

2008

Can the Trustee Recover? Imputation of Fraud to Bankruptcy Trustees in Suits Against Third-Party Service Providers

Samuel C. Wasserman

Follow this and additional works at: <https://ir.lawnet.fordham.edu/flr>



Part of the [Law Commons](#)

Recommended Citation

Samuel C. Wasserman, *Can the Trustee Recover? Imputation of Fraud to Bankruptcy Trustees in Suits Against Third-Party Service Providers*, 77 Fordham L. Rev. 365 (2008).

Available at: <https://ir.lawnet.fordham.edu/flr/vol77/iss1/9>

This Article is brought to you for free and open access by FLASH: The Fordham Law Archive of Scholarship and History. It has been accepted for inclusion in Fordham Law Review by an authorized editor of FLASH: The Fordham Law Archive of Scholarship and History. For more information, please contact tmelnick@law.fordham.edu.

Can the Trustee Recover? Imputation of Fraud to Bankruptcy Trustees in Suits Against Third-Party Service Providers

Cover Page Footnote

J.D. Candidate, 2009, Fordham University School of Law; B.A., 2003, University of Pennsylvania. Thank you to Professor Thomas Lee for his invaluable guidance and to my family for all their support.

CAN THE TRUSTEE RECOVER? IMPUTATION OF FRAUD TO BANKRUPTCY TRUSTEES IN SUITS AGAINST THIRD-PARTY SERVICE PROVIDERS

*Samuel C. Wasserman**

Corporate fraud has become a familiar headline over the last decade and has forced several companies whose managers have committed that fraud to file for bankruptcy. In these cases, a trustee will often be appointed to represent and manage the bankruptcy estate. This trustee is vested with the rights of the debtor corporation upon filing and may try to sue third-party service providers (e.g., accounting firms, law firms, investment banks) for conspiring in, or negligently failing to detect, the fraud. Federal and state courts have disagreed over whether the bankruptcy trustee should be permitted to recover damages from these third parties. Some find that the trustee is burdened by the fraud and cannot recover, while others decide that the trustee should not be burdened by it. But the line between these two camps cannot be drawn cleanly. Courts that reach the same conclusion often do so for significantly different reasons. This Note seeks to place these decisions into a clear and more understandable framework and proposes a balance between the use of federal and state law that should provide guidance to the courts when considering this matter in the future.

INTRODUCTION

In April 2003, DVI Inc. was losing money. The company provided loans for hospitals to buy medical equipment, and many of its borrowers had begun to default. As its cash flow diminished, the company tried to hide its losses by falsifying its Securities and Exchange Commission (SEC) filings.¹ Months later, when investigations indicated that DVI had been concealing its true financial condition, the company filed for bankruptcy.² Steven Garfinkel, DVI's Chief Financial Officer, became one of the first people to be successfully prosecuted under the Sarbanes-Oxley Act.³

* J.D. Candidate, 2009, Fordham University School of Law; B.A., 2003, University of Pennsylvania. Thank you to Professor Thomas Lee for his invaluable guidance and to my family for all their support.

1. Anthony Lin, *Lawyers' New Nightmare: Bankruptcy Trustee Suits*, N.Y.L.J., Nov. 26, 2007, at 1.

2. *Id.*

3. *Id.*

But this was not the end of the story. On behalf of the corporation, the bankruptcy trustee (appointed to oversee DVI's bankruptcy estate) sued Clifford Chance LLP, a law firm that had been retained by DVI at the time of the false SEC filings, for breach of contract.⁴ The trustee alleged that the law firm was aware of the fraud and had participated in it by preparing the false filings.⁵ Clifford Chance moved to dismiss the case, arguing that the trustee should not recover because he "stood in the shoes" of the corporation (DVI) that had allegedly committed the fraud in the first place.⁶ The judge declined to dismiss the claims,⁷ leaving the law firm potentially subject to liability.

Companies such as Enron, WorldCom, Refco, and Parmalat have all become household names in the wake of similar scandals involving managers who falsified financial statements or performed other illegal transactions. By hiding losses, inflating revenues, or other forms of financial manipulation, these managers gave investors and creditors a false impression of their companies' fiscal health.⁸ When the fraud became public and the companies' true financial condition was revealed, investors realized that the companies' stock was not worth what they had thought it was worth. As large numbers of investors sold their stock, the stock price plummeted.⁹ In addition, given the companies' strained financial conditions, managers foresaw an inability to satisfy creditors' demands. As a result, the companies chose to file for bankruptcy relief.¹⁰ Officers of some of the corporations were charged with, and convicted of, fraud;¹¹ and new federal and state statutes were enacted to address the problem.¹²

Third-party service providers, such as banks, law firms, and accounting firms, are, by the nature of their services, often connected to such fraudulent

4. See Complaint at 2, *Buckley v. Clifford Chance LLP*, No. 06-CV-1003 (E.D. Pa. Mar. 6, 2006).

5. Lin, *supra* note 1.

6. *Id.*

7. *Id.*

8. See, e.g., Bloomberg News, *Files Suggest Double-Billing by Parmalat*, N.Y. TIMES, Feb. 2, 2004, at A8 (Parmalat's managers allegedly double booked receivables to inflate revenue, which in turn made it easier for the company to acquire financing); Carl Hulse, *Lawmakers Say Files Show Flagrant WorldCom Fraud*, N.Y. TIMES, July 16, 2002, at C7 (noting that over several years, WorldCom executives helped inflate the company's earnings by hiding costs); Reuters, *Ex-Refco Executive Pleads Guilty*, N.Y. TIMES, Dec. 20, 2007, at C6 (Refco executive Phillip R. Bennett committed fraud by concealing \$430 million in bad customer debt).

9. Enron's stock price, once worth as much as \$90, became nearly worthless around the time it filed for bankruptcy. See Richard A. Oppel Jr. & Andrew Ross Sorkin, *Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES, Dec. 3, 2001, at A1. Refco's stock also became nearly worthless after trading above \$28 the week before the company disclosed its hidden debt. See Eric Dash & Jenny Anderson, *How a Big Investor Fell into the Refco Deal*, N.Y. TIMES, Oct. 19, 2005, at C4.

10. See, e.g., Jonathan D. Glater, *A Bankruptcy Filing Might Be the Best Remaining Choice*, N.Y. TIMES, Nov. 29, 2001, at C6.

11. See, e.g., John R. Emshwiller, Gary McWilliams & Ann Davis, *Lay, Skilling Are Convicted of Fraud*, WALL ST. J., May 26, 2006, at A1.

12. See, e.g., 15 U.S.C. §§ 7241, 7262 (2006); 18 U.S.C. § 1519 (2006).

activity.¹³ The lawyers may have prepared the documents for the false transactions; the banks may have helped structure the transactions; and the accounting firms may have audited the financial statements that contained inflated earnings.¹⁴ It is not always clear whether the third parties actively abetted the fraud, negligently failed to detect the fraud, or were merely innocent victims of the company's deception. Nevertheless, investors and others who have suffered losses as a result of the fraud may be inclined to bring suit against one or more of these third-party service providers, alleging that they were partly responsible for their losses.¹⁵ Such third parties are appealing targets because they tend to have more resources than the now-bankrupt corporation and are therefore more likely to be able to pay damage awards.

As illustrated in the DVI case, the trustee of the bankrupt corporation's estate may be among those who seek recovery from one of the third parties.¹⁶ In theory, the purpose of any suit brought by a bankruptcy trustee would be to recover money that would ultimately be used to satisfy the corporation's creditors.¹⁷ However, there is an important difference between a claim brought against a third party by the trustee and a claim brought by investors or others who have been harmed. Unlike investors, creditors, or others who might bring claims against a third party, the trustee is a legal representative of the bankrupt corporation's estate, "vested with the right, title, and power of the bankrupt as of the date of adjudication."¹⁸

The bankruptcy estate that the trustee represents is defined by section 541 of the federal Bankruptcy Code. "Such estate is comprised of . . . all legal or equitable interests of the debtor in property as of the commencement of the case."¹⁹ Therefore, the trustee inherits all of the debtor's rights and interests at the time of filing. And if, as a matter of law, the trustee is the

13. See, e.g., Lin, *supra* note 1 (explaining that DVI'S law firm allegedly played a role in filing false documents with the SEC).

14. See, e.g., Buckley v. Deloitte & Touche USA LLP, No. 06 Civ. 3291, 2007 WL 1491403, at *2-3 (S.D.N.Y. May 22, 2007) (noting that the accounting firm allegedly produced certified audit opinions evidencing DVI's fiscal health).

15. In perhaps the most well known of this type of case, a class-action suit was brought against Arthur Andersen in 2002 for destroying documents relating to the Enron fraud. See Michael Brick, *Lawyer Known for Class Actions Will Lead the Enron Plaintiffs*, N.Y. TIMES, Feb. 16, 2002, at C1. In 2004, Parmalat filed a lawsuit against Citigroup, claiming that "the investment bank knowingly helped structure complex transactions that misled shareholders and cost them billions of dollars." See Eric Dash, *Parmalat Sues Citigroup over Transactions*, N.Y. TIMES, July 30, 2004, at C7. More recently, the trustee of the Refco Litigation Trust sued Chicago-based law firm, Mayer Brown LLP (formerly Mayer, Brown, Rowe & Maw LLP) for handling sham transactions used to cover up massive losses. See Lin, *supra* note 1.

16. See Lin, *supra* note 1.

17. See, e.g., Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1151 (11th Cir. 2006).

18. ALEXANDER L. PASKAY, HANDBOOK FOR TRUSTEES AND RECEIVERS IN BANKRUPTCY 223 (Matthew Bender & Co, 1978) (1968).

19. 11 U.S.C. § 541(a) (2006).

debtor corporation that committed fraud, why should he be entitled to any recovery?

Over the last decade, a debate has emerged over whether a bankruptcy trustee should be permitted to recover from a third party for abetting, or failing to detect, the past fraudulent behavior perpetrated by the managers of the debtor corporation whose bankruptcy estate he represents. One side of the debate argues that the trustee is tainted by the fraud of the managers of the corporation in whose shoes he appears to stand, and thus should not be able to recover from third parties.²⁰ From this perspective, allowing the trustee to recover would be tantamount to allowing a guilty party to recover damages from "accomplices" to its own fraud.²¹

The other side generally believes that the trustee should not be burdened by the fraud and therefore should be able to recover from third parties.²² Because the recovery will ultimately go to innocent creditors, proponents of this argument see no reason why third parties at fault should not be liable to the trustee for their breach of duty.²³ On this view, the trustee is cast as a vehicle for the satisfaction of the claims of innocent creditors and not as the legal stand-in for the corporation and its managers.

Part I of this Note discusses relevant principles of bankruptcy law, the role and standing of the trustee, and general agency principles. It highlights the basic methods of analysis that courts and commentators have used to decide the issue, while emphasizing the inconsistency of these approaches. Part II articulates, in detail, the split between those who think the bankruptcy trustee (of a corporation whose managers have committed fraud) should be able to recover from third-party service providers for playing a role in the fraud, and those who think recovery should be prohibited.

Part III explains that a principal reason for the split among courts is confusion about the role of section 541 of the Bankruptcy Code in the matter. It then proposes a reading of that section that would resolve the confusion. Section 541 states that the bankruptcy "estate is comprised of . . . all legal or equitable interests of the debtor in property as of the commencement of the case."²⁴ Some courts read this federal statute as foreclosing any possibility, under state or federal law, that the trustee might have any legal claims against third parties that the company would not have had.²⁵ Other courts, relying to some extent on the U.S. Supreme Court's decision in *O'Melveny & Myers v. FDIC*,²⁶ have concluded that the rights

20. See *infra* Part II.A.

21. See *infra* Part II.A.

22. See *infra* Part II.B.

23. See *infra* Part II.B.

24. 11 U.S.C. § 541(a).

25. See *infra* Part II.A.1; see, e.g., Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145 (11th Cir. 2006); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001); *In re Hedged-Invs. Assocs.*, 84 F.3d 1281 (10th Cir. 1996).

26. 512 U.S. 79 (1994).

and interests of the estate are defined exclusively by state law, without reference to section 541.²⁷ Still, other courts fall somewhere between these poles.²⁸ Part III suggests that section 541 does apply to the validity of a trustee's claims against third parties, but that the federal statute itself invites the incorporation of state law. It argues that the statutory phrase, "at the commencement of the case," does place certain limitations on the manner in which state law may define the rights and interests of the bankruptcy estate: namely, that state law may not permit the rights of the estate to be altered because of events occurring after the bankruptcy filing. Part III concludes by suggesting how these insights could be used to guide courts in future cases involving third-party claims by trustees, hopefully leading to more consistent, predictable outcomes.

I. BANKRUPTCY LAW MEETS AGENCY LAW: THE GENESIS OF A DEBATE

Part I.A of this Note discusses the details of the bankruptcy process, as well as the role and standing of the trustee in bankruptcy. Part I.B discusses agency law and imputation doctrine as it relates to bankruptcy cases. Part I.C briefly highlights the basic methods of analysis that courts and commentators have used to decide the issue while pointing out the inconsistency of these approaches.

A. *The Bankruptcy Process and the Trustee*

There tend to be common threads in bankruptcies that result from corporate fraud. In many cases, the fraud consists of inflated earnings or hidden debt that gives the public a misleading picture of a company's fiscal health.²⁹ This false impression of a company's well-being often makes it easier for the company to obtain financing, which, given its actual condition, it is unlikely to be able to repay.³⁰ When the fraud becomes public, the company comes under increasing pressure from its creditors, who now realize that the company may not have the money to repay them.³¹ In the face of such pressure and continuing losses, the company will often file a bankruptcy petition.³²

The filing of a bankruptcy petition constitutes an order of relief, temporarily preventing creditors from seeking to satisfy their claims.³³ In this way, the bankruptcy process helps slow the deterioration of the business, giving the company "breathing space" to turn its business around

27. See *infra* Part II.B.2; see, e.g., *In re Jack Greenberg, Inc.*, 240 B.R. 486 (Bankr. E.D. Pa. 1999); *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871 (N.J. 2006).

28. See, e.g., *Baena v. KPMG*, 453 F.3d 1 (1st Cir. 2006).

29. See *supra* note 8 and accompanying text.

30. See *supra* note 8 and accompanying text.

31. See *supra* note 10 and accompanying text.

32. A debtor need not be insolvent in order to file a bankruptcy petition. CHARLES J. TABB & RALPH BRUBAKER, *BANKRUPTCY LAW: PRINCIPLES, POLICIES, AND PRACTICE* 80 (2d ed. 2006).

33. MARTIN A. FREY ET AL., *AN INTRODUCTION TO BANKRUPTCY LAW* 423 (3d ed. 1997).

if it so chooses and to satisfy its creditors as best it can in an orderly fashion.³⁴

This is in line with the two most commonly stated goals of bankruptcy: to satisfy as many creditors as possible and to relieve unfortunate and honest debtors of "perpetual bondage to their creditors."³⁵ However, there is also a compelling economic justification for the bankruptcy process. Without the bankruptcy process, each creditor would individually rush to claim the debtor's assets when the debtor filed. These assets, sold off to creditors individually, might not be worth as much as the company as a whole if it were to continue operations.³⁶ Therefore, it is often in the creditors' collective interest to have a procedure enabling a company to remain whole and continue operations (if it so chooses) while insolvent.³⁷ In this light, the critical question in bankruptcy is not whether the honest debtor deserves a fresh start, but whether it is economically advantageous for the debtor to remain whole for a time (or perhaps even to continue business), rather than immediately sell off its assets to the first-in-line creditors who demand payment.³⁸

To achieve these goals in an orderly manner, bankruptcy law prescribes an extensive and complicated system of relief. A few integral characteristics of that process are relevant to this discussion. First, upon filing for bankruptcy, a bankruptcy estate is created.³⁹ The estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case."⁴⁰ Put more simply, the estate "includes all kinds of property, including tangible or intangible property," that belonged to the debtor.⁴¹ This includes causes of action that the debtor had against others at the time of filing.⁴²

The abovementioned temporary prohibition on creditors seeking to collect their debt is called the "automatic stay."⁴³ The "automatic stay" goes into effect upon the filing of a bankruptcy petition.⁴⁴ It serves to preserve the assets of the estate so that they can be distributed in accordance with bankruptcy procedures.⁴⁵ In addition to barring actions by creditors to

34. ELIZABETH WARREN, *BUSINESS BANKRUPTCY* 18 (1993).

35. See TABB, *supra* note 32, at 64 (quoting JOSEPH STORY, *COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES* (1833)).

36. See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 14 (1986) ("[T]he most obvious reason for a collective system of creditor collection is to make sure that creditors, in pursuing their individual remedies, do not actually decrease the aggregate value of the assets that will be used to repay them.").

37. Thomas Jackson notes that the bankruptcy process allows creditors not to have to spend excess time and money monitoring the debtor to ensure that they will be the first in line to get repaid. *Id.* at 16.

38. *Id.* at 5.

39. See FREY, *supra* note 33, at 423.

40. 11 U.S.C. § 541(a) (2006).

41. S. REP. NO. 95-989, at 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5868.

42. *Id.*

43. 11 U.S.C. § 362(a)(6); *see also* FREY, *supra* note 33, at 423.

44. 11 U.S.C. § 362(a).

45. See TABB, *supra* note 32, at 193.

satisfy their debts, the stay prohibits “nearly all non-criminal actions against the debtor, the debtor’s property or property of the estate.”⁴⁶

Other features of the process depend on whether the company is filing for bankruptcy under Chapter 7 or Chapter 11.⁴⁷ If a company wants to cease doing business and liquidate its assets, it files a Chapter 7 petition.⁴⁸ In a Chapter 7 proceeding, all the property of the estate is distributed to creditors in accordance with the priority of their claims.⁴⁹ On the other hand, if a company desires to continue operating its business, it files a Chapter 11 reorganization petition.⁵⁰ In such cases, the debtor can create a reorganization plan, showing how the debtor intends to overcome its financial difficulties and become a viable business again.⁵¹ The creditors must accept the plan in order for it to go into effect.⁵²

A trustee is always appointed to manage the estate during the Chapter 7 bankruptcy proceeding.⁵³ A trustee is also commonly appointed in Chapter 11 cases where the current management of the debtor corporation has engaged in fraud or has grossly mismanaged the affairs of the corporation.⁵⁴ The trustee has various administrative duties outlined in the Bankruptcy Code.⁵⁵ For example, it is his duty to collect the property of the estate.⁵⁶ He also has a “duty to preserve all [the] properties” in his possession⁵⁷ and to “be accountable for all property received.”⁵⁸

The trustee’s purpose is to achieve an equitable distribution of the bankrupt’s assets to its creditors, and “to relieve the bankrupt of his debts through [a] discharge proceeding.”⁵⁹ The trustee represents the bankrupt debtor in the sense that he “succeeds to the interest of the bankrupt, and he is vested with the right, title, and power of the bankrupt as of the date of adjudication.”⁶⁰ But he is also a representative of the creditors and holds the assets of the estate in trust for their benefit.⁶¹ He is not subject to the

46. MICHAEL J. HERBERT, *UNDERSTANDING BANKRUPTCY* 106 (1995).

47. There are other chapters under which one can file for bankruptcy, but these are the two most relevant to this discussion.

48. HERBERT, *supra* note 46, at 291.

49. *Id.* at 301; *see also*, FREY, *supra* note 33, at 112–17, 302.

50. *See* HERBERT, *supra* note 46, at 303.

51. *See* FREY, *supra* note 33, at 435.

52. *Id.* at 436. There are circumstances in which a reorganization plan may be approved without the consent of certain creditors, *see, e.g.*, 11 U.S.C. § 1129(b) (2006) (known as the “cramdown” provisions), but they are beyond the scope of this Note.

53. *See* FREY, *supra* note 33, at 243.

54. 11 U.S.C. § 1104(a)(1) (2006); *see also* HERBERT, *supra* note 34, at 312.

55. 11 U.S.C. § 1106.

56. *Id.* § 704(a)(1).

57. *See* PASKAY, *supra* note 18, at 223.

58. 11 U.S.C. § 704(a)(2).

59. *See* PASKAY, *supra* note 18, at 222; *see also* FREY, *supra* note 33, at 7 (stating that one of the trustee’s objectives is to maximize the distribution of assets to the creditors).

60. *See* PASKAY, *supra* note 18, at 223.

61. *Id.* at 222; *see also* DANIEL R. COWANS, *COWANS BANKRUPTCY LAW AND PRACTICE* 451–52 (1963) (describing the trustee as a representative of creditor interests intended as a substitute for individual creditor efforts).

creditors' will, however, and should exercise his own independent judgment.⁶²

As mentioned above, the commencement of a bankruptcy case creates an estate comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case."⁶³ In accordance with these interests, and in his role as representative of this estate, the trustee has the capacity to sue and be sued.⁶⁴ In other words, the trustee has the power to bring any cause of action that would have been available to the company at the time of filing for bankruptcy.⁶⁵ With specific respect to whether the trustee has standing to sue a third-party service provider for aiding or negligently facilitating corporate managers' fraud, it would seem that if the company had standing to sue, so would the trustee.⁶⁶

A company's standing to sue in such cases depends on its fulfillment of constitutional standing requirements. There are three constitutional requirements for Article III standing. First, the plaintiff must allege that he has suffered or will imminently suffer an injury. Second, he must allege that the injury is traceable to the defendant's conduct. Third, the plaintiff must show that a favorable federal court decision is likely to redress the injury.⁶⁷

With regard to the first requirement, there is substantial agreement that where fraud or mismanagement harms a corporation's assets, it is the corporation that suffers the primary injury.⁶⁸ The second and third requirements are easily met in these situations as well. The injury that the corporation alleges is directly related to the wrongful or negligent behavior of the third-party defendants, and any damages recovered by such a suit would flow directly to the debtor's estate.⁶⁹ Since the debtor corporation would meet these constitutional standing requirements, the trustee who succeeds to the rights and interests of the debtor meets them as well.⁷⁰

62. See PASKAY, *supra* note 18, at 222–23.

63. 11 U.S.C. § 541(a)(1).

64. *Id.* § 323(a)–(b). As noted earlier, the trustee may try to bring claims against third parties in this capacity.

65. See S. REP. NO. 95-989, at 82 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5868.

66. See *id.*

67. See *Allen v. Wright*, 468 U.S. 737, 756–58 (1984); ERWIN CHERMERINSKY, FEDERAL JURISDICTION 60–61 (5th ed. 2007); see also *Sierra Club v. Morton*, 405 U.S. 727, 727 (1972) (finding that plaintiff corporation lacked standing because it failed to show injury to itself).

68. See Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1149–50 (11th Cir. 2006); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 348 (3d Cir. 2001). *But see* Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 120 (2d Cir. 1991) (holding that, "although a class of creditors had suffered harm, the corporation itself had not").

69. Failure to meet these latter two requirements is often found in taxpayer standing cases or cases involving generalized grievances. See, e.g., *Allen*, 468 U.S. at 755 (holding that "[r]espondents here have no standing to complain simply that their Government is violating the law").

70. "Simply because the creditors of a[n] estate may be the primary or even the only beneficiaries of such a recovery does not transform the action into a suit by the creditors"

Thus, there would appear to be no federal constitutional standing bar to third-party claims by the trustee.

B. Agency Law and Imputation

How one defines the debtor's estate and how one defines the trustee's rights in relation to the legal rights of that estate are central to the debate over whether the bankruptcy trustee can recover from third parties in the types of situations described above. The threshold question is whether the fraud perpetrated by the corporate managers should be imputed to the corporation itself.⁷¹ In the bankruptcy context, the court must additionally determine whether the fraud, if imputed to the corporation, is to be imputed to the debtor's bankruptcy estate, so as to burden the trustee.

Whether such fraud is imputed to the corporation is a question of agency law. The Restatement of Agency, section 5.03, states that "notice of a fact that an agent knows or has reason to know is imputed to the principal if knowledge of the fact is material to the agent's duties to the principal."⁷² In the corporate context, the manager is the agent, and the corporation is the principal. It follows that if the manager of a corporation commits fraud (or has knowledge of fraud) in a way that is material to his duties to the corporation, the fraud is imputed to the corporation.⁷³ The purpose of this fundamental concept of agency is that a principal should not be able to employ an agent to act on its behalf while remaining immune from liability for acts of the agent it has authorized.⁷⁴ Put another way, the principal "should not, by using an agent, be advantaged . . . compared with the [position he would be in had he] acted personally rather than through an agent."⁷⁵ Because imputation makes the principal liable for an agent's authorized behavior, the doctrine incentivizes principals to hire responsible agents.⁷⁶

and therefore deprive the trustee of standing. *Lafferty*, 267 F.3d at 349 (quoting *In re Jack Greenberg, Inc.*, 240 B.R. 486, 506 (Bankr. E.D. Pa. 1999)) (alteration in original); see also *Caplin v. Marine Midland Grace Trust Co. of N.Y.*, 406 U.S. 416, 429 (1972) (holding that the trustee cannot bring a claim that belongs to the creditors and not the estate).

71. Imputation is defined as "[t]he act or an instance of imputing something, esp[ecially] fault or crime, to a person." BLACK'S LAW DICTIONARY 774 (8th ed. 2004).

72. RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006).

73. See, e.g., *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 454 (7th Cir. 1982).

74. See RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b ("An agent undertakes to act on behalf of a principal A principal's right to control an agent enables the principal . . . to ensure compliance with [his duty to keep the principal informed]."). This is analogous to the principle of vicarious liability in torts. Imputation is the price to be paid for employing another. See W. PAGE KEETON ET AL., PROSSER AND KEETON ON TORTS 500 (5th ed. 1984).

75. Deborah A. DeMott, *When Is a Principal Charged with an Agent's Knowledge?*, 13 DUKE J. COMP. & INT'L L. 291, 312 (2003). This justification is rooted in the identity that is presumed to exist between the principal and the agent. *Id.* It prevents the principal from being able to wait until after the fact to determine whether it wants to be bound by what its agent has done. *Id.* at 316.

76. RESTATEMENT (SECOND) OF TORTS § 909 cmt. b (1979) ("Although there has been no fault on the part of a corporation . . . the imposition of punitive damages upon the [corporation] serves as a deterrent to the employment of unfit persons for important

The U.S. Court of Appeals for the Seventh Circuit decision in *Cenco Inc. v. Seidman & Seidman*⁷⁷ demonstrates how agency imputation principles can be used to prevent a corporation from recovering against third-party service providers for fraud. In that case, Cenco sought to recover from its accountants for taking part in the fraud perpetrated by Cenco's managers.⁷⁸ Abiding by the agency principles stated above, the Seventh Circuit in *Cenco* imputed the fraud perpetrated by the managers to the corporation itself.⁷⁹ Imputing the fraud to the corporation has the effect of treating the corporation as if it had committed the fraud. Treating the corporation as such, the court reasoned that "a participant in a fraud cannot also be a victim entitled to recover damages, for he cannot have relied on the truth of the fraudulent representations."⁸⁰ In other words, the court held that the fraud simply knocked out a crucial element of the plaintiff's prima facie case—reliance.⁸¹ Therefore, the corporation could not recover from the third party.

The Seventh Circuit also acknowledged the policy rationale for using imputation in this scenario. The objective of liability is "to compensate the victims of wrongdoing and to deter future wrongdoing."⁸² The *Cenco* court was concerned that if the corporation and its shareholders were allowed to recover, the corrupt officers could benefit.⁸³ This would not serve as a sufficient deterrent to committing fraud.

When fraud is imputed to the corporation and the corporation tries to recover damages from a third-party service provider for contributing to (or failing to detect) the fraud, the third party may also raise what is called the *in pari delicto* defense. *In pari delicto* literally means "in equal fault."⁸⁴ It is a doctrine of equity that prevents a deliberate wrongdoer from recovering from someone who has aided the wrongdoing.⁸⁵ Therefore, if the managers' fraud is imputed to the corporation, lack of reliance or the *in pari delicto* defense could prevent the corporation from recovering against a

positions."); see also Demott, *supra* note 75, at 315–18; Andrew J. Morris, *Clarifying the Imputation Doctrine: Charging Audit Clients with Responsibility for Unauthorized Audit Interference*, 2001 COLUM. BUS. L. REV. 339, 350.

77. 686 F.2d 449 (7th Cir. 1982) (Judge Richard Posner writing for a unanimous court).

78. *Id.* at 451.

79. *Id.* at 454–56.

80. *Id.* at 454.

81. A necessary element of fraud is reliance. BLACK'S LAW DICTIONARY 685 (8th ed. 2004).

82. *Cenco*, 686 F.2d at 455.

83. *Id.*

84. BLACK'S LAW DICTIONARY 806 (8th ed. 2004).

85. "It is a defense based on the legal doctrine that a party cannot seek relief for a crime or tort for which he or she is also to blame." Lin, *supra* note 1. The doctrine also rests on the rationale that "courts should not lend their good offices to mediating disputes among wrongdoers," and "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality." Risa Lynn Wolf-Smith, *Innocent Trustee/Creditors Barred by Debtors' Past Wrongs: It Just Ain't Right*, AM. BANKR. INST. J., Apr. 2007, at 42, 42 (quoting *Bateman Eichler, Hill Richards Inc. v. Berner*, 472 U.S. 299, 306 (1985)).

third party,⁸⁶ even if the third party were partially to blame for the fraud.⁸⁷ Not only can these defenses be used against solvent corporations; they can theoretically be used against a trustee representing a bankrupt corporation's estate on the assumption of imputation from the corporation to the trustee.

There are exceptions to the rules of imputation stated above that would prevent a third party from being able to use these defenses. An agent's actions might not be imputed to the principal if they were not committed in the course of employment, or if the actions were adverse to the principal's interests.⁸⁸ The latter case is known as the "adverse interest" exception.⁸⁹ The adverse interest exception bars imputation when the actions of an agent demonstrate that he has "totally abandoned" the interests of the corporation.⁹⁰

The court in *In re Sharp International Corp.* found the exception to apply.⁹¹ In *Sharp*, certain managers of the corporation had looted money (that they had fraudulently raised) from the company, diverting more than \$44 million of Sharp funds to companies that had no affiliation with Sharp.⁹² Since the plaintiff sufficiently proved this adversity of interest between the agents and the principal, the fraud was not imputed to Sharp.⁹³

The exception is in line with the principles behind the agency doctrine. The ordinary concern, that the principal will benefit from an agent's actions but avoid liability for them, does not apply here because the principal is being harmed, not helped, by the agent's actions.⁹⁴ It would not be fair to hold the corporation liable for the actions of someone who intends to do it harm.

There is a counterexception to the adverse interest exception, however. If the agent who has acted adversely to the interests of the corporation is the "sole representative" of the principal, then the adverse interest exception does not apply.⁹⁵ This is known as the "sole actor" counterexception to the

86. The applicability of the *in pari delicto* defense may vary depending on the nature of the tort.

87. RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (2006). "Imputation may provide the basis for a defense that may be asserted by third parties when sued by or on behalf of a principal. Defenses such as *in pari delicto* may bar a plaintiff from recovering from a defendant whose conduct was also seriously culpable." *Id.*

88. *Id.* § 5.03(a) (stating the exceptions to imputation of knowledge to the principal). This exception exists because when the agent has acted adversely, his conduct is "outside the control and incentive structures that the principal has created," and the principal, therefore, should not be liable for his conduct. DeMott, *supra* note 75, at 310.

89. *See, e.g., In re Mediators, Inc.*, 105 F.3d 822, 827 (2d Cir. 1997) ("[T]he adverse interest exception rebuts the usual presumption that the acts and knowledge of an agent acting within the scope of employment are imputed to the principal.").

90. *Id.* (citing *Center v. Hampton Affiliates, Inc.*, 488 N.E.2d 828, 830 (N.Y. 1985)).

91. *In re Sharp Int'l Corp.*, 278 B.R. 28 (Bankr. E.D.N.Y. 2002).

92. *Id.* at 32.

93. *Id.* at 39-42.

94. *See supra* note 74 and accompanying text.

95. *See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 359 (3rd Cir. 2001).

“adverse interest” exception.⁹⁶ In *In re Mediators*, a bank assisted Richard Manney, the sole shareholder of a corporation, in a fraudulent transaction to shield an art collection from liquidation.⁹⁷ The U.S. Court of Appeals for the Second Circuit held that because Manney was the sole shareholder, his actions, “by definition” were made on behalf of the corporation, regardless of their adverse effect on it.⁹⁸ The adverse interest exception did not apply, and the sole shareholder’s fraud was imputable to the corporation.⁹⁹

The rationale for this rule is that an “agent” cannot act adversely to the corporation if he *is* the corporation. The counterexception is also in line with agency law because the party who should have been informed of the fraud is the agent himself, also acting in his capacity as principal.¹⁰⁰ To let the principal separate himself from the agent’s actions would be irrational because they are the same person.¹⁰¹

The legal applicability of these general principles of agency depends on their adoption by individual states.¹⁰² In *O’Melveny*, the Supreme Court affirmed that state law governs the question of whether knowledge of fraud is imputed from managers of a corporation to the corporation itself.¹⁰³ “There is no federal general common law,” the court stated.¹⁰⁴ If a federal court is to determine whether imputation from a manager to the corporation is appropriate (in or out of bankruptcy), the court is to apply the relevant state imputation law.¹⁰⁵ If no case law exists, courts have resorted to divining how the state court would rule.¹⁰⁶

C. Framing the Debate over Trustee Recovery

In the bankruptcy context, the court must decide whether the fraud should be imputed to the bankruptcy estate and the trustee who oversees it. If the fraud is imputed, the estate and the trustee are burdened by the fraud and are subject to the defenses described above. If the fraud is not imputed, the trustee may not be subject to those defenses, and is more likely to

96. See, e.g., *In re Mediators, Inc.*, 105 F.3d 822, 827 (2d Cir. 1997).

97. *Id.* at 824.

98. *Id.* at 827.

99. *Id.*

100. See *Lafferty*, 267 F.3d at 359 (citing *In re Jack Greenberg, Inc.*, 212 B.R. 76, 86 (Bankr. E.D. Pa. 1997)).

101. Some courts and commentators have also acknowledged a more controversial exception known as the “innocent decision-maker” exception to imputation. See *In re Adelphia Commc’ns Corp.*, 330 B.R. 364, 381 (Bankr. S.D.N.Y. 2005). This exception holds that if there are one or more innocent decision makers who, if aware of the fraud, would have taken steps to bring the activity to an end, the fraud should not be imputed to the corporation.

102. *O’Melveny & Myers v. FDIC*, 512 U.S. 79, 83–84 (1994).

103. *Id.* (finding the contention that federal common law determines whether an officer’s knowledge should be imputed to the corporation “so plainly wrong”).

104. *Id.* at 83 (citing *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938)).

105. See *id.* at 83.

106. See *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 455 (7th Cir. 1982) (seeking to predict “how the Illinois courts might decide”).

recover. While courts agree that state law governs imputation to a corporation, they have not agreed on the appropriate authority for determining the extent to which corporate fraud should burden the bankruptcy estate and the trustee. Here lies the crux of the debate.

Unfortunately, a line cannot be drawn neatly between proimputation and anti-imputation camps. Courts that reach the same conclusion often do so for significantly different reasons. On the proimputation side, some courts rely heavily on section 541 to bar trustee recovery,¹⁰⁷ while others rely more on state imputation law.¹⁰⁸ Still others analyze the issue as one of standing.¹⁰⁹ On the anti-imputation side, most courts ignore section 541, aggressively interpreting state law to find imputation inappropriate and permit recovery from third parties.¹¹⁰ At the same time, commentators who oppose imputation have conjured rationales for recovery that have little to do with state law. Given these inconsistencies, it is difficult to discern a concrete framework in which to place each decision. Accordingly, Part II of this Note simply divides the courts and commentators into those that find trustee recovery prohibited and those that find it appropriate. Part III seeks to cast each of the courts' approaches into a more concrete and workable framework (even though the courts themselves do not) in order to understand what needs to be done to cure the inconsistent results.

107. Section 541(a) of title 11 of the U.S. Code provides that, "The commencement of a case under . . . this title creates an estate. Such estate is comprised of . . . all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a) (2006). The courts in this category interpret this language to mean that the property and interests of the estate are identical to those of the debtor corporation upon filing (and that no postpetition events may be considered). This interpretation further leads to the conclusion that the trustee who manages that estate also has exactly the same rights and interests as the debtor—no more, no less. *See* S. REP. NO. 95-989, at 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5868. Therefore, he cannot assert any claims that the debtor corporation would not have been able to assert and is subject to the same defenses as the debtor corporation would have been. If past fraud would have prevented the corporation from recovering against another party, then that fraud should prevent the trustee from recovering as well. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 355 (3d Cir. 2001); *In Re Segerstrom*, 247 F.3d 218, 224 (5th Cir. 2001).

108. *See* *Baena v. KPMG LLP*, 453 F.3d 1, 6 (1st Cir. 2006).

109. *See infra* Part II.A.3.

110. According to these courts, since state law governs imputation, state law may allow for some exceptions to the imputation doctrine—for example, barring the imputation defense when the third party has actively participated in the fraud, or when the guilty managers have been removed from the picture. *See infra* Part II.B.2. This side of the debate places greater emphasis on the trustee's role as a substitute for individual creditor efforts. *See supra* notes 58–60 and accompanying text. These courts and commentators emphasize that, in cases where the guilty managers are removed from the picture, there is no reason to impute the fraud to the trustee. By this more nakedly policy-formed analysis, regardless of whether the debtor (in whose shoes the trustee now stands) is saddled by fraud, the trustee should be able to recover for the benefit of innocent creditors who have been harmed by the wrongdoer. Since the end result of a suit would benefit only innocent parties, they argue that recovery should not be barred by defenses such as *in pari delicto*. *See infra* Part II.B.2.

II. CONFLICTING MEANS AND CONFLICTING ENDS: THE VARIETY OF APPROACHES TO THE PERMISSIBILITY OF TRUSTEE RECOVERY

Part II.A of this Note focuses on the cases that have barred the trustee from recovering from third parties. Of these courts, some have relied heavily on section 541 to reach their result, while others have relied on the state law of imputation with little or no awareness of federal bankruptcy law's relevance. Still others have controversially evaluated the issue in light of whether the trustee has standing to sue. It is clear that, despite the uniformity of results on this side of the issue, there are significant inconsistencies in reaching that result.

Part II.B of this Note highlights the cases that have allowed the trustee to recover from third parties. These cases aggressively interpret state law in order to find imputation inappropriate. Part II.B also describes the views of numerous commentators who have come up with a variety of ways to justify trustee recovery from third parties. Interestingly, many of these justifications do not rely on state law and are significantly different than the ones used by the courts.

A. *Cases and Commentators Finding that Recovery by the Trustee Is Barred*

1. Cases Using Section 541 to Bar Recovery

The majority of courts dealing with this issue come to the conclusion that a trustee, representing the bankruptcy estate of a debtor whose managers have committed fraud, should not be able to recover from third-party service providers who may have played a role in that fraud. They hold that fraud by the managers of the corporation should be imputed to the trustee in bankruptcy and allow third parties to invoke certain defenses against the trustee's claims. Courts such as the U.S. Court of Appeals for the Third Circuit in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*¹¹¹ reach this result because they believe that section 541 of the Bankruptcy Code leaves no other choice.

In *Lafferty*, a lease-financing corporation operated a Ponzi scheme¹¹² in which it issued fraudulent debt certificates to investors.¹¹³ When the company could not repay the outstanding debt, it filed for bankruptcy.¹¹⁴ A committee of unsecured creditors, acting as the trustee for the bankrupt

111. 267 F.3d 340.

112. A Ponzi scheme is a fraudulent investment scheme in which money from new investors creates artificially high dividends for original investors without any operation or revenue-producing activity other than the continual raising of new funds. BLACK'S LAW DICTIONARY 1198 (8th ed. 2004).

113. *Lafferty*, 267 F.3d at 343-44.

114. *Id.* at 344.

estate,¹¹⁵ brought suit on behalf of the debtor corporation. It claimed that third parties (its counsel, accountant, and underwriter) had fraudulently induced the corporation to issue the debt securities.¹¹⁶ The third parties argued that the fraud should be imputed to the trustee and that the doctrine of *in pari delicto* established an affirmative defense against his claims.¹¹⁷ The trustee, in turn, argued that under Pennsylvania law, the *in pari delicto* defense should not be available when it would produce an inequitable result.¹¹⁸ It argued that imputation was unwarranted because the fraud-committing managers had been eliminated from the picture, and only innocent creditors would benefit from recovery.¹¹⁹

The court first addressed whether the conduct of the officers should be imputed to the corporation.¹²⁰ The court applied the widely accepted agency law standard (supported by Pennsylvania state law) that the conduct of an agent should be imputed to the principal as long as it is (1) in the course of the agent's employment, and (2) for the benefit of the company.¹²¹ Interestingly, the court found that the second prong was not satisfied because the managers' actions harmed the company by pushing it into greater debt.¹²² This would normally lead to the "adverse interest" exception to imputation, in which the fraud is not imputed to the corporation when the managers have abandoned the corporation's interests.¹²³ However, the court found that the "sole actor" counterexception applied.¹²⁴ It held that if the agent is the "sole representative" of the principal, then the agent's fraudulent conduct is imputable to the principal even though his actions may be adverse to the principal's interests.¹²⁵ Consequently, the officer's fraud was imputed to the corporation.

The court next addressed the issue of whether postpetition events could be considered in evaluating the trustee's claim.¹²⁶ Specifically, it addressed the trustee's claim that fraud should not be imputed because the fraudulent managers had been removed from the picture after filing, and all the beneficiaries of the suit would be innocent creditors.¹²⁷

115. Usually the creditors' committee and the trustee are two different parties. This was a circumstance in which there was a stipulation under which the committee acquired all the attributes of the trustee for the purposes of this case. *Id.* at 345. So for the purposes of this discussion, this Note refers to the committee as the trustee when appropriate.

116. *Id.* at 344.

117. *Id.* at 354.

118. *Id.*

119. *Id.* at 355.

120. *Id.* at 358–59.

121. *Id.*

122. *Id.* at 359.

123. See *In re Sharp Int'l Corp.*, 278 B.R. 28 (Bankr. E.D.N.Y. 2002).

124. *Lafferty*, 267 F.3d at 360.

125. *Id.* at 359; see also *supra* note 96 and accompanying text.

126. *Lafferty*, 267 F.3d at 355–56.

127. *Id.* at 356–57.

To decide whether the innocence of the committee (acting as trustee) could be taken into account, the court looked to section 541 of the Bankruptcy Code. The court held that since the estate consists of all "interests of the debtor in property *as of the commencement*" of bankruptcy,¹²⁸ it was not entitled to take into account events that occurred after the filing of bankruptcy when deciding whether the *in pari delicto* defense should apply.¹²⁹ Consequently, the court could not take into account the removal of guilty managers and the establishment of the committee as an innocent successor because both these events had occurred after the commencement of the case.¹³⁰

Since the innocence of the successor could not be taken into account, if the debtor would have been subject to the defense at the time of filing, the trustee would be subject to the same defense. Here, the debtor was guilty of fraud and would have been subject to the *in pari delicto* defense. As a result, the trustee was subject to the defense as well.¹³¹

The court pointed out that the legislative history was even clearer on this matter: "[Section 541] is not intended to expand the debtor's rights against others more than they exist at the commencement of the case."¹³² Therefore, the fraud is imputed to the trustee, and the *in pari delicto* doctrine constitutes an affirmative defense against the trustee's claims.¹³³

The *Lafferty* decision is a quintessential example of a court using section 541 of the Bankruptcy Code to conclude that the trustee's rights and interests are no greater than those of the corporation at the time of filing. Therefore, just as the fraud is imputed to the corporation, it is also imputed to the trustee so as to prevent him from recovering from third parties in these situations.

The U.S. Court of Appeals for the Tenth Circuit in *In re Hedged-Investments Associates*¹³⁴ came to the same conclusion by a virtually identical, if not more forceful, reading of section 541. The court found that section 541 "expressly prohibits" the trustee from recovering when the debtor would not have been able to recover outside of bankruptcy.¹³⁵ It elaborated that the phrase "as of the commencement of the case" has temporal as well as qualitative limitations: temporal, in "establish[ing] a clear-cut date after which property acquired by the debtor will normally not become property of the bankruptcy estate," and qualitative in "establish[ing] the estate's rights as no stronger than they were when actually held by the debtor."¹³⁶

128. *Id.* at 356 (quoting 11 U.S.C. § 541(a) (2006)).

129. *Id.* at 356-57.

130. *Id.* at 357.

131. *Id.*

132. *Id.* at 356 (citing S. REP. NO. 95-989, at 82 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5868).

133. *Id.* at 357-59.

134. 84 F.3d 1281 (10th Cir. 1996).

135. *Id.* at 1285.

136. *Id.* (citing *Hays & Co. v. Merrill Lynch*, 885 F.2d 1149, 1154 n.7 (3d Cir. 1989)).

Most recently, the U.S. Court of Appeals for the Eleventh Circuit, in *Unsecured Creditors of PSA, Inc. v. Edwards*,¹³⁷ expressed its alignment with the Third and Tenth Circuits. In deciding whether the trustee of a bankrupt Ponzi scheme operator was barred from recovering from a bank for aiding and abetting the fraud, the court held 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.”¹³⁸ It continued, “[i]f a claim of [the debtor] would have been subject to the defense of *in pari delicto* at the commencement of the bankruptcy, then the same claim, when asserted by the trustee, is subject to the same affirmative defense.”¹³⁹

2. Cases Relying on State Imputation Law to Bar Recovery

While the Third, Tenth, and Eleventh Circuits have found that the language of section 541 itself is sufficient to bar the trustee’s claims, other circuits have not relied so heavily on the Bankruptcy Code, instead placing more emphasis on state imputation law. In *Baena v. KPMG*,¹⁴⁰ a case decided in the U.S. Court of Appeals for the First Circuit, the fact pattern was very similar to that in *Lafferty*. A software licensing company took on massive debt in order to finance new acquisitions. It was later found that managers had overstated revenues and profits, so the company, unable to repay its debts, filed for bankruptcy.¹⁴¹ Then, the trustee of the bankruptcy estate tried to sue its accounting firm for failing to alert the company of the fraud.¹⁴² The court in *Baena* reached the same conclusion as the *Lafferty* court. The fraud was imputed to the trustee, prohibiting recovery.¹⁴³ But, notably, the *Baena* court did not refer to the Bankruptcy Code at all in its decision.

Instead, the court simply relied on Massachusetts’s state imputation law. “[O]rdinary agency-based imputation rules appear to operate in Massachusetts,” the court stated.¹⁴⁴ These “ordinary” imputation rules dictated that the managers’ fraud be imputed to the corporation and to the trustee representing its bankruptcy estate. Therefore, when the trustee tries to hold a third party liable for that same fraud, the *in pari delicto* defense applies, barring recovery.¹⁴⁵

Similarly, in one of many opinions on the matter, the Second Circuit also looked to state imputation law to bar trustee recovery from a third-party

137. 437 F.3d 1145 (11th Cir. 2006).

138. *Id.* at 1150 (citing *O’Halloran v. First Nat’l Bank of Fla.*, 350 F.3d 1197, 1202 (11th Cir. 2003)).

139. *Id.*

140. 453 F.3d 1 (1st Cir. 2006).

141. *Id.* at 3.

142. *Id.* at 4.

143. *Id.* at 6–7.

144. *Id.* at 8.

145. *Id.* at 6–7. The court refused to adopt the narrower imputation doctrine proposed by the trustee, stating that such changes were more appropriately left to the state courts. *Id.* at 8.

service provider.¹⁴⁶ In *Official Committee of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, the court considered the Texas law proposition that “‘where the wrong of the one party equals that of the other, the defendant is in the stronger position,’ and a court will not ‘administer a remedy.’”¹⁴⁷ Like the First Circuit in *Baena*, the Second Circuit presumed (without elaboration) that if the corporation were to be subject to the *in pari delicto* defense under state law, so would the trustee of the bankruptcy estate.¹⁴⁸

3. Cases Barring Suits Because the Trustee Lacks Standing

While the decisions described above differ in terms of whether federal or state law governs this issue, they all agree that the trustee at least has standing to bring the claims sought. Other courts, however, believe that the trustee lacks standing to bring the claims in the first place. Notably, lack of standing in these cases is a federal law ground for dismissal. The landmark case that has decided the issue in this way is *Shearson Lehman Hutton, Inc. v. Wagoner*.¹⁴⁹

In *Wagoner*, Herbert Kirschner formed HMK Management Corporation and was its sole shareholder. He sold worthless notes and loan agreements to his fellow church members and then used the proceeds to execute trades in an account with Shearson, a brokerage firm.¹⁵⁰ HMK subsequently went bankrupt, and the trustee sued Shearson, alleging that Shearson had breached its fiduciary duty to HMK.¹⁵¹

Unlike *Lafferty* and *PSA*, where the court ruled against the trustee’s third-party claims but assumed its standing to sue, the court in *Wagoner* held that the trustee did not even have standing to bring the suit against the third party to begin with.¹⁵² It reasoned that the relevant claim only belonged to the creditors.¹⁵³ It stated that, “[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation.”¹⁵⁴

The court’s decision turned on whether or not there had been injury to the corporation “apart from that done to the third-party creditor note-

146. See Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP, 322 F.3d 147 (2d Cir. 2003).

147. *Id.* at 158 (citing 34 TEX. JUR. 3D *Equity* § 31 (2002)).

148. *Id.* at 161–63. The U.S. Court of Appeals for the Second Circuit refrained from actually interpreting Texas law here, but clearly approved of the district court’s use of Texas law as the appropriate authority for deciding whether *in pari delicto* applies. Significantly, the court made no distinction between imputation to the corporation and imputation to the trustee of the bankrupt estate.

149. 944 F.2d 114 (2d Cir. 1991).

150. *Id.* at 116.

151. *Id.* at 117.

152. *Id.* at 120.

153. *Id.*

154. *Id.*

holders.”¹⁵⁵ Interestingly, the court found that there was no injury to the corporation itself, and “to the extent [the] claim alleges money damages to the ‘clients of HMK,’ it belongs only to the creditors.”¹⁵⁶ Without cognizable injury, the trustee representing the debtor’s estate failed to meet the constitutional standing requirements.¹⁵⁷

The *Wagoner* decision has been criticized on several grounds. First, the court’s finding that a corporation is not harmed when its assets are squandered (as they were in this case) effectively ignores the existence of the corporation during the bankruptcy process.¹⁵⁸ This is an illogical conclusion because the corporation often restructures and continues to operate.¹⁵⁹ Furthermore, the *Wagoner* court seems to acknowledge the trustee’s right to sue the guilty managers for damages done to the corporation, so it is inconsistent to hold that the trustee does not have standing to sue a third party for that same damage.¹⁶⁰

Several other holdings within the Second Circuit followed *Wagoner*’s line of reasoning and held that the trustee does not even have standing to sue third parties. *In re Bennett Funding Group*¹⁶¹ further complicated the *Wagoner* doctrine by confusing lack of standing with *in pari delicto*. The court in *Bennett* denied the trustee standing because the trustee could not prove damage to the corporation itself.¹⁶² Furthermore, it held that, even if there was damage to the corporation, the trustee lacked standing because of the debtor’s collaboration with the defendant.¹⁶³ Through this line of reasoning, *Bennett* improperly “ushered in the *in pari delicto* approach” into the standing issue, further complicating its application.¹⁶⁴

4. Policy Concerns of the “Antirecovery” Courts

Many of the circuit courts above have expressed reservations about their own holdings from a policy perspective. Two main concerns arise. First, the courts are hesitant to rule in favor of the defendants when the damages from trustee recovery would be used to repay innocent creditors.¹⁶⁵ But in the final determination, they find that an alternate outcome is not justifiable given the text of section 541: “It falls beyond the province of this court to let policy considerations override our interpretation of the text and clear

155. *Id.* at 118–19.

156. *Id.* at 119.

157. *See supra* note 67 and accompanying text.

158. Jeffrey Davis, *Ending the Nonsense: The In Pari Delicto Doctrine Has Nothing to Do with What Is § 541 Property of the Bankruptcy Estate*, 21 EMORY BANKR. DEV. J. 519, 525 (2005).

159. *Id.* at n.36.

160. *Id.* at 527.

161. 336 F.3d 94 (2d Cir. 2003).

162. *Id.* at 100.

163. *Id.* (citing *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1094 (2d Cir. 1995)).

164. Davis, *supra* note 158, at 528.

165. *In re Hedged-Invs. Assocs.*, 84 F.3d 1281, 1285–86 (10th Cir. 1996).

intent of an act of Congress”¹⁶⁶ Also, while it is appealing to permit trustee recovery so that innocent creditors can benefit, giving these damages to the trustee does not ensure that they will be distributed to creditors in a manner that is proportional to the harm suffered.¹⁶⁷

Second, some courts are concerned with underdetering third-party service providers by allowing them to go unpunished after being at least partially responsible for the wrongdoing.¹⁶⁸ The trustee in *Baena*, for example, argues there is an interest in “conscripting accounting firms as policemen” in the post-Enron era.¹⁶⁹ The court, while sympathetic to this view, finds that adopting such a policy would be the province of the Massachusetts legislature and not the federal judiciary.¹⁷⁰

B. *Cases and Commentators Finding that Recovery Should Not Be Barred*

As articulated in Part II.A, the majority of courts have held that a bankruptcy trustee cannot recover from third-party service providers for negligence or complicity with regard to the fraud of the corporation’s managers. There are a few courts, however, that have permitted recovery in the same or similar circumstances. Ironically, these courts defer to state imputation law in much the same way the First Circuit does in *Baena*. But they achieve their ends by a much more aggressive interpretation of that state law. These courts have found that it is possible for the trustee to inherit more rights than the debtor had upon filing, and purport to reach this conclusion in the name of more equitable results. This is inconsistent with the federal courts that have held that section 541 precludes such a conclusion as a matter of law.

1. The *O’Melveny* Decision

Before discussing this side of the debate at length, it is necessary to discuss the *O’Melveny* decision in more detail because of the extent to which it is relied on in the “prorecovery” decisions.

O’Melveny is a landmark case in the way that it approaches the law of imputation. In *O’Melveny*, the Federal Deposit Insurance Corporation (FDIC) had stepped in as a receiver for an insolvent savings and loan whose officers had engaged in sham sales of assets to inflate profits.¹⁷¹ The FDIC brought suit against the law firm of *O’Melveny* and Meyers, alleging

166. *Id.* at 1286.

167. *Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1151 (11th Cir. 2006). If the creditors sued independently of the trustee, “[they] would not risk dilution through apportionment to senior creditors or unharmed creditors of equal priority.” *Id.*

168. *Baena v. KPMG*, 453 F.3d 1, 9 (1st Cir. 2006).

169. *Id.*

170. *Id.* In the wake of the recent mortgage crisis, one might also question the appropriateness of assuming that all creditors are innocent. Some may have been negligently complicit, in which case this policy rationale for recovery would be weakened.

171. *Id.* at 81–82.

professional negligence and breach of fiduciary duties.¹⁷² The FDIC asserted that federal common law should govern whether the officers' knowledge is imputed to the corporation, and that federal common law should also govern whether the officers' knowledge should be imputed to itself as receiver.¹⁷³ The Court unequivocally rejected the first contention: "There is no federal general common law' . . . and . . . the remote possibility that corporations may go into federal receivership is no conceivable basis for adopting a special federal common-law rule divesting States of authority over the entire law of imputation."¹⁷⁴

In turning to the FDIC's second contention—that federal common law should determine whether knowledge of the fraud should be imputed to the FDIC, as receiver—the Court took a more nuanced approach. At the time of the decision, there was a statute, the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA),¹⁷⁵ governing the powers and duties of the FDIC as receiver.¹⁷⁶ The statute stated that "the [FDIC] shall . . . by operation of law, succeed to—all rights, titles, powers, and privileges of the [bankrupt] institution."¹⁷⁷ O'Melveny argued that this statute meant that any defense good against the original party is good against the receiver.¹⁷⁸ The FDIC contended that the statute was a "*nonexclusive* grant of rights to the FDIC receiver, which can be supplemented or modified by federal common law . . ."¹⁷⁹ In other words, the FDIC argued that there was a federal interest in giving it, as receiver, more rights than the bankrupt debtor had.

The Court disagreed with the FDIC's arguments. It noted that FIRREA articulated specific federal rules of decision "regarding claims by, and defenses against, the FDIC as receiver."¹⁸⁰ Because of the specificity of the statute, the Court found it "hard to avoid the conclusion that [FIRREA] places the FDIC in the shoes of the insolvent," and that creating federal common law exceptions would not supplement the scheme, but alter it.¹⁸¹

However, after this detailed analysis of how FIRREA would potentially be applied to the case, the Supreme Court decided not to rule on those

172. *Id.* at 82.

173. *Id.* at 83. A receiver plays a role similar to that of a trustee, but does not take power over the estate via the same provision of the Bankruptcy Code. See PASKAY, *supra* note 18, at 183.

174. *Id.* (citing *Bank of Am. Nat'l Trust & Sav. Ass'n v. Parnell*, 352 U.S. 29, 33–34 (1956); *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938)). The court cited *Cenco Inc. v. Seidman & Seidman* for the proposition that federal courts, when ruling on imputation of knowledge to the corporation, are supposed to divine how the state court would rule. *Id.* at 84. The matter is "whether or not California chooses to follow the 'majority rule.'" *Id.* at 85.

175. 12 U.S.C. § 1821(d)(2)(A)(i) (2000).

176. *O'Melveny*, 512 U.S. at 86.

177. *Id.* (citing 12 U.S.C. § 1821(d)(2)(A)(i)).

178. *Id.* at 85–86.

179. *Id.* at 86.

180. *Id.*

181. *Id.* at 86–87.

grounds because FIRREA was not enacted until after the breach.¹⁸² Instead, it decided that federal common law rules of decision were inappropriate in this instance because the respondent had “identified *no* significant conflict [between state law and] an identifiable federal policy or interest.”¹⁸³ “The rules of decision at issue here do not govern the primary conduct of the United States or any of its agents or contractors, but affect only the FDIC’s rights and liabilities, as receiver, with respect to primary conduct on the part of private actors that has already occurred.”¹⁸⁴ Therefore, there was no federal interest significant enough to warrant a federal rule of decision and to preclude the use of the state rule of decision on this issue.¹⁸⁵ As articulated below, some courts have latched onto this decision to justify adopting state imputation doctrines that permit the trustee to recover from third parties.

2. Cases Relying on State Law to Permit Trustee Recovery

The two cases that best exemplify this side of the issue are *In re Jack Greenberg, Inc.*¹⁸⁶ and *NCP Litigation Trust v. KPMG*.¹⁸⁷ Both cases rely on state imputation law (or exceptions thereto) to permit the trustee to recover from third-party service providers.¹⁸⁸ These decisions acknowledge basic agency doctrine. However, they argue that in certain circumstances exceptions to those rules must be made in order to achieve fair results. They aggressively interpret state law to justify these exceptions.

In *Greenberg* (a bankruptcy court case decided before *Lafferty*) the plaintiff was a bankruptcy trustee of a meat importing company that was forced into bankruptcy after it was revealed that one of the officers had fraudulently produced prepaid inventory reports and fraudulently held checks.¹⁸⁹ The trustee filed a claim against the accounting firm, Grant Thornton LLP, alleging professional negligence, fraud, and negligent misrepresentation.¹⁹⁰ Grant Thornton contended that the claims were

182. *Id.* at 87.

183. *Id.* at 88. The court found that the closest the respondent came to identifying a federal interest was the contention that state imputation law might result in the depletion of (or failure to enrich) Federal Deposit Insurance Corporation (FDIC) funds. *Id.*

184. *Id.*

185. Justice Antonin Scalia’s suggestion that there is no federal common law in this area may be the minority view. Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) to address the matter—suggesting the propriety of federal lawmaking as a general matter in the area. This is consistent with federal jurisprudence where common law governs but incorporates state law as the rule of decision. See RICHARD H. FALLON, JR. ET AL., *HART AND WECHSLER’S THE FEDERAL COURTS AND THE FEDERAL SYSTEM* 700 (5th ed. 2003).

186. 240 B.R. 486 (Bankr. E.D. Pa. 1999).

187. 901 A.2d 871 (N.J. 2006).

188. See *infra* notes 194–95, 208 and accompanying text.

189. *Greenberg*, 240 B.R. at 491, 498.

190. *Id.* at 499.

barred because the knowledge of the wrongdoer must be imputed to the trustee.¹⁹¹

The court first decided that, in light of *O'Melveny*, it was required to "predict how the Pennsylvania Supreme Court would rule if it were presented with the [same] question."¹⁹² It held that, in light of Pennsylvania law, equitable defenses (such as *in pari delicto*) are not always valid.¹⁹³ The court relied heavily on the Pennsylvania Supreme Court decision in *Universal Builders v. Mood Motor Lodge*.¹⁹⁴ Using this precedent, it found that it was permitted to use its discretion in determining the applicability of third-party defenses.¹⁹⁵ The court acknowledged that a wrongdoer must not be allowed to profit from his own wrong.¹⁹⁶ Nevertheless, it felt entitled to deny the imputation defense when ruling otherwise would create an inequitable result for innocent creditors.¹⁹⁷ To deny the plaintiff recovery in this case would result in the enrichment of the accountants at the expense of the innocent creditors of the bankrupt corporation.¹⁹⁸

The bankruptcy court in *Greenberg* differentiated between cases where the fraud-committing managers hold a substantial portion of the claims, and cases where the beneficiaries of an action would be only innocent creditors. In the latter case, it would not be just to bar claims based on the doctrine of imputation. "The defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated."¹⁹⁹ Accordingly, the court found that it could grant the trustee more rights than the debtor would have had upon filing.²⁰⁰

NCP is a more recent decision, by the New Jersey Supreme Court, that follows a similar analysis.²⁰¹ In this case, two officers of the corporation intentionally misrepresented details of the corporation's financial status to its independent auditor.²⁰² A litigation trust was assigned to act as successor-in-interest to the corporation and to represent the corporation's shareholders. As in *Greenberg*, the court looked to state law to hold that

191. *Id.* at 500.

192. *Id.* at 501.

193. *Id.* at 504.

194. 244 A.2d 10 (1968).

195. *Greenberg*, 240 B.R. at 504.

196. *Id.* at 504-05.

197. *Id.* at 505-06 ("Accordingly, while the true and oft stated maxim that a trustee standing in the shoes of the corporation takes no greater rights than the debtor is certainly the beginning of my analysis, my inquiry does not end there.")

198. *Id.* at 506.

199. *Id.* at 503 n.26.

200. *Id.* at 505-06.

201. Despite being filed in state court, this suit involved a federal bankruptcy.

202. *NCP Litig. Trust v. KPMG*, 901 A.2d 871, 873 (N.J. 2006).

the imputation doctrine did not bar the trust from recovering from third parties for failing to uncover the fraud of its corporate officers.²⁰³

The court acknowledged basic agency law, noting that the purpose of agency doctrine is to protect innocent third parties and prevent a principal from "avoiding the consequences of [its agent's] misdeeds."²⁰⁴ But the court found that this rationale for imputation breaks down in the corporate auditing context because it is hard to absolve a party from responsibility when it was negligent in its duty to the corporation.²⁰⁵ Since KPMG failed in its duty to detect fraud, it was not in need of the protection that the imputation defense would provide.²⁰⁶ Barring the suit would not "promote the purpose of the imputation doctrine—to protect the innocent."²⁰⁷

The court justified its abandonment of agency doctrine by looking to state jurisprudence, citing a previous New Jersey case, *Integrity Insurance Co. v. Yegen Holdings Corp.*²⁰⁸ That case held that an accountant's culpability prevented it from raising the imputation defense.²⁰⁹ In *Integrity*, however, the third party had actively engaged in the fraud.²¹⁰ The *NCP* court claimed that since the *Integrity* court had not noted a difference between active and passive engagement, it was not required to do so either.²¹¹

In addition to using state law to find exceptions to the agency doctrine, the court took a "results-oriented approach." It concluded, like *Greenberg*, that any recovery would compensate only innocent parties. It found no evidence that the fraudulent managers would benefit from a successful recovery from the auditors.²¹² This argument mainly grew out of a necessity to distinguish this case from the *Cenco* case.²¹³ The New Jersey Supreme Court in *NCP* was unwilling to "punish the many for the faults [of a few]."²¹⁴ The court determined that, because recovery would not go to guilty managers but to innocent creditors, not allowing the trust to recover would be unfair and improper.²¹⁵

203. *Id.* at 873. The *NCP Litigation Trust v. KPMG* court also acknowledged that imputation may be raised as a defense to bar claims against shareholders who engaged in or were aware of the fraud.

204. *Id.* at 879 (citing *Morris*, *supra* note 76, at 350).

205. *Id.* at 880.

206. *Id.* at 882.

207. *Id.*

208. *Id.* at 880–82 (citing *In re Integrity Ins. Co.*, 573 A.2d 928 (N.J. Super. Ct. App. Div. 1990)).

209. *Integrity*, 573 A.2d at 941–42.

210. *Id.*

211. *NCP*, 901 A.2d at 881–82.

212. *Id.* at 885.

213. In a way, *NCP* is consistent with *Cenco* in that its decision largely revolves around who is ultimately going to recover.

214. *Id.* at 885.

215. *Id.* Surprisingly, both *NCP* (a New Jersey Supreme Court case) and *In re Jack Greenberg, Inc.* (a U.S. District Court of the Eastern District of Pennsylvania Bankruptcy court case) are both located in the U.S. Court of Appeals for the Third Circuit—the court that decided *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.* It is interesting

3. Commentators' Justifications for Permitting Recovery

The loudest critique of the imputation doctrine in these circumstances comes from commentators. Several commentators have argued that courts, such as the Third Circuit in *Lafferty*, have erred in their interpretation of section 541 of the Bankruptcy Code and have inappropriately applied the *in pari delicto* doctrine so as to prevent a trustee from recovering against third parties for abetting or failing to detect fraud. These commentators argue that the trustee does not always “stand in the shoes” of the debtor and should not always be subject to the same restrictions. Unlike the cases that come down on this side of the debate, the commentators’ analysis does not involve deference to state law. They seem to acknowledge that section 541 of the Bankruptcy Code is the governing law on the issue, but have devised interpretations that do not compel the conclusion that the trustee cannot recover from third parties. These arguments further illustrate the diversity of approaches to dealing with this issue.

William McGrane argues that courts have misinterpreted the extent to which section 541(a) restrains the trustee. He attempts to ground his argument in the legislative history of that section. “[They] have nearly uniformly misconstrued the legislative history of the bankruptcy code by failing to consider *all* of [the] legislative history in its proper context,” he claims.²¹⁶ McGrane cites a House report, stating that although the trustee inherits the estate “as is” at the commencement of the case, he does *not* inherit defenses that are “personal against the debtor.”²¹⁷

The question then becomes whether the *in pari delicto* defense against fraud is a defense “personal against the debtor.” McGrane believes that *in pari delicto* is the epitome of a personal defense.²¹⁸ Therefore, according to the legislative history, Congress never intended *in pari delicto* to apply to bankruptcy trustees.²¹⁹

Tanvir Alam also argues that section 541 is not as restrictive as the courts have made it out to be. He notes that the language “as of the commencement of the case” applies to the rights to certain assets. However, he argues that the existence of equitable defenses is not subject to

that these court decisions (which, if appealed, would have gone to the Third Circuit) stand in such stark contrast to *Lafferty*.

216. William McGrane, *The Erroneous Application of the Defense of In Pari Delicto to Bankruptcy Trustees*, 29 CAL. BANKR. J. 275, 275 (2007). The article relies on a statement made by a congressman when discussing amendments to the code: “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.” *Id.* at 281 (citing 124 CONG. REC. H11, 1096 (daily ed. Sept 28, 1978) (statement of Rep. Edwards)).

217. *Id.* at 281.

218. *Id.* at 285.

219. *Id.* at 291. This is plausible but seems difficult to square with section 541’s explicit references to the “legal or equitable interests of the debtor.”

that same limiting phrase.²²⁰ Just because section 541 subjects the trustee to the same property rights as the debtor at filing does not mean that it subjects the trustee to the same defenses as the debtor.²²¹

While section 541 freezes in time claims to property, it “should not freeze in time the factual basis for the claims and defenses to a litigation action that is based on a fluid factual underpinning.”²²² By implication, the court should consider certain facts that change over the course of bankruptcy when it evaluates appropriate defenses. For example, if the wrongdoer (e.g., a fraudulent manager) has been eliminated from the situation, that development should be taken into account. Accordingly, Alam believes that the *Lafferty* court erred in not considering the postpetition removal of its guilty managers when evaluating the interests of the estate under section 541. By this logic, if the wrongdoer has been eliminated from the scenario, the rights of the estate can be expanded so that it is no longer saddled by fraud, and the trustee should be allowed to recover from third parties.²²³

Both McGrane and Alam seek to justify their flexible interpretations of section 541 by pointing to the supposedly “fair” outcomes they achieve. The windfall that third parties would receive as a result of imputation, they argue, is inequitable.²²⁴

A third commentator, Jeffrey Davis, also believes the proimputation courts have misinterpreted section 541. His analysis differs in its approach. Interestingly, he argues that state law does not always determine what is property of the bankruptcy estate.²²⁵ He supports this assertion by citing instances in which federal bankruptcy law and policy have been used to determine property of the estate.²²⁶ For example, he notes that the Supreme Court has found that “even though future wages . . . might be transferable under non-bankruptcy law, they would nonetheless not be called property within the meaning of the Bankruptcy Act.”²²⁷ In another example, federal law and bankruptcy policy were used to determine whether a tax refund was part of the estate.²²⁸ Since these property issues were decided with an eye

220. 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, 322 (2003).

221. *Id.* “[T]he debtor, prepetition, and the estate, postpetition, must enjoy the same property rights. This is not to say that they must equally suffer equitable defenses to litigation claims . . .” *Id.*

222. *Id.* This argument seems to directly contradict at least one case explicitly holding that the limitations embodied in the “at the commencement of the case” language of section 541 do not just apply to property. See *supra* Part II.A.1.

223. Alam, *supra* note 220, at 323.

224. See, e.g., *id.* at 324.

225. Davis, *supra* note 158, at 534–35 (“The key to the proper analysis here is to recognize that the question of what is the property of the estate is a question of federal law.”).

226. *Id.* at 536–37.

227. *Id.* at 536 (citing *Segal v. Rochelle*, 382 U.S. 375 (1966)).

228. *Id.* at 537 (citing *Kokoscka v. Belford*, 417 U.S. 642 (1974)).

toward bankruptcy policy instead of state law, Professor Davis argues, “courts [should be] empowered to view the *in pari delicto* defense in light of its effect on federal bankruptcy policy” as well.²²⁹

According to Davis, two fundamental bankruptcy policies are to be furthered by disallowing the *in pari delicto* defense and permitting trustees to recover from third parties for contributing to corporate fraud. First, “the policy of fair treatment of creditors and investors requires that persons who have enriched themselves through breach of a legal duty to the debtor must be held liable in bankruptcy for the harm they have caused.”²³⁰ The second policy is “the promotion of a high standard of business ethics among the professionals who serve and participate in the affairs of corporate managers.”²³¹ For these reasons, he concludes that property of the bankruptcy estate “should include claims against third parties who have participated in harming the estate, and the *in pari delicto* defense should be irrelevant.”²³² Therefore, in his opinion, the trustee should be permitted to recover from third parties on these claims.²³³

Perhaps the most persuasive argument against strict imputation, however, is Davis’s proposal for a more balanced approach. Davis suggests a reformulation of the liability scheme, where third parties who were active participants in the fraud should be liable only in proportion to the injury that they caused.²³⁴ As for the third parties who are merely guilty of failure to blow the whistle, Davis proposes that they should be liable to the extent that they could have prevented the harm.²³⁵

III. DEFINING THE RESPECTIVE ROLES OF FEDERAL AND STATE AUTHORITY TO RESOLVE THE DEBATE

Part II illustrated the lack of consistency with which the state and federal judiciary have addressed the permissibility of trustee recovery in the scenarios described above. The result has been a great deal of confusion, leaving attorneys and judges to weave a seemingly unnavigable web of rationales to justify various conclusions. Part III seeks to untangle this web, clearly articulating the framework within which this issue should be addressed. The proposed framework soundly supports the outcomes of the majority of these decisions (albeit in a slightly different way than the courts themselves do), and identifies those few outliers.

229. *Id.* at 538.

230. *Id.* at 541.

231. *Id.* at 542.

232. *Id.* at 520.

233. One could argue that this point is significantly weakened in light of *O’Melveny & Myers v. FDIC*, which implies that defining the property of the estate is a state law question. See *supra* note 174 and accompanying text.

234. Davis, *supra* note 158, at 548. This is similar to the way that joint tortfeasors who cause indivisible harm are treated.

235. *Id.* at 549.

This Note argues that federal authority, in the form of the federal Bankruptcy Code, undoubtedly governs the creation of bankruptcy estates and the rights of the trustees who oversee them. Specifically, section 541 articulates that the bankruptcy estate is comprised of “all legal or equitable interests of the debtor . . . [at] the commencement of the case.”²³⁶ Significantly, the statute gives no guidance on the definition of “legal or equitable interests of the debtor.” Here, state law can be used to fill in the content of the federal rule. There is strong precedent for using state law to “fill the interstices of federal legislation.”²³⁷ Therefore, it is appropriate to use state imputation law to fill the “interstices” of section 541—and define the rights and interests of the debtor—provided that its use does not contravene the express language of the federal statutory rule in any way.²³⁸ For example, the language, “at the commencement of the case,” prevents the bankruptcy estate from acquiring more rights than the company had upon filing.²³⁹ Therefore, for a state-conferred right to become part of the bankruptcy estate, it must be a right belonging to the solvent company before filing. Consistent with this statutory framework, state legislatures or judiciaries cannot create exceptions to imputation that would confer unique rights upon companies based on their status as bankrupts beyond those provided for by federal bankruptcy law.²⁴⁰

The proposed framework clarifies the relationship between federal and state law on this issue in a way that courts have not. Through this lens, the outcome in *Lafferty* and its progeny can be justified, as can the outcome in *Baena*.²⁴¹ Furthermore, the *Greenberg*²⁴² and *NCP*²⁴³ decisions become outliers because of their attempts to grant special rights based on bankruptcy beyond those conferred by the Bankruptcy Code.

Although they do not articulate the above reasoning, the *Lafferty* line of cases strikes the proper balance between federal and state law on this issue. *Lafferty* and its progeny explicitly acknowledge that section 541 is the

236. 11 U.S.C. § 541(a) (2006).

237. *United States v. Kimball Foods Inc.*, 440 U.S. 715, 727 (1979). In that decision, the Court concluded that “federal law governs questions involving the rights of the United States arising under nationwide federal programs,” and in the absence of a statutory rule of decision, courts should “fill the interstices of federal legislation ‘according to their own standards.’” *Id.* at 726–27 (quoting *Clearfield Trust Co. v. United States*, 318 U.S. 363, 367 (1943)). “[W]hen there is little need for a nationally uniform body of law, state law may be incorporated as the federal rule of decision.” *Id.* at 728.

238. U.S. CONST. art. VI, cl. 2 (dictating that “the Judges in every State shall be bound” by the laws of the United States).

239. *See* S. REP. NO. 95-989, at 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5868 (finding that section 541 “is not intended to expand the debtor’s rights against others more than they exist at the commencement of the case”); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356 (3d Cir. 2001).

240. From a policy perspective, this is an important limitation. Federal bankruptcy law involves a delicate balance between debtor and creditor interests. There is significant federal interest in preventing state law from upsetting this balance.

241. *See supra* notes 140–45 and accompanying text.

242. *See supra* notes 186, 189–200 and accompanying text.

243. *See supra* notes 187, 201–15 and accompanying text.

governing federal rule for defining the rights and interests of the bankruptcy estate.²⁴⁴ The courts rely on state law inasmuch as it is necessary for determining the prepetition rights and property of the debtor, but otherwise look to the Bankruptcy Code as the appropriate authority.²⁴⁵ They find that section 541, in its own right, precludes the bankruptcy estate from obtaining more rights than the company had upon filing.²⁴⁶ For example, in *Lafferty*, the court uses section 541 to explicitly reject the argument, made in *Greenberg*, that postpetition removal of the guilty managers may allow the bankruptcy estate to become “unburdened” by their fraud.²⁴⁷ For this reason, the fraud was imputed to the trustee, prohibiting his recovery from third parties.

Lafferty and its progeny are correct in holding that federal law is the governing authority. To the extent that section 541 explicitly places limitations on the rights and interests of the bankruptcy estate, those limitations cannot be circumvented for equitable reasons. Although these decisions could have placed greater emphasis on the intricacies of state law and its significance in supplying the content of section 541, they properly acknowledge state law as governing the law of imputation.

The *Baena* court, on the other hand, appears to underemphasize the role that federal law plays in defining the rights and interests of the bankruptcy estate. For example, the First Circuit does not even mention the federal statute in its decision. Unlike the cases in the first category, it looks exclusively to state imputation law to supply the rule of decision for that federal law.²⁴⁸ Relying on Massachusetts imputation law, it holds that the managers’ fraud is imputed to the company, and therefore, trustee recovery is barred.²⁴⁹

Despite the differing emphasis, the *Baena* court ends up in the same substantive position as *Lafferty*. Yet, the First Circuit decision should have explicitly acknowledged that federal law was the governing authority and that its reliance on state imputation law was only appropriate inasmuch as it was necessary to supply the content of the applicable federal rule (section 541). To its credit, however, the court does not entertain any of the “fairness” arguments that would eviscerate the federal rule and give the judiciary the exclusive authority to grant the trustee more rights and

244. See *supra* Part II.A.1.

245. See Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1150–51 (11th Cir. 2006); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 359 (3d Cir. 2001); *In re Hedged-Invs. Assocs.*, 84 F.3d 1281, 1285 (10th Cir. 1996).

246. See, e.g., *Lafferty*, 267 F.3d at 359.

247. See *id.* at 357 (holding that the language “at the commencement of the case” prohibits courts from taking into account events that occurred after the commencement of the bankruptcy when deciding whether defenses such as *in pari delicto* should apply).

248. See *Baena v. KPMG*, 453 F.3d 1, 8 (1st Cir. 2006) (“In all events, ordinary agency-based imputation rules appear to operate in Massachusetts . . .”).

249. *Id.* at 6–7.

interests than the debtor had upon filing.²⁵⁰ Nor does it find narrow exceptions to rules of imputation, instead deferring to “ordinary agency-based imputation rules.”²⁵¹

Lastly, this Note finds that *NCP* and *Greenberg* are outliers in this scheme. They are not outliers because they find that trustee recovery is permissible, but rather because to justify trustee recovery they act as if section 541, the governing federal rule, does not place any substantive restrictions on the way in which state law can define the rights and interests of the bankruptcy estate. Instead, these courts aggressively use state law, in its own right, to define the rights and interests of the bankruptcy estate, ignoring the explicit limitations of section 541.²⁵² Specifically, they devise exceptions to imputation that effectively give the bankruptcy estate greater rights than the debtor had upon filing.²⁵³

These two cases interpret the *O'Melveny* decision to unequivocally hold that state law governs imputation.²⁵⁴ But this is not entirely correct. While the *O'Melveny* decision did decide that state law governs imputation law, it also stated that, if there were an applicable federal statute (in that case FIRREA), the court would be bound by that statute.²⁵⁵ In the cases discussed above, a federal statute (11 U.S.C. § 541) does in fact govern.²⁵⁶ So, while it may be appropriate for state imputation law to supply the federal rule of decision, *O'Melveny* dictates that it is not appropriate to act as if there is no governing federal statute, when in fact there is.²⁵⁷ Therefore, *O'Melveny* is perfectly consistent with the main argument made here: that state imputation law does not govern in its own right, but instead, applies as a rule of decision for the applicable federal rule.

A closer look at the authority upon which *NCP* and *Greenberg* base their decisions further undermines their conclusions. For example, the New Jersey case law relied on by the *NCP* court only weakly supports its conclusion that imputation is improper. It cites *Integrity*, in which the court

250. *Id.* at 9 (rejecting the argument that *in pari delicto* should not be applied for equitable reasons).

251. *Id.* at 8–9 (rejecting the innocent decision maker exception).

252. *See supra* Part II.B.2.

253. *See supra* Part II.B.2; *see also In re Jack Greenberg, Inc.*, 240 B.R. 486, 506 (Bankr. E.D. Pa. 1999) (finding that “there are circumstances when the trustee’s position as plaintiff is different from that of the corporation, even when bringing the corporation’s claim”).

254. *Greenberg*, 240 B.R. at 500–02; *NCP Litig. Trust v. KPMG*, 901 A.2d 871, 880 (N.J. 2006).

255. FIRREA, similar to section 541, declared that the FDIC shall “succeed to—all rights, titles, powers, and privileges of the insured depository institution.” *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 86 (1994) (citing 12 U.S.C. § 1821(d)(2)(A)(i) (2000)). The Court said, “this language appears to indicate that the FDIC as receiver ‘steps into the shoes’ of the failed [savings & loan].” *Id.* However, FIRREA had been enacted after the initial suit, so the U.S. Supreme Court declined to apply it. *Id.* at 87.

256. Unlike *O'Melveny*, where the case dealt with a receiver, the subject in the cases at hand is a bankruptcy trustee who takes power over the estate as defined by section 541 of the Bankruptcy Code—a federal statute.

257. *O'Melveny*, 512 U.S. at 86 (finding that, had FIRREA applied in this case, the parties would be bound by its language).

found that imputation was not proper when an auditor had actively engaged in the fraud.²⁵⁸ Rather than acknowledge that *Integrity* did not address the issue, *NCP* held that, since the *Integrity* court did not distinguish between active and negligent participation, it was not required to do so either, and therefore, the *NCP* trustee could sue a negligent auditor as well.²⁵⁹

In justifying trustee recovery, the New Jersey court purports to create its own exception to imputation: negligent participation in the fraud by a third party.²⁶⁰ When a third party has negligently contributed to the fraud, and the guilty managers have been removed from the picture, the court decides that imputation is improper.²⁶¹ It is conceivable that such an exception to imputation could be part of the state's laws applicable to all corporations, including those that have not entered bankruptcy.²⁶² This would potentially give the debtor a right against a third party "as of the commencement of the case," in which case that right would become part of the bankruptcy estate. However, *NCP* did not clearly articulate its exception as one of general application (including companies outside of bankruptcy), and creating the exception in this instance is yet another example of the state court trying to reach a particular conclusion inconsistent with federal rules, federal court decisions, and widely accepted agency doctrine.

The *Greenberg* decision stands on equally precarious precedent. It found that under Pennsylvania law, imputation may fail to act as a total bar to recovery "when the beneficiaries of the action are the corporation's innocent creditors."²⁶³ It based its decision on a 1968 Pennsylvania state case reaching the same conclusion.²⁶⁴ That case, in turn, relied only on a

258. *NCP*, 901 A.2d at 878 (citing *In re Integrity Ins. Co.*, 573 A.2d 928 (N.J. Super. Ct. App. Div. 1990)).

259. See *supra* note 211 and accompanying text.

260. *NCP*, 901 A.2d at 887 (finding that shielding a negligent auditor from liability would violate "principles of fairness and equity"). In a decision issued immediately before the publication of this Note, the Third Circuit agreed with the New Jersey court's finding of such an exception. See *Thabault v. Chiat*, No. 06-2209, 2008 WL 4138407, at *14 (3rd Cir. Sept. 9, 2008). However, that case dealt with a receiver, whose rights are not governed by section 541 of the Bankruptcy Code. *Id.* at *2.

261. Yet, for the proposition that absolving negligent auditors is difficult to justify, the *NCP* court only cites several law review articles. *NCP*, 901 A.2d at 880. It even takes one quote completely out of context to support its conclusion. Quoting Deborah A. DeMott, *supra* note 75, the court states, "Absolving negligent corporate auditors 'is difficult to rationalize and to justify or explain in any satisfying or comprehensive way.'" *NCP*, 901 A.2d at 880. Professor Demott's actual statement is: "Imputation has been characterized as a disorderly doctrine that is difficult to rationalize and to justify or explain in any satisfying or comprehensive way." Demott, *supra* note 75, at 291. The New Jersey Supreme Court manipulates a generally benign statement to mean that absolving negligent third parties is unjustified.

262. Such an exception, however, would violate basic agency principles. Practically, it would mean that a company, whose managers had committed fraud, could immunize itself from imputation by simply firing the guilty managers. Such an exception would render all of agency law unworkable and meaningless. Nevertheless, states are free to diverge from agency principles as they choose.

263. *In re Jack Greenberg*, 240 B.R. 486, 506 (Bankr. E.D. Pa. 1999).

264. *Id.* at 504 (citing *Universal Builders, Inc. v. Moon Motor Lodge, Inc.*, 244 A.2d 10 (Pa. 1968)).

1907 New Jersey decision and a 1934 Second Circuit dissenting opinion for that same proposition.²⁶⁵ The absence of more recent decisions to support its conclusion further weakens a decision already subject to criticism for seeming to ignore the limitations of applicable federal law.

In addition, justifying recovery because imputation would lead to inequitable results for innocent creditors ignores the basic principles of standing discussed above.²⁶⁶ A trustee has standing to bring a suit because he represents the party who has suffered injury. The purpose of the suit is to redress the injury that was inflicted on the debtor corporation.²⁶⁷ Whether innocent creditors will have their injuries redressed as a result of a suit is irrelevant in this regard and therefore should not be taken into account.²⁶⁸

Most of the commentators' arguments discussed in Part II are difficult to square with this Note's thesis.²⁶⁹ There is one, however, that may be workable within the framework proposed by this Note and provides a good example of how this framework may be put to use. Professor Davis argues that third parties who were active participants in the fraud should be liable to the trustee in proportion to the injury that they caused.²⁷⁰ This would be a conceivable outcome, as long as state imputation law permitted such a result. With respect to all companies, a state legislature or judiciary could create an exception to imputation doctrine where a corporation could recover from third parties that actively conspired in the fraud in proportion to the damage the third party caused. As long as the company possessed such a right before the filing of a bankruptcy petition, the trustee could recover from that third party without contravening the express language of section 541.²⁷¹ Such a solution allows for flexibility on a state-by-state basis, while not altering the central premise of section 541: that the rights or interests of the estate may not be altered as a result of the bankruptcy. The rights and interests of the bankruptcy estate are limited to the rights and interests of the debtor as they existed before filing.

CONCLUSION

In the end, it is clear that section 541 of the Bankruptcy Code is a federal rule that applies to the creation of all bankruptcy estates and to the trustees

265. *Universal Builders*, 244 A.2d at 13–14.

266. *See supra* Part I.A.

267. The trustee legally represents the bankruptcy estate of the debtor corporation. *See* 11 U.S.C. § 323(a) (2006).

268. Recently, however, the Second Circuit has ruled that creditors may assign their interest to the trustee, in which case the trustee may be able to bring claims on their behalf. *See In re CBI Holding Co.*, 529 F.3d 432, 459 (2d Cir. 2008) (finding that such an assignment permits more "efficient administration of the reorganization").

269. *See supra* Part II.B.3.

270. *See supra* note 234 and accompanying text.

271. Since the trustee inherits all the rights and interests of the debtor as of the commencement of the case, any interests the debtor obtained before the filing become interests of the bankruptcy estate. *See* 11 U.S.C. § 541(a); *supra* Part II.A.1.

who oversee them. Furthermore, the statute dictates that the estate consists of the legal and equitable interests of the debtor at the time of filing, and those rights and interests cannot be altered by postpetition events. States are free to apply their own law to determine the rights and interests of the company. In doing so, they are entitled to devise their own exceptions to imputation. In order for those exceptions to apply to the bankruptcy trustee, however, they must be exceptions applicable to the company before filing. States should be careful not to create exceptions to imputation that would defy the basic purposes of agency law. This proposed framework would strike a proper balance between acknowledging the supremacy of federal law and allowing the states to have autonomy in determining the rights and interests of the bankruptcy estate.

Notes & Observations