California Bankruptcy Journal
2007

*275 THE ERRONEOUS APPLICATION OF THE DEFENSE OF IN PARI DELICTO TO BANKRUPTCY TRUSTEES

William McGrane [FN1]

I. Introduction

The *in pari delicto* defense, a species of the equitable doctrine of unclean hands, has been widely applied in bankruptcy cases to prevent bankruptcy trustees from suing professionals who, prepetition, aided and abetted the looting of corporate debtors. As will be seen in considerably more detail, *infra*, the federal and state courts applying the *in pari delicto* defense against bankruptcy trustees typically rely on 11 United States Code section 541(a) as interpreted through the prism of one particular aspect of the legislative history of the bankruptcy code, which legislative history is, in turn, widely construed by the courts as absolutely limiting any bankruptcy trustee to whatever rights the prepetition debtor had against its prepetition professionals, thus barring claims where there has been related misconduct by a debtor's prepetition management. [FN2]

This article argues that the federal and state courts considering the question of whether to apply the *in pari delicto* defense to bankruptcy trustees have nearly uniformly misconstrued the legislative history of the bankruptcy code by failing to consider *all* of that legislative history in its proper context. Moreover, this article further argues that the one court that recently *did* consider *all* of the relevant legislative history of the bankruptcy code came to a completely wrong and indefensible conclusion about what that entire body of legislative history meant *vis a vis* applying the *in pari delicto* defense to bankruptcy trustees.

Finally, after considering the correct treatment of *all* of the relevant legislative history of the bankruptcy code in its proper context, this article goes on to argue why, from a public policy standpoint, the current direction of the law on the issue of whether to apply the *in pari delicto* defense to bankruptcy trustees is bad policy as well as bad law, and how the law is badly in need of a course ***276** correction from the Ninth Circuit--where the issue of applying the *in pari delicto* defense to bankruptcy trustees is fortunately still an open one--before that issue becomes immune to change by anything but legislative reform.

II. The *In Pari Delicto* Defense At Common Law and Its Particular Relevance to Bankruptcy Trustees under the Bankruptcy Code

The *in pari delicto* defense is most broadly defined as, "The principle that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing." [FN3] Along the same lines, and as noted in Professor Jeffrey Davis' article, *Ending the Nonsense: The In pari delicto Doctrine Has Nothing to Do With What Is § 541 Property of the Bankruptcy Estate*, "The Latin phrase *in pari delicto* refers to a plaintiff's participation in the same wrongdoing as the defendant ... The doctrine is premised on the equitable principle no court will lend its aid to one who bases a cause of action upon an immoral or illegal act." [FN4]

Historically, the *in pari delicto* defense has been used ubiquitously to thwart various kinds of civil lawsuits. [FN5] It typically arises in the context of bankruptcy proceedings when a court appointed bankruptcy trustee attempts to recover funds from third-party wrongdoers, who then, in response, raise *in pari delicto* as a defense by pointing out prepetition misconduct by former management of the bankrupt entity in question. [FN6]

***277 III. The State of the Law Outside the Eleventh Circuit *Vis a Vis* the I*n Pari Delicto* Defense**

The defense of *in pari delicto* has been applied against bankruptcy trustees at the Circuit level in the Second, Third, Sixth, Eighth and Tenth Circuits. [FN7]

The law regarding the applicability of the defense of *in pari delicto* to bankruptcy trustees is undetermined in any of the First, Fourth, Fifth and D.C. and Federal Circuits, where the issue has either never been reached--or, in the last ***278** case of the Federal Circuit, where the issue is extremely unlikely ever to be reached [FN8]--at the Circuit level.

The law regarding the applicability of the defense of *in pari delicto* to bankruptcy trustees is also undetermined in both the Seventh Circuit and the Ninth Circuit. [FN9] However, analogous reasoning utilized in those two Circuits in the area of receivership law suggests that those two Circuits might *not* apply the defense of *in pari delicto* to bankruptcy trustees. Thus in the Seventh Circuit, as Circuit Judge Posner once colorfully put it, the *in pari delicto* defense was held inapplicable in a federal receivership case because the previously fraudulent corporate wrongdoers were "*no more [former management's] evil zombies.*" [FN10] And, in the Ninth Circuit--again in a receivership context--there is the famous case of *F.D.I.C. v. O'Melveny & Myers*, [FN11] where it was said:

> ***279** 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 a party's shoes pursuant to court order or operation of law. [FN12]

The oft repeated conventional wisdom about *O'Melveny* was most recently set forth in a California Court of Appeal case, *Peregrine Funding, Inc. et. al. v. Sheppard Mullin Richter & Hampton LLP*, [FN13] a legal malpractice case brought by a bankruptcy trustee who unconventionally chose to sue the former legal counsel for a number of related debtors in a non-federal forum. The *Peregrine* court limited the holding of *O'Melveny* to its facts, on the stated grounds that "unlike a receiver, a bankruptcy trustee's standing [and consequent lack of immunity to an *in pari delicto* defense] is based on, and subject to the limits of, 11 U.S.C. § 541." [FN14]

***280 IV. 2006: Judge Pryor and Professor Jeffrey Davis Lock Horns in the Eleventh Circuit Over the Application of the *In Pari Delicto* Defense to Bankruptcy Trustees Under the Bankruptcy Code**

In early 2006, Judge Pryor of the Eleventh Circuit Court of Appeals firmly declared the defense of *in pari delicto* applicable to bankruptcy trustees [FN15] in that Circuit. [FN16] In so holding, Judge Pryor attacked Professor Jeffrey Davis of the University of Florida School of Law on what can only be described as a near personal level. [FN17] This in connection with Judge Pryor's concluding that certain legislative history on which the Davis article had relied in contending that the *in pari delicto* defense was never intended to apply to bankruptcy trustees was flatly misread by Professor Davis. [FN18] Thus, Judge Pryor said:

> *The portion of the legislative history on which [bankruptcy trustee] Laddin relies [Congressional Record, 95th Congress, Second Session, Vol. 124-Part 24, at page 32,399] pertains to section 541(d), not section 541(a).*
>
> ...
>
> ***281** *[Bankruptcy trustee] Laddin provides no support for his assertion that in pari delicto is a personal defense that is excluded from the debtor estate under section 541(a)* [FN19]

In stark contrast to Judge Pryor's so-called 'explanation' of what the legislative history said about section 541 in

PSA--*i.e.*, that it was somehow talking about section 541(d) and only section 541(d) rather than actually talking about section 541(a)--Davis' description of the meaning of Congressman Edwards' remarks is far more intelligible and natural than anything contained in *PSA*. Thus, Davis says:

One perceived constraint on the courts' flexibility here is derived from a misreading of the legislative history [of the Bankruptcy Code]. A number of courts have quoted the following language, which appeared in both the Senate and House Reports [FN. 140 here reads, in pertinent part: "reprinted in 1978 U.S.C.C.A.N. 5963,6323"]:

Though § 541 will include choses in action and claims by the debtor against others, it is not intended to expand the debtor's rights against others more than they exist at the commencement of the case. For example, if the debtor has a claim that is barred at the time of the commencement of the case by the statue of limitations, then the trustee would not be able to pursue that claim, because he too would be barred. He could take no greater rights than the debtor himself had.

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

[A]s section 541(a)(1) clearly states, the estate is comprised of all legal or equitable interest 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* [emphasis in *italics* in original text of Davis article but not in original text of Congressional Record] [citation to FN 141].

...

***282** [FN. 141 reads: "This statement by Congressman Edwards immediately followed a description of § 541(d), which states that where the debtor held only bare legal title without any equitable interest, the estate acquires only bare legal title. *Id*. That is, the defense that the debtor held only bare legal title would be assertable against the trustee. *Congressman Edwards' subsequent reference explicitly to subsection (a)(1) is much more general, referring not only to the kinds of defenses that are assertable against the trustee, but also to the kinds that are not.*"]

...

It is this second statement upon which Collier, the highly respected authority on bankruptcy law, relies in describing the reach of paragraph (1) of §541. [FN. 142 here reads: "5 Collier, *supra*, note 136, ¶ 541.04."] Neither of these broad general statements in the legislative history [i.e., either limiting or delimiting legal or equitable rights in the hands of bankruptcy trustees under § 541] is explained, yet the seemingly absolute limit in the first statement on the trustee's power to assert a claim is clearly contradicted by the mitigating language emphasized in the second statement. Taken together, the meaning of these unexplained contradictory statements is indeterminate. At most, they can only mean that many or even most defenses, such as a statute of limitations bar, will limit the trustee's power to assert a prebankruptcy claim, *BUT THAT SOME DEFENSES, INCLUDING THOSE PERSONAL AGAINST THE DEBTOR, ARE NOT EFFECTIVE AGAINST THE ESTATE. BY IGNORING THE SECOND AND MORE RECENT STATEMENT IN THE LEGISLATIVE HISTORY, COURTS HAVE FOUND THE LEGISLATIVE HISTORY TO BE MORE RESTRICTIVE THAN NEED BE ...* [FN20]

As *PSA* correctly recognizes by beginning its attack on liberating bankruptcy trustees from the *in pari delicto* defense:

[A court] need not resort to legislative history [if] ... the text of section 541(a) is unambiguous [as] ... "the lan-

guage of our laws is the law." [FN21]

***283** And just what is the statutory text that *PSA* finds so clear on its face *vis a vis* the *in pari delicto* defense as to preclude any possible need for its looking for guidance in the legislative history of the Bankruptcy Code on that subject? It reads, in pertinent part, as follows:

> The commencement of a case ... creates an estate. Such estate is comprised of all the following property ... all legal and equitable interests of the debtor ... as of the commencement of the case. [FN22]

There is nothing, plain or otherwise, stated in the actual text of section 541(a) that addresses whether or not the defense of *in pari delicto* should be made applicable to bankruptcy trustees. Rather, all *PSA* can argue in support of its "the law ... is the law" formulation, is *case* law holding that, under section 541(a), "a bankruptcy trustee stands in the shoes of the debtor ... [combined with its conclusion that] there is no suggestion in the text of the Bankruptcy Code that the trustee acquires rights and interests greater than those of the debtor." [FN23]

***284** Section 541(a), quoted above, says absolutely nothing about who stands in anyone else's shoes, or about how a postpetition debtor's rights to property are no greater than its prepetition predecessor-in-interest. [FN24] It is respectfully submitted, therefore, that the plain meaning doctrine simply cannot be stretched so far as to allow the courts to deliberately blind themselves to the legislative history of the Bankruptcy Code in approaching the issue of whether to liberate bankruptcy trustees from the *in pari delicto* defense. Nor--given the paramount importance of this issue in a corporate environment utterly beset on all sides by one of the grossest fiscal scandals in the history of these United States, namely, Enron's multibillion dollar bankruptcy--should any sensible court system want to so blind itself in the first place. [FN25]

***285 V. Question Presented**

Does the legislative history of the Bankruptcy Code--contrary to *PSA's* entirely contrived interpretation thereof and pursuant to sound public policy-- compel liberating bankruptcy trustees from the defense of *in pari delicto*? All conventional wisdom to one side, this article hopes to demonstrate that the answer to this question should be a resounding *yes*.

VI. The Legislative History of Section 541(a) Compels Liberating Bankruptcy Trustees From the *In Pari Delicto* Defense and That Legislative History Has Either Been Improperly Ignored--Or, In The Case Of *PSA*, Misinterpreted--Up Until This Point in Judicial History

A portion of the Congressional Record of September 28, 1978, recounting the remarks made that day by Congressional Representative Don Edwards, Democrat of California, co-sponsor and principal architect of the 1978 Bankruptcy Code, reads:

> [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.* [FN26]

As previously discussed, *supra*, there was an effort by *PSA* to confound the clarion call of this last-in-time legislative history--*in pari delicto* being, by its nature, the "epitome of a personal defense." [FN27] Thus, and again as previously noted, *PSA* seizes on the conflation within one single paragraph of Congressman Edwards' remarks, which make reference to *both* sections 541(d) and 541(a), in order to pretend that section 541(d) was the *sole and only* focus of Congressman Edwards' remarks regarding "personal defenses" as applied to section 541(a) and *not* section 541(d). [FN28]

***286** In that latter regard, one needs a microscope with only small powers of magnification to expose the intel-

lectual fraud being practiced by Judge Pryor in *PSA*. Thus, compare the following expanded version of the Congressional Record, with *PSA* at 1150.

First, read what was actually said by Congressman Edwards, exactly as reported in a single paragraph by the Congressional Record itself:

> 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. [FN29]

Although the first sentence of the paragraph in question makes reference to section 541(d), the focus of the paragraph shifts back to section 541(a) later in the paragraph, where that section is cited. [FN30] Thus, the language in the paragraph clearly applies to section 541(a).

Moreover, section 541(d) appears to be a modifier of section 541(a), which contains the broad catch-all language, namely, the "estate is comprised of all legal and equitable interest of the debtor at the commencement of the case." [FN31] That is to say, even if we assume that the "personal defenses" rubric of the Congressional Record in question applies to section 541(d), there is no reason, as a matter of logic, it should not equally apply to section 541(a) as well. Asserting anything else is analogous to inferring that, since the San Francisco Bay contains some salt water, the Pacific Ocean necessarily has no salt water of its own.

***287** Other than *PSA*, however, and for no apparent good reason--since Collier [FN32] has long cited to this legislative history--not one of the other Circuit Court of Appeals' cases deciding whether to apply the defense of *in pari delicto* to bankruptcy trustees has ever before dealt with the legislative history of the Bankruptcy Code before. [FN33]

So, in adopting a legislative history approach to liberating bankruptcy trustees from the *in pari delicto* defense, not only will the federal courts be writing on what is, practically speaking, a clean (if quite dusty) slate, there is nothing at all complicated about what they are being asked to do. And that is simply to treat bankruptcy trustees and receivers (state or federal) as full equals from a liberation-from-*in-pari-delicto*-defense-perspective.

Why not? If Congress has not flatly outlawed such equality of treatment-- and we have shown here that it clearly has not--then unless there is some public policy reason against it (and every public policy reason imaginable favors it) then, of course, subject to the exercise of ordinary discretion by courts in all cases involving matters of equity, such equality of treatment should be the rule.

288 VII. Public Policy Strongly Favors Liberating Bankruptcy Trustees From the Defense Of *In Pari Delicto

A glance at the headlines shows that nearly every major corporate bankruptcy case contains the seeds for claims against debtor's prepetition lawyers, accountants and other similar outside professionals for both negligence and fraud in connection with the prepetition management of debtor's affairs.

As a matter of law, such claims against professionals belong exclusively to the debtor, and not to its injured corporate stakeholders. [FN34] Because claims of negligence and fraud in such professional liability contexts typically arise out of the same nucleus of operative facts, the *in pari delicto* defense is assertable against both negligence

and fraud claims, with devastating ultimate economic effect on injured corporate stakeholders and correspondingly positive ultimate economic effect on professional liability insurers. [FN35]

***289** Thus, we have a veritable witches' brew, where major assets of corporate bankruptcy estates, i.e., claims against defalcating prepetition professionals, that, because of the law of ownership, cannot be prosecuted by anybody *but* debtors, also cannot be prosecuted *by* debtors, either. And all because of an *in pari delicto* defense that Congress never intended be operative in the first place. And all so insurers, like Lloyd's of London (which dominates the market for professional insurance of the type under discussion here) do not have to earn their premium dollar. [FN36]

***290** Other situations may well exist where the interposition of a bankruptcy trustee as lead prosecutor of non-professional third party looters, who might otherwise escape by virtue of their raising an *in pari delicto* defense against such a bankruptcy trustee, enables the case to proceed. But countervailing concerns about ownership of such third party claims, [FN37] as well as equally valid concerns about what constitutes best practices for prosecuting particular varieties of such third party claims, may exist. [FN38] Accordingly, this article does not stray into such *terra incognita*.

Rather, in discussing public policy matters, this article's sole and only focus is on preserving those claims that no one but a bankruptcy trustee can prosecute in any case. As the now finally lost portion of the *Peregrine* case illustrates, such claims alone can be worth hundreds of millions of dollars to injured corporate stakeholders. And right now, for no reason except blind conventional wisdom combined with a failure by counsel and the courts to read and understand the legislative history of section 541(a), the guilty have been left to have the last laugh at the expense of the innocent. [FN39]

***291 VIII. Conclusion**

The Circuit Courts of Appeals appear poised on the point of uniformly entrapping bankruptcy trustees in a nationwide net of *in pari delicto* defenses. Really, insofar as published decisions are concerned, *O'Melveny* stands as a beacon of hope in a sea of trouble. And the *Peregrine* and *In re Crown Vantage* decisions' twin attacks on *O'Melveny*--while non-binding because in the one case only constituting an Opinion by an intermediate state court of appeals (obviously not persuasive because the court was not itself well-versed in federal bankruptcy law and it, in turn, was apparently misled by weak appellate briefing by the bankruptcy trustee before it) and in the other because literally unpublished--nonetheless constitute a frontal assault on even that slight remaining hope.

But the truth of the matter is that Congressman Edwards never intended the defense of *in pari delicto* to be applied to bankruptcy trustees. With the help of all the very able, exacting, legal scholarship of the many scholars who have gone before this writer, this article has now proven that fact beyond the shadow of a doubt. In light of this fact, there is just no rhyme or reason to go disregarding Congressional intent on the subject of the unavailability of the *in pari delicto* defense against bankruptcy trustees.

A line in the sand affirming *O'Melveny* and thereby preventing imposition of the *in pari delicto* defense on bankruptcy trustees needs to be drawn and this article is written in the sincere hope of aiding the Ninth Circuit and/or the United States Supreme Court in their analysis if and when an appropriate case allowing that line to be drawn ever comes before either of them.

[FN1]. Mr. William McGrane, is a senior partner in McGrane Greenfield LLP, a Bay Area law firm with offices in San Francisco and San Jose. Mr. McGrane is a graduate of the University of California, Berkeley (Boalt Hall) School of Law, Class of 1973. The author wishes to thank his fellow Members of the State Bar of California, Mr. David Stuckey, Esq., University of Virginia School of Law, Class of 2001, Mr. Christian Jinkerson, Esq., Duke University School of Law, Class of 2002, and Ms. Cindy Langenbeck, Esq., McGeorge School of Law, Class of 2006, for all of their considerable assistance in the researching and writing that went into the creation of this article.

[FN2]. Unless otherwise noted, all statutory references are to the Bankruptcy Code (11 U.S.C. § 101 *et. seq.*).

[FN3]. BLACK'S LAW DICTIONARY 806 (8th ed. 2004).

[FN4]. 21 EMORY BANKRUPTCY DEVELOPMENTS JOURNAL 519, 520 (2005) [hereinafter "DAVIS"].

[FN5]. *In pari delicto* is a species of the broader doctrine of unclean hands, Scheiber v. Dolby Labs., Inc., 293 F.3d 1014, 1022 (7th Cir. 2002) ("the Supreme Court [has] equated 'unclean hands' to *in pari delicto* ") citing McKennon v. Nashville Banner Publishing Co., 513 U.S. 352, 360 (1995). The doctrine of unclean hands is defined as "[t]he principle that a party cannot seek equitable relief or assert an equitable defense if that party has violated an equitable principle, such as good faith." (BLACK'S LAW DICTIONARY 806 (8th ed. 2004)). The doctrine has been used at common law as a defense to any kind of action legal or equitable. (*See* William J. Lawrence, Note, *The Application of the Clean Hands Doctrine in Damage Actions*, 57 NOTRE DAME L.REV. 673 (1982) (arguing for the application of the doctrine at law); Zechariah Chafee, Jr., *Coming into Equity with Clean Hands*, 47 MICH L.REV. 877, 904-06 (1949)).

[FN6]. *See, e.g.*, Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145 (11th Cir. 2006) [hereinafter *PSA*].

[FN7]. *See id*. at 1151 (citing Official Comm. of Unsecured Creditors of Color Tile v. Coopers & Lybrand, LLP, 322 F.3d 147, 158-66 (2d Cir. 2003)); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356-57 (3d Cir. 2001); Terlecky v. Hurd (*In re* Dublin Sec.), 133 F.3d 377, 381 (6th Cir. 1997); Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 837 (8th Cir. 2005); Sender v. Buchanan (*In re* Hedged-Inv. Assocs.), 84 F.3d 1281, 1285 (10th Cir. 1996).

In PSA, and as discussed in more detail, *infra*, while Judge Pryor of the Eleventh Circuit was quick to point out that the Eleventh Circuit was merely joining numerous other Circuits in reaching a conclusion that the *in pari delicto* defense should be applied to bankruptcy trustees, Judge Pryor neglected to mention that (i) in coming to their various holdings respecting the applicability of the defense of *in pari delicto* to bankruptcy trustees, none of those other Circuits had discussed the particular aspect of §541(a)'s legislative history that Davis and this article are both concerned with and that (ii) only two of them--the Third and Eighth Circuits--had acknowledged the possible relevance of § 541(a)'s legislative history in the first instance-- with the Second, Sixth and Tenth Circuits contenting themselves with the insupportable assertion that § 541(a) was clear on its face respecting the applicability of the defense of *in pari delicto* to bankruptcy trustees, despite the opacity of the language contained in § 541(a) as more fully described, *infra*.

Lower federal court decisions addressing the issue of the application of the defense of *in pari delicto* to bankruptcy trustees in the Second, Third, Sixth, Eighth and Tenth Circuits include Baena v. KPMG LLP, 389 F. Supp. 2d 112, 118 (D. Mass. 2005) ("Therefore, if the *in pari delicto* doctrine would have barred [the bankrupt corporation] from bringing a claim against Defendants, then the Trustee is barred as well"); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Nickless (*In re* Advanced RISC Corp.), 324 B.R. 10 (Bank. D. Mass. 2005) ("the *in pari delicto* doctrine bars a claim by a bankruptcy trustee where the debtor would have been so barred before the bankruptcy petition was filed"); Aquino v. Curry (*In re* D'Amore), No. 04-10546-JNF, 2005 Bankr. LEXIS 2783 (Bankr. D. Mass Dec. 16, 2005) (citing both to *Merrill, supra*, and to DAVIS, supra note 4); Nisselson v. Lernout, No. 03-10843-PBS, 2004 U.S. Dist. LEXIS 28655 (D. Mass. Aug. 9, 2004) (the litigation trustee for the new company emerging from the bankruptcy proceeding of the bankrupt corporation had no standing to sue for damages which were sustained by shareholders and was barred by the doctrine of *in pari delicto*); Nat'l City Bank of Minneapolis v. Lapides (*In re* Transcolor Corp.), 296 B.R. 343, 367 (Bank. D. Md. 2003) ("The fact that the debtor was acting *in pari delicto* with third parties whose wrongdoing allegedly injured the debtor bars recovery by the trustee on a suit filed against those same third parties on behalf of the debtor's estate"); Logan v. Becker (*In re* Inner City Mgmt., Inc.), 304 B.R. 250 (Bank. D. Md. 2003); Erricola v. Gaudette (*In re* Gaudette), 241 B.R. 491, 500 (Bankr. D.N.H. 1999) (bankruptcy trustee lacked standing to sue defendants on grounds that the debtor corporation was a co-conspirator in the fraud); Goldin v. Primavera Familienstiftung Tag Assocs. (*In re* Granite Partners, LP), 194 B.R. 318, 328 (Bankr. S.D.N.Y. 1996) ("If *in pari delicto*

applies, the trustee cannot sue the third parties for injury that the corporation suffered in connection with the fraudulent scheme"); Drabkin v. L & L Constr. Assocs. (*In re* Latin Inv. Corp.), 168 B.R. 1, 18-19 (Bank. D. D.C. 1993).

[FN8]. Although a complete summary of the subject-matter jurisdiction of the United States Court of Appeals for the Federal Circuit is beyond the scope of this article, in general, the Court's jurisdiction is limited to patent, trademark, and international trade cases. *See* 28 U.S.C. § 1295. Thus, the issue of the applicability of the defense of *in pari delicto* to bankruptcy trustees is highly unlikely to ever arise in the decisions of the Federal Circuit.

[FN9]. While not having the force of precedent because filed August 9, 2006 as an unpublished decision--and thus not delimited by the recent changes made by the United States Supreme Court to F.R.A.P. 32.1(a) [forbidding restrictions on publication after January 1, 2007]--one panel of the Ninth Circuit recently affirmed an earlier unpublished District Court decision in *In re* Crown Vantage, Inc. 2003 WL 25257821 (D.C. N.D. Cal. 2003) holding the defense of *in pari delicto* applicable to bankruptcy trustees despite F.D.I.C. v. O'Melveny & Myers, 61 F.3d 17 (9th Cir. 1995) (hereinafter *O'Melveny*), discussed, infra. This latest Ninth Circuit ruling is itself the subject of a still-pending Petition for Writ of Certiorari to the United States Supreme Court, with Professor Jeffrey Davis of the University of Florida Law School, the Davis author, on the briefs.

Other lower federal court decisions addressing the issue of the application of the defense of *in pari delicto* to bankruptcy trustee in these Circuits include Schneilling v. Thomas (*In re* AgriBioTech, Inc.), CV-S-02-0537-PMP (LRL), 2005 U.S. Dist. LEXIS 6466, at *22-32 (D. Nev. 2005) ("the [bankruptcy] trustee is subject to the imputation and *in pari delicto* doctrines to the same effect and degree as the debtor ... would have been as of the commencement of the bankruptcy proceedings"); Baker O'Neal Holdings, Inc. v. Ernst & Young LLP, No. 1:03-cv-0132-DFH, 2004 U.S. Dist. LEXIS 6277 (S.D. Ind. Mar. 4, 2004); Nasr v. Geary, No. CV 94-8288-JFW (RNBx), 2003 U.S. Dist. LEXIS 13887, at *73-74 (C.D. Cal. 2003) ("Under the *in pari delicto* doctrine, a bankruptcy trustee cannot sue third parties for injuries that a corporation suffered in connection with a fraudulent scheme in which the corporation was involved"); Apostolou v. Fisher, No. 94 C 7244, 1995 U.S. Dist. LEXIS 15634 (N.D. Ill. Oct. 19, 1995); Giacometti v. Arton Bermuda Ltd., (*In re* Sukamto SIA), No. 98-04912, 2006 Bankr. LEXIS 2183 (Bankr. D. Haw. Aug. 25, 2006); Collins v. Kohlbert & Co. (*In re* Southwest Supermarkets, LLC), 325 B.R. 417 (Bankr. D. Ariz. 2005) (asserting in dicta that that "[t]he availability of affirmative relief under Code § 544(a)(2) ... may resolve trustees' *in pari delicto* problem, at least where state law would free a receiver from that defense").

[FN10]. Scholes v. Lehman, 56 F.3d 750, 754 (7th Cir. 1995) (emphasis added).

[FN11]. 61 F.3d 17 (9th Cir. 1995) (hereinafter *O'Melveny*).

[FN12]. *Id*. at 19 (emphasis added). But see discussion of *In re Crown Vantage* in FN. 7, *supra*.

[FN13]. 133 Cal. App. 4th 658, 680 n.14 (2005) (hereinafter *Peregrine*).

[FN14]. A review of the appellate briefs on file in the California Court of Appeal, First Appellate District, Division Three, in Appeal No. A104481, which resulted in the published decision in *Peregrine, supra* note 13, reveals that the plaintiff/respondent bankruptcy trustee's appellate counsel made no argument whatsoever respecting the legislative history of the Bankruptcy Code (which legislative history is a main focus of *PSA* and the entire subject of this article) and, in fact, made only a vague reference to *O'Melveny* to begin with. In response, the defendant/appellee law firm's appellate counsel in *Peregrine* also (wisely in their case) ignored the legislative history of the Bankruptcy Code, instead making a complete, if wholly conventional, argument to the effect that *O'Melveny* should be limited to its facts and implicitly suggesting that *O'Melveny's* inclusive reference to "trustees" be treated as mere *obiter dictum*.

Other cases suggesting *O'Melveny* should be limited to its facts include *Schneilling v. Thomas (In re AgriBioTech, Inc.)*, CV-S-02-0537-PMP (LRL), 2005 U.S. Dist. LEXIS 6466, at *31-32 (D. Nev. Apr. 1, 2005) ("*O'Melveny* involved a receiver, not a bankruptcy trustee. Therefore, although the Ninth Circuit likened a receiver to a bankruptcy trustee, its references to a bankruptcy trustee were dicta [and] the Ninth Circuit had no occasion to consider whether §

541(a)'s language altered the equation"); Lutz v. Chitwood (*In re* Donahue Sec., Inc.), 304 B.R. 797, 799 n.4 (Bankr. S.D. Ohio 2003) ("This proceeding is easily distinguishable from *Scholes* and *O'Melveny* because of the applicability of 11 U.S.C. § 541"); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 358 (3d Cir. 2001) (stating that *Scholes* and *O'Melveny* "are easily distinguishable, however; unlike bankruptcy trustees, receivers are not subject to the limits of section 541"); Official Comm. of Unsecured Creditors v. Shapiro (*In re* Walnut Leasing Co., Inc. and Equipment Leasing Corp. of America, Inc.), No. 99-526, 1999 U.S. Dist. LEXIS 14517, at *16 n. 11 (E.D. Pa. Sept. 8, 1999) ("The Committee is not analogous to a receiver or liquidator, for which reason this case is distinguishable from the cases that hold a receiver is not subject to defenses based on inequitable conduct or unclean hands").

[FN15]. References to bankruptcy trustees throughout this article are intended to be inclusive *vis a vis* debtors-in-possession and creditors' committees, to the extent the Bankruptcy Code accords such persons or entities the rights of bankruptcy trustees. *See, e.g.*, 11 U.S.C. § 1107 (granting debtors-in-possession the same status as a bankruptcy trustee while they so serve]; Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356 (3d Cir. 2001) (treating creditors' committee like trustee as "the representative of the bankruptcy estate"); *In re* Mediators, Inc., 105 F.3d 822, 826 (2d Cir. 1997) (suggesting that, when a committee brings claims on behalf of a debtor, it takes on the characteristics of a trustee); Louisiana World Exposition v. Federal Ins. Co., 858 F.2d 233, 247 (5th Cir. 1988) (holding that "[t]he law is well-settled that in some circumstances, a creditors' committee has standing ... to file suit on behalf of a debtor-in-possession or a trustee"); *see also* Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1363 (5th Cir. 1986) (holding that 11 U.S.C. § 1109(b) implies a basis for the standing of a creditors' committee); *In re* STN Enterprises, 779 F.2d 901, 904 (2d Cir. 1985) ("We agree ... that 11 U.S.C. §§ 1103(c)(5) and 1109(b) imply a qualified right for creditors' committees to initiate suit with the approval of the Bankruptcy Court").

[FN16]. 437 F.3d at 1151.

[FN17]. *PSA*, *supra* note 6, at 1152 (describing Davis as "containing the same flawed arguments about [the] legislative history [of § 541(a)] ... that we have already rejected.").

[FN18]. The legislative history on which Professor Davis relied on consisted on remarks made by Congressman Don Edwards of San Jose, California, a graduate of Stanford Law School, Class of 1939, who served in the United States House of Representatives for 32 years, from 1962 until 1995.

[FN19]. *PSA*, *supra* note 6, at 1150 (emphasis added).

[FN20]. DAVIS, *supra* note 4, at 538-39 (footnotes omitted except as indicated) (emphasis added)

[FN21]. 437 F.3d at 1150. The "plain meaning doctrine" is a valuable tool in statutory interpretation. *See* United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 240-241 (1989) ("... as long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute ... for where, as here, the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms"') (citing Caminetti v. United States, 242 U.S. 470, 485 (1917)); *see also* Union Bank v. Wolas, 502 U.S. 151, 155 (1991) ("a court should look first to the plain meaning of the policy to determine what its terms mean").

Needless to say, the Court's doctrine has been frequently applied to the Bankruptcy Code as well, but it has its limitations which are equally plain. Thus:

> To reconcile the conflicting goals of the Code and to coordinate the Code's interaction with other federal statutes and with state laws, the Court has increasingly embraced a "plain meaning" approach to the statutory text. As developed in a series of recent bankruptcy decisions under Chief Justice Rehnquist, this doctrine emphasizes the literal interpretation of Code provisions, placing an "exceptionally heavy" burden on proponents of any other construction. So long as the plain meaning of a Code section is "coherent and consistent" with the remainder of the Code and with other statutes, the section's legislative history will generally be deemed

> irrelevant. *However, if the provision as written is "open to interpretation," and if bankruptcy law under "the proposed interpretation, (even if literal) is in clear conflict with state or federal laws of great importance," the Court will review the provision's legislative history. The drafters' intent, as revealed by such an inquiry, will then take precedence over construction of the provision's "plain meaning."*

Walter A. Effross, *Grammarians at the Gate: the Rehnquist Court's Evolving "Plain Meaning" Approach to Bankruptcy Jurisprudence*, 23 SETON HALL L. REV. 1636, 1638-39 (1993). (emphasis added)
[FN22]. 11 U.S.C. § 541(a).

[FN23]. 437 F.3d at 1150. *PSA* cites O'Halloran v. First Union National Bank, 350 F.3d 1197 (11th Cir. 2003) for the familiar nostrum that a "bankruptcy trustee stands in the shoes of the debtor," which, as commentator after commentator have now observed--given the legislative history of § 541--in no way means courts are thereby precluded from liberating bankruptcy trustees from the defense of *in pari delicto*. *See* LaDawn Conway, Joe Wielebinski, Phil Appenzeller, Holly Church, *Equity Turned on Its Head: The Applicability of In pari delicto to a Bankruptcy Trustee*, TEXAS LAWYER (TL Alert Bankruptcy 2005) [hereinafter "CONWAY"] (citing to 5 L. King, COLLIER ON BANKRUPTCY ¶ 541.04 (15th ed. rev'd. 2004), which, in turn refers to the legislative history of § 541); *see also* DAVIS, *supra* note 4, at 538-39, again referring to the legislative history of § 541; *see also*, generally, Tanvir Alam, *Fraudulent Advisors Exploit Confusion in the Bankruptcy Code: How In pari delicto Has Been Perverted to Prevent Recovery for Innocent Creditors*, 77 AM. BANKR. L.J. 305 (Summer, 2003) [hereinafter "ALAM"] (discussing, *inter alia*, the very significant negative public policy implications of applying *in pari delicto* defense to bankruptcy trustees in era of widening corporate scandals).

[FN24]. As is pointed out at DAVIS, *supra* note 4, at 538, the actual source of the "no greater rights than the debtor himself had" rubric surrounding § 541 is not the literal language of § 541, but an early excerpt from the Congressional Record that pre-dates the excerpt from the Congressional Record with which we are most concerned in this article. The full text of both relevant excerpts of the Congressional Record are reprinted below.

[FN25]. Various approaches other than use of legislative history have been suggested as a basis for liberating bankruptcy trustees from the *in pari delicto* defense. *See, e.g.* DAVIS, *supra* note 4, at 535-43 (arguing federal common law should control what is property of the estate); CONWAY, *supra* note 23; ALAM, *supra* note 23, at 322 (arguing that claims against third persons who cooperated with debtor in looting debtor are §541 property of the estate because they existed at the commencement of the case and that fact they are subject to possible *in pari delicto* defense is not addressed by language of §541.); *see also* Ralph Brubaker, *Making Sense of the In pari delicto Defense: "Who's Zoomin' Who,"* BANKRUPTCY LAW LETTER, (Thompson West November 2003) (arguing that, as state court receiver acting pursuant to state law might have brought action against third party looter *in pari delicto* with debtor's management at commencement of case regardless of *in pari delicto* defense, so too should bankruptcy trustee not be debarred from so acting postpetition).

Whatever the merit of any of these various approaches, they are ***not*** addressed anywhere herein. What this article is about is intended by the writer to be utterly stark in its simplicity. It is about the plain language of the Congressional Record, and what the Bankruptcy Code was intended to do, i.e., allow bankruptcy trustees--just like their brother state and federal receivers--to proceed without regard to the in pari delicto defense.

Put another way, this article is about how the Ninth Circuit got it exactly right in *O'Melveny*, when it lumped trustees in with receivers. Finally, and most importantly of all, this article is about how, due to blind conventional wisdom--plus, in the case of the Eleventh Circuit, perverse intellectual dishonesty--most of the federal judiciary has now got the answer to the question as to when to apply the *in pari delicto* defense to bankruptcy trustees (the correct answer being hardly ever) absolutely wrong--such that the very state of the law itself is in great jeopardy--all to the ultimate detriment of distressed corporate stakeholders everywhere, as will be explained in greater detail, *infra*.

[FN26]. Congressional Record, 95th Congress, Second Session, Vol. 124-Part 24, at page 32, 399 (emphasis added).

[FN27]. *See* CONWAY, *supra* note 23 and cases cited therein. The cases collected by Conway as holding that the *in*

pari delicto defense is, of definitional necessity, a purely personal defense, are as follows: Pinter v. Dahl, 486 U.S. 622, 632 (1988); Exxon v. Oxxford Clothes, Inc., 109 F.3d 1070, 1078 n. 11 (5th Cir. 1997), Nomura Sec. Int'l, Inc. v. E*Trade Sec., Inc., 280 F. Supp. 2d 184, 196-97 (S.D.N.Y. 2003), J.C. Wykoff & Assocs. v. Aetna Cas. & Sur. Co. (*In re* J.C. Wykoff & Assocs. Inc.), 41 B.R. 791, 792-93 (Bankr. E.D. Mich. 1984).

[FN28]. *PSA*, *supra* note 6, at 1150.

[FN29]. Congressional Record, 95th Congress, Second Session, Vol. 124-Part 24, at page 32, 399.

[FN30]. *Id*.

[FN31]. *Id*.

[FN32]. 5 L. King, COLLIER ON BANKRUPTCY ¶ 541.04 (15th ed. rev'd. 2004).

[FN33]. Decisions of the Circuit Courts of Appeals addressing the application of the defense of *in pari delicto* to bankruptcy trustee, but not discussing the legislative history of § 541(a) of the Bankruptcy Code, include Logan v. JKV Real Estate Servs. (*In re* Bogdan), 414 F.3d 507 (4th Cir. 2005); Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833 (8th Cir. 2005); McNamara v. PFS (*In re* Personal & Bus. Ins. Agency), 334 F.3d 239 (3d Cir. 2003); Baena v. KPMG LLP, 453 F.3d 1, 22-23 (1st Cir. 2003); Terleckey v. Hurd (*In re* Dublin Sec. Inc.), 133 F.3d 377 (6th Cir. 1998); *In re* Royale Airlines, 98 F.3d 852 (5th Cir. 1996); *In re* Leasing Consultants, Inc., 592 F.2d 103 (2d Cir. 1979).

Below the Circuit Court of Appeals level, the writer notes that he personally was co-counsel to bankruptcy trustee R. Todd Neilson in an action entitled Neilson v. Kellman et. al., (*In re* Access HealthNet, Inc.), United States District Court for the Northern District of California (San Jose Division) Case No. 98-20252 SW (hereinafter *Access case*), a legal malpractice case brought by bankruptcy trustee R. Todd Neilson against Fenwick & West LLP. The *in pari delicto* defense was raised as defense in the *Access case* by Gibson Dunn & Crutcher LLP, acting as counsel for Fenwick & West LLP, and litigated during the year 1998. In the *Access case*, the legislative history of the Bankruptcy Code was fully and successfully argued before District Court Judge Spencer Williams so as to ultimately prevent application of the doctrine against Mr. Neilson. (Copies of the files of the *Access case* are maintained in the writer's law offices in San Francisco, California.) Finding the legislative history antidote to the *in pari delicto* defense in the *Access case* back in 1998 was no more complicated than simply reading the then-current edition of Collier on Bankruptcy on the subject matter of the meaning of § 541. (*See also*, CONWAY *supra* note 23 ["[T]his portion of the legislative history [of § 541] has been largely--and inexplicably--overlooked, [but] its validity is recognized by highly respected authorities on bankruptcy law and at least one court. *See*, e.g., 5, L. King, COLLIER ON BANKRUPTCY ¶ 541.04 (15th rev. ed. 2004) ... Davis [at 538-39] ... *In re* Fuzion, 2005 Bankr. LEXIS 718 at *8.]."")

[FN34]. *See* Johnson, Blakely, Pope, Bokor, Ruppel & Burns, P.A. v. Alvarez (*In re* Alvarez), 224 F.3d 1273 (11th Cir. 2000) (claims of legal malpractice "are property of [the] bankruptcy estate and ... accordingly ... can only be asserted by the bankruptcy trustee"); Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP, 212 B.R. 34 (S.D.N.Y. 1997) (bankruptcy trustee owns any claim for relief against debtor's former professionals); *see*, Irve Goldman, *Whose Cause of Action Is It, Anyway?*, AMERICAN BANKRUPTCY INSTITUTE JOURNAL, 23-2 ABIJ 1 (Mar. 2004).

[FN35]. Baena v. KPMG LLP, 453 F.3d 1 (1st Cir. 2006) (negligence claims against accountants barred by *in pari delicto* doctrine); Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145 (11th Cir. 2006) (negligence claim against holders of individual retirement accounts barred); Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 841-842 (8th Cir. 2005) (negligence claim against cattle association barred); Official Comm. of the Unsecured Creditors of Color Tile, Inc. v Coopers & Lybrand LLP, 322 F.3d 147 (2d Cir. 2003) (breach of fiduciary duty and breach of contract claims against accounting firm barred); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001) (creditors committee's fraud claims against attorney, accountant, underwriter, and

financial services provider barred); Terleckey v. Hurd (*In re* Dublin Sec. Inc.), 133 F.3d 377 (6th Cir. 1997) (claims of negligence, fraud, breach of fiduciary duty against prepetition legal counsel); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085 (2d Cir. 1995); Laddin v. Edwards, No. 1:02-CV-3327-TWT, 2006 U.S. Dist. LEXIS 30356, at *7-8 (N.D. Ga. Apr. 21, 2006) (fraud and breach of fiduciary duty claims against prepetition law firm barred); Bondi v. Bank of Am. Corp. (*In re* Parmalat Sec. Litig.), 383 F. Supp. 2d 587 (S.D.N.Y. 2005) (fraud claim against bank barred); Schneilling v. Thomas (In re AgriBioTech), No. CV-S-02-0537-PMP, 2005 U.S. Dist. LEXIS 6466 (D. Nev. Apr. 1, 2005) (negligence, fraud claims against accounting firm barred); Seitz v. Detweiler, Hersey & Associates, P.C. (*In re* CITX Corp.), No. 03-cv-6766, 2005 U.S. Dist. LEXIS 11374, at *32 (E.D. Pa. Jun. 7, 2005) ("deepening insolvency" and malpractice claims against accounting firm barred); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Nickless (*In re* Advanced RISC Corp.), 324 B.R. 10 (D. Mass. 2005) (claims of negligence barred); Wight v. Bankamerica Corp., 1999 U.S. Dist. LEXIS 5087 (S.D.N.Y. Apr. 9, 1999) (no standing as a result of *in pari delicto* doctrine to bring claims of commercial bad faith, aiding and abetting breach of fiduciary duty, and aiding and abetting fraud against bank); Official Comm. of the Unsecured Creditors of Color Tile, Inc.. v. Investcorp S.A., 80 F. Supp. 2d 129 (S.D.N.Y. 1999) (Committee's claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and breach of contract against financial advisor and accountant barred); Granite Partners, LP v. Bear, Stearns & Co., 17 F. Supp. 2d 275 (S.D.N.Y. 1998) (claim of breach of fiduciary duty against investment advisors and brokers barred); Giacometti v. Arton Berm., Ltd. (*In re* Sukamto Sia), No. 98-04912, 2006 Bankr. LEXIS 2183 (Bankr. D. Haw. 2006) (claims against bank barred); Official Comm. of Unsecured Creditors of Verestar, Inc. v. American Tower Corp. (*In re* Verestar, Inc.), 343 B.R. 444 (Bankr. S.D.N.Y. 2006) (claims of conspiracy, aiding and abetting, and breach of contract against financial advisor barred); Hill v. Gibson Dunn & Crutcher, LLP (*In re* ms55, Inc.), 338 B.R. 883 (Bankr. D. Colo. 2006) (claims of breach of fiduciary duty, legal malpractice, negligence, civil conspiracy, aiding and abetting breach of fiduciary duties, and securities fraud against prepetition law firm barred); Securities Investor Protection Corp. v. Munninghoff Lange & Co. (*In re* Donahue Sec., Inc.), 2003 Bankr. LEXIS 964 (Bankr. S.D. Oh. 2003) ("the doctrine of *in pari delicto* bars the Trustee's professional negligence claim" against accounting firm); Logan v. Becker (*In re* Inner City Mgmt., Inc.), 304 B.R. 250 (Bankr. D. Md. 2003) (no standing by trustee as result of *in pari delicto* doctrine to bring claims of breach of contract, fraud, civil conspiracy, and negligence against mortgage brokers); Erricola v. Gaudette (*In re* Gaudette), 241 B.R. 491 (Bankr. D.N.H. 1999) (claims against prepetition law firm barred); Peregrine Funding, Inc. v. Sheppard Mullin Richter & Hampton LLP, 35 Cal. Rptr. 3d 31 (Cal. Ct. App. 2005); Sender v. Kidder Peabody & Co., 952 P.2d 779, 782 (Colo. App. 1997) (claims of aiding and abetting breach of a fiduciary duty, negligence, and breach of fiduciary duty barred); Grove v. Sutliffe, 916 S.W.2d 825 (Mo. Ct. App. 1995) (did not use the term "*in pari delicto*" but applied identical analysis in barring claims of breach of contract, negligence, fraud, and conspiracy against defendant accounting firms).

[FN36]. Lest anyone suggest that large corporate bankruptcy cases typically throw off only uninsurable claims against prepetition professionals, such as lawyers, note, among other things, that issues surrounding a law firm's internal duty to supervise its partners were raised in the *Access case*, which cited to Continental Casualty Co. v. H.S.I. Financial Services Inc., 466 S.E.2d 4 (Ga. 1996) on that subject. *See also* McAdam v. Dean Witter Reynolds, Inc., 896 F. 2d 750 (3d Cir. 1990) (affirming judgment against brokerage firm for negligent supervision of account executive); Kuney v. Cohen, No. 95-2685, 1997 U.S. Dist. LEXIS 14528, at *23 (E.D. Pa. Sept. 17, 1997) ("an attorney may be directly liable for negligent supervision of co-counsel"), citing Tormo v. Yormark, 398 F. Supp. 1159, 1170 (D.N.J. 1975) (an agent might be liable to his principal for loss caused by the intentional wrongs of an agent he or she employed "if the harm were proximately caused by the employing agent's negligence"), and Broad v. Conway, 675 F. Supp. 768 (N.D.N.Y. 1987); *see also* Kravitz v. Pressman, Frohlich & Frost Inc., 447 F. Supp. 203, 214 (D. Mass. 1978) (brokerage firm liable for damages arising from failure to supervise employee); Duggins, Jr. v. Guardianship of Maurice Kendall Washington, 632 So. 2d 420, 426 (Miss. 1993) (attorney held vicariously liable for actions of partner during joint representation), citing Ronald E. Mallen & Jeffrey M. Smith, LEGAL MALPRACTICE, §5.6 (3d ed. 1989). Also, again note that the typical Lloyd's policy provides "innocent partner" (sometimes called "innocent co-insureds") coverage, even in cases of actual fraud by certain other members of a defalcating law firm. (*See* F.D.I.C. v. Mmahat, 907 F.2d 546 (5th Cir. 1990) (describing scope of "innocent co-insureds" coverage); Esoldi v. Esoldi, 930 F. Supp. 1015 (D.N.J. 1996) (interpreting "Innocent Insured" provision of insurance policy in law firm dispute); Sunrise Props. v. Bacon, Wilson, Ratner, Cohen, Salvage, Fialky & Fitzgerald, P.C., 679 N.E.2d 540 (Mass. 1997). *See* Susan Saab Fortney, *Am I My Partner's Keeper? Peer Review in Law Firms*, 66 U. COLO. L. REV. 329, n.17 & 18 (Spring, 1995);

see also Robert W. Minto, Jr. & Marcia D. Morton, *The Anatomy of Legal Malpractice Insurance: A Comparative View*, 64 N.D.L. REV. 547, 574 (1988).

[FN37]. Caplin v. Marine Midland Grace Trust Co. of New York, 406 U.S. 416 (1972) (holding bankruptcy trustee may not prosecute claims owned directly by creditors/investors as opposed to debtor itself); Smith v. Arthur Andersen LLP, 421 F.3d 989, 1003 (9th Cir. 2005) (noting that "the holding of *Caplin* remains valid under the current version of the Bankruptcy Code," and thus that it "is well settled that a bankruptcy trustee has no standing generally to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankrupt corporation itself"); Pereira v. Farace, 413 F.3d 330 (2d Cir. 2005) ("a bankruptcy trustee has no standing generally to sue third parties on behalf of the estate's creditors, but may only assert claims held by the bankrupt corporation itself"); J.B. Heaton, *Deepening Insolvency*, 30 IOWA J. CORP. L. 465, 480 (Spring, 2005); TaeRa K. Franklin, *Deepening Insolvency: What It Is and Why It Should Prevail*, 2 N.Y.U. J. L. & BUS. 435, 451 (Spring, 2006).

[FN38]. DAVIS, *supra* note 4, at 544-47, discusses various cases where separate rights of corporate debtors and injured corporate stakeholders have been held to overlap resulting in simultaneous litigation.

[FN39]. Indeed, on October 2, 2006, the Supreme Court denied cert. in the *PSA* case. *See* Laddin v. Reliance Trust Co., No. 05-1335, 2006 U.S. LEXIS 5711 (Oct. 2, 2006). Thus defendants in *PSA* -- the Reliance Trust Co., PENSCO, Inc., and Community National Bank -- who were sued for aiding and abetting a breach of fiduciary duties, several violations of RICO, and various avoidance claims, need never fear that they will be forced to return their ill-gotten gains, if any.

29 Cal. Bankr. J. 275

END OF DOCUMENT