

The *In Pari Delicto* Defense: Exceptions, Limitations, and Potential Workarounds for Chapter 7 Trustees

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KEY POINTS

1. Where a debtor and its agents have been complicit in wrongdoing, *in pari delicto* can be a potent defense against a chapter 7 trustee's efforts to recover from those agents for the harm the debtor suffered. Trustees therefore must be mindful of this defense as they evaluate the facts and assess potential causes of action to pursue.
2. The applicable law under which the trustee brings the claim will determine whether in pari delicto is an available defense and, if it is, the defense's formulation and exceptions.
3. Because defendants often raise the *in pari delicto* defense in the context of Rule 12(b) motions to dismiss, trustees should design their pleadings to anticipate the defense and, where feasible, to allege sufficient facts that may undermine it.
4. Before bringing suit, trustees should consider other potential means by which to evade or undercut in pari delicto, such as fashioning their claims as an exercise of the chapter 5 avoidance powers, rather than (or as an alternative to) pursuing pre-bankruptcy claims under Bankruptcy Code §541.

The situation is alarmingly common: Before filing bankruptcy, a business debtor was at the epicenter of a Ponzi or other fraudulent scheme. Its trustee believes the debtor's former officers, directors, professionals, auditors, or other agents facilitated the scheme, or negligently failed to detect it, and should be held accountable. When the trustee sues them, though, the defendants argue that the debtor and they were "*in pari delicto*," and seek to dismiss on the grounds that the debtor is as much or more responsible than they were.

The contours of *in pari delicto*

The common law doctrine of *in pari delicto* ("IPD") derives from the Latin, *in pari delicto potior est conditio defendentis*: "In a case of equal or mutual fault . . . the position of the [defending] party . . . is the better one." In other words, a plaintiff who actively participates in misconduct may not recover the resulting damages from others with whom it conspired. In its "classic formulation," IPD bars recovery if (a) the plaintiff bears as much or more responsibility for its injury, and (b) barring the action will not impede the underlying law's objectives or otherwise undermine public policy. *Bateman Eichler, Hill Richards Inc. v. Berner*, 472 U.S. 299, 306 (1985). Despite these traditional limitations, however, many courts have given IPD "a broad application to bar actions where plaintiffs simply have been involved generally in 'the same sort of wrongdoing' as defendants." *Id*. (quoting *Perma Life Mufflers Inc. v. Intern'l Parts Corp.*, 392 U. S. 134, 138 (1968)).

Two premises support IPD: "first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality." *Id.* From a trustee's perspective, though, IPD should never apply because the trustee is an innocent successor. After all, the trustee did not participate in the debtor's wrongdoing.

Nonetheless, the courts have not seen it that way. The starting point is § 541(a)(1). It defines the bankruptcy estate to consist of the debtor's property interests that exist "as of the commencement of the [bankruptcy] case." The trustee therefore can pursue any causes of action that the debtor could have brought had it not filed bankruptcy. In any such lawsuit, the trustee stands in the debtor's shoes. The trustee may assert the debtor's claims – but also is subject to whatever defenses exist against the debtor.

There's the rub. The debtor's management typically will still be in control "as of the commencement of the case." If the debtor participated actively in the wrongdoing, the trustee will be standing in a wrongdoer's shoes. But how does a debtor become a wrongdoer? The answer rests on agency principles and imputation. Organizations have no capacity to commit acts except through their agents. A principal generally is charged with the knowledge and acts of an agent acting within the scope of its authority, on the presumption that the agent disclosed its knowledge or behavior to its principal. *Baena v. KPMG LLP*, 453 F.3d 1, 7 (1st Cir. 2006). The agent's wrongful acts thus can be imputed to its principal, the debtor. In an ensuing bankruptcy, the trustee will step into the debtor principal's tainted shoes. If the trustee sues the agent, one "wrongdoer" may be seeking damages from another -- inviting an IPD defense.

In such instances, all circuit courts of appeals that have considered the issue have concluded that IPD can be a defense to a trustee's lawsuit. Those circuits include the First, Second, Third, Fourth, Sixth, Seventh, Eighth, Tenth, and Eleventh. *See, e.g., Peterson v. McGladrey & Pullen LLP*, 676 F.3d 594, 598-99 (7th Cir. 2012). For IPD to apply, though, the jurisdiction whose law creates the claim also must recognize IPD as a defense. Thus, whether a defendant can invoke IPD is a question of that jurisdiction's law – typically, state law. *See, e.g., Brickley v. Scantech Identification Beams Systems LLC*, 566 B.R. 815, 839 (W.D. Tex. 2017). The precise formulation of the IPD defense – as well as exceptions to it – varies somewhat from one state to the next. A trustee therefore must carefully examine the doctrine under the jurisdiction's law applicable to the controversy.

At the federal level, not all circuit courts have approached IPD the same way. For years, the Second Circuit has framed the issue as whether the trustee lacks "standing" to pursue claims against a "co-conspirator," by evaluating whether the claims at issue belong to the debtor (which the trustee can assert) or belong to creditors (which the trustee cannot assert). *Shearson Lehman Hutton Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991). Other circuits and commentators have criticized *Wagoner* for conflating IPD with standing. *See, e.g., Bash v. Textron Financial Corp. (In re Fair Finance Co.)*, 834 F.3d 651, 675 (6th Cir.



About the Author

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Aside from these layered exceptions, IPD has other potential limitations. For example, IPD typically arises in response to state or federal non-bankruptcy causes of action that may become property of the estate under § 541, such as claims for breaches of fiduciary duties, negligent misrepresentation, malpractice, fraud, RICO and civil conspiracy.

2016) (summarizing cases). In those circuits, IPD is considered an affirmative defense. According to at least one of those other circuits, however, "[g]radually, the Second Circuit and the lower courts within that circuit have shifted from treating the question as one of standing to treating [IPD] as an affirmative defense." *Moratzka v. Morris (In re Senior Cottages of America LLC),* 482 F.3d 997, 1003 (8th Cir. 2007) (discussing the shift among those courts toward the other circuits' view).

IPD's exceptions-within-exceptions

IPD hinges upon imputation from agents to principals. An agent's knowledge and acts will not be imputed to its principal in all circumstances, though. Under the "adverse interest exception," imputation will not occur – and the IPD defense will not be available – if the wrongdoing agent acts (a) adversely to the principal's interests and (b) solely for the agent's or a third party's benefit. *See, e.g., Fair Finance Co., supra,* 834 F.3d at 676-77. Looting corporate funds is a quintessential example. *Baena, supra,* 453 F.3d at 8. But the exception applies only if the agent has "totally abandoned" its principal's interests. If the principal derives *any* benefit from the agent's wrongdoing, then the agent still can assert the IPD defense.

Even if the debtor did not benefit from an agent's malfeasance, the agent nevertheless may resuscitate an IPD defense if the agent and the principal were, basically, one and the same – that is, if the agent was the principal's "sole actor." For instance, if the agents responsible for the adverse actions are officers and directors who so dominated the principal that the principal had "no separate mind, will or existence of its own," then the officers and directors are deemed "alter egos" of the principal and "any malfeasance on their parts is directly attributable" to the principal. *Fair Finance Co., supra,* 834 F.3d at 677 (quoting *Terlecky v. Hurd (In re Dublin Sec. Inc.)*, 133 F.3d 377, 380 (6th Cir. 1997)). In such circumstances, an agent has no one to whom it could impart knowledge and no one from whom to conceal it, so the principal must bear the responsibility for allowing its agent to act improvidently. *See Official Committee of Unsecured Creditors v. R.F. Lafferty & Co. Inc.,* 267 F.3d 340, 359 (3d Cir. 2001). From the defendant agent's perspective, imputation occurs and IPD applies.

Yet, the "sole actor" exception also has a caveat: Imputation ordinarily will not occur (and the IPD defense will not apply) if at least one decision-maker existed in a management role or among the organization's owners who (a) was innocent of the wrongdoing and (b) could have stopped the harmful acts. *See, e.g., In re Bennett Funding Group Inc.*, 336 F.3d 94, 101 (2d Cir. 2003). A mere whistleblower, however, is not sufficient.

The back-and-forth of the IPD defense

Because of IPD's various exceptions-within-exceptions, the arguments typically unfold as follows, if the facts provide support (a) the trustee alleges that a defendant agent's wrongful behavior injured the organization (the debtor) and seeks recovery on the debtor's (estate's) behalf; (b) the defendant alleges imputation to its principal (the debtor) and, therefore, that IPD applies; (c) the trustee responds that the defendant's actions were entirely adverse to the debtor's interests, rendering IPD inapplicable; (d) the defendant replies that one person or group (the "sole actor") entirely dominated the debtor, thus resurrecting the IPD defense; and (e), to rebut the defendant's "sole actor" contention, the trustee counters that the debtor had at least one "innocent decision-maker" who could have stopped the wrong, thereby nullifying IPD.

Limitations on IPD

Aside from these layered exceptions, IPD has other potential limitations. For example, IPD typically arises in response to state or federal non-bankruptcy causes of action that may become property of the estate under § 541, such as claims for breaches of fiduciary duties, negligent misrepresentation, malpractice, fraud, RICO and civil conspiracy. According to most courts, however, IPD does not apply to chapter 5 avoidance powers. *See, e.g., In re The Personal and Business Insurance Agency*, 334 F.3d 239, 245 (3d Cir. 2003). *But see Sender v. Buchanan (In re Hedged-Investments Assocs. Inc.),* 84 F.3d 1281, 1285 (10th Cir.1996). This is because trustees assert avoidance powers on behalf of innocent creditors, not the tainted debtor, and seek to unwind transactions rather than to obtain compensation for a complicit agent's misadventures.

In New York jurisprudence, the *Wagoner* rule – that trustees lack "standing" to pursue claims on behalf of one wrongdoer against others – does not insulate an organization's insiders. That includes not just those persons identified as such in § 101(31) (e.g., officers and directors), but also those who are "non-statutory" insiders in control of the debtor. *See In re T.S. Employment Inc.*, 603 B.R. 700, 709 (Bankr. S.D.N.Y. 2019).

Meanwhile, some courts have concluded that IPD does not apply if the wrongdoers (management) were displaced before bankruptcy – for example, because a receiver was appointed or because an investor committee assumed operational control. *F.D.I.C. v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir. 1995). *But see Baena, supra,* 453 F.3d at 8-10. In such circumstances, "as of the commencement of the case" the trustee becomes the successor to an "innocent" party, not to a complicit wrongdoer.

Potential methods for trustees to overcome an IPD defense

As part of their pre-suit due diligence, trustees should consider several things if they anticipate that defendants may raise an IPD defense. First, because IPD is a function of non-bankruptcy law, trustees should carefully review and understand the nuances surrounding how the governing law formulates IPD and its exceptions.

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where extended reachbacks were used successfully. Many of these involved federal creditors. This particular case did not specifically identify any. Instead, the extended reachback was based on applicable state law which allowed a one-year discovery rule to be applied. This demonstrates the importance of knowing the applicable state law in your cases and whether you have a creditor that could have qualified for the extended reachback as of the petition date. If such a creditor could do so, then so could the trustee. These cases are almost always met with a motion to dismiss as was done here, but once the trustee survives it, there is a good chance for a substantial settlement.][Editor Note: There is a similar holding applying the New Jersey fraudulent transfer statute in *Wolff v. Tzanides*, 574 B.R. 489 (Bankr. D.N.J. 2017)]

§550

Subsequent transferee could not prove that it was without knowledge of the transfers' voidability and therefore entitled to the §550(b)(1) good faith defense

In re Lindstrom, 608 B.R. 283 (Bankr. N.D.Ga. 2019)

The debtor executed a security deed in favor of LoanDepot to secure a debt in the amount of $174,500, in connection with the refinance on her home. The new security deed was timely recorded on the real estate records. Debtor filed a chapter 7 petition on February 22, 2017, and nine months later, an assignment was recorded on the real property records reflecting that the security deed was transferred from LoanDepot to Pingora Loan Servicing, LLC. The trustee sued to avoid the security deed because it lacked the signature of an attesting official witness as required by Georgia law and, therefore, failed to provide constructive notice to a subsequent bona fide purchaser. After review of applicable law, the bankruptcy court agreed with the trustee. The issue then turned to whether Pingora could assert the good faith defense available to a subsequent transferee under §550(b)(1), which provides that a trustee may not recover from a "transferee that takes for value . . . in good faith, *and without knowledge of the voidability of the transfer avoided*." (emphasis added). First, the court noted that Pingora had the burden of proof on this issue, citing *Goldman v. Capital City Mort. Corp. (In re Nieves),* 648 F.3d 232, 237 (4th Cir. 2011). The court determined based on substantial case law that the test is whether the transferee objectively knew or should have known instead of whether the transferee had actual knowledge from a subjective standpoint. "Thus transferees cannot simply bury their heads in the sand and later claim they took in good faith if they remained willfully ignorant in the face of facts which cry out for investigation." *Id.* at 241. Because the subject security deed was patently defective, in that it had only one of the required attesting witnesses, and the trustee had filed a Notice of Bankruptcy Filing and Claim of Chapter 7 Trustee on the real estate records prior to the assignment to Pingora, Pingora was charged with constructive notice under Georgia law. The court held that the patent defect on the security deed coupled with the trustee's notice cried out for an investigation such that Pingora should have further inquired into their implications. Thus, Pingora was held not to have taken the assignment of the security deed in good faith and without knowledge of the transfers voidability and, therefore, was not entitled to the §550(b)(1) defense.

[*Author's comment:* Defendants are always asserting that they had no actual knowledge of the voidability. More and more courts have come around to an objective test that does not permit the mortgage industry to take the ostrich approach that it knew nothing.

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Second, where feasible, trustees may design their pleadings to anticipate and undermine the defense. That may include alleging sufficient facts to show that the wrongdoing agent acted in a manner entirely adverse to the principal on whose behalf the trustee is suing, that the principal had more than one actor, or that an innocent decision-maker existed who had the ability to stop the wrong, if he or she had known about it.

Third, if applicable, trustees should consider pleading claims under § 544 (or other avoidance powers), rather than only under § 541. By asserting claims via § 544 that are available to a hypothetical judgment lien creditor or to the actual holder of an allowed unsecured claim, for example, trustees would be seeking recovery for innocent creditors' benefit, rather than for the benefit of one wrongdoer against another.

Fourth, trustees should evaluate pre-bankruptcy developments that may undermine IPD. For instance, did complicit wrongdoers still control the debtor at the time the bankruptcy case commenced, or had a receiver or other "innocent" party displaced them beforehand?

Fifth, if doing so is in the best interests of the estate, a trustee might side-step IPD by accepting an assignment of non-bankruptcy claims from an "innocent" third party who is not tainted by the debtor's misconduct. *See In re Michael Bogdan,* 414 F.3d 507, 514 (4th Cir. 2005).

Conclusion

IPD may present a serious obstacle for trustees seeking to recover from others who were complicit in a debtor's malfeasance. With proper due diligence, careful pleading, and the right sets of facts, though, IPD is an obstacle that trustees can overcome.