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Developments in the *In Pari Delicto* Doctrine in Massachusetts



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The recent economic downturn and the turmoil in the subprime and broader credit markets are contributing to an increase in commercial litigation and corporate bankruptcies. Once a corporation seeks bankruptcy protection, trustees, examiners, and creditors committees will scrutinize the debtor's pre-bankruptcy affairs. Pre-petition professionals of the debtor, including auditors, financial advisors, lawyers, and investment bankers, may face threatened or actual litigation over their roles in the business failure. These types of claims are often the estate's primary unencumbered assets, and may be the sole means of funding a dividend to unsecured creditors.

Claims of this nature frequently are met with the *in pari delicto* defense. Broadly speaking, the defense prohibits plaintiffs from recovering damages resulting from their own (or their predecessor-in-interest's) wrongdoing. The First Circuit addressed the *in pari delicto* defense under Massachusetts law in *Baena v. KPMG LLP*, 453 F.3d 1 (1st Cir. 2006) and *Nisselson v. Lernout*, 469 F.3d 143 (1st Cir. 2006). There, the court applied *in pari delicto* to dismiss claims, and arguably gave the doctrine an expansive application. Since these decisions, other Massachusetts federal and state courts, inside and outside the bankruptcy context, have been asked to apply *in pari delicto* to dispose of cases before trial. Recent decisions provide guidance to future parties as to how the doctrine may affect litigation. This article provides an overview of the *in pari delicto* doctrine in Massachusetts and discusses case law developments since the *Baena* and *Nisselson* decisions. It also identifies potential issues involving the *in pari delicto* doctrine that litigants may encounter.

Basics of the *In Pari Delicto* Doctrine

The *in pari delicto* doctrine has deep roots in Massachusetts law, with the Supreme Judicial Court having invoked it almost 200 years ago.¹ The doctrine is an affirmative and equitable defense that bars plaintiffs from recovering damages resulting from their own misconduct. It applies in cases where (i) the plaintiff bears at least substantially equal responsibility for the wrong for which a remedy is sought; and (ii) preclusion of the suit would not contravene overriding public policy interests. The doctrine serves two purposes: deterring illegality and avoiding entangling courts in disputes between wrongdoers.²

Traditional agency principles play an important role in an *in pari delicto* analysis. Defendants asserting the defense often seek to impute the misconduct of a plaintiff's agent(s) to the plaintiff, especially where the plaintiff is a corporation. A plaintiff, however, may avoid imputation (and defeat *in pari delicto*), if the agent(s) have committed misconduct solely for their own personal benefit, with the classic example

being looting. This is called the “adverse-interest” exception. This exception is not triggered if an agent was acting at least in part to further a plaintiff’s interests.

There is an exception to the adverse-interest exception, namely the “sole-actor” doctrine, which provides that imputation will result, even if the agent has acted adversely to the principal, where the agent and principal are, in essence, one and the same. Put another way, if agents that are effectively in control of a principal, such as a corporation, participated in wrongful conduct, then that conduct will be imputed on the theory that misconduct authorized by controlling agents is, by definition, authorized by the principal. Massachusetts courts have recognized the adverse-interest exception and sole-actor doctrine.³

The *Baena* and *Nisselson* Decisions

In *Baena*, a bankruptcy trustee sued the corporate debtor’s former accounting firm under Chapter 93A, alleging that the auditor knowingly tolerated an improper accounting scheme perpetrated by the debtor’s former management. 453 F.3d 1, 4 (1st Cir. 2006). The auditor moved to dismiss, asserting, among other things, that the Chapter 93A claim was barred by *in pari delicto*. Applying Massachusetts law, the district court dismissed the claim and the First Circuit affirmed. Relying on the trustee’s own allegations that management had fraudulently misstated the debtor’s earnings, the First Circuit imputed management’s misconduct to the debtor and, by extension, the trustee who sued on the debtor’s behalf. The court also ruled that the adverse-interest exception was inapplicable because the alleged fraud benefited the debtor initially by enabling it to use its inflated stock to facilitate stock sales and acquisitions.

The court rejected two public-policy arguments against applying the *in pari delicto* doctrine. First, it rejected the assertion that the *in pari delicto* doctrine should not be applied where recovery was being sought by trustees on behalf of “innocent” parties, such as creditors and shareholders of a bankrupt entity, declining to follow circuits that had adopted such a rule.⁴ The court also refused to limit the defensive use of the doctrine by auditors, stating that any such change to the

doctrine should be left to the Massachusetts legislature or courts.

In *Nisselson*, which involved a similar scenario, the First Circuit reached a similar result. There, another bankruptcy trustee brought federal and Massachusetts state-law claims against various attorneys, financial advisors, and other professionals arising from a stock-for-stock merger that had created the debtor. 469 F.3d 143, 169 (1st Cir. 2006). The trustee alleged that the defendants knew that the debtor’s management had induced the pre-merger entity to agree to the merger using false financial statements, yet assisted in perpetrating the fraud. The First Circuit, again relying on allegations in the trustee’s own complaint, affirmed dismissal of all claims under *in pari delicto*, holding that management’s misconduct could be imputed to the debtor, in whose shoes the trustee stood. The court held that the adverse-interest exception did not apply because the debtor, although it ultimately collapsed, initially benefited financially from the merger. Nor did the court perceive any public policy that militated against *in pari delicto*, concluding that the trustee had brought claims on behalf of a complicit party, not an innocent target of fraud.

The First Circuit in *Nisselson* commented that Massachusetts courts “have warmly embraced the *in pari delicto* defense.” 469 F.3d at 152. To be sure, Massachusetts courts have long recognized the doctrine. But *Nisselson* and *Baena* have further defined its contours. The First Circuit provided guidance on the doctrine’s scope, agency imputation principles, the adverse-interest exception, and what types of public-policy interests may not override the doctrine.⁵

Further, these appear to have been the first decisions where the *in pari delicto* doctrine was used to dispose of Massachusetts claims at the pleadings stage.⁶ The First Circuit ruled that a motion to dismiss may be allowed on the “inevitable success of an affirmative defense,” such as *in pari delicto*, if the facts could be determined from allowable sources and were sufficient to establish the defense “with certitude.” *Nisselson*, 469 F.3d at 150. That *in pari delicto* may involve a fact-intensive inquiry does not preclude its application if that inquiry can be decided on the pleadings.

Heads Up, continued

organization, and a freeze-out period of ninety days after a borrower fails to make a payment during which a lender may not accelerate the debt. Nor may the lender institute foreclosure proceedings until ninety days after notice of default is given to the borrower. The notice must comply with the requirements of the Act. Finally, the Act imposes additional filing requirements on the lender, who must

provide copies of the notice and an affidavit of compliance to the court with any foreclosure complaint, and to the Commissioner of Banks.

Attorneys representing residential mortgage lenders and consumers should be cognizant of these and other recent legal developments and attuned to the current legal climate. ■

Moreover, by affirming the viability of the *in pari delicto* defense at the earliest stage of a lawsuit, the court placed the onus on plaintiffs to avoid pleading facts that could lead to the dismissal of their claims, before any discovery has been taken. This poses obvious problems for bankruptcy trustees of corporate debtors that participated or were utilized in the commission of a fraud. If trustees choose to sue the former management of such debtors, or the professionals who advised management, for fraud or other fraud-based claims, they must satisfy a heightened pleading standard. *See* Fed. R. Civ. P. 9(b); Mass. R. Civ. P. 9(b). After *Baena* and *Nisselson*, plaintiffs must satisfy that standard while simultaneously attempting to plead around the debtor's own culpability, which almost always will be intertwined with that of former management. This may be a difficult course to navigate. As a result, plaintiffs who might otherwise be inclined to sue both a debtor's former management and its former professionals may instead elect to sue only one of these categories of potential defendants.

More Recent *In Pari Delicto* Decisions in Massachusetts

Since *Baena* and *Nisselson*, several Massachusetts state and federal courts have addressed the *in pari delicto* doctrine in varying contexts. These decisions suggest that the doctrine will continue to be an obstacle for trustees and other plaintiffs.

The first decisions addressing *in pari delicto* following *Baena* and *Nisselson* arose out of the "Chapter 22" bankruptcy cases of High Voltage Engineering Corporation ("HVE"), which first filed for Chapter 11 in March 2004 and emerged less than five months later pursuant to a reorganization plan. *See, Gray v. Evercore Restructuring L.P.*, No. 06-11444-RWZ, 2007 WL 3104597 (D. Mass. Sept. 19, 2007); *In re High Voltage Engineering Corp.*, 360 B.R. 369 and 363 B.R. 8 (Bankr. D. Mass. 2007). The reorganized company failed, and HVE filed for bankruptcy a second time, in February 2005, and was subsequently liquidated. Both bankruptcies were filed in Massachusetts.

The trustee in HVE's second bankruptcy, standing in the shoes of HVE, claimed that the company failed because, among other reasons, HVE and certain professionals retained in HVE's bankruptcy case withheld financial projections and other data which showed that its reorganization plan was unfeasible. According to the trustee, the bankruptcy court unwittingly confirmed a reorganization plan that was doomed to fail, resulting in damages to HVE, its creditors and equity holders.

The trustee attacked the former professionals on two fronts. First, he commenced an action in district court, asserting Massachusetts state-law claims for negligence, gross negligence, and breach of fiduciary duty on the basis that the

defendants aided in HVE's misconduct. *See* 2007 WL 3104597, at *2. The district court granted defendants' motions to dismiss and for judgment on the pleadings, holding that the trustee's own complaint was "replete with description of wrongful conduct by the ... Debtors comparable to that attributed to the defendants and, in some cases, carried out jointly." *Id.* at *6. The court rejected the argument that the relative culpability of the parties could not be determined on the pleadings, pointing to a "litany of wrongdoing and complicity" by HVE detailed in the complaint. *Id.* The court also found that applying the *in pari delicto* doctrine did not offend any public policy interests, stating that HVE could not "conspire with third parties to obtain confirmation of a flawed reorganization plan, then enlist the courts . . . to obtain reimbursement from those third parties for the resulting failure of that plan." *Id.* at *9.

The trustee also moved to vacate, pursuant to Fed. R. Civ. 60(b), the bankruptcy court orders allowing compensation for the professionals in the first bankruptcy. In requesting that the compensation be returned, the trustee made substantially the same allegations underlying the district court action. The Massachusetts bankruptcy court which had allowed the compensation orders at issue denied the trustee's motions to vacate on various grounds, including that the relief was barred by *in pari delicto*. In a decision issued without an evidentiary hearing, the court cited the Trustee's own allegations that HVE withheld information from the court, and concluded that the "Trustee, whose claims derive from those of [HVE], bears equal responsibility, by operation of law, for the wrong he now seeks to address." 360 B.R. at 386. The court also found that the public interest would be advanced by *in pari delicto*, in part because of HVE's misconduct.⁷

The Massachusetts Appeals Court has also recently addressed *in pari delicto* in a decision affirming summary judgment for an accounting firm. *AGM Marine Contractors, Inc. v. Canby, Maloney & Co., Inc.*, 71 Mass. App. Ct. 1119 (2008). This case involved three plaintiffs, two corporations and their sole shareholder, who sued their former accounting firm for preparing allegedly false federal tax returns. After the suit was commenced, the plaintiff-shareholder was convicted for filing the false tax returns at issue in the civil case. Following the convictions, the accounting firm amended its answer to add the *in pari delicto* defense and moved successfully for summary judgment.

The appeals court ruled that the convictions "unequivocally established [plaintiff's] illegal behavior" and barred him from any recovery. *Id.* at 1119. The court stated that the plaintiff-shareholder was *in pari delicto* as it could not be shown that "his guilt may be far less in degree than that of his associate [i. e., the accountant] in the offence." The court found no public

policy interests that prevented application of *in pari delicto*, and further held that the misconduct of the shareholder, who was also the sole officer and director of the other two plaintiffs, could be imputed to them under the sole-actor doctrine. Although Massachusetts courts had recognized the sole-actor doctrine in other contexts, *see, supra*, note 3, this was the first Massachusetts state appellate decision to apply that doctrine in the *in pari delicto* context.

The *AGM* decision is noteworthy because it reaffirmed that a court may, on summary judgment, assess the relative culpability of the parties under *in pari delicto*. This means that once a defendant has produced evidence showing that a plaintiff's claims should be barred, the plaintiff must come forward with evidence showing that "his guilt may be far less in degree than that of his associate." *Id.* Thus, as in federal court, the *in pari delicto* defense will not always present a jury question in Massachusetts state courts.

Finally, Judge Gertner has also recently issued an interesting, albeit limited, decision addressing *in pari delicto* in the context of alleged governmental misconduct. *See United States v. Dynamics Research Corp.*, C.A. No. 03-11965-NG, 2008 WL 886035 (D. Mass. Mar. 31, 2008). In this case, the federal government sued one of its defense contractors for, among other things, breach of contract, claiming that the defendant had violated the contract's conflict-of-interest provision. *Id.* at *19. The defendant asserted *in pari delicto*, arguing that the

government failed to protect its interests by not identifying and raising the conflicts issue sooner. The court rejected the defense and granted summary judgment for the government, concluding that it did not bear at least equal fault. It added that the "*in pari delicto* defense should only be applicable, if at all, in cases where government involvement in the conduct underlying the breach is so complete as to negate the other party's wrongdoing." *Id.* at *20. Although apparently limited to breach of contract cases, parties that do business with government agencies should be aware that courts may apply a different *in pari delicto* standard in the event of a dispute with an agency.

Conclusion

The *in pari delicto* doctrine presents a substantial obstacle to bankruptcy trustees and other plaintiffs who are tainted by the wrongdoing they seek to redress. Massachusetts state and federal courts have shown an increasing willingness to apply the doctrine to bar claims. Defendants will continue to invoke the doctrine in seeking dismissal at the pleadings stage. Accordingly, plaintiffs must take care when drafting complaints not to plead their cases away. Plaintiffs should consider, where appropriate, making specific allegations as to the degree of culpability of defendants relative to any wrongdoing committed by the entity allegedly harmed. Plaintiffs may also have to consider forgoing suing certain defendants to avoid triggering application of the doctrine. ■

ENDNOTES

1 *See Inhabitants of Worcester v. Eaton*, 11 Mass. 368, 376-79 (1814) (ruling that conveyance of realty was void under the *in pari delicto* doctrine where the consideration was illegal).

2 The doctrine's full name is *in pari delicto potior est conditio defendentis*, meaning "in a case of equal or mutual fault, the position of the [defending party] is the better one." *Baena v. KPMG LLP*, 453 F.3d 1, 6 n.5 (1st Cir. 2006) (citation omitted).

3 *See, e.g., Demoulas v. Demoulas*, 428 Mass. 555, 584-85 (1998) (sole-actor doctrine); *Sunrise Props., Inc. v. Bacon, Wilson, Ratner, Cohen, Salvage, Fialky & Fitzgerald, P.C.*, 425 Mass. 63, 67 (1997) (adverse-interest exception outside *in pari delicto* context); *AGM Marine Contractors, Inc. v. Canby, Maloney & Co., Inc.*, 71 Mass. App. Ct. 1119, 1119 (2008) (sole-actor doctrine in *in pari delicto* context); *GTE Prods. Corp. v. Broadway Elec. Supply Co., Inc.*, 42 Mass. App. Ct. 293, 299-300 (1997) (adverse-interest exception).

4 *See FDIC v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir. 1995) (because receivers and bankruptcy trustees "do not voluntarily step into the shoes" of a predecessor, defenses based on inequitable conduct do not generally apply to them); *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th

Cir. 1995) ("[T]he defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated.").

5 The First Circuit is not the only court that has had to address the *in pari delicto* doctrine. Recent decisions from other jurisdictions show that courts are being asked to resolve disputes over the contours of the doctrine with increasing frequency. *See, e.g., Official Comm. of Unsecured Creditors v. PricewaterhouseCoopers LLP*, No. 07-1397, at 15 (3d Cir. July 1, 2008) (recognizing that the "contours of *in pari delicto* in Pennsylvania law are not clear" and certifying to the Pennsylvania Supreme Court the questions of whether (1) an agent's fraud should be imputed to the principal when an allegedly non-innocent third-party seeks to invoke imputation to shield itself from liability; and (2) *in pari delicto* can shield accountants who allegedly conspired with a corporation's management to misstate the corporation's financial statements) (unpublished decision); *Rogers v. McDorman*, 521 F.3d 381, 389 (4th Cir. Mar. 18, 2008) (holding that *in pari delicto* is a cognizable defense to a federal civil RICO claim); *Bullmore v. Ernst & Young Cayman Islands*, - N.Y.S.2d -, 2008 WL 2572931, at *3-4 (N.Y. Sup. Ct. June 19, 2008) (holding that liquidators were barred from bringing claims against hedge fund's auditors because the

wrongful conduct of the fund's investment managers was imputable to the fund).

6 Previously, Massachusetts state courts had, at least in reported case law, made an *in pari delicto* finding only following a trial on the merits or on summary judgment. *See, e.g., Arcidi v. Nat'l Assoc. of Gov't Employees, Inc.*, 447 Mass. 616, 620-21 (2006) (reversing summary judgment in favor of plaintiff, and ruling that parties to illegal contract were *in pari delicto* and therefore contract was not enforceable); *Choquette v. Isacoff*, 65 Mass. App. Ct. 1, 5-8 (2005) (affirming summary judgment on *in pari delicto* grounds in favor of attorney who had been sued for malpractice); *cf. Berman v. Coakley*, 243 Mass. 348, 354-55 (1923) (overruling demurrer that had sought dismissal under *in pari delicto*).

7 This decision was affirmed by the district court on other grounds. *See* 379 B.R. 399 (D. Mass. 2007). The trustee has appealed both decisions to the First Circuit. Among the issues to be decided on appeal are whether the district court erred (i) in applying the *in pari delicto* defense, and (ii) in determining, based on the complaint, that HVE bore at least substantially equal responsibility for the misconduct sought to be redressed.