Client Advisory

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# *Bankruptcy Reform Technical Amendments Act of 2005*

## Introduction

Senators Jon Kyl and Russell Feingold may soon introduce a bill titled "Bankruptcy Reform Technical Amendments Act of 2005" (hereafter "Act") that purportedly makes "technical amendments" to the recently enacted bankruptcy reform bill of 2005. While most of the proposed amendments are administrative in nature, several would be far from "technical" from the perspective of a third-party defendant facing a lawsuit from a bankruptcy trustee suing on behalf of a debtor corporation. To the contrary, such amendments would significantly affect the landscape of post-bankruptcy petition litigation between representatives of the debtors estate, pursuing legal claims on behalf of the debtor, against third-parties.

Specifically, section 301 of the Act, titled "Inapplicability of In Pari Delicto To Trustee Actions," proposes to eliminate the defenses of "in pari delicto," "contra bonos mores" and "unclean hands" to any claims by a bankruptcy trustee on behalf of the estate. This section of the Act proposes to supplement 11 U.S.C. § 541(a)(1) by inserting the following language:

- "A trustee asserting [claims of the debtor against any person] shall not be subject to any defense based on the principles of in pari delicto, contra bonos mores, or unclean hands . . ."
- "[N]or shall the knowledge or conduct of any officer, director, partner, member, employee, or other agent or representative of the debtor be imputed to the trustee."

Section 302 of the Act further proposes to amend 11 U.S.C. § 544(c)(1) to authorize (yet not require) the bankruptcy trustee to assert claims of creditors when such creditors consent or the claim arises out of the creditor's relationship to the debtor. Section 302 also eliminates the defenses of *in pari delicto*, *contra bonos mores* or unclean hands.

## What Are *In Pari Delicto*, *Contra Bonos Mores* and Unclean Hands?

The *in pari delicto* doctrine denies relief to a plaintiff where such plaintiff has acted with at least the same degree of knowledge or culpability as the defendant.[1] The defense of "unclean hands" is akin to *in pari delicto* but slightly different. "The traditional defense of unclean hands applies to facts involving only two parties, plaintiff and defendant, and one transaction involving both parties."[2] Contracts which are "*Contra Bonos Mores*" ("against good morals") are voidable.[3]

## The Current Version of 11 U.S.C. § 541(a)(1)

Under the current section 541(a)(1) of the bankruptcy code, the bankruptcy estate generally includes "all legal and equitable interests of the debtor in

property as of the commencement of [bankruptcy]."[4] These legal and equitable interests include legal claims and causes of action of the debtor against third parties.[5] Given the explicit language of section 541, it has almost universally been held that "trustee stands in the shoes of the debtor and can only assert those causes of action possessed by the debtor. [Conversely,] [t]he trustee is . . . subject to the same defenses as could have been asserted by the defendant had the action been instituted by the debtor."[6] This interpretation comports with the legislative history of section 541.[7]

The *in pari delicto* doctrine serves as an important defense for third-party professionals, such as attorneys, accountants, placement agents, indenture trustees and banks, against claims by a bankruptcy trustee on behalf of the debtor. Typically, the bankruptcy trustee seeks recovery for the estate under § 541(a)(1) by alleging that such third-party professionals either conspired with senior members of the debtors' management in a scheme to defraud the debtors' investors and creditors, aided and abetted the wrongdoing of management and/or breached certain obligations to the debtor. Under well-settled law, the wrongdoing of a company's senior management is typically imputed to the corporation where such conduct was committed in the course of their employment and was intended to benefit the company.[8] In such circumstances, many courts have found the debtor *in pari delicto* with the third-party professional and hence, bar such claims.[9]

Some plaintiff-trustees argue that the act of bankruptcy and the *subsequent* elimination of the senior management's interest in the debtor essentially cleanse the debtor of the bad acts of management. Application of the *in pari delicto* doctrine becomes unnecessary, therefore, because only innocent creditors stand to receive any recovery from the debtor's estate. Many courts reject this contention. The courts reason that the trustees' argument conflicts with the plain language of § 541(a)(1) of the Bankruptcy Code, that provides that the bankrupt estate consists of the debtor's legal and equitable interests "as of the commencement of the case." Thus, the subsequent removal of the debtor's senior management after bankruptcy is of no consequence.[10]

## Ramifications Of Proposed Amendments

The proposed amendment to § 541(a)(1) would eliminate critical defenses of third-party professionals to post-petition claims. It would:

- Alter established law that the acts of senior management of a company are generally attributable to the company when done in the course of such manager's employment.
- Give creditors, through a bankruptcy trustee, the ability to assert claims of a debtor with immunity from recognized defenses to the debtor's contract. The proposed amendments would eliminate, in the context of bankruptcy trustees, the well-settled rule that when claims are transferred from one party to another, the transferee takes such claims subject to any defenses which could have been asserted against the transferor.
- Provide creditors, through the trustee, the ability to pursue recovery from third-parties even though they have no direct claims against those parties or such claims are weak. For example,

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creditors who are not in contractual privity with the third-party professional stand to benefit greatly from these proposed amendments. By allowing creditors to pursue a debtor's claims, creditors bypass the weaknesses of their own direct claims.

- Give creditors potentially "two bites at the apple." Because the proposed Amendments do not prohibit creditors from pursuing their own claims against third-parties, creditors may now be able to pursue their own claims as well as those of the debtor.
- Overturn precedent in a majority of jurisdictions which have addressed this issue.

## Endnotes

1. 27A Am Jur. 2d *Equity* § 132 (1996).
2. *Id.* at § 133.
3. Black's Law Dictionary 341 (8th Ed. 2004).
4. 11 U.S.C. 541(a)(1) (emphasis added).
5. 3 Collier on Bankruptcy, ¶ 323.02[1].
6. *Id.* at ¶ 323.03[2].
7. *See* H.R. Rep. No. 95-595, at 367-68 (1977), *as reprinted in* 1978 U.S.C.C.A.N 5963, 6323. The Senate Report contains identical language. *See* S. Rep. No. 95-989, at 82 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5868.
8. 10 Fletcher Cyclopedia of Private Corp. § 4886 (2005); 3 Am. Jur. 2d *Agency* § 264 (2005).
9. *See, e.g., In re R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001); *In re Hedged-Investments Assocs., Inc.*, 84 F.3d 1281 (10thCir. 1996).
10. *See, e.g., In re R.F. Lafferty*, 267 F.3d at 356-58; *Terlecky v. Hurd*, 133 F.2d 377, 380 (6th Cir. 1997); *In re Mediators, Inc.*, 105 F.3d 822, 826 (2d Cir. 1997); *In re Hedged-Investments*, 84 F.3d at 1285; *In re Advanced RISC Corp.*, 324 B.R. 10, 15 (D. Mass 2005).

For more information or if you would like to obtain a copy of the proposed Bankruptcy Reform Technical Amendments Act of 2005, please contact:

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