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**Feature**

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***1 WHOSE CAUSE OF ACTION IS IT, ANYWAY?**

In the scramble for assets of an insolvent business in bankruptcy, trustees and creditors often turn to potential litigation recoveries against third parties who are perceived as having some culpability for the debtor's demise. Within that dynamic, issues continually arise whether a particular cause of action belongs to the debtor's estate, or to certain or all of the creditors of the debtor. This article provides guidance in answering that sometimes troublesome question with the help of a growing body of caselaw.

It is well-settled that causes of action held by a debtor are considered "legal or equitable interests of the debtor in property" and therefore qualify as property of the debtor's estate.[2] On the other hand, a cause of action that belongs only to one creditor or a select group of creditors of the debtor is not property of the estate and cannot be maintained by a trustee or debtor-in-possession (DIP) on behalf of the estate.[3]

***46** While this distinction seems easy to understand, it has proven difficult to apply in certain cases. The difficulty arises because courts have grappled over whether a particular cause of action against a third party could be maintained by the debtor under state law outside of bankruptcy, and because creditors have artfully pled causes of action that have elements the debtor could not satisfy, but that in substance seek to recover for a harm that is common to all creditors of the debtor.

Most courts agree that whether an action may be maintained by the bankruptcy estate depends on whether the debtor corporation itself could have maintained the action had it not filed for bankruptcy.[4] The answer to this question depends, in turn, on whether state law would permit the debtor or its creditors to assert the cause of action.[5]

The issue of whether a cause of action belongs to the estate or its creditors is perhaps best, if not most frequently, illustrated when a trustee or a creditor seeks to assert an alter-ego claim. The results of the cases dealing with this particular issue vary according to the interpretation of applicable state law.[6]

### Agency Theories Applied

Whether a debtor corporation will be found to have had the right, prior to bankruptcy, to bring a cause of action against a third party who is accused of aiding and abetting some corporate wrongdoing[7] will sometimes turn on whether the debtor participated in the wrongful acts that are said to give rise to the liability of the third party. In such a case, the DIP or trustee will be precluded from asserting the cause of action due to the debtor's own involvement in the challenged actions,[8] with the result that the cause of action will belong to the creditors of the debtor.[9]

To avoid the effects of this so-called *Wagoner* rule, those seeking to preserve a cause of action for the bankruptcy estate have invoked what has been termed the "adverse interest exception" if it is available under applicable state law. This exception provides that if the actions of the corporate agent are adverse to the corporation and designed for his or another's purpose, they will not be imputed to the corporation. For this exception to apply, however, the agent must have "totally abandoned" the principal's interests.[10] When that is the case, the bad acts of the corporate agent will not be imputed to the corporation, and thus, the bankruptcy estate will not be precluded from bringing a claim against the third-party tortfeasors.[11]

The adverse-interest exception is itself subject to an exception termed the "sole actor" rule. This rule precludes the trustee from raising the "adverse interest" exception as a defense to the *Wagoner* rule (imputing insider misconduct to the corporation) notwithstanding the corporate agent's self-dealing.[12]

The sole-actor rule applies "where the principal and agent are one and the same," such that the misconduct of the agent, even if it is adverse to the interests of the corporation, nevertheless will be imputed to the corporation because "the party that should have been informed [*i.e.*, the corporation] was the agent itself albeit in his capacity as principal."[13] In that regard, it has been held that if "there was at least one innocent member of management who could or would have been able to prevent the fraud had he known about it," the sole-actor rule will not apply and the fraudulent conduct will not be imputed to the corporation.[14]

The invocation of these various rules of agency in the bankruptcy context, which at times resembles a game of tennis,[15] was most recently illustrated in the Second Circuit's decision in the *Bennett Funding Group Inc*. case.[16] The fraud in *Bennett Funding* involved a Ponzi-type scheme whereby Patrick Bennett, the CEO and son of the sole shareholders of the company, Bud and Kathleen Bennett, sold or pledged the same office equipment leases on multiple occasions.[17] The trustee sued the company's lawyers and accountants for failing to discover or being complicit in the fraud,[18] and the defendants, invoking the *Wagoner* rule, moved for and were granted summary judgment on the ground that "the trustee lacked standing to sue third parties where the fraud was perpetrated by the debtor itself."[19] The trustee appealed.

The Second Circuit affirmed, ruling that the defrauded investors, not the trustee, had standing to sue.[20] It apparently did not consider it necessary to address the adverse-interest exception because it found applicable a variation of the sole-actor rule, which did not directly apply because the perpetrator of the fraud, Patrick, was not an owner of the company.[21] Specifically, because it was undisputed that Bud and Kathleen Bennett (the owners of the company) were aware of and benefitted from the fraud by diverting funds for their personal benefit, they in effect ratified Patrick's fraud, which had the effect of ***47** imputing Patrick's fraud to them and hence to the company.[22]

While the Second Circuit recognized that the presence of at least one innocent decision-maker in a management role might prevent imputation of the fraud to the debtor-company, it emphasized that this rule requires such a person to actually have a demonstrated ability to stop the fraud.[23] This was found to be lacking in the case before it.[24]

**Competing Lawsuits of Creditors**

Whether the bankruptcy estate has standing to pursue a particular cause of action is sometimes determined when a creditor of the debtor seeks a recovery from third parties for harm suffered while dealing with the debtor. If the harm alleged is merely derivative of harm suffered by the debtor, and the debtor could have maintained the action outside of bankruptcy, the estate will have the exclusive right to pursue it.[25] The cases dealing with this issue are illustrative.

In *National American Insurance Co. v. Ruppert Landscaping Co. Inc*.,[26] sureties of the debtor brought suit against the purchaser of some of the debtor's assets, asserting causes of action for successor liability, tortious interference with contract and other business torts arising out of the purchaser's participation in the sale of the debtor's assets.[27] The Fourth Circuit held that the action could not be sustained because it usurped the bankruptcy estate's potential fraudulent transfer claim, even though the competing causes of action did not contain identical elements.[28] The court reasoned that because the claims had the "same underlying focus" and because all creditors of the debtor had a stake in the subject matter of the sureties' suit, it would not "allow selected creditors to artfully plead their way out of bankruptcy court...."[29]

To the same effect is the Sixth Circuit's decision in *Honigman v. Comerica Bank (In re Van Dresser Corporation)*.[30] In *Van Dresser*, Honigman, a shareholder and creditor of the debtor corporation, Van Dresser, brought suit against Comerica Bank, the debtor's bank; Brown, a bank officer; and Friley, the president of the debtor's parent corporation.[31] The complaint alleged that Friley, with the aid of the bank, bilked the parent corporation out of more than $2.7 million, causing it and its subsidiaries to file bankruptcy and resulting in Honigman being called on his guarantee of Van Dresser's indebtedness.[32] The trustees of two of the bankrupt corporations, however, had previously recovered $200,000 of the loss from Comerica pursuant to a court-approved settlement and were currently proceeding against Friley and Brown.[33] The defendants in Honigman's action successfully removed it to the bankruptcy court presiding over Van Dresser's bankruptcy case, and thereafter moved to dismiss the action based on the theory that it was derivative of harm to Van Dresser and therefore belonged to its estate.[34]

In determining the proper ownership of Honigman's claims, the Sixth Circuit instructed that "if the debtor could have raised a state claim at the commencement of the bankruptcy case, then that claim is the exclusive property of the bankruptcy estate and cannot be asserted by a creditor."[35] If, however, the "cause of action does not explicitly or implicitly allege harm to the debtor," then it "could not have been asserted by the debtor at the commencement of the case, and thus is not property of the estate."[36]

In the case before it, the Sixth Circuit acknowledged that both Honigman and Van Dresser stated actionable claims under Michigan law,[37] but ruled that since the loss sought to be recovered was common to both of the corporations, and Honigman and could not be the subject of a duplicative recovery, the claims of the debtor corporations precluded Honigman's suit.[38]

The Fifth Circuit's decision in *Schertz-Cibolo-Universal City, Independent School District v. Wright (In re Educators Group Health Trust)*[39] provides further guidance on the issue of whether a cause of action may be asserted by creditors of the debtor or the bankruptcy estate. In *Educators Group*, the trustee of the debtor sought a determination from the bankruptcy court that a state court lawsuit brought by certain creditors of the debtor belonged to the estate.[40] The debtor was an organization formed to provide health benefits to teachers in small school districts, and the creditors that brought the competing lawsuit were seven of the more than 200 school districts that participated in the debtor's program. The suit was brought against the managers of the debtor for mismanaging the debtor, fraud and other wrongdoings.[41]

In analyzing which of the causes of action belonged to the school district and which belonged to the estate, the Fifth Circuit ruled that those that alleged a direct injury to the debtor, from which an injury to the school districts was derived—such as negligent management of the debtor, thereby rendering it insolvent and unable to pay the school districts,[42] and conspiring to commit fraudulent transfers[43]—belonged to the estate. This type of derivative injury was contrasted with another claim which alleged that the managers of the debtor made misrepresentations concerning the debtor's solvency directly to the plaintiff school districts, a distinction that was held to entitle them to continue to pursue the claim to the exclusion of the estate.[44] The operative reason was because the claim alleged a direct, not derivative, injury to the plaintiff-school districts.[45]

Several lower court cases have also dealt with the circumstances under which a cause of action asserted by a creditor of the debtor can be sustained because it alleges a direct injury particular to that creditor. For example, in *Riley v. SNECMA Inc.*,[46] Riley, the former president and CEO of the debtor, SPECO, brought suit against SPECO's parent and/or affiliated corporations and several of their officers, alleging, *inter alia*, that they breached their promises not to interfere with his employment with SPECO and intentionally interfered with his employment contract with SPECO.[47] In upholding these claims, the court, following the analysis in *Van Dresser* and *Educators Group*, reasoned that they alleged a direct injury to Riley and could not have been asserted by SPECO in its bankruptcy case.[48]

The decision in *In the Matter of Eagle Enterprises Inc*.[49] dealt with the situation where the injury alleged by a creditor in support of its separate and distinct claim was common to all creditors of the debtor. Although most of the claims sought to be asserted by the creditor were held to be property of the estate and protected by the automatic stay, one claim—tortious interference with contract—was found not to constitute property of the estate even though it alleged an injury that appeared to have been sustained by every creditor of the debtors.

***48** The debtors in *Eagle Enterprises* were in the waste-management business and entered into a business arrangement with USA Waste Inc., whereby USA Waste provided a $1 million revolving-loan facility to the debtors, agreed to pay the debtors a minimum amount per week for transportation services and was granted significant control over various aspects of the debtors' business.[50] It was alleged that USA Waste first intentionally breached this agreement, then agreed to loan the debtors an additional $750,000 if they waived USA Waste's breach and minimum purchase obligations, and finally induced the debtors to file for chapter 11 relief under the false promise that it would provide short-term funding and then acquire the debtors, all with the goal of appropriating the debtors' plans for transporting waste and monopolizing the waste-barging industry in Philadelphia.[51]

After conversion of the debtors' chapter 11 cases to chapter 7, the trustee commenced an adversary proceeding against USA Waste that included claims for breach of USA Waste's agreement with the debtors and fraudulent inducement, as well as claims relating to its attempts to appropriate certain business opportunities of the debtors.[52] Two equipment lessors of the debtors, Interpool and Trac, thereafter moved for relief from the automatic stay to bring their own claims against USA Waste, which sought to hold USA Waste vicariously liable for the debtors' breach of the equipment leases under alter ego, joint venture and agency theories;[53] an additional claim was asserted for tortious interference with the equipment leases.[54]

In analyzing whether relief from the stay should be granted, the district court started with the proposition that "[i]f the claim is a general one that could be brought by any creditor, it is property of the estate."[55] Proceeding from that proposition, the district court held that the claims seeking to impose vicarious liability were property of the estate because the theories upon which liability was based were not unique to the equipment lessors, but rather were common to the potential claims of all creditors.[56]

Interestingly, the tortious interference with contract claim was viewed differently. The district court concluded it was unique to the equipment lessors because, by its nature, such a claim involves conduct and injuries that are specific to the contracting party who was harmed and because other creditors who were not parties to the contract could not assert the claim.[57]

It was acknowledged, however, that the tortious-interference claim was based on the same alleged acts of corporate domination and abuse upon which the trustee's adversary proceeding was based and, as such, a decision on the merits could interfere with the trustee's adversary proceeding,[58] apparently because it could have preclusive effect. As a result, the district court remanded the case with instructions for the bankruptcy court to determine whether the tortious interference claim should be stayed under §105(a) of the Bankruptcy Code.

As the *Eagle Enterprises* decision illustrates, a "tortious interference with contract" claim based on acts that harm the debtor corporation and, consequently, a creditor whose contract with the debtor corporation was interfered with as a result, raises special problems. On the one hand, it is particular to the creditor asserting the claim because the interference involves the creditor's own contract with the debtor. Conversely, however, it would appear that all creditors of the debtor that had a contractual or business relationship with the debtor could bring the same type of claim because their contracts, too, would have been interfered with by the same allegedly actionable conduct that formed the basis of the first creditor's tortious interference claim—*i.e*., conduct that harmed the debtor in general and caused it not to perform its contracts.

Such a common harm to the debtor is arguably a basis for precluding its creditors from bringing individual tortious interference with contract claims against the parties who allegedly caused the harm which, in turn, caused the debtor not to perform its contracts. In a sense, that type of claim "is a general one that could be brought by any creditor,"[59] a recognition that perhaps led the Fourth Circuit in *Ruppert Landscaping* to characterize a suit by a select group of creditors for tortious interference with contract and other assorted business torts, as an attempt to "artfully plead their way out of a bankruptcy court."[60]

At least one other decision lends support to the view that a tortious interference with contract claim based on an alleged harm to the debtor and a resulting interference with its contractual obligations is, in substance, a disguised fraudulent transfer claim that belongs to the estate.[61] In *Ionosphere Clubs*, the bankruptcy court approved the estate's settlement of "fraudulent transfer and breach of fiduciary duty claims against Frank Lorenzo and others for systematically transferring a wide variety of assets from Eastern to Continental..."[62] The preferred shareholders of Eastern appealed the approval of the settlement, which included a provision precluding them from bringing claims against the settling parties for tortious interference with their contractual rights.[63]

In affirming the bankruptcy court's approval of the settlement, the district court observed that the assertedly unique claim of the preferred shareholders stemmed "from the damage done to Eastern and affects all owners of Eastern stock."[64] Based on this observation, the district court concluded that the tortious interference with contract claim, which was based on acts rendering Eastern insolvent and unable to pay its contractual debts to the preferred shareholders, "is for fraudulent conveyance properly brought by the trustee, not for tortious interference with contract."[65]

**Conclusion**

Causes of action can be valuable assets of a bankruptcy estate. But when a cause of action is asserted against a third party for participating in a wrongful act against a debtor corporation, common-law rules of agency must be consulted to determine whether it can be asserted by the estate or by its creditors. Similarly, a cause of action asserted by a single creditor or a select group of creditors of the debtor must be evaluated to determine whether, in substance, it complains of a harm that is particular to the creditor or creditors or a harm to the debtor that derivatively injures its creditors.

Footnotes

1 Board-certified in business bankruptcy by the American Board of Certification.

2 11 U.S.C. §541(a)(1). *Schertz-Cibolo-Universal City, Independent School District v. Wright (In re Educators Group Health Trust)*, 25 F.3d 1281, 1283-84 (5th Cir. 1994) (*citing* cases).

3 *Caplin v. Marine Midland Grace Trust Co*., 406 U.S. 416, 433-34, 92 S.Ct. 1678, 1688, 32 L.Ed 2d 195 (1972) (bankruptcy trustee did not have standing to sue a third party on behalf of debenture holders of the debtor).

4 *Shearson Lehman Hutton Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991); *Edwards Wood Products Inc. v. Thompson (In re Icarus Holdings LLC)*, 290 B.R. 171, 177 (Bankr. M.D. Ga. 2002) ("[i]f the debtor could not bring a cause of action outside of bankruptcy, the trustee cannot pursue that action in bankruptcy.").

5 *Honigman v. Comerica Bank (In re Van Dresser Corp.)*, 128 F.3d 945, 947 (6th Cir. 1997) ("[w]hether a creditor has sole right to a cause of action is determined in accordance with state law."); *Hirsch v. Arthur Anderson & Co*., 72 F.3d 1085, 1093 (2d Cir. 1995) ("[w]hether the rights belong to the debtor or the individual creditors is a question of state law.")

6 *See, e.g., Spartan Tube and Steel Inc. v. Himmelspach (In re RCS Engineered Products Co.)*, 102 F.3d 223, 225-226 (6th Cir. 1996) (trustee lacked standing to pursue alter ego action because under Michigan law, subsidiary corporation does not have standing to sue its shareholders or parent under an alter-ego theory); *Kalb, Voorhis & Co. v. American Financial Corp*., 8 F.3d 130, 133 (2d Cir. 1993) (trustee had standing to assert alter-ego claim because, under Texas law, corporation can pierce its own corporate veil); *St. Paul Fire and Marine Insurance Co. v. PepsiCo*, 884 F.2d 688, 696-99 (2d Cir. 1989) (holding trustee had standing to bring alter-ego claim because corporation could pierce its own veil under Ohio law); *Koch Refining v. Farmers Union Central Exchange Inc*., 831 F.2d 1339, 1346 (7th Cir. 1987) (trustee can bring alter-ego claim under Indiana and Illinois law); *In re Ozark Restaurant Equipment Co*., 816 F.2d 1222 (8th Cir. 1987) (trustee did not have standing to assert alter-ego claim where Arkansas law did not permit corporation to pierce its own veil). *See, also, Steinberg v. Buczynski*, 40 F.3d 890, 892 (7th Cir. 1994) (not quarreling with the concept that if the corporation is injured by its shareholders' disregard of corporate formalities, the trustee can sue, but declining the trustee standing because only a single creditor was injured by conduct on which alter ego liability was asserted).

7 The most common targets of such a claim have been the corporate debtor's former professionals, such as its accountants or attorneys.

8 *See Hirsch v. Arthur Anderson*, 72 F.3d 1085, 1094 (2d Cir. 1995) (trustee precluded from asserting professional malpractice claims against the debtors' former accountants "because of the debtors' collaboration with the defendants' appellees in promulgating and promoting the Colonial Ponzi schemes."); *Shearson Lehman Hutlon Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991) ("when a bankrupt corporation has joined with a third party in defrauding its creditors, the trustee cannot recover against the third party for the damages to the creditors.").

9 *Shearson Lehman Hutton Inc. v. Wagoner*, 944 F.2d 114, 120 (2d Cir. 1991) ("[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation."). The rationale for the rule is "the fundamental principle of agency that the misconduct of managers within the scope of their employment will normally be imputed to the corporation." *Wight v. Bank American Corp*., 219 F.3d 79, 86 (2d Cir. 2000). It does not apply, however, to actions on behalf of the corporate bankruptcy estate against a fiduciary of the corporation, such as an officer or director, as opposed to third parties, such as those who are claimed to have aided and abetted a breach of fiduciary duty. *See Mediators Inc. v. Manney (In re The Mediators Inc.)*, 105 F.3d 822, 826 (2d Cir. 1997).

10 *Wight*, 219 F.3d at 87; *Mediators Inc*., 105 F.3d at 827.

11 *See, e.g., Bankruptcy Services Inc. v. Ernst & Young (In re CBI Holding Co.)*, 247 B.R. 341, 365 (Bankr. S.D.N.Y. 2000) (adverse-interest exception held to apply in action against debtor corporation's former accountants for failing to detect significant unrecorded liabilities of company where chairman and president kept liabilities off books because his bonus and retention of control depended on the company achieving a certain level of earnings).

12 *Sharp International Corp. v. KPMG LLP (In re Sharp International Corp.)*, 278 B.R. 28, 37 (Bankr. E.D.N.Y. 2002). In other words, the insider misconduct will be imputed to the corporation, thereby defeating a cause of action against a third party who is claimed to be legally responsible for such conduct along with the insider.

13 *Mediators*, 105 F.3d at 827.

14 *Sharp International Corp*., 278 B.R. at 36-37 (existence of innocent director and 13 percent shareholder who, it was alleged, could have brought an end to the fraud, sufficient to preclude application of sole-actor rule); *see, also, Wechsler v. Squadron, Elleroff, Plesent & Sheinfield L.L.P*., 212 B.R. 34, 36 (S.D.N.Y. 1997) (trustee's complaint against debtor's former attorneys dismissed based on sole-actor rule where complaint failed to allege existence of an innocent member of management who could have stopped the fraud had he known about it); *Bankruptcy Serv. Inc. v. Ernst & Young LLP (In re CPI Holding Co. Inc.)*, 247 B.R. 341, 364-65 (Bankr. S.D.N.Y. 2000) (innocent 48 percent shareholder and director who testified that had be known of accounting fraud, he would have taken stops to stop it, prevented imputation of president and chairman's fraudulent conduct to corporation).

15 This appearance is created by the non-debtor defendants first arguing that the *Wagoner* rule applies to deprive the trustee of standing, in response to which the trustee asserts the adverse interest exception, in response to which the defendants invoke the sole-actor rule, in response to which the trustee maintains there was at least one innocent member of management who could have prevented the fraud had be known about it.

16 *Breeden v. Kirkpatrick & Lockhart LLP (In re The Bennett Funding Group Inc.)*, 336 F.3d 94 (2d Cir. July 15, 2003).

17 *Id*. at 97.

18 *Id*. at 96-97.

19 *Id*. at 97.

20 *Id*. at 102.

21 *Id*. at 101.

22 *Id*.

23 *Id*. at 101 (existence of innocent, independent directors who could not actually do anything to stop the fraud would not preclude imputation of fraud to debtor).

24 *Id*.

25 *Schertz-Libolo-Universal City, Indep. School Dist. v. Wright (In re Educators Group Health Trust)*, 25 F.3d 1281, 1284 15th Cir. 1994)

26 187 F.3d 439 (4th Cir. 1999).

27 *Id*. at 440-41.

28 *Id*. at 441.

29 *Id*. at 441-42.

30 128 F.3d 945 (6th Cir. 1997).

31 *Id*. at 946.

32 *Id*.

33 *Id*. at 947.

34 *Id*.

35 *Id*.

36 *Id*.

37 *Id*. at 947.

38 *Id*. at 948.

39 25 F.3d 1281 (5th Cir. 1994).

40 *Id*. at 1283.

41 *Id*. at 1282.

42 *Id*. at 1284-85.

43 *Id*. at 1285.

44 *Id*. at 1285.

45 *Id. See, also, Chemtall v. Citi-Chem Inc*., 992 F. Supp. 1390, 1405 (S.D. Ga. 1998) (“[w]here a creditor's complaint against a debtor's corporate principal alleges a direct injury to the plaintiff, such claim belongs solely to that plaintiff... However, where the claims directly impact the debtor corporation...and only indirectly impact the plaintiff creditors, then the claims belong exclusively to the debtor (typically the trustee).”

  

46 105 F. Supp. 2d 793 (S.D. Ohio 1999).

47 *Id*. at 799-800.

48 *Id*. at 798-801.

49 265 B.R. 671 (E.D. Pa. 2001).

50 *Id*. at 675-76.

51 *Id*. at 676.

52 *Id*. at 676.

53 *Id*. at 676-77.

54 *Id*. at 677.

55 *Id*. at 678.

56 *Id*.

57 *Id*. at 680.

58 *Id*. at 681.

59 *Id*. at 678.

60 *National American Insurance Company v. Ruppert Landscaping Co. Inc*., 187 F. 3d 439, 441-42 (4th Cir. 1999).

61 *See AirLine Pilots Association International v. American National Bank and Trust Co. of Chicago (In re Ionosphere Clubs Inc.)*, 156 B.R. 414 (S.D.N.Y. 1993), *aff'd*., 17 F.3d 600 (2d Cir. 1994).

62 *Id*. at 421-22.

63 *Id*. at 425.

64 *Id*. at 439.

65 *Id. But, see Stone's Pharmacy Inc. v. Pharmacy Accounting Management Inc*., 872 F.2d 665, 668 (8th Cir. 1989) (reversing dismissal of creditor's claim against purchaser of a portion of debtor's assets for tortious interference with contract between creditor and debtor).

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