Stanwich Clarifies *Wagoner* Rule in Fraudulent Transfer Cases

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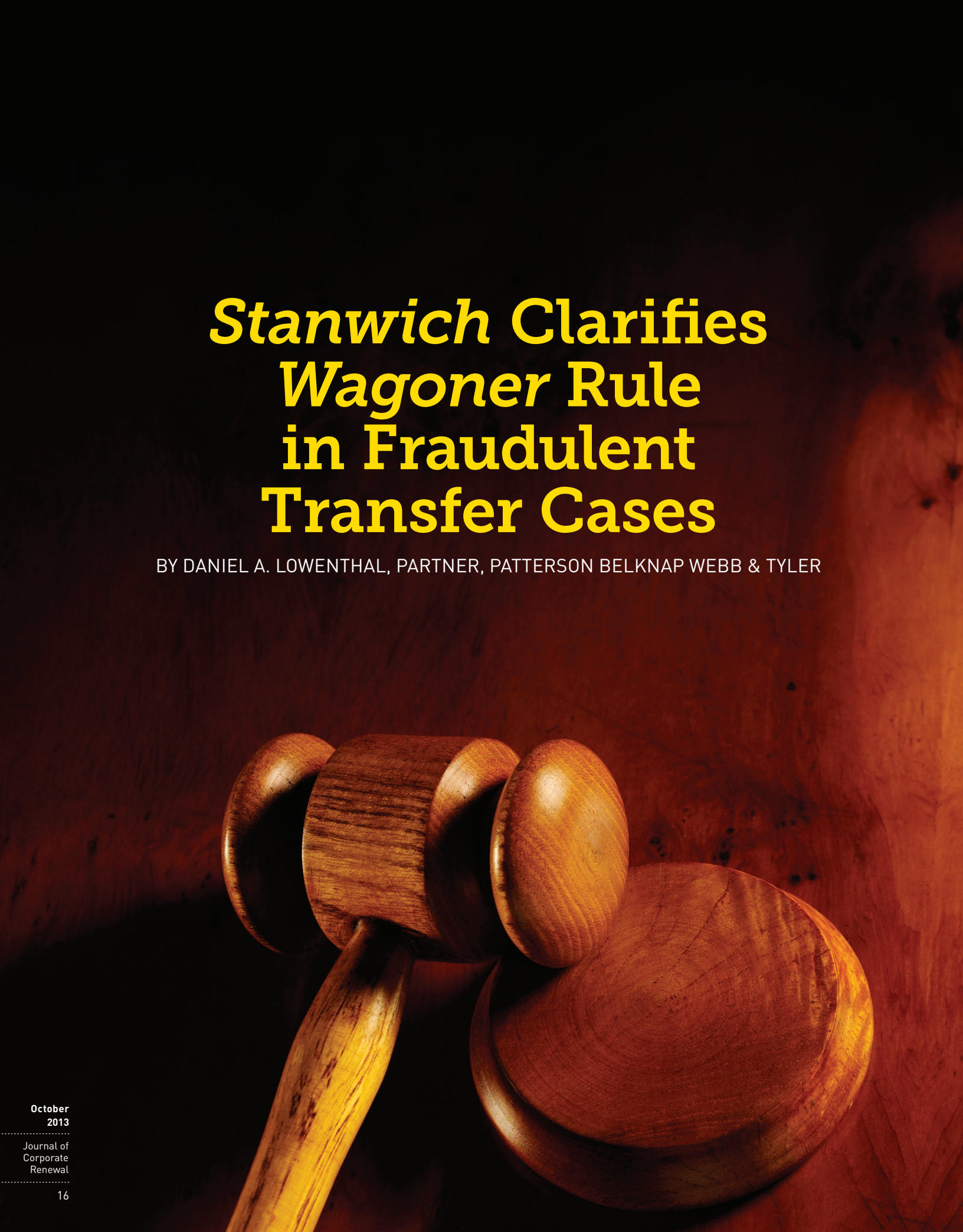

In the Second U.S. Circuit, the so-called *Wagoner* rule deprives a trustee of standing to sue third parties, such as lawyers and investment bankers, if the bankrupt corporation participated with them in defrauding creditors. A recent decision from Connecticut clarifies the limitation of the *Wagoner* rule when a trustee asserts fraudulent transfer claims.

The case involved Settlement Services Treasury Assignments Inc. (SSTAI), which was sold in 1997 in a leveraged buyout (LBO). However, according to allegations in a lawsuit that followed, the deal rendered the company insolvent and unable to pay its debts, and the company's management had allegedly misappropriated corporate funds and improperly amended key corporate documents. SSTAI spiraled downward and, in 2001, filed for Chapter 11 in Connecticut. The debtor confirmed a plan in 2004, and a liquidating agent was appointed.

In 2002, the unsecured creditors' committee in the case had sued the company's principals and professionals to recover fraudulent transfers made in connection with the LBO. The liquidating agent later succeeded the committee as plaintiff in the action.

Early in the case, the Bankruptcy Court had ruled that the plaintiff lacked standing to assert certain claims because management had participated in the fraud. But earlier this year—13 years after the case began—an appellate judge reversed that decision and held that the plaintiff does have standing to assert fraud-related claims that had been dismissed.

At the heart of the case have been basic concepts of standing that apply when management of a company in bankruptcy has engaged in fraudulent conduct. "Whether a claimant has standing is the threshold question in every federal case, determining the power of the court to entertain the suit." *Leasing by Paolo v. Sinatra (In re Cucci),* 126 F.3d 380, 387-88 (2d. Cir. 1997) (quoting *Warth v, Seldin,* 422 U.S. 490, 498 (1975)).

The doctrine of standing stems from the U.S. Constitution's requirement that federal courts only decide cases or controversies. U.S. Const. art. III, sec. 2., cl. 1. "A plaintiff must allege a personal injury fairly traceable to the defendant's allegedly unlawful conduct and likely to be redressed by the requested relief." *Allen v. Wright*, 468 U.S. 737, 751 (1984). The U.S. Supreme Court has held that "[a] plaintiff must always have suffered a 'distinct and palpable injury to himself' . . . ." *Gladstone Realtors v. Village of Bellwood*, 441 U.S. 91, 100 (1979) (quoting *Warth v. Seldin*, 422 U.S. at 501). In addition, the injury cannot be "abstract," "conjectural," or "hypothetical." *City of Los Angeles v. Lyons*, 461 U.S. 95, 101-02 (1983). See *Ass'n of Data Processing Serv. Orgs. v. Camp*, 397 U.S. 464, 472 (1982).

Significantly, the "'case or controversy' requirement coincides with the scope of the powers the U.S. Bankruptcy Code gives a trustee." *Shearson Lehman Hutton, Inc. v. Wagoner,* 944 F.2d 114, 118 (2d Cir. 1991). A debtor or trustee must "allege a personal injury fairly traceable to the defendant's allegedly unlawful conduct that is likely to be redressed by the requested relief." *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1091 (2d Cir. 1995), aff'g *Hirsch v. Arthur Andersen & Co.*, 178 B.R. 40 (D.Conn 1994) *(Hirsch-District)*. "Under the Bankruptcy Code, the trustee stands in the shoes of the bankruptcy corporation and has standing to bring any suit that the bankrupt corporation could have instituted had it not petitioned for bankruptcy." *In re Hampton Hotels Investors, L.P.*, 289 B.R. 563, 573 (Bankr. S.D.N.Y. 2003).

Moreover, "if a trustee has no power to assert a claim because it is not one belonging to the bankrupt estate, then he also fails to meet the prudential limitation that the legal rights asserted must be his own." *Id*. Whether a claim is property of a bankruptcy estate is determined by non-bankruptcy law, either state or federal. *Id*. And "[a] trustee has standing to sue third parties only if the debtor itself was damaged by the conduct of third parties." *Hirsch-District*, 178 B.R at 43. A trustee does not have standing to bring claims that belong to other parties, such as a debtor's creditors.

Wagoner

The adversary proceeding in SSTAI was brought in Connecticut, and thus precedent from the Second U.S. Circuit Court of Appeals applied. The lead case in that jurisdiction regarding standing when a debtor has engaged in fraud is *Wagoner*, in which the 2nd Circuit stated that "when a bankrupt corporation has joined with a third party in defrauding its creditors, the trustee cannot recover against the third party for the damage to the creditors." *Id*. at 119.

In other words, a debtor does not have standing to assert claims if it was "complicit in the wrongdoing allegedly perpetrated by a third-party defendant." *Giddens v. D.H. Blair & Co. (In re A.R. Baron & Co.),* 280 B.R, 794, 800 (Bankr. S.D.N.Y. 2002). If a debtor has engaged in misconduct, then the claims belong to the estate's creditors, not to the bankruptcy estate. As the 2nd Circuit stated in another case, "[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not the guilty corporation." *Wight v. BankAmerica Corp.,* 219 F.3d 79, 86 (2d Cir. 2000).

In *Wagoner,* HMK Management Corporation had one stockholder and director. The company executed trades through a brokerage firm until the firm became concerned about HMK's trading activity and closed the accounts. HMK later filed for bankruptcy and a trustee sued the brokerage firm, alleging that it had engaged in wrongdoing. One claim asserted that the firm had churned HMK's accounts, and a second alleged that the brokerage had aided and abetted HMK in "making bad trades that dissipated corporate funds." *Wagoner*, 944 F.2d at 119.

The Second Circuit held that the bankruptcy trustee had standing to assert the first claim alleging churning, but not the second regarding the aiding and abetting allegation. HMK could have sued the brokerage firm for churning even if the company had not filed for bankruptcy. Therefore, the bankruptcy trustee had standing to assert that claim. But the Second Circuit ruled that the trustee could not assert the aiding and abetting claim because HMK had allegedly engaged in improper conduct. That claim belonged to the company's creditors, not to HMK and its bankruptcy

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estate. Therefore, the doctrine of in pari delicto applied to deny the trustee standing because "the debtor's management had been a participant in wrongful activity." *In re Hampton Hotels Investors, L.P.,* 289 B.R. at 576.

The *Wagoner* rule has an important exception known as the adverse interest exception, which provides that "management misconduct will not be imputed to the corporation if the [corporate] officer acted entirely in his own interests and adversely to the interests of the corporation." *Id*. In other words, the adverse interest exception would apply if the officer is said to be acting for his own benefit rather than that of the corporation. Accordingly, the corporation would have standing to sue a third party that damaged the corporation.

Key concepts of standing and the *Wagoner* rule have been front and center in the SSTAI litigation. SSTAI had served as a third-party administrator in situations resulting from lawsuits brought by seriously injured persons that were settled, resulting in the establishment of trusts to provide payments to those who were injured. SSTAI was the so-called assignment company that made the settlement payments to the beneficiaries. Under the structured settlements, tortfeasors or their insurers assigned the obligation to make the settlements to SSTAI with the payees' consent. Typically in such structured settlements, U.S. treasury bonds and/or annuities are bought to generate income over time to pay the obligations.

In 2002, the debtor and the unsecured creditors' committee stipulated that the committee could bring an adversary proceeding to recover transfers made as part of the LBO. Certain defendants challenged the committee's standing to bring the claims, but the Bankruptcy Court rejected their arguments, holding that, under Second Circuit precedent, the committee had "derivative standing" to bring estate claims when a debtor in possession was reluctant to do so. *Official Committee of Unsecured Creditors v. Pardee (In re Stanwich Fin. Servs. Corp.)*, 288[1] B.R. 24, 27 (Bankr. D. Conn. 2002).

In 2003, the committee sought to amend the initial complaint to add new claims, but the Bankruptcy Court, citing the *Wagoner* rule, denied the request to assert certain claims on behalf of the estate because the debtor arguably had participated in the fraud. *Stanwich*, 317 B.R. 224 (Bankr. D. Conn. 2004). In 2005, the litigating agent moved to amend the complaint again, this time to add factual details about the fraud. An appeal in the case, however, delayed the Bankruptcy Court's consideration of that motion for five years.

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Finally, in April 2011, the Bankruptcy Court ruled that the liquidating agent did not have standing to assert fraudulent transfer claims against the debtor's former law firm and investment bank, again citing management's involvement in the fraud and the *Wagoner* rule. Judge Alan H.S. Shiff concluded that although the complaint deleted the words "aiding and abetting," the fraudulent transfer action was based on allegations that the law firm and investment bank had "assist[ed] or effectuate[d]" the LBO. *Stanwich*, Case No. 01-50831, Adv. Pro. No 02-5023, 2011 Bankr. LEXIS 1259, at *7 (Bankr. D. Conn. Apr. 7, 2011).

The liquidating agent moved for reconsideration, but the Bankruptcy Court denied that motion in September 2011. *Stanwich*, Case No. 01-50831, Adv. Pro. No. 02-5023, 2011 Bankr. LEXIS 3785 (Bankr. D. Conn. Sept. 30, 2011). The liquidating agent then appealed to the U.S. District Court, and that court reversed with respect to the fraudulent transfer claims asserted against the law firm and the investment bank. *Stanwich*, 488 B.R. 829 (D. Conn. 2013).

Standing in Another's Shoes

The Bankruptcy Code specifically affords a trustee standing to assert both state law and federal law fraudulent transfer claims under Sections 544 and 548, respectively. Section 544 permits a trustee to avoid a "transfer of property of the debtor" (Section 544(a)) or "of an interest of the debtor" (Section 544(b)), while Section 548 allows a trustee to avoid transfers of "an interest of the debtor."

As noted earlier, the Bankruptcy Court had dismissed these claims, ruling that the liquidating agent had essentially asserted aiding and abetting claims but without using those words. District Court Judge Stefan R. Underhill disagreed with that conclusion and analyzed the fraudulent transfer claims as they were pled and not as a pretext for other claims.

Underhill held that the liquidating agent had standing to pursue state law fraudulent transfer claims under Bankruptcy Code Section 544, even though management allegedly had engaged in the fraud at issue. He observed that "when acting under [S] ection 544(b), a trustee is vested with the rights of actual creditors to avoid certain transfers. So, even if the trustee itself is otherwise barred from asserting the claim because of *Wagoner*, the trustee, standing in the shoes of the creditors, is not barred from asserting the claim." *Id*. at 834.

Underhill also noted that *Wagoner* cannot override Congress's express grant of standing to a trustee with respect to fraudulent transfer claims. In contrast, he concluded, the liquidating agent would not have standing to bring "fraud, malpractice, and other tort-based claims" against the law firm and the investment bank because of management's participation in the alleged wrongdoing. *Id.* Finally, the liquidating agent could not pursue the Bankruptcy Code Section 548 claim because the transfers at issue had occurred more than two years before the petition date. Therefore, that claim was barred by Section 548 itself rather than by the rules related to standing.

Clarifying Ruling

A debtor's wrongdoing prepetition limits what claims a debtor in possession or bankruptcy trustee can bring against third parties. Unless the adverse interest exception applies, a trustee will not have standing to sue third parties. But the recent decision in *Stanwich* makes clear that the Wagoner rule does not apply to fraudulent transfer claims. A trustee can bring those claims because they belong to the debtor's creditors and not to the debtor.

[1]SSTAI had been renamed Stanwich Financial Services Corp.