STANDING AND *IN PARI DELICTO* ISSUES ARISING IN PONZI SCHEMES CASES

"Shell Games" Ponzi Scheme Cases: The Liability of Investors,
Sales Agents, Professionals and Others

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Trustees and receivers often look to hold the professionals who assisted the Ponzi debtor responsible for the damages arising from the perpetuation of the fraud in a Ponzi scheme. Potential targets can include any third party who did business with the Ponzi operator, including directors, lawyers, accountants, financial institutions and insurance companies. These materials will focus on two types of defenses that third party professionals may try to assert to claims brought by trustees or receivers in Ponzi cases – (1) lack of standing and (2) the *in pari delicto* doctrine.

I. Standing

A first line of attack by a third party defendant to a trustee's or receiver's tort cause of action is a challenge to the standing of the plaintiff to bring the claim. A critical issue in evaluating whether a trustee or receiver has standing to pursue tort theories against professionals is whether the claim belongs to the corporate debtor entity or to the individual investors of the corporate debtor. The Supreme Court held in *Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416, 433-34 (1972), that a bankruptcy trustee has standing to represent only the interests of the debtor corporation and does not have standing to pursue claims for damages against a third party on behalf of one creditor or a group of creditors. Generally speaking, the law regarding a receiver's standing similarly limits a receiver's standing to the pursuit of claims against third parties to the extent that the claim is one belonging to the debtor entity as opposed to the individual investors.

Standing requires (1) a cognizable injury suffered by the plaintiff, that is (2) fairly traceable to the challenged actions of the defendant, and (3) redressable by a court. *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-61, 112 S.Ct. 2130 (1992). In evaluating a

plaintiff's standing in Ponzi cases, applicable case law distinguishes between trustees and receivers.

A. Standing Issues Faced by Trustees

A trustee's standing arises from the right to pursue property of the estate under section 541(a) of the Code. The law is well-settled that a cause of action held by a debtor is a "legal or equitable interests of the debtor in property" and therefore property of the estate pursuant to section 541(a)(1). *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203, 205 n.9 (1983). Therefore, a trustee has standing to assert claims that could have been asserted by the debtor entity as of the date of the petition. *Schertz-Cibolo-Universal City, Indep. School Dis. v. Wright (In re Educators Group Health Trust),* 25 F.3d 1281, 1283-84 (5th Cir. 1994). If, on the other hand, a cause of action belongs solely to the estate's creditors, then the trustee has no standing to bring the cause of action. *See, Caplin* at 433-34 (holding that a trustee does not have standing to sue a third-party on behalf of debenture holders).[1]

The issue in analyzing a trustee's standing therefore becomes one of determining who owns the cause of action against a third party -- the debtor or the creditors. *Smith v. Arthur Andersen, LLP*, 421 F.3d 989, 1002 (9th Cir. 2005) ("Although the line between 'claims of the debtor,' which a trustee has statutory authority to assert, and 'claims of

[1] *See also*, *Regan v. Vinick & Young* (*In re Rare Coin Galleries of America, Inc.*), 862 F.2d 896, 900 (1st Cir.1988) ("The trustee, however, has no power to assert any claim on behalf of the creditors when the cause of action belongs solely to them."); *Steinberg v. Buczynski*, 40 F.3d 890, 893 (7th Cir.1994); *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991); *E.F. Hutton & Co. v. Hadley*, 901 F.2d 979, 985 (11th Cir. 1990); *Williams v. California 1st Bank*, 859 F.2d 664 (9th Cir. 1988); *Mixon v. Anderson (In re Ozark Rest. Equip. Co.)*, 816 F.2d 1222 (8th Cir. 1987); *Am. Nat'l Bank of Austin v. MorgageAmerica Corp.* (*In re MortgageAmerica Corp.*), 714 F.2d 1266 (5th Cir. 1983).

creditors,' which *Caplin* bars the trustee from pursuing, is not always clear, the focus of the inquiry is on whether the Trustee is seeking to redress injuries to the debtor itself caused by the defendants' alleged conduct.").

Whether the claim is a claim of belonging to the debtor or to a creditor or class of creditors is a question of applicable state law. *Honigman v. Comerica Bank (In re Van Dresser Corp.),* 128 F.3d 945, 947 (6th Cir. 1997); *Hirsch v. Arthur Andersen & Co*., 72 F.3d 1085, 1093 (2d Cir. 1995); *Smith*, 421 F.3d at 1002.

In addition to obtaining standing simply from asserting a claim belonging to the debtor, a trustee can obtain standing to pursue claims against third party professionals under the following theories and statutory authority:

1. Trustee Standing Arising from Section 544(a) of the Code

Courts have found that a trustee must draw his or her authority to assert a particular cause of action from Title 11 of the United States Code. Section 541(a) is used by trustees to bring an action as a successor to the debtor's interests which are property of the estate. Section 544(a) can also be used to permit trustees to have standing as a judicial lien creditor and can void transfers of the debtor's property that could have been avoided by an actual creditor. *See, e.g., Sender v. Simon (In re Hedged-Investment Assocs.)*, 84 F.3d 1299 (10th Cir. 1996).[2] These cases distinguish *Caplin* on the fact that

[2] *Koch Ref. v. Farmers Union Cent. Exch*., 831 F.2d 1339 (7th Cir. 1987); *Sender v. Mann*, 423 F. Supp. 1155, 1173-4 (D. Colo. 2006) ("despite *Caplin,"* trustee has standing under § 544 to bring the derivative claims of the creditors.); *In re Porter McLeod, Inc*., 231 B.R. 786, 792 (D. Colo. 1999) (trustee had standing to pursue malpractice claims and aiding and abetting breach of fiduciary duty against debtor's attorneys, both as successor to debtor's cause of action but also derivatively in capacity as creditor); *In re Southwest Supermarkets, LLC,* 325 B.R. 417, 426-427 (Bankr. D. Ariz. 2005) ("Trustee can assert creditors' breach of fiduciary duty claims, even though no such claims are assertable on behalf of the Debtor"); *Zilkha Energy Co. v. Leighton*, 920 F.2d 1520, 1523 (10th Cir.1990) (when proceeding under § 544, "the trustee may invoke [the] state law remedies provided to judgment lien creditors to satisfy judgments against the

all creditors could have asserted the claim, whereas in *Caplin*, the debenture holders did not constitute all of the creditors holding claims against the debtor.

2. Trustee Standing Arising from Deepening Insolvency Theory

An additional theory to afford trustees standing to pursue claims against third parties is the theory of deepening insolvency.[3] Some courts have used this theory to find that the harm caused by the third party was injury to the corporate entity rather than to the creditors, thereby creating standing for the trustee.

The Ninth Circuit, in *Smith v. Arthur Andersen, LLP*, 421 F.3d at 1003 (9th Cir. 2005), found that the trustee had standing to pursue breach of contracts and duties against attorneys, auditors and investment bankers where, if defendants had not concealed the financial condition of debtor, the debtor might have filed for bankruptcy sooner and additional assets might not have been spent on a failing business. "This allegedly wrongful expenditure of corporate assets qualifies as an injury to the firm which is sufficient to confer standing upon the Trustee." *Id.*[4] *See also, Marion v. TDI, Inc.*, 591 F.3d 137, 148 (3d Cir. 2010) ("A receiver no doubt has standing to bring a suit on behalf

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debtor.").

[3] The Third Circuit decision in *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 350 (3d Cir. 2001), stated this theory as follows: "prolonging an insolvent corporation's life through bad debt may . . . cause the dissipation of corporate assets. Th[is] harm can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt".

[4] Although finding injury to the debtor, and therefore standing for the trustee, based on the rationale of deepening insolvency set forth in the Third Circuit's *Lafferty* decision, the Ninth Circuit opined, "We need not make any general pronouncements on the deepening insolvency theory, not least because it is difficult to grasp exactly what the theory entails". *Id.* The court stated that "We rely only on the dissipation of assets in reaching the conclusion that [the debtor] was harmed." *Id.* at 1004.

of the debtor corporation against third parties who allegedly helped that corporation's management harm the corporation").

3. Trustee Standing Arising from Indirect Injury to Creditors from Dissipation of Debtor's Assets

The trustee, and not the creditors, may be found to have standing to pursue claims for breaches of fiduciary duties which injured the debtor directly by causing an expenditure of its assets, even if this may have caused indirect injury to the creditors. *Smith v. Arthur Andersen, LLP*, 421 F.3d at 1004. The *Smith* court stated: "It is, of course, true that the dissipation of assets limited the firm's ability to repay its debts in liquidation. Acknowledgment of this fact is not, however, a concession that only the creditors, and not [the debtor] itself, have sustained any injury. Instead, it is a recognition of the economic reality that any injury to an insolvent firm is necessarily felt by its creditors." The Ninth Circuit went on to explain:

> The existence of such indirect injury to creditors notwithstanding, it is "axiomatic" that a trustee has authority to bring "actions against the debtor's officers and directors for breach of duty or misconduct." *Koch Ref. v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339, 1348 (7th Cir.1987), *citing Pepper v. Litton*, 308 U.S. 295, 307, 60 S.Ct. 238, 84 L.Ed. 281 (1939); *see also La. World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 246 (5th Cir.1988); *Mixon v. Anderson (In re Ozark Rest. Equip. Co.)*, 816 F.2d 1222, 1225 (8th Cir.1987); *Delgado Oil Co. v. Torres*, 785 F.2d 857, 860 (10th Cir.1986). Moreover, neither our own decision in *Williams*, nor any of the other decisions upon which the Non-Settling Defendants principally rely, *see Breeden v. Kirkpatrick & Lockhart LLP (In re Bennett Funding Group, Inc.)*, 336 F.3d 94 (2d Cir.2003); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085(2d Cir.1995); *E.F. Hutton & Co. v. Hadley*, 901 F.2d 979 (11th Cir.1990); *Mixon*, 816 F.2d 1222, are inconsistent with this analysis, as none of these decisions hold that conduct causing an insolvent debtor corporation to expend its assets injures only the creditors and not the corporation.

4. Trustee Standing Arising from Assignment of Claims

Some courts have found that if a trustee takes an unconditional assignment of claims from creditors, the trustee obtains standing to asset claims directly on behalf of the estate. *See, e.g. Logan v. JKV Real Estate Servs.* (*In re Bogdan*), 414 F.3d 507, 512 (4th Cir. 2005).[5] The *Bogdan* court distinguished *Caplin*, finding that the trustee in the *Bogdan* case was not asserting claims on behalf of the creditors as in the case of *Caplin*, but that the unconditional assignments constituted property of the estate.

The *Bogdan* court also distinguished *Williams v. California 1st Bank*, 859 F.2d 664 (9th Cir. 1988), which had found that an assignment does not confer standing on a trustee, concluding that "*Williams* actually suggests that the unconditional assignments acquired by Bogdan's trustee sufficiently confer standing." *Bogdan*, 414 F.3d at 513. In *Williams*, the debtor had engaged in a Ponzi scheme, and the trustee obtained assignments of claims from some injured investors in exchange for the trustee's promise to recommend to the bankruptcy court that those injured investors only receive the balance of any recovery the trustee might secure in the lawsuit against the bank after the estate paid priority claims and recouped its administrative costs. The *Williams* court concluded that the investors remained the "real parties in interest" because "the bulk of any recovery" had been reserved specifically for them. *Williams*, 859 F.2d at 666. The court reasoned that the investors, in effect, "assigned their claims only for purposes of bringing suit" and, as a result, the trustee was improperly at-tempting to collect money owed to the investors, not the estate. *Id.* at 667. In *Bogdan*, the unconditional

[5] *See also, Sender v. Mann*, 423 F. Supp.2d 1155, 1173 (D. Colo. 2006) (the unconditional assignment from the creditors transformed the individual claims to claims of the estate, the note-holders will recover, if at all, only to the same degree as any other creditor by sharing whatever assets the Trustee collects on behalf of the estate).

assignments did not reserve any part of the potential recovery and the assignees were to recover from the general assets of the estate on a pro rata basis with all other creditors, making the trustee the real party in interest in this adversary proceeding.

The Seventh Circuit recently held that a post-liquidation trustee may assert claims assigned by the investors of debtor in order to pursue third party tortfeasors. *Grede v. Bank of New York Mellon*, 598 F.3d 899 (7th Cir. 2010). This decision is at odds with the Ninth Circuit *Williams* decision, leaving the issue of whether investors may assign their claims to a trustee or liquidating trustee ripe for consideration by the Supreme Court.[6]

5. Cases Finding No Trustee Standing

When considering claims by a trustee against a third party for damages on behalf of creditors, many courts have been unable to find any authority in the Bankruptcy Code or *Caplin* to confer standing upon a trustee. Many of the circuit courts have significantly limited a trustee's standing in Ponzi scheme cases, generally finding that the investors, and not the trustee, have standing to pursue the third party claims.[7]

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[6] In the context of a voluntary assignment for collection, the Supreme Court recently held that an assignee does have standing to pursue an assignor's claims even if the assignee has promised all of the proceeds to the assignor. *Sprint Commc'ns Co., L.P. v. APCC Servs., Inc.*, 554 U.S. 269, 128 S.Ct. 2531 (2008).

[7] **Second Circuit**: *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991); *Hirsch v. Arthur Andersen & Co*., 178 B.R. 40 (D. Conn. 1994, decision aff'd, 72 F.3d 1085 (2d Cir. 1995); *Breeden v. Kirkpatrick & Lockhart LLP (In re Bennett Funding Group Inc.)*, 336 F.3d 94 (2d Cir. 2003).
Seventh Circuit: *Steinberg v. Buc*zynski, 40 F.3d 890, 892 (7th Cir. 1994).
Eighth Circuit: *Mixon v. Anderson (In re Ozark Rest. Equip. Co.),* 816 F.2d 1222, 1225 (8th Cir. 1987).
Ninth Circuit: *Williams v. California 1st Bank*, 859 F.2d 664, 666-67 (9th Cir.1988); *but see, Smith v. Arthur Andersen, LLP,* 421 F.3d at 1003 (9th Cir. 2005).
Eleventh Circuit: *E.F. Hutton & Co. v. Hadley*, 901 F.2d 979 (11th Cir. 1990).

B. Standing Issues Faced by Receivers

Similar to trustee standing, the general rule for receivers is that a receiver may commence a lawsuit, but stands in the shoes of the corporation and can only assert those claims which the corporation could have asserted. Many circuits have found that a receiver has standing to pursue claims against third parties to the extent that the claim is one belonging to the debtor entity as opposed to the individual investors.[8]

In Ponzi scheme cases, a finding as to whether the claim being asserted by the receiver is a claim of the debtor or a claim of the investor will likely turn on the facts of the specific case. The Seventh Circuit has expressly contemplated the distinction in a Ponzi scheme case between the claims of the debtor and the claims of the investors, following the general rule that a receiver does not have standing to pursue claims of the individual creditors. *See Knauer v. Jonathon Roberts Fin. Group, Inc.,* 348 F.3d 230 (7th Cir. 2003).

In *Knauer*, the court noted the distinction between the different phases of a Ponzi scheme -- the sales to investors versus the embezzlement by management -- in analyzing the standing of a receiver to pursue claims against third parties.

> For our purposes, it is useful to think of Ponzi schemes as being comprised of two phases. First, the schemer solicits and receives money for investment, guaranteeing high returns while doing little with the money to produce actual profits. While in this first stage, the schemer may generate some income for himself by charging a fee or paying

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[8] **First Circuit**: *Miller v. Harding*, 248 F.3d 1127, 1128 (1st Cir. 2000) ("An equity receiver, like a bankruptcy trustee, has standing for all claims that would belong to the entity in receivership, and which would thus benefit its creditors and investors, but no standing to represent the creditors and investors in their individual claims.").
Second Circuit: *Eberhard v. Marcu*, 530 F.3d 122, 126-27. (2d Cir. 2008).
Third Circuit: *Marion v. TDI Inc.*, 591 F.3d 137 (3d Cir. 2010).
Sixth Circuit: *Wuliger v. Mfr's Life Ins. Co.*, 567 F.3d 787 (6th Cir. 2009).
Seventh Circuit: *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995).
Ninth Circuit: *Donell v. Kowell*, 533 F.3d 762, 777 (9th Cir. 2008).

> himself a salary with the funds, this 'sales' step is not the source of most of his Ponzi gains. After all, the Ponzi schemer is not content to enrich himself modestly by extracting fees or salaries from the funds he has solicited. Rather, the schemer realizes most of his gains by appropriating large sums of money from the solicited funds, the pace of withdrawals accelerating as he is ready to disband the Ponzi entity and make off with its assets. This 'embezzlement' step of the Ponzi scheme depletes the Ponzi entity of resources, which are diverted to the entities principal, the schemer.

Knauer at 233.

The *Knauer* court concluded that the receiver had standing to pursue claims regarding the embezzlement phase of a Ponzi scheme, but not claims relating to the sales process. The *Knauer* court stated:

> Any claim relating to the fraudulent sales rightfully belongs to the wronged investors, and can be made by them against any . . . culpable person or entity, including possibly the defendants here.
>
> Somewhat different rules are in effect for Counts III, IV and V of the instant Complaint, which involve the embezzlement, rather than the sales, step of the Ponzi scheme. The receiver alleges "that injury to [the debtor] occurred when Payne and Danker misappropriated [the debtor's] funds that had previously been paid to [the debtor] by investors." . . . As the district court again properly concluded, the diversion of funds by Payne and Danker from [the debtor] and JMS did arguably constitute injuries to the Ponzi entities, giving [the receiver] standing to pursue Counts III, IV and V.

Id. at 348 F.3d at 234.

Subsequent to the *Knauer* decision, the Sixth Circuit in *Liberte Capital Group, LLC v. Capwill*, 248 Fed. App'x. 650 (6th Cir. 2007), noted the distinction between the investors pre-purchase claims of fraudulent inducement to invest, and the receiver's post-purchase claims of dissipation of the assets, and found that the receiver did not have standing to sue the debtor's brokers for identifying the investors to invest in the debtor's product. The *Liberte* court, in determining that the receivership entities did not have

standing to sue the brokers for misrepresentations that the brokers made to the investors, stated, "when a receiver is appointed over a corporation, the receiver may only assert claims that could have been asserted by the corporation, and the receiver lacks standing to institute action on behalf of the investors in the corporation." *Liberte* at 656. The court could not find any tangible injury to the receivership entities traceable to the brokers' misrepresentations to the investors.

II. The *In Pari Delicto* Doctrine

The phrase *in pari delicto* means "in equal fault" and the *in pari delicto* defense has been defined as, "The principle that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing." *Black's Law Dictionary* 806 (8th ed. 2004). The *in pari delicto* doctrine is frequently invoked in bankruptcy or receivership cases of Ponzi schemes for corporate debtors, where third party defendants attempt to bar trustees, receivers or other successors in interest from asserting claims against them which arise from the unlawful actions of the debtor's principals.[9]

The *in pari delicto* doctrine is based on two premises: (1) "courts should not lend their good offices to mediating disputes among wrongdoers"; and (2) "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality." *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306, 105 S.Ct. 2622 (1985).

[9] Analysis of the defense of *in pari delicto* is distinct from an analysis of whether the plaintiff has standing to pursue the cause of action in the first instance. *Moratzka v. Morris* (*In re Senior Cottages of Am., LLC*), 482 F.3d 997, 1003-4 (8th Cir. 2007) ("'Whether a party has standing to bring claims and whether a party's claim are barred by an equitable defense are two separate questions, to be addressed in their own terms.'"). *But see, Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991) (Second Circuit recognizes the *in pari delicto* defense as an element of standing rather than a defense that the defendant must prove.).

Although the doctrine was initially used to dismiss claims no matter what the scope was of the wrongful activity of the plaintiff as compared to the defendant, the Supreme Court clarified and limited the doctrine to those situations which (1) the plaintiff, as compared to the defendant, bears at least substantially equal responsibility for the wrong he seeks to redress; and (2) preclusion of the suit would not interfere with the purposes of the underlying law or otherwise contravene the public interest. *Id.* at 311.

The United State Supreme Court has held that state law governs whether an agent's actions may be imputed to a corporation for state law claims. *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 84, 85, 87-89, 114 S. Ct. 2048, 2054 (1994). Beyond this general pronouncement, however, courts have reached different results in applying the *in pari delicto* defense, depending on: (1) whether the plaintiff is a trustee or a receiver; (2) a state's laws regarding corporate agency and the applicable exceptions to whether the bad acts of the agents can and should be imputed to the corporation and its successor in interest; and (3) how to apportion culpability between the plaintiff and defendant. The exceptions vary from state to state to the general rule that the actions and knowledge of a corporation's directors and officers bind the corporation, which can influence how the *in pari delicto* doctrine is applied.

A. *In Pari Delicto* Generally a Defense Against Trustee's Claims

Since trustees acquire "all legal and equitable rights of the debtor as of the commencement of the case" pursuant to Bankruptcy Code Section 541(a)(1), a trustee's rights can be no greater than the debtor's rights at the time of the petition. Other than with respect to claims to avoid fraudulent or preferential transfers,[10] all but one circuit

[10] Courts have generally found that the *in pari delicto* doctrine does not apply as a defense to a

has held that, at least in bankruptcy cases, section 541 requires that the courts evaluate defenses as they existed at the commencement of the bankruptcy case and that, therefore, the subsequent appointment of a trustee does not change those defenses, including the applicability of the *in pari delicto* defense.[11] *But see, Logan v. JKV Real Estate (In re Bogdan),* 414 F.3d 507, 514-15 (4th Cir. 2005) (where trustee takes an absolute assignment of creditors' cause of action, the *in pari delicto* defense will not apply to trustee); *NCP Litigation Trust v. KPMG LLP*, 901 A.2d 871, 874 (N.J. 2006) ("the imputation doctrine does not bar corporate shareholders from recovering through a

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trustee's action to avoid fraudulent transfers under section 548 or preferential transfers under section 547. *See, e.g., Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1152 (11th Cir. 2006) ("Fraudulent conveyances . . . are an exception to the general rule that the trustee takes the debtor estate as it is at the commencement of the bankruptcy case."); McNamara v. PFS (*In re Personal and Bus. Ins. Agency*), 334 F.3d 239, 245-47 (3d Cir. 2003); *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc*. 267 F.3d 340, 356-358 (3d Cir. 2001).

[11] **First Circuit**: *Baena v. KPMG LLP*, 453 F.3d 1 (1st Cir. 2006); *Nisselson v. Lernout*, 469 F.3d 143, 153 (1st Cir. 2006) ("there is no 'innocent successor' exception available to a bankruptcy trustee in a case in which the defendant successfully could have mounted an *in pari delicto* defense against the debtor.").
Second Circuit: Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114 (2d Cir. 1991); Official Comm. Of Unsecured Creditors of Color Tile, Inc., v. Coopers & Lybrand, LLP, 322 F.3d 147, 158 (2d Cir. 2003); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085 (2d Cir. 1995).
Third Circuit: *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001); *but see, McNamara v. PFS (In re Personal & Bus. Ins. Agency*), 334 F.3d 239, 247 (3d Cir. 2003) ("nothing in the language of § 548 precludes us from considering replacement of Kesselring by the Trustee and the concomitant removal of the taint of Kesselring's fraud from PBI, and we hold that Kesselring's conduct will not be imputed to the Trustee.")
Fourth Circuit: *Logan v. JKV Real Estate Servs. (In re Bogdan)*, 414 F.3d 507 (4th Cir. 2005).
Fifth Circuit: *Gray v. Evercore Restructuring, LLC*, 544 F.3d 320 (5th Cir. 2008).
Sixth Circuit: *Terlecky v. Hurd (In re Dublin Sec., Inc.)*, 133 F.3d 377 (6th Cir. 1997).
Eighth Circuit: *Grassmueck v. Am. Shorthorn Assoc*., 402 F.3d 833, 836-37 (8th Cir. 2005).
Ninth Circuit: *In re Crown Advantage, Inc*., 2004 WL 1635543 (N.D. Cal. 2004), *aff'd*, 198 Fed. App'x. 597 (9th Cir. 2006).
Tenth Circuit: Sender v. Buchanan (In re Hedged-Investments Assocs.), Inc., 84 F.3d 1281 (10th Cir. 1996).
Eleventh Circuit: Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145 (11th Cir. 2006).

litigation trust against an auditor who was negligent within the scope of its engagement by failing to uncover or report the fraud of corporate officers and directors").

While the law appears to be clear in most circuits that a trustee is subject to the *in pari delicto* doctrine, there remains much discussion on the topic and uncertainty in the Seventh Circuit as to whether it will find that such a doctrine applies to trustees in bankruptcy. The criticism of the application of the *in pari delicto* doctrine to bankruptcy trustees focuses on the sense of unfairness that an estate representative should be imposed with the fiction that a debtor is still a party in interest, when in fact the debtor has been replaced by the trustee for the purpose of trying to recover funds for those who were injured by the debtor in the first place.[12] While the courts have relied on section 541(a) to permit the use of the equitable doctrine of *in pari delicto*, many have found it nonsensical that an equitable doctrine is being used to effect the inequitable result that trustees are being barred from recovering from third parties for the benefit of the debtor's creditors, and not for the benefit of the wrongdoer.[13] "The policy mandate in a bankruptcy case is… forceful because proceeds of the cause of action will go, not to the private litigant who was personally in cahoots with the defendant, but to the innocent creditors and investors." *Ending the Nonsense*, 21 Emory Bankr.Dev.J. at 542.

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[12] *Ending the Nonsense: The In Pari Delicto Doctrine Has Nothing to Do with What is 541 Property of the Estate*, Jeffrey Davis, 21 Emory Bankr.Dev.J. 519 (2005).

[13] *Lafferty,* 267 F.3d at 360 (Cohen, J., dissenting) ("the majority's reasoning rests on a mistaken interpretation of the bankruptcy code, needlessly thwarts recovery for innocent creditors, and insulates from civil liability those who help perpetuate the fraud."); *see also, Leibowitz v. First Chicago Bank & Trust* (*In re IFC Credit Corp.*), 422 B.R. 659, 664 (Bankr. N.D. Ill. 2010) ("the *in pari delicto* defense is intended for situations in which the victim is a participant in the misconduct giving rise to his claim. This is not applicable to the Trustee since he could not be considered a 'wrongdoer'").

However, some courts have tried to get around the application of the *in pari delicto* doctrine by comparing fault of the predecessor debtor to the alleged wrongful acts of the defendant. The Pennsylvania Supreme Court engaged in a thoughtful discussion of the *in pari delicto* defense asserted by an auditor and refused to find a blanket rule regarding the applicability of the rule in auditor liability cases. *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterHouseCoopers, LLP*, 989 A.2d 313 (Pa. 2010). The court instead found that the proper test to determine the applicability of the *in pari delicto* defense depends on whether the defendant auditor dealt with the fraud perpetrator in good faith. The court found that "Imputation does not apply . . . where the defendant materially has not dealt in good faith with the principal. . . This effectively forecloses an *in pari delicto* defense for scenarios involving secretive collusion between officers and auditors to misstate corporate finances to the corporation's ultimate detriment." *Id.* at *21.

Conversely, "[f]or the *in pari delicto* doctrine to apply, . . .the plaintiff must have been an active, voluntary participant in the unlawful activity for which the plaintiff seeks damages." *Lewis v. Brobeck (In re Brobeck)*, 2008 WL 5650052 *4 (Bankr. E.D. Tenn. 2008) (if the plaintiff was not a co-conspirator with the defendant, the *in pari delicto* defense does not apply); *see also*, *Mosier v. Callister, Nebeker & McCullough*, 546 F.3d 1271 (10th Cir. 2008) ("no reasonable jury could conclude . . .that [the law firm and attorney's] conduct was more culpable than that of [debtor].").

Accordingly, while defendants may try to assert the *in pari delicto* defense due to the wrongful acts of the debtor in whose shoes the trustee stands, some courts may refuse

to apply the defense based upon the defendant's own wrongful actions and the extent of any alleged conspiratorial acts of the plaintiff.

B. *In Pari Delicto* Generally Not Applicable as Against Receiver

For the most part, federal courts have consistently declined to apply the *in pari delicto* doctrine to receivers of corporate debtors pursuing third party claims. *Scholes v. Lehman*, 56 F.3d 750 (7th Cir. 1995); *FDIC v. O'Melveny & Meyers*, 61 F.3d 17, 19 (9th Cir. 1995) ("A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the [entity]; it is thrust into those shoes."). The Ninth Circuit noted the following general rule and exception to that rule for receivers: "a receiver occupies no better position than that which was occupied by the person or party for whom he acts and any defense good against the original party is good against the receiver." *Id*. at *19. However, "defenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver." *Id.* (citation omitted).

The rationale in declining to impute the wrongdoers bad acts to a subsequent independent receiver was explained by the Seventh Circuit as follows:

> . . . the wrongdoer must not be allowed to profit from his wrong . . . [but] [t]hat reason falls out now that [the wrongdoer] has been ousted from control of and beneficial interest in the corporations. The appointment of the receiver removed the wrongdoer from the scene. The corporations were no more [the wrongdoer's] evil zombies. Freed from the spell, they became entitled to the return of the moneys – for the benefit not of [the wrongdoer] but of innocent investors . . .

Scholes v. Lehman 56 F.3d at 754.

In other words, in *Scholes v. Lehman*, the Seventh Circuit held that the *in pari delicto* doctrine is not applicable to a receiver because the wrongdoer has been removed

from scene and has been replaced by a receiver, at least in the case of a receiver's claims for avoidance of fraudulent transfers.

In finding that the *in pari delicto* defense is not applicable to receivers, courts have noted the distinction between receivers and trustees, finding that receivers are not bound by section 541 of the Bankruptcy Code and that the bad acts of the corporate entity and its principals should generally not be imputed to the receiver. *See, In re Hedged-Investments Assocs., Inc.*, 84 F.3d 1281 (10th Cir. 1996) ("Put most simply, [a trustee] is a bankruptcy trustee acting under 11 U.S.C. § 541, and bankruptcy law, apparently unlike the law of receivership, expressly prohibits the result [the trustee] urges.").

The Seventh Circuit subsequently limited its holding in *Scholes v. Lehman* when faced with claims brought by the receiver against third party brokerage firms in a Ponzi scheme case for negligence, fraud and conversion, alleging direct injury to the corporate debtor different type of third party claim. *See Knauer v. Jonathon Roberts Fin. Group, Inc.*, 348 F.3d 230 (7th Cir. 2003). In *Knauer*, the Seventh Circuit agreed with its earlier proposition that an exception to the *in pari delicto* doctrine exists for a receiver in exceptional circumstances involving avoidance of fraudulent conveyances; however, the *Knauer* court noted that the exception to the general rule may not apply as to other types of claims against third parties. *Id.* at 236. The *Knauer* court set forth an "equitable balancing" test to determine whether the doctrine of *in pari delicto* should apply, considering the following factors: (1) the types of third party claims being asserted by the receiver, i.e., fraudulent conveyance claims versus tort claims for injury to the corporate debtor; (2) whether the third party defendant had a role in the Ponzi scheme by direct active participation versus whether they just engaged in passive conduct or failed to act;

and (3) the extent of separation between the wrongdoers and the corporate entities compared to the third party defendants.

Knauer has largely been criticized as altering what was a general understanding that the *in pari delicto* doctrine does not apply in receivership cases but remains the law in the Seventh Circuit.

C. Ways to Defeat the *In Pari Delicto* Defense

Whether a trustee or receiver is asserting a third party claim, the applicability of the *in pari delicto* defense will ultimately depend on whether such a defense is appropriate under state law. *O'Melveny & Myers v. FDIC*, 521 U.S. 79, 114 S.Ct. 2048, 2054 (1994) (state law governs whether an agent's actions or knowledge may be imputed to a corporation for state law claims).

Generally speaking, corporate agency rules dictate that the actions and knowledge of a corporation's directors and officers will bind the corporation, but the states have a variety of exceptions to this general rule. The *in pari delicto* defense may depend on what exceptions exist in a particular state's laws to the basic rules of corporate agency.

1. The Adverse Interest Exception

If a plaintiff can show that the officers and directors of the debtor who participated in the fraudulent transactions were acting in their own interests and to the detriment of the debtor, then several courts have found that the adverse interest doctrine defeats the *in pari delicto* doctrine. *Bankruptcy Servs. Inc. v. Ernst & Young* (*In re CBI Holding Co., Inc.*), 529 F.3d 432 (2d Cir. 2008) (*in pari delicto* does not apply if the fraud was not perpetrated for the benefit of the debtor corporation, but rather only for the benefit of the wrongdoer).

Courts considering the adverse interest exception have placed the following limitations on this exception:

Baena v. KPMG, LLP, 453 F.3d 1, 8 (1st Cir. 2006) (the exception generally applies when the agent has "totally abandoned" the interests of the corporate debtor and is acting entirely for his own purposes. Looting of corporate assets is "the classic example" of when the adverse interest exception should be applied).

Breeden v. Kirkpatrick & Lockhard LLP (In re Bennett Funding Group), 336 F.3d 94, 100 (2d Cir. 2003) (adverse interest exception applies only when the agent has "totally abandoned" the principal's interest).

Gray v. Evercore Restructuring L.L.C., 544 F.3d 320, 327 (1st Cir. 2008) ("The bare fact that management received bonuses upon confirmation is not sufficient to establish the exception.")

Bankruptcy Services, Inc. v. Ernst & Young (In re CBI Holding Co.), 529 F.3d 432, 449 (2d Cir. 2008) (Bankruptcy court's finding that management had totally abandoned CBI's interests as required for the "adverse interest" exception to be satisfied was not clearly erroneous.).

Nisselson v. Lernout, 469 F.3d 143, 156 (1st Cir. 2006) ("mere indifference is insufficient to show adversity").

Beck v. Deloitte & Touche, Deloitte, Haskins & Sells, Ernest & Young, LLP, 144 F.3d 732, 737 (11th Cir. 1998) ("a director's wrongful actions toward his corporation do not have to rise to the level of corporate 'looting' . . . or embezzlement in order to be adverse and thereby prevent imputation, as long as the corporation receives no benefit from the director's misbehavior.").

Mosier v. Callister, Nebeker & McCullough, 546 F.3d 1271 (10th Cir. 2008) (adverse interest exception did not apply, in part because debtor's board, which included others besides CEO and chairman, decided to continue debtor's operations even after being warned against doing so by debtor's initial legal counsel.).

Sec. Investor Prot. Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999) (If the agent seeks both personal gain and gain for the corporation, many courts have found that the adverse interest exception will not apply in the face of this mixed motive.).

Baena v. KPMG, LLP, 453 F.3d 1, 7 (1st Cir. 2006) (the adverse interest exception is not automatically triggered just because misconduct resulted in future financial harm to the entity.)

See also, Grede v. McGladrey & Pullen, LLP, 2009 WL 3094850 (N.D. Ill. 2009) ("The later demise of [the debtor] does not mean there was no benefit to [the debtor], here for quite some time, when its officers acted wrongly.").

2. The Sole Actor Rule as Exception to the Adverse Interest Exception

There is an exception to the "adverse interest exception," known as the "sole actor" rule. If the agent principal of the debtor corporation and the principal are essentially one and the same, then the misconduct of the agent principal will be imputed to the debtor corporation and *in pari delicto* will apply. *See Breeden v. Kirkpatrick & Lockhard LLP (In re Bennett Funding Group)*, 336 F.3d 94, 100 (2d Cir. 2003); *Mediators, Inc. v. Manney (In re Mediators Inc.)*, 105 F.3d 822, 827 (2d Cir. 1997); *Munroe v. Harriman*, 85 F.2d 493, 496 (2d Cir. 1936) (exception only applies where

agent exerts "domination" which affects the corporation's actions "with respect to the particular transaction.").

Courts have wrestled with the issue of whether the fact that the corporation received some benefit means that *in pari delicto* will still apply. *Beck v. Deloitte Touche*, 144 F.3d 732, 736 (11th Cir. 1998) (benefit, even of limited duration, is enough even if harm later came to corporation from the fraud).

The adverse interest exception may only apply if the wrongdoer can "[i]n no way . . . be described as beneficial to the company. … [A]dverse interest exception is not automatically triggered whenever misconduct contributes to a future financial harm. If it were, it would effectively eliminate the *in pari delicto* altogether, since unmasked frauds resulting in lawsuits rarely, if ever, benefit a company in the long run." *Grede v. McGladrey & Pullen*, LLP, 421 B.R. 879 at *7 (N.D. Ill. 2009) (citation omitted).

However, courts have also considered whether those benefits are meaningful benefits to the corporation or rather are "illusory ones meant to conceal benefits solely intended for those who controlled [the debtor]." *Grede v. McGladrey & Pullen*, LLP, 421 B.R. 879.

3. "Innocent Decision Maker" Exception

Another exception to the *in pari delicto* defense may apply if not all of the "shareholders and/or decision makers are involved in the fraud" and, i.e., there was at least one innocent insider to whom the defendant could have reported their findings. *Secs. Investor Protection Corp., v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999) quoting *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP*, 212 B.R. 34, 36 n.1 (S.D.N.Y. 1997) (*in pari delicto* does not apply where innocent decision-

makers who were "ignorant of the ongoing fraud and could and would if advised of the facts . . . have taken steps to bring the fraudulent conduct to an end."). *But see, Bankruptcy Services, Inc. v. Ernst & Young* (*In re CBI Holding*), 529 F.3d 432 (2d Cir. 2008) (finding innocent insider exception invalid).

At least one court has clarified that the innocent decision maker exception should apply only if the innocent decision makers are "relevant." *Breeden v. Kirkpatrick & Lockhard*, 268 B.R. 704, 710 (S.D.N.Y. 2001) ("Only management that exercises total control over the corporation – or that exercises total control over the type of transactions involved in the particular fraudulent activity at issue – are relevant."); *see also*, *Smith v. Andersen, LLP*, 175 F.Supp.2d 1180, 1199 (D. Ariz. 2001) (In "cases involving more than one corporate actor, the plaintiff may avoid dismissal for lack of standing by alleging the existence of an 'innocent member… of management who would have been able to prevent the fraud had he known about it.").

The factors applicable to this exception to the *in pari delicto* doctrine there appear to be: (1) the existence of a relevant outside decision maker; (2) who would have taken that action had he been aware of the wrongdoing; and (3) who could have taken action to stop the wrongdoing.

However, some courts have found the innocent decision maker exception inapplicable even where an innocent member of management "could and would have prevented the fraud had they been aware of it." *Ernst & Young v. Bankruptcy Services, Inc.* (*In re CBI Holding*), 311 B.R. 350, 372 (Bankr. S.D.N.Y. 2004), aff'd in part, rev'd in part, 529 F.3d 432 (2d Cir. 2008) ("where a publicly traded company has delegated to a board of directors the owners' role of hiring and supervising managers, and where that

board has failed to prevent managers from committing fraud, the managers' misconduct should be imputed to the company, so as not to disincentivize the innocent managers, board members, and owners from policing the conduct of the guilty."). *See also*, *Lippe v. Bairnco Corp.*, 218 B.R. 294 (S.D.N.Y. 1998) found that the innocent decision maker exception did not apply, allowing *in pari delicto* to bar the plaintiff from asserting claims, where, notwithstanding a relevant innocent decision maker, there was a "sufficient unity" between the corporation and the management wrongdoers.

4. Successor in Interest Exception

As discussed above, the circuit courts have found a distinction between trustee and receivers in applying the successor in interest exception to the doctrine of *in pari delicto*. Most courts have found that, in connection with receivership cases, a receiver is an innocent successor to the wrongdoer corporation and that the doctrine of *in pari delicto* should not apply. *FDIC v. O'Melvey & Myers*, 61 F.3d 17, 19 (9th Cir. 1995); *Scholes v. Lehman*, 56 F.3d 750, 754 (7th Cir. 1995). However, most circuits have found that section 541(a) precludes such a finding and that a trustee must take a cause of action as it existed on the petition, with all applicable defenses including *in pari delicto*. *See, e.g., Nisselson v. Lernout,* 469 F.3d 143, 153 (1st Cir. 2006); *Official Comm.. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 356-57; *Sender v. Buchanan* (*In re Hedged-Investments Assocs., Inc.*), 84 F.3d 1281 (10th Cir. 1996).

5. Assignment of Claims to Trustee

Some courts have also permitted a trustee to pursue claims against third parties despite the *in pari delicto* doctrine where the trustee is pursuing claims assigned to him by creditors. Courts have found the claims clean of the *in pari delicto* doctrine where, for

example, a litigation trust is created pursuant to a plan of reorganization and the creditors opt in to the trust by assigning their litigation claims to the litigation trustee, thereby preserving the purity of the claims. *Sender v. Mann*, 423 F.Supp.2d 1155, 1174 (D. Colo. 2006) (unconditional assignment of creditors' claims into opt-in trust defeats *in pari delicto* defense).

The Fourth Circuit has expressly found that the *in pari delicto* doctrine is not applicable where a trustee is suing on behalf of the estate as an assignee of creditors. *Bogdan v. JKV Real Estate Servs.*, 414 F.3d 507, 514 (4th Cir. 2005) ("As assignee, the trustee stands in the shoes of the mortgage lenders, thereby assuming all rights and interests that the mortgage lenders have in the causes of action and becoming subject to all defenses that could have been asserted against the mortgage lenders.").

6. Section 544 Claims

Section 544(b)(1) allows a trustee to assert the claims of creditors under state law.[14] A trustee "stands in the shoes" of the creditor, subject to any defenses that could be asserted against the creditor. *Sender v. Simon*, 84 F.3d 1299, 1305 n. 5 (10th Cir. 1996).

A trustee may "'assume the guise of a creditor with a judgment against the debtor.'" *Sender v. Mann*, 423 F. Supp. 1155, 1172 (D. Colo. 2006) (quoting *Zilkha Energy Co. v. Leighto*n, 920 F.2d 1520, 123 (10th Cir. 1990). If a trustee brings a claim

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[14] Section 544(b)(1)provides:

> Except as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

as a creditor, he may escape the *in pari delicto* defense since the creditor's claim has not been tainted by the debtor's bad acts. Because the trustee's standing is as a creditor and not on behalf of the debtor, subject to section 541, the *in pari delicto* defense should not apply. *Sender v. Porter (In re Porter McLeod, Inc.)*, 231 B.R. 786, 793-94 (D. Colo. 1999).

7. *In Pari Delicto* Usually Not Ripe for Dismissal of Claim on Motion to Dismiss

In pari delicto is an affirmative defense that is generally not considered on a motion to dismiss. *See, e.g., OHC Liquidation Trust v. Credit Suisse First Boston* (*In re Oakwood Homes Corp.*), 340 B.R. 510 (Bankr. D. Del. 2006); *Stanziale. v. Student Fin. Corp.*, 2006 WL 2346373 (D. Del. 2006).

However, if the affirmative defense appears on the face of the complaint, a court may grant dismissal by motion. *Leveto v. Lapina*, 258 F.3d 156, 161 (3d Cir. 2001); *Terlecky v. Hurd* (*In re Dublin Sec. Inc.*), 133 F.3d 377, 380 (6th Cir. 1997). In determining whether the court should grant dismissal on a Rule 12(b)(6) or Rule 12(c) motion based on an affirmative defense, the facts alleged must (1) be "definitively ascertainable from the complaint and other allowable sources of information; and" (2) sufficient "to establish the affirmative defense with certitude." *Nisselson v. Lernout*, 469 F.3d 143, 150 (1st. Cir. 2006).