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Mixing Up the Equation: Application of the *In Pari Delicto* Defense in Bankruptcy Litigation

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Two recent decisions, one interpreting federal law and the other interpreting Delaware law, provide guidance for the application of the *in pari delicto* doctrine in a bankruptcy context. These decisions demonstrate that the otherwise straightforward defense of *in pari delicto*--literally "in equal fault"--can become quite complicated in bankruptcy-related litigation.

The Basic Equation

Conceptually, the *in pari delicto* defense makes sense. The doctrine "prohibits plaintiffs from recovering damages resulting from their own wrongdoing."[i] The defense is generally available (1) when the plaintiff, as compared to the defendant, bears at least substantially equal responsibility for the wrong he seeks to redress; and (2) when preclusion of the suit would not interfere with the purposes of the underlying law or otherwise contravene the public interest.[ii]*In pari delicto* seeks to promote two judicial purposes: (1) preventing courts from having to "lend their good offices to mediating disputes among wrongdoers"; and (2) deterring illegality by "denying judicial relief to an admitted wrongdoer."[iii]

Analyzing the *in pari delicto* defense involves setting up a basic "equation" to compare the relative fault of the parties involved, with the fault of the defendant on one side of the equation and the fault of the plaintiff on the other. If the plaintiff's fault is substantially equal to the defendant's, then the action may be subject to a valid *in pari delicto* defense.

Mixing Up the Equation

In bankruptcy, however, the math is not always so simple, because it is sometimes difficult to determine who is on each side of the equation and whether the purposes of the *in pari delicto* defense are being served. In bankruptcy litigation, the named plaintiff might be a bankruptcy trustee or creditors' committee, but the action might be a derivative action on behalf of the debtor's shareholders, an action on behalf of the corporation as an entity and/or an action on behalf of the debtor's creditors. In these cases, courts are likely to look behind the nominal plaintiff to see what underlying interests are being represented and whether, as applied to the holders of those underlying interests, application of the *in pari delicto* defense serves the doctrine's purposes.

In other words, the *in pari delicto* equation might not compare the relative faults of the trustee or committee, as plaintiff, and the defendant. Instead, the equation might compare the defendant's fault against the fault of the debtor corporation, its officers and directors, its shareholders, or its creditors.

***Nisselson*: The Fault of the Parent Corporation Imputed to its Merged Subsidiary**

The First Circuit recently tackled a difficult application of the *in pari delicto* defense in *Nisselson v. Lernout & Hauspie*, 469 F.3d 143 (1st Cir. 2006). The plaintiff in this case was the trustee of the Dictaphone Litigation Trust, which was established under the chapter 11 plan of reorganization of New Dictaphone, an entity that resulted from the merger of Old Dictaphone into a subsidiary of Lernout & Hauspie shortly before Lernout & Hauspie's demise. New Dictaphone's chapter 11 plan conveyed to the trust the claims that New Dictaphone might have against Lernout & Hauspie's directors, officers and professionals in connection with the ill-fated merger. The trustee sued these individuals, alleging that they concocted and executed a fraudulent scheme designed to inflate the value of the Lernout & Hauspie stock that was the consideration paid to the shareholders of Old Dictaphone in the merger.[iv]

In analyzing the *in pari delicto* defense, the First Circuit highlighted a very important question: "who, exactly, are the proper parties for the purposes of determining relative blame"?[v] In other words, who falls on each side of the *in pari delicto* equation? The trustee argued that the suit was being brought on behalf of New Dictaphone's creditors who, innocent of any fault in the merger, were immune from an *in pari delicto* defense. But the court concluded otherwise, holding that the trustee brought the suit on behalf of New Dictaphone who, following the merger and at the time of the bankruptcy filing, was the subsidiary of Lernout & Hauspie and shared officers and directors with Lernout & Hauspie. The court imputed the wrongdoing of the shared officers and directors to New Dictaphone and held that New Dictaphone was at least as guilty as the officer and director defendants in perpetrating the fraud.[vi] "[T]he trustee is not bringing claims on behalf of the innocent target of the fraud but, rather, on behalf of a complicit party. Viewed in that light, the trustee's policy concerns ring hollow."[vii]

The First Circuit was unsympathetic to and rejected the trustee's argument that because the recovery to the litigation trust would ultimately benefit the creditors and not the "guilty" corporation, the doctrine should not be applied to preclude recovery. After noting that the beneficiaries of the litigation trust might also have engaged in wrongdoing, the court stated that the best approach would be to require the creditors to pursue the defendants separately, thereby removing the taint of the guilty corporation. And even if the creditors could not sue individually, the court determined that creditors with notice of potential wrongdoing could include that possibility in their decision to extend credit.[viii] Of course, this determination provides little comfort to creditors who existed before the wrongdoing or otherwise had no notice of the wrongdoing--categories likely to include the vast majority of creditors.

Revisiting *Trenwick*: Innocent Creditors Protected from *In Pari Delicto* Defense

The First Circuit's decision is not the only law on this topic, however, and the outcome in *Nisselson*

is at odds with *dicta* from a recent Delaware state court decision discussing the doctrine. In *Trenwick America Litigation Trust v. Ernst & Young, L.L.P., et. al*, 906 A.2d 168 (Del. Ch. 2006), the court found for the defendant and dismissed a trustee's claims against members of the debtor-parent's and debtor-subsidiary's boards of directors (and various former advisors) on theories of breach of fiduciary duty, gross negligence, fraud and "deepening insolvency." But although the court dismissed the complaint, it declined to rely on the *in pari delicto* defense asserted by the defendants. In a footnote, the court observed that an action brought by a bankruptcy trustee for the benefit of injured creditors is analogous to a derivative action brought for the benefit of injured shareholders under Delaware law. Because the "doctrine of *in pari delicto* has never operated in Delaware as a bar to providing relief to the innocent by way of a derivative suit" in a context in which insiders or advisors are alleged to have defrauded the corporation, it does not bar an action in a similar context brought by a bankruptcy trustee for the benefit of creditors.[ix]

Thus, the Delaware court, in *dicta*, appears to have endorsed the same argument that the First Circuit rejected. Both the Delaware court and the First Circuit looked behind the named plaintiffs (the trustees) in setting up the *in pari delicto* equation and applying the defense. But the First Circuit looked only one layer behind the trustee and placed the debtor corporation into the *in pari delicto* equation, while the Delaware court looked behind both the trustee and the debtor corporation to the ultimate beneficiaries of the litigation (the debtor corporation's creditors) and placed those creditors into the *in pari delicto* equation. This distinction makes all the difference where the debtor corporation could be imputed with fault, making the *in pari delicto* defense viable, and where the debtor's creditors do not share any of the fault and can survive the defense.

The Bottom Line

When applying the *in pari delicto* defense in bankruptcy litigation where a trustee or committee is the plaintiff, courts will likely look behind the named plaintiff to determine whether the underlying parties share any fault with the defendants. But how far the courts look behind the named plaintiff may be the difference between a successful and an unsuccessful *in pari delicto* defense.

For more information on this or other bankruptcy and commercial matters, please contact the authors listed above.

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[i]*See Nisselson v. Lernout & Hauspie*, 469 F.3d 143 (1st Cir. 2006).

[ii]*Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 311 (1985).

[iii]*See Id.* at 306.

[iv]*Id.* at 148-49.

[v]*Id.* at 152.

[vi]*Id.* at 157.

[vii]*Id*.

[viii] *Id*. at 158.

[ix] *Id.* at 212, n. 132.

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