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United States District Court, E.D. Pennsylvania.

In re: WALNUT LEASING COMPANY, INC. and
Equipment Leasing Corporation of
America, Inc.

OFFICIAL COMMITTEE OF UNSECURED
CREDITORS

v.

William SHAPIRO, et al.

No. 99-526.

Sept. 8, 1999.

Barbara W. Mather, Pepper, Hamilton & Scheetz,
Phila, PA, for Official Committee on Unsecured
Creditors, Plaintiff.

Marc S. Henzel, Law Offices of Marc S. Henzel, Phila,
PA, for John Orr, Defendant.

Stuart L. Melnick, Tanner Propp, LLP, New York,
NY, for R.F. Lafferty & Co., Inc., Defendant.

David R. Dwares, Ross, Dickson & Bell, L.L.P.,
Washington, DC, for Cogen Sklar, L.L.P., Defendant.

MEMORANDAM

LUDWIG, J.

*1 All sixteen defendants except one move to dismiss the complaint or, in the alternative, for summary judgment. [FN1] Fed.R.Civ.P. 9(b), 12(b)(1), (6), 56. [FN2] The complaint asserts claims under § 10(b) and Rule 10b-5 of the Securities Exchange Act as well as supplementary state claims for fraud, negligent misrepresentation, mismanagement and breach of fiduciary duty, aiding and abetting, professional malpractice, and breach of contract. [FN3] Jurisdiction is federal question, bankruptcy, and supplemental. 28 U.S.C. §§ 1331, 1334(b), 1367.

FN1. Three motions were filed: (1) Cogen, Sklar, L.L.P., accountants; (2) R.F. Lafferty & Co., Inc., stock broker and underwriter; and (3) William Shapiro, for himself, Kenneth

Shapiro, Deljean Shapiro, Lester Shapiro, Nathan Tatter, Adam Varrenti, Jr., and Philip Bagley, as well as Welco Securities, Inc., the Law Offices of William Shapiro, Esq., P.C., Financial Data, Inc., Walnut Associates, Inc., and Kenner Collection Agency, Inc. (Shapiro Organization). John Orr joins in the motion of William Shapiro. Liss Financial Services, Inc. has not entered an appearance.

FN2. Challenges to plaintiff's standing to sue are jurisdictional and are considered under Rule 12(b)(1). If standing is contested, plaintiff has the burden "to plead and prove injury in fact, causation, and redressability." E.F. Hutton & Co., Inc. v. Hadley, 901 F.2d 979, 985 (11th Cir.1990) (quoting Steele v. Nat'l Firearms Act Branch, 755 F.2d 1410, 1414 (11th Cir.1985)). Under Rule 12(b)(1), as under Rule 12(b)(6), the allegations of the complaint are accepted as true and all reasonable inferences are drawn in the light most favorable to the plaintiff. See Warth v. Seldin, 422 U.S. 490, 501, 95 S.Ct. 2197, 2206, 45 L.Ed.2d 343 (1975); Weiner v. Quaker Oats Co., 129 F.3d 310, 315 (3d Cir.1997). Because the motions are decided solely on the basis of the complaint, they will not be converted into motions for summary judgment. Fed.R.Civ.P. 12(b), 56.

FN3. On December 23, 1997, a class action based on negligent misrepresentation was filed against the Shapiros and some other defendants named in this action. Neuberger v. Shapiro, C.A. No. 97-7947. On November 24, 1998, the class was certified. On April 23, 1999, another class action was filed against Summit Bank, the indentured trustee, for breach of contractual and fiduciary duties. Although not formally consolidated, the three actions have been case-managed together.

The motions to dismiss will be granted as to defendants Cogen, Sklar and Lafferty and denied as to the Shapiros and remaining defendants. Both of these rulings are the result of determinations as to plaintiff's standing to sue. Simply stated, accepting plaintiff's theory of actionability, the doctrine of *in pari delicto* bars this suit against Cogen, Sklar and Lafferty. That defense is not available to the other movant defendants.

I. Background

The predicate of the complaint is that William Shapiro and Kenneth Shapiro, with the assistance of the other defendants, operated Equipment Leasing Company, Inc. (ELCOA) and Walnut Leasing Company, Inc. (Walnut) as a "de facto Ponzi scheme." Compl. ¶ 66. In 1986, Walnut--an equipment leasing company wholly owned by a corporation owned by William Shapiro, *id.* ¶ 12--was experiencing financial difficulty and, as a result, could not sell its debt certificates. *Id.* ¶ 28. Allegedly to secure more capital for Walnut, the Shapiros organized ELCOA "as a limited purpose financing subsidiary"--and, thereafter, ELCOA debt certificates kept Walnut financially afloat. ELCOA was wholly owned by Walnut.

According to the complaint, ELCOA was fraudulently marketed as an independent business entity, although its only function was to acquire leases from Walnut and to sell certificates to raise moneys for the Ponzi scheme. *Id.* ¶ 30. Moreover, ELCOA and Walnut were part of a network of businesses owned and operated by the Shapiros as a collective Shapiro Organization that included defendants Welco, Shapiro, P.C., Walnut Associates, Financial Data, and Kenner Collection Agency. *Id.* ¶ 4. Ultimately, the Shapiros, together with their counsel, auditors, underwriters, and brokers, are alleged to have: "fraudulently mismanaged their Organization, expanding its outstanding debt out of all proportion with its ability to pay, in an attempt to perpetuate its existence and thus protect[] their salaries, commissions and fees." *Id.* ¶ 5.

On August 8, 1997, Walnut and ELCOA filed for bankruptcy relief under Chapter 11. On August 21, 1997, plaintiff Official Committee of Unsecured Creditors (the Committee) was appointed by the United States Trustee. On January 19, 1999, Bankruptcy Judge Sigmund approved a stipulation entered into by the debtors and the Committee in which the Committee was authorized to file suit on behalf of the bankrupt debtors. *In re Walnut and ELCOA*, Bankr.no. 97-19699, 97- 19700, order, Jan. 19, 1999.

*2 The complaint avers the fraudulent sale of the debtors' securities and, specifically, the following fraudulent practices:

(1) material misstatements and omissions in Walnut prospectuses dated January 13 and September 14, 1995 and January 13, 1997 regarding the financial position of Walnut and the proposed plan for Walnut's recovery;

(2) material misstatements and omissions in ELCOA prospectuses and financial statements dated from 1991

to 1997 including overstatements of ELCOA's assets, income, and costs;

(3) material misstatements and omissions in Walnut and ELCOA prospectuses since 1986 regarding ELCOA's independence from Walnut and other affiliated Shapiro businesses;

(4) materially misleading sales and renewal practices.

Compl. ¶¶ 71-72.

According to the complaint: Cogen, Sklar knowingly or recklessly issued audit reports that did not fairly represent the debtors' financial positions, *id.* ¶ 73; Lafferty and Liss, as qualified independent underwriters, knowingly or recklessly rendered fairness opinions without undertaking a full due diligence review of the debtors' financial positions, *id.* ¶ 74; the non-Shapiro director defendants violated their fiduciary duty "by negligently failing to properly supervise and oversee the debtors' affairs," *id.* ¶ 96; and the Shapiro Organization defendants acted in concert with William and Kenneth Shapiro, *id.* ¶¶ 20-24.

II. Standing of the Committee

Article III standing consists of three elements: (1) an injury in fact--actual harm suffered by plaintiff; (2) causation--connection between the injury and defendants' conduct; and (3) redressability--likelihood that injury will be redeemed by the requested relief. *See Steel Co. v. Citizens for a Better Environment*, 523 U.S. 83, 118 S.Ct. 1003, 1016-17, 140 L.Ed.2d 210 (1998).

In addition to Article III requirements, there are three prudential considerations that will "discourage judicial action despite a party's satisfaction of the constitutional prerequisites ...:(1) assertion of a third party's rights, (2) allegation of a generalized grievance rather than an injury particular to the litigant, and (3) assertion of an injury outside the zone of interests of the statute or constitutional provision." *E.F. Hutton & Co., Inc. v. Hadley*, 901 F.2d 979, 985 (11th Cir.1990) (citing *Valley Forge Christian College v. Americans United for Separation of Church & State*, 454 U.S. 464, 474-75, 102 S.Ct. 752, 759-60, 70 L.Ed.2d 700 (1982)).

Here, the Committee is suing on behalf of the bankrupt debtor corporations-- not on behalf of the creditors themselves. The injury alleged is that "the debtors were fraudulently induced to register, offer and sell certificates when insolvent and thus without ability to repay their obligations to investors. As a result, the debtors' outstanding debt was continually expanded out

of all proportion with their ability to repay, forcing them into bankruptcy." Compl. ¶¶ 1, 77. Defendants Cogen, Sklar and Lafferty counter that the Committee, suing on behalf of the debtors, does not have standing to assert these claims because (1) the alleged injury--deepening insolvency--belongs to the creditors and not the debtors; and (2) the Committee, standing in the shoes of the debtors, is barred by the doctrine of *in pari delicto*. [FN4]

FN4. The Committee has perfected its right to bring suit on behalf of the debtors under §§ 1103(c)(5) (Creditors' Committee may "perform such other services as are in the interest of those represented") and 1109(b) ("a party in interest, including ... a creditors' committee, ... may raise and may appear and be heard on any issue in a case under this chapter"). 11 U.S.C. §§ 1103(c)(5), 1109(b). To maintain an action on behalf of the debtors, the Committee must show that (1) the claim is meritorious, (2) the debtor-in-possession has refused to sue, and (3) the Committee has obtained the permission of the court. See *In re STN Enter.*, 779 F.2d 901, 904-06 (2d Cir.1985); *In re Christopher Pilavis*, 233 B.R. 1, 3 (Bankr.D.Mass.1999); *In re Nicolet, Inc.*, 80 B.R. 733, 738-39 (Bankr.E.D.Pa.1988) (Scholl, J.) (collecting cases); *Official Comm. of Unsecured Creditors of Corell Steel v. Fishbein and Co.*, 1992 WL 196768,*1-2 (E.D.Pa. Aug. 10, 1992) (Pollack, J.). Alternatively, the debtor-in-possession may stipulate to representation by the Creditors' Committee, as occurred here. See *In re Spaulding Composites Co., Inc.*, 207 B.R. 899, 904 (B.A.P. 9th Cir.1997); *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1362 (5th Cir.1986). Shapiro defendants' argument that notice and opportunity for creditors to challenge the stipulation was required is not pertinent and should have been raised with the Bankruptcy Judge at the time the stipulation was approved. Furthermore, since plaintiff stands in the shoes of the bankrupt debtors, this is not a shareholder derivative action governed by the procedural requirements of Fed.R.Civ.P. 23 .1.

*3 The principle is well-established that a plaintiff must "assert [its] own legal rights and interests, and cannot rest [its] claim to relief on the legal rights or interests of third parties." *Shearson Lehman Hutton,*

Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir.1991) (quoting *Warth v. Seldin*, 422 U.S. 490, 499, 95 S.Ct. 2197, 2205, 45 L.Ed.2d 343 (1975)). In the bankruptcy context, "the trustee stands in the shoes of the bankrupt corporation and has standing to bring any suit that the bankrupt corporation could have instituted had it not petitioned for bankruptcy." *Shearson*, 944 F.2d at 118. [FN5] Plaintiff cannot assert claims on behalf of the bankrupt's creditors. See *id.*; *In re Jack Greenberg, Inc.*, 212 B.R. 76, 82 (Bankr.E.D.Pa.1997) (citing *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 434, 92 S.Ct. 1678, 1688, 32 L.Ed.2d 195 (1972)).

FN5. Section 1107(a) of the Bankruptcy Code provides that "a debtor in possession shall have all the rights ... and powers, and shall perform all the functions and duties ... of a trustee serving in a case under this chapter." 11 U.S.C. § 1107(a). The Committee, suing on behalf of debtors in possession, is in an analogous position to the trustee. See *In re Mediators, Inc.*, 105 F.3d 822, 826 (2d Cir.1997).

Defendants Cogen, Sklar and Lafferty maintain that the alleged Ponzi scheme claims belong exclusively to the creditors, citing *Hirsch v. Arthur Anderson & Co.*, 72 F.3d 1085 (2d Cir.1995). [FN6] While the most obvious damages were those sustained by creditors who purchased certificates, the possibility of a distinct and separate injury to the debtor corporations cannot be eliminated at this stage. See *In re Plaza Mortg. and Fin. Corp.*, 187 B.R. 37, 41 (N.D.Ga.1995) (denying motion to dismiss trustee's claims against accountants who participated in Ponzi scheme and distinguishing *Hirsch* where only allegation of injury was "unpaid obligations of the debtor to the creditors"). [FN7]

FN6. "Whether the rights belong to the debtor or the individual creditors is a question of state law." *Hirsch v. Arthur Anderson & Co.*, 72 F.3d 1085, 1092 (2d Cir.1995). Without focusing on this issue, the parties agree that Pennsylvania law governs.

FN7. At least four cases have concluded that deepening insolvency is a cognizable injury to corporate debtors. See *Schacht v. Brown*, 711 F.2d 1343, 1348 (7th Cir.1983) (where debtor corporation was fraudulently continued in business past the point of insolvency, liquidator had standing to bring RICO claim); *Hannover Corp. of America v. Beckner*, 211

B.R. 849, 854-55 (M.D.La.1997) ("[A] corporation can suffer injury from fraudulently extended life, dissipation of assets, or increased insolvency."); Allard v. Arthur Anderson & Co., 924 F.Supp. 488, 494 (S.D.N.Y.1996) (as to suit brought by bankruptcy trustee, "[b]ecause courts have permitted recovery under the 'deepening insolvency' theory, [defendant] is not entitled to summary judgment as to whatever portion of the claim for relief represents damages flowing from indebtedness to trade creditors"); In re Gouiran Holdings, Inc., 165 B.R. 104, 107 (E.D.N.Y.1994) (denying motion to dismiss claims brought by creditors committee because it was possible that "under some set of facts two years of negligently prepared financial statements could have been a substantial cause of [the debtor] incurring unmanageable debt and filing for bankruptcy protection").

However, the effects on standing of debtors' *in pari delicto* relationship to defendants are more problematical. "A claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation." Shearson, 944 F.2d at 120 (dismissing claims of aiding and abetting against broker); Hirsch, 72 F.3d at 1094; see also Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310-11, 105 S.Ct. 2622, 2628, 86 L.Ed.2d 215 (1985) (*in pari delicto* defense may be asserted in Rule 10b-5 action where "(1) as a direct result of [its] own actions, the plaintiff bears at least substantially equal responsibility for the violations [it] seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public"); Apostolou v. Fisher, 188 B.R. 958, 969 (N.D.Ill.1995) (trustee cannot assert claim on behalf of the debtors when the debtors have "not sustained injury as [] victim[s] of the fraud but [are] injured, if at all, only because [they] participated *in pari delicto* in the fraudulent scheme as [] corporate conspirator[s] and [were] the subject[s] of [] involuntary bankruptcy petition[s] when the scheme went sour."), *rev'd on other grounds*, 155 F.3d 876 (7th Cir.1998).

*4 To apply this principle here involves imputing the Shapiros' participation in the fraud to the debtors. "[F]raud of an officer of a corporation is imputed to the corporation when the officer's fraudulent conduct was (1) in the course of his employment, and (2) for the benefit of the corporation." In re Jack Greenberg, 212 B.R. at 83 (quoting Rochez Bros. v. Rhoades, 527 F.2d

880, 884 (3d Cir.1975)). However, under Pennsylvania law, "knowledge of an agent whose interests are adverse to the principal cannot be imputed to the principal." In re Jack Greenberg, 212 B.R. at 84 (citation omitted); cf. In re Mediators, 105 F.3d 822, 827 (2d Cir.1997) (the adverse interest exception is "a narrow one and applies only when the agent has 'totally abandoned' the principal's interest" (citation omitted)).

Fairly read, the complaint leaves no doubt that the fraud alleged to have been perpetrated by the Shapiros may be imputed to the debtor corporations. William Shapiro is the sole shareholder of defendant Walnut Associates, Inc., which in turn owns debtor Walnut, which owns debtor ELCOA. Compl. ¶ 12. William Shapiro is president and a director of the debtors. Kenneth Shapiro is debtors' vice- president and a director. *Id.* ¶ 13. Defendants Walnut Associates, William Shapiro, P.C., Welco, Financial Data, and Kenner Collection Agency, which are owned by William Shapiro, are alleged to have played a role in the fraudulent certificate offerings. *Id.* ¶¶ 20-24. The debtor corporations are alleged to have been part of the Shapiro Organization--*i.e.*, owned and controlled by the Shapiros. *Id.* ¶¶ 4, 29, 32, 33.

Even if the Shapiros' alleged fraud were considered adverse to the interest of the debtor corporations, [FN8] William Shapiro effectively was the sole shareholder of the debtors companies that he and Kenneth Shapiro operated. Accordingly, the "sole actor" exception should be applied. See In re Jack Greenberg, 212 B.R. at 86 (exception recognized in Pennsylvania); PNC Bank v. Housing Mortg. Corp., 899 F.Supp. 1399, 1405-06 (W.D.Pa.1994) (dismissing corporation's claims against accountants because sole shareholders and officers of corporation participated in alleged fraud); see also In re Mediators, 105 F.3d at 827 ("[T]he adverse interest exception does not apply to cases in which the principal is a corporation and the agent is its sole shareholder."); Sender v. Simon, 84 F.3d 1299, 1307 (10th Cir.1996) ("To the extent [the debtor] was created as a vehicle to further the Ponzi scheme and utilized to give the scheme a veneer of legitimacy, it was in utter complicity with [the sole owner's] fraud."). [FN9]

FN8. "There is a dispute in the case law on whether to evaluate the benefit to the company based on the short term or long term effect of its agent's fraud." In re Jack Greenberg, Inc., 212 B.R. 76, 85 (Bankr.E.D.Pa.1997).

FN9. Plaintiff asserts that imputation is

improper because some board members did not participate in the fraud but only negligently failed to supervise and oversee the debtors' affairs. Compl. ¶ 96. This argument does not affect the imputation analysis, however, given the allegation "there could never be a majority of disinterested" directors. *Id.* at ¶ 32. The complaint is clear that the Shapiros dominated control of the debtors. See Hirsch v. Arthur Anderson & Co., 72 F.3d 1085, 1092 (2d Cir.1995) ("General, conclusory allegations need not be credited ... when they are belied by more specific allegations of the complaint.").

Moreover, the Committee--analogous to a trustee--does not rise above defenses that are available against the debtor corporations. See Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149, 1154 and n. 7 (3d Cir.1989) (the property of the estate is defined within 11 U.S.C. § 541(a)(1) as "all legal and equitable interests of the debtor as of the commencement of the case," which includes causes of action). [FN10] In this sense, "the estate's rights [are] no stronger than they were when actually held by the debtor." In re Hedged-Investments, 84 F.3d 1281, 1285 (10th Cir.1996); see also In re Dublin Sec., Inc., 133 F.3d 377, 380 (6th Cir.1997) (*in pari delicto* defense properly asserted against trustee suing attorneys for malpractice in connection with fraudulent stock offerings). [FN11]

[FN10]. A trustee may also "stand[] in the overshoes of the creditors" when it brings action under 11 U.S.C. § 544, avoidance actions. In re Granite Partnership, L.P., 194 B.R. 318, 324 (Bankr.S.D.N.Y.1996). This provision is not implicated here. *But see* Welt v. Sirmans, 3 F.Supp.2d 1396, 1403 (under Florida law, negligence claim against the directors of a corporation brought by a trustee in bankruptcy would not be imputed to the trustee).

[FN11]. The Committee is not analogous to a receiver or liquidator, for which reason this case is distinguishable from the cases that hold a receiver is not subject to defenses based on inequitable conduct or unclean hands. Compare F.D.I.C. v. O'Melveny & Myers, 61 F.3d 17, 18 (9th Cir.1995) (unclean hands doctrine does not apply to receiver bringing malpractice claim), with In re Hedged-Inv. Asso., Inc., 84 F.3d 1281, 1284

and n. 5 (10th Cir.1996) (drawing distinction from law of receivership and barring trustee's claims arising out of Ponzi scheme).

*5 Since it is pleaded that the debtors, acting through the Shapiros, perpetrated the Ponzi scheme with the assistance of Cogen, Sklar and Lafferty, the doctrine of *in pari delicto*, as encapsulated in Wagoner, 944 F.2d at 120, bars plaintiff from suing these defendants for claims arising out of the fraud. In that the six counts against Cogen, Sklar and Lafferty allege "what is essentially 'a single form of wrongdoing under different names'," see Hirsch, 72 F.3d at 1092 (citation omitted), the complaint against these defendants will be dismissed. However, *in pari delicto* will not preclude the claims against corporate insiders. See In re Granite Partners, L.P., 194 B.R. 318, 332 (S.D.N.Y.1996). Vis-a-vis their corporations, insiders cannot avoid the consequences of their own handiwork. [FN12]

[FN12]. No reported authority suggests that an officer or director can assert the defense of *in pari delicto* as defenses to the claim brought here on behalf of the debtor corporations.

III. Pleading Requirements of Fed.R.Civ.P. 9(b) and PSLRA

The Shapiro defendants' argument that the federal securities claim has not been pleaded with particularity must be rejected.

Claims based on securities fraud shall be pleaded with particularity under Fed.R.Civ.P. 9(b) and the Private Securities Litigation Reform Act of 1995 (PSLRA). To satisfy Rule 10b-5, it must be shown that defendants (1) made misstatements or omissions, (2) of material fact, (3) with scienter, (4) in connection with the purchase or sale of securities, (5) upon which plaintiff relied, and (6) that reliance caused plaintiff's injury. See In re Phillips Petroleum Sec. Lit., 881 F.2d 1236, 1244 (3d Cir.1989). The PSLRA requires plaintiff to "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(2). Furthermore, as to scienter, "[i]t is not enough for plaintiffs to allege generally that defendants 'knew or recklessly disregarded each of the false and misleading statements' for which the defendants were sued." In re Burlington Coat Factory Sec. Lit., 114 F.3d 1410, 1422 (3d Cir.1997) (citation omitted). The complaint must aver facts that give rise to a "strong inference" of scienter by either "(1) identify[ing] circumstances indicating conscious or reckless behavior by defendants, or (2) alleg[ing] facts

