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**EQUITY TURNED ON ITS HEAD:
The Applicability of *In Pari Delicto* to a Bankruptcy Trustee**
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I. INTRODUCTION

The Latin phrase *in pari delicto* refers to a plaintiff's participation in the same wrongdoing as the defendant.¹ The equitable defense of *in pari delicto* prevents wrongdoers from recovering damages resulting from their own wrongful conduct. A line of cases has recently emerged regarding the applicability of the *in pari delicto* defense to bankruptcy trustees. Defendants, such as accounting firms and other professionals, are now trying to use this defense to prevent plaintiffs from recovering for the defendants' own wrongdoing. Unfortunately, some courts have blessed this perverted use of the defense, stripping trustees and creditor's committees of valuable claims and leaving aggrieved parties with little practical redress.

To reach this result, some courts have improperly conflated the *in pari delicto* defense with the concept of standing, while others have applied a restrictive construction of the Bankruptcy Code. In fact, an affirmative defense like *in pari delicto* has nothing to do with standing, and the Bankruptcy Code (itself a body of equitable principles) does not in our opinion require the application of the *in pari delicto* defense as called for by these courts. This line of cases is wrongly decided, as the growing rumblings of bankruptcy experts across the country condemning this trend in the case law portend.²

This article first addresses the standing argument. Second, and more substantively, the article analyzes imputation. Finally, this article provides what the authors believe is the correct interpretation of section 541 of the Bankruptcy Code as it applies to personal defenses such as *in pari delicto*.

II. THE DEFENSE OF IN PARI DELICTO HAS NOTHING TO DO WITH STANDING

An emerging line of cases improperly requires consideration of the affirmative defense of *in pari delicto* within the standing analysis. In these cases, the bad acts of a bankrupt company's controlling insider (a "sole actor") are imputed to the company and then to the trustee, who stands in the shoes of the debtor. The trustee is then "deemed," through a summary application of the *in pari delicto* defense, to lack standing to pursue claims against third parties who assisted in the company's demise. Notably, these cases never analyze whether, under principles of equity, *in pari delicto* should be applied as a defense in the bankruptcy context.

This "standing" analysis derives from the Second Circuit Court of Appeals' decision in *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114 (2d Cir. 1991). Fortunately, *Wagoner's*

¹ *In pari delicto* has its root in the Latin phrase, *in pari delicto potior est conditio defendentis*, which translates to mean, "in the case of equal or mutual fault...the position of the [defending] party...is the better one." *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985).

² See Jeffrey Davis, *Ending the Nonsense: The In Pari Delicto Doctrine Has Nothing to Do with What is § 541 Property of the Bankruptcy Estate*, 21 EMORY BANKR. DEV J. 519 (Summer 2005); 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 (Summer 2003); Gerald L. Baldwin, *In Pari Delicto Should Not Bar a Trustee's Recovery*, 23 AM. BANKR. INST. J. 8 (Oct. 2004); *Making Sense of the In Pari Delicto Defense: "Who's Zoomin' Who?"*, 23 No. 11 BANKR. LAW LETTER 1 (Nov. 2003); Robert T. Kugler, *The Role of Imputation and In Pari Delicto in Barring Claims Against Third Parties*, 1 No. 14 ANDREWS BANKR. LIT. REP. 13 (2004).

application has been limited almost exclusively to courts in the Second Circuit. *See Mediators, Inc. v. Manney (In re The Mediators, Inc.)*, 105 F.3d 822 (2d Cir. 1997); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085 (2d Cir. 1995); *Complete Mgmt., Inc. v. Arthur Andersen, LLP (In re Complete Mgmt., Inc.)*, No. 02-CV-1736, 2003 U.S. Dist. LEXIS 12977 (S.D.N.Y. July 29, 2003); *Official Comm. of the Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, 322 F.3d 147 (2d Cir. 2003); and, *Lippe v. Bairnco Corp.*, 218 B.R. 294 (S.D.N.Y. 1998). The Second Circuit's analysis is fundamentally flawed, however, and has been soundly criticized in other circuits.

In general, "standing consists of both a 'case or controversy' requirement stemming from Article III, Section 2 of the Constitution, and a subconstitutional 'prudential' element." *See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 346 (3d Cir. 2001). The focus for standing is whether the plaintiff has sustained a cognizable injury. *Id.* at 347. The analysis "does not include an analysis of equitable defenses, such as *in pari delicto*." *Id.* at 346 (emphasis added). "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." *Id.*; *see also Tolz v. Proskauer Rose LLP (In re Fuzion Techs. Group, Inc.)*, 332 B.R. 225, 230-31 (Bankr. S.D. Fla. 2005); *Schertz-Cibolo-Universal City Indep. Sch. Dist. v. Wright (In re Educators Group Health Trust)*, 25 F.3d 1281, 1286 (5th Cir. 1994) (same); *Terlecky v. Hurd (In re Dublin Sec., Inc.)*, 133 F.3d 377, 380 (6th Cir. 1997) (analyzing *in pari delicto* separately from standing). A very recent Eighth Circuit opinion agreed with the First, Third, Fifth and Eleventh Circuits that even if an *in pari delicto* defense appears on the face of the complaint, it does not deprive the trustee of constitutional standing to assert the claim although the defense may be fatal to the claim. *In re Senior Cottages, L.L.C.*, 482 F.3d 997, 1004 (8th Cir. 2007).

Accordingly, the law in the Second Circuit conflating standing and *in pari delicto* analyses is an aberration that should not be adopted for the proposition that a trustee does not have standing in cases of *in pari delicto*. Whether a trustee is subject to the equitable affirmative defense of *in pari delicto* is a separate issue from standing.

III. THE EFFECT OF IMPUTATION ON THE IN PARI DELICTO DOCTRINE

The application of the *in pari delicto* doctrine to a corporate bankruptcy trustee is contingent on the rules of imputation and the adverse interest exception to those rules. It is clear that "[s]tate law determines the circumstances under which the misconduct of corporate actors may be imputed to the corporation." *In re Advanced RISC Corp.*, 324 B.R. 10, 14 (D. Mass. 2005) (citing *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 355-56 (3d Cir. 2001)). Thus, a particular state's law on imputation and the defenses to imputation provided under state law will vary the *in pari delicto* analysis across jurisdictions. *See O'Melveny & Myers v. Fed. Deposit Ins. Corp.*, 512 U.S. 79, 83-85 (1994) (noting that what equitable defenses are available is determined by state law, not federal). The reasoning behind the state law decisions on imputation, including the adverse interest exception and on the *in pari delicto* doctrine in general, is used as a basis for applying the law in the bankruptcy context.

This section begins with a brief overview of the First Circuit case *Baena vs. KPMG* and highlights the weaknesses in the opinion. Next is an overview of recently emerging decisions in

various jurisdictions that may be persuasive to any court examining this issue. Then, this article examines the various state court decisions that may affect the application of the *in pari delicto* doctrine to bankruptcy Trustees. Finally, the article concludes by providing the correct interpretation of Bankruptcy Code section 541 as it applies to the *in pari delicto* defense.

A. Baena's Flawed Analysis

The First Circuit's opinion in *Baena v. KPMG, LLP*, 453 F.3d 1 (1st Cir. 2006) was issued on June 22, 2006. The First Circuit held that the *in pari delicto* doctrine barred claims by a Chapter 7 Trustee against the debtor's outside auditor. *Baena v. KPMG, LLP*, 453 F.3d at 9-10. The court refused to apply the adverse interest exception because the corporation had benefited from the management's fraud, at least in the short run, by acquiring target companies and securing loans based on its inflated financial condition. *Id.* at 7-8. The court applied Massachusetts imputation law and the adverse interest exception in reaching this conclusion. A close examination of Massachusetts law reveals it may not fully support the First Circuit's decision.

The *Baena* opinion was not the first time this issue had been before a court in Massachusetts. In 2005, a Massachusetts federal District Court considered the application of the *in pari delicto* doctrine to a claim by a bankruptcy trustee. *See In re Advanced RISC Corp.*, 324 B.R. 10, 14 (D. Mass. 2005). In that case, the court looked to Massachusetts state law imputation rules to determine if the fraudulent conduct of bad actors should be imputed to the corporate debtor. *Id.* The court found imputation applicable under the facts. The decision did not result through an analysis of the scope of employment and benefit to the corporation; rather, this decision was reached because the bad actor had **complete control** over the corporation. *Id.* at 14-15. The adverse interest exception was not analyzed.

The court rejected the argument that it is inequitable to apply *in pari delicto* to a bankruptcy trustee after the corrupt actor has been removed. *Id.* at 15. The court emphasized that the Bankruptcy Code is clear that the trustee inherits the legal interests of the debtor at the commencement of the case and post-petition events will not be considered. *Id.* The court was not inclined to allow policy considerations to override the interpretation of the Code's text. *Id.* at 16. Thus, the Court held "that the *in pari delicto* doctrine bars a claim by a bankruptcy trustee where the debtor would have been so barred before the bankruptcy petition was filed." *Id.* The *Baena* court relied heavily on this holding by the court in *Advanced RISC Corp.*

The *Baena* decision hinged on whether the court would apply the adverse-interest exception to bar imputation of the bad acts of the officers to the Bankruptcy Trustee. *Baena v. KPMG, LLP*, 453 F.3d at 7. The court found that although the corporation was driven to insolvency, it had benefited in the "short-term" from the fraudulent financial reporting. *Id.* at 6. While giving the appearance of being profitable and obtaining new investors, the actual effect of such financial accounting fraud is "to put the corporation farther and farther into debt by incurring more and more liability and to give the corporation the false appearance of profitability in order to obtain new investors." *McHale v. Huff*, 109 B.R. 506, 512 (Bankr. S.D. Fla. 1989).

While *Baena* cites Massachusetts case law in support of its opinion, the cases cited do not necessarily support the court's application of the doctrine. For example, one of the cited cases

notes the "well-established exception to the doctrine of *in pari delicto* provides that where the parties are not in equal fault as to the illegal element, or are not *in pari delicto*, and where there are elements of public policy more outraged by the conduct of one than of the other, then relief in equity may be granted to the less guilty." *Choquette v. Isacoff*, 836 N.E.2d 329, 332 (Mass. App. Ct. 2005) (quoting *Council v. Cohen*, 21 N.E.2d 967, 970 (1939) (quotation marks omitted)). The court went on to note that "there may be on the part of the court itself a necessity of supporting the public interests or public policy in many cases, however reprehensible the acts of the parties may be." *Id.* at 333 (quoting 1 Story, Commentaries on Equity Jurisprudence § 423, at 399-400 (14th ed. 1918) (footnotes omitted)). This part of the *Choquette* case and the cases cited by *Choquette* are not mentioned in Baena opinion at all, yet the court's analysis would have benefited greatly from them. Bankruptcy is an equitable system; knowing that Massachusetts's application of *in pari delicto* requires such equitable considerations might allow an innocent Trustee to bring such claims.

Another case cited by the *Baena* court was *GTE Products Corp. v. Broadway Electrical Supply Co., Inc.*, 676 N.E.2d 1151 (Mass. App. Ct. 1997) ("*GTE*"). *GTE* also fails to support *Baena's* conclusions. In *GTE*, "[t]he central premise underlying the defendants' position that [the employee]'s actions should be attributed to his principal is that the plaintiff still benefited from the fraud []; hence, [the employee] engaged not in an 'independent' fraud but, instead, acted within the general scope of his employment to further his employer's interests. We cannot agree." *GTE*, 676 N.E.2d at 1156. Like in *Baena*, the defendants in *GTE* argued that the agent's actions were not so adverse to the plaintiff's interests that the conduct should not be imputed. *Id.* The court felt that the defendants "hoped to peg plaintiff with [the employee]'s knowledge . . . so as to escape liability on the fraud." *Id.* Unlike *Baena*, however, the court found that the question of whether the agent "acted on his own and against his employer's interests was one of fact for the jury to decide." *Id.* The court noted "that the plaintiff may have benefited in some small way in spite of the agent's fraudulent acts is hardly enough to establish . . . [his] actions were not adverse to his employer's interests." *Id.* Despite state law application to the contrary, the *Baena* court came to the conclusion that if the corporation benefited even slightly from the bad acts of its principles, their acts were imputed to the corporation and eventually to the Trustee. It is this author's opinion that had *Baena* applied Massachusetts law correctly, its analysis would have led to a different outcome—*i.e.*, a conclusion more consistent with Massachusetts law, as stated in *GTE*. See also, *Alan Nisselson, Trustee of the Dictaphone Litigation Trust v. Jo Lernout, et al.*, 469 F.3d 143 (1st Cir. 2006) (following *Baena's* analysis and ruling that bad acts of the directors and officers were imputed to the corporation and thus the trustee. Further, the Court held the creditors may have claims and could pursue those without application of the defense.)

B. Other Persuasive and Better-Reasoned Authority

1. *In re Parmalat Securities Litigation*

This case involves an Italian company in a reorganization proceeding where the equivalent of a Chapter 11 bankruptcy trustee brought claims against Bank of America for structuring transactions that defrauded the debtors by "permitting corrupt insiders to loot the companies with impunity." *In re Parmalat Sec. Litig.*, 412 F. Supp.2d 392, 394 (S.D.N.Y. 2006). The complaint alleged a series fraudulent financial transactions that were designed to conceal the company's insolvency, but eventually resulted in bankruptcy. *Id.* at 395. The

Bankruptcy Court granted the defendant bank's motion to dismiss, holding that the *in pari delicto* doctrine barred recovery "because the original complaint's detailed allegations made it quite clear that the Parmalat entities were crucial actors in the [] transactions." *Id.* (quoting *Bondi v. Bank of Am. Corp.*, 383 F. Supp.2d 587, 596 (S.D.N.Y. 2005) (quotation marks omitted) ("Bondi II")). Since the transactions were intended to benefit Parmalat and the complaint clearly set forth the facts of Parmalat's massive fraud, it was clear that the agents were acting for the company. *Id.*

The trustee filed a First Amended Complaint which contained the same financial transactions, but alleged that Parmalat itself did not benefit from the fraudulent transactions and the only benefit was to the corrupt managers who made it appear the company was creditworthy when it was not. *Id.* at 396. Because the complaint lacked allegations relating to the company's own participation in the fraud, the court refused to bar the company's claims based on the *in pari delicto* doctrine. *Id.* at 401. The court rejected the bank's argument that the insider's knowledge should be imputed to the company because "the complaint specifically alleges that they were acting wholly in their own interests and outside the scope of their employment in looting the Company." *Id.* at 400.

2. *Sender v. Mann*

This case involves claims against third parties (specifically attorneys), where the company was engaged in a ponzi scheme. *Sender v. Mann*, 423 F. Supp.2d 1155 (D. Colo. 2006) ("*Sender I*"). The court notes that "*in pari delicto* generally bars a Trustee from bringing claims on behalf of a debtor acting under § 541 against a third party in a ponzi scheme situation." *Id.* at 1174 (citing *Sender v. Buchanan*, 84 F.3d 1281,1307 (10th Cir. 1996) ("*Sender II*"). The court emphasizes the importance of distinguishing "between claims that the defendant participated in the ponzi scheme itself, and claims that the defendant acted outside of the ponzi scheme to steal or loot from the corporation." *Id.* Since the current claims of harm to the corporation arise from acts outside of the activity that the corporation itself was engaged in, it is not complicit in the illegal conduct which is the basis for the claim. *Id.* Thus, the court found the *in pari delicto* doctrine did not apply. *Id.*

The court went on to state that "direct participation in the ponzi scheme is imputed to the debtor and barred by *in pari delicto*, while defendant's mis-conduct that did not benefit the debtor in any way, but only benefited the defendants and the debtor's principals is not." *Id.* (citing *Sender II*, 84 F.3d at 1307) (quotation marks omitted). In discussing a prior case where acts were imputed and *in pari delicto* applied, the court noted in that case, under Colorado law, "the debtor entity received funds from ponzi scheme participants, and thus benefited from their involvement." *Id.* (citing *Sender II*, 84 F.3d at 1307). Therefore, the district court, in applying Colorado law, appears to apply a benefit analysis that considers funds received by the corporation as a result of the bad acts to be a benefit, regardless of the eventual outcome.

3. *NCP Litigation Trust v. KPMG LLP*

This recent case from the Supreme Court of New Jersey analyzes claims very similar to those in *Baena v. KPMG*. But, this court comes to very different conclusions.³

In *NCP*, two officers of a corporation misrepresented financial details to an independent accounting firm - KPMG. *NCP*, 901 A.2d at 872. KPMG failed to detect the misrepresentations for years, but when the fraud was finally revealed, the corporation was forced to restate its financials, reporting millions of dollars in losses and declared bankruptcy. *Id.* at 875. The litigation trust filed suit against the auditor for negligently conducting the audit; the trial court granted KPMG's motion to dismiss based on imputation of the fraudulent acts to the corporation and to the litigation trust as the corporation's successor-in-interest. *Id.* at 872.

After the Appellate Division reversed the order granting the motion to dismiss, the matter came before the New Jersey Supreme Court to decide if imputation would bar the litigation trust's claims. *Id.* at 873. The Court held that:

"the imputation doctrine does not bar corporate shareholders from recovering through a litigation trust against an auditor who was negligent within the scope of its engagement by failing to uncover or report the fraud of corporate officers and directors; [yet] imputation [] may be raised as a defense by auditors to bar such claims against corporate shareholders who were engaged in and were aware of the wrongdoing of corporate agents."

Id.

As to whether the conduct benefited the corporation, the court noted that while the fraudulent numbers were being reported, the corporation was able to issue stock for sale to the public, acquire another company, and report increased revenues and income every year. *Id.* at 875. But, once the financials were restated, the stock price plummeted and the effect of the disclosures was "disastrous for the corporation." *Id.* at 875. The court held that "inflating a corporation's revenues and enabling a corporation to continue in business 'past the point of insolvency' cannot be considered a benefit to the corporation." *Id.* at 888; *see also In re Investors Funding Corp.*, 523 F. Supp. 533, 541 (S.D.N.Y. 1980) ("A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it.").

IV. SECTION 541 DOES NOT REQUIRE APPLICATION OF THE IN PARI DELICTO DEFENSE

Other courts, have reached the opposite and incorrect result by forcibly applying the *in pari delicto* through the funnel of Bankruptcy Code section 541. *See Sender v. Buchanan (In re Hedged-Investments Assocs.)*, 84 F.3d 1281, 1285-86 (10th Cir. 1996); *Official Comm. of*

³ Compare *NCP Litigation Trust v. KPMG LLP*, 901A.2d 871 (N.J. 2006) ("*NCP*"), with *Baena v. KPMG LLP*, 453 F.3d 1. The facts of the *NCP* case are similar to the facts in *Baena*, but *NCP* is a more reasoned opinion.

Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 356 (3d Cir. 2001); *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1149-51 (11th Cir. 2006).

Under section 541, the filing of a bankruptcy petition creates an estate. The estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a). As section 541's legislative history reflects, causes of action belonging to the debtor fall within this definition. 11 U.S.C.A. § 541 (Revision Notes and Legislative Reports – 1978 Acts); 1978 U.S.C.C.A.N. 5963, 6323-24. And, as a general proposition, section 541 "is not intended to expand the debtor's rights against others more than they exist at the commencement of the case." *Id.* Accordingly, for example, "if the debtor has a claim that is barred at the time of the commencement of the case by the statute of limitations, then the trustee would not be able to pursue that claim, because he too would be barred. He could take no greater rights than the debtor himself had." *Id.*

Relying on this legislative history and the statute's phrase "as of the commencement of the case," cases like *Sender* and *Lafferty* construe section 541 as requiring a blind application to the bankruptcy trustee of all defenses to which the debtor would have been subject under nonbankruptcy law as of the moment of bankruptcy. *See Sender*, 84 F.3d at 1285-86; *Lafferty*, 267 F.3d at 356. This construction is incorrect for many reasons, not the least of which is that the bankruptcy court is a court of equity and equity is not served by applying equitable defenses personal to the debtor to bar a trustee from pursuing claims to the detriment of innocent victims and the benefit of wrongdoers.

Indeed, both the *Sender* and *Lafferty* courts expressly recognize the sound policy considerations for allowing the trustee to pursue such claims, but then (incorrectly) conclude that section 541 precludes the trustee from doing so. *See Sender*, 84 F.3d at 1285 ("To be sure, Mr. *Sender* articulates sound reasons why it might be wise to allow an exception to this rule in cases, such as this one, where the trustee's efforts stand to benefit hundreds of innocent investors."); *Lafferty*, 267 F.3d at 357-58 (quoting *Sender*). Both courts construe section 541 too narrowly – neither appears to have considered the entirety of section 541's legislative history or the policy considerations relevant to the analysis.⁴

⁴ The absurdity of the *Sender* and *Lafferty* courts' hyper-restrictive construction of section 541 is never more evident than in cases like *Hannover Corp. of America v. Beckner*, where the court distinguished *Sender* and refused to apply the *in pari delicto* defense to bar the debtors' claims because the corporation had gone through a federal receivership before entering Chapter 11 bankruptcy. 211 B.R. 849, 859 (M.D. La. 1997). As explained by the *Hannover* court, "Hays was appointed federal receiver before the plaintiff corporations entered chapter 11 bankruptcy. Thus, the corporations were freed from the sting of *in pari delicto* prior to plaintiffs' commencement of bankruptcy proceedings." *Id.* That the perceived restrictions of section 541 can be so easily circumvented is a testament to their invalidity.

As noted by Justice Cowan:

The point of equitable doctrines is to avoid injustice caused by overly inflexible rules: equity is "[t]he recourse to principles of justice to correct or supplement the law as applied to particular circumstances." [citation omitted] Here the majority injects a pointless technicality into an equitable doctrine. For example, . . . if the debtor corporation is placed in receivership prior to the filing of the bankruptcy petition, there is no *in pari delicto* bar on an action by the

First, the perceived restriction of section 541, based on the legislative history limiting the trustee to "no greater rights than the debtor himself had," is incorrect. *See* 11 U.S.C.A. § 541 (Revision Notes and Legislative Reports – 1978 Acts); 1978 U.S.C.C.A.N. 5963, 6323-24. Section 541's legislative history also expressly states that defenses that are "personal against the debtor" are *not* effective against the estate:

Thus, as section 541(a)(1) clearly states, the estate is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case. To the extent such an interest is limited in the hands of the debtor, it is equally limited in the hands of the estate *except to the extent that defenses which are personal against the debtor are not effective against the estate.*

11 U.S.C.A. § 541 (Legislative Statements) (emphasis added); 124 Cong. Rec. 32,399 (1978). Although this portion of the legislative history has been largely – and inexplicably – overlooked, its validity is recognized by highly respected authorities on bankruptcy law and at least one court. *See, e.g.,* 5 Collier on Bankruptcy ¶ 541.04 (15th rev. ed. 2004) ("To the extent an interest is limited in the hands of the debtor, it is equally limited as property of the estate *except to the extent that defenses which are personal against the debtor are not effective against the estate.*") (emphasis added); Jeffrey Davis,⁵ *Ending the Nonsense: The In Pari Delicto Doctrine Has Nothing to Do with What is § 541 Property of the Bankruptcy Estate*, 21 Emory Bankr. Dev. J. 519, 538-39 (Summer 2005) (same); *see also In re Fuzion Tech. Group, Inc.*, 332 B.R. 225, 230-31 (Bankr. S.D. Fla. 2005) (same).

At a minimum, the seemingly absolute limit on the Trustee's power to assert a claim — "[h]e could take no greater rights than the debtor himself had " — is clearly contradicted by section 541's more specific mitigating language — "except to the extent that defenses which are personal against the debtor are not effective against the estate." *See Ending the Nonsense*, 21 Emory Bankr. Dev. J. at 538-39. By ignoring the second phrase, courts have found the legislative history more restrictive than it really is. *Id.* at 541. Hence, under a complete reading of section 541's legislative history, a bankruptcy trustee is subject to the same defenses to which the debtor is at the moment of bankruptcy *except* those defenses that are "personal" against the debtor.

The Latin phrase *in pari delicto* — which, as previously noted, refers to a plaintiff's participation in the same wrongdoing as the defendant — is an equitable principle and defense that prevents a plaintiff who has participated in wrongdoing from recovering damages resulting from the wrongdoing. *See* discussion *supra*; *see also In re Fuzion Techs. Group, Inc.*, 332 B.R. at 230. Accordingly, the primary focus of the defense is on personal malfeasance of the individual seeking to recover damages. This is the epitome of a "personal" defense. *See, e.g., Pinter v. Dahl*, 486 U.S. 622, 632 (1988); *J.C. Wyckoff & Assocs. v. Aetna Cas. & Sur. Co. (In re*

corporation. [citation omitted] It is difficult to understand what is accomplished by forcing future plaintiffs to take that extra step or denying these plaintiffs relief because they failed to take it. *Equity does not turn on that kind of empty technicality.*

Lafferty, 267 F.3d at 362 (Cowan, J., dissenting) (emphasis added).

⁵ Mr. Davis is a Gerald A. Sohn Research Scholar and Professor of Law at the University of Florida Levin College of Law.

J.C. Wyckoff & Assocs., Inc., 41 B.R. 791, 792-93 (Bankr. E.D. Mich. 1984); *Exxon Corp. v. Oxford Clothes, Inc.*, 109 F.3d 1070, 1078 n.11 (5th Cir. 1997); *Nomura Sec. Int'l, Inc. v. E*Trade Sec., Inc.*, 280 F. Supp. 2d 184, 196-97 (S.D.N.Y. 2003).

Because the legislative history of section 541 clarifies that "property of the estate" includes the debtor's claims unencumbered by personal defenses, the *in pari delicto* defense is inapplicable to a trustee's claims.

Courts, including the United States Supreme Court, have historically recognized that state law rights at the moment of bankruptcy are not the sole determinant of what is property of the estate. Bankruptcy principles and policies play an important role in the analysis and can justify the consideration of postpetition events (like the appointment of an innocent bankruptcy trustee) in determining whether a claim is "property of the estate."

For example, in *Segal v. Rochelle*, the Supreme Court allowed a trustee to claim as property of the estate a tax refund for a taxable year that ended postpetition. 382 U.S. 375, 380 (1966). Permitting the consideration of the postpetition event (the ending of the tax year) for purposes of determining "property of the estate," the Court reasoned that the refund was "sufficiently rooted in the pre-bankruptcy past and so little entangled with the bankrupts' ability to make an unencumbered fresh start that it should be regarded as 'property.'" *Id.* In reaching this conclusion, the Court specifically stated that bankruptcy policy and purposes must ultimately govern questions as to what is property of the estate. *Id.* at 379. Accordingly, the Court's focus in *Segal* was not on whether the right to the refund had fully vested at the moment of bankruptcy but, rather, on whether classifying the refund as property of the estate would encumber the bankruptcy policy of giving the debtor a "fresh start." *Id.* at 379-80.

In *Kokoszka v. Belford*, the Supreme Court likewise held that, in determining the scope of the term "property" – and its limitations – the "purposes of the Bankruptcy Act must ultimately govern." 417 U.S. 642, 645 (1974). The Court concluded that a garnishment statute restricting the garnishment of wages to 25% could not limit the right of the bankruptcy trustee to treat the debtor's entire income tax refund as property of the estate. *Id.* at 652. Again, in its analysis, the Court considered whether the purposes of the Bankruptcy Act – to convert the estate of the bankrupt into cash and distribute it among creditors and to give the bankrupt a fresh start – would be served by including the entire tax refund within the property of the estate despite the applicability of the garnishment statute. *Id.* at 646-47; *see also Page v. Edmunds*, 187 U.S. 596, 605-06 (1903) (seat in stock exchange held property of the estate under Bankruptcy Act even though property was exempt under state law).

Further, courts have freely considered postpetition acts in applying other provisions of the Bankruptcy Code – all in service to the equitable nature and purposes of the bankruptcy courts and Code. For example, when a claim against the debtor's fraudulent managers is brought by the Trustee under section 548 of the Bankruptcy Code, a "better rule" prevails on the issue of imputing the manager's fraudulent conduct to the bankruptcy trustee: it's not allowed. Why? Because it "would lead to an inequitable result," – the imputation doctrine and *in pari delicto* defense would serve "only to bar the claims of an innocent successor." *See McNamara v. PFS (In re The Personal & Bus. Ins. Agency)*, 334 F.3d 239, 241 (3d Cir. 2003); *see also PM Denver, Inc. v. Porter (In re Porter McLeod, Inc.)*, 231 B.R. 786, 794-95 (D. Colo. 1999) (refusing to

apply *in pari delicto* defense under section 544(a) where application of the doctrine would not be in the public interest); *Anstine v. Alexander*, 128 P.3d 249, 254-55 (Colo. App. 2005), *rev'd*, 152 P.3d 497 (Colo. 2007) (without any discussion of the *in pari delicto* doctrine).

Finally, in the comparable arenas of antitrust and securities law, federal policy often dictates restrictions on the use of *in pari delicto*, requiring courts to carefully consider public policy implications before the defense is allowed. See *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310-11 (1985) (*in pari delicto* defense is allowed in securities fraud case only if "preclusion of suit would not significantly interfere with the effective enforcement of the laws and protection of the public"); *Perma Life Mufflers, Inc. v. Int'l Parts Corp.*, 392 U.S. 134, 140 (1968) (refusing to recognize *in pari delicto* as a defense to an antitrust action in light of purposes of antitrust laws); see also *Ending the Nonsense*, 21 Emory Bankr. Dev. J. at 539-41.

V. CONCLUSION

In sum, while state law is highly relevant in determining the rights a party has under a federal statute, courts across the board recognize that the purposes and policies behind the applicable federal statute ultimately govern the scope and extent of the parties' rights. In the bankruptcy context, this means that postpetition acts may be considered when doing so would serve the higher cause of preventing inequitable results. Indeed, the trustee is charged with marshaling the assets of the estate and distributing them in the best interests of the parties. 11 U.S.C. § 704(a); *In re Fuzion Techs. Group, Inc.*, 332 B.R. at 234.. The trustee "is the last good person who can help the creditors and ensure that the loss is borne by those who caused it and not by innocent people."

Accordingly, the postpetition replacement of the corrupt sole actor with an innocent trustee should be relevant (and controlling) to the imputation and *in pari delicto* analysis. Refusing to consider it has the ironic effect of turning the defense on its head – instead of preventing a wrongdoer from profiting from his wrong, the defense shields the wrongdoer from liability and punishes the innocent victims. The equitable policies governing the *in pari delicto* defense and underlying federal bankruptcy law preclude such a perverse result. As best articulated by Chief Judge Posner, writing for the Seventh Circuit in a receivership case:

[T]he wrongdoer must not be allowed to profit from his wrong by recovering property that he had parted with in order to thwart his creditors. That reason falls apart 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 his spell they became entitled to return of the moneys—for the benefit not of [the wrongdoer] but of innocent investors—that [the wrongdoer] had made the corporations divert to unauthorized purposes.

Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995). In other words, the doctrine of *in pari delicto* "loses its sting when the person who was *in part delicto* is eliminated." *Id.* at 755.

Finally, even if legislative history and equitable considerations did not preclude the application of the *in pari delicto* defense once the wrongdoer is out of the picture postpetition,

the existence of an equitable defense to a litigation claim should not *define* whether the claim constitutes "property of the estate." As explained by one commentator,

[W]hile the debtor and the estate should have the same rights to bring an action prepetition and postpetition, § 541 should not freeze in time the factual basis for the claims and defenses to a litigation action that is based on a fluid factual underpinning. *In pari delicto*, after all, is concerned with whether a wrongdoer is in the position to recover for his wrong, therefore it makes no sense to analyze the underlying facts frozen at a certain time. If the wrongdoer is eventually removed from a position of recovery, that development should be a key fact whether he or she was removed prepetition or postpetition.

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, 322-23 (Summer 2003).

Thus, if permitted at all, the defense of *in pari delicto* should be analyzed according to the facts as they exist at the time of determination (pre- or postpetition), just like the doctrine of unclean hands can bar a litigant from recovery based on inequitable and unfair conduct that occurred *after* suit is brought. *Id.* That is, the existence of an equitable defense like *in pari delicto* should not dictate whether the corresponding claim is "property of the estate" any more than a third party's defense of anticipatory repudiation based on the debtor's prepetition acts means the debtor's breach of contract claim is not property of the estate or that the third party's postpetition reaffirmation of the contract cannot be considered in litigating the claim. *Id.* Section 541 should simply "have no bearing on the application of an equitable defense to an estate cause of action." *Id.*