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Imputation, the Adverse Interest Exception, and the Curious Case of the Restatement (Third) of Agency

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IMPUTATION, THE ADVERSE INTEREST EXCEPTION, AND THE CURIOUS CASE OF THE RESTATEMENT (THIRD) OF AGENCY

MARK J. LOEWENSTEIN*

The imputation doctrine in the common law of agency provides that knowledge of an agent acquired in the course of the agency relationship is imputed to the principal. An important exception to the imputation doctrine, known as the adverse interest exception, provides that knowledge is not imputed if it is acquired by the agent in a course of conduct that is entirely adverse to the principal. These doctrines play an important role in sorting out liability when senior management of a corporation engages in a financial fraud that harms the company. Typically, new management is brought in and it sues the company's outside service providers (auditors, attorneys, and investment bankers), alleging that their negligence (or, in some cases, intentional wrongdoing) was a proximate cause of the fraud's success. The defense invokes the imputation doctrine—senior management's knowledge of the fraud should be imputed to the company—and in pari delicto. The plaintiff responds that the adverse interest exception makes imputation inappropriate and, therefore, in pari delicto is inapplicable. At this point, the issue is joined and, historically, the outside service providers have prevailed. This settled law may have been altered by the recently adopted Restatement (Third) of Agency. This article explores the history of imputation and the adverse interest exception, the evolution and stance of the Restatement (Third) of Agency as it relates to these issues, and how various policy considerations should inform the legal doctrines at issue.

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INTRODUCTION

Among the most enduring concepts in the law of agency is that an agent's knowledge gained in the course of an agency relationship is imputed to the principal.¹ This simple concept

1. Restatement (Third) of Agency Section 5.03 (2006) reads:
For purposes of determining a principal's legal relations with a third party, notice of a fact that an agent knows or has reason to know is

facilitates the ability of persons—individuals and especially entities—to conduct their business through agents, because third parties dealing with the agent can assume that information given to, or otherwise acquired by, the agent in the course of the agency relationship binds the principal, even if the agent in fact fails to disclose the information to the principal.² When the principal is an entity, the third party has no choice but to deal with an agent and would not do so if the agent's knowledge were not automatically imputed to the principal.³ This much is uncontroversial in the law of agency, but there is an exception to this concept that is controversial: the adverse interest exception. As articulated in the Restatement (Third) of Agency, this exception states that “notice of a fact that an agent knows or has reason to know is not imputed to the principal if the agent acts adversely to the principal in a transaction or matter, intending to act solely for the agent's own purposes or those of another person. . . .”⁴

This exception to imputation was one of the most

imputed to the principal if knowledge of the fact is material to the agent's duties to the principal, unless the agent

(a) acts adversely to the principal as stated in § 5.04, or

(b) is subject to a duty to another not to disclose the fact to the principal.

Id. The rationale for the rule has been variously stated, but seems to rest on the idea that the principal has the ability to monitor the agent and to create incentives for properly handling information. *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 5.04, cmt. b (2006).

2. RESTATEMENT (THIRD) OF AGENCY, § 5.03, cmt. b (2006).

3. Thus, the reason for the imputation rule “is to avoid the injustice which would result if the principal could have an agent conduct business for him and at the same time shield himself from the consequences which would ensue from knowledge of conditions or notice of the rights and interests of others had the principal transacted his own business in person.” *First Ala. Bank v. First State Ins. Co.*, 899 F.2d 1045, 1061 (11th Cir. 1990).

4. RESTATEMENT (THIRD) OF AGENCY § 5.04 (2006). The full section reads:

Section 5.04 An Agent Who Acts Adversely to a Principal

For purposes of determining a principal's legal relations with a third party, notice of a fact that an agent knows or has reason to know is not imputed to the principal if the agent acts adversely to the principal in a transaction or matter, intending to act solely for the agent's own purposes or those of another person. Nevertheless, notice is imputed

(a) when necessary to protect the rights of a third party who dealt with the principal in good faith; or

(b) when the principal has ratified or knowingly retained a benefit from the agent's action.

Id. A third party who deals with a principal through an agent, knowing or having reason to know that the agent acts adversely to the principal, does not deal in good faith for this purpose. There are important qualifications to this principle, discussed in detail in sections II and III, *infra*.

important⁵ and vigorously debated topics during the course of the adoption of the Restatement (Third) of Agency by the American Law Institute ("ALI" or "Institute").⁶ At the core of the debate was a concern about the future of litigation involving accounting frauds committed by senior corporate management.⁷ After the discovery of these frauds, the wrongdoers typically are fired by the board of directors, and new management (or a trustee in bankruptcy) for the corporation seeks to recover its losses from the corporation's outside professional service providers—lawyers, accountants, and investment bankers, among others.⁸ The claims vary, but generally amount to claims for professional malpractice, breach of fiduciary duty, fraud, etc.⁹ The outside service providers typically assert an *in pari delicto* defense,¹⁰ arguing that

5. In the course of the discussion of section 5.04 during the 2002 annual meeting, the President of the ALI, Michael Traynor, noted the importance of the section and cautioned the membership: "There is a concern that we not act precipitously today to try to solve problems that have momentous consequence to the economy of our country." 79 A.L.I. PROC. 134 (2002). Another member, in the course of recommending that the section be reconsidered by the Reporter and consultative group, said that "this is an issue that has a great public moment. It has implications to all our financial-markets investors across the country. . . ." *Remarks of R. James George, Jr.*, 79 A.L.I. PROC. 135 (2002).

6. The matter was considered at the annual meetings held on May 13, 2002, May 14, 2003, and May 17, 2005.

7. See, e.g., 79 A.L.I. PROC. 114–142 (2002).

8. See, e.g., *In re The Bennett Funding Grp., Inc.*, 336 F.3d 94 (2nd Cir. 2003) (claim by trustee in bankruptcy against accountants and attorneys); *In re Nat'l Century Fin. Enter., Inc.*, 783 F. Supp. 2d 1003 (S.D. Ohio 2011) (claim by trustee against investment bank); *Adelphia Recovery Trust v. Bank of Am., N.A.*, 2010 WL 3452374 (S.D.N.Y. Sept. 1, 2010) (claim by trustee against banks).

9. E.g., *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 453–4 (7th Cir. 1982). In *Cenco*, the court noted that the various claims asserted against an auditor amount to "a single form of wrongdoing under different names."

10. Literally, "in equal fault." The phrase is part of a longer Latin phrase, *in pari delicto est conditione defendentis*, which has been translated as, "where both parties are equally in the wrong, the position of the defendant is the stronger." BLACK'S LAW DICTIONARY 1838 (9th ed. 2009). In the prototypical case considered in this article, where a corporation sues its auditors who failed to discover or disclose the fraud of the corporation's managers, the corporation is always at least as culpable as the auditor. In *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985), the Court considered whether the clients of a corrupt stockbroker, who convinced the plaintiffs that he was disclosing valuable inside information to them, could maintain an action against the broker (and his employer) when the information turned out to be bogus. The defendant set up the defense of *in pari delicto*. The Court held that defense was inapplicable under these circumstances because, among other reasons, the public would benefit if this sort of wrongdoing was exposed. There is no comparable public benefit if the auditors are precluded from raising the defense; their wrongdoing will be exposed by others who have been harmed by their negligent or intentional misconduct.

knowledge of the accounting fraud should be imputed to the corporation because, of course, it was known to the corporation's agents who committed the fraud. Since the corporation knew of the fraud that caused its losses, the *in pari delicto* doctrine operates to preclude the suit by one wrongdoer, the corporation, against another alleged wrongdoer, the negligent or even corrupt outside service provider, so long as the culpability of the corporate plaintiff is at least as great as the culpability of the defendant outside service provider.¹¹

The force of the imputation doctrine and its limited adverse interest exception are bolstered by an equally well-entrenched doctrine of agency law: the doctrine of *respondeat superior*.¹² Under this doctrine, a principal is liable to a third party who suffers injury as a result of the wrongdoing of an agent that occurred within the scope of the agent's employment, including losses resulting from fraudulent acts of the agent.¹³ The exception to *respondeat superior* is similar to

Some courts have held that *in pari delicto* is a standing issue: a corporation does not have standing to bring a claim against its auditors if the corporation was at least equally at fault. *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 117–20 (2d Cir. 1991). Most courts reject this approach and treat *in pari delicto* as an affirmative defense. *See, e.g., In re Amerco Derivative Litig.*, 252 P.3d 681, 694 (Nev. 2011) and cases collected there.

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

12. RESTATEMENT (THIRD) OF AGENCY § 2.04 (2006) (“An employer is subject to liability for torts committed by employees while acting within the scope of their employment.”).

13. Typical is the language from *In re Innovative Communication Corp.*, 2011 WL 3439291, at *28 (Bankr. D.V.I. Aug. 5, 2011):

The fraud of an officer of a corporation can be imputed to the corporation in certain circumstances:

when the officer's fraudulent conduct was (1) in the course of his employment, and (2) for the benefit of the corporation. This is true even if the officer's conduct was unauthorized, effected for his own benefit but clothed with apparent authority of the corporation, or contrary to instructions. The underlying reason is that a corporation can speak and act only through its agents and so must be accountable for any acts committed by one of its agents within his actual or apparent scope of authority and while transacting corporate business.

Courts have sometimes appeared to have gone further, holding an employer liable for an employee's fraud “even where the fraud was committed strictly for the agent's own benefit and the principal's detriment.” *Pacific Mut. Life Ins. Co. v. Haslip*, 553 So.2d 537, 541 (Ala. 1989) (quoting with approval from the trial court's opinion). In *Haslip*, an insurance company's agent purported to sell a health insurance policy that, in fact, was not offered by the company. The agent pocketed the premium, but the court held the company liable nonetheless. The touchstone was the fact that the agent actually was an employee, represented himself as such and used the company's facilities and resources. The case, and many others like it, demonstrates that courts will protect innocent third parties injured by the fraudulent acts of an agent who either is, or appears to be, acting

the adverse interest exception to imputation, although phrased somewhat differently: if the agent acted outside of the scope of employment and intended to further no interest of the principal, the principal is not liable for the agent's actions.¹⁴ The parallelism between the imputation doctrine and *respondeat superior* is palpable¹⁵ and has been recognized in numerous cases.¹⁶ The court in *In re Mifflin Chemical Corp.*,¹⁷ noted the relationship in the context of a case in which the employees of Mifflin sold denatured alcohol to bootleggers during Prohibition, contrary to Mifflin's instructions, but increasing Mifflin's sales and their commissions (their likely

within the scope of his authority. This principle was captured succinctly in Restatement (Second) of Agency Section 261 (1958): "A principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud."

14. *E.g.*, *Gov't Employees Ins. Co. v. United States*, 678 F. Supp. 454, 456 (D.N.J. 1988) ("Dunne's conduct was not actuated by a purpose to serve the master"); *Johnson v. Evers*, 238 N.W.2d 474 (Neb. 1976) (motorist was off duty and performing no service for employer at time of accident, and his negligence could thus not be imputed to employer under doctrine of *respondeat superior*); *Miller v. Reiman-Wuerth Co.*, 598 P.2d 20, 24 (Wyo. 1979) ("Grandpre's conduct at the time of the collision was not actuated in any part by a purpose to serve appellee"); *Henderson v. Profl Coatings Corp.*, 819 P.2d 84, 89 (Haw. 1991) ("[t]here was no intention to act in the employer's interest, nor was there any direct benefit to the employer").

15. The first Restatement of Agency recognized this in the comment explaining the "meaning of 'acting adversely,'" where the Reporter wrote: "The mere fact that the agent's primary interests are not coincident with those of the principal does not prevent the latter from being affected by the knowledge of the agent if the agent is acting for the principal's interests. The rule as stated herein [the adverse interest exception to the imputation rule] is substantially similar to the rule . . . [relating to acting outside of the within scope of employment in relation to *respondeat superior*]. . . ." RESTATEMENT (FIRST) OF AGENCY § 282, comment 1b. A typical conflation of *respondeat superior* and imputation of knowledge is evident in *In re Rent-Way Sec. Litig.*, 209 F. Supp. 2d 493, 522 (W.D. Pa. 2002), where the court wrote that "the fraud of an officer . . . is imputable to the corporation when the officer . . . commits the fraud: (1) in the scope of his employment, and (2) for the corporation's benefit."

16. *E.g.*, *Official Comm. of Unsecured Creditors of Allegheny Health, Educ. & Research Found. v. PricewaterhouseCoopers, LLP*, No. 07-1397, 2008 WL 3895559 (3d Cir. July 1, 2008) ("If the agent intended to serve the principal, the fraud is imputed; if, however, the agent intended only to serve himself, the fraud is not imputed . . . Moreover, this approach is familiar in Pennsylvania law, as it is the approach followed in *respondeat superior* cases."); *Battenfeld of Am. Holding Co., Inc. v. Baird, Kurtz & Dobson*, 60 F. Supp. 2d 1189, 1215 (D. Kan. 1999) (The court refers to the *respondeat superior* exception when an employee acts adversely to the corporation in a similar context to the adverse interest exception; the actions of the AMC employees in making false entries into AMC's books is not imputed to AMC.).

17. 123 F.2d 311, 315-16 (3d Cir. 1941).

motive). The government sued for the higher taxes due and Mifflin defended on the basis that it did not know of the illegal sale.¹⁸ Moreover, Mifflin argued, since the employees were acting adversely to Mifflin, their knowledge should not be imputed to Mifflin. The court assumed that the employees did not tell their superiors of the illegal sale, and that the employees engaged in conduct prohibited by Mifflin, but concluded that Mifflin nonetheless was bound by their knowledge.¹⁹ The court tied the adverse interest exception to the doctrine of *respondeat superior*:

One need not talk about actual knowledge by Mifflin or a presumption that the employer knows everything that the employee knows. It has been conceded that these employees were violating instructions and that they concealed from their superiors in the Mifflin organization the knowledge of their activities in promoting illegal diversion of the alcohol. That does not, on principles of agency, *ipso facto* relieve the employer of liability. Responsibility of an employer for things his agent does is not imposed on the basis of knowledge in fact, but under the general rule of *respondeat superior*. No reliance need be made on any fictional attributing of knowledge to Mifflin. The employers are responsible for the knowledge of the facts had by their agents in doing the very business for which they were employed.²⁰

In the accounting fraud cases mentioned above, a simple application of the imputation or *respondeat superior* doctrine devastates the plaintiff's case, compelling the plaintiff to seek to avoid imputation and *respondeat superior*.²¹ Traditionally, the adverse interest exception was the doctrine of choice. Plaintiffs argued that the corrupt officers were acting in their own interests, either because the corrupt officers benefited directly from the fraud or because discovery of the fraud was inevitable and, when it is discovered, the corporation would suffer.²²

The vast majority of the reported cases involving suits by

18. *Id.*

19. *Id.*

20. *Id.* at 316.

21. *In re Mifflin Chem. Corp.*, 123 F.2d 311, 315–16 (3d Cir. 1941).

22. *In re The Bennett Funding Grp., Inc.*, 336 F.3d 94, 100 (2d Cir. 2003).

the corporation (whether directly, derivatively, or by a trustee in bankruptcy) against its outside service providers tended to focus more on imputation/adverse interest exception than on the parallel doctrine of *respondeat superior*/scope of employment.²³ Not surprisingly, when the ALI took up the issue of the liability of outside service providers for the accounting frauds of corporate management, it did so in the context of imputation rather than *respondeat superior*.

When this matter was before the ALI in the early 2000s as it considered the Restatement (Third) of Agency, the accounting scandals that came to light at the turn of the twenty-first century—Enron, Adelphia, Tyco, Health South, and others—were fresh in the minds of the members of the ALI, and shaped the debates on the floor of the ALI annual meetings that considered the relevant sections.²⁴ More importantly, some members of the ALI seemed to have a personal stake in the outcome.²⁵ A broad adverse interest exception, that is, one that precluded imputation in more cases, would allow more lawsuits against outside professional service providers—often with deep pockets—to proceed. The stakes were high when section 5.04 of the Restatement, as well as its comments and illustrations, came to the floor of the ALI in 2002, 2003, and 2005.

Thus, a segment of the ALI may have seen the Restatement project as an opportunity to tweak the law in order to make it more amenable to claims by companies against their outside service providers. If so, they would have to expand the doctrine that precludes imputation—the adverse

23. Aside from cases involving an outside service provider, *respondeat superior* seems to be the predominant doctrine to deal with a principal's liability for its agent's fraudulent conduct. See RESTATEMENT (SECOND) OF AGENCY § 282 cmt. a (1958) ("If, however, an agent fails to reveal [a] fact in order to accomplish some fraud of his own antagonistic to the interests of the principal, the principal is not bound, for the same reason that no liability is imposed upon a master for the tort of a servant acting entirely for his own purposes. . . .").

24. Enron alone was mentioned three times in the 2002 proceedings, 79 A.L.I. PROC. at xi, 125, 145 (2002), three times in the 2003 proceedings, 80 A.L.I. PROC. at 16, 259, 337 (2003), four times in the 2004 proceedings, 81 A.L.I. PROC. at 318, 320, 350, 394 (2004), and seven times in the 2005 proceedings, 82 A.L.I. PROC. at 174, 175, 177, 219, 222, 230, 238 (2004). See generally Anup Agrawal and Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J.L. & ECON. 371 (2005) (analyzing the relationship between corporate governance and the likelihood of an accounting scandal).

25. See, e.g., 79 A.L.I. PROC. 121 (2002), where ALI member Gerald K. Smith, in the course of commenting on section 5.04, acknowledged, "I am a trustee in a case where some of these types of issues are surfaced [sic], and I am the client."

interest exception to imputation. This would be a logical strategy, because the adverse interest exception historically was the doctrine that litigators employed to avoid imputation.²⁶ As it turned out, however, precedent around the adverse interest exception was deep and consistent. In short, it would be difficult to restate and broaden the adverse interest exception. Instead, the proponents of a broad adverse interest exception to imputation may have stumbled upon another tactic: narrow the imputation doctrine directly without reference to the motivations of the corrupt agent. In this they succeeded, perhaps.

This article tells the story of these debates and their outcomes. Of course, imputation and the adverse interest exception apply in a myriad of different situations,²⁷ but because of the importance of auditor (and other outside service provider) liability, and the interest of the ALI membership in that issue, this article focuses primarily on the Restatement (Third) of Agency as it relates to the liability of auditors in the context of management accounting fraud.

Part II reviews the precedent that informed the Reporter's initial draft of section 5.04, which I believe accurately restated the law. Part III considers the debate and the changes to section 5.04, including changes to the comments and illustrations. This Part concludes that those who sought to narrow the circumstances under which imputation is recognized had some success in their efforts, but, in the end, the articulation of the adverse interest exception in the Restatement (Third) misstated and muddled the law. Part IV considers how public policy should have informed the outcome of the debate, especially using insights from psychology research, economic analysis, and robust notions of contractual freedom. This Part concludes that the Reporter's original draft stated the law consistently with sound public policy. Part V

26. See *In re The Bennett Funding Grp., Inc.*, 336 F.3d at 100.

27. *E.g.*, *Am. Bank Ctr. v. Wiest*, 793 N.W.2d 172, 175–180 (N.D. 2010) (affirming rescission of a loan made to Wiest because the fraud of the loan officer was imputed to the bank, holding that the adverse interest exception did not apply because the loan officer was not acting solely out of his own interest); *Martin Marietta Corp. v. Gould, Inc.*, 70 F.3d 768, 774 (4th Cir. 1995) (finding that employees of the seller were completely adverse to the purchaser in the context of a sale of a corporate division); *Mancuso v. Douglas Elliman LLC*, 808 F.Supp.2d 606, 630 (S.D.N.Y. 2011) (finding that the adverse interest exception did not apply to the discriminatory practices of a real estate salesperson so that the acts would be imputed to the real estate brokerage firm).

concludes with some thoughts about the ALI and how the Restatement (Third) of Agency might affect the Institute's influence in the future.

I. THE LAW UNDERPINNING THE ADVERSE INTEREST EXCEPTION

The adverse interest exception is a narrow exception to the broad doctrine of imputation, as I demonstrate in the first section below. I then consider two important qualifications to the adverse interest exception. The first involves claims made not by the principal itself against a third party, but rather by a court-appointed successor, who often is successful in avoiding imputation. The second involves the "sole actor" doctrine, which applies when the agent dominates the principal. Under these narrow circumstances, the courts have held that the adverse interest exception is inapplicable and imputation should be recognized. Neither doctrine, however, has much relevance to the typical management fraud case that is the central concern of this article.

A. *The Adverse Interest Exception and its Rationale*

The adverse interest exception operates to rebut the presumption of imputation if the agent acts adversely to the principal and solely for the agent's own purposes or the purposes of a third party.²⁸ The Restatement (Third) of Agency Section 5.04 suggests an element of intent, requiring that the agent must have *intended* to act solely for the agent's own purposes or those of another person.²⁹ The adverse interest exception thus gives rise to some interpretative issues: what are the meanings of "solely," "adverse," and "intent"?

The case law and commentary to section 5.04 do not examine these terms as independent criteria that must be satisfied. Rather, the three concepts merge in the analysis.

28. RESTATEMENT (THIRD) OF AGENCY § 5.04 (2006).

29. *E.g., In re Wedtech Securities Litigation*, 138 B.R. 5, 9 (S.D.N.Y. 1992) ("The New York courts have found that '[t]o come within the exception, the agent must have totally abandoned his principal's interests and be acting entirely for his own or another's purposes. It cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal.' As we stated in our earlier opinion, '[t]he relevant issue is short term benefit or detriment to the corporation, not any detriment to the corporation resulting from the unmasking of the fraud.'" (citations omitted)).

With respect to “solely,” for instance, courts have explored how actions *primarily* motivated by the agent’s personal interests should be characterized.³⁰ The overwhelming precedent that informed the Restatement (Third) of Agency took a rather orthodox view of the term “solely,” concluding that *any* benefit to the principal from the agent’s misconduct—regardless of the agent’s underlying motivations—precluded the application of the adverse interest exception.³¹ At the same time, case law supported the view that if an agent was motivated to serve the principal’s interest, the adverse interest exception could not apply even if the agent did not, in fact, benefit the principal.³² Put differently, if the principal benefited, regardless of the agent’s motives, or if the agent was motivated to benefit the principal, regardless of the outcome of the agent’s conduct, the agent was not acting adversely.³³ It appears, then, that the

30. *Id.* While the Restatement (Third) of Agency does not address this directly, the Restatement (Second) did. In comment c to section 282, the drafters wrote: “The mere fact that the agent’s primary interests are not coincident with those of the principal does not prevent the latter from being affected by the knowledge of the agent if the agent is acting for the principal’s interests.”

31. *E.g.*, Official Comm. of Unsecured Creditors of Allegheny Health, Educ. and Research Found. v. PricewaterhouseCoopers, LLP, 607 F.3d 346, 351 (3d Cir. 2010) (applying “traditional, liberal test for corporate benefit”); *Baena v. KPMG*, 453 F.3d 1, 7–8 (1st Cir. 2006) (“A fraud by top management to overstate earnings, and so facilitate stock sales or acquisitions, is not in the long-term interest of the company; but, like price-fixing, it profits the company in the first instance and the company is still civilly and criminally liable . . . Nor does it matter that the implicated managers also may have seen benefits to themselves—that alone does not make their interests adverse”) (applying Massachusetts law); *In re Amerco Derivative Litig.*, 252 P.3d 681, 695 (Nev. 2011) (“If the agent’s wrongdoing benefits the corporation in any way, the [adverse interest] exception does not apply.”); *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 952 (N.Y. 2010) (insider’s misconduct must “benefit[] only himself or a third party”); *Cobalt Multifamily Investors I, LLC v. Shapiro*, 2008 WL 833237, at *4 (S.D.N.Y. 2008) (adverse interest exception inapplicable if the principal realized “at least some financial benefit” from the fraud); *Bullmore v. Ernst & Young Cayman Islands*, 861 N.Y.S.2d 578, 582 (N.Y. Sup. Ct. 2008) (same). The commentary to section 5.04 notes that in many cases a determination of the “solely” issue is made without examining the agent’s motives and focuses instead on “whether the principal benefited through the agent’s actions.” RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c (2006). *But see* *Bankr. Servs. v. Ernst & Young (In re CBI Holding Co.)*, 529 F.3d 432 (2d Cir. 2008) (some benefit to corporation was not sufficient to overcome the adverse interest exception where managers did not intend to benefit corporation).

32. *E.g.*, *Baena v. KPMG*, 453 F.3d 1, 8 (1st Cir. 2006) (applying Massachusetts law) (“‘Adverse interest’ in the context of imputation means that the manager is motivated by a desire to serve himself or a third party, and not the company, the classic example being looting”).

33. Some cases, however, do require a showing of the agent’s motive if the benefit to the principal was “not inconsistent with an abandonment [by corrupt

"intent," "solely," and "adverse" requirements are satisfied only if the agent was motivated by personal purposes and the principal did not in fact benefit from the agent's conduct.

The ALI's commentary to section 5.04 notes as well that an agent's motive is irrelevant, despite the fact that the black-letter refers to an agent's "intent," which does suggest motive.³⁴ The commentary posits a case in which a company's chief financial officer misleads the company's auditor and the company is subsequently sued by a person who entered into a transaction with the company relying on the false financial statements.³⁵ The company is liable to the plaintiff and the comment says that the motive of the CFO, though unspecified in the illustration, is irrelevant.³⁶

The rationale that emerges from the Restatement (Third) of Agency to support the adverse interest exception is best understood in light of the rationale that supports the basic imputation doctrine. The drafters of the Restatement (Third) offered two rationales for imputation. First, an agent has a duty to its principal to disclose information material to the agent's responsibilities.³⁷ Second, a "more comprehensive justification" is that the doctrine "creates strong incentives for principals to design and implement effective systems through which agents handle and report information."³⁸ This second justification reduces a principal's incentives to use agents to avoid the legal consequences of knowing information that the principal would prefer not to know.³⁹ An exception to imputation, then, should arise when the agent is not acting in a capacity that requires disclosure (i.e., disclosure would not be within the scope of the agent's responsibilities) or the "agent" is not really acting as such (the adverse interest exception).⁴⁰

management] of the corporation's interest." *In re Crazy Eddie Sec. Litig.*, 802 F.Supp. 804, 818 (E.D.N.Y. 1992).

34. RESTATEMENT (THIRD) OF AGENCY, § 5.04 illus. 4-5 (2006).

35. *Id.*

36. *Id.* But this illustration is a bit misleading; the company's liability arises as a result of *respondeat superior*, so imputation and the adverse interest exception are both irrelevant. See, e.g., *In re Crazy Eddie Sec. Litig.*, 802 F.Supp. 804, 818 (E.D.N.Y. 1992) (principal "is liable for its agents' fraud 'though the agent acts solely to benefit himself, if the agent acts with apparent authority.'").

37. RESTATEMENT (THIRD) OF AGENCY § 5.03, cmt. b (2006).

38. *Id.*

39. *Id.*

40. There is a third possibility, which is not germane to the inquiry of this article. The nature of the agency relationship may be such that, for public policy reasons, principals should be shielded from information known to their agents. This last situation might arise in a firm that must restrict the flow of information

The drafters of the Restatement (Third) did not provide as robust a justification for the adverse interest exception as they did for the underlying imputation doctrine. The comments to section 5.04 focus on when the adverse interest exception should not be invoked as opposed to why it may be invoked at all. The justifications for the imputation doctrine, however, point in the direction of a simple justification for the adverse interest exception: it makes no sense to charge a person with the actions or knowledge of someone purporting to act as the person's agent if the purported agent was not acting at all on that person's behalf.⁴¹

A leading case, decided by the Seventh Circuit Court of Appeals in 1982 and cited in the Reporter's Notes to section 5.04, adopts this narrower view of the adverse interest exception, without ever mentioning the doctrine or, indeed, the Restatement of Agency. The case, *Cenco Inc. v. Seidman & Seidman*,⁴² also provided a cogent rationale for imputation and the *in pari delicto* defense. The case involved fraud by upper-level corporate management, primarily by overstating the value of inventories.⁴³ This overstatement increased the value of the company, which resulted in higher stock price and lower borrowing costs.⁴⁴ The district court and the court of appeals agreed that the knowledge of the corrupt officers was the knowledge of the company;⁴⁵ thus, *in pari delicto* provided a defense for the auditors, who were alleged to have been complicit in the fraud.⁴⁶

The appellate court analyzed the appropriateness of imputation and *in pari delicto* in the context of the objectives of tort liability generally—compensating victims of wrongdoing

from one department to another. For instance, an investment bank that provides advice to a company contemplating a financing might prohibit the transference of that information to its trading department. If, in fact, there is no disclosure from the banking department to the trading department, the trading department should not be subject to a claim of trading on such information, despite the imputation doctrine. Under these circumstances, imputation would be inappropriate.

41. Of course, if a third party dealt with the purported agent reasonably believing, based on conduct of the "principal," that the purported agent was in fact an agent and was acting on behalf of the "principal," then the "principal" may be liable to the third party on grounds such as estoppel. See RESTATEMENT (THIRD) OF AGENCY § 2.05 (2006).

42. 686 F.2d 449 (7th Cir. 1982).

43. *Id.* at 451.

44. *Id.*

45. *Id.* at 454.

46. *Id.*

and deterring future wrongdoing.⁴⁷ As to the former, the court noted that any recovery on behalf of Cenco would benefit its current shareholders, some of whom acquired stock after disclosure of the fraud and others of whom may themselves have committed the fraud.⁴⁸ Neither of these groups, the court concluded, were victims of the fraud.⁴⁹ As to the shareholders who acquired Cenco shares during the perpetration of the fraud, they had a securities fraud claim directly against the auditors, which coincidentally, was settled just as the trial on Cenco's claim against the auditors began.⁵⁰ As to these shareholders, the court concluded that if Cenco succeeded in recovering from the auditor, they would receive a "double recovery."⁵¹

As to the second objective, deterring wrongdoing, the court concluded that the board of directors of Cenco was in a better position to monitor the conduct of corporate management than the auditor.⁵² The court noted that if the auditor were held liable, the board's "incentives to hire honest managers and monitor their behavior will be reduced."⁵³ The court said the shareholders of Cenco bore some of the fault for the fraud because the directors that they elected—their "delegates"—were "slipshod in their oversight."⁵⁴ Finally, the court noted that if Cenco could divorce itself from its corrupt managers, then the auditor should be able to divorce itself from members and employees of the firm who suspected fraud but did not act on their suspicions.⁵⁵

While traditional tort objectives dominated the court's analysis, the court did consider the relevance of the adverse interest exception, albeit not under that rubric.⁵⁶ The analysis

47. *Id.* at 455.

48. *Id.* at 456.

49. *Id.* at 455.

50. *Id.* at 451.

51. *Id.* at 457.

52. *Id.* at 455–56. The notion that a principal bears responsibility for monitoring its agents who conspire with third parties has been affirmed in subsequent circuit cases. *See, e.g.,* Banco Indus. de Venezuela v. Credit Suisse, 99 F.3d 1045, 1051 (11th Cir. 1996) ("[T]he bank must increase its own vigilance and supervision to prevent being made a victim by the culpability of its own responsible officers. In this case the principal employee at fault was the executive vice president of [the bank], and the bank cannot avoid the consequences for his fraudulent actions within the scope of his unsupervised duties.").

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

54. *Id.* at 456.

55. *Id.*

56. *Id.* at 454–55.

of the adverse interest exception arose in the context of considering an earlier English case in which the auditors were held liable to an audit client for negligently failing to discover that the company's manager had misrepresented the company's profits.⁵⁷ This misrepresentation caused the company to pay dividends and bonuses to which the manager otherwise would not have been entitled.⁵⁸ The court distinguished this case from *Cenco* on the basis that the manager "was stealing from, not for, the company."⁵⁹ This pithy distinction, of course, captured the essence of the adverse interest exception. Stealing *from* the company fell within the exception, while stealing *for* it did not. Left unexplained in the court's opinion was why that distinction should make a difference, but the first objective of tort law does provide an answer. If the manager was stealing from the company, the company was the victim and, other things being equal, should be compensated from those whose negligence caused the loss.

B. Corporate Plaintiff Versus Trustee in Bankruptcy or State Liquidator

Many suits against auditors and other outside service providers are initiated by a trustee in bankruptcy or state-appointed liquidator, who succeeds to any claims that the bankrupt company may have had and, presumably, is subject to the same defenses that might have been asserted against the company.⁶⁰ Nevertheless, the fact that the plaintiff is the

57. *Id.* at 454 (citing *Leeds Estate, Bldg. & Inv. Co. v. Shepherd*, 36 Ch.D. 787, 802, 809 (1887)).

58. *Id.* at 454–55.

59. *Id.* at 455.

60. Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1150 (11th Cir. 2006) ("If a claim . . . would have been subject to the defense of *in pari delicto* at the commencement of the bankruptcy, then the same claim, when asserted by the trustee, is subject to the same affirmative defense."); *Grassmuck v. Am. Shorthorn Ass'n*, 402 F.3d 833, 836 (8th Cir. 2005) ("[T]he equitable defense of *in pari delicto* is available in an action by a bankruptcy trustee against another party if the defense could have been raised against the debtor."); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 358 (3d Cir. 2001) (noting that no courts have ruled that *in pari delicto* defense does not apply to a trustee in the bankruptcy context); *In re Advanced RISC Corp.*, 324 B.R. 10, 15 (D. Mass. 2005) ("In short, although the statute does not explicitly state that the bankruptcy trustee is bound by all defenses to which the debtor was subject, that premise is necessarily implied by the Bankruptcy Code and is confirmed by case law and the legislative history."); *In re Scott Acquisition Corp.*, 364 B.R. 562, 570 (Bankr. D. Del. 2007) ("The plain language of the [bankruptcy] statute and the legislative history clearly suggests that if a claim

trustee or liquidator, instead of the company itself, has caused some courts to view these cases differently.

Schacht v. Brown,⁶¹ for instance, which is discussed in the Reporter's Notes to section 5.04, involved a claim by a State Director of Insurance, acting as the liquidator of an insolvent insurer, against the insurer's outside auditors and others.⁶² The outside service provider defendants sought to "estop" the director from pursuing a claim against them, citing the *Cenco* decision, which was decided by a different panel of the same court.⁶³ The essence of this estoppel claim was, of course, just *in pari delicto* by another name. The Reporter characterized *Schacht* as a case that "may" have "modified" the analysis in *Cenco*.⁶⁴ Hardly. In fact, the *Schacht* court carefully distinguished *Cenco*. It rejected the defendants' reliance on estoppel, writing that the Director's claim was based on the federal RICO statute,⁶⁵ so federal policies must be brought "to bear."⁶⁶ In other words, state common law doctrines such as imputation and the adverse interest exception may not necessarily be determinative in a federal RICO claim.

Second, and more relevant for present purposes, the *Schacht* court distinguished *Cenco* on its facts because the conduct of the allegedly corrupt officers in the *Schacht* case could "in no way" be described as beneficial to the company.⁶⁷ Rather, the insurer was "fraudulently continued in business past its point of insolvency and systematically looted of its most profitable . . . business."⁶⁸ The court suggested that this case, unlike *Cenco*, was one in which the corrupt officers were stealing from the corporation rather than for it.⁶⁹ Finally, the court applied the traditional tort analysis of compensation and deterrence, and concluded that due to the deep insolvency of the insurer, recovery would not benefit its shareholders and there was no evidence of the existence of shareholders capable

by a debtor is barred by an *in pari delicto* defense, that same claim brought by a trustee is similarly barred.").

61. 711 F.2d 1343 (7th Cir. 1983).

62. *Id.*

63. *Id.* at 1346–47. This case was decided by Judges Cummings, Wood, and Hoffman (Senior District Judge) while *Cenco* was decided by Judges Bauer, Wood, and Posner.

64. RESTATEMENT (THIRD) OF AGENCY § 5.04 note c (2006).

65. 18 U.S.C. § 1962 (2006).

66. *Schacht*, 711 F.2d at 1347.

67. *Id.* at 1347–48.

68. *Id.* at 1348.

69. *Id.*

of monitoring the insurer's behavior.⁷⁰ In short, the *Schacht* court went to great lengths to distinguish and preserve *Cenco*.

The most that can be said of *Schacht*'s effect on the adverse interest exception is that, after that case, the adverse interest exception will be satisfied if a principal is insolvent at the time that the agents act adversely to it, and the consequence of their conduct is to deepen that insolvency. Some courts have recognized a cause of action in tort for liquidators against outside service providers based on the concept that the company's deepening insolvency harms creditors.⁷¹ This application of the adverse interest exception in situations similar to *Schacht* has been followed by a few courts,⁷² but rejected by others.⁷³ In any case, it is a narrow qualification to

70. *Id.* at 1348–49.

71. See generally Douglas R. Richmond, Rebecca Lamberth & Ambreen Delawalla, *Lawyer Liability and the Vortex of Deepening Insolvency*, 51 ST. LOUIS U. L.J. 127 (2006) (analyzing the liability of lawyers on a tort claim based on prolonging the insolvency of a client).

72. *E.g.*, *Fehribach v. Ernst & Young LLP*, 493 F.3d 905, 908 (7th Cir. 2007) (noting that the deepening insolvency theory could be invoked in a case where management is in cahoots with an auditor or other outsider and concealed the corporation's perilous state, which if disclosed earlier would have enabled the corporation to survive in reorganized form); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349 (3d Cir. 2001) (“[T]he Pennsylvania Supreme Court would determine that ‘deepening insolvency’ may give rise to a cognizable injury.”); *Hannover Corp. of Am. v. Beckner*, 211 B.R. 849, 854 (M.D. La. 1997) (“[A]ggravation of insolvency or prolonging the life of an insolvent business has been considered to constitute injury to the corporation.”); *Allard v. Arthur Andersen & Co. (USA)*, 924 F. Supp. 488, 494 (S.D.N.Y. 1996) (“Because courts have permitted recovery under the ‘deepening insolvency’ theory, [Arthur Andersen] is not entitled to summary judgment as to whatever portion of the claim for relief represents damages flowing from indebtedness to trade creditors.”); *In re Latin Inv. Corp.*, 168 B.R. 1, 5 (Bankr. D.D.C. 1993) (holding that damages inflicted in perpetuating the debtor's existence past the point of insolvency in order to loot is compensable); *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 888 (N.J. 2006) (“[W]e find that inflating a corporation's revenues and enabling a corporation to continue in business ‘past the point of insolvency’ cannot be considered a benefit to the corporation.”).

73. *E.g.*, *In re CitX Corp.*, 448 F.3d 672, 677 (3d Cir. 2006) (holding that purported harm to corporation in the form of deepening insolvency was not a valid theory of damages supporting professional malpractice claim asserted against corporation's accounting firm and its partner under Pennsylvania law); *Florida Dep't of Ins. v. Chase Bank of Texas Nat'l Ass'n*, 274 F.3d 924, 935 (5th Cir. 2001) (“There do not appear to be any reported Texas cases recognizing ‘deepening insolvency.’ ”); *Askanase v. Fatjo*, No. Civ. A.H–91–3140, 1996 WL 33373364, at *28 (S.D. Tex. Apr. 1, 1996) (“The shareholders, who comprise LivingWell could not be damaged by additional losses incurred after the point of insolvency because they had already lost their equity interest in the company. The Court is unpersuaded by the plaintiffs’ ‘deepening insolvency theory.’ ”); *Coroles v. Sabey*, 79 P.3d 974, 983 (Utah Ct. App. 2003) (rejecting “deepening insolvency” as a theory of damages because shareholders rather than the corporation suffer harm).

the adverse interest exception and, in effect, ignores the motive for the fraudulent conduct of the corrupt agents and focuses exclusively on the lack of benefit to the principal. The facts of *Schacht* suggest that it might be a case that is within the traditional analysis because the corrupt officers may not have been motivated to further the insurer's interest and, under the deepening insolvency rationale, the insolvent insurer did not benefit from their conduct.

C. *Equitable Limitations on Imputation*

One recent case, which post-dated the Restatement (Third) of Agency but did not rely on it, recognized an exception to imputation and *in pari delicto* based on what the court characterized as "principles of fairness and equity."⁷⁴ *NPC Litigation Trust v. KPMG LLP*,⁷⁵ a 2006 opinion of the New Jersey Supreme Court, allowed a litigation trust, acting as a corporation's successor-in-interest, to maintain a negligence action against the corporation's outside auditor.⁷⁶ The court expressly rejected *Cenco* and held that "the imputation doctrine does not bar corporate shareholders from recovering through a litigation trust against an auditor who was negligent within the scope of its engagement by failing to uncover or report the fraud of corporate officers and directors."⁷⁷ The court reasoned that imputation was intended to protect innocent third parties who dealt with a principal through an agent and were defrauded by that agent.⁷⁸ As the auditor was not the victim of

For a summary of each state's law on the issue, see Leo R. Beus, *Proximate Cause, Foreseeability, and Deepening Insolvency in Accountants' Liability Litigation*, ALI-ABA BUS. L. COURSE MATERIALS J. 31, 31-34 (2009).

74. *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 887 (N.J. 2006), *remanded sub nom* *NCP Litig. Trust v. KPMG*, 934 A.2d 132 (N.J. Super. Ct. Law Div. 2007).

75. *Id.* at 871.

76. *Id.* at 873.

77. *Id.* With regard to *Cenco*, and the rationale of that court that a recovery by the corporation might benefit wrongdoers and reduce the incentive to monitor corporate management, the court said that if some shareholders are guilty of wrongdoing they can be excluded from the "class" and that it is unrealistic to expect any but the largest shareholders to engage in any monitoring of the corporation. As to those shareholders, they, too, can be precluded from recovery according to the *NPC* court. The court may be mistaken with this observation because the action was not a class action. Instead, the litigation trustee merely stepped into the shoes of the corporation and the recovery, if any, would presumably go into the corporate treasury, not directly to the shareholders.

78. *Id.* at 882.

a fraud and, if negligent, was not innocent, there was no reason, in the court's view, "to stretch [the imputation doctrine] to its breaking point."⁷⁹

A careful reading of *NCP*, however, suggests that it may be more properly characterized as just another deepening insolvency case. First, the *NCP* court cited *Schacht* and seemed to indicate that *NCP* was a case in which the actions of the corrupt officers resulted in deepening insolvency.⁸⁰ Second, in remanding the case to the superior court, the New Jersey Supreme Court instructed the lower court to determine whether the alleged negligence of the auditor was the proximate cause of the corporation's losses.⁸¹ On remand, the superior court analyzed the loss question solely under the theory of deepening insolvency, concluding that if the corrupt officers caused the corporation to continue beyond the time that it otherwise would have declared bankruptcy, such action would constitute harm to the corporation.⁸² This analysis implicitly rejects the importance of identifying the motivation of the corrupt officers and embraces the idea that the actions of the corrupt officers could not have been in the corporation's interest if the only consequence of their conduct was to deepen the corporation's insolvency.⁸³

This narrow reading of the *NCP* litigation, of course, avoids engaging the court's fairness analysis, but that analysis is (as is often the case) devoid of persuasive force. Why is it more fair to allow the corporation to selectively disclaim the knowledge (and conduct) of its own officers acting in the corporate interest, than it is to allow a third party to insist that the corporation be bound by such knowledge? Why is it fairer that a corporation's outside service providers should be liable for the losses caused by corrupt corporate officers than the corporation's shareholders? A vigorous dissent in the opinion also relied on a fairness analysis:

Basic principles of fairness and common sense demand that

79. *Id.*

80. *Id.* at 888.

81. *Id.* at 890.

82. *NCP Litig. Trust v. KPMG*, 945 A.2d 132, 143 (N.J. Super. Ct. Law Div. 2007). The Superior Court was instructed to determine whether the alleged negligence of the auditor was the proximate cause of the harm to the corporation and, to make this determination, the court first had to conclude that deepening insolvency is a harm to the corporation.

83. *Id.* at 143.

when, as here, one who already has knowledge of a fraud, either directly or by imputation, and later seeks relief from a third party because of reasonable reliance on the third party's failure to expose the fraud, that claim must be rejected. It has long been the law in New Jersey that '[o]ne who engages in fraud . . . may not urge that one's victim should have been more circumspect or astute.'⁸⁴

One can, of course, choose either side and, in the end, the rejection of imputation should rest on firmer grounds. Interestingly, the *NCP* court never grappled with the *in pari delicto* defense and so never broached the question as to why it was "fair" to favor one wrongdoer (ironically, the one who committed a fraud) over another (in this case, a merely negligent wrongdoer) in litigation between them.⁸⁵ Whether there was imputation or not, the corporation is clearly responsible for the actions of its corrupt officers and so the court, in essence, undermined *respondeat superior* and the doctrine of constructive notice.⁸⁶

Some other courts have employed *NCP*-style logic to hold that when the beneficiaries of the recovery are not the shareholders, imputation of the knowledge of the corrupt managers to plaintiff (typically the creditors) is not appropriate.⁸⁷ An example is *Comeau v. Rupp*,⁸⁸ an action by the FDIC against the auditors of a failed savings and loan association. The court observed that any recovery would inure to the benefit of the public, represented by the FDIC, and not to the shareholders of the association, thus distinguishing this case from *Cenco*.⁸⁹ By contrast, the FDIC and the compensated

84. *NCP*, 901 A.2d at 898 (LaVecchia, J., dissenting).

85. See, e.g., *id.* at 897 (LaVecchia, J., dissenting) ("[T]he imputation defense traditionally has provided an important bulwark against corporate abuse by requiring that corporations, like individuals, bear responsibility for their statements and actions.").

86. *Id.* at 897 (LaVecchia, J., dissenting).

87. E.g., *Welt v. Sirmans*, 3 F. Supp. 2d 1396, 1402-03 (S.D. Fla. 1997) (distinguishing claim brought by innocent creditors from claim of shareholders); *In re Jack Greenberg, Inc.*, 240 B.R. 486, 506 (Bankr. E.D. Pa. 1999) (articulating the same point as the court in *Welt*); but see *In re Meridian Asset Mgmt., Inc.*, 296 B.R. 243, 256 (Bankr. N.D. Fla. 2003) (rejecting the holding of the *Welt* court because the trustee only has the authority to bring claims belonging to the bankrupt corporation, not those of its creditors).

88. 810 F. Supp. 1127 (D. Kan. 1992).

89. *Id.* at 1142. Recall that *Cenco* court expressed the view that imputation was proper because *Cenco* shareholders would otherwise benefit from a recovery and they were not blameless in the wrongdoing—they could have selected better

party (the public) are innocent of any wrongdoing, direct or imputed. Thus, the court concluded that imputing the wrongdoing of the association's principals to the FDIC "would defeat rather than further the tort principle of compensating the victim, while doing nothing either to deter culpable parties . . . or to encourage the shareholders to employ more trustworthy corporate managers."⁹⁰

This view has merit as a matter of tort policy, but is really beside the point insofar as the imputation doctrine is concerned. The claims of the FDIC or any successor-in-interest derive from the predecessor entity. If a claim is based on a contract of the entity, for instance, logic dictates that the successor-in-interest is subject to any defenses that the defendant could have imposed to a claim by the entity, including, for instance, fraud by the entity's officers. It makes no sense to allow the successor to avoid a claim of fraud in the inducement on the basis that the successor (and those who it represents) is innocent of the fraud. In essence, a claim against auditors for negligence is a breach of contract claim, as the relationship only exists because of the underlying contract.⁹¹ Put differently, the auditor's duty of care arises only because the parties are in privity of contract. The auditor should not be put in a worse position because its counter-party's losses were so great as to require the appointment of a receiver or liquidator, while if that counter-party had avoided bankruptcy or receivership, the auditor could raise imputation and the *in*

agents and engaged in more meaningful monitoring.

90. *Id.*

91. Consider in this regard the economic loss rule, which, subject to certain exceptions, prohibits a person from recovering tort damages from another if the loss is economic in nature and the relationship of the parties arises from a contract between them. *See, e.g.*, *Indem. Ins. Co. of N. Am. v. Am. Aviation, Inc.*, 891 So. 2d 532, 536 (Fla. 2004) ("The economic loss rule is a judicially created doctrine that sets forth the circumstances under which a tort action is prohibited if the only damages suffered are economic losses."); *Prospect High Income Fund v. Grant Thornton, LLP*, 203 S.W.3d 602, 609 (Tex. App. 2006), *rev'd on other grounds*, *Grant Thornton LLP v. Prospect High Income Fund*, 314 S.W.3d (Tex. 2010) (holding that economic loss rule barred a negligence claim of hedge funds against the outside auditor of the LLC that sold bonds to hedge funds because the funds only suffered alleged economic damages); *Hotels of Key Largo, Inc. v. RHI Hotels, Inc.*, 694 So. 2d 74 (Fla. Dist. Ct. App. 1997) ("Hotel franchisees brought action against franchisor, alleging that franchisees were fraudulently induced into entering licensing agreement and that franchisor breached implied duty of good faith and fair dealing and violated state Franchise Act. . . . The [court] held that under economic loss doctrine, franchisees were limited to pursuing their rights in contract.").

pari delicto defense.⁹²

D. *The Sole Actor Exception*

No discussion of the adverse interest exception would be complete without considering the sole actor exception—yes, an exception to an exception. Under this doctrine, imputation is proper *even if* the agent was acting in a manner totally adverse to its principal if the agent was, in effect, the sole person who could act on behalf of the principal or completely dominated others who could act on behalf of the principal.⁹³ The theory behind this exception is that “the sole agent has no one to whom he can impart his knowledge, or from whom he can conceal it, and that the corporation must bear the responsibility for allowing an agent to act without accountability.”⁹⁴ The sole actor doctrine, of course, reflects the underlying philosophy of imputation and emphasizes its narrow scope: the principal is responsible for the acts and knowledge of its agents even, in some cases, if the agent is acting adversely to the principal.

E. *Summary*

In short, then, the adverse interest exception is a narrow exception to imputation. After holding, typically, that “the agent’s actions must be completely and totally adverse to the corporation to invoke the exception,”⁹⁵ a recent opinion went on to observe that “[r]equiring total abandonment of the corporation’s interest renders the exception very narrow.”⁹⁶

92. *In re Wedtech Sec. Litig.*, 138 B.R. 5, 8–9 (Bankr. S.D.N.Y. 1992): “[T]he general principle [is] that ‘[t]he trustee succeeds only to such rights as the bankrupt possessed; and the trustee is subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition.’” *Bank of Marin v. England*, 385 U.S. 99, 101, 87 S.Ct. 274, 276, 17 L.Ed.2d 197 (1966); *see also* 11 U.S.C. § 541 (1988) (“Where, as in the present case, a trustee is asserting claims that belonged to the bankrupt company before its petition, not to the creditors, this general rule applies. We find that plaintiff remains subject to the imputation defense.”).

93. *E.g.*, *In re Pers. and Bus. Ins. Agency*, 334 F.3d 239, 242–43 (3d Cir. 2003); *In re Mediators, Inc.*, 105 F.3d 822, 827 (2d Cir. 1997); *In re Nat’l Century Fin. Enters., Inc.*, 783 F. Supp. 2d 1003, 1017 (S.D. Ohio 2011); *In re Innovative Commun. Corp.*, No. BR 07-30012, 2011 WL 3439291, at *28–29 (Bankr. D.V.I. Aug. 5, 2011); *In re Amerco Derivative Litig.*, 252 P.3d 681, 695 (Nev. 2011).

94. *In re Personal and Bus. Ins. Agency*, 334 F.3d at 243.

95. *In re Amerco Derivative Litig.*, 252 P.3d at 695.

96. *Id.*

The primary qualification—the sole actor doctrine—is equally well established and narrow. Moreover, for present purposes, the facts that support it are not present in the garden-variety fraud cases that concerned the ALI membership.⁹⁷ A second qualification, the deepening insolvency doctrine, is not universally accepted by the courts and, in any event, is irrelevant to many cases where the corrupt managers do not bankrupt the company.⁹⁸ Thus, those seeking to narrow the imputation doctrine needed a different approach. The next section describes their success in finding one.

II. IMPUTATION AND THE ALI'S DEBATES

The ALI's approach to Restatements is fairly well regularized and prescribed. This approach limits what the Institute can do in a Restatement and gives its users confidence in the final product. It is important to understand the ALI's approach to the preparation of a Restatement in order to fully appreciate the criticisms of section 5.04 in this article. After describing how the American Law Institute is organized and operates, this Part provides a short history of section 5.04 from the first draft, in 2001, to its final approval in 2005. Interestingly, the principal changes were not so much in the black-letter provision as in the commentary that followed. This Part concludes with a legal analysis of section 5.04 using the sort of logic that a court might employ in seeking to understand the breadth of the adverse interest exception.

A. *The Procedures of the ALI: A Long and Winding Road*

The ALI was formed in 1923 to “promote the clarification and simplification of the law.”⁹⁹ To that end, one of the principal projects of the ALI is the production of restatements of the law, and many such restatements have been published in

97. Some courts have narrowed the sole actor doctrine, holding that if there was any “innocent decision-maker” who could have thwarted the wrongdoing, the doctrine does not apply (with the result that imputation does apply). *In re* 1031 Tax Group, LLC, 420 B.R. 178, 202–03 (Bankr. S.D.N.Y. 2009). *But see, e.g.*, *Baena v. KPMG LLP*, 453 F.3d 1, 8–9 (1st Cir. 2006) (existence of innocent decision-makers is irrelevant).

98. See discussion, *supra* notes 67–73.

99. AMERICAN LAW INSTITUTE, CAPTURING THE VOICE OF THE AMERICAN LAW INSTITUTE: A HANDBOOK FOR ALI REPORTERS AND THOSE WHO REVIEW THEIR WORK 1 (2005) [hereinafter HANDBOOK].

the ALI's long history.¹⁰⁰ The ALI strives for a consistent look and feel in its restatements as well as an accurate presentation of the law.¹⁰¹ To that end, the Institute recently published a "Handbook" to guide those responsible for producing the restatements and those who review their work.¹⁰² The Handbook painstakingly describes the process of preparing a restatement and explains its purpose:

Restatements are addressed to courts and others applying existing law. Restatements aim at clear formulations of common law and its statutory elements or variations and reflect the law as it presently stands or might plausibly be stated by a court. Restatement black-letter formulations assume the stance of describing the law as it is.¹⁰³

After the ALI's Council,¹⁰⁴ which is the governing body of the ALI, determines that a new restatement is a timely project for the ALI to undertake, it appoints a reporter (the "Reporter") for that restatement. The ALI's Director, in consultation with the Reporter, then appoints an advisory group (the "Advisers") to assist the Reporter in the heavy lifting of preparing the restatement.¹⁰⁵

The initial drafts (called "Tentative Drafts") of a restatement are prepared by the Reporter with the assistance of the Advisers and are circulated to a larger group of ALI members who have volunteered to serve on a "Member Consultative Group."¹⁰⁶ Comments from this group are considered by the Reporter and Advisers in preparing a draft for consideration by the ALI Council (the "Council Draft").¹⁰⁷

100. The ALI has published more than thirty restatements of the law. For a complete list, see Harry G. Kyriakodis, *Past and Present ALI Projects*, AM. LAW INST., http://www.ali.org/doc/past_present_ALIprojects.pdf (last visited Sept. 7, 2012).

101. HANDBOOK, *supra* note 99, at 2.

102. *See id.*

103. *Id.* at 4.

104. According to the bylaws of the ALI, the Council is elected by the members of the ALI at its annual meeting. *Bylaws*, AM. LAW. INST., <http://www.ali.org/index.cfm?fuseaction=about.bylaws> (last visited Sept. 7, 2012). Most members of the ALI are also elected annually after being nominated by a nominating committee. *Id.*

105. HANDBOOK, *supra* note 99, at 15.

106. See the ALI's web site, which describes the "drafting cycle." *Drafting Cycle*, AM. LAW INST., <http://www.ali.org/index.cfm?fuseaction=projects.drafting> (last visited Sept. 7, 2012).

107. HANDBOOK, *supra* note 99, at 16.

Council action may require that this process be repeated one or more times before the Council deems the Reporter's work ready for consideration by the broader ALI membership at the ALI's annual meeting.¹⁰⁸ When this occurs, the membership is provided with a "Discussion Draft" of the restatement.¹⁰⁹ The Reporter typically appears before the assembled membership of the ALI and proceeds through the Discussion Draft section-by-section, explaining what has been done and why.¹¹⁰ The membership has an opportunity to discuss the sections and propose amendments to the draft, including changes to the comments and illustrations.¹¹¹

Typically, each Tentative Draft, Council Draft, and Discussion Draft deals with only a portion of what will be the full restatement. As a result, the process of preparing a restatement typically extends over several years, with the Restatement (Third) of Agency taking about ten years between initiation and final approval by the membership in 2006.¹¹² The project culminates in a proposed final draft submitted to the membership for approval after thorough vetting by the Advisers, Members Consultative Group, and Council. The Handbook indicates that although the membership votes on the various Tentative Drafts and one or more Proposed Final Drafts, ultimately the Council has the final word on the contents of the restatement.¹¹³

The restatement itself includes a black-letter statement of the law, commentary and illustrations (in the form of hypothetical situations) explaining the black-letter statements, along with the notes of the Reporter. All aspects of the restatement are subject to the review process described above, and the Handbook states that the final product is that of the ALI, not the Reporter or any of the groups that assisted in its

108. *Id.* at 17. With the election of twenty-seven new members on January 26, 2012, the ALI's membership stood at 4338 members. The Executive Council of the ALI approves members based on nominations and supporting statements from current members of the Institute. The membership consists of practicing lawyers, members of the judiciary, and academics. Of the most recently elected members, roughly one-half were practicing lawyers, a third academics, and the balance judges. For more information, see the ALI bylaws, available at <http://www.ali.org/doc/Council-Rules-5-21-12.pdf> (last visited Oct. 5, 2012).

109. *Id.* at 18.

110. *Id.*

111. *See id.* at 14–19 (detailing the "drafting cycle").

112. RESTATEMENT (THIRD) OF AGENCY (2006).

113. HANDBOOK, *supra* note 99, at 18.

preparation.¹¹⁴

A key question—perhaps *the* key question—in the preparation of a restatement is the extent to which a black-letter provision may deviate from a fair reading of the law and state the law as the ALI believes it should be. The Handbook recognizes this tension¹¹⁵ and provides a wonderfully murky answer to it. On the one hand, the Handbook states that the black-letter statements should be “attentive to and respectful of precedent” and drafted with the “precision of statutory language.”¹¹⁶ On the other hand, a restatement ought not to reflect precedent “that is inappropriate or inconsistent with the law as a whole.”¹¹⁷ Such precedent should, instead, cause the Institute “to propose the better rule and provide the rationale for choosing it.”¹¹⁸ In addition, restatements may anticipate the direction of the law and express that development “in a manner consistent with previously established principles.”¹¹⁹ Somewhat contrary to these observations, the Handbook also directs that “improvements wrought by Restatements are necessarily modest and incremental, seamless extensions of the law as it presently exists.”¹²⁰ The remainder of this Part considers whether the restatement of the doctrine of imputation and the adverse interest exception, as set forth in section 5.04 of the Restatement (Third) of Agency, are consistent with the principles expressed in the Handbook.

B. History of Section 5.04: Getting the Exception that Mattered

The Reporter¹²¹ of the Restatement (Third) of Agency first

114. *Id.* at 2.

115. “This definition [of a restatement] neatly captures the central tension between the two impulses at the heart of the Restatement process from the beginning, the impulse to recapitulate the law as it presently exists and the impulse to reformulate, thereby rendering it clearer and more coherent while subtly transforming it in the process.” *Id.* at 4.

116. *Id.* at 5.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.* The Handbook continues: “The American Law Institute has limited competence and no special authority to make major innovations in matters of public policy. Its authority derives rather from its competence in drafting precise and internally consistent articulations of law.” *Id.*

121. The Reporter for the Restatement (Third) of Agency was Professor Deborah DeMott of the Duke University Law School, a respected scholar of agency law.

presented a draft of section 5.04 to the Council of the ALI at its meeting on December 5, 2001. That draft, which apparently was approved by the Council without changes, was submitted to the membership of the ALI as Tentative Draft No. 3 for consideration at its 2002 annual meeting:

Section 5.04 An Agent Who Acts Adversely to a Principal

(1) Notice is not imputed to a principal of a fact that an agent knows or has reason to know if the agent acts adversely to the principal in the transaction or matter without the principal's knowledge, unless

(a) the agent deals with a third party who does not know or have reason to know that the agent acts adversely to the principal and who reasonably believes the agent to be authorized so to deal; or

(b) the principal knowingly retains a benefit from action taken by the agent that the principal would not otherwise have received.

(2) For purposes of this Chapter, an agent acts adversely to a principal if the agent acts in the transaction or matter without any intention of benefiting the principal by the action taken.¹²²

This draft accurately reflected the law and was amply supported by the precedent cited in the Reporter's Notes.¹²³

122. RESTATEMENT (THIRD) OF AGENCY § 5.04 (Tentative Draft No. 4, 2003).

123. The Reporter cited three cases involving financial fraud by corporate management where the courts held that the fraud should be imputed to the corporation: *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir. 1982); *Mid-Continent Paper Converters, Inc. v. Brady, Ware & Schoenfeld, Inc.*, 715 N.E.2d 906, 909 (Ind. Ct. App. 1999); *Seidman & Seidman v. Gee*, 625 So. 2d 1, 3 (Fla. Dist. Ct. App. 1992). As examples of cases that do not impute the fraud to the corporation, the Reporter cited *Schacht v. Brown*, 711 F.2d 1343 (7th Cir. 1983), and a few other cases which, like *Schacht*, turn on the "deepening insolvency" rationale. Also cited were a few cases in which the courts held that the auditor could be liable to the corporation if the plaintiff could prove that the auditor was "independently at fault," meaning that management's deceptions were not the cause of the auditor's failure. RESTATEMENT (THIRD) OF AGENCY § 5.04 note c (2006). In short, then, the Reporter's Notes do not establish a case for reversing *Cenco* and that line of authority. There are also numerous other cases consistent with *Cenco*, e.g., *Brown v. Deloitte & Touche LLP*, No. 98 Civ. 6054 JSM, 1999 WL 269901, at *2 (S.D.N.Y. May 4, 1999) (stating that "whatever damages [the accountant's] alleged negligence may have caused the debtors, the damages are the result of a financial transaction debtor management implemented itself."); *Miller v. Ernst & Young*, 938 S.W.2d 313, 316 (Mo. Ct. App. 1997) (holding that "fraudulent conduct [of the manager of the corporation's most financially

The draft included this illustration ("Illustration 3"), which generated considerable discussion on section 5.04 at the 2002 meeting:

3. A, the chief executive officer of P Corporation, believes that P Corporation will benefit if its shares sell at a higher price as opposed to a lower price. Acting on this belief, A withholds material adverse information from T, P Corporation's auditor. As a consequence, T certifies materially inaccurate financial statements for P Corporation. P Corporation sues T for negligence and professional malpractice in certifying the financial statements. P Corporation is charged with notice of the material adverse information known to A and withheld from T.¹²⁴

Illustration 3, of course, captures the garden-variety management fraud that is the concern of this article and, because P Corporation is charged with notice of the information known to A, T could presumably defend P's complaint by pleading the *in pari delicto* defense.

Prior to asking the Reporter to deliver some preliminary remarks on section 5.04, the President of the ALI, Michael Traynor, reiterated an admonition given earlier by the ALI's Executive Director, Lance Liebman, about "the importance of leaving clients at the door in the deliberations of our assembly."¹²⁵ Thus, the membership heard not once, but twice, that they were to consider the draft without regard to how the Restatement might affect their clients (and, perhaps, themselves). It was thus obvious to all present that the leadership of the ALI was aware that some "special interests" might seek to influence the debates and ultimate outcome. Indeed, that proved to be the case.

Immediately after the Reporter completed her preliminary remarks on section 5.04, Mr. Gerald K. Smith of Arizona moved to add an amendment to Illustration 3.¹²⁶ He disclosed that he

important division] is attributable to [the corporation] and precludes plaintiffs, who stand in the shoes of [the corporation], from recovering from [the accountants] for the alleged negligence of [the accountants].").

124. RESTATEMENT (THIRD) OF AGENCY § 5.04 illus. 3 (Tentative Draft No. 4, 2003).

125. *Discussion of Restatement of the Law Third, Agency*, 79 A.L.I. PROC. 119 (2002) [hereinafter *2002 Proceedings*].

126. *Id.* at 121.

was a trustee in bankruptcy and that Illustration 3 would preclude a trustee from pursuing certain claims on behalf of the bankruptcy estate because the trustee would be subject to the same imputation of knowledge as the bankrupt corporation.¹²⁷ Mr. Smith then yielded the floor to his lawyer, Leo R. Beus of Arizona,¹²⁸ who proceeded to argue that Illustration 3 was not an accurate representation of the law because auditors are public watchdogs and the illustration is at odds with generally accepted auditing standards (“GAAS”).¹²⁹ Mr. Beus cited no authority for this latter proposition, which is unsurprising as no auditing standard is in conflict with Illustration 3. The generally accepted auditing standards describe what an auditor is to do,¹³⁰ not whether information is imputed from a corporate employee to his or her employer. Mr. Beus characterized Illustration 3 as “an attempt to impute information when there is supposed to also be total independence.”¹³¹ But the imputation at issue is from the agents (the corrupt officers) to the corporation, not from the corporation to the auditors, or vice versa. In short, Mr. Beus simply failed to address the question that section 5.04 addresses; that is, if the auditor has been misled by the

127. This is so because the trustee “stands in the shoes” of the debtor for purposes of pursuing claims that the debtor might have had. *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1154 (3d Cir. 1989). See generally Henry S. Bryans, *Claims Against Lawyers by Bankruptcy Trustees—A First Course in the In Pari Delicto Defense*, 66 BUS. LAW. 587, 595 (2012).

128. *2002 Proceedings*, *supra* note 125, at 122. Mr. Beus was not a member of the ALI when he spoke at the proceedings and was listed as a guest in the proceedings. See *id.* at xl.

129. *Id.* at 122.

130. Generally Accepted Auditing Standards consist of three “general standards,” three “standards of field work,” and three “standards of reporting.” For instance, the standards of field work provide:

1. The auditor must adequately plan the work and must properly supervise any assistants.
2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.
3. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

See CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1, § 150 (Am. Inst. of Certified Pub. Accountants 1972), available at <http://www.aicpa.org/research/standards/auditattest/downloadabledocuments/au-00150.pdf>.

131. *2002 Proceedings*, *supra* note 125, at 122.

company (albeit through its corrupt employees), should the *company* (or the trustee in bankruptcy pursuing claims of the company) be able to pursue a claim against the auditor. GAAS does not address this question, nor could it. GAAS is a set of "best practices" for auditors to follow and does not delineate causes of action against auditors who fall short of those best practices.¹³²

In any case, Mr. Smith moved that section 5.04 be amended to add an exception to imputation when "the totality of the circumstances would otherwise render it inequitable to impute such notice."¹³³ Such an amendment, if accepted, would have made imputation subject to a case-by-case determination, virtually assuring that a plaintiff would be able to resist an auditor's motion for summary judgment. Mr. Smith also moved that Illustration 3 be replaced with a new illustration that would deny imputation under circumstances similar to those set forth in the original illustration.¹³⁴ His motions generated considerable discussion, with the bulk of the comments favoring some modification to section 5.04. Remarkably, few comments referred to applicable precedent, with most alluding

132. See CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, *supra* note 130.

133. 2002 Proceedings, *supra* note 125, at 123.

134. This is the text of the proposed amendment:

A, the chief executive officer of P Corporation, intending to artificially prolong the existence of P Corporation past the point of its insolvency, fraudulently misrepresents its financial condition to T, P Corporation's auditor. One or more of the top-level decision makers or board members of P Corporation, which is otherwise a legitimate, bona fide enterprise, is unaware of A's misrepresentations. T subsequently certifies materially inaccurate financial statements for P Corporation. As a result of these misrepresentations, loans are secured and additional stock is issued, allowing P Corporation to continue in operation, and allowing A to continue in his well-compensated position and avoid civil and/or criminal charges being brought against him, while burdening P Corporation with additional debt and creditor claims which it cannot satisfy. P Corporation is not charged with notice of A's misrepresentations to T.

Appendix 3: Text of Proposed Amendments Submitted at 2002 Annual Meeting, 79 A.L.I. PROC. 746 (2002). In addition to a different outcome, this illustration differs from the original illustration in that it is cast as a case of "deepening insolvency," meaning that the effect of the officer's misrepresentation was to cause the corporation to become deeper in debt, more insolvent. See *supra* notes 67-73 and accompanying text. This situation leaves open the argument that the corporation did not benefit from the misrepresentation; it was insolvent before and became only more so after. But even in this illustration, the company may have benefited. It may have acquired additional time to resolve its financial difficulties and may have created the possibility of acquiring additional financing which would have been unavailable if accurate financial statements had been disclosed.

instead to the policy implications of the section¹³⁵ or suggesting changes regarding the language of the black letter, comments, and Illustration 3. After extended discussion, the membership voted to table the amendments, with the understanding that the matter would be reconsidered at a future annual meeting.¹³⁶

The matter came before the membership again in 2003 and the proposed draft of section 5.04¹³⁷ made two important substantive changes to the draft presented the preceding year. First, the 2003 version added a new concept: a third party could not assert that an agent's knowledge should be imputed to the principal unless the third party acted in *good faith*, and a third party cannot act in good faith if it knows or has reason to know that the agent was acting adversely to the principal.¹³⁸ This change had the potential to undercut the *in pari delicto* defense for outside service providers, depending on how the courts would interpret "good faith." This is discussed below. The second important change related to when an agent's interests are "adverse" to those of the principal. Under the 2002 version, an agent acts adversely to the principal if the agent acts "without any intention of benefiting the principal by the action taken."¹³⁹ This was deleted from the 2003 version, thus opening the door to the argument that an agent who acts both to benefit himself and the principal may be acting adverse

135. See, e.g., *2002 Proceedings*, *supra* note 125, at 142 (remarks of Judge Howard H. Kestin, who urged the membership in reconsidering the section that "the public interest must be taken primarily into account"); *Remarks of Michael Traynor*, *supra* note 5.

136. *2002 Proceedings*, *supra* note 125, at 144.

137. RESTATEMENT (THIRD) OF AGENCY § 5.04 (Tentative Draft No. 4, 2003). The draft presented to the 2003 annual meeting provided:

Section 5.04 An Agent Who Acts Adversely to a Principal

For purposes of determining a principal's legal relations with third parties, notice is not imputed to the principal of a fact that an agent knows or has reason to know if the agent acts adversely to the principal in a transaction or matter for the agent's own purposes or those of another person. However, notice is imputed

(a) when necessary to protect the rights of a third party who dealt with the principal in good faith; or

(b) when the principal has ratified or retained benefit from the agent's action.

A third party who deals with a principal through an agent, knowing or having reason to know that the agent acts adversely to the principal, does not deal in good faith for this purpose.

Id.

138. *Id.*

139. RESTATEMENT (THIRD) OF AGENCY § 5.04 (Tentative Draft No. 3, 2002).

to the principal for purposes of the imputation doctrine.

More significant than either of these textual changes, however, at least with respect to auditor liability, was their treatment in the commentary. New Illustration 5 set out facts similar to Illustration 3 in the 2002 draft (a corrupt manager deceives the firm's auditors), but reached the exact opposite conclusion.¹⁴⁰ Illustration 5 concluded, in essence, that an auditor who *negligently* fails to detect management fraud does not act "in good faith" and may not assert, as a defense to the principal's claim against it, that the officer's knowledge of the company's true financial situation should be imputed to the principal.¹⁴¹ Thus, with just a minor and, some might say technical, change to section 5.04, the drafters reversed the outcome of a critical interpretation of the imputation doctrine and illustrated that reversal with a hypothetical that ran contrary to most reported appellate decisions. Moreover, this reversal ran contrary to the apparent position of the Restatement (Second).

Although the Restatement (Second) did not explicitly discuss the good faith, or lack thereof, of third parties, such as auditors dealing with agents, the drafters did include a telling illustration accompanying section 282 (which sets forth the adverse interest exception).¹⁴² Illustration 7 under section 282 suggests that the drafters of the Restatement (Second) of Agency would have reached a conclusion contrary to that reached by the drafters of the Restatement (Third). The Illustration provides:

140. RESTATEMENT (THIRD) OF AGENCY § 5.04 illus. 5 (2006).

141. RESTATEMENT (THIRD) OF AGENCY § 5.04 illus. 5 (Tentative Draft No. 4, 2003).

142. Restatement (Second) of Agency Section 282 (1959) states:

(1) 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, except as stated in Subsection (2).

(2) The principal is affected by the knowledge of an agent who acts adversely to the principal:

(a) if the failure of the agent to act upon or to reveal the information results in a violation of a contractual or relational duty of the principal to a person harmed thereby;

(b) if the agent enters into negotiations within the scope of his powers and the person with whom he deals reasonably believes him to be authorized to conduct the transaction; or

(c) if, before he has changed his position, the principal knowingly retains a benefit through the act of the agent which otherwise he would not have received.

A is authorized by P to sell P's horse and to represent it as it is. A, intending to keep the proceeds from the sale and intending also to defraud the purchaser, sells the horse to T, representing the horse to be sound, although knowing the horse to be unsound. A absconds with the proceeds. P is bound by A's knowledge that the horse is unsound.¹⁴³

The drafters concluded that P is bound in this illustration because A appeared to T to be acting in P's interests, and T's expectations are to be protected. Note that T's good faith is not an issue here; that is, the drafters of this illustration did not add to the facts that T was not negligent in determining whether the horse was sound or not. Under the Restatement (Third), however, T would not be able to impute A's knowledge to P if T were negligent, because then T would not have been acting "in good faith," at least if Illustration 5 is faithful to the black letter of section 5.04. These two facts—the lack of any discussion in Restatement (Second) that the good faith of the third party is relevant to the imputation doctrine and an illustration that suggests it is not—leads to the conclusion that section 5.04 is a departure from the Restatement (Second). There is no hint in the commentary to the Restatement (Third) section 5.04 of this departure, which is troubling because of the significance of the change.¹⁴⁴

143. RESTATEMENT (SECOND) OF AGENCY § 282 cmt. f, illus. 7 (1959).

144. The non-imputation idea added to section 5.04, that the agent's knowledge is not imputed to the principal if the third party did not act in good faith, would have a startling impact if it applied to the sole actor cases. For example, if Smith, who was engaged in a pattern of looting the corporation, deceived the auditors, under the traditional analysis of the adverse interest exception, the corporation could maintain a malpractice action against the auditors and would not be saddled with Smith's knowledge of his own wrongdoing, but if Smith dominated the board, it would be so burdened (assuming, again, the traditional notion of the sole actor doctrine applied). If, however, the "good faith" exception applies, and assuming auditor negligence, the corporation could maintain an action against the auditor when the sole actor exception applies. This somewhat startling result points out the weakness of the good faith exception as a doctrinal matter, one not dealt with in the Restatement (Third) of Agency. Indeed, the sole actor doctrine is referred to only one time in the Restatement (Third). Comment d to section 5.04 states the doctrine and provides a garden-variety illustration of it. The Restatement includes no mention of the possibility that a third party may be negligent and the principal dominated by a single agent. The case of *Ash v. Georgia-Pacific Corp.*, 957 F.2d 432, 436 (7th Cir. 1992), sheds some light on the issue. In this case, the CEO of the company defrauded the company with the aid of a third party. When the company subsequently sued the third party, it defended on the theory of imputation and the sole actor doctrine. The court rejected the defense, noting its inapplicability when the third party participated

Mr. Smith, who kicked off the discussion at the 2002 meeting, did not attend the 2003 meeting, but sent a message to the Institute endorsing the draft presented at the meeting and indicating that he withdrew his tabled amendments.¹⁴⁵ This announcement may have affected the debate over the draft, which was subdued in comparison to the prior year's debate. Much of the discussion centered on whether the presence or absence of imputation should be a "defense" to the underlying claim or otherwise be outcome determinative in litigation.¹⁴⁶ There appeared to be a consensus that agency law merely provides rules relating to imputation; other bodies of law (tort, contract, etc.) set forth what consequences flow from imputation.¹⁴⁷ The Reporter certainly was of that view.¹⁴⁸ The more fundamental problem—whether the negligence of the third party who dealt with an agent should preclude imputation—received scant attention. The issue that so engrossed the 2002 annual meeting seemed to have largely disappeared. Ironically, while the straightforward restatement of the law drew considerable consternation at the 2002 meeting, an innovative restatement modifying the existing law (at least as embodied in Illustration 5) went unnoticed.

Section 5.04 came before the ALI membership a third and final time at the 2005 annual meeting. This draft became the final version of section 5.04:

Section 5.04: An Agent Who Acts Adversely to a Principal

For purposes of determining a principal's legal relations with a third party, notice of a fact that an agent knows or has reason to know is not imputed to the principal if the agent acts adversely to the principal in a transaction or matter, intending to act solely for the agent's own purposes or those of another person. Nevertheless, notice is imputed

(a) when necessary to protect the rights of a third party

in the fraud. The court made clear, however, that if the third party were innocent—meaning it was not an active participant in the fraud—it could prevail on the issue of imputation. It is here that the Restatement (Third) of Agency breaks new ground, essentially equating a negligent third party to an active co-conspirator in a fraud.

145. *Continuation of Discussion of Restatement of the Law Third, Agency*, 80 A.L.I. PROC. 323 (2003) [hereinafter *2003 Proceedings*].

146. *Id.* at 323–38.

147. *Id.* at 325.

148. *Id.*

who dealt with the principal in good faith; or

(b) when the principal has ratified or knowingly retained a benefit from the agent's action.

A third party who deals with a principal through an agent, knowing or having reason to know that the agent acts adversely to the principal, does not deal in good faith for this purpose.

This final version made some minor language changes from the preceding versions and the text was reordered slightly. There was, however, one significant substantive change. This text reincorporated the concept, which was in the first draft presented to the ALI membership, that an agent acts adversely if the agent intends "to act *solely* for the agent's own purposes or those of another person."¹⁴⁹ Thus, the final draft reinstated a narrow adverse interest exception.

This time Mr. Smith was in attendance and was a vocal participant in the meeting, immediately objecting to the inclusion of the word "solely" and moving that the phrase "intending to act solely" be deleted.¹⁵⁰ He again disclosed his involvement in bankruptcy litigation and stated the basis for his motion: "I am concerned that we prejudice the claims against professionals that may exist, and I am very serious about that. I think these drafts have the real possibility of doing that."¹⁵¹ After some debate on the motion, it was voted upon and failed. Shortly thereafter, it was moved and seconded that, subject to minor modifications, the Restatement (Third) of Agency be approved. It was, and the work was published shortly thereafter.¹⁵² Given the new language on good faith and, particularly, Illustration 5, it is unclear why Mr. Smith was displeased with the final draft. Perhaps he feared that the illustration did not carry as much weight as necessary. In any event, his motion highlights the conventional wisdom that the adverse interest exception was the key to avoiding imputation.¹⁵³

In any case, questions as to the meaning and possible impact of the ALI's work remain. How is section 5.04 to be

149. RESTATEMENT (THIRD) OF AGENCY § 5.04 (Tentative Draft No. 6, 2005) (emphasis added).

150. *Discussion of Restatement of the Law Third, Agency*, 82 A.L.I. PROC. 184, 219 (2005) [hereinafter *2005 Proceedings*].

151. *Id.* at 218.

152. The publication date of the Restatement (Third) of Agency is 2006.

153. *E.g.*, *In re Mifflin Chem. Corp.*, 123 F.2d 311, 315-16 (3d Cir. 1941).

read? Is Illustration 5 consistent with the black-letter rule of section 5.04? Finally, how has section 5.04 been received by the courts since its publication? These questions are discussed below. The important observation at this point is that while Mr. Smith failed to narrow the adverse interest exception, his ultimate goal—narrowing the imputation doctrine—was somehow achieved with the good faith limitation.

C. *Parsing Section 5.04: A Challenge in Interpretation*

The various iterations of section 5.04, as noted above, were the subject of considerable debate because, in the view of some members, the drafters failed to dramatically change the law. In particular, many members of the ALI were concerned that the proposed drafts failed to address the concern that then gripped the legal profession, if not the nation: Who would be called to account for the seemingly endless stream of corporate scandals then dominating the news? Where were the traditional gatekeepers—the lawyers, accountants, and investment bankers—and to what extent should they bear responsibility for their failure to discover and stop the frauds? The press was filled with stories of complicit auditors, willfully blind lawyers, and the like, who could have made a difference.¹⁵⁴ While these

154. *E.g.*, Daniel Kadlic, *Enron: Who's Accountable?*, TIME (Jan. 13, 2002), <http://www.time.com/time/magazine/article/0,9171,1001636,00.html#ixzz1oMO7NQuH> ("Just four days before Enron disclosed a stunning \$618 million loss for the third quarter—its first public disclosure of its financial woes—workers who audited the company's books for Arthur Andersen, the big accounting firm, received an extraordinary instruction from one of the company's lawyers. Congressional investigators tell Time that the Oct. 12 memo directed workers to destroy all audit material, except for the most basic 'work papers.' And that's what they did, over a period of several weeks. As a result, FBI investigators, congressional probers and workers suing the company for lost retirement savings will be denied thousands of e-mails and other electronic and paper files that could have helped illuminate the actions and motivations of Enron executives."); Barnaby J. Feder, *TURMOIL AT WORLDCOM: THE AUDITOR; Team Leader For Andersen Had Years Of Experience*, N.Y. TIMES (June 29, 2009), <http://www.nytimes.com/2002/06/29/business/turmoil-at-worldcom-the-auditor-team-leader-for-andersen-had-years-of-expertise.html> (Melvin Dick, who worked for Arthur Andersen, had extensive experience in the complex telecommunications industry coupled with an army of auditors, yet this was not enough to spot the crude accounting fraud of Worldcom which included classifying operating expenses as long-term capital investments); *Former Global Crossing exec to sue company*, USA TODAY (Feb. 20, 2002), <http://www.usatoday.com/life/cyber/invest/2002/02/21/globalcrossing.htm> (Global Crossing, saddled with debt from building its massive network, allegedly entered into deals to swap capacity on other companies' networks using instruments called indefeasible rights of use (IRU). Global Crossing recorded the price paid for such transactions as a capital

outside professional service providers certainly faced liability and penalties in various forums and to various claimants, the traditional law of agency, combined with the *in pari delicto* doctrine, seemed to preclude one class of claimants—the companies ultimately guilty of financial frauds—from suing their outside professional service providers. That reality was not far from the debates of the ALI when it considered the relevant sections of the Restatement (Third) of Agency and sought a change in the adverse interest exception to imputation.

Despite this pressure to adapt the adverse interest exception in favor of greater accountability for gatekeepers, a fair reading of the final version of section 5.04, even with the new “good faith” provision, is that it made no substantive change from the first draft. The first sentence of section 5.04, as adopted, states a narrow exception to the broad rule of imputation set forth in section 5.03: no imputation if the agent acts “solely for the agent’s own purposes. . . .”¹⁵⁵ The next sentence states two exceptions; that is, two circumstances when the knowledge of such an agent (for simplicity, an “adverse agent”) is imputed to the principal.¹⁵⁶ The one of most concern for present purposes is that there will be imputation “when necessary to protect the rights of a third party who dealt with the principal in good faith.”¹⁵⁷ The last sentence then provides the critical gloss that a third party who has “reason to know that the agent acts adversely . . . does not deal in good faith.”¹⁵⁸ Read together, the first and second sentences suggest that the “good faith” exception applies *only if* there has been a determination that, in fact, the agent is an adverse agent. Indeed, in addressing the annual meeting, the Reporter characterized the paragraphs (a) and (b) of section 5.04 as an exception to an exception¹⁵⁹ and the comment to section 5.04 does likewise.¹⁶⁰ Thus, in the typical corporate fraud case,

expense amortized over a few years, but recorded IRU income as revenue, immediately boosting earnings. Roy Olofson, a former vice president of finance at Global Crossing, initially voiced concerns about the company’s financial practices in meetings with auditor Arthur Andersen & Co. Olofson was concerned that the company was using aggressive, accounting methods to boost its revenues, yet Arthur Andersen took no action in response to this claim).

155. RESTATEMENT (THIRD) OF AGENCY § 5.04 (2006).

156. *Id.*

157. *Id.*

158. *Id.*

159. 2005 Proceedings, *supra* note 150, at 217

160. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b (2006) (“The adverse

where corrupt managers are far from acting “solely” for their own purposes, the good faith, or lack thereof, of third parties who dealt with those corrupt agents is irrelevant. This is not only the logical reading of section 5.04, but is one consistent with the overwhelming precedent on the subject.

There is another structural reason why this reading is correct. Section 5.04 deals with an exception to the broad rule of imputation when an agent acts adversely to the principal. A reading that concluded that imputation would be improper merely because the third party had reason to know that the agent was acting adversely would more properly be characterized as an exception to imputation and set forth in section 5.03, not an exception to the adverse interest exception.¹⁶¹ Moreover, paragraph (b), which sets forth another circumstance in which the adverse interest exception does not preclude imputation (the principal knowingly retained a benefit from the agent’s action), only makes sense if there has been a prior determination that an agent has acted adversely, a point made clear by the comments to section 5.04¹⁶² and illustration 9:

9. P retains A as manager of P’s investment portfolio. A purchases securities issued by S Corporation for P’s account from T at a bargain price, falsely representing to T that S Corporation has lost the account of its major customer. A does this because A wishes to damage T, a competitor of A’s. P learns of the purchase and refuses to return the securities to T after T learns that A’s statement about S Corporation was false. In a claim by T against P, notice is imputed to P of the true facts known to A.¹⁶³

In this illustration, A is acting adversely because A’s sole motive is to injure A’s competitor, T, thereby furthering A’s interests. Nevertheless, notice is imputed to P because P

interest exception is subject to two exclusions or exceptions.”).

161. See, e.g., *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 883 n.2 (N.J. 2006) (negligence of auditor is both an exception to imputation and a basis for estoppel).

162. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. d (2006) (“The adverse-interest exception serves to shield a principal against imputation of notice of facts known to an agent who acts adversely to the principal. The [adverse interest] exception should not serve as a sword that enables a principal knowingly to retain the benefits of its agent’s wrongdoing.”).

163. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. d, illus. 9 (2006).

retained the benefit of A's action. Thus, if the two exceptions to the adverse interest exception are to be read consistently with one another, paragraph (a) must apply only when the agent acts adversely within the meaning of the section. Bearing in mind the admonition in the Handbook that "Restatements are expected to aspire toward the precision of statutory language,"¹⁶⁴ this sort of parsing is entirely appropriate.

This, then, brings us to a consideration of Illustration 5 to section 5.04. As noted above, it posits a situation in which the chief financial officer ("CFO") of a corporation withholds material financial information from the company's auditor, who had reason to know that the CFO withheld the information.¹⁶⁵ Nonetheless, the auditor certified the inaccurate financial statements. When sued by the company for losses it suffered as a result of the inaccurate financial statements, the Illustration says that the auditor may not assert as a defense that the CFO's knowledge should be imputed to the company, because the auditor did not act "in good faith."¹⁶⁶ This can be squared with the black letter of section 5.04 only if one assumes that the CFO was acting adversely to the company. The Illustration does not say that; indeed, it does not indicate why the CFO withheld the information. If, however, one assumes that the CFO was not acting adversely within the meaning of section 5.04, then this would be an illustration of an exception to imputation, not an exception to the adverse interest exception. To rationalize the inclusion of this Illustration in section 5.04 and preserve a logical reading of the section, it is fair to assume that the CFO was otherwise an adverse agent.

One final observation about section 5.04 relates to the use of the term "good faith" and the importation of a fault standard to determine the appropriateness of imputation or applying the adverse interest exception. Although this modification to section 5.04 generated no discussion from the ALI membership, it probably should have for at least two reasons. First, the good faith exception converted section 5.04 from a rule about imputation to a substantive rule of liability. This is so because it ties imputation not to the knowledge of the agent and the circumstances of the agency relationship, but rather to actions of the third party who dealt with the agent. If, for instance, two outside service providers dealt with a corporation through the

164. HANDBOOK, *supra* note 99, at 5.

165. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c, illus. 5 (2006).

166. *Id.*

corporation's executive officers and one was negligent (say, the auditor) and the other was not (say, the company's outside attorney), the officers' knowledge of the fraud would be imputed to the company in a suit against the attorney, but not against the auditor.¹⁶⁷ This suggests that the issue is not imputation, but fault. Thus, *in pari delicto* is no longer the operative defense for the outside service provider and the focus has shifted from the knowledge of the corporation to the conduct of the outside service provider. In effect, then, imputation is irrelevant, as is the adverse interest exception.

Second, and perhaps more importantly, the limitation incorporates a startling use of the concept of good faith, which typically refers to the motivations with which a person discharges that person's duties.¹⁶⁸ Consider the application of the good faith doctrine in the context of director conduct. Under Delaware law, conduct motivated by "subjective bad intent" and conduct that amounts to "a conscious disregard for one's responsibilities" constitutes bad faith.¹⁶⁹ Obviously, such conduct is a sharp departure from merely negligent conduct. Indeed, the motivational element in determining an actor's good faith or bad faith is absent from the commentary on section 5.04 despite the fact that the case law on good faith is often dependent on that element.¹⁷⁰ Another common

167. A similar point was made by a member of the ALI at the 2003 annual meeting. *2003 Proceedings*, *supra* note 145, at 324.

168. For a discussion of the meaning of "good faith" in the context of the duty of fiduciaries of business organizations to act in good faith, see Mark J. Loewenstein, *The Diverging Meaning of Good Faith*, 34 DEL. J. CORP. L. 433 (2009).

169. *In re Walt Disney Co. Derivative Litig.* (*Disney V*), 906 A.2d 27, 66 (Del. 2006).

170. In the Disney litigation in Delaware, the Delaware Supreme Court and Chancery Court issued a total of five formal opinions, in the course of which the concept of good faith received careful scrutiny of the courts. In *In re Walt Disney Co. Derivative Litig.* (*Disney IV*), 907 A.2d 693, 755 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (emphasis omitted) Chancellor Chandler's opinion, after trial, identified the sources of acting in bad faith: "greed, hatred, lust, envy, revenge, . . . shame or pride." *Disney IV*, 907 A.2d at 754 (quoting *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003)). This, of course, is a list of motives or mental states underlying an action. Interestingly, the Chancellor added that "sloth" might be added to the list "if it constitutes a systematic or sustained shirking of duty." *Id.* Sloth is generally not thought of as a motivation; indeed, it is the absence of motivation. Including sloth, however, highlights the problem with the good faith doctrine because sloth, or a systematic shirking of duty, really describes a lack of care. So, the Chancellor effectively defined an extreme lack of care as bad faith behavior. For a case discussing the duty of good faith of a general partner in a limited partnership, see *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199 (Del. 1993). In that case, Desert Equities, a limited partner, sued the general partner alleging that it acted in bad faith in exercising

formulation of good faith arises in the context of contracting. The doctrine of good faith protects one contracting party from the opportunistic behavior of the other party to the contract.¹⁷¹ This seems to have less of a direct bearing on the concept of good faith employed in section 5.04, but it is clear that this concept, too, turns on intentional conduct and the motivation for that conduct.

The commentary to section 5.04 on this issue is brief,¹⁷² which is noteworthy, as noted above, inasmuch as the adverse interest exception contained in Restatement (Second) of Agency Section 282 included no such concept.¹⁷³ The drafters of Restatement (Third) explained that the good faith exception was justified by a notion of risk assessment: Is it appropriate to impose on the principal the risk of nondisclosure by the agent if the third party colluded with the agent? The drafters concluded, simply, that it was not: "[T]he third party should not benefit from imputing the agent's knowledge to the principal when the third party itself acted wrongfully or otherwise in bad faith."¹⁷⁴ But why not ask if it is appropriate to impose on the principal the risk that a third party dealing with the principal through an agent will negligently fail to discover that the agent acted in a way that harms the principal's interests? That is, more precisely, the issue in Illustration 5 and the accounting fraud cases which are the focus of this article. The answer would seem to be that this is a risk that the principal should bear. The principal, after all, selected the agents (its corporate officers) and was in the best

its authority under the partnership agreement to exclude Desert from participating in investments of the partnership. *Id.* at 1202. Desert alleged that the general partner did this in retaliation for Desert's act of filing a suit against affiliates of the general partner in a different limited partnership. *Id.* The court, in allowing the case to go to the finder of fact, stated that "a claim of bad faith hinges on a party's tortious state of mind." *Id.* at 1208. It quoted as follows from *Black's Law Dictionary* in support of its conclusion that bad faith is a state of mind:

[The] term "bad faith" is not simply bad judgment or negligence, but rather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity; it is different from the negative idea of negligence in that it contemplates a state of mind affirmatively operating with furtive design or ill will.

Id. (quoting BLACK'S LAW DICTIONARY 337 (5th ed. 1983)).

171. See *Anthony's Pier Four, Inc. v. HBC Assocs.*, 583 N.E.2d 806, 821 (Mass. 1991); *Warner v. Konover*, 553 A.2d 1138, 1141 (Conn. 1989).

172. See RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b (2006).

173. See *supra* notes 142–144 and accompanying text.

174. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c (2006).

position to monitor their conduct, which is the rationale that supports imputation in the first instance.¹⁷⁵ The negligence of the third party who dealt with the agent should not change that because the principal is responsible for the agent's conduct, even fraudulent conduct, and that responsibility should not be extinguished because a third party was negligent in failing to discover it. Under traditional principles of tort law, a tort victim's negligent conduct does not diminish the liability of a tortfeasor who acted intentionally.¹⁷⁶

Finally, consider section 5.04 in light of the principles articulated in the Handbook. If, in fact, the good faith exception was intended as an exception to imputation and not merely as a modification of the adverse interest exception, then it surely represents a departure from the weight of authority on imputation. Neither the commentary to the section nor the Reporter's notes set out why existing precedent was "inappropriate or inconsistent with the law as a whole."¹⁷⁷ Moreover, and again with reference to the Handbook, under this reading, section 5.04 marks a sharp departure from existing precedent, not an "incremental, seamless extension of the law as it presently exists,"¹⁷⁸ and the commentary to section 5.04 does not "provide the rationale for choosing" to depart from existing precedent.¹⁷⁹ In short, section 5.04—at least Illustration 5 thereto—appears to represent a stealth attempt to significantly alter the imputation doctrine as it existed for many, many years with no acknowledgment that such an alteration was taking place or why. It also represents a sharp departure from the standards that the ALI announced would guide the preparation of a restatement of the law.

175. The drafters of Restatement (Third) of Agency said as much in comment b to section 5.04: "A principal's opportunity to monitor an agent and create incentives for the proper handling of information warrant imputing an agent's knowledge to the principal even when the agent has breached duties of disclosure to the principal."

176. *E.g.*, *Bradley v. Appalachian Power Co.*, 256 S.E.2d 879, 887 (W. Va. 1979) ("In the case of an intentional tort, contributory negligence is not a defense."); *Stone v. Rudolph*, 32 S.E.2d 742, 744 (W. Va. 1944) ("In a negligence action, growing out of the operation of an automobile, the defense of contributory negligence or assumption of risk on the part of a plaintiff is not available to a defendant who is guilty of wanton and willful conduct, which operates to injure the plaintiff."); *White v. Gill*, 309 So.2d 744 (La. Ct. App. 1975) (holding that contributory negligence is not a defense to intentional torts).

177. *HANDBOOK*, *supra* note 99, at 5.

178. *Id.*

179. *Id.*

D. Summing Up

Given Illustration 5, it seems fair to conclude (despite my careful parsing in section C above and the Reporter's off-handed remarks on the subject) that the drafters added the good faith concept to section 5.04 not as an exception to the adverse interest exception but as an exception to imputation. It ended up in section 5.04 because the adverse interest exception traditionally has been the critical exception to imputation and when attempts to broaden it failed, members of the ALI took a different tack. Instead of focusing on the agent's conduct and motivation, focus shifted to the third party's standard of care. The adverse interest exception thus remained a very narrow exception to imputation, but a much more promising exception arose as an alternative. Regardless of whether the new good faith exception was an accurate restatement of the law, it is appropriate to consider whether sound policy rationales support it. This is the focus of the next Part.

III. PUBLIC POLICY AND THE ADVERSE INTEREST EXCEPTION

After considering the rationale that the ALI provided for its statement of the imputation doctrine and the adverse interest exception, this Part considers several interdisciplinary considerations of the adverse interest exception: a law and economics analysis, traditional logic, literature from cognitive psychology, jurisprudential considerations, and the merits of private ordering.

A. The ALI's Rationale

The official comments to section 5.04 do not provide a rationale to support the good faith exception. Comments b and c simply assert:

If the third party colludes with the agent against the principal or otherwise knows or has reason to know that the agent is acting adversely to the principal, the third party should not expect that the agent will fulfill duties of disclosure owed to the principal A principal should not be held to assume the risk that an agent may act wrongfully in dealing with a third party who colludes with the agent in action that is adverse to the principal. That is, the third

party should not benefit from imputing the agent's knowledge to the principal when the third party itself acted wrongfully or otherwise in bad faith.¹⁸⁰

Two observations about this assertion are in order. First, Comment b states the strongest case for recognizing a good faith exception to imputation, i.e., when the third party "colludes" with the agent.¹⁸¹ Note how the Comment refers to collusion and negligence in the first quoted sentence, but only to collusion in the second. But collusion, which would fit any definition of bad faith, is conduct quite distinct from negligence, which would not. There is almost a bit of sleight of hand in Comment b, as it seeks to equate the two concepts.

Second, Comment c seems to be grounded on some notion of fairness; that it is unfair to saddle the principal with the agent's knowledge when the third party acted wrongfully (in some sense). But why is that unfair? Is it not unfair to permit the principal to avoid the knowledge of its own agents and distance itself from their actions, including their knowing deception of the auditors? Perhaps a stronger case can be stated when the auditors knowingly colluded with the corrupt officers, but the comments to the section suggest a much broader exception and, of course, *in pari delicto* is not limited to mere negligence—one conspirator cannot, under that doctrine, maintain an action against a co-conspirator. Thus, one must look beyond the ALI for a justification for the good faith concept.

B. Other Policy Considerations: Reaching Beyond the ALI

Though not specifically identified or discussed in the Restatement (Third) of Agency, there are a number of policy considerations that either support or challenge the new approach to the adverse interest exception as reflected in section 5.04.

180. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b-c (2006).

181. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b (2006).

1. Economic Analysis

a. Imputation is More Efficient

Judge Posner, in *Cenco*, offers a simple economic justification: If imputation is denied, “incentives to hire honest managers and monitor their behavior will be reduced.”¹⁸² Judge Posner implicitly considers the board of directors, and even the shareholders, as being potentially more efficient monitors than the auditors and this may be true, in some cases. As a practical matter, however, in most cases it is not.¹⁸³ As to the shareholders, for instance, they are ill suited and not adequately incentivized to monitor corporate management except, perhaps, in a closely held corporation where a shareholder owns a significant portion of the corporation’s stock. Such shareholders, however, are typically managers themselves, so they are already active monitors and if they fail to detect the fraud, they bear the consequences. Moreover, such companies are hardly the concern of section 5.04.

As to directors, however, the matter is more complicated. Directors are charged with overseeing management and may be held liable to the shareholders (via a derivative action) for failing to detect the fraudulent conduct of those managers, at least if the board acts with conscious disregard of its oversight duties.¹⁸⁴ This conscious disregard standard is a fairly difficult for one plaintiff to meet, however, and obviously does not provide a sufficient incentive, standing alone, to motivate close monitoring. Reputational concerns provide additional

182. *Cenco v. Seidman & Seidman*, 686 F.2d 449, 455 (7th Cir. 1982).

183. *E.g.*, *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 886 (N.J. 2006) (“the nature of today’s corporations makes it increasingly unlikely that shareholders of large corporations have the ability to effectively monitor the actions of corporate officials”); *A.C. Pritchard, O’Melveny Meyers v. FDIC: Imputation of Fraud and Optimal Monitoring*, 4 SUP. CT. ECON. REV. 179, 197 (1995) (noting that shareholders are not realistically in any position to monitor their managers’ conduct toward third parties, and shareholders might well be willing to pay higher fees to accountants and lawyers who help ferret out fraud by the corporation); *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. Price Waterhouse Coopers, LLP*, 989 A.2d 313, 332 (Pa. 2010) (“Pennsylvania law does not accord with *Cenco* in terms of the degree to which the decision, in an auditor-liability context, prioritizes the policy of incentivizing internal corporate monitoring over the objectives of the traditional schemes governing liability in contract and in tort, including fair compensation and deterrence of wrongdoing.”).

184. *See Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006); *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

motivation, as does incentive compensation for directors. But even these added incentives may not be sufficient to motivate the kind of oversight that would ferret out a carefully conceived and executed fraud. Under these circumstances, directors may argue that they looked to the auditors—indeed, implicitly delegated to them—the task of assuring the absence of fraud. This position, which often reverberates in the litigation against negligent auditors,¹⁸⁵ reduces the issue to one of contract interpretation and is considered in more depth below.

Another consideration is the extent to which holding auditors liable for their negligence reduces management's incentive to carefully prepare the company's financial statements and oversee lower-level employees.¹⁸⁶ Note in this regard that accounting frauds, or at least the unauthorized diversion of corporate funds, may be, and often are, perpetrated by lower-level employees.¹⁸⁷ If management is overly dependent on the company's auditors, these frauds may go undetected for long periods of time, even if the auditors are not negligent. This loss will be borne by the company (or its fidelity insurer). Thus, limiting a company's ability to seek indemnification from auditors for senior management fraud would have the salutary effect of incentivizing the board to implement more rigorous anti-corruption policies within the company.

b. Imputation Depends on the Principal's Solvency or Insolvency

Adam Pritchard has argued that imputing management fraud to the corporation is justifiable when the corporation is

185. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

186. This point was made by Justice Rivera-Soto, who dissented in the NCP case. Justice Rivera-Soto quoted from amici briefs filed by the American Institute of Certified Public Accountants and the New Jersey Society of Certified Public Accountants: "In addition to causing a misallocation of liability, allowing a company's management to shift the consequences of its own executive's fraud to its accountants where the auditor is not alleged to have assisted in that fraud may diminish management's incentive to exercise due care in its own responsibilities." NCP Litig. Trust, 901 A.2d at 904 (Rivera-Soto, J., dissenting).

187. Frauds committed by, for instance, bookkeepers, are common. See, e.g., Claire Galofaro, *Bookkeeper pleads guilty to bank fraud, identity theft*, BRISTOL HERALD COURIER (Va.), 2010 WLNR 23333988 (Nov. 23, 2010); *Ex-bookkeeper in Detroit district gets prison term for fraud*, AM. SCH. & UNIV., 2011 WLNR 16707568 (Aug. 23, 2011).

solvent, but not when it becomes insolvent.¹⁸⁸ His analysis depends on two premises: first, that shareholders prefer risk while creditors do not; and second, that fraudulent conduct cannot easily be differentiated from nonfraudulent conduct.¹⁸⁹ From these premises, he reasons that while solvent, the shareholders prefer that outside monitors, such as accountants and lawyers, be able to impute the fraud of management to the corporation, because then the outside monitors will escape liability for failing to detect fraud and, at the same time, management will not be deterred from engaging in risky behavior that benefits the corporation.¹⁹⁰ Because normal risky behavior or management negligence is sometimes difficult to distinguish from fraud, outside monitors will not be deterred from serving as they will be able to avoid the tort consequences of their negligence should they be sued by the corporation.

On the other hand, when the corporation is insolvent, the creditors become, essentially, the owners or residual claimants of the corporation. Creditors want no part of risky decisions, whether marginally legal or not, so in comparison to shareholders, prefer closer monitoring.¹⁹¹ Because these “owners” expect closer monitoring, the outside professionals should not be able to avoid liability for their negligence. In these circumstances, management’s knowledge of fraud would not be imputed to the corporation and a creditor’s suit (on behalf of the corporation) against the outside professionals would not be subject to the *in pari delicto* defense.

Pritchard argues that not allowing outside professionals to escape liability for negligence when serving solvent corporations

would make it very difficult for speculative—but nonetheless wholly legitimate—enterprises to find the legal and accounting services needed to effect wealth-maximizing transactions. . . . Enlisting professionals to ferret out ‘fraud’ in solvent corporations would likely price such risky opportunities out of the market, thus discouraging investment in enterprises that prove most lucrative to

188. A. C. Pritchard, *O'Melveny Meyers v. FDIC: Imputation of Fraud and Optimal Monitoring*, 4 SUP. CT. ECON. REV. 179 (1995).

189. *Id.* at 181–83.

190. *Id.* at 197.

191. *Id.* at 194–95.

investors in the long run.”¹⁹²

On the other hand, if outside professionals advising or auditing insolvent entities cannot use the imputation doctrine to avoid liability for their negligence, they will be more diligent and advise the board of directors when they suspect fraudulent activity.¹⁹³ In short, then, Pritchard would alter the Restatement doctrine so that imputation occurs when the residual claimants prefer it and not when they do not. This would be economically efficient because the parties ultimately bearing the loss (the shareholders for solvent corporations and creditors for insolvent ones) prefer that level of monitoring and are willing to bear the respective costs.

Pritchard's economic analysis is unconvincing, in part, because he assumes that the rule of imputation protects outside professionals from their negligence. In fact, the only time that imputation achieves that result is when management engages in fraud and actively deceives the outside professionals. In most instances, the outside professional is liable for negligence. If, for instance, an auditor fails to comply with generally accepted auditing standards and, as a result, fails to detect an error in a client's account, the auditor will be liable in an action brought by the audit client.¹⁹⁴ Similarly, lawyers are liable to their clients for their negligent advice.¹⁹⁵ Fraud is different because the entity, through its management, is actively misleading the outside professional, and it is that conduct which precludes imputation. By conflating negligent failure to detect management fraud with negligent professional

192. *Id.* at 198–99.

193. *Id.* at 195.

194. *E.g.*, *Cereal Byproducts Co. v. Hall*, 132 N.E.2d 27, 29 (Ill. App. Ct. 1956) (holding where an auditor accepted a list of accounts and did not make any effort to confirm they were accurately prepared, the auditor was found liable for “inexcusable negligence”); *Maryland Cas. Co. v. Cook*, 35 F. Supp. 160, 166 (E.D. Mich. 1940) (“For the failure to perform this audit engagement in accordance with the terms of this contract as a reasonably prudent and careful auditor would and because of such negligence, this defendant auditor, Jonathon Cook, must respond in damages.”); *NCP Litig. Trust v. KPMG*, 945 A.2d 132, 144–45 (N.J. Super. Ct. Law Div. 2007) (“Auditors engaged to conduct their audits in accordance with GAAS, as KPMG was here, have a duty to exercise due care in obtaining reasonable assurances that the company's financial statements are free of material misstatements. If the auditor fails to exercise such care, it shall be made answerable for such failure.”).

195. *See, e.g.*, *Dixon Ticonderoga Co. v. Estate of O'Connor*, 248 F.3d 151 (3d Cir. 2001); *Collins v. Missouri Bar Plan*, 157 S.W.3d 726 (Mo. Ct. App. 2005); *Fiedler v. Adams*, 466 N.W.2d 39 (Minn. Ct. App. 1991).

services in other contexts, Pritchard creates a false dichotomy. Surely a shareholder does not want his company to forgo all claims for professional malpractice in order to encourage management to take risks.

Pritchard goes astray in this regard because his second premise is false—fraud, except perhaps at the margin, is different from nonfraudulent conduct. He argues that “[r]isky decisions, proved wrong *ex post*, are easily transformed into allegations of fraud by enterprising plaintiffs’ attorneys.”¹⁹⁶ Perhaps, but withstanding a motion to dismiss on the pleadings (as occurred in the sole case that he cited¹⁹⁷) is a far cry from garden-variety management fraud that is the concern of section 5.04. If the inquiry is shareholder preference, it seems counterintuitive and implausible that, *ex ante*, shareholders would likely prefer a rule that incentivizes outside professionals to turn a blind eye to fraud, believing that a counter rule would result in too-close monitoring and management’s avoidance of value-maximizing investments. Thus, to the extent that Pritchard would accommodate the preferences of the residual claimants—be they creditors or shareholders—the rule would likely be the same in both instances: no imputation. If this were the rule, however, it may prompt a different engagement letter, one that absolves the outside service provider from negligence in the event of management fraud but preserves liability in all other instances of negligence. In other words, Pritchard looks at only one-half of the bargaining process and does so (in my opinion) improperly. He assumes that whatever the residual claimant would prefer should be the rule, but the outside service provider has a large stake in the rule as well, and its preferences will be the opposite. The goal of default rules—which is really all that Pritchard is suggesting—is to mimic what the parties would agree upon, and, in fact, inasmuch as auditors and their clients bargain against a default rule that allows imputation in the event of management fraud, his rule would require additional bargaining, relieving auditors and other outside service providers from liability for their negligence if management is guilty of fraud.

196. Pritchard, *supra* note 188, at 198.

197. *Id.* (citing *In re Apple Computer Sec. Litig. v. Vennard*, 886 F.2d 1109 (9th Cir. 1989)).

2. Logic and Consistency

The new good faith exception, at least as reflected in Illustration 5, has embedded within it a conundrum: if a principal (a corporation) is not bound by its agent's (a corrupt officer) knowledge because the third party (an employee of the auditor) was negligent, shouldn't the third party be able to avoid liability on the same basis? In the accounting frauds that are the subject of this paper, the third party is typically some form of business entity. If an employee of the accounting firm negligently fails to discover a fraud committed by a client of the firm, or worse, colludes with the corrupt managers of that client, shouldn't the accounting firm be able to distance itself from its employee's knowledge when sued by the client?¹⁹⁸ The accounting firm can turn the tables on its former client, arguing that the employee was "acting adverse" to the accounting firm. At the very least, the client was negligent in failing to realize that the employee of the accounting firm was acting adverse to her employer. Both the Reporter¹⁹⁹ and *Cenco*²⁰⁰ court noted this dilemma, but only the *Cenco* court's decision was consistent with taking the dilemma seriously. Put simply, the good faith exception is illogical. If logic (and consistency) is a positive value, the good faith exception is not

198. If the auditor colludes with corrupt management, the audit firm should be able to invoke the adverse interest exception. The good faith exception to imputation, however, would seem to be its strongest when the auditor colludes, for how could that be good faith? The drafters of section 5.04 apparently did not consider the possibility that the greater the bad faith of the third party, the stronger the case for the third party to invoke the adverse interest exception. So, ironically, under the logic of section 5.04, the good faith exception would only (or usually) apply when the third party is negligent.

199. In response to a comment from the floor at the ALI's annual meeting in 2002, the Reporter (Professor DeMott) made this point as well:

If the auditor in Illustration 3 is organized as a firm of some sort is this defense [the adverse interest exception] available to that firm as well? Could that firm, for example, say, "The guilty knowledge of the auditor who actually had the engagement should not be imputed to us, the firm, because look at the terrible impact that . . . auditor's behavior has had on our welfare. It would not be fair to us, the firm, to hold us accountable in this lawsuit brought by, for example, the company, or its representative, to hold us accountable for the bad conduct of our agent, i.e., the individual auditor on the account."

2002 *Proceedings*, *supra* note 125 at 129.

200. "But if *Cenco* may be divorced from its corrupt managers, so may Seidman from the members and employees of the firm who suspected the fraud. If Seidman failed to police its people, *Cenco* failed as or more dramatically to police its own." *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982).

justifiable.

A related concern is that if the corporation recovers from its auditors, the shareholders at the time of recovery receive the benefit. Aside from the problem that some of these shareholders may have been complicit in the fraud or have benefited in some way from it, for other shareholders the recovery will be an undeserved windfall. Assuming the recovery is many years after the fraud has been discovered, many of the shareholders at the time of recovery will have purchased their shares after the fraud occurred and was revealed. The company's financial statements will have been restated to accurately reflect the results of operations and the company's assets and liabilities. Presumably, then, the share price at which they purchased their interest in the company will reflect the costs of the fraud, including the losses the company incurred in having to restate its financial statements, reputational harm, etc.—all the losses that the company then seeks to recover from the auditors. Post-fraud purchasers of shares, therefore, will have bought the stock at a price that reflects the costs of the fraud and then recovered those losses from the auditors. The real victims of the fraud, in addition to those who purchased shares on the basis of misleading financial statements, are pre-fraud shareholders who saw the value of their shares plummet as a result of the disclosure of the fraud and then sold their shares. They would not benefit from any recovery,²⁰¹ although investors who bought shares after the fraud would. Put differently, to a large extent allowing recovery against the auditors would compensate the wrong people.

3. Cognitive Biases, Auditor Liability, and Imputation

A number of widely-recognized biases or heuristics may affect the way we think about auditor liability: the hindsight bias, confirmation bias, and the affect heuristic, to name just three. Each is considered below.

Those determining whether auditors have breached their

201. *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co.*, 417 U.S. 703 (1974) (holding that the corporation could not maintain an action against former shareholders for law violations that occurred before the acquisition of the corporation by new shareholders because price paid by new shareholders reflected the wrongdoing).

duty of care make that determination in hindsight and suffer, of course, from a hindsight bias.²⁰² Massive accounting frauds seem so obvious in retrospect that a fact finder considering auditor fault—whether negligence or something worse—inevitably finds against the auditor. This cognitive bias may be a concern in any negligence action, but cognitive biases play an additional role in accounting fraud cases because the auditors themselves are subject to a number of cognitive biases, most of which emanate from the fact that accounting frauds are relatively rare.²⁰³ When a fraud is uncovered—and particularly when it has occurred in a publicly held company—publicity, SEC investigations, civil suits, criminal investigations, and other consequences occur. But most people are not fraudsters, and an auditor may spend a career never having been retained to audit a company that engaged in fraudulent accounting. An auditor, like most people, may be reluctant to suspect that someone with whom he or she may have worked for a number of years and likes and admires is engaged in a fraud and is committed to deceiving the auditor.

The distance that most auditors have from accounting frauds and the tendency to trust those with whom the auditor has a working relationship gives rise to the “confirmation bias,” which is the tendency that one has to seek out and overvalue evidence that supports one’s beliefs and to ignore or devalue evidence that is inconsistent with such beliefs.²⁰⁴ Faced with anomalous or suspicious data, an auditor might search out additional data that explains away the anomaly or suspicion. Whether suspecting fraud or not, the auditor might approach

202. Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 335, 341 (Daniel Kahneman et al. eds., 1982):

In hindsight, people consistently exaggerate what could have been anticipated in foresight. They not only tend to view what has happened as having been inevitable but also to view it as having appeared “relatively inevitable” before it happened. People believe that others should have been able to anticipate events much better than was actually the case.

203. See, e.g., Len Boselovic, *Fraud is More Common than You Think*, PITTSBURGH POST-GAZETTE (June 6, 2010), www.post-gazette.com/pg/10157/1063315-435.stm#ixzz1opIjiYJT (1,843 cases in 106 countries as reported by certified fraud examiners who responded to the association’s online survey, providing information on cases they investigated between January 2008 and October 2009. Financial statement reporting fraud represented 4.8 percent of the total number of frauds).

204. See generally Joshua Klayman, *Varieties of Confirmation Bias*, 32 PSYCHOL. LEARNING & MOTIVATION 385 (1995).

corporate managers, who, if part of the fraud, have the opportunity to deceive the auditor with fabricated explanations and documentation. This explanation confirms the auditor's bias that the client is not engaged in a fraud and causes the auditor to discount the contrary data.²⁰⁵

Another bias that might affect auditor competence is overconfidence. Experimentation has shown that professionals tend to be overconfident in their judgments within their areas of expertise.²⁰⁶ Moreover, there appears not to be a correlation between confidence and accuracy.²⁰⁷ Thus, an auditor predisposed to believe that the corporate managers are truthful will exhibit a high degree of confidence in the audit and, perhaps, not see the need for further inquiry that might otherwise have disclosed the truth.

Other less well-known heuristics might also help explain why auditors tend to fail to uncover management fraud. For instance, the social psychologist Robert Zajonc has demonstrated that "mere repeated exposure of [an] individual to a stimulus is a sufficient condition for the enhancement of his attitude toward it."²⁰⁸ An individual auditor for an accounting firm may work closely with corporate management on audits and throughout the year. The many contacts with

205. A related phenomenon has been described as "motivated skepticism." This describes situations in which individuals are relatively uncritical about information and argumentation that does not support the individual's preferred outcome. Experimentation demonstrates that when confronted by information that is inconsistent with a preferred outcome, people tend to deny both the facts and the implications of those facts. See generally Peter H. Ditto & David F. Lopez, *Motivated Skepticism: Use of Differential Decision Criteria for Preferred and Nonpreferred Conclusions*, 63 J. PERSONALITY & SOC. PSYCHOL. 568 (1992). Other research confirms a supporting hypothesis: people evaluate the probability of an event by "availability"—the ease with which relevant instances come to mind. See generally Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCHOL. 163 (1973).

206. See J. EDWARD RUSSO & PAUL J. H. SCHOEMAKER, *WINNING DECISIONS: GETTING IT RIGHT THE FIRST TIME* 79–80 (2002).

207. See Scott L. Plous & Philip G. Zimbardo, *How Social Science Can Reduce Terrorism*, CHRON. OF HIGHER EDUC. (Sept. 10, 2004), <http://chronicle.com/article/How-Social-Science-Can-Reduce/22815>.

208. Robert B. Zajonc, *Attitudinal Effects of Mere Exposure*, 9 J. PERSONALITY AND SOC. PSYCHOL. 1, 1 (1968); see also Robert F. Bornstein, *Exposure and Affect: Overview and Meta-Analysis of Research, 1968-1987*, 106 PSYCHOL. BULL. 265, 265 (1989). Somewhat relatedly, if one dislikes another person, repeated exposure can reinforce that dislike whereas if one feels neutral toward another person, repeated exposure—that is, increased familiarity—will increase feelings of liking. See generally Walter C. Swap, *Interpersonal Attraction and Repeated Exposure to Rewards and Punishers*, 3 PERSONALITY & SOC. PSYCHOL. BULL. 248, 248–51 (1977).

management may result in a positive and trusting relationship.²⁰⁹ Related to this phenomenon is something that psychologists refer to as the “affect heuristic,” which suggests that affect—the way a person feels about a situation or another person—influences that person’s judgment.²¹⁰ Thus, one study demonstrated that when a person has a favorable feeling toward a risky activity, that person tends to underestimate the risk of the activity.²¹¹ In fact, the study concluded that this tendency explained the “often observed inverse relationship between judgments of risk and benefit.”²¹² Applying this research to auditor behavior suggests that an auditor who has a positive feeling about a client or an audit may underestimate the risk that the client is seeking to deceive the auditor.

These (and perhaps other) cognitive biases might be characterized as excuses for auditor failure, and one might argue that auditors should recognize and overcome these biases. For instance the confirmation bias may be overcome, or at least moderated, if auditors are expressly instructed to consider seriously that the opposite of what they believe may be true.²¹³ Thus, arguably, these heuristics ought to provide no basis to avoid auditor liability. But the answer to this may be that auditors are not retained to ferret out fraud; if they were, no heuristic should provide an excuse. Audit clients could contract for a “fraud audit,” but in the absence of such an agreement, the law should recognize the relative infrequency of management fraud and the difficulty of uncovering it. After all, in the typical management fraud case, the fraudsters design their fraud specifically to deceive the auditors. That intentional deception, combined with the biases that limit the ability of the auditor to uncover the fraud and the hindsight bias of the fact finder asked to determine whether an auditor was negligent,

209. Daniel Kahneman has characterized Zajonc’s findings as a “profoundly important biological fact,” reasoning that humans (as well as other animals) become comfortable and trusting when repeatedly exposed to the same stimulus if no negative consequences occur after the exposure. “Such a stimulus will eventually become a safety signal, and safety is good.” DANIEL KAHNEMAN, *THINKING, FAST AND SLOW* 67 (2011).

210. *Id.* at 103, 139.

211. Melissa L. Finucane et al., *The Affect Heuristic in Judgments of Risks and Benefits*, 13 J. BEHAV. DECISION MAKING 1, 9–13 (2000); KAHNEMAN, *supra* note 207, at 103.

212. Finucane et al., *supra* note 209, at 3.

213. See generally Charles G. Lord, Mark R. Lepper & Elizabeth Preston, *Considering the Opposite: A Corrective Strategy for Social Judgment*, 47 J. PERSONALITY & SOC. PSYCHOL. 1231 (1984).

all argue in favor of retaining the traditional broad rule of imputation, the narrow adverse interest exception, and the *in pari delicto* defense. A contrary rule should be left to private contracting or legislative action.

4. The Distributional Problem

Auditors who negligently certify a company's financial statements are exposed to liability to investors and creditors on theories of negligent misrepresentation, fraud, and aiding and abetting a fraud under both federal and state law.²¹⁴ Although auditor liability under Rule 10b-5 of the Securities and Exchange Act of 1934 has been limited by Supreme Court cases²¹⁵ and the Private Securities Litigation Reform Act of 1995,²¹⁶ common law and state securities law claims pose significant risk for negligent auditors and other outside service providers.²¹⁷ This means, of course, that if the "guilty" corporation recovers on a claim against the outside service provider, the ability of other claimants, injured by the same fraud, to recover against that service provider may be impaired or even eliminated. As a matter of public policy, it may be preferable to limit the ability of corrupt corporations to recover from negligent third parties they deceived so as to preserve the resources of those third parties for other claimants damaged by the same negligent acts.

214. *E.g.*, *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1218 (10th Cir. 1996) (shareholders successfully brought a federal claim of aiding and abetting a fraud against Home-Stake Production Company); *Amorosa v. Ernst & Young LLP*, 672 F. Supp. 2d 493, 495–96 (S.D.N.Y. 2009) (stockholder brought action against auditor, alleging that the auditor engaged in fraud in violation of federal and state law); *Nutmeg Sec., Ltd. v. McGladrey & Pullen*, 112 Cal. Rptr. 2d 657, 664 (Ct. App. 2001) (McGladrey, the auditor, was found liable to Nutmeg Securities under the theory of negligent misrepresentation).

215. Among other things, plaintiff must prove that the auditor was the "maker" of the misleading statement, *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S.Ct. 2296, 2301 (2011), and acted with "scienter" (an intent to deceive), *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

216. Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

217. *E.g.*, auditors face liability for negligent misrepresentation if, among other things, the plaintiff can prove actual reliance. *In re Sunpoint Sec., Inc.*, 377 B.R. 513, 561 (Bankr. E.D. Tex. 2007), *aff'd*, *Richardson v. Cheshier & Fuller, L.L.P.*, No. 6:07-CV-256, 2008 WL 5122122 (E.D. Tex. Dec 3, 2008).

5. Imputation is an Easier Rule to Administer

The traditional analysis of a claim by a corporation against its auditors for failure to discover fraud by senior management, well represented by the *Cenco* analysis, has the virtue of simplicity and clarity. The *Cenco* court assumed that some shareholders would realize the benefit of double recovery if the corporation were successful,²¹⁸ and some shareholders, who may themselves have been fraudsters, would benefit (albeit indirectly) if the corporation were to recover.²¹⁹ The *NCP* majority, responding to this possibility, asserted that "we should not punish the many for the faults of the few[.]"²²⁰ and went on to suggest that "imputation may be asserted against those shareholders who engaged in the fraud, . . . those who, by way of their role in the company, should have been aware of the fraud[.] . . . [and those] shareholders [who], by virtue of their ownership of a large portion of stock, have the ability to conduct oversight of the firm's operations."²²¹ Justice Rivera-Soto, dissenting in *NCP*, took issue with this suggestion:

One is entirely at a loss to understand how the majority's construct can be applied. For example, if a corporation has 1,000 shareholders, must the trial court hold 1,000 separate mini-trials to determine whether each specific shareholder is barred from recovery because he either "engaged in the fraud[.] . . . should have been aware of the fraud[, or who], by virtue of their ownership of a large portion of stock, ha[d] the ability to conduct oversight of the firm's operations[?]" What if the corporation has not 1,000 shareholders, but 5,000,000? Assuming, as one must, that plaintiffs in this new construct still have the burden of proving their entitlement to recovery, must each plaintiff appear and prove himself free of taint? Will the majority ultimately conclude that, contrary to basic tenets of our jurisprudence, the burden should fall on the party asserting the imputation bar to prove it? If so, how can they, given that the proofs of complicity will lie solely with the plaintiffs and are readily susceptible to spoliation? In the end, the parsing-out required by the majority's notion of who can

218. *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 455 (7th Cir. 1982).

219. *Id.*

220. *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 885 (N.J. 2006).

221. *Id.* at 886.

recover under what circumstances is patently impracticable.²²²

Under a *Cenco* approach, by contrast, the court need only determine whether the corrupt managers were committing a fraud on behalf of the company (regardless of their motives and regardless of whether the company benefited) or whether the managers were, in fact, defrauding the company. This difference, of course, describes when the adverse interest exception may be invoked and is relatively straight-forward. From a prudential perspective, then, the good faith exception is not preferable.

Finally, it is worth noting that the corporation is not without a remedy: it has a cause of action against its managers.²²³ The corporate employer may be able to insure against the risk of accounting fraud with a fidelity bond and, of course, can engage in more meaningful monitoring.²²⁴ Moreover, if the rule of imputation did not apply, the auditors would essentially become insurers for management fraud if they are simply negligent. Vice Chancellor Strine of the Delaware Chancery Court noted this in *In re American International Group, Inc.*²²⁵ The Vice Chancellor expressed misgivings about the traditional imputation rule (which, however, he recognized was the operable principle because New

222. *Id.* at 905 (Rivera-Soto, J., dissenting). Justice Rivera-Soto also observed: Finally, it must be recognized that the majority effects a fundamental transformation of the imputation defense. As a result of the majority's construct, the imputation defense ceases to be a defense to liability and becomes, instead, an item in mitigation of damages. Thus, instead of providing a bulwark against claims by vicarious wrongdoers, the now-transformed imputation defense is relegated to the piecemeal diminution of the damages alleged. Having put an untimely end to the imputation defense, the least the majority can do is to give it a proper burial instead of sentencing it to some jurisprudential limbo.

Id.

223. See, e.g., *In re HealthSouth Corp. S'holders Litig.*, 845 A.2d 1096 (Del. Ch. 2003).

224. The typical fidelity bond provides protection from losses resulting from "dishonest or fraudulent acts" that cause loss to the insured. See, e.g., *Federal Deposit Ins. Corp. v. Nat'l Sur. Corp.*, 281 N.W.2d 816, 819 (Iowa 1979) ("The terms 'dishonest' and 'fraudulent' as used in fidelity bonds have a broad meaning. They include acts which show a 'want of integrity' or 'breach of trust.'"). See also *Arlington Trust Co. v. Hawkeye-Security Ins. Co.*, 301 F. Supp. 854, 857-58 (E.D. Va. 1969). They also include acts in disregard of an employer's interest, which are likely to subject the employer to loss. *First Nat'l Bank of Sikeston v. Transamerica Ins. Co.*, 514 F.2d 981, 987 (8th Cir. 1975).

225. 965 A.2d 763, 828 n.246 (Del. Ch. 2009).

York law applied), but that, perhaps, there were better alternatives. He wrote:

A more thoughtful tact, based on the use of heightened pleading standards (e.g., particularized fact pleading), standards of liability (e.g. gross negligence), proof (e.g. clear and convincing evidence), and measures designed to address liability (perhaps capping liability at some multiple of audit fees plus interest and clearly giving negligent audit firms full indemnification rights against any insider who acted with scienter) would be more directly responsive. As a second best, the [New York] rule could just be explained as grounded in the notion that immunity for auditors is, in the view of New York policymakers, the best way to address an imperfect world.²²⁶

6. Private Ordering: A Sensible Default Rule

A final, and in my view preferable, alternative would be to leave the matter to private ordering. Corporate audits are undertaken pursuant to a written engagement letter between highly sophisticated parties. Given the overwhelming precedent that preceded the preparation of the Restatement (Third) of Agency, it is fair to presume that the parties to such an engagement letter understood that the default rule on auditor liability was represented by cases such as *Cenco*. Indeed, the typical engagement letter places on the audit client the responsibility for implementing procedures to detect fraud.²²⁷ Indeed, the dissent in *NCP* embraced the alternative

226. *Id.* at 830 n.246.

227. *See, e.g.*, North American Professional Liability Insurance Agency, LLC, *Sample Letters: Sample Audit Engagement Wording*, ENGAGEMENT LETTERS FOR THE ACCOUNTING PROFESSION, <http://www.naplia.com/resources/engagement%20letters/Example%20Audit%20engagement%20109.DOC>:

You are responsible for the design and implementation of programs and controls to prevent and detect fraud, and for informing us about all known or suspected fraud affecting the Company involving (a) management (b) employees who have significant roles in internal control, and (c) others where the fraud could have a material effect on the financial statements. You are also responsible for informing us of your knowledge of any allegations of fraud or suspected fraud affecting the Company received in communications from employees, former employees, regulators, or others. In addition, you are responsible for identifying and ensuring that the entity complies with applicable laws and regulations.

of private ordering.²²⁸

Private ordering may, however, be problematic in one respect: corrupt managers may have the responsibility of negotiating the terms of the engagement letter with the auditors and, in a supreme act of hubris, may decline to shift the fraud burden to the auditors. In publicly held companies this should not be a significant issue. Under Sarbanes-Oxley, publicly held companies are required to have an audit committee of the board of directors that consists solely of independent directors and, among other things, the audit committee is responsible for engaging the audit firm and overseeing its work on the audit.²²⁹

Relieving auditors from liability to their audit client for failing to detect and report management accounting fraud does not mean that the auditors are exempt from liability or that their incentives to exercise care are reduced. As noted above, they may be liable to certain third parties who relied on the negligently certified financial statements,²³⁰ they may suffer reputational harm, and they are subject to discipline by the SEC,²³¹ the Public Company Accounting Oversight Board,²³² and state agencies that regulate the accounting profession. On the other hand, if auditors are liable to the audit clients, under the circumstances suggested by the Restatement (Third) of

228. NCP Litig. Trust v. KPMG LLP, 901 A.2d 871, 902 (N.J. 2006) (Rivera-Soto, J., dissenting):

These were sophisticated, experienced and knowledgeable parties: if what [the company] wanted was a guarantee that its financial statements as prepared by its selected corporate agents were entirely without blemish, it should have bargained for, and paid for, appropriate agreed-upon procedures engagements instead of seeking to reform its examination or audit engagement agreement through litigation.

229. Sarbanes-Oxley Act of 2002 § 301.

230. For instance, recently it was reported that the accounting firm of Grobstein Horwath & Co. LLP contributed \$2.5 million to a \$10 million class action securities fraud settlement involving financial statements issued by Syntax-Brilliant Corp. Andrew Johnson, *Lawsuit vs. Syntax-Brilliant Settled for \$10 Million*, ARIZ. REPUBLIC (Feb. 14, 2010), <http://www.azcentral.com/arizonarepublic/business/articles/2010/02/14/20100214biz-syntax0214.html>.

231. See, e.g., SEC v. Chiu, 2:12-CV-00200 (D.Ariz. 2012), available at <http://www.sec.gov/litigation/complaints/2012/comp22243.pdf>, where the SEC accused the former auditor of Syntax-Brilliant Corp. of aiding and abetting a securities fraud by knowingly concealing the client's overstatement of revenue.

232. See, e.g., Ernst & Young LLP, PCAOB Rel. No. 105-2012-001 (Feb. 8, 2012) available at http://pcaobus.org/Enforcement/Decisions/Documents/Ernst_Young.pdf, in which the PCAOB imposed a \$2.0 million fine on Ernst & Young LLP for violations for PCAOB rules and auditing standards.

Agency, it will have the effect of increasing litigation against auditors, increasing professional liability insurance premiums, increasing audit fees and, consequently, increasing the cost of goods and services provided by those clients to the market. At the extreme, opening up this area of liability may have the effect of further reducing the number of auditors and making the audit function less available to smaller companies. This seems too high a price to pay to shift the risk of management fraud from the employers of the fraudsters to outside professionals.²³³

CONCLUDING THOUGHTS

Section 5.04 of the Restatement (Third) of Agency is neither clear in its meaning nor accurate in its restatement of the law. Perhaps for that reason, it has not been persuasive authority in the courts. Of the six cases that cited the Restatement (Third) in auditor liability cases,²³⁴ only one cited and relied upon the good faith concept in ruling against an auditor.²³⁵ In one case, the court held that the adverse interest exception applied because the corrupt officers acted entirely in their own self-interests in misappropriating customer assets.²³⁶ The remaining four cases followed prior precedent and held in favor of the defendant auditor.²³⁷ Other cases against auditors that did not cite the Restatement (Third) of Agency Section 5.04 have overwhelmingly followed prior precedent.²³⁸ Finally,

233. See *NCP Litig. Trust*, 901 A.2d at 904 (Rivera-Soto, J., dissenting).

234. These cases were collected by the ALI and are through April, 2011.

235. Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. Price Waterhouse Coopers, LLP, 989 A.2d 269, 313, 319, 321, 324, 338 (Pa. 2010). Note that in this case the auditor was alleged to have colluded with the corrupt managers. *Id.* at 305–06. The court affirmed the doctrine that a negligent auditor may invoke imputation and held that an auditor who colluded with corrupt management may not. *Id.*

236. *In re Sunpoint Sec., Inc.*, 377 B.R. 513, 563 (Bankr. E.D. Tex. 2007).

237. *In re Parmalat Sec. Litig.*, 659 F.Supp.2d 504, 519, 523 (S.D.N.Y. 2009) *aff'd in part, vacated in part*, *Parmalat Capital Fin. Ltd. v. Bank of Am. Corp.*, 412 F. App'x 325 (2d Cir. 2011); *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 953 (N.Y. 2010); *In re American Int'l Grp., Inc., Consol. Derivative Litig.*, 976 A.2d 872, 891 (Del.Ch. 2009); *Grede v. McGladrey & Pullen LLP*, 421 B.R. 879, 886 (N.D. Ill. 2009).

238. See, e.g., *USACM Liquidating Trust v. Deloitte & Touche LLP*, 764 F. Supp. 2d 1210 (D. Nev. 2011) (trust's claims against outside auditor were barred by *in pari delicto* doctrine); *In re Nat'l Century Fin. Enters., Inc.*, 783 F.Supp.2d 1003 (S.D. Ohio 2011) (trustee's claim against financial services provider dismissed under *in pari delicto*); *In re Verilink Corp.*, 405 B.R. 356 (N.D. Ala. 2009); *In re Amerco Derivative Litig.*, 252 P.3d 681 (Nev. 2011). *But see, e.g.,*

NCP, which might be considered a leading post-Restatement case because it was decided by an important commercial state (New Jersey) and gave rise to long and forceful judicial opinions, did not cite or rely upon the Restatement. Moreover, the audit client in that case was a bankrupt corporation and, as noted above, the case may simply be one of deepening insolvency, although the court did paint with a broad brush in denying imputation and the *in pari delicto* defense.²³⁹

Because the ALI seems to have sought to alter the law with the good faith exception and did not explain this modification in the comments, the persuasive force of section 5.04 is in jeopardy and that, in turn, may cast a bit of pall on the whole Restatement. While it is surely an overstatement to suggest that the ALI's credibility has been tainted because of the enormous goodwill that the Institute has built up over the years, the evolution of section 5.04 should be of concern to the Institute going forward and it may reflect a problem without an obvious solution. The ALI faced a similar "special interest" lobbying effort when the Principles of Corporate Governance were considered by the membership. Lawyers representing publicly held corporations appeared to have the interest of their clients in mind when certain provisions of the Principles were under discussion and then, as with section 5.04, the membership was admonished by the leadership of the ALI to "leave their clients at the door." The effectiveness of that admonishment is hard to measure.

When such controversial topics arise in the course of a

Bechtel v. Master, Sidlow & Associates, P.A., 766 F. Supp. 2d 547, 544 (E.D. Pa. 2011) (relying on Pennsylvania law, the court refused to dismiss case against auditor on the basis of imputation and *in pari delicto* because, among other reasons, the auditor may not have acted in good faith, despite the lack of allegations that the auditor colluded with the corrupt officers. The opinion implies that something less than collusion may be lack of good faith precluding imputation). The holding in *Bechtel* seems to be contrary to an earlier advisory opinion of the Pennsylvania Supreme Court to the Third Circuit Court of Appeals. The state court advised the federal court that a negligent auditor could raise an imputation/*in pari delicto* defense against a claim by a creditors committee, writing: "On balance, we believe the best course is for Pennsylvania common law to continue to recognize the availability of the *in pari delicto* defense (upon appropriate and sufficient pleadings and proffers), via the necessary imputation, in the negligent-auditor context." *Allegheny Health Educ. & Research Found.*, 989 A.2d at 335 (Pa. 2010).

239. The court noted that the corporation could not have benefited from the fraud committed by its officers because "enabling the corporation to continue in business 'past the point of insolvency' cannot be considered a benefit to the corporation." *NCP Litig. Trust*, 901 A.2d at 888 (citing *Schacht*, 711 F.2d 1343 (7th Cir. 1983)).

Restatement or other ALI project, and a "partisan" debate occurs, the ALI might consider including in the Reporter's Notes, or perhaps elsewhere, some indication that the section met with controversy and the nature of that controversy. Users of the ALI's final product would then have fuller information about the section in question and judges might take that disclosure into account when weighing the persuasiveness of the section. In the case of section 5.04, an indication that the outcome of Illustration 5 represents a reversal from an illustration in an earlier draft of the Restatement may be of some use to those depending on the section for guidance.

The membership of the ALI includes many of the leading scholars and practitioners of American law. Partially for that reason, its many projects carry considerable influence on the application and development of that law. The ALI must continue to strive to maintain its objectivity and credibility, avoiding even the appearance that partisan influences affect its work. When it is impossible to assure that, however, the next best alternative is to disclose the nature of the debates and the amendments that occurred as a result.