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### Circuit Explores 'Wagoner' Rule On Corporate Management Fraud

By Robert Bernstein and Jeffrey Gross  
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One consequence of the global economic crisis has been the disclosure of several large financial frauds. This should not be surprising because many frauds, such as Ponzi schemes, require injections of fresh capital to prevent their discovery. With credit markets frozen, the Madoff scandal may well be the tip of the iceberg.<sup>1</sup>

There will likely be a wave of litigation in the aftermath of these frauds, including lawsuits in which the corporation which employed the principal wrongdoer - or its bankruptcy trustee - sues professional services companies, banks and counterparties who may have enabled the fraud. Whether these claims will succeed may turn on the extent to which the misconduct of management will be imputed to the corporation, thereby barring the corporation or its successor from recovering for a wrong when the corporation is complicit.

In New York, whether wrongdoing will be imputed to the company will involve the application of a doctrine known as the *Wagoner* rule and principles of agency law. These issues were recently explored at length in the Second Circuit's decision in *In re CBI Holding Company Inc. v. Ernst & Young*, 529 F.3d 432 (2d Cir. 2008).

Robert Castello was the President and Chairman of CBI, a large wholesaler of pharmaceutical products. Mr. Castello and other members of CBI's management engaged in a fraudulent scheme to deceive the company's lenders about CBI's financial condition. The company deliberately failed to record invoices on its balance sheet but recorded payments to its vendors as "advance" payments on the company's balance sheet. This inflated the company's assets and earnings and increased bonuses for management. CBI's management also conducted other false transactions, such as creating fictitious inventory and engaging in sham transactions among its subsidiaries.

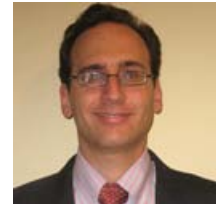
As CBI's auditor, Ernst and Young gave unqualified audit opinions concerning CBI's financial statements for the fiscal years 1992 and 1993. However, the financial statements prepared by E&Y were materially inaccurate because they did not include the unrecorded liabilities. E&Y had not inspected CBI's check register for the weeks immediately after the period had ended. Had E&Y done so, the fraud could have been discovered in its early stages. In any event, once the fraud was discovered, CBI sought the protection of Chapter 11 of the Bankruptcy Code. In bankruptcy, CBI assigned the right to pursue adversary proceedings to its disbursing agent, Bankruptcy Services Inc. (BSI). BSI then sued E&Y for claims which included negligence, breach of fiduciary duty, and breach of contract.

After a bench trial, the bankruptcy court granted judgment for BSI on several claims, rejecting E&Y's argument that BSI lacked standing to assert claims on behalf of CBI because the wrongdoing of Mr. Castello and others had to be imputed to CBI.<sup>2</sup> The bankruptcy court found that while management's knowledge usually is imputed to a corporation, there would be no imputation because of the "adverse interest" exception. Under this exception, knowledge of fraud is not imputed to the company if the wrongdoer was acting solely in his own interest instead of the corporation's interest.

The bankruptcy court found that Mr. Castello had acted to maximize his bonus and keep control of the



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company, as opposed to serving any legitimate corporate purpose. The court also held that there should be no imputation because of another exception known as "innocent insider" doctrine. Under this theory, the court declined to impute wrongdoing because CBI had at least one innocent decision-maker who could have stopped the fraud had he known about it.

E&Y appealed the bankruptcy court's decision to the district court. At first, the court affirmed the bankruptcy court's decision, finding that the evidence supported the adverse interest exception, barring imputation of the fraud to CBI.<sup>3</sup> However, the court granted E&Y's motion for a rehearing and then ruled that BSI lacked standing to pursue its claims against E&Y.<sup>4</sup>

The court examined the evidence in support of the conclusion that CBI's managers had "totally abandoned" CBI's interests when they committed fraud. First, the court found that the bankruptcy court had improperly relied on a document - not properly authenticated at trial - which set forth financial goals that would maximize bonuses.

Second, the court discredited testimony of a former CBI accounting supervisor that the former Controller told him that the "real reason" for failing to record liabilities was to ensure that Mr. Castello maximized his bonus. The district court found this testimony not probative because the witness could not rule out the possibility that the Controller had some additional purpose.

Third, the court found that the bankruptcy court should have drawn an adverse inference from BSI's decision not to offer testimony from CBI's former senior financial officer. Lastly, the court found some evidence in the record that CBI managers hid invoices for reasons other than inflating bonuses, such as avoiding CBI's default on its lending agreements.

The Second Circuit began its review of the district court's decision to impute wrongdoing to CBI by explaining the rule set forth in *Shearson Lehman Hutton Inc. v. Wagoner* that "[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation."<sup>5</sup> The court noted that the *Wagoner* rule was derived from principles of agency law which impute the misconduct of a corporate manager to a corporation.

However, the court noted that the "adverse interest" exception to this rule applied if the manager had "totally abandoned" the corporation's interest.<sup>6</sup> The court then reviewed the bankruptcy court's factual findings on this issue under a clear error standard of review.

The Second Circuit reversed the district court decision in part, finding that the bankruptcy court had not been clearly erroneous when it found that CBI's management had totally abandoned CBI's interest.<sup>7</sup>

The Second Circuit found that the bankruptcy court was entitled to determine the probative weight of the accounting supervisor's testimony that "the real reason" for the fraud was to maximize Mr. Castello's bonus even though the witness could not rule out the existence of other motives.

The Second Circuit also rejected the argument that managers must have had other motives because CBI actually benefited from the fraud. The court recognized that Mr. Castello and his cohorts prevented the company from defaulting so they could stay in control and continue perpetrating their fraud. However, just because the company actually did benefit did not mean that managers intended to benefit the company. Thus, even though the fraud resulted in illusory benefits designed to lull shareholders, banks, or regulators into complacency, the adverse interest exception did not require imputation.

### Unanswered Questions

While the Second Circuit's decision in *CBI* contributes significantly to advancing the case law in this area, there are several ramifications of the decision as well as unanswered questions.

First, because the Second Circuit found that the bankruptcy court's use of the adverse interest exception was not clearly erroneous, it did not have to address directly E&Y's argument that the bankruptcy court should not have applied the "innocent insider" doctrine. In a footnote, however, the court agreed that the district court's conclusion that the "innocent insider" was not a separate exception to prevent imputation of wrongdoing was "extremely persuasive."<sup>8</sup>

Even though the Second Circuit addressed this point in a footnote, it probably forecloses the viability of the "innocent insider" doctrine under New York law, which had been recognized in several district court opinions.<sup>9</sup> It is ironic that CBI may have foreclosed this argument because the facts seemed to lend



themselves to that exception. CBI had a minority shareholder who had the right to take control of the company if CBI breached its financial covenants or defaulted. Thus, Mr. Castello and his cohorts had a strong incentive to deceive this shareholder, who had been unaware of the wrongdoing. In any event, the elimination of the innocent insider exception will make it harder for management to prosecute claims against third parties.

Second, the Second Circuit did not address what other courts have dubbed the "sole actor" exception to the adverse interest exception. Under the "sole actor" principle, the *Wagoner* rule will not apply if a wrongdoer was solely responsible for the activity in question even if he had totally abandoned the corporation's interests.<sup>10</sup> Thus, this line of cases may result in imputing wrongdoing and preventing recovery against third parties even if the wrongdoer's conduct was adverse to the company.

This doctrine applies most often to corporations which are owned and controlled by one individual. However, it has also been applied when the wrongdoer had sole authority with respect to a particular transaction.<sup>11</sup> It will be interesting to see how this doctrine will be applied to the case of Bernard Madoff, Marc S. Dreier or other parties recently accused of committing fraud.

In sum, there are many pitfalls that await claims by defrauded companies against third parties. Not only is it exceedingly difficult to establish that a wrongdoer had totally abandoned the corporation's interest, but the "sole actor" rule may require imputation of wrongdoing to the corporation in some cases even if the perpetrator intended to harm the company.

Moreover, the "innocent insider" rule appears to be a dead letter in the wake of *CBI* and may not prevent imputation. Consequently, the *Wagoner* rule and its progeny may mean that defrauded corporations lack standing to pursue claims against third parties in connection with recently discovered frauds.

While the *Wagoner* decision recognized that a company's creditors may bring these claims instead, New York law is not hospitable to such claims. Under the seminal case of *Credit Alliance Corp. v. Arthur Andersen & Co.*, creditors would have to show that the wrongdoer, such as a negligent auditor, owed it a tort duty.<sup>12</sup>

To do so, the creditor would have to prove, in the context of claims against auditors, that: (i) the accountants knew that the financial statements would be used for a particular purpose; (ii) a particular party intended to rely on the financial statements; and (iii) there was some conduct by the accountants which demonstrated that they understood the party's reliance.<sup>13</sup> It may be very difficult for creditors to establish these *Credit Alliance* factors in a typical case against auditors, outside lawyers or banks.

In light of these formidable barriers to claims against third parties, potentially culpable third parties may escape civil liability under current New York law. Consequently, creative plaintiffs may try to persuade the courts to adopt more favorable aspects of the law in other jurisdictions. For example, the Third Circuit recently affirmed a judgment in favor of a receiver of a defrauded insurance company and against its outside auditors because New Jersey law will not impute wrongdoing to preclude a claim against a culpable third party.<sup>14</sup>

Similarly, in *Cenco v. Seidman & Seidman*, the Seventh Circuit suggested that traditional objectives of tort liability, rather than agency law, may be more appropriate to determine whether a defrauded corporation can bring claims against third parties.<sup>15</sup> These theories have yet to be applied by New York courts.

Recent events remind us that the means of perpetrating fraud are only limited by the human imagination. By the same token, the types of claims against third parties which may be filed by a defrauded corporation are equally boundless. It remains to be seen, however, whether the *Wagoner* rule and its progeny will remain a formidable barrier to claims against third parties.

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#### Endnotes:

1. Leslie Wayne, "Troubled Times Bring Mini-Madoffs to Light," N.Y. Times, Jan. 27, 2009.
2. *Bankr. Servs. Inc. v. Ernst & Young (In re CBI Holding Co.)*, 247 B.R. 341 (Bankr. S.D.N.Y. 2000).
3. *Ernst & Young v. Bankr. Servs. Inc. (In re CBI Holding Co.)*, 311 B.R. 350 (S.D.N.Y. 2004).
4. *Ernst & Young v. Bankr. Servs. Inc. (In re CBI Holding Co.)*, 318 B.R. 761 (S.D.N.Y. 2004).

5. *CBI*, 529 F.3d at 448 (citing 944 F.2d 114, 120 (2d Cir. 1991)).
6. *Id.* (citing *Center v. Hampton Affiliates Inc.*, 66 N.Y.2d 782, 784, 497 N.Y.S.2d 898, 488 N.E.2d 828 (1985)).
7. *Id.* at 454.
8. *Id.* at 447, n.5 (citing *CBI*, 311 B.R. 350).
9. *Alphastar Ins. Group Ltd. v. Arthur Andersen LLP*, 383 B.R. 231, 273 (Bankr. S.D.N.Y. 2008); *Lippe v. Bairnco Corp.*, 218 B.R. 294, 302 (S.D.N.Y. 1998); *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP*, 212 B.R. 34, 44 (S.D.N.Y. 1997).
10. *In re Mediators Inc.*, 105 F.3d 822, 827 (2d Cir. 1997).
11. *In re Parmalat Sec. Litig.*, 477 F. Supp.2d 602, 610 (S.D.N.Y. 2007).
12. 65 N.Y.2d 546, 493 N.Y.S.2d 435 (1985).
13. *Id.* at 551, 493 N.Y.S.2d at 443.
14. *Thabault v. Chait*, 541 F.3d 512, 527-28 (3d Cir. 2008).
15. 686 F.2d 449 (7th Cir. 1982).

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