Application of the *In Pari Delicto* Defense Bars Certain Claims of Innocent Successors

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Should an innocent successor, like a bankruptcy trustee or a creditors' committee, be burdened with the pre-petition sins of the debtor? The Eleventh Circuit Court of Appeals has recently joined several other circuits in holding that the equitable doctrine of in *pari delicto* applies with equal force to claims of a bankruptcy trustee as to claims of a debtor, and therefore bars certain causes of action that these otherwise innocent successor parties would ordinarily pursue to recover damages for the benefit of the creditors of a bankruptcy estate.[1]

Doctrine of In Pari Delicto

Under the equitable doctrine of *in pari delicto*, "a plaintiff who has participated in a wrongdoing may not recover damages resulting from the wrongdoing."[2] The common law defense of *in pari delicto* "derives from the Latin *in pari delicto potior est condition defendentis*: 'In a case of equal or mutual fault...the position of the [defending] party...is the better one.'"[3]

The policy behind the *in pari delicto* doctrine is that "courts should not lend their good offices to mediating disputes among wrongdoers" and "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality."[4]

The Eleventh Circuit Finds *In Pari Delicto* Defense Applicable to a Bankruptcy Trustee

The debtor in the *Edwards* case, ETS Payphone Inc., operated a massive Ponzi scheme defrauding thousands of investors of hundreds of millions of dollars. ETS filed for relief under chapter 11 and, pursuant to the confirmed reorganization plan, a trustee was appointed to pursue recoveries for the benefit of the creditors of ETS's bankruptcy estate.

The trustee commenced litigation against several large custodians of individual retirement accounts (the "IRA custodians") to recover damages for, among other claims, violations of the Racketeer Influenced and Corrupt Organizations Act (RICO). The trustee alleged that the IRA custodians, prior to ETS's bankruptcy proceedings, aided ETS in defrauding investors by funneling money into ETS's investments. According to the trustee's allegations, "by failing to conduct appropriate due diligence and/or ignoring the facts altogether...[t]he IRA custodians enabled thousands of investors to partake of the ETS scheme and caused ETS to incur millions of dollars in additional debt."[5] The IRA custodians moved to dismiss the trustee's complaint arguing, among other things, that the doctrine of *in pari delicto* barred the trustee's claims because ETS's wrongful actions prior to bankruptcy would have prohibited a remedy for its injuries.

The Eleventh Circuit began its analysis in *Edwards* by examining §541(a) of the Code, which provides that property of the debtor's estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case."[6] The legal interests or equitable interests that constitute

property of the estate "include any causes of action the debtor may bring."[7] As the representative of the debtor's estate, a trustee succeeds to the rights of the debtor and therefore has standing to bring any suit that the debtor could have brought outside of the bankruptcy case. The *Edwards* trustee urged that his claims as trustee of the legal or equitable interests of the bankruptcy estate against the IRA custodians are not subject to the doctrine of *in pari delicto*. The trustee claimed that the doctrine of *in pari delicto* depends on the "personal malfeasance of the individual seeking to recover."[8] Thus, ETS's malfeasance or that of its principals should not be imputed to a bankruptcy trustee. In support of his argument, the trustee directed the court to the legislative history of §541(d) of the Code.

The Eleventh Circuit determined that there was no need to resort to legislative history due to the unambiguous language of §541(a).[9] The Eleventh Circuit did not find any suggestion in the text of the Code that the trustee acquires rights and interests greater than those of the debtor. It further noted that the Second, Third, Eighth and Tenth Circuits had unanimously concluded that the *in pari delicto* defense applies with equal force to a trustee as to a debtor outside of bankruptcy.[10] The Eleventh Circuit determined that "if a claim of ETS would have been subject to the defense of *in pari delicto* at the commencement of the bankruptcy, then the same claim, when asserted by the trustee, is subject to the same affirmative defense."[11]

Accordingly, the Eleventh Circuit found that because the IRA custodians could have asserted the *in pari delicto* defense against ETS, the defense therefore extended to bar the RICO claims of the trustee.

The Third Circuit Extends the *In Pari Delicto* Defense to an Official Committee of Unsecured Creditors

The Eleventh Circuit followed the same reasoning that the Third Circuit used in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.* to allow the defense of *in pari delicto* to bar the claims of an unsecured creditors' committee. In *Lafferty*, the Third Circuit reviewed whether the pre-petition wrongful conduct of the debtors' shareholder and managers could be imputed to the debtor and, in turn, to the official committee of unsecured creditors. Confirming that the legal and equitable interests described in §541 include causes of action, the Third Circuit found that the Code authorized the committee to "commence and prosecute any action or proceeding in behalf of the estate before any tribunal."[12] These actions fall into two categories: (a) actions brought as successor to the debtor's interest included in the estate under §541 and (b) actions brought pursuant to avoiding powers set forth in the Code.

With regard to a bankruptcy trustee, the Third Circuit noted in *Lafferty* that it had previously held that "in actions brought by the trustee as successor in interest to the debtor's interest under §541, the 'trustee stands in the shoes of the debtor and can only assert those causes of action possessed by the debtor. [Conversely,] [t]he trustee is, of course, subject to the same defenses as could have been asserted by the defendant had the action been instituted by the debtor.'"[13] Using this same reasoning, the Third Circuit determined that there was no difference between a bankruptcy trustee and a creditors' committee in that the *in pari delicto* defense must be evaluated "without regard to whether the committee is an innocent successor."[14] Because the fraud of the debtors' shareholders and managers could be imputed to the debtor and ultimately to the creditors' committee, the doctrine of *in pari delicto* barred the creditors' committee, standing in the shoes of the debtor, from asserting its claims against the defendant.

The Seventh Circuit Finds the *In Pari Delicto* Defense Inapplicable to a Receiver

In *Scholes v. Lehmann*, the Seventh Circuit addressed the *in pari delicto* defense and its applicability to a receiver pursuing fraudulent transfer claims.[15] In *Scholes*, a receiver was appointed by the U.S. Securities and Exchange Commission (SEC) to liquidate assets of three corporations whose principal had masterminded a Ponzi scheme. The receiver in the case pursued fraudulent-transfer actions under

Illinois law to recover assets to disburse to the corporations' creditors. According to Chief Judge Posner, though injured by the principal, the corporations "would not be heard to complain as long as they were controlled by him, not only because he would not permit them to complain, but also because of their deep, their utter, complicity in the [principal's] fraud. This rule is that the maker of the fraudulent conveyance and all those in privity with him—which certainly includes the corporations—are bound by it."[16]

However, in contrast to the reasoning applied in *Edwards* and *Lafferty*, the Seventh Circuit found that the appointment of the receiver removed the wrongdoer from the picture. The corporations were freed from the "evil zombies" of the principal.[17] "Freed from his spell, they [the corporations] became entitled to the return of the moneys—for the benefit not of the [principal] but of innocent investors—that the [principal] had made the corporations divert to unauthorized persons."[18]

Stated differently, the Seventh Circuit found that "the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated."[19] With the appointment of the receiver whose objective is to maximize the value of the corporate assets in order to benefit creditors, the Seventh Circuit determined that the receiver's suit seeking to recover corporate assets unlawfully dissipated by the principal was appropriate.

The Seventh Circuit recognized that individual investors could have brought separate actions or even a class action to recover their losses from the Ponzi scheme but found that, from a public-policy perspective, the most efficient course of action was to permit the receiver to bring the suits. "The conceivable alternative to [the receiver's suits] for getting the money back into the pockets of its rightful owners are a series of individual suits by the investors, which, even if successful, would multiply litigation...."[20]

The Third Circuit in *Lafferty* specifically distinguished Judge Posner's ruling in *Scholes*. In *Lafferty*, the Third Circuit noted that the Seventh Circuit's reasoning in *Scholes* may have been preferable from a public-policy perspective, but the ruling did not comport with the plain language of §541. According to the Third Circuit, "the bankruptcy estate 'is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case...Congress intended the trustee to stand in the shoes of the debtor and take no greater rights than the debtor himself had had.'"[21] The Third Circuit distinguished the receivership proceeding in *Scholes* from bankruptcy cases because "unlike bankruptcy trustees, receivers are not subject to §541."[22]

The dissent in the *Lafferty* decision looked to Judge Posner's reasoning in *Scholes* and the public policy behind both the Code and the doctrine of *in pari delicto*. According to Judge Cowen in his dissent, permitting a trustee to pursue claims regardless of the *in pari delicto* defense would deter corporate misconduct and help compensate victims. Moreover, Judge Cowen stated that an equitable doctrine, like the *in pari delicto* defense, is "highly sensitive to the facts and readily adapted to achieve equitable results. What is sufficient to satisfy the doctrine, in other words, need not be parsed like a statute."[23] If the point of equitable doctrines is to avoid injustice, "equity is the recourse of principles of justice to correct or supplement the law as applied to particular circumstances."[24] The dissent in *Lafferty* stated that the majority's conclusion involved a misinterpretation of an equitable doctrine and a review of the Code that was too narrow.

Does §541 Control?

Comparing the analyses contained in the decisions relying on §541 and the decision of the Seventh Circuit, if a trustee brought an action pursuant to his or her avoidance powers rather than a cause of action inherited from the pre-petition debtor, it seems clear that §541 would not apply. An action brought pursuant to the trustee's avoidance powers would be independent from an action available to the debtor prior to its bankruptcy. The trustee would not be "stepping into the shoes of the debtor" and, therefore, would not be subject to the same defenses that could be asserted against the debtor.

The more difficult analysis is the conflict between public policy considerations and a strict statutory construction. Permitting defendants to assert the *in pari delicto* defense against an innocent successor eliminates significant sources of recovery for the benefit of a debtor's creditors, which is counter to the policy that §541 is intended to enhance the recovery for creditors of a debtor. One legal commentator complaining about the decisions that have upheld the applicability of the doctrine of *in pari delicto* against a trustee using §541 stated that "[i]gnoring dissenting cries for good sense and fidelity to bankruptcy policy, the majorities in these cases have felt bound by this language [§541] to treat the bankruptcy estate as though it were an individual seeking to recover under state law from someone with whom it had been in cahoots."[25]

In antitrust and securities litigation, the Supreme Court has refused to permit the *in pari delicto* defense when such defense prohibits recovery in a lawsuit of public importance.[26] In the *Perma Life Mufflers* decision, the Supreme Court held "that the doctrine of *in pari delicto*, with its complex scope, contents and effects, is not to be recognized as a defense to an antitrust action."[27] The Supreme Court warned against "invoking broad common law barriers to relief where a private suit serves important public purposes."[28] The public policy behind the antitrust laws is to encourage competition. "A more fastidious regard for the relative moral worth of the parties would only result in seriously undermining the usefulness of the private action as a bulwark of antitrust enforcement."[29]

Subsequent to *Perma Life*, the Supreme Court refused to apply the *in pari delicto* defense to prevent "tippees" from recovery for insider trading under federal securities laws. In *Bateman Eichler*, the Supreme Court noted that the public policy goal of the securities laws is to protect "the investing public and the national economy through the promotion of a 'high standard of business ethics...in every facet of the securities industry.'"[30] The Supreme Court found that the tippee's complaint should be barred by the *in pari delicto* defense only "where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public."[31] According to the Supreme Court, the tippees in *Bateman Eichler* were not "equally culpable" to the tippers who "masterminded the scheme to manipulate the market for their own personal benefit...."[32]

Conclusion

Applying the *in pari delicto* defense to prohibit the pursuit of claims by an innocent successor seeking to maximize the benefit to the creditors of a debtor's bankruptcy estate is undoubtedly a harsh result. Nevertheless, if a cause of action available to the debtor pre-petition is pursued by stepping into the shoes of the debtor, then the innocent successor must recognize that courts addressing this issue so far have found that the claims are also subject to the defenses that could be asserted against the debtor. To avoid the implications of §541, a trustee should consider bringing actions pursuant to his or her avoidance powers rather than asserting claims available to the debtor pre-petition that may be vulnerable to the imputation of the debtor's bad actions.

Footnotes

1 *Official Comm. of Unsecured Creditors of PSA Inc. v. Edwards*, *et al*., 2006 WL 212219 (11th Cir. Jan. 30, 2006).

2 *Black's Law Dictionary*, 806 (8th Ed. 2004).

3 *Edwards*, 2006 WL 212219, at *6 (*quoting Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985)).

4 *Id*.

5 *Id*. at *1.

6 *Id*.

7 *Id*. (*quoting Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 356 (3d Cir. 2001)).

8 *Id*. at *3. (internal quotations omitted).

9 "Under the plain meaning of §541(a), the debtor [sic] estate includes all 'legal and equitable interests of the debtor as of the commencement of the case...A bankruptcy trustee stands in the shoes of the debtor and has standing to bring any suit that the debtor could have instituted'...." *Id*. The Eleventh Circuit also noted that the trustee's reliance upon the legislative history of §541(d) was inapplicable to the matters at issue.

10 *See Grassmueck v. The Am. Shorthorn Assoc.*, 402 F.3d 833 (8th Cir. 2005); *Official Comm. of Unsecured Creditors of Color Tile Inc. v. Coopers & Lybrand LLP*, 322 F.3d 147 (2d Cir. 2003); *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001); *In re Dublin Securities Inc.*, 133 F.3d 377 (6th Cir. 1998); *Sender v. Buchanan*, 84 F.3d 1281 (10th Cir. 1996).

11 *Edwards*, 2006 WL 212219 at *4.

12 *Lafferty*, 267 F.3d at 356.

13 *Id*. at 356 (*quoting Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 885 F.2d 1149, 1154 (3d Cir. 1989)).

14 *Id*. at 357.

15 *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995).

16 *Id*. at 754.

17 *Id*. (emphasis added).

18 *Id*.

19 *Id*.

20 *Id*.

21 *Lafferty*, 267 F.3d at 357-58 (*quoting In re Hedged-Investments Assocs. Inc.*, 84 F.3d 1281 (10th Cir. 1996)).

22 *Id*. at 358.

23 *Id*. at 362.

24 *Id*. (*quoting Black's Law Dictionary* 560 (7th ed. 1999)).

25 Davis, Prof. Jeffrey, "*Ending the Nonsense: The In Pari Delicto Doctrine Has Nothing to Do with What Is §541 Property of the Estate*," 21 Emory Bankr. Dev. J. 519 (2005).

26 *See Bateman Eichler, Hill Richards Inc. v. Berner*, 472 U.S. 299 (1985); *Perma Life Mufflers Inc. v. Int'l. Parts Corp.*, 392 U.S. 134 (1968).

27 *Perma Life Mufflers*, 392 U.S. at 140.

28 *Id*.

29 *Id*.

30 *Bateman Eichler*, 472 U.S. at 315 (*citing SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 186-87 (1963)).

31 *Id*. at 310-11.

32 *Id*. at 312-13.

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