

New York Law Journal

GC New York

WWW.NYLJ.COM

©2009 INCISIVE MEDIA US PROPERTIES, LLC

An incisivemedia publication

VOLUME 241—NO. 111

THURSDAY, JUNE 11, 2009

CORPORATE FRAUD

'Wagoner Rule' Dismissal Motions Alive and Well

The Second Circuit's decision last June in *In re CBI Holding Co.*¹ created fears that it might spell the end for early dismissal motions under New York's "Wagoner Rule," which restricts the ability of companies injured by the fraud of their own management to assert claims against third-party professionals who had worked with management. But a pair of recent decisions on accountants' liability claims arising from the Refco bankruptcy² by Southern District Judge Gerard Lynch—himself recently nominated for a position on the Second Circuit—suggest that CBI might end up posing little hindrance to the ability of such defendants to obtain pre-answer "Wagoner Rule" dismissals of such claims.

The Basics of the Rule

In a line of cases starting in 1991 with *Shearson Lehman Hutton Inc. v. Wagoner*, the U.S. Court of Appeals for the Second Circuit and other courts have held that bankruptcy trustees and other corporate representatives have no standing to sue third-party professional advisers to a company for actions they may have taken in connection with management-led misconduct.³

"The rationale underlying the *Wagoner* rule derives from the fundamental principle of agency that the misconduct of managers within the scope of their employment will normally be imputed to the corporation.... [B]ecause 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."⁴ As explained by one district court in an accounting malpractice case, when a corporation "accuses [its auditor] of dereliction with respect to the very financial statements that [the corporation's] officers and directors manipulated," the corporation "cannot now be heard to claim that it was duped into believing those financials were accurate simply because [the auditor] certified them."⁵

'Adverse Interest' Exception

Notwithstanding the basic "Wagoner Rule" concept, where a corporate manager has completely forgone the interests of the company in favor of his or her own personal interests, the rule may not apply. This is commonly referred to as the "adverse interest" exception to the "Wagoner Rule."

This exception derives from the agency-law

By
**Robert A.
Schwinger**



roots of the rule. "The theory is that where an agent, though ostensibly acting in the business of the principal, is really committing a fraud for his own benefit, he is acting outside of the scope of his agency, and it would therefore be most unjust to charge the principal with knowledge of it."⁶ In such circumstances, "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."⁷

The "adverse interest" exception "is a narrow one" and "applies only when the agent has totally abandoned the principal's interests."⁸ Thus, "the exception does not apply when the agent acts both for himself and for the principal, though the primary motivation for the acts is inimical to the principal."⁹ "It is not enough that the agent has a conflict of interest or does not act primarily for his principal."¹⁰

In applying the "adverse interest" exception, the nature of management's fraud must be carefully examined. Courts need to distinguish between circumstances where the managers are stealing from the company and when they are stealing for the company. When managers are stealing for the company—even if they are also simultaneously stealing from the company—they are victimizing persons other than the corporation's owners, and it is therefore deemed proper to impute management's knowledge of the misconduct to the corporate entity so as to bar the corporation's claim against third parties.¹¹

The 2008 'CBI' Decision

These principles were put to the test in the long-running Chapter 11 proceedings for CBI Holding Company, in which an adversary proceeding for professional malpractice was filed against CBI's auditing firm. CBI's president and other members of management allegedly had engaged in a scheme to deceive the company's lenders as to CBI's true financial condition, principally through various forms of inventory fraud. CBI used the capital it obtained by deceiving its lenders as to its inventory to help finance its strategy of growth through

acquisition. The auditors, however, certified the company's financial statements.¹²

Following a bench trial, the bankruptcy court rejected the auditor's "Wagoner Rule" defense, finding that "the evidence showed that the fraud was perpetrated for the purpose of obtaining a bigger bonus for [the company's president], and to preserve [his] personal control over the company."¹³ The district court, however, reversed, holding that there was "some evidence that various corporate purposes were served by the managers' acts of fraud" besides inflating the president's bonus, such as to "give false representations of CBI's profitability to lending banks, without which CBI would have risked triggering an event of default."¹⁴

On appeal, the Second Circuit last year reversed the district court's holding in favor of the defendant auditor under the "Wagoner Rule." The court held that the bankruptcy court's finding that management had totally abandoned the interests of the company could not be deemed clearly erroneous. The Second Circuit held that the bankruptcy court was entitled to credit testimony that the company's controller had said that "the real reason" for the fraud was to maximize the president's bonus by manipulating CBI's income to reach the gross profit percentage necessary for the president's bonus criteria to be met, notwithstanding testimony by one of the auditor's personnel that a member of the company's board had told him the fraud had been designed to "help the company prosper, grow, increase in value."¹⁵

The Second Circuit also rejected the district court's conclusion that some benefit to the corporation necessarily existed under these facts, asserting that "the 'total abandonment' standard looks principally to the intent of the managers engaged in misconduct."¹⁶ Thus, "[e]vidence that CBI actually benefitted from CBI's management's fraud does not make the bankruptcy court's finding that CBI's management did not intend to benefit the company clearly erroneous," noting that the fraudulent scheme benefitted the president by allowing him to maintain control when the true facts would have cost him control of the company and his bonuses.¹⁷

The Second Circuit also suggested that the purported "benefits" to CBI from management's machinations were "illusory" in any event. Borrowing language frequently used in the "deepening insolvency" context, the court stated:

A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it. Prolonging a corporation's existence in the face of ever increasing insolvency may be doing no more

ROBERT A. SCHWINGER is a partner in the commercial litigation group at Chadbourne & Parke. He is reachable at rschwinger@chadbourne.com.

than keeping the enterprise perched at the brink of disaster. Even the ‘benefit’ provided by ‘further indebtedness’—capital—may provide an illusory financial cushion that lulls shareholders into postponing the decision to dissolve the corporation.¹⁸

The court thus upheld the bankruptcy court’s determination that the facts shown at trial were sufficient to trigger the “adverse interest” exception to the “Wagoner Rule.”

The CBI ruling led some to wonder whether it would still be possible to dismiss a claim on “Wagoner Rule” grounds on a Rule 12 motion. It was feared that by focusing the “adverse interest” exception inquiry on the issue of management’s intent, and not being willing to find corporate benefit as a matter of law even when increased capital was being brought into the company, the Second Circuit’s decision might lead courts to require discovery and fact-finding on the issue of management’s subjective intent before ruling on “adverse interest” issues. But the recent decisions on the “Wagoner Rule” defenses raised by accounting firms in the Refco bankruptcy indicate that CBI does not pose the barrier to early dismissal of such claims that some had feared.

The Refco Cases

The Refco bankruptcy arose from a complex fraudulent scheme to artificially enhance Refco’s performance and hide Refco’s true financial condition by concealing uncollectible debt and misappropriating customer assets, so that certain insiders, through a leveraged buyout and an initial public offering, could cash out their interests in Refco on lucrative terms. The illusion of a thriving company enabled these insiders to get their interests bought out by others for far more than the interests were worth.¹⁹

In the aftermath of Refco’s bankruptcy, Refco’s litigation trustee brought professional malpractice claims against various accounting firms that had been involved with Refco. In response, those firms raised “Wagoner Rule” defenses on Rule 12 motions to dismiss. Judge Gerard Lynch granted the motions.

Judge Lynch held that the “Wagoner Rule” and the “adverse interest” exception foreclosed the trustee’s claims because “[t]he complaint is saturated by allegations that Refco received substantial benefits from the insiders’ alleged wrongdoing.” He noted that “the Trustee [had] allege[d] both that had Refco’s trading losses been disclosed, it would have ‘severely damaged Refco’s business’ and that the improper [activity was] designed to, and did, in fact, buttress Refco’s organization.”

According to Judge Lynch, “the gravamen of the trustee’s allegations is not that the insiders stole assets from Refco, but rather that the insiders’ fraudulent scheme was to steal for Refco—to inflate the value of Refco’s interests on behalf of Refco itself by maintaining the illusion that Refco was ‘fast-growing, highly profitable, and able to satisfy its substantial working capital needs without having to borrow money.’”²⁰

The trustee had argued that the “adverse interest” exception should apply “because the insiders intended to benefit only themselves,” and that resolving this issue required a “fact-intensive exercise unsuitable for a motion to dismiss.” The trustee argued that at the pleading stage his allegations “that the Refco insiders were acting ‘solely to enrich themselves’ by ‘sell[ing] their interests in Refco at a fraudulently inflated price’” were sufficient to plead the “adverse interest” exception under CBI.²¹

Judge Lynch disagreed. He termed the trustee’s argument that under CBI the “adverse interest” exception “does not apply if the wrongdoers were ultimately motivated by their own interests, thereby establishing an ‘intent-based’ standard,” to be “industrious, but without merit.”²²

“The Trustee interprets [CBI’s] holding as affirming that the applicability of the adverse-interest exception to the Wagoner rule may not be resolved on a motion to dismiss. Such an interpretation is unwarranted, however, because deferring to a finder-of-fact’s choice as to which evidence to credit after a trial, or acknowledging that facts related to intent could contribute to the explication of how a fraud worked and to whose benefit it accrued, does not make the participants’ intent the ‘touchstone’ of the analysis such that it precludes dismissal on the pleadings. Nor does [CBI] hold that the mere allegations of an insider’s intent to personally profit is sufficient to defeat application of the Wagoner rule at the pleading stage.”²³

Judge Lynch explained further that this result flows from the fact that “the Wagoner rule concerns standing,” i.e., “the question of who has a claim for relief, which, in the context of fraud, means who has been harmed and who has benefitted by the fraudulent conduct alleged. This question concerns the nature and consequences of the alleged fraud, not the extent to which the perpetrators acted from self-interested motives.”

The recent decisions on the ‘Wagoner Rule’ defenses raised by accounting firms in the Refco bankruptcy indicate that ‘CBI’ does not pose the barrier to early dismissal of such claims that some had feared.

Indeed, he said, to hold otherwise would be to “explode” the “adverse interest” exception into a “new, and nearly impermeable rule barring imputation” of management’s knowledge of the fraud to the corporate entity, since “[w]henver insiders conduct a corporate fraud they are doing so, at least in part, to promote their own advantage, whether by obtaining unearned bonuses, embezzling funds, or selling their stock at an inflated price.”²⁴ Thus, he concluded, “the Trustee must allege, not that the insiders intended to, or to some extent did, benefit from their scheme, but that the corporation was harmed by the scheme, rather than being one of its beneficiaries.”²⁵

Judge Lynch also rejected the argument that a scheme involving an “imprudent” LBO and IPO did in fact allege harm to the corporate entity.

It is a basic principle of corporate finance that extending credit to a distressed entity in itself does the entity no harm[,]...[e]ven where, as here, credit is extended to an entity that is, as the Trustee alleges, ‘insolvent or in the zone of insolvency.’... [A]ny harm done to the corporation is not done by the extension of credit itself but by any subsequent looting or embezzlement.²⁶

Since the trustee did not allege looting of corporate assets but rather the sale of interests in Refco to outside parties at fraudulently induced prices, “the benefit procured by the insiders came at the expense of the securities purchasers, not of Refco itself.” In such circumstances, the “adverse interest” exception is inapplicable, and the claims against the accounting firms were dismissed on Rule 12 motions.²⁷

The Refco accounting firm cases show that early fears that the Second Circuit’s CBI decision would make “Wagoner Rule” dismissals impossible at an early Rule 12 stage, before a full plenary factual inquiry into management’s subjective intent, were overblown. Even under CBI, the “Wagoner Rule” still provides an effective tool for third-party professionals to get dismissed from cases arising from management fraud at the pre-answer stage, without first having to get embroiled in lengthy and expensive discovery.

1. *In re CBI Holding Co.*, 529 F.3d 432 (2d Cir. 2008), cert. denied sub nom. *Ernst & Young v. Bankr. Serv. Inc.*, No. 08-1042 (U.S. April 20, 2009).

2. *Kirschner v. Grant Thornton LLP*, 2009 WL 996417 (S.D.N.Y. April 14, 2009); *Kirschner v. KPMG LLP*, 2009 WL 1010060 (S.D.N.Y. April 14, 2009).

3. 944 F.2d 114, 117-18 (2d Cir. 1991). Other leading Second Circuit cases in this area include *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085 (2d Cir. 1995); *In re Mediators Inc.*, 105 F.3d 822 (2d Cir. 1997); *Wight v. Bankamerica Corp.*, 219 F.3d 79 (2d Cir. 2000); and *In re Bennett Funding Group Inc.*, 336 F.3d 94 (2d Cir. 2003).

4. *Wight*, 219 F.3d at 86-87; accord, e.g., *CBI*, 529 F.3d at 448; *Bennett Funding*, 336 F.3d at 100; *Mediators*, 105 F.3d at 826; *Hirsch*, 72 F.3d at 1094.

5. *Am. Tissue Inc. v. Arthur Andersen, LLP*, 275 F.Supp.2d 398, 405 (S.D.N.Y. 2003).

6. *Wight*, 219 F.3d at 87 (quotations omitted).

7. *Center v. Hampton Affiliates Inc.*, 66 N.Y.2d 782, 784, 488 N.E.2d 828, 829, 497 N.Y.S.2d 898, 900 (1985).

8. *Mediators*, 105 F.3d at 827 (quotations omitted); accord *Bennett Funding*, 336 F.3d at 100; *Wight*, 219 F.3d at 87.

9. *SIPC v. BDO Seidman, LLP*, 49 F.Supp.2d 644, 650 (S.D.N.Y. 1999).

10. *In re AlphaStar Ins. Group Ltd.*, 383 B.R. 231, 273 (Bankr. S.D.N.Y. 2008); see 546-552 W. 146th St. LLC v. Arfa, 54 A.D.3d 543, 544, 863 N.Y.S.2d 412, 414 (1st Dept. 2008).

11. *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 454-56 (7th Cir. 1982).

12. *CBI*, 529 F.3d at 439-440.

13. *Id.* at 443.

14. *Id.* at 446 (quotations omitted).

15. *Id.* at 449-50 (quotations omitted).

16. *Id.* at 451 (citing *Capital Wireless Corp. v. Deloitte & Touche*, 216 A.D.2d 663, 666, 627 N.Y.S.2d 794 (3d Dept. 1995)).

17. *Id.* (emphases in original).

18. *Id.* at 453 (quotations and citations omitted).

19. *Kirschner v. Grant Thornton LLP*, 2009 WL 996417, at *1-3.

20. *Id.* at *6.

21. *Id.* at *7 (alteration in original).

22. *Id.*

23. *Id.*

24. *Id.* at *7 & n.14.

25. *Id.* at *7.

26. *Id.* at *8-9 (emphasis in original).

27. *Id.* at *9-10; see also *Kirschner v. KPMG LLP*, 2009 WL 1010060, at *1.

Reprinted with permission from the June 11, 2009 edition of GC NEW YORK © 2009. Incisive Media US Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@customerservice@incisivemedia.com. #070099-06-09-01