

In Pari Delicto, Reconsidered

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The *in pari delicto* doctrine has become a prominent feature of modern bankruptcy practice. In its most basic form, the doctrine is used as a defense by the people that a bankrupt company's trustee sues for any harm their acts or omissions caused the company. Meaning "at equal fault," *in pari delicto* will relieve the defendants from liability, or even the burden of litigation, if the court determines that the company bore responsibility along with the defendants for its harm.

However, suppose that a lot of what we think we know about *in pari delicto* is wrong, that a large part of modern bankruptcy case law misapplies the doctrine? It is time to explore that possibility.

In Pari Delicto Is Unrelated to Agency Principles

In recent years, there has been a remarkable change in the courts' application of the *in pari delicto* doctrine. Its modern use is typified by *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*,¹ where the court determined that a bankrupt company may be found *in pari delicto* with the people who ran it and committed the bad acts that harmed third parties and the company itself.

The problem that *Lafferty* represents is that it marries the *in pari delicto* doctrine to agency law, with the tie that binds being the concept of imputation, *i.e.*, the bad acts of a corporation's insiders are imputed to the corporation, rendering the corporation *in pari delicto* with the real life actors. In current case law, the argument generally runs along these lines:

- The trustee asserts harm to the corporation and demands recovery on its behalf;
- The defendant asserts imputation and, therefore, *in pari delicto*;
- The trustee argues that defendant's actions were adverse to the corporation; and
- The defendant raises the sole-actor exception to the adverse-interest rule.²

¹ 267 F.3d 340 (3d Cir. 2001).

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Without imputation, of course, *in pari delicto* cannot apply because a corporation has no capacity to commit any act, whether good or bad, without the people who run it and make decisions. Beyond that, the agency line of argument has no historic relevance to the *in pari delicto* doctrine.

A very general Lexis search bears out the novelty of linking agency principals with the *in pari delicto* doctrine. A search on "'*in pari delicto*' and adverse /2 interest" from 1875-1990 produced only 38 cases, and in all of these the appearance of the terms was coincidental. By contrast, the same search on cases decided from 1991 through Aug. 6, 2009, produced 119 results, which include the *Lafferty*-type

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cases. I confess that I did not read all 119 cases to weed out those that have no application to the present discussion. The point nevertheless remains that the modern decisions have employed an analytical framework for the *in pari delicto* doctrine never before seen in U.S. case law.

Imputation then ought to be considered as merely a predicate to application of the *in pari delicto* doctrine. The prevailing habit of treating agency concepts—adverse interest and the sole-actor exception—as responses to a defense of *in pari delicto* puts the horse behind the cart. Agency law does not address whether the trustee actually is *in pari delicto* with the defendant, but only whether it is proper to impute to the corporation, and therefore to the trustee, of whatever wrongful conduct occurred that harmed the corporation. If imputation is proper, *in pari delicto* is not decided upon, but is the next line

² In some courts, the additional argument that there was an innocent insider who would have stopped the wrongdoing had he or she known of it might be raised. *In re Adelpia Communs. Corp.*, 365 B.R. 24 (Bankr. S.D.N.Y. 2007); *Nisselson v. Ford Motor Co. (In re Monahan Ford Corp.)*, 340 B.R. 1 (Bankr. E.D.N.Y. 2006), (citing *Sharp Int'l Corp. v. KPMG LLP (In re Sharp Int'l Corp.)*, 278 B.R. 28 (Bankr. E.D.N.Y. 2002)).

of inquiry, including whether any of its exceptions should apply.

Exceptions to the Doctrine

The consequence of using agency rules in response to a charge of *in pari delicto* is that an important component of the doctrine never makes its way into the discussion. There are exceptions to the doctrine, long ago established, that have nothing whatsoever to do with agency law. These exceptions have received scant attention in the modern case law, but there are four of them:

- The underlying contract, which is an unlawful contract, is executory and unperformed, or only partially performed, and it is repudiated;
- The illegality is a violation of a law intended for the protection of one of the parties to the contract;
- A party's execution of the contract is accomplished by constrained acquiescence, such as where there is oppression, hardship, undue influence or great inequality of condition or age;³ and

- Public policy considerations override the interests served by the doctrine.⁴

The first exception can easily be set aside for the purposes of this discussion because it is not likely to arise. After all, if the bad acts are not committed or a promise of future misconduct is repudiated, bankruptcy professionals are not likely to come into the scene. Instead, it is the commission of the wrongdoing that lands the company in bankruptcy.

With respect to the second exception, there is an argument to be made that statutes imposing duties on officers and directors, as well as those imposed on attorneys and other professionals, are intended for the protection of the corporation. Similarly, no corporation is permitted to be formed for an unlawful or improper purpose. If duties are breached or the corporation is put to unlawful or improper purposes, this exception could apply.

³ See *Thomas v. Richmond*, 79 U.S. 349 (1870).

⁴ See, e.g., *Marshall v. Lovell*, 11 F.2d 632, 638 (D. Minn. 1926) (where parties are "in equal wrong, will nevertheless a wise regard for the general welfare be better subserved by the punishment of the defendant than by denial of relief to the complaining party?") (quoting *Stewart v. Wright*, 147 F. 321 (8th Cir. 1906)).

The third exception, that of constrained acquiescence, suggests that while the sole-actor exception is appropriate for determining whether imputation is proper for agency law purposes, the analytical framework upon a charge of *in pari delicto* runs in the opposite direction. If, as it is true in many modern cases, an insider, or group of them, completely dominates the corporation, it is appropriate to ask whether the corporation's participation was had by oppression or undue influence, in which case the corporation would not be *in pari delicto* with the individuals who controlled it.

The fourth exception, whether public policy considerations override the interests that *in pari delicto* serves, is touched on in some modern jurisprudence. A recent decision from an Illinois district court, for example, dismissed rather summarily the importance of public policy:

The Trustee urges that it has additional worthy incentives that the private party might not have and that these incentives are enhanced by the absence of personal stakes in the outcome. That is, these suits deter wrongdoing, and this suit is not about a mere claim to assets but an attempt to right a wrong. And some courts have suggested that deterring auditors from future misconduct is part of the value of malpractice lawsuits. Given the events of the past decade, I am quite unsure if some big judgments here or there deter anything. Moreover, deterrence of future wrongdoing is not part of the duties of the trustee. The trustee sues for money and may well be satisfied by an amount that is less than that which would deter a future auditor so long as the amount satisfies the creditors. Whatever weight deterrence by civil actions should be given, it is not enough to justify declining to allow a defense established by now settled law.⁵

Other courts express less cynicism. In a decision emanating from the Adelpia bankruptcy,⁶ the court discussed two Pennsylvania cases, one from the state's Supreme Court and the other from a federal bankruptcy court. In both, the courts eschewed a mechanical

application of the unclean hands and *in pari delicto* doctrines. Each instead took into account equitable considerations, particularly that innocent parties could be affected by application of both doctrines.⁷

The thinking about in pari delicto in bankruptcy cases is quite at odds with the comparative-negligence regime, irrespective of the variances among the states.

The Adelpia court noted that these decisions did not make their way into cases such as *Lafferty*, which helped kick-start the trend of dismissing trustees' complaints simply because the trustee would be subject to an *in pari delicto* defense. Despite this discussion, the Adelpia court conformed to the general body of modern case law, *i.e.*, that agency principles provide the proper analytical framework for determining whether *in pari delicto* should apply, and decided only that dismissal on a Rule 12(b)(6) motion was inappropriate.

The public policy exception could enable some critical thought about the current application of the *in pari delicto* doctrine. If nothing else, we need to consider whether we have created a regime in which the likelihood of success on an *in pari delicto* defense increases along with the magnitude of the misconduct. It is also worth considering whether we are placing an undue degree of emphasis on what an artificial entity is capable of in assuming that it can thwart fraudulent intent or resist negligent, grossly negligent or reckless behavior. New York's highest court addressed this latter point some 135 years ago:

The defendant is an artificial body, acting only as moved by its trustees or corporators and stockholders, having no will or capacity to act except through their action and instrumentality; and, although it is liable for all the legal consequences of its transactions, done under their direction and authority, it appears to be a perversion of every rule and principle in determining the relative culpability or fault of parties, to say that a corporation

thus acting and impelled to such action is more culpable than a living, intelligent trustee, who was a party moving and active in causing the action to be had[.]⁸

Admittedly, there is not a great deal of case law on any of the exceptions to the *in pari delicto* doctrine, and the cases on some points are quite old. However, since the law operates on the principle of *stare decisis*, they should, perhaps must, be factored into the analysis today. At a minimum, they can no longer be ignored.

In Pari Delicto Is Displacing Traditional Tort Law Defenses

It will be recalled that *in pari delicto* was ushered into modern bankruptcy jurisprudence as a part of the deepening insolvency discussion. Allegations of deepening insolvency, whether as a cause of action or a measure of damages, are usually premised on negligent or fraudulent conduct (or some derivative thereof) on the defendant's part, and *in pari delicto* is usually raised on a Rule 12(b)(6) motion before the defendant even files an answer. Those courts that grant defendants' motions to dismiss on *in pari delicto* grounds are effectively displacing the defenses normally provided under applicable law.

This displacement is most easily seen when negligence forms the basis of the trustee's complaint. Stated generally, negligence requires that the trustee prove breach of duty, harm, proximate cause and damages. In addition to refuting these elements, the defendant may also ask the fact-finder to consider the extent to which the plaintiff bears responsibility for its own harm.

At first blush, this general description seems also to describe how bankruptcy cases play out. The problem is that the examination of the plaintiff's own fault derives from the state's law of contributory or comparative negligence. Just as with the agency rules on imputation, *in pari delicto* has no place in determining relative fault on a negligence claim.

More critically, apportioning blame is a function of damages and therefore should follow a determination on the elements of a negligence claim. Again speaking generally, the analysis involves a reduction in damages relative to the plaintiff's fault. In some states, the reduction does not preclude recovery, even if the plaintiff is found to be almost entirely at fault. For example, if the jury sets the plaintiff's

⁵ *Grede v. McGladrey & Pullen LLP*, 2008 U.S. Dist. LEXIS 74011 at *21-22 (N.D. Ill. Sept. 26, 2008).

⁶ *In re Adelpia Communs. Corp.*, 365 B.R. 24 (Bankr. S.D.N.Y. 2007).

⁷ *See id.* at 47-49 (discussing *Universal Builders Inc. v. Moon Motor Lodge Inc.*, 430 Pa. 550 (1968)), and *Waslow v. Grant Thornton LLP (In re Jack Greenberg Inc.)*, 240 B.R. 486 (Bankr. E.D. Pa. 1999).

⁸ *Knowlton v. Congress & Empire Spring Co.*, 57 N.Y. 518 (1874).

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damages at \$100 and its blame at 90 percent, the plaintiff gets a \$10 recovery.

Other states fix a point at which the plaintiff may not recover at all. In some states, the plaintiff's fault must exceed that of the defendant, meaning that a 50/50 apportionment runs in favor of the plaintiff. Other states require that the plaintiff's share of the blame be at 49 percent or less.

The thinking about *in pari delicto* in bankruptcy cases is quite at odds with the comparative-negligence regime, irrespective of the variances among the

states. Not only does the *in pari delicto* analysis precede, rather than follow, a merits-based determination on the elements of negligence, it may be resulting in the dismissal of cases that, under state law, would allow the plaintiff to recover.⁹

Conclusion

The research that led to this article resulted from a simple question that came to mind as I was preparing materials for a panel presentation: As a law student, why

⁹ See, e.g., *Nisselson v. Lernout*, 568 F.Supp.2d 137, 142 (D. Mass. 2008) (*in pari delicto* applies where plaintiff bears "substantially equal responsibility").

did I learn about agency rules from my torts professor while *in pari delicto* was taught in contracts? As an amateur historian, I was only too glad to roam through the dusty and often-forgotten decisions of long ago to discern what relationship existed between agency and *in pari delicto*, and when it came about. My hope is that you will take interest in the conclusions that my research produced and consider its implications. That we have a large body of modern case law applying *in pari delicto* does not mean that we are precluded from reconsidering how we amassed it. ■

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