INTO THE PERFECT STORM: THE FAILURE OF TRUSTEE ACTIONS AGAINST THIRD PARTIES

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INTRODUCTION

In 2009, Ponzi schemes[1] collapsed in record numbers. From January of 2007 to June of 2009, they made up 3.5% of the federal

1. The courts define a Ponzi scheme as any scheme that uses fraudulently obtained funds to pay off previous investors, forestalling disclosure of the fraud. Bayou Superfund, LLC v. WAM Long/Short Fund II (*In re* Bayou Grp., LLC), 362 B.R. 624, 633 (Bankr. S.D.N.Y. 2007) (rejecting a narrower definition of Ponzi scheme that required high returns and no legitimate business and collecting cases embracing the more general definition). *See also* Danning v. Bozek (*In re* Bullion Reserve of N. Am.), 836 F.2d 1214, 1219 n.8 (9th Cir. 1988) ("[a] 'Ponzi' scheme is any sort of fraudulent arrangement that uses later acquired funds or products to pay off previous investors.").

class action docket, up from just .2% throughout all of 2005–2006.[2] Bernard L. Madoff's multi-decade fraud was the largest of these Ponzi schemes. Over the course of 20 years, Madoff defrauded his investors of billions of dollars in cash, generating sixty-five billion dollars in paper losses.[3] The victims included major institutional investors, individuals, and charities, including, among others, Nobel Laureate Elie Weisel and his Elie Weisel Foundation for Humanity.[4] Though the Madoff fraud was the largest such scheme in history, it was by no means an isolated incident: R. Allen Stanford is alleged to have defrauded investors of more than $7 billion[5] and Mark Dreier another $400 million dollars.[6] The schemes themselves are not new. After all, Charles Ponzi perpetrated his eponymous fraud over 80 years ago. Modern Ponzi schemers, however, take advantage of global capital markets and sophisticated electronic trading systems to prolong their schemes for far longer than they previously could have.[7] Yet this only delays an inevitable collapse. Eventually the music stops and the party ends. A rush of redemptions, like those tied to the global financial meltdown, often triggers the collapse.[8] When the end does come, the most common result is a Chapter 7 liquidation under the Bankruptcy Code ("Code").

In a Chapter 7 liquidation of a Ponzi scheme, the Bankruptcy Trustee, a practitioner appointed by the court and overseen by the United States' Trustee's office, is charged with unwinding such a scheme. Courts, however, have interpreted the Code to leave the trustee with few prospects for recovery.[9] First, the nature of the

2. Kenneth C. Johnston et al., *Ponzi Schemes and Litigation Risks: What Every Financial Services Company Should Know,* 14 N.C. BANKING INST. 29, 34 n.38 (2010).

3. *See* Christine Hurt, *Evil Has A New Name (And A New Narrative): Bernard Madoff*, 2009 MICH. ST. L. REV. 947, 952 (2009) (recording sixty-five billion dollars in paper losses and citing estimates that put actual losses at twenty billion).

4. *See* Stephanie Strom, *Elie Wiesel Levels Scorn at Madoff*, N.Y. TIMES, Feb. 26, 2009, http://www.nytimes.com/2009/02/27/business/27madoff.html.

5. Complaint, S.E.C. v. Int'l Bank, Ltd., *available at* http://www.sec.gov/litigation/complaints/2009/comp20901.pdf.

6. *See* Benjamin Weiser, *Lawyer Pleads Guilty in $400 Million Fraud*, N.Y. TIMES, May 12, 2009, at A23, *available at* http://www.nytimes.com/2009/05/12/nyregion/12dreier.html.

7. *See, e.g.*, Picard v. JPMorgan Chase & Co., 460 B.R. 84 (S.D.N.Y. 2011) (summarizing decades long relationship between Bernard Madoff and JPMorgan Chase); *see also* Clarence L. Pozza, Jr., et al., *A Review of Recent Investor Issues in the Madoff, Stanford and Forte Ponzi Scheme Cases,* 10 J. BUS. & SEC. L. 113, 115 (2010) (discussing claims against the banks and counterparties involved in various Ponzi Schemes).

8. Joshua Marcus & Jake Greenberg, *Ponzi Schemes: Washed Ashore by Recession's Low Tide, Reveal Controversial Issues,* 29 AM. BANKR. INST. J. 48 (2010).

9. *See infra* Part 2 and accompanying notes.

scheme means that the debtor itself is unlikely to have many assets.[10] Second, although veil-piercing is an option, in recent cases like the Madoff Ponzi scheme, it has done little good.[11] Finally, a series of formalistic bars prevents the trustee from going after the deep-pocketed third parties that may have contributed to the fraud.[12] Commentators and judges alike have pointed out the inequities created by this "perfect storm" of code provisions.[13] The trustee cannot sue on behalf of the estate because, in theory, he was a part of the fraud[14] and often there are no transfers or preferences to avoid. At the same time, the trustee's power under Section 544 has been interpreted by courts to preclude the trustee from suing as a hypothetical lien creditor.[15] The result is that creditors who could not have contracted for protection are out of luck. Commentators have spilled much ink analyzing potential loopholes in the courts' reasoning and others have brought a contortionist's skill to statutory interpretation seeking an exception.[16] The answer is more straightforward: the trustee's powers should extend only as far as

10. Ponzi schemes collapse when there are insufficient new funds to cover redemptions, thus by definition they are already insolvent at the time of collapse. Compare Madoff's 65 billion in liabilities and 200–300 million in unredeemed assets. Complaint at 5, 6, SEC v. Madoff, No. Civ. 08-10791, 2009 WL 980288 (S.D.N.Y. Apr. 10, 2009), 2008 WL 5197070, *available at* http://www.sec.gov/litigation/complaints/2008/comp-madoff121108.pdf; Pozza, Jr., et al., *supra* note 7, at 116.

11. The Madoff proceeding was substantively consolidated with his personal case. Consent Order Substantively Consolidating the Estate of Bernard L. Madoff into the SIPA Proceeding of Bernard L. Madoff Investment Securities LLC and Expressly Preserving All Rights, Claims and Powers of Both Estates, Sec. Investor Prot. Corp. v. Bernard L. Madoff Investment Securities LLC (*In re* Bernard L. Madoff), No. 09–11893 (Bankr. S.D.N.Y. June 9, 2009), *available at* http://madoff.com/document/dockets/000525-252-order.pdf. *See generally* 1 COLLIER ON BANKRUPTCY ¶ 105.08[1], at 105–23 (Alan N. Resnick & Henry J. Sommer eds., LexisNexis, 16th ed. 2008) (discussing the linkages in bankruptcy law between veil piercing and substantive consolidation); *Union Savings Bank v. Augie/Restivo Banking Co., 8*60 F.2d 515, 518 (2d Cir. 1988).

12. *See infra* Part 3.

13. *See, e.g.*, 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, 315–17 (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 (2005); William McGrane, *The Erroneous Application of the Defense of In Pari Delicto to Bankruptcy Trustees*, 29 CAL. BANKR. J. 275 (2007); Samuel C. Wasserman, *Can the Trustee Recover? Imputation of Fraud to Bankruptcy Trustees in Suits Against Third-Party Service Providers*, 77 FORDHAM L. REV. 365 (2008).

14. *See infra* Part 3.A.ii.

15. *See infra* Part 3.A.ii.

16. *See* note 13 & accompanying text (collecting articles).

they can be justified by the doctrines that motivate bankruptcy law. Doing so would provide the trustee with precisely the powers she has been denied with far less complexity. This Note argues that the courts have misconstrued the role of the bankruptcy trustee by limiting her powers without any theoretical justification. Specifically it argues that an application of the basic, foundational principles of the Bankruptcy Code suggests that the trustee should have the power to bring actions against third parties on behalf of creditors. Practitioners and judges cannot be expected to remedy the situation alone without departing from a plain reading of the Code. Legislative action would therefore provide the most effective mechanism for aligning bankruptcy law with its theoretical justifications. In the absence of a willing legislature, however, the Bar and the judges who face this issue on a daily basis would do well to confront the policy implications of the issue head-on and interpret the Code to permit the trustee to bring actions against third parties.

There are two leading theoretical explanations for bankruptcy: the collectivist and traditional theories. The collectivist account focuses on maximizing recovery and justifies bankruptcy as a tool to reduce administrative costs and decrease strategic behavior by individual creditors.[17] The traditional account is broader and considers the benefits of bankruptcy for the debtor and the creditors.[18] In the collectivist account, the trustee's powers to maximize the creditors'

17. *See generally* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Douglas G. Baird, *Bankruptcy's Uncontested Axioms,* 108 YALE L.J. 573, 592 (1998); Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 726 (1984) [hereinafter Jackson, *Avoiding Powers*]; Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 866 (1982) [hereinafter Jackson, *Bankruptcy, Non-Bankruptcy*]; Thomas H. Jackson, *Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules*, 60 AM. BANKR. L.J. 399, 400 (1986) [hereinafter Jackson, *Of Liquidation*]; Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain,* 75 VA. L. REV. 155, 190 (1989).

18. *See* Theodore Eisenberg, *A Bankruptcy Machine that Would Go of Itself*, 39 STAN. L. REV. 1519 (1987); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 721 (1991) [hereinafter Korobkin, *Rehabilitating Values*]; Donald R. Korobkin, *Value and Rationality in Bankruptcy Decisionmaking*, 33 WM. & MARY L. REV. 333 (1992) [hereinafter Korobkin, *Value and Rationality*]; Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 55–59 (1992) (arguing creditors' bargain theory ignores reality); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 795–97 (1987) [hereinafter Warren, *Bankruptcy Policy*]; Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World,* 92 MICH. L. REV. 336 (1993) [hereinafter Warren,

return are circumscribed by the need to minimize the potential for forum shopping and distortion of bargained-for state law entitlements.[19] At times, this suggests a narrow role for the trustee. For instance, she theoretically should not always be able to rearrange rights between creditors.[20] Yet applying the same limits to trustee suits against third parties misses the fundamental differences between the aftermath of a Ponzi scheme and a normal Chapter 7 or Chapter 11 bankruptcy case. As I explain in Part Four below, collectivist theory, as applied to a Ponzi scheme, suggests a far broader role.[21] In a Ponzi bankruptcy, there are few participants, no secured creditors, and little going-concern value.[22] Crucially, individual creditors do not have incentives to bring claims against third parties in this situation, even though doing so would maximize the group's total recovery.[23] The costs of racing behavior and uncertainty plague the process. Far from suggesting a narrow role for the trustee, these are precisely the circumstances where the collectivist account dictates that the trustee should have broad powers.

Part Two begins with a brief overview of the mechanics of a Ponzi scheme, with a particular focus on the causes of action typically available against third parties in a bankruptcy case. They range from negligence and deepening insolvency to more traditional theories of aiding and abetting fraud. Part Three considers the courts' construction of Sections 541, 544, and 704 in light of the Supreme Court's holding in *Caplin v. Marine Midland Grace Trust Co. of New York*.[24] Part Four presents the collectivist and traditional accounts. The Note then returns to the first principles of bankruptcy law by evaluating whether the courts' approach is in line with either theory of bankruptcy. It finds that the courts' construction of the trustee's power is inconsistent with either the collectivist or traditional bankruptcy theory and misconstrues the trustee's proper role. Finally, Part Five considers some of the remedies that have been suggested, from reinterpreting Section 544 to amending the Code as suggested by the *Caplin* majority. Ultimately, this Note concludes that while amending the Code to provide the trustee with the power to sue third parties on behalf of creditors is a good idea, the

Policymaking]; Elizabeth Warren & Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 WASH. U. L.Q. 1257, 1265–86 (1994).

19. *See infra* notes 171–86 & accompanying text.
20. *See infra* notes 209–11 & accompanying text.
21. *See infra* notes 208–28 & accompanying text.
22. *See supra* notes 8–10 & accompanying text.
23. *See infra* notes 218–19 & accompanying text.
24. 406 U.S. 416 (1972).

power has no place in Section 544 and properly requires Congress to either adopt a new Code provision or modify §704.

I.
THE MODERN PONZI SCHEME

As the recent financial crisis spiraled outward, the Commodities Futures Trading Commission ("CFTC") filed twenty-two actions to halt ongoing schemes during the first six months of 2009.[25] Though many schemes are smaller, a few stand out for their incredible scope, with losses in the billions. For example, according to the Department of Justice, R. R. Allen Stanford's scheme totaled seven billion dollars, second only to Madoff's sixty-eight billion dollar fraud.[26] While all of these schemes are fundamentally similar—each using new money to pay out old investors—the larger schemes are more likely to require the involvement of third party facilitators like banks and brokers.[27] For instance, while some smaller schemes rely on cash from victims, it would be difficult to operate a securities-based scheme like Madoff's without the use of banks, and the same holds for Stanford's scheme, which relied on savings accounts.[28] Along with several other characteristics common to all Ponzi schemes, this makes them particularly attractive targets for enterprising trustees. This Part explains the characteristics that make third parties frequent targets for trustees and then examines the causes of action trustees most frequently pursue.

A. Three Reasons to Target Third Parties

First, courts consider all Ponzi schemes insolvent from the moment they begin to operate.[29] Moreover, every transfer made as a part of a Ponzi scheme has no purpose other than to "hinder, delay

25. *See* Kevin McCoy, *Recession Forces Unraveling Ponzi Schemes into the Open*, USATODAY.COM (Apr. 17, 2009), http://www.usatoday.com/money/markets/2009-04-17-markets-recession-scheme-ponzi_N.htm.

26. *See* Zachary Goldfarb and Anita Kumar, *Stanford, 5 Associates Charged with Running $7 Billion Ponzi Scheme*, WASH. POST. (June 20, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/06/19/AR2009061900078.html; Leslie Wayne, *Troubled Times Bring Mini-Madoffs to Light*," N.Y. TIMES (Jan. 28, 2009), http://www.nytimes.com/2009/01/28/business/28ponzi.html.

27. *See infra* notes 38–45 & accompanying text.

28. *See infra* note 38 & accompanying text.

29. Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 401 (2009); Bayou Superfund, LLC v. WAM Long/Short Fund II (*In re* Bayou Group, LLC), 362 B.R. 624 (Bankr. S.D.N.Y. 2007).

or defraud" creditors.[30] Because they are insolvent, this makes any transfer made during the course of the scheme technically a fraudulent conveyance.[31] Under Section 548 of the Bankruptcy Code, these transfers can be voided in excess of the amount transferred by the debtor in good faith.[32] Finally, the nature of the scheme means that excepting net-winners and the complicit, on a theoretical level, each investor is defrauded equally on a pro rata basis.[33]

The second reason trustees target third parties in Ponzi scheme bankruptcies is the relatively small size of the estate. Although Madoff's estate eventually grew to over nine billion dollars,[34] before the trustee began bringing avoidance actions and clawbacks, the estate was unlikely to offer much solace for the creditors.[35] This flows logically from the nature of the scheme: Ponzi schemes fail because their perpetrators run out of money to cover redemptions. Thus, in most cases, there is initially little left over in the estate besides the furniture.[36] This leads trustees to look outward at avoidance actions and potential suits against third parties to bolster prospects for recovery to enlarge the estate.[37]

Lastly, the most complex (and often most harmful) Ponzi schemes are likely to involve deep-pocketed third parties on some level.[38] Again, consider the Madoff scheme. Perpetuating such a scheme required recruiting new investors and satisfying old inves-

30. *In re* Manhattan Inv. Fund, 397 B.R. 1, 8 (S.D.N.Y. 2007) ("There is a general rule—known as the 'Ponzi scheme presumption'—that such a scheme demonstrates 'actual intent' as matter of law because 'transfers made in the course of a Ponzi scheme could have been made for no purpose other than to hinder, delay or defraud creditors.'") (quoting *In re* Manhattan Fund Ltd., 359 B.R. 510, 517–18 (Bankr. S.D.N.Y. 2007)).

31. Cherry & Wong, *supra* note 29, at 399; Hurt, *supra* note 3, at 971–72; UNIF. FRAUDULENT TRANSFER ACT §§ 4–5 (1984).

32. 11 U.S.C. § 548(a)(1) (2006) ("The trustee may avoid any transfer . . . if the debtor voluntarily or involuntarily . . . incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred.").

33. Cherry & Wong, *supra* note 29, at 407.

34. THE MADOFF RECOVERY INITIATIVE, http://madoff.com/recoveries-04.html (last visited Feb. 28, 2012) (recording over nine billion dollars in recoveries).

35. *See id.* (noting that the trustee was able to glean less than one billion from the estate before avoidance and clawback actions, less than 1/17th of the losses recognized by the courts).

36. *See supra* note 10.

37. Wasserman, *supra* note 13, at 366–68. *See also* Johnston et al., *supra* note 2, at 45–47.

38. *See* Johnson et al., *supra* note 2, at 34–43 (discussing various doctrines for establishing the liability of financial institutions for their role in Ponzi schemes); Del Quentin Wilber, *Economic Downturn Accelerates Collapse of Ponzi Schemes*, WASH.

tors that their investments were safe and growing. The Madoff trustee estimates that some eight billion dollars of Madoff's investments were recruited through the use of "feeder funds" marketed by major banks.[39] Funds like these require administrators and custodians, who are likely to be large and reputable financial services companies.[40] Moreover, keeping current investors happy requires falsified trade records and accounting records, which implicates additional third parties.[41] For instance, in *Hirsch v. Arthur Andersen*, Ponzi scheme victims sued the auditors who failed to uncover the fraud.[42] In *Shearson Lehman Hutton, Inc. v. Wagoner*, victims sued the brokers responsible for "churning" the portfolio, a process used to generate the appearance of legitimate trading activity.[43] In schemes like Stanford's and Madoff's, both of which involved fictitious savings accounts, third-party banks are often crucial counterparties.[44] Finally, Ponzi schemes involving hundreds of millions or billions of dollars may rely on banks to warehouse proceeds before distribution.[45]

Taken together, these three factors make lawsuits against third parties, and especially against financial service providers, extremely attractive. The transactions themselves are definitively fraudulent, the paltry estate leaves the trustee with few other options, and third-parties—often large, deep-pocketed financial institutions—are necessarily involved. In short, it is unsurprising that so many trustees hear the siren's song of third-party liability.

B. Available Causes of Action

When they do bring suit, trustees can choose from several different state law causes of action. Chief among them are negligence, fraudulent transfer, breach of fiduciary duty, aiding and abetting

POST, Jun. 12, 2009, at B1 (discussing role of banks and new technologies in perpetuating Ponzi schemes).

39. Amended Complaint at 21, Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, No. 08-01789 (BRL) (Bankr. S.D.N.Y. Dec. 5, 2010).

40. *Id.* at 137–38.

41. *See* Hirsch v. Arthur Andersen & Co., 72 F.3d 1085 (2d Cir. 1995) (trustee suit against third party accountants for their complicity in a Ponzi Scheme); Sharp Int'l Corp. v. KPMG LLP (*In re* Sharp Int'l Corp.), 278 B.R. 28 (Bankr. E.D.N.Y. 2002) (trustee suit against third party accountants for their negligent and reckless failure to uncover and disclose Chapter 11 corporate debtor's fraud).

42. Hirsch, 72 F.3d 1085.

43. 944 F.2d 114, 117 (2d Cir. 1991).

44. Zachary A. Goldfarb, *SEC Alleges $8 Billion Savings Fraud*, WASH. POST, Feb. 18, 2009, at D1.

45. Johnston et al., *supra* note 2, at 43–45 (discussing lawsuits against J.P. Morgan Chase & Co. for its complicity in the Madoff scheme).

fraud, and deepening insolvency.[46] Though the claims operate under different names, the crux of each allegation is fundamentally the same.[47] Each is predicated on the claim that professional malfeasance either intentionally or negligently perpetuated the scheme. As I explain in Part Four, the availability of a state law cause of action is essential because minimizing the deviation between underlying state law and bankruptcy is a central goal of the Supreme Court's bankruptcy jurisprudence.[48] Thus, while I explain each possible cause of action below, it is important to keep in mind that so long as at least one theory is viable, the analysis stands.

For a negligence action to succeed, the third party must (1) owe the creditors a duty of care, (2) breach that duty, and (3) proximately cause damages.[49] The difficulty with this cause of action is that, except in a few anomalous cases, the third party is unlikely to owe the creditors a duty of care.[50] For instance, a duty of care may arise when a bank or investment fund directly solicits investments from creditors.[51] Absent such a relationship, however, there is un-

46. *See id.* at 34–43 (discussing theories of liability under which bank liability obtains including breach of fiduciary duty, negligence, negligent misrepresentation, fraudulent transfer, and aiding and abetting fraud).

47. Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 453 (7th Cir. 1982) (Posner, J.) ("[B]reach of contract, negligence, and fraud, when committed by auditors, are a single form of wrongdoing under different names.").

48. *See* Butner v. U.S., 440 U.S. 48, 55 (1979)

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy."

(citations omitted).

49. *See* Prosser, Torts (4th ed), § 30; Integrated Waste Servs., Inc. v. Akzo Nobel Salt, Inc., 113 F.3d 296, 299 (2d Cir. 1997). Generally "professional malpractice is a species of negligence." Hydro Investors, Inc. v. Trafalgar Power Inc., 227 F.3d 8, 15 (2d Cir. 2000) (quoting *Marks Polarized Corp. v. Solinger & Gordon*, 476 N.Y.S.2d 743, 744 (1984)).

50. *See* Prosser, Torts (4th ed.), § 30. *See also* Sharp Int'l Corp v. KPMG LLP (*In re* Sharp Int'l Corp.), 278 B.R. 28, 35 (Bankr. E.D.N.Y. 2002) (finding Trustee had sufficiently pled negligence based on accountant's failure to uncover fraud). *But see* Sec. Investor Prot. Corp. v. BDO Seidman, LLP, 222 F.3d 63, 73 (2d Cir. 2000) (establishing a test for negligent misrepresentation when the professional is aware that plaintiffs would rely on their work product in the context of a suit against an accounting firm).

51. This may arise out of a vehicle like a feeder fund, which refers potential investors to the scheme in exchange for fees. *See, e.g.,* S.E.C. v. Cohmad Sec. Corp., No. 09-CV-5680, 2010 WL 363844, at *3 (S.D.N.Y. Feb. 2, 2010) (finding a duty for

likely to be such a claim. Moreover, if an action does exist, it would only accrue to those individual creditors who were actually induced to invest by the third party. As I explain in Part Three, trustees attempting to bring these individual-based actions have not had success in court and the theoretical basis for a collective bankruptcy process does not support making such actions available to the trustee.[52]

Fraudulent transfer claims rely on the Uniform Fraudulent Transfers Act,[53] as embodied in Section 548 of the Code.[54] As noted above, Ponzi schemes are technically insolvent from their inception. But for a transfer to be fraudulent, it must actually be a transfer, as opposed to a bailment.[55] Taken together, these two requirements doom most fraudulent transfer actions against third-party service providers. The payments for services, which are more likely to be considered transfers, are unlikely to be of a magnitude to make a dent in losses running into the billions. Although Section 548 may play a role in recovery, it is primarily clawback actions that redistribute the costs of the fraud between net winners and losers.[56]

a Madoff feeder fund, however dismissing under Rule 9(b) for failing to plead facts "with particularity . . . constituting fraud").

52. *See infra* notes 92–168 & accompanying text.

53. UNIF. FRAUDULENT TRANSFER ACT § 4(a)(1) (1984) ("A transfer made . . . by a debtor is fraudulent as to a creditor . . . if the debtor made the transfer or incurred the obligation: [w]ith actual intent to hinder, delay, or defraud any creditor of the debtor.").

54. "The trustee may avoid any transfer . . . if the debtor voluntarily or involuntarily . . . made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted." 11 U.S.C. § 548(a)(1) (2006).

55. Section 548 only applies to transfers of interests in property and thus cannot be applied to a bailment. *Id.*; Golden v. The Guardian (*In re* Lenox Healthcare, Inc.), 343 B.R. 96, 100 (Bankr. D.Del. 2006) (noting that an exercise of avoidance powers requires "a transfer of property of the estate"). *See also* Maxwell v. Penn Media (*In re* marchFirst), No. 01-B-24742, 2010 WL 4027723, at *8 (Bankr. N.D. Ill. Oct. 14, 2010) ("[T]here was no such transfer in this case because marchFirst made the payments to Penn with NCS funds it was holding as agent or bailee.").

56. *See* Bayou Superfund, LLC v. WAM Long/Short Fund II (*In re* Bayou Grp., LLC), 396 B.R. 810, 827 (Bankr. S.D.N.Y. Oct. 16, 2008) (discussing the "equitable" role of Section 548 in effecting "Congress' determination that under limited circumstances creditors must share equally in the insolvency. . . ."); Karen E. Nelson, *Turning Winners into Losers: Ponzi Scheme Avoidance Law and the Inequity of Clawbacks*, 95 MINN. L. REV. 1456, 1475 (2010) (discussing use of Section 548 in Ponzi schemes to clawback fictitious profits). In a clawback action the trustee relies on Section 548(a)(1), which empowers the trustee to void transfers if he can show that (1) less than reasonably equivalent value was received, and (2) the transferee

This distribution of losses between the creditors is the subject of constant attention and debate among both judges and academics[57] and is beyond the scope of this Note.

Several courts have embraced deepening insolvency as a cause of action, starting with the Seventh Circuit in *Schact v. Brown*.[58] Though exact definition is elusive, the essence of this cause of action is that a third party's conduct allowed the corporation to prolong its existence, incurring additional debt and wasting additional resources.[59] In *Schact,* Judge Posner wrote that courts that reject deepening insolvency as a cause of action:

> [R]est upon a seriously flawed assumption, i.e., that the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests. This premise collides with common sense, for *the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability*.[60]

Despite Judge Posner's forceful words, not every court accepts the theory and it remains a question of state law. Thus, although the Third Circuit accepted deepening insolvency as a stand-alone cause of action in *Official Committee of Unsecured Creditors v. R.F. Lafferty*,[61] a result that has been endorsed by the Ninth[62] and Second

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was insolvent at the time of the transfer. 11 U.S.C. § 548(a)(1) (2006); Bayou Superfund, LLC v. WAM Long/Short Fund II (*In re* Bayou Grp., LLC), 396 B.R. at 827 (applying section 548(a)(1) to trustee's Ponzi scheme clawback action).

57. *See generally* Adler, *supra* note 17 (critiquing the use of loss distribution amongst creditors as a risk-sharing mechanism); Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993); Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006) (discussing deviations from absolute priority and distributions of equity in Chapter. 11 cases); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27, 44–68 (1991); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994).

58. 711 F.2d 1343, 1350 (7th Cir. 1983), *cert. denied,* 464 U.S. 1002 (1983) ("[T]he corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability.").

59. *See id.*; Smith v. Arthur Andersen, LLP, 421 F.3d 989, 1003–04 (9th Cir. 2005) (finding a "cognizable harm" when an insolvent corporation's existence was prolonged); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 350 (3d Cir. 2001) (recognizing deepening insolvency based on continued corporate existence); Allard v. Arthur Andersen & Co., 924 F. Supp. 488, 494 (S.D.N.Y. 1996) (same); Feltman v. Prudential Bache Sec., 122 B.R. 466, 473 (S.D. Fla. 1990) (same).

60. Schacht, 711 F.2d at 1350 (emphasis added) (citations omitted).

61. 267 F.3d 340 (3d Cir. 2001).

62. *Cf.* Smith, 421 F.3d at 1003–04.

Circuits,[63] acceptance is by no means universal.[64] In the Delaware Chancery Courts, then-Vice Chancellor Strine refused to recognize it.[65] Moreover, commentators have questioned the logic of accepting deepening insolvency as a stand-alone cause of action, as opposed to merely as a theory of damages.[66] Even if accepted, the application of deepening insolvency to a Ponzi schemes remains unclear. For instance, *Schact* distinguishes between *Cenco*-like corporations, which are established purely as vehicles for fraud, and legitimate corporations that can be harmed, as in *Schact* itself.[67] As a theoretical matter this would seem to conflict with the application of deepening insolvency actions to Ponzi schemes, as was the case in *R.F. Lafferty*.[68] Where the corporation's sole interest is in perpetuating a fraud, it is difficult to see how deepening insolvency does the corporation any harm.

Finally, even if one accepts deepening insolvency as a cause of action there still exists the subsidiary question of a standard of conduct. The Ninth Circuit has recognized liability predicated on a negligence standard.[69] However, in *In re CitX*, the Third Circuit took a harder line by requiring proof of something more, but left the ultimate standard unclear.[70]

Regardless of these uncertainties, deepening insolvency remains attractive from the trustee's point of view, as theoretically al-

63. Allard, 924 F. Supp. at 494. *But see* Official Comm. of Unsecured Creditors v. Blomen (*In re* Hydrogen, LLC), 431 B.R. 337, 357 (Bankr. S.D.N.Y. 2010) (construing New York law to reject deepening insolvency as a stand-alone cause of action).

64. *See, e.g.*, Bondi v. Citigroup, Inc., No. BER-L-10902-04, 2005 WL 975856, at *16 (N.J. Super. Ct. Law Div. 2005), *appeal granted by* 878 A.2d 850 (N.J. 2005); *In re* Hydrogen, LLC, 431 B.R. at 357 (construing New York law to reject deepening); Limor v. Buerger (*In re* Del-Met Corp.), 322 B.R. 781, 807 (Bankr. M.D. Tenn. 2005) (discussing the lack of a clear definition of deepening insolvency); *In re* VarTec Telecom, Inc., 335 B.R. 631 (Bankr. N.D. Tex. 2005) (construing Texas law); Schnelling v. Crawford (*In re* James River Coal Co.), 360 B.R. 139, 178–180 (Bankr. E.D. Va. 2007) (construing Virginia law).

65. Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168, 205 (Del. Ch. 2006).

66. *Cf.* William Bates III, *Deepening Insolvency: Into the Void,* 24 AM. BANKR. INST. J. 1, 1 (2005) (criticizing the lack of coherence in the theory of deepening insolvency).

67. Schacht v. Brown, 711 F.2d 1343, 1347–48 (7th Cir. 1983), *cert. denied* 464 U.S. 1002 (1983).

68. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 343–44 (3d Cir. 2001) (applying deepening insolvency to a Ponzi scheme).

69. Smith v. Arthur Andersen, LLP, 421 F.3d 989 (9th Cir. 2005).

70. *In re* CitX Corp., Inc., 448 F.3d 672, 681 (3d Cir. 2006) (requiring more than negligence and some level of fraudulent intent).

most all of the costs incurred by the firm during its prolonged existence can be recovered.[71]

The trustee has two other potential causes of action: (1) derivative suits based on breach of the fiduciary duty the third party owes the debtor[72] and (2) actions against the third party for aiding and abetting the debtor's fraud.[73] These two represent the trustee's best hopes for recovery and are the subject of Part Two. Often times they go together. For instance, in *In re CitX*, the trustee brought suit against an individual accountant and his firm for their failure to detect the former CEO's securities fraud and misappropriation of company resources.[74]

However, it is important to distinguish between actions brought by creditors derivatively, which are brought *on behalf* of the corporation, and actions brought by creditors in their independent capacity because state law may bar derivative actions. As the Eighth Circuit noted in *In re Senior Cottages of America,* "If the corporation owned a cause of action against the principal who breached a duty, it follows that it also owns the cause of action for aiding and abetting the principal's breach."[75] The aiding and abetting breach of fiduciary duty action is brought by a party on behalf of the corporation.[76] If malfeasance would be imputed to the corporation, it

71. Bates, *supra* note 66 (noting that you can recover for a great deal of payments, basically every cost of the firm).

72. *See* Whitney v. Citibank, N.A., 782 F.2d 1106, 1115 (2d Cir. 1986) (noting that to prove a claim of aiding and abetting breach of fiduciary duty requires: 1) a breach of fiduciary duty, 2) defendant knowingly inducing or participating in the breach, and 3) damages resulting from the breach).

73. *See* Mazzaro de Abreu v. Bank of America Corp., 525 F. Supp. 2d 381, 387 (S.D.N.Y. 2007) ("[T]o state a claim for aiding and abetting fraud . . . a plaintiff must allege: (1) the existence of an underlying fraud; (2) actual knowledge of the fraud by the aider and abettor; and (3) substantial assistance by the aider and abettor in the achievement of the underlying fraud.").

74. 448 F.3d 672, 676 (3d Cir. 2006).

75. Moratzka v. Morris (*In re* Senior Cottages of Am., LLC), 482 F.3d 997, 1002 (8th Cir. 2007).

76. *See* Delgado Oil Co., Inc. v. Torres, 785 F.2d 857, 861 (10th Cir. 1986) (holding that claims common to all creditors belong to the trustee and can only be brought on behalf of the corporation); Ford Motor Credit Co. v. Minges, 473 F.2d 918, 920–21 (4th Cir. 1973) (holding that the right of action for directors' negligent mismanagement may only be maintained in the name of corporation or its receiver if it is insolvent); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101–02 (Del. 2007) (holding that creditors may maintain a derivative action on behalf of the corporation for breach of fiduciary duty); Dana Molded Products, Inc. v. Brodner, 58 B.R. 576, 580 (N.D.Ill. 1986) (explaining that creditor may not bring action against corporation's fiduciaries where the creditor is harmed indirectly).

would therefore also be imputed to the party bringing the suit derivatively, including a trustee.[77] In these cases, the doctrine of *in pari delicto,* which translates as "in equal fault," blocks the suit.[78] Likewise, when the aiding and abetting cause of action is brought derivatively, the same rule can apply.[79] I explain the courts' application of *in pari delicto* in these situations in Part Three.

Although *in pari delicto* may bar derivative suits, it cannot bar an aiding and abetting fraud action brought directly by or on behalf of the creditors. This distinction makes aiding and abetting fraud the most viable state law cause of action. The trustee's suit against HSBC in the Madoff litigation is a textbook example of such a claim.[80] The aiding behavior varies, but in the securities fraud context, one of the best examples is churning, which involves third-party brokers helping to simulate the appearance of trading activity through economically meaningless trades.[81] The downside to an aiding and abetting claim is that, unlike a breach of fiduciary duty action, it requires meeting the pleading standard for fraud claims.[82] For example, the court in *In re Alphastars* required that the plaintiff raise a strong inference of fraud by proving both motive and oppor-

77. *See* Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982) (describing how agency principles impute a manager's fraud to the corporation); RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006) ("[N]otice 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 . . . ."). *See also* Wasserman, *supra* note 13, at 373–74. In bankruptcy, the trustee succeeds to the estate. 11 U.S.C. § 541(a) (2006). Thus fraud that would be imputed to the debtor corporation is also imputed to the trustee. *See* E.F. Hutton & Co., Inc. v. Hadley, 901 F.2d 979, 987 (11th Cir. 1990) (imputing fraud of the corporation to the trustee).

78. *See infra* notes 98–101 & accompanying text.

79. *See infra* note 101 & accompanying text.

80. Picard v. HSBC Bank PLC, 454 B.R. 25, 28 (S.D.N.Y. 2011) ("[T]he trustee . . . seeks to recover under various common law theories such as unjust enrichment, aiding and abetting fraud and aiding and abetting breach of fiduciary duty.").

81. This is known as "churning." *See* Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149, 1150 (3d Cir. 1989) (trustee in bankruptcy for corporation brought churning claim against securities broker); DeRance, Inc. v. PaineWebber Inc., 872 F.2d 1312, 1314–19 (7th Cir. 1989) (not-for-profit corporation brought breach of contract, fraud, and breach of fiduciary duty claims based in part on alleged churning of its account); M & B Contracting Corp. v. Dale, 795 F.2d 531, 532–33 (6th Cir. 1986) (corporation brought churning claim against securities broker).

82. *See* Bondi v. Bank of Am. (*In re* Parmalat), 383 F. Supp. 2d. 587, 593 (S.D.N.Y. 2005) (applying Rule 9(b) pleading standard to trustee's claim against third party for aiding and abetting debtor's fraud).

tunity.[83] Finally, the *prima facie* case itself is daunting as a plaintiff must prove that a fraud occurred, that the third party had sufficient knowledge of the violation, and that the third party provided substantial assistance.[84] Despite these challenges, the claim is available as a matter of state law.

As noted at the beginning of this section and as the court in *Cenco* recognized, all of these claims are conceptually similar.[85] At their core, these suits allege that third-party providers either aided fraud or breached their fiduciary duties to the debtor. Although the facts of each individual suit may be similar, state law raises barriers to many of these claims. Not every state court recognizes deepening insolvency as a stand-alone theory; negligence and breach of fiduciary duty require a relationship (requirements do vary by state and circuit); and the doctrine of *in pari delicto* is likely to bar derivative actions, as explained in Part Three. To succeed, the trustee must rely on a cause of action that runs directly to the creditors. Aiding and abetting liability meets this requirement and should be available to the trustee. Indeed trustees have succeeded in bringing such claims outside of bankruptcy. This raises the question addressed in Part Three: why have bankruptcy courts refused to allow the trustee to bring such claims during Chapter 7 proceedings?

II.
CASE LAW AND FORMALISTIC SHORTCOMINGS

If legislators and judges worked from a blank slate determining whether the trustee should have the power to sue third parties,

83. O'Connell v. Arthur Andersen LLP (*In re* Alphastar Insurance Group Ltd.), 383 B.R. 231, 257 (Bankr. S.D.N.Y. 2008).

84. *See* Lerner v. Fleet Bank, N.A., 459 F.3d 273, 286 (2d Cir. 2006) (setting out *prima facie* case for aiding and abetting fraud). Proving substantial assistance can also be a challenge as it may require either affirmative assistance or failure to act in the face of a duty. *See In re* Sharp Int'l Corp., 403 F.3d 43, 52 (2d Cir. 2005) (finding that mere knowledge of fraud is insufficient without duty to disclose); Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d. 452, 470 (S.D.N.Y. 2001) (including knowledge of the fraud in aiding and abetting liability when there is a duty to disclose). The plaintiff must also prove knowledge negligence does not suffice for liability. RESTATEMENT (SECOND) OF TORTS § 876(b) (1977) (stating that a person must "know" another's conduct constitutes a breach of duty to be subject to liability for acting in concert). Some courts consider proof of scienter and the level of assistance in tandem, requiring less assistance when scienter is clear. *See In re* Enron Corp. Sec., Derivative & "ERISA" Litigation, 511 F. Supp. 2d. 742, 803 (S.D.Tex. 2005) (quoting *Witzman v. Lehrman & Flom*, 601 N.W.2d 179, 188 (Minn. 1999)).

85. *See* Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 453 (7th Cir. 1982) (Posner, J.).

then finding a solution would be a relatively straightforward task. Considering the availability of an aiding and abetting fraud or deepening insolvency action as explained in Part One, policy-makers would then simply ask whether the principles of bankruptcy discussed in Part Three warrant that power. Indeed, this is what I do in this Part Three. Practitioners, however, do not work from a blank slate. While trustees continue to claim that the current Code already authorizes them to bring these claims, this Part explores their arguments, which focus on Sections 541 and 544 of the Code. I begin with Section 541 and explain how *in pari delicto* and standing analysis act to block the trustee from relying on this Section to bring a claim against third parties. I then consider the trustee's prospects for an aiding and abetting action using Section 544. Although it is a closer case, I conclude that courts have correctly construed the Code and Supreme Court precedent to block these actions as well.

A. *The Failure of Section 541*

On its face, Section 541(a) is simple. If a debtor has an interest in property pre-petition, then that interest becomes property of the estate post-petition.[86] In short, the trustee stands in the shoes of the debtor. This undoubtedly includes causes of action that the debtor could have brought.[87] Thus Section 704 entrusts the trustee to "collect and reduce to money the property of the estate for which [the] trustee serves . . . ."[88] This power has been interpreted to implicitly extend to bringing causes of action that belong to the debtor.[89]

86. "The commencement of a case. . . creates an estate. Such estate is comprised of all the following property . . . all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a) (2006).

87. *See* Sierra Switchboard Co. v. Westinghouse Electric Corp., 789 F.2d 705, 709 (9th Cir. 1986) (construing § 541(a) broadly to include all causes of action and discussing legislative history of the Bankruptcy Act supporting this understanding); Howe v. Richardson (*In re* Howe), 232 B.R. 534, 537 (B.A.P. 1st Cir. 1999) ("The inclusion of choses in action within the sweep of § 541 represented a significant departure from the more limited composition of the bankruptcy estate under the Bankruptcy Act."). *See also* 5 COLLIER ON BANKRUPTCY ¶ 541.03, at 541–15 (Alan N. Resnick & Henry J. Somme eds., LexisNexis, 16th ed. 2008).

88. 11 U.S.C. § 704(a) (2006). *See also* Koch Refining v. Farmers Union Cent. Exch., Inc., 831 F.2d 1339, 1348 (7th Cir. 1987) ("It is axiomatic that the trustee has the right to bring any action in which the debtor has an interest, including actions against the debtor's officers and directors for breach of duty or misconduct.") (citing Pepper v. Litton, 308 U.S. 295, 307 (1939)).

89. This logically follows from the fact that the trustee, as the debtor's successor, is the real party in interest. *See* Wieburg v. GTE Sw. Inc., 272 F.3d 302, 306 (5th Cir. 2001) ("Because the claims are property of the bankruptcy estate, the Trustee

Specifically, courts recognize that the trustee's authority to bring suit on behalf of the debtor extends to breaches of fiduciary duty by insiders and third parties:

> For example, these sections give the trustee authority to bring an action for damages on behalf of a debtor corporation against corporate principals for alleged misconduct, mismanagement, or breach of fiduciary duty, because these claims could have been asserted by the debtor corporation, or by its stockholders in a derivative action.[90]

This makes sense in light of underlying state law, which, as discussed in Part One, would as an initial matter allow a debtor to bring these actions. In fact, this is how it works when the trustee attempts to bring an action against corporate principals for breach of fiduciary duty.[91] However, it is important to reiterate the distinction between claims that belong to the creditors and claims that belong to the debtor. The trustee stands in the shoes of the debtor under Section 541. Therefore, the claim must belong to the debtor and not the creditors individually. This is a question of state law, and certain claims—like veil-piercing or fraudulent conveyance—may belong to the creditors, meaning they could not be the subject of a Section 541 suit by the trustee.[92] However, at a minimum, a claim for breach of fiduciary duty that a third party owed the corporation should be available to the debtor.[93] But *in pari delicto* and standing analysis have led courts to reject Section 541 actions in these situations.

is the real party in interest with exclusive standing to assert them.") (citations omitted); Feist v. Consol. Freightways Corp., 100 F.Supp.2d 273, 274–75 (E.D.Pa. 1999), aff'd, 216 F.3d 1075 (3d Cir. 2000), cert. denied, 532 U.S. 920 (2001).

90. Mixon v. Anderson (*In re* Ozark Rest. Equip. Co., Inc.), 816 F.2d 1222, 1225 (8th Cir. 1987) (citing *Pepper v. Litton*, 308 U.S. 295, 307 (1939)).

91. *See, e.g.*, Mediators, Inc. v. Manney (*In re* Mediators, Inc.), 105 F.3d 822, 826–27 (2d Cir. 1997) ("We agree that a bankruptcy trustee, suing on behalf of the debtor under New York law, may pursue an action for breach of fiduciary duty against the debtor's fiduciaries.").

92. *See In re* Ozark, 816 F.2d at 1225 ("Where . . . 'the applicable state law makes such obligations or liabilities run to the corporate creditors personally, rather than to the corporation, such rights of action are not assets of the estate under Section 541(a) that are enforceable by the trustee [under Section 704(1)].''). However, there are states where this is not the case and the corporation can essentially pierce its own veil. *See, e.g.*, Koch Ref., 831 F.2d at 1346 (finding that both Indiana and Illinois state law allow trustee to pierce the veil under § 541).

93. *See In re* Mediators, 105 F.3d at 826–27.

Courts have done this for several reasons. In the first instance, the court may decide to impute the debtor's fraud to the trustee.[94] In general, a corporation is presumed to have all of the knowledge of its employees who act as its agents.[95] The corollary to this is that the employees' actions are also considered those of the corporation.[96] As such, when the agent commits fraud, the corporation does as well.[97] This bit of agency law is critical to a Section 541 claim because it means that the trustee who stands in the shoes of the debtor and sues a third party for aiding and abetting fraud is technically suing his own accomplice. The doctrine of *in pari delicto,* which means "equally at fault,"[98] bars such suits as a matter of public policy, preventing one wrongdoer from collecting from another.[99] As Judge Posner wrote in *Cenco Inc. v. Seidman & Seidman,* "[a] Participant in a fraud cannot also be a victim entitled to recover damages, for he can't have relied on the truth of the fraudulent representations."[100] The upshot is that the trustee cannot use Section 541 to sue third-party service providers for breach of fiduci-

94. *See* E.F. Hutton & Co., Inc. v. Hadley, 901 F.2d 979 (11th Cir. 1990) (imputing fraud of the corporation to the trustee); Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982) (describing how agency principles impute a manager's fraud to the corporation and then to the trustee); *In re* Mediators, 105 F.3d 822 (same).

95. *See In re* Sharp Int'l Corp., 278 B.R. 28, 36 (Bankr. E.D.N.Y. May 20, 2002) ("The general rule is that knowledge acquired by an agent acting within the scope of his agency is imputed to his principal and the latter is bound by such knowledge although the information is never actually communicated to it . . . Underlying the rule is the presumption that an agent has discharged his duty to disclose to his principal 'all the material facts coming to his knowledge with reference to the subject of his agency.'") (*quoting Center v. Hampton Affiliates, Inc.,* 66 N.Y.2d 782, 784 (1985)). *See also* RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006) ("[N]otice 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.").

96. *See* RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. c. (2006) ("Imputation recognizes that an organization constitutes one legal person and that its link to the external world is through its agents . . .").

97. This is corporate criminal liability. *See* N.Y. Cent. & Hudson River R.R. Co. v. U.S., 212 U.S. 481, 494–95 (1909) ("[W]e see no good reason why corporations may not be held responsible for and charged with the knowledge and purposes of their agents, acting within the authority conferred upon them.").

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

99. *See* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 306 (1985) ("The defense is grounded on two premises: first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.") (citations omitted).

100. Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982).

ary duty or aiding and abetting the fraud. This result has largely been ratified by the circuits.[101]

The textbook example of such an instance is *R.F. Lafferty*.[102] In *R.F. Lafferty*, the Third Circuit was confronted with a Ponzi scheme operating through fraudulent debt certificates.[103] When the scheme collapsed, the corporations entered bankruptcy and the trustee sought to bring deepening insolvency actions against third parties that helped issue the securities.[104] The Third Circuit held that because Section 541 places the trustee in the debtor's shoes at the moment the petition is filed, the fraud was necessarily imputed to the trustee and any defense that could have been raised against the debtor was available against the trustee regardless of whether the trustee was an innocent successor.[105] Thus the third party could assert *in pari delicto* against the trustee. While the court recognized the seemingly inequitable result, it also joined the vast majority of circuits that recognize that the text of Section 541 requires evaluation *at the moment of the petition*.[106] The Pennsylvania Supreme Court

101. *See, e.g.*, Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1151 (11th Cir. 2006); Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 836 (8th Cir. 2005); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356–57 (3d Cir. 2001); *In re* Dublin Sec., Inc., 133 F.3d 377, 381 (6th Cir. 1997); *In re* Hedged-Invs. Assocs. Inc., 84 F.3d 1281, 1285 (10th Cir. 1996); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094 (2d Cir. 1995).

102. 267 F.3d 340 (3d Cir. 2001).

103. *Id.* at 344.

104. *Id.*

105. *See id.* at 356–57.

106. *See In re* Hedged Investments, 84 F.3d at 1285

> We emphasize § 541(a)(1) limits estate property to the debtor's interests 'as of the commencement of the case.' This phrase places both temporal and qualitative limitations on the reach of the bankruptcy estate. In a temporal sense, it establishes a clear-cut date after which property acquired by the debtor will normally not become property of the bankruptcy estate.

See also Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991) ("[W]e must determine what claims HMK possessed against Shearson *before* HMK went bankrupt."); R.F. Lafferty, 267 F.3d at 356 ("[T]he explicit language of section 541 directs courts to evaluate defenses as they existed at the commencement of the bankruptcy."); Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 429 n.19 (1972); 5 COLLIER ON BANKRUPTCY, ¶ 541.04, at 541–12 (Alan N. Resnick & Henry J. Somme eds., LexisNexis, 16th ed. 2008) at 541–42 (15th ed. 1989) ("Under section 541(a) . . . the bankruptcy estate consists of all of the debtor's legal and equitable property interests that existed as of the commencement of the case, that is, as of the time that the bankruptcy petition. . . is filed."); This result has been muddied by the decisions that consider the power of a *receiver* to bring a very similar action. *See* Scholes v. Lehman, 56 F.3d 750, 754 (7th Cir. 1995) ("That reason falls out now that Douglas has been ousted from control of and beneficial interest in the corporations. The appointment of the receiver re-later narrowed *R.F. Lafferty,* but nonetheless recognized that *in pari delicto* may apply.[107] Thus, while it seems unfair to ignore the differences between the trustee and the debtor, the Code's "at the commencement of the case"[108] language leaves no other choice.

There is, of course, an exception to this rule and an exception to that exception. When the fraud operates in a manner that is adverse to the corporation's interests, the so-called "adverse interest" exception may apply and block the application of *in pari delicto*.[109] Like *in pari delicto*, adverse interest is a logical outgrowth of agency law.[110] When the agent is not acting for the principal's benefit, the agent's actions are not imputed to the corporation. Likewise, when a third party aids an agent in defrauding a corporation, the corporation is not "in equal fault." A district court reached this result in

moved the wrongdoer from the scene. The corporations were no more Douglas's evil zombies."). In that context, without the bar imposed by Section 541, the courts may distinguish the receiver from the guilty debtor and refuse to apply *in pari delicto. See* FDIC v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) ("[D]efenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver.") (citations omitted).

107. *See* Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PriceWaterhouseCoopers, LLP, 989 A.2d 313, 332 (Pa. 2010) ("We agree with the Seventh Circuit to the extent it has held that *in pari delicto* may be available as a defense in some cases arising in the corporate auditing context, across the broader part of the spectrum of the various common-law causes of action which may be asserted.").

108. 11 U.S.C. § 541(a)(1) (2006) ("[The following comprises the estate:] [e]xcept as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.").

109. *See In re* Sharp Int'l Corp., 278 B.R. 28, 36 (E.D.N.Y. May 20, 2002) ("Even if the *Wagoner* rule applies, a trustee may have standing to assert a claim against the corporation's third party professionals under the adverse interest exception to that rule. The adverse interest exception applies where 'the officer acted entirely in his own interests and adversely to the interests of the corporation.' 'The theory is that 'where an agent, though ostensibly acting in the business of the principal, is really committing a fraud for his own benefit, he is acting outside of the scope of his agency, and it would be most unjust to charge the principal with knowledge of it.'''") (quoting *Wight v. BankAmerica Corp.*, 219 F.3d 79, 87 (2d Cir. 2000)) (citations omitted). *See also* RESTATEMENT (SECOND) OF AGENCY § 282(1) (1958) ("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 . . . .").

110. *See supra* notes 95–97 & accompanying text. Acts that are intended to defraud the corporation or are otherwise adverse to the corporation's interest cannot be said to fall within the scope of employment. *See In re* Mediators, Inc., 105 F.3d 822, 827 (2d Cir. 1997) ("Under New York law, the adverse interest exception rebuts the usual presumption that the acts and knowledge of an agent acting within the scope of employment are imputed to the principal.").

In re Sharp.[111] However, the exception is narrow and the adversity of interests must be complete.[112]

It would seem that the adverse interest exception would solve the trustee's problem in most Ponzi bankruptcy cases. After all, a Ponzi scheme clearly benefits the individual fraudster and not the corporation, which makes no real profit off the scheme.[113] However, as explained in Part One, Ponzi schemes are typically operated by individual actors. Unlike corporate frauds like Enron, which operate on a massive scale and involve many agents and many parts of the corporation, a Ponzi scheme like Madoff's can inflict billions of dollars in damages with just a few employees. This distinction has given rise to an exception to the adverse interest exception called the "sole actor exception."[114] To understand how this works, take for example an instance where the veil could be pierced under an instrumentality rationale.[115] In such a situation there can be no adverse interest. Everything done by the agent is done by the corporation and everything that benefits the agent benefits the corporation. As explained above, given the nature of the scheme,

111. 278 B.R. at 41.

112. *In re* Mediators, 105 F.3d at 827.

113. *See supra* notes 1, 29–31, 35 & accompanying text.

114. *See In re* Mediators, 105 F.3d at 826–27

> [T]he adverse interest exception does not apply to cases in which the principal is a corporation and the agent is its sole shareholder . . . 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 . . . Where, as here, a sole shareholder is alleged to have stripped the corporation of assets, the adverse interest exception to the presumption of knowledge cannot apply.

See also Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 838 (8th Cir. 2005) ("The sole actor doctrine is an established principle of agency law.").

115. The instrumentality test is one of several alternative theories used to pierce the veil. *See* Dzikowski v. Friedlander, 411 B.R. 434, 446 (Bankr. S.D. Fla. 2009) (quoting *Zaist v. Olson*, 227 A.2d 552, 576 (Conn. 1967) ("The instrumentality rule requires proof of three elements: (1) Control, not merely majority or complete stock control, but complete domination, not only of finances but of policy and business practice *in respect to the transaction attacked* so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; (2) that such control must have been used by the [principal] to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest or unjust act in contravention of [defendant's] legal rights; *and* (3) that the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of."). *See also* 1 WILLIAM D. FLETCHER, FLETCHER CYCLOPEDIA ON THE LAW OF PRIVATE CORPORATIONS § 41 (1983) ("[Alter ego] fastens liability on the individual who uses a corporation merely as an instrumentality to conduct his own personal business, and such liability arises from fraud or injustice perpetrated not on the corporation but on third persons dealing with the corporation.").

the sole actor exception often acts to reinstate *in pari delicto* and block trustees from using Section 541 to sue third parties.[116]

The Second Circuit has complicated things even further by sometimes applying *in pari delicto* as a part of standing analysis. In *Shearson Lehman Hutton, Inc. v. Wagoner*, the trustee sued a broker for aiding and abetting breach of fiduciary duty and fraud by churning accounts and disregarding standard verification and compliance rules.[117] The court wrote that, unlike other circuits:

> In our analysis of the question presented, the "case or controversy" requirement coincides with the scope of the powers the Bankruptcy Code gives a trustee, that is, if a trustee has no power to assert a claim because it is not one belonging to the bankrupt estate, then he also fails to meet the prudential limitation that the legal rights asserted must be his own.[118]

In *Shearson*, the estate did not have a claim because *in pari delicto* applied. Most of the other circuits that have confronted this line of reasoning have rejected the Second Circuit's rationale, often explicitly.[119] However, although courts in the Second Circuit have taken a few tenuous steps towards distinguishing standing and *in pari delicto*, *Shearson* remains the law of the circuit.[120] The distinction also remains important because under *Shearson* the trustee truly cannot bring the claim at all, while under *R.F. Lafferty,* the obstacle is an affirmative defense that the defendant must assert.[121]

116. *See supra* notes 109–115 & accompanying text.

117. 944 F.2d 114, 119 (2d Cir. 1991).

118. *Id.* at 118.

119. *See, e.g.*, *In re* Senior Cottages of Am., LLC, 482 F.3d 997, 1003–04 (8th Cir. 2007); Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1149–50 (11th Cir. 2006); Baena v. KPMG, LLP, 453 F.3d 1, 6–10 (1st Cir. 2006); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 346 (3d Cir. 2001); *In re* Dublin Sec., Inc., 133 F.3d 377, 379–80 (6th Cir. 1997).

120. *See* In re Parmalat, 383 F. Supp. 2d 587, 595–99 (S.D.N.Y. 2005) (narrowing *Wagoner* to applications of New York law and applying *in pari delicto* separately). *See also* Senior Cottages, 482 F.3d at 1003 (8th Cir. 2007) (discussing recent trends away from the *Wagoner* rule in the Second Circuit).

121. *Compare* Wagoner, 944 F.2d at 117 ("Because standing is jurisdictional under Article III of the United States Constitution . . . it is a threshold issue in all cases since putative plaintiffs lacking standing are not entitled to have their claims litigated in federal court.") (citations omitted), *with* R.F. Lafferty, 267 F.3d 340, 361 (3d Cir. 2001) (Cowen, J., dissenting) ("[A]s a general matter, the ultimate merits of an affirmative defense do not raise questions about a plaintiff's standing, or else the moment the court was poised to rule in favor of the defendant on the affirmative defense, the court would lose jurisdiction . . . .").

B. Section 544(a)(1) Actions

When *in pari delicto* bars a trustee from suing from the shoes of a debtor, the trustee may attempt to stand in the shoes of a creditor using Section 544(a)(1) of the Code. Under Section 544(a)(1), the trustee is empowered to bring all of the actions a hypothetical lien creditor could bring:

> As the Tenth Circuit has explained, "Congress has fashioned a legal fiction [that] permits the trustee . . . to assume the guise of a creditor with a judgment against the debtor. Under that guise, the trustee may invoke whatever remedies provided by state law to judgment lien creditors to satisfy judgments against the debtor."[122]

This "strong arm power" is another potential avenue through which trustees have tried to assert claims for aiding and abetting fraud or breach of fiduciary duty.[123] In addition, Section 544(b) allows the trustee to stand in the shoes of a particular unsecured creditor.[124] A claim against a third party is naturally at home within Section 544, which typically is used to avoid transfers to third parties that delay, hinder, or defraud creditors.[125] It is also a more natural fit because an action brought on behalf of the creditors does not rely on the relationship between the third party and the corporation. Thus the context of the third party's actions is less important. *In pari delicto* cannot bar the trustee when he stands in the shoes of the victims. Unfortunately, under the Supreme Court's de-

122. Picard v. JPMorgan Chase & Co., 460 B.R. at 93 (S.D.N.Y. 2011) (quoting Zilkha Energy Co. v. Leighton, 920 F.2d 1520, 1523 (10th Cir. 1990)).

123. *See, e.g.*, Mixon v. Anderson (*In re* Ozark Rest. Equip. Co.), 816 F.2d 1222, 1225 (8th Cir. 1987) (rejecting Trustee's attempt to use strong arm power to bring breach of fiduciary duty and alter ego causes of action), *cert. denied*, 484 U.S. 848 (1987); Picard, 460 B.R. at 93 (rejecting Trustee's § 544 claim against broker dealers); Hill v. Gibson Dunn & Crutcher, LLP (*In re* MS55, Inc.), No. 06-CV-01233, 2007 WL 2669150 (D.Colo. Sept. 6, 2007) (allowing Trustee's § 544 claim for aiding and abetting breach).

124. "Except as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title." 11 U.S.C. § 544(b)(1) (2006).

125. *See In re* Ozark, 816 F.2d at 1229 ("In this vein, we note that Sections 544(a) and (b) are flavored with the notion of the trustee having the power to avoid 'transfers' of the debtor, as were its predecessors, sections 70c and e of the Act."); *Picard*, 460 B.R. at 93 ("The purpose of this section is to allow the trustee in bankruptcy to cut off any secret or unperfected liens on debtor property that would bind the debtor itself, but not the debtor's judgment creditor, who typically enjoys top priority under state creditor/debtor laws.").

cision in *Caplin v. Marine Midland Grace Trust Co.*[126] and the lower courts' subsequent interpretations of that case, the Section 544 avenue has been closed off as well.

In *Caplin* the Supreme Court addressed the equivalent of Section 544 under the old Bankruptcy Act ("Act").[127] The trustee, standing in the shoes of bondholders, sued the indenture trustee of a bankrupt real estate developer.[128] The trustee alleged that the indenture trustee willfully or negligently signed off on "grossly overvalued appraisals"[129] and failed to ensure compliance with the terms of the indenture and allowed the debtor to engage in transactions that resulted in "great financial losses."[130] As the Court noted, a Section 541 claim would not work as the indenture trustee and the debtor were likely *in pari delicto*, meaning the trustee had no choice but to make his claim from the shoes of the creditors via Section 544.[131] Relying on Second Circuit precedent interpreting Section 567 of the Act, the trustee argued that Congress intended to remedy collective action problems and reduce litigation by empowering the trustee to bring suits on behalf of the creditors.[132]

In a 5–4 decision, the Court rejected the trustee's arguments.[133] The Court raised three objections. First, Section 567 gave the trustee responsibility to collect money and investigate fraud, but it did not explicitly authorize the trustee to bring suit. The Court construed this as evidence of congressional intent to give the trustee a limited role.[134] Second, the Court believed subrogation would be required in the event of any recovery.[135] If this were the case, the insurer would have a claim for contribution from the estate for at least a portion of the amount paid out to the bondholders. Thus there would be little point to bringing the actions because any amount received from the insurer would lead to an equal increase in the claims against the estate, leaving the creditors exactly where they started. Finally, the Court was concerned with potentially divergent interests among the creditors.[136] The Court believed disagree-

126. 406 U.S. 416 (1972).
127. *Id.* at 423–28 (discussing sections 567 and 587 of Chapter X of the Bankruptcy Act).
128. *Id.* at 419–20.
129. *Id.*
130. *Id.*
131. *Id.* at 430.
132. Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 427 (1972).
133. *Id.* at 428–32.
134. *Id.* at 428.
135. *Id.* at 430.
136. *Id.* at 432.

ment over which claims to pursue and how much to demand in damages made individual actions likely, regardless of whether the trustee brought the claim, in the absence of any procedure to bind the creditors to the outcome of the trustee's suit.[137] In short, while the discharge makes bankruptcy a mandatory collective procedure, the Court was unsure the same would be the case when the trustee sues third parties. The Court has not revisited trustee claims against third parties on behalf of the creditors since *Caplin*. This complicates matters in view of the overhaul of the Code in 1978, six years after *Caplin*. However, the circuit courts have heard similar cases since and addressed some of the issues arising from *Caplin*.

The Eighth Circuit was one of the first to do so. In *In re Ozark Restaurant Equipment Co.*, a three-judge panel reviewed a district court decision holding that, despite the broader powers granted to the trustee by Section 544, *Caplin* still did not permit her to bring an action on behalf of the creditors against a third party.[138] In *Ozark,* the trustee sought to pierce the veil, a cause of action that belongs to the creditors individually under the applicable state law.[139] This meant that Section 541 was unavailable.[140] In applying *Caplin* to the new Section 544, the Eighth Circuit considered in turn whether any of the three *Caplin* rationales applied. It found that although the trustee's powers under the new Section 544 were broad, *Caplin*'s concern that an action by the trustee could not bind the creditors applied. This meant that the concern that empowering the trustee would lead to duplicative litigation remained:

> If the trustee in the instant case was allowed to pursue and recover on the alter ego cause of action on behalf of Ozark's creditors, there obviously would be questions as to which creditors were bound by the settlement. This is because the trustee is not the real party in interest, and thus does not have the power to bind the creditors to any judgment reached in the litigation.[141]

Ozark is also notable because of its treatment of the Code's legislative history. In *Caplin,* the Court invited Congress to consider

137. *Id.*

138. Mixon v. Anderson (*In re* Ozark Rest. Equip. Co., Inc.), 816 F.2d 1222, 1229 (8th Cir. 1987).

139. *Id.* at 1225 ("Thus, the obligations and liabilities of an action to pierce the corporate veil in Arkansas do not run to the corporation, but to third parties, *e.g.,* creditors of the corporation.").

140. *Id.*

141. *Id.* at 1230 (citations omitted).

expanding the reach of Section 567.[142] As the court in *Ozark* noted, Congress in fact proposed a Section 544(c),[143] which would have given the trustee precisely this power.[144] The *Ozark* court found the eventual deletion of this provision "extremely noteworthy"[145] and treated it as positive congressional approval of the *Caplin* Court's construction of the trustee's role. The court therefore continued to narrowly construe the trustee's power under Section 544 and the Section 704 power to collect monies. In doing so, it reaffirmed the three rationales listed in *Caplin* and added its own: Congress' rejection of Section 544(c).

Like the Eighth Circuit, the other circuits to apply *Caplin* under the Code have continued to inquire whether any of the three rationales—subrogation, preemption, and construction of the trustee's role—require the court to dismiss the trustee's claim. Like the *Ozark* court, they have also placed great emphasis on Congress's exclusion of the proposed Section 544(c).[146] Because these courts

142. Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 434–35 (1972) ("Congress could determine that the trustee in a reorganization was so well situated for bringing suits against indenture trustees that he should be permitted to do so. In this event, Congress might also determine that the trustee's action was exclusive, or that it should be brought as a class action on behalf of all debenture holders, or perhaps even that the debenture holders should have the option of suing on their own or having the trustee sue on their behalf . . . .Whatever the decision, it is one that only Congress can make.").

143. The proposed § 544(c) would have read:

> (c)(1) The trustee may enforce any cause of action that a creditor, a class of creditors, an equity security holder, or a class of equity security holders has against any person, if-
>
> (2) If the trustee brings an action on such cause of action-
>
> (3) A judgment in any such action brought by the trustee binds all creditors or equity security holders that could have brought an action on such cause of action. Any recovery by the trustee, less any expense incurred by the trustee in effecting such recovery, shall be for the benefit only of such creditors or equity security holders.

In re Ozark, 816 F.2d at 1228 n.9. The legislative history gives no reason for the exclusion of the proposed section. *See id.* at 1228, n.10.

144. Mixon v. Anderson (*In re* Ozark Rest. Equip. Co.) 816 F.2d 1222, 1227–28 (8th Cir. 1987).

145. *Id.* at 1228.

146. *See, e.g.*, Grede v. Bank of New York Mellon, 598 F.3d 899, 901–02 (7th Cir. 2010) ("*Caplin* gave three reasons for its conclusion that a bankruptcy trustee may not pursue third-party claims . . . None of these reasons applies to suit by a liquidation trustee on assigned claims."); E.F. Hutton & Co. Inc., v. Hadley, 901 F.2d 979, 985–86 (11th Cir. 1990) ("On the facts of this case, however, we approve the reasoning of . . . the Eighth Circuit . . . In rewriting the bankruptcy laws in 1978, Congress considered and rejected a provision that expressly would have overruled *Caplin.*"); St. Paul Fire & Marine Ins. Co. v. Pepsi Co., Inc., 884 F.2d 688,

have not applied *Caplin* mechanically and because the underlying state cause of action continues to vary, the results have been mixed. However, in cases analogous to those in a Ponzi scheme where the trustee brings *tort* claims, *Caplin* and *Ozark* have usually been followed.[147]

Confusion occurs because the line between a debtor's claim and a creditor's claim is not always so clear. In particular, when trustees have brought alter-ego actions, a subspecies of veil-piercing actions generally, the circuits have been split. In *Koch Refining v. Farmers Union Central Exchange, Inc.*, the trustee brought suit on behalf of trade creditors who had sold petroleum to the debtor arguing that he could bring an action to pierce the debtor's veil under Section 544 and Illinois state law.[148] The Court found that Illinois allowed either the creditors or the debtor corporation to bring a veil-piercing action.[149] According to the court, an action that belongs to the corporation but can be brought by the creditors derivatively is a *general* claim as opposed to a *personal* claim, which properly belongs to each creditor individually.[150] The *Koch* court's distinction between general and personal claims, between those that accrue to the debtor's estate and also to the creditors *on behalf* of the corporation and those that arise solely out of direct injury to the individual creditors, explains why this line of Section 544 cases

700–701 (2d Cir. 1989) (assessing the applicability of each of *Caplin*'s rationales to the trustee's claim against third parties); Williams v. California 1st Bank, 859 F.2d 664, 666 (9th Cir. 1988) ("The Bank contends that *Caplin* and its progeny control this case. We agree . . . Evaluating the Trustee's claim in light of the three concerns that informed the Court's holding in *Caplin* reveals that substantially the same problems exist.").

147. *See* Picard v. JPMorgan Chase & Co., 460 B.R. 84, 95 (S.D.N.Y. 2011) ("For these reasons, the Trustee's theory has been rejected in numerous persuasive cases, including cases from at least three Circuit Courts of Appeals."). *But see* Hill v. Gibson Dunn & Crutcher, LLP (In re *MS55, Inc.)*, No. 06-CV-01233, 2007 WL 2669150 (D.Colo. Sept. 6, 2007) (disagreeing with *Ozark*'s application of *Caplin* to § 544).

148. Koch Ref., v. Farmers Union Cent. Exch., Inc., 831 F.2d 1339, 1340 (7th Cir. 1987).

149. *Id.* at 1345–46.

150. *Id.* at 1348–49.

> However, the trustee has no standing to bring *personal* claims of creditors. A cause of action is "personal" if the claimant himself is harmed and no other claimant or creditor has an interest in the cause. But allegations that could be asserted by any creditor could be brought by the trustee as a representative of all creditors. If the liability is to all creditors of the corporation without regard to the personal dealings between such officers and such creditors, it is a general claim.

Id.

is of little help to the trustee in a Ponzi scheme.[151] As explained below, it is also broadly consistent with *Caplin's* preemption rationale.

Distinguishing between personal and general claims can be difficult, as there seems to be a rather arbitrary line separating the two. However, the circuits that have confronted the distinction have embraced it.[152] The *Koch* court itself did not provide much help: "to determine whether an action accrues individually to a claimant or generally to the corporation, a court must look to the injury for which relief is sought and consider whether it is peculiar and personal . . . or general and common."[153] In *Delgado,* the Tenth Circuit asked whether the injury was common to all creditors and treated all of them equally.[154] This broad definition would seem to include some Ponzi scheme claims. Likewise, in *St. Paul Fire and Marine Insurance Co. v. Pepsico, Inc.*, the Second Circuit accepted the distinction but added to the confusion by referencing the *Caplin* rationale: When the claim is general and the injury indirect the automatic stay operates to bar anyone but the trustee from asserting it.[155] The corollary is that all the creditors are bound by the result, making *Caplin's* concern for preemption irrelevant.[156]

The general claims rationale would seem to apply to torts that do equal harm to all the creditors. However, most courts continue to exclude such actions when they arise out of Ponzi schemes. In *E.F. Hutton & Co., Inc. v. Hadley*, the Eleventh Circuit drew this distinction based on whether *in pari delicto* would apply to the debtor.[157] In *Hirsch v. Arthur Andersen & Co.*,[158] the Second Circuit reached the same conclusion but relied instead on the distinction between fraud committed against the corporation itself, where the

151. *See* Picard, 460 B.R. at 96–97 (determining that the trustee was asserting claims *on behalf* of the creditors, while general claims are asserted *on behalf* of the corporation).

152. *See, e.g.*, E.F. Hutton & Co., Inc. v. Hadley, 901 F.2d 979, 986–87 (11th Cir. 1990) (finding trustee was bringing a specific claim and discussing *Koch Refining*); St. Paul Fire & Marine Ins. Co. v. Pepsi Co., Inc., 884 F.2d 688, 700–01 (2d Cir. 1989) (distinguishing between specific and general claims); Delgado Oil Co., Inc. v. Torres, 785 F.2d 857, 861 (10th Cir. 1986) (finding the automatic stay applies to general claims); Cissell v. Am. Home Assurance Co., 521 F.2d 790, 793 (6th Cir. 1975) (finding the trustee may only pursue general claims); *Picard*, 460 B.R. 84 (collecting cases).

153. Koch Ref., 831 F.2d at 1349.

154. Delgado Oil, 785 F.2d at 861.

155. St. Paul, 884 F.2d at 700–01.

156. *Id.*

157. 901 F.2d 979, 987 (11th Cir. 1990).

158. 72 F.3d 1085 (2d Cir. 1995).

debtor and the creditors on its behalf might have an action, and fraud committed against the individuals, like in a Ponzi scheme.[159] While a trustee can bring a claim for the former, the latter is barred by *Caplin*.[160] Most recently, the Madoff trustee, Irving Picard, made the same argument. In *Picard v. JPMorgan Chase & Co.*,[161] a bankruptcy court rejected his claims and elaborated on the differences between a tort claim arising out of a Ponzi scheme and a truly general claim.[162] According to the court in *JPMorgan Chase & Co.*, a general claim requires not only that all the creditors benefit but also that they all benefit *equally*.[163]

A few enterprising trustees have sought to circumvent the limits of Section 544(a) by relying on assignment. This method has had some success but its requirements make it somewhat impracticable. In *Grede v. Bank of New York Mellon*, the Seventh Circuit recognized that if the creditors assigned their claims to a trustee, the trustee would have standing to bring those claims after a Chapter 7 liquidation was confirmed.[164] When the claims are assigned, *Caplin*'s preemption concern is not relevant provided that the court concludes the trustee is the real party in interest and that there is no potential for subrogation after confirmation. Nonetheless, for this to succeed, the assignments would have to be unconditional,[165] making recovery purely *pro rata*, and the action would likely need to wait until after the bankruptcy plan is confirmed.[166] Yet even then, in *Williams v. California 1st Bank*, the Ninth Circuit refused to allow the

159. *Id.* at 1093–95.

160. *Id.*

161. 460 B.R. 84 (S.D.N.Y. 2011).

162. See *id.* at 96 ("A trustee may maintain only a general claim. His right to bring a claim 'depends on whether the action vests in the trustee as an assignee for the benefit of creditors or, on the other hand, accrues to specific creditors.' Requiring an equal right and interest in all creditors is the only justification for vesting exclusive standing in the trustee. Where, as here, the right to relief and the benefits of relief are peculiar to individual or groups of creditors, the right is not a generalized one that belongs to the debtor's estate.") (citation omitted).

163. *Id.*

164. 598 F.3d 899, 901 (7th Cir. 2010), *cert. denied,* 131 S. Ct. 418 (2010).

165. *See In re* Bogdan, 414 F.3d 507, 511–13 (4th Cir. 2005) (distinguishing *Williams* based on unconditional assignment and finding that *Caplin*'s concerns do not apply to unconditional assignments); Mukamal v. Bakes, 383 B.R. 798, 811–14 (S.D. Fl. 2007) (finding partial assignment was insufficient to ameliorate *Caplin*, and leaving unresolved whether *Bogdan*'s absolute assignment avoidance of *Caplin* would be followed). *Cf. In re* Bennett Funding Group, Inc., 336 F.3d 94, 99–100 (2d Cir. 2003) (finding assignment did not give the trustee standing).

166. *See* Grede v. Bank of New York Mellon, 598 F.3d 899, 902 (7th Cir. 2010) (explaining that because the Bankruptcy case was over the Code's limits on trustee standing were no longer applicable).

trustee to proceed, finding that the creditors were still the "real parties in interest."[167] In additional to these hurdles, the practical challenges of convincing every creditor to voluntarily and unconditionally assign their claims to the trustee while knowing that a claim might not brought for some time make it unlikely that a trustee would be able to rely on *Grede*.

Since *Caplin*, Congress has overhauled and amended the Code. However, the 5–4 opinion continues to shape the scope of the trustee's powers under Section 544(a)(1). Under *Caplin*, *Ozark,* and, most recently, *JPMorgan Chase & Co.*, the trustee's role is narrow. A literal reading of Section 704, confining the trustee to collecting monies for the estate, and a focus on the avoidance power in the second sentence of Section 544(a)(1) circumscribes the trustee's ability to stand in the shoes of creditors. Even where *Caplin*'s three concerns do not apply, the courts have construed the general-versus-specific claims distinction narrowly. The result is what the Court in *Ozark* termed the "flavor" of Section 544(a)(1): a limited addition to the trustee's ability to expand the estate under Section 541 through avoiding transactions.[168]

C. Conclusion

Courts' analyses of Sections 541 and 544 leave little room for a trustee to recover from third parties in Ponzi schemes. The text of Section 541 requires the courts to consider whether the fraud would have been imputed at the moment of the petition. In almost every case, the answer is yes as a result of the application of *in pari delicto*. Defeating *in pari delicto* requires relying on Section 544 and arguing that the creditors are the real parties in interest. However, *Caplin* and *Ozark* teach that the courts are wary of expanding the trustee's power through the backdoor, so to speak. Reading Section 544 in the context of the other avoiding powers and the history of the trustee's role, courts are only willing to grant the trustee standing when she is actually acting "on behalf of the debtor in possession."[169] Setting aside the circular nature of this dilemma, one has to ask whether this makes any sense. The trustee's powers should carry her no further than they can be justified by the background principles of bankruptcy. The purpose of Part Three is to explore

167. *See* Williams v. California 1st Bank, 859 F.2d 664, 666–67 (9th Cir. 1988) (finding that *Caplin*'s concerns applied to block the trustee even after the close of the bankruptcy case).

168. *See* Mixon v. Anderson (*In re* Ozark Rest. Equip. Co., Inc.), 816 F.2d 1222, 1229 (8th Cir. 1987).

169. *See supra* notes 124–26 & accompanying text.

whether the result of Sections 541 and 544 is consistent with the theoretically appropriate scope of the trustee's role given the first principles and purposes of bankruptcy law.

III.
FUNDAMENTALS OF BANKRUPTCY AND APPLICATION TO CREDITOR ACTIONS AGAINST THIRD PARTIES

Part Three addresses the theoretical justifications for having a bankruptcy forum at all and analyzes whether these justifications support giving the trustee standing to sue third parties in the context of Ponzi schemes. There are two rationales for the bankruptcy forum: the "creditors' bargain" and the "traditionalist" accounts.[170] I begin with an explanation of each theory. I then argue that either model supports granting trustees standing to sue third parties given the peculiar circumstances of a Ponzi scheme.

A. *Theoretical Justifications*

1. The Theory of the Creditors' Bargain

Leaving aside distributional questions, the "creditors' bargain" theory begins from the assumption that the purpose of bankruptcy should be to maximize the creditors' collective benefits.[171] In a world free of transaction costs, the creditors would agree *ex ante* to the loss-distribution regime that maximizes welfare.[172] Thomas Jackson proposes three core reasons why the creditors in such a hypothetical world would choose a collective proceeding: (1) reduction of strategic costs; (2) increased aggregate asset pools; and (3) administrative efficiencies.[173]

In the absence of a functioning collective action regime, each unsecured creditor has incentives to race to the courthouse and

170. *See supra* notes 17–20 & accompanying text. The classification of Warren and others' theory as "traditionalist" is borrowed from *Bankruptcy's Uncontested Axioms*. Baird, *supra* note 17, at 575. However, while Professor Baird refers to his school of thought as "proceduralist," I borrow Thomas H. Jackson's moniker for the heuristic that forms the basis for the proceduralist theory—the creditors' bargain. *See generally* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Adler, *supra* note 17, at 444–45 (applying the creditors' bargain and explaining the heuristic).

171. *See supra* note 17 & accompanying text.

172. *See* Jackson, *Bankruptcy, Non-Bankruptcy*, *supra* note 17, at 860 (characterizing the creditors' bargain as an ex ante agreement amongst the creditors).

173. *Id.* at 862–68; THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, 7–19 (1986); Jackson, *Avoiding Powers, supra* note 17, at 728 n.10.

secure a lien as soon as it believes a debtor is likely to default.[174] The "race to the courthouse" may not involve an actual courthouse. Instead, creditors may demand collateral, repayment, or increased interest payments.[175] In many cases, this is a costly endeavor because, assuming the debtor does not willingly give up collateral, which may be a voidable preference, the creditor will have to pay court fees and attorney's fees. Moreover, if the creditors all rush to demand their money or secure a judgment, the debtor's business is likely to suffer in the end, leaving a smaller estate for the creditors. As Jackson notes, this race is likely to be worse in a homogenous creditor pool where claims are differentiated only by the order in which they are filed.[176] The unpredictable results of this strategic behavior also increase risk *ex ante* by increasing the variance of a given creditor's expected return and ultimately result in higher *ex ante* borrowing costs for everyone. The creditors' bargain theory postulates that creditors may in part prefer a collective collection procedure to prevent the costs of this strategic behavior.

As noted above, the race to the courthouse also may reduce the size of the estate itself. When creditors demand collateral or repayment when they believe the debtor is likely to fail, the result is a self-fulfilling prophecy: faced with an onslaught from its creditors, the debtor fails before it is economically unviable.[177] The size of the estate is likely to suffer further if no collective proceeding ever occurs. In the absence of a bankruptcy proceeding, each creditor will eventually reduce their claim to a judgment, obtain a writ of execution, and establish a lien on whatever property is left. The problem is that the estate is frequently greater than the sum of its parts. A piecemeal individual collection regime may destroy any going-concern value still in the business.[178] Thus, when the debtor is economically viable, the hypothetical creditors would agree *ex ante* to a

174. *See* Jackson & Scott, *supra* note 17, at 169–70 (discussing the incentives for creditors to coerce payment from debtors when bankruptcy becomes foreseeable); Jackson, *Avoiding Powers, supra* note 17, at 758–59 (discussing the role of avoidance powers in counteracting these incentives).

175. *See* Jackson, *Avoiding Powers, supra* note 17, at 772 (discussing use of collateral as a means to improve priority during a race).

176. *See* Jackson, *Bankruptcy, Non-Bankruptcy*, *supra* note 17, at 863–64.

177. *Id.* at 860–65.

178. *Id. See generally* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL. STUD. 127, 133–40 (1986) [hereinafter Baird, *Uneasy Case*] (discussing the case for preservation of going concern value in the choice between chapter 7 and chapter 11 filings). Preservation of going-concern value is also essential to the traditionalist account. *See, e.g.*, Warren, *Bankruptcy Policy*, *supra* note 18, at 798 (discussing preservation of going concern value as a part of the rehabilitative goals of bankruptcy law).

collective regime that preserves any going-concern value of the debtor in the event of a financial failure.[179]

Finally, the creditors should prefer a collective regime because of the administrative efficiencies it is likely to generate.[180] Each creditor faces the same costs of a court proceeding. A collective proceeding reduces duplicative expenses reserving as much of the estate as possible to satisfy the creditors' claims.[181]

According to the creditors' bargain theory, there are no other reasons to have a collective bankruptcy procedure. The creditors do not achieve this desirable outcome without bankruptcy because it is impossible to contract with every potential future creditor, making government, in the form of the Code, necessary to effectuate the creditors' bargain.[182] The corollary to this idea is that bankruptcy should only disturb state-based entitlements when it is necessary to achieve the goals of the system in the first place.[183] To otherwise

179. *See* Jackson, *Bankruptcy, Non-Bankruptcy*, *supra* note 17, at 864–65. However, creditors' bargain theorists do suggest that this will rarely be the case. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, 11–17 (1986). Some commentators have also suggested that the business may be preserved to avoid the transactional costs of a sale or piecemeal liquidation. *See generally* Baird, *Uneasy Case*, *supra* note 186, at 136.

180. *See* Jackson, *Bankruptcy, Non-Bankruptcy*, *supra* note 17, at 866 (discussing the reduction in duplicative litigation in a collective proceeding). Thus, a central concern in the literature discussing the trustee's role is that providing him with expansive powers will increase administrative costs. *See generally* Bryan D. Hull, *A Void in Avoidance Powers? The Bankruptcy Trustee's Inability to Assert Damages Claims on Behalf of Creditors Against Third Parties,* 46 U. MIAMI L. REV. 263, 301 (1991) (discussing the increase in administrative fees likely if Congress had passed Section 544(c) or if the trustee was otherwise empowered).

181. *See* Jackson, *Bankruptcy, Non-Bankruptcy*, *supra* note 17, at 866.

182. *See* Jackson & Scott, *supra* note 17, at 203. *See also id.* at 156 n.2 ("One of the touchstones of this model is that . . . collective regime such as bankruptcy is sometimes necessary as a device to induce cooperative behavior . . . ."); Jackson, *Bankruptcy, Non-Bankruptcy*, *supra* note 17, at 866 ("As a result, the creditors themselves cannot be expected to negotiate this agreement, even though it would be in their joint interest to do so. A federal bankruptcy rule solves this problem by making available a mandatory collective system after insolvency has occurred.").

183. *See* Jackson & Scott, *supra* note 17, at 160–62 (describing the importance of preserving state law entitlements to entice secured creditors to join the hypothetical bargain and to reduce strategic behavior). This also implicitly follows from the rejection of rehabilitation rationale for the collective proceeding which would require additional deviations from state law. *See id.* at 164 ("A central premise of the simple creditors' bargain is that redistribution in bankruptcy is inconsistent with the maximizing objectives of the collective. Insolvency is seen as a foreseeable risk that is borne individually by the various claimants of any business enterprise. Thus the model assumes, inter alia, that none of the risks of business failure will be shared among claimants of different classes, except as otherwise explicitly agreed.").

disturb entitlements is to reshape contractually agreed-to rights that do not face the same collective action problems that lead to the creditors' bargain.[184] Disturbing entitlements can lead to forum shopping and may undermine the certainty that is an important justification for the collective system in its own right.[185] In the creditors' bargain, a particular policy or Code provision can be judged on whether the creditors would hypothetically agree *ex ante* to include the particular policy or provision in their bargain.[186]

2. The Traditional Account

Instead of asking how to maximize creditor welfare, the traditionalist account considers loss distribution on a grander scale.[187] Traditionalists approach bankruptcy with a broader perspective by considering the rights of the creditors, the debtor, and other affected constituencies, such as employees.[188] Like the creditors' bargain theory, bankruptcy at its core remains a collection procedure to traditionalists but while the basis of that procedure may be prebankruptcy state entitlements, the traditionalist account accepts that deviation may be necessary to accomplish distributional goals.[189]

Traditionalists do not ignore the value of ending the race to the courthouse. These theorists recognize that a collective procedure is necessary to preserve value by reducing strategic behavior, eliminating redundant transaction costs, and preserving any going-

184. *Id.* at 160–61.

185. *Id.* at 162–63. *See also* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren,* 54 U. CHI. L. REV. 815, 825–28 (1987) [hereinafter Baird, *Loss Distribution*] (explaining how creating an additional forum for enforcement with different rules can lead to costly strategic behavior).

186. *See, e.g.*, Baird, *Loss Distribution*, *supra* note 185, at 827 (explaining bankruptcy's recognition of state priority through the creditors' bargain); Jackson & Scott, *supra* note 17, at 164–66 (explaining risk-sharing in bankruptcy through the creditors' bargain); Adler, *supra* note 17 (evaluating risk-sharing theory through the creditors' bargain).

187. *See* Warren, *Policymaking*, *supra* note 18, at 346 ("Federal law creates a multifaceted, integrated system to cope with the competing concerns of a wider range of interested parties in more complicated relationships and more distressed circumstances.").

188. *See* Warren, *Bankruptcy Policy*, *supra* note 18, 789–90 (explaining bankruptcy's concern for distribution and employees).

189. *See* Warren, *Policymaking*, *supra* note 18, at 353 ("Every distribution that benefits a particular creditor at the expense of the collective estate represents a considered judgment to depart from the norm in a particular instance. Equality—and deliberate deviations from equality—stand at the center of bankruptcy policy.").

concern value.[190] However, because they believe that the Code accomplishes this through collectivizing the process under the aegis of a bankruptcy court, the judge or trustee may have enhanced power under the traditionalist account.[191] Indeed, a central difference between the two theories is the traditionalist recognition that bankruptcy judges can, and probably should, have a great deal of discretion.[192] The traditionalists believe that this discretion is built into the Code by providing for abbreviated trials, emergency orders, and restricted notifications.[193]

Traditionalists also recognize the role of distributional concerns in the Code:

> Congress was acutely aware of the wider effect of a business failure on the surrounding community, and it adopted the 1978 Bankruptcy Code specifically to ameliorate those harmful effects—that is, to redistribute the benefits that would stem from some creditors' collection rights to other parties who did not enjoy those rights.[194]

Elizabeth Warren proposes that this solicitude towards distributional effects is at least in part premised on the idea that the Code should protect those unable to do so. Thus Warren argues that the Code should favor employees.[195] Moreover, the idea that "equity is equality" motivates the decision to treat like creditors the same regardless of where they finish in the race to the courthouse.[196] Even attempts to preserve going-concern value can be motivated by distributional concerns: "The economy of an entire town can be disrupted when a large factory closes. . . . Some believe that preventing such consequences is worth the costs of trying to keep the firm running and justifies placing burdens on a firm's secured creditors."[197]

190. *Compare* Warren, *Bankruptcy Policy*, *supra* note 18, at 792–93 (discussing estate value maximization), *with* Baird, *Loss Distribution*, *supra* note 185, at 815–17 (discussing traditional theory and the commonalities between the two camps).

191. *See* Warren, *Bankruptcy Policy*, *supra* note 18, at 805–08 (discussing the expansive authority of judges in the traditional account); *see also* Baird, *supra* note 17, at 590–95 (discussing the broader role for judges in the traditional account).

192. *See* Warren, *Policymaking*, *supra* note 18, at 351–52 (discussing the "enormous discretion" of bankruptcy judges).

193. *Id.* at 348.

194. *Id.* at 355.

195. *Id.* at 355–57 (explaining bankruptcy's protections for employees through reorganization and rehabilitation).

196. *Id.* at 357.

197. Warren, *Bankruptcy Policy*, *supra* note 18, at 798.

3. Internalizing Costs and the Moralist Account

In addition to the theories outlined above, two other policies also motivate bankruptcy: (1) internalization of costs, and (2) private monitoring.[198] The Code internalizes costs by operating as a self-supporting system.[199] It also limits the spillover of costs by prioritizing tax payments to the government ahead of distributions to private creditors.[200] Finally, by making the decision to opt into the system a private choice, the Code allows debtors, and, in limited situations, creditors, to decide between the two forums as they see fit.[201] This saves costs and ensures that the decision is made by the party with the best information. This is so even though incentives dictate that at certain times, creditors must be able to force the debtor's hands.[202]

The creditors' bargain and, to a lesser extent, the traditionalist account, have been criticized by moralist commentators.[203] These theorists argue that an economic analysis misses the social context and moral values that drive important sections of the Code.[204] For moralists, bankruptcy is a means to distribute losses, calm chaos, and rehabilitate the debtor.[205] However, once we move beyond the realm of the individual debtor, moralist concerns become less relevant.

Similarly, beyond the context of an individual debtor, the differences between the traditionalist and creditors' bargain accounts are less noticeable than they first appear. Both theories conclude

198. *See* Warren, *Policymaking*, *supra* note 18, at 343–44.

199. *Id.* at 361.

200. *Id.* at 382 n.124 (discussing IRS priority).

201. *See* 11 U.S.C. § 301 (2006) (voluntary petitions).

202. *See* 11 U.S.C. § 303 (2006) (conditions for involuntary petitions). There is some debate on whether it is normatively desirable for bankruptcy to be a contractual default rule or a mandatory rule. *Compare* Rasmussen, *supra* note 18, at 55–63 (critiquing the creditors' bargain conception of chapter 11 as mandatory and arguing that it is better analyzed as a default contractual term), *with* Baird, *Uneasy Case*, *supra* note 186, at 135 (explaining that bankruptcy must be mandatory to effectuate the creditors' bargain).

203. *See generally* Korobkin, *Rehabilitating Values*, *supra* note 18, at 721; Korobkin, *Value and Rationality*, *supra* note 18; Donald R. Korobkin, Contractarianism and the Normative Foundations of Bankruptcy Law, 71 TEX. L. REV. 541 (1993).

204. *See* Korobkin, *Rehabilitating Values*, *supra* note 18, at 721 (offering a "values-based" account for bankruptcy). Other scholars have also criticized the creditors' bargain's economic analysis as unrealistic. *See, e.g.,* Eisenberg, *supra* note 18, at 1522, 1529 (arguing that the creditors' bargain oversimplifies things); Rasmussen, *supra* note 18, at 55–59 (same).

205. *See* Korobkin, *Rehabilitating Values*, *supra* note 18, at 765–66.

that bankruptcy should work from the baseline of pre-bankruptcy state entitlements, that collective action and strategic behavior are important rationales for bankruptcy, and that the bankruptcy process should remain a procedural collection system.[206] Indeed, when faced with a decision that does not involve distribution between creditors but rather between creditors and a third party, the two theories are very likely to reach the same result.

B. When the Two Theories Agree: Ponzi Schemes

The open question after *Ozark* and *JPMorgan Chase & Co.* is not whether the trustee currently has the power to bring tort claims against third parties on behalf of the creditors: she does not. But that does not mean that the trustee should not be able to do so. The concerns in *Caplin* are relevant, as concerns about preemption and subrogation do affect whether it is in the interests of the debtor and creditors for the trustee to take on this role.[207] And under either conception of bankruptcy, there are conditions where we would not want the trustee to have this authority. For instance, a Chapter 11 reorganization complicates the analysis by introducing the relationship of the debtor to the creditors. However, policymakers and judges should analyze the problem in the context of a modern Ponzi scheme: few participants, a liquidation proceeding, and no secured creditors. Under these conditions, either theory of bankruptcy suggests the trustee should have the power to bring tort claims against third parties for aiding and abetting the schemer's fraud.

1. Trustee Suits and the Creditors' Bargain

According to the creditors' bargain theory, the creditors as a group hypothetically agree to a collective process because it ultimately leads to the largest estate possible by preventing strategic behavior and curing collective action problems.[208] The trustee and her avoidance powers play an important role in this model because it is through the mechanism of the trustee that the rights of creditors vis-a-vis each other are sorted out.[209] Meanwhile, the trustee

206. *See* Baird, *Loss Distribution*, *supra* note 185, at 815–17 (discussing traditional theory and the commonalities between the two camps).

207. *See supra* notes 146–47 and accompanying text. *See also* Hull, *supra* note 188, at 280–81 (recognizing the linkage between the theoretical underpinnings for bankruptcy and the *Caplin* concerns).

208. *See supra* notes 17–18 & accompanying text.

209. *See* Jackson, *Avoiding Powers, supra* note 17, at 726 (distinguishing avoidance powers based on whether they adjust rights between creditors or between

saves the individual creditors the costs and uncertainty of a race and, through the role of a "hypothetical lien creditor," is able to avoid transfers no individual creditor could necessarily reach.[210] However, whereas scholars, notably Thomas Jackson, have explored whether the trustee should be able to bring claims that rearrange rights between the creditor and the debtor,[211] little attention has been devoted to whether the trustee rearranging rights between creditors and third parties is consistent with the creditors' bargain theory.

Unlike many of the trustee's avoidance powers, the power to sue third-party creditors does not alter pre-bankruptcy state entitlements. Part One explained that the tort creditors in a Ponzi scheme have several available causes of action. Negligence and breach of fiduciary duty are difficult to make out because they require a duty between the creditors themselves and the third parties.[212] However, secondary liability predicated on the third party's relationship with the debtor has been recognized as a viable cause of action[213] even by the courts that have found that the trustee does not have standing.[214] Likewise, while deepening insolvency is controversial, it remains a stand-alone cause of action in many states.[215] Thus allowing the trustee to bring the claim leaves state law entitlements as they were outside of bankruptcy. Relatedly, the absence of any secured creditors means that state property rights are also unaffected by the additional powers.[216] Empowering the trustee modifies the procedures used. It does not modify the underlying substantive state-based entitlements. This makes empowering the trustee consistent

creditors and the debtor); *see also* David Gray Carlson, *Bankruptcy's Organizing Principle,* 26 FLA. ST. U. L. REV. 549, 551–53 (1999) (presenting avoidance, instead of successorship, as the centerpiece of the author's theory of bankruptcy).

210. *See* 11 U.S.C. § 544(a) (2006); Jackson & Scott, *supra* note 17, at 179–82 (discussing the prototypical use of § 544). However, because trustee expenses are administrative expenses entitled to priority there is a fine line between savings created by a collective process and potentially duplicative and costly litigation. *See* Steve H. Nickles & Edward S. Adams, *Tracing Proceeds to Attorneys' Pockets (and the Dilemma of Paying for Bankruptcy)*, 78 MINN. L. REV. 1079, 1166–77 (1994). Thus a central distinction Jackson makes is between actions that creditors could already bring outside of bankruptcy, like fraudulent conveyances, and what he considers to be "true" avoidance powers like § 544(a) and § 547(a) preferences. *See* Jackson, *Avoiding Powers, supra* note 17, at 726.

211. *See* Jackson, *Avoiding Powers, supra* note 17.

212. *See supra* notes 49–52 & accompanying text.

213. *See supra* notes 86–90 & accompanying text.

214. *See supra* notes 91–101 & accompanying text.

215. *See supra* notes 58–71 & accompanying text.

216. *See supra* notes 182–83 & accompanying text.

with the creditors' bargain theory's goal of limiting the deviation from state law except where necessary to effectuate a collective proceeding.[217]

It is relatively easy to see how empowering the trustee would ultimately increase the creditors' collective recovery by ameliorating collective action problems and reducing strategic behavior. With the exception of the Tenth Circuit, the automatic stay does not apply to these actions.[218] Thus each creditor can choose whether and when to bring suit. This choice is governed by the costs, in terms of legal fees, and by the expected payoff. Both of these factors are dependent in part on the bankruptcy process and the actions of other creditors. If other creditors bring suit first, the hypothetical claimant may benefit from their success through offensive collateral estoppel or by their loss as an indication of their own probability of success. At the same time, if their claim is completely satisfied by the bankruptcy process, their expected payoff may be minimal. Moreover, if the trustee chooses to claw back net winners, the payoff may be altered even further.[219] The result is that no individual creditor has incentives to bring suit quickly, if at all.

Importantly, the decision not to bring suit is only indirectly based on the probability of success. When the trustee is responsible for the decision whether to bring the claim, these concerns are less important. When the trustee is empowered, the automatic stay applies; thus she cannot benefit from a wait-and-see approach.[220] Moreover, clawbacks and net-winners are no longer relevant. Any recovery by the trustee will go into the general pool to be paid out to creditors as determined by the other parts of the bankruptcy proceeding.[221] Every creditor benefits and each benefits according to his priority and pro rata share.[222] Thus a collective remedy solves

217. *See supra* notes 183–86 & accompanying text.

218. *See supra* notes 152–63 & accompanying text.

219. *See* Nelson, *supra* note 56, at 1458–63 (discussing the application § 544 and § 548 in Ponzi schemes to clawback "net winners"). *See also* Pickard v. Estate of Chais (*In re* Bernard L. Madoff Inv. Sec. LLC), 445 B.R. 206 (Bankr. S.D.N.Y. 2011) (finding that trustee could claw back fictitious profits as fraudulent transfers).

220. *See* Hill v. Gibson Dunn & Crutcher, LLP *(In re* MS55, Inc.), No. 06-CV-01233, 2008 WL 2358699 (D.Colo. June 6, 2008) (explaining that the stay would apply if the trustee has the power to bring claims under § 544(a)).

221. *See* 11 U.S.C. § 550 (2006).

222. *See* Picard v. JPMorgan Chase & Co., 460 B.R. 84, 96 (S.D.N.Y. 2011) (finding that recovery would follow the order of priority established by other parts of the code, but requiring that recovery be equal before the trustee could be empowered). The Court's reasoning here is not immediately clear as there is no reason why an exactly equal right to payment would make the claim any less "peculiar" to the individual or on a theoretical level implicate any reason why the

the collective action problem and reduces incentives for strategic behavior.

According to the creditors' bargain theory, the collective process also serves to reduce transaction costs.[223] In the Ponzi scheme context, that interest is clearly served. In the absence of a trustee, each individual creditor would need to independently evaluate its prospects for recovery and hire counsel. These efforts are likely to be duplicative. Just as bankruptcy saves the costs of levying on a debtor's property individually,[224] empowering the trustee saves the costs of bringing suit. The unique position of the trustee is also likely to increase the savings. With access to substantially more information than an individual creditor, the trustee can take advantage of the work already done and reduce the costs of discovery.[225] Moreover, he will not need to spend additional resources identifying claimants as that process has already occurred.[226] A collective suit improves efficiency by reducing the number of proceedings, reaping economies of scale, and saving money.

In some situations, the creditors might also prefer the trustee to evaluate the merits of the claim. In a liquidation proceeding, the trustee has control over the estate and has access to all of its records.[227] She also acts as a clearinghouse for all of the claims.[228] This allows her to evaluate the expected payoff of a claim in terms of its probability of success and its expected damages more effi-

creditors would prefer to go it alone. After all, even those at the back of the priority line benefit from expanding the estate, regardless of whether that benefit is equal. *See id.* ("It is true that allowing the Trustee to pursue claims that belong properly to individual creditors would accrue to the benefit of all creditors by augmenting the bankruptcy estate.").

223. *See* Jackson, *Bankruptcy, Non-Bankruptcy*, *supra* note 17, at 866.

224. *See supra* notes 174–81 & accompanying text.

225. *See* Warren, *Policymaking*, *supra* note 18, at 347 ("Savings are also realized by imposing stiff requirements on debtors to cooperate with creditors' efforts to monitor a troubled business. A few examples illustrate the point. Following a bankruptcy filing, the debtor must reveal detailed information about the past operation of the business and its projected business activities."); *see also* Mixon v. Anderson (*In re* Ozark Rest. Equip. Co., Inc.), 816 F.2d 1222, 1225 (8th Cir. 1987) (acknowledging that empowering the trustee would save time and money).

226. *See* 11 U.S.C. § 704(a)(5) (2006) (empowering trustee to investigate claims).

227. *See* 11 U.S.C. § 704(a)(1) (2006) (empowering trustee in liquidations); 6 COLLIER ON BANKRUPTCY ¶ P. 704.05[2] (Matthew Bender & Co., 16th ed. 2012) (explaining the trustee's duty to account for the debtor's estate and keep records). *But see* 11 U.S.C. § 363(b)(1) (2006) (limiting trustee's ability to dispose of property outside the normal course of business).

228. 6 COLLIER ON BANKRUPTCY ¶ 704.02[3] (Matthew Bender & Co., 16th ed. 2012) (discussing trustee's duties to expeditiously close the estate pursuant to § 704); *id.* at ¶ 704.08 (discussing trustee's duties to object to improper claims).

ciently than an individual litigant. She has access to better information and may already be in a position to subpoena documents from third parties.

Caplin's three concerns can also be evaluated through the lens of the creditors' bargain theory as reasons why the creditors might not want the trustee to have the power to bring these sorts of claims. While the claim is not general in the sense used by the *Koch* court in that the injury is not indirect, it is functionally general in the sense of the term as used by the *Delgado* court, which makes *Caplin*'s preemption rationale longer relevant.[229] Every creditor could make the same argument and each has the same probability of success. The only difference between their claims is the amount of damages, but this is fundamentally no different than the *pro rata* distribution the bankruptcy process uses to satisfy unsecured claims. Thus, under the Tenth and Second Circuits' approach, the stay should operate to block any of the creditors from bringing the claim, making the trustee the sole party able to bring it. If the stay operates, then logically the individual creditors are also bound by the result of the trustee's action.[230] Thus the creditors would be preempted from bringing suit individually but, as explained above, they are likely to prefer this state of affairs. Additionally, the Securities Investor Protection Corporation ("SIPC") requires assignment. To the extent any of the creditors wish to recover through insurance, they therefore already have to accept preemption.[231] Assignment also helps mitigate the argument that the trustee is not the real party in interest.[232]

Subrogation is not an issue because unlike *Caplin*, a Ponzi scheme is unwound as a SIPA liquidation, not a reorganization.[233]

229. *See* St. Paul Fire & Marine Ins. Co. v. Pepsi Co., Inc., 884 F.2d 688, 700 (2d Cir. 1989) (finding preemption wasn't possible where the trustee is the only party with standing as bankruptcy law would bind the creditors); Delgado Oil Co., Inc. v. Torres, 785 F.2d 857, 861 (10th Cir. 1986) (finding the automatic stay applies to general claims); Hill v. Gibson Dunn & Crutcher, LLP (*In re* MS55, Inc.), No. 06-CV-01233, 2007 WL 2669150, at *13 (D.Colo. Sept. 6, 2007) (finding *Caplin*'s preemption rationale unpersuasive where the automatic stay applies).

230. *See supra* notes 152–56 & accompanying text.

231. *See* 15 U.S.C. §§ 78fff-2(c)(1)-(3) (2006) (requiring recovered customer property to be used to repay SIPC prepayments and treating recovered transfers as customer property).

232. *See supra* notes 165–67 & accompanying text.

233. In *Caplin*, the Court found it plausible that the business would be reorganized, giving the debenture trustee (the third party being sued) a claim for subrogation against the corporation. *See* Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 430–32 (1972). However, given the realities of liquidating a Ponzi scheme, where claims far outstrip assets, this seems unlikely to come to pass. *See*

Moreover, to the extent *Caplin* relied on the potential harm subrogation posed to equityholders as residual claimants, that concern is inapt under the creditors' bargain theory, where equity is irrelevant.[234]

Finally, *Caplin*'s construction of the trustee's role is inconsistent with the creditors' bargain theory. As noted above, the Court in *Caplin* gave the trustee a narrow role, based merely on collecting information and money for the estate.[235] In the creditors' bargain theory, the trustee is charged with implementing the hypothetical agreement through the collective process.[236] So long as she is not reordering pre-bankruptcy entitlements between the creditors in the process, there is no reason to construe her role so narrowly. Additionally, while the court in *Ozark* rejected the trustee's claim, it found that Congress had intended to substantially enlarge the trustee's powers under the Code as compared to the trustee's powers under the old Bankruptcy Act.[237] There is no clear basis for treating the Court's decision in *Caplin*, which is arguably inconsistent with congressional intent and entailed interpreting a statute that has since been replaced, as binding.

The result of this analysis is that hypothetical creditors would likely agree to empower the trustee to bring these claims as a way reduce collective action problems, generate efficiencies, and expand the estate. Meanwhile, the *Butner* principle,[238] which states

Logan v. JVK Real Estate Servs. (*In re* Bogdan), 414 F.3d 507, 514–15 (4th Cir. 2005) (remarking that subrogation was very unlikely in the context of a liquidation, as it would require recovery of more than the amount of claims against the debtor and even then would likely be barred by *in pari delicto*). Moreover, under SIPA, SIPC would have first crack at any of these potential assets ahead of any third parties asserting subrogation rights. *See* 15 U.S.C. § 78fff-2(c) (2006). Even if this was not the case, as the dissent in *Caplin* pointed out, a subrogee typically needs clean hands, a condition no party found liable for aiding and abetting fraud could satisfy. *See Caplin,* 406 U.S. at 440 (Douglas, J., dissenting). Finally, the subrogation rationale has less force when the trustee stands in the creditors', rather than the debtor's, shoes. *See* Williams v. California 1st Bank, 859 F.2d 664, 667 (9th Cir. 1988) (acknowledging that the third party's subrogation defense applies to actions by the debtor, but not necessarily to actions on behalf of the creditors).

234. *See supra* notes 172–81 & accompanying text; *Caplin,* 406 U.S. at 438 ("Whether conditions have changed so as to leave some equity for the old stockholders, we do not know . . . In some cases the elimination of one entire class of creditors or a pro rata reduction in their claims would give stockholders a chance to participate in the plan.").

235. *See Caplin,* 406 U.S. at 428–29.

236. *See supra* notes 180–81 & accompanying text.

237. *See* Mixon v. Anderson (*In re* Ozark Rest. Equip. Co., Inc.), 816 F.2d 1222, 1227 (8th Cir. 1987).

238. *See supra* note 48 & accompanying text.

that state law entitlements should be respected in a bankruptcy proceeding, remains unaffected. In addition, analyzing *Caplin*'s tripartite rationale as reasons why the hypothetical creditors would not want the suit brought shows that none of these three factors suggests that the trustee should not have standing. Given that empowering the trustee serves the purposes of the creditors' bargain theory and does not alter substantive state law, the theory confirms that the trustee should be empowered.

2. Traditionalist Conceptions

Recognizing the distinctions between a corporate liquidation and an individual bankruptcy is central to understanding why the traditional explanation for bankruptcy also supports empowering the trustee. The traditionalist account stresses the fresh start policy as an important rationale for deviating from a free-for-all state collection system.[239] However, in a corporate liquidation, the "fresh start" policy is irrelevant.[240] By definition, a Ponzi scheme has no going-concern value: in short, there is nothing to preserve and thus no independent interest of the debtor. Yet at least one rationale for limiting the trustee's power to sue on behalf of the creditors stems from the conflict of interests between creditors and a trustee acting as the debtor-in-possession.[241] In such a situation, the role of the trustee, and by extension the Code, is to further the interests of the creditors and potentially other affected constituencies but not the debtor.[242]

Distributional concerns are also prominent in the traditionalist account.[243] In a typical corporate bankruptcy, there are secured creditors, unsecured creditors, employees, future tort claimants, customers, and past employees. All parties have some stake in the business even if that stake may not be recognized as a formal claim

239. *See* Warren, *Policymaking*, *supra* note 18, at 341–42.

240. *See id.* (drawing a distinction between business bankruptcy and consumer bankruptcy). *See also* Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1396 (1985) ("The fresh-start policy is thus substantively unrelated to the creditor-oriented distributional rules that give bankruptcy law its general shape and complexity.").

241. *See* Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 433 nn. 21–22 (1972) (expressing concern that the trustee may stand on both sides of the suit).

242. *See* Warren, *Policymaking*, *supra* note 18, at 344–52 (prioritizing enhancement of value in business bankruptcies).

243. *See supra* notes 187–97 & accompanying text.

under the Code.[244] The Code accommodates these stakeholders by accelerating contingent and unmatured claims to force future claimants into[245] and through the Chapter 11 process,[246] which may preserve jobs by preserving going-concern value.

In a Ponzi scheme bankruptcy, none of these concerns is relevant. When the "sole actor" exception applies, there are few other constituencies to consider. Ponzi schemes have few employees and even fewer who are innocent of wrong-doing.[247] More importantly, the mechanism for considering their jobs—preserving the business—is untenable. There are also few, if any, secured creditors.[248] With the exception of a situation in which a secured creditor is also a target for the trustee, secured claims should be unaffected by these suits. The collateral that served as a security interest is untouched and any deficiency claim bifurcated by Section 506 benefits from the expansion of the estate.[249] Finally, bankruptcy serves as a mechanism to distribute losses.[250] If the trustee can make out an aiding and abetting claim against a third party, then their complicity and concomitant benefit from the scheme suggest they should share some of the costs.

244. *See* Warren, *Policymaking*, *supra* note 18, at 355–57 (discussing the Code's protections for parties with no legal rights in terms of distributing losses in bankruptcy); Warren, *Bankruptcy Policy*, *supra* note 18, at 808–11 (discussing the primary importance of apportioning losses in bankruptcy).

245. *See* 11 U.S.C. § 502 (2006) (including contingent and unmatured liabilities as claims).

246. *See* Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75, 78 ("While employees, communities, and other business dependents may not have traditional claims, the failure of businesses nevertheless implicates their interests. Thus, an analysis of the reorganization process that excludes the interests of these constituencies is too narrow. On this view reorganization can only be understood as a broadly inclusive mechanism of social policy intended to distribute the social costs of business failure.").

247. *See supra* notes 27–28 & accompanying text.

248. *See supra* notes 8–10 & accompanying text.

249. *See* 11 U.S.C. § 506(a)(1) (2006) ("An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim.").

250. *See* Baird, *Loss Distribution*, *supra* note 185, at 816–18 (discussing the traditional account and the importance of loss distribution therein); Warren, *Bankruptcy Policy*, *supra* note 18, at 788 ("By giving the debtor business an opportunity to reorganize, the bankruptcy scheme acknowledges the losses of those who have depended on the business and redistributes some of the risk of loss from the default.").

The traditionalist account also recognizes that a collective proceeding can serve to calm chaos.[251] Preventing a mad dash to levy the assets of a debtor does not just reduce strategic behavior but it also calms contagion and prevents fear from rippling outward into the markets.[252] SIPC insurance is also designed to reduce the impact of collapse on *ex ante* investment.[253] However, when a Ponzi scheme collapses and there are few initial assets in the estate, the process is unlikely to engender confidence among investors and victims. Empowering the trustee furthers the goals of the broader statutory scheme by consolidating the proceeding and providing certainty and fixed liabilities faster than would otherwise be the case.

As with an analysis of empowering the trustee under the creditors' bargain theory, the traditional theory also supports allowing suit against third parties. This conclusion stems from an appreciation of the differences between a Ponzi scheme bankruptcy and a personal bankruptcy or Chapter 11 reorganization. Constituencies to consider are narrower, the debtor itself is out of the picture entirely, and distribution amongst the creditors is unaffected. Indeed, to the extent any of the concerns specific to the traditionalist account are relevant, they suggest that empowering the trustee to vindicate the rights of third parties is also consistent with this theory of bankruptcy.

3. Forum Shopping and Incentives

Although expanding the trustee's power does not alter the substantive state-based entitlement, it may still have worrisome implications. Regardless of the underlying theoretical model, changes to the bankruptcy process may be undesirable to the extent that they incentivize forum shopping and increase moral hazard.[254] Indeed,

251. *See supra* notes 190–93 & accompanying text.

252. *See* Korobkin, *Rehabilitating Values*, *supra* note 18, at 764–66 (discussing the potential for contagion without an orderly bankruptcy process). *See generally* Warren, *Policymaking*, *supra* note 18 (describing the importance of bankruptcy as a self-contained system that limits spillover and provides counterparties with time to uncouple themselves from failing businesses).

253. *See* Hurt, *supra* note 3, at 969–71 (discussing the role of SIPC compensation in Ponzi schemes); Pozza, Jr., et al., *supra* note 7, at 122–23 (explaining Congress' goal of "restoring investor confidence" in enacting SIPA).

254. *See* Baird, *Loss Distribution*, *supra* note 185, at 826 (evaluating forum shopping as a cost of creating an additional avenue of enforcement); Jackson, *Avoiding Powers, supra* note 17, at 730–31 n.17 (discussing the potential for forum-shopping); Jackson, *Of Liquidation*, *supra* note 17, at 400 (discussing the role of the *Butner* principle in limiting forum-shopping).

critics of allowing trustees to sue third parties have suggested that forum shopping could result. However, given the peculiar facts of Ponzi schemes, neither of these concerns are valid.

Moral hazard occurs when an *ex post* remedy or result provides a disincentive to seeking contractual protection or to monitor.[255] To use a timely example, when banks are "too big to fail" they may have incentives to make riskier bets, knowing that a share of the risk at the left tail of the probability distribution is cut off.[256] In the case of a Ponzi scheme, the concern is that empowering the trustee will cause investors to decrease their due diligence and monitoring.

This concern is misplaced. Any decrease in investors' incentives to monitor is likely to be offset by the increased incentives for third parties to monitor. This may in fact be the most efficient model as large banks and other counterparties that are repeat players have inside information and access to more sophisticated monitoring mechanisms.[257] Additionally, moral hazard may presuppose that investors have an ability to contract for protection. In the case of creditor-debtor relations, this is true. For instance, a creditor can seek seniority from other creditors or security from a debtor. What they cannot do is seek protection from a third party with which they have no direct relationship. The Ponzi schemer has a fiduciary duty to his investors but, as explained above, the claim against third parties sounds in tort.[258] Thus *ex ante* contracting for protection is not an option. In fact, given the challenges to individual claims explained above, a collective remedy may actually ameliorate a third party's perverse incentives not to monitor, thereby serving the incentive purpose of tort liability in the first place.[259]

255. *See* Adler, *supra* note 17, at 473–74 (discussing the potential for risk sharing to create perverse investment incentives similar to moral hazard); Rasmussen, *supra* note 18, at 96 (discussing the potential for moral hazard in Chapter Eleven cases).

256. *See* Governor Daniel K. Tarullo, Fed. Reserve Bd., Confronting Too Big to Fail, Speech at the Exchequer Club (Oct. 21, 2009) (transcript available at http://www.federalreserve.gov/newsevents/speech/tarullo20091021a.htm) (describing too-big-to-fail as "classic" moral hazard).

257. This could be considered similar to a form of gatekeeper liability. *See generally* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687 (1997) (describing the effects of different liability regimes on corporate incentives to take care). Gatekeeper liability can also make up for insufficient enforcement mechanisms. *See* Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 889 (1984).

258. *See supra* notes 46–84 & accompanying text.

259. On the incentive goals of tort liability, see generally ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 3–4 (2d ed. 1987) (discussing incentive effects

An underlying premise of the *Butner* principle is that a deviation from state law may lead to undesirable forum shopping.[260] When a debtor can get a better deal in bankruptcy, it disrupts the contractual relationship the parties initially agreed to and may lead to strategic behavior.[261] However, forum shopping is also not an issue in the context of a Ponzi scheme. A Ponzi bankruptcy is almost certainly a liquidation.[262] The debtor has no choice in the matter and already has incentives to avoid bankruptcy and the attendant collapse of the scheme for as long as possible.[263] For forum shopping to be a concern, there have to be several options available, but a class action in state court is barred by the Securities Litigation Uniform Standards Act (SLUSA)[264] and SIPC already

of tort liability); WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 312–16 (1987); STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 297–98 (1987); Guido Calabresi, Some Thoughts on Risk Distribution and the Law of Torts, 70 YALE L.J. 499, 517–19 (1961); R. H. Coase, The Problem of Social Cost, 3 J.L. & ECON. 1, 44 (1960); John C.P. Goldberg, *Twentieth-Century Tort Theory,* 91 GEO. L.J. 513, 544–55 (2003) (discussing the modern economic deterrence theory of tort law, which places an emphasis on *ex ante* incentives); ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 3–4 (2d ed. 1987) (discussing incentive effects of tort liability); WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 312–16 (1987).

260. *See supra* notes 48, 254 & accompanying text.

261. *See supra* note 254 & accompanying text.

262. The scheme only ends when the vehicle runs out of cash and the authorities put an end to the scheme. *See supra* notes 8–10 & accompanying text. Forum shopping is generally more of a concern in the context of a reorganization, which managers may use to avoid unfavorable contracts. *See* Baird, *Uneasy Case*, *supra* note 186, at 133–40; Jackson, *Of Liquidation*, *supra* note 17, at 400 (assessing reorganization and noting the potential for forum shopping); Lynn M. LoPucki & William C. Whitford, Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies, 1991 WIS. L. REV. 11 (1991).

263. *See supra* notes 9–16 & accompanying text.

264. *See* 15 U.S.C. § 78bb(f)(1) (2006):

> No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—
>
> (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or
>
> (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

SLUSA has also been consistently applied to Ponzi schemes, including the Madoff case. *See* Croscill, Inc. v. Gabriel Capital, LP (*In re* Merkin), 817 F. Supp. 2d 346, 359 (S.D.N.Y. 2011) (finding SLUSA applied to claims alleging debtor aided and abetted Madoff's fraud and collecting cases). Given that SLUSA applies, the Trustee must meet the pleading requirements of the PSLRA. *See* Picard v. Kohn, No.

requires assignment.[265] To the extent plaintiffs are able to bring suit outside of bankruptcy, the potential for undesirable forum shopping may actually be greater. Outside of bankruptcy, plaintiffs would have the option of filing suit in any number of different venues. For instance, while the locus of the Madoff fraud was in New York, plaintiffs have avoided that state's Martin Act, which limits securities fraud claims,[266] by filing in Connecticut.[267]

The only other option, a class action under Federal Rule of Civil Procedure 23, would entail the same pleading standards under the Private Securities Litigation Reform Act (PSLRA).[268] In addition, the substantive and procedural hurdles claimants would face in a hypothetical class action make it an unattractive option.

The recent experiences of Madoff victims who have filed class actions are illustrative. In *In re Merkin*, victims sued a feeder fund that had invested 100% of their proceeds in Madoff vehicles.[269] They argued that the fund's managers had failed to conduct due diligence and had been consciously reckless to the fraud.[270] However, the district court rejected the securities fraud claims and

11-CV-1181, 2012 WL 566298, at *6 (S.D.N.Y. Feb. 22, 2012) (finding that the PSLRA scienter requirements applied to certain of trustee's claims).

265. *See supra* note 231 & accompanying text.

266. *See* N.Y. C.L.S. GEN. BUS. LAW, ART. 23–A, § 352-c(1)(a)-(c) (Consol. 1955):

> 1. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices:
>
> (a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale;
>
> (b) Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances;
>
> (c) Any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made . . . .

267. *See, e.g.*, Levinson v. PSCC Servs., Inc., No. 3:09-CV-00269, 2010 WL 5477250 (D. Conn. Dec. 29, 2010).

268. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007) (explaining that class actions covered by the PSLRA must raise an inference of scienter at least as compelling as any opposing inference of non-fraudulent intent); Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71 (2006) (finding SLUSA and the PSLRA apply broadly to securities fraud class actions); *see also In re* Tremont Sec. Law, State Law & Ins. Litig., 703 F. Supp. 2d 362, 370 (S.D.N.Y. 2010) (applying PSLRA standard to a class action complaint filed against Madoff's auditors).

269. 817 F. Supp. 2d 346, 361 (S.D.N.Y. 2011).

270. *Id.* at 350–52.

found that the common law breach of fiduciary duty and aiding and abetting fraud claims were barred by SLUSA.[271] In addition, most courts to consider the matter have found that the Martin Act bars Ponzi scheme-related securities fraud claims in the state of New York.[272] Even when SLUSA and the Martin Act can be avoided through artful pleading, the result may be a class that is too narrow and fact-specific to provide a substantial recovery for victims as a whole. For instance, in *Levinson v. PSCC Services, Inc.*, two Madoff victims were able to circumvent SLUSA by arguing that two banks had violated their custodial agreements and the Connecticut Unfair Trade Practices Act.[273] This is precisely the sort of piece-meal, inefficient litigation that necessitates a collective solution. Empowering the trustee is more efficient but it does not affect incentives to choose bankruptcy over other forums.

4. Conclusion

The result of this analysis is that, in the circumstances of a Ponzi scheme, both the collective and traditional account for bankruptcy support empowering the trustee. In a corporate liquidation, where no individual has incentives to bring the claim and all benefit equally from the bankruptcy proceeding, it is both more efficient and consistent with policy for the trustee to bring such claims. Moreover, the nature of the scheme renders the fresh start and distributional concerns irrelevant. Finally, concerns about forum shopping and perverse incentives are misplaced; the proceeding is involuntary and the impetus to monitor is undisturbed.

CONCLUSION

There are several ways to empower the trustee. The courts to do so have focused on an expansive interpretation of Section 544(a)(1).[274] However, as explained in Part Two, this is inconsistent with the "flavor" of that section.[275] Located within the part of the

271. *Id.* at 359–61.

272. *Id.* at 361 ("The vast majority of courts in this district have held that the Martin Act preempts New York state law claims brought by investors seeking to recover losses related to the Madoff scandal.").

273. Levinson v. PSCC Servs., Inc., No. 3:09-CV-00269, 2010 WL 5477250, at *5 (D. Conn. Dec. 29, 2010).

274. *See* Hill v. Gibson Dunn & Crutcher, LLP (*In re* MS55, Inc..), No. 06-CV-01233, 2007 WL 2669150 (D.Colo. Sept. 6, 2007) (allowing Trustee's § 544 claim for aiding and abetting breach).

275. *See* Mixon v. Anderson (*In re* Ozark Rest. Equip. Co., Inc.), 816 F.2d 1222, 1229 (8th Cir. 1987).

Code defining the estate and the avoidance powers, Section 544 is an imperfect fit. There is no transfer to avoid, and, as explained in the analysis of Section 541, only a tenuous link to the estate itself.[276] Finally, Congress' rejection of Section 544(c) suggests that Congress did not intend for the trustee to have this power as a part of the avoidance powers.[277]

Other trustees have sought to locate this power within Section 105(a),[278] which broadly empowers the court.[279] However, such a construction of Section 105(a) is inconsistent with the usual approach. The courts have construed Section 105(a) to empower the trustee only where it furthers a purpose in a collateral section of the Code.[280] In this case, that would necessarily be either Sections 541 or 544, neither of which supports the trustee's argument. Thus Section 105(a) is likewise an undesirable solution.

The last and most desirable option would be to amend Section 704 itself. As explained above, *Caplin* and *Ozark* rejected the trustee's claims in part through an interpretation of Section 544 and in part based on the courts' understanding of the trustee's role.[281] That role is defined by Section 704.[282] As currently written, there is

276. *See supra* notes 86–93 & accompanying text.

277. *See supra* notes 143–45 & accompanying text.

278. *See In re Ozark*, 816 F.2d at 1230.

279. *See* 11 U.S.C. § 105(a) (2006):

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

See also U.S. v. Energy Res. Co., 495 U.S. 545, 549 (1990) (quoting 11 U.S.C. 105(a) (2010)) ("The Code . . . states that bankruptcy courts may 'issue any order, process, or judgment that is necessary or appropriate to carry out the provisions' of the Code. Th[is] statutory directive [is] consistent with the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships.").

280. *See* Jamo v. Katahdin Fed. Credit Union, 283 F.3d 392, 403 (1st Cir. 2002) ("But section 105(a) does not provide bankruptcy courts with a roving writ, much less a free hand. The authority bestowed thereunder may be invoked only if, and to the extent that, the equitable remedy dispensed by the court is necessary to preserve an identifiable right conferred elsewhere in the Bankruptcy Code."); United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986) ("[Section 105 does not] authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.").

281. *See supra* notes 127–47 & accompanying text.

282. *See supra* notes 88–90 & accompanying text.

no doubt that Section 704 does not empower the trustee. Her job is to "collect and reduce to money the property of the estate" and to "investigate the financial affairs of the debtor."[283] As noted above, the cause of action does not belong to the debtor and *Caplin* construes the "investigate" function to be a reporting requirement.[284] However, by amending Section 704 to include the same language as Section 544(c),[285] Congress can harmonize the Code and the theoretical role of the trustee.

Faced with the rubble Ponzi schemes leave behind, the case law and the Code deny the trustee the power to sue third parties on behalf of the creditors even when such suits are in the best interests of all creditors and even when such suits are the most efficient way to maximize the estate. The courts and Congress should take stock of whether this outcome makes sense in light of the unique characteristics of a Ponzi scheme liquidation and the principles of why we have a bankruptcy forum in the first place. While a legislative solution would be both the cleanest and clearest solution, it may be unrealistic to hope for such reform in the near future. Left to choose between two evils, manipulation of the Code and an inequitable and theoretically unjustified result, courts and trustees should not shy away from confronting the theoretical basis for a broader role for the trustee.

283. 11 U.S.C. § 704(a) (2006).

284. *See* Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 428 (1972).

285. The proposed § 544(c) would have read:

> (c)(1) The trustee may enforce any cause of action that a creditor, a class of creditors, an equity security holder, or a class of equity security holders has against any person, if-
> (2) If the trustee brings an action on such cause of action-
> (3) A judgment in any such action brought by the trustee binds all creditors or equity security holders that could have brought an action on such cause of action. Any recovery by the trustee, less any expense incurred by the trustee in effecting such recovery, shall be for the benefit only of such creditors or equity security holders.

See Mixon v. Anderson (*In re* Ozark Rest. Equip. Co., Inc.), 816 F.2d 1222, 1228 n.9 (8th Cir. 1987).