

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for Today's Busy Insolvency Professional

Innocent Trustee/Creditors Barred by Debtors' Past Wrongs: It Just Ain't Right

Written by:

Risa Lynn Wolf-Smith
Holland & Hart LLP; Denver
rwolf@hollandhart.com

The story begins well before a bankruptcy is filed. The debtor's officers and directors have made some bad decisions. They may have breached their duties to the debtor, shareholders and creditors. They may have concealed material information, lied or even looted the company. Professionals are implicated. The debtor's auditors have somehow overlooked the debtor's dire financial situation or even aided in a fraud on investors. Attorneys may have assisted in perpetrating an illegal scheme or helped to raise capital in violation of securities laws. The result is inevitable. The debtor plummets into bankruptcy, and creditors' damages run in the millions or even billions of dollars.



Risa Lynn Wolf-Smith

Enter the debtor-in-possession (DIP), creditors' committee, and/or chapter 11 or 7 trustee, who sue on behalf of innocent creditors to right the debtor's past wrongs. The complaints are righteous and include a litany of claims against a panoply of defendants: negligence, breach of fiduciary duty, breach of contract, negligent misrepresentation, intentional fraud, conversion, unjust enrichment, deepening insolvency, professional malpractice, aiding and abetting breach of fiduciary duty, civil conspiracy, RICO and the usual claims to recover constructive and/or intentional fraudulent conveyances. But hold on: The defendants file a motion to dismiss, alleging that the innocent's case is barred by the equitable doctrine of *in pari*

About the Authors

Risa Lynn Wolf-Smith is a partner of Holland & Hart LLP, a regional law firm with offices throughout the Rocky Mountain Region, where she chairs its Bankruptcy and Creditors' Rights Department.

delicto.

Cases addressing this defense are numerous.¹ This article explores the unique legal issues that arise when a trustee, creditors' committee or other creditor representative sues the "bad guys" for wrongs committed against creditors, and practical devices for avoiding the litigation landmines that await.

Feature

In Pari Delicto

In pari delicto is an equitable doctrine that holds that "a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing." *Black's Law Dictionary* 794 (7th ed. 1999). The common law defense "derives from the Latin, *in pari delicto potior est conditione defendentis*: 'In a case of equal or mutual fault...the position of the [defending] party...is the better one.'"² The doctrine is based on the policy 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."³

Reasoning that a DIP, trustee or creditors' committee stands in the shoes of the debtor, some courts have concluded that if the debtor was soiled by acts of wrongdoing, the defense of *in pari delicto* applies to bar claims brought by these plaintiffs. In other words, these plaintiffs are subject to all of the defenses to which the debtor would be subject, despite the uncontested innocence of the trustee, creditors' committee and their creditor beneficiaries.⁴

Importantly, courts have recognized certain exceptions to the *in pari delicto* defense so that a plaintiff's claims may proceed despite allegations that the debtor was a complicit wrongdoer. For example,

under the "adverse interest" exception to the *in pari delicto* defense, the malfeasance of corporate actors will not be imputed to the corporation when they act adversely to the corporation. If the misconduct did not benefit the debtor, but rather only benefited the debtor's principals, the *in pari delicto* defense can be overcome.⁵ The test is whether the corporate agent acted adversely to the interest of the corporation, and if so, the knowledge and conduct of the agent will not be imputed to the corporation.

Contrary to the "adverse interest" exception is the "sole actor" exception, which holds that if the wrongdoer principals are the sole representatives or "alter ego" of the corporation, their wrongdoing will be imputed to the

¹ See, e.g., recent opinions in *In re CitX Corp.*, 448 F.3d 672 (3d Cir. 2006); *Smith v. Arthur Andersen*, 421 F.3d 989 (9th Cir. 2005); *Official Committee of Unsecured Creditors of PSA Inc. v. Edwards*, 437 F.3d 1145 (11th Cir. 2006); *Sender v. Mann*, 423 F. Supp. 2d 1155 (D. Colo. 2006); *In re OODC LLC*, 321 B.R. 128 (Bankr. D. Del. 2005); *In re Mediators Inc.*, 190 B.R. 515 (S.D.N.Y. 1996); *In re Porter McLeod Inc.*, 231 B.R. 786 (Bankr. D. Colo. 1999).

² *Bateman Eichler, Hill Richards Inc. v. Berner*, 472 U.S. 299, 306, 105 S.Ct. 2622, 2626, 86 L.Ed.2d 215 (1985).

³ *Id.*

⁴ See, e.g., *Official Committee of Unsecured Creditors of PSA Inc.*, *supra*, 437 F.3d 1145, 1150.

⁵ See, e.g., *Sender v. Mann*, *supra*, 423 F.Supp. 2d 1155, 1174; *In re MS55 Inc.*, 338 B.R. 883, 897; *In re Fuzion Technologies Group Inc.*, 332 B.R. 225 (Bankr. S.D. Fla. 2005) (citing *Wight v. BankAmerica Corp.*, 219 F.3d 79 (2d Cir. 2000).

corporation even when they act adversely to it.⁶

Policy Considerations

As a policy matter, it seems inconceivable that a trustee or creditors' committee should be barred from pursuing recoveries that would inure to the benefit of innocent creditors because of the debtor's prior misconduct. Isn't the very purpose of bankruptcy to remedy wrongs of the debtor through the marshalling assets for the benefit of creditors? Why should creditors be deprived of their rights to recover damages in what seems to be a technical application of law contrary to equity?

Indeed, several commentators have argued that the *in pari delicto* defense focuses on the past wrongful conduct of the debtor, while the trustee, DIP or creditors' committee is a different legal entity. These new entities are conceived and created by the Bankruptcy Code as bankruptcy fiduciaries, whose very function is to serve creditors. They should not be blemished by the debtor's prior wrongs. Detractors of the *in pari delicto* defense argue that its application needlessly prejudices innocent creditors on whose behalf the fiduciaries are to function.⁷

Navigating the Course

Before pursuing any claims, the plaintiff must first determine who actually owns the claims to be asserted. In other words, who has standing to bring claims asserting that creditors have been damaged? Certainly, the DIP or trustee succeeds to claims that arise out of injuries to the company, such as claims for professional malpractice against its accountants and attorneys.⁸ But what about those claims that sound in injury to creditors rather than the debtor itself, such as claims for negligent misrepresentation or fraud? Some cases hold that "a bankruptcy trustee has no standing generally to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankrupt corporation itself."⁹ Where a trustee or debtor is found not to have the requisite standing, the case will be dismissed.

More to the point, the plaintiff must consider how to avoid the doctrine of *in pari delicto*. Recent case law provides some helpful hints.

First, there is authority that a trustee may bring creditors' claims as the representative of hypothetical judgment lien creditors under §544 of the Code. Thus, the trustee may "assume the guise of a creditor with a judgment against the debtor."¹⁰ By suing as creditor, the trustee may escape the *in pari delicto* defense since the claims of creditors remain pure and are not soiled by the debtor's wrongs. Because the trustee's standing is as a creditor under §544, rather than as the successor to the debtor under §541, the *in pari delicto* defense does not apply.¹¹ "In bankruptcy, the doctrine applies only to the trustee in his 'debtor' status, not as 'creditor.'"¹²

Notably, in cases where the *in pari delicto* defense has been determined to bar an action, the plaintiffs have failed to argue that they possess standing under §544 to bring the derivative claims of creditors. Nevertheless, numerous cases hold that because the claims of creditors generally are derivative claims, a trustee has standing to bring such claims.¹³ The lesson to be learned is that the complaint should specifically assert the claims of creditors, which under §544 are derivative claims.

Another possible way to steer around the *in pari delicto* defense is to have creditors assign their litigation claims directly to the plaintiff trustee, creditors' committee or a litigation trust. In this way, the putative plaintiff is not only imbued with standing to pursue creditors' claims, but the claims assigned remain clean and free from the *in pari delicto* conduct of the debtor. Thus, for example, a reorganization plan may provide that creditors may opt in to a litigation trust by assigning their litigation claims to the litigation trustee. The purity of the claims may then be preserved.¹⁴

Finally, if the plaintiff can show that the officers and directors of the debtor

who participated in the wrongful transactions were acting in their own interests and to the detriment of the debtor, the adverse interest doctrine will trump the *in pari delicto* defense. In that circumstance, the plaintiff must pay close attention to how facts are pled in the complaint to preserve this very specific exception to the *in pari delicto* defense.

Conclusion

Though it may seem instinctively wrong, and even offensive, for a bankrupt fiduciary to face possible dismissal of its claims at the outset, the road to recovery is treacherous. Before embarking on a course to rescue the innocents, the trustee, DIP or creditors' committee and their attorneys must appreciate the many obstacles that may block prosecution of claims on behalf of creditors. Understanding the standing and *in pari delicto* issues that surround these kinds of claims is essential to navigate the course and maneuver around the landmines. It just ain't right, but it may be so. ■

Reprinted with permission from the ABI Journal, Vol. XXVI, No. 4, May 2007.

The American Bankruptcy Institute is a multi-disciplinary, nonpartisan organization devoted to bankruptcy issues. ABI has more than 11,000 members, representing all facets of the insolvency field. For more information, visit ABI World at www.abiworld.org.

⁶ See, e.g., *Matter of Mediators Inc.*, supra, 190 B.R. 515, 528.

⁷ See Davis, Jeffrey, "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 (2005); Alam, Tanvir, "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 (2003).

⁸ See *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 428-29, 92 S.Ct. 1667, 1685-86, 32 L.Ed.2d 195 (1972).

⁹ See *Matter of The Mediators*, supra, 190 B.R. 515, 526; *Smith v. Arthur Andersen*, supra, 421 F.3d 989, 1002.

¹⁰ *Sender v. Mann*, supra, 423 F.Supp. 2d 1155, 1172.

¹¹ *In re Porter v. Mcleod*, supra, 231 B.R. 786, 793.

¹² *Id.*

¹³ *Bondi v. Grant Thornton Int'l*, 377 F.Supp 2d 390, 420 (S.D.N.Y. 2005) ("a trustee may assert only the claims that belong to the bankruptcy estate, those claims may include the interests of creditors in the sense that the trustee has the duty to marshal the assets of the estate so that they can be distributed to creditors on a *pro rata* basis"); *Bd. of Trs. v. Foodtown Inc.*, 296 F.3d 164, 170 (3d Cir. 2002) (quoting *St. Paul Fire & Marine Ins. Co. v. Pepsico Inc.*, 884 F.2d 688, 701 (2d Cir. 1989) ("If a claim is a general one, with no particularized injury arising from it, and if that claim could be brought by any creditor of the debtor, the trustee is the proper person to assert the claim.").

¹⁴ *Sender v. Mann*, supra, 423 F.Supp. 2d 1155 (unconditional assignment of creditors' claims into opt-in trust defeats *in pari delicto* defense).