

267 F.3d 340
38 Bankr.Ct.Dec. 147
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United States Court of Appeals,
Third Circuit.

OFFICIAL COMMITTEE OF UNSECURED
CREDITORS, Appellant,

v.

R.F. LAFFERTY & CO., INC.; [FN*] Cogen Sklar,
L.L.P.

FN* (Dismissed Pursuant to Court's February
14, 2001 Order)

No. 00-1157.

Argued on May 31, 2001.
Filed Oct. 9, 2001.

Debtor corporations filed bankruptcy petitions seeking relief from their creditors after Ponzi scheme ran its course. Bankruptcy court authorized creditors' committee to pursue litigation on behalf of debtors' estates. After commencement of litigation, the United States District Court for the Eastern District Of Pennsylvania, Edmund V. Ludwig, J., dismissed committee's claims. Committee appealed. The Court of Appeals, Fuentes, Circuit Judge, held that: (1) committee had standing to pursue "deepening insolvency" claim on behalf of debtor corporations; (2) corporations' existence could not be disregarded; and (3) committee, having status of debtor corporation, was in pari delicto with sole shareholders.

Affirmed.

Cowen, Circuit Judge, filed a dissenting opinion.

West Headnotes

[1] Consumer Protection ⚡12
92Hk12 Most Cited Cases

A "Ponzi scheme" is a fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts even larger investments.

[2] Federal Civil Procedure ⚡103.2
170Ak103.2 Most Cited Cases

[2] Federal Courts ⚡12.1
170Bk12.1 Most Cited Cases

In general, standing consists of both a case or controversy requirement and a prudential element. U.S.C.A. Const. Art. 3, § 2, cl. 1.

[3] Federal Civil Procedure ⚡103.2
170Ak103.2 Most Cited Cases

An analysis of standing does not include an analysis of equitable defenses, such as in pari delicto.

[4] Bankruptcy ⚡2154.1
51k2154.1 Most Cited Cases

Creditor's committee, who had acquired all the attributes of a bankruptcy trustee for purposes of the case, had standing to pursue "deepening insolvency" claim on behalf of debtor corporations against sole shareholders of corporation; although a trustee may not assert claims on behalf of a creditor, committee properly asserted claims of debtors.

[5] Bankruptcy ⚡2154.1
51k2154.1 Most Cited Cases

In the context of bankruptcy, whether a right of action belongs to the debtor or to individual creditors is a question of state law.

[6] Corporations ⚡1.3
101k1.3 Most Cited Cases

In Pennsylvania, a corporation is a distinct and separate entity, irrespective of the persons who own all its stock.

[7] Corporations ⚡1.4(5)
101k1.4(5) Most Cited Cases

[7] Corporations ⚡65
101k65 Most Cited Cases

Under Pennsylvania law, the fact that one person owns all of the stock does not make him and the corporation one and the same person, nor does he thereby become the owner of all the property of the corporation; the shares of stock of a corporation are essentially distinct and different from the corporate property.

[8] Corporations ⚡202
101k202 Most Cited Cases

An injury to the corporate body is legally distinct from an injury to another person; thus, under Pennsylvania law, where fraud, mismanagement, or other wrong damages a corporation's assets, a shareholder does not have a direct cause of action, rather, it is the corporate body that suffers the primary wrong and, consequently, it is the corporate body that possesses the right to sue.

[9] Corporations ↪202
101k202 Most Cited Cases

Under Pennsylvania law, an action to redress injuries to the corporation cannot be maintained by an individual shareholder, it must be brought as a derivative action in the name of the corporation.

[10] Corporations ↪207.5
101k207.5 Most Cited Cases

A corporation can suffer an injury unto itself, and any claim it asserts to recover for that injury is independent and separate from the claims of shareholders, creditors, and other persons.

[11] Bankruptcy ↪2154.1
51k2154.1 Most Cited Cases

When conducting a standing analysis in a bankruptcy action, where a court must determine upon whose behalf a cause of action is brought, whether by the debtor or creditors, it is irrelevant that a successfully prosecuted cause of action leads to an inflow of money to the estate that will immediately flow out again to repay creditors.

[12] Federal Courts ↪390
170Bk390 Most Cited Cases

In the absence of an opinion from the state's highest tribunal, a federal court must don the soothsayer's garb and predict how the state's highest tribunal would rule if it were presented with the question.

[13] Torts ↪5
379k5 Most Cited Cases

Under Pennsylvania law, "deepening insolvency," which is the fraudulent expansion of corporate debt and prolongation of corporate life, may give rise to a cognizable injury.

[14] Torts ↪1
379k1 Most Cited Cases

[14] Torts ↪5
379k5 Most Cited Cases

Although an identifiable and compensable injury is essential to the existence of tort liability, once tort liability is established and an injury occurs, tort law attempts to place the injured party in the same position he occupied before the injury.

[15] Damages ↪117
115k117 Most Cited Cases

When a contractual breach occurs, contract law seeks to give to the nonbreaching party the benefit of his or her bargain, to put him or her in the position he or she would have been in had there been no breach.

[16] Corporations ↪1.4(1)
101k1.4(1) Most Cited Cases

[16] Corporations ↪1.4(3)
101k1.4(3) Most Cited Cases

[16] Corporations ↪1.4(5)
101k1.4(5) Most Cited Cases

Corporation's existence could not be disregarded, in lawsuit asserting a "deepening insolvency" cause of action against corporation's sole shareholders, officers, and consultants; although corporation's sole shareholders, officers, and consultants used corporation to commit a fraud, corporation was not fictional or a sham, corporate formalities were not ignored, and corporation did not lack an identity separate from sole shareholders.

[17] Corporations ↪1.4(1)
101k1.4(1) Most Cited Cases

The "piercing the corporate veil doctrine" treats a corporation and its shareholders as identical for purposes of suit, thereby imposing personal liability on shareholders.

[18] Corporations ↪1.4(1)
101k1.4(1) Most Cited Cases

[18] Corporations ↪1.4(2)
101k1.4(2) Most Cited Cases

[18] Corporations ↪1.4(3)
101k1.4(3) Most Cited Cases

In Pennsylvania, courts will disregard the corporate entity only in limited circumstances when the form is used to defeat public convenience, justify wrong, protect fraud, or defend crime.

[19] Corporations ↪1.4(1)
101k1.4(1) Most Cited Cases

Under Pennsylvania law, when considering if the corporation veil should be pierced, a court must start from the general rule that the corporate entity should be recognized and upheld, unless specific, unusual circumstances call for an exception; care should be taken on all occasions to avoid making the entire theory of the corporate entity useless.

[20] Federal Courts ↪414
170Bk414 Most Cited Cases

"Deepening insolvency," which is the fraudulent expansion of corporate debt and prolongation of corporate life, is generally a valid theory for federal law claims.

[21] Bankruptcy ↪3024
51k3024 Most Cited Cases

Creditor's committee, having status of debtor corporation, was in pari delicto with sole shareholders, officers, and consultants of corporation that it was suing, precluding recovery, in "deepening insolvency" lawsuit which arose in context of bankruptcy petition, since sole shareholders' conduct, as sole actors of corporation, was required to be imputed to debtor corporation. Bankr.Code, 11 U.S.C.A. § 541.

[22] Action ↪4
13k4 Most Cited Cases

The "in pari delicto doctrine" provides that a plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim.

[23] Equity ↪65(1)
150k65(1) Most Cited Cases

Under Pennsylvania law, as well as federal law, in pari delicto is a doctrine of equity; the broad idea captured by the doctrine may involve a number of different defenses, depending on whether a contract, tort, or other claim is asserted.

[24] Torts ↪21
379k21 Most Cited Cases

"Imputation" refers to the attribution of one person's wrongdoing to another person.

[25] Bankruptcy ↪2151
51k2151 Most Cited Cases

The application of the in pari delicto doctrine is affected by the rules governing bankruptcies when invoked in the context of a bankruptcy.

[26] Bankruptcy ↪2553
51k2553 Most Cited Cases

The legal and equitable interests of a bankruptcy estate include causes of action. Bankr.Code, 11 U.S.C.A. § 541.

[27] Bankruptcy ↪2553
51k2553 Most Cited Cases

Courts are to evaluate defenses to a cause of action as they exist at the commencement of the bankruptcy. Bankr.Code, 11 U.S.C.A. § 541.

[28] Bankruptcy ↪2553
51k2553 Most Cited Cases

When evaluating the defenses to a cause of action, courts are prevented from taking into account events that occur after the commencement of the bankruptcy case. Bankr.Code, 11 U.S.C.A. § 541.

[29] Bankruptcy ↪2553
51k2553 Most Cited Cases

While bankruptcy law mandates that the trustee step into the shoes of the debtor when asserting causes of action, state law generally provides the substantive law governing imputation for state law claims.

[30] Corporations ↪423
101k423 Most Cited Cases

Under the law of "imputation," courts impute the fraud of an officer to a corporation when the officer commits the fraud in the course of his employment and for the benefit of the corporation.

[31] Corporations ↪430
101k430 Most Cited Cases

The second part of the imputation test, whether fraudulent conduct was perpetrated for the benefit of the debtor corporation, is often analyzed under the adverse interest exception; under the "adverse interest exception," fraudulent conduct will not be imputed if the officer's interests were adverse to the corporation and not for the benefit of the corporation.

[32] Corporations ↪430
101k430 Most Cited Cases

The "adverse interest exception" of the imputation test, of whether fraudulent conduct was perpetrated for the benefit of the corporation, is itself subject to an exception, the "sole actor exception"; the general principle of the "sole actor exception" provides that, if

an agent is the sole representative of a principal, then that agent's fraudulent conduct is imputable to the principal regardless of whether the agent's conduct was adverse to the principal's interests.

[33] Corporations ↪ 430
101k430 Most Cited Cases

When a corporation has a sole agent that has no one to whom he can impart his knowledge, or from whom he can conceal it, the corporation must bear the responsibility for allowing an agent to act without accountability according to the "sole actor exception" to the general rule that an agent's fraudulent conduct will not be imputed to a corporation.

*343 Barbara W. Mather (argued), Francis J. Lawall, Matthew J. Hamilton, Pepper Hamilton LLP, Philadelphia, PA, Attorney for Appellant.

Stuart L. Melnick (argued), Tanner Propp LLP, New York, NY, Attorney for Appellee.

Before: SLOVITER, FUENTES, and COWEN, Circuit Judges.

OPINION OF THE COURT

FUENTES, Circuit Judge:

[1] This matter arises out of the bankruptcy of two lease financing corporations, which were allegedly operated as a "Ponzi scheme." [FN1] Like all such schemes, this one collapsed, leaving numerous investors with significant losses. To operate the scheme, William Shapiro, aided by others, allegedly caused the corporations to issue fraudulent debt certificates, which were then sold to *344 individual investors. When the corporations lost any reasonable prospect of repaying the outstanding debt, they filed for bankruptcy.

FN1. A "Ponzi scheme" is "[a] fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts even larger investments." *Black's Law Dictionary* 1180 (7th ed.1999).

A Committee of Creditors, appointed by a bankruptcy trustee, brought claims in the District Court on behalf of the two debtor corporations alleging that third-parties had fraudulently induced the corporations

to issue the debt securities, thereby deepening their insolvency and forcing them into bankruptcy. These third-parties allegedly conspired with the debtors' management, who were also the debtors' sole shareholders, in engineering the Ponzi scheme. On these allegations, the District Court concluded that it could not rule out the possibility of a cognizable injury. Nevertheless, the District Court held that the Committee lacked standing to assert its claims against the third-parties because of the doctrine of *in pari delicto*. The Committee appeals.

We conclude that "deepening insolvency" constitutes a valid cause of action under Pennsylvania state law and that the Committee therefore has standing to bring this action. However, evaluating the Committee's claims "as of the commencement" of the bankruptcy, we hold that because the Committee, standing in the shoes of the debtors, was *in pari delicto* with the third parties it is suing, its claims were properly dismissed. Accordingly, we will affirm the judgment of the District Court.

I.

The following allegations are taken from the Amended Complaint of the appellant, the Official Committee of Unsecured Creditors ("the Committee"), which was appointed by the bankruptcy trustee and which was authorized by stipulation to assert claims on behalf of the debtor corporations. The essence of the Committee's allegations is that the Shapiro family (or "the Shapiros"), with the assistance of other defendants, including third-party professionals, [FN2] operated Walnut Equipment Leasing Company, Inc., ("Walnut"), and its wholly owned subsidiary, Equipment Leasing Corporation of America ("ELCOA"), as a Ponzi scheme.

FN2. The sixteen defendants in the original case before the District Court are as follows: (1) William Shapiro, (2) Kenneth Shapiro, (3) DelJean Shapiro, (4) Lester Shapiro, (5) Nathan Tattar, (6) Adam Varrenti, Jr., (7) John Orr, (8) Philip Bagley, (9) Walnut Associates, Inc., (10) Welco, Inc., (11) The Law Offices of William Shapiro, Esq., P.C., (12) Financial Data, Inc., (13) Kenner Collection Agency, Inc., (14) Cogen, Sklar, L.L.P., (15) R.F. Lafferty & Co., Inc., and (16) Liss Financial Services, Inc.

The scheme originated with Walnut, which was owned by defendant Walnut Associates, Inc., and which, in turn, was owned by William Shapiro. In 1986, Walnut

was experiencing financial difficulties. As a result, Walnut could not raise sufficient capital through the sale of debt securities. In a purported effort to secure more capital for Walnut, the Shapiro family organized ELCOA as "a limited purpose financing subsidiary," wholly owned by Walnut, to provide a platform to sell debt securities through a new company with a clean financial picture.

According to the Amended Complaint, ELCOA was fraudulently marketed as an independent business entity, even though its only function was to acquire leases from Walnut and to sell debt certificates to raise money. In reality, Walnut and ELCOA were part of a network of businesses owned and operated by the Shapiro family. This network included defendants Welco, Inc., The Law Offices of William Shapiro, Esq., P.C., Walnut Associates, Inc., Financial Data, Inc., and Kenner Collection Agency, Inc. As part of the scheme to keep *345 this network afloat, the Shapiros allegedly misstated Walnut and ELCOA's financial position in order to induce these companies to register, offer, and sell additional debt certificates to raise capital. Numerous investors purchased the ELCOA debt securities, and the Committee claims that the Shapiros funneled those monies into Walnut. At the same time, the Shapiros and their co-conspirators continued receiving salaries and fees from Walnut and ELCOA. Moreover, the issuance of debt securities allegedly deepened the insolvency of Walnut and ELCOA, and put them on the path to bankruptcy.

The Amended Complaint states that certain third-party professionals were essential to the Shapiro family's operation, namely, their counsel, defendant William Shapiro, Esq. P.C., their accountant, defendant Cogen Sklar, L.L.P. ("Cogen"), and their qualified independent underwriters, defendant R.F. Lafferty & Co., Inc. ("Lafferty"), and defendant Liss Financial Services, Inc. ("Liss"). Each of these parties was responsible for professional opinions that served as prerequisites for the registration of each public offering and sale of ELCOA's debt securities. Each allegedly conspired with the Shapiro family to render opinions replete with multiple fraudulent misstatements and material omissions concerning Walnut and ELCOA's financial statements. The parties allegedly lacked any foundation for their conclusions.

Ultimately, the artifice collapsed, leading to the bankruptcies of Walnut and ELCOA, which became the debtor corporations (or "the Debtors"). The companies filed Chapter 11 petitions, and the Debtors' management, which included members of the Shapiro family and their co-conspirators, were removed. The Bankruptcy Court then appointed a bankruptcy trustee. Thereafter, the trustee, pursuant to section 1102 of the

Bankruptcy Code, 11 U.S.C. § 1102, appointed the Committee to represent the claims of unsecured creditors in connection with the bankruptcy proceedings. The Committee is comprised entirely of creditors; no member of the Debtors' former management is present.

On January 19, 1999, the Bankruptcy Court approved a Stipulation between the Committee and the Debtors authorizing, among other things, "the Committee to commence and prosecute ... [l]itigation on behalf of the Debtors' estates." *Stipulation Among the Debtors and the Official Committee of Unsecured Creditors of the Debtors Authorizing the Committee to Commence Litigation on Behalf of the Debtors' Estates*, Bankr.No. 97-19699-DWS, at *2 (Bankr.E.D.Pa. Jan. 19, 1999). Under the Stipulation, the Committee effectively acquired all the attributes of a bankruptcy trustee for purposes of this case. See *In re The Mediators, Inc.*, 105 F.3d 822, 826 (2d Cir.1997) ("[T]he Committee, while not a trustee in bankruptcy, is in a position analogous to a trustee because it is suing on behalf of the debtor.").

On February 1, 1999, the Committee, on behalf of the Debtors' estates, commenced a civil action in the District Court for the Eastern District of Pennsylvania against the Debtors' officers, directors, affiliated companies (the Shapiro family and their network of companies), and outside professionals (Cogen and Lafferty) on the ground that the defendants, through their mismanagement of the Debtors and their participation in a fraudulent scheme, had "wrongfully expanded the [D]ebtors' debt out of all proportion of their ability to repay and ultimately forced the [D]ebtors to seek bankruptcy protection." The Committee brought claims against the Shapiros and their alleged co-conspirators--including Cogen and Lafferty--*346 based upon violations of federal securities laws, as well as common law fraud and negligent misrepresentation, mismanagement and breach of fiduciary duty, breach of contract, professional malpractice, and aiding and abetting breach of fiduciary duty. In addition, the Committee brought claims against some defendants--DelJean Shapiro, Lester Shapiro, Adam Varrenti, Jr., John Orr, and Philip Bagley--in their capacity as directors of either Walnut or ELCOA or both, asserting that they had mismanaged and breached their fiduciary duties to the Debtors by allegedly failing to supervise and oversee the Debtors' affairs.

All defendants (except Liss, who failed to appear) moved to dismiss the Committee's Amended Complaint or, alternatively, for summary judgment. On September 8, 1999, the District Court dismissed the claims against Cogen and Lafferty, reasoning that,

"[s]ince it is pleaded that the [D]ebtors, acting through the Shapiros, perpetrated the Ponzi scheme ... the doctrine of *in pari delicto* ... bars [the Committee] from suing these defendants for claims arising out of the fraud." Official Committee of Unsecured Creditors v. William Shapiro, et al., No. 99-526, slip op. at 11, 1999 WL 729267 (E.D.Pa. Sept. 8, 1999). At the same time, however, the District Court denied the motion to dismiss as to the other defendants on the ground that *in pari delicto* did not preclude claims against corporate insiders. *Id.* at 12. Thereafter, the court severed the Committee's claims against Cogen and Lafferty, and the Committee appealed the dismissal of those claims. Cogen has settled with the Committee, leaving Lafferty as the only appellee.

II.

The District Court had subject matter jurisdiction over the case under 28 U.S.C. §§ 1331 and 1334(b). We have jurisdiction to hear the appeal under 28 U.S.C. § 1291.

We have plenary review over the District Court's dismissal of the Committee's claims against Lafferty. See Maio v. Aetna, Inc., 221 F.3d 472, 481-82 (3d Cir.2000). We apply the same standard used by the District Court, namely, we must determine whether, under any reasonable reading of the pleadings, the Committee may be entitled to relief, accepting as true all well pleaded allegations in the Amended Complaint and drawing all reasonable inferences in favor of the Committee. Nami v. Fauver, 82 F.3d 63, 65 (3d Cir.1996). The District Court's order granting the motion to dismiss will be affirmed only if it appears that the Committee can prove no set of facts that would entitle it to relief. Conley v. Gibson, 355 U.S. 41, 45-46, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957).

III.

[2][3] As a preliminary matter, we believe that the District Court's conception of the standing issue in this case was somewhat flawed. The District Court stated that both cognizable injury and the doctrine of *in pari delicto* were elements of the standing analysis. Official Committee of Unsecured Creditors, No. 99-526, slip op. at 6. This formulation, however, was incorrect. In general, "[s]tanding consists of both a 'case or controversy' requirement stemming from Article III, Section 2 of the Constitution, and a subconstitutional 'prudential' element." See The Pitt News v. Fisher, 215 F.3d 354, 359 (3d Cir.2000). An analysis of standing does not include an analysis of equitable defenses, such as *in pari delicto*. Whether a party has standing to bring claims and whether a party's claims are barred by an equitable defense are two separate questions, to be

addressed on their own terms. See *347In re Dublin Secs., Inc., 133 F.3d 377, 380 (6th Cir.1997) (analyzing *in pari delicto* separately from standing).

That said, we will address both doctrines because, together, they formed the basis of the District Court's judgment. As a threshold requirement, standing demands our initial attention. See Valley Forge Christian College v. Americans United for Separation of Church & State, Inc., 454 U.S. 464, 471-74, 102 S.Ct. 752, 70 L.Ed.2d 700 (1982) (discussing the fundamental requirement of standing). Citing Warth v. Seldin, 422 U.S. 490, 501, 95 S.Ct. 2197, 45 L.Ed.2d 343 (1975), for the proposition that standing requires a "distinct and palpable injury," Lafferty argues that the Committee lacks standing because the Debtors have not sustained a "cognizable injury" separate and apart from any injury sustained by investors who had purchased the Debtors' debt securities. As such, Lafferty maintains that the Committee may not bring those claims under the Supreme Court's decision in Caplin v. Marine Midland Grace Trust Co., in which the Court held that a bankruptcy trustee has no standing to assert claims on behalf of an estate's creditors. See 406 U.S. 416, 434, 92 S.Ct. 1678, 32 L.Ed.2d 195 (1972).

Lafferty made the same argument to the District Court, which rejected it on the ground that, at the motion to dismiss stage, the court could not foreclose the existence of a separately cognizable injury to the Debtors distinguishable from the injuries suffered by purchasers of the Debtors' certificates:

Here, the Committee is suing on behalf of the bankrupt debtor corporations [Walnut and ELCOA]--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 [] and Lafferty maintain that the alleged Ponzi scheme claims belong exclusively to the creditors, citing Hirsch v. Arthur Andersen & Co., 72 F.3d 1085 (2d Cir.1995). [However, I believe that, w]hile the most obvious damages were those sustained by the creditors who purchased certificates [and securities], *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

