2006

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Original Citation

Jonathan Witmer-Rich, Corporate Complicity Claims: Why There Is No Innocent Decison-Maker Exception to Imputing an Officer's Wrongdoing to a Bankrupt Corporation, 74 Tennessee Law Review 47 (2006)

CORPORATE COMPLICITY CLAIMS: WHY THERE IS NO INNOCENT DECISION-MAKER EXCEPTION TO IMPUTING AN OFFICER'S WRONGDOING TO A BANKRUPT CORPORATION

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I. INTRODUCTION

Allegations of misconduct by high-ranking corporate officers have surrounded many of the most notorious recent bankruptcies.[1] In 2006, former Enron CEOs Kenneth Lay and Jeffrey Skilling were convicted of charges including securities fraud, and sixteen former Enron executives have pled guilty to similar charges.[2] In 2005, former WorldCom CFO Scott Sullivan pled guilty to accounting fraud, and former CEO Bernard Ebbers was convicted on similar charges.[3] Similarly, in 2004 Adelphia founder and CEO John Rigas and his son, former Adelphia CFO Timothy Rigas, were convicted of various fraudulent acts.[4]

A multitude of legal claims, brought by several different parties, invariably follow in the wake of such scandals, including securities fraud claims on behalf of shareholders,[5] fraud and other claims brought on behalf of creditors,[6] and

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1. *See In re* WorldCom Inc., No. 02-13533 (AJG) (Bankr. S.D.N.Y. filed July 21, 2002); *In re* Adelphia Commc'ns Corp., No. 02-41729 (REG) (Bankr. S.D.N.Y. filed June 25, 2002); *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. filed Dec. 2, 2001).

2. *See* Mark Babineck, Mary Flood & John Roper, *Enron Jurors Find Lay, Skilling Guilty*, HOUSTON CHRON., May 26, 2006, at A1, *available at* http://www.chron.com/disp/story.mpl/front/3893599.html; Alexei Barrionuevo, *Enron Executive Points a Finger at Former Chiefs*, N.Y. TIMES, Mar. 8, 2006, at A1. Lay's conviction was vacated on October 17, 2006, due to his sudden death on July 5, 2006, before his sentencing. *See* Tom Fowler, *Judge Vacates Ken Lay's Enron Conviction*, HOUSTON CHRON., Oct. 17, 2006, *available at* http://www.chron.com/disp/story.mpl/special/enron/4265806.html.

3. *See* Jennifer Bayot & Roben Farzad, *WorldCom Executive Sentenced*, N.Y. TIMES, Aug. 12, 2005, at C1.

4. *See* Ken Belson, *WorldCom Head Is Given 25 Years for Huge Fraud*, N.Y. TIMES, July 14, 2005, at A1.

5. *See, e.g.*, Hallisey & Johnson Profit Sharing Plan v. Citigroup Global Mkts., Inc. (*In*

claims by the debtor itself to recover lost assets.[7] This Article focuses on a specific type of claim from the last category, which can be referred to as a "corporate complicity claim." Corporate complicity claims are asserted by the bankruptcy representative of the debtor corporation and seek to recover damages from third parties such as accountants, lawyers, and banks. Such claims are based on allegations that those third parties participated with the debtor's officers in the misconduct that led to the corporation's demise.[8]

Corporate complicity claims often place billions of dollars at stake. Enron filed an adversary proceeding against ten banks, seeking to recover for the banks' aiding and abetting of the alleged fraud and breach of fiduciary duties committed by Enron's former officers. Enron's claim has resulted in settlements with five banks for a total of $735 million.[9] In the case of Adelphia, the federal bankruptcy court granted leave for the Official Committee of Unsecured Creditors, as co-plaintiff with Adelphia, to sue more than a dozen banks for alleged cooperation in wrongdoing by Adelphia's former officers.[10] Similarly, the WorldCom bankruptcy examiner's report identified potential corporate complicity claims against KPMG, Arthur Andersen, and Salomon Smith Barney for allegedly aiding and abetting in WorldCom executives' wrongdoing.[11]

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re Worldcom, Inc. Sec. Litig.), No. 02 Civ. 3288 (S.D.N.Y. filed Apr. 30, 2002); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., MDL No. 1446 (S.D. Tex. filed Apr. 16, 2002).

6. *See, e.g.*, Terlecky v. Hurd (*In re* Dublin Sec., Inc.), 133 F.3d 377, 380 (6th Cir. 1997) (dismissing claims by trustee on behalf of debtors against third party law firms, but noting the existence of "other actions filed by the creditors seeking compensation for the allegedly fraudulent activity in which the defendants engaged").

7. *See, e.g.*, cases cited *infra* note 8.

8. *See, e.g.*, Breeden v. Kirkpatrick & Lockhart LLP (*In re* Bennett Funding Group, Inc.), 336 F.3d 94, 101 (2d Cir. 2003); Mediators, Inc. v. Manney (*In re* Mediators, Inc.) 105 F.3d 822, 827 (2d Cir. 1997); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094 (2d Cir. 1995); Ross v. Bolton, 904 F.2d 819 (2d Cir. 1990); Stone v. Freeman, 82 N.E.2d 571 (N.Y. 1948). Commentators have also noted this trend. *See* Stephen J. Shimshak & Susan E. Welber, *Revisiting Rule on Trustee Standing: In New Economy, 'Wagoner' Doctrine Takes on Added Significance*, 227 N.Y. L.J. 9 (2002) ("When corporate irregularities are revealed, a bankruptcy trustee is often appointed, vested with statutory authority to pursue those causes of action belonging to the debtor corporation's bankruptcy estate against third parties.").

9. *See* Julie Creswell, *J.P. Morgan and Toronto-Dominion Agree to Settle Suits in Enron Fraud*, N.Y. TIMES, Aug. 17, 2005, at C3. In addition, Enron has subordinated over $3 billion of the banks' claims. *Id.*

10. Adelphia Commc'ns Corp. v. Bank of Am., N.A. (*In re* Adelphia Commc'ns Corp.), 330 B.R. 364, 368, 376-77 (Bankr. S.D.N.Y. 2005).

11. Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner at Parts IV.D, V.H, VII.F, *In re* WorldCom, Inc., No 02-13533 (AJG) (Bankr. S.D.N.Y. Jan. 26, 2004), *available at* http://www.klng.com/files/tbl_s48News/PDFUpload307/10129/Worldcom_Report_final.pdf. The additional bankruptcy examiner's reports are also available. Second Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, *In re* WorldCom, Inc., No 02-13533 (AJG) (Bankr. S.D.N.Y. June 9, 2003), *available at* http://www.klng.com/files/tbl_s48News/ PDFUpload307/8838/Worldcom_Reports2.pdf; First

One initial hurdle in corporate complicity claims is the longstanding common law principle that one wrongdoer cannot sue another wrongdoer for losses incurred as part of their joint malfeasance. This common law principle is expressed in the maxim "*in pari delicto potior est conditio defendentis*," or "where parties are equally at fault, the defending party is in the stronger position."[12] In the context of corporate complicity claims, the *in pari delicto* principle is sometimes stated (at least in the Second Circuit) as a rule of standing known as the *Wagoner* rule: "[A] trustee lacks standing to sue third parties who have joined [the bankrupt corporation] in defrauding creditors."[13]

In such cases, the corporation is deemed a wrongdoer because the misconduct of high-level corporate officers is imputed to the corporation under traditional principles of agency law.[14] Nevertheless, corporations can avoid the *in pari delicto* defense and the *Wagoner* rule if they can escape being held responsible for the wrongdoing of their former officers. Traditionally, only one limited exception to imputed responsibility existed: the "adverse interest" rule.[15] According to this principle, "management misconduct will not be imputed to the corporation if the [wrongdoing] officer acted entirely in his own interests and adversely to the interests of the corporation."[16]

More recently, a second, broader exception has emerged that, if accepted, would greatly increase a corporation's ability to avoid being tainted by its officers' misconduct. Under the "innocent decision-maker" exception, the *in pari delicto* defense and "the *Wagoner* rule would not apply if there were someone 'involved in [the debtor's] management who was ignorant of the ongoing fraud and could and would if advised of facts known to [the] defendant

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Interim Report of Dick Thornbugh, Bankruptcy Court Examiner, *In re* WorldCom, Inc., No. 02-13533 (AJG) (Bankr. S.D.N.Y. Nov. 4, 2002), *available at* http://www.klng.com/files/tbl_s48News/PDFUpload307/8072/ Worldcom_Examiner_Report.pdf.

12. *Ross*, 904 F.2d at 824 (citing BLACK'S LAW DICTIONARY 898 (4th ed. 1968)). *See also Stone*, 82 N.E.2d at 572 (explaining that the doctrine of *in pari delicto* generally provides that wrongdoers ought to bear the consequences of their wrongdoing without legal recourse against each other). The *Stone* court further stated: "For no court should be required to serve as paymaster of the wages of crime, or referee between thieves. Therefore, the law 'will not extend its aid to either of the parties' or 'listen to their complaints against each other, but will leave them where their own acts have placed them.'" *Id.* (citation omitted).

13. *Hirsch*, 72 F.3d at 1094 (citing Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991)).

14. *See, e.g.*, Curtis, Collins & Holbrook Co. v. United States, 262 U.S. 215, 222 (1923); Wight v. BankAmerica Corp., 219 F.3d 79, 86 (2d Cir. 2000); RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 4, 2003); HAROLD GILL REUSCHLEIN & WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 59 (2d ed. 1990).

15. *Wight*, 219 F.3d at 87.

16. *Id.* (citing Center v. Hampton Affiliates, Inc., 488 N.E.2d 828 (1985)); *see also Curtis*, 262 U.S. at 223 (noting that an exception to imputation exists "when the agent's attitude is one adverse in interest to that of the principal, because of which it can not be inferred that the agent would communicate the facts against his own interest to his principal").

have taken steps to bring the fraudulent conduct to an end.'"[17] For example, in Adelphia's bankruptcy proceedings, the court permitted the Creditors' Committee to pursue claims (on behalf of Adelphia) against the defendant banks because it had "satisfactorily pleaded the facts necessary to trigger the 'innocent decision-maker' exception."[18]

This Article evaluates the innocent decision-maker exception in light of the doctrinal foundations of the *in pari delicto* defense and the *Wagoner* rule, general principles of agency law, and the lower court decisions that address these issues. It concludes that the innocent decision-maker exception is a doctrinal error, traceable to the logical misstep of a single lower court whose decision continues to be mistakenly followed.[19] The innocent decision-maker exception is inconsistent with the basic principles of agency law that underlie imputation in the context of *in pari delicto* and the *Wagoner* rule. No court of appeals has explicitly addressed the innocent decision-maker exception,[20] but one can predict that a court of appeals would reject the exception if squarely presented with the issue.[21]

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17. Breeden v. Kirkpatrick & Lockhart, LLP, 268 B.R. 704, 710 (S.D.N.Y. 2001) (first alteration in original) (citing Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP, 212 B.R. 34, 36 (S.D.N.Y. 1997)), *aff'd on alt. grounds sub nom. In re* Bennett Funding Group, Inc., 336 F.3d 94, 101 (2d Cir. 2003); *see also* Adelphia Commc'ns Corp. v. Bank of Am., N.A. (*In re* Adelphia Commc'ns Corp.), 330 B.R. 364, 381 (Bankr. S.D.N.Y. 2005) (recognizing the innocent decision maker exception); Sharp Int'l Corp. v. KPMG LLP (*In re* Sharp Int'l Corp.), 278 B.R. 28, 36 (Bankr. E.D.N.Y. 2002) (same); Smith v. Arthur Andersen LLP, 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001) (same); Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A., 80 F. Supp. 2d 129, 136 (S.D.N.Y. 1999) (same); Sec. Investor Prot. Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 651 (S.D.N.Y. 1999) (same); Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP (*Wechsler II*), 994 F. Supp. 202, 207-08 (S.D.N.Y. 1998) (same); Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP (*Wechsler I*), 212 B.R. 34, 36 (S.D.N.Y. 1997) (same). These decisions are discussed at greater length below in Part III.B.

18. *In re Adelphia Commc'ns Corp.*, 330 B.R. at 381.

19. *See Wechsler I*, 212 B.R. at 36.

20. In *Bennett Funding*, the Second Circuit noted several lower court decisions endorsing the innocent decision-maker exception but declined to "resolve the question of whether the presence of innocent directors would provide the trustee with standing where fewer than all shareholders are implicated in the fraud, because that case is not before us." 336 F.3d at 101. The First Circuit likewise noted that the innocent decision-maker exception "has been adopted in a few trial courts in the Second Circuit," but explained that "the Second Circuit has reserved the issue." Baena v. KPMG LLP, 453 F.3d 1, 8-9 (1st Cir. 2006). The *Baena* court declined to adopt the innocent decision-maker rule itself. *Id.* at 8.

21. Apart from the purported innocent decision-maker exception, there are several other disputes surrounding the *Wagoner* rule. First, as discussed in some detail in Part III.B, *Wagoner* has been criticized as a rule of standing on the ground that whether a corporation's claims are barred by its own wrongdoing is determined by the affirmative defense of *in pari delicto*, not the corporation's standing to bring suit. *See* Ralph Brubaker, *Making Sense of the* In Pari Delicto *Defense: "Who's Zoomin' Who?"*, BANKR. L. LETTER, Nov. 2003, at 1, 7. Second, some have argued that the doctrine of *in pari delicto* should not be applied when the

Part II of this Article describes, in more detail, the substance of corporate complicity claims and explains how the doctrines of *in pari delicto*—an affirmative defense—and the *Wagoner* rule—a rule of standing—pose obstacles to such claims. Part III describes the legal exceptions to the general rule of imputing the wrongdoing of corporate officers to the corporation: First, the narrow adverse interest exception, and second, the recently-articulated innocent decision-maker exception. Part III goes on to show that the innocent decision-maker exception began as a doctrinal error by one federal district court, which was subsequently repeated by other lower courts, and then highlights one court's decision that correctly exposes this error and rejects the existence of the innocent decision-maker exception. Part IV discusses the general principles of agency law that undergird imputation rules and examines how imputation operates in contexts like *in pari delicto* outside of corporate bankruptcies, corporate liability for damages based on wrongful intent, and corporate criminal liability. Part IV shows that an innocent decision-maker exception has no foundation in agency law and has not been recognized in any other legal context. Finally, Part V considers whether the innocent decision-maker exception, apart from its flawed origins, is desirable as a matter of policy, concluding that continued recognition of the exception is not vindicated by the underlying policies put forth by the courts.

II. THE NATURE OF CLAIMS BY CORPORATIONS AGAINST OTHERS FOR ASSISTING IN THE CORPORATE OFFICERS' WRONGDOING, AND THE IMPACT ON THOSE CLAIMS OF *IN PARI DELICTO* AND THE *WAGONER* RULE.

This section discusses the nature of corporate complicity claims and explains how the doctrines of *in pari delicto*, an affirmative defense, and the *Wagoner* rule, a rule of standing, can defeat those claims.

As noted in the Introduction, corporate bankruptcies give rise to many types of legal claims, and any indication of corporate wrongdoing can cause these claims to proliferate. Most of these claims—not the main subject of this article—are brought by third parties such as corporate shareholders, lenders, former transaction counterparties, and other creditors of the corporation. These plaintiffs seek redress for alleged complicity in the corporate wrongdoing from the corporation, former corporate officers and directors, and third-party defendants such as accountants, lawyers, banks, or transaction counterparties. The *in pari delicto* defense is not usually implicated in these cases, because they are not brought by the corporation that (through its officers) committed the

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corporation is in bankruptcy, when the wrongdoers have been removed from the corporation, and when the wrongdoers will not benefit from any recovery. *See* 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, 306, 330 (2003); 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, 519-22 (2005). This debate is addressed in Part V.

wrongdoing. In addition to claims by third-party plaintiffs, the bankrupt corporation, either as debtor-in-possession or through a bankruptcy representative such as a trustee, may bring corporate complicity claims—the main subject of this article—against those third-party defendants for assisting in the corporation's wrongdoing. The Enron and Adelphia bankruptcies provide two recent, high-profile examples of such claims.

In its bankruptcy proceedings, Enron, as a debtor-in-possession, filed an adversary claim against ten banks and their affiliates.[22] Enron's 505 page complaint alleges that the defendant banks "participated with a small group of senior officers and managers of Enron (the 'Insiders') in a multi-year scheme to manipulate Enron's financial statements and misstate its financial condition," and asserts claims against the banks for aiding and abetting the officers' breaches of fiduciary duty.[23] Thus, Enron seeks to recover money damages it claims to have suffered when its own high-ranking employees, such as CFO Andrew Fastow and CAO Rick Causey, engaged in accounting fraud to present an artificially positive financial picture of the company.[24]

In one of his reports, Neil Batson, the court-appointed examiner in the Enron bankruptcy, examined the legal standards under which Enron's claims would be evaluated by the bankruptcy court.[25] He reported that "[t]here are two recognized exceptions to the *Wagoner* rule: (i) the 'adverse interest' exception; and (ii) the 'innocent decision-maker' exception."[26] Enron's complaint appears to have been drafted with the innocent decision-maker exception in mind. The complaint alleges that a supermajority of Enron's Board of Directors was unaware of any wrongdoing by Enron's officers, and that "[h]ad the outside directors become aware of the Insiders' and the Bank Defendants' scheme to

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22. The ten defendant banks and affiliated entities are Barclays Bank PLC, Canadian Imperial Bank of Commerce, Citigroup Inc., Credit Suisse First Boston, Inc., Deutsche Bank AG, J.P. Morgan Chase Bank, Merrill Lynch & Co., Inc., Royal Bank of Canada, The Royal Bank of Scotland Group, Inc., and Toronto-Dominion Financial Group. Debtors' Amended Complaint For The Avoidance And Return Of Preferential Payments And Fraudulent Transfers, Equitable Subordination, And Damages, Together With Objections And Counterclaims To Creditor Defendants' Claims, Enron Corp. & Enron N. Am. v. Citigroup Inc. (*In re* Enron Corp.), Ch. 11 Case No. 01-16034, Adv. No. 03-09266 (Bankr. S.D.N.Y. filed Dec. 4, 2003) [hereinafter Enron Complaint], *available at* http://www.elaw4enron.com/ (follow "Enron – Chapter 11 Document Repository" hyperlink; select "Enron Corp. and Enron North America v. Citigroup Inc"; select "2003"; select "December"; select "4"; follow "show me the document" hyperlink; follow "Main Document" hyperlink for docket entry 8).

23. Enron Complaint, *supra* note 22, at 1, 412, 416.

24. Barrionuevo, *supra* note 2, at A1.

25. *Id.*; *see* Third Interim Report of Neal Batson, Court-Appointed Examiner, Appx. B at 64, *In re* Enron Corp., No 01-16034 (AJG) (Bankr. S.D.N.Y. June 30, 2003), *available at* http://www.enron.com/corp/por/pdfs/examiner3/appendixB.pdf. Mr. Batson issued four reports totaling over two thousand pages. Links to all four of Mr. Batson's reports are available at http://www.enron.com/corp/por/supporting.html.

26. Third Interim Report of Neal Batson, Court-Appointed Examiner, *supra* note 25, at 64.

manipulate Enron's financial statements and profit at Enron's expense, they certainly would have stopped it."[27] In light of Mr. Batson's report, Enron's complaint, and case law recognizing the innocent decision-maker exception, five of the defendants in Enron's adversary action settled for approximately $735 million and subordinated substantial claims, without even raising the *in pari delicto* defense or *Wagoner* rule of standing in a motion to dismiss.[28]

In Adelphia, the court granted the motion of the Official Committee of Unsecured Creditors "to prosecute claims, as a co-plaintiff with Adelphia, on behalf of the Debtors' estates."[29] The Creditors' Committee's complaint seeks, from the defendant banks, "damages for breaches of fiduciary duties to the Debtors and for aiding and abetting fraud and breaches of fiduciary duties by the Rigas Family."[30] The complaint alleges that the defendant banks "funded the [Rigas's] fraud by extending undisclosed senior loans to the Rigas Family secured by the Debtors' assets" through Co-Borrowing Facilities.[31] The complaint also argues that the defendants:

> [K]new or recklessly disregarded the fact that the Rigas Family was using the Co-Borrowing Facilities to defraud the Debtors, their creditors and other stakeholders . . . [and] the fact that the Rigas Family was causing the Debtors to fraudulently conceal from the public and other creditors up to $3.4 billion of their balance sheet liabilities under the Co-Borrowing Facilities.[32]

Thus, just as in the Enron proceedings, Adelphia and the Creditors' Committee seek to recover money damages from banks that allegedly assisted Adelphia employees in defrauding third parties like the company's shareholders and creditors.

The defendants in Adelphia objected to the Creditors' Committee's motion to prosecute claims on behalf of Adelphia, arguing that either the *in pari delicto* doctrine or the *Wagoner* rule barred the claims.[33] The court rejected this argument and granted the Committee's motion in August 2005, stating that "the Creditors' Committee has satisfactorily pleaded the facts necessary to trigger the 'innocent decision-maker' exception."[34]

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27. Enron Complaint, *supra* note 22, at 70-72.

28. Creswell, *supra* note 9, at C3.

29. Adelphia Commc'ns Corp. v. Bank of Am., N.A. (*In re* Adelphia Commc'ns Corp.), 330 B.R. 364, 368 (Bankr. S.D.N.Y. 2005).

30. Complaint at 15, Adelphia Commc'ns Corp. v. Bank of Am., N.A. (*In re* Adelphia Commc'ns Corp.), Ch. 11 Case No. 02-41729, Adv. No. 03-04942 (Bankr. S.D.N.Y. filed July 6, 2003) [hereinafter Adelphia Complaint], *available at* http://www.iiiglobal.org/country/usa/060922Phelan_a.PDF. Adelphia's 244-page complaint was filed in an adversary action of its bankruptcy proceedings and names about two dozen banks and affiliate entities as defendants.

31. *Id.* at 10.

32. *Id.* at 12.

33. *In re Adelphia Commc'ns Corp.*, 330 B.R. at 378-79.

34. *Id.* at 381.

The Enron and Adelphia adversary actions are only two examples of the many recent cases where bankruptcy representatives have attempted to recover against third parties for participating in wrongdoing by high-level corporate officers.[35] For purposes of this Article, the most notable commonality among these corporate complicity claims is that the corporation seeks to recover money damages based on wrongdoing spearheaded by the corporation's own high-ranking officers. This type of claim, when one wrongdoer seeks to recover from a co-wrongdoer for misconduct against third parties, is normally barred by the *in pari delicto* doctrine. In the context of claims by bankruptcy representatives, this principle has been articulated by some courts as a rule of standing known as the *Wagoner* rule.

A. The In Pari Delicto Defense

The *in pari delicto* doctrine is a common law affirmative defense providing that "where parties are equally at fault, the defending party is in the stronger position."[36] The doctrine "means the plaintiff should not therefore recover, and the parties should be left where they are [and it] . . . is predicated on the principle that to grant plaintiff relief would contravene the public good by aiding one to profit from his own wrong."[37]

Based on basic principles of agency law, which state that the actions of an agent acting within the scope of his employment are imputed to the principal,[38] the *in pari delicto* defense bars actions by corporations when their former officers engaged in the disputed wrongdoing. Stated alternatively, insofar as the corporate officers' wrongdoing is imputed to the corporation, the corporation itself is guilty of wrongdoing and claims by or on behalf of the corporation are subject to the *in pari delicto* defense.[39]

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35. *See* cases cited *supra* notes 8, 17.

36. Ross v. Bolton, 904 F.2d 819, 824 (2d Cir. 1990) (citing BLACK'S LAW DICTIONARY 898 (4th ed. 1968)).

37. *Id.* at 824; *see also* 1 AM. JUR. 2D *Actions* § 40 (2005) ("The doctrine of *in pari delicto* generally provides that wrongdoers ought each to bear the consequences of their wrongdoing without legal recourse against each other. A court will not extend aid to either of the parties to a criminal act or listen to their complaints against each other but will leave them where their own act has placed them.") (citation omitted).

38. *See, e.g.*, Curtis, Collins & Holbrook Co. v. United States, 262 U.S. 215, 222 (1923) ("The general rule is that a principal is charged with the knowledge of the agent acquired by the agent in the course of the principal's business."); RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 3, 2002); REUSCHLEIN & GREGORY, *supra* note 14, § 59, at 117 ("The general rule is that the knowledge of an agent is to be imputed to the principal.").

39. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 358 (3d Cir. 2001) (Application of the *in pari delicto* doctrine depends on whether "the Shapiro family's conduct should, in fact, be imputed to the Debtors . . . [thus] barr[ing] the Committee's claims.").

B. The Wagoner Rule

In the particular context of corporate complicity claims, some courts have articulated the *in pari delicto* principle as a rule of standing known as the *Wagoner* rule. This rule states that "when a bankrupt corporation has joined with a third party in defrauding its creditors, the trustee [lacks standing to] . . . recover against the third party for the damage to the creditors."[40] According to the Second Circuit Court of Appeals, "the *Wagoner* rule derives from the fundamental principle of agency that the misconduct of managers within the scope of their employment will normally be imputed to the corporation."[41]

As explained below, the innocent decision-maker exception to imputing wrongdoing originated in the context of the *Wagoner* rule, although courts now typically discuss the exception in the context of both the *Wagoner* rule and the *in pari delicto* defense. Thus, to understand the origins of the innocent decision-maker exception, a brief explanation of the *Wagoner* rule and its relationship to the *in pari delicto* defense is required.

Briefly stated, the *Wagoner* rule seems to combine two separate legal issues into one rule. First, the rule addresses whether certain claims accrue to creditors or to the corporation, which relates to the corporation's standing to bring certain claims. Second, the rule focuses on whether the wrongdoing of corporate officers will bar a trustee's claims against third parties, which relates to the affirmative defense of *in pari delicto*. By combining these two issues, the *Wagoner* rule turns the *in pari delicto* question into a rule of standing. As one commentator noted, the standing "aspect of the *Wagoner* rule . . . is somewhat mysterious . . . [and] seems to be a gross misstatement that has badly distorted the *in pari delicto* analysis of subsequent decisions."[42]

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40. Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991) *cited in* Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094 (2d Cir. 1995). While the Second Circuit is the only federal circuit court to date to articulate this principle as a rule of standing, at least two district courts in other circuits have followed the *Wagoner* rule. *See* Smith *ex rel.* Estate of Boston Chicken, Inc. v. Arthur Andersen L.L.P., 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001); Sec. Investor Prot. Corp. v. Capital City Bank (*In re* Meridian Asset Mgmt., Inc.), 296 B.R. 243, 257-58 (Bankr. N.D. Fla. 2003). In at least two instances where lower courts outside the Second Circuit relied on the *Wagoner* rule, those decisions were reversed on appeal by the circuit court. *See* Apostolou v. Fisher, 188 B.R. 958, 969 (N.D. Ill. 1995) ("The rule in these cases is that 'when a bankrupt corporation has joined with a third party in defrauding its creditors, the trustee cannot recover against the third party for the damage to the creditors.'" (quoting *Wagoner*, 944 F.2d at 118)), *rev'd*, 155 F.3d 876, 880 (7th Cir. 1998); Logan v. Becker (*In re* Inner City Mgmt., Inc.), 304 B.R. 250, 254 (Bankr. D. Md. 2003) ("The trustee also lacks standing under the doctrine of *in pari delicto*, according to which a debtor who was complicit in wrongdoing with third parties is precluded from pursuing a claim against a nondebtor third party."), *rev'd*, Logan v. JKV Real Estate Servs. (*In re* Bogdan), 414 F.3d 507 (4th Cir. 2005).

41. Wight v. BankAmerica Corp., 219 F.3d 79, 86 (2d Cir. 2000).

42. Brubaker, *supra* note 21, at 2.

In the *Wagoner* case, Herbert "Kirschner, a member of the Jehovah's Witnesses," was founder and sole shareholder of HMK Management Corporation.[43] HMK opened several trading accounts with Shearson Lehman Hutton, Inc.[44] These accounts were non-discretionary and required an express order from Kirschner to execute a trade.[45] Because HMK's trading was active and Kirschner was a good customer, Shearson permitted him to use a desk and video monitor in its office building.[46] As it happened, Kirschner was issuing notes and loan agreements to fellow Jehovah's Witnesses and using the proceeds to trade in the HMK accounts.[47] When HMK began experiencing losses, Shearson offered advice to Kirschner to minimize his losses.[48] In the course of this advice, Kirschner misrepresented to Shearson that he was trading only with his own funds, and when Shearson learned that Kirschner might in fact be trading with others' funds, Shearson "closed the HMK accounts and terminated Kirschner's use of" its office space.[49] HMK soon filed for bankruptcy, and its trustee, "Walter Wagoner, Jr., filed a demand for arbitration with the New York Stock Exchange," alleging that Shearson had wrongfully manipulated Kirschner to obtain excessive trading fees.[50] In response, Shearson sought a temporary restraining order and preliminary injunction in federal court to restrain the arbitration.[51] The district court granted the preliminary injunction, and eventually a permanent injunction, on the basis that the claims raised in arbitration were barred by the statute of limitations.[52]

On appeal, the Second Circuit first addressed whether the trustee had standing to pursue the claims in arbitration.[53] Shearson argued:

> [T]he trustee lacks standing because the claims he alleges on behalf of HMK's estate are really those of the noteholders, and because any action HMK itself might assert regarding Shearson's alleged participation in looting the corporation is barred by virtue of the fact that HMK's sole shareholder and officer was the principal that engaged in the looting.[54]

The Second Circuit held that "to the extent [the trustee's] claim alleges money damages to the 'clients of HMK,' it belongs only to the creditors and the trustee has no standing to assert it."[55] The court went on to add:

43. *Wagoner*, 944 F.2d at 116.
44. *Id.*
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.*
49. *Id.* at 116-17.
50. *Id.* at 117.
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.* at 117-18.
55. *Id.* at 119-20.

> [T]o the extent the demand alleges money damages to HMK itself, it is uncontested that HMK's sole stockholder and decisionmaker, Kirschner, not only knew of the bad investments, but actively forwarded them. A claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation.[56]

The basis for the court's reasoning on this second point is not entirely clear; on one hand, it seems to be basing its decision on management's involvement in the wrongdoing, but on the other, its decision could rest on the fact that the claim accrues to the creditors rather than the corporation. Nevertheless, the court's decision does not explain the relationship, if any, between these two aspects of its ruling.

Subsequent Second Circuit decisions that interpret *Wagoner* treat these two rationales as independently sufficient bases for barring a trustee's claims. That is, (1) a trustee's claims are barred when the claims are really those of another party, not the debtor,[57] and (2) a trustee's claims are barred, even when the corporation itself has been harmed, if the corporation is deemed to have participated in the wrongdoing.[58] Nevertheless, these decisions continue to treat both issues as relevant to the determination of a trustee's standing.

For example, *Hirsch v. Arthur Andersen & Co.*[59] involved a "Ponzi" scheme "aris[ing] out of the sale of limited partnership interests in various real estate properties by Colonial Realty Company ('Colonial') and its general partners."[60] Colonial and its general partners had allegedly "engaged in a scheme to enhance [Colonial's] financial appearance . . . to induce [creditors] . . . to lend money [and] provide services" to Colonial.[61] Hal Hirsch, the trustee of the consolidated estates of the bankrupt Colonial and its partners, sued Colonial's former law firms and accounting firms, alleging that they participated in the Ponzi scheme.[62] Using the *Wagoner* rule, the district court dismissed the claims for lack of standing, and the Second Circuit affirmed on appeal.[63]

In its decision, the Second Circuit noted that *Wagoner* "would appear to foreclose any action by [the trustee] to hold the defendants-appellees liable for professional malpractice on the basis that activities undertaken by them to effectuate the Ponzi scheme *also* impacted adversely on [the debtors' estates]."[64] In its analysis, the court addressed the first aspect of the *Wagoner*

56. *Id.* at 120.

57. *Id.* at 119-20.

58. Wight v. BankAmerica Corp., 219 F.3d 79, 87 (2d Cir. 2000).

59. 72 F.3d 1085 (2d Cir. 1995).

60. Hirsch v. Arthur Andersen & Co., 178 B.R. 40, 41 (D. Conn. 1994).

61. *Id.* at 43.

62. *Hirsch*, 72 F.3d at 1087-88. Hirsch's complaint was massive, asserting "465 causes of actions, sounding in breach of contract, negligence, breach of fiduciary duty, negligent misrepresentation, fraud, and RICO." *Hirsch*, 178 B.R. at 42.

63. *Hirsch*, 72 F.3d at 1090, 1096.

64. *Id.* at 1094.

rule in noting "that there is likely to be little significant injury that accrues separately to the Debtors in this case."[65] In other words, most of the alleged injuries in *Hirsch* were suffered by third parties, not by the debtors themselves, so the trustee could not maintain suit based on those injuries alone.[66] In applying the second aspect of the *Wagoner* rule, the court noted that "there is at least a theoretical possibility that some independent financial injury to the Debtors might be established . . . as a result of the alleged professional malpractice by defendants-appellees."[67] But even if that were the case, the court was "persuaded that the *Wagoner* rule should be applied here, and that Hirsch is precluded from asserting the professional malpractice claims alleged in the Complaint because of the Debtors' collaboration with the defendants-appellees in promulgating and promoting the Colonial Ponzi schemes."[68] In other words, under the imputation rationale, even if the corporation was in fact injured, its corporate complicity claims were nonetheless barred for the sole reason that the corporation had participated in the wrongdoing.[69]

The connection between the *Wagoner* rule and the imputation rationale was made more explicit several years later in *Wight v. BankAmerica Corp.*,[70] when the Second Circuit explained that "[t]he rationale underlying the *Wagoner* rule derives from the fundamental principle of agency that the misconduct of managers within the scope of their employment will normally be imputed to the corporation."[71] The court explained that "[b]ecause management's misconduct is imputed to the corporation, and because a trustee stands in the shoes of the corporation, the *Wagoner* rule bars a trustee from suing to recover for a wrong that he himself essentially took part in."[72]

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65. *Id.*

66. *See id.*

67. *Id.*

68. *Id.*

69. As *Hirsch* demonstrates, the first aspect of the *Wagoner* rule—that a trustee's claims are barred when those claims are really those of another party—is independent of the imputation aspect of the rule. Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 119-20 (2d Cir. 1991). Whether creditors have a claim against third parties such as accountants is a matter of state law and is governed by different considerations than those implicated for the issue of imputation. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 358 (3d Cir. 2001). Accordingly, this first aspect of *Wagoner* is independent and beyond the scope of this article, which is limited to the question of imputation and does not address the separate question of claims accrual.

70. Wight v. BankAmerica Corp., 219 F.3d 79 (2d Cir. 2000).

71. *Id.* at 86; *see also* Goldin v. Primavera Familienstiftung (*In re* Granite Partners, L.P.), 194 B.R. 318, 328, 330 (Bankr. S.D.N.Y. 1996) (In referring to *Wagoner* and *Hirsch* as "recent Second Circuit cases consider[ing] the applicability of *in pari delicto* to investor fraud cases," the bankruptcy court explained "that the law imputes to the corporation the knowledge and conduct of the guilty insider; a corporation only acts through its agents, and the imputation of the agent's wrongful conduct lies at the heart of *in pari delicto*.").

72. *Wight*, 219 F.3d at 87. The court went on to agree with the district court that the trustee had standing at the pleadings stage because "the complaint pled facts sufficient to trigger

While the *Wagoner* rule has remained as a rule of standing in the Second Circuit, other circuits have refused to follow suit in combining the question of a trustee's standing with the *in pari delicto* bar.[73] Courts and commentators have argued that *Wagoner* improperly treats an affirmative defense like *in pari delicto* as a matter of standing,[74] but this does not affect the proposed broader thesis that there is no place for a stand-alone innocent decision-maker exception to imputation under either *in pari delicto* or *Wagoner*. For the purpose of analyzing the innocent decision-maker exception in the context of corporate complicity claims, the critical point is that, under either the *Wagoner* rule or the *in pari delicto* defense, the ability to maintain suit depends on imputing an officer's wrongdoing to the corporation.

III. EXCEPTIONS TO IMPUTATION UNDER *IN PARI DELICTO* AND THE *WAGONER* RULE

Whether as a rule of standing, as in *Wagoner*, or as a common law defense, the *in pari delicto* principle would bar most actions by or on behalf of a corporation against third parties for allegedly participating in wrongdoing with the corporation's officers. There is, however, one longstanding exception to both the *in pari delicto* defense and the *Wagoner* rule known as the adverse interest exception.[75] To complicate matters further, there is an exception to this exception known as the "sole actor" rule.[76] Finally, recent decisions have suggested a second stand-alone exception to the *in pari delicto* defense and the *Wagoner* rule: the innocent decision-maker exception.[77]

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the adverse interest exception." *Id.*

73. The Third Circuit explained that "[a]n analysis of standing does not include an analysis of equitable defenses, such as *in pari delicto*. Whether a party has standing to bring claims and whether a party's claims are barred by an equitable defense are two separate questions, to be addressed on their own terms." *Lafferty*, 267 F.3d at 346 (citing Terlecky v. Hurd (*In re* Dublin Sec., Inc.), 133 F.3d 377, 380 (6th Cir. 1997)); *see also* Official Comm. of Unsecured Creditors of PSA, Inc. *ex rel.* PSA, Inc. v. Edwards, 437 F.3d 1145, 1149-50 (11th Cir. 2006) (agreeing with the district court's finding "that Laddin had standing based on an alleged injury to debtor estate") (citing *Lafferty*, 267 F.3d at 346-48)); Logan v. JKV Real Estate Servs. (*In re* Bogdan), 414 F.3d 507, 518 n.2 (4th Cir. 2005) (King, J., concurring in part, dissenting in part) ("[A]s I see it, the lower courts incorrectly conflated the applicability of the *in pari delicto* defense with the issue of standing. The standing question is properly a separate issue from whether the defense of *in pari delicto* applies.").

74. *See In re Bogdan*, 414 F.3d at 518 n.2 (King, J., concurring in part, dissenting in part); *Lafferty*, 267 F.3d at 346; *see also* Brubaker, *supra* note 21, at 6.

75. *Wight*, 219 F.3d at 87.

76. Mediators, Inc. v. Manney (*In re* Mediators, Inc.), 105 F.3d 822, 827 (2d Cir. 1997).

77. *See* cases cited *infra* note 101.

A. The Adverse Interest Exception and the Sole Actor Rule

1. The Adverse Interest Exception

The adverse interest exception states that "management misconduct will not be imputed to the corporation if the officer acted entirely in his own interests and adversely to the interests of the corporation."[78] If management's misconduct is not imputed to the corporation, then the corporation is free from wrongdoing and therefore is not subject to the *in pari delicto* defense.

In the context of the *Wagoner* rule, the imputation rules are the same. In *In re Mediators, Inc.*,[79] the Second Circuit recognized "the usual presumption that the acts and knowledge of an agent acting within the scope of employment are imputed to the principal."[80] The *Mediators* court went on to discuss how general imputation rules operate within agency law. First, the court noted the adverse interest exception: "[T]he adverse interest exception rebuts the usual presumption" of imputation in cases "when the agent has 'totally abandoned' the principal's interests."[81] If the adverse interest exception applies, an officer-agent's wrongdoing will not be imputed to the corporation-principal, and the corporation, or its representative in bankruptcy, will not be barred from bringing suit against other wrongdoers.

The adverse interest exception "is a narrow one and applies only when the agent has 'totally abandoned' the principal's interests."[82] The exception "cannot be invoked merely because [the agent] has a conflict of interest or because he is not acting primarily for his principal."[83] Furthermore, "[t]he fact that the predominant motive of the servant is to benefit himself or a third person does not prevent the act from being within the scope of employment."[84]

78. *Wight*, 219 F.3d at 87; *see also* Curtis, Collins & Holbrook Co. v. United States, 262 U.S. 215, 223 (1923) (stating that an exception to imputation exists "when the agent's attitude is one adverse in interest to that of the principal, because of which it can not be inferred that the agent would communicate the facts against his own interest to his principal"); Williams Elecs. Games, Inc. v. Garrity, 366 F.3d 569, 575 (7th Cir. 2004) ("An agent's knowledge is not imputed to his principal when the agent is acting adversely to the principal . . . .").

79. 105 F.3d 822 (2d Cir. 1997).

80. *Id.* at 827.

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

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

83. Center v. Hampton Affiliates, Inc., 488 N.E.2d 828, 830 (N.Y. 1985).

84. RESTATEMENT (SECOND) OF AGENCY § 236 cmt. b (1958); *see also* Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP, 322 F.3d 147, 164 n.13 (2d Cir. 2003) (stating that "the test is 'not whether there is some slight adverse interest' between the corporation and its agent but whether 'under all the circumstances of the particular case, the agent's interests are so incompatible with the interests of his principal as practically to destroy the agency or to render it reasonably probable that an ordinary person . . . will withhold such knowledge from the principal.'" (quoting Goldstein v. Union Nat'l Bank, 213 S.W. 584, 590-91 (Tex. 1919))).

In one sense, fraud committed by corporate insiders is never in the long-term interest of the corporation because the corporation is harmed once "the fraud is unmasked."[85] If this were the measure of whether wrongful conduct fit within the adverse interest exception, the exception would threaten to swallow the rule; but this is not how adverse interest is evaluated. "The relevant issue is short term benefit or detriment to the corporation, not any detriment to the corporation resulting from the unmasking of the fraud."[86] If the rule were otherwise, and agency law permitted a principal to evade responsibility every time its agent committed wrongdoing without the principal's express approval, agency law would simply serve as a shield protecting principals from the costs associated with wrongdoing but allowing them to reap the benefits of their agent's conduct. This is why the adverse interest exception applies only "when an agent has *totally abandoned* the interests of his principal, and acted *entirely* in his own or a third party's interest."[87]

2. An Exception to the Exception: The Sole Actor Rule

Even if a plaintiff corporation successfully shows that the adverse interest exception applies, the defendants may still have a rejoinder because there exists an exception to the exception, known as the sole actor rule. As the court in *Mediators* explained, "the adverse interest exception does not apply to cases in which the principal is a corporation and the agent is its sole shareholder."[88] The court observed that "where the principal and agent are one and the same, the adverse interest exception is itself subject to an exception styled the 'sole actor' rule."[89] The sole actor counter-exception "imputes the agent's knowledge to the principal notwithstanding the agent's self-dealing because the party that should have been informed was the agent itself albeit in its capacity as principal."[90] In other words, even when an officer-agent acts with wholly adverse interest, the agent's wrongdoing is imputed to the corporation-principal when the officer-agent is the sole actor of the corporation, thereby barring the corporation's claims against third parties.

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

86. Wedtech Corp. v. KMG Main Hurdman (*In re* Wedtech Corp.), 81 B.R. 240, 242 (S.D.N.Y. 1987).

87. Ernst & Young v. Bankr. Servs., Inc. (*In re* CBI Holding Co.) (*CBI II*), 311 B.R. 350, 369-70 (S.D.N.Y. 2004).

88. Mediators, Inc. v. Manney (*In re* Mediators, Inc.), 105 F.3d 822, 827 (2d Cir. 1997); *accord Color Tile*, 322 F.3d at 165; Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 359-60 (3rd Cir. 2001); FDIC v. Ernst & Young, 967 F.2d 166, 170-71 (5th Cir. 1992).

89. *In re Mediators, Inc.*, 105 F.3d at 827 (citing REUSCHLEIN & GREGORY, *supra* note 14, § 64, at 121).

90. *Id.* at 827 (citing Munroe v. Harriman, 85 F.2d 493, 495-97 (2d Cir. 1936)).

The steps of this analysis, as set forth in *Mediators*, are illustrated in Figure 1:

Figure 1

General Rule:
Agent's wrongdoing is imputed to Principal.

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Sole Actor Counter-Exception:
If Wrongdoer is the sole actor at the corporation, wrongdoing is imputed even if Agent acted with adverse interest.

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Adverse Interest Exception:
Wrongdoing is not imputed if Agent acts entirely adversely to Principal's interest. (If Agent acts partly in the Principal's interest, wrongdoing is imputed.)

3. A Corollary to the Sole Actor Rule: The Presence of Innocent Decision-Makers

The sole actor rule is fairly straightforward in the context of a corporation with one dominant insider, such as a corporation whose sole shareholder is also its chief executive.[91] In business organizations with multiple officers and directors, the sole actor rule is more complicated, but courts still apply the sole actor rule when "all *relevant* shareholders and decisionmakers [sic] were involved in the fraud."[92] In determining whether all relevant decision-makers were involved in the fraud, courts may ask whether there are any relevant decision-makers at the corporation who are innocent of the fraud.[93] Thus, when multiple insiders exist, courts sometimes characterize the sole actor counter-exception as the presence or absence of innocent decision-makers at the corporation.[94] For example, in *In re Sharp Int'l Corp.*[95] the court explained that to determine whether the sole actor counter-exception applied, courts "have looked to the complaint to see whether the plaintiff has alleged that there was an innocent member of management or [a] shareholder who could or would

91. *See, e.g.*, *id.* at 827.

92. *CBI II*, 311 B.R. at 373.

93. *See, e.g.*, Sharp Int'l Corp. v. KPMG LLP (*In re* Sharp Int'l Corp.), 278 B.R. 28, 37 (Bankr. E.D.N.Y. 2002).

94. *See id.*

95. 278 B.R. 28 (Bankr. E.D.N.Y. 2002).

have prevented the fraud had he known about it."[96] As a result, "[t]he sole-actor rule applies 'where the principal and agent are one and the same,' . . . [but] it has been held that if 'there was at least one innocent member of management who could or would have been able to prevent the fraud had he known about it,' the sole-actor rule does not apply."[97]

In other words, in the context of a complex business organization, determining whether a wrongdoing officer should be treated as a sole actor, whose wrongdoing is imputed to the corporation regardless of whether he acted with adverse interest, turns on whether there are innocent decision-makers who could or would have prevented the fraud had they known about it and whether the wrongdoer effectively dominated the corporation.[98] If there are no innocent decision-makers who could or would have prevented the fraud, the sole actor counter-exception applies, and the wrongdoing is imputed whether the wrongdoer acted with adverse interest or not.[99]

Accordingly, the presence of innocent decision-makers means that the sole actor counter-exception to the adverse interest exception does not apply. When the sole actor counter-exception does not apply, the issue of imputation depends only upon the adverse interest exception: If the wrongdoers were acting partly in the corporation's interest, their wrongdoing is imputed and bars the trustee's claim, but if the wrongdoers were acting with wholly adverse interests, their wrongdoing is not imputed and the trustee may assert his claims.

96. *Id.* at 37 (citing Sec. Investor Prot. Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 651 (S.D.N.Y. 1999)); *see also* Official Comm. of Unsecured Creditors of Grumman Olson Indus., Inc. v. McConnell (*In re* Grumman Olson Indus., Inc.), 329 B.R. 411, 425 (Bankr. S.D.N.Y. 2005) ("[T]he adverse interest exception is . . . inapplicable unless there is at least one 'innocent' decision maker among management or the shareholders who could have stopped the fraud."); Tolz v. Proskauer Rose LLP (*In re* Fuzion Techs. Group, Inc.), 332 B.R. 225, 231 (Bankr. S.D. Fla. 2005) ("[T]he plaintiff may defeat the sole actor exception that imputes the wrongdoing to the plaintiff by showing that there was someone 'involved in [debtor's] management who was ignorant of the ongoing fraud and could and would if advised of facts known to defendant have taken steps to bring the fraudulent conduct to an end.'" (quoting Breeden v. Kirkpatrick & Lockhart, LLP, 268 B.R. 704, 710 (S.D.N.Y. 2001))) (alteration in original).

97. Irve J. Goldman, *Whose Cause of Action Is It, Anyway?*, AM. BANKR. INST. J., Mar. 2004, at 1, 46 (quoting Mediators, Inc. v. Manney (*In re* Mediators, Inc.), 105 F.3d 822, 827 (2d Cir. 1997); *In re Sharp Int'l Corp.*, 278 B.R. at 36-37).

98. *See In re Sharp Int'l Corp.*, 278 B.R. at 36-37.

99. *Id.*

Figure 2 illustrates this analysis:

Figure 2

General Rule:
Agent's wrongdoing is imputed to Principal.

Adverse Interest Exception:
Wrongdoing is not imputed if Agent acts entirely adversely to Principal's interest. (If Agent acts partly in the Principal's interest, wrongdoing is imputed.)

Sole Actor Counter-Exception:
If Wrongdoer is the sole actor at the corporation, wrongdoing is imputed even if Agent acted with adverse interest.

Innocent Decision-Maker Corollary:
If there are innocent decision-makers, Wrongdoer is not the sole actor, and the counter-exception does not apply.

B. The Emergence of the Innocent Decision-Maker Exception to Imputation

As explained above, the existence of innocent decision-makers plays a significant role in the imputation analysis, as it is a corollary to the sole actor rule. In recent years, however, several federal district courts have suggested that the presence of innocent decision-makers provides a stand-alone exception to imputation, even when the requirements of the adverse interest exception are not met.[100] These courts assert that the *Wagoner* rule and the *in pari delicto* defense "would not apply if there were someone 'involved in [debtor's] management who was ignorant of the ongoing fraud and could and would if advised of facts known to [the] defendant have taken steps to bring the fraudulent conduct to an end.'"[101] For example, in Adelphia's bankruptcy

100. *See, e.g.*, cases cited *infra* note 101.

101. *Breeden*, 268 B.R. at 710 (S.D.N.Y. 2001) (quoting *Wechsler I*, 212 B.R. 34, 36 (S.D.N.Y. 1997)) (first alteration in original), *aff'd on other grounds sub nom.* Breeden v. Kirkpatrick & Lockhart LLP (*In re* Bennett Funding Group, Inc.), 336 F.3d 94, 101 (2d Cir. 2003); *accord* Smith *ex rel.* Estate of Boston Chicken, Inc. v. Arthur Andersen, L.L.P., 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001); Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A., 80 F. Supp. 2d 129, 136 (S.D.N.Y. 1999); *BDO Seidman*, 49 F. Supp.

proceedings, the court permitted the Creditors' Committee to pursue its claims against the defendant banks because "the Creditors' Committee has satisfactorily pleaded the facts necessary to trigger the 'innocent decision-maker' exception."[102]

The stand-alone innocent decision-maker exception has been recognized often enough that the court-appointed bankruptcy examiners in both the Enron and WorldCom bankruptcy proceedings repeated the exception as a valid second exception to the *Wagoner* rule and the *in pari delicto* defense. Neil Batson, the court-appointed examiner in the Enron bankruptcy, asserted that "[t]here are two recognized exceptions to the *Wagoner* Rule: (i) the 'adverse interest' exception; and (ii) the 'innocent decision-maker' exception." [103] Similarly, Richard Thornburgh, the examiner in WorldCom's bankruptcy, asserted:

> Whether treated as a standing issue or as an affirmative defense, two recognized exceptions exist to the imputation doctrine: (1) the "adverse interest" exception, applicable where corporate agents acted adversely to the interests of the corporation, in such a manner that they "have totally abandoned the principal's interest;" and (2) the "innocent decisionmaker" exception, applicable where there existed within the corporation an officer or director who could have prevented the wrongdoing had he or she been aware of the misconduct.[104]

Neither of these reports conveys any doubt as to whether the innocent decision-maker exception is a legally sound doctrine to the imputation of wrongdoing.

Because the innocent decision-maker exception is much broader than the adverse interest exception, recognizing an innocent decision-maker exception would dramatically increase the number of claims that could be brought by corporations whose officers committed wrongdoing. The adverse interest exception applies only when the wrongdoing officers have wholly abandoned the corporation's interests. In many of the recent high-profile corporate bankruptcies, the wrongdoing attributed to high-level officers relates, at least in part, to efforts to inflate the company's financial statement figures. This type of wrongdoing does advance the interests of the corporation, albeit wrongfully and perhaps only in the form of "short term benefit . . . to the corporation."[105] Thus,

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2d at 651; *Wechsler II*, 994 F. Supp. 202, 205 (S.D.N.Y. 1998); *Wechsler I*, 212 B.R. at 36; Adelphia Commc'ns Corp. v. Bank of Am., N.A. (*In re* Adelphia Commc'ns Corp.), 330 B.R. 364, 379-81 (Bankr. S.D.N.Y. 2005); *In re Sharp Int'l Corp.*, 278 B.R. at 36.

102. *In re Adelphia*, 330 B.R. at 381.

103. Third Interim Report of Neal Batson, Court-Appointed Examiner, *supra* note 25, Appx. B at 64.

104. Third and Final Report of Dick Thornburgh, *supra* note 11, Appx. B at B-2 (citations omitted).

105. Wedtech Corp. v. KMG Main Hurdman (*In re* Wedtech Corp.), 81 B.R. 240, 242 (S.D.N.Y. 1987). For example, one bankruptcy court stated, "[g]iven that . . . A.R. Baron [the corporate debtor] pleaded guilty to one count of enterprise corruption . . ., it is impossible for

it should not satisfy the terms of the adverse interest exception because "the exception is inapplicable 'when the agent acts both for himself and for the principal though the primary motivation for the acts is inimical to the principal.'"[106] But in many of these cases, there are at least some members of corporate management who are unaware of the fraud and whose presence could satisfy the terms of the innocent decision-maker exception. Consequently, recognizing a stand-alone innocent decision-maker exception to the *in pari delicto* defense and the *Wagoner* rule would significantly expand the number of cases where a bankruptcy representative could recover from third parties for their participation in the corporation's employee's misconduct.

1. The Mistaken Origin of the Innocent Decision-Maker Exception

The first use of a stand-alone innocent decision-maker exception appears in *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP* ("*Wechsler I*").[107] In *Wechsler I*, the bankruptcy trustee of Towers Financial Corporation filed suit against Towers's former law firm, Squadron, Ellenoff, Plesent & Sheinfeld ("Squadron") for malpractice, breach of fiduciary duty, and breach of contract, all based on Squadron's alleged involvement in a Ponzi scheme perpetrated by officers of the corporation.[108] The case was referred to a magistrate judge, whose report and recommendation was incorporated into the district court's *Wechsler I* opinion.[109]

Magistrate Judge Peck first addressed whether the trustee had standing, under *Wagoner*, to bring his claims against Squadron.[110] Judge Peck construed the *Wagoner* rule as requiring "dismissal of a bankrupt company's damage claims where the company's sole shareholder participated in the fraudulent scheme."[111] Applying this rule to the facts, Judge Peck addressed part one of the *Wagoner* rule and noted that "the claim that Towers was damaged by its payment of legal fees to Squadron . . . is a claim that inures to the corporation and not to its creditors. The Trustee therefore has standing to assert the claim."[112] Because the trustee was not asserting claims based on damage to the

the Trustee to contend that management was not acting on behalf of A.R. Baron, even though management's actions may have been to the detriment of the brokerage firm." Giddens v. D.H. Blair & Co. (*In re* A.R. Baron & Co.), 280 B.R. 794, 802 (Bankr. S.D.N.Y. 2002).

106. *In re A.R. Baron & Co.*, 280 B.R. at 801 (quoting *BDO Seidman*, 49 F. Supp. 2d at 650).

107. 212 B.R. 34 (S.D.N.Y. 1997).

108. *Id.* at 36, 38.

109. *Id.* at 36-46. In fact, the magistrate judge's twelve-page opinion provides a substantial portion of the district court's opinion.

110. *Id.* at 42-44.

111. *Id.* at 44 (citing *Mediators* for the proposition that an "agent's misconduct will be attributed to the corporation so as to preclude bankruptcy claims where the corporation's sole shareholder participated in the wrongdoing").

112. *Id.*

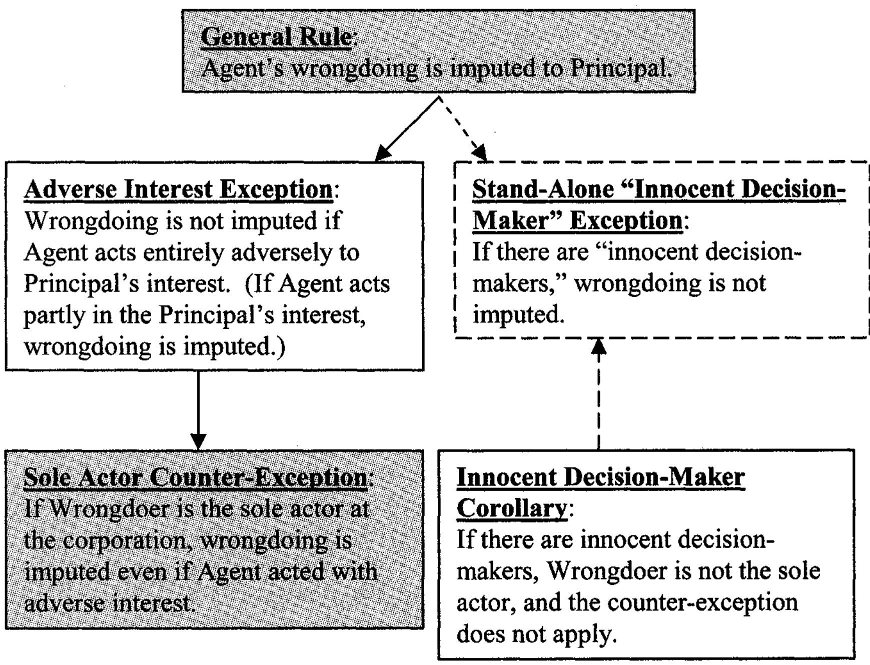
creditors but was instead asserting damage to the debtor corporation itself, the trustee's claims were not barred. As for the second part of the *Wagoner* rule, Judge Peck stated in his report:

> The *Hirsch-Wagoner* exception—where the sole shareholder participated with the defendant in the fraudulent scheme—is factually inapplicable here: Hoffenberg was not Towers'[s] sole shareholder, nor is it alleged that all of Towers'[s] shareholders participated in Hoffenberg's wrongdoing. Thus, *Hirsch* and *Wagoner* do not deprive the Trustee of standing . . . .[113]

This is the critical mistake. While Judge Peck correctly noted that wrongdoing is *always* imputed when the wrongdoer *is* the sole shareholder, he mistakenly assumed that the opposite was also true—that wrongdoing is *never* imputed when the wrongdoer is *not* the sole shareholder. In essence, the magistrate judge treated the issue of sole actor versus innocent decision-maker as determinative of the entire standing question, rather than placing the innocent decision-maker question in its proper context—as a response to the sole actor counter-exception to the adverse interest exception.

Judge Peck's mistake is illustrated by the dotted lines in Figure 3:

Figure 3



113. *Id.*

As explained in *Mediators*, wrongdoing is always imputed when the wrongdoer is the sole shareholder, even if that wrongdoer acted with wholly adverse interest, because "where the principal and agent are one and the same, . . . the agent's knowledge [is imputed] to the principal notwithstanding the agent's self-dealing because the party that should have been informed was the agent itself albeit in its capacity as principal."[114] Thus, the presence of innocent decision-makers *is* relevant to the question of imputation, but only when the wrongdoer has acted with interests wholly adverse to the corporation. When the principal and agent are not one and the same, and where innocent decision-makers are present, the general rule is still "that the acts and knowledge of an agent acting within the scope of employment are imputed to the principal . . . [except] when the agent has 'totally abandoned' the principal's interests."[115] Accordingly, when a high-level corporate officer commits wrongdoing that is at least partially in the corporation's interest, his wrongdoing is imputed to the corporation whether or not others at the corporation were innocent.[116]

The district court in *Wechsler I* adopted the magistrate judge's opinion and amplified the aforementioned *Wagoner* error in stating that it "agree[d] with Judge Peck's finding that the *Wagoner* rule only applies where *all* relevant shareholders and/or decisionmakers [sic] are involved in the fraud," and that "[a]bsent such a finding, the fraud cannot be imputed to the corporation."[117] Just as Judge Peck had done in his *Wagoner* analysis, the district court erroneously concluded that because wrongdoing is *always* imputed when the wrongdoer is the sole shareholder or decision-maker, it must also be true that wrongdoing is *never* imputed when the wrongdoer is not the sole actor.[118] In other words, while the court correctly concluded that "the *Wagoner* rule . . . applies where *all* relevant shareholders and/or decisionmakers [sic] are involved in the fraud," it incorrectly asserted that the rule applies *only* in that circumstance.[119]

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114. Mediators, Inc. v. Manney (*In re* Mediators, Inc.), 105 F.3d 822, 827 (2d Cir. 1997).

115. *Id.* (citing Center v. Hampton Affiliates, Inc., 488 N.E.2d 828, 829-30 (N.Y. 1985)).

116. RESTATEMENT (SECOND) OF TORTS § 909, cmt. b (1979) ("Although there has been no fault on the part of a corporation . . ., if a person acting in a managerial capacity . . . does an outrageous act . . ., the imposition of punitive damages upon the [corporation] serves as a deterrent to the employment of unfit persons for important positions."); Premium Fin. Specialists, Inc. v. Hullin, 90 S.W.3d 110, 113 (Mo. App. Ct. 2002) ("[I]n this action seeking to impute liability for the fraudulent acts of an agent acting within his apparent authority, . . . the principal can be vicariously liable to wronged third parties [when a principal cloaks his agent with apparent authority] . . . even when the principal is innocent and deprived of any benefit.").

117. *Wechsler I*, 212 B.R. at 36.

118. One commentator has argued that *Wechsler I*'s conclusion "that *Wagoner* rule only applies where 'all relevant shareholders and/or decisionmakers [sic] are involved in the fraud,'" is in "conflict[]" with the Second Circuit's decision in *Hirsch*, which "applied *Wagoner* on the basis of the debtor's general partners' involvement in the wrongdoing." Shimshak & Welber, *supra* note 8, at 12 (quoting *Wechsler I*, 212 B.R. at 36).

119. The district court in *Wechsler I* concluded that the complaint did not allege the existence of an innocent decision-maker and ultimately dismissed the complaint and referred the

The *Wechsler I* court's mistake is somewhat understandable given the complexities of the general rule of imputation, the adverse interest exception, the sole actor exception, and the innocent decision-maker corollary. Nonetheless, the mistake's effect has rippled through many other decisions and threatens to dramatically change the viability of corporate complicity claims.

2. The Innocent Decision-Maker Exception Gains Credence Through Repetition and Ex Post Justifications

Shortly after the *Wechsler I* decision, lower courts began to repeat the district court's flawed dictum that the presence of an innocent decision-maker prevents the imputation of wrongdoing.[120] Mindful of the Second Circuit's

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matter back to the magistrate "to determine whether plaintiff could amend the Complaint to allege the existence of some person(s) involved in Towers' management who was ignorant of the ongoing fraud and could and would if advised of facts known to defendant have taken steps to bring the fraudulent conduct to an end." *Wechsler I*, 212 B.R. at 36. Thus, the court's analytical mistake did not necessarily render its holding erroneous; since the complaint alleged that the wrongdoers acted with adverse interest but failed to identify any innocent decision-makers, the court's holding that the trustee lacked standing was arguably correct.

120. *See* AKRO Investicni Spolecnost, A.S. v. A.B. Watley, Inc., No. 01 Civ. 7693(LAP), 2003 WL 1108135, at *6-7 (S.D.N.Y. Mar. 12, 2003) (The "decision rests on the absence of any allegation in the Complaint that a member of Private Investors' management was innocent of the fraud and could have stopped it."); Breeden v. Kirkpatrick & Lockhart, LLP, 268 B.R. 704, 710 (S.D.N.Y. 2001) ("[T]he *Wagoner* rule would not apply if there were someone 'involved in [debtor's] management who was ignorant of the ongoing fraud and could and would if advised of facts known to defendant have taken steps to bring the fraudulent conduct to an end'" (quoting *Wechsler I*, 212 B.R. at 36)) (alteration in original); Smith *ex rel.* Estate of Boston Chicken, Inc. v. Arthur Andersen, L.L.P., 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001) ("As set forth in *Wechsler*, cases involving more than one corporate actor, the plaintiff may avoid dismissal for lack of standing by alleging the existence of 'an innocent member . . . of management who would have been able to prevent the fraud had he known about it.'" (quoting *Wechsler I*, 212 B.R. at 36)); Sec. Investor Prot. Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 651 (S.D.N.Y. 1999) (Case dismissed for lack of standing based "on the absence of any allegation in the Complaint that a member of Baron's management was innocent of the fraud and could have stopped it. . . . If he can do so consistent with Fed.R.Civ.P. [sic] 11, the Trustee may . . . replead his claim to allege the existence of an innocent member of Baron's management who could have prevented the fraud."); Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A., 80 F. Supp. 2d 129, 136 (S.D.N.Y. 1999) ("As set forth in *Wechsler*, in cases involving more than one corporate actor, the plaintiff may avoid dismissal for lack of standing by alleging the existence of 'an innocent member of . . . management who would have been able to prevent the fraud had he known about it.'" (quoting *Wechsler I*, 212 B.R. at 36)); Lippe v. Bairnco Corp., 218 B.R. 294, 302 (S.D.N.Y. 1998) (noting the *Wechsler I* innocent decision-maker exception, concluding that "even if the clarification noted in *Wechsler* is valid, it does not apply here" due to the unity between the principal and agent); *Wechsler II*, 994 F. Supp. 202 (S.D.N.Y. 1998) (denying a motion to dismiss because the amended complaint adequately alleged innocent directors who would and could have prevented the fraud); Sharp Int'l Corp. v. KPMG LLP (*In re* Sharp Int'l Corp.), 278 B.R. 28, 36 (Bankr. E.D.N.Y. 2002)

decision in *Mediators*, these lower courts struggled to reach an understanding of *Wechsler I* that was compatible with *Mediators*. Several decisions attempt to combine the two approaches by essentially reversing the order of the adverse interest exception and the sole actor counter-exception.[121] For example, in *BDO Seidman* the court stated that the *Wagoner* rule applies only when "'all relevant shareholders and/or decisionmakers [sic] are involved in the fraud.'"[122] Next, the court explained that under the adverse interest exception, the presumption of imputation is rebutted "when the agent has totally abandoned the principal's interest."[123] This approach seems to state that *Wagoner* applies only when the wrongdoer is the sole actor, but that even when a sole actor exists, wrongdoing will not be imputed if the wrongdoers act with adverse interests.[124] This analysis reverses the application of exceptions: The sole actor counter-exception does not precede, but instead follows the adverse interest exception in the analysis.[125] By reversing the usual agency presumption that the acts of an agent are imputed to the principal, this approach would permit the wrong set of claims to go forward.

Other courts have more closely tracked the analysis from *Mediators* and *Wight* by first setting out the general rule of imputation and then explaining the adverse interest exception to that rule; they then note that the sole actor counter-exception imputes wrongdoing regardless of adverse interest.[126] For example, in *Breeden v. Kirkpatrick & Lockhart, LLP* the district court notes that the *Wagoner* rule "'derives from the fundamental principle of agency that the misconduct of managers within the scope of their employment will normally be imputed to the corporation.'"[127] The court then sets out "the so-called 'adverse interest exception' to the imputation rule," whereby misconduct is not imputed when the agent acts with wholly adverse interest.[128] "However, 'the adverse

("Under *Wechsler*'s expanded interpretation of *Wagoner*, management's fraudulent conduct and knowledge will not be imputed to the corporation if the complaint alleges that there was at least one innocent member of management who could or would have been able to prevent the fraud had he known about it.").

121. *See, e.g.*, *BDO Seidman*, 49 F. Supp. 2d at 650.

122. *Id.* (quoting *Wechsler I*, 212 B.R. at 36 & n.1).

123. *Id.*

124. *See also* Giddens v. D.H. Blair & Co. (*In re* A.R. Baron & Co.), 280 B.R. 794, 800-01 (Bankr. S.D.N.Y. 2002). (explaining that *Wagoner* applies when all relevant decision-makers are involved in the wrongdoing and that imputation may nonetheless be "avoided . . . if the 'adverse interest' exception applies").

125. *See* Wight v. BankAmerica Corp., 219 F.3d 79, 86-87 (2d Cir. 2000) (discussing general rule of imputation, adverse interest exception to that general rule, and sole actor exception to the adverse interest exception); Mediators, Inc. v. Manney (*In re* Mediators, Inc.), 105 F.3d 822, 827 (2d Cir. 1997) (presenting same discussion).

126. *See, e.g.*, Breeden v. Kirkpatrick & Lockhart, LLP, 268 B.R. 704 (S.D.N.Y. 2001).

127. *Id.* at 709 (quoting *Wight*, 219 F.3d at 86).

128. *Id.*

interest exception is itself subject to an exception styled the "sole actor" rule.'"[129]

The court summarizes that "the *Wagoner* rule imputes the misconduct of corrupt management to the corporation whenever management dominates the company—such as in the sole shareholder context—or where the corporation delegates all authority over a portion of its business to a particular manager or managers."[130] While this statement is true, the court has stated only half of the rule: A manager's misconduct "'will normally be imputed to the corporation'"[131] whether or not that manager is a sole actor, so long as the manager is acting partially in the interests of the corporation rather than "'entirely in his own interests and adversely to the interests of the corporation.'"[132]

By erroneously omitting this part of the imputation rule, the *Breeden* court was able to reconcile *Wechsler I* with *Mediators* and *Wight.* The court explained that "the *Wechsler* [*I*] decision simply restates these basic premises when it notes that 'the *Wagoner* rule only applies where *all* relevant shareholders and/or decision[-]makers are involved in the fraud.'"[133] This represents a subtle but critical shift from the correct formulation of the rule—"the *Wagoner* rule imputes the misconduct of corrupt management to the corporation . . . in the sole shareholder context"[134]—to the incorrect formulation of the rule—"'the *Wagoner* rule *only* applies'" in the sole shareholder context.[135] As explained above, *Wechsler I* does *not* merely restate the basic premises of *Mediators* and *Wight*, but instead mischaracterizes the significance of the sole actor counter-exception.

This same mistaken approach was followed by the district court in *Official Committee of the Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A.*[136] First, the court correctly explained that the misconduct of the sole shareholder in *Wagoner* "was . . . clearly attributable to the corporation under the 'sole actor' exception to the adverse interest exception doctrine of agency law."[137] Then the court attempted to reconcile *Wechsler I*, and erroneously elevated the rule to a stand-alone imputation principle: "[I]n cases involving more than one corporate actor, the plaintiff may avoid dismissal for lack of standing by alleging the existence of 'an innocent member of . . . management who would

129. *Id.* (quoting *In re Mediators, Inc.*, 105 F.3d at 827).

130. *Id.* at 710.

131. *Id.* at 709 (quoting *Wight*, 210 F.3d at 86).

132. *Id.* (quoting *Wight*, 210 F.3d at 87).

133. *Id.* at 710 (quoting *Wechsler I*, 212 B.R at 36).

134. *Id.*

135. *Id.* (quoting *Wechsler I*, 212 B.R at 36) (emphasis added).

136. 80 F. Supp. 2d 129 (S.D.N.Y. 1999), *aff'd sub nom.* Official Comm. Of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP, 322 F.3d 146 (2d Cir. 2003).

137. *Id.* at 136 (citing Mediators, Inc. v.Manney (*In re* Mediators, Inc.), 105 F.3d 822, 827 (2d Cir. 1997)).

have been able to prevent the fraud had he known about it.'"[138] On appeal, the Second Circuit construed the district court's decision as consistent with *Mediators* and disregarded the erroneous dicta, holding that "the District Court properly concluded that the sole actor rule negated the applicability of the adverse interest exception."[139]

In *Wechsler I*, where the mistaken innocent decision-maker dicta first appeared, neither the magistrate judge nor the district court attempted to explain why wrongdoing would not be imputed if innocent decision-makers existed within the company. A few subsequent cases have sought to justify this purported exception, but their rationales are contrary to basic principles of agency law and further illustrate why the innocent decision-maker rule is not a viable exception to the *Wagoner* rule or the *in pari delicto* defense.[140]

The district court decision in *Breeden* states, "the presence of a person with the ability to bring an end to the fraudulent activity at issue would demonstrate that principal and agent are distinct entities and that the total control necessary for an application of the *Wagoner* rule is not present."[141] Thus, the court suggests that wrongdoing is imputed under *Wagoner* because (1) some sort of "unity" exists between principal and agent, such that the principal and agent are not "distinct entities", or (2) the principal exercises total control over the agent. Instead of supporting the innocent decision-maker exception, these proffered rationales show why the exception is unfounded and contrary to agency law.

First, an agent's misconduct is not imputed to the principal based on some sort of "unity" between the two. Actually, the very idea of the principal-agent relationship presupposes the existence of two distinct entities. As the draft of the Restatement (Third) of Agency explains, "[d]espite their agency relationship, a principal and an agent retain separate legal personalities. Agency does not merge the principal's personality into that of the agent, nor is

138. *Id.* (quoting *Wechsler I*, 212 B.R. at 36).

139. *Color Tile*, 322 F.3d at 166. The district court had applied the *Wagoner* standing analysis even though it concluded that Texas, not New York, law governed the claims against Coopers & Lybrand for negligence and breach of fiduciary duty. *Color Tile*, 80 F. Supp. 2d at 135. On appeal, the Second Circuit held that under Texas law a corporation's own wrongdoing was an affirmative defense against the trustee's action (under *in pari delicto*), not a matter of standing. *Color Tile*, 322 F.3d at 157. Nonetheless, in applying the *in pari delicto* doctrine, the Second Circuit made clear that it understood the substance of *in pari delicto* to mirror that of the *Wagoner* rule, quoting the analysis in *Mediators*—a *Wagoner* decision—as setting out the proper framework for *in pari delicto*. *Id.* at 165.

140. *See, e.g.*, *Breeden*, 268 B.R. at 710.

141. *Id.* A few lower court decisions have hinted at this rationale. *See* Sec. Investor Prot. Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 651 (S.D.N.Y. 1999) (The lack of innocent decision-makers "strongly suggests the existence of 'sufficient unity' between Baron and its management to deprive the Trustee of standing, as the Court found in *Lippe*."); Lippe v. Bairnco Corp., 218 B.R. 294, 302 (S.D.N.Y. 1998) ("Thus, claim plaintiffs, 'unity of person between corporation and defendants does not exist here as it did in *Mediators* and *Wagoner*.' ... [E]ven if the clarification noted in *Wechsler* is valid, it does not apply here, for there is a sufficient 'unity' between Keene and defendants to implicate Keene in the alleged wrongdoing.").

the agent, as an autonomous person or organization with distinct legal personality, merged into the principal."[142] While courts have held that an officer's wrongdoing is imputed to a corporation when there is unity of identity between the principal and the agent,[143] that unity is not *necessary* to the imputation of wrongdoing. Instead, wrongdoing is imputed under *Wagoner* based on "the usual presumption that the acts and knowledge of an agent acting within the scope of employment are imputed to the principal."[144]

The second rationale—the principal's total control over the agent—is more analogous to the principal's right to control the agent, which is one of the essential elements of the principal-agent relationship under agency law.[145] The error in this rationale is that the control required to show the existence of an agency relationship is the principal's *right* to control the agent, not that the principal actually participated in or directed that the agent commit specific wrongful acts.[146] If the rule were otherwise, a principal could always disclaim

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142. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c (Tentative Draft No. 2, 2001); *see also id.* § 1.01 cmt. f(2) ("A corporation's agents are its own because it [the corporation] is a distinct legal person."). For example, in *Nat'l Petrochemical Co. of Iran v. M/T Stolt Sheaf*, 930 F.2d 240, 244 (2d Cir. 1991), the Second Circuit imputed the Saudi agent's knowledge to the Iranian corporation-principal to bar the corporation's claims under *in pari delicto*, even though the Saudi agent was not even an officer or employee of the Iranian corporation. *See also* Bank of China, N.Y. Branch v. NBM LLC, 359 F.3d 171, 179 (2d Cir. 2004) (imputing wrongful conduct of bank officers to the bank under general principal-agent imputation principles, with no suggestion of any *unity* of identity between the bank and its officers); Wal-Mart Stores, Inc. v. Crist, 855 F.2d 1326, 1335 (8th Cir. 1988) (imputing independent insurance agent's wrongful acts to Wal-Mart under *in pari delicto*); Thypin Steel Co. v. Certain Bills of Lading, No. 96 Civ. 2166(RPP), 2002 WL 31465791, at *9 (S.D.N.Y. Nov. 4, 2002) (imputing knowledge of information by the independent agent, M&R, to the principal, Asoma, thereby defeating Asoma's claim that it purchased steel in good faith), *aff'd in part, vacated in part on other grounds sub nom.* Thypin Steel Co. v. Asoma Corp., 82 Fed. Appx. 738, 739-40 (2d Cir. 2003).

143. Mediators, Inc. v. Manney (*In re* Mediators, Inc.), 105 F.3d at 827 ("[W]here the principal and agent are one and the same, the adverse interest exception is itself subject to an exception styled the 'sole actor' rule").

144. *Id.*; *see also* Wight v. BankAmerica Corp., 219 F.3d 79, 86 (2d Cir. 2000) ("The rationale underlying the *Wagoner* rule derives from the fundamental principle of agency that the misconduct of managers within the scope of their employment will normally be imputed to the corporation.") *quoted in* Breeden v. Kirkpatrick & Lockhart LLP (*In re* Bennett Funding Group, Inc.), 336 F.3d 94, 100 (2d Cir. 2003).

145. *See* RESTATEMENT (SECOND) OF AGENCY § 14 (listing as an "essential characteristic[]" of the agency relationship, the fact that "[a] principal has the right to control the conduct of the agent with respect to matters entrusted to him").

146. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c (Tentative Draft No. 2, 2001) ("The principal's right to control the agent is a constant across relationships of agency. . . . A principal's failure to exercise the right of control does not eliminate it, nor is it eliminated by physical distance between the agent and principal."); *see also* MJ & Partners Rest. Ltd. v. Zadikoff, 10 F. Supp. 2d 922, 931 (N.D. Ill. 1998) ("To determine whether an agency relationship exists the court must consider . . . whether the principal has the right to control the

an agent's wrongful conduct so long as the principal did not actually participate in or knowingly ratify the wrongdoing. In addition, the presence of an innocent decision-maker capable of stopping the fraud does not, in and of itself, demonstrate the absence of *total control* by the principal over the agent. Regardless of the principal's level of control over an agent, agents routinely operate, without the immediate knowledge of their principal, in ways that the principal later deems to be incorrect and unwanted. Nevertheless, "the usual presumption [is] that the acts and knowledge of an agent acting within the scope of employment are imputed to the principal."[147]

In attempting to reconcile *Wechsler I* with *Mediators* and *Wight*, most of the lower courts which have addressed the issue have ultimately concluded that the wrongdoers were the sole actors.[148] As a result, the courts hold that the wrongdoing is imputed to the corporation and that the bankruptcy representative lacks standing under *Wagoner*.[149] Thus, these cases typically involve factual situations in which the *Mediators* and *Wechsler I* decisions are in accord: When the wrongdoer is the sole actor—no innocent decision-maker exists—wrongdoing is imputed and the bankruptcy representative lacks standing to sue third parties based on that wrongdoing. Because these cases did not involve factual situations in which the *Mediators* and *Wechsler I* decisions conflict—innocent decision-makers exist, but the wrongdoers acted partially in the interests of the corporation—the courts were not required to confront the inconsistency between the *Mediators* and the *Wechsler I* courts' respective approaches to the significance of the sole actor counter-exception. Accordingly, it is unsurprising that these decisions incorrectly resolved this inconsistency.

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manner and method in which agent performs his services . . . ."); Official Comm. of Unsecured Creditors of Sunbeam Corp. v. Morgan Stanley & Co. (*In re* Sunbeam Corp.), 284 B.R. 355, 366 (Bankr. S.D.N.Y. 2002) ("[T]he right to control is the critical factor in establishing an agency relationship." (citing Abex, Inc. v. Koll Real Estate Group, Inc., No. 13462, 1994 WL 728827, at *14 (Del. Ch. Dec. 22, 1994)).

147. *In re Mediators, Inc.*, 105 F.3d at 827; *see also* Jackson v. Mishkin (*In re* Adler, Coleman Clearing Corp.), 263 B.R. 406, 454 (S.D.N.Y. 2001) ("The knowledge of the agent acting within the agency power entrusted may be imputed to the principal, and the principal's liability is affected by the agent's knowledge for the purposes of enabling a defrauded party to rescind a transaction procured through an agent's fraud, even if the principal did not authorize the agent's fraud.").

148. *See* Breeden v. Kirkpatrick & Lockhart, LLP, 268 B.R. 704, 709-10 (S.D.N.Y. 2001), *aff'd*, *In re Bennett Funding Group, Inc.*, 336 F.3d at 100-01; Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A., 80 F. Supp. 2d 129, 136-37 (S.D.N.Y. 1999); Sec. Investor Prot. Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 650-51 (S.D.N.Y. 1999); Lippe v. Bairnco Corp., 218 B.R. 294, 302 (S.D.N.Y. 1998) ("Hence, even if the [innocent decision-maker rule] is valid, it does not apply here" because the complaint does not show "that innocent members of management would have been able to prevent the fraud had they known about it."); Giddens v. D.H. Blair & Co. (*In re* A.R. Baron & Co.), 280 B.R. 794, 801-02 (Bankr. S.D.N.Y. 2002).

149. *See* cases cited *supra* note 148.

Nevertheless, in several other cases, the innocent decision-maker exception did influence the courts' ultimate decisions to permit plaintiffs to pursue their claims.[150] For example, in *In re CBI Holding Co.*, Ernst & Young argued that BSI, the successor-in-interest to the bankrupt CBI, "lack[ed] standing to assert claims . . . against E[rnst] & Y[oung] because the knowledge of certain CBI officers and management level employees who were involved in the accounting fraud must as a matter of law be imputed to CBI itself."[151] The bankruptcy court rejected this argument, stating:

> [A] corporation whose management was involved in an accounting fraud is not barred from asserting claims for professional malpractice in not detecting the fraud, provided the corporation had at least one decision-maker in management or among its stockholders who was innocent of the fraud and could have stopped it.[152]

The bankruptcy court then made a finding of fact that a forty-eight percent shareholder and one of its representatives on the board were innocent of the fraud and would have stopped it had they known.[153]

In support of its proposition that the presence of innocent decision-makers prevented the imputation of wrongdoing, the *CBI I* bankruptcy court erroneously cited several lower court decisions as holding that the presence of an innocent decision-maker gives the trustee standing.[154] For example, the bankruptcy court characterized *Wechsler I* as "permitting [a] malpractice complaint against [a] law firm to stand despite fraud by company CEO, because imputation rule applies only 'where all relevant shareholders and/or decision-makers are involved in the fraud.'"[155] Yet, the *Wechsler I* decision did not permit the claim to stand—it *dismissed* the complaint, albeit without prejudice to replead.[156]

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150. *See* Smith *ex rel.* Estate of Boston Chicken, Inc. v. Arthur Andersen L.L.P., 175 F. Supp. 2d 1180, 1200 (D. Ariz. 2001) (denying motion to dismiss on alternative grounds that (1) the adverse interest exception was adequately alleged and (2) the innocent decision-maker exception was adequately alleged); Sharp Int'l Corp. v. KPMG LLP (*In re* Sharp Int'l Corp.), 278 B.R. 28, 39 (Bankr. E.D.N.Y. 2002) (same); Bankr. Servs. Inc. v. Ernst & Young) (*In* re CBI Holding Co.) (*CBI I*), 247 B.R. 341, 365 (Bankr. S.D.N.Y. 2000) (same).

151. *CBI I*, 247 B.R. at 364.

152. *Id.* at 364-65 (citing *BDO Seidman*, 49 F. Supp. 2d at 649-51).

153. *Id.* at 365. As an alternative basis for its holding, the court also concluded that "CBI would still have standing to assert its claims under the so-called 'adverse interest exception.'" *Id.* On appeal, the district court eventually dismissed the claims against Ernst & Young and held that the terms of the adverse interest exception were not met. Ernst & Young v. Bankr. Servs., Inc. (*In re* CBI Holding Co.) (*CBI III*), 318 B.R. 761, 764-65 (S.D.N.Y. 2004).

154. *CBI I*, 247 B.R. at 364-65.

155. *CBI I*, 247 B.R. at 365 (quoting *Wechsler I*, 212 B.R. 34, 35-36 (S.D.N.Y. 1992)).

156. *Wechsler I*, 212 B.R. 34, 35-36 (S.D.N.Y. 1997). The *Wechsler I* court referred the matter "back to [the magistrate judge] to oversee any discovery necessary to determine whether plaintiff" could properly amend the complaint. *Id.* at 36. The plaintiff then filed a motion to

The *CBI I* bankruptcy court also cited to *BDO Seidman* as "permitting [a] malpractice complaint against [an] auditor to stand provided [the] trustee repleads to assert the existence of an innocent member of management who could have prevented the fraud."[157] Just as in *Wechsler I*, the court in *BDO Seidman* dismissed the trustee's claim because no innocent decision-maker had been alleged.[158] The court simply added, in dicta, that "[i]f he can do so consistent with Fed.R.Civ.P. [sic] 11, the Trustee may . . . replead this claim to allege the existence of an innocent member of Baron's management who could have prevented the fraud."[159] In fact, the trustee never replead those claims, and the *BDO Seidman* court never evaluated the adequacy of a complaint amended to allege an innocent decision-maker.[160]

The bankruptcy court in *CBI I* also cited to *In re Wedtech Securities Litigation*[161] as "refusing to dismiss [a] malpractice complaint against [an] accountant on imputation grounds where officers guilty of misconduct were not the company's sole shareholders."[162] While it is factually accurate that the officers in *Wedtech* were not the sole shareholders, this was not the reason the

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amend, which the magistrate judge recommended granting. *Wechsler II*, 994 F. Supp. 202, 214 (S.D.N.Y. 1998). The district court ultimately followed the magistrate judge's recommendation, granted the motion to amend the complaint, and denied the motion to dismiss on the ground that the amended complaint adequately alleged the presence of innocent decision-makers who could have stopped the wrongdoing. *Id.* at 203-04. In *Wechsler I* the magistrate judge concluded that the complaint also alleged that the wrongdoers acted with adverse interest. *Wechsler I*, 212 B.R. at 44-46. The district court, in *Wechsler II*, did not disturb this finding in denying a motion to dismiss a complaint that (1) adequately alleged an adverse interest and (2) adequately alleged the presence of innocent decision-makers. *Wechsler II*, 944 F. Supp. at 204. *Wechsler II*'s holding was arguably correct, even if arrived at by a flawed analysis.

157. *CBI I*, 247 B.R. at 365 (citing *BDO Seidman*, 49 F. Supp. 2d at 649-51).

158. *BDO Seidman*, 49 F. Supp. 2d at 651. The court held that the trustee had standing to maintain separate claims in its capacity as bailee of a customer fund but dismissed those claims on the merits. *Id.* at 653, 656-58. In addition, the court dismissed the separate claims brought by SIPC and held that SIPC lacked standing to sue on its own behalf and that its claims on behalf of customers failed on the merits. *Id.* at 653, 656-58.

159. *Id.* at 651.

160. Instead of repleading, the trustee and SIPC appealed the district court's other rulings. On appeal, the Second Circuit did not mention the dismissal of the trustee's claims brought on its own behalf, which suggested that the trustee did not raise that issue on appeal. Instead, the Second Circuit addressed only the district court's dismissal of SIPC's and the trustee's claims on behalf of customers, which the court affirmed, and the court's dismissal of SIPC's own claims for lack of standing. Sec. Investor Prot. Corp. v. BDO Seidman, LLP, 222 F.3d 63, 66 (2d Cir. 2000). The Second Circuit disagreed with the district court's conclusion that SIPC lacked standing but certified a question related to the merits of SIPC's claim to the New York Court of Appeals. *Id.* After receiving the New York court's response to the certified question, the Second Circuit dismissed SIPC's claims on the merits. Sec. Investor Prot. Corp. v. BDO Seidman, LLP, 245 F.3d 174, 175 (2d Cir. 2001) (per curiam).

161. CEPA Consulting, Ltd. v. King Main Hurdman (*In re* Wedtech Sec. Litig.), 138 B.R. 5 (S.D.N.Y. 1992).

162. *CBI I*, 247 B.R. at 365 (citing *In re Wedtech Sec. Litig.*, 138 B.R. at 7-9).

Wedtech court found that the trustee had standing. The *Wedtech* court, after noting that the case did not involve a sole shareholder, correctly explained that "the question of whether the guilt of the corporate officers can be imputed to the corporation is the key unresolved issue."[163] The court added that the determination of this "central issue" turned on "whether the 'adverse interest' exception applies to the present case."[164] The court concluded that "material facts clearly remain in dispute" on the issue of adverse interest and, therefore, denied summary judgment.[165]

3. The Innocent Decision-Maker Error Is Explained and Corrected, but Still Persists

In Ernst & Young's appeal of the bankruptcy court's decision in *CBI I*, Judge Kimba Wood was the first to uncover and explain the mistaken nature of the innocent decision-maker exception.[166] Judge Wood described the adverse interest exception as "entirely consistent with the principles of agency law" because the legal fiction of imputed knowledge "is untenable . . . when an agent has *totally abandoned* the interests of his principal, and acted *entirely* in his own or a third party's interest."[167]

Judge Wood then turned to "the so-called 'innocent insider' exception," which she noted as being premised on the following notion:

> [W]here only some members of management are guilty of the misconduct, and the innocent members could and would have prevented the misconduct had they known of it, the culpability of the malefactors should not be imputed to the company because that imputation would punish innocent insiders (*e.g.*, non-culpable shareholders) unfairly.[168]

Judge Wood rejected this rationale and noted that refusing to impute wrongdoing to innocent officers and directors might "disincentivize the innocent managers, board members, and owners from policing the conduct of the guilty."[169] Thus, the court "decline[d] to adopt any innocent insider exception to the *Wagoner* rule."[170]

Next, the court "address[ed] what appears to be substantial confusion evidenced by several courts, including the bankruptcy court below, regarding the nature of the so-called 'innocent insider' exception."[171] Judge Wood

163. *In re Wedtech Sec. Litig.*, 138 B.R. at 8.
164. *Id.* at 9.
165. *Id.*
166. *CBI II*, 311 B.R. 350, 372-73 (S.D.N.Y. 2004).
167. *Id.* at 369-70.
168. *Id.* at 371-72.
169. *Id.* at 372 (citing Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 454-56 (7th Cir. 1982)).
170. *Id.*
171. *Id.*

explained that "unless the adverse interest exception to the presumption of imputation applies, it is immaterial whether innocent insiders exists [sic]; the agent is still acting on behalf of the company, and his actions will be imputed to the company notwithstanding the existence of those innocent insiders."[172] Under traditional agency law principles, "[e]ven when an agent is defrauding his principal, unless the agent has totally abandoned the interests of the principal and is acting entirely in his own, or another person's, interest, that agent is acting within the scope of his agency."[173]

Judge Wood next mentioned the "exception to the adverse interest exception, styled the 'sole actor rule,'" which holds that even an agent's acts falling "outside of the scope of his agency" are nonetheless "imputed to the principal 'where the principal and the agent are one and the same.'"[174] This sole actor rule "operates most clearly in the context of a corporation owned and managed by a single person," and if that person acts wrongfully "it would be nonsensical to refrain from imputing the agent's acts of fraud to the corporation, despite the agent's total abandonment of the corporation's interests, because the agent is identical to the corporation."[175]

Even if multiple people owned and managed a corporation, the sole actor principle would still apply "so long as all of them were involved together in a fraud against the corporation."[176] In this context, the question becomes whether any of the corporation's officers or directors were innocent of the fraud. When there are officers or directors who were not involved in the fraud, "courts consider whether those insiders . . . had sufficient authority to stop the fraud."[177] According to Judge Wood, "[w]hen the innocent insiders lack authority to stop the fraud, the 'sole actor' exception to the 'adverse interest' exception applies, and imputation is thus proper, because all *relevant* shareholders and decisionmakers [sic] were involved in the fraud."[178] In contrast, when there are officers and directors who are both (1) innocent of the fraud, and (2) would and could have stopped it, the sole actor rule does not apply. In other words, when there are innocent decision-makers, the question of imputation turns on the adverse interest exception: The officers' wrongdoing is imputed to the corporation if the wrongdoers acted at least in part on behalf of the corporation, and wrongdoing is not imputed if the wrongdoers wholly abandoned the corporation's interests and acted entirely in their own interests.

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172. *Id.* at 373.

173. *Id.*

174. *Id.* (citing Breeden v. Kirkpatrick & Lockhart LLP (*In re* Bennett Funding Group, Inc.), 336 F.3d 94, 100 (2d Cir. 2003)).

175. *Id.* (citing Mediators Inc. v. Manney (*In re* Mediators, Inc.), 105 F.3d 822, 827 (2d Cir. 1997)).

176. *Id.*

177. *Id.*

178. *Id.*

In the wake of *CBI II*, at least two courts have followed Judge Wood's rejection of the innocent decision-maker exception.[179] In *Baena v. KPMG LLP*, the First Circuit declined to expand Massachusetts state law by adopting an innocent decision-maker exception. It called that exception a "radical alteration" of state law that "clearly deviates from traditional agency doctrine."[180] Other courts, however, continue to repeat the innocent decision-maker error, notwithstanding Judge Wood's explanation of the faulty nature of the exception. Most notable is the decision in the Adelphia bankruptcy proceeding to grant the Creditors' Committee's motion to pursue certain claims against third party defendant banks.[181] In opposition to the Creditors' Committee's motion, the defendant banks argued that granting the motion would be "pointless" because Adelphia's claims would be barred under the *Wagoner* rule due to its "imputation to a bankruptcy trustee or deputized creditors' committee of the predecessor management's wrongful conduct."[182] The Creditors' Committee responded that *Wagoner* and *in pari delicto* did not apply because of both the adverse interest exception and "another exception to the application of *in pari delicto*: That an *in pari delicto* defense does not bar recovery by the estate upon a showing of one or more decision makers that could have stopped the fraud or breaches of fiduciary duty . . . [such] as Adelphia's independent directors."[183]

In rejecting the defendants' arguments, the bankruptcy court agreed with the Creditors' Committee that dismissal on the basis of the complaint was inappropriate because "the Committees' [sic] first two points—as to the 'adverse interest' and 'innocent decision-maker' exceptions—will be incapable of resolution under Rule 12(b)(6), and will require factual inquiry."[184] As for the adverse interest exception, the court observed that "it is at least arguable, given the facts of which this Court has already become aware . . . that the Creditors' Committee will be able to make the necessary factual showing to make out the 'adverse interest' exception."[185] Even apart from that exception, the court held that "the Creditors' Committee has satisfactorily pleaded the facts necessary to trigger the 'innocent decision-maker' exception. Determining whether that exception applies, in light of the totality of the

179. *See* Am. Tissue, Inc. v. Donaldson, Lufkin & Jenrette Sec. Corp., 233 F.R.D. 327, 330 (S.D.N.Y. 2005) ("[T]his Court agrees with the reasoning of those courts that have rejected it, *see, e.g., In re CBI Holding Co.*, 311 B.R. 350, 372 (S.D.N.Y. 2004), at least on facts such as those present here, where plaintiff's own complaint demonstrates its participation in the very fraudulent acts on which it seeks to sue."); Baena v. KPMG LLP, 453 F.3d 1, 8-9 (1st Cir. 2006).

180. *Baena*, 453 F.3d at 8-9.

181. Adelphia Commc'ns Corp. v. Bank of Am., N.A. (*In re* Adelphia Commc'ns Corp.), 330 B.R. 364, 369 (Bankr. S.D.N.Y. 2005).

182. *Id.* at 378-79.

183. *Id.*

184. *Id.* at 380.

185. *Id.* at 380-81.

circumstances concerning the knowledge and actions of Adelphia's outside directors . . . , will present an issue of fact."[186]

What is most striking about the bankruptcy court's error in *Adelphia* is that the court apparently recognized Judge Wood's reasoning in *CBI II* yet failed to understand that the analysis meant that reliance on the innocent decision-maker exception was inappropriate as a matter of law. In a footnote, the bankruptcy court noted that "[s]trictly speaking, [the innocent decision-maker exception] is an exception to the 'sole actor' exception to the 'adverse interest' exception to the *in pari delicto* doctrine."[187] The court continued, "[i]t is unnecessary, for the purposes of the discussion of this motion, to become immersed in that level of detail here."[188] There are several layers of confusion in this footnote. First and foremost is the court's failure to recognize that if the innocent decision-maker doctrine is merely a part of the sole actor rule, it would be inappropriate to rely on it as a stand-alone exception to imputation of wrongdoing. Second, as explained above, the innocent decision-maker doctrine is not an "*exception* to the 'sole actor' exception," as the court erroneously notes.[189] Instead, this doctrine is simply another way of defining sole actor: When there are innocent decision-makers at a firm, the wrongdoing officer and the corporation are not "one in the same."[190]

To summarize, several lower courts have endorsed the innocent decision-maker exception, while two district court decisions have rejected it.[191] In at least one case, the Second Circuit acknowledged the lower-court decisions endorsing the exception but declined to "resolve the question of whether the presence of innocent directors would provide the trustee with standing where fewer than all shareholders are implicated in the fraud, because that case is not before us."[192] The First Circuit has declined to endorse the exception under Massachusetts law, but did so without much analysis.[193]

IV. THE PURPORTED INNOCENT DECISION-MAKER EXCEPTION TO IMPUTATION IS NOT RECOGNIZED IN ANY OTHER AGENCY LAW CONTEXT

The question of whether to impute an agent's wrongdoing to the principal occurs in a variety of legal contexts, not just a bankruptcy representative's corporate complicity claim. Imputation of an agent's acts may be examined in claims alleging corporate liability for punitive damages, corporate criminal

186. *Id.* at 381.

187. *Id.* at 379 n.48.

188. *Id.*

189. *Id.* (emphasis added).

190. Mediators, Inc. v. Manney, (*In re* Mediators, Inc.), 105 F.3d 822, 827 (2d Cir. 1997).

191. Am. Tissue, Inc. v. Donaldson, Lufkin & Jenrette Sec. Corp., 233 F.R.D. 327 (S.D.N.Y. 2005); *CBI II*, 311 B.R. 350 (S.D.N.Y. 2004).

192. Breeden v. Kirkpatrick & Lockhart LLP (*In re* Bennett Funding Group, Inc.), 336 F.3d 94, 101 (2d Cir. 2003).

193. Baena v. KPMG LLP, 453 F.3d 1, 8-9 (1st Cir. 2006).

liability, and the availability of the *in pari delicto* defense in other situations. If the innocent decision-maker exception were a valid exception to imputing officers' wrongdoing in corporate complicity claims, one would expect that the exception would be recognized—or at least discussed—in some of these other contexts. An evaluation of imputing wrongdoing in other agency-law contexts, however, reveals the opposite: No courts even suggest that the presence of innocent decision-makers serves as a reason not to impute an agent's wrongdoing to the principal. To the contrary, in each of these contexts courts generally impute an agent's wrongdoing to the principal, so long as the misconduct occurs in the course of duties performed for the principal. As Parts IV.A-C illustrate, the adverse interest exception and the sole actor counter-exception are recognized in these contexts, but the innocent decision-maker exception is never discussed or endorsed.

A. Basic Principles of Agency Law

According to the most recent draft of the Restatement (Third) of Agency:

> For purposes of determining a principal's legal relations with a third party, 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, unless the agent . . . acts adversely to the principal . . . or . . . is subject to a duty to another not to disclose the fact to the principal.[194]

Comment b to section 5.03 notes that "[i]mputation 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."[195] While the Restatement recognizes an adverse interest exception to imputation, it does not mention or acknowledge any exception to imputation based on the existence of innocent decision-makers.[196]

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194. RESTATEMENT (THIRD) OF AGENCY § 5.03 (Tentative Draft No. 6, 2005). The Restatement contains another exception to imputing an agent's knowledge to the principal; it applies when the agent "is subject to a duty to another not to disclose the fact to the principal." *Id.* § 5.03(b). This exception is separate from and has no bearing on the adverse interest exception or the innocent decision-maker exception. *See also* REUSCHLEIN & GREGORY, *supra* note 14, § 59, at 117 ("The general rule is that the knowledge of an agent is to be imputed to the principal. The clearest exception to the rule is when the agent is acting out of an adverse interest to the principal."); *id.* § 63, at 121 ("The knowledge of a corporate officer, who is, of course, an agent of the corporation, which he acquires while acting within the scope of his authority . . . is imputed to the corporation . . . .").

195. RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (Tentative Draft No. 6 2005) (italics added).

196. *Id.*; *see also* RESTATEMENT (SECOND) OF AGENCY § 282 ("A principal is not affected by the knowledge of an agent in a transaction in which the agent secretly is acting adversely to the principal and entirely for his own or another's purposes," failing to mention an innocent

B. Imputation and In Pari Delicto in Other Contexts

While the *in pari delicto* doctrine applies to all agency relationships, the *Wagoner* rule seems limited to corporate complicity claims.[197] Apart from the cases discussed in Part III.B involving corporate complicity claims, case law does not suggest that the presence of innocent decision-makers prevents imputation of an agent's wrongdoing to the principal. Even though no case expressly rejects such a contention, several cases impute an agent's wrongdoing to the principal even though the agent's superiors, i.e., relevant decision-makers, were innocent of wrongdoing.[198]

For example, in *National Petrochemical Co. of Iran v. M/T Stolt Sheaf*,[199] a corporation owned by the Iranian government, NPC, filed suit for breach of contract against a tanker and its owners for goods originally shipped from the United States to Iran that were diverted and resold.[200] The Second Circuit affirmed the district court's dismissal of the claim because the corporation was charged with knowledge that the contract violated the U.S. embargo against Iran.[201] The court explained:

> Monnris, NPC's agent, knew of the illegal nature of the transaction—that goods were being shipped from the United States to Iran. This knowledge is attributable to NPC, because "[i]t is a basic tenet of the law of agency that the knowledge of an agent . . . is imputed to the principal."
>
> . . . [Therefore], the district court correctly ruled that there was no genuine issue of fact whether NPC was *in pari delicto* as to the Stolt Sheaf shipment.[202]

There is no suggestion that NPC knew of the illegal nature of the transaction or that no innocent decision-makers existed at NPC who could have stopped the fraud. Nonetheless, the court attributed Monnris' knowledge of the wrongdoing to NPC under standard agency-law imputation rules.

Likewise, in *Wal-Mart Stores, Inc. v. Crist*,[203] the Eighth Circuit reversed the district court's $20 million award to Wal-Mart's insurer, Transit, holding that Transit was *in pari delicto* with Wal-Mart.[204] Transit's agent, Carlos Miro,

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decision-maker exception.).

197. The *Wagoner* rule's limitation to this context stems from the fact that *Wagoner* combines *in pari delicto* principles with questions of whether certain claims accrue to creditors or corporations in the bankruptcy setting. *See supra* Part II.B.

198. *See, e.g.*, Nat'l Petrochemical Co. of Iran v. M/T Stolt Sheaf, 930 F.2d 240 (2d Cir. 1991); Wal-Mart Stores, Inc. v. Crist, 855 F.2d 1326 (8th Cir. 1988).

199. 930 F.2d 240 (2d Cir. 1991).

200. *Id.* at 241-42. The goods were diverted to Taiwan. *Id.*

201. *Id.* at 244.

202. *Id.* (quoting Mallis v. Bankers Trust Co., 717 F.2d 683, 689 n.9 (2d Cir. 1983) (citing RESTATEMENT (SECOND) OF AGENCY § 272 (1958)).

203. 855 F.2d 1326 (8th Cir. 1988).

204. *Id.* at 1328, 1335.

had entered into a workers' compensation insurance contract with Wal-Mart, which both Miro and Wal-Mart knew to illegally under-represent Wal-Mart's annual payroll.[205] The Eighth Circuit held that Transit was *in pari delicto* because "it [was] charged with responsibility for the acts of its agent, Miro, who structured the deal from the start."[206] There was no suggestion in the opinion that Transit's upper management knew of Miro's wrongdoing or that they would have failed to correct it had they known. Nevertheless, Miro's knowledge of the illegal contract was imputed to Transit.

C. Imputation in the Context of Corporate Responsibility for Wrongful Intent

The same general rule of imputation applies to claims for punitive damages or fraud-based damages based on the conduct of managerial employees or officers.[207] In *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*,[208] the United States Supreme Court held that the plaintiff was liable for treble damages under the Sherman Act due to the acts of one of its employee-agents who acted with apparent authority.[209] The Court noted that "[i]n a wide variety of areas, the federal courts . . . have imposed liability upon principals for the misdeeds of agents acting with apparent authority."[210] In the context of

205. *Id.* at 1328-30.

206. *Id.* at 1335.

207. *See* Doralee Estates, Inc. v. Cities Serv. Oil Co., 569 F.2d 716, 721-22 (2d Cir. 1977) (affirming award of punitive damages against corporation for knowingly discharging pollutants onto plaintiff's property as the corporation's liability was based on imputed knowledge of the pollution by responsible management officials); RESTATEMENT (SECOND) OF AGENCY § 217C ("Punitive damages can properly be awarded against a master or other principal because of an act by an agent if . . . (c) the agent was employed in a managerial capacity and was acting in the scope of employment . . . ."); RESTATEMENT (SECOND) OF TORTS § 909 (prescribing the same rule).

208. 456 U.S. 556 (1982).

209. *Id.* 577-78.

210. *Id.* at 568 (citing cases involving tax liability, securities fraud, and common law fraud); *see also* Apollo Fuel Oil v. United States, 195 F.3d 74, 76-77 (2d Cir. 1999) (per curiam) (The court affirmed a tax penalty against the corporation based on an employee's knowledge of the impermissible use of tax-exempt red-dyed fuel for highway vehicles. The court stated that "when an agent is employed to perform certain duties for his principal and acquires knowledge material to those duties, the agent's knowledge is imputed to the principal" and commented that even though company policy prohibited improper use of red-dyed fuel, the company "did not show any way in which such use would benefit an employee, raising a strong inference that whoever introduced the red-dyed fuel into the truck's propulsion tank did so to benefit Apollo."); United States v. 7326 Highway 45 N., 965 F.2d 311, 316 (7th Cir. 1992) (stating that, in the context of civil forfeiture statutes, "[c]orporate criminal and civil cases reflect the application of agency principles . . . [that] knowledge obtained by corporate employees acting within the scope of their employment is imputed to the corporation") (citation omitted).

corporate liability for the wrongdoing of one of its agents, courts have recognized the adverse interest exception and the sole actor counter-exception but make no mention of the innocent decision-maker exception to imputation.[211] Similarly, in the context of punitive damages, the defendant in *Conseco Finance Servicing Corp. v. North American Mortgage Co.*[212] argued that wrongdoing by various individual employees "do[es] not amount to 'corporate' wrongdoing by North American."[213] The court disagreed, stating, "a corporate defendant is required to pay punitive damages so long as the employees were acting within the scope of their employment."[214]

A corporation's wrongful intent—imputed to the corporation through the wrongful intent of an employee—can also serve as a defense to an action by the corporation. In one such case, a purchaser was held not to have bought in good faith because of its agent's knowledge of information inconsistent with a good faith purchase.[215] In similar cases, courts have rejected corporations' tort claims against third parties because the corporations' imputed knowledge of the wrongdoing prevented them from claiming that they detrimentally relied on third party misrepresentations.[216]

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211. *See* Damato v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 94-C-3143, 1996 WL 164312, at *4-5 (N.D. Ill. Apr. 1, 1996) (explaining that, in the context of corporate liability for the fraud of its agents, "an agent's knowledge is usually imputed to its principal," but that knowledge will not be imputed when "'an agent act[s] adversely to the principal, and for his own benefit,'" except that "'where the self-interested agent is the sole or an essential representative of the corporation in the transaction in question, . . . his knowledge is held to be imputable to the corporation'" under the sole actor exception) (quoting Ash v. Georgia-Pacific Corp., 957 F.2d 432, 436 (7th Cir. 1992)); KE Prop. Mgmt. Inc. v. 275 Madison Mgmt. Corp., Civ. A. No. 12683, 1993 WL 285900, at *5-7 (Del. Ch. July 27, 1993) (laying out, in the context of civil fraud-based claim, general principles of imputation, the adverse interest exception, and the sole actor counter-exception).

212. 381 F.3d 811 (8th Cir. 2004).

213. *Id.* at 825.

214. *Id.* ("stating that it is 'generally held that an agent's malice is imputable to the corporation making the latter liable for malicious, willful or criminal torts of its agents or employees within the scope of their employment'" (quoting Webb Agency, Inc. v. Commercial Standard Ins. Co., 333 F. Supp. 966, 968 (E.D. Mo. 1971))).

215. Thypin Steel Co. v. Certain Bills of Lading, No. 96 Civ. 2166(RPP), 2002 WL 31465791, at *9 (S.D.N.Y. Nov. 4, 2002) (knowledge of information by M&R imputed to Asoma because M&R acted as agent for Asoma, thereby defeating Asoma's claim that it had purchased steel in good faith), *aff'd in part, vacated in part on other grounds*, 82 Fed. Appx. 738, 739-40 (2d Cir. 2003) (affirming the district court's determination that M&R acted as Asoma's agent but vacating the district court's dismissal of tort claims against Asoma because bad faith of the agent would be imputed to the principal).

216. *See* Bank of China, N.Y. Branch v. NBM LLC, 359 F.3d 171, 179 (2d Cir. 2004) ("[I]f the Bank's officers were aware of, and participated in the defendants' allegedly fraudulent activities, then neither they, *nor the Bank* relied on the purported misrepresentations in granting loans to the defendants," unless officers acted with adverse interest); FDIC v. Ernst & Young, 967 F.2d 166, 170-71 (5th Cir. 1992) (affirming the district court's dismissal of claims because "[the bank officer's] knowledge could be imputed to [the bank's] board of directors, and,

D. Imputation in the Context of Corporate Criminality

Oftentimes, the wrongdoing of high-ranking corporate officers is imputed to the corporation for purposes of corporate criminal liability. According to the Model Penal Code, "[a] corporation may be convicted of the commission of an offense if," among other things, "the commission of the offense was authorized, requested, commanded, performed or recklessly tolerated by the board of directors or by a high managerial agent acting in behalf of the corporation within the scope of his office or employment."[217] In cases of criminal liability, the adverse interest exception applies just as it did in cases involving punitive damages: "An official's misuse of corporate authority *in furtherance of the business interests of the company*, however illegal and misguided, will bind the corporation criminally."[218]

There is no suggestion in these traditional agency contexts—wrongdoing by non-employee agents of a corporation, corporate liability for fraud-based or punitive damages, or corporate criminal liability—that the existence of innocent corporate decision-makers, either on the board of directors or in other managerial positions, precludes imputation of wrongdoing to the corporation. To the contrary, imputation of wrongdoing is premised on the notion that the corporation itself is without fault:

> Although there has been no fault on the part of a corporation . . . , if a person acting in a managerial capacity either does an outrageous act or approves of the act by a subordinate, the imposition of punitive damages upon the

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therefore, [the bank] did not rely on the Arthur Young audit").

217. MODEL PENAL CODE § 2.07(1)(c) (1985); *see also* N.Y. PENAL LAW § 20.20 (McKinney 2004) (permitting a corporation to be found "guilty of an offense when . . . [t]he conduct constituting the offense is engaged in, authorized, solicited, requested, commanded or recklessly tolerated by the board of directors or by a high managerial agent acting within the scope of his employment and in behalf of the corporation"); United States v. Sun-Diamond Growers of Cal., 138 F.3d 961, 970 (D.C. Cir. 1998) (sustaining a corporation's criminal conviction based on the imputed wrongdoing of its vice-president for corporate affairs as "[t]he facts in the record . . .—that Douglas hid the illegal contribution scheme from others at the company and used company funds to accomplish it—do not preclude a valid finding that he undertook the scheme to benefit Sun-Diamond"); United States v. Automated Med. Labs., Inc., 770 F.2d 399, 406-07 (4th Cir. 1985) (noting that an agent's conduct, even if detrimental to corporation, may nonetheless be imputed to the corporation in a criminal case if motivated by intent to benefit the corporation); 1 KATHLEEN F. BRICKEY, CORPORATE CRIMINAL LIABILITY § 3:01-02 (2d ed. 1992) (noting that criminal liability is imposed on a corporation due to the conduct of its managers and officers within the scope of their duties: "if any agent possessed the capacity to act on behalf of the corporation—whether properly or not—it is an executive whose responsibilities include directing corporate affairs").

218. BRICKEY, CORPORATE CRIMINAL LIABILITY § 3:02 (emphasis added) (quotation omitted).

> [corporation] serves as a deterrent to the employment of unfit persons for important positions.[219]

Accordingly, wrongdoing is imputed because the corporation is responsible for the wrongdoing of *any one* of its high-level decision-makers, not because *all* of the decision-makers at a corporation are guilty of wrongdoing.

In sum, apart from the lower-court decisions suggesting an innocent decision-maker exception to imputation in the context of the *Wagoner* rule or the *in pari delicto* defense to corporate complicity claims, no cases or commentary involving the imputation of an agent's wrongdoing to the principal in any context even suggest, let alone hold, that the presence of innocent decision-makers provides an exception to imputing an agent's wrongdoing to the principal.

V. THE INNOCENT DECISION-MAKER EXCEPTION IS UNDESIRABLE AS A MATTER OF POLICY

To this point, this Article has focused on the innocent decision-maker exception in the context of existing legal doctrines, without considering whether the exception is desirable from a public policy perspective. The innocent decision-maker exception was not created by lower courts in a conscious attempt to refashion the law so as to better vindicate underlying policy concerns. Instead, the exception emerged as the result of an analytical mistake in applying the adverse interest exception and the sole actor rule. More specifically, courts have mistakenly inferred that if the *absence* of innocent decision-makers requires imputing responsibility to the corporation, then the *presence* of innocent-decision makers precludes imputation altogether. Nevertheless, it may be that the repetition and ex-post justification of this erroneous exception reflects some underlying desire on the part of courts to permit corporate complicity claims. One commentator noted that when courts believe that the *in pari delicto* doctrine requires them to dismiss corporate complicity claims by bankruptcy representatives, "[t]he frustration of the judges . . . is palpable."[220] Thus, the erroneous innocent decision-maker exception may have found fertile ground because courts believe that corporate complicity claims should not be barred.

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219. RESTATEMENT (SECOND) OF TORTS § 909 cmt. b (1979); *see also* Gleason v. Seaboard Air Line Ry. Co., 278 U.S. 349, 356 (1929) ("[F]ew doctrines of the law are more firmly established or more in harmony with accepted notions of social policy than that of the liability of the principal without fault of his own."); Premium Fin. Specialists, Inc. v. Hullin, 90 S.W.3d 110, 113 (Mo. Ct. App. 2002) ("[I]n this action seeking to impute liability for the fraudulent acts of an agent acting within his apparent authority . . . involving a principal [that] cloaks his agent with apparent authority, the principal can be vicariously liable to wronged third parties . . . even when the principal is innocent and deprived of any benefit.").

220. Davis, *supra* note 21, at 522.

Some courts and commentators do reject the *in pari delicto* defense in corporate complicity claims, not because of the innocent decision-maker exception, but rather on public policy grounds and interpretation of the bankruptcy code.[221] To date, these policy arguments have not been used to justify perpetuating the innocent decision-maker exception, but they could be and thus merit consideration. Part V.A, below, describes these policy arguments and the current state of relevant case law. Part V.B concludes that adopting an innocent decision-maker exception to imputation would not advance those policies. Moreover, creating an innocent decision-maker exception to imputation in the context of corporate complicity claims could create confusion about the rules of imputation in other agency law contexts and undermine the basic functions of those very rules.

A. Policy Grounds for Rejecting the In Pari Delicto Doctrine As Applied to Claims by Bankruptcy Representatives

The general rationale for the *in pari delicto* doctrine is that "to grant plaintiff relief would contravene the public good by aiding one to profit from his own wrong."[222] In the specific context of corporate complicity claims, the concern "is that the wrongdoer must not be allowed to profit from his wrong by recovering property that he had parted with in order to thwart his creditors."[223] Nevertheless, it may be argued that this concern disappears when all of the wrongdoers have been removed from their corporate roles. In *Scholes v. Lehmann*, Judge Posner explained that "the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated."[224] In that case, which involved a set of corporations in receivership rather than bankruptcy, Judge Posner explained that once the receiver was appointed, "[t]he corporations were no more [the wrongdoer's] evil zombies. Freed from his spell they became entitled to the return of the moneys—for the benefit not of [the wrongdoer] but of innocent investors—that [the wrongdoer] had made the corporations divert to unauthorized purposes."[225] At least one commentator has argued that the same is true for a corporation in bankruptcy: "The creation of the estate and appointment of a trustee transforms the zombie, to whom the unlawful acts of its agents were attributable, into a debtor entitled to compensation for the benefit of its innocent creditors for damage previously done to it."[226]

In light of these policy concerns, several courts faced with a corporation in receivership have held that once the receiver is appointed to manage the corporation and the wrongdoers are removed, the defense of *in pari delicto* no

221. *See, e.g.*, Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995); Alam, *supra* note 21.
222. Ross v. Bolton, 904 F.2d 819, 824 (2d Cir. 1990).
223. *Scholes*, 56 F.3d at 754.
224. *Id.*
225. *Id.*
226. Davis, *supra* note 21, at 522.

longer applies to claims on behalf of the corporation.[227] The Seventh Circuit appears to have endorsed this approach in the bankruptcy context as well,[228] and some commentators have argued forcefully that *in pari delicto* should not apply against a corporation's bankruptcy representatives.[229] Yet, almost all circuit courts of appeal have felt constrained by the terms of section 541 of the bankruptcy code to hold the trustee to the *in pari delicto* defense.[230] For example, the Tenth Circuit noted:

> Though the Seventh Circuit's reasoning in *Scholes* enjoys a certain appeal, both from doctrinal and public policy perspectives, we cannot adopt it in this case. Put most simply, Mr. Sender is a bankruptcy trustee acting under 11 U.S.C. § 541, and bankruptcy law, apparently unlike the law of receivership, expressly prohibits the result Mr. Sender urges.[231]

In response to holdings such as this, commentators have argued otherwise, contending that section 541 does not compel courts to apply the *in pari delicto* doctrine to bankruptcy trustees.[232]

B. The Innocent Decision-Maker Exception Does Not Vindicate These Policy Concerns

This Article does not attempt to analyze section 541 or determine whether the current circuit majority or the commentators are correct in their answers to whether *in pari delicto* applies to a trustee in bankruptcy.[233] For present

227. *See* FDIC v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) (adopting the rule when the FDIC is appointed as receiver); *Scholes*, 56 F.3d at 754 (adopting the rule in the context of a receivership).

228. *See* Fisher v. Apostolou, 155 F.3d 876, 880-81 (7th Cir. 1998) (stating that "the trustee's *Scholes* argument is convincing on the inapplicability of the *in pari delicto* doctrine," and declaring the priority of the trustee's claims against the wrongdoer defendants and accomplices).

229. *See* Alam, *supra* note 21, at 306, 330; Davis, *supra* note 21, at 519-20.

230. *See* Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1150-52 (11th Cir. 2006); Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 836 (8th Cir. 2005); Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP, 322 F.3d 147, 162-63 (2d Cir. 2003) (applying Texas law); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 354 (3d Cir. 2001); Terlecky v. Hurd (*In re* Dublin Sec., Inc.), 133 F.3d 377, 381 (6th Cir. 1997); Sender v. Buchanan (*In re* Hedged-Invs. Assocs., Inc.), 84 F.3d 1281, 1285 (10th Cir. 1996).

231. *In re Hedged-Invs. Assocs., Inc.*, 84 F.3d at 1285 (citation omitted).

232. *See* Alam, *supra* note 21, at 330; Davis, *supra* note 21, at 519-20.

233. It is worth noting that one of the Eleventh Circuit's recent decisions, in which it held that trustees cannot escape the application of *in pari delicto*, specifically considers the arguments of both Alam and Davis, concluding that "the legal commentator[s] make[] the same flawed arguments about legislative history and the *Scholes* decision that we have already rejected." *Edwards*, 437 F.3d at 1152.

purposes, it is only asserted that the innocent decision-maker exception is not a proper vehicle for vindicating the policy concerns underlying this debate. In fact, because the innocent decision-maker doctrine is an unwitting doctrinal error rather than a conscious attempt to fashion an exception that vindicates certain policy concerns, it should come as no surprise that the exception fails to address those concerns properly.

These policy concerns favor permitting suits by a corporation's bankruptcy representative on the assumption that the wrongdoing officers have been removed from their positions and will not benefit from any recovery. Following this approach, corporate complicity claims should be permitted *only* when one can be assured that the wrongdoers have been removed from their positions, no longer have any ownership interest in the company, and do not stand to benefit should the corporation recover from a third party.

Recognition of the innocent decision-maker exception does not lead to this result. The presence or absence of innocent decision-makers *at the time of the fraud* who could and would have put an end to the misconduct does not correspond with whether the wrongdoers *now* stand to benefit from the corporation's potential recovery. For example, picture a corporation run entirely by wrongdoers, with no innocent decision-makers. If this corporation declares bankruptcy and a court appoints a trustee, the policy arguments suggest that the corporation should be allowed to recover from third parties.[234] But, due to the lack of innocent decision-makers at the time the wrongdoing was committed, the innocent decision-maker exception does not apply. On the other hand, imagine a corporation with innocent decision-makers and wrongdoing officers who retain either a position within the company or an ownership interest. These wrongdoing officers stand to benefit if the corporation is allowed to recover against third parties, notwithstanding the existence of innocent decision-makers. In short, the innocent decision-maker exception does not vindicate the policy interests that may be leading some courts to perpetuate its existence.

In addition, perpetuating the innocent decision-maker exception to the imputation of wrongdoing to a corporation via the *in pari delicto* defense or *Wagoner* rule is unwise because the exception would likely spill over into other areas of agency law. As shown in Part IV, the knowledge or wrongdoing of an agent is imputed to the principal under traditional principles of agency law unless the adverse interest exception applies. In many of these contexts, knowledge or wrongdoing is imputed even though the principal is innocent and ignorant of any wrongdoing. Recognizing an innocent decision-maker exception to imputation in the context of corporate complicity claims would threaten to reverse the traditional imputation rules in these other contexts.

Moreover, even if claims by bankruptcy representatives against third parties are barred under the *in pari delicto* defense or *Wagoner* rule, that does not necessarily absolve those third parties of all liability. As noted in the outset,

234. *See* Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995).

plaintiffs typically file assorted claims after a corporate bankruptcy, particularly when wrongdoing by corporate insiders is suspected. If those wrongdoers combine with third parties to wrongfully harm specific creditors or shareholders, the creditors or shareholders—who committed no wrongdoing and thus face no *in pari delicto* problem—may assert direct claims for recovery against both the insiders and the compliant third parties.[235]

VI. CONCLUSION

Corporate complicity claims brought by a corporation's bankruptcy representative against third parties for their alleged participation in wrongdoing with the corporation's former officers are a significant part of the suite of legal remedies pursued in the wake of corporate wrongdoing. Enron, "the name that had become synonymous with corruption and fraud,"[236] has collected over $700 million through corporate complicity claims against its former bankers to settle allegations of aiding and abetting Enron executives' accounting fraud.[237] Similarly, the Adelphia bankruptcy court recently permitted multi-million

235. *See In re Dublin Sec., Inc.*, 133 F.3d at 380 ("[B]y dismissing the trustee's suit against the attorneys and law firms, the district court did not insulate the defendants from all civil liability. In fact, as the court noticed judicially, the defendants here are also named as defendants in other actions filed by the creditors seeking compensation for the allegedly fraudulent activity in which the defendants engaged."); Davis, *supra* note 21, at 545 & n.172 ("Courts regularly point out that the creditors themselves may assert these claims on their own, and courts sometimes point out that such litigation is pending.").

If third parties violate the federal securities laws along with corporate insiders, they can be named in federal securities claims. In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the Supreme Court rejected aiding-and-abetting liability under the federal securities laws; thus, third parties can be held liable only if their actions rise to the level of primary violations of the securities laws. *Id.* at 185, 191. Courts are widely split over the standard for a primary violation. *Compare In re* Homestore.com, Inc. Sec. Litig., 252 F. Supp. 2d 1018, 1037-38 (C.D. Cal. 2003) (rejecting primary liability for third parties for alleged knowing participation in transactions with Homestore.com that Homestore.com allegedly later misrepresented in its financial statements) *and* Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Dynegy, Inc. (*In re* Dynegy, Inc. Sec. Litig.), 339 F. Supp. 2d 804, 916-18 (S.D. Tex. 2004) (rejecting primary liability for third-party bank for its allegedly knowing participation in transactions where Dynegy allegedly misrepresented its financial statements) *with* Quaak v. Dexia, S.A., 357 F. Supp. 2d 330, 341-42 (D. Mass. 2005) (holding that plaintiff stated a claim for securities fraud against Dexia Bank Belgium based on allegations of bank's knowing involvement in transactions with Lernout & Hauspie, who allegedly misrepresented its financial statements) *and In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 695-704 (S.D. Tex. 2002) (holding that plaintiff stated a claim for securities fraud against defendant banks based on allegations of the banks' knowing involvement in transactions with Enron, who allegedly misrepresented its financial statements).

236. Robert Kahn, *Manager's Journal: Meet Pipeco (Née Enron)*, WALL ST. J., May 27, 2003, at B2.

237. Creswell, *supra* note 9, at C3.

dollar claims to proceed against dozens of banks based on their alleged complicity in Adelphia's top officers' wrongdoing.[238]

These claims have become easier to plead and prove due to some courts' acceptance of an innocent decision-maker exception to the general rule that an officer's wrongdoing is imputed to the corporation and bars any action by the corporation against third parties for their participation. But these courts have recognized the innocent decision-maker exception only by mischaracterizing the sole actor counter-exception to the adverse interest exception to the general rule of imputation. Corporations should not be permitted to evade responsibility for the acts of their officers solely because innocent decision-makers existed somewhere in their corporate hierarchy. The innocent decision-maker exception to imputing wrongdoing by corporate officers to the corporation should be rejected because it is a doctrinal error and contradicts the basic imputation rules of agency law.

238. Adelphia Commc'ns Corp. v. Bank of Am., N.A. (*In re* Adelphia Commc'ns Corp.), 330 B.R. 364, 368, 376-77 (Bankr. S.D.N.Y. 2005).