THE**RECEIVER**

N.A.F.E.R.
NATIONAL ASSOCIATION OF FEDERAL EQUITY RECEIVERS

ISSUE 1 • FEBRUARY 2013

Message from the President

Welcome to the inaugural edition of The Receiver. Our plan is to have a newsletter that contains substantive information on issues we are likely to face as receivers as well as news of our organization. Each edition will contain one or two articles written by members, a profile of a member, and news about NAFER. In future editions, we will include announcements submitted by members—new jobs, new appointments, new firms.

I would like to thank Eddy Espinosa and Michael Napoli for spearheading this edition of The Receiver and for agreeing to take on the task of editing future editions. If you would like to help out on the newsletter, have an article you would like to publish or an announcement, please contact Eddy or Michael.

Our first edition features an article by Kathy Phelps on the in pari delicto defense and an article by Michael Napoli on the impact of bankruptcy on an equity receivership. We also profile founding member, Dennis Roossien. I hope that you find The Receiver to be informative and helpful to you.

Steve Donell, President

Stephen J. Donell is President of FedReceiver, Inc. a Los Angeles, California based firm specializing in equity, real estate and business receivership matters located throughout the United States.

In This Issue:

In November, the Board of Directors decided to increase dues for 2013 to $495 for full members and $295 for associate members.

2013 Platinum Sponsors:

Sponsorship Opportunity

You still have the opportunity to become a NAFER sponsor and gain invaluable exposure to NAFER members across the country.

Sponsorship levels range from $500 as a Bronze sponsor to $5,000 as a Platinum sponsor.

Platinum: $5,000
- Featured in member area of website through a digital ad placed throughout 2013
- Featured in three communications to all members, including the initial President's Letter in 2013 (to be included in the President's Letter, applications must have been received by January 20th)
- Featured in the classified section of the website

Gold: $3,500
- Featured in two communications to all members
- Featured in the classified section of the website

Silver: $2,000
- Featured in one communication to all members
- Featured in the classified section of the website

Bronze: $500
- Featured in the classified section of the website

If you would like to be a sponsor, please contact John Thuet at: john.thuet@naferforum.org

NAFER Profile: Dennis L. Roossien Jr.

by Eduardo S. Espinosa

It's true what they say about first impressions—they're usually right. I first met Dennis Roossien when he was appointed receiver over one of my enforcement defense clients. From our first meeting, I was favorably impressed by Dennis. He was clearly in charge, knew what he was doing and would brook no foolishness from my clients. Yet, he was also professional and respectful. Throughout that receivership, I never questioned that Dennis would treat my clients fairly. In the end, we were able to work out a resolution that was satisfactory to all involved.

Since that first meeting, our practices have continued to intersect and my first impression has been consistently reinforced. From the onset, it was clear that Dennis understood the law. But, as any receiver can appreciate, the likelihood of a successful receivership hinges not just on the receiver's grasp of the law, but on the receiver's understanding of the industry and asset-class at issue. Here is where Dennis excels.

For over a decade, Dennis has served as receiver over a myriad of schemes that, in the aggregate, defrauded investors out of more than a billion dollars. His receiverships have involved foreign exchange funds, real estate offerings, oil & gas offerings, equipment leasing, distressed asset salvaging, fraudulent business opportunities and credit restructurings. Most significantly, Dennis has developed an expertise in international asset recovery. Dennis has investigated, located, and recovered assets from, to name a few: Costa Rica, Luxembourg, Liechtenstein, Hong Kong, Greece, Panama, Bali, Benin, England, Germany, and other E.U countries. If you attended the NAFER Inaugural Annual Conference, then you heard Dennis' presentation on "Locating and Seizing Assets in Foreign Jurisdictions." Moreover, his investigations have assisted U.S. authorities in their efforts to extradite and incarcerate of many of the fraudsters responsible for these schemes.

Dennis began practicing law in Texas in 1992. He obtained his Juris Doctor from Boston University and a Bachelors of Science from Cambridge University. In 1997, Dennis joined Munsch Hardt Kopf & Harr, P.C. Dennis, along with Steve Harr and Joseph Wielebinski have established Munsch Hardt as one of Texas preeminent federal receivership practices. NAFER's genesis in Texas is largely attributable to Dennis, Steveand Michael Quilling (Quilling, Selander). Their practice of occasionally informally meeting led to two "receiver's roundtable" conferences, which, in turn, took on a new dimension when they were introduced to their Utah brethren, Wayne Klein, Gil Miller, and Robert Wing. The concept of a formal organization of federal equity receivers congealed and NAFER was created shortly thereafter.

Eduardo S. Espinosa, is a Shareholder in the Dallas office Cox Smith Matthews, Incorporated. Eddy represents middle market enterprises with their formation, governance, capitalization and commercial transactions. He is an alumni of the SEC's Division of Enforcement and represents market participants in proceedings before the SEC, state securities administrators and FINRA. Eddy is also a state court receiver and an associate member of NAFER.

Avoiding the Automatic Turnover of Assets Required by Section 543 of the Bankruptcy Code

by Michael D. Napoli

The filing of a bankruptcy by or on behalf of a receivership entity typically divests the receiver of authority. In most cases, removing the receiver will be detrimental to the estate. At the very least, the bankruptcy court will have to appoint a trustee to replace the receiver resulting in disruption in the management of the assets and additional costs. These costs can be most easily avoided by drafting the receivership order with the potential of bankruptcy in mind. Failing that, the receiver must convince the bankruptcy court that it is in the best interests of all concerned that the receiver continues in control over the debtor.

Upon the filing of a bankruptcy, receivership property becomes estate property. Control over that property then shifts from the receivership court to the bankruptcy court. Section 543 of the Bankruptcy Code directs receivers to turnover any property of the debtor in their control to the bankruptcy trustee or debtor-in-possession.[1] It also forbids the receiver from taking action except as necessary to preserve the property.

The turnover requirement of section 543 can present a significant problem for the estate. At the start of a case under chapter 11 or an involuntary case under chapter 7, the debtor's management typically continues to act on behalf of the

Michael D. Napoli is a Shareholder in the Dallas office of Cox Smith Matthews Incorporated.

He represents parties, including receivers, involved in civil proceedings brought by federal and state securities regulators as well as litigants in private securities disputes.

In addition, Michael has a broad commercial practice including contract, corporate governance, insurance and intellectual property disputes. Michael is an associate member of NAFER.

debtor. Normally, the receiver would have to return whatever property in his control to the debtor's management. In an equity receivership, however, the receivership court, usually at the request of a regulatory agency, has removed the company's managers from control based on their misfeasance. The bankruptcy court would surely wish to avoid allowing the disgraced managers to regain control. Thus, it will have to appoint a trustee to replace the receiver. Replacing the receiver will lead to significant additional costs and disruption as one court appointee is replaced with another. The key, then, is to avoid the operation of section 543.

There are several options that the court may use to avoid section 543. The bankruptcy court can abstain from hearing the case. If it abstains, the bankruptcy court will either dismiss the bankruptcy outright or stay it in favor of the pending receivership action.[2] If the bankruptcy court chooses to keep the case, it can recognize the receiver as the debtor-in-possession, excuse turnover under section 543(d), or appoint the receiver as the trustee. In all cases, however, the receiver should immediately seek an order from the bankruptcy court temporarily excusing it from complying with section 543 while the court determines how best to go forward.

1. Abstention

The best solution is for the bankruptcy court to abstain under section 305 of the Bankruptcy Code. While it is discretionary, bankruptcy courts generally abstain when the following factors exist: (1) the petition was filed by a few recalcitrant creditors and most creditors oppose the bankruptcy; (2) there is a pending state insolvency proceeding; and (3) dismissal is in the best interest of the debtor and all creditors.[3] Some courts have additionally held that "economy and efficiency of the administration must be key considerations in the abstention decision."[4] Abstention is particularly appropriate "where considerations of comity with state and federal administrative proceedings would dictate that the Bankruptcy Court stay its hand in order to prevent undue interference or entanglement with state or federal administrative and regulatory schemes."[5]

The seminal case in this area is *In re Michael S. Starbuck, Inc.*[6] There, a receiver was appointed to administer the estate of two entities shut down by the SEC. The receiver retained counsel and independent professionals to assist in the administration of the estate. Nearly fifteen months after the appointment of the receiver, a group of estate creditors, unhappy with the results of the receivership, filed involuntary petitions against the estate.

The receiver moved for abstention. Evaluating the receiver's motion, the *Starbuck* court noted that "there is no need to invoke the machinery of the bankruptcy process if there is an alternative means of achieving the equitable distribution of assets."[7] Ultimately, the court held that it was in the best interests of the creditors and the debtors to dismiss the proceedings; in so deciding, it stated that:

> Allowing this matter to continue as a debtor proceeding under the Bankruptcy Code would result in a terrible waste of time and resources. Many services, already rendered in the administration of the receivership estate, would have to be repeated at additional expense to the estate. No advantage would accrue to the creditors if this matter were to proceed in the bankruptcy court. Rather, their best interests will be served by the continued administration of the equity receivership.[8]

A receiver seeking abstention should present evidence that she is successfully administering the estate and that the equity receivership is proceeding towards an equitable conclusion. It is also helpful if the parties seeking bankruptcy can be portrayed as dissatisfied with the rulings of the receivership court. This is precisely the situation Congress envisioned when it wrote section 305.[9] The legislative history reveals that the law was designed to permit dismissal or suspension "where an arrangement is being worked out by creditors and the debtor out of court, there is no prejudice to the rights of creditors in that arrangement, and an involuntary case has been commenced by a few recalcitrant creditors to provide a basis for future threats to extract full payment."[10]

2. Recognize the Receiver as the Debtor-in-Possession in a Chapter 11 Case

In cases where the debtor's management is no longer capable of managing the company and the receiver is appointed not only to administer the assets, but also to manage the company, some courts have found that the receiver acts as the manager of the debtor-in-possession.[11] As such, the receiver is "automatically authorized to act as the debtor-in-possession," alleviating the need to appoint a separate Chapter 11 trustee.[12]

The notion that a receiver appointed to take control of and manage a distressed company becomes, in effect, the debtor-in-possession upon the filing of a bankruptcy finds support in state law. It is a general rule that "the appointment of a general receiver displaces and supersedes in its entirety the pre-receivership management of an entity."[13] Accordingly, "when a general receiver is appointed by state court to wind up the affairs of a limited partnership, the receiver acts as management of the entity over which he has been appointed and has the authority to act for and on behalf of the limited partnership."[14]

Recently, the Second Circuit held in *In re Bayou Group, L.L.C.*,[15] that a receiver appointed to resolve a securities fraud and given managerial power of the entity in receivership acted as the manager of the debtor-in-possession. In that case, a group of hedge funds were operated as a Ponzi scheme until the massive fraud eventually collapsed, resulting in numerous investigations and lawsuits, including actions taken by the Securities and Exchange Commission and the Commodity Futures Trading Commission. Eventually, the fraudulent enterprise was forced into a federal receivership in the Southern District of New York. The district court appointed a "non-bankruptcy federal equity receiver and exclusive managing member" of the hedge funds. Shortly after his appointment, the receiver caused the hedge funds to file voluntary Chapter 11 petitions for relief. In response, the U.S. Trustee moved to appoint a chapter 11 trustee under 11 U.S.C. § 1104(a), arguing that a trustee was necessary to "fill the vacuum" of management because (i) Bayou's former managers were guilty of crimes or otherwise incapable of managing the fund and (ii) the receiver's role as manager ceased upon the filing of bankruptcy and he simply became a custodian of property that must be turned over to the debtor.[16] The bankruptcy court rejected the U.S. Trustee's arguments and permitted the receiver to control the debtor-in-possession in its bankruptcy proceedings.

The Second Circuit affirmed, holding that the receiver was empowered with "two hats—one as custodian, and one as "sole and exclusive" managing member of Bayou . . . . While the receiver's 'custodian' hat came off upon commencement of the Chapter 11 proceedings, his 'managing member' hat remained."[17] Moreover, the Court held that "[the receiver's] authority to manage the bankruptcy proceedings stems not from his position as 'federal equity receiver' but from the language in the Order specifically appointing him as Bayou's 'sole and exclusive managing member . . . .'"[18] Accordingly, the Court determined that the receiver was empowered to manage and control the debtor throughout the bankruptcy proceedings, and that the U.S. Trustee did not otherwise meet its extraordinary high burden to show that a replacement chapter 11 trustee should be appointed.[19]

Similarly, in *SEC v. Byers*, a receiver was appointed upon request of the SEC to manage the proceeds of a massive Ponzi scheme.[20] That receiver was also granted authority by the receivership court to continue managing the receivership entities if a bankruptcy were filed. Citing to *Bayou Group*, the Second Circuit again held that a pre-petition court order empowering a receiver to manage and control a fraudulent enterprise results in "the receiver automatically becom[ing] debtor-in-possession by operation of law."[21] The Court further stated that "[t]here is no reason a district court cannot, pre-petition, appoint a manager for the entities, and there is nothing in the Bankruptcy Code that prevents that manager from continuing after the bankruptcy filing, subject to challenge by others."[22]

The lesson of *Bayou Group* and *Byers* is that a carefully drafted receivership order can carry through to a subsequent bankruptcy. Both cases, however, involved receivers appointed by federal courts. Although the reasoning used by the Second Circuit in each case suggests that the answer would be the same if the receiver had been appointed by a state court in similar circumstances, the authority forbidding state courts from preventing a bankruptcy may lead to a different result.

3. Excuse Turnover under Section 543(d)

The Court can also excuse the receiver from his section 543 obligations permitting him to retain control over the debtor. Section 543(d)(1) of the Code allows a bankruptcy court to excuse compliance with the section where "the interests of creditors … would be better served" by allowing the receiver to continue in control.

Section 543(d) cases are highly fact-intensive and decided on a case-by-case basis.[23] Factors that may be considered include the existence of preference actions for a trustee that a receiver could not implement, and overall effect of the Bankruptcy Code on the circumstances of the case.[24] The fundamental question under section 543 is whether the creditors would be better served by having the debtor take back control over property placed into the hands of a receiver by another court. Ultimately, this question turns on whether the debtor can be trusted to operate its business in the interests of the creditors. In an equity receivership, a court, albeit not the bankruptcy court, has already determined that the debtor cannot be trusted. Excusing turnover allows the bankruptcy court to retain control over the case without displacing the receiver.

The exact status of a receiver excused under section 543(d) is not settled. One line of cases holds that the excused receiver continues to act in accordance with the duties and responsibilities provided by state law and the order appointing him.[25] A second line of cases holds that, once excused from its section 543 obligations, a receiver "becomes the functional equivalent of a trustee."[26]

4. Appoint the Receiver as the Trustee

Finally, the bankruptcy court may appoint the receiver to serve as the trustee.[27] *In re Petters* is instructive. The district court appointed a receiver at the request of the United States Attorney's office to control the personal assets of Tom Petters, who was incarcerated for running a massive scam involving a variety of public and private businesses.[28] The receiver later put the fraudulent enterprise into Chapter 11 bankruptcy. At the time of the bankruptcy, the debtors had no remaining management or decision makers.[29] All of the decisions and actions on behalf of the debtors were made by the receiver, with the advice of bankruptcy counsel.[30] The U.S. Trustee, concerned about the legal status of the receiver during the bankruptcy, sought to appoint the receiver to serve as trustee.[31] A group of creditors objected to, among other things, the appointment of the receiver as the trustee, primarily asserting that the receiver was not disinterested within the meaning of the Bankruptcy Code.[32] The bankruptcy court affirmed the appointment of the receiver as trustee, holding that the status of pre-petition receiver did not alone create a conflict of interest, nor did the receiver's duty to assist in the underlying fraud investigation. The court also stated that appointing another third-party to be trustee "would entail a two-staged duplication of effort," including "significant extra transactional expense . . . particularly if that trustee were to hire a second group of attorneys and financial analysts."[33] The Eighth Circuit affirmed the bankruptcy court's appointment of the receiver as trustee.[34]

Receivers and the *In Pari Delicto* Doctrine

By: Kathy Bazoian Phelps

Portions of this article are derived from The Ponzi Book as well as from In Pari Delicto and the Blame Game: Should Receivers Get Caught in the Fray?, Receivership News, Issue 38, page 1 (Fall 2010). The Ponzi Book is available at theponzibook.com.

Receivers are brought in as the white knights to recover funds in a regulatory receivership case for the benefit of defrauded investors and creditors. As part of their duties, they often file lawsuits against wrongdoing auditors, lawyers, financial institutions, officers, directors, and others. However, receivers quickly hit a brick wall—the *in pari delicto* doctrine—the moment they sue a third party for damages. Asserting *in pari delicto* is often the target defendant's first line of defense.

The phrase *in pari delicto* means "in equal fault." This judicial doctrine prevents a plaintiff who participates in wrongdoing from recovering damages resulting from those wrongful acts. Third-party defendants often invoke the *in pari delicto* doctrine in receivership cases in an effort to bar the receiver's claims against them. They attempt to impute the corporate insider's wrongful conduct to the corporation itself, and then to the receiver as the corporation's successor-in-interest.

The question becomes whether the receiver can or should be held responsible for the bad acts of the agents of the debtor and, therefore, whether the receiver should be barred from suing another wrongdoer. Can the receiver really be held responsible for others' bad acts that preceded the receiver's appointment? Or, should the receiver be permitted to sue wrongdoing defendants for damages to the corporate entity?

The answer to these questions is governed by the applicable state laws of imputation and a court's interpretation of the *in pari delicto* doctrine. It is also ever-changing.

Application of In Pari Delicto to Receivers

The ultimate authority—the United States Supreme Court —says the *in pari delicto* doctrine is based on two grounds: (1) "courts should not lend their good offices to mediating disputes among wrongdoers"; and (2) "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality."[1] The doctrine is applied unevenly by courts and often differently depending on the character of the plaintiff bringing the claims. To better understand the application of *in pari delicto* to regulatory receivers, it is instructive to first analyze how courts have applied the doctrine to bankruptcy trustees.

As Applied to Trustees

Since trustees acquire "all legal and equitable rights of the debtor as of the commencement of the case" pursuant to Bankruptcy Code § 541(a)(1), a trustee's rights can be no greater than the debtor's rights at the time of the petition. Other than with respect to claims to avoid fraudulent or preferential transfers, most circuits have held that, at least in bankruptcy cases, § 541 requires that the courts evaluate defenses as they existed at the commencement of the bankruptcy case and that, therefore, the subsequent appointment of a trustee does not change those defenses, including the *in pari delicto* defense.[2]

Kathy Bazoian Phelps is a lawyer practicing in Los Angeles California and is the co-author of The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes (LexisNexis® 2012).

She has special expertise in all areas of bankruptcy and receivership law and in representing trustees and receivers in large-scale litigation involving fraudulent and Ponzi schemes.

She is a Board Member of the National Association of Federal Equity Receivers and a Board Member of the Los Angeles/ Orange County Chapter of the California Receivers Forum.

However, while the law appears to be clear in most circuits that a trustee is subject to the *in pari delicto* doctrine, there remains much criticism of the application of the *in pari delicto* doctrine to bankruptcy trustees. The criticism focuses on the sense of unfairness that the trustee, as the estate representative, should be imposed with the fiction that a debtor is still a party in interest, when in fact the debtor has been replaced by the trustee for the purpose of trying to recover funds for those who were injured by the debtor in the first place. It is then the creditors who are penalized by the bar on the trustee's claims, and the wrongdoing defendant is able to escape liability.

As Applied to Receivers

Many of the same legal, equitable, and policy considerations that weigh for and against the application of the *in pari delicto* doctrine to a trustee also apply to a receiver. However, a receiver is not bound by § 541 of the Bankruptcy Code, so some courts have found that the *in pari delicto* doctrine does not apply to receivers.[3]

The Ninth Circuit noted the following general rule and exception to that rule for receivers: "[A] receiver occupies no better position than that which was occupied by the person or party for whom he acts and any defense good against the original party is good against the receiver." However, that court went on to explain that "defenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver."[4]

The Seventh Circuit explained its rationale in declining to impute the wrongdoers bad acts to a subsequent independent receiver as follows:

> . . . the wrongdoer must not be allowed to profit from his wrong . . . [but] [t]hat reason falls out now that [the wrongdoer] 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 wrongdoer's] evil zombies. Freed from the spell, they became entitled to the return of the moneys – for the benefit not of [the wrongdoer] but of innocent investors . . .[5]

The Seventh Circuit subsequently limited its holding in *Scholes v. Lehman* when faced with claims brought by the receiver against third party brokerage firms in a Ponzi scheme case for negligence, fraud and conversion, alleging direct injury to the corporate debtor.[6] In *Knauer*, the Seventh Circuit agreed with its earlier proposition that an exception to the *in pari delicto* doctrine exists for a receiver in exceptional circumstances involving avoidance of fraudulent conveyances; however, the *Knauer* court noted that the exception to the general rule may not apply as to other types of claims against third parties.[7]

Courts continue to struggle with the issue applicability of the *in pari delicto* doctrine to receivers. Some courts follow *Scholes v. Lehman* and *O'Melveny* and hold that the *in pari delicto* doctrine does not bar the receiver's claims. The Fifth Circuit recently noted:

> In this case, the district court specifically authorized the Receiver to pursue actions for the benefit of "all investors who may be the victims of the fraudulent conduct" of W Financial and to institute actions "as may in his discretion be advisable or proper for the identification, collection, recovery, preservation, liquidation, protection, and maintenance of the Receivership Assets or proceeds therefrom." The Receiver brought this suit on behalf of W Financial to recover funds for defrauded investors and other innocent victims. Application of in pari delicto would undermine one of the primary purposes of the receivership established in this case, and would thus be inconsistent with the purposes of the doctrine.[8]

In a more tempered decision to decline to apply *in pari delicto* to a receiver, the court in *Mosier v. Stonefield Josephson, Inc.* reasoned:

> While the Court recognizes that *O'Melveny & Myers* does not necessarily stand for the broad proposition that equitable defenses may never be asserted against federal receivers, see *O'Melveny & Myers, 61 F.3d at 19*, it nonetheless agrees with the Receiver that the same equitable considerations that guided the Ninth Circuit in *O'Melveny & Myers* compel the same conclusion in this case. Like the receiver in *O'Melveny & Myers*, the Receiver in this case was not a party to any of the alleged misconduct conduct in which the PEM Group Principals engaged. Rather, he was appointed by the Court "to take such action as is necessary and appropriate to preserve and take control of and to prevent the dissipation, concealment, or

> disposition of any assets . . . ." The Court finds persuasive the Receiver's assertion that allowing Stonefield to invoke the defense of *in pari delicto* would frustrate the Court's plan by "diminishing the value of the asset pool held," thereby hurting innocent third-party creditors, while benefitting alleged an alleged wrongdoer.[9]

However, several courts have opted to apply the *in pari delicto* doctrine to a receiver and bar the receiver's claims, unless any exceptions apply.[10]

Exceptions to *In Pari Delicto*

If a receiver is in a jurisdiction that applies the *in pari delicto* doctrine to bar a receiver's claims, the next question is whether any of the exceptions to the doctrine apply so that the receiver's claims will still be allowed to proceed.

The Adverse Interest Exception

The most frequently invoked exception is the adverse interest exception. Under this exception, the *in pari delicto* doctrine does not bar the receiver's claims if the wrongdoing agent of the debtor: (a) acted entirely in his own interests and (b) adversely to the corporation.[11] However, courts apply the adverse interest exception to the *in pari delicto* doctrine using varying standards.

Some courts hold that the *in pari delicto* doctrine bars the receiver's claims only when (a) the guilty manager "totally abandoned" the interest of the principal corporation; and (b) the corporation received no benefit whatsoever from the agent's fraud.[12] The agent's looting of a corporation in a Ponzi scheme is a "classic example" of an adverse interest that does not bar the receiver's claims under this interpretation.[13]

Other courts look to the agent's subjective motives instead of the benefit that the debtor received from the agent's activities.[14] This position has been criticized, however, as making the adverse interest exception too expansive.[15]

Yet other courts evaluate the nature of the benefit. Often a corporation receives a benefit in the short term from the wrongful conduct of the debtor's insiders, but later ends up in an insolvency proceeding due to that wrongful conduct. For example, new funds may be loaned to the wrongdoing company, or new investments made, which funds are received into the debtor's accounts and arguably provide a short- term benefit. The question then becomes whether these short-term benefits constitute a benefit to the corporation which would bar the application of the adverse interest exception to the *in pari delicto* doctrine. Courts disagree on whether a short benefit is sufficient to bar the receiver's claims.

Many courts have found that short term benefit, even of limited duration, is enough to prevent the application of the adverse interest exception and that "the ultimate fate of [the debtor] does not decide the question of benefit.[16] These courts have found that the adverse interest exception is not automatically triggered just because the misconduct may have later resulted in future financial harm to the entity.[17]

However, other courts have found that this short term benefit is illusory and should not qualify as benefit to the corporation which would thereby negate the adverse interest exception. "[T]he purported 'benefits' that . . . [the debtor] itself received as a result of managements machinations are illusory. A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[18]

Sole Actor Limitation

The sole actor exception to the adverse interest exception makes the *in pari delicto* doctrine even more complex. If the agent principal of the debtor corporation and the principal are essentially one and the same, then the misconduct of the agent principal will be imputed to the debtor corporation and *in pari delicto* will bar the receiver's claims even if the adverse interest exception might otherwise allow them.[19]

"Innocent Decision Maker" Exception

Another exception to the *in pari delicto* defense may apply if not all of the "shareholders and/or decision makers are involved in the fraud" and, i.e., there was at least one innocent insider to whom the defendant could have reported their findings.[20]

The factors applicable to this exception are: (1) the existence of a relevant outside decision maker; (2) who would have taken that action had he been aware of the wrongdoing; and (3) who could have taken action to stop the wrongdoing.[21]

However, some courts have found the innocent decision maker exception inapplicable even where an innocent member of management "could and would have prevented the fraud had they been aware of it."[22] Other courts have rejected the "innocent decision maker" doctrine as a "radical alteration" that "clearly deviate[d] from traditional agency doctrine."[23]

A Special Exception for Auditors

Some courts appear to have created a special exception to the *in pari delicto* doctrine for auditors and have allowed a receiver's or trustee's claims against an auditor when the auditor was engaged in negligent or collusive behavior. The New Jersey Supreme Court held that the in pari delicto doctrine does not bar a negligence claim against a corporation's auditors.[24]

The Pennsylvania Supreme Court similarly refused to apply *in pari delicto* where "the defendant materially has not dealt in good faith with the principal."[25] These courts conclude that the auditors were engaged to detect the fraud in the first place and cannot use the fraud they failed to detect to bar claims against them.[26]

On the other hand, some courts place the blame on the debtor's insiders rather than the auditors and reach the opposite conclusion. "[I]f the owners of the corrupt enterprise are allowed to shift the costs of its wrongdoing entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced."[27] The New York Court of Appeals issued a significant decision, holding that even negligent and collusive auditors can assert the *in pari delicto* defense to bar the claims against them.[28]

Conclusion

The moral of the story is that *in pari delicto* cannot remain a foreign word to receivers. Some courts may apply the doctrine with a broad brush to receivers, thus barring otherwise meritorious claims for damages. If faced with the *in pari delicto* barrier at the first turn, the determined receiver will need to dive into the facts to determine whether any of the various exceptions or interpretations of the exceptions can establish a way around the *in pari delicto* barrier.

Citations

Avoiding the Automatic Turnover of Assets Required by Section 543 of the Bankruptcy Code

[1]11 U.S.C. §543(a). Section 543 applies to "custodians" of the debtor's property. The Code defines "custodians" to include a receiver appointed by any court. 11 U.S.C. §101(11).

[2]11 U.S.C. §305(a)

[3]*GMAM Inv. Funds Trust I v. Globo Comunicacoes e Participacoes S.A.*, 317 B.R. 235, 254 (Bankr. S.D.N.Y. 2004); *In re Sherwood Enters., Inc.*, 112 B.R. 165, 168 (Bankr. S.D. Tex. 1989).

[4]*Id. In re O'Neil Village Personal Care Corp.*, 88 B.R. 76, 80 (Bankr. W.D. Pa. 1988). (citing cases).

[5]In re First Fin. Enters., Inc., 99 B.R. 751, 754 (Bankr. W.D. Tex. 1989); *see also Barbee v. Colonial Healthcare Center, Inc.*, 2004 WL 609394, *1-*2 (N.D. Tex. 2004) (upholding bankruptcy court's permissive abstention out of deference to comity and to the existence of a closely related state law proceeding under way).

[6]14 B.R. 134 (Bankr. S.D.N.Y. 1981).

[7]*Id.* at 135.

[8]*Id.*

[9]*See In re Nina Merchandise Corp.*, 5 B.R. 743, 747 (Bankr. S.D.N.Y. 1980) (stating that "it is evident that §305 cotemplates the instance where a non-federal insolvency has proceeded so far in those proceedings that it would be costly and time consuming to start afresh with the federal bankruptcy process.").

[10]*See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 325 (1977).

[11]*See, e.g., Byers*, 609 F.3d at 93; In re Bayou Group, L.L.C., 564 F.3d 541, 548 (2d Cir. 2009) *(Bayou Group II)*.

[12]*In re Bayou Group, L.L.C.*, 363 B.R. 674, 686 (S.D.N.Y. 2007) *(Bayou Group I)*.

[13]*In re Statepark Bldg. Group, Ltd.*, 316 B.R. 466, 471 (Bankr. N.D. Tex. 2004) (citing *Murphy v. Argonaut Oil Co.*, 23 S.W.2d 339, 342 (Tex. 1930); *see Brown v. Warner*, 14 S.W. 1032, 1033 (Tex. 1890) (holding that a receiver is appointed to "manage and preserve the property."); *Chitex Comm's., Inc. v. Kramer*, 168 B.R. 587, 590 (S.D. Tex. 1994) (stating that "Texas law asserts that the receiver has the full rights that the corporation had.").

[14]*In re Statepark Bldg. Group, Ltd.*, 316 B.R. at 471.

[15]*Bayou Group II*, 564 F.3d at 548.

[16]*Id.* at 545.

[17]*Id.*

[18]*Id.*

[19]*Id.* at 549.

[20]609 F.3d 87, 90-91 (2d Cir. 2010).

[21]*Id.* at 93.

[22]*Id.*

[23]*Dill v. Dime Savings Bank, FSB (In re Dill)*, 163 B.R. 221, 225-27 (E.D.N.Y. 1994); *In re Uno Broadcasting Corp.*, 167 B.R. 189, 200 (Bankr. D. Ariz. 1994). In applying section 543(d)(1), courts have considered: "(1) whether reorganization is likely; (2) that funds are necessary for such reorganization; and (3) mismanagement." *Powers Aero Marine Servs., Inc. v. Merrill Stevens Dry Dock Co. (In re Powers Aero Marine Servs., Inc.)*, 42 B.R. 540, 544 (Bankr. S.D. Tex. 1984); *In re WPAS, Inc.*, 6 B.R. 40 (Bankr. M.D. Fla. 1980). "[A] bankruptcy court should also consider whether or not there are avoidance issues raised with respect to the property retained by the receiver, because a receiver does not possess avoiding powers for the benefit of the estate." *In re Constable Plaza Assocs., L.P.*, 125 B.R. 98, 103 (Bankr. S.D.N.Y. 1991).

[24]*Dill*, 163 B.R. at 225-27; *In re Constable Plaza Assocs., L.P.*, 125 B.R. at 103.

[25]*See In re 400 Madison Avenue L.P.*, 213 B.R. 888, 895 (Bankr. S.D.N.Y. 1997) (holding that the excused receiver's role is limited to that set out in the order appointing him). The cases following *400 Madison Avenue L.P.* generally hold that the bankruptcy court "does not have leave to change the scope of the responsibilities placed upon the receiver by the state court except where specifically mandated by the Bankruptcy Code (e.g., §§ 327, 330, 331, 543(b))." *In re R&G Properties, Inc.*, 2008 WL 4966774 at *5 (Bankr. D. Vt. 2008); *also In re Falconridge, LLC*, 2007 WL 3332769 at *6 (Bankr. N.D. Ill. 2007) (holding that excused receiver would proceed pursuant to order of the state court appointing it).

[26]*In re 245 Assocs., Ltd.*, 188 B.R. 743, 750 (Bankr. S.D.N.Y. 1995); *In re Uno Broadcasting Corp.*, 167 B.R. 189, 201 (Bankr. D. Ariz. 1994); *In re Posadas Assocs.*, 127 B.R. 278, 281 (Bankr. D. N.M. 1991).

[27]*See Ritchie Special Credit Invs., Ltd. v. U.S. Trustee (In re Petters Co.)*, 620 F.3d 847, 853-54 (8th Cir. 2010) (appointing receiver to serve as trustee); *In re Stratesec, Inc.*, 324 B.R. 156, 158 (Bankr. D.C. 2004) (entering show cause order as to why the court should not order the U.S. Trustee to appoint the receiver as trustee).

[28]*In re Petters Co.*, 401 B.R. 391, 394 (D. Minn. 2009).

[29]*Id.* at 395.

[30]*Id.* at 394-95.

[31]*Id.* at 395.

[32]*Id.* at 405.

[33]*Id.* at. 413.

[34]*See Ritchie Special Credit Invs.*, 620 F.3d at 850.

Receivers and the In Pari Delicto Doctrine

[1]*Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985).

[2]*See, e.g., Peterson v. McGladrey & Pullen*, 676 F.3d 594, 598-99 (7th Cir. 2012); *Baena v. KPMG LLP*, 453 F.3d 1 (1st Cir. 2006); *Nisselson v. Lernout*, 469 F.3d 143, 153 (1st Cir. 2006; *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001).

[3]*See In re Hedged-Investments Assocs., Inc.*, 84 F.3d 1281 (10th Cir. 1996) ("Put most simply, [a trustee] is a bankruptcy trustee acting under 11 U.S.C. § 541, and bankruptcy law, apparently unlike the law of receivership, expressly prohibits the result [the trustee] urges."); *FDIC v. O'Melveny & Meyers*, 61 F.3d 17, 19 (9th Cir. 1995) ("A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the [entity]; it is thrust into those shoes.").

[4]*O'Melveny at 19* (citation omitted).

[5]*Scholes v. Lehman*, 56 F.3d 750, 754 (7th Cir. 1995).

[6]*See Knauer v. Jonathon Roberts Fin. Group, Inc.*, 348 F.3d 230 (7th Cir. 2003).

[7]*Id.* at 236.

[8]*Jones v. Wells Fargo Bank*, 666 F.3d 955 (5th Cir. 2012); *see also Reneker v Offill*, 2012 U.S. Dist. LEXIS 83017 (N.D. Tex. 2012); *Wiand v. EFG Bank*, 2012 U.S. Dist. LEXIS 30323 (M.D. Fla. Feb. 8, 2012); *Perlman v. Wells Fargo Bank*, 830 F. Supp. 2d 1308 (S.D.

Fla. 2011) (under Florida law, "a receiver does not always inherit the sins of his or her predecessors."); *Harmelin v. Man Financial Inc.*, 2007 U.S. Dist. LEXIS 73851, at *22 (E.D. Pa. Oct. 2, 2007); *Pearlman v. Alexis*, 2009 U.S. Dist. LEXIS 88546, at *7 (S.D. Fla. Sept. 25, 2009); *Kirschner v. Wachovia Capital Markets, LLC (In re Le-Nature's Inc.)*, 2009 U.S. Dist. LEXIS 98700, at *11 (W.D. Pa. Oct. 23, 2009) (holding that the appointment of a receiver just days before the filing of a bankruptcy case for the debtor was sufficient to wash the claims of the *in pari delicto* taint so there was "nothing to impute" to the trustee when the trustee later sued).

[9] *Mosier v. Stonefield Josephson, Inc.*, 2011 U.S. Dist. LEXIS 124058, at *16-17 (C.D. Cal. Oct. 25, 2011) (citation omitted).

[10] *See, e.g., Wuliger v. Mfrs. Life Ins. Co*, 567 F.3d 787 (6th Cir. 2009); In re Wiand, 2007 U.S. Dist. LEXIS 24069, at *24 (M.D. Fla. Mar. 27, 2007); *Marwil v. Cluff*, 2007 U.S. Dist. LEXIS 65996, at *25 (S.D. Ind. Sept. 5, 2007); *Hays v. Pearlman*, 2010 U.S. Dist. LEXIS 116803, at *16-17 (D.S.C. Nov. 2, 2010).

[11] *Bankruptcy Servs. Inc. v. Ernst & Young (In re CBI Holding Co., Inc.)*, 529 F.3d 432 (2d Cir. 2008).

[12] *Thabault v. Chait*, 541 F.3d 512, 527 (3d Cir. 2008) ("[F]raudulent conduct will not be imputed if the officer's interests were adverse to the corporation and not for the benefit of the corporation."); *Baena v. KPMG, LLP*, 453 F.3d 1, 8 (1st Cir. 2006) (holding that the adverse interest exception generally applies when the agent has "totally abandoned" the interests of the corporate debtor and is acting entirely for his own purposes); *Breeden v. Kirkpatrick & Lockhard LLP (In re Bennett Funding Group)*, 336 F.3d 94, 100 (2d Cir. 2003).

[13] *Baena v. KPMG, LLP*, 453 F.3d 1, 8 (1st Cir. 2006).

[14] *CBI Holding*, 529 F.3d at 451 ("[T]he issue [is] whether mismanagement of [the company] was the vehicle by which [the manager] *intended* to advance his own interest or whether it was simply incidental to his continued efforts to retain some economic viability in the company.").

[15] *Kirschner v. KPMG, LLC,* 938 N.E.2d 941, 959 (N.Y. 2010).

[16] *Grede v. McGladrey & Pullen, LLP*, 421 B.R. 879, 886 (N.D. Ill. 2009) ("The later demise of [the debtor] does not mean there was no benefit to [the debtor], here for quite some time, when its officers acted wrongly.").

[17] *Baena v. KPMG, LLP*, 453 F.3d 1, 7 (1st Cir. 2006) (finding that adverse interest exception is not automatically triggered whenever misconduct contributes to a future financial harm. If it were, it would effectively eliminate the *in pari delicto* altogether, since unmasked frauds resulting in lawsuits rarely, if ever, benefit a company in the long run").

[18] *CBI Holding*, 529 F.3d 451, 453 ("Prolonging a corporation's existence in the face of ever increasing insolvency may be 'doing no more than keeping the enterprise perched at the brink of disaster.'") (citations omitted).

[19] *See Breeden v. Kirkpatrick & Lockhard LLP (In re Bennett Funding Group)*, 336 F.3d 94, 100 (2d Cir. 2003); *Mediators, Inc. v. Manney (In re Mediators Inc.)*, 105 F.3d 822, 827 (2d Cir. 1997) ("This rule imputes the agent's knowledge to the principal notwithstanding the agent's self-dealing because the party that should have been informed was the agent itself albeit in its capacity as principal"); *Grassmueck v. Am. Shorthorn Assoc.*, 402 F.2d 833, 838 (8th Cir. 2005) ("[W]here the principal and agent are alter egos, there is no reason to apply an adverse interest exception to the normal rules imputing the agent's knowledge to the principal, because 'the party that should have been informed [of the fraudulent conduct] was the agent itself albeit in its capacity as principal.").

[20] *SIPC v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999) quoting *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP*, 212 B.R. 34, 36 n.1 (S.D.N.Y. 1997) (finding that *in pari delicto* does not apply where innocent decision-makers who were "ignorant of the ongoing fraud and could and would if advised of the facts . . . have taken steps to bring the fraudulent conduct to an end."); *but see CBI Holding*, 529 F.3d at 432 (finding innocent insider exception invalid).

[21] *Breeden v. Kirkpatrick & Lockhart, LLP*, 268 B.R. 704, 710 (S.D.N.Y. 2001) ("Only management that exercises total control over the corporation—or that exercises total control over the type of transactions involved in the particular fraudulent activity at issue—are relevant."); *see also Smith v. Andersen, LLP*, 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001) (noting that, in "cases involving more than one corporate actor, the plaintiff may avoid dismissal for lack of standing by alleging the existence of an 'innocent member… of management who would have been able to prevent the fraud had he known about it."); *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145 (11th Cir. 2006). If not all of the "shareholders and/or decision makers are involved in the fraud" so that there was at least one innocent insider to whom the defendants could have reported their findings, then the *in pari delicto* doctrine does not bar the claims. *Sec. Investor Protection Corp., v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999).

[22] *CBI Holding*, 311 B.R. 350, 372 (Bankr. S.D.N.Y. 2004), *aff'd in part, rev'd in part*, 529 F.3d 432 (2d Cir. 2008) ("[W]here a publicly traded company has delegated to a board of directors the owners' role of hiring and supervising managers, and where that board has failed to prevent managers from committing fraud, the managers' misconduct should be imputed to the company, so as not to disincentivize the innocent managers, board members, and owners from policing the conduct of the guilty.").

[23] *Baena v. KPMG LLP*, 453 F.3d 1, 9 (1st Cir. 2006).

[24] *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 882-83 (N.J. 2006) (claim permitted "against an auditor who was negligent within the scope of its engagement by failing to uncover or report the fraud of corporate officers and directors").

[25] *Official Comm. Of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PriceWaterhouseCoopers, LLP*, 989 A.2d 313, 339 (Pa. 2010) ("This effectively forecloses an *in pari delicto* defense for scenarios involving secretive collusion between officers and auditors to misstate corporate finances to the corporation's ultimate detriment.").

[26] *Thabault v. Chait*, 541 F.3d at 529 (holding that the auditor was not a victim of the agent's fraud and that "allowing the auditor to invoke the *in pari delicto* doctrine would not serve the purpose of the doctrine—to protect the innocent."); *Freeman v. BDO Seidman, LLP (In re E.S. Bankest, L.C.)*, 2010 Bankr. LEXIS 1288, at *31 (Bankr. S.D. Fla. Apr. 6, 2010) ("BDO's agreement to detect fraud as Bankest's auditor precludes BDO from using that fraud it failed to detect to assert the imputation/*in pari delicto* defense as a shield to Plaintiff's claims").

[27] *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982).

[28] *Kirschner v. KPMG, LLC*, 938 N.E.2d 941, 959 (N.Y. 2010).