Bobsledding: Steering around Prior Bad Actors — Litigation Following Fraud and Other Misconduct

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The Battle for D&O Insurance Proceeds in Bankruptcy

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I. INTRODUCTION

As resources available to make distributions to unsecured creditors decrease, directors and officers liability insurance ("D&O Insurance") becomes a more important source of recovery for creditors. As a result, there is often competition for access to policy proceeds among estate fiduciaries and directors and officers, and bankruptcy courts must determine whether, and to what extent, access should be granted.

II. WHAT IS D&O INSURANCE?

D&O Insurance is intended to protect corporate directors and officers ("Ds&Os"), and sometimes the corporation itself, from liability for claims based on wrongful acts of Ds&Os. For instance, D&O Insurance often covers claims alleging violations of securities laws or the mismanagement of corporate funds by Ds&Os. The typical policy provides a specific amount of coverage, and claims for defense costs are deducted from, and reduce, the remaining available coverage. This type of policy is commonly referred to as a "wasting" policy. For example, assume that the policy limit on liability is $10 million and plaintiffs asserting breach of fiduciary duty claims obtain a $10 million judgment against Ds&Os. If $4 million was paid to the Ds&Os for defense costs, then the remaining policy proceeds and, hence, the maximum amount that the plaintiffs could recover from the policy, would be $6 million.

A. Types of Coverage

D&O Insurance differs from one policy to the next, but the most common types of insuring agreements are referred to as Side A, Side B and Side C. Ds&Os are directly protected by Side A and indirectly protected by Side B coverage. Companies are directly protected by Side C coverage although, traditionally, many companies have chosen to self-insure and have opted out of Side C coverage. D&O Insurance policies can include any combination of the different coverage types. Under the standard D&O Insurance policy with multiple types of

insuring agreements, Side A, B, and C coverage share the same aggregate limits of liability; therefore, payment of a Side B or Side C claim reduces the amount of proceeds available for Side A claims and vice versa.

1. Side A Coverage

Side A coverage protects the individual Ds&Os from personal liability when the corporation, or entity, is unable to indemnify them. Sample Side A language is as follows:

> A. Insured Person Coverage:
>
> This policy shall pay the Loss of any Insured Person that no Organization has indemnified or paid, and that arises from any:
>
> (1) Claim (including any Insured Person Investigation) made against such Insured Person (including any Outside Entity Executive) for any Wrongful Act of such Insured Person . . . .

2. Side B Coverage

Side B coverage protects a company by reimbursing it for the indemnification of its Ds&Os. A company's obligation to indemnify its Ds&Os arises from contract, corporate governance documents, or state law. However, Side B coverage is not triggered if the company is not required, or is unable, to indemnify its Ds&Os. Although Side B coverage reimburses the company, it is intended to benefit the Ds&Os as an alternative source of recovery for losses. Sample Side B insuring language might be as follows:

> B. Indemnification of Insured Person Coverage:
>
> This policy shall pay the Loss of an Organization that arises from any:
>
> (1) Claim (including any Insured Person Investigation) made against any Insured Person (including any Outside Entity Executive) for any Wrongful Act of such Insured Person . . . .

3. Side C Coverage

Unlike Side A and Side B, Side C coverage protects against loss incurred by the company itself as opposed to loss incurred by the Ds&Os. Side C coverage is commonly referred to as "entity" coverage, and it is triggered when claims are made against the company. Therefore, Side C coverage may be triggered regardless of whether claims are made against the Ds&Os. For publicly traded companies, Side C coverage typically protects the company against losses arising from the violation of securities laws. Sample Side C language is as follows:

> C. Organization Coverage:
>
> This policy shall pay the Loss of any Organization:
>
> (1) arising from any Securities Claim made against such Organization for any Wrongful Act of such Organization;
> (2) incurred as Derivative Investigation Costs, subject to $250,000 aggregate sublimit of liability; or
> (3) incurred by an Organization or on its behalf by any Executives of the Organization (including through any special committee) as Defense Costs in seeking the dismissal of any Derivative Suit against an Insured.

B. Additional Provisions Impacting Coverage

In addition to insuring agreements, most D&O Insurance policies include provisions that further establish the extent and scope of coverage. Many of these provisions are designed to limit coverage, while others set forth the manner in which proceeds are to be allocated between insured parties. Although D&O Insurance policies are not homogenous, most will include one or more of the provisions discussed below, all of which become especially important in the bankruptcy context.

1. Insured v. Insured Exclusion

The "Insured v. Insured" exclusion is a common provision in D&O Insurance policies. This particular exclusion is designed to preclude coverage for collusive claims by and against

insured parties. For example, if a policy includes Side C coverage as well as Side A or Side B coverage, then the Insured v. Insured exclusion would prevent the company from suing its Ds&Os for their wrongful acts. An Insured v. Insured exclusion might read as follows:

> The insurer shall not be liable to make any payment for loss which is based upon, or attributable to, any claim made against any director or officer by any director or officer or by the insured institution as defined in the policy, except for a shareholder derivative action brought by a shareholder of the insured institution which is instigated and continued totally independent of, and totally without the solicitation, assistance, active participation, or intervention of, any director or officer or the insured institution.

The Insured v. Insured exclusion becomes particularly relevant in bankruptcy as, despite the intent to bar collusive claims, insurers nonetheless have relied on it to deny coverage for non-collusive claims. For example, some insurers have taken the position that the exclusion bars coverage for a bankruptcy trustee's claims against Ds&Os because the trustee "stands in the shoes" of the debtor. Indeed, courts have ruled in favor of insurance companies on this issue. *See, e.g.*, *Biltmore Associates, LLC v. Twin City Fire Insurance Co.*, 572 F.3d 663, 677 (9th Cir. 2009) (holding that the "insured versus insured exclusion bars coverage for claims brought as the assignee of the debtor in possession"); *National Union Fire Ins. Co. of Pittsburgh v. Olympia Holding Corp.*, No. 1:94-CV-2081, 1996 WL 33415761, at *7 (N.D. Ga. June 4, 1996) (stating that "there is no legal distinction . . . between [the debtor] and . . . Trustee for the bankruptcy estate" and holding that "any claims brought by . . . [the] Trustee fall within the exclusion clause"). But, courts have also gone the other way. *See, e.g., Grafenauer v. Mukamal (In re Laminate Kingdom, LLC)*, Nos. 07-10279, 07-01792, 2008 WL 704396 at *3 (Bankr. S.D. Fla. March 13, 2008) (holding that claims bought by trustee were not subject to the insured versus insured exclusion); *Cohen v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. (In re County Seat*

Stores, Inc.), 280 B.R. 319, 327 (Bankr. S.D.N.Y. 2002) (same); *In re Molten Metal Technology, Inc.*, 271 B.R. 711, 732 (Bankr. D. Mass. 2002) (same).

Often the issue is one of draftsmanship. For example, language such as "coverage shall be denied for any claims filed on behalf of the Insured Organization" is more likely to result in the denial of coverage for a trustee's claims than the language used in the example above (that is, the insurer is not liable for "any claim made against any director or officer by any director or officer or by the insured institution . . ."). That is because insurers would focus on the fact that a trustee's claims are filed *on behalf of* an insured party, namely, the debtor. The opposing argument is that the trustee represents the debtor's *estate* rather than the pre-petition company *itself*. Accordingly, the trustee represents the interests of non-debtor constituents such as the creditors and shareholders, which is why bankruptcy courts usually decline to apply the exclusion in this context. Typically, courts find either (a) the language is ambiguous and should be interpreted against the insurer or (b) the language is unambiguous but the exclusion does not apply because the trustee is not an insured party. *See, e.g.*, *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1116-17 (9th Cir. 2006) (construing the exclusion against the insurer because it was ambiguous); *Yessenow v. Executive Risk Indemnity, Inc.*, 953 N.E.2d 433, 443-44 (Ill. App. Ct. 2011) (finding that "where a court appointed trustee is working on behalf of creditors and under the authority of the bankruptcy court, . . . the trustee and the debtor . . . are not the same entity for purposes of the insured versus insured exclusion"); *Laminate Kingdom,* 2008 WL 704396 at *3-4 (same); *In re County Seat Stores, Inc.*, 280 B.R. at 324-27 (holding that the exclusion was unambiguous but inapplicable because the trustee was distinct from the company or an insured).

To be safe and avoid the potential for this dilemma, D&O Insurance policies may include an express carve-out from the exclusion to insure coverage for claims brought by, among others, a bankruptcy trustee or a creditors' committee. Insurers commonly agree to include the carve-out language because it does not conflict with the purpose underlying the Insured v. Insured exclusion, which is to protect against collusive lawsuits. A carve-out provision might read as follows:

> The [Insured v. Insured Exclusion] does not apply to:
>
> (1) a Claim by the Examiner, Trustee, Receiver, Liquidator, or similar official appointed for the Insured Organization (or any assignee thereof); or
> (2) a Claim by a Creditors' Committee, Bondholders' Committee, Equity Committee, Noteholders' Committee, or similar committee established for the Insured Organization (or any assignee thereof).

2. Bankruptcy Exclusion

D&O Insurance policies may also contain what are commonly referred to as "bankruptcy exclusions." This provision expressly excludes from coverage a bankruptcy trustee's claims against individual directors and officers. In effect, the bankruptcy exclusion is the opposite of a carve-out from the Insured v. Insured exclusion. A bankruptcy exclusion might read as follows:

> Bankruptcy Exclusion:
>
> (1) In the event that a bankruptcy or equivalent proceeding is commenced by or against the Insured Entity, no coverage will be available under this Policy for any Claim brought by or on behalf of:
>
> (a) the bankruptcy estate or the Insured Entity in the capacity as Debtor-in-Possession; or
> (b) any trustee, examiner, receiver, liquidator, rehabilitator, conservator or similar official appointed to take control of, supervise, manage or liquidate the Insured Entity, or any assignee of any such official (including, but not limited to, any committee of creditors or committee of equity security holders).

Not surprisingly, this provision is important in the bankruptcy context. When a debtor in possession, trustee, committee (standing in the debtor's shoes) or post-confirmation vehicle sues

Ds&OS, some insurers may attempt to deny coverage, relying on the bankruptcy exclusion (in addition to, or in lieu of, the Insured v. Insured exclusion). Some courts have refused to enforce bankruptcy exclusion provisions, while other courts have enforced them.

After acknowledging that a trustee's claim was technically subject to the bankruptcy exclusion, one court held that the bankruptcy exclusion was nonetheless unenforceable under section 541(c)(1)(B) of the Bankruptcy Code. *See Yessenow v. Executive Risk Indemnity, Inc.*, 953 N.E.2d 433, 440-41 (Ill. App. Ct. 2011) (holding that the bankruptcy court did not err in finding that the bankruptcy exclusion was "unenforceable under section 541(c)" because it "is conditioned on the commencement of [a] bankruptcy case"). Section 541(c)(1)(B) provides that a debtor's property "becomes property of the estate . . . notwithstanding any provision in an agreement . . . that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title . . . and that effects . . . termination of the debtor's interest in property." 11 U.S.C. § 541(c)(1)(B). In essence, the *Yessenow* court held that the bankruptcy exclusion was an invalid *ipso facto* clause because, if given effect, it would have precluded coverage that arose from a property interest protected by section 541(c). *Yessenow*, 953 N.E.2d. at 441.

In contrast, another court analyzing the same issue held that the bankruptcy exclusion was enforceable. *See Tex. Attorney Gen. v. Brown (In re Fort Worth Osteopathic Hosp.)*, 387 B.R. 706, 710 (Bankr. N.D. Tex. 2008). There, the court concluded that as of the petition date, the debtor owned the policy itself but not the proceeds. *Id*. at 715. Instead, the bankruptcy estate's right to the proceeds arose post-petition under section 541(a)(6),[2] and according to the court, section 541(c)(1) does not invalidate *ipso facto* clauses unless they impact an interest in

[2] Section 541(a)(6) provides that property of the bankruptcy estate includes "[p]roceeds, product, offspring, rents, or profits of or from property of the estate . . . ." 11 U.S.C. § 541(a)(6).

property held by the debtor on the petition date. *Id*. at 713-14. Thus, the court found that the *ipso facto* clause was enforceable and the trustee's claims were excluded from coverage. *Id*. at 715.

3. Order of Payments

An "Order of Payments" provision is commonly included in D&O Insurance policies to govern the priority of payments when amounts are due under more than one insuring agreement. The typical Order of Payments provision requires the insurer to pay Side A claims before paying claims covered by Side B or Side C coverage. This language is most beneficial to Ds&Os when the policy includes Side C coverage. In a policy that includes Side A, Side B and Side C coverage, the provision might read as follows:

> Order of Payments:
>
> In the event of Loss arising from a covered Claims(s) and/or Pre-Claim Inquiry(ies) for which payment is due under the provisions of this policy, the Insurer shall in all events:
>
> (1) First, pay all Loss covered under Insuring Agreement A. *Insured Person Coverage.*
>
> (2) Second, only after payment of Loss has been made pursuant to subparagraph (1) above and to the extent that any amount of the Limit of Liability shall remain available, at the written request of the chief executive officer of the Named Entity, either pay or withhold payment of Loss covered under Insuring Agreement B. *Indemnification of Insured Person Coverage*; and
>
> (3) Lastly, only after payment of Loss has been made pursuant to subparagraphs (1) and (2) above and to the extent that any amount of the Limit of Liability shall remain available at the written request of the chief executive officer of the Named Entity, either pay or withhold payment of Loss covered under Insuring Agreement C. *Organization Coverage*.

The Order of Payments provision becomes particularly important in the bankruptcy context for two reasons. First, the practical reality is that most, if not all, corporate debtors are unable to indemnify Ds&Os for losses. If a policy includes Side A and Side C insuring agreements and existing claims are covered by both, then the Order of Payments provision

dictates the order in which those claims are to be paid. In other words, this provision applies when the insurer owes both the company and its directors and officers. Second, the Order of Payments is critical in the bankruptcy context because it may control whether insured parties (Ds&Os) will be able to access proceeds, or whether the proceeds will be "off limits" as property of the bankruptcy estate. *See, e.g., In re Downey Financial Corp*., 428 B.R. 595, 607 (Bankr. D. Del. 2010) ("Courts generally closely examine the debtor's rights under the terms of the liability insurance policy . . . in order to determine whether holding that the policy proceeds are property of the estate would improperly 'expand the debtor's rights against others beyond what rights existed at the commencement of the case.'"). Where the Order of Payments provision gives priority to Ds&Os, bankruptcy courts are more likely to find that the proceeds do not constitute property of the estate. *See, e.g.*, *In re World Health Alternatives, Inc.*, 369 B.R. 805, 811 (Bankr. D. Del. 2007) (stating that the Order of Payments provision was an obstacle that the Trustee would have to overcome to recover from the policy). This finding, of course, allows Ds&Os to access the proceeds to fund defense costs, but in a wasting policy scenario, reduces the amount of proceeds available to a trustee or post-confirmation trust.

For example, in *In re Downey Financial Corp*., 428 B.R. 595 (Bankr. D. Del. 2010), the policy provided that available limits would fund Side A, Side B and Side C claims, in that order. Before concluding that the proceeds were not property of the estate, however, the court commented on the Order of Payments provision and noted that a determination that the proceeds were property of the estate would effectively grant the estate rights it would not otherwise have. *Id*. at 608. As the court explained: "[s]ection 541(a) 'is not intended to expand [a] debtor's rights against others beyond what rights existed at the commencement of the case.'" *Id*. at 607 (quoting *In re Bake-Line Group, LLC*, 359 B.R. 566 (Bankr. D. Del. 2007)). Because the policy provided

that Side B and C claims were junior to Side A claims, treating the proceeds as property of the estate would elevate the estate's interest in the Side B and C coverage "to become at least equal to the Insureds' interest in [Side] A [coverage] . . . ." *Id*. at 608.

On the other hand, if the language does not clearly place Ds&Os at the front of the line, then bankruptcy courts may be more willing to limit Ds&Os access to defense costs. *See In re Allied Systems Holdings, Inc.*, No. 1:12-11564-CSS [Docket No. 1248] (Bankr. D. Del. June 4, 2013). In *Allied Systems*, the creditors' committee argued that the proceeds were property of the bankruptcy estate because the Order of Payments provision gave priority treatment to the claims of the individual Ds&Os only if losses, in the aggregate, exceeded the policy limits. *In re Allied Systems Holdings, Inc.*, No. 1:12-11564-CSS [Docket No. 1225] (Bankr. D. Del. May 31, 2013). Because there had been no showing that that was the case, the creditors' committee objected to the motion of the Ds&Os to advance defense costs, and asked the court to restrict D&O access to proceeds by imposing reporting requirements. *In re Allied Systems Holdings, Inc.*, No. 1:12-11564-CSS [Docket No. 1196] (Bankr. D. Del. May 28, 2013). Although the court did not find that the proceeds were property of the estate, it did require the directors and officers to satisfy particular reporting requirements. *In re Allied Systems Holdings, Inc.*, No. 1:12-11564-CSS [Docket No. 1248] (Bankr. D. Del. June 4, 2013). Specifically, the court required the insured parties to submit written, quarterly reports detailing the amounts disbursed and incurred, as well as the amount of remaining coverage. *Id*. Other courts have implemented reporting requirements, or have limited the amount of legal fees that could be paid to directors and officers without further court approval. *See, e.g.*, *In re Beach First Nat'l Bancshares, Inc.*, 451 B.R. 406, 411-12 (Bankr. D.S.C. 2011) (cautioning the parties that the recipient of any defense costs that are unreasonable or unnecessary could be subject to disgorgement, and requiring insurer to

review defense counsel's fees for reasonableness and to notify the trustee of the amounts being paid); *In re Laminate Kingdom, LLC*, No. 07-10279-BKC-AJC, 2008 WL 1766637, at *5 (Bankr. S.D. Fla. March 13, 2008) (requiring defense counsel to file a fee application); *In re Arter & Hadden, L.L.P.*, 335 B.R. 666, 674 (Bankr. N.D. Ohio 2005) (same).

III. THE BANKRUPTCY BATTLE FOR D&O INSURANCE PROCEEDS

The battle for D&O Insurance proceeds is common in the context of a bankruptcy. After a company files bankruptcy, Ds&Os are more likely to need the proceeds to defend lawsuits based on their prior actions (or inactions), but they may be surprised to learn that the proceeds are not immediately available because they may constitute property of the bankruptcy estate. In addition to potentially competing with one another for policy proceeds, Ds&Os may also find themselves competing for the policy proceeds with a fiduciary of the bankruptcy estate. And, because most D&O Insurance policies are "wasting" policies, the competition for proceeds during bankruptcy can be (and often is) fierce.

To determine whether, and to what extent, Ds&Os may access D&O Insurance proceeds during a bankruptcy, courts are faced with the following issues: (1) whether the proceeds are property of the estate and, if so, (2) whether the automatic stay should be lifted to allow the directors and officers to access the proceeds anyway. In analyzing these issues, courts consider the language of the policy, including the insuring agreements and other provisions, as well as the facts of the case. It is generally accepted and established that D&O Insurance *policies* constitute property of the estate, but there is a lack of consensus regarding the *proceeds* of D&O Insurance policies.

A. Proceeds are Not Property of the Estate

1. *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391 (5th Cir. 1987).

In *In re Louisiana World Exposition*, the Fifth Circuit emphasized the distinction between owning the *policy* and owning the *proceeds*. 832 F.2d 1391, 1400-01 (5th Cir. 1987). In *Louisiana World*, the court found that the proceeds were not property of the estate and, therefore, allowed the proceeds to be distributed to the Ds&Os. *Id*. at 1398-1401. Prior to seeking an injunction and enforcement of the automatic stay with respect to the proceeds, the creditors' committee filed various complaints against the debtor's Ds&Os, alleging malfeasance and mismanagement, and also named the insurance companies as defendants. *Id*. at 1394. In the complaint seeking an injunction from the bankruptcy court, the creditors' committee acknowledged the legitimacy of the Ds&Os' claims for defense costs. *Id*. However, the committee argued that the automatic stay should preclude access to proceeds because there "may not be enough liability coverage for [the creditors' committee's] damages and the directors' and officers' legal expenses." *Id*.

The policy in question included only Side A and Side B coverage, and the lack of Side C coverage was critical to the court's analysis. *Id*. at 1398-1401. The court distinguished the facts before it from other cases where policies provided the corporation with direct protection against losses. *Id*. at 1399. In those cases, unlike *Louisiana World*, the Fifth Circuit explained that the "estate owns not only the policies, but also the proceeds designated to cover corporate losses or liability." *Id*. at 1400. In addition, the court focused on the plaintiff's identity and purpose for suing, which was that of a creditors' committee attempting to enlarge the debtor's estate. *Id*. Because the suit was initiated on behalf of the estate, as opposed to a third-party plaintiff, the court concluded that allowing the Ds&Os to access proceeds would not increase the estate's

exposure to risk. *Id*. Finally, the court held that the proceeds were not property of the estate, rejecting the notion that proceeds must be property of the estate if the policy is property of the estate. *Id*. at 1401.

2. *In re Allied Digital Technologies, Inc*., 306 B.R. 505 (Bankr. D. Del. 2004) .

In *In re Allied Digital Technologies*, the bankruptcy court authorized the insurer to pay director and officer defense costs because it determined that the proceeds were not property of the bankruptcy estate. 306 B.R. 505, 514 (Bankr. D. Del. 2004). As explained by the court, "the conundrum of this case [was] that both the Trustee, as plaintiff, and the Individual Defendants [sought] to be paid from the same wasting D & O Policy." *Id*. at 508. After acknowledging a lack of consensus among courts regarding whether D&O Insurance proceeds constitute property of the estate, the court stated that the "outcome usually hinges on who is the named insured . . . ." *Id*. at 509-10. The court recognized that if the policy had provided coverage only to Ds&Os, as in *Louisiana World*, then the proceeds would not be property of the estate. *Id*. at 510. Similarly, the court explained that if the policy had provided coverage exclusively and directly to the debtor, then "the proceeds of the policy [would have been] property of the bankruptcy estate." *Id*. at 511. If, however, the policy directly covers both the corporate debtor and its Ds&Os, then the proceeds constitute property of the estate only if "depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from dimunition." *Id*. at 512. Finally, the court held that when the policy provides the debtor company with Side B coverage but indemnification "has not occurred, is hypothetical, or speculative," as was the case, "the proceeds are not property of the bankruptcy estate." *Id*.

Even if it had not determined that the proceeds were property of the estate, the court would have lifted the automatic stay to allow funds to be advanced the Ds&Os for defense costs,

because the Ds&Os had shown that cause existed to do so. *Id*. at 514. Specifically, the court stated that "[w]ithout funding, the Individual Defendants would be prevented from conducting a meaningful defense to the Trustee's claims and may suffer substantial and irreparable harm," and they "bargained for this coverage." *Id*. Additionally, the court pointed out that the Trustee offered no evidence of any claims that "would require direct coverage" and "any payment of defense costs [would] remove any indemnification claim the Individual Defendants would have . . . ." *Id*.

3. *In re World Health Alternatives, Inc*., 369 B.R. 805 (Bankr. D. Del. 2007).

In *World Health Alternatives*, the court denied the trustee's motion for a preliminary injunction because it determined that the trustee was unlikely to succeed on the merits of his claim. 369 B.R. 805, 811 (Bankr. D. Del. 2007). Specifically, the trustee claimed that proceeds were property of the estate and sought a court order enjoining the settlement of certain non-bankruptcy securities litigation. *Id*. at 806. The settlement agreement provided for the payment of $1.7 million from the proceeds of a policy that included Side A, B and C coverage as well as an Order of Payments provision that placed the Ds&Os ahead of the company. *Id*. at 807-08. Once consummated, the settlement would have exhausted most, if not all, of the available coverage, leaving little, if any, for the trustee on account of estate claims against the Ds&Os. *Id*. For this reason, the trustee tried to prevent consummation of the settlement to preserve the policy limits for a potential judgment on the estate's claims. *Id*. at 806.

After reviewing multiple cases, the court was most influenced by *Allied Digital* and concluded that the proceeds did not constitute property of the estate. *Id*. at 809-11. As in *Allied Digital*, the policy in question was a "wasting" policy, and although it provided the debtor with indemnification coverage, no indemnification claims had been made. *Id*. at 809-11. Applying

the rule of law set forth in *Allied Digital,* the court permitted the Ds&Os to utilize the proceeds, thereby exhausting policy limits to settle actions pending outside of bankruptcy. *Id*. at 811. Like the court in *Allied Digital*, the *World Health* court was unwilling to treat the trustee differently than any other "third party plaintiff suing defendants covered by a wasting policy." Thus, if the "Trustee is seeking to recover for wrongs of the defendants in the Trustee's Action pending in this Court, it is not entitled to preference over the settlement of the [securities action]." *Id.* Or, put another way, because the trustee could have recovered only under the "more junior" Side B or Side C coverage, the trustee would not be permitted to access proceeds from Side A coverage.

4. *In re Adelphia Communications Corp*., 298 B.R. 49 (S.D.N.Y. 2003).

In *Adelphia*, a bankruptcy court treated D&O Insurance proceeds as property of the estate but modified the automatic stay to allow insurers to pay "up to $300,000 per insured for defense costs." *In re Adelphia Communications Corp*., 285 B.R. 580, 600 (Bankr. S.D.N.Y. 2002). Directors and officers had been charged with corporate fraud in the management of two debtor corporations. *Id.* at 588. As a result, they sought reimbursement of legal defense costs but were unable to access the proceeds without relief from the automatic stay. *Id*. at 584. Although the bankruptcy court "granted partial relief from the stay," on appeal, the district court determined that the proceeds were not property of the debtors' estates. *In re Adelphia Communications Corp*., 298 B.R. 49, 51-53 (S.D.N.Y. 2003) (remanding and vacating with instructions to determine whether an injunction to "extend the automatic stay" should be issued pursuant to section 105(a) of the Bankruptcy Code).

The district court determined that the proceeds were not property of the debtors' estates for two reasons. First, no indemnification payments had been made nor were any expected to be made, so Side B coverage had not been triggered. *Id*. Second, despite the existence of entity coverage, no actual Side C claims existed. *Id*. Under these circumstances, the court described

the debtors' alleged interest as "akin to a car owner with collision coverage claiming he has the right to proceeds from his policy simply because there is a prospective possibility that his car will collide with another tomorrow, or a living person having a death benefit policy, and claiming his beneficiaries have a property interest in the proceeds even though he remains alive." *Id*.

5. *In re Downey Financial Corp.*, 428 B.R. 595 (Bankr. D. Del. 2010).

In *Downey Financial*, the court determined that the proceeds were not property of the estate and that the Ds&Os could access the proceeds. 428 B.R. 595, 608 (Bankr. D. Del. 2010). Here, eleven of the former Ds&Os sought an order declaring that the automatic stay did not preclude them from using the proceeds to defend securities actions. *Id*. at 598. Alternatively, they sought relief from the automatic stay. *Id*. The securities actions were ultimately dismissed with prejudice, but in state court, shareholder derivate actions were filed against the debtor and certain of its Ds&Os. *Id*. at 601-602. Upon the filing of the bankruptcy, however, the derivative actions were stayed. *Id*. at 602. Similar to the facts in most of the cases discussed above, including *Allied Digital*, this policy provided Sides A, B and C coverage, and was a wasting policy. *Id*. at 600-601. Accordingly, the court began its analysis with a rule similar to that announced in *Allied Digital*, "the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate, but only to the extent that the Policy's indemnification coverage or entity coverage actually protects the estate's other assets from dimunition." *Id*. at 604.

With respect to the policy's entity coverage, the court concluded that it was not "protecting the estate's other assets from dimunition" because no Side C claims existed. *Id*. at 605. The *Downey* court explained that courts generally hold "that the insurance proceeds are not property of the estate" where the "policy includes entity coverage, but there are no covered

Securities Claims outstanding." *Id*. at 604. Here, although a securities class action had been filed against the debtor, among others, it was dismissed and terminated, and the derivative action against the debtor was stayed by the bankruptcy. *Id.* at 604-05. Thus, like the debtor in *Allied Digital*, the debtor in *Downey* "no longer enjoy[ed] any direct entity coverage." *Id*. at 605.

With respect to the indemnification coverage, the court concluded that it was not actually protecting the estate's other assets from dimunition because indemnification was "hypothetical or speculative," and "would not deplete the Policy's proceeds. *Id*. at 606-607. The trustee attempted to show that indemnification was not "hypothetical or speculative" because actual indemnification of $588,000 had been paid pre-petition. *Id*. at 606. The court disagreed, however, because the policy included a $1 million retention. Therefore, as the court pointed out, "no indemnification for which the Debtor would [have been] entitled to coverage under the policy [had] occurred." *Id*.

The *Downey* court's analysis did not end with determining that the proceeds were not property of the estate. Instead, the court took the analysis a step further by adding that it would have lifted the stay even if the proceeds had constituted property of the estate. *Id*. at 608. Among other things, the court found that the debtor's interest in the proceeds, if any, was insufficient to outweigh the prejudice that the Ds&Os would suffer by imposition of the automatic stay. *Id*. at 609. It was important to the court that the policy provided $10 million in coverage and the Ds&Os were only requesting access to $880,000 for defense costs. *Id*. Moreover, the court noted that the Ds&Os had "likely incurred all or nearly all the defense costs that they [would] ever incur in the Securities Class Action." *Id*.

B. Proceeds are Property of the Estate

1. *In re Circle K Corp.*, 121 B.R. 257 (Bankr. D. Ariz. 1990).

In *Circle K Corp.*, the court treated the proceeds as property of the estate because the policies in question included indemnification coverage. 121 B.R. 257, 260 (Bankr. D. Ariz. 1990). The policies provided Side A and Side B coverage, but no Side C coverage. The court placed great weight on the fact that the debtor could possibly "make a claim for reimbursement for indemnification claims paid." *Id.* at 261. In reaching its decision the court found that the policies protected against "dimunition of estate assets" since the debtor's assets would be at risk if the insurer failed to pay Side A claims owing to Ds&Os. *Id.* Based on this finding, the court granted the debtor's request for an injunction against the "prosecution of . . . security litigation affect[ing] the debtor's property interests in a valuable estate asset in violation of the automatic stay." *Id.* In justification of its decision and in addressing the plaintiffs' rights to "seek redress" for securities fraud claims, the court stated that it was "convinced that . . . it would benefit [the] debtor, its estate and thousands of creditors not to divert management's attention or resources into . . . complex issues involving securities law." *Id.* at 262.

2. *In re Vitek, Inc.*, 51 F.3d 530 (5th Cir. 1995).

In *Vitek*, the court acknowledged that the law was unclear in the Fifth Circuit with respect to whether proceeds constitute property of the estate when (1) a policy provides direct coverage to the debtor and the Ds&Os; (2) the rights of the additional insured parties "are *not* merely derivative of the rights of one primary named insured" party (such as, for example, where an insured vendor's rights are completely derivative of the primary insured's rights);[3] and (3) the "aggregate potential liability substantially exceeds the aggregate limits of available insurance coverage." 51 F.3d 530, 535 (5th Cir. 1995). Although the court identified the issue, it left the

[3] *See MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 92 (2d Cir. 1988).

issue unresolved. *Id*. The court decided the case on a different basis, sidestepping the issue altogether. *Id*. The Fifth Circuit found that the district court misapplied "what [the district court] perceived to be a broad, general principle of insurance law" but what the Fifth Circuit doubted as valid. *Id*. at 536-37. However, in dicta, the court seemed to suggest that that if it had reached the issue, it would have held that the proceeds were property of the estate because the policy included Side C coverage. *Id*. at 534. Specifically, the court stated that "[t]he policies [in *Louisiana World*] did *not* afford the debtor corporation any direct coverage for liability to third-party claims," and in that "narrow, factual context, we concluded that the debtor corporation's ownership of the policies was not enough to render the proceeds of those policies property of the corporation's bankruptcy estate." *Id*. (emphasis in original).

3. *In re Sacred Heart Hosp. of Norristown*, 182 B.R. 413 (Bankr. E.D. Pa. 1995).

In *Sacred Heart Hosp.*, in the context of a contested plan confirmation, the bankruptcy court determined that D&O Insurance proceeds were property of the estate. 182 B.R. 413, 418 (Bankr. E.D. Pa. 1995). The court discussed and distinguished *Louisiana World* because the policy before it included Side C coverage, whereas the policy in *Louisiana World* did not. *Id*. at 419-20. The court added, however, that it would "not be inclined" to follow *Louisiana World* even if it could not be distinguished. *Id*. at 420. Instead, the court would have held that the proceeds were property of the estate even if the policy had not included Side C coverage because the debtor could have "been required to indemnify" the Ds&Os. *Id*. Unlike the *Louisiana World* court, this court made no distinction between direct liability coverage to the entity and indemnification coverage because to the *Sacred Heart* court "such an indemnification interest in proceeds is sufficient to bring those proceeds into the estate." *Id*.

4. *In re Jasmine, Ltd.*, 258 B.R. 119 (D.N.J. 2000).

In *Jasmine, Ltd.*, the bankruptcy court held that proceeds were property of the estate where the policy provided Side A and Side B coverage but not Side C coverage. 258 B.R. 119 (D.N.J. 2000). The bankruptcy trustee sought court approval to settle with the insurer after the insurer sought to rescind the D&O policy due to misrepresentations made in the policy renewal application. *Id*. at 122. The Ds&Os objected to the trustee's motion, arguing, *inter alia*, that the trustee lacked authority to extinguish their rights to the proceeds because the proceeds were not property of the estate. *Id*. at 128. Citing *Sacred Heart*, the court determined that the proceeds were property of the estate because the policy provided indemnification coverage. *Id*.

The *Jasmine* court seemed to place greater emphasis on the interest of the bankruptcy estate versus those of the Ds&Os. Like the trustee, the court was concerned that allowing Ds&Os to continue litigating against the insurer would cause the estate to suffer because the litigation costs would likely have outweighed any value realized. *Id*. at 129. Although the court recognized "the unfortunate circumstance befalling the directors and officers of being denied access to $2 million in insurance coverage," it explained, "those proceeds would not be available anyway under a Policy that was deemed void as a result of material misrepresentations on the Policy application." *Id*. Ultimately, the court agreed with the trustee that, "given the likelihood of success on the merits, the proposed settlement of $125,000 represent[ed] the maximum value that the estate could [have] realize[d]." *Id*.

5. *In re CyberMedica, Inc.*, 280 B.R. 12 (Bankr. D. Mass. 2002).

In *CyberMedica*, the court determined that the proceeds were property of the estate but lifted the automatic stay with respect to the proceeds. 280 B.R. 12, 17-19 (Bankr. D. Mass. 2002). The policy in question provided Side A, B, and C coverage. *Id*. at 14. The court began its analysis by acknowledging that "courts are in disagreement on whether or not insurance

proceeds are property of the estate." *Id*. at 16. After discussing different holdings from a number of cases, including *Louisiana World*, the court "adopted the logic of the cases holding that D&O Insurance proceeds are property of the estate." *Id*. at 17. Ultimately, the court applied a "fundamental test" established by the Ninth Circuit and found that the proceeds were property of the estate because "the estate [was] worth more with [the D&O policy] than without it because it insures the Debtor against indemnity and entity claims." *Id*; s*ee also In re Minoco Group of Cos., Ltd*., 799 F.2d 517, 519 (9th Cir. 1986). Next, the court considered whether cause existed to grant relief from the automatic stay. *Id*. at 18. After weighing the harm that would be suffered if defense cost claims were denied in light of the fact that no Side B or Side C claims existed, the court found that cause for stay relief existed. *Id*. In response to the trustee's argument "that there [would] be indemnification claims," the court noted, that notwithstanding, "the Debtor [would] not be harmed because the claims . . . being paid for defense costs are among the claims for which the Debtor is ultimately obligated to indemnify the directors and officers." *Id*. Therefore, the court lifted the stay and allowed payments to be made on claims for defense costs. *Id*.

6. *In re Beach First Nat'l Bancshares*, 451 B.R. 406 (Bankr. D.S.C. 2011).

In *Beach First Nat'l Bancshares*, the policy included Side A, Side B and Side C coverage, and it was a wasting policy. 451 B.R. 406, 408 (Bankr. D.S.C. 2011). Because the debtor, as well as its directors and officers, had a direct interest in the proceeds the court applied the following standard: "the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from dimunition." *Id*. at 409 (citing *Downey Fin. Corp*., 428 B.R. 595, 603 (Bankr. D. Del. 2010)). Because the policy in question was a wasting policy, the court noted that if the "defense costs exhaust[ed] the policy limit, then [the] Debtor could be forced to use other assets of its bankruptcy estate to satisfy any potential claims." *Id*. at 410. Thus, the court concluded

that the applicable standard was satisfied in this case, and "the proceeds constitute[d] property of the estate." *Id*.

C. Not Necessary to Determine Whether Proceeds are Property of the Estate

In *In re MF Global Holdings, Ltd.*, the court made no determination as to whether the proceeds were property of the estate because it found, regardless of whether the proceeds were property of the estate, the stay should be lifted to allow the Ds&Os to access up to $30 million for defense costs. 469 B.R. 177, 181 (Bankr. S.D.N.Y. 2012). The policy in this case was a wasting policy, which was significant to the court's analysis, and it provided all three types of coverage. *Id*. at 183.[4] When the insurer sought authorization from the court to advance defense costs to Ds&Os, objections were made by plaintiffs in a class action that the Ds&Os were defending. *Id*. at 181. Because the policy was a wasting policy and claims for defense costs totaling approximately $8.3 million had already been made, the class action plaintiffs argued that the proceeds were property of the debtor's estate and asked the court to deny relief from the automatic stay. *Id*. at 181-83. The court rejected the plaintiffs' arguments and held that cause for relief existed because the Ds&Os needed access to the proceeds for payment of their defense costs and the debtor's needs, if any, were minimal in comparison. *Id*. at 191-93. However, the court limited the amount of proceeds available for defense costs to $30 million. *Id*. at 197.

In reaching its decision to lift the stay, the court explained that the overall purpose of D&O Insurance is to protect Ds&Os and there was little risk of litigation exposure to the debtors in this case, especially since securities claims had not been filed directly against the debtors. *Id*. at 192. In other words, the court found that the immediate need for defense costs to the Ds&Os "far outweigh[ed] the Debtors' hypothetical or speculative need for coverage." *Id*. Guided by

[4] The policy coverage was $70 million and $120 million, in total, for the 2010-2011 and 2011-2012 policy periods, respectively.

Allied Digital, the court also discussed equitable concerns in support of lifting the automatic stay. *Id*. at 196. In short, the court found that it would be unjust if plaintiffs could prosecute claims against Ds&Os, without interference from the automatic stay, while using the stay to prevent non-debtor Ds&Os from accessing proceeds to cover defense cost claims. *Id*. However, the court did not grant total access to the proceeds. *Id*. at 197. Instead, the court imposed what it described as a "'soft cap' of $30 million for defense costs." *Id*.

IV. CONCLUSION

An overwhelming majority of courts have held that D&O Insurance policies purchased by debtors constitute property of the estate, but courts differ with respect to whether the actual proceeds are property of the bankruptcy estate. With traditional policies, which include Side A and Side B coverage but no Side C coverage, courts disagree. The Fifth Circuit examined this issue in the seminal case *Louisiana World*, and drew a distinction between owning the proceeds and owning the policy. The Fifth Circuit held that the proceeds were not property of the estate because the policy did not directly cover the debtor with Side C coverage. Other courts, such as the *Jasmine* court, disagree with the Fifth Circuit's analysis. Instead, these courts hold that the indemnification (Side B) coverage provides the debtor with a sufficient interest to make the proceeds property of the estate. With respect to nontraditional policies that include Side C coverage, courts also differ in their analysis. However, most courts acknowledge that these policies present the most troubling scenario with respect to the proceeds issue. In *Adelphia Communications*, the court held that the proceeds were not property of the estate even though the policy included entity coverage because no Side C claims existed, but in *In re Vitek* the court seemed to suggest that the inclusion of Side C coverage would be sufficient to bring the proceeds into the estate.

When the entity and its Ds&Os are both directly protected by the policy there is the least amount of consensus among the courts, and it gets even more uncertain in cases where the suit is filed as a derivative action. The battle rages on . . . .

Illegality Defenses

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Importance of Illegality Defense

As discussed in the concurrent portion of this presentation, the doctrine of *in pari delicto* can force debtors in possession or trustees to the deal with the consequences of a debtor's misdeeds. This portion of the presentation is intended to address potential illegality defenses to contract breach, to categorize and classify various types of illegality (although there is substantial overlap between these categories), and to discuss courts' willingness to enforce seemingly legal contracts entered into to effectuate illegal transactions.

The Doctrine of the Illegality Defense

The principle that a contract based on illegal consideration is voidable has its roots in the common law of England, if not earlier.[1] This maxim has also been universally adopted by courts in the United States without exception.

Nearly two centuries ago, the Supreme Court considered whether a plaintiff may recover for breach of contract when the contract is based on illegal consideration:

> Questions upon illegal contracts have arisen very often, both in England and in this country; and no principle is better settled, than that no action can be maintained on a contract, the consideration of which is either wicked in itself, or prohibited by law.[2]

Thus, when consideration for a contract is prohibited by law, the resulting contract is also illegal. "[N]either party to an illegal contract will be aided by the court, whether to enforce it or to set it aside," and even if an illegal contract has been fully performed by one party and remains wholly executory by the other, "neither a court of law nor a court of equity will assist the plaintiff to recover back the property conveyed or money paid under the contract."[3]

More recently, the New York Court of Appeals considered whether a plaintiff could recover on a contract, which appeared to be valid on its face, but which was the fruit of a crime: "Proper and consistent application of a prime and long-settled public policy closes the doors of our courts to those who sue to collect the rewards of corruption."[4] The court explained:

1 *See Mann v. Brady*, 196 P. 346, 350 (Okla. 1921) (Oklahoma Supreme Court cited both English common law and Roman law as the source of the principle).

2 *Armstrong v. Toler*, 24 U.S. 258, 271-272 (1826).

3 *St. Louis R.R. v. Terre Haute R.R.*, 145 U.S. 393, 407 (1892).

4 *McConnell v. Commonwealth Pictures Corp.*, 7 N.Y.2d 465, 469 (N.Y. 1960).

The money plaintiff sues for was the fruit of an admitted crime and no court should be required to serve as paymaster of the wages of crime. … No one shall be permitted to profit by his own fraud, or to take advantage of his own wrong, or to found any claim upon his own iniquity, or to acquire property by his own crime. These maxims are dictated by public policy, have their foundation in universal law administered in all civilized countries, and have nowhere been superseded by statutes.[5]

The Court of Appeals concluded emphatically: "We are not working here with narrow questions of technical law. We are applying fundamental concepts of morality and fair dealing not to be weakened by exceptions."[6]

However, illegality of any sort does not automatically render a contract unenforceable. The mere unlawfulness of an act does not necessarily void all contracts made in contravention of the act. As stated by the Supreme Court more than 150 years ago:

[W]hatever may be the structure of the statute in respect to prohibition and penalty, or penalty alone, that it is not to be taken for granted that the legislature meant that contracts in contravention of it were to be void, in the sense that they were not to be enforced by a court of justice. . . . It is true that a statute containing a prohibition and a penalty, makes the act which it punishes *unlawful*, and the same may be implied from a penalty without a prohibition; but it does not follow that the unlawfulness of the act was meant by the legislature to avoid a contract made in contravention of it.[7]

Thus, proving that a contract provision violates a statute, or was entered into contrary to public policy does not end the inquiry. As stated by the Sixth Circuit Court of Appeals:

While it is frequently asserted that an illegal bargain is void, meaning thereby, presumably, that the situation is just as if no contract had been made, this is not strictly so. What the courts really have done, in such cases, in the absence of a statute specifying otherwise, is to take the view merely that the judicial machinery is not available for use to one who has participated in an illegal transaction.[8]

Thus, the presence of illegality does not automatically nullify a contract. However, as explained below, if a party was a participant in the illegality or is put in the position of the party who know of and committed the illegal transgression, courts will not enforce the underlying contract. Below is a brief summary of various types of illegality along with a summary of courts' application of illegality arguments to facially valid contracts.

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5 *Id.*

6 *Id.* at 470.

7 *Harris v. Runnels*, 53 U.S. 79, 84 (1851) (emphasis in original).

8 *Kermath Mfg. Co. v. Brownell*, 222 F.2d 577, 580 (6th Cir. 1955).

A. Void by Statute or Formed for an Illegal Purpose

Finding a contract illegal and unenforceable based on a penal statute requires three steps. The court must determine (1) what the terms of the contract are; (2) what the statute prohibits; and (3) whether the statute or public policy demands that the contract be deemed unenforceable.[9]

A majority of the cases under this category deal with promissory notes given in exchange for illegal consideration. In general, courts have declared that the statutory violation upon which these contracts were predicated renders those promissory notes unenforceable by either party. Some representative examples of these unenforceable promissory notes are promissory notes given: (a) in exchange for supplies intended for the Confederate government, which were held to be "void *in toto*[;]"[10] (b) in exchange for "spirituous liquors" in violation of a Vermont statute;[11] (c) for the purchase of repackaged fertilizer in violation of Georgia law;[12] (d) in exchange for the unlawful sale of slaves;[13] (e) for the illegal consideration of cutting timber in violation of federal law.[14]

However, a contract formed in violation of a statute is not necessarily automatically void. One prominent example of this is the Supreme Court case of in *St. Louis R.R. v. Terre Haute R.R.*[15] In *St. Louis*, an Indiana railroad company and an Illinois railroad company agreed to allow the Indiana railroad to lease and operate the Illinois railroad company's railroad and equipment for a period of 999 years, in exchange for a share of the profits in contravention of an Illinois statute preventing out of state ownership of Illinois railroads absent the written consent of the Illinois shareholders.[16] Although the contract was *ultra vires* and beyond the corporate powers of the companies at the time it was formed, both parties performed under it for seventeen years.[17] The Illinois railroad then brought suit to void the contract, lost, and appealed to the Supreme Court.[18] The Supreme Court

9 *Peterson v. Sunrider Corp.*, 2002 UT 43 ¶ 27 (Utah 2002).
10 *Hanauer v. Doane*, 79 U.S. 342, 346 (1870).
11 *Converse v. Foster*, 32 Vt. 828, 832 (1860).
12 *Johnston Bros. & Co. v. McConnell*, 65 Ga. 129, 131 (1880).
13 *Shelton v. Marshall*, 16 Tex. 344, 355 (1856).
14 *Swanger v. Mayberry*, 59 Cal. 91, 94 (1881).
15 145 U.S. 393 (1892).
16 *Id.* at 401-02.
17 *Id.* at 407.
18 *Id.* at 397-98.

ruled that the Illinois railroad was *in pari delicto* with the Indiana railroad and could not invoke the assistance of a court of equity to void the contract.[19] Further, because the parties had performed under the contract for 17 years any claim to rescind the contract was barred by laches.[20]

Additional relevant cases on contract formation for an illegal purpose are seen in the sphere of antitrust law. Under the Sherman Act,[21] "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal."[22] Under section one of the Sherman Act, courts in the Tenth Circuit "determine the illegality of a contract, combination or conspiracy by examining whether: (1) it 'constitutes a per se violation of the statute'; or (2) its 'purpose or effect is to create an unreasonable restraint of trade.'"[23]

In sum, if a contract is illegally entered into by the parties in contravention of a statute, a court will not enforce it. A court may also decide not to void the illegal contract if the parties to the contract were both complicit in the illegality.

B. Formed for in an Illegal Manner; or Based on an Illegal Act.

Other contracts are unenforceable because those contracts were formed in an illegal manner or contemplate the performance of an illegal act or violate public policy.

The paradigm example of a contract formed in an illegal manner is a contract formed because of the payment of a bribe. Simply put, a contract formed because of a bribe is illegal and unenforceable by the person who paid the bribe. Similarly, a person convicted of bribery has no right to have the bribe money returned to him.[24]

Courts will also not aid those whose cause of action is based upon an illegal act.[25] In *United States v.*

19 *Id.* at 407.

20 *Id.*

21 15 U.S.C. §§ 1-7.

22 15 U.S.C. § 1.

23 *TV Comm'ns Network, Inc. v. Turner Network Television, Inc.*, 964 F.2d 1022, 1027 (10th Cir. 1992); *citing Cayman Exploration Corp. v. United Gas Pipe Line Co.*, 873 F.2d 1357, 1359 (10th Cir. 1989).

24 *Clark v. United States*, 102 U.S. 322, 331-32 (1880).

25 *United States v. Farrell*, 606 F.2d 1341, 1349 (D.C. 1979) (internal citations omitted).

Farrell,[26] the appellant, who was convicted of attempting to distribute heroin, filed a motion seeking the return of $5,000 that he "voluntarily paid to an undercover police officer in the mistaken belief that the officer would deliver him some very pure heroin . . . ."[27] The government (unsurprisingly) opposed returning the money to the attempted drug distributor arguing that the money was an instrumentality of crime and because appellant was no more entitled to the money than a convicted briber is entitled to recover sums paid in bribes.[28] Because the $5,000 was derivative contraband – not inherently illegal on its own – no statute mandated forfeiture of the money to the drug trafficker.[29] The *Farrell* Court relied on a corollary of the government's bribery argument and used public policy to conclude that the trafficker would not be aided by the court in any attempt to recover the $5,000 that he illegally paid.[30]

C. Attempts to Enforce Seemingly Valid Contracts Predicated on Underlying Illegality

A contract can also be facially valid, but nevertheless may be unenforceable by a trustee or a debtor in possession. As stated by the California Supreme Court:

> A bargain may be illegal by reason of the wrongful purpose of one or both of the parties making it. This is true even though the performances bargained for are not in themselves illegal and even though in the absence of the illegal purpose the bargain would be valid and enforceable. A party who makes such bargain in furtherance of his wrongful conduct cannot enforce it . . . .[31]

This standard has been applied to prevent parties from enforcing provisions of facially valid agreements, which were entered into in the context of an illegal venture.[32] This concept has caused courts to assess the underlying motivation of the parties when forming the contract to determine whether the party seeking to enforce the contract had an illegal purpose when it entered into the contract.[33]

26 606 F.2d 1341 (D.C. 1979)

27 *Id.* at 1343.

28 *Id.*

29 *Id.* at 1344-45.

30 *Id.* at 1349-50.

31 *Tri-Q, Inc. v. Sta-Hi Corp.*, 63 Cal.2d 199, 404 P.2d 486, 498 (1965).

32 *See Sender v. Simon*, 84 F.3d 1299 (10th Cir. 1996) (holding that trustee could not enforce partnership agreement entered into in the context of a Ponzi scheme); *Rutkin v. Reinfeld*, 229 F.2d 248 (2d. Cir. 1955) (holding that partner in an illegal bootlegging operation could not enforce any rights depending on the partnership agreement).

33 *See Guardian Title Agency, LLC v. Matrix Capital Bank*, 141 F.Supp.2d 1277, 1282 (D. Colo. 2001) (refusing to enforce contract when plaintiff failed to require "good funds" for real estate transaction in violation of state

In *Sender v. Simon*,[34] the Tenth Circuit addressed enforcement of a facially valid contract in the context of underlying illegality. In *Sender*, the trustee, who was charged with administering the estate of the Hedged-Investment, Inc. ("HIA") Ponzi scheme, brought an action under Colorado law to avoid payments made to certain limited partners of a limited partnership in which HIA was the managing general partner.[35] Although the Tenth Circuit acknowledged that the partnership agreements, which formed the basis for the trustee's claims, were facially valid, it concluded that the partnerships were created and operated to further the debtor's underlying Ponzi scheme.[36] The Tenth Circuit refused to enforce the partnership agreements and affirmed the district court's summary judgment in favor of the defendants stating:

> this court will not aid the effort of a fraudulent entity that used the trappings of legal formality to lure its victims to turn around and try to hold its victims accountable under those same legal formalities.[37]

In sum, courts will look beyond the facial validity of a contract and evaluate the underlying motivation of parties to a contract to determine whether to enforce a facially valid contract.

D. Application to Bankruptcy Practice

Courts will refuse to lend their aid to a guilty party seeking to enforce an illegal contract. While those contracts are generally not void *ab initio*, courts will rely on the principle of *in pari delicto* to avoid making a ruling which benefits a guilty party to an illegal contract. Thus, because the debtor in possession or the trustee stands in the shoes of the debtor, a pre-petition debtor's misdeeds can prevent recovery even on a superficially valid claim.

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statute).

34 84 F.3d 1299 (10th Cir. 1996).

35 *Id.* at 1301, 1305-06.

36 *Id.* at 1307.

37 *Id.* at 1308.

Parallel Civil and Criminal Proceedings and the 5th Amendment Conundrum

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I. Introduction

Bankruptcy practitioners generally do not encounter the Fifth Amendment privilege on a regular basis and may be somewhat dumbfounded when a witness asserts this privilege either in the context of a meeting of creditors, Rule 2004 examination, or during an evidentiary hearing. Often times, both the inquisitor and the counsel for the party claiming the Fifth Amendment privilege are surprised that the witness has claimed the Fifth Amendment privilege. Consequently, they are left scratching their heads trying to resuscitate from the deep regions of their mind what they learned in law school during criminal law class. Moreover, the bankruptcy judge may not have enough information in the case so as to adequately be informed as to whether the privilege is even a valid assertion of the privilege.

The term "parallel proceeding" refers to two proceedings – one civil in nature (and here we are discussing bankruptcy as the civil proceeding) and the other criminal – when a person or business entity is involved in simultaneous litigation in related, but not necessarily identical, controversies.[3] While dealing with the Fifth Amendment issues, counsel or the trustee may also be dealing with the interplay of an ongoing criminal investigation. This article does not address the obvious ethical concerns of trying to settle civil proceedings while the criminal investigation is ongoing. However, this article attempts to convey some of the basics and some of the concerns that bankruptcy counsel should be aware of in litigating in the face of the Fifth Amendment privilege.

II. The Basics of the Assertion of the Fifth Amendment Privilege

A. The Fifth Amendment Privilege

As a predicate for understanding the Fifth Amendment in the context of parallel proceedings counsel needs to have a basic understanding of the Fifth Amendment privilege.[4] Simply stated, "[t]he Fifth Amendment privilege against self-incrimination protects an individual from being compelled to give testimony that may be incriminating or that may provide a link in the chain of evidence that tends to establish guilt of a crime and that the witness reasonably believes could be used in a criminal prosecution."[5]

The Fifth Amendment may be invoked in the course of any proceeding, civil or criminal.[6] Specifically, the Fifth Amendment may be invoked in a bankruptcy proceeding.[7] The privilege applies to protect an individual from any incriminating testimony and even non-verbal communications. Moreover, this privilege "protects against any disclosures which the witness reasonably believes could be used in a criminal prosecution [against the individual] or could lead to other evidence that might be so used."[8]

B. Who May Claim the Privilege?

The Fifth Amendment privilege "is a personal privilege: it adheres basically to the person, not to the information that may incriminate him."[9] The Fifth Amendment does not protect artificial entities.[10] Moreover, a custodian of corporate records may not refuse to produce

corporate documents on the basis of an individual privilege against self-incrimination, even if the documents incriminate the custodian.[11]

C. To What Does the Privilege Apply?

Something that is often lost on counsel is that the contents of documents and records are *never* privileged under the Fifth Amendment.[12] The distinction is that, while the contents of a document may not be privileged, the act of producing documents is within the scope of the privilege.[13] This presents a unique situation in the context of the debtor who files for relief under the Bankruptcy Code[14] because of the requirements of disclosure and transparency necessary to obtain the relief sought in bankruptcy.[15]

The privilege only applies to compelled communications. Arguably, the voluntary act of filing bankruptcy, itself, puts into question whether a voluntary Chapter 7 individual debtor can actually assert the privilege with anything related to the filing of the bankruptcy case. A person cannot claim the privilege as to the contents of personal records that he has already prepared because no form of compulsion is involved.

D. Asserting the Privilege

The party invoking the Fifth Amendment privilege, is not entitled to a blanket invocation of the privilege, but must make a specific showing that a response "will pose a substantial and real hazard of subjecting [the individual] to criminal liability."[16] Also, the witness is not simply relieved from answering a question because the witness asserts the privilege; the witness has some minimal burden to justify the invocation of the privilege.[17]

When a witness asserts the Fifth Amendment, courts usually address the matter as it comes up during the course of discovery or trial.[18] That is, the Court, at least in the context of a trial, will usually make the witness go through the process of testifying and asserting the privilege where appropriate. Consequently, a witness may have to answer questions related to their name, address, and questions where the privilege is not being asserted. But, when it comes to the incriminating questions, the witness will assert the privilege to the individual questions.

The person invoking the privilege must establish that the risk of incrimination resulting from their testimonial communications must be more than a product of their own active imagination and must be "substantial and real.[19] The Fifth Amendment privilege ceases to apply once the witness has been convicted of the offense which he fears incrimination.[20] However, if an appeal of the conviction is pending, the witness may still claim the privilege.

III. The Fifth Amendment in Bankruptcy

A. Application of the Fifth Amendment in Bankruptcy

In the context of bankruptcy, parallel proceedings – where criminal and civil may converge – often arise in the context of adversary proceedings brought under 11 U.S.C. §§ 523 and 727.[21] An individual can invoke the Fifth Amendment in a bankruptcy proceeding.[22] When a person invokes the Fifth Amendment, the court should consider the matter and then issue a judicial ruling on the validity of the claim.[23] Once the court rules, the court should permit the witness an opportunity to either continue to invoke the privilege or accept the consequences of not testifying.[24]

B. Chapter 7 Individual Debtors

"The purpose of the Bankruptcy Code is to provide the honest, but unfortunate debtor a fresh start."[25] Because a discharge is the "heart of the fresh start provisions of the bankruptcy law,"[26] when a debtor fails to comply with bankruptcy court's orders to compel discovery or otherwise testify the debtor may be at risk of being denied a discharge.[27]

The difficulty for individuals in addressing parallel civil and criminal proceedings is not whether there is a right to invoke the privilege; it is whether they should invoke the privilege.[28] Simply put, the privilege "can be asserted in any proceeding, civil or criminal, administrative or judicial, investigatory or adjudicatory; and it protects against any disclosure which the witness reasonably believes could be used in a criminal prosecution or could lead to other evidence that might be so used."[29]

Notably, although the Fifth Amendment privilege gives a defendant in a criminal matter an absolute right to not testify, it does not confer such a right in bankruptcy matters. Moreover, in defending either a section 523 matter or a 727 matter, the only way a bankruptcy defendant can really defend against the allegations is by revealing that which he would otherwise not be compelled to testify to in a criminal matter.

By way of example, under 11 U.S.C. § 727(a)(6),[30] a debtor's failure to comply with a bankruptcy court's discovery order can be an independent ground for denying discharge of a debt.[31] In the context of discovery, the bankruptcy court may deny a debtor a discharge if he or she has "refused to" obey a lawful order of the court.[32] The court may also deny a debtor's discharge if the debtor willfully or intentionally refuses to testify after improperly asserting the Fifth Amendment.[33]

C. Adverse Inference

The effect of not testifying in a *criminal matter* cannot confer an adverse inference on the defendant; however, in a bankruptcy adversary proceeding the court *can make an adverse inference from the failure to testify*. As the Tenth Circuit noted in *In re Martinez*:

> While we are cognizant the Bankruptcy Code, including § 727, must be construed liberally in favor of the debtor because denial of a discharge is an extreme penalty, we also acknowledge § 727(a)(6) is intended to give the bankruptcy court a means to ensure the debtor is straightforward in dealings with creditors and complies with its orders. Denial of discharge under § 727(a)(6) for refusing to obey a court order follows the general proposition that the court order "must be obeyed by the parties until it is reversed by order and property proceedings."
>
> With this said, this court also recognizes that "[w]hen the Fifth Amendment privilege is invoked …, the person claiming its protection ordinarily 'receives a judicial ruling at that time on the validity of his claim, and … an opportunity to reconsider it before being [penalized] for refusal to answer.'" "Not affording one who asserts the privilege an opportunity to answer, once his claim of privilege has been rejected is to penalize him merely for asserting the privilege." But once the noncomplying party has an opportunity to reconsider whether to testify in contradiction of a judicial ruling on the Fifth Amendment privilege and then continues to refuse, he or she may be denied certain benefits and exposed to negative consequence as a result of improperly reinvoking the privilege.[34]

When a witness testifies and asserts the Fifth Amendment privilege, the court, at its discretion, may find that a witness' refusal to answer the question is a basis for a finding that the witness would have answered in a self-incriminating way.[35] The Second Circuit has held that when a court makes an adverse inference it must appropriately focus on the circumstances of the case.[36] Moreover, to determine if the adverse inference is trustworthy, the court might consider whether it is corroborated by independent and admissible evidence.[37] The creditor or trustee that is pursuing the adversary would be seeking to move forward with the litigation and the adverse inference while the Debtor, as set out below, will seek a stay.

Courts also draw adverse inferences from a witness's failure to produce documents.[38] An adverse inference can be made when some of these nonexclusive factors are present:

> (1) It appears that the documentary evidence exists or existed; (2) the suppressing party has possession or control of the evidence; (3) the evidence is available to the suppressing party, but not to the party seeking production; and (4) it appears that there has been actual suppression or withholding of evidence.[39]

Consequently, the only options for an individual confronting parallel civil and criminal proceedings and the conundrum presented by the adverse inferences that may be taken is to either: (1) seek a stay of the bankruptcy proceeding and adversary proceeding until the criminal matter may be concluded; or (2) enter into a protective order limiting the use of statements the individual makes in the course of the civil case. More often than not, the stay option is the best for the Debtor for several reasons. First, it allows the Debtor to use his or her limited resources to defend the criminal case. Second, it limits the risk of another Court taking a different view on the effect of the protective order. Third, it allows the Debtor to determine whether or not he wants to pay to defend the adversary. For example, if the Debtor is convicted in the criminal

case, and sentenced to jail, or loses his or her principal livelihood, the discharge issue may be of minor importance.

IV. Stay of the Civil Proceeding When Criminal Investigation is Ongoing or Criminal Case is Pending

Parallel bankruptcy proceedings and criminal proceedings present a very serious problem for debtors. That is, if the individual waives the privilege in order to defend a civil action on its merits, the statements he or she makes can be used against him or her in a criminal proceeding. But, if the Fifth Amendment is pled, there can essentially be the imposition of an economic death penalty, the denial of discharge under 11 U.S.C. § 727.

A bankruptcy court may stay a bankruptcy proceeding when the proceeding may expose the party to possible exposure in a criminal matter. In instances where this has occurred, the Court looks to the facts of the civil and criminal cases to ascertain if they are similar enough that a stay should be granted.[40] The Ninth Circuit, in *Keating v. Office of Thrift Supervision*,[41] identified six factors to consider when staying a civil proceeding. In considering these factors the Ninth Circuit advised that courts should analyze the extent to which the defendant's Fifth Amendment rights are implicated, as well as the following non-exhaustive factors:

> (1) the interest of the plaintiffs in proceeding expeditiously with [the] litigation or any particular aspect of it, and the potential prejudice to plaintiffs of a delay;
> (2) the burden which any particular aspect of the proceedings may impose on defendants;
> (3) the convenience of the court in the management of its cases, and the efficient use of judicial resources;
> (4) the interests of persons not parties to the civil litigation; and
> (5) the interest of the public in the pending civil and criminal litigation.[42]

If there is a pending criminal indictment, the factors can become much clearer for a judge to determine. For example, an unrelated criminal proceeding would weigh against a stay. More commonly, the fact patterns underlying the indictment and the adversary are very similar. If there is an ongoing investigation but no indictment, the burden on the debtor to demonstrate that the fact patterns are intertwined is a little more difficult.

V. Competent Representation

A. Advising a Client as to the Consequence of Filing Bankruptcy

Debtors who seek the protections of Title 11 should be aware that by filing bankruptcy, they must do so with utmost disclosure and transparency of their affairs. Moreover, if there is a likelihood that there is a criminal proceeding that may be going forward contemporaneously with the bankruptcy case, the debtor must realize that he or she may be giving creditors the opportunity to investigate their financial affairs. Criminal counsel should be part of the filing discussion so that the Debtor is properly advised prior to filing. In addition, if the debtor is considering a filing under Chapter 11, rather than Chapter 7, the viability of the debtor remaining

as a debtor in possession needs to be considered. It is extremely unlikely that a court or the United States Trustee will allow a fiduciary that is the subject of a criminal investigation to remain in that fiduciary capacity.

Counsel should assess whether it is prudent to file a bankruptcy case if the potential debtor is facing possible prosecution or is in the midst of a criminal proceeding. It may be wise to delay the bankruptcy filing altogether if resolution of the criminal proceeding may open the door to available defenses in bankruptcy and the relief bankruptcy affords.

B. Seeking Wise Counsel When the Fifth Amendment Appears

Because bankruptcy counsel often rarely deals with the nuances presented by the assertion or non-assertion of the Fifth Amendment privilege in the context of a bankruptcy case, if the issue is presented or could be presented, one should confer with criminal counsel if the instance may arise or actually arises in a case.[43] The privilege is not without limitations or exception and able counsel must be engaged to ascertain when the privilege should be invoked or not.[44] Moreover, one cannot rely on the bankruptcy court or the U.S. Trustee in educating as to the Fifth Amendment during the course of proceedings.[45]

C. Creditors and Trustees

Creditors and bankruptcy trustees must realize that there are limitations on the invocation of the Fifth Amendment in bankruptcy. Creditors and trustees can often obtain information without the defense of privilege impeding their actions when the documents are available or when a custodian holds the documents. Moreover, creditors and trustees must be able to distinguish to whom and when the privilege is applicable. Often, the privilege is claimed as a screen to legitimate discovery and/or testimony at trial.

D. 11 U.S.C. § 344

When information is essential to the fair administration of the bankruptcy case, immunity can be granted under 11 U.S.C. § 344.[46] However, such immunity must be requested by the U.S. Attorney by means of an application to the district court in which the bankruptcy case is pending. Moreover, immunity can be granted to the debtor or any other person, however, such immunity is subject to certain fairly limited conditions.[47] Moreover, even though 11 U.S.C. § 344 seems to grant immunity for testimony in a bankruptcy case or adversary proceeding, counsel should be fully informed as to the consequences of 11 U.S.C. § 344.[48] The likelihood of a bankruptcy judge actually granting immunity is relatively slim. Moreover, the legislative history reflects the fairly limited scope of 11 U.S.C. § 344.[49] The Court will likely defer to the Court where the criminal proceeding or investigation is pending. It is unlikely that the bankruptcy court will want to interfere in the criminal prosecution. The Trustee will, at the same time, cooperate with the criminal investigators and would generally defer to requests from the prosecutors or investigators.

VI. Closing Comments

As with all legal matters an effective strategy must be plotted before a successful outcome can be reached. The assertion of the Fifth Amendment should be anticipated by counsel as one of the many defenses available to a debtor. For counsel representing a debtor who may be subject to criminal prosecution, the Fifth Amendment and its ramifications must be considered before even filing a bankruptcy case. Timing will be of the essence and may result in the effective use of the Fifth Amendment privilege. Or, if timing and the Fifth Amendment are not considered by counsel for the debtor, it may result in significant detrimental consequences in the bankruptcy case and/or the criminal proceeding. For trustees and creditors presented with the assertion of the Fifth Amendment, considerations must be made in advance of prosecuting the matter to effectively prosecute actions brought against the debtor.

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[3] Craig Peyton Gaumer, *Principles of, and Problems With, Parallel Bankruptcy and Criminal Proceeding, Materials for Annual Spring Meeting*, American Bankruptcy Institute, April 27, 2000.

[4] The Fifth Amendment provides:

> No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a grand jury, except in cases arising in the land or naval forces, or in the militia, when in actual service in time of war or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

U.S. Const. amend. V.

[5] Allan B. Diamond and Erin Jones, *Avoiding Litigation Pitfalls: An Introduction to the Fifth Amendment Privilege Against Self-Incrimination in Bankruptcy Proceedings*, 27 Am. Bankr.Inst. J. 20 (April, 2008).

[6] *See, e.g., Lefkowitz v. Cunningham,* 431 U.S. 801, 805 (1977); *Bank One of Cleveland, N.A. v. Abbe,* 916 F.2d 1067, 1074 (6th Cir. 1990); *Thomas v. Tyler,* 841 F.Supp. 1119, 1124 (D. Kan. 1993); *See also, In re Lindsey*, 229 B.R. 797, 801 (10th Cir. BAP 1999) (citing *Kastigar v. United States*, 406 U.S. 441, 442 (1972)).

[7] *In re Sharp*, 361 B.R. 559, 566 (10th Cir. BAP 2007).

[8] *Lindsey*, 229 B.R. at 801 (quoting *Kastigar v. United States*, 406 U.S. at 444-45).

[9] *Couch v. U.S.*, 409 U.S. 322, 328 (1973).

[10] *Braswell v. United States*, 487 U.S. 99, 103-105 (1988).

[11] *Id.,* at 110 (The Supreme Court concluded that the custodian of a corporation is acting in a representative capacity for the corporation).

[12] *United States v. Doe*, 465 U.S. 605, 617 n. 18 (1984).

[13] *In re Blinder, Robinson & Co., Inc.,* 140 B.R. 790, 793 (D. Colo. 1992) (in limited circumstances, document production can be testimonial).

[14] 11 U.S.C. § 101, et seq.

[15] By way of example, the Bankruptcy Code defines "property of the estate" to include "all legal or equitable interest of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). The debtor must "surrender to the trustee all property of the estate and any recorded information … relating to property of the estate." 11 U.S.C. 521(4). The Federal Rules of Bankruptcy Procedure further set forth requirements for disclosures in bankruptcy. *See also, e.g.,* Fed. R. Bankr.P. 1007 ("Lists, Schedules, Statements, and Other Documents…"), 1008 ("Verification of Petitions and Accompanying Papers"), and 1009 ("Amendments of Voluntary Petitions, Lists, Schedules and Statements").

[16] *Lindsey*, 229 B.R. at 801 (quoting *United States v. Schmidt,* 816 F.2d 1477, 1482 (10th Cir. 1987)).

[17] *Hoffman v. United States*, 341 U.S. 479, 486 (1951).

[18] *In re Larson*, 466 B.R. 147, 151 (10th Cir. BAP 2012).

[19] *Marchetti v. United* States, 390 U.S. 39 (1968). One court examined it this way:

> It is for the court to decide whether a witness' silence is justified and to require him to answer if it clearly appears to the court that the witness asserting the privilege is mistaken as to its validity. The valid assertion of the Fifth Amendment privilege exists where a witness has reasonable cause to apprehend a real danger of incrimination. A witness must, however, show a "real danger," and not a mere imaginary, remote or speculative possibility of prosecution. While the privilege is to be accorded liberal application, the court may order a witness to answer if it clearly appears that he is mistaken as to the justification for the privilege in advancing his claim as a subterfuge. A blanket assertion of the privilege by a witness is not sufficient to meet the reasonable cause requirement

> and the privilege cannot be claimed in advance of the questions. The privilege must be asserted by a witness with respect to particular questions, and in each instance, the court must determine the propriety of the refusal to testify.

Lindsey, 229 B.R. at 801 (citations omitted).

[20] *Lindsey*, 229 B.R. at 802.

[21] Specifically, some non-exclusive examples of when adversary proceedings bump up against criminal matters include matters include adversary proceedings brought under the following:

> (a) 11 U.S.C. § 523(a)(2) - which provides that a debt may be determined nondischargeable:
>
> > (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
> > (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;
> > (B) use of a statement in writing—
> > (i) that is materially false;
> > (ii) respecting the debtor's or an insider's financial condition;
> > (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
> > (iv) that the debtor caused to be made or published with intent to deceive;
>
> (b) 11 U.S.C. § 523(a)(4) - whereby debts for "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny" may be determined nondischargeable.
>
> (c) 11 U.S.C. § 523(a)(6) - which provides that a debt may be determined nondischargeable for "willful and malicious injury by the debtor to another entity or to the property of another entity."
>
> (d) 11 U.S.C. § 727(a)(2) - which provides that a discharge may be denied where the debtor, "with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed – (A) property of the debtor, within one year before the date of the filing of the petition; or (B) property of the estate, after the date of the filing of the petition."

[22] *In re Sharp*, 361 B.R. at 566.

[23] *Id.*

[24] *Id.* As one court noted, "[n]ot affording one who asserts the privilege an opportunity to answer, once his claim of privilege has been rejected, is to penalize him merely for asserting the privilege." *Rogers v. Webster,* 776 F.2d 607, 612 (6th Cir. 1985).

[25] *Dalton v. Internal Revenue Service (In re Dalton)*, 77 F.3d 1297, 1300 (10th Cir. 1996).

[26] *Id.* (quoting *Rosen v. Besner*, 996 F.2d 1527, 1531 (3d Cir. 1993).

[27] *Id.*; see 11 U.S.C. § 727(a)(6)(a debtor's failure to comply with court orders may result in denial of discharge).

[28] Susan W. Benner and Lori E. Shaw, *Federal Grand Jury: A Guide to Law and Practice,* 2 Fed. Grand Jury § 25:4 (2d Ed. Oct. 2013).

[29] *Id.* (quoting *Kastigar v. United States,* 406 U.S. 441, 444-45 (1972).

[30] 11 U.S.C. §727(a)(6) provides that a discharge may be denied if:

> (6) the debtor has refused, in the case—
> (A) to obey any lawful order of the court, other than an order to respond to a material question or to testify;
> (B) on the ground of privilege against self-incrimination, to respond to a material question approved by the court or to testify, after the debtor has been granted immunity with respect to the matter concerning which such privilege was invoked; or
> (C) on a ground other than the properly invoked privilege against self-incrimination, to respond to a material question approved by the court or to testify.

[31] *In re Martinez*, 126 Fed.Appx. 890, 896 (10th Cir. 2005).

[32] In *Martinez*, the Court noted that:

> The word "refuse," in the context of § 727(a)(6), "requires the Court to go further than to simply find that a debtor failed to comply with a discovery request. Rather, it must find that the disobedience was willful or intentional."

Id.

[33] 11 U.S.C. § 727(a)(6)(C); *In re Connelly*, 59 B.R. 421, 446 (Bankr. N.D. Ill. 1986).

[34] *Martinez*, 126 Fed. Appx. at 897.

[35] Allan B. Diamond and Erin Jones, *Avoiding Litigations Pitfalls: An Introduction to the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 27 Am.Bankr.Inst.J. 20 (2008).

[36] *Libutti v. United States*, 107 F.3d 110 (2d Cir. 1997). The Second Circuit suggested the following nonexhaustive list of factors to guide a court in determining whether an adverse inference is appropriate under the circumstance when a nonparty invokes the privilege: (1) the nature of the relationship between the party and the nonparty; (2) the degree to which the party controls the nonparty; (3) the compatibility of interest of the party and the nonparty in the outcome of the litigation; and (4) the roles of the nonparty witness in the litigation. *Id.* at 123.

[37] *Rudey-Glanzer v. Glanze*r, 232 F.3d 1258, 1264 (9th Cir. 2000); *LaSalle Bank Lake View v. Seguban*, 54 F.3d 387, 391 (7th Cir. 1995).

[38] E*vans v. Robbins*, 897 F.2d 966, 970 (8th Cir. 1990).

[39] *Id*. at 970.

[40] *See e.g., Campbell v. Eastland*, 307 F.2d 478, 487-488 (5th Cir. 1962).

[41] 45 F.3d 322, 324-35 (9th Cir. 1995).

[42] *Id.* at 325. This framework has been adopted by several jurisdictions. *See, e.g., S.E.C. v. Nicholas*, 569 F. Supp. 2d 1065, 1068-69, 1072 (C.D. Cal. 2008) and *Sterling Nat. Bank v. A-1 Hotels Intern., Inc*., 175 F. Supp. 2d 573, 576 (S.D.N.Y. 2001).

[43] Colo. Rule of Prof. Conduct 1.1 provides: "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

[44] Allan B. Diamond and Erin Jones, *Avoiding Litigations Pitfalls: An Introduction to the Fifth Amendment Privilege against Self-Incrimination in Bankruptcy Proceedings*, 27 Am. Bankr.Inst. J. at 64.

[45] *See, In re Skobinsky*, 167 B.R. 45, 48-49 (E.D. Pa. 1994).

[46] 11 U.S.C. § 344 provides that:

> Immunity for persons required to submit to examination, to testify, or to provide information in a case under this title may be granted under part V of title 18.

[47] *See e.g., In re Minton Group, Inc*., 43 B.R. 705, 708-09 (Bankr. S.D. N.Y. 1984).

[49] The House report for the Bankruptcy Reform Act of 1978 provided:

> Part V of title 18 of the United States Code governs the granting of immunity to witnesses before Federal tribunals. The immunity provided under part V is only use immunity, not transactional immunity. Part V applies to all proceedings before Federal courts, before Federal grand juries, before administrative agencies, and before Congressional committees. It requires the Attorney General or the U. S. attorney to request or to approve any grant of immunity, whether before a court, grand jury, agency, or congressional committee.
>
> This section carries Part V over into bankruptcy cases. Thus, for a witness to be ordered to testify before a bankruptcy court in spite of a claim of privilege, the U. S. attorney for the district in which the court sits would have to request from the district court for that district the immunity order. The rule would apply to both debtors, creditors, and any other witnesses in a bankruptcy case. If the immunity were granted, the witness would be required to testify. If not, he could claim the privilege against self-incrimination.
>
> Part V is a significant departure from current law. Under section 7a(10) of the Bankruptcy Act, a debtor is required to testify in all circumstances, but any testimony he gives may not be used against him in any criminal proceeding, except testimony given in any hearing on objections to discharge. With that exception, section 7a(10) amounts to a

> blanket grant of use immunity to all debtors. Immunity for other witnesses in bankruptcy courts today is governed by Part V of title 18.
>
> The consequences of a claim of privileges by a debtor under proposed law and under current law differ as well. Under section 14c(6) of current law, any refusal to answer a material question approved by the court will result in the denial of a discharge, even if the refusal is based on the privilege against self incrimination. Thus, the debtor is confronted with the choice between losing his discharge and opening himself up to possible criminal prosecution.
>
> Under section 727(a)(6) of the proposed title 11, a debtor is only denied a discharge if he refuses to testify after having been granted immunity. If the debtor claims the privilege and the U. S. attorney does not request immunity from the district courts, then the debtor may refuse to testify and still retain his right to a discharge. It removes the Scylla and Charybdis choice for debtors that exists under the Bankruptcy Act.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 332-333 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 43-44 (1978).

The *In Pari Delicto* Defense in Bankruptcy

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I. The Doctrine of *In Pari Delicto* – A Primer

A. The Doctrine Defined

The doctrine of *in pari delicto* derives from the Latin, *in pari delicto potior est conditio defendentis*. In modern English this means "[i]n a case of equal or mutual fault … the position of the [defending] party … is the better one."[3] This common-law doctrine "asserts the principle that a participant in illegal, fraudulent or inequitable conduct cannot recover from another participant in that conduct."[4] Thus, courts have concluded that "[t]he law will aid neither but rather, will leave them where it finds them."[5] Simply put: If two people enter into a scheme to conspire to commit fraud, one of the schemers cannot sue the other for damages he or she suffered based on the accomplice's conduct.[6]

As noted by the Supreme Court in *Bateman Eichler, Hill Richards, Inc. v. Berner*: "The [*in pari delicto*] 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 wrongdoing is an effective means of deterring illegality."[7] The Court further noted that:

> In its classic formulation, the *in pari delicto* defense was narrowly limited to situations where the plaintiff truly bore at least substantially equal responsibility for his injury, because "in cases where both parties are in delicto, concurring in an illegal act, it does not always follow that they stand in *pari delicto*; for there may be, and often are very different degrees of their guilt.
> …
> Notwithstanding these traditional limitations, many courts have given the *in pari delicto* defense a broad application to bar actions where plaintiffs simply have been involved generally in "the same sort of wrongdoing" as defendants.[8]

The Supreme Court has further noted that like all equitable doctrines, courts "are not bound by formula or restrained by any limitation that tends to trammel the free and just exercise of discretion."[9] Despite the historical limited application of the doctrine of *in pari delicto*, it appears that both federal and state courts considering the doctrine have often limited a bankruptcy trustee's ability to seek actions against defendants that have participated in the same wrongdoing as the debtor.[10] Moreover, this limitation has been applied to creditors committees when suing on behalf of the debtor.[11]

B. Why is the Doctrine of *In Pari Delicto* Showing Up More Frequently?

In recent years with the exposure of many Ponzi schemes following the decline of the world economy in 2008 and the years that followed, bankruptcy trustees and state court receivers have been faced with pursuing third parties for their participation and/or contributions to the fraudulent Ponzi scheme. By way of example, an entire course on the subject of *in pari delicto* doctrine can be surmised from litigation involving Bernie Madoff, Allen Stanford, and others. As this article will address, because trustees stand in the shoes of the debtor, defendants

frequently assert the defense of the *in pari delicto* doctrine … often effectively. This paper will discuss the history of the doctrine of *in pari delicto* in the context of bankruptcy litigation involving bankruptcy trustees and the current trend in the law.

II. A Hypothetical Analysis for a Real World Problem

Historically, courts, with some frequency, have held that when the wrongful conduct is perpetrated by a debtor who subsequently files for bankruptcy, the defense of *in pari delicto* is available in an action by a bankruptcy trustee against another party pursuant to or consistent with 11 U.S.C. § 541(a)(1),[12] if the defense could have been raised as against the debtor.[13] In effect, many courts have determined that the court must consider the claim asserted by the trustee in a hypothetical prepetition world.[14] In this instance, however, all benefit would be to the debtor, not creditors or the estate. In the real world of bankruptcy, however, the benefit goes to the estate and the debtor's creditors. Consequently, it appears that courts have addressed a real world problem – a debtor who has committed fraud and the trustee is trying to recover from other schemers and fraudsters for the benefit of the estate – by a hypothetical "non-real world approach – precluding a trustee from recovering from other schemers and fraudsters because of the fraud of the debtor.

A. A Standing Problem – The Trustee in the Shoes of the Debtor

The doctrine of *in pari delicto* has been held to bar a claim by a Chapter 7 trustee for the reason that he or she does not have standing.[15] Under the Bankruptcy Code, the trustee stands in the shoes of the debtor and has standing to bring any suit that the debtor could have instituted had the debtor not filed for bankruptcy.[16] The problem is, if the debtor is subject to the *in pari delicto* defense, many courts find that the trustee is also barred from pursuing a claim that the debtor himself or herself could not bring. Why is this?

Under 11 U.S.C. § 541, all legal and equitable interest the debtor acquired prior to the petition date becomes property of the estate. Legal and equitable interests include causes of action.[17] In actions brought by a trustee under 11 U.S.C. § 541, the trustee stands in the shoes of the debtor and can only assert those causes of action possessed by the Debtor.[18] Consequently, courts, in assessing standing, determine whether the *debtor* could bring the cause of action since the trustee, as the estate representative, is standing in the shoes of the debtor.[19] Many courts, when concluding the issue on the standing issue, have determined that the trustee has no greater rights than the debtor had and thus is subject to the same defenses the debtor would have faced prepetition.[20] Where courts find that the debtor has participated in the wrongdoing, and the trustee is standing in the shoes of the debtor, Courts have determined that a trustee does not have standing because, under the doctrine of *in pari delicto*, the injury asserted is not protected where the debtor participated in the wrongdoing.[21]

Using the standing analysis in the context of 11 U.S.C. § 541, courts have generally held that a trustee does not have standing to sue third parties. This is premised on the principle that when a participant (the debtor and by implication, the trustee in the shoes of the debtor) in illegal, fraudulent, or inequitable conduct seeks to recover from another participant in that

conduct, the parties are deemed *in pari delicto*, and the law will aid neither, but rather, leave them where it finds them.[22]

B. 11 U.S.C. § 541 v. 11 U.S.C. §544

Courts have, however, allowed a trustee to pursue claims under11 U.S.C. § 544(a)(1).[23] The distinction, here, is that the doctrine of *in pari delicto* only applies to the trustee in his debtor status conveyed upon him by 11 U.S.C. § 541, not in his or her status as creditor as conveyed upon him by 11 U.S.C. § 544.[24] As explained by the Tenth Circuit:

> [F]rom the reservoir of equitable powers granted to the trustee to maximize the bankruptcy estate, Congress has fashioned a legal fiction. Not only is a trustee empowered to stand in the shoes of a debtor to set aside transfers to third parties, but the fiction permits the trustee also to assume the guise of a creditor with a judgment against the debtor. Under that guise, the trustee may invoke [the] remedies provided by state law to judgment lien creditors to satisfy judgments against the debtor.[25]

As noted in *Anstine v. Alexander*,[26]

> The rights provided to a trustee under § 544 are therefore measured by the substantive law of the jurisdiction governing the property in question. In Colorado, a judgment lien creditor has the right to pursue all claims available to a debtor corporation before bankruptcy is declared. In the context of a breach of fiduciary duty claim, the trustee brings the claim under § 544(a) "in the name of the corporation for the benefit of all persons entitled to participate in the recovery."[27]

In the *Anstine* case, the Trustee was held to have standing as a fictitious judicial lien creditor pursuant to § 544(a), and because he was pursuing the claim as such, he was not deemed to be a participant in the president of the debtor-corporation's breach of fiduciary duty.

III. Defending Against the *In Pari Delicto* Defense

A. Important Strategic Decisions

To navigate through the nuances of the *in pari delicto* doctrine, a plaintiff must ascertain against whom he or she is pursuing claims and in what capacity the trustee intends to pursue the claims. Thus, the trustee must determine who owns the claims to be asserted and who has standing to bring those claims. It is also equally important to understand when the defense is not applicable. Specifically, the defense of *in pari delicto* does not apply to causes of action brought under sections 547 or 548.[28]

B. Strategies for Actions Brought under 11 U.S.C. § 541

If a trustee brings claims under 11 U.S.C. § 541 for wrongs committed in conjunction with the debtor's actions prepetition, the trustee will likely have to defend and address the *in pari delicto* defense. Consequently, it should be well thought out what possible offense can be raised as against the *in pari delicto* defense. Below, is a discussion of strategies to implement.

1. The "Adverse Interest Exception"

The "Adverse Interest Exception" to the defense of *in pari* delico, acts to bar the assertion of the defense when the plaintiff can establish that the debtor's former management acted for their own interest and adversely to the interest of the debtor. As discussed herein, in those instances where a trustee is pursuing claims against a corporate agent who has acted adversely to the interest of a corporation, the trustee should be prepared to demonstrate that the corporate agent was acting solely for his or her own benefit in contravention of the interest of the corporation.

The "Adverse Interest Exception" is fairly narrow and courts have taken various approaches in dealing with the same. In the Tenth Circuit, the agent's subjective motions are not necessarily dispostive and if there is any benefit to the corporation, the "Adverse Interest Exception may not apply.[29] In the First Circuit, the "Adverse Interest Exception" may be applied if the wrongdoing is done primarily for the personal benefit of the agent and the action(s) are adverse to the interest of the corporation.[30] The Second Circuit has recognized the "Adverse Interest Exception" when the agent has completely abandoned his or her principal's interest.[31] The District Court of Colorado held that under Colorado law the doctrine of *in pari delicto* did not bar a bankruptcy trustee from bringing claims on behalf of the debtor corporation against the corporation's attorneys for allegedly aiding and abetting corporation's Ponzi scheme.[32] In this case, the doctrine did not apply even though corporation was under promoters' control, where attorneys' malfeasance did not benefit debtor in any way, but only benefited attorneys and promoters, and occurred after and outside of the Ponzi scheme.[33]

2. Sole Actor Exception

Under this exception, if the agent is the sole representative of a principal, then that agent's fraudulent conduct will be imputed to the principal regardless of whether the agent's actions were adverse to the principal's interest.[34] "The rationale for this rule is that the sole agent has no one to whom he can impart his knowledge, or from whom he can conceal it, and that the corporation must bear the responsibility for allowing an agent to act without accountability."[35]

3. Strategies for Actions Brought under 11 U.S.C. § 544

The plaintiff must make sure that he or she is bringing the claim consistent with 11 U.S.C. § 544 because some cases hold that "a bankruptcy trustee has not standing generally to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankruptcy corporation itself."[36] Consequently, the trustee may bring the claims as the representative of a hypothetical judgment lien creditor under 11 U.S.C. § 544.[37] Pursuing this course of action may evade the *in pari delicto* defenses, since the claims of a creditor are not tainted by a debtor's wrongs.

4. Assignment of Claims/Derivative Standing

Some courts have used their equitable power to grant creditors' committees derivative standing to pursue estate claims if the debtor consents and the court believes the action being

prosecuted is in the best interest of the estate and the action is necessary and beneficial to the fair and efficient resolution of the bankruptcy proceeding.[38] Since creditors themselves may have their own claims which materially overlap with the claims of the estate, but are not subject to the *in pari delicto* defense, the creditors can create a trust to hold their claims and have them be additional plaintiffs in the lawsuit.[39] However, the creditors do not get the same extension of the statute of limitation that the Trustee receives.[40]

5. Insiders

The defense of *in pari delicto* has also been held to be unavailable to defendants who are insiders or fiduciaries of a corporate wrongdoer, or otherwise exercise control over a corporate debtor.[41] Consequently, in those instances where a plaintiff adequately alleges a defendant's insider status, courts have declined to allow the *in pari delicto* defense.[42]

6. The Missing Legislative History Argument

Although the legislative history has largely been ignored by case law,[43] it would seem that the defense of *in pari delicto* was not intended to apply to trustees. Moreover, it is evident that this is an argument that is fairly often ignored by trustees, plaintiffs, and courts in addressing the defense of *in pari delicto.*[44] Specifically Representative Don Edwards, D. Calif., co-sponsor of the 1978 Bankruptcy Codes stated:

> Section 541(d) of the House amendment is derived from section 541(e) of the Senate amendment and reiterates the general principle that where the debtor holds bare legal title without any equitable interest, that the estate acquires bare legal title without any equitable interest in the property. Examples of this are mortgages sold for which legal title has been retained for servicing. Similarly, if the debtor holds an equitable interest in property without legal title, the estate would acquire only the equitable interest of the debtor in property and not the legal title. Thus, as section 541(a)(1) clearly states, the estate is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case. *To the extent such an interest is limited in the hands of the debtor, it is equally limited in the hands of the estate except to the extent that defenses which are personal against the debtor are not effective against the estate*.[45]

7. *Scholes v. Lehmann* – Zombies and their Progeny

The Seventh Circuit in *Scholes v. Lehmann* addressed whether the doctrine of *in pari delicto* barred fraudulent conveyance claims by a receiver against prepetition recipients of "profits" from a Ponzi scheme.[46] The Court declined to bar the claims because the man who orchestrated the Ponzi scheme had been ousted from control and any beneficial interest in the debtor corporations, and, therefore, there was no concern that the claims by the trustee would allow him to benefit from his wrongdoing.[47] As the Court stated, "[p]ut differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated."[48]

As the *Scholes* Court went on to say:

> But the reason, of course, [for the *in pari delicto* defense], is that the wrongdoer must not be allowed to profit from his wrong by recovering property that he had parted with in order to thwart his creditors. That reason falls out now that [the scheme operator] has been ousted from control of and beneficial interest in the corporations. The appointment of the receiver removed the wrongdoer from the scene. The corporations were no more [the scheme operator's] evil zombies. Freed from his spell they became entitled to the return of the moneys-for the benefit not of [the scheme operator] but of innocent investors-that [the scheme operator] had made the corporations divert to unauthorized purposes.[49]

Some courts have agreed with the *Scholes* rationale and have held that a receiver may *not* be precluded from bringing the claim as the debtor-wrongdoer is out of the picture.[50] However, the *Scholes* reasoning as applied to Chapter 7 trustees has not been adopted in most courts at this time.[51]

This being said, since the trustee has all of the rights of a judgment lien creditor under 11 U.S.C. 544, perhaps a Trustee can argue that he or she has the rights of a judgment lien creditor who could have sought the appointment of a receiver.[52] An alternative strategy, perhaps, is to have the trustee bring the claim for relief under the Uniform Fraudulent Transfer Act (UFTA). In theory then, a trustee, as the hypothetical lien creditor, may be able to bring a state court action for the appointment of a receiver for an entity related to the Debtor and involved in the Ponzi scheme to trigger *Scholes*.[53]

V. Closing Thoughts

Trustees and their counsel must always realize that the doctrine of *in pari delicto* may show up as an affirmative defense in actions to recover against a wrongdoer. Before any action is taken to recover from the wrongdoer, counsel should always keep in mind the minefield that may lay ahead that may block prosecution of claims on behalf of the estate. A competent strategy is the key to successful recovery. Moreover, a full and complete understanding of the doctrine and the application of the same by courts is essential for successful prosecution of claims. The best strategic approach of the trustee or receiver is to bring as many alternative claims for relief as are justified based upon the fact pattern. The trustee will usually bring the actions under sections 541 and 544. In addition and to the extent practical and as founded in the law, the trustee should also bring any possible claims under 11 U.S.C. §§547 and 548, to avoid the defense when and where possible.

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[2] Robert Lantz joined the firm of Sender Wasserman and Wadsworth, P.C., as an associate in April, 2013. Before his association with the firm, he was the law clerk to the Honorable Sidney B. Brooks, Bankruptcy Judge for the District of Colorado for 13 years. Prior to his employment with Judge Brooks, Mr. Lantz practiced for over 5 years in private practice at Martin, Leigh, Laws & Fritzlen, P.C. in Kansas City, Missouri, where he primarily represented creditors in bankruptcy and insolvency matters. He began his career with the Department of Justice, Office of the U.S. Trustee, in Kansas City, Missouri, as an Honors Program attorney out of law school.

[3] *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985) (quoting BLACK'S LAW DICTIONARY 711 (5th Ed. 1979)).

[4] *Sender v. Mann*, 423 F.Supp.2d 1155, 1174 (D. Colo. 2006) (citing *PMN, Inc. v. Porter (In re Porter McLeod, Inc.)*, 231 B.R. 786, 793 (D. Colo. 1999).

[5] *Id*.

[6] Robert Bruner, *The Collapse of the In Pari Delicto Defense to Bankruptcy Trustee Claims: How the Fifth Circuit Has Opened a New Door for Trustee Litigation*, 18 Tex. Wesleyan L. Rev. 91, 97 (2011).

[7]*Bateman,* 472 U.S. at 306.

[8] *Id*. at 307.

[9] *Keystone Driller Co. v. Gen. Excavator Co.,* 290 U.S. 240, 245 (1933).

[10] *See, e.g., Mosier v. Callister, Nebeker & McCullough,* 546 F.3d 1271, 1276 (2008) (on summary judgment, the court determined that the trustee was barred from pursuing claims based on the doctrine of *in pari delicto*); *Grassmueck v. Am. Shorthorn Ass'n,* 402 F.3d 833, 837 (8th Cir. 2005) (a bankruptcy trustee is barred under the doctrine of *in pari delicto* from bringing negligence claims against parties who facilitated the debtor's fraudulent investments when the debtor knew the investments were fraudulent); *Sender v. Kidder Peabody & Co.,* 952 P.2d 779, 782 (Colo. App. 1997) (a bankruptcy trustee lacks standing to bring claims against a third party when the debtor has joined with the third party in defrauding its creditors); *Sender v. Buchanan (In re Hedged Investments Assocs., Inc.),* 84 F.3d 1281, 1284 (a trustee cannot recover from an investor in a Ponzi scheme perpetrated by the debtor); and *Sender v. Simon,* 84 F.3d 1299, 1305 (10th Cir. 1996) ("the trustee stands in the shoes of the debtor and can take no greater rights than the debtor himself had.").

[11] *Official Comm. of the Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, 322 F.3d 147, 152 (2d Cir. 2003) (the doctrine of *in pari delicto* barred a committee's claims, where committee was assigned claims against debtor's accounting firm for breach of fiduciary duty based on its failure to disclose negative information relating to a merger and acquisition when the debtor was aware of the information); *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 357-60 (3d Cir. 2001) (committee asserted it was seeking damages on behalf of the creditors, but the court concluded that the claims belong to the debtors, not creditors, thus standing was not permitted).

[12] 11 U.S.C. § 541(a)(1) provides that:

> The commencement of a case … creates an estate. Such estate is comprised of … all legal or equitable interests of the debtor in property as of the commencement of the case.

[13] *Mosier v. Callister, Nebeker & McCullough*, 546 F.3d at 1275 (citing *Grassmueck v. Am. Shorthorn Ass'n.,* 402 F.3d at 837).

[14] Robert Bruner, *The Collapse of the In Pari Delicto Defense to Bankruptcy Trustee Claims: How the Fifth Circuit Has Opened a New Door for Trustee Litigation*, 17 Tex. Wesleyan L. Rev. at 97.

[15] *Sender v. Kidder Peabody & Co.,* 952 P.2d at 782 (Under Colorado law, "[r]esolution of the standing issue presents two considerations: whether the complaining party has alleged an actual injury from the challenged action; and whether the injury is to a legally protected or cognizable interest as contemplated by statutory or constitution provisions.").

[16] *Caplin v. Marine Midland Grace Trust Co.,* 406 U.S. 416, 429 (1972); *See also, Hirsch v. Arthur Andersen & Co.,* 72 F.3d 1085, 1094 (2d Cir. 1995) and *Shearson Lehman Hutton, Inc., v. Wagoner,* 944 F.2d 114, 118 (2d Cir. 1991).

[17] *Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards,* 437 F.3d 1145 (11th Cir. 2006) and *Official Committee of Unsecured Creditors v. R.L. Lafferty & Co*., 267 F.3d 340 (3d Cir. 2001).

[18] *See, Moratzka v. Morris (In re Senior Cottages of America, LLC), 482 F.3d 997 (8 th Cir. 2007);* 11 U.S.C. § 323 provides:

> (a) The Trustee in a case under this title is the representative of the estate
> (b) The trustee in a case under this title has capacity to sue and be sued.

[19] *St. Paul Fire & Marine Ins. Co. v. PepsiCo, Inc.,* 884 F.2d 688, 700 (2d Cir. 1989).

[20] *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.3d at 118.

[21] *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. at 434.

[22] *Sender v. Kidder Peabody & Co.,* 952 P.2d at 782.

[23] 11 U.S.C. § 544(a)(1) provides:

> (a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
>
> > (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists

[24] *Sender v. Porter (In re Porter McLeod, Inc.),* 231 B.R. 786, 792 (D. Colo. 1999).

[25] *Zilkha Energy Co. v. Leighton*, 920 F.2d 1520, 1523 (10th Cir. 1990).

[26] 128 P.3d 249, 254 (Colo. App. 2005).

[27] *Id.* (internal citations omitted).

[28] *Notinger v. Migliaccio (In re Fin. Res. Mort., Inc.)*, 454 B.R. 6, 24 (Bankr. D. N.H. 2011); *Kipperman v. Onex Corp*., 411 B.R. 805, 826 (N.D. Ga. 2009); and *Gecker v. Goldman Sachs & Co. (In re Automotive Professionals, Inc.)*, 398 B.R. 256, 262 (Bankr. N.D. Ill. 2008).

[29] *Mosier v. Callister, Nebeker & McCullough*, 546 F.3d at 1276.

[30] *Nisselson v. Lernout,* 469 F.3d 143, 153 (1st Cir. 2006) (but, where the corporate principal is indifferent to the acts of the agent, the "Adverse Interest Exception" may not apply).

[31] *CBI Holding Company, Inc. v. Ernst & Young*, 529 F.3d 432, 449 (2d Cir. 2008).

[32] *Sender v. Mann*, 423 F.Supp.2d 1155, 1174 (D. Colo. 2011).

[33] *Id.*

[34] *Thabault v. Chait*, 541 F.3d 512, 527 (3d Cir. 2008) (as cited in the unpublished decision from the District of Kansas, *Rajala v. Gardner*, 2012 WL 1189773, *13 (D. Kan. 2012)).

[35] *Id.*

[36] Risa Lynn Wolf-Smith*, Innocent Trustee/Creditors Barred by Debtors' Past Wrongs: It Just Ain't Right*, 26 Am. Bankr. Inst. J. 42, 55 (April, 2007) (citing *In re Mediators*, 190 B.R. 515 at 526 (S.D.N.Y. 1995) and *Smith v. Arthur Anderson*, 421 F.3d 989, 1002 (9th Cir. 2005).

[37] *Hill v. Gibson Dunn & Crutcher, LLP (In re MS55, Inc.)*, 2007 WL 2669150 (D. Colo. Sept. 6, 2007).

[38] *Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 562 (3d 2003); *Official Comm. of Unsecured Creditors v. R.L. Lafferty & Co.*, 267 F.3d 340, 348 (3d Cir. 2001); *see also, e.g., Sender v. Mann*, 423 F.Supp.2d at 1174 (the doctrine of *in pari delicto* did not bar a liquidation trust trustee from bringing claims on behalf of debtor corporation against its attorneys).

[39] *See, e.g., Official Comm. of Unsecured Creditors v. Felt (In re Felt Mfg. Co., Inc,)*, 371 B.R. 589, 610 (Bankr. D. N.H. 2007 (in examining the question, in part, under New Hampshire law, the court concluded that the *in pari delicto* defense is not a bar to a creditors' committee's pursuit of breach of fiduciary duty claims against the former officers and directors of debtor). However, if the creditors are participants in the fraud, they, themselves may be subject to the affirmative defense of the *in pari delicto* doctrine. *See, e.g., Official Comm. of Unsecured Creditors v. American Tower Corp. (In re Verestar, Inc.),* 343 B.R. 444, 478 (Bankr. S.D.N.Y. 2006).

[40] *See e.g.*, 11 U.S.C. §§ 108, 550; *but see, In re High Voltage Eng'g Corp*., 363 B.R. 8, 27-28 (Bankr. D. Mass. 2007) (liquidating trustee of trust established under debtor's confirmed Chapter 11 plan was barred by the doctrine of *in pari delicto*).

[41] *Indus. Enter. of America v. Mazzuto (In re Pitt Penn Holding Co.*), 484 B.R. 25, 39 (Bankr. D. Del. 2012); *See In re Bernard L. Madoff Inv. Secs., LLC*, 458 B.R. 87, 123-25 (Bankr. S.D. N.Y. 2011).

[42] *Pitt Penn Holding*, 484 B.R. at 39. 11 U.S.C. § 101(31) defines "insider" as:

(31) The term "insider" includes—
(A) if the debtor is an individual—
(i) relative of the debtor or of a general partner of the debtor;
(ii) partnership in which the debtor is a general partner;
(iii) general partner of the debtor; or
(iv) corporation of which the debtor is a director, officer, or person in control;
(B) if the debtor is a corporation—
(i) director of the debtor;
(ii) officer of the debtor;
(iii) person in control of the debtor;
(iv) partnership in which the debtor is a general partner;
(v) general partner of the debtor; or
(vi) relative of a general partner, director, officer, or person in control of the debtor;
(C) if the debtor is a partnership—
(i) general partner in the debtor;
(ii) relative of a general partner in, general partner of, or person in control of the debtor;
(iii) partnership in which the debtor is a general partner;
(iv) general partner of the debtor; or
(v) person in control of the debtor;
(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;
(E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and
(F) managing agent of the debtor.

The *in pari delicto* defense was denied to the spouse of Bernie Madoff as she was an insider. *Picard v. Madoff (In re Bernard L. Madoff Inv. Sec., LLC*, 468 B.R. 620, 632 (Bankr. S.D. N.Y. 2012)

[43] *See, e.g., Official Comm. of Unsecured Creditors of PSA, Inc., v. Edward*s, 437 F.3d 1145 (11th Cir. 2006) (the court stated: "[w]e need not resort to legislative history because the text of section 541(a) is unambiguous.").

[44] William McGrane, *The Erroneous Application of the Defenses of In Pari Delicto to Bankruptcy Trustees*, 29 Cal. Bankr. J. 275, 285 (2007).

[45] *Id*. (citing 124 Cong. Rec. H11096 (daily ed. September 28, 1978) (emphasis added).

[46] 56 F.3d 750 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995).

[47] *Id*. at 754.

[48] *Id.*

[49] *Id.*

[50] *Wing v. Dockstader,* 482 Fed.Appx. 361, 362-63 (10th Cir. 2012) (Tenth Circuit found the reasoning persuasive in *Scholes* and held that a state court receiver has standing in a case). The reasoning in *Scholes* was also endorsed by the Second and Ninth Circuits. *Donell v. Kowell,* 533 F.3d 762, 776-77 (9th Cir. 2008) and *Eberhard v. Marcu*, 530 F.3d 122, 132-33 (2d Cir. 2008). In the Tenth Circuit *Hedged-Investments Assoc., Inc.* case the Court recognized that this approach was pragmatic but contrary to bankruptcy law:

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

Sender v. Buchanan (In re Hedged-Investments Assoc., Inc.), 84 F.3d 1281, 1285 (10th Cir. 1996).

[51] *Alberts v. Tuft (In re Greater Southeast Cmty. Hosp*.), 353 B.R. 324, 366-67 (Bankr. D.C. 2006) (court held that bankruptcy trustees were restricted by 11 U.S.C. 521 to pursue claims on behalf of debtor); *Lutz v. Chitwood (In re Donahue Sec. Inc.)*, 304 B.R. 797, 800 n. 4 (Bankr. S.D. Ohio 2003); *Erricola v. Gaudette* (*In re Gaudette*), 241 B.R. 491, 502 (Bankr. D. N.H. 1999) (the court declined to allow a trustee standing and disagreed with any expansion of the trustee's enumerated powers under 11 U.S.C. § 704); *Hannover Corp. of America v. Beckne*r, 211 B.R. 849, 854 (M.D. La. 1997)(court declined to extend to trustees); *But see, Collins v. Kohlberg and Co. (In re Southwest Supermarkets LLC)*, 335 B.R. 417, 427 (a trustee has standing under 11 U.S.C. § 544(a) consistent with the state law receiver progeny from *Scholes*); *Fisher v. Apostolou,* 155 F.3d 876, 879 (7th Cir. 1998) (finding the rationale of *Scholes* was applicable to a bankruptcy trustee*); Gordon v. Barsoon* (*In re Plaza Mortg. and Finance Corp.)*, 187 B.R. 37, 43 (Bankr. N.D. Ga. 1995) (Chapter 11 trustee was permitted to sue debtor's former accounts for malpractice and fraud arising out of the Ponzi scheme of the debtor).

[52] As noted by the Delaware bankruptcy court in *In re Scott Acquisition Corp.*, 364 B.R. 562, 571 (Bankr. D. Del. 2007):

> Other courts have questioned the application of the *in pari delicto* doctrine where its equitable underpinnings are not implicated. For instance, the Ninth Circuit ruled that an *in pari delicto* defense that applies to a corporation would not apply to that corporation's receiver:
>
> > 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. Moreover, when a party is denied a defense under such circumstances, the opposing party enjoys a windfall. This is justifiable as against the wrongdoer himself, not against the wrongdoer's innocent creditors. As we noted in our earlier pinion: "A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the [debtor]; it is thrust into those shoes." [*Fed. Deposit Ins. Co. v. O'Melveny & Myers*,] 61 F.3d 17, 19 (9th Cir. 1995) (quoting *FDIC v. O'Melveny & Myers*, 969 F.2d 744, 751 (9th Cir. 1992)).

Perhaps, the transmutation of the claim to a receiver from the trustee may produce the opposite result as that articulated in *In re NJ Affordable Homes Corp*. 2013 WL 6048836, *26 -27 (Bankr. D. N.J. 2013). In Affordable Homes, the Court found that a trustee following a receiver is bound by 11 U.S.C. § 541 and cannot prosecute claims that would have been the debtor's claims, notwithstanding the appointment of the receiver. *Id.* The Court in *Edgewater Med. Ctr. v. Rogan* (*In re Edgewater Med. Ctr.)*, 332 B.R. 166, 177 (Bankr. N.D. Ill. 2005), held that 11 U.S.C. § 541 of the Code subjects the trustee, who is in the shoes of the debtor, to the *in pari delicto* defense. However, the appointment of a receiver alters the defenses to which a corporation is subject, by removing the wrongdoer from the scene. *Id*.; *See also, Collins v. Kohlberg and Co. (In re Southwest Supermarkets, LLC)*, 325 B.R. 417, 427 (Banker. D. Ariz. 2005) (the court noted that using 11 U.S.C. § 544 may resolve the trustees' in pari delicto problem, at least where state law would free a receiver from that defense).

[53] *Southwest Supermarkets*, 325 B.R. at 427.

Asserting Individual and Derivative Claims in Bankruptcy

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Introduction

This presentation is designed to discuss standing issues when prosecuting causes of action that may also belong to the bankruptcy estate. First, we will discuss differences between claims of the bankruptcy estate and claims capable of being asserted directly by individual creditors of the estate. Second, we will discuss the test for obtaining derivative standing, which varies based on whether the debtor or trustee consents to or opposes the creditor's exercise of derivative standing. Finally, we will discuss the somewhat unsettled nature of the law of derivative standing in the Tenth Circuit.

A. Defining Claims of the Estate and Creditor Claims

Property of the bankruptcy estate includes all legal or equitable interests of the debtor in property as of the commencement of the case.[1] The term "all legal or equitable interests" has been defined broadly to include causes of action and if a cause of action belongs to the estate, then the debtor in possession or the trustee has exclusive standing to assert it.[2] Conversely, if a cause of action does not belong to the debtor's estate, the trustee or debtor in possession lacks standing to assert it.[3] To determine whether the debtor or trustee could have raised a claim as of the commencement of the case, courts look at the nature of the injury for which relief is sought.[4] If a cause of action alleges only indirect harm to a creditor and the debtor could have raised a

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[1] 11 U.S.C. § 541(a)(1).

[2] *See Smith v. Rockett*, 522 F.3d 1080, 1084 (10th Cir. 2008).

[3] *In re Educators Grp. Health Trust*, 25 F.3d 1281, 1284 (5th Cir. 1994).

[4] *Id.*

claim for its direct injury under applicable law, then the cause of action belongs to the estate.[5] On the other hand if the cause of action does not explicitly or implicitly allege harm to the debtor, then the cause of action could not have been asserted by the debtor and is not property of the estate.[6] Simply put, a claim can be brought in a direct action by a creditor if the injury alleged in the action was sustained directly by the creditor bringing the suit, and it is separate and distinct from injuries sustained by the corporation and all other shareholders equally.[7]

Further, it is possible that both the bankruptcy estate and an individual creditor can have separate claims against a third party, which arise from the same series of events or course of conduct.[8] Just because the bankruptcy estate may have its own claims for direct injuries does not mean that the creditor's claims are merely derivative of the debtor's.[9]

In particular courts will ask two questions: "(1) who suffered the alleged harm (the corporation or the suing stockholders individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"[10] Further, to determine whether the claims asserted by a creditor are actually property of the estate, courts will look beyond the nominal title given to a claim by the creditor to assess whether it is actually duplicative of or derivative of a claim of the estate.[11]

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5 *Id.*

6 *Id.*

7 *See Cowin v. Bresler*, 741 F.2d 410, 415 (D.C. Cir. 1984).

8 *In re Seven Seas Petroleum, Inc.*, 522 F.3d 575, 585 (5th Cir. 2008).

9 *Id.* at 587.

10 *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004).

11 *See In re Madoff*, 848 F.Supp.2d 469, 482 (S.D.N.Y. 2012); citing *In re Ionosphere Clubs, Inc.*, 156 B.R. 414, 439 (S.D.N.Y. 1993).

B. Obtaining Derivative Standing When the Debtor or Trustee Agrees

Courts have found an implied but qualified right for a committee or an individual creditor to obtain derivative standing to pursue a cause of action on behalf of the bankruptcy estate through 11 U.S.C. §§ 1103(c)(5) and/or 1109(b).[12]

If the debtor in possession or trustee agrees to allow a creditor to exercise derivative standing, courts generally require the creditor to demonstrate two things: (1) that the creditor does in fact have the trustee's or debtor in possession's consent; and (2) that the bankruptcy court finds that the suit is (a) in the best interest of the bankruptcy estate; and (b) necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings.[13]

Although the better practice is to request that the court grant derivative standing prior to filing an action, most courts, including courts in the Tenth Circuit will allow for a creditor to retroactively seek approval to file suit. As explained by the Eighth Circuit in *Racing Services*:

> In most cases, regardless of whether a creditor seeks permission before or after filing its complaint, the bankruptcy court will expend similar resources when considering the creditor's request to proceed derivatively. . . . Because a creditor may not prosecute a derivative suit without the bankruptcy court's permission, the filing of an adversary complaint in itself does not affect the estate's administration. In other words, the timing of the creditor's motion is in most cases of little consequence.[14]

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[12] *See Unsecured Creditors' Comm. v. Noyes (In re STN Enters.)*, 779 F.2d 901, 904 (2d Cir. 1985); *Starzynski v. Sequoia Forest Indus.*, 72 F.3d 816, 821 (10th Cir. 1996).

[13] *In re Commodore Int'l, Ltd.*, 262 F.3d 96, 100 (2d Cir. 2001); accord *In re Ellicott Springs Resources, LLC*, 485 B.R. 626, 636-37 (Bankr. D. Colo. 2013); citing *In re Racing Servs., Inc.*, 540 F.3d 892, 898 (8th Cir. 2008).

[14] *Racing Servs.*, 540 F.3d at 903-04; accord *Ellicott Springs*, 485 B.R. at 639.

In practice, allowing a creditor or a committee to obtain derivative standing to prosecute a claim of the debtor's estate can impact litigation of those claims. For instance, in *In re Dewey & LeBoeuf LLP*,[15] the debtor approved of the creditors' committee's filing of complaints against the debtor law firm's former chairman, executive director, and chief financial officer.[16] The debtor's decision to allow the creditors' committee to prosecute the actions against former firm insiders was primarily motivated by the estates desire to maximize its recovery against $50 million in aggregate insurance coverage and to avoid potential "insured versus insured" exclusions set forth in the insurance policies that could prevent the debtor from recovering under those policies.[17] The *Dewey* Court concluded that the motion brought by the creditors' committee established colorable claims against the insider defendants, and found that allowing the committee to prosecute the claims was in the best interests of the estate because prosecution by the committee could potentially avoid an insured versus insured dispute.[18] However, the *Dewey* Court declined to rule that the committee could settle the claims outside of plan confirmation and required court-approval if the claims were attempted to be settled prior to such confirmation.[19]

From the creditor's or committee's perspective it is preferable to obtain the debtor or trustee's approval to bring a derivative action to avoid having to clear the additional hurdles discussed below in the context of derivative actions where the debtor or trustee does not consent. While from the trustee or debtor's perspective, as illustrated by the *Dewey* case discussed above, allowing a third party to prosecute an estate claim can also benefit the estate by potentially

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[15] Case No. 12-12321 (MG) (Bankr. S.D.N.Y.).

[16] *See In re Dewey & LeBoeuf LLP*, 2012 Bankr. LEXIS 5536 at *2-4 (Bankr. S.D.N.Y. Nov. 29, 2012).

[17] *Id.* at *8-9.

[18] *Id.* at *23-24.

[19] *Id.* at *24-25.

preventing insured versus insured arguments or other potential arguments that could foreclose the debtor's right to recovery.

C. **Creditor Remedies When the Debtor or Trustee Refuses to Pursue an Avoidance Action or Other Claims of the Estate**.

If the debtor or trustee refuses to pursue an avoidance action, the creditor or committee is not left without recourse, but it is more difficult to obtain derivative standing. Although the Tenth Circuit has not ruled on whether a creditor or committee can obtain derivative standing to pursue an avoidance claim over the objection of the trustee or debtor,[20] other Circuit courts have unanimously concluded that obtaining derivative standing even over the trustee's objection is possible.[21] Those Circuits have established similar standards, which the creditor or committee must meet to be granted derivative standing.

In *Racing Services*, the Eighth Circuit announced the following four-part test:

> To establish derivative standing a creditor must show: (1) it petitioned the trustee to bring the claims and the trustee refused; (2) its claims are colorable; (3) it sought permission from the bankruptcy court to initiate an adversary proceeding; and (4) the trustee unjustifiably refused to pursue the claims.[22]

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[20] *See Vill. of Overland Pointe, LLC v. Terra Bentley II, LLC (In re Bentley II, LLC)*, 2011 Bankr. LEXIS 806 at *11-12 (Bankr. D. Kansas).

[21] *See Smart World Techs., LLC v. Juno Online Servs., Inc. (In re Smart World Techs., LLC)*, 423 F.3d 166, 176 (2d Cir. 2005) (citing *In re STN Enters.*, 779 F.2d 901); *Official Comm. of Unsecured Creditors v. Chinery (In re Cybergenics Corp.)*, 330 F.3d 548, 553 (3d Cir. 2003) (en banc); *Fogel v. Zell*, 221 F.3d 955, 965 (7th Cir. 2000); *Avalanche Mar., Ltd. v. Parekh (In re Parmetex, Inc.)*, 199 F.3d 1029, 1031 (9th Cir. 1999); *Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd. (In re Gibson Group, Inc.)*, 66 F.3d 1436, 1440-41 (6th Cir. 1995); *La. World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 247-48 (5th Cir. 1988); *Cf. United Phosphorus, Ltd. v. Fox (In re Fox)*, 305 B.R. 912 (10th Cir. BAP 2004) (holding that creditor standing alone could not bring derivative suits to collect assets for the bankruptcy estate and affirmed bankruptcy court's decision to dismiss fraudulent conveyance claims brought by the creditor).

[22] *Racing Servs.*, 540 F.3d at 900.

In *In re Gibson Group, Inc.*,[23] the Sixth Circuit established a similar but somewhat different standard stating:

> a bankruptcy court may permit a single creditor in a Chapter 11 case to initiate an action to avoid a preferential or fraudulent transfer instead of the debtor-in-possession if the creditor: 1) has alleged a colorable claim that would benefit the estate, if successful, based on a cost-benefit analysis performed by the bankruptcy court; 2) has made a demand on the debtor-in-possession to file the avoidance action; 3) the demand has been refused; and, 4) the refusal is unjustified in light of the statutory obligations and fiduciary duties of the debtor-in-possession in a Chapter 11 reorganization.[24]

The notable difference in the two tests is the express inclusion of a cost to benefit analysis under the *Gibson Group* test. However, in practice, this is a distinction without a difference as even the *Racing Services* Court explained that courts must undertake a cost to benefit analysis of the proposed claims to evaluate whether the trustee's refusal to bring an action was justified.[25]

While the first three requirements of the *Racing Services* test are easily achieved, the fourth requirement, which also encompasses a cost to benefit analysis, is obviously more difficult to satisfy. The creditor, who bears the burden,[26] must persuade the court that the trustee or debtor's refusal to pursue the claim was unjustified.

While a trustee or debtor clearly abuses this discretion by refusing to bring a claim that if successful would clearly benefit the estate, and does not abuse its discretion by refusing to bring a claim that would confer only a marginal benefit on the estate, a more difficult situation arises if

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[23] 66 F.3d 1436 (6th Cir. 1995).

[24] *Id.* at 1439-40.

[25] *Racing Servs.*, 540 F.3d at 900-01.

[26] *Racing Servs.*, 540 F.3d at 900.

successful prosecution of the creditor's claims would confer "more than marginal benefits to the estate but not necessarily a windfall,"[27] or if the creditor or committee is willing to shoulder the costs of litigation and the fee arrangement does not burden the estate.[28] In conducting this analysis courts consider: (1) the probabilities of legal success and financial recovery in event of success; (2) the creditor's proposed fee arrangement; and (3) the anticipated delay and expense to the bankruptcy estate that the initiation and continuation of litigation will likely produce.[29] This analysis should not take the form of a mini-trial, but should allow the court to determine the likelihood of success and the attendant expenses involved.[30]

D. The "Unsettled" Nature of Derivative Standing in the Tenth Circuit

Although as noted above, the United States Court of Appeals for the Tenth Circuit has not ruled on a creditor's ability to exercise derivative standing, the *dicta* of two previous opinions indicate that the Tenth Circuit would allow creditors to exercise derivative standing under appropriate circumstances. In *Starzynski v. Sequoia Forest Indus.*,[31] the Tenth Circuit stated in *dicta* that "a creditors' committee or even an individual creditor may, with leave of the bankruptcy court, initiate avoidance and other actions when the debtor-in-possession has failed to do so."[32] Similarly, in *Hill v. Akamai Techs., Inc. (In re MS55, Inc.)*,[33] the Tenth Circuit stated

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[27] *Racing Servs.*, 540 F.3d at 900.

[28] *See STN Enters.*, 779 F.2d at 906.

[29] *Racing Servs.*, 540 F.3d at 901; citing *STN Enters.*, 779 F.2d at 905-06.

[30] *See STN Enters.*, 779 F.2d at 905-06.

[31] 72 F.3d 816 (10th Cir. 1995).

[32] *Id.* at 821.

[33] 477 F.3d 1131 (10th Cir. 2007).

again in *dicta* that it is "among those courts to allow a committee to bring" a derivative action, but that:

> [R]ecent Supreme Court precedent may undermine this practice. In *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*,[34] the Supreme Court held that statutory language granting certain powers on behalf of trustees did not grant the same powers to unnamed entities, such as a creditors' committee. On this authority, Akamai argues, the creditors' committee here had no right to bring an avoidance action. Since *Hartford*, however, other circuits have continued to allow committees to bring avoidance actions.[35]

Although the *dictum in both Starzynski and MS55 indicates* that the Tenth Circuit will allow individual creditors or committees to exercise derivative standing, the issue has not been put squarely before the Court.

In contrast, the Bankruptcy Appellate Panel for the Tenth Circuit has held that the Supreme Court's decision in *Hartford* overrides the *Starzynski dictum*. In *United Phosphorus, Ltd. v. Fox (In re Fox)*,[36] the Tenth Circuit BAP applied the plain language of 11 U.S.C. § 548(a)(1) along with the statutory construction provision announced in *Hartford*,[37] to conclude that the trustee has the exclusive right to bring avoidance complaints.[38] In the wake of *Fox*, however, bankruptcy courts in the Tenth Circuit have continued to apply the tests described

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[34] 530 U.S. 1, 7-8, 120 S. Ct. 1942, 147 L. Ed. 2d 1 (2000).

[35] *MS55, Inc.*, 477 F.3d at 1139 n. 9.

[36] 305 B.R. 912 (2004).

[37] *Hartford*, 530 U.S. at 6-7 ("where a statute . . . names the parties granted [the] right to invoke its provisions, . . . such parties only may act.").

[38] *Fox*, 305 B.R. at 916.

above and the *dicta* in *Starzynski* to consider whether committees or individual creditors can exercise derivative standing.[39]

The Tenth Circuit's *dicta* in *MS55*,[40] which was penned three years after *Fox* provides the best indication that derivative standing is available to committees or creditors in the Tenth Circuit, but arguments based on *Fox* and *Hartford* can be made that such standing is inappropriate when the creditor or committee attempts to assert a claim, which the Bankruptcy Code expressly reserves for the trustee.

Derivative standing can be a powerful tool for creditors to attempt to recover assets for the benefit of the estate in circumstances where the trustee or debtor in possession does not have the resources or the desire to prosecute potentially meritorious actions. However, if the trustee or debtor has investigated the action and found it meritless it is difficult to persuade a court that prosecuting such action is in the best interests of the estate. Further, although it has given indications that derivative standing is permissible, the Tenth Circuit has not yet ruled on the propriety of derivative standing. Thus, parties opposing derivative standing can make strong arguments that such standing is never proper when the creditor or committee seeks to pursue a cause of action that is statutorily delegated to the trustee.

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[39] *See Ellicott Springs*, 485 B.R. at 637-38; *Markus v. Fried (In re Geneva Steel LLC)*, 389 B.R. 231, 240 (Bankr. D. Utah 2008).

[40] *MS55, Inc.*, 477 F.3d at 1139 n. 9.