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Ending the Nonsense: The *In Pari Delicto* Doctrine Has Nothing to Do With What Is § 541 Property of the Bankruptcy Estate

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ENDING THE NONSENSE: THE IN PARI DELICTO
DOCTRINE HAS NOTHING TO DO WITH WHAT
IS § 541 PROPERTY OF THE BANKRUPTCY
ESTATE

Jeffrey Davis*

The recent wave of disregard for corporate fiduciary responsibilities has provided numerous opportunities for courts to consider whether the corporations bankrupted by the unlawful acts of their principals should be prohibited by the in pari delicto doctrine from pursuing liability claims against third parties who contributed to the harm. In an array of recent cases, courts have reluctantly and apologetically, yet uniformly, permitted third parties who contributed to the demise of these corporations to escape liability because they felt § 541 of the Bankruptcy Code (the “Code”)¹ left them no other choice.²

Section 541 provides that the filing of a bankruptcy petition creates an estate. With certain exceptions not relevant here, the estate is comprised of “all legal or equitable interests of the debtor in property as of the commencement of the case.”³ Ignoring dissenting cries for good sense and fidelity to bankruptcy policy, the majorities in these cases have felt bound by this language 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. In this Article, I argue that § 541 makes no such demand, and these courts have missed the point. The focus should be not on the state law rights of the debtor on the date of bankruptcy, but on

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² See, e.g., infra note 15.
the property of the estate on that date—a very different matter. Properly conceived, that property should include claims against third parties who have participated in harming the estate, and the in pari delicto defense should be irrelevant.

Part I of this Article describes the ancient in pari delicto defense and explains why its application in bankruptcy cases undermines bankruptcy policy. Part II examines the recent circuit court cases. Part III then discusses what is meant by "property of the estate" in § 541, and Part IV concludes with a discussion of how these cases should properly be analyzed. It is my thesis that in many, if not most, instances federal policy requires direct inquiry into the merits of the debtor's claim against third parties without regard to the in pari delicto doctrine.

I. THE IN PARIDELICTO DOCTRINE AND ITS POLICY IMPLICATIONS IN BANKRUPTCY

The Latin phrase in pari delicto refers to a plaintiff's participation in the same wrongdoing as the defendant. The entire phrase in pari delicto potior est conditionis defendantis translates literally to mean, "[i]n a case of equal or mutual fault... the position of the [defending] party... is the better one." The doctrine is premised on the equitable principle that no court will lend its aid to one who bases a cause of action upon an immoral or illegal act. Where the plaintiff has acted wrongfully through an agent in the scope of the agency, the usual presumption is the wrongful act of the agent is attributed to the principal. However, where the agent, in his or her own interest, acts adversely to the interests of the principal, such acts are so incompatible that they destroy the agency, and the defense based on those acts is then no longer available to the defendant. This is known as the adverse interest exception to the in pari delicto rule. Where, however, the persons dominating or controlling the principal orchestrate the unlawful conduct, so that

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5 Terlecky v. Hurd (In re Dublin Secs., Inc.), 133 F.3d 377, 380 (6th Cir. 1997).
6 Mediators, Inc. v. Manney (In re Mediators, Inc.), 105 F.3d 822, 827 (2d Cir. 1997).
8 In re Mediators, Inc., 105 F.3d at 827.
the party who could have put an end to the conduct is the agent itself in its capacity as principal, the adverse interest exception is negated. This is known as the "sole actor" rule, which operates as an exception to the adverse interest exception.

When a corporation or partnership enters bankruptcy, an estate is created apart from the debtor itself and apart from the agents who previously acted on the debtor's behalf. The debtor is then represented by a wholly distinct legal entity, the bankruptcy trustee or the debtor-in-possession. The job of this new representative is to gather up the property of the estate and apply it to the best interests of the creditors of the debtor. In such a case, the personal conduct of the debtor's erstwhile agents should no longer serve to shield from liability persons who have done harm to the debtor. In Scholes v. Lehman, a receivership case arising out of a Ponzi scheme, Chief Judge Posner of the Seventh Circuit clearly and colorfully explained why in such instances the normal rule should no longer be applicable:

[T]he reason [for the in pari delicto defense], of course, is that the wrongdoer must not be allowed to profit from his wrong by recovering property that he had parted with in order to thwart his creditors. That reason falls out now that the [scheme operator] has been ousted from control of and beneficial interest in the corporations. The appointment of the receiver removed the wrongdoer from the scene. The corporations were no more [the scheme operator's] evil zombies. Freed from his spell they became entitled to the return of the moneys—for the benefit not of [the scheme operator] but of innocent investors—that [the scheme operator] had made the corporations divert to unauthorized

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9 Color Tile, 322 F.3d at 165.
10 Id.
12 If the debtor files a chapter 7 petition, §§ 701 and 702 provide for the appointment or election of a trustee. If the debtor files a chapter 11 petition, the debtor becomes a "debtor-in-possession" unless a trustee is appointed. Id. § 1101(1).
13 A Ponzi scheme is a fraudulent investment scheme in which "profits" to investors are not created by the success of the underlying business venture, but instead are derived fraudulently from the capital contributions of other investors. Sender v. Nancy Elizabeth R. Heggland Family Trust (In re Hedged-Inv. Assocs.), 48 F.3d 470, 471 n.2 (10th Cir. 1995).
purposes.... Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated.\textsuperscript{14}

The equities in bankruptcy are no different. The creation of the estate and appointment of a trustee transforms the zombie, to whom the unlawful acts of its agents were attributable, into a debtor entitled to compensation for the benefit of its innocent creditors for damage previously done to it. The frustration of the judges, believing §541 prohibits achieving this appropriate result, is palpable. In the words of the Tenth Circuit, for example:

Though the Seventh Circuit's reasoning in *Scholes* enjoys a certain appeal, both from doctrinal and public policy perspectives, we cannot adopt it in this case. Put most simply, [the bankruptcy trustee is] acting under 11 U.S.C. § 541, and bankruptcy law, apparently unlike the law of receivership, expressly prohibits the result [the trustee] urges.\textsuperscript{15}

II. THE RECENT CASES

Thus far, the Second, Third, Sixth, and Tenth Circuit Courts have ruled on this issue, all arriving at the same erroneous conclusion: If the debtor, prior to bankruptcy, would have been prohibited by the doctrine of *in pari delicto* from seeking a remedy for injuries caused by third parties in cooperation with its managers, §541 requires the bankrupt debtor be so prohibited as well.

A. The Journey of the Second Circuit

The cases in which trustees were denied the power to assert claims of a corporate debtor against third parties due to the pre-bankruptcy conduct of the debtor's principals began to appear in the Second Circuit Court of Appeals in the early 1990s. Over time, the theory upon which this power was denied evolved from one which disregarded the existence of the corporate entity to one that wholly respected it.

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\textsuperscript{14} 56 F.3d 750, 754 (7th Cir. 1995).

\textsuperscript{15} Sender v. Buchanan (*In re* Hedged-Invs. Assocs.), 84 F.3d 1281, 1285 (10th Cir. 1996).
The first case, *Shearson Lehman Hutton, Inc. v. Wagoner*, makes no mention of the *in pari delicto* defense. In *Wagoner*, the HMK Management Corporation ("HMK"), through Kirschner, its sole stockholder, director, and president, moved into the offices and used the equipment of the Shearson Lehman brokerage firm. HMK borrowed money from Kirschner's fellow Jehovah's Witnesses, issuing HMK notes and loan agreements. It then used those funds to trade in volume in violation of Connecticut law. In less than a year, HMK began to incur losses. Shearson terminated Kirchner's brokerage accounts and his use of its offices, and eventually HMK filed for bankruptcy. The note holders sued Shearson in federal court, and three years later, the bankruptcy trustee for the Estate of HMK, Walter Wagoner, Jr., also went after Shearson, demanding arbitration. Wagoner sought to arbitrate Shearson's liability for two types of claims. First, knowing the trading in the HMK accounts was unsuitable for HMK, Shearson allegedly manipulated Kirschner into excessively speculative trading—thereby making Kirschner its implied agent—and allowing him to trade with highly leveraged funds—hence gaining for itself extraordinarily high commissions. This was characterized as a "churning" claim. Second, Shearson allegedly engaged in conduct intended to strip HMK of its assets—conduct that in essence "aided, abetted, and unduly influenced Kirschner in making bad trades that dissipated corporate funds." This was characterized as a fraud claim.

Shearson sought an injunction in federal court against arbitration, which the district court granted on the ground that the three year statute of limitations had run on these tort claims. On appeal to the Second Circuit, because only the arbitrability of these

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16 944 F.2d 114 (2d Cir. 1991).
17 Id. at 116.
18 Id.
19 Id.
20 Id.
21 Id. at 117.
22 Id.
23 Id.
24 Id. at 119.
25 Id.
26 The court characterized this as "a claim against a third party for defrauding the corporation . . . ." Id.
27 Id. at 117.
claims was at issue, the court was unconcerned with their merits. However, the court viewed the trustee’s standing to assert these claims as highly germane to the propriety of arbitration. Beginning with the premise that the trustee is empowered only to assert claims of the debtor and not claims of the debtor’s creditors, the court stated: “[W]e review the claims the trustee asserts only to determine whether a corporation in HMK’s position is entitled to bring such a claim, not whether it has merit.” Citing numerous cases in which corporations brought churning claims against brokerages, the court held the trustee had standing to bring this one and arbitration of it would be proper.

As to the second claim, however, in which Shearson allegedly “aided, abetted, and unduly influenced Kirschner in making bad trades that dissipated corporate funds,” the court concluded Kirschner “not only knew of the bad investments, but actively forwarded them.” Therefore, the court held the corporation and the trustee would not have standing to bring this claim because a “claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation.” The rationale for this rule is “though a class of creditors ha[s] suffered harm, the corporation itself ha[s] not.” This ruling has been severely criticized for failing to recognize the

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28 See id. at 119.
29 See id. at 118-20.
30 Id. at 119.
31 Id.
32 Id. at 119-20.
34 Id. (citing In re D.H. Overmyer Telecasting Co., 56 B.R. at 661). The court said: “[A] question remains whether in the case at hand there is any damage to the corporation, apart from that done to the third-party [creditors or] creditor noteholders.” Id. at 118-19. The court then discussed In re D.H. Overmyer Telecasting Co., 56 B.R. 657, a case in which third parties had allegedly helped pack the unsecured creditors’ committee with employees and subordinates, thereby subverting the committee’s function. Wagoner, 944 F.2d at 120. The Wagoner court noted that the Overmyer court held these acts had harmed the creditors and not the corporation so that the cause of action belonged to the creditors. Id. The Wagoner court then stated it “believe[d] these cases control the instant issue,” relying on Overmyer for the proposition that there was no damage to the HMK corporation apart from that done to the third party creditors. Id. The reliance is hardly well placed. Clearly, the harm to an already bankrupt corporation in stacking the creditors’ committee is a far cry from the harm in making bad trades that dissipate corporate funds and drive the corporation into bankruptcy.
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injury to the corporation as well as creditors as a basis for standing.\textsuperscript{35} A finding that the squandering of corporate assets does not harm the corporation is possible only if one ignores its existence.\textsuperscript{36} The court also misapplied the rule in finding standing to assert the churning claim but not the fraud claim. Churning requires, at the very least, the cooperation of corporate principals who are unaware that they are being churned. In Wagoner, Kirschner did not share the alleged goal of dissipating corporate funds.\textsuperscript{37} In fact, the court stated he was allegedly unduly influenced in making bad trades.\textsuperscript{38} This is not the type of cooperation in defrauding the corporation to which the cases cited by the court refer,\textsuperscript{39} and the court’s distinct treatment of the two types of claims for standing purposes does not withstand scrutiny. The conduct of Kirschner in both instances was essentially the same. Consequently, the Wagoner court both encouraged application of a rule that disregards the corporate entity, and by misapplying it, encouraged its overly simple application.

In Hirsch v. Arthur Andersen & Co, Colonial Realty and its two general partners, Googel and Sisti, operated a Ponzi scheme that led to the bankruptcy of all three, which were consolidated into a single bankruptcy estate.\textsuperscript{40} The trustee sued Arthur Andersen, the accounting firm, and various others who allegedly participated in producing the misleading figures that facilitated the scheme.\textsuperscript{41}


\textsuperscript{36} The fact that once a corporation becomes insolvent the stake holders shift from shareholders to creditors does not mean the corporation ceases to exist. Frequently the result is that the corporation, once restructured, continues to operate for the benefit of new owners.

\textsuperscript{37} Surely Kirschner’s objective was to make profitable investments for the benefit of himself and his fellow Jehovah’s Witnesses, who had trusted him with their money.

\textsuperscript{38} Wagoner, 944 F.2d at 119.

\textsuperscript{39} In Overmeyer, the defendant law firm had allegedly helped Overmeyer defraud the corporation by packing the committee with employees, subverting the committee’s function. Id. at 120 (discussing In re D.H. Overmeyer Telecasting Co.). The Second Circuit’s statement that “Overmeyer Telecasting Co. illustrates the point,” id., is profoundly incorrect. There is no suggestion in Wagoner that Kirschner shared in the goal of dissipating corporate funds. The allegation was that he was unduly influenced. Id. at 119. The Wagoner court also cited Barnes v. Shatkin, 215 A.D. 10 (N.Y. App. Div. 1925), a case holding simply that the trustee in bankruptcy cannot assert the claims of creditors against third parties that were not property of the estate. Wagoner, 994 F.2d at 118.

\textsuperscript{40} 72 F.3d 1085, 1087 (2d Cir. 1995).

\textsuperscript{41} Id. at 1088.
Applying the *Wagoner* rule, the Second Circuit held the trustee lacked standing to assert the claims of the consolidated estate. In doing so, the court distinguished the case from *Kalb, Voorhis & Co. v. American Financial Corp.* In *Kalb*, the court held the trustee for the bankrupt corporation had standing to bring a suit against another corporation, the former controlling shareholder of the bankrupt debtor, because the debtor was forced to act for the benefit of the controlling shareholder through domination and control. Therefore, the trustee was not barred on the ground that the debtor was *in pari delicto* with the defendant. In contrast, in *Hirsch*, despite allegations that Arthur Andersen "knew everything," domination and control by Andersen was not meaningfully alleged in the complaint. Lacking allegations of domination and control, the court held the third parties could not be sued. Recognizing there was "at least a theoretical possibility of some independent financial injury to the [debtor] as a result of the defendant's professional malpractice, the court nevertheless applied the *Wagoner* rule. The court appears to have relied on the idea that any damage suffered by the debtors was passed on to the investors, and "there [was] likely to be little significant injury that accrues separately to the Debtors...." By recognizing, but minimizing, the likelihood of separate injury to the debtor, the court took a small step away from the *Wagoner* premise that there is no such injury.

In *Mediators, Inc. v. Manney (In re Mediators, Inc.)*, Manney had been the sole shareholder of Mediators, Inc., a corporation in "the business of acquiring radio and television advertising time for its clients in exchange for the clients' products and services rather than for cash." Over time, the corporation amassed a large art collection, and when severe financial problems arose, Manney set about buying the collection from the corporation for the bargain

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42 Id. at 1094.
43 Id. at 1094-95 (citing *Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130 (2d Cir. 1993)).
44 Id. at 1095 (citing *Kalb, Voorhis & Co.*, 8 F.3d at 133).
45 *Kalb, Voorhis & Co.*, 8 F.3d at 133-34.
46 72 F.3d at 1095.
47 Id. at 1094-96.
48 See id. at 1094.
49 Id. (emphasis added).
50 105 F.3d 822, 824 (2d Cir. 1997).
price of $12.6 million to protect the collection from the corporation’s expected bankruptcy.\(^5\) Manney was assisted in this effort by Citibank and its lawyers, the “Astor defendants.”\(^6\) Three years later, an involuntary bankruptcy ensued, and the initial chapter 7 was soon converted to chapter 11.\(^5\) When Manney, as debtor-in-possession, did not proceed against himself, the Committee for Unsecured Creditors was appointed to represent the estate, whose assets had been stripped.\(^5\) In addition to suing Manney in bankruptcy court, the Committee also sued Citibank and the Astor defendants for aiding and abetting the Manneys in breaching their fiduciary duties to the corporation and its creditors.\(^5\) The court, relying on *Wagoner*, held that even though the corporation, and thus the trustee, can sue its principals for breach of fiduciary duties, where third parties aid and abet a fiduciary’s breach of duty to the corporation, the creditors can sue in their own right, and the trustee lacks standing to do so.\(^5\)

One should recall the *Wagoner* court reasoned that in such instances, the creditors are harmed but the corporation is not.\(^5\) This leads to the absurd result that when management and its accomplices defraud a corporation, management can be sued on behalf of the corporation for the harm caused to the corporation, but the accomplices cannot be sued on behalf of the corporation because the corporation was not harmed—only the creditors were harmed. The irony of this curious reasoning is magnified because in this case, the claim by creditors in their own right was time-barred under New York law,\(^5\) leaving the alleged accomplices to skate free.\(^5\)

\(^5\) *Id.* at 825.
\(^6\) *Id.*
\(^5\) *Id.* at 824-25.
\(^5\) *Id.* at 825.
\(^5\) *Id.*
\(^5\) *Id.* at 827.
\(^5\) See supra note 34 and accompanying text.
\(^5\) *In re Mediators, Inc.*, 105 F.2d at 825.
\(^5\) *Mediators* illustrates an additional difficulty that arises when corporate existence is ignored: Some corporations are harder to ignore than others. Unlike closely held, highly controlled corporations whose separate existence might be questioned, Mediators, Inc., appeared to have a very real existence with substantial assets and enormous debt. See id. Wang Labs had just obtained a $17 million judgment against the corporation. *Id.* There was no such judgment against Manney. *Id.* It is one thing to disregard the existence of a shell-like
The Second Circuit transition from the lack-of-standing theory to the *in pari delicto* theory began with *Breeden v. Kirkpatrick & Lockhart LLP (In re Bennett Funding Group).* In that case, the Bennett family, through the Bennett Funding Group ("BFG"), fraudulently sold and resold office equipment leases to investors. Once BFG was bankrupt, the trustee brought actions against an accounting firm and a law firm for failing to blow the whistle. The court denied standing, relying on *Wagoner* for the proposition that "the trustee can sue only if it can establish that there has been damage to the corporation apart from the damage to third-party creditors." Relying on *Hirsch,* the court stated: "Even if there is damage to the corporation itself, the trustee cannot recover if the malfeasant was the corporation's sole shareholder and decision maker." The court then completed the dubious logic circle by saying even if independent financial injury might be established, the *Wagoner* rule precluded standing because of the debtor's collaboration with the third parties. Of course the *Wagoner* rule is that standing is precluded because there is no independent harm to the corporation.

Perhaps recognizing the illogic of these statements, the court went on to pursue a different theory, stating the unmentioned "rationale for *Wagoner* is that the misconduct of managers within the scope of their employment will normally be imputed to the corporation." Finding the owners of the corporation had fully acquiesced in and ratified the managerial acts of their son Patrick, those acts were imputed to the corporation and the trustee's standing to sue the third parties denied. Without using the phrase, this ushered in the *in pari delicto* approach. One should appreciate...
the unarticulated theoretical shift at this point: Because the in pari delicto doctrine's availability turns on the intention of the actors to benefit the corporation, the doctrine wholly regards rather than disregards the corporation's existence.

Official Committee of Unsecured Creditors of Color Tile v. Coopers & Lybrand, LLP completed the Second Circuit's shift in approach. In Color Tile, Color Tile, a Texas retailer of floor coverings, was a portfolio company of Investcorp Group. “[T]o make Color Tile a more attractive candidate for an initial public offering,” Investcorp, with the participation of the Coopers & Lybrand accounting firm, caused Color Tile to purchase American Blind Factory (“ABF”), a family owned company that sold blinds and wallpaper, at a price that was too high and on terms too severe. When Color Tile defaulted on a $10.4 million interest payment, it filed for relief under chapter 11. As part of a global settlement with its creditors, an assignment was made to the Color Tile Committee in order to pursue various claims on behalf of the estate. In federal district court in New York, the Committee sued Coopers for breach both of contract and its fiduciary duties in failing to inform the board of directors the purchase was detrimental to the interests of Color Tile and “created a grave risk” of inability to meet “its obligations as they came due . . . .” The Committee sued Investcorp Group for violating the duty of loyalty by forcing Color Tile to buy ABF on unreasonable terms for the benefit of the Investcorp Group defendants and directors. Applying Texas law, the district court dismissed the case against Coopers because the decision to purchase ABF was allegedly made by the Color Tile board of directors and its sole shareholder knowing it was based on grossly inflated and exaggerated projections; an affirmative in pari delicto defense was alleged in the complaint.

The Second Circuit affirmed the findings that the allegations in the pleadings established that Color Tile’s board and shareholders

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69 322 F.3d 147 (2d Cir. 2003).
70 Id. at 152.
71 Id. at 153.
72 Id.
73 Id. at 153-54.
74 Id. at 154.
75 Id.
76 Id. at 155.
were at least equally at fault as was Coopers.\footnote{Id. at 164.} The Committee had argued for application of the adverse interest exception.\footnote{Id.} That is, because Investcorp Group's interests were allegedly adverse to Color Tile's, the actions of the corporate agents should not be imputed to the corporation because such adverse actions destroy the agency.\footnote{See id.} The exception was not applied, however, under the "sole actor" rule, which negates the exception when the principal and agent are one and the same.\footnote{Id. at 165.} The agent's knowledge is imputed to the principal despite the agent's self-dealing because the party that should have been informed was the agent itself in its capacity as principal.\footnote{Id. at 166 (citing In re Mediators, Inc., 105 F.3d 822, 827 (2d Cir. 1997)).} Thus, because the \textit{in pari delicto} defense would have been effective under state law, it was effective against the Committee.\footnote{Id. Despite a dearth of Texas authority to support the trial court's ruling, the Committee's various tactical dilemmas caused it to waive its argument that the district court's formulation of Texas's \textit{in pari delicto} defense was incorrect. \textit{Id.} Declining to endorse the district court's analysis, the court essentially applied "general" state law. \textit{Id.} at 163-66.}

\textbf{B. The Third, Sixth, and Tenth Circuit Courts' Cases}

The Tenth Circuit decided \textit{Sender v. Buchanan (In re Hedged-Investments Associates)} in 1996.\footnote{84 F.3d 1281 (10th Cir. 1996).} Before his imprisonment, James Donahue operated a long-running Ponzi scheme, selling limited partnership interests through a solely-owned corporation and three limited partnerships.\footnote{Id. at 1283.} When the scheme collapsed, Sender was appointed trustee of the bankrupt entities.\footnote{Id. at 1285.} Sender went after Ms. Buchanan, one of the few investors to profit from the scheme,
taking out $2 million after investing $750,000. Sender sought to enforce her partnership agreement, claiming her profit violated the agreement. The district court rejected the theory, stating enforcement of the partnership agreement would serve to further the illegitimate scheme. On appeal to the Tenth Circuit, Sender argued, based on Judge Posner's evil zombie language in Scholes v. Lehman, that sound policy supported his position in that he was trying to rectify the fraud, not perpetuate it. Despite the attractiveness of the argument, the court reluctantly rejected it because § 541 "expressly prohibits" the result Sender urged.

In the Sixth Circuit case, Terlecky v. Hurd (In re Dublin Securities), Dublin Securities had devised and carried out fraudulent initial public stock offerings represented by two law firms and four lawyers. The principals were convicted and the company filed a chapter 7 petition. Terlecky was appointed trustee and sued the lawyers and law firms in tort. The defendants' motions to dismiss were granted by the district court on the ground that the claims were barred under the in pari delicto doctrine. The court of appeals affirmed, concluding that because the corporation was at least as culpable as the defendants, the in pari delicto defense applied.

In the Third Circuit case, Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., the Shapiros operated a Ponzi scheme through a network of businesses, causing their corporations to issue fraudulent debt certificates, which were then sold to individual investors. Lafferty was one of the outsiders that was allegedly "essential." When the scheme collapsed, the companies filed chapter 11 petitions. A trustee was appointed, and the creditors'

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86 Id. at 1283.
87 Id.
88 Id.
89 56 F.3d 750, 754 (7th Cir. 1995); see supra text accompanying note 14.
90 84 F.3d at 1284.
91 Id. at 1285.
92 133 F.3d 377, 379 (6th Cir. 1997).
93 Id.
94 Id.
95 Id.
96 Id. at 380.
97 267 F.3d 340, 344 (3d Cir. 2001).
98 Id. at 345.
99 Id.
committee was authorized to litigate on behalf of the debtors' estates. Lafferty was one of the defendants sued by the committee, which asserted numerous common law claims in addition to violations of federal securities laws. The district court dismissed the claims against the third parties, reasoning the doctrine of *in pari delicto* barred the committee from suing them for claims arising out of the fraud.

On appeal, the Third Circuit first determined the committee had standing to sue on behalf of the debtor for the tort of "deepening insolvency." Recognizing that conduct that drives a corporation deeper into debt injures not only the corporate creditors, but the corporation itself, the court held the committee had standing to sue the outsiders on behalf of the debtor. Turning to Lafferty's *in pari delicto* defense, the court affirmed the dismissal of the committee's case against Lafferty. The court noted the Tenth, Sixth, and Second Circuits had "applied the *in pari delicto* doctrine to bar claims of a bankruptcy trustee, standing in the shoes of a debtor, against third-parties, without regard to the trustee's status as an innocent successor," and no courts had held otherwise. The court followed the now familiar analytical path, beginning with the conclusion that § 541 limits the estate to the rights the debtor actually held at the moment bankruptcy was filed. The court acknowledged that several courts have declined to apply the *in pari delicto* doctrine in the receivership context, but distinguished them easily, saying, "unlike bankruptcy trustees, receivers are not subject to the limits of section 541." Having determined § 541 does not allow for consideration of post-filing events, such as the removal of the Shapiros, the court applied a three-step state law imputation analysis: (1) The acts of an officer of a corporation (here, the Shapiros) are imputed to the corporation when the officer commits fraud in the course of employment and

*Id.*

*Id.* at 345-46.

*Id.* at 344.

*Id.* at 349.

*Id.* at 354.

*Id.* at 359.

*Id.* at 358 (citations omitted).

*See id.* at 357.

*Id.* at 358.
for the benefit of the corporation; (2) the acts are not imputed if, as here, the acts of the officer (such as conspiring to deepen the insolvency of the corporation) are adverse to it and not for its benefit (the adverse interest exception); and (3) the exception does not apply where the sole representatives cooperated in the fraud with the persons who dominated the debtor corporations (the sole actor exception to the exception).109 Because the Shapiros totally dominated their corporations, Lafferty escaped unscathed, free of responsibility for its alleged role in perpetrating the fraud on investors.110

In a strong dissent, Judge Cowen criticized the majority for a result that "needlessly thwarts recovery for innocent creditors, and insulates from civil liability those who help perpetrate fraud."111 He argued that once the Shapiros were removed, the doctrine, which is "readily adapted to achieve equitable results," need not have been applied, and that restricting the trustee to the debtor’s causes of action and subjecting the trustee to the same defenses assertable against the debtor does not mandate that postpetition events never be considered.112

C. Summary Comment on the Circuit Courts’ Cases

The cases in these four circuits establish, without variation, that by including in the bankruptcy estate property of the debtor “as of the commencement of the case,” § 541 demands an inquiry into what the state-law rights of the debtor would have been on the date of bankruptcy. If the conduct of the debtor, or that of its agents, would give rise to the in pari delicto defense, that defense is assertable against the trustee or debtor in possession regardless of the extent to which this result undermines bankruptcy policy. In the next Part of this Article, I argue that § 541 makes no such demand and that

109 Id. at 358-59.
110 Id. at 360.
111 Id.
112 Id. at 362-63. Judge Cowen argued that in Segal v. Rochelle a loss-carryback tax refund was property of the estate because it was rooted in the prebankruptcy past, even though it could not have been claimed until the end of the tax year, which occurred after the petition had been filed. 382 U.S. 375, 380 (1966). As discussed infra, text accompanying notes 116-38, it is significant that the issue before the Segal court was whether the refund was property of the estate, and not what the rights of the debtor might have been under non-bankruptcy law at the moment of filing.
courts are well empowered to arrive at results consonant with bankruptcy goals.

III. THE PROPERTY OF THE ESTATE

When a bankruptcy case is commenced, the trustee or debtor-in-possession must gather up the property of the estate and be responsible for its use or disposition in the bankruptcy case.\textsuperscript{113} If someone has caused legally cognizable harm to the debtor prior to the filing, the debtor will have a cause of action against that person, which the trustee will assert. The defendant will, as in any legal dispute, seek to minimize liability in any number of ways, such as denying that a claim exists by attacking the basis of the claim, by raising any legal or equitable defenses that may be available, asserting counterclaims, claims for recoupment, and the like. The effect in bankruptcy of these mitigating strategies will depend on their nature. But the first question posed, though not often confronted directly, must be precisely what is and what is not property of the estate. Quite clearly, the trustee can gather up only the debtor's interests.\textsuperscript{114} In this context, to ask, "What is the property of the estate?" is to ask, "To what extent do the mitigating strategies of the defendant affect the debtor's property interests?"

The key to the proper analysis here is to recognize that the question of what is the property of the estate is a question of federal law. The question is not simply how much the debtor would get if the case were tried outside of bankruptcy. This is where the Second, Third, Sixth and Tenth Circuits went awry. Those courts felt bound by the phrase "as of the commencement of the case" to decide how the lawsuit would have come out under state law had bankruptcy not been filed. But § 541 requires something else: It requires an identification of debtor's property as a matter of bankruptcy law. The phrase "as of the commencement of the case"\textsuperscript{115} simply identifies the moment at which one does so. Of course the rights of the parties under nonbankruptcy law must be taken into account in


\textsuperscript{114} Under § 541(a)(1), the estate is comprised of "all legal or equitable interests of the debtor in property...."

\textsuperscript{115} 11 U.S.C. § 541(a)(1).
making this determination, but the proper inquiry is decidedly different from that to which these courts have felt bound.

A. Property of the Bankruptcy Estate Is a Matter of Federal Law

Because the bankruptcy system functions within the federal system, reference to nonbankruptcy law is inescapable. The existence and nature of the debtor’s rights and interests in property are determined by nonbankruptcy law, usually state law. Beyond this necessary reliance on nonbankruptcy law, § 70 of the Bankruptcy Act of 1898 (the “Bankruptcy Act”) added an additional layer of reliance on nonbankruptcy law. Most importantly, the property of the estate included all property which, prior to the filing, the debtor could have “transferred or which might have been levied upon and sold under judicial process against him . . . .” This required an inquiry into state limitations on both transferability and creditor process.

Confronted with these limitations, the United States Supreme Court concluded in 1903 that state law rights at the moment of bankruptcy were not the sole determinant of what is property of the estate. In Page v. Edmunds, the debtor, a long-time member of the Philadelphia Stock Exchange, had filed bankruptcy and failed to list his membership as an asset because he did not consider it to be one. The trustee petitioned for an order to sell it. Memberships on the exchange were limited in number and conferred only on persons who were elected by existing members after a complex recommendation and voting process. Sale was possible only if all debts to members were paid. Because of these limitations, the Supreme Court of Pennsylvania had twice held a seat on the exchange was not property and could not be seized in execution. The United States Supreme Court held that despite the limitations and restrictions on membership, and despite the rulings of the Pennsylvania Supreme Court, the membership was property. The

116 Ch. 541, § 70(a), 30 Stat. 550 (1898).
117 Id. § 70(a)(5).
118 187 U.S. 596, 597 (1903).
119 Id. at 597-98.
120 Id. at 598.
122 Page, 187 U.S. 596.
Court stated the issue had virtually been ruled upon previously in *Hyde v. Woods*, in which the Court held that despite such limitations in a bankruptcy case, a seat on a board of exchange was property.\(^{125}\) Affirming that the issue is one of federal law, the Court stated the decision of the Pennsylvania Supreme Court "expresses no rule with which we need to take issue or which is relevant to the pending controversy. Nor indeed if the case may be construed more broadly. The Bankruptcy Act of 1898 has made its own rule."\(^{124}\)

In *Segal v. Rochelle*, the United States Supreme Court again made clear that what is property of the estate is a federal question under § 70(a) (5).\(^{125}\) At issue was whether a loss-carryback tax refund arising out of losses immediately prior to bankruptcy, but not to be collected until the end of the calendar year, was property of the estate.\(^{126}\) The Court stated that in determining the question of what is property, it must be guided by the policy of the Bankruptcy Act.\(^{127}\) The loss-carryback tax refund was little entangled with the bankrupt's ability to make a fresh start, an important bankruptcy goal.\(^{128}\) In contrast, the Court said even though future wages or expected bequests might be transferable under nonbankruptcy law, they would nonetheless not be called property within the meaning of the Bankruptcy Act because this would defeat the fresh start policy embodied in the bankruptcy discharge.\(^{129}\)

Cases subsequent to *Segal* continued to look to bankruptcy policy as a matter of federal law in resolving questions as to what is property of the estate. In *Lines v. Frederick*, the Supreme Court determined whether earned but unpaid vacation pay was property of the estate.\(^{130}\) The Court emphasized that "the problem of classification for purposes of the Bankruptcy Act could not be resolved simply by reference to the time when the right to the payment 'vested,' or to definitions of property drawn from other

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\(^{125}\) *Id.* at 604 (citation omitted).

\(^{124}\) *Id.*

\(^{125}\) *Segal v. Rochelle*, 382 U.S. 375 (1966).

\(^{126}\) *Id.* at 376-77.

\(^{127}\) "Whether an item is classed as 'property' by the Fifth Amendment Just-Compensation Clause or for purposes of a state taxing statute cannot decide hard cases under the Bankruptcy Act, whose own purposes must ultimately govern." *Id.* at 379.

\(^{128}\) *Id.*

\(^{129}\) *Id.* at 379-80.

\(^{130}\) 400 U.S. 18 (1970).
areas of the law."131 Unlike the bankrupt in Segal, whose business had ceased to operate, the debtors in Lines were wage earners. In order to facilitate the bankruptcy policy of the fresh start, the Court held the accrued pay was not property of the estate.132 In Kokoschka v. Belford, the question was whether a debtor’s income tax refund was property of the estate.133 Again, the Court emphasized, “[i]n determining the term’s scope—and its limitations—the purposes of the Bankruptcy Act ‘must ultimately govern.’”134 Finding, as in Segal that the refund was sufficiently rooted in the prebankruptcy past, and not, as in Lines a surrogate for future wages, the Court held the refund to be property of the estate.135 Nowhere in the opinion is there any reference to definitions of property drawn from other law.

While no explicit statement exists either in the Code or its legislative history, it seems without question that the determination of what is property of the estate remains a matter of federal law to be resolved in light of bankruptcy policy. The first indication of this is that the § 541 definition of property of the estate, and the policy it entails, departs even farther from state law than did the Bankruptcy Act. Reliance on state transferability, susceptibility to creditor process, and vesting of title were scrapped, eliminating “any unnecessary, avoidable dependence on nonbankruptcy law.”136 The legislative history refers deferentially to Segal,137 and the only case under the Code to speak to the issue holds:

While the interest of a debtor in property is determined by State law, the question whether such property is property of the debtor’s estate is a federal question to be resolved under the Bankruptcy Code . . . . It seems clear, at the very least, the Bankruptcy Court has jurisdiction to resolve the competing claims to the property in question by

131 Id. at 19-20.
132 Id. While the logic of the majority’s holding can be criticized, as in Justice Harlan’s dissent characterizing the holding as giving the debtor a partial head start, id. at 21-22 (Harlan, J., dissenting), there is no question as to whether the telling inquiry is into federal policy.
134 Id. at 645 (quoting Segal, 382 U.S. at 379).
135 Id. at 651-52.
scrutinizing the respective legal and equitable interests and decide whether the debtors' interest is such that it is property of the estate within the meaning of Section 541 of the Code.  

Freed from the belief that state law determines what is property of the bankruptcy estate, courts are then empowered to view the *in pari delicto* defense in light of its effect on federal bankruptcy policy.

B. Implications of the Legislative History

One perceived constraint on the courts’ flexibility here is derived from a misreading of the legislative history. A number of courts have quoted the following language, which appeared in both the Senate and House Reports:

Though [§ 541] will include choses in action and claims by the debtor against others, it is not intended to expand the debtor’s rights against others more than they exist at the commencement of the case. For example, 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. He could take no greater rights than the debtor himself had.

In isolation, the above language, though unexplained, is quite directive. However, elsewhere in the legislative history, a different picture is presented. In describing the final amendments that conformed the House and Senate bills to one another, Congressman Edwards stated:

>[A]s 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

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are not effective against the estate.\textsuperscript{141}

It is this second statement upon which Collier, the highly respected authority on bankruptcy law, relies in describing the reach of paragraph (1) of § 541.\textsuperscript{142}

Neither of these broad general statements in the legislative history is explained, yet the seemingly absolute limit in the first statement on the trustee's power to assert a claim is clearly contradicted by the mitigating language emphasized in the second statement. Taken together, the meaning of these unexplained contradictory statements is indeterminate. At most, they can only mean that many or even most defenses, such as a statute of limitations bar, will limit the trustee's power to assert a prebankruptcy claim, but that some defenses, including those personal against the debtor, are not effective against the estate. By ignoring the second and more recent statement in the legislative history, courts have found the legislative history to be more restrictive than need be. Perhaps it would be more accurate to say that courts have found the legislative history to provide greater support for their reliance solely on state law than it truly does.

\section*{C. Implications of Federal Securities and Antitrust Law}

In the parallel universes of securities and antitrust law, realms in which federal law takes a strong position in regulating business conduct, the \textit{in pari delicto} defense has been relegated to the back seat when in conflict with federal policy. In the case of \textit{Bateman Eichler, Hill Richards, Inc. v. Berner}, the \textit{in pari delicto} defense was raised against an investor (a tippee) who sued insiders for damages flowing from fraudulent disclosures.\textsuperscript{143} Both plaintiff and defendants had allegedly violated federal securities law. The United States Supreme Court relied heavily on an antitrust case, \textit{Perma Life

\textsuperscript{141} 124 CONG. REC. H11, 1096 (daily ed. Sept 28, 1978) (emphasis added). This statement by Congressman Edwards immediately followed a description of § 541(d), which states that where the debtor held only bare legal title without any equitable interest, the estate acquires only bare legal title. \textit{Id.} That is, the defense that the debtor held only bare legal title would be assertable against the trustee. Congressman Edwards' subsequent reference explicitly to subsection (a)(1) is much more general, referring not only to the kinds of defenses that are assertable against the trustee, but also to the kinds that are not.

\textsuperscript{142} 15 COLLIER, supra note 136, ¶ 541.04.

\textsuperscript{143} 472 U.S. 299, 301 (1985).
Mufflers, Inc. v. International Parts Corp., in which the Court had refused to allow the in pari delicto defense and emphasized "the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes," and held "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." Resolving a split among the lower courts in securities cases, the Court stated:

We therefore conclude that the views expressed in Perma Life apply with full force to implied causes of action under the federal securities laws. Accordingly, a private action for damages in these circumstances may be barred on the grounds of the plaintiff's own culpability 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.

The Court's requirement that the plaintiff bear at least substantially equal responsibility is a direct reference to the reality that despite the implication in the phrase pari delicto of an equal fault requirement, "many courts have given the... defense a broad application to bar actions where plaintiffs simply have been involved generally in 'the same sort of wrongdoing' as defendants." This loose moralistic approach is clearly rejected. But even if the plaintiff's actions were predominant, the defense would still not lie if permitting it would interfere with federal policies. The Court added "that denying the in pari delicto defense in such circumstances will best promote the primary objective of the federal securities laws—protection of the investing public and the national economy..."
through the promotion of 'a high standard of business ethics . . . in every facet of the securities industry.'

Of course, in antitrust and securities law cases, courts are not restrained by provisions analogous to § 541. However, once courts are freed from the belief that identification of § 541 property requires fealty to state law, these principles should not be difficult to translate into the bankruptcy realm. Surely bankruptcy law should also promote a high standard of business ethics in every facet of business affecting the lending and investing communities.

D. Furthering Bankruptcy Policy by Disregarding the In Pari Delicto Defense

The recent cases discussed here are corporate liquidations. Thus, unlike Segal, Lines, and Kokoszka, the fresh start policy is not implicated, although if an injured corporation were left with sufficient assets to seek reorganization, the fresh start policy could be implicated. In these cases, the fundamental bankruptcy policy to be furthered is that of fair treatment of creditors and investors by maximizing the distribution to them of the remains of the debtor. The distribution is maximized by giving the trustee not only the duty to collect and reduce to money the property of the estate, but by providing the trustee broad investigative and avoidance powers. People who have enriched themselves to the detriment of the estate are called to account for their improper gains. Some are called to account even if they have acted in good faith. Certainly, the policy of fair treatment of creditors and investors requires that persons who have enriched themselves through breach of a legal duty to the debtor must be held liable in bankruptcy for the harm they have caused.

Recall that in the antitrust and securities arenas, the Supreme Court has refused to permit the in pari delicto defense to operate as a

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148 Id. at 315 (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-87 (1963)).
150 Id. § 704(4).
151 Id. §§ 542-553.
152 Id. § 550(a).
153 Section 550(b) and (e) provides only limited protection to good faith transferees. Id. § 550 (b), (e).
barrier to relief where a private suit serves important public purposes. By comparison, the policy mandate in bankruptcy cases is even more forceful because proceeds of the cause of action will go, not to the private litigant who was personally in cahoots with the defendant, but to the innocent creditors and investors. Two important federal policies are furthered: fair treatment to creditors and investors and the promotion of a high standard of business ethics among the professionals who serve and participate in the affairs of corporate managers.

E. The Views of Other Commentators

I am not the first to discuss recent treatment of the in pari delicto defense in bankruptcy. All commentators have been highly critical of the result in these cases, but only one has commented at length. Tanvir Alam has published a fine piece entitled, Fraudulent Advisors Exploit Confusion in the Bankruptcy Code: How In Pari Delicto Has Been Perverted to Prevent Recovery for Innocent Creditors. In his article, he has much of value to say. It is his view of precisely how the circuit courts have misapplied § 541 and the consequence of that misapplication with which I differ. His premise is that bankruptcy law should not overrule state law when it comes to establishing property rights. For this proposition, he quotes a passage from Butner v. United States: “Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.” However, by ignoring the emphasized phrase, he

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154 See supra notes 143-48 and accompanying text.
155 See, e.g., Jordan A. Kroop, A Ponzi Scheme and a “Pointless Technicality,” 21 AM. BANKR. INST. J. 26 (2002); Brubaker, supra note 35.
157 Id. at 322.
158 Id. at 323 n.118 (quoting 440 U.S. 48, 55 (1979)) (emphasis added).
159 Ignoring the phrase, “[u]nless some federal interest requires a different result,” reflects a critical misunderstanding of Butner, which reversed the practice in a minority of courts that had “rejected state law [but had] not done so because of any congressional command, or because their approach [served] any identifiable federal interest.” Butner, 440 U.S. at 55. In that case, state law varied as to the steps a mortgagee was required to take in order to obtain a security interest in rents from the mortgaged property. Id. at 56. A minority of courts had adopted a uniform federal approach because of their perception of the demands of equity. Id. at 55. Stating that “undefined considerations of equity provide no
remains tied, as have the courts, to state law conceptions of what is property. He then argues it is the debtor’s ability to assert a claim that determines what is property of the estate and the in pari delicto defense has a bearing on the strength or weakness of the claim, but no bearing on ownership of that claim.\(^6\) He cites no authority for this assertion, which, in my view, is quite a stretch under state law—one bankruptcy courts might well be hesitant to take. His second and stronger argument is that if the wrongdoer is eventually removed from a position of recovery, even if after bankruptcy is filed, that development should be taken into account.\(^6\) It makes no sense, he argues, to analyze the underlying facts frozen in time.\(^6\) This argument, however, has been explicitly considered and rejected by the circuit courts.\(^6\)

In contrast, my view explicitly recognizes that the question of what is property for the purposes of § 541 is a matter of federal law to be determined in light of federal bankruptcy policy. Thus, courts may follow the well-trod path laid down by Segal, Lines, and Kokoszka that permits disregard of the in pari delicto defense on the ground that, as in the antitrust and securities arenas,\(^6\) doing so promotes federal policy.

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\(^6\) Alam, *supra* note 156, at 322.
\(^6\) Id.
\(^6\) Id. at 322-23.
\(^6\) *See* Official Comm. of Unsecured Creditors v. Lafferty, 267 F.3d 340, 356-59 (3d Cir. 2001); *In re* Hedged Invs. Assocs., 84 F.3d 1281, 1284 (10th Cir. 1996).
\(^6\) *See supra* text accompanying notes 143-48.
IV. HOW TO APPROACH A CLAIM TO WHICH THE DEFENSE OF IN PARI DELICTO IS RAISED

A. The Effect of the Debtor's Conduct on the Debtor's Property

When a person is injured by the unlawful conduct of another, the law provides a right to a remedy. That right normally takes the form of a civil cause of action or a number of causes of action. Each cause of action is the property of the injured party. The conduct of the debtor before, during, and after the injury can affect the debtor's rights, creating defenses to the debtor's cause of action. Depending on its nature, the debtor's conduct may or may not affect the debtor's property. Some sorts of conduct undermine the enforceability of the cause itself, while others, such as the *in pari delicto* defense, may create only *personal* barriers to assertion of the cause. It is my thesis, supported by at least some of the legislative history\(^{165}\) and the bankruptcy policies discussed above,\(^{166}\) that the possible availability of the *in pari delicto* defense under state law does not affect the debtor's property for the purposes of § 541.\(^{167}\)

There are many examples of the first type of conduct, which undermines an element in the cause of action or a requisite to its enforceability. If a victim of negligence has been contributorily negligent, liability will normally be apportioned in accord with the relative contributuon of each negligent act to the causation of the injury.\(^{168}\) Causation is, of course, an element in all civil actions, and

\(^{165}\) See *supra* notes 141-42 and accompanying text.

\(^{166}\) See *supra* notes 149-54 and accompanying text.

\(^{167}\) There are parallels to this notion in nonbankruptcy property law. For example, suppose a tenant on an enforceable lease promises to paint the landlord's portrait, and the parties expressly agree that "this covenant shall be a covenant running with the land, binding and benefiting the parties' grantees and assigns forever and ever." ROGER A. CUNNINGHAM ET AL., *THE LAW OF PROPERTY* 471 (West 2d ed. 1993). If the tenant then assigns the leasehold, the covenant will continue to bind the assignor, but it will not be binding on the new lessee. *Id.* Such covenants do not run with the land because, to do so, a covenant must touch and concern the land. *Id.* For the same reason, the benefit of the covenant would not be enforceable by the landlord's grantee. *Id.* The benefit and burden of the covenant are personal to the original parties, but despite their intention, it does not affect the property, the leasehold. *Id.*

In the instant context, one might say that, being a purely personal limitation, the *in pari delicto* defense does not touch and concern the cause of action. Thus its benefits and burdens do not affect the property, the cause of action.

\(^{168}\) The overwhelming majority of American states now follow the comparative negligence system, either through legislation or by judicial adoption. DAN B. DOBBS, *THE LAW
Ending the Nonsense

if an alleged victim has been a contributing cause, this will normally either lessen or wholly destroy the claim for compensation. If a defrauded buyer of goods has personally inspected the goods, to the extent the buyer has or should have discovered the truth, this will undermine the requirement that the buyer reasonably rely on the misrepresentations of the seller. If a party to a contract does not receive the performance contracted because he or she has committed a material breach, there will be no case for breach because the breach will operate as failure of the constructive condition precedent to the other’s duty to perform. If a victim of a civil wrong waits to assert it until the statutory period of limitations has run, absent circumstances that might toll the running of the period, the enforceability of the cause is destroyed. In all of these examples, the effect of the would-be plaintiff’s conduct has been to limit or eliminate the enforceability of the cause of action itself, destroying to that extent its value as property. While the mere availability under state law of the in pari delicto defense should be irrelevant to whether a cause of action is property of a debtor’s estate, the debtor’s conduct should be assessed directly for its impact, if any, on the cause itself.

In proposing these claims against third parties should be assertable in bankruptcy, I recognize that issues of judicial economy are presented. Courts regularly point out that the creditors themselves may assert these claims on their own, and courts sometimes point out that such litigation is pending. The possibility exists that suit by creditors in state court and suit by the trustee might be brought simultaneously. The two law suits may be

OF TORTS § 201 (2000). Almost all systems of comparative fault reduce the plaintiff’s recovery in proportion to the plaintiff’s relevant fault. Id. The plaintiff’s fault is not relevant if it is not one of the causes in fact of the plaintiff’s harm. Id. Nor is it relevant if it is not a proximate cause. Id.

See RESTATEMENT (SECOND) OF TORTS § 541 (1981). If the plaintiff’s investigation reveals the whole truth, the plaintiff does not rely on the misrepresentation. When no evidence shows what the plaintiff learned from the investigation, courts may conclude she did not rely on the defendant’s misrepresentation, but upon her own investigation. DOBBS, supra note 168 § 475.


51 AM.JUR. 2D Limitation of Actions § 3 (2004).

E.g., "[A]s the [bankruptcy] court noticed judicially, the defendants here are also named as defendants in other actions filed by the creditors seeking compensation for the allegedly fraudulent activity in which the defendants engaged." In re Dublin Secs., 133 F.3d 377, 380 (6th Cir. 1997).
wholly redundant, or they might entail independent elements, as where there is a clear injury to the corporation or its shareholders separate from injury to creditors. Fortunately, because of its broad jurisdictional authority, the bankruptcy court is the perfect place to identify and minimize inefficiencies of this sort. The bankruptcy court can assert jurisdiction over both suits and decide how best to proceed. If the creditors are the only parties in interest and they are well represented, or if the litigation has substantially progressed prior to the filing of the petition, the court can abstain from asserting jurisdiction or bifurcate the litigation and abstain from involvement in a part of it.

Alternatively, representing themselves outside of bankruptcy is not easy, requiring significant cooperation and cost-sharing among creditors whose interests are not always coherent. The creditors might agree that the trustee or the unsecured creditors' committee is the better champion. Indeed, in numerous bankruptcy cases, it is the unsecured creditors' committee that urges assertion of these claims in bankruptcy court. Worse yet, contrary to the courts' glib assertions that the claims against the third parties accrue to the creditors, it is often far from clear that the creditors will effectively be able to assert them. Lack of privity will normally defeat contract-based claims. Moreover, claims sounding in tort such as in negligence, negligent misrepresentation, and even intentional

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173 See 28 U.S.C. § 1334(b) (2000) (providing the district court jurisdiction over all civil proceedings "arising in or related to cases under title 11").

174 Id. § 1334(c)(1). The district court may abstain from hearing a particular proceeding arising in or related to a case under title 11 "in the interest of justice, or in the interest of comity with State courts or respect for State law . . . ." Id. Where an action under 28 U.S.C. § 1334(c)(1) that could not have been brought in federal court has been commenced in state court, abstention is mandatory if it can be timely adjudicated. Id. § 1334(c)(2).

175 See, e.g., Judge Posner's comment on the alternatives to representation by a receiver: "The conceivable alternatives to these 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; a class action, by the investors—and class actions are clumsy devices . . . ." Scholes v. Lehman, 56 F.3d 750, 755 n.14 (7th Cir. 1995).

176 In three of the eight circuit court cases discussed supra, the claim against third parties was brought by the Committee. See, e.g., Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP, 322 F.3d 147, 164-65 (2d Cir. 2003); Comm. of Unsecured Creditors v. Lafferty, 267 F.3d 340, 356 (3d Cir. 2001); In re Mediators, Inc., 105 F.3d 822, 827 (2d Cir. 1997).

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misrepresentation are often stymied by inability to prove privity,\textsuperscript{178} causation,\textsuperscript{179} or sufficient “linking conduct” between the third party and the debtor’s customers.\textsuperscript{180} As the cases disclose, there are numerous instances in which dismissal of the claim on \textit{in pari delicto} grounds permits third parties to escape responsibility.

The eight recent circuit court cases discussed above illustrate some of the common settings in which these issues are likely to be posed. Thus, they provide apt examples of how the prebankruptcy conduct of the debtor’s principals might affect the debtor’s claims against third parties who contributed to the debtor’s harm. In three of the cases, \textit{Wagoner, Hirsch, and Lafferty}, the third parties allegedly assisted the debtor in defrauding the lending or investing public. In three of the cases, \textit{Bennett Funding, Color Tile, and Dublin Securities}, the third parties allegedly failed in their professional obligation to blow the whistle on the principals. In one, \textit{Mediators}, the third parties allegedly assisted the principals in looting the corporation, and in another, \textit{Buchanan}, the defendant was simply a lucky investor who managed to withdraw from a Ponzi scheme with a profit. How would these cases properly have been analyzed under the approach I advocate in this Article?

B. Third Parties Who Assist the Debtor’s Principals in Defrauding the Public

In \textit{Wagoner}, Shearson allegedly defrauded Kirschner into making poor investments with the money loaned to his corporation by his fellow Jehovah's Witnesses.\textsuperscript{181} By providing him an office, a video monitor, and by manipulating him onto excessively speculative trading,\textsuperscript{182} Shearson facilitated Kirschner’s illegal operations and contributed to the demise of the enterprise. But it was Kirschner who solicited the loans for the purpose of engaging in illegally speculative investing.\textsuperscript{183} If the allegations were true, Kirschner probably could not have done so much harm on his own,
and Shearson's contributory harm to the corporation was significant. In such a case, joint liability of Shearson and Kirschner would be proper.

In *Hirsch*, the Arthur Andersen accounting firm allegedly participated in producing misleading figures that facilitated the scheme to defraud investors. The principals were the prime movers, of course, but the importance of the approval of a respected accounting firm like Arthur Andersen cannot be understated. Investors are far more likely to trust the assertions of the principals when backed by the support of such a firm. Similarly, in *Lafferty*, the Lafferty firm was allegedly an essential participant, along with the Shapiro:Gs, in perpetrating a fraud on public investors who were induced to invest in fraudulent debt certificates. If the allegations were true, both the Andersen and Lafferty firms should have shared in the liability for the harm caused.

In all three of these cases, the joint contributory conduct of the principals was palpable, perhaps primary, but such conduct would in no way serve to excuse or relieve the third parties from liability for their contribution to the harm.

Refinements as to the extent of liability may be in order here. For example, perhaps Shearson, Arthur Andersen, and Lafferty should not be liable for all of the injury suffered by the debtors, as would be the normal result where joint tortfeasors cause indivisible harm. Perhaps some theory of proportionate liability should be applied, rendering the third party abettors liable in bankruptcy only for the proportionate injury they caused. The debtor's property in the form of its cause of action could be limited in that way as a matter of bankruptcy policy. The conduct of the debtor's managers would not be ignored; it would detract from the cause of action to the extent that the managers' conduct operated as a contributing cause.

Perhaps the attractiveness of the *in pari delicto* doctrine in cases such as these is that it avoids the windfall effect of imposing enormous liability on a participant who has a deep pocket, or who

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185 Googel and Sisti, the principals, perpetrated their Ponzi schemes through their partnership, Colonial. Arthur Anderson performed extensive services by providing forecasts, analyses, and access to potential investors. *Id.* at 1088.
has the only remaining pocket. Apportioned liability would avoid the sense of excessiveness or inequity in applying the traditional joint liability rule.\textsuperscript{188} But the complete escape of guilty third parties afforded by the in pari delicto doctrine is just as inappropriate as would be complete responsibility.

C. Third Parties Who Fail to Blow the Whistle

In \textit{Bennett Funding}, the corporation was used as a vehicle for a Ponzi scheme.\textsuperscript{189} The third party accountants allegedly knew of these illegal activities and failed to inform anyone.\textsuperscript{190} At issue was whether there was anyone around to whom to make the disclosures because the innocent parties interested in the enterprise were allegedly powerless to do anything.\textsuperscript{191} In \textit{Color Tile}, the Coopers accounting firm allegedly knew and failed to disclose to the parties trusting Coopers for a disinterested appraisal of the deal that the principals had arranged a purchase of ABF at a price too high and on terms too severe.\textsuperscript{192} The purchase was the undoing of the corporation.\textsuperscript{193} In \textit{In re Dublin Securities}, for seven years Dublin Securities devised and carried out over $60 million worth of fraudulent initial public stock offerings.\textsuperscript{194} The principals were jailed, and the chapter 7 trustee sued the firm’s lawyers, alleging they knew or should have known of the illegal nature of the

\textsuperscript{188} The apportionment of liability among joint tortfeasors is consistent with state law, which normally permits an action in contribution among joint tortfeasors in which the joint obligors are left to achieve the apportionment in a separate action wholly apart from the main action in which liability is established. \textit{See DOBBS, supra note 168, §§ 386-87. But in bankruptcy, the managers are likely to be insolvent, in jail, or in Timbuktu, so that an action in contribution would be meaningless. For this reason, depending on circumstances such as the egregiousness of the defendant’s conduct and the depth of its pocket, it may be appropriate to consider apportioning liability in the bankruptcy case. The bankruptcy court, after all, is often said to be a court of equity. \textit{See JOHN D. AYER \& MICHAEL L. BERNSTEIN, BANKRUPTCY IN PRACTICE} 42 (2002) (stating “[n]o principle of bankruptcy jurisdiction is more familiar . . . than the notion that the bankruptcy court is a ‘court of equity’” and pointing out a computer search reveals over 350 published opinions so stating).}

\textsuperscript{189} \textit{In re Bennett Funding Group, Inc.}, 336 F.3d 94, 96 (2d Cir. 2003).

\textsuperscript{190} The complaint against the law firms alleged that they submitted a false letter to the SEC designed to hinder the SEC investigation of the company. \textit{Id.}

\textsuperscript{191} \textit{Id.} at 99.

\textsuperscript{192} \textit{Official Comm. of Unsecured Creditors of Color Tile v. Coopers \& Lybrand, LLP}, 322 F.3d 147, 154 (2d Cir. 2003).

\textsuperscript{193} \textit{Id.}

\textsuperscript{194} 133 F.3d 377, 378 (6th Cir. 1997).
activities but failed to apprise the business of those illegalities. Accordingly, the issues were posed in these cases and the trustee should have been put to the proof: Did the defendants have a duty to disclose what they knew? To whom should they have made these disclosures? And what harm might have been avoided if they had done so?

In these cases, the unlawful conduct of the principals does not excuse the alleged failures of the professionals. Indeed, it is precisely that unlawful conduct that gives rise the professionals' alleged duty to disclose. In these cases, the extent of liability caused by the alleged breach of duty is simply the extent to which the defendant could have prevented harm and failed to do so. The role of management is important to the causation analysis in determining the extent to which harm might have been avoided if the duty had not been breached. If management was in a position to undermine the effect of the required disclosures, this would mitigate the effect of breach. These can be quirky issues of fact, to be sure, but issues well worthy of pursuit.

D. Third Parties Who Assist in Looting the Corporation

In Mediators, Citibank and the Astor defendants allegedly aided and abetted the sole shareholders, the Manneys, in looting the corporation by buying the corporate art collection at far less than fair value. The Astor defendants were the lawyers who advised the Manneys to enter the transaction, which they opined was "legal, valid and binding," and Citibank loaned the $12 million purchase price to the Manneys, taking a security interest in the art and a corporate guarantee, leaving the corporation with liability for the price and far less cash than the collection was worth. Citibank was charged with actual or constructive knowledge of both the low price and the fraudulent nature of the conveyance. Eventually, the corporation landed in chapter 11 and the Committee for Unsecured Creditors sued the Astor Group and Citibank for aiding and abetting in the looting.

195 Id.
197 Id. at 520.
198 Id.
199 Id.
These causes of action should have been seen as property of the estate. Surely the Astor defendants' assurance that this fraudulent transfer was "legal, valid and binding" amounted to malpractice. Furthermore, the Committee should have been permitted to attempt to prove the allegations that Citibank knew or should have known that it was facilitating a fraudulent looting of the corporation. The conduct of management would not provide Citibank with a complete defense, but would be relevant to the inquiry into how management so effectively bamboozled Citibank into believing, if it did, that the transaction was genuine.

E. The Investor Who Did Not Lose

Perhaps the most intriguing of the eight cases is Buchanan. Hedged Investments ran a long-running Ponzi scheme in which Ms. Buchanan and her children became limited partners. As is typical of Ponzi schemes, early investors get paid from the contributions of subsequent investors. She was fortunate enough to receive payments of $2 million as a result of a $750,000 investment. When the scheme went under, the trustee in bankruptcy went after Ms. Buchanan, claiming that her profit violated the partnership agreement. Had the court been willing to disregard the unlawfulness of the scheme and hear the trustee out, it is unclear how the case would have come out. Perhaps the trustee would have succeeded under state law, depending on the terms of the agreement and state partnership law. Persons who have received unlawful dividends, even innocently, may properly be seen to have been unjustly enriched, and thus obligated to disgorge their improper gains. Sharing her gain with other investors would be consistent with the bankruptcy policies of treating similarly situated parties equally. In other instances, such as those of preference and sometimes fraudulent conveyance avoidance, innocent parties are forced to disgorge benefits received prior to bankruptcy to be shared by other claimants. Yet, because there is no suggestion that

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200 Id.
201 In re Hedged-Invs. Assocs., 84 F.3d 1281, 1283 (10th Cir. 1996).
202 See supra note 13.
203 In re Hedged-Invs. Assoc., 84 F.3d at 1283.
204 Id.
205 There is no escape from avoidance of preferential transfers under § 547 based on
Ms. Buchanan did anything wrong, forcing disgorgement of her profits would not provide incentive to professionals to conduct themselves ethically in the securities arena. In that light, perhaps this is one instance in which there is not a federal interest sufficient to justify disregard of state property law.

CONCLUSION

In collecting the property of the estate, I have argued the trustee should be permitted to sue third parties who have, in cooperation with the debtor's managers, caused harm to the debtor. In doing so, any defense that might arise from the managers' conduct under the *in pari delicto* doctrine should normally be disregarded in furtherance of federal bankruptcy policy. However, the debtor's conduct through its managers should not be ignored entirely. If the debtor's conduct through its managers has substantive impact on the debtor's causes of action, such as by defeating an element in the *prima facie* case or by creating a substantive affirmative defense, then those meritorious defenses should be available against the trustee.

As application of these ideas to the above eight cases suggests, the conduct of the managers will sometimes, perhaps often, play an important role in determining the extent of the third party liability under substantive law. This is as it should be. What is not as it should be is that third parties who have contributed to the bankruptcy of the debtor in cooperation with the debtor's managers wholly escape liability to the estate. Nothing in § 541 demands such a result.

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*innocent intent or good faith. Nor are such defenses available to initial transferees under § 550(a)(1). Good faith transferees of fraudulently conveyed property receive a lien on the property to the extent of value given, § 548(c), but they forfeit any value the property may have in excess of that amount.*