2020

The In Pari Delicto Defense May Bar Trustees That Bring Claims Which Are Property of the Estate Under 11 U.S.C. § 541(a)

Carmine Broccole

ST. JOHN'S UNIVERSITY
SCHOOL OF LAW

The *In Pari Delicto* Defense May Bar Trustees That Bring Claims Which Are Property of the Estate Under 11 U.S.C. § 541(a)

2020 Volume XII No. 5

The *In Pari Delicto* Defense May Bar Trustees That Bring Claims Which Are Property of the Estate Under 11 U.S.C. § 541(a)

Carmine Broccole, J.D. Candidate 2020

Cite as: *The In Pari Delicto Defense May Bar Trustees That Bring Claims Which Are Property of the Estate Under 11 U.S.C. § 541(a)*, 12 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 5 (2020)

Introduction

The *in pari delicto* doctrine states that "[i]n a case of equal or mutual fault … the position of the [defending] party … is the better one."[1] This doctrine is guided by the premise that it is not within the purview of the court to resolve disputes among wrongdoers, and that denial of judicial relief in these instances effectively deters illegal activity.[2] Within the bankruptcy context, "every Circuit to have considered the question has held that *in pari delicto* can be asserted against a trustee bringing a claim on behalf of a debtor in bankruptcy."[3]

Under Section 541(a)(1) of title 11 of the United States Code (the "Bankruptcy Code"), the debtor's bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case."[4] Courts have looked to the plain meaning of this language to determine that where a debtor's claim would have been subject to *in pari delicto* as of the commencement of the bankruptcy, then the trustee, by asserting the same claim, is also subject to *in pari delicto*.[5] Moreover, the legislative history to Section 541 supports this

---

[1] *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985).
[2] *Id.*
[3] *In re Crown Vantage, Inc.*, No. 02-3836 MMC, 2003 WL 25257821, at *6 (N.D. Cal. Sept. 25, 2003).
[4] 11 U.S.C. § 541(a)(1) (2014).
[5] *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1150 (11th Cir. 2006).

interpretation by stating that Section 541(a)(1) "is not intended to expand the debtor's rights against others more than they exist at the commencement of the case."[6]

Although all circuits agree that *in pari delicto* is a part of a debtor's estate under Section 541(a), only a majority of the circuits have held that *in pari delicto* is an affirmative defense.[7] In contrast, the Second Circuit has concluded that it is an issue of a trustee's standing.[8] This memorandum explores the contours of these two views in order to determine when trustees may avoid being held *in pari delicto*. Part I analyzes the elements that establish the affirmative defense of *in pari delicto*. Part II examines the exceptions a trustee may argue in order to defeat a proper claim of the defense. Part III explains the Second Circuit's minority rule that *in pari delicto* is an issue of the trustee's standing rather than an affirmative defense.

I. Establishing the *In Pari Delicto* Defense

A. In Pari Delicto is an Affirmative Defense

The majority rule among circuit courts is that *in pari delicto* is an affirmative defense that precludes recovery from a plaintiff's participation in wrongdoing with the defendant.[9] To affirmatively raise this defense, the facts used to support *in pari delicto* must be "ascertainable from the complaint and other allowable sources of information, and … suffice to establish the affirmative defense with certitude."[10]

B. The Elements of the In Pari Delicto Defense

---

[6] H.R. Rep. No. 95-595, at 367-68 (1977).
[7] *See Nisselson v. Lernout*, 469 F.3d 143, 153 (1st Cir. 2006).
[8] *See Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991).
[9] *Nisselson*, at 153; *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 354–60 (3d Cir. 2001); *In re Derivium Capital LLC*, 716 F.3d 355, 367 (4th Cir. 2013); *Gray v. Evercore Restructuring*, LLC, 544 F.3d 320, 324–25 (5th Cir. 2008); *Terlecky v. Hurd* (*In re Dublin Sec., Inc.*), 133 F.3d 377, 380 (6th Cir. 1997); *Grassmueck v. Am. Shorthorn Ass'n*, 402 F.3d 833, 836–37 (8th Cir. 2005); *Sender v. Buchanan* (*In re Hedged-Invs. Assocs., Inc.*), 84 F.3d 1281, 1284–86 (10th Cir. 1996); *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d at 1149–56.
[10] *In re Rollaguard Sec., LLC*, 570 B.R. 859, 883 (Bankr. S.D. Fla. 2017).

The *in pari delicto* defense is broadly applied "to bar actions where plaintiffs have been involved 'in the same sort of wrongdoing' as defendants."[11] In order to properly raise this affirmative defense, a defendant must establish that: (1) the debtor bears equal responsibility for the violations the trustee seeks to redress; (2) the debtor participated in the wrongful conduct; and (3) the debtor's wrongdoing must be generally of the type asserted against the defendant.[12]

For example, in *In re Mortgage Fund*, the sole owner of Mortgage Fund '08 (the "Debtor") engaged in a fraudulent transfer scheme with R.E. Loans.[13] This scheme substantially depleted all of the Debtor's assets in breach of the owner's fiduciary duty to the Debtor.[14] Wells Fargo, with knowledge of this breach, approved these transfers because it financially benefitted from them.[15] The United States District Court for the Northern District of California held that trustees who file claims on behalf of the bankruptcy estate do not hold rights greater than those that were held by the debtor.[16] Consequently, such trustees are subject to the *in pari delicto* defense.[17] Because the pleadings established that the actions of the Debtor's owner were "at least as blameworthy as" Wells Fargo in perpetrating fraud, his conduct was imputed to the Debtor and to the trustee.[18] Therefore, the *in pari delicto* defense barred the trustee's claim.[19]

In contrast, *In re Bogdan,* the Fourth Circuit concluded that *in pari delicto* did not bar the claims of a Chapter 7 trustee. After Bogdan and his corporation (collectively, "Bogdan") filed for bankruptcy, mortgage lenders unconditionally assigned their fraud and conspiracy claims against Bogdan to the trustee of Bogdan's estate.[20] After concluding that these assignments were

---

[11] *Bateman*, at 307.
[12] *Id.*; *In re Brobeck*, No. 03-21784, 2008 WL 5650052, at *3 (Bankr. E.D. Tenn. Nov. 6, 2008).
[13] *In re Mortg. Fund '08 LLC*, 527 B.R. 351, 355 (N.D. Cal. 2015).
[14] *Id.*
[15] *Id.*
[16] *Id.* at 367.
[17] *Id.*
[18] *Id.* at 369.
[19] *Id.* at 370.
[20] *In re Bogdan*, 414 F.3d 507, 509 (4th Cir. 2005).

"property of the estate" under Section 541(a), the court found that the trustee stood "in the shoes of the mortgage lenders," rather than Bogdan.[21] Because the mortgage lenders were not involved in any of the alleged wrongdoing, the *in pari delicto* defense did not apply.[22]

II. Exceptions to *In Pari Delicto*

A. The "Adverse Interest" Exception

The "adverse interest" exception to *in pari delicto* states that an agent's wrongdoing will not be imputed to a debtor-principal where the wrongdoing agent acted for its own interests to the detriment of the debtor-principal.[23] As such, a trustee may avoid the *in pari delicto* defense where it can establish that the defendant acted fraudulently against the debtor's interests.[24] For example, in *R.F. Lafferty*, the Third Circuit held that the defendant-agent's Ponzi scheme was adverse to the interests of the debtor because its led to the deepening of the debtor's insolvency.[25]

B. The "Sole Actor" Exception to "Adverse Interest"

The adverse interest exception is subject to the "sole actor" exception.[26] This qualification provides that "'where the principal and agent are one and the same,' the agent's knowledge is imputed to the principal despite the fact that the agent is acting adversely to the principal."[27] An agent or agents are "one and the same" with the principle when they have sufficient decision making control over the principle.[28]

---

[21] *Id.* at 514.
[22] *Id.*
[23] *R.F. Lafferty & Co.*, at 359.
[24] *Id.*
[25] *Id.*
[26] *Grassmueck*, at 837.
[27] *Id.* at 838.
[28] *Id.*; *See In re Yellow Cab Coop., Inc.*, 602 B.R. 357, 362 (Bankr. N.D. Cal. 2019) (applying the sole actor exception to officers and directors of a debtor-corporation who conspired with the defendant to defraud the debtor-corporation of its valuable assets).

In *Grassmeuck*, the investment partnerships of debtor Hoyt Entities (collectively, "Hoyt") were found to be one and the same with Hoyt because they were indistinguishable from each other.[29] Specifically, Hoyt "assum[ed] the role of principal as well as agent" when it became a general partner of the investment partnerships.[30] Additionally, Hoyt singularly dominated the decisions of the partnerships because it acted on the behalf of the investor partners.[31] Consequently, the partnerships "existed in form only and were indistinguishable from Hoyt."[32] Therefore, the Eighth Circuit held that the sole actor rule applied and that doctrine of *in pari delicto* barred the trustee's action of fraud.[33]

C. The Sixth Circuit's Innocent-Insider Exception to the Sole Actor Rule

The Sixth Circuit has recognized a corollary to the "sole actor" exception called the "innocent decision-maker" exception.[34] Where an agent that has the power to stop wrongdoing against its debtor-principal, "'the culpable agents who had totally abandoned the interests of the principal, and were thus acting outside the scope of their agency, [are] not identical to the

[29] *Id.* at 837.
[30] *Id.* at 841.
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *In re Fair Fin. Co.*, 834 F.3d 651, 679 (6th Cir. 2016) (holding that the Ohio Supreme Court would apply the innocent decision-maker exception because it "flows ineluctably from the agency principles that underlie the sole actor doctrine.").

principal.'"[35] Therefore, a defendant would not be able to assert the sole actor exception and the trustee may use the adverse interest rule to avoid the *in pari delicto* defense.[36]

III. The Second Circuit's Approach: *In Pari Delicto* is a Standing Issue

A. The Wagoner Rule

In *Shearson Lehman Hutton, Inc. v. Wagoner*, the Second Circuit distinguished itself from other circuit courts when it held that the *in pari delicto* doctrine is an element of the trustee's standing rather than an affirmative defense.[37] Specifically, a trustee lacks standing to sue third parties "when a bankruptcy corporation has joined with [a] third party in defrauding its creditors."[38] Like the affirmative defense of *in pari delicto*, trustees are barred under the *Wagoner* rule "[b]ecause management's misconduct is imputed to the corporation, and because the trustee stands in the shoes of the corporation."[39]

B. Application of the Wagoner Rule

In *Hirsch v. Arthur Andersen & Co.,* a chapter 11 trustee lacked standing to assert a professional malpractice claim against the Arthur Anderson & Company ("Andersen") because the debtors participated with Andersen in defrauding creditors.[40] This bankruptcy proceeding arose out of a fraudulent scheme where the debtors would form limited partnership syndications so that Andersen could exert greater control over the debtors while generating substantial fees.[41]

---

[35] *Id.* (citing *In re CBI Holding Co.*, 311 B.R. 350, 373 (S.D.N.Y. 2004)). In effect, the sole actor rule is inapplicable because "'the agent[s] and the [principal] are not mere alter egos.'" *Id.* at 678 (citing *Unencumbered Assets, Tr. v. Great Am. Ins. Co.*, 817 F.Supp.2d 1014, 1036 (S.D. Ohio 2011)).
[36] *Id.*
[37] *Wagoner*, 944 B.R. at 118.
[38] *Id.*
[39] *Wright v. BankAmerica Corp.*, 219 F.3d 79, 86-87 (2d Cir. 2000).
[40] *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1095 (2d Cir. 1995).
[41] *Id.* at 1089.

Analyzing the trustee's complaint, the Second Circuit found that the trustee did not meaningfully allege "domination and control of the [d]ebtors by Andersen" because the debtor collaborated with Andersen in promulgating the Ponzi scheme.[42] Instead, the complaint described the debtors as "Ponzi Participants" because of their willingness to work with Andersen to revise financial forecasts which "primarily carried forward" the Ponzi schemes.[43] Furthermore, the debtors were not "entirely subordinate" because they were general partners of various limited partnerships used to perpetuate a system that they knew was unable to generate adequate income to meet their commitments to investors.[44] Consequently, the trustee did not meaningfully allege that Andersen dominated the debtors, and thus lacked standing under to assert this claim.[45]

C. The Adverse Interest, Sole Actor, and Insider Exceptions to the Wagoner Rule

Similar to the affirmative defense of *in pari delicto*, the *Wagoner* rule is also subject to the adverse interest exception.[46] As such, the Second Circuit has found that this exception is also subject to the sole actor rule.[47]

---

[42] *Id.* at 1094–95.
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Wight v. BankAmerica Corp.*, 219 F.3d at 87 (concluding that a complaint which alleged that a bank was totally dominated by corrupt management was sufficient to trigger the adverse interest exception).
[47] *In re Mediators, Inc.*, 105 F.3d 822, 827 (2d Cir. 1997) (holding that a sole shareholder, with total decision making power on behalf of the corporation, precluded application of the adverse interest exception).

Several district courts have held that the "innocent decision-maker" rule is a stand-alone exception to the *Wagoner* rule.[48] This is distinct from the Sixth Circuit's formulation because even where the "adverse interest" exception is inapplicable, a trustee's claim may still be barred if the innocent decision-maker exception is established.[49] Within this formulation, the *Wagoner* rule does not apply where someone in the debtor's management could and would have taken steps to end ongoing fraudulent conduct if he or she were aware of it.[50] Therefore, a trustee's claim may only be valid where a complaint "identif[ies] such person(s), and explain[s] how he could and would have brought the fraud to an end."[51]

The debtor's management at issue in this context are its "non-statutory insiders."[52] "Non-statutory insiders" include a debtor's directors, officers, and managers.[53] To be considered an insider, it is enough that one plausibly fulfills the role of one or more of these groups rather than hold a formal title.[54] In order to determine whether a person fulfills the role of an insider, courts utilize a "totality of the circumstances" test on an individualized basis.[55] This test weighs the following factors: "(1) the close relationship between the debtor and the third party; (2) the degree of the individual's involvement in the debtor's affairs; (3) whether the defendant had opportunities to self-deal; and (4) whether the defendant holds or held a controlling interest in the debtor corporation."[56] Additionally, an insider must exert "actual management" over the

[48] *See Breeden v. Kirkpatrick & Lockhart, LLP*, 268 B.R. 704, 706 (S.D.N.Y.2001); *See In re Adelphia Commc'ns Corp.*, 330 B.R. 364, 379 (Bankr. S.D.N.Y. 2005); *See In re Sharp Int'l Corp.*, 278 B.R. 28, 36 (Bankr. E.D.N.Y. 2002).
[49] *In re Adelphia Commc'ns Corp.*, 330 B.R. at 379.
[50] *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P.*, 212 B.R. 34, 36 (S.D.N.Y. 1997).
[51] *Id.*
[52] *In re TS Employment, Inc.*, 603 B.R. 700, 703 (Bankr. S.D.N.Y. 2019).
[53] *Id.*
[54] *Id.* at 710.
[55] *In re Borders Grp., Inc.*, 453 B.R. 459, 469 (Bankr. S.D.N.Y. 2011).
[56] *In re PHS Grp. Inc.*, 581 B.R. 16, 33 (Bankr. E.D.N.Y. 2018) (internal citations omitted).

debtor such that the individual has control over "the debtor's personnel or contract decisions, production schedules or accounts payable."[57]

For example, in *In re TS Employment, Inc.*, the United States Bankruptcy Court for the Southern District of New York held that a Chapter 11 trustee plausibly alleged that the defendant-accountants were insiders of a debtor.[58] In its complaint, the trustee sufficiently alleged that the accountants plausibly filled the roll of a CFO or Treasurer because they had "decision making authority over the [d]ebtor concerning financial matters."[59] Specifically, the second factor of the totality of the circumstances test was satisfied because the accountants exerted exclusive control over the debtor's financial reporting systems and internal accounting functions.[60] Furthermore, the accountants were found to exercise "actual management" because they filed quarterly payroll tax returns for the debtor.[61] Therefore, the court held that the trustee had standing to assert its claim and was not barred by the *Wagoner* rule.[62]

Conclusion

Although the *in pari delicto* defense and the *Wagoner* rule are tools defendants may use to escape a trustee's claim on behalf of the debtor's estate, they are not death knells of a proceeding. Rather, the trustee may use the adverse interest exception in every jurisdiction so long as there is sufficient factual basis to assert that the defendant acted to the detriment of a debtor it did not have sole control over. On the other hand, while a debtor may have committed

[57] *In re Chas P. Young Co.*, 145 B.R. 131, 137 (Bankr. S.D.N.Y. 1992).
[58] *In re TS Employment, Inc.*, 603 B.R. at 710.
[59] *Id.* at 709.
[60] *Id.*
[61] *Id.* at 710.
[62] *Id.* at 711.

illegal or fraudulent conduct with the defendant, claims which arise separate and distinct from such conduct may foreclose a defendant's ability to utilize either doctrine.