With a rise in the number of discovered Ponzi schemes and bankruptcy filings has come a growth in the number of in pari delicto defenses. Over the past decade, a number of courts have been asked to consider in what circumstances and to what extent an in pari delicto defense should prevail. This article explores two cases that are on opposite sides of the discussion of when in pari delicto should succeed as a defense and discusses the future implications of these decisions.

First-of-a-Kind Victory
Deloitte’s Successful In Pari Delicto Defense in USACM

A recent successful use of in pari delicto as a defense in a fraudulent-transfer adversary occurred in USACM Liquidating Trust and USA Capital Diversified Trust Deed Fund LLC v. Deloitte & Touche LLP, et al. The defendant, Deloitte & Touche, asserted in pari delicto in response to a fraudulent-transfer claim of aiding and abetting a breach of fiduciary duty, asserted by the liquidating trust created by the debtor’s reorganization plan. The trust had the right to enforce the debtor’s causes of action.

Deloitte served as an auditor for USACM, a Nevada corporation that functioned as a mortgage loan originator and loan servicer for its own originated loans. From 1998-2001, Deloitte performed fiscal year-end audits of USACM, providing unqualified audit opinions and certifying that the company’s financial statements were fairly stated. USACM caught the attention of the Nevada Financial Institutions Division, a state regulatory agency, for various deficiencies for which the company was fined in 1999, 2000 and 2001. USACM ultimately filed for bankruptcy in April 2006.

In conjunction with USAIP, a land acquisition holding company, and two investment funds, USACM was run by Thomas Hantges and Joseph Milanowski. Until USACM’s demise, Hantges and Milanowski “never owned less than [83] percent of USACM’s stock.” Hantges and Milanowski regularly transferred large sums of money from USACM to their other entities with neither business reasons to do so nor any benefit to USACM. After USACM filed for bankruptcy, it was discovered that Hantges and Milanowski were operating a Ponzi scheme by using new investor funds to make payments owed to prior investors. When loan defaults became increasingly more frequent and the funds from new investors could not cover payments to lenders, the scheme collapsed.

Deloitte asserted an in pari delicto defense to the fraudulent-transfer claims of the trust. The fraudulent transfers were based on tort claims possessed by the debtor for malpractice and aiding and abetting of Deloitte against the debtor before the debtor company filed for bankruptcy.

Deloitte argued that the trust should not be able to bring a suit as the successor in interest to USACM because the agents’ criminal conduct and knowledge should be imputed to USACM. Therefore, Deloitte claimed that “USACM cannot sue Deloitte for failing to stop USACM from engaging in its own fraudulent conduct.” Bankruptcy law affords a trustee expansive powers executable on behalf of an estate; however, 11 U.S.C. § 541(a) clearly states that the estate is comprised of “all legal or equitable interests of the debtor in property as of the commencement of the case.” As such, the trustee (in this case, the trust) steps into the debtor’s shoes. In moving for summary judgment,
An Inapplicable Defense

Who Is In Pari Delicto? I Don’t See Anyone….14

More than a decade earlier, the Seventh Circuit addressed the in pari delicto defense in Scholes v. Lehmann.15 In this case, a receiver, appointed by the Securities and Exchange Commission (SEC), sued the ex-wife/transferee of a Ponzi scheme. The Ponzi scheme mastermind, Michael Douglas, created multiple corporations that sold general partnership interests between investors and corporations. Earlier investors were paid their promised returns from a new investor cash flow. The scheme was eventually discovered, and the SEC filed suit against the principal of the corporations, requesting the establishment of a receivership.

The receiver proceeded to initiate fraudulent-transfer lawsuits against many insiders and friends of Douglas and eventually met with a defense of in pari delicto in the Lehmann case. The defense argued that the receiver lacked standing to bring suit for the fraudulent transfer because it only possessed the interests that the company would have otherwise had to sue on the company’s own tort claims on the company’s behalf. The defense added that there was no way that the transfers, for which the trustee was suing, could have hurt the debtor because the debtor was one in the same as Douglas, and he orchestrated the transfers and owned all of the stock. In sharp contrast to the Nevada District Court, the Seventh Circuit rejected the defendant’s in pari delicto argument, framing the type of fraudulent-transfer action at issue differently. The court categorized the action as one being asserted by the receiver on behalf not of the debtor, but of the creditors who would have otherwise had actions for fraudulent transfers against the transferees. It further explained that once the receiver was appointed, Douglas was stripped of control and beneficial interest, and “the corporations were no more Douglas’ evil zombies.”16 The court reasoned that because in pari delicto serves no purpose when the person who would have been in pari delicto is removed from the situation, the defense failed.

Where Do We Go from Here? Will USACM Survive on Appeal?

The trustee has appealed the district court’s application of the in pari delicto defense in USACM.17 The case is currently pending before the Ninth Circuit. While scholars and practitioners speculate that the implications of the USACM decision may be far-reaching and detrimental to trustees in the area of fraudulent-transfer law, this assertion may be overstating the consequences of the case. In order to effectively use in pari delicto as a defense, a defendant must be able to not only impute the bad acts, but also prove that debtor was, at the very least, equally responsible for the fraudulent acts.

The facts in USACM lend themselves well to this defense because imputation in a situation where a closely-held business that was run by its shareholders who also happen to compose the majority of the board of directors and management leaves no other line of defense between the actors and the principal company. Therefore, the line between actor and principal is transparent. This transparency adds strength to the district court’s conclusion that the sole-relevant-actor exception did not apply. Furthermore, the actor’s intentional creation and continued maintenance of a Ponzi scheme far outweighed Deloitte’s professional malpractice and any purported aiding and abetting in which they may have participated. This reasoning is especially important in this “type” of fraudulent-transfer case because these were tort actions on behalf of the debtor company for damages caused to the debtor company by the party being sued.

An evaluation of the Seventh Circuit’s analysis in Scholes demonstrates that the analysis of in pari delicto will always be fact-intensive in nature. Yet, the facts of the two cases are very similar. The debtor-company in USACM was a closely-held corporation being used for a Ponzi scheme masterminded by the very persons who owned the company, as was the company in the Seventh Circuit case that was placed into receivership by the SEC, yet the two courts came out on different sides of the coin when presented with similar in pari delicto defenses. Notably, however, the line between agent and principal in the Seventh Circuit case was sharply drawn, making the distinction between the two unmistakably clear.

Depending on how the Ninth Circuit rules in the USACM appeal, a seemingly sharp divide may be seen to split fraudulent-transfer claims into two distinct categories: those claims that a trustee inherits from the debtor, tort or contract claims where the debtor was wronged by a defendant, and those that a trustee brings on behalf of creditors victimized by the fraudulent displacement of assets to transferees that usually turn out to be insiders.

Conclusion
Will In Pari Delicto Become the New Defense Rule?

There are hundreds of fraudulent-transfer actions pending in connection with the Bernard Madoff Ponzi scheme, so is the trustee about to be overrun with in pari delicto defenses from every direction? While some practitioners may now view this as the first defense to be asserted in fraudulent-transfer actions, the viability of this defense looks to be limited by the type of fraudulent-transfer action at hand.