The historic basis for the in pari delicto doctrine is axiomatic: Individual wrongdoers should not be able to profit from those fellow wrongdoers of equal or lesser fault. Courts must often examine whether the tortious conduct of corporate officers, directors or employees should be imputed to their principal. In the modern bankruptcy world, courts have largely ignored the rationale behind in pari delicto, instead applying the doctrine in all cases where wrongdoing is present. Victims of fraud often have only the bankrupt debtor’s estate as a source of remuneration. Expansive application of in pari delicto has resulted in denying these victims legitimate recoveries while immunizing third-party defendants for their complicity in the fraud. This ignores, inter alia, one of the pillars on which the equitable doctrine stands: deterrence. Recent decisions have attempted to develop rules, making it extremely difficult for a bankruptcy trustee or estate representative to avoid the imputation of wrongdoing agents’ conduct. For example, courts have only applied the “adverse-interest exception” where plaintiffs can show that what the principal received was absolutely not a benefit from a wrongdoing agent’s acts.

Further, in order to avoid application of the “sole-actor” exception to the adverse-interest exception, some courts have held that representative plaintiffs must prove the existence of an officer or director with corporate authority and hypothetical willingness to stop the wrongdoing. As a result, the evidence required to avoid imputation and the resulting application of in pari delicto is so great that it sadly has become virtually impossible to avoid.

Equitable Roots
In pari delicto finds its origins in the ancient Latin maxim, “in pari delicto potior est conditio defendentis,” or “In a case of equal or mutual fault...the position of the [defending] party...is the better one.” The rationale behind the doctrine is two-fold: (1) courts should not mediate disputes between wrongdoers; and (2) denying relief to wrongdoers deters illegal conduct. In pari delicto has long been a part of American jurisprudence and is discussed in cases dating back to at least the 18th century. In early cases, in pari delicto allowed courts to refuse to hear cases between parties for claims based on illegal contracts, but these courts recognized that although parties may stand in pari delicto, the equitable doctrine should not apply where it would ultimately frustrate its intended purpose.

The Supreme Court recognized this long-standing principle in the context of federal claims. In Batemen Eichler, Hill Richards Inc. v. Berner, the trial court determined that in pari delicto barred the plaintiffs from recovering damages for stock losses where the plaintiffs’ allegations reflected that they had intended to trade on insider information, which “violated the statutory provision under which recovery [was] sought.” In affirming the Ninth Circuit’s reversal, the Court held that a plaintiff’s claim under federal securities laws would only be barred under in pari delicto if “(1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress and (2) preclusion of the suit would not significantly interfere with the effective enforcement of the securities laws and protection of the public.” A determination of relative culpability is only the first step in a proper in pari delicto analysis. Of equal import (as indicated by the conjunctive nature of the Court’s requirements), the defense does not apply when it would serve to frustrate its public-policy purposes.

Modern courts applying in pari delicto often fail to examine the equities of its application. Once parties stand at equal fault, all meaningful analysis stops, and the plaintiff is barred from recovery. Some courts dismiss bankruptcy trustee

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Litigator’s Perspective
...
Most courts apply the “total-abandonment” standard in applying the adverse-interest exception, but this standard is subject to variation. Some courts refuse to apply the exception where the principal received any benefit from the agent’s actions, no matter how slight. Other courts reject a rigid standard, noting that the existence of some benefit should not preclude application of the exception. These differences might be explained by whether the courts examine total abandonment through an objective standard (any peppercorn of benefit defeats the adverse-interest exception), or alternatively, by looking to the subjective intent of the agent (some benefit is not the determinative factor).

Application of the “any benefit” test can lead to absurd results. For example, assume that the CFO of ABC Corp. engages in fraudulent financial reporting to conceal that he was funnelling corporate assets to an entity he owns. To justify the transfers, payables to an alleged “vendor” were entered in the company’s accounting records with corresponding fictitious sales to explain the lack of increased inventory at ABC’s warehouses. Most courts would agree that theft is the classic example for application of the adverse-interest exception. Thus, the CFO’s actions should not be imputed to the company.

What if these “sales” and increased reported revenues helped the company to obtain a loan? This benefit would preclude application of the adverse-interest exception under the “any-benefit” standard. If sued by ABC for negligence, the auditors would escape liability under in pari delicto because the CFO’s knowledge would be imputed to ABC regardless of the auditor’s lack of adherence to professional standards or participation in the fraud. This is but one example of why the adverse-interest exception should not be contingent upon the receipt of “any” benefit.

Sole-Actor Rule

Even where the adverse-interest exception applies, the sole-actor rule may still result in imputation. When the agent and principal are “one and the same,” courts will impute the agent’s conduct and knowledge to the principal because “the sole agent has no one to whom he can impart his knowledge, or from whom he can conceal it.” Again, the treatment of the sole-actor rule is far from consistent.

The rule originally developed where the offending agent was also the corporation’s sole shareholder. Some courts have refused to apply the sole-actor exception unless the agent literally is the sole owner of the entity. When other innocent owners exist, the wrongdoer has someone “to whom he can impart his knowledge, or from whom he can conceal it.” This application implicitly recognizes minority shareholders’ legal rights and ability to halt a majority shareholder’s deprivations.

Other courts have expanded the application of sole actor to include agents who are found to completely dominate or control the principal. This approach has opened a Pandora’s box of legal issues. Some courts require plaintiffs to show what the company’s innocent stakeholders “could” and “would” have done had they been informed of the wrongful conduct. Evidence of what individuals “would” have done requires hypothetical lay testimony that, in turn, begets an array of evidentiary objections. Moreover, testimony regarding what one “could or would” have done in the face of information regarding fraudulent conduct creates a catch-22 for many innocent officers and directors. These individuals may have taken steps to halt the fraudulent activity if they were apprised of the truth. To avoid potential liability, they may want to testify that there was nothing they could have done to stop the wrongdoers.

Imputation, Considerations of “Good Faith”

Some recent opinions have considered whether the defendant exercised “good faith” in dealing with the wrongdoing agent. These cases are not an expansion of the imputation doctrine exceptions, but instead represent a modern examination of the traditional basis for the imputation rules.

Last year, the Pennsylvania Supreme Court addressed the availability of

10 See, e.g., Baena v. KPMG LLP, 453 F.3d 1, 7 (1st Cir. 2006).
11 See, e.g., The Mediators Inc. v. Manney, 105 F.3d 822, 827 (3d Cir. 1997).
12 See, e.g., id.
14 See, e.g., id. (holding that plaintiff must show that corporation “did not benefit in any way”).
15 See, e.g., McIntire v. Oldham 420 B.R. 178, 201 (S.D.N.Y. 2009) (“Third parties allegedly complicit in an insider’s Ponzi scheme should not so easily be able to escape liability by arguing that any benefit to the company that perpetuated its existence strips a trustee of standing to recover damages to the company” (emphasis in original)).
17 See, e.g., McIntire, 420 B.R. at 201 (S.D.N.Y. 2009) (looking to intent as "keystone" for analysis).
21 See, e.g., The Mediators Inc. v. Manney, 105 F.3d 822, 827 (3d Cir. 1997).
22 In re GB Holding Co., Inc., 529 F.3d 432, 453-9.n.9 (2d Cir. 2008) (finding sole actor inapplicable because wrongdoers “were not the sole shareholders of the corporation”).

In Pari Delicto and Interplay of Agency Principles

In bankruptcy cases where the plaintiff is the debtor or its representative(s), “the rules of imputation determine whether the Debtor will be deemed to have participated in wrongdoing because of the acts of its [agent].” However, the application of the imputation doctrine should not be confused with the application of in pari delicto. The question of imputation addresses only whether the plaintiff was at equal fault.

The imputation question typically includes the following analysis: Generally, an agent’s actions and knowledge are imputed to its principal. This rule is subject to the adverse-interest exception where the agent has totally abandoned his or her principal’s interests. The adverse-interest exception is itself subject to an exception known as the sole-actor rule, applicable when the wrongdoer and principal “are one and the same.” Nevertheless, how imputation is applied can vary greatly among different courts and jurisdictions.

Adverse-Interest Exception

The genesis of the adverse-interest exception can be found in the basic principles of agency law. Under respondeat superior, principals may be held liable for the tortious actions of their agents undertaken during the course and scope of the agent’s employment. However, “[i]f the agent was acting solely for his or her own benefit and to the detriment of the corporation, it cannot be said that the agent was acting in the scope of his or her employment.”
imputation involving an auditor allegedly complicit in its client’s fraudulent acts. After receiving certified questions from the Third Circuit, the court held that “[t]he proper test to determine the availability of defensive imputation in scenarios involving non-innocents depends on whether or not the defendant dealt with the principal in good faith.”

This holding represents some deviation from the ever-broadening embrace of imputation and in pari delicto, at least when involving a “collusive” auditor. Much of the court’s reasoning was grounded in historic agency principles. In Mutual Life Insurance Company of New York v. Hilton-Green, the Supreme Court discussed the historic basis of the rule of imputation and the requirement of good faith:

The general rule, which imputes an agent’s knowledge to the principal, is well established. The underlying reason for it is that an innocent third party may properly presume the agent will perform his duty and report all facts which affect the principal’s interest. But this general rule does not apply when the third party knows there is no foundation for the ordinary presumption, when he is acquainted with circumstances plainly indicating that the agent will not advise his principal. The rule is intended to protect those who exercise good faith, and not as a shield for unfair dealing.

Moreover, the good-faith requirement is not limited to the context of intentional or collusive behavior. One court noted that imputation is improper in instances of collusion against the principal “or where the facts and circumstances are such as to raise a clear presumption that the agent will not perform his duty” to communicate knowledge to the principal.

Similarly, the Tenth Circuit has held that “[a]n agent’s knowledge, therefore, will not be imputed to the [principal] if the [third party] knows, or should know, that the agent is not going to transmit the correct information to the insurer and that the insurer is being deceived.”

**Conclusion**

In recent years, courts have obsequiously adhered to the trend of applying imputation and in pari delicto broadly to dismiss cases involving substantively credible claims. These cases frequently involve fraud where third parties are negligent, if not complicit, with the wrongdoers. As a result, bankruptcy trustees representing a plethora of innocent beneficiaries are left with limited legal recourse. It is time for courts to re-examine the historical roots and public policies behind the application of the rules of imputation and in pari delicto. By so doing, it should become luminously apparent that the doctrines and their underlying policies are being too casually frustrated, if not abrogated, resulting in the inequitable application of equitable doctrines.


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