Third Circuit Holds Creditors' Committee Has Standing to Pursue "Deepening Insolvency" Claim, but Dismisses Case

by Michael McLaughlin

On October 9, 2001, the Third Circuit Court of Appeals, in a two to one decision in *Official Committee Of Unsecured Creditors v. R.F. Lafferty & Company, Inc.*, held that a creditors' committee had standing to pursue a "deepening insolvency" claim on behalf of debtor corporations, but that the defense of *in pari delicto* barred the committee vested with legal status identical to the debtor from pursuit of these claims.[1] In the *R.F. Lafferty* case, a creditors' committee was authorized by a stipulation to assert claims against third-party professionals who had been hired by two debtors in the lease financing business for their actions in enabling the debtors to orchestrate a Ponzi scheme.[2]

A major contention set forth in the creditors' committee complaint was a deepening insolvency claim that the Shapiro family and its chief instigator, William Shapiro, caused entities known as Walnut Equipment Leasing Company, Inc. and its wholly owned subsidiary, Equipment Leasing Corporation of America (ELCOA) to issue fraudulent debt certificates that were in turn purchased by individual investors. The debtors were alleged to have fraudulently registered debt certificates while insolvent with no intent or ability to repay investors. The companies, heavily burdened by the debt created by the fraudulent scheme, resorted to Chapter 11 filings.

The creditors' committee's lawsuit was filed in the district court, and raised claims for violation of federal securities law, along with numerous state law causes of action including fraud, negligence, misrepresentation, mismanagement, and breach of fiduciary.[3] The district court severed the committee's claims against two entities, Cogan Sklar LLP, the former accounting firm for Walnut and ELCOA, and R.F. Lafferty & Company, Inc., the underwriters whose professional opinions served as a pre-requisite for recognition of the public offering of stock sold by the debtor entities.

Cogan was alleged to have issued audit reports on the debtors that knowingly or recklessly misrepresented the debtor's financial status. The committee complaint alleged Lafferty, as a qualified independent underwriter, failed to undertake sufficient due diligence of the debtors' financial position in rendering their fairness opinion.

The *R.F. Lafferty* decision in the Third Circuit, while affirming the district court's decision, left innocent creditors with no remedy against entities whose role was essential to initiate and perpetuate the fraud and the Ponzi scheme.

The issues discussed in the district court opinion[4] were raised before the court in the context of a motion to dismiss a complaint of the creditors' committee by 16 defendants who were joined in the action.[5] Essentially, the district court case, with the exception of a single federal securities law count in the complaint, alleged only state law claims on behalf of the debtors. The essence of the deepening insolvency claim was defined by the court as follows:

> In other words, the committee alleges an injury to the debtor's corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life. This type of injury has been referred to as 'deepening insolvency.'[6]

The Third Circuit was required to examine whether a cause of action under deepening insolvency would be recognized by the Pennsylvania Supreme Court and may give rise to a cognizable injury.[7] The essence of a deepening insolvency claim is that a company, by incurring debt rather than dissolving itself in a timely manner, can damage the corporate body through increased liability to creditors. Shareholders, had they been aware of the corporate insolvency, may have chosen to exercise a right to

dissolve the company in order to mitigate any losses. The Third Circuit, explaining the legal theory, stated "prolonging an insolvent corporation's life through bad debt may cause a dissipation of corporate assets."[8]

GENERAL FACTUAL BACKGROUND ON DEBTOR ENTITIES AND PONZI SCHEME

In order to understand the causes of action that arose as a result of the operation of the insolvent entities Walnut and ELCOA, that were central to the Ponzi scheme, it is necessary to review the inter-relationship of companies under the dominion and control of the Shapiro family. Both Walnut and ELCOA were part of a network of businesses owned and controlled by William Shapiro and the Shapiro family. Once Walnut ran into financial difficulties and needed to raise working capital, ELCOA, a limited purpose financing subsidiary, was formed to sell "debt securities through a new company with a clean financial picture."[9] ELCOA was organized solely to acquire leases from Walnut and then to sell debt certificates to raise funds for the benefit of Walnut. The continued issuance of debt securities, while Shapiro and their companies siphoned salaries and fees, exacerbated the financial position of the insolvent entities. Ultimately, the Ponzi scheme collapsed, causing substantial losses to numerous investors.

The Shapiros, without the assistance of their third-party professionals, R.F. Lafferty & Company, Inc., whose written opinion was necessary to register the public offering, would have been unable to operate the fraudulent scheme. The misrepresentation of ELCOA's and Walnut's financial position necessary to register the public offerings gave rise to numerous state law and one federal cause of action raised by the creditors' committee. ELCOA was a wholly owned subsidiary of Walnut who provided the *platform* to sell securities through a new company with a clean financial picture. Walnut was unable to sell its debt certificates because of its financial problems. The opinions of R.F. Lafferty were alleged to contain "multiple fraudulent misstatements and material omissions concerning Walnut and ELCOA's financial statements."[10]

Upon filing of the Chapter 11 petitions, the debtor's management, including the Shapiro family and various entities under their control, were removed. Under 11 U.S.C. 1102, a creditors' committee was formed. Approximately a year and a half after the bankruptcy petition was filed, the committee was authorized by stipulation to commence litigation on behalf of the debtor estates. The stipulation empowered the committee by its express terms with all legal attributes of a bankruptcy trustee.[11] The case was commenced against the debtor's officers, directors, affiliated companies, outside professionals and certain directors who were alleged to have breached their fiduciary duties to oversee their debtors' affairs.

All defendants, with the exception of one individual who had defaulted, moved to dismiss the committees' amended complaint and for summary judgment. The district court dismissed claims against outside professionals, Cogan and defendant R.F. Lafferty, holding that the creditors' committee lacked standing because the equitable doctrine of *in pari delicto* barred the claim. The motion to dismiss with respect to other defendants was denied on the grounds that the defense did not bar claims against corporate insiders.[12] The committees' claims against Cogan and Lafferty were severed, and Cogan settled its claims.

Simply stated, the equitable doctrine of *in pari delicto* prevents a plaintiff from asserting claims against a defendant if the plaintiff bears some fault for the claim. In *Lafferty,* the creditors' committee stepped into the shoes of the Walnut and ELCOA corporations. The committee was then tainted with the same knowledge as the Shapiros and other insiders who had instigated the fraud in the first instance.

Application of the *in pari delicto* doctrine required the court to impute the conduct of the Shapiro family and the debtors to the committee who had, by written stipulation, acquired all legal attributes of the debtor.[13]

LEGAL ANALYSIS OF STANDING ISSUE BY THIRD CIRCUIT COURT OF APPEALS

In adjudicating the standing of the creditors' committee, under Article III of the Constitution, the district court, in its preliminary discussion of the parties standing to proceed with the lawsuit, considered the equitable defense of *in pari delicto.* The Third Circuit Court of Appeals concluded that the standing analysis does not "include an analysis of equitable defenses, such as *in pari delicto.*"[14] The court reviewed the general proposition that standing requires a "distinct and palpable injury." Appellant Lafferty had argued to the district court unsuccessfully that a bankruptcy trustee had no standing to assert claims on behalf of an estate's creditors as held by the U.S. Supreme Court in *Caplan v. Marine Midland Grace Trust Company.*[15] This argument was rejected by the district court.

At the early stage in a case adjudicating a motion to dismiss, the court drew a distinction between the injuries suffered by creditors, *i.e.* the purchasers of debtor certificates, and the debtor as separate legal injuries. Appellant Lafferty argued that injuries suffered by claimants as victims of a Ponzi scheme belong only to creditors. However, the court concluded the committee's injuries could be considered separate and distinct.

The committee's complaint alleged the debtors had wrongfully

expanded their debt out of proportion with their ability to repay creditors. This scheme ultimately caused the debtors to seek bankruptcy protection. The court did not believe the committee was attempting to recover for injuries to creditors.

In discussing under Pennsylvania state law that the committee could assert a separate claim than that of creditors, the court stated "a corporation can suffer an injury onto itself, and any claim it asserts to recover for that injury is independent and separate from the claims of shareholders, creditors and others."[16]

The court then shifted its analysis to whether Pennsylvania state law recognizes the legal theory of deepening insolvency, and whether the injury sustained by the creditors' committee was illusory which would not meet the prudential requirement of the standing analysis. The court, predicting Pennsylvania's Supreme Court ruling, if confronted with the issue, concluded the deepening insolvency claims gave rise to cognizable injuries that were not illusory. The court examined cases outside the jurisdiction[17] recognizing the deepening insolvency theory, but also discussed in its opinion the basic legal maxim under common law that where a legal injury arises, the law provides a remedy.

In considering the issue of whether the injury to the debtor was illusory, the Third Circuit boiled appellant Lafferty's argument down to a request to invoke the "piercing the corporate veil" doctrine, treating the shareholders of ELCOA and Walnut as identical for the purpose of suit.[18] The court believed that Walnut's corporate existence could not be ignored, thus the purported injury to the debtors was not illusory.[19]

APPLICATION OF *IN PARI DELICTO* EQUITABLE DEFENSE AS AN AFFIRMATIVE DEFENSE AGAINST THE COMMITTEE'S CLAIMS

Having resolved the standing question in favor of the creditors' committee, the court moved to consideration of the *in pari delicto* affirmative defense. Application of the defense necessitated that the court impute the Shapiro controlling entities' conduct of the debtors, Walnut and ELCOA, to the creditors' committee, who under the stipulation authorized in the litigation acquired the legal attributes of the debtor. The court believed that the committee's argument that the *in pari delicto* defense would produce an inequitable result required the resolution of two related questions. These were:

> First, we must decide whether in evaluating a claim brought by a bankruptcy trustee, a court of law may consider post-petition events that may affect an equitable doctrine such as *in pari delicto*. Second, we must decide whether in light of our answer to the first question the Shapiro family's conduct should in fact be imputed to the debtors, such that the doctrine of *in pari delicto* bars the committee's claims.[20]

In undertaking the analysis on these two claims, the court looked to the explicit language of 11 U.S.C. 541 that requires a court to evaluate defenses that exist at the commencement of the bankruptcy. Based upon the plain language of 541, the court rejected the committee's argument that the post-petition events including the removal of the Shapiro family and co-conspirators from the debtor's management, and the status of the committee as a blameless successor should play a role in the analysis of the *in pari delicto defense*. Thus, the court found the bankruptcy estate and the creditors' committee succeeded only to the rights possessed by the debtor as of the date of the filing of the Chapter 11 bankruptcy petitions.

The court examined the 10th Circuit opinion *In re Hedged Investments Associates, Inc.*,[21] in which the court held that *in pari delicto* defense barred a bankruptcy trustee's suit against an investor to recover funds received by that investor in excess of their contribution. *The Hedged Investments* case also involved a Ponzi scheme where one individual, through a solely owned corporation and several limited partnerships, drove these entities into bankruptcy. Claims were brought by the debtors against third-party investors who profited from the Ponzi scheme. The court held that the rights of the trustee could not achieve any higher status than those possessed by the debtor. The court also cited recent opinions of the Second Circuit Court of Appeals and the Sixth Circuit Court of Appeals that have applied the *in pari delicto* doctrine to bar claims of a bankruptcy trustee who held the same legal status as the debtor and did not take into consideration the trustee's status as an innocent successor.[22]

IMPUTATION OF SHAPIRO FAMILY CONDUCT TO DEBTORS UNDER *IN PARI DELICTO* TO BAR COMMITTEE'S CLAIMS

The Third Circuit's analysis of whether the Shapiro family's misconduct should be imputed to debtors ELCOA and Walnut, and hence to the creditors' committee, applied the substantive state law of Pennsylvania. Citing precedent from prior Third Circuit and district court opinions from Pennsylvania, imputation or the fraud of an officer to the corporation will occur when: (1) the actions occur in the course of employment, and (2) the actions are for the benefit of the corporation.[23] Next, the specific allegations of the creditors' committee complaint were examined, including the core allegation that the Shapiros' conduct perpetuated their fraudulent scheme through affiliated companies, including ELCOA and Walnut.

The court had little difficulty concluding that the first part of the imputation test was satisfied.

In examining whether the Shapiros' conduct was for the benefit of the ELCOA and Walnut corporations, the court next undertook an analysis of the adverse interest exception. The court explained "under this exception, fraudulent conduct will not be imputed if the officers' interest[s] were adverse to the corporation and 'not for the benefit of the corporation.'"[24] The committee argued that the Shapiros' actions were not for the benefit of the debtors, and thus their conduct should not be imputed to the corporations.

Analysis of the adverse interest exception to the imputation test to determine whether an individual's conduct was for the benefit of the corporation also contains another exception — the sole actor exception.[25] The sole actor exception has as its rationale that "the sole agent has no one to whom he can impart his knowledge, or from whom he can conceal it, that the corporation must bear the responsibility for allowing an agent to act without accountability."[26]

In examining the corporate structure of ELCOA and Walnut, William Shapiro was the sole shareholder for both corporations. The Third Circuit applied the sole actor exception in its adverse interest analysis since the domination of both entities and the control asserted by Shapiro justified application of the sole actor exception. The court rejected the committee's argument that some of the debtor's directors did not participate in, and were innocent of, any fraudulent conduct.[27] The court cited the lack of any connection to be fraud, and the possible existence of an independent director did not change the Shapiros' dominion and control of the debtor corporations.[28] In conclusion, the court had little difficulty imputing the fraudulent conduct of the Shapiros to ELCOA and Walnut that fatally barred the committee who had acquired the standing of the debtors from asserting their claims against Lafferty.[29]

DISSENT OF JUSTICE COWEN

In a separate dissent, Justice Cowen indicated that he agreed with the outcome reached by the majority, that a creditors' committee had standing to sue. Nonetheless, Justice Cowen believed the reasoning of the majority opinion improperly interpreted the Bankruptcy Code, resulting in a loss of recovery for innocent creditors that would insulate those with civil liability from their fraud.[30] Justice Cowen looked to the definition of *in pari delicto* in *Black's Law Dictionary* and quoted the definition as "a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing.[31] Justice Cowen looked to the policy reasons of an equitable doctrine, which is to avoid the injustice created by overly inflexible rules. Further policy considerations discussed in the dissent include the problem that those individuals who facilitated the fraud and professional misconduct will go unpunished, while their victims recover nothing.

In applying the equitable doctrine of *in pari delicto,* Justice Cowen states

> an equitable doctrine like in pari delicto is highly sensitive to the facts and readily adapted to achieve equitable results. What is sufficient to satisfy the doctrine in other words, need not be parsed like a statute.[32]

The dissent disagrees with the hard and fast rule set forth by the majority, that a trustee is restricted to the debtor's causes of action and subject to the same defenses as the debtor, with no consideration of post-petition events in evaluating the causes of action and defenses.

CONCLUSION

The *R. F. Lafferty & Company, Inc.* case holding, despite its in-depth reasoning and legal conclusions based on precedent, left the committee frustrated in its ability to recover losses suffered by the debtor corporations caused by its culpable professionals. This is a case where the strong language in the dissent by Justice Cowen — that the majority's decision "needlessly thwarts recovery for innocent creditors to insulate those from civil liability those to help perpetrate fraud" — has particular resonance.[33] The object lesson of the opinion is that prior to undertaking the time and expense to initiate complex litigation, a full analysis of the potential plaintiff's standing, and the *in pari delicto* defense, must be carefully evaluated. ■

ENDNOTES

1. *Official Committee of Unsecured Creditors v. R. F. Lafferty & Company, Inc.,* 267 F. 3d 340 (3rd Cir. 2001).
2. *Id.* at 345. A Ponzi scheme is a fraudulent investment scheme where money contributed by later investors funds artificially high returns for earlier investors that by example attracts new investors to make even larger investments.
3. *Id.* at 346. Other causes of action included breach of contract, professional malpractice and aiding and abetting breach of fiduciary duty.
4. *In re Walnut Leasing Company, Inc., Official Committee of Unsecured Creditors v. Shapiro,* 1999 W.L. 729267. (E.D. Pa.)
5. *Id.* at page 1.
6. *Official Committee of Unsecured Creditors v. R. F. Lafferty & Company, Inc.,* 267 F. 3d 340, 348 (citations omitted).
7. *Id.* at 349 and 350. In reviewing the case law that had interpreted this cause of action and secondary authorities, the court concluded that the Pennsylvania Supreme Court, if faced with the issue, would recognize the deepening insolvency claim.
8. *Id.* at 350.
9. *Id.* at 344.
10. *Id.* at 345.
11. *Id.*
12. *Id.* at 346.
13. *Id.* at 358
14. *Id.* at 346.

15. 406 U.S. 416, 434 (1972).
16. *R. F. Lafferty & Company, Inc., supra.* at 348.
17. The primary cases relied upon by the court in recognizing the deepening insolvency theory were *Schact v. Brown,* 711 F. 2d 1343 (applying Illinois law) *Hannover Corp. of America v. Beckner,* 211 B.R. 849 (N.D. La. 1997) and *Allard v. Arthur Anderson & Company,* 924 F. Supp. 488 (S.D.N.Y. 1996).
18. *In re Official Committee of Unsecured Creditors v. R. F. Lafferty & Company, Inc.,* 267 F. 3d 340, 353 (3rd. Cir. 2001).
19. *Id.* at 353.
20. *Id.* at 354.
21. 84 F. 3d 1281 (10th Cir. 1996).
22. *Hirsch v. Arthur Anderson & Company,* 72 F. 3d 1085, 1093-1094 (2d Cir. 1995); *In re Dublin Securities,* 133 F. 3d 377, 380 (Sixth Cir. 1997).
23. *R. F. Lafferty & Company, Inc., supra.* at 358 *citing Waslow v. Grant Thornton (In Re Jack Greenberg, Inc.),* 212 B.R. 76, 83 (Bkrtcy. E.D. Pa. 1997).
24. *R. F. Lafferty & Company, Inc., supra.* at 359, 360.
25. *Id.* at 359.
26. *Id.*
27. *Id.* at 360.
28. In the case of *Breeden as Trustee of Bennett Funding Group, Inc. v. Kilpatrick and Lockhart, LLP,* 268 B.R. 704 (S.D.N.Y. 2001), District Judge Sprizzo denied standing to a bankruptcy trustee to pursue claims arising out of the Bennett Funding Ponzi scheme against Arthur Anderson, former accountants for Bennett. The court applied the Wagoner Rule applied by the Second Circuit Court of Appeals in *Wight v. BankAmerica Corp.,* 219 F. 3d 79, 86 (2d. Cir. 2000). The Wagoner Rule under New York law prohibits a bankruptcy trustee from recovery from third parties for injuries incurred by the debtor due to misconduct by a company's controlling managers due to lack of standing. In the *Bennett Funding* case the principal decision makers, the Bennetts, were the only relevant decision makers in the company and there were no innocent bystanders. Judge Sprizzo held that the presence of alleged innocent officers and directors, not members of the Bennett family, was irrelevant since there was "no evidence to support that any of the individuals either could have or would have stopped the fraud" since they lacked any real authority. *Id.* at 712.
29. *Official Committee of Unsecured Creditors v. R. F. Lafferty & Company, Inc.,* 267 F. 3d 340 at 360.
30. *Id.* at 360.
31. *Black's Law Dictionary,* 794 (7th Ed. 1999).
32. *R. F. Lafferty, supra.* at 362.
33. *Id.*

Michael McLaughlin *practices with Wasserman, Jurista & Stolz in Millburn.*

Protecting Professional Chapter 11 Administrative Fees After a Case Confirms and Then Converts

Continued from page 4

such confirmation ...."
19. *In re Benjamin Coal,* 978 F.2d at 827. The language of the reorganization plan provided that: [u]pon the Confirmation Date, the Debtors shall be discharged of the claims of all Claimants, Interest holders and all other entities. The only remaining obligations of the Debtors shall be as specified in the Plan." (Amended Plan of Reorganization, August 26, 1985, p. 18). *Id.*
20. *In re Benjamin Coal,* 978 F.2d at 826.
21. *Id.* at 827.
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.* (Emphasis added).
26. *Id.*
27. *Id.* at fn. 1.
28. *Id.*
29. *See Id.*
30. *See e.g., In re American Metallurgical Prods. Co., Inc.,* 228 B.R. 146 (Bankr. W.D. Pa. 1998). The language in the plan that the American Metallurgical Prods. court relied upon provided in pertinent part that:
    (a) upon confirmation and...substantial consummation of the Plan...all Claims against[,] and Interests in [, the instant] Debtors of any nature whatsoever [shall be discharged].
    (b) Upon the confirmation Date of the Plan...all Claims against[,] and Interests in[,] Debtors of any nature whatsoever [shall be discharged], provided the payments and distributions under the Plan are made, and each of the other of their obligations provided for in the Plan are performed, when, as, and to the extent provided for in the Plan...*Id.* at 152 fn.4

    The Plan further provided that:

    If the Proponents of [the] Plan revoke and withdraw the Plan pursuant to §5.06, or if the consummation of the Plan does not occur, the Plan shall be deemed null and void, and in such event nothing contained herein shall be deemed to constitute a waiver or release of any claims by or against the Debtors or any other person or to prejudice in any manner the right s of the Debtors in any further proceedings involving such Debtors. *Id.* at fn. 5.

    Lastly, the order confirming the plan provided that:

    Except as otherwise provided or permitted by the Plan or this Order:
    1. the above named Debtors shall be released from all dischargeable debts upon successful completion of the Plan;
    2. Any judgment heretofore or hereafter obtained in any Court other than this Court shall be null and void as to debts dischargeable under the Bankruptcy Code upon successful completion of the Plan. *Id.* at fn. 6.
31. *Id.* at 151-52.
32. The authors would recommend using the express language successful completion to prevent any arguments or interpretations as to whether the plan had been substantially consummated.

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