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## *IN PARI DELICTO*: CAN THE TRUSTEE SEEK RECOVERY FROM CO-CONSPIRATORS?

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A CLE Presentation

By: William J. Tucker\*  
Attorney at Law  
[bill@tucker-hester.com](mailto:bill@tucker-hester.com)

Tucker | Hester, LLC  
[www.tucker-hester.com](http://www.tucker-hester.com)

Pennsylvania Center, Suite 100  
429 North Pennsylvania Street  
Indianapolis, IN 46204-1816

317.833.3030 | 317.833.3031 [fax]

\*Also written by: Amanda G. Koziura

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## **§ 541. Property of the estate**

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

(2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is--

(A) under the sole, equal, or joint management and control of the debtor; or

(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

(3) Any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723 of this title.

(4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title.

(5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date--

(A) by bequest, devise, or inheritance;

(B) as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree; or

(C) as a beneficiary of a life insurance policy or of a death benefit plan.

(6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.

(7) Any interest in property that the estate acquires after the commencement of the case.

## **Introduction**

*In pari delicto* literally means "in equal fault," and refers to "a plaintiff's participation in the same wrongdoing as the defendant." Conway, LaDawn, et al., *Equity Turned on Its Head: The Applicability of In Pari Delicto to a Bankruptcy Trustee*,

[www.munsch.com/pubs/files/Texas%20Lawyer%20Equity%20Turned.pdf](http://www.munsch.com/pubs/files/Texas%20Lawyer%20Equity%20Turned.pdf) (citing *Bateman*

*Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985)). As an affirmative defense and

equitable principle, the doctrine “prevents a wrongdoer from recovering damages resulting from the wrongdoing.” *Id.* The primary focus of the defense is on the personal malfeasance of the individual seeking to recover damages. *Id.* Application of the *in pari delicto* doctrine raises several complicated issues in bankruptcy, and recently a troubling line of cases has emerged allowing defendants to use the rulings to prevent their victims from recovering from wrongdoing – to the detriment of both the victims and bankruptcy trustees. *Id.*

### **The In Pari Delicto Defense**

Conceptually, the *in pari delicto* defense is straightforward. The doctrine “prohibits plaintiffs from recovering damages resulting from their own wrongdoing.” Goldblatt, Craig, et al., *Mixing up the Equation: Application of the In Pari Delicto Defense in Bankruptcy Litigation*, January 10, 2007, [www.wilmerhale.com/publications/whPubsDetail.aspx?publication=3539](http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=3539) (citing *Nisselson v. Lernout & Hauspie*, 469 F.3d 143 (1<sup>st</sup> Cir. 2006)). “The defense is generally available (1) when the plaintiff, as compared to the defendant, bears at least substantially equal responsibility for the wrong he seeks to redress; and (2) when preclusion of the suit would not interfere with the purposes of the underlying law or otherwise contravene the public interest.” *Id.* (citing *Berner*, 472 U.S. at 311). The defense of *in pari delicto* promotes two judicial purposes: (1) “preventing courts from having to ‘lend their good offices to mediating disputes among wrongdoers’; and (2) deterring illegality by ‘denying judicial relief to an admitted wrongdoer.’” *Id.* (citing *Berner*, 472 U.S. at 306).

Analysis of the *in pari delicto* defense requires a comparison of the relative fault of the parties involved. *Id.* “If the plaintiff’s fault is substantially equal to the defendant’s, then the action may be subject to a valid *in pari delicto* defense.” *Id.*

### **General Application of In Pari Delicto in Bankruptcy**

Application of *in pari delicto* in the context of bankruptcy may raise several complicated issues. “In bankruptcy litigation, the named plaintiff might be a bankruptcy trustee or creditors’ committee, but the action might be a derivative action on behalf of the debtor’s shareholders, an action on behalf of the corporation as an entity and/or an action on behalf of the debtor’s

creditors.” Goldblatt, *Mixing up the Equation*. This complicates the *in pari delicto* equation, because it may not compare the relative faults of defendant and the trustee or committee, as plaintiff. *Id.* “Instead, the equation might compare the defendant’s fault against the fault of the debtor corporation, its officers and directors, its shareholders, or its creditors.” *Id.*

### **Application of *In Pari Delicto* to Bankruptcy Trustees**

Recently, a troubling line of cases has emerged regarding the applicability of the *in pari delicto* defense to bankruptcy trustees. Conway, *Equity Turned on Its Head*. Bankruptcy defendants have been using the *in pari delicto* “defense and these rulings to their advantage to prevent victims from recovering for wrongdoing and to set wrongdoers free.” *Id.* Unfortunately, some courts have allowed this use of the defense, which has had the effect of stripping trustees and creditors’ committees of valid claims. *Id.* Allowing *in pari delicto* to be used in this manner has been applied for two separate reasons by courts. *Id.* “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. *Id.* In actuality, “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. *Id.* Many scholars and commenters consider these cases to be wrongly decided, and condemn this trend in case law. *Id.*

### **Standing of the Bankruptcy Trustee**

One line of emerging cases on this issue improperly require consideration of the *in pari delicto* defense with the standing analysis. Conway, *Equity Turned on Its Head*. “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.” *Id.* “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.” *Id.* Many of these cases notably never “analyze whether, under principles of equity, *in pari delicto* should be applied as a defense in the bankruptcy context.” *Id.*

This approach derives from the 2<sup>nd</sup> Circuit decision in *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114 (2<sup>nd</sup> Cir. 1991)(holding “[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation”). *Id.* However, this approach has nearly been limited to the courts of the 2<sup>nd</sup> Circuit, and the analysis has been rejected by other circuits. *Id.*

Generally, “standing consists of both a ‘case or controversy’ requirement stemming from Article III, Section 2 of the Constitution, and a subconstitutional ‘prudential’ element.” *Id.*(citing *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 346 (3<sup>rd</sup> Cir. 2001)). The analysis for standing “does not include an analysis of equitable defenses, such as *in pari delicto*,” but instead focuses on whether plaintiff sustains a cognizable injury. *Id.* (citing *Lafferty*, 267 F.3d at 346-47). “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*, 332 B.R. 225 (Bankr.S.D.Fla.2005); *In re Educators Group Health Trust*, 25 F.3d 1281, 1286 (5<sup>th</sup> Cir.1994); *In re Dublin Sec., Inc.*, 133 F.3d 377, 380 (6<sup>th</sup> Cir.1997).

### **Section 541 & Application of the *In Pari Delicto* Defense**

The second emerging line of cases has based dismissal of trustees’ claims on § 541 of the Bankruptcy Code. The filing of a bankruptcy petition under § 541 creates an estate, which 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); *Conway, Equity Turned on Its Head*. “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.* (citing 11 U.S.C. § 541 note (West 2004)). Accordingly, “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.” *Id.* The trustee can take not greater rights than the debtor has himself. *Id.*

This approach derives from the 10<sup>th</sup> Circuit case *Sender*, as well as the 3<sup>rd</sup> Circuit case *Lafferty*. *Sender v. Buchanan*, 84 F.3d 1281, 1285-86 (10<sup>th</sup> Cir.1996); *Lafferty*, 267 F.3d at 356). These courts have construed “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.” *Id.* (citing *Sender*, 84 F.3d at 1285-86; *Lafferty*, 267 F.3d at 356). The *Sender* and *Lafferty* courts both “expressly recognize the sound policy considerations for allowing the trustee to pursue such claims, but then [] conclude that section 541 precludes the trustee from doing so.” *Id.* (citing *Sender*, 84 F.3d at 1285; *Lafferty*, 267 F.3d at 357-58).

It is the opinion of many scholars and commenters that these cases have been wrongly decided, specifically noting that § 541 does not require application of the *in pari delicto* defense to preclude bankruptcy trustees from pursuing a debtor’s co-conspirators. “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.” *Id.* The legislative history of § 541 expressly states that defenses which are “personal against the debtor” are not effective against the estate: *Id.*

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. § 541 note (West 2008) (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.” *Id.* (citing 5 Collier on Bankruptcy ¶ 541.04 (15<sup>th</sup> rev. ed. 2004); 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, 538-39 (2005); *In re Fuzion*, 332 B.R. at 232).

Bankruptcy authorities have also argued that “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.” *Id.* (citations omitted). Therefore, “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.” *Id.* In bankruptcy, this means that consideration of post-petition acts is appropriate when it would serve the higher cause of preventing inequitable results. *Id.* Indeed, 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.” *Id.* (citing *In re Fuzion*, 332 B.R. at 234).

Accordingly, replacement of the corrupt sole actor with an innocent bankruptcy trustee postpetition should be both relevant and controlling to the imputation and *in pari delicto* analysis. *Id.* “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.” *Id.* The principles of equity which govern the *in pari delicto* defense and federal bankruptcy law preclude such a result, and § 541 should arguably “have no bearing on the application of an equitable defense to an estate cause of action.” *Id.* (quoting 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 (2003)).

The Southern District of New York in *Adelphia* has recently held that § 541 of the Bankruptcy Code and the doctrine of *in pari delicto* do not necessarily bar recovery by a creditors’ committee on behalf of the debtors’ estates where the debtors’ personnel have acted wrongfully. Davis, Polk & Wardwell, *Insolvency and Restructuring Update*, June 22, 2007, available at [http://www.dpw.com/1485409/newsletters/insolvency/ir\\_20070622\\_adelphia.htm](http://www.dpw.com/1485409/newsletters/insolvency/ir_20070622_adelphia.htm) (citing *In re Adelphia Communications Corp.*, 365 B.R. 24 (Bkrcty. S.D.N.Y. 2007)). In *Adelphia*, the defendants argued, that under the doctrine of *in pari delicto* the Adelphia bankruptcy estate could not recover on its claims against certain agent and investment bank defendants, even if they acted wrongfully, because the conduct of the debtor’s personnel is imputed to the committee. *Id.* (citing *In re Adelphia*, 365 B.R. at 53). The *Adelphia* court disagreed with other courts which have held that under § 541 a trustee or official committee is subject to the same defenses as available to the debtor at the commencement of a bankruptcy case. *Id.* (citing *In re Adelphia*, 365 B.R. at 54-56). The court reasoned that while § 541 “is relevant to granting ownership of causes of action to the insolvent estate representative, section 541 places no federal limits on the application of state law in determining defenses that might be good against the estate, including that of *in pari delicto*.” *Id.* (citing *In re Adelphia*, 365 B.R. at 53).

### ***In Pari Delicto: Fault of Parent Corporation Imputed to its Subsidiary***

The 1<sup>st</sup> Circuit recently addressed a complex application of the *in pari delicto* defense in *Nisselson v. Lernout & Hauspie*, 469 F.3d 143 (1st Cir. 2006). In that case, the plaintiff was the trustee of the Dictaphone Litigation Trust. Goldblatt, *Mixing up the Equation*. The trust “was established under the chapter 11 plan of reorganization of New Dictaphone, an entity that resulted from the merger of Old Dictaphone into a subsidiary of Lernout & Hauspie shortly before Lernout & Hauspie’s demise.” *Id.* “New Dictaphone’s chapter 11 plan conveyed to the trust the claims that New Dictaphone might have against Lernout & Hauspie’s directors, officers and professionals in connection with the ill-fated merger.” *Id.* “The trustee sued these individuals, alleging that they concocted and executed a fraudulent scheme designed to inflate the value of the Lernout & Hauspie stock that was the consideration paid to the shareholders of Old Dictaphone in the merger.” *Id.* (citing *Nisselson*, 469 F.3d at 148-49).

In its analysis of the *in pari delicto* defense, the 1<sup>st</sup> Circuit emphasized a very important question: “who, exactly, are the proper parties for the purposes of determining relative blame”? *Id.* (citing *Nisselson*, 469 F.3d at 152). “The trustee argued that the suit was being brought on behalf of New Dictaphone’s creditors who, innocent of any fault in the merger, were immune from an *in pari delicto* defense.” *Id.* However, they disagreed, and held “that the trustee brought the suit on behalf of New Dictaphone who, following the merger and at the time of the bankruptcy filing, was the subsidiary of Lernout & Hauspie and shared officers and directors with Lernout & Hauspie.” *Id.* “The court imputed the wrongdoing of the shared officers and directors to New Dictaphone and held that New Dictaphone was at least as guilty as the officer and director defendants in perpetrating the fraud.” *Id.* (citing *Nisselson*, 469 F.3d at 157) The court determined the trustee was bringing claims on behalf of a complicit party, therefore the trustee’s policy concerns were inapplicable. *Id.*

Ultimately, “[t]he First Circuit was unsympathetic to and rejected the trustee’s argument that because the recovery to the litigation trust would ultimately benefit the creditors and not the “guilty” corporation, the doctrine should not be applied to preclude recovery.” *Id.* “After noting that the beneficiaries of the litigation trust might also have engaged in wrongdoing, the court

stated that the best approach would be to require the creditors to pursue the defendants separately, thereby removing the taint of the guilty corporation.” *Id.* “And even if the creditors could not sue individually, the court determined that creditors with notice of potential wrongdoing could include that possibility in their decision to extend credit.” *Id.* (citing *Nisselson*, 469 F.3d at 158). “Of course, this determination provides little comfort to creditors who existed before the wrongdoing or otherwise had no notice of the wrongdoing--categories likely to include the vast majority of creditors.” *Id.*