

Bankruptcy

Equity Turned on Its Head: The Applicability of *In Pari Delicto* to a Bankruptcy Trustee

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A. Introduction

The Latin phrase *in pari delicto* refers to a plaintiff's participation in the same wrongdoing as the defendant.¹ An equitable principle and affirmative defense, *in pari delicto* prevents a wrongdoer from recovering damages resulting from the wrongdoing. *Tolz v. Proskauer Rose LLP (In re Fuzion Techs. Group, Inc.)*, No. 03-2198-BKC-RBR-A, 2005 Bankr. LEXIS 718, at *9 (Bankr. S.D. Fla. Mar. 2, 2005). The primary focus of the defense is on the personal malfeasance of the individual seeking to recover damages.

A troubling line of cases has recently emerged regarding the applicability of the *in pari delicto* defense to bankruptcy trustees. Defendants are using this defense and these rulings to their advantage to prevent victims from recovering for wrongdoing and to set wrongdoers free. Unfortunately, some courts have blessed this perverted use of the defense, stripping trustees and creditors' committees of valuable claims. This cannot be and is not the law. To reach this unfortunate result, some courts have improperly confused the *in pari delicto* defense with the concept of standing, while others have applied an overly restrictive construction of the Bankruptcy Code. In fact, an affirmative defense like *in pari delicto* has nothing to do with standing, and the proper application of the Bankruptcy Code (itself a body of equitable principles) does not require this result. These cases are wrongly decided, as the rumblings of bankruptcy scholars across the country condemning this trend in the case law portend.²

¹ The doctrine of *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, 105 S. Ct. 2622, 2626 (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).

This article addresses the applicability of the *in pari delicto* defense to bankruptcy trustees. It also analyzes the reasoning of the courts in applying the defense against a trustee and highlights why the reasoning is flawed. The article then outlines what the authors believe to be the correct interpretation of section 541 of the Bankruptcy Code as it applies to personal defenses such as *in pari delicto*.

B. The defense of *in pari delicto* has nothing to do with standing.

One line of cases emerging on this subject 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 bankruptcy 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 corrupt demise of the company. 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) (holding that "[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation."). *Id.* at 120. Fortunately, *Wagoner's* application has been limited almost exclusively to courts in the Second Circuit. See *The 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); *Lippe v. Bairnco Corp.*, 218 B.R. 294 (S.D.N.Y. 1998). In fact, as demonstrated below, the Second Circuit's analysis is fundamentally flawed and has been soundly rejected 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.*; *In re Fuzion*, 2005 Bankr. LEXIS 718, at *7-8 (same); *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). The *Wagoner* court and the cases that follow *Wagoner's* reasoning ignore these recognized principles of jurisprudence and improperly combine the application of *in pari delicto* to the traditional standing analysis.

The law in the Second Circuit combining the standing and *in pari delicto* analyses is flawed and should not be adopted for the proposition that a trustee does not have standing in cases where the *in pari delicto* defense is asserted. Whether a trustee is subject to the defense of *in pari delicto* is a separate issue from standing. The issue for standing is cognizable injury, not the viability of an equitable affirmative defense. By combining the analysis, the Second Circuit has created a convenient escape for parties who may have participated in the demise of a company.

C. Section 541 does not require application of the *in pari delicto* defense.

Other courts, outside the Second Circuit, have reached the same incorrect result as in *Wagoner* (dismissal of the trustee's claims) on a different, but still incorrect, ground - section 541 of the Bankruptcy Code. See *Sender v. Buchanan (In re Hedged-Investments Assocs.)*, 84 F.3d 1281, 1285-86 (10th Cir. 1996); *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 356 (3d Cir. 2001). Section 541 does not require this result.

Under section 541 of the Bankruptcy Code, 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 the legislative history of section 541 reflects, causes of action belonging to the debtor fall within this definition. 11 U.S.C.A. § 541 note (West 2004) (Revision Notes and Legislative Reports - 1978 Acts); 1978 U.S.C.C.A.N. 5963, 6323-24. 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," the *Sender* and *Lafferty* courts 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 an innocent trustee from pursuing claims to the detriment of innocent victims and to 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.³ A point by point analysis of the reasons why this is so, is provided below.

³ 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 Am 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.

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

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 note (West 2004) (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 note (West 2004) (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,⁴ *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*, 2005 Bankr. LEXIS 718, at *8 (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 the 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.

As stated in the opening paragraph of this article, *in pari delicto* is an equitable principle and defense that prevents a plaintiff who has participated in wrongdoing from recovering damages resulting from the wrongdoing. *In re Fuzion Tech.*, 2005 Bankr. LEXIS 718, at *9. 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 J. C. Wyckoff & Assocs., Inc.*), 41 B. R. 791, 792-93 (Bankr. E. D. Mich. 1984); *Exxon Corp. v. Oxxford 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.

in receivership prior to the filing of the bankruptcy petition, there is no *in pari delicto* bar on an action by the 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).

⁴ Mr. Davis is a Gerald A. Sohn Research Scholar and Professor of Law at the University of Florida Levin College of Law.

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.

Second, state law rights at the moment of filing bankruptcy are not the sole determinate of what is "property of the estate" - the question is ultimately a matter of federal policy. Courts, including the United States Supreme Court, have historically recognized that state law rights at the moment of filing 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, 86 S. Ct. 511, 515 (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, 515. 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, 515.

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, 94 S. Ct. 2431, 2433 (1974). The Court in that case 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, 2437. 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, 2434. See also *Page v. Edmunds*, 187 U.S. 596, 605-06, 23 S. Ct. 200, 203-204 (1903) (seat in stock exchange held property of the estate under Bankruptcy Act even though property was exempt under state law).

Furthermore, 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*, 2005 WL 913503, at *3 (Colo. App. Apr. 21, 2005).

Third, 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, 105 S. Ct. 2622, 2629 (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. International Parts Corp.*, 392 U.S. 134, 140, 88 S. Ct. 1981, 1985 (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.

In conclusion, 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 statute ultimately govern the scope and extent of those 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 Tech*, 2005 Bankr. LEXIS 718, at *21. 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." *In re Fuzion Tech*, 2005 Bankr. LEXIS 718, at *21.⁵

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 principles 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,

⁵ The "fundamental bankruptcy policy to be furthered is that of fair treatment to creditors and investors by maximizing the distribution to them of the remains of the debtor." *Ending the Nonsense*, 21 EMORY BANKR. DEV. J. at 541. This policy "requires that persons who have enriched themselves through breach of a legal duty to the debtor must be held liable in bankruptcy for the harm they have caused." *Id.*

[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 the 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.*

D. Conclusion

The premise of this article is that courts that have barred a trustee's claims on the basis of *in pari delicto* have done so incorrectly. Clearly, the courts and the commentators are not in agreement on how this issue should ultimately be resolved. For the practitioner, this leaves a perplexing issue. If the debtor is owned and run primarily by a sole shareholder, who is aided by other third parties in breaching his duties to the debtor, how can those claims be preserved so that innocent parties, such as investors and creditors, are made whole for their damages? In such a situation, practitioners will need to structure plans of reorganization and litigation trusts created by such plans to preserve and prosecute claims in such a way that the rights of investors and/or creditors are protected. Until there is judicial agreement on this issue, careful and creative drafting may be the only tool on which practitioners can rely to equitably protect the rights of the innocent.