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Problems in the Code

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Inequitable: *In Pari Delicto* vs. Bankruptcy Trustees

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Enron. *Madoff*. *Stanford*. These cases evoke the same set of rotten facts: a company in bankruptcy, investor funds missing and executives indicted. Creditors swarm, and a bankruptcy trustee is appointed to recover whatever assets can be found. In all likelihood, recoveries will be pennies on the dollar.

But then, a new fact comes to light: The company's auditor was negligent in detecting the fraud. For years, and despite countless red flags, the auditor allegedly failed to follow basic auditing standards and issued one clean audit report after another. As a result, investors continued to pour money into the company, only to have it vanish.

Intuitively, what comes next seems obvious: Courts ought to hold the auditor liable for its role in the fraud, and order damages to be paid to the bankruptcy estate for the benefit of creditors. Yet almost without exception, the auditor in such cases escapes liability to the trustee for its negligence under the *in pari delicto* doctrine. Such outcomes have no basis in equity or common sense, and distort the fundamental principles underlying bankruptcy law. This article summarizes existing case law and highlights a new way of thinking about the *in pari delicto* defense when it is raised against trustees.

"In Equal Fault," or "Don't Call the Kettle Black"

In pari delicto (short for *in pari delicto potior est conditio defendentis*, which means that "if both (parties) are in the wrong, the position of the defendant is the stronger") is a judge-made, affirmative defense rooted in principles of equity.[1] Two major concepts underlie this doctrine: (1) Courts should not lend their offices to mediating disputes among wrongdoers, and (2) denying judicial relief to wrongdoers will effectively deter illegality. In essence, *in pari delicto* tells wrongdoers that the courts will not countenance finger-pointing between similarly culpable parties.

The *in pari delicto* doctrine is frequently invoked in bankruptcy litigation when a trustee seeks to hold defendants liable for conduct that is related to a debtor's pre-petition fraud. Defendants raise *in pari delicto* as a defense to any recovery for the estate, blaming damages on the wrongful acts of the debtor's principals, which are imputed to the debtor itself. A bankruptcy filing establishes an estate consisting of "all legal or equitable interests of the debtor in property as of the commencement of bankruptcy."[2] A debtor's claims held by the estate are "no stronger than they [would be] when actually held by the debtor."[3] Thus, even if an estate assigns the debtor's claims to an innocent trustee, the trustee does not take greater rights than the debtor had in those claims.[4] In other words, a trustee assumes the debtor's causes of action and is subject to whatever defenses exist against the debtor.[5] Therefore, most courts of appeals have held that *in pari delicto* may bar a trustee's claims based on § 541(a) of the Bankruptcy Code, even though the trustee acts for the benefit of defrauded creditors.

Applying Equity to Do ... Inequity?

Section 541(a)(1) provides that a bankruptcy estate includes a debtor's causes of action, subject to whatever defenses may attach. Such claims and defenses are normally defined by state law, and courts cannot ignore valid state law defenses in

1 *Pinter v. Dahl*, 486 U.S. 622, 632 (1988); *Bateman Eichler, Hill Richards Inc. v. Berner*, 472 U.S. 299, 306 (1985).

2 11 U.S.C. § 541(a)(1).

3 *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 357 (3d Cir. 2001).

4 *Id.*

5 *Bank of Marin v. England*, 385 U.S. 99, 101 (1966).

bankruptcy.[6] Thus, "a person sued by a bankruptcy trustee may assert the defense of *in pari delicto* if the jurisdiction whose law creates the claim permits such a defense outside of bankruptcy."[7] Defendants in numerous cases have done just that to thwart recoveries for innocent creditors.

In *Lafferty*, the Third Circuit held that *in pari delicto* barred a trustee-appointed creditors' committee from bringing fraud claims against a third-party professional alleged to have assisted the debtors in perpetrating a fraudulent scheme.[8] The court "agree[d] with the analysis" of its sister circuits that *in pari delicto* applies to a bankruptcy trustee's claims against third parties.[9] Four additional courts of appeals have since followed suit.[10]

Texas Method: A Flexible Approach

However, other courts (and the *Lafferty* dissent) have reasoned that since *in pari delicto* is an equitable doctrine, it should not be confined by the hyper-technical analysis that is applicable to static defenses such as statutes of limitations.[11] The whole point of equitable doctrines is to "avoid injustice caused by overly inflexible rules."[12] The maxim that "a trustee stands in the shoes of the debtor" does not mandate that in evaluating a trustee's claims on behalf of an estate, post-petition events can never be considered.[13]

Courts in the Southern District of Texas have held that proper application of state law in conjunction with § 541 demands that courts conduct an equitable balancing test to determine the effect of an *in pari delicto* defense on a trustee's claims.[14] The question is not whether a trustee is subject to *in pari delicto*, but rather how a particular state's formulation of the doctrine applies to the trustee under the equities and facts of the case, including post-petition events. This approach is consistent with the U.S. Supreme Court's application of *in pari delicto* to claims asserted under non-bankruptcy federal statutes.[15] It is also equally consistent with the application of *in pari delicto* to receivers and other innocent parties.[16]

Even if § 541(a) is construed to restrict a court's ability to consider events beyond the petition date, it cannot be ignored that a debtor's culpable principals will ordinarily not benefit further from prior wrongful acts after the bankruptcy petition has been filed. As noted in the *Lafferty* dissent, "[t]he bankruptcy court would not have allowed itself to become an instrument of their fraud."[17] When a debtor that has perpetrated a fraud files for bankruptcy protection, the discovery and removal of culpable principals is usually inevitable. Although some time may pass before an examiner or trustee is appointed, "there is nothing in the equitable doctrine of *in pari delicto* that insists [that] those formalities must be completed before the doctrine is triggered."[18] Upon the actual appointment of an independent fiduciary, the traditional justification for *in pari delicto* is completely destroyed. In addition, trustees can propose reorganization plans that prohibit recoveries to wrongdoers, further weakening the justification for *in pari delicto*.

Nevertheless, the majority of courts — relying on a "strict" reading of the Bankruptcy Code — reflexively follow the rule that a properly asserted *in pari delicto* defense is an absolute bar to a trustee's § 541(a)-based claims. The result is an inequitable windfall for culpable third-party defendants at the expense of innocent creditors.

A Contingency Plan: Section 541(a)(7)

However, there is a third way to analyze *in pari delicto* that is consistent with the equity and principles of strict construction. Nothing in § 541(a)(1) expressly requires courts to ignore post-petition events, or assume facts that do not exist. Section 541(a)(1) defines "property of the estate" to include, *in part*, property of the debtor as of the time that the bankruptcy case was commenced. Thus, courts have held that a debtor's claims (and applicable defenses), must have been evaluated as they existed on the petition date. This approach is problematic on an intuitive level, because it requires courts to ignore all post-petition events, no matter their importance. It also requires courts to evaluate the equitable defense of *in pari delicto* in a fictional world whereby the debtor's principals might benefit from a trustee's litigation. The approach is also flawed because an estate's claims and interests are subject to change due to post-petition events.

Section 541(a)(1) sets forth the time at which a debtor's interests *become* property of the estate, but does not preclude such interests from changing in character. Indeed, § 541(a)(7) provides that "property of the estate" also include "any interest in property *that the estate acquires after the commencement of the case*."[19] Pursuant to § 541(a)(7), property belonging to the debtor's estate can change in both character and value, sometimes dramatically, as a result of post-petition events.[20] Stated differently, at the same time that a debtor's interest becomes property of the estate, the possibility that such interest might change also becomes property of the estate.[21]

A contingent-property interest is a particularly instructive example of this concept. Although contingent interests are clearly property of the estate pursuant to § 541(a)(1), the contingency of the interest may prevent a trustee from ever utilizing the property for the estate's benefit because the trustee's rights are limited to the same extent as the debtor's rights.[22] Thus, if for any reason a debtor's contingent interest

6 *Peterson v. McGladrey & Pullen LLP*, 676 F.3d 594, 598 (7th Cir. 2012).
7 *Id.*
8 267 F.3d at 360.
9 *Id.* at 357-58 (citing *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1094-95 (2d Cir. 1995); *In re Dublin Secs. Inc.*, 133 F.3d 377, 380-81 (6th Cir. 1997); and *In re Hedged-Invs. Assocs.*, 84 F.3d 1281, 1284 (10th Cir. 1996)).
10 *Peterson*, 676 F.3d at 598-99 (7th Cir.); *Nisselson v. Lernout*, 469 F.3d 143, 158 (1st Cir. 2006); *Official Comm. of Unsecured Creditors of PSA Inc. v. Edwards*, 437 F.3d 1145, 1155 (11th Cir. 2006); *Grassmueck v. Am. Shorthorn Ass'n*, 402 F.3d 833, 836 (8th Cir. 2005).
11 *Lafferty*, 267 F.3d at 362 (dissent) ("Whatever the inflexibility of the Bankruptcy Code, an equitable doctrine like *in pari delicto* is highly fact-sensitive and readily adapted to achieve equitable results.").
12 *Id.*
13 *Segal v. Rochelle*, 382 U.S. 375 (1966).
14 *See, e.g., In re IFS Fin. Corp.*, 2007 Bankr. LEXIS 4708 (Bankr. S.D. Tex. May 3, 2007); *Floyd v. CIBC World Mkts. Inc.*, 426 B.R. 622, 642 (S.D. Tex. 2009).
15 *Bateman*, 472 U.S. at 306-19 (emphasizing need to consider *in pari delicto*'s effects on goals of federal statutes, and stating that "[t]he classic formulation of the *in pari delicto* doctrine itself required a careful consideration of such [public policy] implications before allowing the defense").
16 *FDIC v. O'Melveny & Myers*, 61 F.3d 17, 18 (9th Cir. 1995); *Scholes v. Lehmann*, 56 F.3d 750, 753-55 (7th Cir. 1995); *Porter v. Canyon Cty. Farmers' Mut. Fire Ins. Co.*, 263 P. 632, 634 (Idaho 1928).
17 *Lafferty*, 267 F.3d at 362.
18 *Id.*
19 Emphasis added.
20 *In re Greer*, 242 B.R. 389, 397 (Bankr. N.D. Ohio 1999) ("[O]nce a contingent right in property vests, any rights [that] the debtor would have acquired as a result of the vesting of the property interest become included within a debtor's bankruptcy estate, and may be therefore utilized by the bankruptcy trustee."); *see also In re Alsberg*, 68 F.3d 312, 315 (9th Cir. 1995) (post-petition appreciation in home value is property of estate).
21 *See In re Doemling*, 116 B.R. 48, 50 (Bankr. W.D. Pa. 1991) ("Property interests acquired by the estate after commencement of the case will, in most instances, arise out of property in which the debtor had an interest as of commencement of the case.").
22 *Greer*, 242 B.R. at 396-97.

in an item of property is later divested, the trustee's interest in the property would also be subject to divestment.[23] Pursuant to § 541(a)(7), however, the converse is also true: Once a contingent right vests, any rights that the debtor would have acquired as a result also become property of the estate and might be utilized by the trustee.[24] Any defense based on the contingency of that interest, although perfectly viable on the petition date, would be nullified.

In the *in pari delicto* context, a debtor's wrongful prepetition conduct makes the estate — and the trustee — subject to an *in pari delicto* defense to certain causes of action against third parties. However, determining that a trustee is subject to the defense does not end the inquiry; the defense must still be applied, and courts should follow the *Lafferty* dissent and do so equitably. Indeed, as previously explained, some states' formulations of *in pari delicto* expressly require analysis of the larger equities. In addition, because § 541(a)(7) provides for an estate to acquire property "interests" post-petition, including property interests that were already part of the estate,[25] courts may properly consider the effect of a trustee's appointment, which divests culpable principals of control over the debtor on the continuing viability of *in pari delicto*.

Finding that an *in pari delicto* defense is nullified pursuant to § 541(a)(7) upon a trustee's appointment does not violate the black-letter rule that an estate takes no greater rights in property than those held by the debtor prior to bankruptcy. Under the *in pari delicto* doctrine, the possibility that the defense could be removed as a limitation on a debtor's claims (*e.g.*, through the appointment of a fiduciary) always existed and was in place "as of the commencement of the case." Simply put, the potential for the *in pari delicto* defense to lose its effect was always part of the debtor's "bundle of sticks" transferred to the estate. Section 541(a)(7) is merely the statutory vehicle that allows a trustee, on behalf of innocent creditors, to realize the full benefit of a debtor's claims, which are no longer restricted by *in pari delicto*. In this sense, a trustee's appointment and the simultaneous detachment of the *in pari delicto* defense can be viewed as post-petition appreciation in the value of a debtor's claims.

Thus, even if *in pari delicto* would be fatal to a debtor's claims on the petition date, those claims might become insulated from the defense upon the appointment of an independent fiduciary. This application of the defense is loyal to the underlying equitable principles, statutory interpretation, and purpose and policy of bankruptcy law. The interests of innocent creditors should not be held hostage by a debtor's wrongful acts.

Conclusion

Courts reading § 541(a)(1) to automatically bar a trustee's claims that were subject to *in pari delicto* "as of the commencement of the case" ignore the unambiguous language in § 541(a)(7), by which the *in pari delicto* doctrine may lose its sting upon the appointment of an independent fiduciary and result in an increased value of the estate's claims. Bankruptcy Code provisions cannot be read in isolation, but should instead be interpreted in light of the remainder of the statutory scheme. A complete reading of § 541(a) dictates that a debtor's rights in its causes of action are not static and may become more (or less) valuable to the estate — just like any other property interest — based on post-petition events.

A fresh look at the proper application of *in pari delicto* against bankruptcy trustees is long overdue. Ultimately, the most effective solution would be an amendment to § 541 that expressly requires courts to consider the effect of a trustee's appointment on a defendant's *in pari delicto* defense. This would align the bankruptcy and nonbankruptcy applications of *in pari delicto*, and provide a tangible benefit to defrauded creditors. abi

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23 *Id.*
24 *Id.*; *Doemling*, 116 B.R. at 50.
25 *See Alsberg*, 68 F.3d 312.