding that Refco was solvent in August of 2005.

¹¹²⁷ See Section VII of this Report.

Conclusion

It is the Examiner's belief that the potential consequences to a company like Refco from the public disclosure made in October of 2005 would likely have been greater after it registered the Senior Subordinated Notes with the SEC and after the completion of its IPO in August of 2005, than before the registration and IPO. In other words, the public aspects of the registration of the notes and the IPO made it more difficult for Refco to recover from revelations of improprieties than it would have been while it was a private company without registered debt or having engaged in a public offering. Accordingly, while Refco's financial condition may have improved in some respects from the date of the LBO until the Petition Date, the Examiner believes it is more likely than not that a court would find that Refco was insolvent at all times between the closing of its LBO in August of 2004 and the filing of the bankruptcy petitions in October of 2005, including at the time of the closing of its IPO in August of 2005.

Based on the foregoing, it is the Examiner's conclusion that a court would likely find Refco was insolvent and with unreasonably small capital to conduct its business at all points from the closing of the LBO in August of 2004 until the filing of the bankruptcy petitions in October of 2005. This conclusion is solely that of the Examiner and does not express the opinion of any of the consultants the Examiner met with or represent their work product that was reviewed by the Examiner.

B. PREFERENTIAL TRANSFERS

Several of the professionals who were subjects of the Examination, including GT, Mayer Brown, Weil, Levine Jacobs, and KPMG, received, or are believed to have received, payments of

professional fees or other monies on or within ninety (90) days prior to the Petition Date.¹¹²⁸

These payments, commonly referred to as “preferences,” may be subject to avoidance on behalf of, and recovery by, the Debtors’ bankruptcy estates.¹¹²⁹ The Examiner has not investigated or analyzed potential defenses each professional might assert to the avoidance of a payment for professional fees.¹¹³⁰

To establish a *prima facie* case for avoidance of each preferential payment, a representative of the Debtors’ estates must show that each payment was made: (i) to the professional, as a creditor of the Debtors; (ii) for or on account of an antecedent debt; (iii) while the Debtors were insolvent;¹¹³¹ (iv) on or within ninety (90) days prior to the petition date; and (v) that the transfer enabled the professional to receive more than it would have received had the Debtors liquidated through a chapter 7.

C. DAMAGES

Once liability for a tort claim is established, the measure of damages is the actual loss suffered by the plaintiff as a direct result of the defendant’s wrong.¹¹³² A plaintiff may recover damages caused by a professional’s negligence, including: (1) fees paid to the negligent professional itself,¹¹³³ as well as, in some cases, fees paid to a new professional whose services

¹¹²⁸ According to the Statement of Financial Affairs of Refco Capital, LLC, these amounts total at least: (1) GT - \$1,045,793.00; (2) Levine Jacobs - \$55,545.00 (3) Mayer Brown - \$1,629,866.68; (4) Weil - \$842,723.16; and (5) KPMG - \$18,570.00.

¹¹²⁹ See 11 U.S.C. §§ 547 & 550; App. B. This Report has previously discussed preferential transfers with respect to the \$82.2 million dividend.

¹¹³⁰ See 11 U.S.C. § 547(c).

¹¹³¹ Insolvency is presumed for the ninety (90) day period prior to the Petition Date. 11 U.S.C. § 547(f).

¹¹³² *Vogt v. Abish*, 663 F. Supp. 321, 324 (S.D.N.Y. 1987); *Gouiran Holdings, Inc. v. DeSantis, Prinzi, Springer, Keifer & Shall (In re Gouiran Holdings, Inc.)*, 165 B.R. 104, 106 (E.D.N.Y. 1994).

¹¹³³ *Stanley L. Bloch, Inc. v. Klein*, 258 N.Y.S.2d 501, 507-8 (N.Y. Sup. Ct. 1965); *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP*, 212 B.R. 34, 42 (S.D.N.Y. 1997), *appeal after remand at 994 F. Supp. 202 (S.D.N.Y. 1998)*.

were necessitated by the prior, negligently rendered services;¹¹³⁴ (2) funds lost to misappropriation or embezzlement attributable to negligently rendered auditing services,¹¹³⁵ and, possibly, legal malpractice;¹¹³⁶ and (3) a company's increased insolvency,¹¹³⁷ financial decline, and costs of bankruptcy.¹¹³⁸ As to the third category of damages, negligent issuance of an unqualified audit opinion with respect to financial statements that falsely represent a company's solvency may damage a company by causing it to delay filing for bankruptcy or taking other appropriate corrective action.¹¹³⁹ Further, injury to a company's reputation, creditworthiness, and going-concern value may adequately measure damages caused by delay in filing for bankruptcy or taking other corrective action.¹¹⁴⁰

Damage calculations in these Bankruptcy Cases would be very complex, and require extensive fact discovery on damage issues and retention of financial damage experts.¹¹⁴¹ Such

¹¹³⁴ *Bloch*, 258 N.Y.S.2d at 507-08.

¹¹³⁵ See *Gouiran Holdings*, 165 B.R. at 107; *Lincoln Grain, Inc. v. Coopers & Lybrand*, 345 N.W.2d 300, 309 (Neb. 1984).

¹¹³⁶ See *Wechsler*, 212 B.R. at 42.

¹¹³⁷ New York courts have historically viewed "deepening insolvency" as nothing more than a measure of damages once liability is established on an underlying tort. See *Bondi v. Bank of Am. Corp. (In re Parmalat Sec. Litig.)*, 383 F. Supp. 2d 587, 601-02 (S.D.N.Y. 2005) (acknowledging compensability for deepening a corporation's insolvency where underlying claim for breach of fiduciary duty, or aiding and abetting thereof, is established). The concept of "deepening insolvency" as an independent tort is no longer viable in many jurisdictions. See *Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp.)*, 353 B.R. 820, 842 (Bankr. D. Del. 2006); *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 204-07 (Del. Ch. 2006).

¹¹³⁸ See *Plan Comm. v. PricewaterhouseCoopers, LLP*, 335 B.R. 234, 249-50 (D.D.C. 2005); *Allard v. Arthur Anderson & Co. (USA)*, 924 F. Supp. 488, 494 (S.D.N.Y. 1996); *Gouiran Holdings*, 165 B.R. at 107; *Wechsler*, 212 B.R. at 42 (increased obligations to investors incurred by the debtor that the debtor had no hope of repaying).

¹¹³⁹ See, e.g., *River Oaks Furniture, Inc. v. BDO Seidman (In re River Oaks Furniture, Inc.)*, 276 B.R. 507, 531-39 (Bankr. N.D. Miss. 2001) (damages are fact-specific).

¹¹⁴⁰ See *Bankr. Servs., Inc. v. Ernst & Young (In re CBI Holding Co., Inc.)*, 247 B.R. 341, 363 (Bankr. S.D.N.Y. 2000), *rev'd in part on other grounds*, 311 B.R. 350 (S.D.N.Y. 2004), *vacated on other grounds*, 318 B.R. 761 (S.D.N.Y. 2004); *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962, 986 (E.D.N.Y. 1988), *vacated in part on other grounds*, *In re Crazy Eddie Sec. Litig.*, 714 F. Supp. 1285 (E.D.N.Y. 1989).

¹¹⁴¹ See, e.g., *River Oaks Furniture*, 276 B.R. at 531-39.

endeavors are beyond the scope of this Report. However, the Examiner believes significant damages likely would be recoverable for each of the claims the Examiner has concluded exist.

D. APPLICABILITY OF THE *WAGONER* RULE AND DOCTRINE OF *IN PARI DELICTO* TO POTENTIAL CLAIMS AGAINST REFCO'S PROFESSIONALS

If the potential claims identified by the Examiner in this Report are brought against the various Refco professionals, it is likely that the Refco professionals will assert the *Wagoner* rule¹¹⁴² and/or the doctrine of *in pari delicto*¹¹⁴³ as a defense to those claims.¹¹⁴⁴ As described in more detail in Appendix C, the *Wagoner* rule may preclude a bankruptcy trustee from asserting claims on behalf of the company against third parties for injuries that arise out of wrongful acts or misconduct committed by the company's controlling managers.

Here, because Bennett and other individuals appear to have orchestrated the fraudulent manipulation of Refco's financial statements, in part in order to hide uncollectible Refco losses, Refco's prepetition professionals likely will argue that the acts of Bennett and others are properly imputed to Refco and thus, Refco itself engaged in the fraud. Refco's prepetition professionals may then argue that, under the *Wagoner* rule, Refco (through a trustee acting on its behalf) cannot recover for injuries arising out of its own fraud.

There are, however, two possible exceptions to the *Wagoner* rule — the “adverse interest” exception and the “innocent decision maker” exception — for which supporting facts

¹¹⁴² The *Wagoner* rule was established by the U.S. Court of Appeals for the Second Circuit in *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114 (2d Cir. 1991).

¹¹⁴³ *Baena v. KPMG LLP*, 453 F.3d 1, 6 (1st Cir. 2006).

¹¹⁴⁴ The doctrine of *in pari delicto* is an affirmative defense substantially similar to the *Wagoner* rule. For convenience, the concept will generally be referred to herein as the *Wagoner* rule. Both doctrines are based on the principle that the law will not help one wrongdoer recover from another and apply the same standards; also, under New York law, which for purposes of this Report the Examiner has assumed will likely govern, the *Wagoner* rule applies. Despite the similarity of underlying concepts, the *Wagoner* rule and the doctrine of *in pari delicto* are separate and distinct doctrines; the first deals with standing and the second is an equitable, affirmative defense similar to the “unclean hands” doctrine. *See Adelphia Commc'ns Corp. v. Bank of Am. (In re Adelphia Commc'ns Corp.)*, 330 B.R. 364, 381 n.51 (Bankr. S.D.N.Y. 2005); App. C.

may be alleged to defeat a Rule 12 motion by the Refco professionals asserting a defense based on the *Wagoner* rule.

1. Adverse Interest Exception

Under the “adverse interest” exception, the *Wagoner* rule does not bar claims against third parties where it can be established that the company’s controlling managers’ misconduct was undertaken solely to defraud the company. Under such circumstances, the controlling managers’ interests are adverse to those of the company and the managers’ fraudulent conduct will not be imputed to the company. If the fraudulent conduct is not imputed to the company, the *Wagoner* rule will not apply, because the trustee is no longer bringing claims on behalf of a company which engaged in the fraud.¹¹⁴⁵

For the adverse interest exception to apply, however, it must be established, and the complaint must allege, that the managers’ fraudulent actions were done entirely for their own or another’s purpose, with no benefit to the company.¹¹⁴⁶ Generally, the exception does not apply if the managers’ misconduct results in any benefit to the company, even if unintended, or if the primary motivation for the fraud is contrary to the company’s interest.¹¹⁴⁷ In other words, it must be shown that the managers totally abandoned the company’s interests in favor of their own

¹¹⁴⁵ *Center v. Hampton Affiliates, Inc.*, 488 N.E.2d 828, 829 (N.Y. 1985); *see also In re Bennett Funding Group, Inc.*, 336 F.3d 94, 100 (2d Cir. 2003) (the act of the agent will not be charged to the corporation if the agent is actually “committing a fraud for his own benefit”); *Wight v. BankAmerica Corp.*, 219 F.3d 79, 87 (2d Cir. 2000) (allegations that bank was adversely dominated by corrupt management who acted in their own interest and not in the interest of the bank were sufficient at the pleading stage to trigger the adverse interest exception); *Mediators, Inc. v. Manney (In re Mediators, Inc.)*, 105 F.3d 822, 827 (2d Cir. 1997); *In re CBI Holding Co.*, 247 B.R. 341, 365 (Bankr. S.D.N.Y. 2000); *Sec. Investor Protection Corp. v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999).

¹¹⁴⁶ *Center*, 488 N.E.2d at 830; *accord Bennett Funding*, 336 F.3d at 100; *Wight*, 219 F.3d at 87; *Mediators*, 105 F.3d at 827; *BDO Seidman*, 49 F. Supp. 2d at 650; *CEPA Consulting, Ltd. v. King Main Hurdman (In re Wedtech Sec. Litig.)*, 138 B.R. 5, 9 (S.D.N.Y. 1992).

¹¹⁴⁷ *BDO Seidman*, 49 F. Supp. 2d at 650 (citing *Oppenheimer-Palmieri Fund, L.P. v. Peat Marwick Main & Co. (In re Crazy Eddie Sec. Litig.)*, 802 F. Supp. 804, 817 (E.D.N.Y. 1992)).

interests.¹¹⁴⁸ A typical example of adverse conduct engaged in solely for the benefit of the managers is looting.¹¹⁴⁹ Where managers enlist the assistance of third parties in order to structure sham transactions that perpetuate a false impression of corporate solvency, thereby enabling management to raise additional capital in order to keep the company afloat while they loot it, the managers act adversely to the company.¹¹⁵⁰

The Examiner concludes that the facts and circumstances surrounding the fraud described in this Report provide support for the application of the adverse interest exception. The Examiner's investigation has revealed that Bennett, and members of Refco's senior management acting under Bennett's authority and direction, appear to have engaged in the Round Trip Loans and related fraudulent manipulation of Refco's financial statements for the sole purpose of hiding the RGHI Receivable. The purpose for these sham transactions was to conceal Refco's true financial condition so that Refco could be sold at an artificially inflated price during the 2004 LBO and subsequent IPO in 2005. Had the fraud not occurred and Refco's true financial condition been known, the LBO and IPO likely would not have taken place. The only beneficiaries of Refco's fraudulently inflated sale price were RGHI and its shareholders, as well as the senior executives who had profit interests.

In addition, the Round Trip Loans did not serve any legitimate business purpose for Refco and did not result in any benefit to Refco. In each of the loans, Refco paid a third party sums (in the form of interest) solely for their assistance in hiding the RGHI Receivable. Moreover, Refco assumed legal liability when RGL agreed to guarantee the loans to RGHI and

¹¹⁴⁸ *Center*, 488 N.E.2d at 830.

¹¹⁴⁹ *Baena v. KPMG LLP*, 453 F.3d 1, 8 (1st Cir. 2006) ("‘Adverse interest’ in the context of imputation means that the manager is motivated by a desire to serve himself or a third party, and not the company, the classic example being looting.”) (citation omitted).

to indemnify the third party loan participants for any claims arising out of their participation in the sham transactions. Again, RGL's assumption of these liabilities had no conceivable benefit for Refco. In short, in perpetuating the fraudulent loans, Refco's senior management appear to have totally abandoned the interest of Refco in favor of Bennett's and their personal interests in an inflated sale price for the company and, as such, the Examiner believes there are sufficient facts to allege the applicability of the adverse interest exception and preclude a Rule 12 dismissal of claims against Refco's prepetition professionals on *Wagoner* rule grounds.¹¹⁵¹

2. Innocent Decision Maker Exception

Another exception to the *Wagoner* rule is the "innocent decision maker" exception.¹¹⁵² Under that exception, the *Wagoner* rule does not apply in situations where the company had an innocent officer or director who could have stopped the fraudulent conduct if he had been aware of it.¹¹⁵³

(footnote continued from previous page)

¹¹⁵⁰ See *In re Parmalat Sec. Litig.*, No. 04 MD 1653(LAK), 2007 WL 656845, *3 (Feb. 28, 2007).

¹¹⁵¹ See *Oppenheimer-Palmieri Fund, L.P. v. Peat Marwick Main & Co. (In re Crazy Eddie Sec. Litig.)*, 802 F. Supp. 804, 818 (E.D.N.Y. 1992) (noting that transactions designed to inflate the sale of a company and facilitate a public offering are "not inconsistent with an abandonment by [insiders] of the corporation's interest").

¹¹⁵² Some trial courts in the Second Circuit have recognized the innocent decision maker exception to the *Wagoner* rule. See *Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A.*, 80 F. Supp. 2d 129, 136 (S.D.N.Y. 1999); *Sec. Investor Protection Corp. v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 651 (S.D.N.Y. 1999); *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P.*, 212 B.R. 34, 36 (S.D.N.Y. 1997); *Nisselson v. Ford Motor Co. (In re Monahan Ford Corp. of Flushing)*, 340 B.R. 1, 24 (E.D.N.Y. 2006); *Sharp Int'l Corp. v. KPMG LLP (In re Sharp Int'l Corp.)*, 319 B.R. 782, 788 (E.D.N.Y. 2005); and *O'Neil v. New England Rd. Inc. (In re Neri Bros. Constr. Corp.)*, 323 B.R. 540, 543 (Bankr. D.Conn. 2005). Nevertheless, the current legal status of that exception in the Second Circuit remains unclear, as some trial courts in the Second Circuit have declined to recognize the exception, and "[t]he Second Circuit has expressly declined to approve or disapprove the . . . exception." *Am. Tissue, Inc. v. Arthur Andersen L.L.P.*, No. 02 Civ. 7751 (SAS), 2005 WL 712201, *2 & n.16 (S.D.N.Y. Mar. 28, 2005) (citation omitted); see *Am. Tissue, Inc. v. Donaldson, Lufkin & Jenrette, Sec. Corp.*, 233 F.R.D. 327, 330 (S.D.N.Y. 2005); *In re CBI Holding Co., Inc.*, 311 B.R. 350, 372 (S.D.N.Y. 2004), vacated in part, 318 B.R. 761 (S.D.N.Y. 2004) (declining to adopt the exception), appeal pending at, *In re CBI Holding Co. (Bankr. Servs., Inc. v. Ernst & Young)*, Docket No. 04-5972 (2d Cir.) (04-6300, cross appeal); see also *Baena v. KPMG LLP*, 453 F.3d 1, 8-9 (1st Cir. 2006).

¹¹⁵³ *Bennett Funding*, 336 F.3d 94, 101 (2d Cir. 2003); *Sec. Investor Prot. Corp. v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 651 (S.D.N.Y. 1999) (exception did not apply where complaint failed to allege existence of an innocent decision maker who could have stopped the unlawful conduct); *Wechsler*, 212 B.R. at 36 (to survive an assertion of

(footnote continued on next page)

The Examiner concludes that there are facts sufficient to support the application of the innocent decision maker exception. Following the August 2004 LBO, four THL personnel joined Refco's Board of Directors. In January 2005, three independent directors joined the Board. The Examiner did not locate evidence that any of the THL or independent directors had actual knowledge of the fraud used to hide Refco's true financial condition. In addition, the Examiner did not find evidence to suggest that these directors would not have promptly put a stop to the fraudulent activity if they had been made aware of it. Immediately after the Board of Directors and its Audit Committee were alerted to the fraud in October 2005, they commenced an internal investigation, with the assistance of professionals, and subsequently publicly announced the discovery, removed Bennett from his positions of power, and took steps designed to remedy the malfeasance. Under these circumstances, the Examiner concludes sufficient facts exist, at least from the time of the LBO in August 2004, to allege the applicability of the innocent decision maker exception and preclude a Rule 12 dismissal of claims against Refco's prepetition professionals on *Wagoner* rule grounds.

3. Sole Actor Exception

The adverse interest and innocent decision maker exceptions are themselves subject to the sole actor rule, which provides that where the principal and agent are one and the same, the agent's knowledge is imputed to the principal because the agent is the principal.¹¹⁵⁴ The sole actor rule may also be applied where the agent, even if not the sole decision maker or director,

(footnote continued from previous page)

imputation under the *Wagoner* rule, a complaint must include both an allegation that an innocent insider existed and an explanation of "how he could and would have brought the fraud to an end").

¹¹⁵⁴ See App. C.

nevertheless controls and dominates the corporation to the exclusion of the other managers' ability to exercise power.

The Examiner concludes that there is sufficient evidence to allege that from the time of the LBO in August 2004, at the latest, the THL Directors were decision makers with the ability to exercise real power sufficient to defeat the application of the sole actor rule. The Examiner concludes that for the time period prior to the LBO, a question of fact exists as to whether the sole actor rule could be applied based on an argument that Bennett, and the other insiders complicit in the fraud, exercised control over Refco.

July 11, 2007

Respectfully submitted,

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EXHIBIT 1

GLOSSARY

AA - Arthur Andersen LLP, Refco's outside auditors from the late 1980's to 2002

BAWAG - BAWAG P.S.K. Bank für Arbeit Und Wirtschaft Und Österreichische Postsparkasse Aktiengesellschaft

Beckenham Trading - Beckenham Trading Company, Inc., a Round Trip Loan Participant

Bennett - Phillip R. Bennett, former President and CEO of Refco Inc., and majority or sole owner of RGHI at all times relevant to this Report

BOI - BAWAG Overseas, Inc.

BriBank - Bulgarian-Russian Investment Bank, a Round Trip Loan Participant

Broudy - Barbra Broudy, associate at Weil involved in coordination of IPO due diligence

Cappel - Steven Cappel, E&Y tax partner, relationship partner from approximately 2000 until mid 2002

CFTC - Commodities Futures Trading Commission

CIM Ventures - CIM Ventures, Inc., a subsidiary of Ingram Micro, Inc. and a Round Trip Loan Participant

CME - Chicago Mercantile Exchange

Coast - Coast Asset Management, L.P.

Collins - Joseph P. Collins, engagement partner at Mayer Brown from 1994 to the Petition Date

Creditors Committee - Official Committee of Unsecured Creditors appointed in the Bankruptcy Cases

CS Land - CS Land Management LLC, an entity related to Coast -and a Round Trip Loan Participant

Debtors - Refco Inc. and its affiliated debtors in the Bankruptcy Cases

Delta Flyer - Delta Flyer Fund, LLC, a Round Trip Loan Participant

DiDomenico - Daniel M. DiDomenico, Vice-President of Murray Devine who wrote and oversaw solvency opinion in connection with the declaration of the \$82.2 million dividend

E&Y - Ernst & Young LLP, Refco's tax accountant from the early 1990s to at least 2004

EMF - EMF, Ltd., an entity related to EMF Financial, EMF Core Fund and Delta Flyer, a Round Trip Loan Participant

EMF Core Fund - EMF Core Fund Limited, a Round Trip Loan Participant

EMF Financial - EMF Financial Products, LLC, Round Trip Loan Participant

EMF/Delta Entities - EMF Financial Products, LLC, EMF, Ltd., EMF Core Fund Limited, Delta Flyer Fund, LLC, Round Trip Loan Participants

Flanagan - Eric Flanagan, President of EMF Financial

FTI - FTI Consulting, Inc., financial consultant to the Debtors

Goldin - Goldin Associates, LLC, the Debtors' restructuring firm

Grant - Tone N. Grant, former Refco executive, and, prior to the LBO, co-owner of RGHI

GT - Grant Thornton LLP, Refco's outside auditors from 2002 to the Petition Date

Harkins - David Harkins, senior partner with THL

Henneman - Andrea Henneman, associate with Mayer Brown until approximately April 2001, involved with Round Trip Loans

Houlihan - Houlihan Lokey Howard & Zukin Capital, Inc., financial advisor to the Creditors Committee

Ingram Micro - Ingram Micro, Inc., a worldwide distributor of information technology products based in Santa Ana, California, a Round Trip Loan Participant

Jaeckel - Scott Jaeckel, senior partner with THL

Klejna - Dennis Klejna, General Counsel to Refco

KMPG - KPMG LLP, LBO due diligence advisor to THL

Koury - Paul Koury, associate with Mayer Brown until approximately May 2005, involved with Round Trip Loans

Kreiger - Andrew Krieger, founder of Beckenham Trading

LCPMF - Liberty Corner Patriot Master Fund, Ltd., a proposed Round Trip Loan Participant

Levine Jacobs - Levine Jacobs & Company, L.L.C., Refco's tax accounts from approximately 2004 to 2005

Liberty Corner - Liberty Corner Capital Strategies, LLC, a Round Trip Loan Participant

Lynch - Alexander Lynch, partner at Weil responsible for Weil's work in connection with Refco's registered note offering and IPO

Madden - Thomas Madden, former CFO of Ingram Micro, Round Trip Loan Participant

Maggio - Santo Maggio, Refco executive

Mascio - Nick Mascio, Refco executive

Mayer Brown - Mayer, Brown, Rowe & Maw LLP, Refco's main outside counsel from 1994 until the Petition Date

McCarthy - Peter McCarthy, Refco executive

McDermott Will - McDermott Will & Emery LLP, counsel for BAWAG and Refco

Meisler - Michael Meisler, E&Y tax partner who assumed responsibility for the day-to-day management of the Refco engagement in mid-2002

Messina - Vincent Messina, Chief Technology Officer of EMF Financial

MLA - McKenna Long & Aldridge LLP, counsel to the Examiner

MLC - MLC International Corp. and MLC Emerging Markets HSE-Cox

Monk - Robert A. Monk, former Mayer Brown associate involved with Round Trip Loans

Murray Devine - Murray, Devine & Company, Inc., valuation company that provided a solvency opinion to Refco in connection with the declaration of the \$82.2 million dividend

Neidhardt - Kurt Neidhardt, E&Y tax partner who was the lead partner for the Refco engagement from 1993 until E&Y's decision to resign in late 2003

New Refco - New Refco Group Ltd., LLC

Niederhoffer - Victor Niederhoffer and his investment companies, who lost more than \$90 million on investments placed through Refco, Inc. in 1997

Pazzol - Ross Pazzol, of counsel to Mayer Brown, involved with Round Trip Loans

Petitt - Christopher Petitt, Coast's former CFO and former Executive Vice President of CS Land

Pigott - William T. Pigott, owner of Liberty Corner

PwC - PricewaterhouseCoopers, one of Refco's tax accountants

Ramler - Mark Ramler, lead partner on the Refco engagement first at AA then GT

RCM - Refco Capital Markets Ltd.

Refco - Refco Inc. and its affiliated debtors

Refco Group - Refco Group Ltd., LLC

Repco - Repco Holdings, Inc.

RGF - Refco Global Finance, a subsidiary of RCM

RGHI - Refco Group Holdings, Inc., parent company of Refco Inc., wholly-owned by Bennett from the LBO forward

RGHL - Refco Group Holdings, LLC

RGL - Refco Group, Ltd., LLC, f/k/a Refco Group Ltd., Inc.

Ricketts - James Ricketts, corporate treasurer of Ingram Micro

RSL - Refco Securities Ltd.

Schoen - Scott Schoen, senior partner with THL

Schultz - Peter Schultz, associate with Mayer Brown involved with Round Trip Loans

SEC - Securities and Exchange Commission

Sexton - William Sexton, Refco's COO

Sherer - Gerald Sherer, Refco CFO who replaced Trosten

Schneider - Dara Schneider (Moore), audit manager at AA

Silverman - Phillip Silverman, Refco executive

Tabor - Jay Tabor, attorney at Weil responsible for THL's legal due diligence in connection with the LBO

Taylor - George Taylor of THL

THL - THL Refco Acquisition Partners, an affiliate of Thomas H. Lee Partners, L.P., and its affiliates and co-investors

Tindale - H. Whitney Tindale, CFO of EMF Financial

Trosten - Robert C. Trosten, CFO of Refco until September 2004

U.S. Trustee - Office of the United States Trustee for the Southern District of New York

USAO - United States Attorney's Office for the Southern District of New York

Weaver - David Weaver, Refco executive

Westra - James Westra, relationship partner at Weil for the THL and Refco engagements

Weil - Weil, Gotshal & Manges LLP, counsel to THL during the LBO and counsel to Refco Inc. for the registration of the Senior Subordinated Notes and the IPO

Wells - Wells, Ltd., a wholly owned subsidiary of RGHI

EXHIBIT 2

PRIVATE PARTIES WHOSE DOCUMENTS ARE REFERRED TO IN THE REPORT

Alix Partners	KPMG LLP
Arthur Andersen LLP	Levine Jacobs & Company, L.L.C.
BAWAG	Liberty Corner (various entities)
Beckenham Trading Company	Mayer, Brown, Rowe & Maw LLP
Coast Asset Management	NorthBridge Capital Management, Inc.
Deerhurst Management Co., Inc.	PricewaterhouseCoopers
EMF Financial Products/Delta Flyer Fund	Refco Group Holdings Inc.
Ernst & Young LLP	T.H. Lee/ Thomas H. Lee Partners
FTI Consulting, Inc.	The Refco Debtors
Grant Thornton LLP	Weil, Gotshal & Manges LLP
Ingram Micro	

EXHIBIT 3

WITNESSES INTERVIEWED BY THE EXAMINER AND HIS COUNSEL

<u>COMPANY</u>	<u>WITNESS</u>
AA	Jason Blumkin William Denehey Brian Falahee Melissa Kesh Dara Moore Amy Lynn Murphy
Beckham Trading Company	Andrew Kreiger
E&Y	Steven Cappel Michael Meisler Kurt Neidhardt
EMF Financial Products, LLC	H. Whitney Tindale
Ingram Micro	Thomas Madden James Ricketts
KMPG	John Berndsen
Levine Jacobs	Robert Blackwell Richard Hoffman Timothy Shore
Liberty Corner	Mike Lisi William T. Pigott Miriam Yoshida
Mayer Brown	Joseph Collins Andrea Henneman Paul Koury Robert Monk Ross Pazzol Peter G. Schultz
Murray Devine	Ralph Colucci Daniel DiDomenico
THL	Scott Schoen (by proffer)

COMPANY

Weil

WITNESS

Barbra Broudy
Alex Lynch
Jay Tabor
James Westra

APPENDIX A

THE LAW RELATING TO PROFESSIONAL LIABILITY

I. INTRODUCTION

This Appendix A sets forth legal standards that inform the Examiner's conclusions in the Report regarding professionals, including auditors, attorneys, and accountants. Part II discusses choice of law issues. Part III discusses malpractice/professional negligence. Part IV discusses liability for aiding and abetting fraud and breaches of fiduciary duty. Finally, Part V discusses contractual defenses.

II. CHOICE OF LAW

Assuming claims against Refco's prepetition professionals are brought in New York state or federal courts, the Examiner assumes, without deciding, that New York choice of law rules likely will apply.¹ In tort cases, the New York Court of Appeals has applied two different choice of law analyses. The first, reflecting the recent trend,² endorses the "interest analysis" approach,³ under which "a court looks to the policies behind [the] states' laws and thereby determines which state has a 'superior interest' in having its law applied to the issue before it."⁴

¹ Where a federal court sits in diversity, it applies the forum state's choice of law rules. *See, e.g., Klaxon v. Stentor Elec. Mfg., Inc.*, 313 U.S. 487, 496 (1941); *Am. Fuel Corp. v. Utah Energy Dev. Co.*, 122 F.3d 130, 134 (2d Cir. 1997); *In re OPM Leasing Servs., Inc.*, 40 B.R. 380, 391-92 (Bankr. S.D.N.Y. 1984), *aff'd*, 44 B.R. 1023 (S.D.N.Y. 1984). If the claims are brought in the courts of a different state, the choice of law analysis may be different.

² *See Globalnet Financial.Com, Inc. v. Frank Crystal & Co., Inc.*, No. 03 Civ.0733 RWS, 2004 WL 1632594, *3 (S.D.N.Y. July 22, 2004); *OPM Leasing*, 40 B.R. at 392.

³ *See, e.g., Schultz v. Boy Scouts of Am., Inc.*, 65 N.Y.2d 189, 197 (1985); *Towley v. King Arthur Rings, Inc.*, 40 N.Y.2d 129 (1976); *Globalnet Fin.*, 2004 WL 1632594, at *3.

⁴ *OPM Leasing*, 40 B.R. at 392 (citing *Rosenthal v. Warren*, 475 F.2d 438, 442 (2d Cir. 1973)). The only significant considerations are the parties' domiciles and the location of the tort. *See Schultz*, 65 N.Y.2d at 197; *Globalnet Fin.*, 2004 WL 1632594, at *3. "If conflicting conduct-regulating laws are at issue, the law of the jurisdiction where the tort occurred will generally apply because that jurisdiction has the greater interest in regulating behavior within its borders." *Cooney v. Osgood Mach., Inc.*, 81 N.Y.2d 66, 72 (1993); *accord Nw. Mut. Life Ins. Co. v. Wender*, 940 F. Supp. 62, 66 (S.D.N.Y. 1996); *Chase Manhattan Bank v. New Hampshire Ins. Co.*, 749 N.Y.S.2d 632, 634-35 (N.Y. Sup. Ct. 2002).

The second test adopts the “center of gravity” or “grouping of contacts” approach.⁵ This approach, derived from the corresponding analysis in the contract context,⁶ directs the court to give controlling effect to the law of the jurisdiction that has the greatest concern with the issue raised in the litigation by virtue of its relationship or contact with the occurrence or the parties.⁷

In contract cases, New York choice of law principles require application of the “center of gravity” or “grouping of contacts” analysis to contract claims.⁸ Under this analysis, courts “consider a ‘spectrum of significant contacts,’ beyond the prior standard of the law of the place where the contract was made or was to be performed.”⁹ New York courts apply the law of the state that ultimately proves to be the “center of gravity” of the particular contract dispute.

Under any of the tests discussed above, the Examiner assumes, without deciding, that New York law likely will generally apply.¹⁰

⁵ See, e.g., *RCA Corp. v. Tucker*, 696 F. Supp. 845, 854-55 (E.D.N.Y. 1988); *Cousins v. Instrument Flyers, Inc.*, 44 N.Y.2d 698, 700 (N.Y. 1978); *Babcock v. Jackson*, 12 N.Y.2d 473, 479 (N.Y. 1963).

⁶ See *Babcock*, 12 N.Y.2d at 481.

⁷ See *OPM Leasing*, 40 B.R. at 392; *Babcock*, 12 N.Y.2d at 481. The court will consider such factors as “(a) the place where the injury occurred, (b) the place where the conduct causing the injury occurred, (c) the domicil, residence, . . . place of incorporation and place of business of the parties, and (d) the place where the relationship, if any, between the parties is centered.” *RCA Corp.*, 696 F. Supp. at 855 (quoting RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 145(2) (1969)).

⁸ See, e.g., *Matter of Allstate Ins. Co. (Stolarz)*, 81 N.Y.2d 219, 266 (1993); *Auten v. Auten*, 308 N.Y. 155, 160 (1954); *Globalnet Fin.*, 2004 WL 1632594 at *3.

⁹ *Globalnet Fin.*, 2004 WL 1632594, at *3 (quoting *Allstate*, 81 N.Y.2d at 225-26); accord *Auten*, 308 N.Y. at 161. Among the factors for consideration are “the place of contracting, negotiation and performance; the location of the subject matter of the contract; and the domicile of the contracting parties.” *Allstate*, 81 N.Y.2d at 227.

¹⁰ However, New York choice of law rules recognize the “internal affairs doctrine,” which provides matters relating to the internal affairs of a corporation are decided in accordance with the law of the state of incorporation. Thus, claims for breach of fiduciary duty may be governed by the law of the state of incorporation. See *BBS Norwalk One, Inc. v. Raccolta, Inc.*, 60 F. Supp. 2d 123, 129 (S.D.N.Y. 1999) (citing *Walton v. Morgan Stanley & Co.*, 623 F.2d 796, 798 n.3 (2d Cir. 1980)). Claims for aiding an abetting a breach of fiduciary duty may or may not be governed by the law of the state of incorporation. Compare *Granite Partners, L.P. v. Bear, Stearns & Co.*, 17 F. Supp. 2d 275, 306 n.16 (S.D.N.Y. 1998) (“[U]nder New York’s choice of law rules, the law of the state of incorporation controls a breach of fiduciary duty claim while New York law controls the plaintiff’s claim for aiding and abetting the breach of fiduciary duty because the acts giving rise to the claim took place, in significant part, in New York.”); *Solow v. Stone*, 994 F. Supp. 173, 177 (S.D.N.Y. 1998) (“The same choice-of-law analysis would not seem to apply to plaintiff’s remaining claims for aiding and abetting the breach of fiduciary duty and tortious interference with

(footnote continued on next page)

III. MALPRACTICE/PROFESSIONAL NEGLIGENCE

A. INTRODUCTION

Under New York law, “a professional’s failure to perform his job in accordance with the standards required of one in his field states a claim in tort or malpractice.”¹¹ Professional malpractice is a form of negligence.¹² When a professional negligently performs its duties, its client has a cause of action against the professional.¹³ Upon the client’s filing for bankruptcy, the claim becomes property of the estate.¹⁴ The elements of a claim for professional negligence are: (1) a duty owed to the plaintiff, (2) a breach of that duty, (3) “a reasonably close causal connection” between the breach of duty and the injury, and (4) “actual loss, harm, or damage.”¹⁵

B. DISTINCTIONS BETWEEN THE STANDARDS OF CARE APPLICABLE TO AUDITORS, ATTORNEYS, AND ACCOUNTANTS

1. Auditors

An auditor owes its client a duty to “use skill and due professional care and to exercise good faith and to observe generally accepted auditing standards and professional guidelines, with the appropriate reasonable, honest judgment that a reasonably skillful and prudent auditor would

(footnote continued from previous page)

contract. These two claims are not directed against the administrators in their capacity as officers or directors . . . but rather as independent actors.”), with *Lou v. Belzberg*, 728 F. Supp. 1010, 1023 (S.D.N.Y. 1990) (citing *Terrydale Liquidating Trust v. Barness*, 611 F. Supp. 1006 (S.D.N.Y. 1984), *aff’d*, 846 F.2d 845 (1988). See also *BBS*, 60 F. Supp. 2d at 129; *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962, 986 (E.D.N.Y. 1988) (“Since Delaware law will determine whether the individual defendants breached their fiduciary obligations . . . Delaware law should determine whether third-party defendants conspired with them to assist in that breach.”), *vacated in part on other grounds sub nom.*, *In re Crazy Eddie Sec. Litig.*, 714 F. Supp. 1285 (E.D.N.Y. 1989).

¹¹ *Bloor v. Dansker (In re Investors Funding Corp. of New York Sec. Litig.)*, 566 F. Supp. 193, 201 (S.D.N.Y. 1983).

¹² *Hydro Investors, Inc. v. Trafalgar Power, Inc.*, 227 F.3d 8, 15 (2d Cir. 2000).

¹³ See *Ultramar Corp. v. Touche*, 174 N.E. 441, 448 (N.Y. 1931).

¹⁴ *Sharp Int’l Corp. v. KPMG LLP (In re Sharp Int’l Corp.)*, 319 B.R. 782, 790 (Bankr. E.D.N.Y. 2005).

¹⁵ *Integrated Waste Servs., Inc. v. Akzo Nobel Salt, Inc.*, 113 F.3d 296, 299 (2d Cir. 1997); accord *Brady v. Bisogno & Meyerson*, 819 N.Y.S.2d 558, 559 (N.Y. App. Div. 2006).

use under the same or similar circumstances.”¹⁶ By performing an audit, an auditor does not guarantee the correctness of every account, and innocent mistakes do not necessarily give rise to liability.¹⁷

Generally Accepted Auditing Standards (“GAAS”) are widely accepted as the standards of practice for auditors.¹⁸ The American Institute of Certified Public Accountants (“AICPA”) also issues pronouncements called Statements on Auditing Standards (“Statements”), which amplify, modify, and interpret GAAS.¹⁹ Proof of deviation from GAAS does not establish negligence *per se*, but it does shift a trial burden to the auditor to explain the deviation.²⁰ Conversely, by proving its compliance with GAAS, an auditor-defendant absolves itself of liability.²¹ The ultimate burden of proof lies always with the plaintiff.²²

¹⁶ *Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F. Supp. 531, 538 (S.D.N.Y. 1990).

¹⁷ *Id.*

¹⁸ *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 811 (1984).

¹⁹ The Statements have been codified in a volume of professional standards, referred to as auditing interpretations, which are cited with the prefix AU.

²⁰ *Mishkin*, 744 F. Supp. at 537-38. The following are examples of violations of auditing standards that, in various aggregations, support a claim that an auditor has breached its duty of care: (1) failure to exercise the requisite skepticism throughout the auditing process; (2) failure to gather competent evidential matter to support financial statements; (3) failure to adequately verify the client’s accounts receivable; (4) failure to adequately verify, corroborate, or confirm the client’s representations; (5) failure to investigate whether the values assigned to assets are correct; (6) failure to gain adequate understanding of the client’s internal control structure; (7) failure to utilize an approach that relies more on the auditor’s independent testing and less on the client’s internal control structure; (8) adjusting audit procedures based on results found in the audit; (9) inadequate supervision and staffing of the audit by management; (10) inadequate time spent on the audit; and (11) failure to discuss the audit with appropriate members of the client’s management. *See id.* at 539; *Togut v. Arthur Anderson & Co. (In re Mid-Atl. Fund, Inc.)*, 39 B.R. 88, 90 (S.D.N.Y. 1984); *Sharp Int’l Corp. v. KPMG LLP (In re Sharp Int’l Corp.)*, 278 B.R. 28, 35 (Bankr. E.D.N.Y. 2002); *Bankr. Servs., Inc. v. Ernst & Young (In re CBI Holding Co., Inc.)*, 247 B.R. 341, 363 (Bankr. S.D.N.Y. 2000), *rev’d in part on other grounds*, 311 B.R. 350 (S.D.N.Y. 2004), *vacated on other grounds*, 318 B.R. 761 (S.D.N.Y. 2004), *appeal pending at, In re CBI Holding Co. (Bankr. Servs., Inc. v. Ernst & Young)*, Docket No. 04-5972 (2d Cir.) (04-6300, cross appeal). This list is not exclusive.

²¹ *Monroe v. Hughes*, 31 F.3d 772, 774 (9th Cir. 1994); *In re Sharp Int’l Corp.*, 278 B.R. at 3.

²² *Mishkin*, 744 F. Supp. at 538.

2. Attorneys

To establish an attorney's negligence, a plaintiff must show the attorney "failed to exercise that degree of care, skill, and diligence commonly possessed and exercised by a member of the legal community."²³ Attorneys are not liable for honest mistakes of judgment where a proper course of action is open to reasonable doubt, and the selection of one of multiple reasonable options does not constitute malpractice.²⁴ However, an attorney undertaking a task in a specialized area of the law must exercise the degree of skill and knowledge possessed by attorneys who practice in that specialty.²⁵ "An important duty of securities counsel is to make a "reasonable, independent investigation to detect and correct false or misleading materials."²⁶

The New York Code of Professional Responsibility ("CPR") contain Canons, Ethical Considerations, and Disciplinary Rules ("DR" or in the plural "DRs"). The DRs are mandatory and represent "the minimum level of conduct below which no lawyer can fall without being subject to disciplinary action."²⁷ Although violation of the CPR does not necessarily give rise to civil liability, courts have held "conduct constituting a violation of a disciplinary rule may also constitute evidence of malpractice."²⁸ DRs 7-102(A) and (B) are relevant where an attorney has

²³ See *Nobile v. Schwartz*, 265 F. Supp. 2d 282, 288 (S.D.N.Y. 2003) (quoting *Hwang v. Bierman*, 614 N.Y.S.2d 51, 52 (N.Y. App. Div. 1994)).

²⁴ *Grago v. Robertson*, 370 N.Y.S.2d 255, 258 (N.Y. App. Div. 1975).

²⁵ See, e.g., *Wahl v. Foreman*, 398 F. Supp. 526, 538 (S.D.N.Y. 1975). This requirement is expressed in the Disciplinary Rules of the New York Code of Professional Responsibility ("CPR"), which provide that a lawyer shall not "[h]andle a legal matter which, the lawyer knows or should know that he or she is not competent to handle, without associating with a lawyer who is competent to handle it."

²⁶ *FDIC v. O'Melveny & Myers*, 969 F.2d 744, 749 (9th Cir. 1992), *rev'd and remanded on other grounds*, 512 U.S. 79 (1994), *prior opinion adopted in haec verba*, 61 F.3d 17 (9th Cir. 1995) (quoting *Felts v. Nat'l Account Sys. Ass'n, Inc.*, 469 F. Supp. 54, 67 (N.D. Miss. 1978)); cf. *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643, 690 (S.D.N.Y. 1968).

²⁷ See Preliminary Statement, New York CPR.

²⁸ *Swift v. Choe*, 674 N.Y.S.2d 17, 21 (N.Y. App. Div. 1998); accord *William Kaufman Org., Ltd. v. Graham & James LLP*, 269 A.D.2d 171, 173 (N.Y. App. Div. 2000); *GD Searle & Co., Inc. v. Pennie & Edmonds LLP*, No. 602374/00, *1 (N.Y. Sup. Ct. Jan. 14, 2004); cf. *Tilton v. Trezza*, No. 005818/2003, 2006 WL 1320738 (N.Y. Sup.),

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knowledge that a client intends to use false statements of fact or law in a transaction for an improper purpose. DR7-102 states, in pertinent part:

In the representation of a client, a lawyer shall not: . . . 3. Conceal or knowingly fail to disclose that which the lawyer is required to reveal . . . 5. Knowingly make a false statement of fact or law . . . 7. Counsel or assist the client in conduct that the lawyer knows to be illegal or fraudulent . . . 8. Knowingly engage in other illegal conduct or conduct contrary to a Disciplinary Rule.²⁹

An attorney is more than a mere scrivener.³⁰ “In our complex society the accountant’s certificate and the lawyer’s opinion can be instruments for inflicting pecuniary loss more potent than the chisel or crowbar.”³¹ An attorney may not blindly execute his client’s wishes without any regard for the propriety of his conduct.³² “Our legal system depends on attorneys who appropriately question requests by clients that should arouse suspicion, and an attorney must not permit his or her judgment to be influenced by the desire to please a client.”³³

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*5 (Mar. 27, 2006) (holding expert may testify about ethical standards in legal malpractice action but may not cite CPR).

²⁹ See DR7-102(a)(3),(5),(7),(8). Similarly, Model Rule of Professional Responsibility 4.1 provides, “In the course of representing a client, a lawyer shall not knowingly: (a) make a false statement of material fact or law to a third person; or (b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.”

³⁰ See *SEC v. Frank*, 388 F.2d 486, 489 (2d Cir. 1968); *Haines v. Gen. Motors Corp.*, 603 F. Supp. 471, 479 (S.D. Ohio 1983); *In re Oliver*, 323 B.R. 769, 774 (Bankr. M.D. Ala. 2005).

³¹ *Frank*, 388 F.2d at 489 (citing *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964), *cert. denied* 377 U.S. 953). “A lawyer has no privilege to assist in circulating a statement with regard to securities which he knows to be false simply because his client furnished it to him . . . [A] lawyer, no more than others, can escape liability by closing his eyes to what he saw and could readily understand.” *Id.*

³² See DR 7-102; *Florida Bar v. Brown*, 790 So. 2d 1081, 1087-88 (Fla. 2001).

³³ *Brown*, 790 So. 2d at 1088; Ass’N OF THE BAR OF THE CITY OF N.Y., FORMAL OPINION 2002-1, available at <http://www.nycbar.org/Ethics/eth2002-1.html>.

3. Accountants

The practice and ethical rules promulgated by the AICPA provide the professional standards applicable to accountants.³⁴ An accountant owes his client a duty to perform within the accepted standards of practice of his profession.³⁵ Generally Accepted Accounting Principles (“GAAP”), promulgated by the AICPA, generally embody the substantive standards.³⁶ In general, an accountant’s good faith compliance with GAAP discharges the accountant’s obligation to act with reasonable care.³⁷ An accountant’s conduct “does not give rise to a malpractice claim unless that conduct is alleged to have negatively impacted on the professional services rendered.”³⁸ Unless the fact-finder has a sufficient basis for judging the adequacy of the accountant’s conduct, “expert testimony will be necessary to establish that the [accountant] breached a standard of professional care.”³⁹

C. CAUSATION AND DAMAGES

While the substantive duties owed by auditors, attorneys, and accountants may differ, in all cases a plaintiff must prove the professional’s negligence caused it to suffer damages in order to prevail on a claim for professional negligence. This requires showing both loss causation and

³⁴ Generally, the AICPA Code of Professional Conduct provides that “[m]embers should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.” AICPA Code of Professional Conduct, Art. II § 53.

³⁵ Rule 201(D) of the AICPA Code of Professional Conduct provides that accountants shall “[o]btain sufficient relevant data to afford a reasonable basis for conclusions and recommendations in relation to any professional services rendered.” *See Friedman v. Anderson*, 803 N.Y.S.2d 514, 514 (N.Y. App. Div. 2005) (citing source of accountant’s duty to perform within scope of accepted standards).

³⁶ *Cumis Ins. Soc’y Inc. v. Tooke*, 739 N.Y.S.2d 489, 493 (N.Y. App. Div. 2002).

³⁷ *In re Sharp Int’l Corp.*, 278 B.R. at 33.

³⁸ *Block v. Razorfish, Inc.*, 121 F. Supp. 2d 401, 403 (S.D.N.Y. 2000).

³⁹ *Bd. of Trs. of the Teamsters Local 918 Pension Fund v. Freeburg & Freeburg, C.P.A.*, No. 98CV4895(SJ), 1999 WL 803895, at *6 (E.D.N.Y. Sept. 28, 1999).

transaction causation.⁴⁰ Loss causation is analogous to proximate cause; a plaintiff need only show the damage suffered was a foreseeable result of the defendant's negligence to establish loss causation.⁴¹ Transaction causation is a higher standard and is most closely analogous to reliance.⁴² To establish transaction causation, a plaintiff must prove "the violations in question caused the [plaintiff] to engage in the transaction in question."⁴³

In order to show the professional's negligence caused its damages, a plaintiff must show that, had the professional's services been performed in a non-negligent manner, the plaintiff would have taken steps to avoid the injury alleged or would have abstained from entering into the transactions that caused the injury.⁴⁴ A plaintiff must show actual, rather than speculative, damages.⁴⁵ For example, a plaintiff may recover damages for fees paid for services that did not provide any value to the client, increased liability caused by the defendant's deficient services, and funds lost to misappropriation and embezzlement.⁴⁶

The question of causation is premised on the objective, "reasonable person" standard. The U.S. Court of Appeals for the Second Circuit has defined this standard by holding, "[I]t is enough [for a plaintiff] to introduce evidence from which reasonable persons may conclude that

⁴⁰ *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 209 (2d Cir. 2000) (applying New York law).

⁴¹ *Id.*

⁴² See *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 157 n.1 (2d Cir. 2007); *Currie v. Cayman Res. Corp.*, 835 F.2d 780, 785 (11th Cir. 1988).

⁴³ *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *overruled on other grounds by Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1101 n.9 (1991); *accord Togut v. Arthur Anderson & Co. (In re Mid-Atl. Fund, Inc.)*, 39 B.R. 88, 90 (S.D.N.Y. 1984).

⁴⁴ *Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A.*, 80 F. Supp. 2d 129, 139 (S.D.N.Y. 1999); *D.D. Hamilton Textiles, Inc. v. Estate of Mate*, 703 N.Y.S.2d 451, 453 (N.Y. App. Div. 2000).

⁴⁵ See *Ehlinger v. Ruberti, Girvin & Ferlazzo, PC*, 758 N.Y.S.2d 195, 196 (N.Y. App. Div. 2003).

⁴⁶ See *Allard v. Arthur Anderson & Co. (USA)*, 924 F. Supp. 488, 494 (S.D.N.Y. 1996); *Gouiran Holdings, Inc. v. De Santis, Prinzi, Springer, Keifer & Shall (In re Gouiran Holdings, Inc.)*, 165 B.R. 104, 106 (E.D.N.Y. 1994); *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP*, 212 B.R. 34, 42 (S.D.N.Y. 1997), *appeal after remand at*, 994 F. Supp. 202 (S.D.N.Y. 1998); *Stanley L. Bloch, Inc. v. Klein*, 258 N.Y.S.2d 501, 508 (N.Y. Sup. Ct. 1965).

it is more probable that the event was caused by the defendant than ... not.”⁴⁷ So long as the professional’s negligence was a proximate cause of the injury, causation may be established even though others’ mistakes also contributed to the injury.⁴⁸

D. DEFENSES TO CLAIMS FOR MALPRACTICE

Several potential defenses are commonly asserted by auditors, attorneys, and accountants charged with professional negligence, including the running of the statute of limitations and the doctrine of comparative negligence.⁴⁹ Each of these defenses is addressed in this subsection.

The statute of limitations for bringing a claim for professional malpractice under New York law is three years.⁵⁰ In the absence of fraud, a malpractice action “accrues when an injury occurs, even if the aggrieved party is ignorant of the wrong or injury.”⁵¹

In some cases, the limitations period may be extended by the “continuous representation doctrine”⁵² where the parties have a continuous, ongoing relationship in which the defendant professional provides services related to the transaction which is the subject of the malpractice claim.⁵³ The doctrine does not apply solely by virtue of the continuation of a general,

⁴⁷ *Rubens v. Mason*, 387 F.3d 183, 189 (2d Cir. 2004) (quoting W. Page Keeton et al., *PROSSER AND KEETON ON TORTS* § 32 (5th ed. 1984)).

⁴⁸ *Skinner v. Stone, Raskin & Israel*, 724 F.2d 264, 265-66 (2d Cir. 1983).

⁴⁹ See N.Y. C.P.L.R. § 214(6) (statute of limitations); *Caiati v. Kimel Funding Corp.*, 546 N.Y.S.2d 877, 878 (N.Y. App. Div. 1989) (comparative negligence). The *Wagoner* rule, another common defense, is discussed in Section IX.D. of this Report and in App. C.

⁵⁰ N.Y. C.P.L.R. § 214(6).

⁵¹ *Ackerman v. Price Waterhouse*, 84 N.Y.2d 535, 541 (N.Y. 1994); accord *Williamson v. PricewaterhouseCoopers, LLP*, 817 N.Y.S.2d 61, 63 (N.Y. App. Div. 2006); *Levin v. PricewaterhouseCoopers, LLP*, 754 N.Y.S.2d 541, 541 (N.Y. App. Div. 2003); *Bastys v. Rothschild*, No. 97 Civ. 5154 CMGAY, 2000 WL 1810107, *50 (S.D.N.Y. Nov. 21, 2000); *Glamm v. Allen*, 57 N.Y.2d 87, 93 (N.Y. 1982).

⁵² See *Williamson*, 817 N.Y.S.2d at 64; *Kearney v. Firley, Moran, Freer & Eassa, P.C.*, 651 N.Y.S.2d 781, 781 (N.Y. App. Div. 1996).

⁵³ *Mitschele v. Schultz*, 826 N.Y.S.2d 14, 18 (N.Y. App. Div. 2006); see also *Bastys*, 2000 WL 1810107 at *51 (statute of limitations tolled only when accountant “continues to perform services for the plaintiff that relate to the specific matter in dispute, not merely the continuation of a professional relationship”); *Ashmead v. Groper*, 673

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professional relationship; its application requires that a professional render the same or related services after the alleged malpractice.⁵⁴

A plaintiff may also seek to extend the limitations period under a theory of fraudulent concealment, which is synonymous with equitable estoppel under New York law.⁵⁵ A plaintiff can assert fraudulent concealment when the defendant either affirmatively makes a false statement the plaintiff relies upon in not filing a complaint or when the defendant deliberately conceals facts underlying a claim it is under a duty to disclose.⁵⁶ A plaintiff may only toll the statute of limitations if it has no notice of the facts underlying its claims.⁵⁷ Whether fraudulent concealment can be used to toll the statute of limitations on a claim against a non-medical professional under New York law is unclear.⁵⁸ Assuming a plaintiff may toll the statute of limitations based on fraudulent concealment, the plaintiff will have to demonstrate it commenced

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N.Y.S.2d 779, 779 (N.Y. App. Div. 1998) (“It is established law that a professional’s failure to take action or provide services necessary to protect a patient or client’s interests cannot of itself constitute a course of treatment or representation.”); *Kearney*, 651 N.Y.S.2d at 781 (doctrine not applicable where no continuity of services with respect to a specific tax condition) (citing *Goulding v. Solomon*, 475 N.Y.S.2d 723, 725 (N.Y. Civ. Ct. 1984)).

⁵⁴ *Mitschele*, 826 N.Y.2d at 18 (citing *Muller v. Sturman*, 437 N.Y.S.2d 205 (N.Y. App. Div. 1981)). In the auditor context, for example, where the same firm performs annual audits for a client and the court finds (1) the auditor made the same errors year after year and (2) those errors resulted in miscalculations the auditor relied upon in performing the subsequent audit(s), the plaintiff can seek recovery for all of the negligent audits so long as the final audit fell within the statutory period. *Williamson*, 817 N.Y.S.2d at 64; see also *Wedtech Corp. v. KMG Main Hurdman (In re Wedtech Corp.)*, 81 B.R. 240, 242 (S.D.N.Y. 1987).

⁵⁵ *In re Fischer*, 308 B.R. 631, 656 (Bankr. E.D.N.Y. 2004). Equitable estoppel is sometimes used interchangeably with the term “equitable tolling” in New York case law, although federal courts distinguish between the two. *Coleman & Co. Sec. Inc. v. Giaquinto Family Trust*, 236 F. Supp. 2d 288, 299 (S.D.N.Y. 2002).

⁵⁶ *Tenamee v. Schmukler*, 438 F. Supp. 2d 438, 444 (S.D.N.Y. 2006).

⁵⁷ See *O’Brien v. Nat’l Prop. Analysts Partners*, 719 F. Supp. 222, 231 (S.D.N.Y. 1989) (“Plaintiffs must make ‘distinct averments as to the time when the fraud, mistake, concealment, or misrepresentation was discovered, and what the discovery is, so that the court may clearly see, whether by the exercise of ordinary diligence, the discovery might not have been before made.’”) (quoting *Moviecolor Ltd. v. Eastman Kodak Co.*, 288 F.2d 80, 88 (2d Cir. 1961), cert. denied, 368 U.S. 821 (1961)); see also *Abercrombie v. Andrew College*, 438 F. Supp. 2d 243, 265 (S.D.N.Y. 2006) (stating fraudulent concealment must be pled with particularity and is invoked sparingly).

⁵⁸ Compare *Seippel v. Jenkens & Gilchrist, P.C.*, 341 F. Supp. 2d 363, 375 (S.D.N.Y. 2004) (“New York courts have rejected the proposition that fraudulent concealment tolls the statute of limitations in non-medical malpractice

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its suit within a reasonable time after the fraud “ceased to be operational” and show affirmative acts of fraud in addition to the original alleged malpractice.⁵⁹

Comparative negligence may also be asserted as a partial defense to a claim for professional malpractice.⁶⁰ New York is a comparative negligence state. Therefore, to the extent a plaintiff is culpable along with the defendant, the plaintiff’s recovery will be diminished.⁶¹

IV. AIDING AND ABETTING FRAUD/AIDING AND ABETTING BREACH OF FIDUCIARY DUTY

A. INTRODUCTION

Under New York law, a corporation may sue a third party for aiding and abetting officers’ and directors’ breaches of fiduciary duty.⁶² The elements of a claim for aiding and abetting breach of fiduciary duty are: (1) the existence of a breach by a fiduciary of a duty owed to the plaintiff,⁶³ (2) knowing inducement or participation in the breach by the defendant, and

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cases.”), with *Tenamee*, 438 F. Supp. 2d at 444 (recognizing the availability of fraudulent concealment to toll the statute of limitations in an attorney malpractice claim).

⁵⁹ *Tenamee*, 438 F. Supp. 2d at 445; *accord Kremen v. Brower*, 793 N.Y.S.2d 3, 3 (N.Y. App. Div. 2005) (“There can be no fraudulent concealment based on the same act that forms the basis of the negligence claim.”).

⁶⁰ N.Y. C.P.L.R. § 214(6); *see also Caiati v. Kimel Funding Corp.*, 546 N.Y.S.2d 877, 878 (N.Y. App. Div. 1989); *Cicorelli v. Capobianco*, 453 N.Y.S.2d 21, 21 (N.Y. App. Div. 1982).

⁶¹ N.Y. C.P.L.R. § 214(6).

⁶² *See Terrydale Liquidating Trust v. Barness*, 611 F. Supp. 1006, 1015 (S.D.N.Y. 1984); *Granite Corp. v. Primavera Familienstiftung (In re Granite Partners, L.P.)*, 194 B.R. 318, 328 (Bankr. S.D.N.Y. 1996).

⁶³ The fiduciary duties owed by directors of a Delaware corporation are due care and loyalty. *See Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006); *see also Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1994). The duty of care requires that a director inform himself of material information prior to making a decision so that the decision constitutes a reasonably informed business judgment. *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). The duty of loyalty “requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest.” *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939). Within the duty of loyalty lies a subsidiary duty of good faith, the violation of which establishes a breach of the duty of loyalty. *Stone*, 911 A.2d at 370. The duty of good faith requires honesty in purpose and genuine care for corporate constituents. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 753 (Del. Ch. 2005).

(3) damages suffered by the plaintiff.⁶⁴ A corporation also has standing under New York law to bring a claim for aiding and abetting fraud.⁶⁵ The elements of a claim for aiding and abetting fraud are: (1) existence of a fraud,⁶⁶ (2) the defendant's knowledge of the fraud, (3) provision by the defendant of substantial assistance to advance the fraud's commission, and (4) damages suffered by the plaintiff.⁶⁷ A plaintiff alleging a claim for aiding and abetting fraud must plead the elements of fraud with the "particularity necessary to survive the heightened pleading requirements of Federal Rule of Civil Procedure 9(b)."⁶⁸ Upon a corporation's filing for bankruptcy, these claims become property of the estate.⁶⁹

These two claims parallel each other in several respects. First, both require that the defendant have actual knowledge of the wrongdoing.⁷⁰ Second, the conduct element of each claim ("substantial assistance" and "knowing inducement or participation") may be satisfied by showing the defendant "affirmatively assists, helps conceal, or by virtue of failing to act when required to do so" allows the wrongdoing to proceed.⁷¹ Third, both claims require that the aiding

⁶⁴ *Sharp Int'l Corp. v. State St. Bank & Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43, 49-50 (2d Cir. 2005); *Kaufman v. Cohen*, 760 N.Y.S.2d 157, 169 (N.Y. App. Div. 2003).

⁶⁵ See *Ross v. Patrusky, Mintz & Semel*, No. 90 Civ. 1356 (SWK), 1997 WL 214957, *15 (S.D.N.Y. Apr. 29, 1997).

⁶⁶ The elements of a claim for common law fraud are a representation of a material fact, falsity, scienter, reliance, and injury. *Kline v. Taukpoint Realty Corp.*, 302 A.D.2d 433, 433 (N.Y. App. Div. 2003) (citation omitted).

⁶⁷ *Wight v. BankAmerica Corp.*, 219 F.3d 79, 91 (2d Cir. 2000).

⁶⁸ *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273, 293 (2d Cir. 2006).

⁶⁹ See *Granite Corp. v. Primavera Familienstiftung (In re Granite Partners, L.P.)*, 194 B.R. 318, 328 (Bankr. S.D.N.Y. 1996).

⁷⁰ *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of America Sec., LLC*, 446 F. Supp. 2d 163, 201 (S.D.N.Y. 2006).

⁷¹ *Id.* (quoting *Diduck v. Kaszycki & Sons Contractors, Inc.*, 974 F.2d 270, 284 (2d Cir. 1992)); *Kolbeck v. LIT Am., Inc.*, 939 F. Supp. 240, 247 (S.D.N.Y. 1996).

and abetting defendant itself proximately cause the harm suffered as a result of the primary violator's wrongdoing.⁷²

B. THE MAJORITY VIEW REQUIREMENT OF ACTUAL KNOWLEDGE

The "overwhelming weight of authority" requires actual knowledge to establish liability for aiding and abetting.⁷³ Willful blindness, or conscious avoidance of facts, describes a greater degree of knowledge than constructive knowledge or recklessness and is a well-established substitute for actual knowledge in the criminal context.⁷⁴ "[T]here is no reason to believe that New York law would not accept willful blindness as a substitute for actual knowledge in connection with aiding and abetting claims."⁷⁵ The burden of proving actual knowledge is borne by the plaintiff.⁷⁶

To allege actual knowledge through circumstantial evidence, a plaintiff must plead "specific facts that would give rise to an inference that [the auditor] actually knew of [the debtor's] allegedly fraudulent activities."⁷⁷ Averring that a defendant should have known of the

⁷² See *Montreal Pension*, 446 F. Supp. 2d at 201-02 (addressing aiding and abetting both breach of fiduciary duty and fraud); *McDaniel v. Bear Stearns & Co.*, 196 F. Supp. 2d 343, 359 (S.D.N.Y. 2002) (addressing aiding and abetting fraud); *Kolbeck*, 939 F. Supp. at 249 (addressing aiding and abetting breach of fiduciary duty).

⁷³ *Montreal Pension*, 446 F. Supp. 2d at 202 n.279 (citing numerous cases); accord *Lerner v. Fleet Bank N.A.*, 459 F.3d 273, 292 (2d Cir. 2006).

⁷⁴ *Cromer Fin. Ltd. v. Berger*, No. 00 Civ.2284 DLC, 2003 WL 21436164, *9 (S.D.N.Y. June 23, 2003).

⁷⁵ *Id.*; but see *Montreal Pension*, 446 F. Supp. 2d at 202 n.279 ("actual knowledge is required, rather than a lower standard such as recklessness or willful blindness").

⁷⁶ See *Ascot Fund Ltd. v. UBS PaineWebber, Inc.*, 814 N.Y.S.2d 36, 36-37 (N.Y. App. Div. 2006).

⁷⁷ *Vtech Holdings Ltd. v. Pricewaterhouse Coopers LLP*, 348 F. Supp. 2d 255, 269 (S.D.N.Y. 2004); accord *Wight*, 219 F.3d at 92. For example, in *Wight*, the court found a plaintiff liquidator pled actual knowledge of a fraud by offering deposition testimony from a bank's officer that funds were being moved among "shell companies," there was no legitimate business purpose for the cycling of money, he suspected the money may have been moved to launder money, and that the bank had been paid larger fees than other clients. *Id.* A plaintiff may show an auditor had actual knowledge of wrongdoing by producing an auditor's internal documents recognizing and identifying the wrongdoing. *Ryan v. Hunton & Williams*, 99-CV-5938, 2000 U.S. Dist. LEXIS 13750, *29 (E.D.N.Y. Sept. 20, 2000); *Ross v. Patrusky, Mintz & Semel*, No. 90 Civ. 1356 (SWK), 1997 WL 214957, *15 (S.D.N.Y. Apr. 29, 1997); *Bloor v. Dansker (In re Investors Funding Corp. of N.Y. Sec. Litig.)*, 523 F. Supp. 533, 542 n.2 (S.D.N.Y. 1980); *Lavin v. Kaufman, Greenhut, Lebowitz & Forman*, 640 N.Y.S.2d 57, 58 (N.Y. App. Div. 1996); *Nate B. & Frances Spingold Found. v. Wallin, Simon, Black & Co.*, 585 N.Y.S.2d 416, 417 (N.Y. App. Div. 1992). However, merely

(footnote continued on next page)

wrongdoing alleges only constructive knowledge.⁷⁸ Ordinary economic motive, such as for payment of fees in exchange for work performed, is insufficient evidence of motive to aid in the fraud.⁷⁹

C. THE REQUIREMENT OF PARTICIPATION OR SUBSTANTIAL ASSISTANCE

A plaintiff must also prove participation (for breach of fiduciary duty) or substantial assistance (for fraud).⁸⁰ Whether particular conduct constitutes substantial assistance or participation is best viewed in the context of causation; an aider and abettor provides substantial assistance to a fraud or participates in a breach of fiduciary duty when it proximately causes the harm of which the plaintiff complains.⁸¹ This requirement may be satisfied by showing the defendant “affirmatively assists, helps conceal, or by virtue of failing to act when required to do so” allows the wrongdoing to proceed;⁸² “[w]hen a plaintiff adequately pleads such assistance, concealment, or failure to act, she fulfills both the ‘substantial assistance’ element of the fraud-based claim and the ‘participation’ element of the breach of fiduciary duty-based claim.”⁸³

(footnote continued from previous page)

alleging a client committed a fraud and the client’s auditor had access to the client’s records, from which the existence of the fraud could have been discovered, is not enough to show the auditor had actual knowledge sufficient to state a claim for aiding and abetting fraud. *Vtech Holdings*, 348 F. Supp. 2d at 269. Similarly, alleging an auditor relied on fraudulent monthly account statements given to it by the client in issuing an unqualified audit report, without alleging specific wrongful conduct by the auditor, is not enough to show the auditor had actual knowledge sufficient to state a claim for aiding and abetting either breach of fiduciary duty or fraud. *Cromer Fin.*, 137 F. Supp. 2d at 494-95.

⁷⁸ *Vtech Holdings*, 348 F. Supp. 2d at 269.

⁷⁹ *Primavera Familienstiftung v. Askin*, 173 F.R.D. 115, 127-28 (S.D.N.Y. 1997).

⁸⁰ *Wight*, 219 F.3d at 91.

⁸¹ *Filler v. Hanvit Bank*, 339 F. Supp. 2d 553, 557 (S.D.N.Y. 2004); *Primavera*, 173 F.R.D. at 126 (“The substantial assistance element has been construed as a causation concept, requiring that the plaintiff allege that the acts of the aider and abettor proximately caused the harm upon which the primary liability is predicated.”).

⁸² *Montreal Pension*, 446 F. Supp. 2d at 201 (quoting *Diduck v. Kaszycki & Sons Contractors, Inc.*, 974 F.2d 270, 284 (2d Cir. 1992)).

⁸³ *Id.*

Liability by virtue of failure to act, however, attaches only when the defendant itself owes a duty to the plaintiff, “that the primary violator owes a fiduciary duty to the plaintiff is not enough.”⁸⁴ “Absent a duty to act, the only action prescribed is not to ‘affirmatively assist’ or to ‘help conceal,’ which is another form of assistance and is likewise affirmative in nature.”⁸⁵ Attorneys, of course, do owe their clients fiduciary duties, including the “duty to deal fairly, honestly, and with undivided loyalty.”⁸⁶

An attorney who facilitates or closes a transaction with actual knowledge of the transaction’s improper purpose may substantially assist in the achievement of that improper purpose sufficient to sustain an aiding and abetting claim.⁸⁷ With respect to auditors, pleading that an auditor concealed adverse information about the client, permitted management to loot the client, and agreed to conceal management’s wrongdoing states a claim for aiding and abetting fraud sufficient to survive a motion to dismiss.⁸⁸

⁸⁴ *Kolbeck*, 939 F. Supp. at 247; *accord Ryan*, 2000 U.S. Dist. LEXIS 13750, at *29.

⁸⁵ *In re Sharp Int’l*, 403 F.3d at 52.

⁸⁶ *Lightman v. Flaum*, 761 N.E.2d 1027, 1032 (N.Y. 2001) (quoting *In re Cooperman*, 633 N.E.2d 1069, 1071 (N.Y. 1994)). In limited circumstances, an auditor or accountant may be a fiduciary to its client under New York law. *See Ross v. Patrusky, Mintz & Semel*, No. 90 Civ. 1356, 1997 WL 214957, at *14 (S.D.N.Y. Apr. 29, 1997); *Bloor*, 523 F. Supp. at 542 n.2; *Lavin*, 640 N.Y.S.2d at 58; *Spingold Found.*, 585 N.Y.S.2d at 417.

⁸⁷ *See Phifer v. Home Savers Consulting Corp.*, No. 06 CV 3841(JG), 2007 WL 295605, *5 (E.D.N.Y. Jan. 30, 2007); *Banks v. Consumer Home Mortgage, Inc.*, No. 01-CV-8508 (ILG), 2003 WL 21251584, *11 (E.D.N.Y. Mar. 28, 2003) (“where the aider and abettor allegedly was aware that he would be enlisted by the principal fraudfeasors to deceive the victims and he knowingly did assist, his liability may be established. The allegations that [the attorney] served as the attorney to an alleged fraudfeasor and facilitated the commission of the purported fraud at the closing are sufficient to state a claim for aiding and abetting.”) (citations omitted); *Vaughn v. Consumer Home Mortgage, Inc.*, No. 01-CV-7937(ILG), 2003 WL 21241669, *6-*7 (E.D.N.Y. Mar. 23, 2003); *Cohen v. Goodfriend*, 665 F. Supp. 152, 157-58 (E.D.N.Y. 1987) (denying defendant-attorney’s motion to dismiss claim for aiding and abetting fraud where the defendant “actively associated himself with and participated in the Partnership’s activities including its formation and the offering and sale of partnership interests as something he tried, by his actions, to make succeed.”); *see also Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992, 999 (S.D.N.Y. 1991) (holding allegation that lender knew directors’ approval of LBO constituted breach of fiduciary duty to company and provided bridge loans to company knowing the proceeds of the loans were being used to purchase the stock of the target and provided no benefit to the company sufficient to state claim for aiding and abetting breach of fiduciary duty).

⁸⁸ *See Ross*, 1997 WL 214957, *15; *Kolbeck*, 939 F. Supp. at 249.

D. CAUSATION AND DAMAGES

Claims for both aiding and abetting fraud and aiding and abetting breach of fiduciary duty require a showing of proximate cause.⁸⁹ Proximate cause requires a showing of both loss causation and transaction causation.⁹⁰ The plaintiff's injury must be proximately caused by the actions of the aider and abettor itself.⁹¹ "But-for" causation is insufficient.⁹²

Among other types of damages, a plaintiff may recover fees paid to its professionals. Although money damages are generally legal in nature, they are "equitable where they are restitutionary, such as in 'action[s] for disgorgement of improper profits.'"⁹³ Unjust enrichment gives rise to the equitable remedy of restitution.⁹⁴ To obtain restitution under an unjust enrichment theory, a plaintiff must show (1) the defendant was enriched, (2) at the plaintiff's expense, and (3) it would be unjust not to compensate the plaintiff under the circumstances.⁹⁵ A professional may be unjustly enriched by payment of a fee when the services rendered in

⁸⁹ *Montreal Pension*, 446 F. Supp. 2d at 201-02.

⁹⁰ *Ram Inv. Assocs. v. Citizens Fidelity Bank & Trust Co.*, 91 Civ. 3617, 1992 U.S. Dist. LEXIS 13695, *8 (S.D.N.Y. Sept. 10, 1992).

⁹¹ *Montreal Pension*, 446 F. Supp. 2d at 201-02.

⁹² *Kolbeck*, 939 F. Supp. at 249. The causation principles with respect to malpractice/professional negligence claims discussed above in Part III.C. of this Appendix also apply to claims for aiding and abetting fraud and aiding and abetting breach of fiduciary duty.

⁹³ *Chauffeurs, Teamsters & Helpers, Local No. 391 v. Terry*, 494 U.S. 558, 570 (1990) (quoting *Tull v. U.S.*, 481 U.S. 412, 424 (1987)).

⁹⁴ See *In re Rezulin Prods. Liab. Litig.*, 390 F. Supp. 2d 319, 342 n.109 (S.D.N.Y. 2005). Because unjust enrichment is an equitable doctrine, "principles of equity mandate consideration of the totality of the circumstances" in determining whether restitution is warranted. *Newbro v. Freed*, 409 F. Supp. 2d 386, 398 (S.D.N.Y. 2006) (quoting *Lake Minnewaska Mountain Houses, Inc. v. Rekis*, 259 A.D.2d 797, 799 (N.Y. App. Div. 1999)). "A conclusion that one has been unjustly enriched is essentially a legal inference drawn from the circumstances surrounding the transfer of property and the relationship of the parties. It is a conclusion reached through the application of principles of equity." *Sharp v. Kosmalski*, 40 N.Y.2d 119, 123 (N.Y. 1976).

⁹⁵ *Khreativity Unlimited v. Mattel, Inc.*, 101 F. Supp. 2d 177, 184 (S.D.N.Y. 2000).

exchange for the fee are worthless,⁹⁶ or when fees are paid as compensation for defrauding a debtor in cooperation with management.⁹⁷

E. THE STATUTE OF LIMITATIONS FOR AIDING AND ABETTING CLAIMS

The statute of limitations for bringing a claim for aiding and abetting a breach of fiduciary duty is three years where a plaintiff seeks monetary relief and six years where a plaintiff seeks equitable relief.⁹⁸ The doctrine of continuing representation applies to claims for aiding and abetting breaches of fiduciary duty and can toll the running of the statute of limitations when the defendant is a professional.⁹⁹

The statute of limitations for aiding and abetting fraud is the greater of (1) six years from the date the cause of action accrued or (2) two years from the date the plaintiff discovered or should have discovered the fraud.¹⁰⁰ The test for whether a plaintiff should have discovered the fraud is an objective one,¹⁰¹ and is a mixed question of law and fact.¹⁰² “[A]lthough a plaintiff may not shut his eyes to facts which call for investigation, mere suspicion will not suffice as a

⁹⁶ See *Cindy Royce Creations, Inc. v. Simmons*, No. 92 Civ. 9404 (RPP), 1993 WL 288291, *6 (S.D.N.Y. July 28, 1993) (dismissing claim for unjust enrichment against law firm on grounds of *forum non conveniens*). Whether services rendered are worthless is a question of fact. *Id.*

⁹⁷ See *Mediators, Inc. v. Manney (In re Mediators, Inc.)*, 190 B.R. 515, 530 n.7 (S.D.N.Y. 1995) (“On plaintiff’s theory, [the accounting firm] was paid for assisting in defrauding the debtor. If, contrary to the facts alleged, the debtor had sufficiently clean hands to invoke the aid of equity, an unjust enrichment claim would lie.”).

⁹⁸ *Ram Inv. Assocs.*, 1992 U.S. Dist. LEXIS 13695, at *13 (holding statute of limitations for aiding and abetting a breach of fiduciary duty is same as that for breach of fiduciary duty); *Carlingford Ctr. Point Assocs. v. MR Realty Assocs., L.P.*, 772 N.Y.S.2d 273, 274 (N.Y. App. Div. 2004).

⁹⁹ See *Williamson v. PricewaterhouseCoopers LLP*, 817 N.Y.S.2d 61, 64 (N.Y. App. Div. 2006); *Transp. Workers Union of Am. Local 100 AFL-CIO v. Schwartz*, 821 N.Y.S.2d 53, 56 (N.Y. App. Div. 2006).

¹⁰⁰ N.Y. C.P.L.R. § 213(8) (statute of limitations for fraud); *Wolff v. UBS PaineWebber, Inc.*, 01 Civ. 4039, 2004 U.S. Dist. LEXIS 8305, *3 (S.D.N.Y. May 12, 2004) (statute of limitations for aiding and abetting fraud same as that for fraud).

¹⁰¹ *Armstrong v. McAlpin*, 699 F.2d 79, 88 (2d Cir. 1983).

¹⁰² *Erbe v. Lincoln Rochester Trust Co.*, 144 N.E.2d 78, 80 (N.Y. 1957).

ground for imputing knowledge of the fraud.”¹⁰³ A defendant’s concealment of facts giving notice of the fraud can also prevent the statute of limitations from running.¹⁰⁴

V. CONTRACTUAL AFFIRMATIVE DEFENSES AVAILABLE TO ACCOUNTING PROFESSIONALS

New York law permits contractual indemnification among parties to absolve one party of liability for ordinary negligence.¹⁰⁵ However, contractual indemnification cannot absolve a party of liability arising from gross negligence or willful misconduct.¹⁰⁶ New York law also permits parties to limit by contract the amount of damages a plaintiff may recover. These limitation clauses are treated in the same manner as exculpatory clauses in general: clauses limiting the amount and type of damages recoverable from an accounting professional will be upheld in the absence of willful misconduct or gross negligence.¹⁰⁷ Contractual disclaimers of fiduciary duty are also effective and permitted in New York.¹⁰⁸

¹⁰³ *Schmidt v. McKay*, 555 F.2d 30, 37 (2d Cir. 1977).

¹⁰⁴ See *K&E Trading & Shipping, Inc. v. Radmar Trading Corp.*, 570 N.Y.S.2d 557, 558-59 (N.Y. App. Div. 1991).

¹⁰⁵ See *Am. Tissue, Inc. v. Donaldson, Lufkin & Jenrette Sec. Corp.*, 351 F. Supp. 2d 79, 99 (S.D.N.Y. 2004); *Colaghi, U.S.A., Ltd. v. Jewelers Prot. Servs. Ltd.*, 81 N.Y.2d 821, 823 (N.Y. 1993); *Sommer v. Fed. Sig. Corp.*, 79 N.Y.2d 540, 554 (N.Y. 1992).

¹⁰⁶ *Am. Tissue*, 351 F. Supp. 2d at 99 (stating this type of indemnification is void as against public policy).

¹⁰⁷ *Sommer*, 79 N.Y.2d at 554.

¹⁰⁸ *Cooper v. Parsky*, 140 F.3d 433, 440 (2d Cir. 1998); *Seippel v. Jenkens & Gilchrist, PC*, 341 F. Supp. 2d 363, 381-82 (S.D.N.Y. 2004).

APPENDIX B

THE LAW RELATING TO AVOIDANCE ACTIONS

I. INTRODUCTION

This Appendix B sets forth legal standards that inform the Examiner’s conclusions in the Report regarding avoidance actions and solvency determinations. Part II discusses avoidance of preferential transfers under 11 U.S.C. § 547. Part III discusses avoidance of fraudulent transfers under applicable state and federal law. Finally, Part IV discusses solvency determinations.

II. PREFERENTIAL TRANSFERS

A. ELEMENTS OF A PREFERENTIAL TRANSFER

Title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (as amended and supplemented, the “Bankruptcy Code”) provides for the avoidance and recovery of preferential transfers.¹ The purpose of the Bankruptcy Code’s preferential transfer provisions is to “promote the Code’s policy of preserving a financially distressed debtor’s estate so that the debtor’s assets may be fairly distributed amongst all creditors, not merely those who are favored.”² Section 547(b) provides a trustee or debtor may avoid a transfer of an interest of the debtor in property that is made: (1) to or for the benefit of a creditor; (2) for or on an account of an antecedent debt; (3) while the debtor was insolvent;³ (4) on or within ninety days before the petition date, or between ninety days and one year if the transfer was made to an insider; (5) where the transferee received more than it would have in a liquidation under chapter 7.⁴

¹ See 11 U.S.C. §§ 547 & 550.

² *DeRosa v. Buildex Inc. (In re F&S Cent. Mfg. Corp.)*, 53 B.R. 842, 846 (Bankr. E.D.N.Y. 1985).

³ A presumption of insolvency exists for the ninety day period preceding the filing of the petition. 11 U.S.C. § 547(f).

⁴ 11 U.S.C. § 547(b).

B. POTENTIAL DEFENSES TO AVOIDANCE OF A PREFERENTIAL TRANSFER

Section 547(c) of the Bankruptcy Code sets forth various affirmative defenses to avoidance of a preferential transfer. Commonly used defenses are the contemporaneous exchange for new value defense,⁵ the ordinary course of business defense,⁶ and the new value defense.⁷ Once the trustee or debtor carries its burden of establishing a *prima facie* case for avoidance of a preferential transfer under § 547(b),⁸ the defendant bears the burden of establishing a defense under § 547(c).⁹

The contemporaneous exchange for new value defense provides an otherwise preferential transfer may not be avoided to the extent the transfer was for new value given to the debtor in what was intended to be, and in fact was, a contemporaneous exchange.¹⁰ “Contemporaneous new value exchanges are not preferential because they encourage creditors to deal with troubled debtors *and* because other creditors are not adversely affected if the debtor’s estate receives new value.”¹¹ That the exchange of value be contemporaneous requires that the payment not be on account of an antecedent debt.¹² New value is defined as “money or money’s worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation

⁵ See 11 U.S.C. § 547(c)(1).

⁶ See 11 U.S.C. § 547(c)(2).

⁷ See 11 U.S.C. § 547(c)(4).

⁸ The trustee bears the burden of proving the avoidability of a transfer. 11 U.S.C. § 547(g).

⁹ 11 U.S.C. § 547(g).

¹⁰ 11 U.S.C. § 547(c)(1); *Official Comm. of Unsecured Creditors of 360networks (USA) Inc. v. U.S. Relocation Servs., Inc.* (*In re 360networks USA, Inc.*), 338 B.R. 194, 204 (Bankr. S.D.N.Y. 2005).

¹¹ *Jones Truck Lines, Inc. v. Cent. States, Se. & Sw. Areas Pension Fund* (*In re Jones Truck Lines, Inc.*), 130 F.3d 323, 326 (8th Cir. 1997) (emphasis in original).

substituted for an existing obligation.”¹³ Forbearance does not constitute new value.¹⁴ The value given to the debtor need not necessarily be provided by the preference defendant, it may be provided by a third party.¹⁵

The ordinary course of business defense provides an otherwise preferential transfer may not be avoided to the extent it was: (1) in payment of a debt incurred in the ordinary course of business between the debtor and defendant; and (2) the transfer was made (i) in the ordinary course of business between the debtor and defendant, or (ii) according to ordinary business terms.¹⁶ “[T]he policies underlying the ordinary [course of] business exception are two-fold: (1) to encourage creditors to continue dealing with troubled debtors; and (2) to promote equality of distribution.”¹⁷

The new value defense provides an otherwise preferential transfer may not be avoided to the extent the defendant gave new value to or for the benefit of the debtor that was not secured by an otherwise unavoidable security interest and on account of which the debtor did not make an otherwise unavoidable transfer.¹⁸ The basic elements of the defense are that: (1) the debtor received new value after the transfer; and (2) the new value remained unpaid.¹⁹ This defense

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¹² *Sapir v. Keener Lumber Co. (In re Ajayem Lumber Corp.)*, 143 B.R. 347, 352 (Bankr. S.D.N.Y. 1992).

¹³ 11 U.S.C. § 547(a)(2).

¹⁴ *360networks*, 338 B.R. at 205.

¹⁵ *Id.*

¹⁶ 11 U.S.C. § 547(c)(2). Whether a transfer is made according to ordinary business terms is measured objectively. *Kaplla v. Media Buying, Inc. (In re Ameri P.O.S. Inc.)*, Bankr. No. 04-24429-BKC-RBR-A, Adv. No. 06-1077-BKC-RBR-A, 2006 WL 3231274, *4 (Bankr. S.D. Fla. Oct. 24, 2006).

¹⁷ *Harrah's Tunica Corp. v. Meeks (In re Armstrong)*, 291 F.3d 517, 527 (8th Cir. 2002).

¹⁸ 11 U.S.C. § 547(c)(4).

¹⁹ See *Savage & Assocs., P.C. v. Level(3) Commc'ns (In re Teligent, Inc.)*, 315 B.R. 308, 314 (Bankr. S.D.N.Y. 2004).

“recognizes that the ‘new value’ effectively repays the earlier preference, and offsets the harm to the debtor’s other creditors.”²⁰

III. FRAUDULENT CONVEYANCES

Sections 544 and 548 of the Bankruptcy Code provide for a trustee’s avoidance of fraudulent conveyances.²¹ Section 544 makes state fraudulent conveyance law applicable in bankruptcy cases.²² Section 548 is a substantive federal law providing standards under which a conveyance may be avoided. Under New York law, fraudulent conveyances are governed by the New York Uniform Fraudulent Conveyance Act²³ (hereinafter “DCL”). Because the provisions of the DCL governing avoidance of fraudulent conveyances are substantially similar to those of the Bankruptcy Code,²⁴ this Appendix discusses federal law and New York law together, pointing out relevant differences where they exist.²⁵

²⁰ *Id.* at 315.

²¹ See 11 U.S.C. §§ 544 & 548.

²² Section 544 authorizes a trustee to “avoid any transfer of an interest of the debtor in property . . . that is voidable under applicable law[.]” 11 U.S.C. § 544(b). The term “applicable law” refers to non-bankruptcy state law. *See Hassett v. Far W. Fed. Sav. & Loan Ass’n (In re O.P.M. Leasing Servs., Inc.)*, 40 B.R. 380, 384 (Bankr. S.D.N.Y. 1984), *aff’d*, 44 B.R. 1023 (S.D.N.Y. 1984). In order for a trustee to avoid a conveyance under § 544(b), there must exist an unsecured creditor that actually had a claim under state law at the time the bankruptcy case was filed. *Official Comm. of Asbestos Claimants of GI Holding, Inc. v. Heyman*, 277 B.R. 20, 29 (S.D.N.Y. 2002).

²³ N.Y. Debt. & Cred. Law §§ 270-81.

²⁴ “There is no dispute that if a transfer is fraudulent under the DCL, it is also fraudulent under Section 548 of the Bankruptcy Code.” *Geron v. Shulman (In re Manshul Constr. Corp.)*, 2000 WL 1228866, *43, n.7 (S.D.N.Y. Aug. 30, 2000) (citing *In re Schwartz*, 58 B.R. 923, 926 n.2 (Bankr. S.D.N.Y. 1986)).

²⁵ For example, the DCL provides for avoidance of transfers made within six years of the commencement of the avoidance action, CPLR § 213(8), while the fraudulent transfer provisions of the Bankruptcy Code provide for the avoidance of both actual and constructive fraudulent conveyances made within one year of the petition date, *see* 11 U.S.C. § 548. (The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) amended 11 U.S.C. § 548 so that it now provides for the avoidance of fraudulent conveyances made within two years of the petition date. However, this provision of BAPCPA did not take effect until April 20, 2006. Because Refco filed its petition on October 17, 2005, before the effective date of the amendment, the fraudulent conveyance claims in Refco’s Bankruptcy Cases are governed by the older, one year rule.)

A. ACTUAL FRAUDULENT CONVEYANCES

DCL § 276 governs actual fraudulent conveyances under New York law and states “[e]very conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in the law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.” To prevail under § 276, a plaintiff must show: “(1) the thing transferred has value out of which the creditor could have realized a portion of its claim; (2) that this thing was transferred or disposed of by the debtor; and (3) that the transfer was done with the actual intent to defraud.”²⁶ Section 548(a)(1)(A) of the Bankruptcy Code provides a trustee may avoid a transfer when the debtor “made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation incurred, indebted

....²⁷

Actual intent to hinder, delay, or defraud must be pled with the particularity required by Rule 9(b) of the Federal Rules of Civil Procedure.²⁸ Actual intent is a question of fact²⁹ and must be established by the party seeking to set aside the conveyance through clear and convincing evidence.³⁰

²⁶ *Kittay v. Flutie N.Y. Corp. (In re Flutie N.Y. Corp.)*, 310 B.R. 31, 56 (Bankr. S.D.N.Y. 2004) (citing *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 535 (1994)).

²⁷ 11 U.S.C. § 548(a)(1)(A).

²⁸ Fed. R. Bankr. P. 7009(b); *A.J. Heel Stone, L.L.C. v. Evisu Int'l, S.R.L.*, No. 03 Civ. 1097(DAB), 2006 WL 1458292, at *3 (S.D.N.Y. May 25, 2006); *Am. Tissue, Inc. v. Donaldson, Lufkin & Jenrette Sec. Corp.*, 351 F. Supp. 2d 79, 106 (S.D.N.Y. 2004).

²⁹ *United States v. McCombs*, 30 F.3d 310, 328 (2d Cir. 1994).

³⁰ *Marine Midland Bank v. Murkoff*, 120 A.D.2d 122, 126 (N.Y. App. Div. 1986).

Because direct proof of actual fraudulent intent is difficult to obtain, a plaintiff may prove fraudulent intent through circumstantial evidence known as “badges of fraud.”³¹ The badges of fraud include, but are not limited to: (1) inadequacy of consideration received; (2) the closeness of the relationship between parties to the transfer; (3) that the transferor was rendered insolvent by the conveyance; (4) suspicious timing of the conveyance; (5) use of fictitious parties or secrecy; (6) the transferor’s knowledge of a creditor’s claim and subsequent inability to pay it; and (7) retention of control of the property by the transferor after the transfer.³² “Depending on the context, badges of fraud will vary in significance, though the presence of multiple indicia will increase the strength of the inference.”³³

So long as a conveyance is made with the actual intent to defraud, the transfer is fraudulent under the law regardless of whether the transferee paid fair consideration³⁴ and regardless of the transferor’s state of solvency.³⁵ However, it is a defense to avoidance under both the DCL and the Bankruptcy Code if the transferee establishes both payment of fair consideration *and* lack of knowledge of the fraud, or good faith, at the time of the conveyance.³⁶

³¹ See *Salomon v. Kaiser (In re Kaiser)*, 722 F.2d 1574, 1582 (2d Cir. 1983); *Marine Midland*, 120 A.D.2d at 128.

³² See *Eclaire Advisor Ltd. v. Daewoo Eng’g & Constr. Co.*, 375 F. Supp. 2d 257, 268-69 (S.D.N.Y. 2005) (citing *Bulkmatic Transp. Co. v. Pappas*, No. 99 Civ. 12070(RMB)(JCF), 2001 WL 882039 (S.D.N.Y. May 11, 2001)); *MFS/SUN Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp. 913, 935 (S.D.N.Y. 1995).

³³ *Van Dusen*, 910 F. Supp. at 935.

³⁴ *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 639 (2d Cir. 1995) (“*HBE Leasing I*”); *Van Dusen*, 910 F. Supp. at 934.

³⁵ *Nisselson v. Ford Motor Co. (In re Monahan Ford Corp. of Flushing)*, 340 B.R. 1, 38 (Bankr. E.D.N.Y. 2006).

³⁶ Although the Bankruptcy Code and DCL use different terminology in describing this defense, the substantive elements of the defense are the same under both bodies of law. Section 548(c) of the Bankruptcy Code states “[A] transferee or obligee of [a fraudulent] transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred . . . to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.” Good faith means “viewed objectively, the transferee neither knew nor should have known of the fraudulent nature of the transfer.” *Maddalena v. Maddalena*, 176 B.R. 551, 555 (Bankr. C.D. Cal. 1995). Likewise, DCL § 278(1) states “[w]here a conveyance or obligation is fraudulent as to a creditor, such creditor, when his claim has matured, may, as against any person except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase, or one who has

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B. CONSTRUCTIVE FRAUDULENT CONVEYANCES

Under both the DCL and the Bankruptcy Code, a plaintiff must establish two basic elements to avoid a constructive fraudulent conveyance: (1) an unfair exchange; and (2) failure of one of three solvency tests. In order to state a claim for constructive fraudulent conveyance under the DCL, a plaintiff must allege a conveyance was made: (1) without fair consideration; and (2) the transferor (i) was insolvent at the time of the conveyance or rendered insolvent thereby, (ii) was left with unreasonably small capital to conduct its business as a result of the transfer, or (iii) intended or believed it would incur debt beyond its ability to repay as a result of the transfer.³⁷ Under the Bankruptcy Code, a trustee may avoid a transfer in which the debtor: (1) received less than reasonably equivalent value; and (2) (i) was insolvent at the time of the transfer or was rendered insolvent thereby, (ii) was engaged or was about to engage in business or a transaction for which the debtor was left with unreasonably small capital after the transfer, or (iii) intended to incur or believed it would incur debts beyond its ability to repay.³⁸

1. Unfair Exchange

The DCL treats the unfair exchange element of a constructive fraudulent conveyance as involving a conveyance made without “fair consideration,” while the Bankruptcy Code treats the unfair exchange element of a constructive fraudulent conveyance as involving a conveyance made for “less than reasonably equivalent value.” Both concepts involve factual determinations

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derived title immediately or mediately from such a purchaser, (a) [h]ave the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim, or (b) [d]isregard the conveyance and attach or levy execution upon the property conveyed.”

³⁷ *A.J. Heel Stone*, 2006 WL 1458292, at *3 n.3 (summarizing the solvency tests found in DCL §§ 273-275).

³⁸ 11 U.S.C. § 548(a)(1)(B).

specific to the circumstances of each case.³⁹ The party seeking to set aside the conveyance bears the burden of proof in showing lack of fair consideration or reasonably equivalent value.⁴⁰ In determining whether there has been an unfair exchange, courts compare the value of that which was given to the value of that which was received, although a debtor “need not collect a dollar-for-dollar equivalent . . .”⁴¹

While, under the Bankruptcy Code, reasonably equivalent value does not contain a good faith component,⁴² the U.S. Court of Appeals for the Second Circuit, in seeking to define fair consideration under the DCL, stated the recipient of a transfer must “either (a) convey property in exchange or (b) discharge an antecedent debt in exchange; *and* (2) such exchange must be a ‘fair equivalent’ of the property received; *and* (3) such exchange must be ‘in good faith.’”⁴³ This distinction between the Bankruptcy Code and the DCL is important in the context of transfers to insiders on account of antecedent debts.⁴⁴ The good faith required under DCL § 272 is that of the transferee,⁴⁵ and when a transfer on account of an antecedent debt is made to an insider while the transferor is insolvent, the insider does not meet the “good faith” requirement of DCL § 272 and there can be no fair consideration for the transfer.⁴⁶ If a transfer on account of an antecedent

³⁹ See *United States v. McCombs*, 30 F.3d 310, 326 (2d Cir. 1994); *Am. Tissue*, 351 F. Supp. 2d at 106. “What constitutes fair consideration under [DCL § 272] must be determined upon the facts and circumstances of each particular case.” *Orbach v. Pappa*, 482 F. Supp. 117, 119 (S.D.N.Y. 1979).

⁴⁰ *Barber v. Golden Seed Co.*, 129 F.3d 382, 387 (7th Cir. 1997); *McCombs*, 30 F.3d at 323.

⁴¹ See *Barber*, 129 F.3d at 387; *Butler Aviation Int'l Inc. v. Whyte (In re Fairchild Aircraft Corp.)*, 6 F.3d 1119, 1125-26 (5th Cir. 1993).

⁴² *Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 247 B.R. 51, 106-07 (Bankr. S.D.N.Y. 1999).

⁴³ *HBE Leasing Corp. v. Frank*, 61 F.3d 1054, 1058-59 (2d Cir. 1995) (“*HBE Leasing II*”) (emphasis in original).

⁴⁴ *Farm Stores, Inc. v. School Feeding Corp.*, 477 N.Y.S.2d 374, 378 (N.Y. App. Div. 1984), *aff'd*, 479 N.E.2d 222 (N.Y. 1985).

⁴⁵ *HBE Leasing II*, 61 F.3d at 1059 n.5.

⁴⁶ *Farm Stores*, 477 N.Y.S.2d at 378.

debt is made in an arms-length transaction with an outsider, however, the transfer may be in good faith.⁴⁷

2. Failure of a Solvency Test

The second requirement to set aside a conveyance under both the DCL and the Bankruptcy Code is failure of a solvency test. Under the DCL, a plaintiff must satisfy one of the solvency tests found in DCL §§ 273-75.⁴⁸ Under DCL § 273, a conveyance is fraudulent if made for less than fair consideration and the transferor is insolvent at the time of the conveyance or is rendered insolvent by it. “A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured.”⁴⁹ Under DCL § 275, a conveyance for less than fair consideration is fraudulent even though the transferor’s assets exceed its liabilities if, at the time of the transfer, the transferor “intends or believes” it will be unable to pay its debts as they mature; this is a forward looking test referred to as equitable insolvency.⁵⁰ Finally, under DCL § 274, a conveyance for less than fair consideration is fraudulent if it leaves the transferor with unreasonably small working capital. This is a financial condition short of equitable insolvency and applies where the transferor is left “technically solvent but doomed to fail.”⁵¹

The Bankruptcy Code’s solvency tests parallel those found in the DCL. Under 11 U.S.C. §548(a)(1)(B), a conveyance is fraudulent if made for less than reasonably equivalent value and

⁴⁷ *Sharp Int'l Corp. v. State St. Bank & Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43, 54 (2d Cir. 2005).

⁴⁸ Under the DCL, once a plaintiff meets its burden on the issue of fair consideration, a presumption of insolvency arises and the burden of proving solvency shifts to the defendant. *ACLI Gov't Sec., Inc. v. Rhoades*, 653 F. Supp. 1388, 1393 (S.D.N.Y. 1987); *Geltzer v. Artists Mktg. Corp. (In re Cassandra Group)*, 338 B.R. 583, 597 (Bankr. S.D.N.Y. 2006).

⁴⁹ DCL § 271(1).

⁵⁰ *MFS/SUN*, 910 F. Supp. at 943.

⁵¹ *Id.* at 944.

the transferor: (1) was insolvent at the time of the transfer or was rendered insolvent thereby; (2) was engaged or was about to engage in business or a transaction for which the debtor was left with unreasonably small capital after the transfer; or (3) intended to incur or believed it would incur debts beyond its ability to repay.⁵²

IV. SOLVENCY DETERMINATIONS

The Bankruptcy Code defines insolvency as a “financial condition such that the sum of [an] entity’s debts is greater than all of such entity’s property, at a fair valuation, exclusive of [] property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity’s creditors....”⁵³ Bankruptcy courts generally apply a traditional balance sheet test when determining whether a company is insolvent as defined by the Bankruptcy Code.⁵⁴ Solvency determinations are issues of fact, and a court has broad discretion in considering evidence.⁵⁵ “The matrix within which questions of solvency and valuation exist in bankruptcy demands that there be no rigid approach taken to the subject. Because the value of property varies with times and circumstances, the finder of fact must be free to arrive at the ‘fair valuation’ defined in §101(32) by the most appropriate means.”⁵⁶

⁵² 11 U.S.C. § 548(a)(1)(B).

⁵³ 11 U.S.C. § 101(32). DCL § 271 provides in relevant part: “A person is insolvent when the present fair saleable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured.” In *Hirsch v. Gersten* (*In re Centennial Textiles, Inc.*), 220 B.R. 165 (Bankr. S.D.N.Y. 1998), the court noted that “there is no accepted test for determining insolvency under the DCL,” 220 B.R. at 172, and that New York courts generally do not draw a distinction between DCL § 271 and insolvency as defined under the Bankruptcy Code. 220 B.R. at 173 (citing *U.S. v. 58th St. Plaza Theater, Inc.*, 287 F. Supp. 475, 497 (S.D.N.Y. 1968)). One court, however, has described this test, adopted from the UFCA, as an equitable test based on an ability to pay debts as they come due. *Bay Plastics, Inc. v. BT Commercial Corp.* (*In re Bay Plastics, Inc.*), 187 B.R. 315 (Bankr. C.D. Cal. 1995).

⁵⁴ *Coated Sales, Inc. v. First Eastern Bank, N.A.* (*In re Coated Sales, Inc.*), 144 B.R. 663, 666 (Bankr. S.D.N.Y. 1992).

⁵⁵ *Lawson v. Ford Motor Co.* (*In re Roblin Indus., Inc.*), 78 F.3d 30, 35 (2d Cir. 1996).

⁵⁶ *Id.* at 38.

A company, or its assets, should be valued as of the time of the transfer in question.⁵⁷ It is, however, appropriate for a court to use “current awareness” of prior facts (facts discovered after the transaction) to adjust solvency analyses.⁵⁸ A court may consider evidence uncovered after a company files for bankruptcy in determining the value of a debtor’s assets at the time of the transaction in question.⁵⁹ The subsequent discovery of fraudulent acts by management, including the existence of false receivables and illegal transfers, must be taken into account in determining solvency as of the relevant date.⁶⁰ Contingent liabilities are also included in a solvency determination.⁶¹

“Courts often utilize the well-established bankruptcy principles of ‘retrojection’ and ‘projection,’ which provide for the use of evidence of insolvency on a date before and after the [transfer] date as competent evidence of the debtor’s insolvency on the [transfer] date.”⁶² Courts “may consider evidence uncovered after the advent of bankruptcy to determine the value of the debtor’s assets at the time the alleged insolvency occurred. Alleged credits and creative accounting that have the effect of grossly overstating a company’s financial condition cannot be the basis of a court’s solvency analysis.”⁶³ “The discovery of ongoing fraudulent acts by [the debtor’s] officers and its resulting impact on the company’s balance sheet clearly question the appropriateness of treating [the debtor] as a going concern.”⁶⁴ In these situations, goodwill

⁵⁷ *Coated Sales*, 144 B.R. at 667; *In re Le Café Crème, Ltd.*, 244 B.R. 221, 242 (Bankr. S.D.N.Y. 2000).

⁵⁸ See *Coated Sales*, 144 B.R. at 668.

⁵⁹ *Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 247 B.R. 51, 111 (Bankr. S.D.N.Y. 1999).

⁶⁰ *Coated Sales*, 144 B.R. at 668.

⁶¹ *In re W.R. Grace & Co.*, 281 B.R. 852, 854 (Bankr. D. Del. 2002).

⁶² *Coated Sales*, 144 B.R. at 666.

⁶³ 247 B.R. at 111 (internal quotations omitted).

⁶⁴ 144 B.R. at 668.

carried on a debtor's books should not be included as an asset in the solvency determination, because, among other reasons, it cannot be liquidated to satisfy claims of creditors.⁶⁵

The value of a company's assets is dependent on whether the company is to be valued as a going concern or on its deathbed.⁶⁶ Ordinarily, fair value should be determined based on a going concern valuation.⁶⁷ "Fair value" in the context of a going concern valuation, as the term is used in the definition of "insolvent" in the Bankruptcy Code, is determined by the "fair market price of the debtor's assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay the debtor's debts."⁶⁸ Put another way: "Fair value is not synonymous with a forced sale or the value of a continuing unhampered business. Rather it refers to: The amount of money that the debtor could raise from its property in a short period of time, but not so short as to approximate a forced sale, if the debtor operated as a reasonable prudent and diligent businessman with his interests in mind, especially a proper concern for the payment of his debts."⁶⁹ In contrast to liquidation value, "[f]air market value presumes that all relevant information is known by seller and buyer. It follows, that a party purchasing assets at the time of the alleged . . . transfer would be aware of all relevant factors, which would include knowledge

⁶⁵ *Bay Plastics*, 187 B.R. at 330; *Coated Sales*, 144 B.R. at 672.

⁶⁶ A company's own "book value" of its assets may be evidence of market value; however, it is not conclusive because book values are historical rather than market-based. *Roblin Indus.*, 78 F.3d at 36. In valuing assets for purposes of determining insolvency, the book value of assets must be updated to determine their current market value. *Bay Plastics*, 187 B.R. at 330. Although not the exclusive or dispositive method, whenever possible valuation should be based on appraisals and expert testimony. 78 F.3d at 38.

⁶⁷ *Gilman v. Scientific Research Products, Inc. of Delaware (In re Mama D'Angelo, Inc.)*, 55 F.3d 552, 556 (10th Cir. 1995).

⁶⁸ *Roblin Indus.*, 78 F.3d at 35.

⁶⁹ *Coated Sales*, 144 B.R. at 667.

of a massive business-wide fraud . . .; otherwise, that party would be the victim of fraud. In sum, fair market value entails a hypothetical sale, not a hypothetical company.”⁷⁰

Where a company is on its deathbed, however, the value assigned to its assets is that which could be obtained in a liquidation sale.⁷¹ “It is well-settled that if a company is only nominally extant, to treat it as a going concern would be misleading and would fictionalize the company’s true financial condition. Liquidation value is appropriate if at the time in question the business is so close to shutting its doors that a going concern standard is unrealistic.”⁷² While “a business need not be thriving to receive a going concern value. . . . [I]t must have had a realistic capacity to [continue to operate]; a going concern valuation is appropriate only if it is believed that the enterprise will continue as a going concern.”⁷³ “‘Deathbed’ indications include ongoing fraud, struggling to stay in business before fraud is discovered, fraud used in an attempt to alleviate cash flow problems, and an inability to reorganize post-bankruptcy.”⁷⁴ The difference between going concern valuation and deathbed valuation is that the former involves a reasonable time frame for a hypothetical liquidation, while the latter does not.⁷⁵

⁷⁰ *Id.* at 668.

⁷¹ *Id.* at 667.

⁷² *In re Mama D’Angelo*, 55 F.3d at 555-56 (internal quotations and citations omitted).

⁷³ *Id.* at 556.

⁷⁴ *Adler, Coleman*, 247 B.R. at 111; *Coated Sales*, 144 B.R. at 667-68.

⁷⁵ *Adler, Coleman*, 247 B.R. at 111.

APPENDIX C

THE LAW RELATING TO THE *WAGONER* RULE

I. INTRODUCTION

This Appendix C discusses a potential significant defense¹ to claims against third parties on behalf of a debtor's estate: the *Wagoner* rule.²

II. THE *WAGONER* RULE

The *Wagoner* rule was established by the U.S. Court of Appeals for the Second Circuit in *Shearson Lehman Hutton, Inc. v. Wagoner*.³ The *Wagoner* rule states “[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation.”⁴ Because a trustee may only bring claims the debtor itself could have

¹ The applicability of affirmative defenses is a matter of state law. *FDIC v. O'Melveny & Myers*, 969 F.2d 744, 748-49 (9th Cir. 1992), *rev'd and remanded on other grounds*, 512 U.S. 79 (1994), *prior opinion adopted in haec verba*, 61 F.3d 17 (9th Cir. 1995); *Breeden v. Kilpatrick & Lockhart LLP (In re Bennett Funding Group, Inc.)*, 336 F.3d 94, 100 (2d Cir. 2003); *Wight v. BankAmerica Corp.*, 219 F.3d 79, 86 (2d Cir. 2000).

² The doctrine of *in pari delicto* is an affirmative defense related to the *Wagoner* rule. For convenience, the concept will generally be referred to herein as the *Wagoner* rule, because both doctrines are based on the principle that the law will not help one wrongdoer recover from another, and apply the same standards; also, under New York law, which for purposes of this Report the Examiner has assumed will likely govern, the *Wagoner* rule applies. It is noted, however, that most courts view the *Wagoner* rule and the doctrine of *in pari delicto* as separate and distinct doctrines because the first deals with standing and the second is an equitable, affirmative defense similar to the “unclean hands” doctrine. *See Adelphia Commc'ns Corp. v. Bank of Am. (In re Adelphia Commc'ns Corp.)*, 330 B.R. 364, 381 n.51 (Bankr. S.D.N.Y. 2005) (“It is important to note . . . that the *Wagoner* Rule . . . is one of standing, and *in pari delicto* is not one of standing but rather an equitable defense applicable in some cases where the plaintiff has standing. The two separate concepts should not be confused.”) (citation omitted); *Official Comm. of Unsecured Creditors v. R. F. Lafferty & Co., Inc.*, 267 F.3d 340, 346 (3d Cir. 2001). However, other courts have taken the position that the *Wagoner* rule merely represents the Second Circuit’s decision to treat the doctrine of *in pari delicto* as a question of standing rather than an affirmative defense. *See, e.g., Baena v. KPMG LLP*, 389 F. Supp. 2d 112, 118 (D. Mass. 2005) (“While some courts assess the doctrine of *in pari delicto* as an equitable defense, the Second Circuit and courts in the First Circuit have viewed it as a standing issue.”) (citation omitted). Whether treated as bar to standing raised through a Rule 12(b)(1) motion to dismiss for lack of subject matter jurisdiction or as an affirmative defense raised through a motion under Rule 12(b)(6) for failure to state a claim upon which relief may be granted, the questions remain the same: (1) can the wrongful acts by members of a company’s management be imputed to the company and (2) do the exceptions to the *Wagoner* rule apply such that claims on behalf of a company against the third party professionals may be maintained?

³ 944 F.2d 114 (2d Cir. 1991).

⁴ *Id.*; *see also Am. Tissue, Inc. v. Arthur Andersen*, 275 F. Supp. 2d 398, 404 (S.D.N.Y. 2003) (debtor-in-possession lacks standing to sue third parties for defrauding debtor if principals participated in misconduct). Similarly, *in pari delicto*, “which literally means ‘in equal fault,’ is a doctrine commonly applied in tort cases to prevent a deliberate

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brought prepetition,⁵ and because the acts of agents are typically imputed to the principal,⁶ misconduct by the debtor’s controlling managers may bar recovery on behalf of the estate under the *Wagoner* rule. The *Wagoner* rule thus provides that neither a trustee nor any other representative of a debtor’s estate has “standing under New York law to seek recovery on behalf of a debtor company against third-parties for injuries incurred by the misconduct of the debtor’s controlling managers.”⁷

III. EXCEPTIONS TO THE WAGONER RULE

Even if claims against third parties on behalf of a debtor’s estate fall within the scope of the *Wagoner* rule, one of two exceptions may apply: namely, the “adverse interest” exception and the “innocent insider” or “innocent decisionmaker” exception. In addition, an exception to the two exceptions, known as the “sole actor” rule, may apply.

A. THE ADVERSE INTEREST EXCEPTION

The *Wagoner* rule will not apply if the estate’s representative can show that the members of the debtor’s management who engaged in misconduct were not acting as agents of the company. This exception has become known as the “adverse interest” exception.

New York agency law generally recognizes an exception to the doctrine of imputation “when an agent is engaged in a scheme to defraud his principal, either for his own benefit or that

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wrongdoer from recovering from a co-conspirator or accomplice.” *Baena v. KPMG LLP*, 453 F.3d 1, 6 (1st Cir. 2006) (internal citation omitted).

⁵ A trustee bringing a claim that accrued to the estate under 11 U.S.C. § 541 is subject to the same defenses to which the debtor would have been subject had the debtor brought the claim prepetition, including the *Wagoner* rule. See *R.F. Lafferty*, 267 F.3d at 355-56. The *Wagoner* rule does not apply to non § 541 claims. See *CEPA Consulting, Ltd. v. King Main Hurdman (In re Wedtech Sec. Litig.)*, 138 B.R. 5, 9 n.1 (S.D.N.Y. 1992).

⁶ *Center v. Hampton Affiliates, Inc.*, 488 N.E.2d 828, 829 (N.Y. 1985).

⁷ *Breeden v. Kirkpatrick & Lockhart, LLP*, 268 B.R. 704, 709 (S.D.N.Y. 2001), *aff’d*, 336 F.3d 94 (2d Cir. 2003).

of a third person. . . .”⁸ The rationale underlying the exception is that, typically, an agent is presumed to have disclosed his knowledge to his principal; however, where the agent engages in a scheme to defraud his principal, imputation of the agent’s knowledge is not warranted because the agent “cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose.”⁹

In order for the adverse interest exception to apply, “the agent must have totally abandoned his principal’s interests and be acting entirely for his own or another’s purposes. It cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal.”¹⁰ “Thus, the exception does not apply when the agent acts both for himself and for the principal, though the primary motivation for the acts is inimical to the principal.”¹¹ The adverse interest exception may apply where an agent loots the company¹² or uses company funds to satisfy personal obligations.¹³

While courts generally use language requiring that the agent totally abandon his principal’s interests and act entirely for his own or another’s benefit, few courts have discussed how such a determination should be made. In *Wedtech*, the court held the pertinent question is whether the misconduct or fraud was of “short term benefit or detriment to the corporation,” not

⁸ *Center*, 488 N.E.2d at 829 (citations omitted).

⁹ *Id.* See also *Wight*, 219 F.3d at 87; *Mediators, Inc. v. Manney (In re Mediators, Inc.)*, 105 F.3d 822, 827 (2d Cir. 1997); *Sec. Investor Protection Corp. v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999).

¹⁰ *Center*, 488 N.E.2d at 830; accord *Bennett Funding*, 336 F.3d at 100; *Wight*, 219 F.3d at 87; *Mediators*, 105 F.3d at 827; *BDO Seidman*, 49 F. Supp. 2d at 650; *Wedtech Sec. Litig.*, 138 B.R. at 9.

¹¹ *BDO Seidman*, 49 F. Supp. 2d at 650 (citing *Oppenheimer-Palmieri Fund, L.P. v. Peat Marwick Main & Co. (In re Crazy Eddie Sec. Litig.)*, 802 F. Supp. 804, 817 (E.D.N.Y. 1992)).

¹² *Adelphia Commc’ns*, 330 B.R. at 381 n.52 (“By any standard, theft from a corporation by insiders is self dealing by the insiders and not in any sense in the interest of the entity. The insiders’ actions and knowledge in engaging in such conduct therefore cannot be imputed to the company.”).

¹³ *See Nisselson v. Ford Motor Co. (In re Monahan Ford Corp. of Flushing)*, 340 B.R. 1, 24 (Bankr. E.D.N.Y. 2006).

whether there was “any detriment to the corporation resulting from the unmasking of the fraud.”¹⁴ The court declined to determine whether benefit to the debtor should be measured objectively, by determining whether the debtor’s value had increased as a result of the fraud, or subjectively, by determining the motivation of the wrongdoers.¹⁵

Another court considered the possibility that, where the short-term benefit to the company is merely a by-product of the bad actor’s attempt to increase his fraudulent gains, it does not defeat the adverse interest exception.¹⁶ In *Crazy Eddie*, the court denied summary judgment to the debtor’s former auditor on its *in pari delicto* defense because the court determined that, while a jury may be persuaded that the insiders acted partially in the debtor’s interest, “the evidence now before the court is certainly susceptible of the interpretation that any short term benefit to [the debtor] was intended to redound to the advantage of only the [insiders] and their conspirators.”¹⁷ The court reasoned, “[t]he fact that some of the embezzled money was put back into the corporation to help inflate sales and facilitate public offerings is not inconsistent with an abandonment by the [insiders] of the corporation’s interest.”¹⁸

It should also be noted that whether the bad actors have “totally abandoned” the company’s interests, such that the debtor’s estate may invoke the adverse interest exception, may

¹⁴ 138 B.R. at 9 (citations omitted).

¹⁵ *Id.*

¹⁶ See *Crazy Eddie*, 802 F. Supp. at 818; but see *Baena*, 389 F. Supp. 2d at 119 (while looting a company probably constitutes a bad act totally adverse to the company’s interests and warrants imposition of adverse interest exception, allegations that wrongdoers artificially inflated the company’s revenues and earnings, or otherwise fraudulently increased the value of the company, would not warrant application of adverse interest exception). “A fraud by top management to overstate earnings, and so facilitate stock sales or acquisitions, is not in the long-term interest of the company; but, like price-fixing, it profits the company in the first instance and the company is still civilly and criminally liable. Nor does it matter that the implicated managers *also* may have seen benefits to themselves – that alone does not make their interests adverse.” *Baena*, 453 F.3d at 7-8 (internal citations omitted).

¹⁷ *Crazy Eddie*, 802 F. Supp. at 818 (citation omitted).

¹⁸ *Id.*

be determined separately for each fraudulent scheme upon which the estate seeks recovery from third parties.¹⁹

B. THE INNOCENT INSIDER EXCEPTION

Another possible exception to the *Wagoner* rule is the “innocent insider,” or “innocent decisionmaker,” exception. While some trial courts in the Second Circuit have recognized this exception, others have expressly declined to do so.²⁰ Indeed, the District Court for the Southern District of New York has referred to the innocent insider exception as “controversial” and noted that “[t]he Second Circuit has expressly declined to approve or disapprove the ‘innocent insider’ exception.”²¹

Two factors must be met for the innocent insider exception to apply. First, it must be shown that there existed within management a decision maker innocent and ignorant of the misconduct. Second, it must be shown that this innocent insider had the power to stop the misconduct and would have done so given knowledge of the wrongdoing.²² As explained by one court:

¹⁹ “[I]f the malfeasor has engaged in more than one scheme, it is possible to find that certain schemes inured to the benefit of the corporation but that others did not.” *Bennett Funding*, 336 F.3d at 100 (citing *Wight*, 219 F.3d at 89).

²⁰ Compare cases recognizing exception: *Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A.*, 80 F. Supp. 2d 129, 136 (S.D.N.Y. 1999); *BDO Seidman*, 49 F. Supp. 2d at 651; *Wechsler v. Squadron, Ellenoff, Plessent & Sheinfeld, L.L.P.*, 212 B.R. 34, 36 (S.D.N.Y. 1997); *Monahan Ford*, 340 B.R. at 24; *Sharp Int'l Corp. v. KPMG LLP (In re Sharp Int'l Corp.)*, 319 B.R. 782, 788 (E.D.N.Y. 2005), and *O'Neil v. New England Rd. Inc. (In re Neri Bros. Constr. Corp.)*, 323 B.R. 540, 543 (Bankr. D.Conn. 2005), with cases declining to adopt the innocent insider exception: *Am. Tissue, Inc. v. Donaldson, Lufkin & Jenrette, Sec. Corp.*, 233 F.R.D. 327, 330 (S.D.N.Y. 2005); *In re CBI Holding Co., Inc.*, 311 B.R. 350, 372 (S.D.N.Y. 2004), vacated in part, 318 B.R. 761 (S.D.N.Y. 2004) (declining to adopt the exception), appeal pending at, *In re CBI Holding Co. (Bankr. Servs., Inc. v. Ernst & Young)*, Docket No. 04-5972 (2d Cir.) (04-6300, cross appeal); *Baena*, 453 F.3d at 8-9.

²¹ *Am. Tissue, Inc. v. Arthur Andersen L.L.P.*, No. 02 Civ. 7751 (SAS), 2005 WL 712201, *2 & n.16 (S.D.N.Y. Mar. 28, 2005) (citation omitted).

²² *Bennett Funding*, 336 F.3d 94, 101 (2d Cir. 2003); *Am. Tissue*, 2005 WL 712201, at *3 (trustee cannot create standing to sue on behalf of debtor through the innocent insider exception where allegedly innocent insider is effectively in retirement and largely served as a mere “figurehead” for the company at the time of the fraudulent activities); *Wechsler*, 212 B.R. at 36 (holding to survive an assertion of imputation under the *Wagoner* rule, a

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[The debtor's] mere unsubstantiated speculation that [the innocent insider] could and would have stopped the fraud if he had known about it is not sufficient to establish the applicability of the 'innocent insider' exception. As the Second Circuit has emphasized, 'the *Wagoner* rule [cannot be] defeated by a would-a, could-a, should-a test.' To apply the 'innocent insider' exception in this case would perversely reward [the debtor] for having selected a chairman who played almost no role in policing the activities of the corporation.²³

To satisfy the innocent insider exception, there must exist someone involved in the company's management who lacked knowledge of the fraud and, given such knowledge, would have had the power to put an end to it.²⁴ For example, in *In re Sharp Int'l Corp.*, a trustee brought a claim against Sharp's auditor, alleging the auditor's negligence in performing deficient audits allowed management to loot Sharp.²⁵ The auditor brought a motion for summary judgment arguing the wrongdoing of Sharp's management should be imputed to Sharp and bar a claim on behalf of the estate.²⁶ In denying the auditor's motion, the court held the crucial fact was that, although the controlling family that managed and ran the day-to-day operations of Sharp (the "Spitzes") looted more than \$43 million from it, the Spitzes had sold 13% of Sharp's stock to an innocent party, Bohorodzaner, Inc., and executed a shareholder agreement with it. Under the shareholder agreement, Bohorodzaner, Inc. was given a seat on Sharp's board (assumed by that company's namesake) and given the power to veto major corporate transactions, rights which could not be removed. The trustee alleged that, had the other directors

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complaint must include both an allegation that an innocent insider existed and an explanation of "how he could and would have brought the fraud to an end").

²³ *Am. Tissue*, 2005 WL 712201, at *3 (citations omitted); accord *Wallach v. McDermott, Will & Emery (In re Promedicus Health Group, LLP)*, Bankr. No. 03-10102K, Adv. No. 02-1023K, 2006 WL 3848736, *1 (Bankr. W.D.N.Y. Dec. 15, 2006).

²⁴ See *Sharp Int'l*, 319 B.R. at 789.

²⁵ *Id.*

not concealed their looting, Bohorodzaner could have commenced a derivative action against them to stop the improprieties.²⁷ The court declined to dismiss the trustee's claim because the trustee sufficiently alleged facts that could support the innocent insider exception.²⁸ The court stated “[m]ost telling of all is Bernard Spitz's testimony that he and his brothers regarded Bohorodzaner as capable of putting a stop to the fraud and therefore took pains to conceal it from him. The fact that the Spitz's efforts were successful does not mandate imputation of that fraud to Sharp.”²⁹

C. THE SOLE ACTOR EXCEPTION TO THE ADVERSE INTEREST EXCEPTION AND THE INNOCENT INSIDER EXCEPTION

“[W]here the principal and agent are one and the same, the adverse interest exception is itself subject to an exception styled the ‘sole actor’ rule.”³⁰ The sole actor rule “imputes the agent’s knowledge to the principal notwithstanding the agent’s self-dealing because the party that should have been informed was the agent itself albeit in its capacity as principal.”³¹

In addition to applying the sole actor rule where the principal and agent are one and the same, courts have applied it “to cases in which the agent ‘dominated’ the corporation.”³² For

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²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.* at 790.

²⁹ *Id.*

³⁰ *Mediators*, 105 F.3d at 827 (citation omitted).

³¹ *Bennett Funding*, 336 F.3d at 100 (citation omitted); *accord R.F. Lafferty*, 267 F.3d at 359 (if agent and principal are one and the same, “then that agent’s fraudulent conduct is imputable to the principal regardless of whether the agent’s conduct was adverse to the principal’s interests”) (citation omitted).

³² *R.F. Lafferty*, 267 F.3d at 359-60; *accord In re Parmalat Sec. Litig.*, Nos. 05 Civ. 9934, 06 Civ. 0704, 2007 WL 634082, *5 (S.D.N.Y. Feb. 28, 2007); *Official Comm. of Unsecured Creditors of Grumman Olson Indus., Inc. v. McConnel (In re Grumman Olson Indus., Inc.)*, 329 B.R. 411, 425 (Bankr. S.D.N.Y. 2005) (adverse interest exception “does not apply if the wrongdoing agent is the corporation’s sole shareholder or where all of the corporation’s management participate in the wrongdoing”) (citations omitted).

instance, in *In re Verestar*,³³ the sole shareholder allegedly totally controlled and subverted the board of directors. The court found the actions of the sole shareholder would be imputed to the company despite the existence of other innocent directors because the other directors exercised no real authority within the company.³⁴ Similarly, in *Bennett Funding*,³⁵ the debtor was closely-held and run by the family members who allegedly engaged in the wrongdoing. While there were independent directors and officers, the wrongdoers within management fired one such officer and director for asking questions that could have uncovered the fraud and, without the board's approval or involvement, fired an outside auditor who refused to issue a clean opinion to the company.³⁶ The court determined that such control by the wrongdoers of the company required a finding that the trustee lacked standing to sue despite the fact that the bad actor was not the sole, or even principal, owner of the company.³⁷ The sole actor exception negates the innocent insider exception because the sole shareholder generally has the power to remove management at will, thereby negating the innocent insider's ability to put a stop to the wrongdoing.³⁸

³³ *Official Comm. of Unsecured Creditors of Verestar, Inc. v. Am. Tower Corp. (In re Verestar, Inc.)*, 343 B.R. 444 (Bankr. S.D.N.Y. 2006).

³⁴ *R.F. Lafferty*, 267 F.3d at 480.

³⁵ 336 F.3d 94.

³⁶ *Id.* at 98.

³⁷ *Id.* at 101-02.

³⁸ See, e.g., *In re Crown Vantage, Inc.*, No. 02-3836 MMC, 2003 WL 25257821, *9-*10 (N.D. Cal. Sept. 25, 2003), aff'd *Crown Paper Liquidating Trust v. PricewaterhouseCoopers LLP*, 198 Fed. Appx. 597 (9th Cir. 2006), cert. denied No. 06-870, 2007 WL 559904 (Feb. 26, 2007) (dismissing, under doctrine of *in pari delicto*, claims based on conduct occurring while bad actor was plaintiff's sole shareholder but declining to dismiss claims based on conduct occurring when bad actor was no longer sole shareholder).