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***In Pari Delicto* Doctrine May Bar  
Receiver's Third-Party Claims  
*Knauer v. Jonathon Roberts, Inc., et al.***

Reynolds B. Brissenden, IV\*

INTRODUCTION

A general understanding exists among bankruptcy and commercial lawyers that the doctrine of *in pari delicto*<sup>1</sup> is applicable as a defense against third-party claims asserted by trustees in corporate bankruptcy cases but is not applicable as a defense against third-party claims asserted by receivers in corporate receivership cases. This general understanding stemming from the Heartland Financial Services, Inc. receivership.

In the wake of recent mass fraud bankruptcies (e.g., Enron and Worldcom) where third-party advisors have allegedly participated in or passively failed to discover and/or disclose management's fraudulent activity, a number of articles have recently been published calling upon federal courts in bankruptcy cases to adopt the same rationale followed in receivership cases for not applying the doctrine of *in pari delicto*.<sup>2</sup> One such receivership case commonly cited and discussed is the Seventh Circuit Court of Appeal's decision of *Scholes v. Lehman*.<sup>3</sup> However, the Seventh Circuit in the case of *Knauer v. Jonathon Rob-*

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1. The defense of *in pari delicto* refers to "equal fault or guilt". BLACK'S LAW DICTIONARY 791 (6th ed. 1990). With the merger of law and equity, the doctrine of *in pari delicto* is a "counterpart" of the equitable defense of unclean hands, which "forbade a plaintiff to recover damages if his fault was equal to the defendant's." *Byron v. Clay*, 867 F.2d 1049, 1052 (7th Cir. 1989). The *in pari delicto* maxim is closely related and considered a corollary of the unclean hands maxim. 27A Am.Jur.2d, Equity § 132, citing, *Morrissey v. Bologna*, 123 So.2d 537 (Miss. 1960).

2. Tanvir Alam, *Fraudulent Advisors Exploit Confusion In The Bankruptcy Code: How In Pari Delicto Has Been Perverted To Prevent Recovery for Innocent Creditors*, 77 AM. BANKR. L.J. 305 (2003); *Making Sense of the In Pari Delicto Defense: "Who's Zoomin' Who?"* 23 NO.11 BANKR. L. LETTER 1 (Nov. 2003); Jordan A. Kroop, *A Ponzi Scheme And A "Pointless Technicality"*, 2 Am. Bankr. Inst. J. 26 (2002).

3. *Scholes v. Lehman*, 56 F.3d 750 (7th Cir. 1995).

erts, Inc.,<sup>4</sup> revisited the issue and significantly limited the approach previously followed by the court in *Scholes*. The approach followed by the court in *Knauer* lessens the legal significance of the appointment of a receiver in relation to the *in pari delicto* doctrine, limiting a receiver's ability to pursue certain third-party claims.

The *Knauer* and *Scholes* decisions involved litigation arising from the operation of Ponzi schemes<sup>5</sup> and fraudulent misconduct by the principals of corporations causing injury to the business entities themselves and to creditors. However, the *Knauer* decision leaves no remedy for injuries caused to a corporate entity, particularly where the claims asserted by the receiver are found to belong to the corporate entity and thus the receiver and not the creditors of the receivership estate, i.e., the investors. Thus, third-party defendants are able to assert the defense as a shield to escape liability, producing an inequitable result.

This Article seeks to put the Seventh Circuit's decision in context. It provides an overview of pertinent bankruptcy and receivership decisions leading up to the *Knauer* decision. It describes the factual and procedural history of *Knauer* and examines the Seventh Circuit's rationale. Finally, the Article examines other court decisions in receivership cases following the *Knauer* decision. Thus it seeks to explore some of the consequences of the *Knauer* decision upon the applicability of the *in pari delicto* doctrine in the context of receivership cases.

#### OVERVIEW OF *IN PARI DELICTO* DOCTRINE IN BANKRUPTCY CASES

Federal courts addressing the *in pari delicto* doctrine in the context of bankruptcy cases recognize the distinction between equitable receivership law and federal bankruptcy law mandating different treatment of the *in pari delicto* defense in the bankruptcy context.<sup>6</sup>

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4. *Knauer v. Jonathon Roberts, Inc., et al.* 348 F.3d 230 (7th Cir. 2003).

5. "A Ponzi scheme involves individuals, . . . who convince investors to purchase interests in phony or unprofitable investment schemes, paying off old investors with the money obtained from new investors." *United States v. Frykholm*, 267 F.3d 604, n.1 (7th Cir. 2001). "The term 'Ponzi Scheme' is derived from Charles Ponzi, a famous Boston swindler. With a capital of \$150, Ponzi began to borrow money on his own promissory notes at a 50% rate of interest payable in 90 days. Ponzi collected nearly \$10 million in 8 months beginning in 1919, using the funds of new investors to pay off those whose notes had come due." *United States v. Masten*, 170 F.3d 790, 797 n.9 (7th Cir. 1999).

6. *Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, 322 F.3d 147 (2d. Cir. 2003); *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3rd Cir. 2001); *In re Dublin Securities, Inc.*, 133 F.3d 377 (6th Cir. 1997); *In re: Hedged-Investments Assocs., Inc.*, 84 F.3d 1281 (10th Cir. 1996); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085 (2d. Cir. 1995); *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114 (2d. Cir. 1991); *In re Donahue Sec., Inc.*, 304 B.R. 797 (S.D. Ohio 2003).

The Third Circuit's opinion in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*,<sup>7</sup> clearly illustrates the distinction drawn by the courts. In *R.F. Lafferty*, litigation arose from the misconduct of wrongdoers who used corporate entities as tools to conduct a Ponzi scheme.<sup>8</sup> Two principal wrongdoers, William Shapiro and Kenneth Shapiro controlled and operated two equipment leasing companies.<sup>9</sup> The Shapiros, together with the assistance of legal counsel, brokers, and underwriters, fraudulently mismanaged their companies and expanded the corporations' debt out of proportion with its ability to pay, resulting in the deepening insolvency of the corporations.<sup>10</sup> The principal wrongdoers sought bankruptcy relief for the two corporate entities under Chapter 11 of the U.S. Bankruptcy Code.<sup>11</sup> Thereafter, a trustee was appointed and by stipulation, an official committee of unsecured creditors ("Committee") was formed and authorized to pursue claims on behalf of the bankrupt corporations.<sup>12</sup>

In turn, the Committee filed suit against the principal wrongdoers as well as the corporations' brokers, underwriters and accountants ("third-parties") alleging violations of the Securities & Exchange Act, and asserting state law claims of breach of contract, misrepresentation, negligence, and breach of fiduciary duty.<sup>13</sup> In response, the third-parties filed motions to dismiss contending the Committee's claims were barred by the doctrine of *in pari delicto*.<sup>14</sup> The district court stated that the Committee – analogous to a trustee—did not rise above defenses that are available against the debtor corporations.<sup>15</sup> The district court relied upon prior federal court decisions in bankruptcy cases for the principle that in bankruptcy cases the property of the estate is defined within section 541(a)(1) of the Bankruptcy Code

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7. *R.F. Lafferty*, 267 F.3d at 340.

8. *Id.*

9. *Id.*

10. *Id.*

11. *Id.*

12. *R.F. Lafferty*, 267 F.3d at 345. Under the stipulation, the Committee effectively acquired all the attributes of a bankruptcy trustee. *Id.*

13. *Id.* at 346.

14. *In re Walnut Leasing Co., Inc.*, 1999 WL 729267 at \*2 (E.D. Pa. Sept. 8, 1999). The defendants in their motions to dismiss also argued that the Committee lacked standing in that it was not the corporations that were injured but rather the creditors of the estate and that the claims being asserted belonged to the creditors not the bankrupt corporations. The District Court however found the injury, i.e., the deepening insolvency, to be a cognizable injury to corporate debtors rather than to creditors, thus the corporations and not the creditors had standing to pursue the claims asserted.

15. *Id.* at \*4 (citing, *Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1154 and n.7 (3rd Cir. 1989)).

as “all legal and equitable interests of the debtor as of the commencement of the case”, which includes causes of action”.<sup>16</sup> Therefore, the “estate’s rights are no stronger than they were when actually held by the debtors.”<sup>17</sup>

The district court went on to point out the distinction of the applicability of the *in pari delicto* doctrine to bar third-party claims asserted by trustees in bankruptcy cases and its non-applicability in receivership cases.<sup>18</sup> The court stated, “The Committee is not analogous to a receiver or liquidator, for which reasons this case is distinguishable from the cases that hold a receiver is not subject to defenses based on inequitable conduct or unclean hands.”<sup>19</sup> Therefore, the district court concluded that since the complaint alleged that the corporations, acting through the principal wrongdoers, perpetrated the Ponzi scheme with the assistance of the brokers, underwriters and accountants that the doctrine of *in pari delicto* barred the Committee from asserting third-party claims.<sup>20</sup>

On appeal, the Third Circuit addressed both the standing of the Committee to assert third-party claims and the application of the *in pari delicto* doctrine. The court first confirmed that the corporations, although used by the principal wrongdoers as tools to commit a fraud, nonetheless maintained an identity separate from the wrongdoers which may have suffered a distinct and separate injury which could not be ruled out at the motion to dismiss stage.<sup>21</sup> The Third Circuit next examined the issue of *in pari delicto*. The Third Circuit set forth a two step analysis: first, whether the court could consider post-petition events that may affect an equitable defense (the appointment of a trustee after the petition for bankruptcy was filed) and second, whether the misconduct by the wrongdoers should in fact be imputed to the corporations such that the doctrine of *in pari delicto* bars the Committee’s claims.<sup>22</sup>

In relation to the first step, the Committee argued that its status as an innocent successor justified not applying the doctrine since the fact of bankruptcy and the resulting removal of the wrongdoers from management of the corporations prevented bad actors from benefiting

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16. *In re Walnut Leasing* 1999 WL 729267 at \*4.

17. *Id.* (quoting, *In re Hedged-Investments*, 84 F.3d 1281, 1285 (10th Cir. 1996)).

18. *Id.*

19. *Id.*; citing, *Fed. Deposit Ins. Corp. v. O’Melveny & Myers*, 61 F.3d 17, 18 (9th Cir. 1995); See, e.g., *In re Hedged-Investments*, 84 F.3d at 1284, n.5.

20. *In Re Walnut Leasing*, 1999 WL 729267 at \*5.

21. *R.F. Lafferty*, 267 F.3d at 354.

22. *Id.* at 354-355.

from any recovery by the corporations.<sup>23</sup> However, the Third Circuit noted that in bankruptcy cases, section 541 of Chapter 11 of the Bankruptcy Code governs such claims and directs courts to evaluate defenses as they existed at the commencement of the bankruptcy.<sup>24</sup> The court concluded that the plain language of section 541 prevented courts from taking into account post-petition events and therefore the *in pari delicto* doctrine was applicable to the third-party claims asserted by the Committee.<sup>25</sup> In response to the Committee's citation to and reliance upon principles followed in receivership cases, the Third Circuit clearly drew the distinction between bankruptcy cases and receivership case:

We certainly acknowledge that, in the receivership context, several courts have declined to apply *in pari delicto* to bar the receiver from asserting the claims of an insolvent corporation on the ground that application of the doctrine to an innocent successor would be inequitable. These courts have thought it proper to consider events arising after a corporation enters into receivership. . . These cases are easily distinguishable, however; unlike bankruptcy trustees, receivers are not subject to the limits of section 541.<sup>26</sup>

Examining the second step of its analysis, the Third Circuit found that the fraudulent conduct of the principal wrongdoers could be imputed to the corporations.<sup>27</sup> This is due to the fact the wrongdoers perpetrated the fraud in the course of their employment and since, even though the wrongdoers acted adversely to the interests of the corporations, they were the sole actors engaged in the alleged wrongdoing.<sup>28</sup> Thus, the court affirmed dismissal of the third-party claims.<sup>29</sup>

In the dissenting opinion, Justice Cowen expressed his disagreement with the majority's view of the distinction between bankruptcy cases and receivership cases.<sup>30</sup> He called their decision not to follow the reasoning set forth in receivership case and not to consider post-petition events due to the language of section 541(a) a "pointless technicality".<sup>31</sup>

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23. *Id.* at 355-356.

24. *Id.* at 356.

25. *Id.* at 357.

26. *R.F. Lafferty*, 267 F.3d at 358.

27. *Id.* at 360.

28. *Id.*

29. *Id.*

30. *Id.* at 362.

31. *R.F. Lafferty*, 267 F.3d at 358.

OVERVIEW OF *IN PARI DELICTO* DOCTRINE IN  
RECEIVERSHIP CASES

Federal courts addressing the *in pari delicto* doctrine in the context of receivership cases have declined to apply the *in pari delicto* doctrine to bar a receiver from asserting claims of an insolvent corporation.<sup>32</sup> In *Scholes v. Lehman*, the wrongdoer created three corporations for orchestrating a Ponzi scheme, raising \$30 million from investors.<sup>33</sup> Following the appointment of a receiver to the corporations, the receiver pursued state law claims of fraudulent-conveyance against third-party defendants including the wrongdoer's ex-wife, charities and one investor who received "profits" from the corporations.<sup>34</sup> The third-party defendants raised the *in pari delicto* defense in response to the receiver's efforts to recover assets fraudulently conveyed to them through the Ponzi scheme, arguing the receiver's claims were barred.<sup>35</sup> The Seventh Circuit however reasoned:

That although injured by [the wrongdoer], the corporations would not be heard to complain as long as they were controlled by him, not only because he would not permit them to complain but also because of their deep, their utter, complicity in [the wrongdoer's] fraud.<sup>36</sup>

The court further explained the legal significance of the appointment of a receiver in relation to the *in pari delicto* doctrine:

. . .the wrongdoer must not be allowed to profit from his wrong. . .[but] [t]hat reason falls out now that [the wrongdoer] has been ousted from control of and beneficial interest in the corporations. The appointment of the receiver removed the wrongdoer from the scene. The corporations were no more [the wrongdoer's] evil zombies. Freed from the spell, they became entitled to the return of the moneys – for the benefit not of [the wrongdoer] but of innocent investors. . .

32. *Scholes*, 56 F.3d 750; *Fed. Deposit Ins. Corp. v. O'Melveny & Myers*, 61 F.3d 17 (9th Cir. 1995); *Hannover Corp. of Am. v. Beckner*, 211 B.R. 849 (M.D. La. 1997).

33. *Scholes*, 56 F.3d at 754.

34. *Id.*

35. *Id.* (The third-party defendants in their motion to dismiss also argued the receiver lacked standing in that it was not the corporations that were injured but rather the creditors of the estate and that the claims being asserted belong to the creditors not the corporations. The Seventh Circuit rejected this argument as follows: "The answer — so far as the corporations are concerned, and we need go no further — turns out to be straightforward. The corporations, [the wrongdoer's] robotic tools, were nevertheless in the eyes of the law separate legal entities with rights and duties. They received money from unsuspecting, if perhaps greedy and foolish investors. That money should have been used for the stated purpose of the corporation. . . Instead [the wrongdoer] caused the corporation to pay out the money they received to himself, his ex-wife, his favorite charities, and an investor. . . ." The court concluded that such transfers by the principal from the entities for an unauthorized purpose injured the corporations).

36. *Id.* at 754-755.

Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated. . . .

The court concluded that now that the corporations which were created and initially controlled by the wrongdoer are controlled by a receiver whose object is to maximize the value of the corporations for the benefit of their investors and any creditors, we cannot see an objection to the receiver bringing suit to recover corporate assets unlawfully dissipated by [the wrongdoer].<sup>37</sup>

The Seventh Circuit concluded that the *in pari delicto* defense was not applicable against the receiver since the wrongdoer who had previously controlled the receivership entity had been removed.<sup>38</sup> The appointment of a receiver removed the wrongdoer from the scene.<sup>39</sup> Therefore, the wrongdoer will not profit from any recovery by the receiver asserting the claims.<sup>40</sup>

The Ninth Circuit has likewise held the equitable defense based on a party's unclean hands does not apply against a receiver.<sup>41</sup> In *Fed. Deposit Ins. Corp. v. O'Melveny & Myers*, the Federal Deposit Insurance Corporation ("FDIC") as receiver for a failed savings and loan ("S&L"), sued the former counsel of the S&L for legal malpractice and breach of fiduciary duty. The former counsel raised the equitable defense of *in pari delicto* and argued that the receiver was barred from bringing claims against third parties due to the entity's unclean hands.

The Ninth Circuit held that the receiver was not barred by the *in pari delicto* doctrine from asserting claims against third-parties.<sup>42</sup> The Ninth Circuit recognized the general rule that, "a receiver occupies no better position than that which was occupied by the person or party for whom he acts and any defense good against the original party is good against the receiver."<sup>43</sup> The Ninth Circuit went on to state however, that this general rule is subject to exceptions including, "defenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver."<sup>44</sup> The Ninth Circuit further noted that, while a party may itself be denied a right or defense on account of its misdeeds, there is little reason to impose the same

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37. *Id.* at 755.

38. *Id.* at 754-755.

39. *Scholes*, 56 F.3d at 754-755.

40. *Id.*

41. *Fed. Deposit Ins. Corp. v. O'Melveny & Myers*, 61 F.3d 17 (9th Cir. 1995).

42. *Id.* at 19.

43. *Id.*, citing *Allen v. Ramsay*, 179 Cal. App. 2d 843, 854 (1960).

44. *Id.*



punishment on a receiver that steps into the party's shoes pursuant to a court order.<sup>45</sup> The court explained:

A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the [entity]; it is thrust into those shoes. It was neither a party to the original inequitable conduct nor is it in position to take action prior to assuming the [entity's] assets to cure any associated defects or force the [entity] to pay for incurable defects.<sup>46</sup>

Moreover, the Ninth Circuit reasoned that to hold otherwise would allow the opposing party to enjoy a windfall.<sup>47</sup> The Ninth Circuit concluded:

In light of these considerations, we conclude that the equities between a party asserting an equitable defense and a[n entity not in receivership] are at such variance with the equities between the party and a receiver of the [entity] that equitable defenses good against the [entity] should not be available against the receiver. To hold otherwise would be to elevate form over substance—something courts sitting in equity traditionally will not do.<sup>48</sup>

The non-applicability of the *in pari delicto defense* in receivership cases as opposed to bankruptcy cases has also been discussed in the case of *Hannover Corp. of America v. Beckner*.<sup>49</sup> In *Beckner*, litigation arose from an underlying SEC enforcement action brought against the plaintiff corporations and two wrongdoers.<sup>50</sup> During the course of the SEC's case, the U.S. District Court, Eastern District of Louisiana, appointed a receiver on behalf of the corporations.<sup>51</sup>

Two months after the receiver was appointed, the receiver petitioned for bankruptcy protection in the U.S. Bankruptcy Court for the Middle District of Louisiana and the corporations became debtors-in-possession pursuant to a liquidating plan of reorganization with the receiver also acting as the administrator of the debtors-in-possession.<sup>52</sup> The corporations acting through their appointed receiver filed suit against the corporations' counsel and law firm as well as their malpractice insurance carrier, alleging inter alia negligence and malpractice.<sup>53</sup>

45. *Id.*

46. *Fed. Deposit Ins. Corp.*, 61 F.3d at 19.

47. *Id.*

48. *Id.*

49. *Hannover Corp. of Am. v. Beckner*, 211 B.R. 849 (M.D. La. 1997).

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

In response, defendants filed motions to dismiss arguing the claims were barred by the doctrine of *in pari delicto*. However, the *Beckner* court rejected the defendant's argument holding that the doctrine of *in pari delicto* did not bar the receiver's claims.<sup>54</sup> Rather, the court found the Seventh Circuit's reasoning in *Scholes* "highly persuasive, both for its legal logic and common sense approach."<sup>55</sup> The court stated:

Specifically, the [Seventh Circuit] court looked at the rationale underlying the *in pari delicto* doctrine B that the wrongdoer must not be allowed to profit from his wrong by recovering property that he had parted with in order to thwart his creditors. The [Seventh Circuit] court noted that this reason for *in pari delicto* defense vanished upon the appointment of the receiver and removal of the wrongdoer from control and beneficial interest in the corporations.<sup>56</sup>

The court further rejected defendants' reliance upon the bankruptcy case, *In re Hedged Investments Associates, Inc.*<sup>57</sup> and distinguished the case on the basis of the appointment of a receiver rather than a bankruptcy trustee.<sup>58</sup> Although the corporations entered into bankruptcy, a receiver was appointed before the corporations filed for bankruptcy protection.<sup>59</sup> Therefore, the corporations were freed from the wrongdoers when they filed bankruptcy and were not subject to the sting of the *in pari delicto* doctrine upon the commencement of the bankruptcy proceedings.<sup>60</sup>

#### THE FACTS OF *KNAUER V. JONATHON ROBERTS, INC., ET. AL.*

Heartland Financial Services, Inc. ("Heartland") was founded by Kenneth R. Payne ("Payne") in January 1991 as a brokerage, insurance and estate planning firm. Payne was Heartland's president and

54. *Hannover*, 211 B.R. at 852.

55. *Id.* at 858.

56. *Id.*

57. The Tenth Circuit in the *Hedged Investments* case also noted the distinction between the applicability of the *in pari delicto* doctrine in the receivership context vis-a-vis the bankruptcy context and specifically approved of the Seventh Circuit's reasoning in the *Scholes* case stating:

[The trustee] asks us to apply the "evil zombie" rule announced in *Scholes* to this case. Now that the partnership represented by the [trustee] is free of [the wrongdoer] and [the entities'] evil spell, misrepresentations to Defendant are no longer relevant. Though the Seventh Circuit's reasoning in *Scholes* enjoys a certain appeal, both from doctrinal and public policy perspectives, we cannot adopt it in this case. Put most simply, [a trustee] is a bankruptcy trustee acting under 11 U.S.C. § 541, and bankruptcy law, apparently unlike the law of receivership, expressly prohibits the result [the trustee] urges.

*In re Hedged-Investments Assocs., Inc.*, 84 F.3d 1281 (10th Cir. 1996).

58. *Id.*

59. *Id.* at 859.

60. *Id.*

Daniel Danker ("Danker") was its vice-president. Heartland was not registered with the SEC. Payne and Danker were licensed securities brokers. At various times from 1996 to 2000, several different broker dealers held their licenses making Payne and Danker registered securities representatives of the firms. As a result, Payne and Danker had the ability to represent to investors they were members of the National Association of Securities Dealers ("NASD") and the investments were protected by Securities Investors Protection Corporation ("SIPC").

For several years, Payne and Danker operated Heartland as a legitimate firm. However, commencing in 1994, and continuing through August, 2001, Payne and Danker, directly and indirectly, through Heartland and other affiliated companies engaged in a massive, fraudulent Ponzi scheme whereby they held themselves out as licensed registered securities representatives and induced investors to invest millions of dollars through the fraudulent sale of securities. Investors were told that their investments would be used to purchase securities and were promised a high rate of return.

Though a nominal amount of investor funds were used to purchase securities, most of the investments were never made. Rather, the investors' money was used to perpetuate the Ponzi scheme and/or pay the personal and business expenses of Payne, Danker and Heartland. Payne and Danker wrongfully converted the funds to their own use and personal benefit or to that of others. Meanwhile, investors were sent fraudulent confirmations and monthly statements on Heartland letterhead and/or that of the affiliated company which indicated the investments were earning high rates of return.

By 1998, Heartland purportedly had over 700 clients and approximately \$22.6 million in assets (investor funds). From at least January 1998 through August 2000, Payne and Danker raised another \$29.1 million from at least 330 investors. Additionally, from December 1997 through at least December 1999, Payne and Danker raised at least another \$18.5 million from at least 257 investors through an affiliated company.

In the end, Payne and Danker collected in excess of \$60 million dollars from investors. Danker has been convicted of wire fraud and money laundering. Payne has been convicted of mail fraud and money laundering. Both were sentenced to lengthy prison sentences.

*THE HISTORY OF KNAUER V. JONATHON ROBERTS, INC., ET. AL.*

On August 10, 2000, the SEC instigated an action in the Southern district court of Indiana against Payne, Danker and Heartland. As a

part of the proceedings, the district court removed Payne and Danker from control of Heartland and appointed James Knauer receiver. Thereafter, on August 10, 2001, Knauer filed his complaint against the brokerage firms who held the security licenses of Payne and Danker at various times, asserting various state law claims. The claims asserted included negligent hiring, negligent supervision and monitoring of Payne and Danker and for fraud and conversion based on the brokerage firm's liability for the actions of their registered agents. The receiver asserted that the brokerage firm's actions or failure to act caused direct injury to Heartland and permitted millions of dollars to be misappropriated from Heartland.

In response, the brokerage firms filed motions to dismiss asserting, inter alia, the receiver lacked standing to assert the claims and the claims were barred by the doctrine of *in pari delicto*.<sup>61</sup> In support of their argument, the brokerage firms primarily relied upon bankruptcy case law.

The district court agreed that the receiver had alleged injury to Heartland and that the claims brought by the receiver against the brokerage firms belonged solely to the receiver and not to the investors in Heartland.<sup>62</sup> However, the district court ruled that the doctrine of *in pari delicto* barred the receiver's claims.<sup>63</sup> The district court, rather than focusing on whether the equitable defense was applicable post-appointment of the receiver after the wrongdoers were removed from the scene, focused upon whether the wrongful conduct could be imputed to Heartland, citing *R.F. Lafferty*<sup>64</sup> The court noted the complaint expressly alleged that Heartland participated in the scheme and had knowledge of the fraudulent activities, thereby proceeding to find the claims were barred by the doctrine of *in pari delicto*.<sup>65</sup> The district court distinguished the *Scholes* decision on the basis that the receiver in *Scholes* was asserting a fraudulent conveyance claim rather than state tort law claims.<sup>66</sup>

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61. Keeping in mind the *in pari delicto* doctrine is an affirmative defense and generally dependent upon the facts, a court may nevertheless address the issue in a motion to dismiss, pursuant to FED. R. CIV. P. 12(b)(6) where the allegations of the complaint are taken as true, and the complaint provides sufficient allegations of fact for the court to perform an equitable balancing test. However, in cases where less factual detail is alleged in the complaint, a court will probably leave the issue to be addressed in a motion for summary judgment.

62. Knauer v. Jonathon Roberts, Inc., et. al., 2002 WL 31431484 at \*7 (S.D. Ind. Sept. 30, 2000).

63. *Id.* at \*7-8.

64. *Id.*

65. *Id.* at \*8.

66. *Id.*

On appeal, the receiver argued the district court improperly failed to apply the reasoning of *Scholes* and other receivership case law and dismissed the claims based solely upon the application of the *in pari delicto* doctrine in the context of a corporate receivership. The receiver also contended the district court chose to base its decision upon bankruptcy case law, overlooking a clear distinction between the application of the *in pari delicto* doctrine in bankruptcy cases versus receivership cases.

#### THE SEVENTH CIRCUIT'S DECISION

In *Knauer v. Johnathan Roberts, Inc.*, the Seventh Circuit held the doctrine of *in pari delicto* barred the receiver's third-party claims against the brokerage firms.<sup>67</sup> Surprisingly, the court re-examined the teachings of *Scholes* and reined in the breadth of its earlier decision. The court determined that while *Scholes* may recommend a "generous approach" toward certain lawsuits brought by corporate receivers, even where the corporation has been complicit in the misconduct, the court would look to state law to provide context to *Scholes*.<sup>68</sup> Yet, the court recognized that no Indiana case law had addressed the issue.<sup>69</sup>

Nevertheless, the court cited a decision by the Indiana Supreme Court from 1908 indicating the general rule in an "ordinary" receivership is that the receiver can only sue in the right of the corporation, which subjects him to all of the equities which would have been available against the corporation.<sup>70</sup> However, in a "non-ordinary" receivership (i.e., one involving fraud – and perhaps one such as this where a Ponzi scheme raised \$60 million from investors) the general rule that a receivership stands in the shoes of the corporation is subject to an exception.<sup>71</sup> The exception is that the receiver may pursue claims or defend claims in some circumstances where the corporation might have been estopped by its own fraud.<sup>72</sup> One such circumstance involves allowing receivers to avoid transactions which constitute fraudulent conveyances and violate the rights of creditors, like the claims asserted in the *Scholes* case.<sup>73</sup>

But the *Knauer* court lost sight of the type of receivership involved and the legal significance of appointing a receiver in relation to the *in*

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67. 348 F.3d 230 (7th Cir. 2003).

68. *Id.* at 235.

69. *Id.*

70. *Id.* at 236 (citing, *Marion Trust Co. v. Blish*, 170 Ind. 686, 84 N.E. 814, 816 (1908)).

71. *Id.*

72. *Knauer*, 348 F.3d at 236 (citing, 7 INDIANA LAW ENCYCLOPEDIA *Corporations* §181).

73. *Id.* (citing, *Hamond v. Cline*, 170 Ind. 452, 84 N.E. 827, 828 (1908)).

*pari delicto* doctrine. Instead the court focused its analysis upon the type of third-party claims being asserted (fraudulent conveyance or tort claims) by the receiver and proceeded to limit the teachings of the *Scholes* decision. The court drew the line at fraudulent conveyance claims against third-parties stating, “If the case before us involved the voiding of a fraudulent conveyance, as in *Scholes* or the Indiana cases just cited, we would likely apply *Scholes*. . . This case, however, presents a different equitable alignment. The key difference, for purposes of equity. . . is the identity of the defendants.”<sup>74</sup>

The court then proceeded to engage in an “equitable balancing test,” considering various factors, including the identity of the parties. The court found as a matter of fact, based upon the allegations of the complaint, that the brokerage firms derived no benefit from diversion of funds but were allegedly partly to blame for their occurrence.<sup>75</sup> The court next found that Heartland and JMS (an affiliated entity) were charged with fault at least equal to that of the broker dealers, and were very much at the forefront of the Ponzi scheme.”<sup>76</sup> The court noted, “[i]n sum, all of the liability, according to the complaint, arises from the employment or agency relationship between the broker dealer defendants and Payne and Danker”.<sup>77</sup> The court reasoned that had the broker dealers been directly involved in the embezzlements, or attained some tangible benefit from them, this would be a different case.<sup>78</sup> “The basic equity is that a broker dealer, which apparently had little to do with the Ponzi scheme, should not be liable to Heartland, which was deeply complicit in the crimes.”<sup>79</sup>

The court recognized its teachings in *Scholes* as true; that the appointment of a receiver removes the wrongdoer from control of the corporation and from the scene, and separates the receiver from the wrongdoer’s past crimes.<sup>80</sup> However, the court limited *Scholes*, reasoning the “extent of the separation” is an equitable determination.<sup>81</sup> Despite the appointment of a receiver, the court found as a matter of fact that the relationship or “nexus” between the wrongdoers and the corporate entities was far more immediate than the relationship between the wrongdoers and the brokerage firms.<sup>82</sup> Therefore, the court

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74. *Id.*

75. *Id.*

76. *Id.* at 237.

77. *Knauer*, 348 F.3d at 237.

78. *Id.*, at n.6.

79. *Id.*

80. *Id.* at 238.

81. *Id.*

82. *Knauer*, 348 F.3d at 238.

concluded the broker dealers should not be deprived of the defense of *in pari delicto*.<sup>83</sup>

The court's opinion alters the general understanding that the *in pari delicto* doctrine does apply in bankruptcy cases and does not apply in receivership cases. The *Knauer* decision indicates that in receivership cases, determining whether the *in pari delicto* doctrine applies is not based solely upon the doctrine's underlying rationale. Rather, courts may also perform an "equitable balancing test," considering the context in which the defense is being applied and such factors as (1) the types of third-party claims being asserted by the receiver (fraudulent conveyance claims to recover assets versus tort claims for injury to the corporate entity), (2) the role of the third-party defendants in the Ponzi scheme in relation to the corporate entity (direct, active participation versus passive conduct or a failure to act), (3) the benefit, if any, received by the defendants from the Ponzi scheme and, (4) the extent of separation between the wrongdoers and the corporate entities compared to the third-party defendants.

By focusing on these factors, the court lost sight of the underlying rationale of the *in pari delicto* doctrine and the legal significance of appointing a receiver over a corporate entity. The appointment of a receiver removes the wrongdoer from control of the corporation, thus preventing the wrongdoer from profiting or recovering from claims asserted by the receiver against third-parties. Limiting the reasoning in *Scholes* to fraudulent conveyance claims also overlooks the rationale for allowing receivers appointed in "non-ordinary" receiverships to pursue fraudulent conveyance claims. When pursuing third-party claims which belong to the corporate entities in "non-ordinary" receiverships involving fraud, a receiver should not be subject to the same defenses applicable to the corporate entities, pre-appointment.

The court also lessened the legal significance of the appointment of a receiver by focusing on the "extent of the separation" between the wrongdoers and the corporate entities, compared to that between the wrongdoers and third-party defendants. This factor alone will in most, if not all, receivership cases where corporate entities are used as tools in carrying out Ponzi schemes, weigh in favor of the third-party defendant since the wrongdoers are typically controlling officers and/or directors of the corporate entities. In *Knauer*, the relationships between the wrongdoers and the brokerage firms were arguably just as immediate because Payne and Danker were registered securities representatives of the brokerage firms. Also, considering whether the third-

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83. *Id.*

party defendants were actively participating in and benefiting from the Ponzi scheme will also often weigh against a receiver asserting claims against third-party defendants, particularly where third-parties passively fail to discover and/or disclose management's fraudulent activity. These factors allow third-party defendants to wrongfully use the *in pari delicto* doctrine to shield themselves from liability where the wrongdoer can no longer benefit from any recovery.

#### THE IMPACT OF THE *KNAUER* DECISION ON RECEIVERSHIP CASES

Following the *Knauer* decision, the Southern District Court of Indiana was faced with the same issue in *Marwil v. Farah*.<sup>84</sup> In *Marwil*, the court appointed a receiver over a corporate entity operated by wrongdoers in a Ponzi scheme, raising nearly \$85 million from investors who believed their investments were being used primarily for interest-bearing loans to local churches. The receiver asserted a fraudulent conveyance claim and sought the disgorgement of funds from a third-party defendant that received the funds as a part of a "bargain-sale" transaction.<sup>85</sup> In response, the third-party defendant moved for judgment on the pleadings asserting the defense of *in pari delicto* as a basis for barring the receiver's claims.

The district court commented on the teachings of the *Knauer* decision, and understood the main distinction between *Scholes* and *Knauer* as being the type of claims asserted by the receiver (fraudulent conveyance versus tort claims).<sup>86</sup> The court further opined: "*In pari delicto* was appropriate in *Knauer* because the equitable balancing favored the defendants, who had not seen a cent of the diverted funds and 'whose involvement in the Ponzi scheme as a whole was quite minor'. . . On the other side of the equation, the Ponzi entities, as a result of the machinations of Payne, 'were very much at the forefront of the Ponzi scheme.'"<sup>87</sup> The court concluded however based upon the pleadings alone, that it could not apply the equitable balancing test and determine whether the "equitable alignment" of the parties appeared to resemble the equitable alignment in *Scholes* or *Knauer* more closely.<sup>88</sup>

The Southern District Court of Indiana has recently had a second opportunity to interpret and comment upon the teachings of the

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84. *Marwil v. Farah*, 2003 WL 23095657 (S.D. Ind. 2003).

85. *Id.* at \*2.

86. *Id.* at \*9.

87. *Id.* (citing, *Knauer*, 248 F.3d at 236).

88. *Id.*



*Knauer* decision.<sup>89</sup> In *Baker*, the court stated: “[The wrongdoer’s] removal from [the corporate entities] lessens the “sting” of *in pari delicto* to some degree. . .but does not totally exculpate the entity.”<sup>90</sup> Clearly the district court now views the appointment of a receiver as having less legal significance in relation to the *in pari delicto* doctrine.

Most recently, the Eastern District Court of Pennsylvania considered the application of the *in pari delicto* doctrine in a receivership case similar to the *Knauer* case.<sup>91</sup> In *Marion v. TDI, Inc.*,<sup>92</sup> a wrongdoer used corporations as a tool to conduct a Ponzi scheme where investors believed they were purchasing federally insured certificates of deposits, when in fact they were purchasing unregistered “IOU’s.”<sup>93</sup> The scheme raised \$4 billion from investors.<sup>94</sup> Following his appointment as a receiver over the corporate entities, the receiver asserted third-party tort claims, including negligent supervision, against the broker dealers.<sup>95</sup> Defendants in response moved to dismiss arguing the receiver’s claims were barred by the doctrine of *in pari delicto*.<sup>96</sup> However, it appears the *Marion* court did not follow *Knauer*, placing more emphasis upon the legal significance of the appointment of a receiver. The court explained, “the plaintiff, receiver, as an innocent successor-in-interest, does not suffer from the same handicap. . .[T]he defense of *in pari delicto* ‘loses its sting’ when the bad actor is eliminated.”<sup>97</sup>

## CONCLUSION

Prior to the *Knauer* decision, federal courts in the *Scholes*, *O’Melveny* and *Beckner* decisions had maintained a bright line as to the non-applicability of the *in pari delicto* doctrine to receivership cases. This bright line was also recognized by federal courts in bankruptcy cases. Of significance is the reasoning that after the appointment of a receiver the *in pari delicto* doctrine “loses its sting.” To hold otherwise would allow the opposing party to enjoy a windfall, which might be justifiable against the wrongdoer but not as to a liberated

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89. *Baker O’Neal Holdings, Inc. v. Ernst & Young, LLP*, 2004 WL 771230 (S.D. Ind. 2004).

90. *Id.* at \*8 (emphasis added).

91. *Marion v. TDI, Inc.*, 2004 WL 1175740 (E.D. Pa. 2004).

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Marion* at \*1.

97. *Id.* at \*3 (citing *In re Personal and Business Ins. Agency*, 334 F.3d 239, 246 (3rd Cir. 2003); *R.F. Lafferty*, 267 F.3d at 358; see, e.g., *O’Melveny & Myers*, 61 F.3d at 19; see *Knauer*, 348 F.3d 230) (emphasis added).

corporate entity and its innocent creditors. This reasoning is particularly applicable to receivership cases involving Ponzi schemes where the claims are found to belong to the corporate entity (and thus the receiver) and not to the innocent creditors. Had the innocent investors asserted the same claims, either individually or via class action, against the brokerage firms, the court would have dismissed for lack of standing. Thus, barring a receiver's claims against third-parties allows claims for injury caused to the corporate entity to be without a remedy, producing an inequitable result.

By limiting the rationale followed in *Scholes*, the *Knauer* decision teaches courts the appointment of a receiver only "lessens" the sting of the *in pari delicto* doctrine and to engage in an "equitable balancing" of the parties to determine whether to apply the *in pari delicto* doctrine. This approach allows courts to overlook the legal significance of the appointment of a receiver in relation to the *in pari delicto* doctrine. Removing the wrongdoer from the scene erodes the underlying rationale for applying the *in pari delicto* doctrine. Courts should not lose site of this legal significance. With the wrongdoers removed from control of business entities, any recovery by the receiver from third-party defendants, whether through fraudulent conveyance claims or tort claims, will ultimately inure to the benefit of the receivership estate and thus the innocent creditors, the true victims of any scam.

The doctrine of *in pari delicto* works to preclude wrongdoers from profiting by their unlawful acts. Conversely, it should not be used by third-parties to shield themselves from liability where the wrongdoer can no longer benefit from any recovery.

