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BANKRUPTCY LAW

Bearing the Sins of the Father

Is the doctine of in pari delicto a viable defense against a corporate bankruptcy trustee?

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The doctrine of in pari delicto, meaning "of equal fault," precludes a plaintiff from recovering damages resulting from its own wrongdoing. The doctrine derives from two premises: (i) a court should not mediate a dispute among wrongdoers; and (ii) the denial of judicial relief to a wrongdoer is an effective means of deterring illegality. If the plaintiff is a corporation, in pari delicto can protect a defendant from liability for acts committed in complicity with agents of the corporation, such as its officers. Suppose, however, the corporation is in bankruptcy and it is a trustee or other estate representative, standing in the shoes of the corporation, who is suing on behalf of the corporation's bankruptcy estate. Can the defendant still invoke the doctrine against the trustee? In this Circuit, the answer depends on the resolution of two issues: (i) whether the court can consider post-petition events such as the removal of the corporate agents from management and the trustee's status as an innocent successor; and (ii) whether the corporate agents' conduct can be imputed to the corporate debtor, and hence, the trustee. This article briefly examines these concepts.

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The Third Circuit has held that the determination of whether a court can consider post-petition events rests on the type of claim asserted. Bankruptcy Code Section 541, governing the determination of property of the estate, specifically bars consideration of events occurring after the commencement of bankruptcy; thus, a court evaluating an in pari delicto defense to a Section 541 claim cannot consider whether the plaintiff, such as a trustee, is an innocent successor. *Off. Comm. of Unsecured Creds. v. R.F. Lafferty & Co.*, 267 F.3d 340, 357 (3d Cir. 2001). In contrast, statutes conferring avoidance powers, such as Section 548, contain no such restriction. Therefore, a court adjudicating an in pari delicto defense to an avoidance claim can consider post-petition events. *McNamara v. PFS a/k/a Premium Fin. Specialists (In re Personal & Bus. Ins. Agency)*, 334 F.3d 239, 245-46 (3d Cir. 2003).

In *Lafferty*, an official committee of unsecured creditors alleged, on behalf of the debtor corporations, that the corporations' counsel, accountant and underwriters had conspired with the corporations' officers to perpetuate a Ponzi scheme and thereby deepen the corporations' insolvency and force bankruptcy. The district court imputed the officers' wrongdoing to the corporations and held that in pari delicto barred the committee, standing in the shoes of the corporations, from bringing claims such as fraud and breach of fiduciary duty. On appeal, the committee argued that the district court had erred in discounting the committee's status as an innocent successor to the debtor corporations.

In addressing the issue of whether a court can consider post-petition events, the Third Circuit noted that actions brought by a bankruptcy representative such as a creditors' committee fall into two categories: (1) those brought by the representative as successor to the debtor's interest included in the estate under Section 541; and (ii) those brought under the trustee's avoidance powers. The Third Circuit recognized that the committee had brought its claims in its capacity as a successor to the debtor corporations' interest. Thus, the court found, Section 541 covered such claims. Under Section 541, it further noted, the bankruptcy estate includes "all legal or equitable interests of the debtor in property *as of the commencement*" of bankruptcy. Based on such language, the court found, not only can an estate representative assert only those causes of action possessed by the debtor, it is subject to the defenses that could have been asserted by the defendant against the debtor. Therefore, the Third Circuit determined, courts must evaluate defenses to actions asserted under Section 541

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as they existed at the commencement of the bankruptcy. The Third Circuit concluded that Section 541 prevented the district court from considering events occurring after the commencement of the bankruptcy case, such as the removal of officers from management as well as the committee's status as an innocent successor, and that the court had to evaluate the in pari delicto defense without regard to whether the committee qualified as an innocent successor.

In reaching its conclusion, the Third Circuit acknowledged that because they relate to the trustee's power to resist pre-bankruptcy transfers of property, the trustee's avoidance powers were not implicated in *Lafferty*. Also, it distinguished cases in the receivership context, in which courts had declined to apply in pari delicto on the basis that application of the doctrine would be inequitable. In so finding, it noted that receivers, unlike bankruptcy trustees, are not subject to the limits of Section 541.

The Third Circuit subsequently had cause, in *McNamara*, to evaluate the application of in pari delicto in an avoidance action. In *McNamara*, a Chapter 7 trustee sought to avoid, as fraudulent transfers, payments made by the debtor in repayment of loans fraudulently obtained through the debtor's chief executive officer from a lender. The bankruptcy court dismissed the claim on the basis that it was precluded under the in pari delicto doctrine. On appeal, the trustee maintained that even if the officer's pre-petition fraud was properly imputed to the debtor, such fraud could not, given his post-petition appointment, be imputed to himself.

The Third Circuit agreed. It cited the distinctions made in *Lafferty* between the language of Sections 541 and 548 and between receivers and bankruptcy trustees asserting claims under Section 541. Also, it found that in cases under Section 548, the doctrine of imputation, sustainable against the corporation, fails to act as a bar to recovery when the "bad actor" has been removed and the beneficiaries of the action are the corporation's innocent creditors. The Third Circuit held, therefore, that a court adjudicating a Section 548 claim can consider post-petition events, that the bankruptcy court could consider the debtor's fraudulent transfer claim in light of the trustee's appointment and the removal of the officer, and that imputation of the officer's fraud to the trustee would lead to an inequitable result. As a result, it reversed the dismissal of the fraudulent transfer claim.

Other Bankruptcy Code sections governing avoidance, such as Sections 547 and 549, similarly do not prevent a court from considering post-petition events. Accordingly, while a court can impute a corporate agent's wrongdoing to a debtor corporation's trustee in a Section 541 action, it generally cannot impute such wrongdoing in an avoidance action.

In addressing the second issue — whether the corporate agents' conduct could be imputed to the debtors, and hence the trustee — in *Lafferty*, the Third Circuit noted that state law generally provides the substantive law governing the imputation for state law claims. Under the law of imputation in Pennsylvania, the substantive law applicable in *Lafferty*, courts impute the fraud of an officer to a corporation when the officer commits the fraud (1) in the course of his employment; and (2) for the benefit of the corporation. The Third Circuit found that the fraud allegedly perpetrated by the debtors' officers had taken place in the course of their employment for the debtors; thus, the first element of the test was satisfied.

The Third Circuit noted that the "adverse interest exception" often governs the second element of the Pennsylvania imputation test. Under this exception, fraudulent conduct will not be imputed if the officer's interests were adverse to the corporation and "not for the benefit of the corporation." Although the committee argued that the officers had caused damage to the interests of the debtors, and hence, that the officers' interests were adverse to the interests of the debtors and that the officers' conduct could not be imputed to the debtors, the Third Circuit observed that, even assuming such adversity existed, the "adverse interest" exception is itself subject to an exception — the "sole actor" exception. The "sole actor" exception provides that if an agent is the sole representative of a principal, that agent's fraudulent conduct is imputable to the principal regardless of whether the agent's conduct was adverse to the principal's interests. Because the debtors' officers in *Lafferty* qualified as "sole actors" under this exception, the second element of the Pennsylvania imputation test was satisfied. The Third Circuit thus imputed the fraudulent conduct of the debtors' officers to the debtors because the officers had perpetrated the alleged fraud in the course of their employment and because even though the officers may have acted adversely to the interests of the debtors, they were the sole actors engaged in the alleged fraudulent conduct. The Third Circuit concluded that the in pari delicto doctrine barred the committee, standing in the shoes of the debtors, from bringing its claims.

The law of imputation in New Jersey differs from its Pennsylvania counterpart. Under New Jersey law, unlike Pennsylvania law as summarized by the Third Circuit in *Lafferty*, the imputation doctrine does not bar corporate shareholders from proceeding against wrongdoers, or wrongdoer auditors at the least. See, e.g., *NCP Litig. Trust v. KPMG LLP*, 187 N.J. 353, 372 (2006); *In re Liquidation of Integrity Ins. Co.*, 240 N.J. Super. 480, 505-06 (App. Div. 1990); *Nischne v. Firestone Tire & Rubber Co.*, 116 N.J. Eq. 305, 307-08 (Ch. 1934), *aff'd*, 119 N.J. Eq. 541 (1936). The Supreme Court of New Jersey has reasoned that although a shareholder should not benefit from his own wrongdoing, the improper acts of some shareholders acting as officers or directors should not bar the recovery of *all* shareholders.

This general rule is subject to certain limited exceptions. Because the imputation defense should protect only the innocent and not the guilty, shareholders must themselves be "innocent" of wrongdoing. Therefore, a defendant

can invoke imputation against those shareholders who engaged in the conduct at issue. Further, the defendant can invoke imputation against those who, by virtue of their role in the company, should have been aware of the conduct. Finally, the defendant can invoke imputation in a case in which the shareholders, by virtue of their ownership of a large portion of stock, had the ability to conduct oversight of the firm's operations. In any event, even assuming that the shareholders did engage in wrongdoing, such fact, alone, does not represent a complete bar to liability; rather, it constitutes only a factor in the apportionment of damages.

Therefore, in a corporate bankruptcy case, the trustee can argue that, under New Jersey law, a defendant generally cannot invoke imputation, and concomitantly, in pari delicto. Conversely, the defendant can argue that any damages should be reduced to the extent that the debtor's shareholders participated in or to the extent that they should have been aware of the wrongdoing at issue.

Given the language of the Bankruptcy Code sections governing avoidance, a defendant generally cannot invoke in pari delicto against a corporate bankruptcy trustee in an avoidance action. Further, it would appear that the defendant cannot invoke imputation, and hence, in pari delicto, as to claims asserted under New Jersey law, except to the extent that the debtor's shareholders engaged in or to the extent that they should have been aware of the wrongdoing at issue. ■