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ARTICLES

THE COLLAPSE OF THE *IN PARI DELICTO* DEFENSE TO BANKRUPTCY TRUSTEE CLAIMS: HOW THE FIFTH CIRCUIT HAS OPENED A NEW DOOR FOR TRUSTEE LITIGATION

By Robert Bruner†

SUMMARY

The implosion of market bubbles has laid the groundwork for an explosion in bankruptcy litigation arising from Ponzi schemes.[1] The Assistant Attorney General for the Department of Justice's criminal division explains that "[t]he financial meltdown has resulted in the exposure of numerous fraudulent schemes that otherwise might have gone undetected for a longer period of time."[2] The Bernard Madoff and Allan Stanford cases are not isolated. Consider the following 2009 statistics:

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1. Curt Anderson, *Ponzi Schemes' Collapses Nearly Quadrupled in '09*, LAW.COM, Dec. 29, 2009, http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=1202437299784.

2. *Id.*

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- An estimated $16.5 billion in investor funds wiped out by fraudulent investment schemes[3]
- Over 2,100 investment fraud cases opened by the FBI[4]
- An 82% annual increase in restraining orders issued by the SEC[5]
- 100%+ increase in actions filed by the Commodity Futures Trading Commission in Ponzi scheme cases[6]

As investigations mature, numerous entities orchestrating Ponzi schemes will be forced into bankruptcy and trustees will be handed the job of collecting estate assets and fairly distributing these assets to creditors.

For much of the last twenty years, the trustee's task has been hampered by the common-law equitable doctrine of *in pari delicto*. *In pari delicto* means "of equal fault"[7] and is used to prevent a wrongdoer from using the courts to recover against a fellow wrongdoer.[8] It is well established that bankruptcy trustees must prosecute claims subject to an *in pari delicto* defense.[9] Traditionally, trustee's claims have been dismissed when they were unable to defeat the defense.[10]

Commentators and dissents have criticized the holdings for their inequitable results.[11] Criticism notes that dismissing trustee claims

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3. *Id.*
4. *Id.*
5. *Id.*
6. *Id.*
7. Perma Life Mufflers, Inc. v. Int'l Parts Corp., 392 U.S. 134, 135 (1968), *overruled by* Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984).
8. Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 306 (1985); *see also* Thomas J. Hall & Janice A. Payne, *Defenses to Claims by Bankruptcy Trustees Against Lenders: The* In Pari Delicto *Defense and the "Wagoner Rule,"* 123 BANKING L.J. 3, 4 (2006) ("*In pari delicto* is a broadly recognized common law doctrine under which a plaintiff is barred from pursuing claims against a defendant where the plaintiff was involved in the defendant's wrongful conduct on which the claims are based, and is at least equally at fault with the defendant for that wrongful conduct.").
9. *See, e.g.*, Mosier v. Callister, Nebeker & McCullough, 546 F.3d 1271, 1276 (10th Cir. 2008) ("Thus, it is well established that *in pari delicto* may bar an action by a bankruptcy trustee against third parties who participated in or facilitated wrongful conduct of the debtor."); *see also* Eric W. Anderson & Joshua J. Lewis, *Aiding and Abetting Breach-of-Fiduciary-Duty Claims in a Post-Recession Economy*, 28 AM. BANKR. INST. J. 34, 34 (2009) (noting that courts have applied *in pari delicto* such that third-parties "were almost, by definition, immunized from any possible liability for aiding and abetting in a breach-of-fiduciary-duty.").
10. Tanvir Alam, *Fraudulent Advisors Exploit Confusion in the Bankruptcy Code: How* In Pari Delicto *Has Been Perverted To Prevent Recovery for Innocent Creditors*, 77 AM. BANKR. L.J. 305, 307 (2003) (describing the "mechanical analysis" circuit courts have used "to bar the trustee or a creditors' committee from pursuing state law claims such as fraud or breach of fiduciary duties against the third party advisors of the debtor").
11. *Id.* at 306 ("In reality, however, application of the equitable doctrine produces wholly inequitable results: creditors, who did not participate in the wrongdoing, are prevented from recovering the money that was, in essence, swindled from them in the

merely punishes innocent creditors while granting a windfall to complicit outside professionals.[12] The result could not be more opposed to *in pari delicto*'s purpose of preventing wrongdoers from using courts to benefit from their malfeasance and deterring future illegal conduct.

Recent opinions from the Fifth Circuit have recently given trustees a new legal foundation that may withstand *in pari delicto* attacks.[13] The opinions demonstrate that the assertion of the *in pari delicto* defense merely creates an equitable hurdle rather than an absolute bar to trustee prosecutions.[14] Since 2007, three federal courts in Texas have issued opinions that applied *in pari delicto* to a trustee without dismissing the trustee's claims.[15] The Fifth Circuit has not directly ruled on *in pari delicto*'s application to trustees. However, the Fifth Circuit may have pre-ordained its interpretation of *in pari delicto* in the Court's 2008 *Kane v. National Union Fire Insurance Company* opinion.[16] The *Kane* opinion considered the application of another equitable defense, judicial estoppel, to trustees.[17] The Fifth Circuit applied an analysis of § 541 consistent with the Texas lower courts to hold that the debtor's wrongful conduct should not bar the trustee's claims.[18]

Prior holdings were not wrong so much as incomplete. Much of the precedent was presented only with the question of whether or not *in pari delicto* applies to trustees.[19] The precedent recognized that, pursuant to § 541, a trustee stands in the shoes of the debtor so that the

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most logical and cost-efficient context—the bankruptcy process."); Jeffrey Davis, *Ending the Nonsense: The* In Pari Delicto *Doctrine Has Nothing to Do with What Is § 541 Property of the Bankruptcy Estate*, 21 EMORY BANKR. DEV. J. 519, 541–42 (2005) (arguing that dismissing trustee claims based on *in pari delicto* interferes with the purposes of bankruptcy: "fair treatment to creditors and investors and the promotion of a high standard of business ethics among professionals who serve and participate in the affairs of corporate managers").

12. Alam, *supra* note 10, at 305–06 (noting that "[b]ecause some courts have misapplied the doctrine of '*in pari delicto*,' . . . bankruptcy estates may be forced to let these third party wrongdoers escape civil liability" while innocent creditors are punished).

13. *See* Kane v. Nat'l Union Fire Ins. Co., 535 F.3d 380 (5th Cir. 2008) (per curiam); Floyd v. CIBC World Mkts., Inc., 426 B.R. 622 (S.D. Tex. 2009); Milbank v. Holmes (*In re* TOCFHBI, Inc.), 413 B.R. 523 (Bankr. N.D. Tex. 2009) (mem. op.); Hill v. Day (*In re* Today's Destiny, Inc.), 388 B.R. 737 (Bankr. S.D. Tex. 2008) (mem. op.); Smith v. Woodforest Nat'l Bank (*In re* IFS Fin. Corp.), Bankr. No. 02-39553, Adv. No. 04-3841, 2007 WL 1308321 (Bankr. S.D. Tex. May 3, 2007) (mem. op.).

14. *See Kane*, 535 F.3d at 386–88; *Floyd*, 426 B.R. at 642–43; *In re TOCFHBI*, 413 B.R. at 536–37; *In re Today's Destiny*, 388 B.R. at 746–50; *In re IFS*, 2007 WL 1308321, at 3.

15. *Floyd*, 426 B.R. at 642; *In re TOCFHBI*, 413 B.R. at 536–37; *In re Today's Destiny*, 388 B.R. at 747–50; *In re IFS*, 2007 WL 1308321, at *3–5.

16. *Kane*, 535 F.3d 380.

17. *Id.* at 383.

18. *Id.* at 386–88.

19. *See, e.g.*, Sender v. Buchanan (*In re* Hedged-Invs. Assocs.), 84 F.3d 1281, 1284–86 (10th Cir. 1996).

trustee's claims are subject to any defenses that could have been asserted against the debtor.[20] Accordingly, the debtor's wrongful conduct is imputed to the trustee and the trustee's claims are subject to the *in pari delicto* defense.[21] Analysis ended with the conclusion that *in pari delicto* applied and the courts dismissed the trustee's claims.[22] Trustees apparently failed to ask courts to consider the distinction between *defining* rights and *applying* rights.

Fifth Circuit courts completed the analysis by taking the next step of applying the *in pari delicto* defense. Fifth Circuit courts were presented with a different question: not whether or not the debtor's wrongful conduct must be imputed to the trustee, but whether the trustee's claims should be dismissed because of that imputation.[23] Consistent with prior precedent, Fifth Circuit courts recognized that when determining what rights and liabilities a debtor is subject to, § 541 requires courts to consider only the facts existing pre-petition.[24] But Fifth Circuit courts also recognized that § 541's limitations are not imposed when applying the rights and liabilities.[25] When applying a defense, courts must take into account the post-petition reality.[26] Otherwise, courts would have to award judgments for claims on unpaid accounts without taking into account post-petition payments. Otherwise, courts would have to dismiss breach of contract claims based on a failure to mitigate damages because the mitigation occurred post-petition. Otherwise, an equitable doctrine becomes a tool of inequity. *Definition* is distinct from *application.*

The Fifth Circuit courts' analysis is consistent with Supreme Court precedent. The Supreme Court has not considered *in pari delicto*'s application to bankruptcy trustees. But the Court has twice considered *in pari delicto*'s application to claims arising under other federal statutes.[27] In both instances, the Court refused to dismiss the claims on *in pari delicto* grounds.[28] The Court emphasized that "[w]e have often indicated the inappropriateness of invoking broad common-law

20. *Id.* at 1285 ("Congress intended the trustee to stand in the shoes of the debtor and 'take no greater rights than the debtor himself had.'" (quoting H.R. REP. NO. 95-595, at 368 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6323)).

21. *Id.* ("Therefore, to the extent that Mr. Sender must rely on 11 U.S.C. § 541 for his standing in this case, he may not use his status as a trustee to insulate the partnership from the wrongdoing of Mr. Donahue and HIA Inc.").

22. *Id.*

23. *See, e.g.*, Hill v. Day (*In re* Today's Destiny, Inc.), 388 B.R. at 737, 748 (Bankr. S.D. Tex. 2008) (mem. op.) (noting that Texas law requires courts to consider the public policy implications of dismissing claims "even when parties are *in pari delicto*").

24. *Id.*

25. *See id.* at 748–49.

26. *Id.*

27. Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 306–11 (1985); Perma Life Mufflers, Inc. v. Int'l Parts Corp., 392 U.S. 134, 138–40 (1968), *overruled by* Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984).

28. *Bateman Eichler*, 472 U.S. at 306–11; *Perma Life*, 392 U.S. at 138–40.

barriers to relief where a private suit serves important public purposes."[29] The Court reasoned that *in pari delicto* cannot be applied without considering its effect on the federal statute giving rise to the cause of action.[30] In the context of antitrust statutes, the Court held that *in pari delicto* could not be applied without unduly impinging upon the statute's purpose of fostering competition.[31] In the context of securities statutes, the Court held that *in pari delicto* could not be applied without unduly impinging upon the statute's purpose of deterring illegal trading.[32] In the context of the Bankruptcy Code, *in pari delicto* cannot be applied without unduly impinging upon the statute's purpose of providing an orderly and equitable distribution of estate assets to creditors.[33]

A boom in bankruptcy-related litigation is dawning.[34] Persuasive opinions from Fifth Circuit courts now give trustees the legal framework to pursue *in pari delicto* causes of actions to ensure participants in fraudulent schemes are held accountable, and innocent creditors receive a more equitable recovery.

The following Article is organized in five parts: (1) part I places the *in pari delicto* issue in context by describing a hypothetical scenario in which *in pari delicto* typically arises; (2) part II describes the *in pari delicto* doctrine and its purposes; (3) part III summarizes the circuit court opinions applying *in pari delicto* to dismiss trustee claims; (4) part IV explains the Fifth Circuit's application of *in pari delicto*; and (5) part V argues that the Fifth Circuit application is most consistent with § 541's plain-language, Supreme Court precedent, and the purposes of the *in pari delicto* doctrine.

I. THE BIG PICTURE

Fred awoke with a lingering vision that lead paint would be the hot commodity of 2005. Fred decides that he will incorporate Hot Stock Inc. to engage in lead paint trading. He decides that the most prudent way to run the business is by risking other people's money. Accordingly, through Hot Stock, Fred will sell investors promissory notes and

29. *Bateman Eichler*, 472 U.S. at 307; *Perma Life*, 392 U.S. at 138.

30. *Bateman Eichler*, 472 U.S. at 310–11; *Perma Life*, 392 U.S. at 138–39.

31. *Perma Life*, 392 U.S. at 139–40 (holding that *in pari delicto* does not apply to anti-trust actions because the statute favors private actions "to further the overriding public policy in favor of competition").

32. *Bateman Eichler*, 472 U.S. at 310 (holding that *in pari delicto* cannot be inflexibly applied to securities actions because the actions "provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964), *abrogated by* Touche Ross & Co. v. Redington, 442 U.S. 560 (1979))).

33. Pepper v. Litton, 308 U.S. 295, 307–08 (1939) (noting that the Bankruptcy Code vests bankruptcy courts with "the power and duty" to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate").

34. Anderson, *supra* note 1.

use the investor proceeds to fund his trades. Fred hires a team of lawyers to help him incorporate Hot Stock and draft the promissory notes. He hires a team of investment bankers to help him sell the notes and execute trades. He hires lawyers and accountants to ensure compliance with applicable financial regulations.

Fred produces Hot Stock account statements showing 20% annual returns and mails them to investors. He uses the account statements to encourage existing investors to buy more promissory notes and solicit their friends to buy notes. He even promises investors who solicit new investors a 10% commission on new investor funds they attract. With ballooning account balances and super-sized returns, few investors request account withdrawals while most invest additional funds.

Five years and $100 million later, investors awake with the lingering vision that their funds are lost. Fred knew nothing about commodity trading and never intended to create a profitable company, it turns out. Fred simply grew tired of driving a Honda and furnishing at Ikea. He wanted the good life and knew that an old-fashioned Ponzi scheme was a quick road to riches.

The lawyers, investment bankers, and accountants never *intended* for the investors to be duped. Of course, they knew that Fred had no background in commodity trading and never asked how he planned to make a profit. They knew that Fred personally typed up the Hot Stock account statements. They knew that Fred personally created the financial statements that were sent to the accountants for auditing. No one asked how Fred arrived at the numbers on the financial statements or asked to do an internal audit. Fred paid his bills on time and never asked for a fee reduction.

A creditor forces Hot Stock into bankruptcy and a trustee is appointed. The trustee files an adversary proceeding asserting claims for fraud and breach of fiduciary duty against Fred. The trustee also asserts claims for aiding and abetting fraud and breach of fiduciary duty against the professionals. The trustee contends that Fred could not have defrauded a thousand people out of $100 million without the professionals' assistance. Moreover, even if the professionals did not *actually* know that Fred was orchestrating a Ponzi scheme, they at least *should have* known.

Logic and equity suggest that the trustee has strong aiding and abetting claims. Yet since 1991, circuit courts that have considered a bankruptcy trustee's claims in this context have routinely dismissed the trustee's claims. The circuit courts did not dismiss the claims based on improper conduct engaged in by the trustee or creditors. Nor did the courts dismiss the claims based on an inflexible defense like a statute of limitations bar. Rather, the circuit courts dismissed the claims and effectively immunized complicit outsiders by applying *in pari delicto*.

II. *IN PARI DELICTO*'S PURPOSE

In pari delicto is a common-law doctrine meaning "[i]n a case of equal or mutual fault . . . the position of the [defending] party . . . is the better one."[35] It means that when two crooks conspire to cheat and steal, one crook cannot sue the other crook for damages he suffered based on his accomplice's conduct. "The defense is grounded on two premises: first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality."[36] "The equitable powers of this court can never be exerted in behalf of [one] who has acted fraudulently, or who by deceit or any unfair means has gained an advantage . . . [t]o aid a party in such a case would make this court the abetter of iniquity."[37]

The defense is an equitable doctrine.[38] Like all equitable doctrines, *in pari delicto* should be interpreted flexibly and take into account the facts and circumstances of each case to fashion an equitable result.[39] The Supreme Court has repeatedly stated that, when applying equitable doctrines, courts "are not bound by formula or restrained by any limitation that tends to trammel the free and just exercise of discretion."[40]

Applying the *in pari delicto* defense to dismiss a lawsuit brought by a corporate insider against outside professionals makes sense. Dismissing the claim prevents the malfeasant insider from using the courts to profit from his wrong and deters future illegal conduct by precluding the insider from mitigating his liability.

In Fred's case, applying the defense to dismiss a trustee's claims does not fit as neatly with *in pari delicto*'s purpose. When the trustee asserts the claim to increase estate distributions to innocent creditors, Fred becomes irrelevant. Any proceeds from the claim will go only to Fred's innocent creditors. The only malfeasant parties affected are the defendants who aided and abetted Fred's fraud. Allowing the trustee to prosecute the claims deters future illegal conduct by ensuring that those who aided and abetted are held fully accountable. Dismissing the trustee's claims encourages aiding and abetting by insulating those defendants from liability.

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35. *Bateman Eichler*, 472 U.S. at 306 (quoting BLACK'S LAW DICTIONARY 711 (5th ed. 1979)).

36. *Id.*

37. Keystone Driller Co. v. Gen. Excavator Co., 290 U.S. 240, 245 (1933) (quoting Bein v. Heath, 47 U.S. (6 How.) 228, 247 (1848)).

38. *See id.*

39. *See Bateman Eichler*, 472 U.S. at 310 (noting that courts must undertake "a careful consideration of such [public policy] implications before allowing the defense").

40. *Keystone*, 290 U.S. at 245–46.

III. PRIOR PRECEDENT

From 1991 to the present, the seven circuit courts that have considered *in pari delicto*'s application to bankruptcy trustees have applied the doctrine to dismiss trustees' claims for aiding and abetting fraud and breach of fiduciary duties against third parties.[41] The circuits' analysis has shifted from a focus on standing to the language of § 541, but the results have remained the same.

According to the circuit courts, seven words within § 541 of the Bankruptcy Code demand dismissal regardless of the practical equities involved: "as of the commencement of the case."[42] The circuit courts reason that these seven words require courts to analyze the claim in a hypothetical pre-petition world.[43] In this hypothetical world, the debtor is asserting the claim, not the trustee. In this hypothetical world, the debtor benefits from the claim, not innocent creditors. The post-petition reality is irrelevant. Though the dismissal of the claims leads to inequitable results in the real post-petition world, dismissal serves *in pari delicto*'s purposes in the hypothetical pre-petition world and § 541 requires courts to ignore the real for the hypothetical.[44]

A. *The Second Circuit's Standing Analysis*

The Second Circuit first considered *in pari delicto* in *Shearson Lehman Hutton, Inc. v. Wagoner*.[45] In *Wagoner*, Mr. Kirschner created HMK Management Corporation to execute stock trades.[46] He issued promissory notes in HMK's name to investors and used the note proceeds to fund the stock trading.[47] Kirschner opened trading accounts with Shearson Lehman Hutton to execute his trades.[48] Shearson also allowed Kirschner to use a desk and equipment in its offices.[49] After Kirschner's enterprise crumbled and HMK filed for bankruptcy, the bankruptcy trustee filed a suit asserting, among other claims, breach

41. Mosier v. Callister, Nebeker & McCullough, 546 F.3d 1271 (10th Cir. 2008); Baena v. KPMG LLP, 453 F.3d 1 (1st Cir. 2006); Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145 (11th Cir. 2006); Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833 (8th Cir. 2005); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001); Terlecky v. Hurd (*In re* Dublin Sec., Inc.), 133 F.3d 377 (6th Cir. 1997); Sender v. Buchanan (*In re* Hedged-Invs. Assocs.), 84 F.3d 1281 (10th Cir. 1996); Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114 (2d Cir. 1991).

42. *See, e.g.*, *In re Hedged-Invs.*, 84 F.3d at 1285.

43. *See id.*

44. *See id.*

45. *Shearson*, 944 F.2d at 114.

46. *Id.* at 116.

47. *See id.*

48. *Id.*

49. *Id.*

of contract and breach of fiduciary duty claims against Shearson and on behalf of the HMK estate.[50]

The Second Circuit ruled that the trustee lacked standing to assert the claims against Shearson.[51] The Court noted that, as representative of the estate, the trustee "stands in the shoes of the bankrupt corporation."[52] Under § 541, all legal and equitable interests the debtor acquired prior to the petition date became property of the estate.[53] Accordingly, the trustee has no greater rights than the debtor had and was subject to the same defenses the debtor would have faced.[54] The Court held that New York law simply does not recognize an aiding and abetting cause by a corporation that committed fraud against a third party alleged to have assisted the fraud.[55] Rather, under New York law, only the creditors could bring such a claim.[56] Accordingly, the Court dismissed the trustee's aiding and abetting claims for lack of standing.[57]

B. *From Standing to § 541*

Subsequent circuit court opinions recognized that the *Wagoner* Court erred by focusing on standing.[58] "An analysis of standing does not include an analysis of equitable defenses, such as *in pari delicto*. Whether a party has standing to bring claims and whether a party's claims are barred by an equitable defense are two separate questions, to be addressed on their own term."[59] The shift in the analysis's focus from standing to merits did not alter the results.

The Tenth Circuit's 1996 *In re Hedged-Investments* opinion set forth the *in pari delicto* analysis adopted by the other circuit courts.[60] In *Hedged-Investments*, Mr. Donahue created limited partnerships and sold interests in the partnerships to investors.[61] The partnerships were organized to effectuate a Ponzi scheme.[62] The entities generated no real revenue and the enterprises' continued operation depended on paying old investments with new investments.[63] After Hedged-Invest-

50. *Id.* at 117.
51. *Id.* at 120.
52. *Id.* at 118.
53. 11 U.S.C.A. § 541 (West 2004 & Supp. 2010).
54. *Shearson*, 944 F.2d at 118.
55. *See id.*
56. *Id.* at 119–20.
57. *Id.* at 120.
58. *See, e.g.*, Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 346 (3d Cir. 2001); Terlecky v. Hurd (*In re* Dublin Sec., Inc.), 133 F.3d 377, 380 (6th Cir. 1997).
59. *Lafferty*, 267 F.3d at 346 (citing *In re Dublin Sec.*, 133 F.3d at 380).
60. Sender v. Buchanan (*In re* Hedged-Invs. Assocs.), 84 F.3d 1281 (10th Cir. 1996).
61. *Id.* at 1282.
62. *Id.*
63. *Id.* at 1282 & n.1.

ments filed a Chapter 7 bankruptcy petition, the trustee sued Mr. Donahue's wife for violations of the state partnership statute.[64] Ms. Donahue allegedly executed several partnership agreements and received funds in violation of the state partnership laws.[65]

The Tenth Circuit held that Mr. Donahue's wrongful conduct barred the trustee's suits based on *in pari delicto*.[66] The Tenth Circuit noted that standing was not an issue.[67] Section 541 gave the trustee standing to assert the claim.[68] The trustee has control over property of the estate and § 541(a)(1) defines as property of the estate "all legal or equitable interest of the debtor in property *as of the commencement of the case*."[69] The Tenth Circuit placed special emphasis on the phrase "as of the commencement of the case."

The Court reasoned that the phrase had both "temporal and *qualitative* limitations" on estate property.[70] The temporal component defines property of the estate based on the petition date.[71] "In a temporal sense, it establishes a clear-cut date after which property acquired by the debtor will normally not become property of the bankruptcy estate."[72]

The qualitative component defines the contours of the estate's rights in the property.[73] The qualitative component limits the estate's rights to the rights the debtor had prior to the petition date and precludes the petition from enlarging those rights.[74] The Court explained that "Congress intended the trustee to stand in the shoes of the debtor and 'take no greater rights than the debtor himself had.'"[75] To ensure that the trustee takes no greater right, the courts must consider the claim as it existed "as of the commencement of the case."[76]

Under the Tenth Circuit's view, § 541 is a winnower of rights. Imagine all the debtor's property interests as sticks gathered into a bundle. The temporal component removes those sticks that were acquired af-

64. *Id.* at 1282.

65. *Id.* at 1283.

66. *Id.* at 1284 ("We base our decision on 'the elementary principle that one who has himself participated in a violation of law cannot be permitted to assert in a court of justice any right founded upon or growing out of the illegal transaction.'" (quoting Merrill v. Abbott (*In re* Indep. Clearing House Co.), 77 B.R. 843, 857 (D. Utah 1987) (mem. op.))).

67. *Id.* at 1285.

68. *Id.*

69. 11 U.S.C.A. § 541 (West 2004 & Supp. 2010); *In re Hedged-Invs. Assocs.*, 84 F.3d at 1285 (emphasis added).

70. *In re Hedged-Invs.*, 84 F.3d at 1285 (emphasis added).

71. *See id.*

72. *Id.* (citing 4 COLLIER ON BANKRUPTCY ¶ 541.05).

73. *See id.*

74. *Id.*

75. *Id.* (quoting H.R. REP. NO. 95-595, at 368, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6323); *see also* Baena v. KPMG LLP, 453 F.3d 1, 6 (1st Cir. 2006).

76. *In re Hedged-Invs.*, 84 F.3d at 1285.

ter the petition date. The qualitative component shaves down sticks that have grown post-petition to their pre-petition form.

Under this view, courts must evaluate the trustee's claim as it existed in the pre-petition world. In the hypothetical pre-petition world, only the debtor could have brought the claim on the debtor's own behalf. In the pre-petition world, *in pari delicto* would bar the debtor from recovering on the claim based on his wrongful conduct. Pursuant to § 541's qualitative component, the trustee must be treated the same as the debtor would have been treated in the hypothetical pre-petition world. The trustee "may not use his status as trustee to insulate the partnership from the wrongdoing" of the partnership's principal.[77] The fact that an innocent party is bringing the claim on behalf of innocent creditors is irrelevant.[78] The trustee's claim must be dismissed just as if the debtor himself asserted the claim.[79]

The Tenth Circuit acknowledged the inequities of its decision.[80] "To be sure, Mr. Sender articulates sound reasons why it might be wise to allow an exception to this rule in cases, such as this one, where the trustee's efforts stand to benefit hundreds of innocent investors."[81]

The Court also acknowledged that the Seventh and Ninth Circuits had not applied *in pari delicto* to receivers seeking recoveries for innocent creditors.[82] However, the receivership cases did not implicate the Bankruptcy Code and the Court felt that its result was compelled by the qualitative component of the "as of the commencement of the case" language of § 541.[83] The Court noted that "[i]t falls beyond the province of this court to let policy considerations override our interpretation of the text and the clear intent of an act of Congress . . . ."[84]

The First,[85] Third,[86] Sixth,[87] Eighth,[88] and Eleventh[89] Circuits subsequently considered the trustee's ability to assert claims against third parties who participated in the debtor's fraud. All the cases involve a factual scenario similar to the Fred Hot Stock Inc. hypothetical. Debtors created corporations or partnerships to run a fraudulent scheme, and the trustee for the debtor's bankruptcy estate sued outsiders who allegedly aided and abetted fraud or breaches of fiduciary duties.

77. *Id.*
78. *Id.* at 1285–86.
79. *Id.*
80. *Id.*
81. *Id.* at 1285.
82. *Id.* at 1284–85.
83. *Id.* at 1285–86.
84. *Id.* at 1286.
85. Baena v. KPMG LLP, 453 F.3d 1, 6–9 (1st Cir. 2006).
86. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356 (3d Cir. 2001).
87. Terlecky v. Hurd (*In re* Dublin Sec., Inc.), 133 F.3d 377, 379–80 (6th Cir. 1997).
88. Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 841–42 (8th Cir. 2005).
89. Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1150–51 (11th Cir. 2006).

Each Circuit adopted the Tenth Circuit's *Hedged-Investments* analysis of § 541 to bar trustee claims against third parties based on *in pari delicto.*

Unfortunately, the early circuit court cases were only presented with the question of whether *in pari delicto* applied. In *In re Hedged-Investments*, the trustee argued only that courts should exempt trustees from *in pari delicto* for equitable reasons.[90] Trustees focused on the Seventh and Ninth Circuit receivership cases and the "adverse interest" and "sole-actor" exceptions to imputation of wrongful conduct to argue that trustees should be immune from *in pari delicto's* application.[91] The argument was a losing one. Long-standing precedent has interpreted § 541 as placing the trustee in the shoes of the debtor such that the trustee can assert no greater claim than the debtor. A corollary of that principal is that the trustee is subject to all the defenses that the debtor would have faced. Because the fight was narrowed to whether *in pari delicto* should be applied, the courts were never given the opportunity to consider *how* the defense should be applied. Parties assumed that finding that the defense applied ended the analysis and barred the claim. The assumption would not change the result for static defenses like a statute of limitations that requires no discretionary balancing of facts. But what about a fluid defense whose equitable origins demand just such a discretionary balancing? What happens when a court parses through the applicable state law conception of *in pari delicto* and applies that conception to the facts presented?

None of the courts were presented with the question addressed in this Article. Does the *in pari delicto* defense act as a complete bar or merely as an equitable hurdle that may be overcome? Fifth Circuit courts were presented with the more nuanced question of *how* the defense applies and completed the analysis begun by the prior circuit court precedent. The Fifth Circuit courts recognized that § 541 subjects trustees to *in pari delicto.* But Fifth Circuit courts also recognized that § 541 has no bearing on how *in pari delicto* is applied.

IV. THE FIFTH CIRCUIT'S COMPLETION OF THE *IN PARI DELICTO* ANALYSIS

Since 2007, Fifth Circuit courts have issued four opinions that completed the *in pari delicto* analysis begun by prior courts.[92] The Fifth

90. Sender v. Buchanan (*In re* Hedged–Invs. Assocs.), 84 F.3d 1281, 1284–85 (10th Cir. 1996).

91. *See e.g.*, Mosier v. Callister, Nebeker & McCullough, 546 F.3d 1271, 1276–77 (10th Cir. 2008) (rejecting the trustee's "argument that a trustee in bankruptcy is immune to *in pari delicto* and other defenses based on the debtor's conduct"); *Edwards*, 437 F.3d at 1149–52; Breeden v. Kirkpatrick & Lockhart LLP (*In re* Bennett Funding Group, Inc.) 336 F.3d 94, 100–01 (2d Cir. 2003) (arguing that the debtor's wrongful conduct should not be imputed to the trustee).

92. *See* cases cited *supra* note 13.

Circuit courts did not focus on whether trustees are subject to *in pari delicto*. The courts adopted the abundant precedent holding that trustees are subject to *in pari delicto*. The Fifth Circuit courts instead focused on a more nuanced question: How does the Texas formulation of *in pari delicto* apply to the facts presented?

A. *The Bankruptcy Court's Application of In Pari Delicto*

The analysis of *in pari delicto*'s application started with *Smith v. Woodforest Nat'l Bank (In re IFS Finanical Corp.)*.[93] IFS was part of a conglomeration of corporate entities allegedly organized as a Ponzi scheme to defraud investors from Mexico.[94] Woodforest National Bank funded loans incurred by individuals to invest in IFS.[95] Woodforest then executed a participation agreement with an IFS affiliated entity whereby the IFS entity agreed to purchase a 95% interest in the loans.[96] Under the agreement, Woodforest remained responsible for collecting the notes.[97] Investors never paid on the notes, despite retaining the loan proceeds and other transfers from IFS.[98] The trustee filed an adversary proceeding against Woodforest, asserting various claims, including conversion and unjust enrichment.[99]

Woodforest filed a motion for summary judgment contending that the trustee lacked standing because *in pari delicto* barred his claim.[100] The court quickly dismissed the standing argument.[101] The court noted that the trustee's right to bring a claim and the strength of that claim are independent issues and cited the supporting post-*Waggoner* circuit court precedent.[102] The court then considered the effect of *in pari delicto* on the strength of the trustee's claim.

Consistent with precedent, the Court began its analysis with § 541's plain language. The Court noted that § 541's plain language provides that property of the estate includes only the debtor's interests that existed "as of the commencement of the case."[103] Pursuant to § 541,

93. Smith v. Woodforest Nat'l Bank (*In re* IFS Fin. Corp.), Bankr. No. 02-39553, Adv. No. 04-3841, 2007 WL 1308321 (Bankr. S.D. Tex. May 3, 2007) (mem. op.).
94. *Id.* at *1.
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.*
99. *Id.*
100. *Id.* at *3.
101. *Id.*
102. Baena v. KPMG LLP, 453 F.3d 1, 6–10 (1st Cir. 2006); Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1149–50 (11th Cir. 2006); *In re* IFS, 2007 WL 1308321, at *3 ("[W]hether a party has standing and whether the party's claims are barred by an equitable defense are separate questions.") (citing Schertz-Cibolo-Universal City Indep. Sch. Dist. v. Wright (*In re* Educators Grp. Health Trust), 25 F.3d 1281, 1286 (5th Cir. 1994)).
103. *In re IFS*, 2007 WL 1308321, at *3 (citing 11 U.S.C.A. § 541(a)(1) (West 2004 & Supp. 2010)).

the pre-petition facts define the trustee's right and limitations on that right.[104] Accordingly, "the Trustee holds only those rights that the debtor held at the commencement of the case . . . a trustee is ***subject to*** the *in pari delicto* defense if the defense would have been available in an action against the debtor."[105] The trustee did not seriously dispute that he was *subject to* the defense.

Instead, the trustee focused his argument on the application of Texas's formulation of the *in pari delicto*. The trustee contended that even though he may be subject to *in pari delicto*, that finding did not end the analysis.[106] Rather, the trustee contended that under Texas law, the finding merely triggered a second analysis that required a discretionary balancing of the equities.[107]

The Court agreed that special attention needed to be given to the application of state law.[108] *In pari delicto* is a product of state law—not federal bankruptcy law.[109] Under Texas state law, finding that the plaintiff is *in pari delicto* does not end the analysis. The Court quoted the Texas Supreme Court's conception of *in pari delicto* in *Lewis v. Davis*:

> It has been said that even where the parties are *in pari delicto* relief will sometimes be granted if public policy demands it. There is often involved, in reaching a decision as to granting or withholding relief, the question whether the policy against assisting a wrongdoer outweighs the policy against permitting unjust enrichment of one party at the expense of the other. The solution of the question depends upon on the peculiar facts and the equities of the case, and the answer usually given is that which it is thought will better serve public policy.[110]

Pursuant to Texas Supreme Court precedent, finding that a party is subject to the *in pari delicto* defense begins, rather than ends, the analysis. Courts must balance the policy of not lending judicial assistance to a wrongdoer with that of not permitting another wrongdoer's unjust enrichment. The defense is fluid, requiring a balancing of the equities. When "determining whether allowing a culpable party to recover promotes public policy, the Court may overlook the respective guilt of the parties . . . [t]he court should consider the 'higher right

104. *Id.*
105. *Id.* (emphasis added).
106. *Id.* at *4.
107. *Id.*
108. *Id.* at *3 ("Whether the Trustee's claim is barred by the *in pari delicto* defense is governed by Texas law.").
109. *Id.*
110. *Id.* at *4 (quoting Lewis v. Davis, 145 Tex. 468, 477, 199 S.W. 2d 146, 151 (1947)).

of the public; the guilty party to whom relief is granted being only the instrument by which the public is served.'"[111]

The Court did not interpret § 541 as limiting the Court to considering a hypothetical pre-petition claim when undertaking the policy analysis. Though the Court agreed that § 541 made the trustee subject to the same defenses that could have been asserted against the debtor, the Court found that § 541 had no bearing on the *application* of a defense. The Court held that whether the trustee's claims should be barred would depend on parties's degrees of culpability and who would benefit from the trustee's claim.[112] The Court noted that if evidence demonstrated that only innocent creditors would benefit from the trustee's claim, "the higher right of the public" may dictate that the trustee should be allowed to prosecute the claim even though the trustee is *in pari delicto* with the defendants.[113] The Court denied the defendants' motion for summary judgment, holding that it could not undertake the required policy prior to the presentation of evidence at trial.

Approximately one year later, the same court again considered *in pari delicto*'s application to a bankruptcy trustee in the *In re Today's Destiny* bankruptcy case.[114] The Day brothers incorporated Today's Destiny to sell predictive auto-dialing equipment to dentists and chiropractors.[115] The Days allegedly represented that the equipment would perform telemarketing services and guaranteed that the equipment would bring the purchasers a certain number of new clients.[116] Today's Destiny sold the equipment through third-party lenders.[117] The lenders financed sales-and-leasing agreements for the equipment.[118] However, the equipment allegedly never worked as promised and Today's Destiny was forced to file a chapter 7 bankruptcy petition.[119]

The trustee filed an adversary proceeding against the Days and the lenders, asserting various claims, including breach of fiduciary duty and denuding against the Days and other insiders, and aiding and abetting the debtor's fraud and contribution claims against the lend-

111. *Id.* (quoting Wright v. Wight & Wight, 229 S.W. 881, 882 (Tex. Civ. App.—El Paso 1921, no writ)).

112. *Id.*

113. *Id.* (quoting Wright v. Wight & Wight, 229 S.W. 881, 882 (Tex. Civ. App.—El Paso 1921 no writ)).

114. Hill v. Day (*In re* Today's Destiny, Inc.), 388 B.R. 737 (Bankr. S.D. Tex. 2008) (mem. op.).

115. *Id.* at 742.

116. Hill v. Day (*In re* Today's Destiny, Inc.), Bankr. No. 05-90080, Adv. No. 06-3285, 2009 WL 1232140, at *4 (Bankr. S.D. Tex. May 1, 2009) (mem. op.); *In re Today's Destiny*, 388 B.R. at 742.

117. *In re Today's Destiny*, 388 B.R. at 742.

118. *Id.*

119. *Id.*

ers.[120] The trustee alleged that the lenders knew Today's Destiny was selling sham equipment and continued to execute and demand payments on lease agreements despite their knowledge.[121] The Days and lenders filed motions to dismiss, arguing that the trustee lacked standing to assert the claims and, in the alternative, that *in pari delicto* barred the claims.[122]

The Court again denied the standing argument: "*in pari delicto* can not independently defeat the Trustee's *standing* to raise a claim."[123] "In the bankruptcy context, the Trustee's standing is a claim *ownership* issue" whereas *in pari delicto* is an affirmative defense that goes to a claim's merits.[124] The Court then considered how *in pari delicto* affected the merits of the trustee's claims.

The court repeated that a trustee may be subject to *in pari delicto* pursuant to § 541.[125] The court cited the abundant circuit courts dismissing trustee claims based on *in pari delicto*.[126] The court then proceeded to complete the second step of the *in pari delicto* analysis prior courts were never prompted to consider.

The court cited the Texas Supreme Court's *Lewis* opinion for the proposition that *in pari delicto* does not automatically bar a claim.[127] The court still must *apply* the defense. When applying the defense, the court again considered the importance of the post-petition reality. The court noted that the equities of the case would be influenced by the extent of the debtor's and lender's culpability and whether only innocent creditors would benefit from any recovery.[128] "The Trustee may be able to demonstrate that any recovery would benefit only innocent creditors, not the wrongdoers."[129] The court declined to dismiss the trustee's claims at the motion to dismiss stage because the parties' proportional fault and the creditors' recovery could not be determined prior to the presentation of evidence.[130]

The court also recognized grossly inequitable results and conflicts with state law that result by dismissing claims without considering the post-petition reality. If post-petition reality were ignored, then nothing would preclude the insiders who directly orchestrated the fraud from relying upon their own wrongful conduct to defeat a trustee's claims.[131] The court reasoned:

120. *Id.* at 742, 744–45.
121. *In re Today's Destiny*, 2009 WL 1232140, at *3.
122. *In re Today's Destiny*, 388 B.R. at 743.
123. *Id.* at 746.
124. *Id.*
125. *Id.* at 747–48.
126. *Id.* at 748.
127. *Id.* at 748–49.
128. *Id.* at 749.
129. *Id.*
130. *Id.*
131. *Id.*

> The Trustee is not asserting claims against third-parties for injuries arising from Insiders' wrongful conduct. The trustee is asserting claims against the very Insiders for their own wrongful conduct. No case, logic, or equitable proposition supports the conclusion that insiders of a bankrupt corporation can insulate themselves from liability by virtue of the illegal character of their conduct. Granting Insiders relief based on *in pari delicto* would directly oppose *in pari delicto*'s purpose of denying assistance to wrongdoers.[132]

The court ruled that the insiders who allegedly orchestrated the fraud could not rely on *in pari delicto*.[133]

The court also ruled that *in pari delicto* did not bar trustee's contribution claim against the lenders.[134] The court first noted that the Texas Civil Practices and Remedies Code did not bar joint tort-feasors from seeking contribution from another tort-feasor.[135] Moreover, the court held that allowing the trustee to assert a contribution claim was consistent with the purposes of *in pari delicto*.[136] *In pari delicto* was designed to ensure that wrongdoers "bear full responsibility for their criminal conduct."[137] Contribution claims are based on proportionate responsibility.[138] A wrongdoer can recover from a joint-tortfeasor only to the extent of the joint-tortfeasor's proportionate responsibility.[139] Accordingly, the contribution claim only assures that the debtor's liability more closely matches the debtor's responsibility.[140] The court also noted that any proceeds from the contribution claim would go to innocent creditors rather than the debtor.[141]

B. *The District Court Affirms the Bankruptcy Court's Approach*

In *Floyd v. CIBC World Markets*, a Houston district court adopted *Today's Destiny*'s approach to *in pari delicto*'s application approximately one year after *Today's Destiny* was issued.[142] Seven Seas, the debtor, was a South American oil and gas exploration company.[143] In 2001, Seven Seas faced liquidity problems.[144] Seven Seas hired CIBC to raise funds and issue a fairness opinion for any financial transaction CIBC helped Seven Seas execute.[145] CIBC obtained a $45 million financing deal with Chesapeake Energy Corporation and Seven Seas

132. *Id.*
133. *Id.*
134. *Id.* at 750.
135. *Id.*
136. *Id.*
137. *Id.*
138. *Id.*
139. *Id.*
140. *Id.*
141. *Id.*
142. Floyd v. CIBC World Mkts., Inc., 426 B.R. 622, 642–43 (S.D. Tex. 2009).
143. *Id.* at 630.
144. *Id.*
145. *Id.*

insiders.[146] CIBC issued multiple fairness opinions approving the financing.[147] The financing proved insufficient to save Seven Seas.[148]

Seven Seas filed a Chapter 11 petition in January of 2003 to void an involuntary Chapter 7.[149] The bankruptcy court confirmed Seven Seas' Chapter 11 plan of reorganization.[150] Post-confirmation, the reorganized debtor asserted various claims against CIBC, including breach of fiduciary duty, and aiding and abetting Seven Seas' directors' breaches of fiduciary duties.[151] CIBC filed a motion to dismiss.[152] CIBC argued that the reorganized debtor lacked standing to assert the claims.[153] In the alternative, CIBC argued that *in pari delicto* barred the claims.[154]

The district court first rejected the standing argument. The court noted that the Chapter 11 plan transferred the bankruptcy trustee's claims to the reorganized debtor.[155] The plan contained a provision providing that the reorganized debtor could assert any claims the Chapter 11 trustee could have asserted on behalf of the debtor's bankruptcy estate.[156] Pursuant to the plan provision, the reorganized debtor had standing to assert the trustee's claims on behalf of the bankruptcy estate.[157]

The district court then considered the *in pari delicto* issue and adopted *Today's Destiny*'s two-step approach. It first held that reorganized debtor was subject to *in pari delicto*.[158] The court cited the Bankruptcy Court's *Today's Destiny*'s opinion for the proposition that the Fifth Circuit would likely follow its sister courts in finding that bankruptcy trustees were subject to *in pari delicto*.[159] Accordingly, the court found that the estate's claim was burdened with the same defenses that the debtor would have faced had the debtor asserted the claim pre-petition.[160]

The district court followed *Today's Desitny* in recognizing that the *in pari delicto* analysis required a second step.[161] Finding that an estate claim is subject to *in pari delicto* does not end the analysis. The court recognized that it needed to apply Texas's formulation of *in pari*

146. *Id.*
147. *Id.*
148. *Id.*
149. *Id.*
150. *Id.* at 631.
151. *Id.*
152. *Id.*
153. *Id.* at 633.
154. *Id.* at 642.
155. *Id.* at 635.
156. *Id.*
157. *Id.*
158. *Id.* at 642.
159. *Id.*
160. *Id.*
161. *Id.*

delicto to the facts presented.[162] "[E]ven in situations where the parties are found to be *in pari delicto*, under Texas law, 'relief will sometimes be granted if public policy demands it.'"[163] The court held that *application* of the defense "'depends upon the peculiar facts and the equities of the case, and the answer usually given is that which it is thought will better serve public policy.'"[164] Such facts and equities would include consideration of the post-petition reality of a reorganized debtor bringing the claim on behalf of the estate and could not be considered prior to the presentation of evidence.[165]

The *Today's Destiny in pari delicto* analysis has become the prevailing approach in the Fifth Circuit. In July of 2009, a Dallas bankruptcy court has also adopted the *Today's Destiny* approach.[166] In *TOCFHBI*, the trustee sued the debtor's pre-petition lawyers for allegedly assisting the debtor with structuring fraudulent transfers.[167] The court declined to grant summary judgment based on *in pari delicto*.[168] The court cited *Lewis* and *Today's Destiny* for the principal that *in pari delicto* could not be used to dismiss claims prior to undertaking a policy analysis that included consideration of the post-petition reality of who would benefit from the claim.[169] The Court quoted *Today's Destiny*: "The need to consider the 'peculiar facts and equities' is particularly acute when a defendant is asserting the defense against a trustee who seeks recovery for the benefit of creditors of a wrongdoer rather than the wrongdoer himself."[170]

As of the date of this article's publication, no Texas court has issued an opinion disagreeing with *Today's Destiny*'s *in pari delicto* analysis.

C. *The Fifth Circuit's Guidance in Kane*

The Fifth Circuit has not directly ruled on *in pari delicto*'s application to bankruptcy trustees. However, in *Kane v. Nat'l Fire Ins.*, the Fifth Circuit held that judicial estoppel, another equitable doctrine, was not an automatic bar to a bankruptcy trustee's claims.[171] Issued just months after *Today's Destiny*, *Kane* held that courts must take into account the post-petition reality when applying an equitable de-

162. *Id.* at 642–43.

163. *Id.* (quoting Lewis v. Davis, 145 Tex. 468, 477, 199 S.W.2d 146, 151 (1947)).

164. *Id.*

165. *Id.* (citing Hill v. Day (*In re* Today's Destiny, Inc.), 388 B.R. 737, 749 (Bankr. S.D. Tex. 2008) (mem. op.)).

166. Milbank v. Holmes (*In re* TOCFHBI, Inc.), 413 B.R. 523 (Bankr. N.D. Tex. 2009) (mem. op.).

167. *Id.* at 527–28.

168. *Id.* at 537.

169. *Id.*

170. *Id.*

171. Kane v. Nat'l Union Fire Ins. Co., 535 F.3d 380, 386–88 (5th Cir. 2008) (per curiam).

fense to claims asserted by a bankruptcy trustee on behalf of the debtor's estate.[172]

Kane considered whether a trustee could prosecute a lawsuit on behalf of estate creditors despite the debtor's failure to disclose the lawsuit in his bankruptcy schedules.[173] In 2002, Kane was injured in a car accident.[174] Kane filed a lawsuit against the driver, the driver's employer, and the employer's insurance company.[175] In 2005, Kane filed a Chapter 7 bankruptcy petition.[176] Kane did not disclose the personal injury claim.[177] In 2006, the defendants filed a motion to dismiss, arguing that Kane's failure to disclose the claim judicially estopped him from pursuing the claim.[178] The bankruptcy trustee for the Kane estate moved to substitute himself for Kane.[179] The district court granted the defendant's summary judgment motion on judicial estoppel grounds and dismissed as moot the trustee's motion to substitute.[180]

The Fifth Circuit reversed the district court decisions.[181] The court noted that judicial estoppel bars a debtor from asserting a claim that he failed to disclose in his bankruptcy schedules.[182] Otherwise, debtors could avoid liabilities and injure creditors by failing to fulfill their obligation to disclose all assets.[183] The equities lead to a different conclusion when the trustee is asserting the claim.

The court began with an explanation of how § 541 made the trustee the real owner of Kane's personal injury claim.[184] Under § 541, the court noted that all the debtor's assets become property of the estate.[185] Once property of the estate, the debtor's interests are extinguished.[186] Failure to disclose an asset does not remove that asset from the estate.[187] An asset that a trustee has no knowledge of cannot be administered, but the non-disclosure does not affect the character of the asset.[188] The asset was and thus remains property of the estate.[189] Accordingly, the lawsuit never became property of the debtor but was and remained property of the estate over which the trustee

172. *See id.*
173. *Id.* at 383–84.
174. *Id.* at 383.
175. *Id.*
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.* at 383–84.
181. *Id.* at 388.
182. *Id.* at 386.
183. *Id.*
184. *Id.* at 385–87.
185. *Id.* at 385.
186. *Id.*
187. *See id.* at 385–87.
188. *See id.*
189. *Id.*

had exclusive control.[190] The trustee was the real-party in interest in the Kane's personal injury lawsuit and the motion to substitute should have been granted.[191]

The court then considered how it should apply judicial estoppels to the trustee. The court found that the trustee had standing to assert the claim under the same provision that gave the trustee standing to assert the aiding-and-abetting claims in the *in pari delicto* cases: § 541.[192] But the Fifth Circuit diverged from prior circuit court opinions' approach to *in pari delicto* when applying the equitable defense. Though the trustee had standing to assert the claim under § 541, the Fifth Circuit did not read that provision as requiring the court to ignore the post-petition reality. Rather than ignoring the fact that the trustee rather than the debtor was bringing the claim, the court anchored its decision on that fact.

The court held that the equitable concerns that demand estoppel of debtors when they bring the claim on their own behalf are absent when the trustee brings the claim on behalf of creditors.[193] The court cited a Seventh Circuit opinion explaining how the equitable analysis differed depending on the party bringing the claim:

> [The debtor's] nondisclosure in bankruptcy harmed his creditors by hiding assets from them. Using this same nondisclosure to wipe out [the debtor's claim against the defendant] would complete the job by denying creditors even the right to seek some share of the recovery. Yet the creditors have not contradicted themselves in court. They were not aware of what [the debtor] has been doing behind their backs. Creditors gypped by [the debtor's] maneuver are hurt a second time by the district judge's decision. Judicial estoppel is an equitable doctrine, and using it to land another blow on the victims of bankruptcy fraud is not an equitable application.[194]

Kane may preordain the Fifth Circuit's application of *in pari delicto* to bankruptcy trustees. The Fifth Circuit's statutory analysis and logic applies equally to *in pari delicto* claims. In *Kane*, the trustee had standing to pursue his claim under the same Code provision the trustees relied upon in the *in pari delicto* cases: § 541. Section 541 required the court to impute the debtor's wrongs to the trustee. However, the court did not read § 541 as also requiring the court to ignore the post-petition reality when *applying* the equitable analysis triggered by the imputation. The court not only considered the fact that the trustee rather than the debtor was bringing the claim, the court anchored its decision on this fact. Ignoring the post-petition reality would trans-

190. *See id.*
191. *Id.* at 386–87.
192. *Id.* at 385.
193. *Id.* at 387.
194. *Id.* at 387–88 (quoting Biesek v. Soo Line R.R. Co., 440 F.3d 410, 413 (7th Cir. 2006)).

form an equitable doctrine into a tool of inequity. Using the debtor's fraudulent conduct "to wipe out [the debtor's claim against the defendant] would complete the job by denying creditors even the right to seek some share of the recovery."[195] The creditors "were not aware of what [the debtor had] been doing behind their backs."[196] *In pari delicto,* like judicial estoppel, "is an equitable doctrine, and using it to land another blow on the victims of bankruptcy fraud is not an equitable application."[197]

Parties may try to distinguish the Fifth Circuit opinions by noting that those courts applied Texas law's *in pari delicto* doctrine. Other courts applied the state law applicable to their cases. Admittedly, some state law conceptions may lack the Texas Supreme Court's clear direction that "even where the parties are *in pari delicto* relief will sometimes be granted if public policy demands it."[198] Some conceptions may exclude a public policy exception and find that under no circumstances can parties who are *in pari delicto* seek relief. However, a fifty-state survey of *in pari delicto* is beyond the scope of this Article.

This Article does not argue that courts across jurisdictions should apply the Texas Supreme Court's *Lewis* analysis and never again dismiss trustee claims on *in pari delicto* grounds. It argues that courts across jurisdictions should adopt the Fifth Circuit court's more complete analysis of the *in pari delicto* issue. Prior courts concentrated on whether trustees were subject to the defense. That question has been answered in the affirmative by all the courts. The more important question dissected by the Fifth Circuit courts is how that defense applies.

To determine how the defense applies, courts should not focus on the federal precedent so much as the applicable state law formulations of *in pari delicto*. *In pari delicto* is not a federal equitable doctrine that requires uniform application. *In pari delicto* is a product of state law. Though each state's body of law may articulate the *in pari delicto* doctrine with different phrases, the underlying nature and purpose of the doctrine transcends state boundaries. The nature is fluid, as an equitable doctrine must be to fulfill its purpose of effectuating equity. The fluid nature and equitable purpose demand consideration of the individualized facts born by each case. These facts include who is bringing the claim and who will benefit from the claim.

195. *Id.*
196. *Id.*
197. *Id.*
198. Lewis v. Davis, 145 Tex. 468, 477, 199 S.W.2d 146, 151 (1947).

V. THE DIFFERENCE BETWEEN DEFINING AND APPLYING

The Fifth Circuit courts' opinions provided a more complete application of *in pari delicto* than prior precedent. Much of the prior precedent asked only whether *in pari delicto* applied to the trustee rather than whether "public policy demands" allowing the trustee to pursue claims despite being *in pari delicto*. Accordingly, the prior precedent was not asked to recognize the distinction between *defining* a right and *applying* a right.

Precedent and Fifth Circuit courts both correctly note that § 541's phrase "as of the commencement of the case" circumscribes the trustee's rights and liabilities to those that the debtor bore prior to the petition date. The proposition that the trustee "stands in the shoes" of the debtor and is therefore subject to all the defenses that the debtor would have faced pre-petition is undisputed across circuits. If one types in the phrase "stands in the shoes" and "bankruptcy" within the Westlaw electronic search engine for all federal court cases, over 1,100 cases appear. Section 541 effectively defines what rights and liabilities the trustee is *subject to*. Pursuant to § 541, both precedent and Fifth Circuit courts correctly hold that a trustee may be *in pari delicto* with defendants alleged to have aided and abetted the debtor.

The Fifth Circuit courts then went beyond determining whether *in pari delicto* applies to trustees to consider whether, despite being *in pari delicto*, the trustee should nevertheless be allowed to assert claims. The Fifth Circuit courts were forced to recognize that *defining* rights and liabilities is separate from *applying* those rights and liabilities. Though § 541 defines what defenses apply by defining the trustee's rights, § 541 does not dictate the *application* of those rights. Section 541 only speaks to "interest of the debtor." Section 541 does not speak to the *application* of the debtor's interest.

Consider the example of an unpaid account. A trustee can assert a claim for an unpaid account only if the debtor could have asserted the claim. Section 541 requires courts to consider the pre-petition world to determine if the debtor has a claim. If, pre-petition, the debtor sold goods to a customer and the customer did not pay, the debtor could assert a claim for the unpaid account. Under § 541, the trustee can assert this claim. If the creditor paid half of what was owed on the account post-petition, the court does not ignore this payment and issues a judgment for the full amount that was owed pre-petition. The existence of the trustee's right to sue on the account was determined by pre-petition facts, but the actual *application* must take into account the post-petition reality. Nothing within § 541 limits a court's application of rights to pre-petition facts and reading such a limit into § 541 only leads to inequitable results that run counter to the purposes of the Bankruptcy Code.

In the *in pari delicto* context, the debtor's wrongful conduct makes the trustee subject to an *in pari delicto* defense just as a customer's default on an account makes the creditor subject to a claim for an unpaid account. Pre-petition, the debtor would be subject to the defense. Under § 541, the trustee is also subject to the defense. But, determining that the trustee is subject to the defense no more ends the inquiry than a determination that a trustee has a claim for an unpaid account. The defense must still be *applied*.

The distinction between static and fluid defenses must also be considered. With respect to many rights and liabilities, determining whether a party is subject to the right or liability ends the analysis. For many defenses, the *application* will not turn on facts. The court will have to evaluate pre-petition facts to determine if the defense exists. However, once the defense is determined to exist, application of the defense does not require consideration of facts. Consider a statute of limitations defense: If the statute of limitations passed pre-petition, the debtor could not have brought the suit, nor could the trustee. The *application* of the defense does not invite consideration of post-petition facts. The defense is static. Finding that the defense exists ends the analysis.

Other defenses are fluid in the sense that finding that a party is subject to a defense does not end the analysis. Though pre-petition facts trigger *application* of the defense, an essential component of the defense also requires consideration of facts. For example, *in pari delicto* has two components: the first component asks if the debtor engaged in wrongful conduct; the second component requires a balancing of the equities. Section 541's "as of the commencement of the case" language answers the first question. The phrase imputes the debtor's wrongful conduct to the trustee and triggers consideration of the defense.

In pari delicto's second component asks whether dismissing the plaintiffs' claims would serve the purposes of the doctrine. Would dismissal preclude wrongdoers from gaining from their malfeasance and deter future conduct? Analysis of the first component is limited to the window of facts existing before the petition date. Analysis of the second component has no such limitation The second component invites a discretionary analysis regarding the relative equities of the case. To consider the equities and serve the equitable purpose of the doctrine, courts must take into account the post-petition reality of the trustee bringing the claim on behalf of innocent creditors just as a court must take into account a trustee's post-petition mitigation of damages in a breach of contract suit and a defendant's post-petition payments on an account that was in default pre-petition.

The Fifth Circuit courts' approach has significant support. The approach is consistent with the Supreme Court's application of *in pari*

delicto to claims asserted under non-bankruptcy federal statutes, and the Seventh and Ninth Circuit's application to receivers.

A. *The Supreme Court's* In Pari Delicto *Application*

The Supreme Court has not directly considered *in pari delicto*'s application to bankruptcy trustees. However, the Supreme Court has twice considered *in pari delicto*'s application to claims arising under federal statutes.[199] In both cases, the Supreme Court held that courts cannot apply the doctrine without considering how its application will interact with the implicated federal statute. In both cases, the Supreme Court applied the same two-part analysis invited by the Fifth Circuit courts: (1) consideration of the plaintiff's wrongful conduct; and (2) the public policy implications of dismissing the plaintiff's claim.

In *Perma Life Mufflers*, the Supreme Court considered whether *in pari delicto* should bar a claim under the federal-antitrust statutes.[200] Plaintiffs were muffler dealers who signed sales agreements with Midas.[201] The sales agreements restricted what the dealers could buy and what and how they could sell.[202] Plaintiffs alleged that Midas and affiliated entities and insiders subsequently conspired to violate sections of the Sherman and Clayton antitrust acts through discriminatory pricing.[203] Defendants alleged that by entering into sales agreements alleged to have violated the antitrust statutes, dealers participated in the violations.[204] Based on the dealers' own involvement in the antitrust violations, defendants argued that *in pari delicto* barred their claims.[205] The district court agreed and dismissed the dealers' suit.[206]

The Supreme Court reversed the district court, holding that equitable doctrines cannot be applied to claims asserted under federal statutes without considering the effect on the purposes of the statute.[207] The Court stated, "[w]e have often indicated the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes."[208] The Court then considered whether applying *in pari delicto* to the dealers' claim would disserve

199. Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 301 (1985); Perma Life Mufflers, Inc. v. Int'l Parts Corp., 392 U.S. 134, 138–39 (1968), *overruled by* Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984).

200. *Perma Life*, 392 U.S. at 135.

201. *Id.*

202. *Id.* at 136–37.

203. *Id.* at 135.

204. *Id.* at 140.

205. *Id.* at 135–36.

206. *Id.*

207. *Id.* at 138–40.

208. *Id.* at 138.

the purposes of the antitrust statutes and serve the purposes of *in pari delicto*.

The Court found that applying *in pari delicto* would be inconsistent with both the purposes of the antitrust statutes and *in pari delicto*.[209] The Court noted that the antitrust statutes were enacted to foster competition, and their ability to protect competition depended on private enforcement through private lawsuits.[210] Barring the dealers' claims would diminish the antitrust statute's enforcement mechanism. Moreover, rejecting the defense would not lead to an inequitable result. Though a wrongdoing plaintiff may obtain financial gain from the lawsuit, the plaintiff remains civilly and criminally liable for his own conduct.[211]

Perma Life did not wholly foreclose application of *in pari delicto* to antitrust suits. The Court implied that *in pari delicto* could still bar a lawsuit where the plaintiffs played a more active role in the underlying criminal conduct.[212] The Court effectively invited the same two-party analysis applied by the Texas lower courts. A plaintiff's wrongful conduct makes the plaintiff subject to the defense. However, whether or not the defense should lead to dismissal of the plaintiff's claims depends on analysis of the doctrines "complex scope, contents, and effects."[213]

The Supreme Court subsequently applied *Perma Life's* reasoning to an *in pari delicto* defense to a lawsuit arising under the federal Securities Exchange Act.[214] In *Bateman Eichler*, corporate insiders and broker-dealers passed what they represented as being material, true, nonpublic information to certain investors.[215] The investors purchased securities based on these representations.[216] The representations were in fact false and the investors suffered losses.[217] Subsequently, the investors sued the insider and dealers under the federal Securities and Exchange Act.[218] Defendants sought dismissal, arguing that the investors were *in pari delicto* since their own trading on insider information also violated the Securities Act.[219] The district court dismissed the case, and the Ninth Circuit reversed based on *Perma Life*.[220]

The Supreme Court affirmed the Ninth Circuit, emphasizing the need to consider *in pari delicto*'s effects on the goals of the federal

209. *Id.* at 139–40.
210. *Id.* at 139.
211. *Id.*
212. *Id.* at 140.
213. *Id.*
214. Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985).
215. *Id.* at 301–03.
216. *Id.* at 302.
217. *Id.*
218. *Id.* at 303–04.
219. *See id.* at 304.
220. *Id.* at 304–05.

statute.[221] The Court reiterated "the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes."[222] "[T]he classic formulation of the *in pari delicto* doctrine itself required a careful consideration of such [public policy] implications before allowing the defense."[223] Private lawsuits for violations of the Securities Act, like private actions to enforce the antirust acts, equally serve the public purpose of enforcing the statutes. Therefore, the Court concluded "that the views expressed in *Perma Life* apply with full force to implied causes of action under the federal securities laws."[224] Dismissing the lawsuits "would inexorably result in a number of alleged fraudulent practices going undetected by the authorities and unremedied."[225]

Nothing in the Supreme Court's *Perma Life* or *Bateman* decisions suggests that their reasoning would not be applied with equal force to trustee claims arising under the Bankruptcy Code. The Bankruptcy Code, like the antirust and securities statutes, is a federal statute that serves an important public purpose. The underlying purpose of the Bankruptcy Code is to provide a mechanism to afford an orderly and equitable distribution of estate assets to creditors.[226] Uniformly applying *in pari delicto* to bankruptcy trustees disserves this purpose in two ways. First, it encourages creditors to pursue individualized litigation, creating a competition among creditors for the debtor's assets. Second, it reduces innocent creditors' recovery from the bankruptcy estate by granting a windfall to a malfeasant third party.

The Author found only one circuit court opinion that discussed the Supreme Court *in pari delicto* opinions. In *Edwards*, the Eleventh Circuit acknowledged that the Supreme Court twice declined to apply *in pari delicto*, but reasoned that the Court's decisions were distinguishable from *Edwards* because the plaintiffs in the instances in which the Supreme Court declined to apply *in pari delicto* had not played a substantial or active role in the alleged fraud.[227] In *Edwards*, the debtor was the main culprit.[228] None of the courts acknowledged how dismissing the trustee's claims thwarts the equitable distribution purpose of the Bankruptcy Code.

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221. *Id.* at 305–19.

222. *Id.* at 307 (quoting Perma Life Mufflers, Inc. v. Int'l Parts Corp., 392 U.S. 134, 138 (1968), *overruled by* Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984)).

223. *Id.* at 310.

224. *Id.*

225. *Id.* at 315.

226. Pepper v. Litton, 308 U.S. 295, 307–08 (1939); G.H. Leidenheimer Baking Co. v. Sharp (*In re* SGM Acquisition Co.), 439 F.3d 233, 238 (5th Cir. 2006).

227. Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1153–56 (11th Cir. 2006).

228. *Id.* at 1155.

B. *The Receiver Cases*

The Seventh and Ninth Circuits have issued opinions explaining *in pari delicto*'s flexible nature and the potential for inequity when applying the defense to innocent third parties asserting claims on behalf of innocent creditors.[229] Both courts considered cases involving receivers asserting claims against third parties who allegedly assisted a corporate fraud.[230] In *O'Melveny & Myers*, the FDIC took over a failed savings and loan.[231] The appointed receiver sued the savings and loan's attorneys for malpractice and breach of fiduciary duty.[232] In *Scholes*, the SEC had a receiver appointed for a conglomerate of corporate entities organized for a ponzi scheme.[233] The receiver asserted fraudulent transfer claims against individuals and entities who received transfers from the corporate entities.[234]

The *O'Melveny* and *Scholes* courts both recognized how substituting an innocent party for the wrongdoer as the plaintiff affects the *in pari delicto* analysis. Both courts considered cases involving receivers asserting claims against third parties who allegedly assisted a corporate fraud. The Courts acknowledged that "'[a] receiver occupies no better position than that which was occupied by the person or party for whom he acts . . . and any defense good against the original party is good against the receiver.'"[235]

However, the Courts reasoned that the purposes of *in pari delicto* would be disserved if the doctrine were used to dismiss the receiver's claim. "While a party may itself be denied a right or defense on account of its misdeeds, there is little reason to impose the same punishment on a trustee, receiver or similar innocent entity that steps into the party's shoes pursuant to court order or operation of law."[236] "Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated."[237] Applying *in pari delicto* grants a windfall to the malfeasant defendant while punishing innocent third parties. To apply *in pari delicto* "would be to elevate form over substance—something courts sitting in equity traditionally will not do."[238]

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229. *See* FDIC v. O'Melveny & Myers, 61 F.3d 17 (9th Cir. 1995) (per curiam); Scholes v. Lehmann, 56 F.3d 750 (7th Cir. 1995).

230. *See O'Melveny*, 61 F.3d at 18–19; *Scholes*, 56 F.3d at 752.

231. *O'Melveny*, 61 F.3d at 17.

232. *Id.*

233. *Scholes*, 56 F.3d at 752.

234. *Id.* at 753.

235. *O'Melveny*, 61 F.3d at 19 (quoting Allen v. Ramsay, 4 Cal. Rptr. 575, 583 (Ct. App. 1960)).

236. *Id.*

237. *Scholes*, 56 F.3d at 754–55 (citing McCandless v. Furlaud, 296 U.S. 140, 160 (1935)).

238. *O'Melveny*, 61 F.3d at 19 (citing Drexel v. Berney, 122 U.S. 241, 254 (1887)).

The circuit courts dismissing bankruptcy trustee claims recognized the Seventh and Ninth Circuit opinions and the inequities that would result in dismissing the trustee's claims on *in pari delicto* grounds.[239] Many expressed reservations about dismissing the claims and suggested that they would rule otherwise if the law allowed.[240] Yet the courts noted that *Scholes* and *O'Melveny* involved claims by receivers brought pursuant to state receivership statutes. The claims were not subject to § 541's qualitative component.[241]

Though bankruptcy trustee claims are subject to § 541's qualitative component, as discussed earlier, the qualitative component does not apply to the application of *in pari delicto*. Section 541 may make a trustee subject to *in pari delicto*, but determining that the trustee is subject to *in pari delicto* does not end the analysis. Public policy may dictate that relief must be granted even when a party is said to be *in pari delicto*. When engaging in this second half of the *in pari delicto* analysis, § 541 does not limit courts to consideration of pre-petition facts. Courts are free, and in some states, compelled by the applicable state law, to consider the post-petition reality when determining how dismissal would affect public policy. Recognizing that § 541's qualitative component does not apply to the *application* of the *in pari delicto* defense, courts are free to weigh the very same considerations that determined the *Scholes* and *O'Melveny* rulings.

C. *Alternative Interpretations*

The inequitable results of precedents dismissing trustee claims have been subject to much criticism. Alternative interpretations of § 541's interaction with *in pari delicto* have accompanied the criticism.

Professor Davis contends that, when interpreting § 541, courts should ignore state law and create a new property conception based on federal law.[242] Under his federal property-law concept, *in pari delicto* would have no place when an innocent trustee is asserting claims on behalf of innocent creditors.[243] However, Professor Davis's contention would require a reversal of longstanding precedent that property interests are defined by applicable state law. The Supreme Court has unequivocally held that federal courts cannot create federal equitable doctrines to supplant state-law property rights.[244]

239. *See, e.g.*,Sender v. Buchanan (*In re* Hedged-Invs. Assocs.), 84 F.3d 1281, 1284–85 (10th Cir. 1996).

240. *Id.*

241. *Id.*

242. Davis, *supra* note 11, at 519–20.

243. *Id.*

244. Butner v. United States, 440 U.S. 48, 54 (1979) (absent specific provisions to the contrary, "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law."), *superseded by statute*, 11 U.S.C. § 541(a) (1994).

Professor Alam has argued that § 541 only defines "property of the estate" rather than defenses to claims against "property of the estate."[245] Under this view, § 541 simply defines the trustee's standing to assert a claim rather than the merits of the claim.[246] A New York bankruptcy court recently adopted this view in *In re Adelphia Communications*.[247] Judge Gerber held that "[w]hile section 541 is relevant to an analysis of the *ownership* of the cause of action, and standing to assert it," § 541 is irrelevant to determining what state law defenses exist against the estate.[248] Accordingly, § 541 limits the standing analysis to pre-petition facts but it imposes no such limit when considering defenses.

This view is difficult to reconcile with the longstanding and unwavering precedent holding that a trustee "stands in the shoes of the debtor" when asserting a claim that constitutes property of the estate. Interpreting § 541 so that it has no bearing on determining the defenses a trustee is subject to would constitute a momentous reversal of decades of rulings.

The view errors by circumscribing § 541 to defining procedural standing rights rather than defining the particular scope of a party's *legal* right. Standing speaks to a party's *procedural* right to be heard with respect to property, but does not define the party's particular *legal* rights. Section 541 is the source of a party's standing in that it defines what claims belong to the estate. But § 541 does excise the debtor's interest from all other related interest. Interests do not exist in a vacuum. A joint-tenants interest in a home is limited by the rights of other joint-tenants. A claim for an unpaid account is limited by any applicable state law defenses. Section 541 brings into the estate the joint-tenant's interest subject to the other tenant's interest. Section 541 brings into the estate the debtor's claim for an unpaid account subject to a statute of limitations or any other applicable defenses. Section 541 does not bring into the estate absolute dominion over the home by virtue of the debtor's rights as a joint-tenant anymore than it brings into the estate a claim for an unpaid account stripped of any applicable defenses.

The standing-focused view would also lead to inequitable results. Under this view, *in pari delicto* would never apply to trustees. Under this view, defining "property of the estate" and defenses to estate claims are wholly independent. Because defining the claim and defining defenses to the claim are independent, § 541's qualitative compo-

245. Alam, *supra* note 10, at 307 ("In assessing the property rights of the bankruptcy estate, these courts have confused the possible existence of an equitable defense with the very existence of the bankruptcy estate's claim.").

246. *Id.* at 321–24.

247. Adelphia Commc'ns Corp. v. Bank of Am., N.A. (*In re* Adelphia Commc'ns Corp.), 365 B.R. 24, 51 (Bankr. S.D.N.Y. 2007).

248. *Id.*

nent has no bearing on defining the defense. Without § 541 requiring courts to consider pre-petition facts, courts could evaluate the defenses only with respect to the actual parties. The actual plaintiff, the trustee, did not participate in the wrongdoing. Without wrongdoing, the first prong of the two-part *in pari delicto* analysis is not met. Without meeting the first prong, the second prong of balancing the equities is never triggered.

There may in fact be situations where *in pari delicto* should be applied to trustees. The trustee will always be bringing claims on behalf of the estate, but the trustee may not always be bringing claims on behalf of innocent creditors. Not all estates are insolvent. Some estates may be able to pay all creditors in full and even pay returns on equity holders. Insiders involved in a corporate fraud may have claims against the estate or could be equity holders that could in fact receive proceeds from trustee litigation where the estate is solvent.

VI. CONCLUSION

For most of the last two decades, circuit court precedent has placed a substantial obstacle to trustee recoveries from third parties who were complicit in a corporate fraud. Commentators and lower courts have railed against the inequities of these results. Yet prior precedent accurately interpreted the applicable provisions of the Bankruptcy Code and state law. Prior precedent was not wrong but incomplete.

Faced with different questions, courts within the Fifth Circuit have been given the opportunity to complete the analysis. The Fifth Circuit courts recognize that trustees are subject to the *in pari delicto* defense. But the Fifth Circuit courts also recognize that finding that the trustee is *in pari delicto* begins rather than ends the analysis. Courts must rigorously consider the applicable state law's formulation of the doctrine. Many state law formulations, like Texas's, may require courts to consider the public policy implications of dismissing trustee claims. When considering the public policy implications, courts are free to consider the fact that a trustee rather than the actual malfeasant party is bringing the claim. Section 541 subjects trustees to *in pari delicto*, but § 541 does not require courts to ignore the post-petition reality when analyzing public policy implications. Section 541 *defines* rights and defenses. Section 541 has no relevance to *applying* the defined rights and defenses.

The Fifth Circuit courts' completion of the *in pari delicto* analysis could not have been more timely. The financial meltdown has uncovered a bevy of fraudulent investment schemes that will keep bankruptcy courts busy for years to come. The Fifth Circuit courts' *in pari delicto* analysis will give trustees the opportunity to increase estate assets and allow for more equitable distributions to innocent creditors.