St. John's Bankruptcy Research Library
A project of St. John's School of Law and the American Bankrupcty Institute Law Review
2009 Volume I No. 1

Defense of In Pari Delicto Does Not Affect Trustee Standing

Elizabeth L. Anderson, J.D. Candidate 2010

Rejecting the Second Circuit's Wagoner rule and agreeing with the First, Third, Fifth, and Eleventh Circuits, the United States Court of Appeals for the Eighth Circuit held that the collusion of corporate insiders with third parties to injure the corporation does not deprive the corporation's trustee of standing to sue third parties, resulting in a greater rift between Second Circuit and the other Courts of Appeal on this issue. Moratzka v. Morris, 482 F.3d 997, 1004 (8th Cir. 2007). Nevertheless, the court affirmed that such a situation may give rise to the defense of *in pari delicto* barring the trustee's action. Id.

In Moratzka, the plaintiff-trustee brought suit against a third party-defendant alleging that it committed malpractice, aided and abetted a breach of fiduciary duty by the Chief Manager of the debtor corporation, and assisted the Chief Manager in looting the assets of the debtor corporation. Id. at 999. The Bankruptcy Court first dismissed the plaintiff-trustee's complaint on the grounds that the trustee alleged only an injury to the creditors, not an injury to the corporation.[1] The court then denied a motion to amend the complaint, reasoning that doing so would be futile because the defense of *in pari delicto* would bar the complaint anyway. Id. On appeal the district court affirmed on different theory, finding that the trustee lacked standing to bring such a claim, because it belonged to the creditors of the debtor corporation. Id. at 1000.

The Eight Circuit disagreed with the holdings of both lower courts. Id. at 1007. Throughout its analysis, the court stated that there were two distinct issues that had to be

Cite as: *Defense of In Pari Delicto Does Not Affect Trustee Standing*, 1 ST. JOHN'S BANKR. RESEARCH LIBR. No. 1, at 1 (2009), http://www.stjohns.edu/academics/graduate/law/journals/abi/sjbrl/volume/v1/anderson.stj (follow "View Full PDF").

addressed: the issue of standing and the issue of defenses, and that the lower courts failed to deal with these issues correctly. Id. at 1004. The court then concluded that the plaintiff-trustee was the proper party to bring the claims against the third party-defendant for malpractice, and for aiding and abetting the Chief Manager's breach of fiduciary duty. Id. at 1006. As to the issue of *in pari delicto*, the court held that it did not have to determine the merits of the defense, because defendants had not asserted it. Id. at 1005.

Although the decision of the Eight Circuit affirms the idea that trustee standing and the *in pari delicto* defense are two issues that should be dealt with separately, the implications of the case may be less substantial than expected. Although the circuits disagreed about whether issues of standing and *in pari delicto* should be separated, the Eight Circuit affirms the rule that *in pari delicto* may be asserted as a defense against a plaintiff-trustee defeating his recovery. Id. at 1005. The following discussion focuses on two issues: first it will examine why the constitutional issue of standing requires a separate and distinct analysis from affirmative defenses, like *in pari delicto*; and second the article will examine the impact of the Eight Circuit's decision.

The Circuit Majority

Prior to the Eight Circuit's holding in Moratzka, the First, Third, Fifth, Sixth and Eleventh Circuits held that plaintiff-trustee's standing to bring a case involved a separate analysis from whether third-party defendants can assert the defense of *in pari delicto*. In Official Comm. of Unsecured Creditors v. R. F. Lafferty & Co., 267 F.3d 340, 346 (3rd Cir. 2001), the Third Circuit struck down the lower court's analysis, which treated *in pari delicto* as a standing issue. Instead the court held "[a]n analysis of standing does not include an analysis of equitable

defenses, such as *in pari delicto*. Whether a party has standing to bring a claim and whether a party's claim is barred by an equitable defense are two separate questions, to be addressed on their own terms."[2] Id. By adopting the view of its sister circuit courts of appeal, the Eight Circuit has further chipped away at the idea that an *in pari delicto* defense deprives a trustee of standing. See Moratzka, 482 F.3d at 1004. However, since its decision in Wagoner, the Second Circuit has prevented a consensus between the circuit courts by holding these are not issues that should be addressed separately.

The Wagoner Rule

The Second Circuit, in Wagoner, analyzed defense of *in pari delicto* as presenting a constitutional standing problem, and held that a claim against a third party for defrauding a corporation with the cooperation of management does not accrue to the trustee. 944 F.3d at 118-120. In Wagoner, Herbert M. Kirchner ("Kirchner") formed HMK Management Corporation ("HKM") and was the sole controller of the daily operations. Id. at 116. HKM began opening accounts at Shearson Lehman Hutton ("Shearson") and closely worked with them in executing trades. Id. Moreover, Shearson taught Kirchner how to minimize losses. Id. After Kirchner acted in violation of state law and was forced to close HKM accounts, HKM filed for bankruptcy. Id. at 117. The plaintiff-trustee for HKM then brought a claim against Shearson alleging that it had breach its fiduciary duty to the corporation. Id. at 117.

After reviewing the facts set forth above, the court determined that the trustee failed to have standing to bring the second claim because "a claim against a third party for defrauding a corporation with the cooperation of management accrues to the creditors, not to the guilty corporation." Id. at 120. Although the court did not use the term *in pari delicto* the court's

holding suggested that when the defense exists, a trustee is barred from bringing his claim on the basis of standing, instead of the merits. Id. The decision on the Second Circuit, in Wagoner, has been criticized by other Courts of Appeals as well as academics as confusing an *in pari delicto* defense with the "case or controversy" standing requirement. Moratzka, 482 F.3d at 1003.

In the cases that followed Wagoner, the Second Circuit seemingly moved away from strict adherence to its holding, as two different exceptions to the rule have emerged: "(i) where the officers of the corporation or agents acted with an adverse interest to the corporation, abandoning the interests of the company; and (ii) where there was an 'innocent decision-maker' within the debtor corporation that could have prevented the misconduct of the officers and directors." Dennis J. Connolly and Bess M. Parrish, Current Issues Involving The Application Of Exculpation And The Business Judgment Rule To Creditors' Suits Against Directors Of Insolvent Corporations, 2006 ANN. SURV. OF BANKR. LAW Part I § 1. When any of these exceptions are met a plaintiff-trustee will have standing. Id. However, despite these exceptions, the Second Circuit remains out-of-step with the other circuit courts by failing to treat trustee standing and *in pari delicto* as separate issues.

Ending the Circuit Split

The Eight Circuit's opinion in Moratzka not only creates a distinct majority that standing and *in pari delicto* are separate issues, but it also directly takes on the Second Circuit's decision in Wagoner, revealing why it is a misapplication of the law. Id. at 1002-03. In Moratzka, Chief Manager Murray Klane was one of two owners of Senior Cottages of America ("Senior Cottages") and owned a 60% interest in the company. Id. at 999. In 1998, Senior Cottages became insolvent, and as a result needed to sell its valuable assets. Id. at 1000. However, rather

than finding an arms-length buyer, Klane created a new company, Millennium Properties, LCC ("Millennium"), and transferred all the assets of Senior Cottages to Millennium. Id. In return, Millennium assumed the debts of Senior Cottages, but paid nothing for the assets it received, which the complaint valued at $4.8 million. Id.

The firm Morris Carlson, Hoelscher, P.A. ("Morris") was outside counsel for Senior Cottages and also represented Klane. Id. It advised Senior Cottages to transfer the assets and assisted in the transaction. Id. As a result, the Senior Cottages trustee alleged that the Morris knew that the transfer of was inadequate consideration and that Klane was breaching his fiduciary duty to Senior Cottages by making the transfer. Id. In his suit, the trustee claimed Morris committed malpractice, aided and abetted the breach of fiduciary duty by Klane, and assisted Klane in looting Senior Cottages' assets. Id. at 999.

Unlike Second Circuit in Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114 (2d Cir. 1991), this court emphasized that standing and the defense of *in pari delicto* were two issues, not one in the same and therefore should be addressed separately. Moratzka, 483 F.3d at 1004. In examining the standing issue, the court stated the constitutional requirement of standing is satisfied if the plaintiff alleges "an injury that is fairly traceable to the defendant's conduct, and the requested relief must be likely to redress the alleged injury." Id. at 1004 (quoting Novartis Seeds, Inc. v. Monsanto Co., 190 F.3d 868, 871 (8th Cir. 1999)). In addition to the constitutional requirements of standing, the trustee must also be within the scope of the Bankruptcy Code. Moratzka, 483 F.3d at 1004. The Bankruptcy Code only empowers a trustee to bring causes of action belonging to the debtor corporation. 11 U.S.C. § 704(1). This rule prevents a trustee from asserting a claim belonging to the creditor, and when the trustee attempts to do so he will be denied standing before the bankruptcy court. Moratzka, 483 F.3d at 1004.

While section 704(1) limits the types of claims a trustee can bring, a trustee does have authority to bring an action for damages on behalf of the debtor corporation when it is an action the debtor himself could have brought. Id. at 1002. For example, where third parties have breached a fiduciary duty to the corporation, the trustee may bring a claim against that third-party, because this right originally belonged to the debtor. Id. In Moratzka, the trustee alleged that the actions of Morris aided Klane's breach of fiduciary duty causing Senior Cottages to suffered an injury. Moreover, Klane, the debtor, could have brought this claim against Morris, giving the trustee standing under the Bankruptcy Code. Moratzka, 483 F.3d at 1004. Furthermore, the injury was traceable to the actions of the defendant and could be redressed by damages, fulfilling the other requirements of standing. Id. The court agreed and determined that the plaintiff-trustee had standing to bring suit against the third-party defendants. Id. at 1005.

Moving to the issue of defenses, the court stated the availability of the defense i*n pari delicto*, does not automatically end the plaintiff's ability to bring the claim. Id. at 1004. Instead, it is a defense on the merits requiring the facts and circumstances surrounding the case to be examined. Id. 1004-05. Therefore, even if an *in pari delicto* defense appears on the face of the complaint, it does not deprive the trustee of constitutional standing, even though the defense may eventually be fatal to the claim. Id. at 1004. In the case at hand, the third-party defendant's did not assert the defense of *in pari delicto*, and therefore the court did not have to address whether the defense was meritorious based on the facts before them. Id. at 1005.

Keeping in step with the other circuits, the decision of the Eight Circuit in Moratzka has further chipped away at the authority of Wagoner. Moreover, this decision has aided in the creation a majority rule among the Federal Courts of Appeal that the defense of *in pari delicto*

does not deprives a trustee of standing. While this decision was important in helping to bring a consensus on the law, the overall implications of the case may be less substantial than expected.

Does it Really Matter?

Although the circuit courts have disagreed about whether issues of standing and *in pari delicto* should be separated, their treatment of the defense *in pari delicto* in bankruptcy cases always produces the same result: the defense bars the trustee's claim. In Moratzka, Eight Circuit continued to follow this pattern by finding that *in pari delicto* can be asserted as a defense against a trustee, defeating the trustee's recovery. 482 F.3d at 1005. The next section of the article will first explore the doctrine of *in pari delicto* in bankruptcy law and how a majority the circuit courts have used *in pari delicto* to preclude a trustee from pursuing charges against defendants. Finally, the last portion will explore the arguments used to make the defense inapplicable to a plaintiff-trustee in bankruptcy law.

In pari delicto is an equitable defense that can bar a plaintiff-trustee from recovering on his claim. 9 NORTON BANKR. L. & PRAC., 3d. § 174.36 (revised Jan. 2009). The doctrine provides that where two parties are involved in wrongdoing, one party cannot recover from the other damages suffered as a result of the wrongdoing. Id. The defense is based on the principle that a party should not profit from its own misconduct. Id. Although in most situations the doctrine prevents the court from aiding a plaintiff who bases his cause of action upon his own immoral or illegal acts, Terleckly v. Hurd, 133 F.3d 377, 380 (6th Cir. 1997)(citations omitted), in the bankruptcy context the courts have employed the doctrine to unjustly allow third-party defendants, who contributed to the demise of the debtor corporation, to escape liability. Jeffery

Davis, *Ending the Nonsense: The In Pari Delicto Doctrine Has Nothing To Do With What is § 541 Property of the Bankruptcy Law*, 21 EMORY BANKR. DEV. J. 519, 522 (2005).

This seeming misapplication of justice occurs for two main reasons: first when a trustee is assigned to represent a bankruptcy estate, he steps into the shoes of the debtor and takes no greater rights than the debtor had himself. Official Comm. of Unsecured Creditors v. R. F. Lafferty & Co., 267 F.3d 340, 346 (3rd Cir. 2001); and second, the language 11 U.S.C. § 541(a)(1) states the "estate is comprised of …all legal or equitable interests of the debtor in property as of the commencement of the case." Using these reasons, a majority of the courts have held that when the plaintiff-trustee steps into the shoes of the debtor, a defense good against the debtor is also good against the plaintiff-trustee. Id. For example in Sender v. Buchanan, 84 F.3d 1281, 1284 (10th Cir. 1996), the plaintiff-trustee asserted that his claim against a third-party defendant for fraud should not be barred by the defense of *in pari delicto*. However, Tenth Circuit disagreed, stating that of language section 541(a)(1) established that the estates rights were no greater than they were when actually held by the debtor. Id. at 1285. Moreover, the court looked to Congressional intent of the trustee's role in the bankruptcy proceeding and found that the trustee was to stand in the shoes of the debtor and take no greater rights. Id. As a result, the court concluded that the plaintiff-trustee could not use his status as a trustee to insulate the corporation from the wrongdoing of the debtor. Id.

Similarly, in Grassmueck v. American Shorthorn Ass'n, 402 F.3d 833, 836-37 (8th Cir. 2005) the Eight Circuit held the defense of *in pari delicto* can bar a claim by a bankruptcy trustee against a third-party defendant. The court stated that *in pari delicto* could be used by a third-party defendant against a plaintiff-trustee, if the defense could have been raised against the debtor. Id. The court then went onto conclude that given the debtor's involvement in the

fraudulent actions along with the third-party defendants, the plaintiff-trustee was barred from pursuing his claim.[3] Id. at 841.

The Second Circuit has joined the Tenth, Eight, and Sixth Circuits in analyzing the application of *in pari delicto*. Although the Second Circuit's application of *in pari delicto* has been treated as a constitutional standing issue, see supra, 6 at ¶ 3, the result reached by the court in the application of the doctrine has been the same: the trustee is barred from bringing his claim. See Wagoner, 944 F.3d at 120. In Wagoner, the Court stated: "[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to the creditors, not to the guilty corporation." Id. Although the court does not mention the defense of *in pari delicto* its rational for barring the claims in clearly based on the same principles of the doctrine.

Injustice of In Pari Delicto

While a majority of the circuits have concluded that *in pari delicto* can bar a trustee's action against a third party, the injustice that often results has been recognized by the courts. See Terlecky, 133 F.3d at 380; Sender, 84 F.3d at 1285. The application of *in pari delicto* in the bankruptcy context seems unjust for two main reasons. First, it goes against public policy to allow third parties participating in immoral or illegal action to escape civil liability. Terlecky, 133 F.3d at 380. Second, the application of the doctrine punishes innocent investors, represented by the trustee, who have been injured by the immoral or illegal behavior of the debtor and third parties. Sender, 84 F.3d at 1285.

The Circuits have been given the opportunity to remedy this injustice, but so far have chosen not to do so. In Sender, the plaintiff-trustee claimed that as a bankruptcy trustee he was immune from any defenses based on the debtor's wrongdoing. He argued that as a trustee he

was attempting to rectify the fraud perpetrated by the debtor, thus making the misrepresentations attributable to the debtor no longer legally relevant. Id. The plaintiff-trustee bolstered this argument by pointing the court to the Seventh Circuit's holding in Scholes v. Lehmann, 56 F.3d 750, 754–55 (7th Cir. 1995).

In Scholes, the defendants attempted to assert the defense of *in pari delicto* against an appointed receiver for the corporation. Id. at 754. The court rejected the defense reasoning that the purpose of *in pari delicto* is to prevent the wrongdoer from profiting from his own bad acts by recovering damages. Id. However, when a receiver was appointed in the case the wrongdoer was removed from the scene, and therefore could no longer profit from his wrong doings. Id. As a result, the court held that the defense of *in pari delicto* could not be asserted against the plaintiff-receiver. Id. at 754–55. Using parallel reasoning, the plaintiff-trustee in Sender stated that with his appointment as trustee, the debtor and his wrongful action was removed from the scene, and therefore the defense of *in pari delicto* could not be asserted against him. 84 F.3d at 1285.

While the Tenth Circuit recognized the appeal of the applying of the holding in Scholes to the case before them, it rejected its application given the language of section 541(a)(1) and the role of the trustee in the eyes of Congress. Id. The court went so far as to say that the Bankruptcy Code expressly prohibited the result sought by the trustee. Id. However, by focusing only the language of section 541(a)(1), the court failed to consider the purpose of *in pari delicto*.

In *in pari delicto* when the one of the wrongdoing parties is completely removed from the action the requirements of the defense have not been satisfied, and therefore it falls away. 9 NORTON BANKR. L. & PRAC., 3d. § 174.36 (revised Jan. 2009). In the bankruptcy context

this is exactly what has occurred, the wrongdoing debtor has completely been removed from the situation by the appointment of a trustee, and therefore the defense of *in pari delicto* should fall away. In Sender, the court could have arguably exclude the defense of *in pari delitco* based on the requirements the defense alone. However, this argument is weakened by Congress's intent that the trustee step into the shoes of the debtor and take no greater right than the debtor had at the time of filing for bankruptcy. Sender, 84 F.3d at 1285. In preventing the defendants from asserting the defense of *in pari delicto* against the trustee when they could have done so against the debtor, the trustee is acquiring rights the debtor never had. Id.

The Circuit Courts have set the precedent that the defense of *in pari delicto* can be asserted against a trustee, if the defense could have been asserted against the debtor. See Official Comm. of Unsecured Creditor, 267 F.3d at 360; Sender, 84 F.3d at 1285. Although some circuit courts have recognized that this can led to unjust results and that an exception may be necessary, such exception cannot be found in the Bankruptcy Code. Sender, 84 F.3d at 1286. As a result, the injustice of these situations will continue to persist.

Conclusion

The decision of the Eight Circuit in Moratzka, 482 F.3d 997, 1004, affirms that trustee standing and *in pari delicto* are two issues that should be dealt with separately, seemingly solidifying the law on this issue. However, as seen, the implications of the case may be less substantial than expected, because whether the court addresses *in pari delicto* during a standing analysis or as a separate issue the circuit courts have reached the same result: the plaintiff-trustee is barred from bringing his claims against a third-party defendant guilty of wrongdoing. The injustices resulting from this application of the law will continue until the legislature takes

action, because although the courts recognizing the public policy for having such an exception they are unwilling to create one.

[1] The trustee only has standing to bring claims that are the property of the estate and therefore a trustee cannot bring a claim on behalf of the creditors of a debtor corporation. Moratzka v. Morris, 482 F.3d 997, 1000 (8th Cir. 2007).
[2] *Accord* Official Comm. of Unsecured Creditors v. Edwards, 437 F.3d 1145. 1149–50 (11th Cir. 2006) (holding that although the trustee had standing to bring the case, the defense of in pari delicto ended the trustee's claim); Baena v. KPMG, LLP, 453 F.3d 1, 4–7 (1st Cir. 2006) (addressing the issue of standing and defense of *in pari delicto* independently); Schertz-Cibolo-Universal City Indep. School Dist. v. Wright, 25 F.3d 1281, 1286 (5th Cir. 1994) (stating the ability of the defendant to assert a defense against the debtor does not preclude the debtor from brining the claim).
[3] Accord Official Comm. of Unsecured Creditor, 267 F.3d at 360 (agreeing with Tenth Circuit's finding *in pari delitco* barred the trustee's action against third parties when employing section 541).