

**AMERICAN BANKRUPTCY INSTITUTE**

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**Bankruptcy Trustee Suits  
Against Former Counsel for  
Bankrupt Public Companies**

*Standing  
And The  
In Pari Delicto Defense*

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The prevalence of corporate fraud through ponzi schemes and the like has caused bankruptcy trustees<sup>1</sup> to increase their attempts to recover assets for the benefit of the estate by aggressively pursuing claims against third parties that provided assistance to the debtor's agents during their acts of wrongdoing. These third parties often include, among others, accountants/auditors, attorneys, financial advisers and lenders.

## **I. POSSIBLE CAUSES OF ACTION AGAINST THIRD PARTY PROFESSIONALS**

The causes of action that trustees have relied on have included both common law and bankruptcy claims. The common law claims have included: (1) breach of fiduciary duties; (2) aiding and abetting breaches of fiduciary duties; (3) deepening insolvency; (4) breach of contract; (5) malpractice; (6) negligence; (7) negligent misrepresentation; (8) intentional fraud; (9) conversion; (10) unjust enrichment; (11) civil conspiracy, (12) RICO and (13) state law fraudulent transfer or conveyance. The bankruptcy claims have included: (1) fraudulent transfer, (2) equitable subordination, and even (3) preference claims, on the theory that the third party professional's misconduct defeats the "ordinary course of business" defense.

## **II. STATE LAW CAUSES OF ACTION**

The bankruptcy law framework for asserting common law claims is as follows:

- If the trustee asserts state law claims as the debtor's successor, such claims (other than state law avoidance actions) are typically covered by Section 541 of the Bankruptcy Code.
- The bankruptcy estate under § 541 includes "all legal and equitable interests of the debtor in property *as of the commencement*" of bankruptcy. 11 U.S.C. § 541(a) (2008).
- These legal and equitable interests include the right to assert causes of action. As a result, for actions brought by the trustee as successor to the debtor's interest under § 541, the trustee stands in the shoes of the debtor and can only assert those causes of action possessed by the debtor as of the commencement of the bankruptcy.<sup>2</sup> Similarly, the trustee is subject to the same defenses that could have been asserted by the defendant had the action been brought by the debtor.<sup>3</sup>
- The third party defendants, in turn, often file a motion to dismiss alleging the trustee's lack of standing to assert such claims or allege that the trustee's claims are barred by the equitable defense of *in pari delicto*.

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<sup>1</sup> At all times, the term "trustee", when used to refer to his capacity as one standing in the shoes of the debtor to bring causes of actions against third parties, will also be used interchangeably with a creditors committee that has derivative standing to bring actions on behalf of the estate.

<sup>2</sup> See, e.g., *In re Hedged Invs. Assocs., Inc.*, 84 F.3d 1281, 1285 (10<sup>th</sup> Cir. 1996) ("Hedged-Invs.") and *In re CBI Holding Co., Inc.*, 318 B.R. 761, 767 (S.D.N.Y. 2004) ("CBI Holding").

<sup>3</sup> *Bank of Marin v. England*, 385 U.S. 99, 101 (1966) ("Marin"); *Official Comm. Of Unsecured Creditors v. Lafferty*, 267 F.3d 340, 356 (3d Cir. 2001) ("Lafferty")

### **III. STANDING AND IN PARI DELICTO – TWO DISTINCT DOCTRINES THAT RESTRICT A TRUSTEE’S RIGHT TO BRING CLAIMS**

Standing, which is a constitutional requirement if a plaintiff is to assert claims, and the *in pari delicto* defense, which is fundamentally an equitable doctrine, are distinct legal principles, both of which may bar a trustee from bringing claims against a third party. Whether a plaintiff has standing to bring claims because it has been injured by the defendant’s conduct, and whether a plaintiff’s claims are nevertheless barred by the equitable defense of *in pari delicto*, are two separate questions that should be addressed on their own distinct terms.<sup>4</sup>

Although most courts acknowledge the difference between the two doctrines, several courts have confused the two doctrines or have collapsed them into one and erroneously treated them as one and the same. The Second Circuit, for example, has connected the *in pari delicto* defense with standing, but the Third Circuit seems to recognize that even if a trustee has standing to assert claims, the trustee may still be denied recovery due to the *in pari delicto* defense.<sup>5</sup> The Third, Sixth, Eighth and Eleventh Circuits appear to distinguish between standing and the *in pari delicto* defense, and the most recent cases in the Second Circuit recognize the distinction as well.<sup>6</sup>

#### **A. Standing and The Wagoner Rule**

- Standing is a constitutional requirement and derives from the “case or controversy” requirement of Article III. It requires the party invoking the power of a federal court to have a “personal stake in the outcome of the controversy” because that party has suffered or may suffer a legally cognizable injury.<sup>7</sup>
- Judge-imposed “prudential” considerations also require that a party must assert his own legal rights and cannot rest his claim to relief on the legal rights of third parties.<sup>8</sup>
- Standing is a threshold issue because putative plaintiffs who lack standing are not entitled to have their claims litigated in federal court.<sup>9</sup>

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<sup>4</sup> See, e.g., Lafferty, 267 F.3d at 346-47; In re Grumman Olson Indus., Inc., 329 B.R. 411, 424 n.5 (Bankr. S.D.N.Y. 2005) (“Grumman Olson”); Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP, 212 B.R. 34 (S.D.N.Y. 1997) (“Wechsler”) (analyzing standing and *in pari delicto* separately); Off Comm. Of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1149 (11th Cir. 2006) (“PSA”); In re Felt Mfg., 371 B.R. 589 (Bankr. D.N.H. 2007) (analyzing standing and *in pari delicto* separately) (“Felt Mfg.”); In re Food Mgmt Group, LLC, Case No. 04-22880 (ASH), Adv. Pro. No. 07-08221 (MG), Memorandum Opinion Granting In Part And Denying In Part Motion To Dismiss (January 23, 2008) (“Food Mgmt”).

<sup>5</sup> Compare Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991) (“Wagoner”) with Lafferty, 267 F.3d 340.

<sup>6</sup> See In re Senior Cottages of America, LLC, 482 F.3d 997, 1004 (8<sup>th</sup> Cir. 2007); In re Adelpia Commc’ns Corp., 365 B.R. 24, 46 (S.D.N.Y. 2007) (discussing history of Second Circuit cases conflating the two doctrines, but not agreeing with the general trend). See also Andrew P. Moratzka, *Eight Circuit Refuses to Conflate Constitutional Standing Doctrine with In Pari Delicto Defense*, American Bankruptcy Institute Journal, June 2007 at 18.

<sup>7</sup> See, e.g., Wight v. Bank of America Corp., 219 F.3d 79, 86 (2d Cir. 2000) (“Wight”) (citing Warth v. Seldin, 422 U.S. 490, 498 (1975)).

<sup>8</sup> See, e.g., Wight, 219 F.3d at 86.

<sup>9</sup> Wagoner, 944 F.2d at 118.

- Under the Bankruptcy Code, the trustee stands in the shoes of the bankrupt corporation and has standing to bring any suit that the bankrupt corporation could have instituted had it not petitioned for bankruptcy.<sup>10</sup>
- In a bankruptcy proceeding, state law determines as an initial matter whether a right to bring a state law claim belongs to the debtor or to individual creditors.<sup>11</sup>
- Individual creditors may not bring claims for breach of fiduciary duties against officers or directors, but some courts allow those claims to be brought derivatively.<sup>12</sup>
- A corporation can itself suffer a legal injury independent from any injury to shareholders, creditors and others.<sup>13</sup> If the debtor suffered an injury, the trustee has standing to pursue a claim to rectify the injury.<sup>14</sup> If, as a matter of law, the debtor would have standing to bring a cause of action, the trustee also has standing to bring the cause of action.<sup>15</sup>
  - The question is essentially whether the trustee alleges a distinct harm to the debtor and not just harm to creditors.<sup>16</sup>
  - The mere fact that recovering on a claim may benefit creditors does not necessarily mean that the claim is being brought *on behalf of* creditors – and not on behalf of the bankruptcy estate -- so as to preclude standing (3d Cir./9th Cir.).<sup>17</sup>
  - On the other hand, if a claim can be brought under state law for the benefit of the estate, the trustee has standing to bring the debtor's claims against the third party for that claim.<sup>18</sup>
  - The question whether a cause of action is asserted for the benefit of the estate as opposed to its creditors can be difficult and controversial. For example, some courts have held that trustees can assert claims for “deepening insolvency” or for breaching fiduciary duties by “prolonging an insolvent corporation’s life.”<sup>19</sup>

<sup>10</sup> Wagoner, 944 F.2d at 118; Smith v. Arthur Anderson LLP, 421 F.3d 989, 1002 (9th Cir. 2005) (“Smith”); PSA, 437 F.3d at 1149.

<sup>11</sup> See, e.g., Lafferty, 267 F.3d at 348; Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1093 (2d Cir. 1995) (“Hirsch”); Wight, 219 F.3d at 86; In re Mediators, Inc., 105 F.3d 822, 825 (2d Cir. 1997) (“Mediators”); In re The Bennett Funding Group, 336 F.3d 94, 99-100 (2d Cir. 2003) (“Bennett Funding”); Grumman Olson, 329 B.R. at 423.

<sup>12</sup> See, e.g., Felt Mfg., 371 B.R. at 612.

<sup>13</sup> See, e.g., Wight, 219 F.3d at 348.

<sup>14</sup> Smith, 421 F.3d at 1003; Sender v. Mann, 423 F. Supp. 2d 1155, 1173 (D. Colo. 2006) (“Sender”)

<sup>15</sup> Wagoner, 944 F.2d at 119.

<sup>16</sup> Sender, 423 F. Supp. 2d at 1173.

<sup>17</sup> Lafferty, 267 F.3d at 348-49; Smith, 421 F.3d at 1004.

<sup>18</sup> Lafferty, 267 F.3d at 354.

<sup>19</sup> Fehribach v. Ernst & Young LLP, 493 F.3d 905, 908 (7<sup>th</sup> Cir. 2007); In re Global Service Group, LLC, 316 B.R. 451, 456 (Bankr. S.D.N.Y. 2004).

However, others have disagreed,<sup>20</sup> and it is not obvious that a debtor corporation, as opposed to its creditors, should have the right to complain that the corporation's life has been prolonged.

1. Caplin v. Marine Midland Grace Trust Co. (“Caplin”)

- The Supreme Court's holding in Caplin has been cited by many courts that have analyzed the issue of a trustee's standing.

- In Caplin, the debtor-corporation and its subsidiaries had been engaged in several real estate activities and executed an indenture trust with Marine Midland providing for the issuance of debentures by the debtor-corporation.<sup>21</sup> A critical part of the indenture required the debtor-corporation to maintain an asset-liability ratio of 2:1 to protect debenture purchasers by providing a cushion against any business losses.<sup>22</sup> To demonstrate continued compliance with this requirement, the debtor-corporation had agreed to file an annual certificate with Marine Midland indicating whether the debtor-corporation had complied with all of its responsibilities under the indenture in the previous year.<sup>23</sup> The indenture trustee, Marine Midland, undertook the responsibility of exercising the “same degree of care and skill in their exercise as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.”<sup>24</sup> Pursuant to language in the indenture trust, the indenture trustee, Marine Midland, was permitted to rely on the accuracy of these certificates.<sup>25</sup> The debtor-corporation began to experience significant financial losses every year.<sup>26</sup> Eventually, Marine Midland filed an involuntary petition for reorganization under Chapter X of the Bankruptcy Act against the debtor-corporation.<sup>27</sup> After his appointment, the reorganization trustee began to uncover the debtor-corporation's failure to maintain the 2:1 asset liability ratio required by the indenture and concluded that the indenture trustee, Marine Midland, had willfully or negligently failed to fulfill its obligations under the indenture because it knew or should have known of certain inflated appraisals.<sup>28</sup> The trustee filed an independent action on behalf of the debenture holders against Marine Midland and sought to recover the principal amount of the outstanding debentures as damages for Marine Midland's failure to compel compliance with the indenture.<sup>29</sup> The district court held that the trustee did not have standing to raise claims of misconduct by an indenture trustee on behalf of debenture holders and granted Marine Midland's motion to dismiss the case. The trustee appealed the dismissal of his claims.<sup>30</sup>

- The Supreme Court held that a reorganization trustee under the Bankruptcy Act did not have standing to assert, on behalf of the holders of the debtor's debentures, claims of misconduct against an indenture trustee for failing to fulfill certain obligations of the indenture.

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<sup>20</sup> In re Parmalat Securities Litigation, 501 F. Supp. 2d, 560, 574 (S.D.N.Y. 2007).

<sup>21</sup> Caplin, 406 U.S. at 417-18.

<sup>22</sup> Caplin, 406 U.S. at 418-19.

<sup>23</sup> Caplin, 406 U.S. at 418-19.

<sup>24</sup> Caplin, 406 U.S. at 418.

<sup>25</sup> Caplin, 406 U.S. at 418.

<sup>26</sup> Caplin, 406 U.S. at 418.

<sup>27</sup> Caplin, 406 U.S. at 418.

<sup>28</sup> Caplin, 406 U.S. at 419-20.

<sup>29</sup> Caplin, 406 U.S. at 419-20.

<sup>30</sup> Caplin, 406 U.S. at 420.

- The Supreme Court so held because: (a) the Bankruptcy Act did not contain any provision suggesting that the trustee could “assume the responsibility of suing third parties on behalf of the debenture holders”; (b) the debtor itself had no claims against the trustee and the claims may have been subject to subrogation by other creditors; and (c) the claims brought by the trustee on behalf of the debenture holders would not preclude subsequent suits that could be brought by the individual debenture holders.<sup>31</sup>

- The holding in Caplin remains valid under the present version of the Bankruptcy Code and is equally applicable to both reorganization and liquidation trustees.<sup>32</sup>

## 2. Wagoner Rule (Second Circuit)

- The key standing case in the Second Circuit is the 1991 Wagoner case in which the court held that a trustee lacks standing if allowing a suit to proceed would expand the trustee’s powers beyond those held by the debtor at the commencement of the case.

- The trustee generally has no standing to sue third parties on behalf of the estate’s creditors, but may only assert the claims of the bankrupt corporation.<sup>33</sup> Accordingly, a trustee must establish that there has been damage to the corporation apart from the damage to third party creditors.<sup>34,35</sup>

- Applying these principles, the Second Circuit has held that when a bankrupt corporation has joined with a third party in defrauding its creditors, the trustee cannot recover against the third party for the damage to the creditors (the “Wagoner Rule”).<sup>36</sup> A claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation.<sup>37</sup>

- One rationale for Wagoner is based on traditional notions of standing: the question is whether the right the trustee asserts “would run to the corporation rather than its creditors” and whether the trustee’s claim “would have been able to withstand a motion to dismiss for failure to state a claim.”<sup>38</sup>

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<sup>31</sup> Caplin, 406 U.S. at 428-32.

<sup>32</sup> Smith, 421 F.3d at 1002; Wagoner, 944 F.2d at 119-20.

<sup>33</sup> Wagoner, 944 F.2d at 118; Bennett Funding, 336 F.3d at 99-100; Mediators, 105 F.3d at 826; Smith, 421 F.3d at 1002.

<sup>34</sup> Bennett Funding, 336 F.3d at 100.

<sup>35</sup> Smith, 421 F.3d at 1003.

<sup>36</sup> Wagoner, 944 F.2d at 118; Grumman Olson, 329 B.R. at 423.

<sup>37</sup> Wagoner, 944 F.2d at 120; Wight, 219 F.3d at 86. Bennett Funding, 336 F.3d at 100.

<sup>38</sup> 944 F.2d at 119.

- A second rationale for the Wagoner Rule derives from principles of agency wherein the misconduct of managers within the scope of their employment will normally be imputed to the corporation.<sup>39</sup> Therefore, since management’s misconduct is imputed to the corporation, and a trustee stands in the shoes of the corporation, the Wagoner Rule prevents a trustee from bringing a claim for a wrong that he himself essentially engaged in.<sup>40</sup>
- Because the Wagoner Rule applies only when a bankrupt corporation has joined with a third party in defrauding its creditors, it does not bar an estate representative from suing a dishonest fiduciary for breach of fiduciary duties.<sup>41</sup> For this reason, it also should not bar suits against professionals who aided and abetted dishonest fiduciaries in breaching their duties.
- The District Court for the Southern District of New York has asserted that the Wagoner Rule only applies where all relevant shareholders and/or decisionmakers are involved in the fraud. Absent such a finding, the fraud cannot be imputed to the corporation and the trustee has standing to litigate [malpractice] claims against third parties.<sup>42</sup>
- Moreover, if applicable state law allows for the adoption of charter provisions exculpating directors or officers from payment of monetary awards based on breaches of the duty of care, such as the case in Delaware, the trustee may be barred from bringing claims for breaches of duty of care.<sup>43</sup> If the debtor would be barred from bringing such claims outside of bankruptcy due to such exculpatory provisions in a corporate charter, the trustee is similarly barred from bringing those claims.<sup>44</sup>

## **B. In Pari Delicto**

- The doctrine of *in pari delicto* provides that a plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim or where the plaintiff participated in the same wrongdoing.<sup>45</sup>
- *In Pari Delicto* means “in equal fault” or “equally culpable or criminal.”<sup>46</sup> Where parties are equally at fault, the defending party is deemed to be in the stronger position.<sup>47</sup>
- The doctrine is premised on the equitable principle that a court will not lend its aid to a man who founds his cause of action on an immoral act<sup>48</sup> and that “denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.”<sup>49</sup>

<sup>39</sup> Wight, 219 F.3d at 86; Bennett Funding, 336 F.3d at 100.

<sup>40</sup> Wight, 219 F.3d at 86; Grumman Olson, 329 B.R. at 423.

<sup>41</sup> Grumman Olson, 329 B.R. at 427; Mediators, 105 F.3d 827.

<sup>42</sup> Wechsler, 212 B.R. at 36.

<sup>43</sup> Pereira v. Farace, 413 F.3d 330, 341-42 (2d Cir. 2005) (“Pereira”).

<sup>44</sup> Pereira, 413 F.3d at 341-42.

<sup>45</sup> Lafferty, 267 F.3d at 354; In re Dublin Securities, Inc., 133 F.3d 377, 380 (6<sup>th</sup> Cir. 1997) (“Dublin”); Felt Mfg., 371 B.R. at 608.

<sup>46</sup> Sender, 423 F. Supp. 2d at 1173.

<sup>47</sup> Ross v. Bolton, 904 F.2d 819, 824 (2d Cir. 1990).

<sup>48</sup> Dublin, 133 F.3d at 380; Felt Mfg., 371 B.R. at 608.

<sup>49</sup> PSA, 437 F.3d at 1153; Felt Mfg., 371 B.R. at 608.

- In federal securities laws cases, the Supreme Court has restricted the *in pari delicto* doctrine to situations in which (a) the plaintiff bears at least substantially equal responsibility for the wrong he seeks to redress, and (b) preclusion of the suit would not interfere with the purposes of the underlying law or otherwise contravene the public interest.<sup>50</sup>

- *In pari delicto* has also been supplemented or restricted under state law to some extent by the doctrine of comparative fault.<sup>51</sup>

- The bottom line issue is whether the debtor corporation is complicit in the improper conduct that is the basis for the claim.<sup>52</sup> Insofar as a third party professional's wrongdoing can be imputed to the corporation, the corporation itself is guilty of wrongdoing and claims by, or on behalf of, the corporation are subject to the *in pari delicto* defense.<sup>53</sup>

- In considering whether post-petition events, such as the appointment of a trustee, may be considered in evaluating a claim in bankruptcy, the Third Circuit held that the *in pari delicto* defense is affected by the rules governing bankruptcies because the trustee is the representative of the bankruptcy estate.<sup>54</sup>

- The language of § 541 directs courts to evaluate defenses as they existed at the commencement of the bankruptcy. Accordingly, the Third Circuit has held that courts may not take into account events that occurred after the commencement of the bankruptcy case.<sup>55</sup>

- As such, a court must evaluate the *in pari delicto* defense as it applies to causes of action under § 541 without regard to whether the trustee is alleged to be an innocent successor.<sup>56</sup>

- If a claim of a debtor under § 541 would be barred due to the *in pari delicto* defense at the commencement of a bankruptcy, the same claim is subject to the *in pari delicto* defense when brought by a trustee.<sup>57</sup>

- 1. Receivers vs. Trustees

- Some circuits treat *receivers* differently than bankruptcy trustees because receivers are not subject to the limits imposed by the plain language of § 541.<sup>58</sup>

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<sup>50</sup> Pinter v. Dahl, 486 U.S. 622, 635-38 (1988); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310-11 (1985).

<sup>51</sup> Off Comm. Of the Unsecured Creditors of Color Tile, Inv. v. Coopers & Lybrand, LLP, 322 F.3d 147, 155 (2d Cir. 2003).

<sup>52</sup> Sender, 423 F. Supp. 2d at 1175.

<sup>53</sup> Lafferty, 267 F.3d at 358.

<sup>54</sup> Lafferty, 267 F.3d at 356.

<sup>55</sup> Lafferty, 267 F.3d at 357.

<sup>56</sup> Lafferty, 267 F.3d at 357; Hedged-Invs., 84 F.3d at 1284; Hirsch, 72 F.3d at 1093-94.

<sup>57</sup> PSA, 437 F.3d at 1150-52; Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 836-37 (8th Cir. 3005) ("Grassmueck").

<sup>58</sup> See, e.g., Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995) ("Scholes"); In re Advanced RISC Corp., 324 B.R. 10, 15 (D. Mass. 2005) ("RISC").

- Where a *receiver* seeks to bring claims against defendants who are thought to have acted in concert with the debtor or have contributed to the debtor's downfall, some courts have held that the replacement or removal of the wrongdoer allows the receiver to proceed with the action.<sup>59</sup>
- State law provides the substantive law governing imputation of state claims for *in pari delicto* purposes.<sup>60</sup> For example, to impute the fraud of an officer/director to the corporation in Pennsylvania, the officer must: (a) commit the fraud in the course of his employment; and (b) commit the fraud for the benefit of the corporation.<sup>61</sup>
- The doctrine of *in pari delicto* does not bar a trustee's pursuit of breach of fiduciary duty claims against former officers and directors because when wrongful acts are committed against a corporation by its officers and directors, the wrongful nature of such acts is not imputed to the corporation.<sup>62</sup>
- The district court for the Southern District of New York has asserted that, similar to requirements to impute fraud to a corporation in standing cases, application of *in pari delicto* requires finding that all relevant shareholders or decisionmakers of a corporation were engaged in the fraud.<sup>63</sup>
- *In Pari Delicto* does not bar a trustee's claims for post-petition injuries to the debtor-corporation.<sup>64</sup> The agency principles that underlie the *in pari delicto* defense do not require imputation of post-petition conduct to the trustee.<sup>65</sup>

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<sup>59</sup> See, e.g., Knauer v. Jonathan Roberts Financial Group, Inc., 348 F.3d 230, 234-37 (7th Cir. 2003), Scholes, 56 F.3d at 754; F.D.I.C. v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) (court found that, although a receiver occupies no better position than that occupied by the debtor, the general rule is subject to exceptions and defenses based on a party's "unclean hands" will not be applied against the party's receiver).

<sup>60</sup> Lafferty, 267 F.3d at 358; Felt Mfg., 371 B.R. at 609; RISC, 324 B.R. at 14.

<sup>61</sup> Lafferty, 267 F.3d at 358.

<sup>62</sup> Felt Mfg., 371 B.R. at 610.

<sup>63</sup> Wechsler, 212 B.R. at 36.

<sup>64</sup> Food Mgmt, Memorandum Opinion Granting In Part and Denying In Part Motion To Dismiss (Jan. 23, 2008).

<sup>65</sup> Food Mgmt, Memorandum Opinion Granting In Part and Denying In Part Motion To Dismiss (Jan. 23, 2008).

#### IV. EXCEPTIONS TO WAGONER RULE AND IN PARI DELICTO DEFENSE

##### A. Adverse Interest Exception

- Management misconduct will not be imputed to the corporation if the third party / wrongdoer acted *entirely* in his own interests and adversely to the interests of the corporation.<sup>66</sup> This exception is very narrow and applies only when an agent has “totally abandoned” the principal’s interests.<sup>67</sup> Of course, if management’s misconduct cannot be imputed to the corporation, then the corporation is free from wrongdoing and therefore not subject to the *in pari delicto* defense and the estate representative may bring suit against wrongdoers.
- If the wrongdoer has engaged in more than one scheme, it is possible that the court may find certain schemes inured to the benefit of the corporation while others did not.<sup>68</sup>
- The law is still developing in this area, but application of the adverse interest exception as it is usually stated may yield ambiguous or counter-intuitive results. Whether an officer’s manipulation of a corporation’s books was an action entirely in the officer’s interest, for example, appears to be an open-ended fact question.<sup>69</sup> Also, if the wording of the exception is taken literally, an officer who shared 1% of his ill-gotten gains with the corporation would deny it recourse to the adverse interest exception by his seemingly meager generosity.
- In New York, the Adverse Interest Exception rebuts the presumption that the acts and knowledge of an agent acting within the scope of employment are imputed to the principal.<sup>70</sup> This is because where an agent is committing fraud for his own benefit, he is acting outside the scope of his agency, and therefore, it would be unjust to charge the principal with knowledge of such acts.<sup>71</sup>
- Some courts have found that while direct participation by a defendant in a ponzi scheme or fraud is imputed to the debtor and barred by *in pari delicto*, a defendant’s misconduct that did not in any way benefit the debtor, but only benefited the defendants, is not.<sup>72</sup>

##### B. Sole Shareholder or Sole Actor Exception

- The Adverse Interest Exception is itself subject to another exception, the “Sole Actor Exception.” If an agent is the sole representative of a plaintiff, then that agent’s conduct is imputable to the plaintiff regardless of whether the agent’s conduct was adverse to the plaintiff’s interests.<sup>73</sup>

<sup>66</sup> Wight, 219 F.3d at 87; Lafferty, 267 F.3d at 359. See also Buckley v. Deloitte & Touche USA LLP, 2007 WL 191403 at \*7 (S.D.N.Y. 2007).

<sup>67</sup> Wight, 219 F.3d at 87; Mediators, 105 F.3d at 827; Bennett Funding, 336 F.3d at 100; Grumman Olson, 329 B.R. at 425.

<sup>68</sup> Bennett Funding, 336 F.3d at 100.

<sup>69</sup> See In re Friedman’s Inc., 2008 WL 131163 at \*57 (S.D. Ga. 2008).

<sup>70</sup> Wight, 219 F.3d at 87.

<sup>71</sup> Wight, 219 F.3d at 87; Bennett Funding, 336 F.3d at 100.

<sup>72</sup> Sender, 423 F. Supp. 2d at 1174.

<sup>73</sup> Lafferty, 267 F.3d at 359.

- Because the sole agent has nobody to whom he can impart his knowledge of wrongdoing, or anyone from whom he can conceal it, the corporation bears the responsibility for allowing the agent to act without accountability.<sup>74</sup>

- This exception has been applied in cases where the agent committing the fraud is the sole shareholder of the corporation<sup>75</sup>, where the agent “dominated” the corporation<sup>76</sup> or where all the corporation’s management participated in the wrongdoing (because it would then be subject to the Adverse Interest Exception).<sup>77</sup>

### C. Innocent Decisionmaker Exception

- Another exception to *in pari delicto* recognizes that an agent’s misconduct may not be properly imputed to a corporation if the misconduct might have been stopped by an innocent decisionmaker but was concealed from that decisionmaker.<sup>78</sup>

- If there are no innocent decisionmakers who would have prevented the fraud, then the wrongdoing is imputed to the corporation regardless of whether the actor acted with adverse interest.<sup>79</sup> This is especially the case in the Second Circuit.

- On the other hand, in Adelphia Commc’ns Corp. v. Bank of Am., N.A., the court permitted the creditors committee to pursue its claims against the defendant banks because the committee had successfully pleaded facts necessary to trigger the “innocent decisionmaker exception”.<sup>80</sup>

- The “innocent decisionmaker” exception has also been advocated in the Enron and Worldcom bankruptcy cases as a valid exception to the Wagoner Rule and *In Pari Delicto* defense by the bankruptcy examiners appointed to those cases.<sup>81</sup>

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<sup>74</sup> Lafferty, 267 F.3d at 359; Bennett Funding, 336 F.3d at 100.

<sup>75</sup> Lafferty, 267 F.3d at 359-60; Mediators, 105 F.3d at 827; Grumman Olson, 329 B.R. at 425.

<sup>76</sup> Lafferty, 267 F.3d at 359-60 (citing PNC Bank v. Hous. Mtg. Corp., 899 F. Supp. 1399, 1405-06 (W.D. Pa. 1994)).

<sup>77</sup> Grumman Olson, 329 B.R. at 425; CBI Holdings, 311 B.R. at 373.

<sup>78</sup> See, e.g., Adelphia Commc’ns Corp. v. Bank of Am., N.A., 330 B.R. 364, 379-81 (Bankr. S.D.N.Y. 2005)

(“Adelphia”); Sharp Int’l, 278 B.R. at 36.

<sup>79</sup> Sharp Int’l, 278 B.R. at 36-37; Grumman Olson, 329 B.R. at 425 (holding that the committee lacked standing to sue prospective purchaser of debtor’s assets for aiding and abetting because the adverse interest exception was inapplicable, as it was the board’s goal to sell the company, the corrupt CEO was left in sole charge of the debtor, and there was no innocent insider who could have stopped the misconduct by the CEO); Food Mgmt, Memorandum Opinion Granting In Part and Denying In Part Motion To Dismiss (Jan. 23, 2008) (finding that the sole actor rule cannot apply because a sale in bankruptcy requires court approval and that the court was the innocent decisionmaker deceived by facts withheld in a collusive auction bid); Bennett Funding, 336 F.3d at 101 (where independent directors were “impotent” to take any action to prevent fraud, the trustee lacked standing to pursue claims against accountants and attorneys).

<sup>80</sup> Adelphia, 330 B.R. at 381.

<sup>81</sup> See, Third Interim Report of Neal Batson, Court-Appointed Examiner, Appx. B. at 64, In re Enron Cop., No. 01-16034 (AJG) (Bankr. S.D.N.Y. June 30, 2003), available at [http://www.enron.com/media/3rd\\_Examiners\\_Report.pdf](http://www.enron.com/media/3rd_Examiners_Report.pdf) Links to all of Mr. Batson’s reports are available at [http://www.enron.com/index.php?option=com\\_content&task=view&id=43&Itemid=45](http://www.enron.com/index.php?option=com_content&task=view&id=43&Itemid=45); Third Interim Report of

- In addition, some other courts have looked to the presence or absence of “innocent decisionmakers” who could or would have prevented the fraud had they known about it to determine whether the Sole Actor Exception is applicable.<sup>82</sup>

- If at least one innocent decisionmaker would have been able to prevent the fraud had he known about it, some courts have found that the Sole Actor Exception does not apply.<sup>83</sup>

#### **D. Risks of Substantive Consolidation of Debtors’ Estates**

- Many arguments made in attempting to substantively consolidate debtors’ estates may serve to bar a trustee from bringing claims when a trustee’s standing is challenged based on the Sole Actor Exception.

- In Grassmueck v. Am. Shorthorn Ass’n, a chapter 7 trustee brought a negligence action against an association that allegedly breached the duty of care it owed to the debtors, which were investment partnerships.<sup>84</sup> The trustee had previously successfully consolidated the debtors’ estates and had made numerous representations as to the controlling partner’s dominating influence over the debtors.<sup>85</sup> When the trustee, however, claimed that the controlling partner was not the sole actor for purposes of the Sole Actor Exception to the Adverse Interest Rule, the court disagreed and cited the trustee’s representations in his motion for substantive consolidation that the controlling partner’s actions were indistinguishable from those of the investment partnerships, that the controlling partner dominated the investment partnerships and that the investment partnerships were not independent entities with an identity separate from the controlling partner.<sup>86</sup> As such, the court found that the Sole Actor Exception applied and imputed the controlling partner’s fraud to the investment partnerships.<sup>87</sup> Because the partnerships were deemed to have participated in the wrongdoing, the trustee was barred from pursuing the negligence claim under the doctrine of *in pari delicto*.<sup>88</sup>

#### **E. Attempting to Circumvent *in pari delicto* by Obtaining An Assignment Of Claims From Creditors**

- It is, at best, questionable whether a trustee may circumvent the issue of standing or the doctrine of *in pari delicto* by obtaining an assignment of claims from creditors depending on the jurisdiction in which the assignment is made.

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Dick Thornburgh, In re Worldcom, Inc., No. 02-13533 (AJG) (Bankr. S.D.N.Y. Jan. 26, 2004), available at [http://www.klmg.com/files/tbl\\_s48news/PDFUpload307/10129/Worldcom\\_Report\\_final.pdf](http://www.klmg.com/files/tbl_s48news/PDFUpload307/10129/Worldcom_Report_final.pdf).

<sup>82</sup> See, e.g., Sharp Int’l Corp. v. KPMG LLP, 278 B.R. 28, 37 (Bankr. E.D.N.Y. 2002) (“Sharp Int’l”).

<sup>83</sup> Sharp Int’l, 278 B.R. at 36-37.

<sup>84</sup> Grassmueck, 402 F.3d 833, 835-36 (8th Cir. 2005).

<sup>85</sup> Grassmueck, 402 F.3d at 836.

<sup>86</sup> Grassmueck, 402 F.3d at 840-41.

<sup>87</sup> Grassmueck, 402 F.3d at 841.

<sup>88</sup> Grassmueck, 402 F.3d at 841.

- The Fourth Circuit, for example, has allowed a trustee to circumvent the lack of standing issue raised by defendants by obtaining an assignment of creditors' claims. In In re Bogdan, a chapter 7 trustee brought claims against the debtor's co-conspirators after the debtor's creditors assigned their claims against the co-conspirators to the trustee.<sup>89</sup> The Fourth Circuit held that Caplin was distinguishable from the facts of the case because: (a) the trustee was bringing claims on behalf of the estate as assignee of the creditors' claims; (b) the creditors gave up their own rights and chose to share any recovery with other creditors by assigning their claims; and (c) the assignment eliminated the possibility of creditors' duplicative claims.<sup>90</sup> The Fourth Circuit held that the meaning of "property of the estate" includes property acquired post-petition, including by assignment.<sup>91</sup> Moreover, the court found the doctrine of *in pari delicto* inapplicable because the trustee was standing in the shoes of the creditor-lenders who had assigned their claims to the trustee, not the debtor, and as such was only vulnerable to the defenses that could have been raised against the lenders.<sup>92</sup>

- By contrast, in the Second Circuit, a trustee cannot cure his lack of standing to assert claims for a third party's participation in a debtor's own fraudulent misconduct by obtaining a post-petition assignment of claims from an innocent creditor.<sup>93</sup>

## V. BANKRUPTCY LAW CLAIMS: ASSERTING AVOIDANCE ACTIONS TO ESCAPE THE WAGONER RULE AND IN PARI DELICTO DEFENSE

### A. Avoiding Wagoner and In Pari Delicto with Avoidance Actions

- By bringing a preference action under § 547, or a fraudulent conveyance action under §§ 548 or 544, a trustee can avoid the textual limitations in § 541 that only gives trustees the ability to bring causes of action belonging to the debtor "as of the commencement."<sup>94</sup>

- For example, in In re Personal and Business Ins. Agency ("Personal"), the Third Circuit noted that Lafferty applies only to actions brought under § 541 of the Bankruptcy Code and not to actions based on the trustee's avoidance powers because the avoidance sections do not contain the "as of the commencement of the case" language provided in §541.

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<sup>89</sup> In re Bogdan, 414 F.3d 507, 509-10 (4th Cir. 2005) ("Bogdan").

<sup>90</sup> Bogdan, 414 F.3d at 511-12.

<sup>91</sup> Bogdan, 414 F.3d at 512.

<sup>92</sup> Bogdan, 414 F.3d at 514.

<sup>93</sup> See, e.g., Bennett Funding, 336 F.3d at 102 ("[E]ven when defrauded creditors assigned to the trustee their claims against another for aiding and abetting the fraud, the trustee lacked capacity to sue."), In re CBI Holding Co., Inc., 318 B.R. 761, 767 (S.D.N.Y. 2004) ("[A] trustee does not have standing to bring claims belonging to creditors of the bankrupt corporation, notwithstanding the fact that those creditors assigned their claims to the trustee.")

<sup>94</sup> Personal, 334 F.3d 239 (3d Cir. 2003).

- In that case, the chapter 7 trustee brought a claim under § 548 of the Bankruptcy Code against the debtor's lender to recover payments made by the debtor to repay loans that the debtor's sole owner fraudulently obtained.<sup>95</sup> The chapter 7 trustee argued that his appointment was a post-petition event that should be considered in determining whether the transfers to the lender were fraudulent under § 548.<sup>96</sup> The trustee asserted that his appointment purged the evil, such as the case where the appointment of a receiver was said to have removed the evil actor in other cases, and the court should take that post-petition event into account to avoid an inequitable result to the debtor's creditors.<sup>97</sup> Unlike the wrongdoer who committed the fraud, the trustee argued that he came with "clean hands".<sup>98</sup>

- The court held that Lafferty does not apply to cases where a trustee is acting under § 548 rather than § 541.<sup>99</sup> Moreover, a court may take a trustee's appointment into account as a post-petition act, and the accompanying removal of the taint of fraud, in evaluating his fraudulent conveyance claim.<sup>100</sup> Because there is no limiting language in § 548, the court said it would refrain from imputing the sole owner's conduct to the trustee because doing so would lead to an inequitable result.<sup>101</sup>

- Where a trustee does not bring a claim under his avoidance powers, however, such as for negligence based on a theory of "deepening insolvency", courts are not likely to be sympathetic to the "removal of the taint of fraud" and equitable arguments asserted in the Personal case standing alone.<sup>102</sup>

- For example, in RISC, where a trustee of a chapter 7 estate brought an adversary proceeding against a broker whose alleged fraud had induced creditors to make loans to the debtor and thereby deepened the debtor's insolvency, the court was not convinced by the trustee's arguments that the taint of fraud was removed by his appointment nor that it would be inequitable to apply the doctrine of *in pari delicto*.<sup>103</sup>

- The court pointed to § 541 as limiting the trustee's actions to all legal and equitable interests of the debtor "as of the commencement of the case" and thereby caused the trustee to be bound by the same defenses to which the debtor would have been subject, including *in pari delicto*.<sup>104</sup>

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<sup>95</sup> Personal, 334 F.3d at 240-42.

<sup>96</sup> Personal, 334 F.3d at 245-46.

<sup>97</sup> Personal, 334 F.3d at 246.

<sup>98</sup> Personal, 334 F.3d at 244-46.

<sup>99</sup> Personal, 334 F.3d at 245-46.

<sup>100</sup> Personal, 334 F.3d at 246.

<sup>101</sup> Personal, 334 F.3d at 247.

<sup>102</sup> RISC, 324 B.R. at 15.

<sup>103</sup> RISC, 324 B.R. at 14-16.

<sup>104</sup> RISC, 324 B.R. at 15,

- Moreover, the court noted that the absence of limiting language in § 548, per the Personal case, strengthened the fact that under §541, post-petition acts may not be considered.<sup>105</sup>

- Another example of a trustee attempting to circumvent the limitations of § 541 can be found in In re Porter McLeod.<sup>106</sup> In that case, a chapter 7 trustee brought malpractice claims against attorneys that had assisted the corporate debtors in their post-petition restructuring attempts.<sup>107</sup> In his complaint, the trustee expressly cited § 544(a), as opposed to §541.<sup>108</sup> When the defendants claimed that the trustee's claims should be barred under the doctrine of *in pari delicto*, the court disagreed.<sup>109</sup> The court found that, under Colorado law, judgment lien creditors have the right to pursue all prepetition claims of a debtor.<sup>110</sup> As such, the right was in line with the reasoning that a trustee has standing to pursue both claims of a debtor and also those claims obtained derivatively from creditors.<sup>111</sup> The court found that because the trustee was acting in his capacity as a creditor under § 544(a) in presenting a creditor's bill, the trustee had standing.<sup>112</sup> Moreover, the court held that where a trustee acts in his §544(a) capacity as a creditor, the doctrine of *in pari delicto* does not apply because the creditor did not participate in the wrongdoing.<sup>113</sup> Such a rule, the court noted, complies with the fundamental purpose of the Bankruptcy Code, which is to equally distribute the assets of the estate among similarly situated creditors.<sup>114</sup>

- Another bankruptcy court also suggested that a trustee may be able to circumvent the *in pari delicto* doctrine by relying on the terms of section 544(a). In In re Southwest Supermarkets, LLC, a reorganization trustee brought claims against the corporate parent of the debtor-subsiary for, among other things, breach of fiduciary duties.<sup>115</sup> The trustee had been assigned all the claims which had been earlier assigned to the secured creditors pursuant to a global settlement agreement in the debtor-subsiary's chapter 11 case.<sup>116</sup> The assignment to the trustee provided that any proceeds generated from the litigation of claims against the corporate parent would be distributed to the creditors according to the priority scheme of the Bankruptcy Code.<sup>117</sup> The trustee's claims were based in the trustee's ability to sue as a hypothetical creditor under § 544(a).<sup>118</sup> The court noted that §544(a) not only permits avoidance, but may also entitle the trustee to some affirmative rights to recovery.<sup>119</sup> Although the court admitted that most affirmative relief that a trustee may seek under §544(a) would not be available since a creditor that extends credit on the petition date will always become a creditor after the committed wrong,

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<sup>105</sup> RISC, 324 B.R. at 15.

<sup>106</sup> In re Porter McLeod, Inc., 231 B.R. 786 (D. Colo. 1999) ("Porter").

<sup>107</sup> Porter, 231 B.R. at 791.

<sup>108</sup> Porter, 231 B.R. at 791.

<sup>109</sup> Porter, 231 B.R. at 793.

<sup>110</sup> Porter, 231 B.R. at 793-94.

<sup>111</sup> Porter, 231 B.R. at 793-94.

<sup>112</sup> Porter, 231 B.R. at 793-94.

<sup>113</sup> Porter, 231 B.R. at 793-94.

<sup>114</sup> Porter, 231 B.R. at 793-94.

<sup>115</sup> In re Southwest Supermarkets LLC, 325 B.R. 417, 421-22 (Bankr. D. Ariz. 2005) ("Southwest Supermarkets").

<sup>116</sup> Southwest Supermarkets, 325 B.R. at 422.

<sup>117</sup> Southwest Supermarkets, 325 B.R. at 422.

<sup>118</sup> Southwest Supermarkets, 325 B.R. at 425.

<sup>119</sup> Southwest Supermarkets, 325 B.R. at 425.

the court still noted that one claim that might still be available is a breach of fiduciary duties claim brought by a creditor after insolvency has shifted managers' fiduciary duties from shareholders to creditors.<sup>120</sup> A claim for breach of fiduciary duties may be available to creditors who became creditors after the point of insolvency, and thus to creditors who extended credit on the petition date.<sup>121</sup> As such, the court held that a trustee could assert creditors' breach of fiduciary duties claims even where the trustee could not assert such claims on behalf of the debtor.<sup>122</sup> The court suggested that the expansion of a trustee's ability to bring claims under § 544(a) may possibly help the trustee circumvent the *in pari delicto* problem if applicable state law allows receivers to bring such claims even where the debtor contributed to the wrongdoing.<sup>123</sup>

- Such attempted reliance on § 544(a), however, has not been met with approval by all courts. For example, in Greater Southeast Community Hospital Corp., where a chapter 7 trustee brought claims against the debtors' former directors, officers and two of the debtor's former law firms, alleging that the debtor purchased hospitals with financing from the debtor's lender in furtherance of a ponzi scheme perpetrated by the lender, and where the defendants challenged the trustee's standing to bring such claims, the court was less sympathetic to the trustee's contention that §544(a) provided him with the authority to bring claims belonging to creditors.<sup>124</sup> The court questioned whether the phrase "rights and powers" in § 544(a) includes the ability to file any claims that a creditor with a judicial lien might possess as opposed to merely the rights attained by virtue of the hypothetical status of a judicial lien or execution creditor.<sup>125</sup> The court noted that nothing in the text or legislative history of the Bankruptcy Code contradicts the Supreme Court's holding in Caplin and moreover legislative history indicates congressional intent not to overrule Caplin.<sup>126</sup> The court held that § 544(a) does not transform the trustee into a "super creditor" with the ability to bring claims distinct from those possessed by the estate.<sup>127</sup> The court found that § 544(a) merely augments the trustee's rights under § 541 and does not allow the trustee to freely switch freely between a creditor entity to a debtor entity.<sup>128</sup>

- Finally, it should be noted that preference actions under § 547 may also provide a useful remedy to which the restrictive language of § 541 does not apply. Although preference actions afford a limited remedy and have a restricted look-back period relative to fraudulent conveyance actions under § 548, the wrongdoing by third party professionals will often be both extensive and expensive in the ninety days prior to bankruptcy in situations in which wrongdoing has occurred.

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<sup>120</sup> Southwest Supermarkets, 325 B.R. at 426.

<sup>121</sup> Southwest Supermarkets, 325 B.R. at 426.

<sup>122</sup> Southwest Supermarkets, 325 B.R. at 425-26.

<sup>123</sup> Southwest Supermarkets, 325 B.R. at 426.

<sup>124</sup> In re Greater Southeast Community Hospital Corp., 333 B.R. 506, 513-17 (Bankr. D.D.C. 2005) ("Southeast").

<sup>125</sup> Southeast, 333 B.R. at 518.

<sup>126</sup> Southeast, 333 B.R. at 519.

<sup>127</sup> Southeast, 333 B.R. at 520.

<sup>128</sup> Southeast, 333 B.R. at 521.

- If the trustee can show that the professionals' wrongdoing negates any defense that the debtor's prepetition payments were merely paid in the "ordinary course of business," and can show that the wrongdoing professionals did not provide genuine value to the corporation, recovery on a preference theory may be relatively straightforward. This strategy has been attempted by Enron, for example, and is currently *sub judice* in the Southern District of New York.