

BANKRUPTCY FOR BANKERS

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TRUSTEE'S FRAUD CLAIMS MAY BE BARRED BY "IN PARI DELICTO" DOCTRINE

Generally speaking, the law is clear that a company in bankruptcy cannot sue a third-party for fraud that the debtor itself participated in because that claim actually accrues to the debtor's creditors.¹ In a leading decision, *Shearson Lehman Hutton, Inc. v. Wagoner*,² the U.S. Court of Appeals for the Second Circuit found that "[a] claim against a third party [such as an auditor] for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation." Moreover, because management's misconduct is imputed to the corporation, and because a trustee in bankruptcy "stands in the shoes of the corporation," the Second Circuit has held that the rule bars a bankruptcy trustee from suing to recover for a wrong "that he himself essentially took part in."³ Other courts have reached similar results.⁴

Recently, the U.S. Court of Appeals for the First Circuit issued an

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important decision involving this legal principle, known as the “Wagoner” rule or, more particularly, the doctrine of *in pari delicto*. The circuit court’s ruling in *Baena v. KPMG LLP*⁶ may make it difficult for bankruptcy trustees in other cases involving alleged fraud to recover from third parties.

Background

The *KPMG* case involved Lernout & Hauspie Speech Products, N.V. (“L&H”), a Belgian company with its U.S. headquarters in Massachusetts, that had been engaged in developing and licensing speech recognition software. Its first public stock offering occurred in 1995. From 1998 to 2000, L&H reported soaring revenues and profits. In March 2000, it contracted to acquire two U.S. companies — Dictaphone Corp. and Dragon Systems, Inc. — and took on massive new debt in connection with these acquisitions.

In August 2000, newspaper stories triggered investigations that concluded that the company had greatly overstated revenues and profits. In November 2000, an audit ordered by the audit committee of the L&H board found that revenues during the prior two and a half years had been overstated by over \$250 million. Ultimately, certain top officers and directors were implicated in apparent fraud (hereinafter, “the implicated managers”).

The accounting devices employed in overstating the revenues and profits apparently included recording revenue from contracts L&H had yet to execute, booking revenue in a lump sum where the amount should have been amortized across several years, and recording revenue from clients that did not exist or that had not made payments or commitments that could properly be recorded. Following the disclosures, the chairman of the board of directors, the managing directors, and the company’s chief executive officer, among others, resigned, and shortly thereafter L&H filed for Chapter 11 reorganization in Delaware bankruptcy court.

In May 2003, the bankruptcy court approved a plan of liquidation. The plan gave authority to prosecute claims on behalf of L&H to a litigation trustee appointed by a committee of unsecured creditors; there was apparently no prospect of anything being left over for stockholders. In August 2004, after the plan had become effective, the trustee brought suit against L&H’s former accountants — KPMG’s U.S. and Belgian affiliates. Among

the claims was one under Massachusetts General Laws Chapter 93A. As it applies to business-to-business transactions, Chapter 93A provides a civil cause of action, with the possibility of multiple damages and attorneys' fees for willful violations, for unfair or deceptive trade practices. To apply at all, it requires not only a level of fault going beyond mere negligence but also connections between the wrong and Massachusetts.

The complaint charged that KPMG had wide access to L&H's financial records and activities; that despite discovering and in some cases warning managers of serious problems, KPMG failed to alert the independent directors of L&H and instead issued unqualified opinions and certified balance sheets and operating statements of L&H for fiscal years 1998 and 1999; and that these actions permitted L&H to proceed with the Dictaphone and Dragon acquisitions, thereby incurring \$340 million in new debt which, after the disclosures, it could not repay.⁶

The allegations included but went beyond claims of negligence by KPMG and in effect charged that the accounting firm had knowingly tolerated patently improper accounting practices by L&H to retain a lucrative client for KPMG.

In moving to dismiss the complaint, KPMG argued, among other things, that the Chapter 93A claim was barred by the doctrine of *in pari delicto*. The Massachusetts federal district court agreed with KPMG that *in pari delicto* barred the trustee's claim under Chapter 93A and dismissed the action. The trustee appealed.

The Circuit Court Ruling

In its opinion, the First Circuit explained that *in pari delicto*, which literally means "in equal fault,"⁷ is a doctrine commonly applied in tort cases to prevent a deliberate wrongdoer from recovering from a coconspirator or accomplice. In addition, the circuit court noted, the doctrine is applied by Massachusetts courts in tort cases, including claims under Chapter 93A.⁸ In substance, the First Circuit explained, the doctrine offers a policy-based defense reflecting a principle echoed in other, somewhat different legal doctrines, e.g., the "unclean hands" defense in equity,⁹ and contributory negligence in tort actions.¹⁰

The trustee raised two significant arguments in opposition to application of the *in pari delicto* doctrine in this case. First, the trustee argued that exceptions applied — in particular, that its application would undermine federal law and policy. The trustee also suggested that an issue of fact precluded a grant of the motion to dismiss. The circuit court was not persuaded.

The First Circuit noted that, assuming fraudulent financial statements, senior L&H management was, on the trustee's version of events, the primary wrongdoer. Thus, it continued, in the ordinary course, Massachusetts courts would not allow L&H managers to sue a secondary accomplice such as KPMG for helping in the wrong.¹¹ And, the First Circuit observed, if the managers' actions were imputed to L&H, neither could L&H (via the bankruptcy trustee) recover against KPMG.

The appellate court acknowledged that there is a question of just whose actions should be imputed to "the corporation," and what exceptions should exist to such imputation. It then pointed out that the trustee asserted that the chairman of the board, the CEO, and the managing directors were all knowing parties to the financial statements. The approval and oversight of such statements was an ordinary function of management that was done on the company's behalf, which the First Circuit found was "typically enough to attribute management's actions to the company itself."¹²

The trustee did not argue that under traditional standards imputation in this case would be improper, but instead argued that the doctrine should not apply in this case for two reasons: one, the "adverse interest" exception applies, and two, the doctrine should not apply where "innocent decision-makers" could have prevented the harm.

Under the first limitation,¹³ imputation may be avoided where the wrongdoing was done primarily for personal benefit of the officer and was "adverse" to the interest of the company. Thus, for example, if a salesperson used a company car in a bank robbery, the company would not normally be liable.¹⁴

However, the First Circuit ruled that this limitation did not apply in this case. As it explained, while a fraud by top management to overstate earnings would facilitate stock sales or acquisitions, it was not in the long-term interest of the company; but, like price-fixing, it profited the company in the first instance, rendering the company civilly and criminally liable. Nor did it

matter that the implicated managers also may have benefited personally — that alone did not make their interests adverse, the circuit court decided.¹⁵

The trustee claimed that whether the implicated managers' conduct was adverse to L&H was a question of fact improperly resolved on a motion to dismiss, but the circuit court rejected that argument. It emphasized that the complaint did not suggest that the defalcating managers were acting solely out of self-interest or otherwise attempting primarily to benefit anyone other than the company through their behavior. Indeed, it noted, there were no facts in dispute that would warrant application of the adverse interest exception to bar imputation.

The First Circuit also rejected the trustee's argument that the *in pari delicto* doctrine should be dispensed with where independent directors in the company could, if alerted, have frustrated the fraud. According to the appellate court, this proposed limitation "clearly deviates from traditional agency doctrine."

The appellate court then addressed the trustee's final arguments against application of the *in pari delicto* doctrine, which came in two forms. First, the trustee contended that under reforms in federal securities law, accounting firms can be viewed as having an independent federal responsibility to alert a company's audit committee and independent directors to wrongdoing by management;¹⁶ allowing the *in pari delicto* defense frustrated this federal interest, the trustee contended.

The circuit court easily rejected this argument, pointing out that the trustee was not asserting any cause of action under federal law, but rather was asserting a claim under a Massachusetts statute.

It then addressed the trustee's other contention, namely that the same policy that underlies the federal statute — essentially conscripting accounting firms as police officers — was one that Massachusetts could also adopt and, among various ways to implement it, the state could choose to expand the prospect of civil liability for defaulting accountants by limiting the use of the *in pari delicto* doctrine in cases such as this one.

The First Circuit pointed out that such a policy change, for reasons of fair warning and incentive effects, should be done prospectively by legislation. In any event, the appellate court was not prepared to make that change, and it accordingly affirmed the district court's decision.

Conclusion

Despite the First Circuit's decision, a minority of courts have said that in pari delicto is an equitable doctrine and have concluded that it could be inequitable to apply it where prior management was at fault but the claim was asserted on behalf of creditors or shareholders.¹⁷ The U.S. Court of Appeals for the Second Circuit is expected to rule once again on the in pari delicto doctrine shortly, too, and its decision is likely to have important implications for the future of this rule.¹⁸

It is conceivable that Congress could amend the Bankruptcy Code to prohibit the application of the doctrine to bar claims brought by trustees, or that individual states could act. However, unless that happens, or unless other courts reach a result significantly different than the First Circuit's ruling, the kind of claim attempted to be asserted by the trustee in the *KPMG* case may be doomed.

Notes

¹ See, e.g., *American Tissue, Inc. v. Donaldson*, 351 F.Supp.2d 79 (S.D.N.Y. 2004).

² 944 F.2d 114, 120 (2d Cir. 1991).

³ *Wight v. BankAmerica Corp.*, 219 F.3d 79, 87 (2d Cir. 2000).

⁴ See, e.g., *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001) (applying Pennsylvania law); *In re Dublin Secs., Inc.*, 133 F.3d 377 (6th Cir. 1997) (applying Ohio law).

⁵ 453 F.3d 1 (1st Cir. 2006).

⁶ The trustee's claim was an example of a "deepening insolvency" claim. See, e.g., *Branch v. Ernst & Young U.S.*, 311 F.Supp.2d 179 (D.Mass. 2004); *Hannover Corp. of America v. Beckner*, 211 B.R. 849 (M.D.La.1997); and *Allard v. Arthur Andersen & Co.*, 924 F.Supp. 488 (S.D.N.Y.1996).

⁷ The full maxim is in pari delicto potior est conditio defendentis, meaning "[i]n a case of equal or mutual fault, the position of the [defending party] is the better one." Black's Law Dictionary 791 (6th ed. 1990).

⁸ *Choquette v. Isacoff*, 836 N.E.2d 329 (Mass. App. Ct. 2005); *GTE Prods. Corp. v. Broadway Elec. Supply Co.*, 676 N.E.2d 1151, 1156 (Mass. App. Ct. 1997).

⁹ See Dobbs, Law of Remedies § 2.4(2), at 68-72 (2d ed. 1993).

¹⁰ Prosser & Keeton on Torts § 65, at 451-62 (5th ed. 1984).

¹¹ See, e.g., *Choquette*, supra n. 8.

¹² See *Restatement (Second) of Agency* § 257 (1958); *Askanase v. Fatjo*, 130 F.3d 657, 666 (5th Cir. 1997).

¹³ See *Restatement (Second) of Agency* § 282(1); *Lafferty*, *supra*.

¹⁴ See *Prosser & Keeton*, *supra* § 70, at 503-05 (frolic and detour).

¹⁵ See, e.g., *Beck v. Deloitte & Touche*, 144 F.3d 732 (11th Cir. 1998); *FDIC v. Shrader & York*, 991 F.2d 216 (5th Cir. 1993); see also *Restatement (Second) of Agency* § 282(1).

¹⁶ 15 U.S.C. § 78j-1(a)-(b) (2000).

¹⁷ See, e.g., *FDIC v. O'Melveny & Myers*, 61 F.3d 17 (9th Cir. 1995); *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995). Additionally, the "innocent decision-maker" limitation has been adopted in a few trial courts in the Second Circuit to bar in pari delicto defenses against a bankruptcy trustee seeking to recover against outside professionals, see, e.g. *In re Sharp Int'l Corp.*, 278 B.R. 28 (Bankr. E.D.N.Y. 2002); *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P.*, 212 B.R. 34 (S.D.N.Y. 1997). The Second Circuit has reserved the issue, *In re Bennett Funding Group, Inc.*, 336 F.3d 94 (2d Cir. 2003).

¹⁸ See *In re CBI Holding Co., Inc.*, 311 B.R. 350 (S.D.N.Y. 2004).