Strafford

Presenting a live 90-minute webinar with interactive Q&A

The In Pari Delicto Defense to Bankruptcy and Other Claims Against Directors, Officers and Third Parties

Anticipating or Raising the Defense in Bankruptcy and Other Asset Recovery Litigation

WEDNESDAY, JUNE 15, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Jon Maxwell Beatty, Partner, **Diamond McCarthy**, Houston

Craig D. Singer, Partner, **Williams & Connolly**, Washington, D.C.

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-866-873-1442** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 35.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

The In Pari Delicto Doctrine: Application in Asset Recovery Litigation

Craig D. Singer
Williams & Connolly LLP
725 Twelfth Street, N.W.
Washington, D.C. 20005
(202) 434-5964
csinger@wc.com

J. Maxwell Beatty
Diamond McCarthy, LLP
909 Fannin Street, 15th Floor
Houston, Texas 77010
(713) 333-5149
mbeatty@diamondmccarthy.com

Common Claims Against D&Os and Outside Professionals

- Fraud
- Breach of Fiduciary Duty
- Aiding and Abetting
- Malpractice or Other Negligence-Based Claims
- Fraudulent Transfer
- "Deepening Insolvency"

Applicability of the In Pari Delicto Defense

- Traditionally an affirmative defense against a corporation whose representatives committed wrongdoing
- In Second Circuit, sometimes framed as a doctrine of standing, under the "Wagoner Rule."
- Powerful defense against bankruptcy trustee or liquidation trustee, who stands in the shoes of the bankrupt company
- Trustee for company that failed as a result of insider fraud or other misconduct typically will be vulnerable to in pari delicto defense

Applicability of the In Pari Delicto Defense

- Based on principle that wrongdoing should not be rewarded, and courts should not intercede to resolve disputes among wrongdoers.
- Classic formulation: plaintiff's fault must be equal to or greater than defendant's fault.
  - *E.g., Uddin v. Goodson*, No. 2:15-cv-8025, 2016 WL 2901670, at *5-6 (D. N.J. May 18, 2016).
- In a typical case of Trustee versus Professional, the degree of fault will not be an issue.
  - Where professional allegedly assisted or failed to catch fraud committed by insiders, the insiders' fault is the greater.
  - *E.g., Terlecky v. Hurd (In re Dublin Securities, Inc.)*, 133 F.3d 377, 380 (6th Cir. 1997)

Applicability of the In Pari Delicto Defense

- Typically applies to outside professionals or other third parties sued by the company.
  - Outside lawyers
  - Auditors or other accountants
  - Financial advisers
  - Underwriters
- Typically does *not* apply in favor of the corporate insiders themselves, who cannot rely on imputation of their own conduct to defeat the corporation's claim.
  - *See, e.g., In re Wojtkun*, 534 B.R. 435, 459 (Bank. D. Mass. 2015); *In re Pitt Penn Holding Co.*, 484 B.R. 25, 39 (Bankr. D. Del. 2012); *Picard v. Madoff (In re Bernard L. Madoff Investment Securities LLC)*, 458 B.R.87, 124 (Bank. S.D.N.Y. 2011).

Scope of In Pari Delicto Doctrine

- The defense applies to most claims for tort and contract, including intentional torts.
- The defense may not apply to claims for fraudulent transfer or preference in bankruptcy, which are asserted on behalf of creditors, not the bankrupt, and are designed to undo a transaction rather than to compensate for wrongdoing.
  - *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC*, No. 08-01789, 2016 WL 1695296, at *4 (Bank. S.D.N.Y April 25, 2016)
  - *Gecker v. Goldman Sachs & Co. (In re Automotive Professionals, Inc.)*, 398 B.R. 256, 262-63 (Bank. N.D.Ill. 2008)
  - *Wedtech Corp. v. Nofziger*, 88 B.R. 619, 622 (Bank. S.D.N.Y. 1988)

Is the Debtor a "Wrongdoer"?

- Based on ordinary agency principles.
- A corporation or other entity can only act through its agents.
- Corporate insiders' wrongdoing is typically imputed to the corporation itself.

The Adverse Interest Exception to Imputation

- This exception is the focus of much recent litigation on in pari delicto.
- Under ordinary agency doctrine, an agent's wrongdoing that is completely adverse to the principal's interest is not imputed to the principal.
- If a corporate insider's fraud was for his own benefit and completely adverse to the corporation, in pari delicto will not bar the corporation's claim.
- Classic example: Looting corporate funds. *E.g.*, *Baena v. KPMG*, 453 F.3d 1, 8 (1st Cir. 2006)

The Adverse Interest Exception to Imputation

- Generally, a very narrow exception.
  - Typically requires *total abandonment* of the principal's interests.
  - If the insiders act in any part for the benefit of the corporation, the exception is inapplicable.
  - However, state law formulation differs and analysis is required
    - *Anchor Equities, Ltd. v. Joya*, 773 P.2d 1022 (Ariz. Ct. App. 1989)
- Distinction between fraud *against* the corporation (which may be adverse), and fraud against third parties *through* the corporation (which is not).
  - *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir. 1982).

The Adverse Interest Exception to Imputation

- Jurisdictions formulate the exception in different ways
  - "Actions that aggravate a corporation's insolvency and fraudulently prolong its life do not benefit the corporation. . . . The mere fact that an officer's actions result in insolvency, however, does not establish that the actions were adverse to the corporation's interests. The officer must intentionally act against the corporation's interests; negligence or a mere miscalculation about what is in the corporation's interests is not 'adverse' conduct." *Pioneer Liquidating Corp. v. San Diego Trust & Savings Bank (In re Consolidated Pioneer Mortgage Entities)*, 166 F.3d 342, 1999 WL 23156 (9th Cir. 1999) (Table); *accord Schacht v. Brown*, 711 F.2d 1343, 1348 (7th Cir. 1983).
  - "So long as the corporate wrongdoer's fraudulent conduct enables the business to survive—to attract investors and customers and raise funds for corporate purposes—this test is not met." *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 953 (2010).

The Sole Actor Rule

- Exception to the Adverse Interest Exception
- When the wrongdoers dominate the corporation, even wrongdoing "adverse" to the corporation is imputed.
- *In re Bennett Funding*, 336 F.3d 94 (2d Cir. 2003): Adverse interest exception does not apply unless "at least one decision-maker in a management role or amongst the shareholders is innocent and could have stopped the fraud."

The Sole Actor Rule

- Requires at least one "decision-maker"
  - Someone with authority to act within the corporation to stop the fraud.
  - Whistleblower is not enough
- The decision-maker must be "innocent."

"Innocent Successor" Arguments

- Trustees, receivers, or other corporate representatives often argue that they should not be bound by IPD because the wrongdoers are gone from the company and the trustee or new management is innocent.
- Call themselves "innocent successors."
- Defendants cite the common-law rule that agents' wrongdoing is imputed to the principal if they acted for the principal at the time of the wrongdoing.
- Application of Bankruptcy Code § 541:
  - The trustee subject to all defenses that could have been asserted against the bankrupt. *Peterson v. McGladrey & Pullen, LLP*, 676 F.3d 594, 596 (7th Cir. 2012)
  - The substance of such defenses is determined by governing state law, not by § 541 itself. *In re Adelphia Communications Corp.*, 365 B.R. 24, 53 (Bankr. S.D.N.Y. 2007) ("The language of section 541 says nothing whatever about evaluating defenses. It speaks instead to *what* is the property of the estate, and, in cases where the distinction is relevant, *when* property becomes (or ceases to become) property of the estate."); *see also, In re Le-Nature's Inc.*, 2009 WL 3571331 (W.D. Pa. Sept. 16, 2009)

"Innocent Successor" Arguments

- In contrast to bankruptcy trustees, receivers may find immunity from in pari delicto based on the innocent successor argument
  - *FDIC v. O'Melveny & Myers*, 61 F.3d 17, 18 (9th Cir. 1995) ("[D]efenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver.")
  - *Jones v. Wells Fargo Bank, N.A.*, 666 F.3d 955, 966 (5th Cir. 2012) ("Application of in pari delicto would undermine one of the primary purposes of the receivership . . . and would thus be inconsistent with the purposes of the doctrine")
- But some courts have applied in pari delicto to receivers as well as trustees
  - *E.g., Knauer v. Jonathon Roberts Financial Group, Inc.*, 348 F.3d 230 (7th Cir. 2003) (holding that in pari delicto defeated receiver's tort claims)
  - *See also Baena v. KPMG LLP*, 453 F.3d 1, 8-10 (1st Cir. 2006) (in trustee case, questioning soundness of "innocent successor" reasoning, including receivership cases that applied it)

Other Arguments and Exceptions

- States have different formulations of IPD, and with that, different exceptions
  - "[T]he principle that a wrongdoer should not profit from his own misconduct is so strong in New York that we have said the defense applies even in difficult cases and should not be weakened by exceptions." *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 950 (2010) (internal quotations omitted).
  - "[C]ourts should not be so enamored with the [L]atin phrase '*in pari delicto*' that they blindly extend the rule to every case where illegality appears somewhere in the transaction." *Norwood v. Judd*, 93 Cal.App.2d 276, 289 (1949).
  - "However, even when parties are *in pari delicto,* relief will sometimes be granted if public policy demands it." *In re Today's Destiny, Inc.*, 388 B.R. 737, 748 (Bankr. S.D. Tex. 2008)(internal quotations omitted).

Recent Developments: New York

- *Kirschner v. KPMG LLP*, 938 N.E.2d 941 (N.Y. 2010).
- Upholds traditional formulation of in pari delicto and rejects "innocent successor" defense.
- Characterizes adverse interest exception as the "most narrow of exceptions," reserved for cases of outright looting, embezzlement or fraud on the corporation.

Recent Developments: New York

- A fraud that keeps a corporation alive is a fraud for the benefit of the corporation, and the adverse interest exception is inapplicable.
- The wrongdoing insider's subjective intent to benefit himself does not matter.
  - Disapproves arguably contrary discussion in Second Circuit's decision in *In re CBI Holding Co.*, 529 F.3d 432 (2d Cir. 2008).
- Harm to corporation from the discovery of the fraud does not bear on whether the adverse interest exception applies.

Recent Developments: New Jersey

- *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871 (NJ 2006).
- In pari delicto defense raised by auditors.
- Court finds that IPD is not an absolute defense on a motion to dismiss by the auditors who allegedly negligently failed to uncover or report the insiders' fraud.
- Suggests that IPD is a manner of apportioning fault rather than a complete defense.
- This decision led many to conclude that New Jersey had taken a narrow view of IPD

Recent Developments: New Jersey

- *Bondi v. Citigroup,* 32 A.3d 1158 (N.J. Super. App. Div. 2011), *certif. denied*, 45 A.3d 983 (N.J. 2012).
- Court applies traditional view of IPD and narrowly construes adverse interest exception, in line with New York law.
- Construes *NCP* narrowly, as applying only to "the context of a direct undertaking by the auditor to provide audit services to the corporation, where some of the services were calculated to detect fraud."
- It now appears that New Jersey law is similar to New York law.

Recent Developments: Pennsylvania

- *Official Comm. Of Unsecured Creditors of Allegheny Health Educ. & Research Found. V. PricewaterhouseCoopers, LLP ("AHERF")*, 989 A.2d 313 (Pa. 2010).
- Pa Supreme Court holds that availability of imputation and, therefore, in pari delicto defense, depends on the culpability of the defendant – in that case, the accounting firm.

Recent Developments: Pennsylvania

- When the defendant acted in "good faith" – i.e., negligently failed to uncover corporate wrongdoing – the insiders' wrongdoing is imputed to the corporation under ordinary agency principles.
  - The adverse interest exception applies in its traditional formulation.
- When the defendant did not act in good faith – i.e., intentionally colluded with the corporate insiders in committing fraud – there is no imputation and therefore no IPD defense.

Recent Developments - Madoff

- Trustee appointed pursuant to the Securities Investor Protection Act of 1970 ("SIPA")
- Brought claims against third-parties, including JPMorgan Chase and HSBC Bank
  - *Picard v. JPMorgan Chase & Co.*, 460 B.R. 84 (S.D.N.Y. 2011)
  - *Picard v. HSBC Bank PLC*, 454 B.R. 25 (S.D.N.Y 2011)
- Court dismissed claims on the basis of IPD
  - Denied argument that Trustee was actually bringing the underlying "customer" claims
  - As a result, the claims were analyzed from the perspective of the debtor, and IPD applied
- Both cases were appealed, and a decision has been issued

Recent Developments - Madoff

- Second Circuit issued decision affirming the lower court's decision. *In re Bernard Madoff Inv. Secs. LLC*, 721 F.3d 54 (2d. Cir. 2013)
  - Cited *Kirschner v. KPMG LLP* in affirming the lower court's opinion with respect to the majority of claims
  - Further rejected the trustee's authority to bring claims of creditors under the theory of "generalized harm," bailment, or subrogation
- *But see*, *Secs. Inv. Protection Corp. v. Bernard L. Madoff Inv. Secs. LLC*, --F.Supp.2d--, 2013 WL 6301415 (S.D.N.Y. Dec. 5, 2013) (discussing assignment of investor claims)

Recent Developments – Peterson

- Trustee for bankrupt entity, Lancelot, which had invested in Petters Ponzi scheme sued the entity's auditors, McGladrey
- N.D. Illinois court dismissed trustee's claim on IPD grounds under Illinois law; 7th Circuit reversed because it found that the insider's complicity with Petters was a question of fact unresolved by the complaint. *Peterson v. McGladrey & Pullen, LLP*, 676 F.3d 594 (7th Cir. 2012)
- In 2014, the District Court granted summary judgment for the auditors on IPD grounds, finding that the undisputed evidence showed that the insider's misconduct contributed to Lancelot's losses at least as significantly as the auditors' conduct. *Peterson v. McGladrey & Pullen, LLC.*, 2014 WL 1389478 (N.D. Ill. Apr. 8, 2014).

Recent Developments – Peterson

- The Seventh Circuit recently upheld the dismissal by the lower court. *Peterson v. McGladrey LLP*, 792 F.3d 785 (7th Cir. 2015).
  - The Seventh Circuit rejected the trustee's arguments that the underlying wrongdoing must be the same for both plaintiff and defendant for in pari delicto to apply.
  - *See also Kirschner*, 938 N.E.2d at 950, 959; *Trainor v. John Hancock Mut. Life Ins. Co.*, 54 N.Y.2d 213 (1981) (applying *in pari delicto* when plaintiff and defendant engaged in separate acts of misconduct contributing to same injury).
- *But see MF Global Holdings Ltd. v. PricewaterhouseCoopers LLP*, 57 F.Supp.3d 206 (S.D.N.Y. 2014) (denying MTD where insiders' wrongdoing was alleged to be separate from the auditors' negligent advice).

Recent Developments – Delaware

- *Stewart v. Wilmington Trust SP Services, Inc.*, 112 A.3d 271 (Del. Ch. 2015).
- Applying Delaware law, Chancery Court holds:
  - IPD applies to receiver's tort claims
  - Receiver could not claim the adverse interest exception, and in any event, sole actor rule applied
  - Court would not apply public policy exception to IPD or a blanket "auditor exception" urged by receiver.
  - Court dismissed the negligence and contract claims.

Recent Developments – Delaware

- But, the Court found that the well-pled aiding and abetting claims against the auditors were *not* barred by IPD because of a "fiduciary duty exception":
  - "The policy goals advanced by *in pari delicto,* while important enough to outweigh this Court's interest in adjudicating breaches of contract and negligence claims at the periphery of a corporation's affairs, should not outweigh the importance of this Court's ability to adjudicate core fiduciary duty claims arising out of entities organized under Delaware law."

Recent Developments – Delaware

- The Chancery Court certified its decision for interlocutory appeal by the receiver, and the Supreme Court of Delaware affirmed the decision in an unpublished order. *Stewart v. Wilmington Trust SP Services, Inc.*, 126 A.3d 1115 (Del. 2015) (Table).
- "The balance the Court of Chancery struck between the need for accountability of professional advisors and the costs of exposing professional advisors to potentially excessive risks is a sensible one, and reflects the one chosen by sister states, such as New York, whose laws are often involved in situations involving Delaware corporations. This harmony is beneficial and if it is to be disturbed, that decision is best made by the General Assembly." *Id.* (footnote omitted).

Conclusions

- IPD can be a potent defense for a professional defendant against a bankruptcy trustee.
- State law varies significantly, so one should review the jurisdiction's law carefully in anticipating or asserting the defense.
- Be sensitive to the adverse interest exception. Consider whether the fraud was against the corporation or on behalf of it.

Q&A

To ask a question from your touchtone phone, press *1.
To exit the queue, press *1 again.

You may also use the Chat function to ask questions, or email questions to **bankruptcylaw@straffordpub.com**

CLE CODE: **TXCBVB**

Tell us how we did!

Look for our 'Thank You' email (which you should receive within 24 hours) for details and a link to the program survey and attendance attestation.

Thanks.

Please join us for our next conference, “Oil and Gas E&P Bankruptcies: Tackling the Unique Complexities of E&P Restructuring - Navigating Characterization of Oil and Gas Leases Under Sec. 365, Treatment of JOAs in Bankruptcy, Lien Priority, and DIP Financing” scheduled on Wednesday, June 29, 2016 at 1pm EDT.

Strafford Publications, Inc.
1-800-926-7926
www.straffordpub.com