Post-Confirmation Entities Created Under Restructuring Plans

The *In Pari Delicto* Doctrine

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The American Bankruptcy Institute's Commission to Study the Reform of Chapter 11

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I. Introduction

In 2012, the American Bankruptcy Institute established the Commission to Study the Reform of Chapter 11 (the "Commission") to evaluate U.S. business reorganization laws. The Commission undertook a three-year study of the resolution of financially distressed businesses under chapter 11 of the Bankruptcy Code before publishing a report, titled the "ABI Commission to Study the Reform of Chapter 11," in late 2014. In its report, the Commission reviewed an extensive list of issues related to chapter 11 reorganizations, including (1) post-confirmation entities created under restructuring plans and (2) the *in pari delicto* doctrine. The following paper introduces these two topics and evaluates the Commission's proposals related to each.

II. Post-Confirmation Entities Created Under Restructuring Plans

A. Background

Non-debtor post-confirmation entities created through restructuring plans are playing an increasingly prominent role in facilitating the resolution of chapter 11 business reorganizations. Post-confirmation entities – including litigation trusts, liquidation trusts and business trusts – are creatures of contract created for the benefit of creditors of a debtor.[2] The trusts typically receive an initial cash contribution from the debtor's bankruptcy estate to fund the post-confirmation prosecution and distribution of proceeds from debtor assets. Often, the assets are causes of action against third parties or affiliates.[3]

Post-confirmation entities are particularly crucial in allowing debtors to emerge from bankruptcy when lengthy litigation or liquidation processes threaten to delay a reorganization.[4] Indeed, courts have recognized that Section 1123(b)(3)(B) of the Bankruptcy Code, discussed in further detail below, contemplates the creation of post-confirmation entities precisely to "make possible the formulation and consummation of a plan before completion of the investigation and prosecution of causes of action such as those for previous insider misconduct and

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[2] *See* P.H. Montgomery & C.A. Burton, An Introduction to Litigation Trusts, located on July 22, 2015 at http://apps.americanbar.org/litigation/committees/commercial/articles/spring2013-0513-an-introduction-to-litigation-trusts.html.

[3] *Id*.

[4] *See* G.E. Ponto & P. J. Ulrich, Post-Confirmation Litigation And Liquidation Trusts: Consideration Of Certain Required Plan Provisions And Tax Implications, located on July 22, 2015 at http://www.gibbonslaw.com/Files/Publication/4fea6809-63aa-4ae1-b631-d44e96258c64/Presentation/PublicationAttachment/5a5132b7-4982-4cc8-a663-d88fff718cda/Ulrich.pdf.

mismanagement of the debtor."[5] Although post-confirmation entities are perhaps most widely known for their use by debtors looking to cleanse themselves of asbestos-related liabilities, their applications have been far wider in recent years, particularly when a debtor's estate includes potentially valuable avoidance actions that could take years to resolve. An overview of the legal framework governing post-confirmation entities, and a discussion of potential reforms to that framework, follows.

B. Brief Summary of the Law

Pursuant to Section 1141(b) of the Bankruptcy Code, "[e]xcept as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor."[6] Property of the estate, in turn, includes all legal or equitable interests of the debtor in property, wherever located or by whomever held, as of the commencement of the case.[7] Causes of action against third parties or affiliates, including Bankruptcy Code-based avoidance actions and state law-based fraudulent transfer, securities law and tort claims are therefore all considered property of the estate that presumptively belong to the reorganized debtor post-confirmation. Section 1123 of the Bankruptcy Code, however, provides a statutory basis for reorganization plans providing for the transfer of estate property to post-confirmation entities other than the reorganized debtor.[8]

Under Section 1123(b)(3)(B), a reorganization plan may "provide for . . . the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any . . . claim or interest [belonging to the debtor or to the estate]."[9] This statutory framework gives rise to the key legal issues related to post-confirmation entities: (i) actions that the debtor must take to retain claims or interests and (ii) prerequisites for serving as a representative of an estate eligible to prosecute retained claims and interests.

<u>Retention of Claims and Interests</u>

Courts have generally viewed Section 1123(b)(3)(B)'s retention requirement, at least in part, as a notice provision designed to alert creditors to potential causes of action that could result in recoveries that would enlarge the estate.[10] Creditors are entitled to "seek a share of any

[5] 11 U.S.C. § 1123(b)(3)(B); *In re Acequia, Inc.*, 34 F.3d 800, 808 (9th Cir. 1994).
[6] 11 U.S.C. § 1141(b).
[7] 11 U.S.C. § 541(a).
[8] 11 U.S.C. § 1123.
[9] 11 U.S.C. § 1123(b)(3)(B).
[10] *Harstad v. First Am. Bank*, 39 F.3d 898 (8th Cir. 1994).

such recoveries, contingent though they may be, and to have the mechanics" of the sharing detailed in the reorganization plan, but, as courts have pointed out, they are in no position to do so unless notified that the claim may exist and be pursued.[11] Still, courts have disagreed about the exact degree of specificity that Section 1123(b)(3)(B) requires debtors to include in reorganization plans and attendant disclosure statements in order to retain the right to pursue claims or interests post-confirmation.[12]

In *Harstad*, the court was confronted with the question of whether a debtor had standing to pursue a preference action post-confirmation despite failing to disclose in the reorganization plan or related disclosure statement its intent to pursue the claim. The court rejected the notion that denying the debtor standing would amount to a windfall to the pre-petition payment recipient, and instead halted the debtor's efforts, holding that the debtor lacked standing to pursue the preference claim because it failed to specifically reserve the right to pursue such claim post-confirmation.[13] Similar to the approach adopted by the *Harstad* court, some courts focus on whether sufficient information is included in disclosure statements – including, for example, the facts underlying the potential claim or the names of the potential defendants – to allow creditors to take into account the value of potential claims when voting on a reorganization plan.[14] Other courts, however, have been more forgiving, requiring only "a general provision in the plan or disclosure statement reserving the reorganized debtor's right to pursue a particular type of action."[15] As demonstrated by *Harstad*, reorganization plans and disclosure statements must provide the degree of specificity required under applicable case law for post-confirmation entities to maintain standing, while simultaneously preserving flexibility to pursue meritorious claims.[16] The same principles and concerns apply when the claims and interests are being retained not for the debtor, but for a representative of the estate to pursue post-confirmation.[17]

<u>Appointment of Estate Representative</u>

Although Section 1123(b)(3)(B) of the Bankruptcy Code contemplates that a "representative of the estate appointed for such purpose" may pursue any claims or interests

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[11] *Id*.
[12] 7 Collier on Bankruptcy ¶ 1123.02[3].
[13] *Harstad*, 39 F.3d 898.
[14] *Browning v. Levy*, 283 F.3d 761 (6th Cir. 2002).
[15] 7 Collier on Bankruptcy ¶ 1123.02[3].
[16] Ponto & Ulrich, Post-Confirmation Litigation And Liquidation Trusts: Consideration Of Certain Required Plan Provisions And Tax Implications.
[17] *Rahl v. Bande*, 328 B.R. 387, 401 (S.D.N.Y. 2005).

retained under a reorganization plan, the Bankruptcy Code does not provide clarity on what, if any, qualifications such an appointee must hold in order to represent the estate.[18] The Court of Appeals for the Tenth Circuit has held that parties (other than the debtor or trustee) seeking to enforce a claim or interest held by a debtor's estate may do so if they prove that (1) they have been expressly appointed under a confirmed plan and (2) they are a representative of the estate.[19]

The first requirement is easily satisfied upon a court's confirmation of a reorganization plan with language clearly appointing a party as representative of the estate, and is not contingent on the any "magic words" appearing in the plan.[20] This requirement tends not to be an issue with post-confirmation entities such as the trusts described above that are often integral components of, and clearly detailed in, reorganization plans and disclosure statements. The second requirement, however, requires "the court to decide on a 'case-by-case' basis whether a successful recovery by the appointed representative would benefit the debtor's estate and, more particularly, the debtor's unsecured creditors."[21] In the context of post-confirmation litigation trusts, courts will deploy this prong of the estate representative test to ensure that similarly situated creditors are treated alike, and that the purported representative will not pursue claims or interests post-confirmation for the benefit of some creditors to the exclusion of other, similarly situated creditors.[22]

The interaction between the requirements to retain claims and interests on the one hand, and to appoint an estate representative to pursue such claims and interests on the other, is critical to the successful establishment of post-confirmation entities. Indeed, courts have recognized that "express provisions of plans of reorganization that confer the right to bring particular kinds of actions on a particular party" satisfy Section 1123(b)(3)(B)'s requirements.[23] Conversely, plan provisions that do not clearly connect the proposed estate representative with the retained interests or claims to be pursued may be jeopardized. In *In re Mako*, for example, the Court of Appeals for the Tenth Circuit rejected a secured creditor's attempt to pursue avoidance actions post-confirmation for its own benefit because, *inter alia*, the plan did not clearly reserve for that

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[18] 11 U.S.C. § 1123(b)(3)(B).
[19] *Search Market Direct, Inc. v. Jubber (In re Paige)*, 685 F.3d 1160, 1191 (10th Cir. 2012); *Citicorp Acceptance Co., Inc. v. Robison (In re Sweetwater)*, 884 F.2d 1323, 1326, 21 C.B.C.2d 1034, 1038 (10th Cir. 1989).
[20] 7 Collier on Bankruptcy ¶ 1123.02[3].
[21] *Id*.
[22] *In re Mako, Inc.*, 985 F.2d 1052, 1056 (10th Cir. Okla. 1993).
[23] *In re Amarex, Inc.*, 96 B.R. 330 (W.D. Okla. 1989).

particular creditor the right to pursue avoidance actions post-confirmation.[24] Indeed, the court was loathe to deprive the litigation trustee – appointed pursuant to the same reorganization plan – of the right to pursue avoidance actions for the benefit of unsecured creditors, and therefore found the provisions purporting to empower the secured creditor to pursue avoidance claims too vague to be enforceable.[25] Ultimately, clear provisions and disclosure detailing the claims and interests being retained, and the estate representative being appointed to pursue such claims and interests, should satisfy the legal requirements for the establishment of post-confirmation entities.

Recent Developments

The importance of the content included in reorganization plans and disclosure statements has been magnified in light of recent cases addressing the appealability of bankruptcy court orders at and after the plan confirmation stage. In the first, the Supreme Court held that a bankruptcy court order denying confirmation of a plan while granting the plan proponent leave to amend is not a "final" order, and therefore is not appealable as of right.[26] As a result, reorganization plans providing for the establishment of post-confirmation entities can be appealed as of right only if the plan is either denied without leave to amend, or confirmed. The second decision, delivered by the Court of Appeals for the Ninth Circuit, highlighted the risk that even when bankruptcy court orders confirming reorganization plans are appealable, the appeal may be rendered "equitably moot" based upon a weighing of factors, including whether (1) the appellant sought a stay, (2) the plan has been substantially consummated, (3) the remedy would unduly burden innocent third parties and (4) a remedy can be fashioned that offers equitable relief without undermining the plan.[27] Although the Court of Appeals for the Ninth Circuit ultimately held that the appellant-creditor's appeal was *not* equitably moot in that case, limitations on the appealibility of bankruptcy court orders confirming reorganization plans can likewise limit the ability of creditors to object to the terms of post-confirmation entities established through such confirmation orders.[28]

[24] *In re Mako, Inc.*, 985 F.2d at 1056.
[25] *Id*.
[26] *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686 (2015).
[27] *In re Transwest Resort Properties, Inc.*, 2015 U.S. App. LEXIS 11312 (9th Cir. 2015).
[28] *Id*.

C. ABI Commission Recommendations

In the Commission's report, the Commission reviewed, and recognized, the role that post-confirmation entities can play in facilitating plan confirmation and implementation. However, the Commission identified problems that have arisen as post-confirmation entities have proliferated. First, the Commission noted that prior to confirmation, stakeholders have little time to review trust and organizational documents, as those documents are often filed just before the confirmation hearing. Second, the Commission noted that after a plan is confirmed, courts do not take an active role in overseeing the operations or administration of the trust. Although the Commission declined to recommend sweeping statutory guidelines to govern all post-confirmation entities, it did make disclosure-based recommendations aimed at mitigating many of the criticisms of post-confirmation entities. As a threshold matter, it recommended introducing as a condition to the establishment of post-confirmation entities a requirement that courts make a determination, "based on the evidence presented at the confirmation hearing, that the entity and its organizational documents provide sufficient protections and procedures for creditors and other beneficiaries relying on the entity for their recoveries in the case."[29]

In addition to imposing on courts an affirmative obligation to review information detailing the protections and procedures relating to post-confirmation entities, the Commission also recommended specific improvements to the disclosures provided to other parties to ensure they have a meaningful opportunity to review and evaluate the material terms relating to and governing post-confirmation entities. Here, the Commission drew a sharp distinction between the disclosure of information relating to pre-confirmation activity and information related to post-confirmation activity. The Commission determined that reorganization plans and disclosure statements generally contain adequate levels of disclosure regarding the events leading up to, and occurring during, chapter 11 cases, as well as regarding the state of the debtor's assets, liabilities and business.[30] With respect to the governance and operations of post-confirmation entities, on the other hand, many of the Commissioners believed that disclosure is frequently inadequate.[31] To address the Commissioners' disclosure concerns, the Commission recommended that Section 1125 of the Bankruptcy Code, which sets forth the "adequate disclosure" requirements for disclosure statements, be amended to require specific disclosures concerning:

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[29] American Bankruptcy Institute, Commission to Study the Reform of Chapter 11, pg. 244 (2014).
[30] *Id*.
[31] *Id*.

- Governance matters, including the individuals or entities managing the entity's affairs, general decision-making process, procedures for changing key personnel and voting protocols and equity security holders' or beneficiaries' rights with respect to governance matters;
- The assets of the reorganized debtor or post-confirmation entity;
- Details of the claims and interests dispute, reconciliation and distribution process; and
- The process to raise issues with the court concerning the post-confirmation entity or the implementation of the chapter 11 plan.[32]

The amendments recommended by the Commission, if adopted, should provide greater clarity to all interested parties on how post-confirmation entities will be administered and governed. Transparency surrounding those fundamental details is critical, particularly because many post-confirmation entities will exist for years and provide some creditors with their primary – or sometimes only – source of recovery. The enhanced transparency measures, if designed properly, can push objecting parties to the fore pre-confirmation and improve the understanding and alignment of all parties if and when reorganization plans establishing post-confirmation entities are ultimately confirmed.

D. Conclusion

Non-debtor post-confirmation entities created through restructuring plans have long held the promise of improving the speed with which debtors can emerge from chapter 11. While many debtors have successfully deployed post-confirmation entities to that very end, a host of recurring issues – some practical, some legal – have plagued the efficacy of many post-confirmation entities in their prosecution of reserved claims or interests and the distribution of any proceeds derived therefrom.

In practice, post-confirmation entities often cause unanticipated hardships on the reorganized debtor. Litigation trusts, for example, may unintentionally damage the relationship between a reorganized debtor and its vendors by seeking to avoid pre-petition payments made by the debtor to those vendors. In addition, the demands of litigation preparation, including those relating to discovery, document production and deposition and trial preparation, are an unwelcome distraction and a very direct imposition on reorganized debtors.[33] Post-confirmation

[32] *Id*.
[33] *Id*.

entities also confront a slew of legal hurdles when prosecuting claims or interests. In addition to challenges alleging a lack of standing or *res judicata* deriving from a failure to meet the Section 1123(b)(3)(B) legal requirements discussed above, post-confirmation entities often find themselves confronting *in pari delicto* defenses that could bar recoveries.[34] The *in pari delicto* defense, discussed in detail in the next section, has had mixed success when used against claims brought by post-confirmation entities.[35]

Despite these practical and legal challenges, the prevalence of post-confirmation entities continues to grow. In fact, a bankruptcy and restructuring advisory firm recently announced a joint venture with a litigation finance company aimed at funding post-confirmation litigation trusts.[36] While the advent of investment firms with mandates focused on funding post-confirmation entities is a very recent phenomenon that may or may not attract followers, their mere existence highlights the ever-growing role that post-confirmation entities play in chapter 11 reorganizations and the potential of such entities to create value for creditors from uncertain claims well after a reorganization plan is confirmed.

III. The *In Pari Delicto* Doctrine and Chapter 11

A. Background

The *in pari delicto* doctrine derives from the fundamental principle that "one wrongdoer may not recover against another."[37] Indeed, the Latin phrase comes from the Latin saying, "*In pari delicto potior est conditio defendentis*," or, "Where both parties are equally in the wrong, the position of the defendant is the stronger."[38] At common law, the doctrine was historically understood to be a crystallization of two ideas: "first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an

[34] *Id*.; 11 U.S.C. § 1123(b)(3)(B).
[35] *See, e.g.*, *Nisselson v. Lernout*, 469 F.3d 143 (1st Cir. 2006); *compare*, *ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 430 (S.D. Tex. 2008).
[36] "Chilmark Partners and Burford Capital Launch Bankruptcy Litigation Financing Joint Venture," accessed on July 30, 2015 at http://www.burfordcapital.com/wp-content/uploads/2015/07/28July_Bankruptcy_LF_Release_FINAL.pdf.
[37] *In re Bernard Madoff Inv. Secs. LLC*, 721 F.3d 54 (2d Cir. 2013) (citing *Kirschner v. KPMG LLP*, 15 N.Y.3d 446 (N.Y. 2010)).
[38] Black's Law Dictionary app. B, at 1838 (9th ed. 2009).

admitted wrongdoer is an effective means of deterring illegality."[39] In the chapter 11 context, the doctrine serves as a potentially powerful limitation on the ability of bankruptcy trustees or post-confirmation entities – often litigation trusts – to pursue claims under Section 541 of the Bankruptcy Code relating to aiding and abetting fraud, breach of fiduciary duty, negligence, malpractice, aiding and abetting breach of fiduciary duty, negligent misrepresentation, negligent supervision or conspiracy against officers and directors, managers, outside professionals and other parties stemming from pre-petition conduct.[40] It is important to note, however, that the *in pari delicto* defense is unavailable to defendants in causes of action available only to a bankruptcy trustee, such as preference and fraudulent conveyance claims.[41]

B. Brief Summary of the Law

In pari delicto's application to chapter 11-related claims arises, in the first instance, from Section 541(a)(1) of the Bankruptcy Code.[42] Under Section 541(a)(1), the debtor's estate generally includes "all legal or equitable interests of the debtor in property, wherever located or by whomever held, as of the commencement of the case."[43] Courts interpret the definition quite broadly, and understand it to include all causes of action that the debtor could have brought prior to the bankruptcy petition.[44] The bankruptcy trustee, which steps into the shoes of the debtor, therefore has standing to bring any pre-petition causes of action that the debtor could have brought. However, in so doing, the bankruptcy trustee is also subject to all of the defenses that could have been asserted against the debtor had the debtor brought the claim prior to filing for bankruptcy.[45] The defenses, in turn, are often a function of state agency law, which determines when an agent's conduct will be imputed to a principal.[46] The precise contours of agency law vary by state – and are beyond the scope of this summary – but in general, claims pursued by a bankruptcy trustee or litigation trust are likely to confront *in pari delicto* defenses when the defendant's conduct can be imputed to the debtor, leaving the trustee barred from recovering for

[39] Henry S. Bryans, Claims Against Lawyers by Bankruptcy Trustees – A First Course on the *In Pari Delicto* Defense, The Business Lawyer; Vol. 66 (2011) (citing *Bateman Eichler, Hill Richards, Inc. vs. Berner*, 472 U.S. 299, 306 (1985) (footnote omitted)).
[40] American Bankruptcy Institute, Commission to Study the Reform of Chapter 11, pg. 186 (2014).
[41] *Id*. at pg. 188.
[42] *Id*.
[43] 11 U.S.C. § 541(a)(1).
[44] Collier on Bankruptcy ¶ 541.03.
[45] Bryans, Claims Against Lawyers by Bankruptcy Trustees – A First Course on the *In Pari Delicto* Defense (2011).
[46] *Id*.

the underlying wrongdoing.[47] Indeed, all but one circuit has held that the "*in pari delicto* doctrine bars a trustee's claims when the doctrine would have barred the claims if they had been brought by the debtor."[48] For example, when state agency law imputes notice to a principal-debtor of pre-petition fraud perpetrated by an agent-manager, the *in pari delicto* doctrine could preclude the debtor from asserting claims against the relevant member of management. Similar principles apply when a principal-debtor is liable for conduct of its agent-managers imputed under *respondeat superior* or other theories of vicarious liability.[49]

In practice, because bankruptcy trustees step into the shoes of the debtor, and can assert no greater rights than the debtor could have, bankruptcy trustees (and litigation trusts) may be precluded from pursuing claims not only against management, but also against the company's advisors or consultants.[50] The reach of New York's *in pari delicto* doctrine was demonstrated with renewed force in the aftermath of the bankruptcy of Refco, Inc., a provider of brokerage and clearing services that was forced to file for bankruptcy after it disclosed that its president and chief executive officer perpetrated a fraud that "hid hundreds of millions of dollars of the company's uncollectible debt from the public and regulators" and was therefore not reflected in the company's public financials.[51] A litigation trust benefitting Refco, Inc.'s general unsecured creditors was established under the reorganization plan, and the litigation trustee filed suit against the company's accounting firms, investment banks and law firm alleging that the defendants participated in defrauding the company's creditors.[52] The defendants made a motion to dismiss, relying on the *in pari delicto* doctrine, which the United States District Court for the Southern District of New York granted and the Court of Appeals for the Second Circuit affirmed.[53] The holding is consistent with other cases under New York law in which plaintiffs have been stymied in their efforts to recover from accounting firms and other third party advisors for failing to detect or otherwise participating in a company's fraudulent activity, an application of the *in pari delicto* doctrine that is particularly problematic for creditors in situations where

[47] *Id*.
[48] American Bankruptcy Institute, Commission to Study the Reform of Chapter 11, pg. 186 (2014) (footnote omitted).
[49] Bryans, Claims Against Lawyers by Bankruptcy Trustees – A First Course on the *In Pari Delicto* Defense (2011).
[50] *Id*.; Collier on Bankruptcy ¶ 541.03.
[51] *Kirschner v. KPMG LLP*, 626 F.3d 673, 677 (2d Cir. 2010).
[52] *Id*.
[53] *Id*.

they have made investing and lending decisions in reliance on financial statements that were prepared fraudulently.

There are, however, limited exceptions to the *in pari delicto* doctrine that enable bankruptcy trustees or litigation trusts to pursue claims against the alleged wrongdoers. The "adverse-interest" exception is the most prevalent such exception. While the details are similarly a function of state law, in general it provides, first, that *notice* "of a fact known to an agent is not imputed to the principal 'if the agent acts adversely to the principal in a transaction or matter'" and second, that *conduct* of an agent is not imputed to the principal if the agent acts outside the scope of its principal-agent relationship.[54] The "adverse-interest" exception is motivated by the idea that "when an agent is engaged in a scheme to defraud his principal, either for his own benefit or that of a third person . . . he cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose."[55] Although trustees and litigation trusts often invoke the adverse-interest exception in an effort to break the chain of imputation, they have done so with only limited success.[56] Courts have generally set a high bar for invoking the exception, requiring trustees to show that "the corporate officer . . . '*totally abandoned'* the corporation's interest and '[acted] entirely for his own or another's purposes.'"[57] Only upon such a showing is the chain of imputation between the corporate officer and the corporation broken such that a trustee, standing in the shoes of an "innocent" debtor, may pursue claims against the corporation's advisors for participating in the corporate officer's misconduct.

The narrow scope of the exception was highlighted in the aftermath of the Bernie Madoff Ponzi scheme. Irving Picard, appointed trustee under the Securities Investor Protection Act (SIPA), sought to recover funds lost as a result of the Ponzi scheme Madoff perpetrated through his brokerage firm, Bernard L. Madoff Investment Securities, LLC (BLMIS).[58] SIPA empowers trustees appointed under the law with all of the powers of chapter 11 trustees, and Picard relied on that authority to pursue claims against major financial institutions for conduct arising out of Madoff's scheme, including claims of unjust enrichment, breach of fiduciary duty, aiding and

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[54] *Id*. (citing Restatement (Third) of Agency § 5.04 (2006)).
[55] *Kirschner*, 626 F.3d at 677 (2d Cir. 2010) (citing *Kirschner I*, 2009 WL 1286326, at *6 (internal quotation omitted); *see People v. Kirkup,* 4 N.Y.2d 209 (1958); *Benedict v. Arnoux,* 154 N.Y. 715 (1898)).
[56] *Id*.
[57] *Id.* (emphasis added).
[58] *In re Picard*, 721 F.3d 54 (2d. Cir. 2013).

abetting fraud, and negligence.[59] Faced with the defendants' use of the *in pari delicto* defense, Picard attempted to invoke the "adverse-interest" exception. The Court of Appeals for the Second Circuit, however, upheld two district court opinions rejecting Picard's attempted use of the exception, explaining that the "adverse-interest" exception is "reserved for cases of 'outright theft or looting or embezzlement . . . where the fraud is committed *against* a corporation rather than on its behalf."[60] The court reasoned that because Madoff could not be separated from BLMIS, Madoff's fraud was not committed against BLMIS, rendering the "adverse-interest" exception inapplicable.[61]

Another exception that has been deployed with limited success is the "innocent decision maker" exception, which potentially applies if the underlying conduct was limited to a subset of the shareholders or decision-makers. The "innocent decision maker" exception is premised on the idea that the conduct could have been reported to one of the non-participating shareholders or decision-makers, but has likewise been deployed with only limited success.[62]

Lastly, it should be noted that the Court of Appeals for the Second Circuit has diverged from its sister circuits and views *in pari delicto*-based challenges as questions of standing rather than as affirmative defenses (known under New York law as the *Wagoner* rule).[63] Nevertheless, courts explaining the *Wagoner* rule on standing "have acknowledged its similarity to the *in pari delicto* defense, and most of the exceptions to the *in pari delicto* defense apply with equal force to the application of the *Wagoner* rule on standing."[64] Still, the scope of the "adverse-interest" exception to the applicability of the *in pari delicto* defense is narrower in New York than in some other jurisdictions.

C. ABI Commission Recommendations

Similar to its review of post-confirmation entities discussed above, the Commission likewise reviewed the *in pari delicto* doctrine before debating and ultimately recommending certain changes to existing law. As a preliminary matter, the Commissioners highlighted the basic principles – outlined above – necessitating the doctrine's availability to defendants outside

[59] *Id*.
[60] *Id*.
[61] *Id*.
[62] American Bankruptcy Institute, Commission to Study the Reform of Chapter 11, pg. 187 (2014) (footnote omitted).
[63] *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 117 (2d Cir. 1991).
[64] Bryans, Claims Against Lawyers by Bankruptcy Trustees – A First Course on the *In Pari Delicto* Defense (2011) (citing *In re Parmalat Sec. Litig.*, 477 F. Supp. 2d 602, 609 n.45 (S.D.N.Y. 2007)).

of the bankruptcy context. Some Commissioners, however, believed that in bankruptcy, the principles are less relevant, and the application of the doctrine unjust.[65]

For example, in bankruptcy, a party not involved with the alleged misconduct – such as a trustee or a litigation trust – may be the claimant, rendering the principle of not allowing a wrongdoer to recover from another wrongdoer arguably inapplicable. According to some Commissioners, the general principle that the bankruptcy trustee steps into the shoes of the debtor works as an injustice to innocent creditors when it leaves estate representatives unable to pursue meritorious claims on their behalf. For those Commissioners, the result is particularly troubling for creditors that outside of bankruptcy could have pursued the same claims directly or relied on state or federal receivers to pursue the claims on their behalf. The Commissioners that focused on the parties represented by the trustee, generally unsecured creditors, ultimately supported eliminating the *in pari delicto* doctrine in bankruptcy.[66]

Other Commissioners, however, were reluctant to support changes to the existing law. In their view, any change would necessarily create new causes of action for the estate that are not otherwise available under state law. For those Commissioners, empowering the trustee to bring claims that the *in pari delicto* doctrine would have precluded the debtor from bringing outside of bankruptcy was an unacceptable contradiction of the long-standing principle that bankruptcy should not enhance a debtor's property rights.[67]

In an attempt to bring the Commissioners together, the Commission considered two compromise reforms. First, the Commissioners debated "allowing individual creditors to pursue claims that they in fact hold under applicable non-bankruptcy law against third parties allegedly acting in concert with the prepetition debtor free of the *in pari delicto* defense."[68] Relatedly, the Commissioners considered allowing creditors to pursue, within bankruptcy, claims on behalf of all creditors in situations where there was a generalized harm.[69] Although the Commissioners were ultimately unable to reach a consensus on those recommendations, they did agree to recommend eliminating the *in pari delicto* doctrine as a defense against claims brought by chapter 11 trustees.[70] Notably, this recommendation does not include eliminating the defense

[65] American Bankruptcy Institute, Commission to Study the Reform of Chapter 11, pg. 187 (2014).
[66] *Id*.
[67] *Id*. (citing S. Rep. No. 95-989, at 82 (1978)).
[68] American Bankruptcy Institute, Commission to Study the Reform of Chapter 11, pg. 190 (2014).
[69] *Id*. at pg. 191.
[70] *Id*.

with respect to claims brought by other estate representatives (including litigation trusts), the debtor-in-possession or unsecured creditors' committees.[71]

D. Conclusion

Outside of bankruptcy, the *in pari delicto* doctrine operates sensibly to prevent debtors from recovering from parties with whom it was complicit – often through imputed knowledge or conduct of its agents – in the underlying misconduct giving rise to the debtor's claim. Within bankruptcy, however, the doctrine prevents not just the debtor-in-possession from pursuing such claims, but also prevents court-appointed trustees and other estate representatives – most often representing the interests of unsecured creditors – from pursuing recoveries from parties with whom the trustee or estate representative likely had no prior connection. Rigid adherence to the axiomatic principles that bankruptcy may not enhance a debtor's property rights and that trustees must step into the exact shoes of the debtor are of little solace to innocent (often unsecured) creditors who find themselves involuntarily forfeiting the ability to pursue potentially meritorious claims that they, or a receiver, could have brought before the debtor filed for bankruptcy.

Although the Commission's recommendations represent a significant step in the right direction and would eliminate the most indefensible chapter 11-related application of the *in pari delicto* defense, the Commission did not go far enough. Debtors in possession are perhaps best thought of as post-petition extensions of the debtor and should therefore arguably remain subject to any defenses that the pre-petition debtor would have been subject to. Litigation trusts, creditors' committees and other estate representatives, however, clearly cannot be viewed as extensions of the pre-petition debtor. Instead, they represent parties that did not act in concert with the wrongdoer and should not be precluded from pursuing claims against the wrongdoer outside of bankruptcy through the wrongdoer's reliance on the *in pari delicto* doctrine. As some Commissioners pointed out, it remains unclear why an intervening bankruptcy should alter the rights of third parties against the initial wrongdoer: parties that could have brought claims against non-debtor entities prior to the petition date should be able to rely on estate representatives to bring those same claims on their behalf after the petition date. Disallowing the pursuit of otherwise meritorious claims that would accrue to the benefit of innocent creditors is anathema to the goals of the Bankruptcy Code, and the Commission's recommendations should be

[71] *Id*.

broadened to reflect the critical role of litigation trusts, creditors' committees and other estate representatives in chapter 11 reorganizations.