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# Through the Looking Glass: The Mechanical Misapplication of *In Pari Delicto* in Bankruptcy

*By Michael Napoli, Eduardo Espinosa, and Patrick Stanton\**

*Applied mechanically, the in pari delicto doctrine morphs from a doctrine designed to prevent wrongdoers from profiting from their misconduct, to a doctrine that allows wrongdoers to escape the consequence of their wrongdoing. The authors of this article explore the in pari delicto doctrine and suggest counseling victims of fraudulent schemes to carefully consider the doctrine's application when considering whether to file an involuntary bankruptcy or seek the appointment of a receiver.*

The goal of the bankruptcy laws is to provide a fresh start for “the honest but unfortunate debtor.”<sup>1</sup> To that end, the Bankruptcy Code is based on the fundamental assumption that commercial debtors operate legitimate businesses that are largely free from fraud. As the sordid affairs of Bernie Madoff, Tom Petters, Allen Stanford, and the Bayou Group have demonstrated, there are a number of financial enterprises that are largely, if not entirely, fraudulent.

Most fraudulent schemes are unwound by receivers appointed by federal district courts exercising their equitable powers. Many, however, end up before bankruptcy courts. Bankruptcy law, unfortunately, is not well suited to the essentially equitable task of unwinding a fraudulent enterprise. At base, bankruptcy law is designed to rehabilitate the impecunious; not the illicit. Its rules, theories and presumptions are a poor fit to the affairs of fraudsters where entities, contracts and perceived relationships are merely window dressing designed to lure in the unwary with the patina of legitimacy.

Nowhere is this shortcoming more apparent than in the formalistic, mechanical nature in which courts apply the equitable *in pari delicto* doctrine

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<sup>1</sup> *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)(Bankruptcy “gives to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.”).

to bankruptcy trustees. Applied mechanically, the *in pari delicto* doctrine morphs from a doctrine designed to prevent wrongdoers from profiting from their misconduct, to a doctrine that allows wrongdoers to escape the consequence of their wrongdoing. As a result, the combination of *in pari delicto* and generally accepted principles of standing leads to the unwanted result of defrauded investors left with no means of recovering their losses and defendants whose misconduct led to the losses being held unaccountable.

**AS APPLIED BY STATE COURTS, *IN PARI DELICTO* IS AN EQUITABLE DOCTRINE WHOSE APPLICATION TURNS ON THE PUNISHMENT OF WRONGDOERS AND THE PROTECTION OF THE INNOCENT**

*In pari delicto* is a state law equitable doctrine that prevents bad actors from recovering from one another. In its traditional formulation, the doctrine generally prohibits the enforcement of illegal contracts. Over the years, however, the doctrine has been expanded to prohibit plaintiffs who participate in wrongdoing from recovering damages for those wrongful acts.

Its application is by no means automatic under state law. Instead, state courts typically examine the impact of the doctrine on the parties before them. In so doing, they often distinguish between individual wrongdoers and the entities with which they are or were associated.<sup>2</sup> This is particularly true when the bad actor is no longer affiliated with the entity.<sup>3</sup> Accordingly, when the persons who would actually benefit from a recovery are themselves innocent of wrongdoing, state courts generally do not bar recovery on *in pari delicto* grounds.<sup>4</sup> Thus, the doctrine is rarely applied in suits involving receivers or state liquidators.<sup>5</sup>

In applying the doctrine, courts look to public policy. While policy

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<sup>2</sup> *E.g.*, *Geis v. Colina Del Rio LP*, 362 S.W.3d 100, 108–09 (Tex. App.—San Antonio 2011, pet. denied)(refusing to impute bad acts of general partner to limited partnership which ultimately suffered from misconduct); *Holland v. Arthur Andersen & Co.*, 469 N.E.2d 419, (Ill. App. 1984)(refusing to impute bad acts of corporate managers to bankruptcy trustee because bad acts allowed business to be maintained past the point of insolvency). Interestingly, the claims at issue in *Geis* were acquired in a bankruptcy sale.

<sup>3</sup> *E.g.*, *McRaith v. BDO Seidman LLP*, 909 N.E.2d 310, 336 (Ill. App. 2009)(noting that *in pari delicto* “loses its sting once the person who is in *in pari delicto* is removed”).

<sup>4</sup> *Id.*

<sup>5</sup> *E.g.*, *McRaith*, 909 N.E.2d at 336–37 (refusing to apply doctrine to suit brought by liquidator appointed to resolve fraudulent insurance scheme); *Jones v. Wells Fargo Bank, N.A.*, 666 F.3d 955, 965–66 (5th Cir. 2012)(refusing to apply doctrine to receiver on ground that doctrine would prevent recovery of funds necessary to repay fraud victims).

considerations may vary based on the unique circumstances of each case,<sup>6</sup> the overriding policy consideration at issue is the deterrence of wrongdoing. Accordingly, the doctrine will be applied only as necessary to deter wrongdoing. In the context of a Ponzi scheme or other fraudulent enterprise, there is a strong need to deter those who participated in the scheme (such as sales agents) and those professionals (such as lawyers and accountants) who turned a blind eye to or failed to uncover the scheme. Applying the doctrine to protect such actors from liability would not further this goal.

**IN CONTRAST, FEDERAL COURTS APPLY *IN PARI DELICTO* TO BANKRUPTCY TRUSTEES IN A MECHANICAL WAY THAT WHOLLY FAILS TO CONSIDER THE DOCTRINE’S EQUITABLE PURPOSES**

In bankruptcy, defendants often invoke the doctrine to bar claims brought by trustees. The typical fact pattern is that a fraudster uses an entity as a vehicle to commit fraud; the purpose of which is to generate money which rapidly finds its way into the pockets of the fraudster and his cronies. Eventually, the entity collapses under the weight of the fraud and enters bankruptcy. The trustee, eager to recover money with which to repay the defrauded victims and other creditors, sues both those involved in the fraud and the professionals—lawyers and accountants—who assisted in, or at least failed to stop, the fraud. The defendants respond to the trustee’s suit arguing that the fraudster’s misconduct is attributable to the entity and, by operation of bankruptcy law, to the trustee barring the suit. More often than not, these defendants succeed where they would not have succeeded outside of bankruptcy.

Courts evaluating the doctrine in the context of bankruptcy hold that Section 541 of the Bankruptcy Code *requires* that they apply *in pari delicto* differently in bankruptcy than outside of it.<sup>7</sup> These courts assert that when not exercising avoidance powers provided by the Code, a bankruptcy trustee is merely a successor to the debtor’s interests. Under Section 541, the bankruptcy estate includes “all legal and equitable interests of the debtor in property as of the commencement” of bankruptcy. Accordingly, these courts hold that they evaluate *in pari delicto* and other defenses as they existed at the commencement

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<sup>6</sup> *Lewis v. Davis*, 199 S.W.2d 146, 151 (Tex. 1947)(holding that the application of *in pari delicto* depends upon the “peculiar facts and equities of the case”).

<sup>7</sup> *Peterson v. McGladrey & Pullen, LLP*, 676 F.3d 594, 598–99 (7th Cir. 2012); *Cf. Jones*, 666 F.3d at 967–68 (distinguishing treatment of *in pari delicto* in bankruptcy and in equity).

of the bankruptcy.<sup>8</sup> In other words, these courts ignore the fact that the fraudsters are no longer in control of the debtor and that the recovery would inure solely to the benefit of innocent creditors.<sup>9</sup> While there are significant flaws in this line of reasoning,<sup>10</sup> it has been adopted by each federal circuit to consider the issue.

The consequences of the mechanical application of *in pari delicto* to trustees are demonstrated by the U.S. Court of Appeals for the Seventh Circuit's recent opinion in *Peterson v. McGladrey LLP*.<sup>11</sup> At first glance, *McGladrey* appears to be another in a long line of cases in which courts have applied the doctrine of *in pari delicto* to prevent a bankruptcy trustee from recovering from those who have harmed the debtor.

What makes the *McGladrey* case unique is that the debtor, Lancelot, was the victim of a fraud practiced not by its management but by a third party, Thomas Petters and his entities. Lancelot and Petters entered into an agreement by which Lancelot loaned money to Petters which was to be used to finance Costco's inventory of electronics. To secure the loan, Petters agreed to a lockbox arrangement into which Costco's payments would be deposited. Costco would not pay directly into the lockbox. Instead, it would pay Petters who would then deposit the money into the lockbox.

Unfortunately, Petters had no deal with Costco. The purported loans were just another aspect of Petters' ever expanding Ponzi scheme. Five years into the Ponzi scheme, Greg Bell, then the head of Lancelot's management committee and investment advisor, discovered the Ponzi scheme and joined it. He, like Petters, was subsequently convicted and jailed. Lancelot filed for bankruptcy and a trustee was appointed.

The trustee sued McGladrey alleging that it had negligently conducted its audits of Lancelot by failing to perform "the sort of spot checks that would have revealed that Petters had no business other than recycling investors' funds while

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<sup>8</sup> *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 356 (3rd Cir. 2001).

<sup>9</sup> *Id.*

<sup>10</sup> The dissent in *R.F. Lafferty* argued that (i) the majority ignored the equitable nature of the doctrine applying it inflexibly to deny relief that would benefit the innocent; (ii) while the trustee stands in the debtor's shoes, post-petition events are often considered in evaluating a trustee's claims and (iii) the strict application of *in pari delicto* would allow the fraudsters and not just their accomplices to escape without liability. *Id.* at 362–63 (Cowen, J., dissenting); also Jeffrey Davis, *Ending the Nonsense: The In Pari Delicto Doctrine Has Nothing to Do with What Is § 541 Property of the Bankruptcy Estate*, 21 EMORY BANKR. DEV. J. 519 (2005).

<sup>11</sup> 792 F.3d 785 (7th Cir. 2015).

skimming some off.”<sup>12</sup> Given Bell’s involvement in the Ponzi scheme beginning in 2008, the trustee limited his suit to McGladrey’s 2006 and 2007 audits in an attempt to avoid application of the *in pari delicto* doctrine.

McGladrey, nonetheless, moved for summary judgment on *in pari delicto* grounds. Instead of arguing that Bell knew of the Ponzi scheme in 2006 and 2007, McGladrey argued that the trustee’s suit was barred because of a separate fraud committed by Lancelot against its investors. In its offering documents, Lancelot misrepresented the lockbox arrangement with Petters and Costco falsely representing to the investors that Costco would be making payments directly into the lockbox. The trial court granted summary judgment and the trustee appealed.

On appeal, the Seventh Circuit held that Lancelot’s securities fraud barred the trustee’s negligence claim against McGladrey. Conceding that no court had applied *in pari delicto* to a case exactly like this, the court reasoned that “Illinois regularly disallows litigation between one wrongdoer (here, Bell and the Funds) and another (here, McGladrey) whose acts may have added to the loss or failed to reduce it.”<sup>13</sup> The court thus found that both McGladrey’s alleged negligence and Lancelot’s fraud “led to the same loss: investors’ money went down a rabbit hole.”<sup>14</sup>

Respectfully, this is where the Seventh Circuit went wrong. There was not one injury but two injuries suffered by two different people. The first injury was the fraud practiced on Lancelot by Petters. The injured person was Lancelot. The second injury was the fraud practiced on the investors by Lancelot. The injured persons were the investors.

The only injury at issue in the *McGladrey* case was the loss suffered by Lancelot due to Petters’ fraud. On the summary judgment record, neither Bell nor Lancelot had anything to do with this loss. The only persons potentially responsible were Petters who committed the fraud and McGladrey who may have negligently failed to uncover it. There is nothing in Illinois *in pari delicto* or contribution law that suggests that McGladrey should get a free pass if it was negligent.

While the investors (and Lancelot’s other creditors) ultimately suffer from Lancelot’s injury due to its insolvency, their injuries are not direct but derivative of Lancelot’s injury. The investors lack standing to sue for injuries suffered by Lancelot. They must therefore rely on Lancelot’s recovery through the trustee to

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<sup>12</sup> *Id.* at 786.

<sup>13</sup> *Id.* at 787.

<sup>14</sup> *Id.*

generate the funds necessary to pay their claims—the very result foreclosed by the court.

Moreover, Illinois law (and that of other states) generally prevents investors or creditors of a company from suing the company's accountants for their own damages. By the Illinois Public Accounting Act ("IPAA"), Illinois has eliminated an accountant's liability to third parties unless the accountant "was aware that a primary intent of the client was for the professional services to benefit or influence the particular person bringing the action."<sup>15</sup> Both Illinois courts and the Seventh Circuit have strictly applied the IPAA to limit claims against accountants by investors and lenders.<sup>16</sup>

The net result of the *McGladrey* opinion is that Lancelot's accountants will likely escape from any liability for whatever role they played in Lancelot's losses to the Petters Ponzi scheme. If in fact, McGladrey was negligent; such a result would be inequitable. Even the Seventh Circuit recognized that inequity, noting:

Corporate and securities law rely on both managers and accountants to protect investors' interests. There would be a major gap in those bodies of law if, when one turns out to be scamp, then the other is excused from performing his own duties, and investors are left unprotected.<sup>17</sup>

The court resolved this perceived inequity by assuming (likely incorrectly) that the investors could sue the accountants directly. For this proposition, the court cited, but apparently ignored, the substantial Illinois law that would likely preclude such a suit.<sup>18</sup>

Admittedly, *McGladrey* presents a somewhat unusual fact pattern. A more typical fact pattern would have been for management and the accountant to have combined—management intentionally and the accountant

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<sup>15</sup> 225 ILCS 450/30.1.

<sup>16</sup> *E.g.*, *Bank of America v. Knight*, 725 F.3d 815, 816–17 (7th Cir. 2013)(holding that accountant's knowledge that client intended to furnish copies of financial statements to lender insufficient to impose liability under IPAA); *Tricontinental Industries, Ltd. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824, 838–39 (7th Cir. 2007)(holding that allegations that accountant knew of plaintiff's reliance on its audit opinion, that accountant knew the audited financials were misstated and did not disclose misstatement not sufficient to state a claim under IPAA); *Kopka v. Kamensky & Rubenstein*, 354 Ill.App.3d 930, 936–37, 821 N.E.2d 719, 724–25 (2004)(holding that accountant owed no duty to client's shareholders). *Cf.* *Builders Bank v. Barry Finkel & Associates*, 339 Ill.App.3d 1, 9–10, 790 N.E.2d 30, 37 (2003)(holding that lender who had met with client's accountants could state a claim under IPAA against the accountants).

<sup>17</sup> *McGladrey*, 792 F.3d at 788.

<sup>18</sup> *Id.* at 788–89.

negligently—to defraud investors. In such a circumstance, there is little question that the court would apply the *in pari delicto* doctrine mechanically against the trustee to the ultimate detriment of the defrauded investors.

Short of an amendment to Section 541, *in pari delicto* will remain a significant obstacle to recovery against those who participate in or turn a blind eye to fraudulent schemes. Counsel to victims of such schemes should keep in mind the negative consequences of bankruptcy filing by an entity used in fraudulent scheme. Receiverships, which are purely equitable, are not bound by the Bankruptcy Code and may provide a better avenue for recovery by victims.<sup>19</sup> A federal court supervising a receivership can prevent the filing of a bankruptcy.<sup>20</sup> While a state court cannot prevent a bankruptcy from being filed, the appointment of a state court receiver interjects an innocent successor prior to the bankruptcy limiting the application of the *in pari delicto* doctrine.<sup>21</sup>

If already in bankruptcy, the best path is to emphasize state law controlling the imputation of bad actors' conduct to entities in the context of *in pari delicto*. For example, in *Holland v. Arthur Andersen & Co.*,<sup>22</sup> a state court refused to apply the doctrine to bar a suit by a bankruptcy trustee against an accountant. In *Holland*, the trustee alleged that the accountant had allowed management to misstate the company's financials. As a result of the accountant's failures, management was allowed to artificially prolong the company's life, presumably so that they could continue to rake off money.<sup>23</sup> Finding that management's fraud was not for the benefit of the company, the court refused to impute management's fraud to the company blocking the application of the *in pari delicto* doctrine.<sup>24</sup> As *Holland* illustrates, state courts will often apply imputation less strictly in the context of *in pari delicto* due to the doctrine's equitable basis.

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<sup>19</sup> While most receiverships arising out of fraudulent schemes are created at the request of a regulator such as the SEC, victims can request and obtain the appointment of a receiver without waiting for the government to act. See *In re Bayou Group, LLC*, 363 B.R. 674 (S.D.N.Y. 2007). In *Bayou Group*, the victims requested the appointment of a receiver who then placed the fraudulent entities into bankruptcy.

<sup>20</sup> *SEC v. Byers*, 609 F.3d 87, 91–93 (2nd Cir. 2010).

<sup>21</sup> *Mukamal v. BDO Seidman, LLP (In re E.S. Bankest, L.C.)* (S.D. Fla. July 23, 2010); *Kirschner v. Wachovia Capital Markets, LLC (In re Le-Nature's Inc.)* (W.D. Pa. Oct. 23, 2009). In *Mukamal* and *Kirschner*, a receiver had been appointed prior to bankruptcy. As a result, Section 541 did not require the application of *in pari delicto* because the entity had rid itself of the corrupt influence of the fraudsters prior to bankruptcy.

<sup>22</sup> 127 Ill. App. 3d 854, 469 N.E.2d 419 (1984).

<sup>23</sup> *Id.* at 866–67, 469 N.E.2d at 427–28.

<sup>24</sup> *Id.*

## CONCLUSION

*In pari delicto* is a potent obstacle in the path of a trustee seeking to unwind a fraudulent scheme. Counsel to victims of such a scheme should carefully consider the doctrine's application when considering whether to file an involuntary bankruptcy or seek the appointment of a receiver. If a bankruptcy is, on balance, preferable, then counsel should strongly consider attempting to have a receiver appointed and asking the court to authorize the receiver to file bankruptcy on behalf of any receivership entities.