

In Pari Delicto Should Not Bar A Trustee's Recovery

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Every bankruptcy practitioner has heard these time honored maxims: *The bankruptcy trustee stands in the shoes of the debtor* and *The trustee is subject to all defenses available against the debtor*. Without any doubt, these statements apply in the vast majority of situations. But are they always true? Are there any exceptions? What happens when they conflict with another well known maxim: *The bankruptcy court is a court of equity*?

The first two statements have their genesis in § 541 of the Code, which provides that the estate includes “all legal and equitable interests of the debtor in property as of the commencement of the case.” Since the estate includes the debtor’s choses in action, the trustee succeeds to the right to assert those claims. It may also seem entirely logical that the trustee would find himself or herself subject to all the defenses that would have been available against the debtor.

The legislative history appears to support this position. The House and Senate Reports state that § 541 was not intended to “expand the debtor’s rights against others more than they exist at the commencement of the case,”¹ so it might seem that there is no room for debate on the subject. After all, set-offs are preserved. The statutes of limitations still apply (with some statutory extensions). Who would question the validity of payment and release as a defense? But there is one defense for which trustees wrestle to find an exception to the general rule—the

¹ S. Rep. No. 95-989, at 82; H.R. Rep. No. 95-595, at 367-68.

equitable defense of *in pari delicto*.² Is this a defense that should be treated differently, perhaps as personally available against the debtor and *not* affecting the claim of the trustee appointed in the debtor's bankruptcy?

Typically, the issue arises when the trustee has asserted a claim of negligence or malpractice against the debtor's former accountant after discovering that audits of the debtor's financial statements failed to uncover a fraud committed by the debtor's principal owner.³ Claims against outside counsel for negligently permitting corporate principals to defraud customers provide another example.⁴ As long as the business remains under the control of the person perpetrating the fraud, there is no reason to permit the company or its owner to recover for the negligence of the third party in failing to discover or prevent the fraud. To permit a recovery would reward the owner for his or her misconduct. The equitable defense of *in pari delicto* is applied; there is no recovery and the wrongdoer is prevented from profiting from his or her own misdeeds.

Because a corporation acts only through its agents, knowledge and actions of employees are generally imputed to their corporate employer. Nonetheless, courts do recognize the distinction between the corporation and its employees where an employee has acted in his own interest rather than in pursuit of some advantage for the corporation. Thus, a corporation is not subjected to defenses based upon the actions of its employee who has acted for his own benefit.⁵

² Other similar defenses are "equitable estoppel" and "unclean hands."

³ A Ponzi scheme is a prime example. See *In re: The Bennett Funding Group Inc.*, 336 F.3d 94 (2nd Cir. 2003).

⁴ See *In re: Dublin Securities Inc.*, 133 F.3d 377 (6th Cir. 1997).

⁵ See, e.g., *American Export & Inland Coal Corp. v. Matthew Addy Co.*, 112 Ohio St. 186 (1925).

However, an exception to this rule has often been applied where the corporation is dominated or controlled by the individual wrongdoer.⁶

In the eyes of some, however, the equities change as soon as a bankruptcy trustee takes over the business. The trustee is like new management. The trustee has committed no wrongdoing, and any recovery he or she obtains from the third party benefits the innocent creditors of the debtor, often those who were the real victims of the fraud. When the successor is a receiver, as opposed to a bankruptcy trustee, courts routinely find an exemption from the *in pari delicto* defense. For example, in *Scholes v. Lehmann*,⁷ the Seventh Circuit held that a receiver appointed at the request of the SEC should not be prevented by the doctrine of *in pari delicto* from recovering fraudulent conveyances made by the receiver's corporate predecessor. The court found no legal or practical objection to permitting recovery by the receiver. Since the wrongdoer, who formerly controlled the corporations, had been replaced by the innocent receiver whose directive was to maximize the recovery of creditors, equity should not impede that result.

However, this approach has not traditionally been followed in cases involving a bankruptcy trustee as the claimant. Equitable considerations have lost to various legal arguments. Neither the change in the control of the debtor nor the innocence of the ultimate beneficiaries of the trustee's claims have proved to be persuasive.⁸

A few courts have said that a trustee lacks standing to bring a claim when the former owner was guilty of a fraud, in effect holding that the existence of an affirmative defense

⁶ See, e.g., *FDIC v. Ernst & Young*, No. 3-90-0490-H, 1991 WL 197111 (N.D. Tex. Sept. 30, 1991), *aff'd*, 967 F.2d 166 (5th Cir. 1992).

⁷ 56 F.3d 750, 754 (7th Cir. 1995) ("Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated").

⁸ In re: The Bennett Funding Group Inc., 336 F.3d 94 (2d Cir. 2003); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc, 267 F.3d 340 (3d Cir. 2001); In re: Dublin Securities, Inc., 133 F.3d 377; In re: Hedged-Investments Associates Inc., 84 F3d 1281 (10th Cir. 1996).

eliminates standing.⁹ These cases appear to misapply the concept of standing. In order for a trustee to have standing, the corporation need merely to have sustained an injury separate and apart from its creditors. The potential existence of an affirmative defense does not deprive the trustee of standing.¹⁰ Standing springs from the existence of an injury to the debtor, now represented by the trustee.¹¹ If the corporation itself had brought an action against the third party, the case would not have been dismissed on standing grounds; the defense would have been framed in terms of the appropriate equitable defense.¹²

In the majority of bankruptcy cases, courts have recognized the trustee's standing but, nonetheless, have applied the *in pari delicto* defense to bar a recovery.¹³ Courts in these cases never examine the principles behind the defense or the inequity of its application to a trustee's claim. These courts generally conclude that permitting the trustee to avoid the defense would constitute an enlargement of the claims the debtor possessed, thus violating the tenets of § 541.¹⁴

At least one bankruptcy court has rejected this approach and has allowed the trustee to proceed against a third-party tortfeasor.¹⁵ In *In re: Jack Greenberg, Inc.*, the court determined it would violate the principles of equity to rigidly apply an equitable defense if the result would be inequitable. In reaching this decision, the court relied on the Supreme Court's decision in *O'Melveny & Myers v. FDIC*,¹⁶ which determined that state law, not federal law, controls

⁹ *Bennett Funding* is a recent appellate decision describing the trustee's problem as one of standing.

¹⁰ See *Warth v. Seldin*, 422 U.S. 490 (1975); *Lafferty*, 267 F.3d 340 (3d Cir. 2001).

¹¹ See supra n. 6, *Lafferty* and *Dublin Securities*.

¹² However, some courts have applied the lack of standing defense, saying only the creditors or injured investors have suffered a loss. *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085 (2d Cir. 1995). Where the corporation had otherwise been engaged in a legitimate, viable business other than the Ponzi, scheme, the corporation also suffers a loss because it insures liability to the creditors.

¹³ See supra n. 6, *Dublin Securities* and *Hedged-Investments*.

¹⁴ Section 541 "establishes the estate's rights as no stronger than they were when actually held by the debtor." *Hedged-Investments*, 84 F.3d at 1285.

¹⁵ *In re: Jack Greenberg Inc.*, 240 B.R. 486 (Bankr. E.D. Pa. 1999).

¹⁶ 512 U.S. 79 (1994).

whether equitable defenses are available against the trustee.¹⁷ In *O'Melveny*, the FDIC, as receiver for a failed Savings & Loan, sued the company's former counsel for its alleged role in the insolvency. The Ninth Circuit held that equitable principles would not permit equitable defenses to prevent a recovery by the receiver.¹⁸ The United States Supreme Court then instructed the Court of Appeals that federal courts were to apply state law in determining whether equitable defenses were applicable in a federal receivership.¹⁹ On remand, the Ninth Circuit again held that equitable defenses are not a bar to recovery by a receiver, purely on the basis of California law.²⁰

Building on the *O'Melveny* decision and finding little state law on the application of the *in pari delicto* defense to a claim brought by a trustee, the *Greenberg* court looked to the Ninth Circuit's opinions in *O'Melveny* as well as other state cases that dealt with equitable defenses and held that a bankruptcy trustee should be treated like a receiver:

[T]here are circumstances when the trustee's position as plaintiff is different from that of the corporation, even when bringing the corporation's claim. Accordingly, while the true and oft stated maxim that a trustee standing in the shoes of the corporation takes no greater rights than the debtor is certainly the beginning of my analysis, the inquiry does not end there. . . . [E]quitable defenses such as the doctrine of imputation that may be sustainable against the corporation may fail to act as a total bar to recovery when the beneficiaries of the action are the corporation's innocent creditors.²¹

Although the *Greenberg* decision was not reversed, since it was not appealed, it has not met with favor in the Third Circuit Court of Appeals. In *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, the Third Circuit discussed the approach taken by the

¹⁷ In re: Jack Greenberg Inc., 240 B.R. at 501.

¹⁸ *FDIC v. O'Melveny*, 969 F.2d 744, 751-52 (9th Cir. 1992).

¹⁹ *O'Melveny*, 512 U.S. at 83.

²⁰ *O'Melveny*, 61 F.3d 17 (9th Cir. 1995).

²¹ In re: Jack Greenberg Inc., 240 B.R. at 506.

Greenberg court and rejected it, ruling that the Code required the application of the *in pari delicto* defense to prevent enlargement of the trustee's rights beyond those possessed by the debtor.²² The *Lafferty* court specifically acknowledged cases such as *O'Melveny* and *Scholes* but determined that the Bankruptcy Code controlled, stating that those cases were "easily distinguishable, however; unlike bankruptcy trustees, receivers are not subject to the limits of section 541."²³

However, the *Lafferty* decision was not unanimous. The dissent chose to emphasize that equitable rules are not to be applied rigidly.

Whatever the inflexibility is of the Bankruptcy Code, an equitable doctrine like *in pari delicto* 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. . . . The point of equitable doctrines is to avoid injustice caused by overly inflexible rules . . .²⁴

While the *Lafferty* majority simply accepted as controlling the concept that § 541 subjects the trustee to all defenses, the dissent focused upon the incongruity of an equitable defense creating an inequitable result. Neither opinion examined the basic assumption that has created the dilemma for the trustee seeking to recover for third party negligence, that is, the idea that the Bankruptcy Code itself requires that the trustee be subject to all defenses available against the debtor. The logical starting point for any court faced with this issue would seem to be an analysis of whether statutory interpretation requires that conclusion.

The *O'Melveny* case provides a good parallel when examining the argument that the legislative history of § 541 requires that a trustee be subject to all pre-bankruptcy defenses. In *O'Melveny*, the Supreme Court emphatically stated that there is no federal common law on the

²² 267 F.3d at 340.

²³ *Id.* at 358.

²⁴ *Id.* at 362

issue of whether rules of corporate attribution for dishonest acts apply in federal court.²⁵ Thus, unless the particular federal statute requires such attribution, relevant state law will be determinative. Although the Court in *O'Melveny* was interpreting the Financial Institutions Reform, Recovery, and Enforcement Act of 1989²⁶ (“FIRREA”), not the Code, the Supreme Court’s interpretation of the language of the FIRREA supports the same result when examining the position of a bankruptcy trustee. FIRREA provides that the FDIC succeeds to the rights of the failed institution just as the Code vests the rights of the debtor in the trustee. In discussing FIRREA, the Supreme Court said that “the FDIC as receiver ‘steps into the shoes’ of the failed S&L, obtaining the rights of the insured depository institution” that existed prior to receivership.²⁷ In light of this characterization of the FDIC’s position in its role as receiver, the statutory history of § 541 would hardly seem to offer any more compelling rationale for the adoption of a federal rule requiring attribution of corporate dishonesty where the Code is concerned.²⁸

However, none of the arguments against applying the *in pari delicto* defense have ever had much success once the threshold between receivership and bankruptcy has been crossed. Even in the quasi-bankruptcy arena of a liquidation proceeding under the Securities Investor Protection Act,²⁹ the defense has generally seemed to survive, preventing the SIPA trustee from recovering against negligent third parties. If ever there were an appropriate vehicle for introducing the *O'Melveny* approach to cases under the Code, a SIPA liquidation is it. Generally, under SIPA, the liquidation of a securities brokerage begins as a proceeding in the

²⁵ 512 U.S. at 84.

²⁶ 12 U.S.C. § 1821 (2004).

²⁷ *O'Melveny*, 512 U.S. at 86 (internal citation omitted).

²⁸ In fact, one could argue that “standing in the shoes” of one’s predecessor is more limiting. After all, the history of § 541 speaks to the rights of the debtor, not the defenses available to the defendant.

²⁹ 15 U.S.C. § 78aaa – 78lll (1987) (referred to hereinafter only as “SIPA”).

United States District Court.³⁰ Once that court determines that the customers are in need of protection because of the insolvency of the member broker, the court appoints a trustee selected by the Securities Investor Protection Corporation (“SIPC”) and the case is removed to the Bankruptcy Court.³¹ There, the case is to be conducted under the provisions of SIPA and like a chapter 7 case to the extent consistent with SIPA.³² Thus, a SIPA liquidation is subject to general chapter 7 principles.

Most importantly, SIPC and trustees appointed in SIPA liquidations perform a customer protection and indemnification role not unlike that of the FDIC in the liquidation of a bank.³³ Considering the trustee’s unique position and the purposes of a SIPA liquidation, a SIPA trustee should enjoy a status similar to the FDIC where the *in pari delicto* defense is concerned. After all, the trustee is not a bankruptcy trustee and § 541 applies only “to the extent consistent with” SIPA. Yet courts have applied *in pari delicto* to deny a SIPA trustee’s claims.³⁴ Even though a SIPA liquidation does not arise under Title 11 of the United States Code, the concept that “the trustee stands in the shoes of the debtor” seems to be too strongly rooted in bankruptcy lore to be easily overcome.³⁵

³⁰ See SIPA § 78eee.

³¹ SIPA § 78eee(b)(3) and (4).

³² SIPA § 78fff(b).

³³ SIPA § 78ccc and 78ddd. At least one court has held that the *D’Oench, Duhme* doctrine, originally applied to protect the FDIC in a bank insolvency, should also be available to protect the trustee in a SIPA liquidation. *In re Fitzgerald, De Arman & Roberts, Inc.* 129 B.R. 652, 1991 Bankr. LEXIS 975 (Bankr. N.D. Okla. 1991).

³⁴ See, e.g., *Securities Investor Protection Corp. v. Munninghoff Lange & Co. (In re Donahue Securities, Inc.)*, 2003 Bankr. LEXIS 964, *18-19 (Bankr. S.D. Ohio 2003) (holding trustee in a SIPA liquidation possesses the same rights as a trustee in bankruptcy); *Bondy v. Chemical Bank*, 1975 U.S. Dist. LEXIS 15538, *5 (S.D.N.Y. 1975) (finding that even if a SIPA trustee could bring an action on behalf of the debtor, the complaint would be barred by the *in pari delicto* defense). *But see In re Bell & Beckwith*, Case No. C 83-1071 (N.D. Ohio June 26, 1984) (unreported) where the defendant’s Motion to Dismiss based on *in pari delicto* and standing arguments was denied.

³⁵ The author must disclose that he currently represents the SIPA trustee in *In re: Donahue Securities, Inc.*, Adv. No. 01-1027, U.S. Bankr. Ct., S.D. Ohio).

Conclusion

The purpose of the *in pari delicto* defense is to prevent the perpetrator of a fraud from benefiting from his wrongful act, not to shield a negligent defendant from all liability for his actions. The reason for the application of the defense to bar a recovery no longer exists once an innocent fiduciary has been appointed and any recovery would compensate innocent creditors. As the dissent in *Lafferty* found, equitable principles then dictate that the defense is no longer viable. If the defense remains viable in a bankruptcy, the equitable goals that created the *in pari delicto* doctrine are being ignored in the name of statutory construction. The defense was not fashioned by the courts for the protection of a negligent the accountant or lawyer. Despite the fact that the law should prohibit recovery by a person guilty of dishonesty, the law should also encourage those whose role it is to prevent that dishonesty to properly perform their duties. Unless exposed to liability, the lawyer, accountant, appraiser or other professional working for a sole proprietor or a single shareholder entity has little incentive to discover and report fraud.