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LAW FIRM SUED BY TRUSTEE

He says McGuireWoods "was aware of, supported and profited" from activities of former partner.

By DAN MARGOLIES
The Kansas City Star

The trustee of bankrupt Ethanex Energy Inc. has sued a major multinational law firm over an alleged multimillion-dollar fraud scheme by a former partner that contributed to Ethanex's demise.

The trustee, Eric Rajala, is seeking unspecified damages from 900-lawyer McGuireWoods, which is based in Richmond, Va., and has 17 offices worldwide. Rajala's complaint says that McGuireWoods "was aware of, supported and profited" from the activities of the former partner, Louis W. Zehil.

Zehil, of Ponte Vedra Beach, Fla., was forced out of McGuireWoods in February 2007 after his alleged scheme was uncovered. Shortly afterward, federal prosecutors in New York brought criminal fraud charges against him, and the Securities and Exchange Commission brought parallel civil charges.

The criminal case is pending, with Zehil scheduled to make his next appearance in court in late April. The SEC case is also pending, awaiting resolution of the criminal case.

The SEC charged that Zehil made more than $17 million in illegal profits by selling the unregistered shares of seven energy companies, including those of Ethanex and Kansas City-based Alternative Energy Sources Inc.

"We believe that McGuireWoods is responsible for Zehil's conduct," said Kansas City attorney John M. Edgar, who filed the complaint on Rajala's behalf.

William Allcott, a partner with McGuireWoods, said the firm did not believe the suit had merit.

"This suit is based on the alleged activities of a former partner in the firm, Louis Zehil. Those activities were conducted secretly, without the firm's knowledge, solely for Mr. Zehil's personal benefit," Allcott said.

"When McGuireWoods discovered his activities, it immediately demanded and received his resignation and reported his activities to the appropriate authorities. We intend to vigorously defend this suit."

Like Ethanex, Alternative Energy Sources was an ethanol company that has since ceased operations. Alternative Energy Sources also sued McGuireWoods, but for malpractice rather than securities fraud. The case was settled on confidential terms a few months ago.

Ethanex, which filed for bankruptcy in March, had planned to build a 132-million-gallon-per-year ethanol plant in southeast Missouri. Toward that end, it raised $20 million in a private placement in August 2006.

Zehil represented Ethanex and the other companies he allegedly swindled in what are known as PIPE deals – transactions in which the companies offered unregistered, restricted shares to investors at a discount to the market price. Shares issued in PIPE transactions are supposed to bear restrictive legends prohibiting trading in the stock until it is registered with the SEC.

Zehil supposedly circumvented the trading restriction by forming two companies – Strong Branch Ventures IV LP and Chestnut Capital Partners II LLC – that invested in Ethanex's and other companies' private placements. He then allegedly told the agents handling the stock transactions that the shares purchased by Strong and Chestnut did not need to bear restrictive legends. Strong and Chestnut then allegedly sold the shares in the public market.

Through Strong and Chestnut, Zehil purchased 3 million shares of Ethanex's unregistered stock, paying $3.75 million. They then sold the shares for $12.3 million. That means Zehil pocketed $8.55 million in profits.

In addition to seeking damages for federal and state securities law violations, Rajala's complaint also seeks to hold McGuireWoods liable for fraud, wrongful interference with business expectations, negligent supervision and breach of fiduciary duty.