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BANKRUPTCY LAW

Revisiting Rule on Trustee Standing

In New Economy, 'Wagoner' Doctrine Takes on Added Significance

BY STEPHEN J. SHIMSHAK AND SUSAN E. WELBER

AS THE "New Economy" bubble bursts and a fresh batch of high-profile corporations are forced to seek bankruptcy protection, increased scrutiny is brought to bear on debtor corporations by everyone from investors and creditors to the media and government agencies charged with monitoring corporate practices. When corporate irregularities are revealed, a bankruptcy trustee is often appointed, vested with statutory authority to pursue those causes of action belonging to the debtor corporation's bankruptcy estate against third parties.[1]

In this context, accountants, lawyers and bankers — the failed corporation's professionals — often become defendants charged with torts ranging from negligence, aiding and abetting breach of fiduciary duty and fraud stemming from their perceived role in failing to reveal and even facilitating the corporation's wrongdoing. Because the trustee's statutory role is to prosecute such actions on behalf of the debtor's estate, the trustee's success in recovering damages translates into increased distributions for each of the debtor's creditors, who generally share in the estate on an equal, pro rata basis.

This article concerns what has proven to be a significant obstacle to the success in such suits — the trustee's standing. Under the rule established in the 1991 U.S. Court of Appeals for the Second Circuit decision, *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114 (2d Cir. 1991), a trustee often lacks standing to assert claims against third parties where the debtor corporation itself is complicit in the wrongdoing allegedly perpetuated by the third party defendant.[2]

This article offers practitioners a general overview of a trustee's standing under the so-called "*Wagoner* rule" and its progeny, including the use of the adverse interest exception and its counter-exception, and contrasts the *Wagoner* rule to the use of the common law in pari delicto defense; it also examines a recent application of the *Wagoner* rule, the *Breeden v. Kirkpatrick & Lockhart, LLP*, 268 B.R. 704 (Bankr. S.D.N.Y. 2001) decision decided by the U.S. District Court for the Southern District of New York, which denied a trustee standing to sue certain of the debtor's accountants and attorneys.

Apart from its usefulness in defending professionals, the *Wagoner* rule raises significant questions regarding the role of the bankruptcy trustee, judicial economy and creditors' ultimate ability to recover from third parties liable for their losses.

Hurdles to Standing

Like any plaintiff, a bankruptcy trustee pursuing claims against non-debtor defendants must have standing to assert its claims. Standing in the bankruptcy context is based on the same principles governing standing in other federal courts, namely, the assertion of a case or controversy justiciable under Article III of the Constitution and consistency with other, prudential considerations. As a general matter, a trustee stands in the shoes of the bankrupt corporation and has standing to bring any suit that the bankrupt corporation could have instituted had it not petitioned for bankruptcy, as determined under state law. *Wagoner*, 944 F.2d at 118.

Specifically, in the Second Circuit, the standing analysis consists of two inquiries. First, whether the trustee has alleged that the third party professional has injured the debtor in a manner distinct from injuries suffered by the debtor estate's creditors.[3] In many jurisdictions, the question of the trustee's standing ends here.[4]

In the Second Circuit, *Wagoner* has added a second inquiry to the analysis of trustees' standing — absence of the debtor's complicity in the wrongdoing allegedly perpetuated by the third party defendant. The *Wagoner* rule, as described by the Second Circuit in a recent decision, "derives from the fundamental principle of agency that the misconduct of managers within the scope of their employment will normally be imputed to the corporation. Because management's misconduct is imputed to the corporation, and because a trustee stands in the shoes of the corporation, the *Wagoner* rule bars a trustee from suing to recover for a wrong that he himself essentially took part in." *Wight v. BankAmerica Corp.*, 219 F.3d 79, 86-87 (2d Cir. 2000) (citations omitted.

In *Wagoner*, the issue was whether a bankruptcy trustee had standing to sue a brokerage firm given that the debtor's

> *Under the 'Wagoner' rule, a trustee often lacks standing to assert claims against third parties where the debtor corporation itself is complicit in the wrongdoing allegedly perpetuated by the third party defendant.*

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principal, who was also the debtor's sole shareholder, director and president, sold worthless notes and loan agreements to customers of the corporation, the proceeds of which were used to trade securities through a brokerage firm. The trustee alleged two claims against the firm: first, that the broker had churned the debtor's accounts, and second, that the broker had defrauded the corporation with the cooperation of the debtor's management.

On appeal from the district court, the Second Circuit first considered whether the trustee had asserted claims that belonged solely to the debtor. The court found that the trustee had standing to bring the claim for churning because churning can form the basis for causes of action in fraud and breach of contract, which would otherwise be asserted by the estate. *Wagoner*, 944 F.2d at 119.

With respect to the second claim, essentially for the broker having aided, abetted and unduly influenced the debtor's principal into making bad trades that dissipated corporate funds, the court first found that to the extent the claim alleged money damages to the debtor's clients, it belonged to the creditors and could not therefore form a basis for the trustee's standing. Id. at 119-20. Second, the court noted that even if the trustee had alleged money damages to the debtor itself, under New York law he would have no standing because the debtor's sole stockholder and decision-maker not only knew of the bad investments but actively forwarded them. Id. at 120. Thus, the court established the rule that "[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to the creditors, not the guilty corporation." Id.

Accordingly, where the *Wagoner* rule applies, the shareholder/decision-maker misconduct is imputed to the debtor, and the debtor is deemed not to have suffered an injury itself; rather, an injury flows directly to the creditors. "As a result, an action by a trustee in bankruptcy on such claims is deemed by New York courts to be the equivalent of an action based on claims owned by third parties rather than by the bankruptcy estate." *Mediators, Inc. v. Manney (In re Mediators, Inc.)*, 105 F.3d 822, 825 (2d Cir. 1997). Therefore, the trustee has no standing to assert such claims, and the debtor's creditors and/or shareholders may individually assert claims against third party professionals (or collectively, via a class action).

'Wagoner' Decision's Progeny

Subsequent cases have fleshed out the parameters of the basic rule laid down in *Wagoner*, addressing in particular, whether allegations of a distinct injury is a sufficient basis for standing, and more significantly, what constitutes the "cooperation of management" such that the *Wagoner* rule would apply. This latter inquiry is especially important because in *Wagoner* the debtor was managed by a sole shareholder, leaving open the question of how the rule applies where there are multiple management personnel and more widely held stock ownership.

In *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085 (2d Cir. 1995), the Second Circuit began to answer these questions, applying the reasoning of its *Wagoner* decision to assess the standing of a trustee standing in the shoes of debtor Colonial Realty, a once legitimate investment company, which, at the direction of its general partners, was transformed into a vehicle for a Ponzi scheme. The trustee alleged that the debtor's accountant had instigated and orchestrated the fraud. The court perceived the trustee's complaint as asserting two categories of wrong by the accountant: the provision of misleading information to the Ponzi investors and the provision of deficient professional services to the debtor. *Hirsch*, 72 F.3d at 1092.

The Second Circuit held that the claims predicated on the misleading information to investors were the property of the investors and could only be asserted by them. Id. at 1094. With respect to those claims premised on the accountant's professional malpractice, the court cited the *Wagoner* principles, and noted that while there was at least a "theoretical possibility" that some independent financial injury to the debtor might be established based on such malpractice, it was "persuaded that the *Wagoner* rule should be applied … and that … [the trustee] is precluded from asserting the professional malpractice claims alleged in the [c]omplaint because of the [d]ebtors' collaboration with the defendants-appellees in promulgating and promoting the Colonial Ponzi schemes." Id. at 1094. Accordingly, finding the trustee to lack standing with respect to both claims, the court affirmed the lower court judgment dismissing the trustee's complaint. Id. at 1096.

Other cases decided in the Second Circuit have followed and applied the *Wagoner* rule. See, e.g., *Mediators*, 105 F.3d at 826 (denying standing to creditors committee seeking to assert claim for aiding and abetting breach of fiduciary duty against third party on behalf of debtor, by application of *Wagoner* rule that claim against third party who cooperated with debtor redounds to creditors qua creditors, not committee acting as trustee); *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld*, LLP, 212 B.R. 34, 36 (S.D.N.Y. 1997) (holding that *Wagoner* rule only applies where "all relevant shareholders and/or decisionmakers are involved in the fraud …"; where complaint alleges existence of an innocent manager who could have prevented the fraud, the trustee has standing).

Conflicts among the cases have appeared, particularly with respect to the level of debtor complicity necessary to apply *Wagoner*. For instance, whereas the Second Circuit in *Hirsch* applied *Wagoner* on the basis of the debtor's general partners' involvement in the wrongdoing, in *Wechsler* the district court held that wrongdoing should be imputed only "where all relevant shareholders and/or decision-makers are involved in the fraud." *Wechsler*, 212 B.R. at 35-36. Likewise, in *Lippe v. Bairnco* the district court rejected a bankruptcy trustee's argument that imputation was not appropriate where the debtor entity was not dominated by an individual, sole shareholder and decision-maker. *Lippe v. Bairnco Corp.*, 218 B.R. 294, 302 (S.D.N.Y. 1998). Rather, the *Lippe* court found that the allegation that "a number of key officers and directors" knew about the fraud was sufficient to deny the trustee standing on its claim for aiding and abetting breach of fiduciary duty. Id.

Exceptions

The imputation of wrongdoing to the debtor at the heart of *Wagoner* is based on traditional agency law principles. Accordingly, in determining whether *Wagoner* applies, courts often examine a state agency law exception to imputation, known as the "adverse interest" exception. The exception "rebuts the usual presumption that the acts and knowledge of an agent acting within the scope of employment are imputed to the principal." *In re Mediators*, 105 F.2d at 827 (citing *Center v. Hampton Affiliates*, 66 N.Y.2d 782, 784 (1985)). The exception is narrow; it applies only when the agent has "totally abandoned" the principal's interests. Id. (quoting *Hampton Affiliates*, 66 N.Y.2d at 784-85).

As the New York Court of Appeals has

described, where the agent's actions are adverse to the corporation, "the presumption that knowledge held by the agent was disclosed to the principal fails because he cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose." *Hampton Affiliates*, 66 N.Y.2d at 784. In determining whether an agent's actions were indeed adverse to the corporation, courts have looked to the short-term benefit or detriment to the corporation, not the detriment resulting from the unmasking of the fraud. See *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir.), cert. denied, 459 U.S. 880 (1982).

If it could be shown that "misconduct was entirely oriented toward the ultimate bleeding of … [the debtor] by its corrupt managers, the 'adverse interest' exception would be operative." *Wedtech Corp. v. KMG Main Hurdman (In re Wedtech Corp.)*, 81 B.R. 240, 242 (S.D.N.Y. 1987). In contrast, the adverse inference exception does not apply when the agent acts both for himself and the principal, even though his primary interest is inimical to the principal. *Allard v. Arthur Andersen & Co.*, 924 F.Supp. 488, 495 (S.D.N.Y. 1996). This inquiry is purely factual and depends on both the subjective intent of the agent as well as the objective benefit received by the principal.

A trustee will not be found to have standing under the adverse interest exception where the "sole actor rule" counter-exception applies. Under the sole actor rule, an agent's knowledge is imputed to the principal notwithstanding the agent's self-dealing, because the party that should have been informed was the agent itself (albeit in its capacity as principal). *Mediators*, 105 F.3d at 827. Thus, the sole actor rule applies where "the corporate principal and its agent are indistinguishable, such as where the agent is a corporation's sole shareholder … or where the corporation bestows upon its agent unfettered control and allows the agent to operate without any meaningful supervision with respect to a particular type of transaction." *Breeden*, 268 B.R. at 709 (citations omitted).

In Pari Delicto Doctrine

The equitable doctrine of "in pari delicto" (meaning "in equal fault") arises in the same context as *Wagoner*, where a party seeking to sue third parties for misconduct is itself implicated. The in pari delicto doctrine is premised on a refusal by courts to mediate claims between wrongdoers. The doctrine thus generally prohibits any party from seeking affirmative relief for losses caused by its own wrongdoing. As with *Wagoner*, applicability of the "adverse interest exception" and "sole actor rule" may also be considered.

The in pari delicto doctrine is significant to any discussion of the *Wagoner* rule for at least three reasons. First, in many jurisdictions where the *Wagoner* rule is not followed, there is no "second prong" to the test for standing. Rather, standing is premised on a distinct injury being shown, and imputation of misconduct to the debtor is only raised via the in pari delicto doctrine, as an affirmative defense. See, e.g., *Official Comm. of Unsecured Creditors v. R.F. Rafferty & Co., Inc.*, 267 F.3d 340, 347 (3d Cir. 2001) ("An analysis of standing does not include an analysis of equitable defenses, such as in pari delicto."); *Terlecky v. Hurd (In re Dublin Securities, Inc.)*, 133 F.3d 377 (6th Cir.) (treating in pari delicto defense as distinct from standing analysis), cert. denied, 525 U.S. 812 (1998).

Thus, in the Second Circuit, the burden on the trustee is significantly higher than in such other jurisdictions. Where *Wagoner* applies, before the trustee's suit can go forward, the trustee must resolve complex factual issues relating to the debtor's management's role in the alleged misconduct in order to move forward with his or her suit; whereas in other jurisdictions the defendant bears the burden of raising such issues as an affirmative defense and proving them at trial.

Second, though neither *Wagoner* nor *Hirsch* explicitly apply in pari delicto, courts in the Second Circuit often refer to in pari delicto as if it were interchangeable with *Wagoner*,[5] and practitioners should be careful to determine in any given case whether, in substance, it is the in pari delicto or the *Wagoner* standing analysis that defendants seek to employ.

Third, to the extent *Wagoner* and its progeny have only been applied to the claims of a trustee against third party professionals, the related in pari delicto doctrine may apply more generally to defend against claims by the debtor in possession (where no trustee is appointed) against third party professionals where the debtor's management is implicated in the misconduct at issue. See *Granite Ptrs., L.P. v. Bear Stearns & Co. Inc.*, 17 F. Supp.2d 275, 309 (S.D.N.Y. 1998) (applying in pari delicto to claims of investment funds against third parties).

Applying 'Wagoner'

Judge John E. Sprizzo's decision in *Breeden* is the most recent case applying the *Wagoner* rule by a Second Circuit court, and it offers a coherent synthesis of the various case law preceding it as well as useful guidance to the practitioner stepping into the complicated area of a trustee's standing. In addition, the *Breeden* decision was rendered on the defendant professionals' motion for summary judgment after an evidentiary hearing, unlike many of the cases in this area, which are decided in the motion to dismiss context and are therefore less specific regarding the quality and quantum of evidence required to defeat a trustee's standing.

The *Breeden* adversary proceeding is one of many arising out of the 1996 bankruptcies of the Bennett Funding Group, Inc. (BFG) and related debtors, the management of which is alleged to have orchestrated the largest Ponzi scheme in history. Through the trustee's investigation, it became apparent that the dominant managers, including the only two shareholders, husband and wife, and their children, were responsible for a massive fraud on the companies' creditors.

Against this backdrop, the trustee in *Breeden* filed complaints against certain law firms and accountants that had been engaged by the debtors pre-bankruptcy, for various causes of action, including professional malpractice, breach of fiduciary duty, breach of contract, unjust enrichment, fraudulent transfer of funds, and against the accountants only, negligence and negligent misrepresentation. The trustee's claims were based on the grounds that each of the professional defendants knew, had reason to know, or could have known through reasonable investigation of the Ponzi scheme the debtors and their management had orchestrated.

The defendants moved for summary judgment on the grounds that the *Wagoner* rule defeated the trustee's standing because the company's controlling officers and shareholders had either perpetrated or ratified the fraud. The defendants also contended that the debtors had not suffered a distinct injury as a result of the defendants' allegedly deficient services. The court granted the defendants' motion for summary judgment, rejecting the trustee's contention that the adverse interest exception applied. On the basis of its holding that the *Wagoner* rule defeated standing, the court declined to consider whether the debtors had suffered a "distinct injury."

The *Breeden* court's decision centered on whether the adverse interest exception, and application of its "federal law corollary" as distilled in *Wechsler*, took the trustee's standing out of the square application of the *Wagoner* rule. The trustee argued, based on *Wechsler*, that the *Wagoner* rule does not apply where there is present "any" innocent officer, director or shareholder. *Breeden*, 268 B.R. at 710.

The *Breeden* court rejected that reading of *Wechsler*, explaining that to the extent the *Wechsler* court refers to " 'all relevant shareholders and decision[-]makers' it concedes the well-accepted proposition that some members of management are irrelevant for the purposes of applying the *Wagoner* rule." Id. (quoting *Wechsler*, 212 B.R. at 36). Rather, "[o]nly management that exercises total control over the corporation — or that exercises total control over the type of transactions involved in the particular fraudulent activity at issue — are relevant." Id. The presence of a person with the ability to bring an end to the fraudulent activity at issue would demonstrate that principal and agent are distinct entities and that the total control necessary for an application of the *Wagoner* rule is not present.

Based upon the evidence adduced at the hearing, the *Breeden* court proceeded to find as a matter of fact, that the trustee had failed to prove that such a relevant, innocent decision-maker existed at the Bennett companies. Specifically, the court found that the four members of the Bennett family were the only relevant decision-makers at the debtor companies; and that no member of the Bennett family was innocent with respect to the Ponzi scheme. Id.

These findings were based on, among other things, (i) testimony that the ultimate decision-making authority on all issues of significance rested to varying degrees with each of the Bennetts; (ii) documentary evidence, consisting of internal memoranda concerning the Bennetts' ultimate authority and board meeting agenda for which Bennett family members had literally scripted speaking parts for the various attendees; and evidence that the two shareholders had delegated unfettered control over the company's financial operations to their son, as opposed to the company's treasurer, and that they were active managers who were both aware of and acquiesced in the fraudulent activities orchestrated by their son. Id. at 712.

On the basis of such evidence, the court determined that the innocent officers and directors identified by the trustee were irrelevant for the purposes of applying the *Wagoner* rule. Id. No evidence suggested that any of those individuals "either could have or would have stopped the fraud." Id.

Finally, the court rejected the innocent insiders' contentions that if informed of the fraud they would have taken action to stop it; not one of them alerted the company's counsel, outside auditors or government authorities, despite ample opportunity to do so. Even if such insiders had exposed the fraud, the court held that the trustee would still lack standing, because each of the insiders was "impotent and irrelevant" for the purposes of applying the *Wagoner* rule. Id. at 714. In sum, the court held that "because BFG's injury is traceable to its own dominant management, the trustee lacks standing to pursue claims on BFG's behalf against defendants." Id.

Breeden is a somewhat unique case due to the magnitude of the Ponzi scheme from which it stems and the overwhelming evidence of the shareholders' wrongdoing. The decision is nevertheless a significant addition to the *Wagoner* family of cases. It defines the scope of the "adverse interest exception" broadly to include all "relevant" decision-makers and shareholders.

Given that there could be hundreds of parties arguably falling within this category, *Breeden* may prove to heighten the trustee's evidentiary burden necessary to defeat application of the *Wagoner* rule, and certainly increase the litigation expense associated with its defense. The case also serves as a useful guide to the type of evidence necessary to prove decision-maker status and to demonstrate decision-maker and shareholder control.

Implications

Apart from the *Wagoner* rule's usefulness as a defense to counsel defending against trustee-initiated bankruptcy litigation, the doctrine is significant in that it raises important questions about the role of a bankruptcy trustee and the efficient distribution of estate property under the Bankruptcy Code. Successful application of the *Wagoner* rule says nothing about the merits of the claims asserted against third party professionals, but merely determines who can rightfully assert such claims. Once a trustee's standing is defeated, creditors and shareholders are left to pursue these claims themselves.

While a class action could prove an efficient and appropriate vehicle to assert such claims, where the debtors' constituents are not organized, they would each bear the burden of hiring counsel and litigating the claims, against what are likely to be parties equipped with greater resources to expend on such litigation. By the same token, defendants are forced to defend multiple lawsuits, and risk inconsistent judgments against them, and courts must expend precious judicial resources hearing multiple suits, for what may be nominal damages.

Such inadvertent effects of what amounts to a technical rule of standing seem inconsistent with the overall purpose of the bankruptcy laws to provide for the orderly distribution of debtor companies' assets, including the litigation recoveries obtained by a trustee. No answers to such questions can be offered here, but as bankruptcy litigation everywhere appears to be ramping up, application of the technical doctrines such as the *Wagoner* rule take on added significance.

(1) See 11 U.S.C. §323 (providing that a trustee is a representative of the estate and has the capacity to sue and be sued).

(2) The *Wagoner* rule has only been applied in cases in which a trustee has been appointed. Accordingly, this article does not address the issues raised where a debtor corporation itself sues third party professionals in the bankruptcy context.

(3) Distinct injuries alleged in this context include, among others, the debtor's "deepening insolvency" and losses stemming from the looting of corporate assets.

(4) For a recent example from the Third Circuit, see *Official Comm. of Unsecured Creditors v. R.F. Rafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001).

(5) *Goldin v. Primavera Familienstiftung, TAG Assocs., Ltd.*, 194 B.R. 318, 328 (Bankr. S.D.N.Y. 1996) (citing *Wagoner* and *Hirsch* as two Second Circuit cases considering the application of in pari delicto).

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