THE ELEVATED RISKS ASSOCIATED WITH INSOLVENT CLIENTS

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I. INTRODUCTION

Professionals face significant challenges and responsibilities whenever they represent clients. Other than assuring a source of payment for our anticipated fees, though, the financial status of the client usually is considered an irrelevant factor. In fact, unless the representation specifically addresses financial issues, counsel is usually—and understandably—oblivious to any "background" financial status. After all, what is more common than counsel, or accountants, or auditors, advising a corporation in the normal course of its business?

Conversely, professionals may knowingly undertake to represent clients who are insolvent, or discover that their clients may be insolvent, and nevertheless offer counsel and guidance as the client tries to navigate the presumably arid territory of insolvency. Unfortunately, in either scenario, the insolvency of a client magnifies the normal challenges and responsibilities which the professionals face.

Take a view from another perspective: the client may be financially hearty-Dr at least stable-but the financial health of the parties with whom the client is dealing may be precarious. Often the professional may choose to ignore that precariousness as irrelevant to his own interests of those of the client. It is a problem, after all, only for the other side's counsel. Or so it appears.

In other situations, a professional may be accustomed to representing an entire corporate family-perhaps the owner and his or her companies, perhaps a parent and subsidiaries, or a partner and a partnership-with consent all around. What are the repercussions should one of these entities turn insolvent?

Or, if a client reveals litigation may be looming, or insolvency, or both, and asks counsel to help construct a plan to shield assets -- perhaps phrased as a felicitously timed estate plan, and perhaps just plain felicitously timed - what ramifications can be foreseen?

Lawyers and accountants have for years been attractive targets of litigation. The number and size of claims stemming from the insolvency of some entity-maybe a client, maybe a related party-has recently blossomed (or, from the point of view of the defendants and their insurers, festered).

In the current atmosphere, it is a reasonable assumption that if there is a bankruptcy filing of a sizable company, the representatives of the Bankruptcy estate, who will be anyone *except* the individuals with whom the lawyers or accountants are accustomed to dealing, will aim their complaints and summonses at the lawyers and accountants (tenderly keeping their insurers very much in mind). Malpractice, aiding and abetting fiduciary breaches, participating in fraud, causing an insolvent company to become even more insolvent (now a separate tort in some jurisdictions), all constitute the normal vocabulary of the day.

This program, and the associated materials, is designed to provide an overview of the current issues facing professionals who find themselves entwined in insolvency cases. What are the risks in helping a client transfer assets? What are the risks and applicable standards in advising directors and officers what actions to take when their company is insolvent? Who faces the consequences of these insolvencies, and who therefore has the best opportunity to forestall, or at least pre-identify, the litigation and claims that flow therefrom? Among the candidates:

- Internal risk managers (usually attorneys), who have the responsibility to provide advice and prophylaxis to the very firms-lawyers and accountants especially whose profession is giving advice and prophylaxis to their own clients;
- Insurers, who may be in a position to identify which of their clients may be canaries in the mine, and which issues represents the fumes that can kill the canaries;
- Defense counsel, whose first involvement may come too late to avoid the accusations, but who, if knowledgeable, can try to affect the results and outcome; and
- Coverage counsel, who face the increasingly *de rigueur* declaratory judgment actions brought by insurers seeking to deny coverage in these cases, or brought by insureds seeking to establish that coverage.

The materials which follow illustrate the aggressive activity in this area. Some of the cases cited are less than a month old, and it is likely that more decisions will emerge between the date hereof and the program in September.

August 12,2008

II. THE UNIQUE PERILS OF REPRESENTING PARTIES IN BANKRUPTCY.[1]

A. **Certification by attorney**. The signature of a Debtor's attorney certifies that a bankruptcy filing is not an "abuse", as defined by complicated mathematical "means test"; that the attorney has performed a reasonable investigation and has personally determined that the petition is well grounded in fact; and that the attorney has no knowledge that the Schedules are not accurate. This is apart from extensive documentation required to be amassed and collated.

B. **Mandatory advice**. The Bankruptcy Code dictates certain advice that a lawyer must give a client, *e.g.,* don't borrow in order to file Bankruptcy.

C. **Major bankruptcy deadlines - in unlikely places**.

1. Filing proofs of claim. The deadline is rigorously established. It is difficult to correct a lapse, and efforts to do so are usually expensive and unavailing. Most common exception invoked is prior course of correspondence between representatives of creditor and trustee during proceedings that constitute the clear assertion of a claim.

2. Real estate leases. A trustee or Chapter 11 Debtor-in-Possession has the option (circumscribed to some degree by law) of asking the Bankruptcy Court to permit the assumption of a lease, *i.e.,* to continue a lease in effect either for the purposes of selling the Debtor's rights to a new tenant, or for the purposes of the Debtor's continued operations post-Bankruptcy. However, there is a firm deadline within which the Court must authorize the assumption where the Debtor is the tenant. If the Court does not authorize such an assumption of a lease within the time fixed by the Bankruptcy Code, the lease is irretrievably dead. This applies also to sub-leases and the like.

   In a recent legal malpractice case, the client wanted to purchase from a Debtor a communications tower constructed on leased real estate. The chapter 7 trustee missed the deadline for assuming the tower lease. As a result, the tower lease expired, and with it the subleases of spaces on the tower for satellite dishes of communications companies. Result: no towers, no satellites, but malpractice litigation against the purchaser's lawyer for not having called the looming deadline to the attention of the chapter 7 trustee, the Court, or anyone else.

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[1] For ease of reading, terms like "filing Bankruptcy" and references to "Debtors" are used informally. Under the Bankruptcy Code, there are no Bankruptcy filings, but "petitions for relief." There are no "Bankrupts", but only "Debtors". In this presentation, a "Debtor" is generally used to refer to someone who owes money, unless the meaning clearly otherwise indicates.

3. Deadlines for filing Plans of Reorganization and for collecting creditor votes on Plan ("exclusivity period"). These also are established by statute. If they are missed, any party in interest can file a Plan, and thereby try to acquire the Debtor or its assets. This may not be consequential in a small case without an active creditor body, but could be devastating in large cases with active creditors or competitors.

D. The risks of collusion with other bidders in Bankruptcy auctions. See 11 U.S.C. §363(n). This could present a significant problem for clients, and perhaps an uncomfortable ethical or criminal investigation for the lawyer.

In a recent case, the lawyer represented X who accepted money not to bid against Y in a Bankruptcy auction. The results included a claim against the client by trustee for reimbursement of all related expenses, an investigation by prosecuting attorneys against the client and the lawyer, a claim by the client against the lawyer, and the generation of lots of unforeseen fees and embarrassment.

E. Jurisdictional risks. Consider before filing a proof of claim that any such filing may give jurisdictional consent to the Bankruptcy Court to preside over any counterclaims brought by the Debtor. 28 U.S.C. §157(b)(2)(c).

F. Automatic stay. (11 U.S.C.§362(a).) Obey it. Actual knowledge of the pendency of a bankruptcy proceeding is sufficient to trigger contempt findings. No formal service of process is needed. Any action taken will be void except in extraordinary circumstances, and subject non-debtors and their professionals to contempt sanctions. Opaque issues of law arise in multi-party litigation, *e.g.,* if fewer than all defendants are in Bankruptcy, the whole action might be stayed, or the action might proceed by carving out Bankrupt parties. In the latter case, the consequences could be uneconomic, unless Debtors are permanently dropped as defendants. Otherwise, there could be a risk of multiple sets of discovery, motions, etc. Non-debtors can seek relief from stay, and should do so if there is any question. (Similar rules exist in connection with the statutory permanent injunction which takes effect, and which replaces the automatic stay, when an individual debtor receives a discharge. (11 U.S.C. §524).)

G. Judicial estoppel prevents a party from taking inconsistent positions in separate courts. If a Debtor fails to list a claim as an asset on the Schedules, the Debtor may be estopped from pursuing it at conclusion of Bankruptcy. If an attorney represents a client who winds up in Bankruptcy, that attorney should advise Bankruptcy lawyer of existence of claim. If a Bankruptcy plaintiff forgets to list claim as asset, the defendant should consider sitting still, let the Bankruptcy case proceed, and then seek dismissal of the lawsuit in trial court, based on judicial estoppel. If a Debtor does list the claim on the Schedules, the defendant could consider trying to purchase the claim in Bankruptcy. A bidding war may be less expensive than settlement discussions. Some Courts will welcome bidding wars, others will not (because the process gives a cheap walk to wealthy defendants), but there is no harm in making the effort. This tactic will not work where a trustee is aggressively pursuing an action, but can be effective where a trustee believes that any significant recovery is unlikely, or where the debtor is indolent, and not focused on the litigation.

H. **The madding crowd: an increased reservoir of potential plaintiffs.**

1. Debtor-in-Possession (when an entity is in chapter 11, the DIP has virtually all the powers of a trustee). 11 U.S.C. §1107.

2. Chapter 7 Trustee (a liquidating trustee, almost always appointed by the United States Trustee – part of the Department of Justice – but sometimes elected by creditors). U.S.C. §§701-2.

3. Chapter 11 Trustee (operates the business of a Chapter 11 Debtor, almost always appointed by the United States Trustee, but theoretically could be elected by creditors). 11 U.S.C. §1104.

4. Creditors' Committee (can become the plaintiff in litigation in a Chapter 11 case with permission of the Court, usually with showing of reason why such litigation shouldn't be maintained by the Debtor-in-Possession or trustee).

5. Chapter 11 Plan Trustee or Administrator (or similar title) (person or committee designated in a confirmed Chapter 11 Plan of Reorganization to bring litigation following confirmation of a Plan). 11 U.S.C. §1123(b)(3).

6. Individual creditors bringing "derivative"-type actions in absence of Bankruptcy filing.

7. Individual creditors bringing actions for avoidance of debt as fraudulent transfers in absence of Bankruptcy filing.

8. State (or under Federal statutes, including diversity) Receivers.

I. Insolvency – a **chameleon concept.** "Insolvent" may refer either to the excess of liabilities over assets, or illiquidity, depending on the context, and on the jurisdiction. 11 U.S.C. §101(32*); Geyer v. Ingersoll,* 621 A.2d 784, 789 (Del. Ch. 1992).

III. TRANSFERS - and CONSEQUENCES

A. Preferences. Transfers (including cash, security interest, and attachments) made within 90 days before Bankruptcy filing (one year if the non-debtor transferee is an "insider" of Debtor), for pre-existing debt, are preferences. Preferences are voidable, which means that they can be undone by a Bankruptcy trustee or a Chapter 11 debtor. Payments in advance are not preferences.

A common example of malpractice exposure: a simultaneous exchange of a check by an insolvent defendant, and the release of that defendant (usually accompanied by dismissal of litigation with prejudice) before the preference period runs on the check. The result? The former plaintiff/client must return the payment, but the release and dismissal are still effective.

A contractual term voiding transaction in event of bankruptcy is ineffective. 11 U.S.C. §§547, 365(e)(1).

B. Fraudulent transfers. Inadequate consideration received by insolvent debtor in exchange for asset transferred, or regardless of insolvency if transfer was intended to hinder, delay, or defraud creditors, constitutes the basic outline of a fraudulent transfer. The settlement of a dispute, including litigation, could be fraudulent transfer if court later finds an imbalance in consideration.

An example: a delinquent tenant settles for forgiveness of unpaid rent, and agrees to vacate premises before termination of lease. Future value of lease (such as if rates were below market) may be so high that settlement constitutes a fraudulent transfer received by landlord. See 11 U.S.C. §548, and Uniform Fraudulent Transfer Act.

C. Fees. Fees paid by the "wrong" entity, *i.e.,* not the entity that received the benefit of the advice, are at substantial risk. If the paying entity is insolvent (assume, *e.g.,* a subsidiary), and the beneficiary of advice was a different entity (assume, *e.g.,* a corporate parent or owner), the payment is likely a fraudulent transfer. This also creates obvious conflict issues.

D. "Asset planning", *i.e.,* "I was only helping my client protect his assets, Your Honor." Transfers of assets out of reach of creditors of insolvent entities, such as to spouses, irrevocable trusts, kids, can all be fraught with peril for those involved.

1. Generally, a professional who assists in this effort is risking exposure. If the entity is already insolvent, then any transfer other than in the ordinary course of business is likely to be a fraudulent transfer. If the entity is not insolvent, but claims or litigation are looming, then the transfer could still be fraudulent in that it is intended to hinder, delay, or defraud creditors.

See the recent decision in *Coffey's Case,* JD-2007-03 (N.H. Supreme Court, April 18, 2008), where the New Hampshire Supreme Court disciplined a state court judge for helping her husband transfer assets from the reach of a state agency to which he owed money. (The parties in that case mutually operated from the premise that assisting the transfer was wrongful, so the Supreme Court did not get to address the underlying issue of whether a lawyer who helped a client might have had a defense, but there is little in that opinion that would give solace to the next lawyer caught in the same position as the judge.)

2. Knowingly and fraudulent transferring or concealing assets in contemplation of a bankruptcy proceeding is a crime. 18 U.S.C. §I52(7).

3. Transferring assets with intent to hinder, delay, or defraud a creditor within one year before a Bankruptcy filing, in contemplation of a bankruptcy proceeding, can bar the Debtor from obtaining a discharge of all debts. 11 U.S.C. §727(a)(2).

4. A possible exception is the creation of homestead exemptions. The creation of other exemptions could be questioned – *e.g.*, stuffing all possible assets into a 401(k) at the last minute – and the more arcane, the more questions that arise. There is real inconsistency in the case law on whether the creation of exemptions in the face of actual or threatened litigation constitutes fraudulent transfers.

5. It should be permissible to assist in asset planning when no trouble is looming.

6. A transfer should be protected from attack if as much full notice as possible is given to creditors, to eliminate any allegation of subterfuge. This is not a guaranteed result, because of other legal principles, like successor liability. There is also a risk that such a notice might trigger an attack by creditors, and even create a litigation roadmap.

7. If an attorney assists in a transaction which is later found to be a fraudulent transfer, the attorney may have to persuade his or her licensing authority that a "fraudulent transfer" doesn't necessarily involve actual fraud, and that the word "fraudulent" in this context is only a quaint relic from the sixteenth century, like doublets and curtseying. For obvious reasons, it is probably dangerous to assume that that logic will prevail, even though in the right circumstances it might.

E. Attorneys holding funds. Some clients transfer funds to their attorneys to hold in client accounts, for fees and as a "bank", in order to keep the funds out of the reach of creditors. Such a transfer is fraudulent: actual intent to hinder, delay, or defraud creditors. (Uniform Fraudulent Transfer Act.) Use of a lawyer's client fund account is sanctionable. *Coppock v. State Bar of California,* 44 Ca1.3d 665(1988)(2 year suspension).

Also, the fraudulent transfer law does not always provide for a reduction for amounts paid out for the benefit of the client, so the lawyer may have to return gross, not net, amounts received. Example: a client gives the lawyer $10,000 for prior fees earned of $2,000, and "banks" the balance with the lawyer. The lawyer then pays out $3,000 to other creditors. Upon a finding of fraudulent transfer, the lawyer may then have to disgorge all $10,000, with no credit for either his fees or the amounts already disbursed to third parties.

F. Violation of security agreements. Usually security interests limit in great detail what loan proceeds can be spent on, so the acceptance of fees paid from the proceeds of accounts receivable, for instance, may violate an existing security agreement.

This could arise in even the simplest context: a client in trouble pays the lawyer a fee. It would not be unusual for that payment to violate the client's security agreement, which often limits payments to categories that don't include out-of-the-ordinary fees to professionals, or which might require pre-approval by the secured lender of all payments above a certain amount. If the professional knew or should have known of such a provision (which, if the advice was in the area of finances, would probably be the case), then in the ensuing litigation and accusations, it won't be the secured party who is on the defensive.

IV. CONFLICTS OF INTEREST

Scenarios: Simultaneous representation of parent/subs, partners/partnership, corporation/stockholder, etc., where at least one in the set is insolvent. This can present significant problems, particularly because the issue often arises in difficult political situation, such as where a professional has represented the entire corporate and personal group for a long time.

A. The sub or parent may have a claim against the other, in which case the creditors of one may object or even sue "their" lawyer for representing the interests of the other entity. In an insolvency situation, the professional will be dealing with representatives of the former client, not the actual former client. "The dual representation of a general partnership and its general partners almost invariably entails a plain conflict of interest." *In re R&R Associates of Hampton,* 402 F. 3d 257 (1st Cir. 2005); *In re TMA Assocs., Ltd.,* 129 B.R. 643, 647 (Bankr.D.Colo.1991); *In re Bonneville Pacific Corp.,* 196 B.R. 868, 886 (Bankr.D.Utah 1996).

B. An owner of a Debtor may also be a borrower or lender with respect to that Debtor, or the recipient of preference or fraudulent transfer. If an owner is also a client of the same professional as the subsidiary, this creates a conflict if an attorney represents both. For example, even if money had been intended as a "loan", creditors may seek to recharacterize debt to equity, or subordinate debt to other creditors, or accuse counsel of not pursuing collection of that debt. Those fights are usually ugly and expensive.

C. Possible waiver of privilege. A trustee or receiver can waive privilege in many cases, the result of which would be the public disclosure of advice the attorney gave.

D. Is a lawyer responsible for the broader financial or contractual impacts of any transaction? Example: a lawyer represents a client in a business transaction, which incidentally (and without the lawyer's knowledge) may have violated the client's loan covenants. The risk of an accusation against the attorney illustrates the importance of the attorney's carefully circumscribing the extent of his/her responsibilities.

V. "ZONES", "DEEPENING", "AIDING AND ABETTING" – CONCEPTS THAT ONLY AN INSOLVENCY-CASE PLAINTIFF COULD LOVE

A. **Fiduciary duty to corporation – the background for the claims**. If a corporation is solvent, the directors and officers owe fiduciary duties to that corporation. Among them:

1. Duty of care. (A Delaware corporation can elect to exculpate directors from unintentional breach.) 8 Del.Code Ann. §102(b)(7)(2001).

2. Duty of loyalty (includes duty of good faith). Actions by directors taken in good faith are usually protected from attack by the "business judgment rule". (No exculpation for breach of duty of loyalty available, however.)

If the corporation is insolvent, the fiduciary duty to the "corporate enterprise" remains. Arguably, however, the residual beneficiaries are now the creditors, as compared with, or in addition to, stockholders of a solvent corporation.

In a recent case, the Delaware court determined that creditors have no direct cause of action against directors or officers, whether the corporation is solvent or insolvent. *National Catholic Educational Programming Foundation, Inc. v. Gheewalla,* 930 A.2d 92 (Del. 2007). To the extent that a corporation is insolvent, the creditors have the right to bring a derivative action in the name of the corporation, just as stockholders have always been able to do. *Gheewalla, supra, at 101-2.* Those claims, though, must assert the rights of the entire corporate enterprise, and not merely those of the creditors: "An insolvent company is not required to turn off the lights and liquidate when that company's directors believe that continuing operations will maximize the value of the company." *Nelson v. Emerson, 2008 WL 1961150 at* *2 *(Del.Ch. May 6,2008).*

B. **The "Zone of Insolvency."** If a corporation is floundering, having some actual or anticipated financial difficulties, it is in the "zone of insolvency" – maybe it is technically insolvent, maybe not. The term was first used by the Delaware Chancery court, but never defined. *Lyonnais Bank Nederland N. V. v. Pathe Communications Corp.,* 1991 WL 277613 (DeI.Ch. 1991).

The language in *Gheewalla,* above, would suggest that there is no cause of action by creditors, derivative or otherwise, if a corporation is solvent, even while operating in the zone of insolvency. *See, e.g.,* Veasey, "Counseling the Board of Directors of a Delaware Corporation in Distress," *XXVII American Bankruptcy Institute Journal,* No.5, pp. 1,63 (June 2008). A growing number of commentators, in fact, believe that the concept of even discussing a "zone" of insolvency was not intended to expand the exposure of officers and directors, but rather to protect them against suits by stockholders who complain that the interests of creditors should not have been considered by the directors. *E.g., Trenwick America Litigation Trust* v. *Ernst & Young, LLP,* 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom, Trenwick America Litigation Trust v. Billett,* 931 A.2d 438 (Del. 2007).

C. **Deepening insolvency**. If the actions of the directors and officers (or others) caused a debtor to become even more insolvent than it was, then – depending on the jurisdiction and the court – one of three alternatives emerges:

1. There is such a cause of action. *OHC Liquidation Trust v. Credit Suisse First Boston,* 340 B.R. 510, 531, *supra; In re LTV Steel Co., Inc.,* 333 B.R. 397, 422 (Bankr.N.D.Ohio 2005). Both cases assumed that Delaware and other named jurisdictions would so hold. They turned out to be wrong about Delaware. *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.,* 267 F.3d 340, 352 (3d Cir. 2001) (tort of deepening insolvency is recognized in Pennsylvania).

2. There is no such cause of action, nor can deepening insolvency constitute a basis for measuring damages. *In the Matter of SI Restructuring,* 532 F.3d 355 (5th Cir. June 20, 2008); *Seitz v. Detweiler, Hershey & Assoc., P.C. (In re CitX Corp.),* 448 F.3d 672, 678 (3d Cir. 2006). *Trenwick, supra* (a claim asserting that a breach of the duty of care caused a diminution in a corporation's fortune is a deepening insolvency claim by another name); *In re Wheland Foundry, LLC.,* 2008 WL 2952483 (Bankr.E.D.Tenn. July 29, 2008) (applying Georgia law); *In re James River Coal Co.,* 360 B.R. 139 (Bankr.E.D.Va. 2007); *In re Radnor Holdings Corp.,* 353 B.R. 820,842 (Bankr.D.Del. 2006).

3. There is no such cause of action, but deepening insolvency constitutes a valid measure of damages under related causes of action. *Alberts v. Tuft,* 353 B.R. 324, 338 (Bankr.D.C. 2006) ("Unless and until this court is told differently by a higher court in its own circuit, deepening insolvency will remain a viable theory of damages in this jurisdiction."); *In re The Brown Schools,* 2008 WL 1849790 (Bankr.D.Del. April 24, 2008) (a claim asserting breach of loyalty is not a disguised deepening insolvency claim, and can be maintained, with damages measured by deepening insolvency); *Tabas v. Greenleaf Ventures, Inc.,* 269 B.R. 721 (Bankr.S.D.Fla. 2001)(Florida).

D. Alternative levels of culpability applicable to the cause of action:

1.Where deepening insolvency is recognized as a cause of action, only fraudulent conduct will sustain a complaint. *In re CitX Corp.,* 448 F.3d 672 (3d Cir. 2006); *OHC Liquidation Trust v. Credit Suisse First Boston,* 340 B.R. 510, 531 (Bankr.D.Del. 2006).

2. Where deepening insolvency is recognized as a cause of action, negligence will suffice to sustain a complaint. *Smith v. Arthur Andersen LLP,* 421 F.3d 989, 995 (9th Cir. 2005).

3. Deepening insolvency is not a tort under North Carolina law, but a tort for breach of fiduciary duty is equivalent, and – apparently – negligence is a sufficient basis. *In re Parmalat,* 383 F.Supp.2d 587, 601 (S.D.N.Y. 2005).

E. **The defense of *in pari delicto*** (in New York, the *"Wagoner* Rule"). If a corporation benefited from the improper or negligent acts of others, it is precluded from then bringing an action against those others, as it is inequitable to allow recovery by the beneficiary, *i.e.,* the corporation, for the actions of which it complains when it was a participant in the very actions. *Shearson Lehman Hutton Inc. v. Wagoner,* 944 F.2d 114 (2d Cir. 1991).

Example: Receiver of a bankrupt foreign corporation brings actions against bank and the corporation's former professional advisers, alleging they structured financial transactions in a way that defrauded company and its creditors. Defendants move to dismiss, arguing that the company, through its directors and officers, benefited from the transactions, and indeed directed the structure the transactions took. Accordingly, without more, the receiver would be blocked from pursuing any claim against the bank and professionals.

Defendants in various litigation contexts, including professional malpractice and breach of fiduciary duty claims, can avail themselves of the defense. *See, Bennett Funding,* 336 F.3d 94, 100 (2d Cir. 2003)(New York law); *Hirsch v. Arthur Andersen* & *Co.,* 72 F.3d 1085, 1094 (2d Cir. 1995); *Baena v. KPMG,* 389 F.Supp.2d 112 (D.Mass. 2005), *affd,* 453 F.3d 1 (lst Cir. 2006).

The defense is available against a trustee or creditors' committee, even though such entities are different from the debtor, and obviously did not personally participate in any wrongdoing. *E.g., In re Hedged-Investments Associates, Inc.,* 84 F.3d 1281, 1285 (l0th Cir.1996). *Committee of Unsecured Creditors v. R.F. Lafferty* & *Co., Inc., supra,* 267 F.3d at 357.

Courts vary widely on whether *in pari delicto,* and its exceptions, can be argued in the context of motions to dismiss, or must await discovery. *E.g., In re Total Containment, Inc.,* 335 B.R. 589, 621 (Bankr.Del. 2005); *Leveto v. Lapina,* 258 F.3d 156, 161 (3d Cir. 2001).

F. Undermining the *in pari delicto* defense:

The "innocent director" exception to *in pari delicto*. The existence of an "innocent director" (or shareholder, according to some courts), *i.e.*, one who did not participate in the wrongdoing, and who, if alerted to the wrongdoing, could have voted to prevent it, but whom the defendant failed to contact, will preclude the defendant from employing the defense. *E.g., In re Food Management Group, LLC,* 2008 WL 183410 (Bankr.S.D.N.Y. Jan. 28, 2008). If a company is so completely dominated by the decision makers that even an innocent director could not have stopped the improprieties, however, then the defense may still be available. *In re Parmalat Sec. Litig.,* 477 F.Supp.2d 602 (S.D.N.Y. 2007), citing *Munroe v. Harriman,* 85 F.2d 493, 494 (2d Cir. 1936). *Matanuska Valley Bank v. Arnold,* 223 F.2d 778, 781 (9th Cir. 1955).

The "adverse interest" exception to the "innocent director" exception. If the wrongdoing was "solely" for the benefit of the malefactors, meaning that they had "totally abandoned" the company's interests and none of the benefits of the bad acts flowed to the corporation, then the *in pari delicto* defense would not be available, as the wrongdoing officer or director has developed an "adverse interest" to the company's interests. See, *e.g.*, *In re AlphaStar Ins. Group Ltd.,* 383 B.R. 231, 272-73 (Bankr.S.D.N.Y. 2008). *Mediators, Inc. v. Manney,* 105 F.3d 822, 827 (1997).

Example: an accountant who failed to discover thefts from the corporation by its treasurer would first assert the *in pari delicto* defense to a claim for negligence brought by a trustee or similar claimant, only to find it unavailable by virtue of the "adverse interest" exception to the use of that defense, which came about through the bad acts of the corporation's directors or officers.

However, even a short-term benefit to the corporation is sufficient to render the adverse interest exception inapplicable and to preserve the defense: "Fraud by top management to overstate earnings, and so facilitate stock sales or acquisitions," while "not in the long-term interest of the company," nevertheless "profits the company in the first instance." *Baena v. KPMG LLP,* 453 F.3d 1 (1st Cir. 2006).

But see, e.g., In re Investors Funding Corp., Inc., 523 F.Supp. 533, 541(S.D.N.Y.l980): "A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." Where law firm was sued for assisting corporate insiders in fraud, the court held the adverse interest exception was inapplicable since the insiders had misappropriated a majority, but not all, of fraudulently raised funds. Therefore, the *in pari delicto* defense was effective. *Cobalt Multifamily Investors I, LLC v. Shapiro,* 2008 WL 833237 (S.D.N.Y. March 28, 2008).

Some courts require the existence of *either* an "innocent director" or of an "adverse interest" when precluding a defendant from invoking the *in pari delicto* defense. *E.g., In re AlphaStar Ins. Group Ltd.,* 383 B.R. 231, 272-73 (Bankr.S.D.N.Y. 2008). Other courts require the existence of *both* – not just one – in order to destroy the *in pari delicto* defense. *E.g., Baena, supra,* at 8.

The "sole actor" exception to the "adverse interest" exception. If an agent, by reason of power or formal vote, is the sole representative of the corporation (its principal), then that agent's acts are attributed to the corporation regardless of any adverse interest. The "adverse interest" exception accordingly would be overridden, and the *in pari delicto* defense would be available. *Adelphia Recovery Trust v. Bank of America,* – B.R.__, 2008 WL 217057 (S.D.N.Y. January 17, 2008).

G. Aiding and abetting breach of fiduciary duty. A professional must knowingly participate in the breach in order to be held liable therefor, *e.g., Malpede v. Townson,* 780 A.2d 1075, 1096 (Del. 2001).