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Business busts pose risk for lawyers, accountants

They are increasingly
targets of trustees of
bankrupt companies.

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THE PAST DECADE has seen a significant rise in lawsuits brought by bankruptcy trustees or receivers against an insolvent company's former accountants and attorneys. Trustees and receivers presiding over the estate of a failed company victimized by – or, more often, utilized for – fraud or other misconduct are now routinely looking to causes of actions against the debtor's professionals as the estate's primary, if not the only, assets.

Questioned about the recent rise, one often-appointed federal receiver, Lewis B. Freeman, offered two explanations in a recent discussion with the author: "That's where the money is" and in the recent years of "growth at any cost, some lawyers and accountants have put growth and billing before quality and ethics."

This article reviews a sample of such actions and considers how courts and litigants are responding to them – including the *in pari delicto* doctrine against plaintiffs recovering for their own wrongdoing, and the mixed reviews being given to "deepening insolvency" as a cause of action. The article will also look at the ways professionals (and their insurance companies) are dealing with the potentially increased exposure.

The opening paragraph by the 3d U.S. Circuit Court of Appeals ruling in a recent professional malpractice case briefly summarizes an all-too-familiar

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fact pattern: "An insolvent . . . company involved in an illegal Ponzi scheme used its financial statements, compiled by its accounting firm, to attract investors. After the company spent the investors' money and incurred millions more in debt, it filed for bankruptcy. A bankruptcy trustee was appointed, and he sued the accounting firm, along with the partner responsible for compiling the financial statements, for, among other things, malpractice and 'deepening insolvency.'" *In re CITX Corporation*, 448 F.3d 672 (3d Cir. 2006).

This fact pattern has been repeated in dozens of cases in recent years, with the courts coming to differing outcomes.

In one case, *Friedman's Inc.*, a large jewelry chain, filed bankruptcy following the failure of several financial transactions it had with an affiliate, *Crescent Jewelers Inc.* *Friedman's* and *Crescent* shared a controlling shareholder and had overlapping directors. *Friedman's* bankruptcy trustee filed actions against several entities, including claims for malpractice and breach of fiduciary duty against *Friedman's* long-term outside counsel. The trustee alleged that the lawyers failed to disclose material facts to *Friedman's* independent directors regarding the financial condition of *Crescent*, and provided erroneous legal advice concerning the security of *Friedman's* investment in *Crescent*. *In*

re Friedman's Inc., No. 407CV041, 2008 WL 131163 (S.D. Ga. January 10, 2008). The district court allowed the malpractice action to proceed over the defenses of standing and *in pari delicto*. *Id.* at *59.

In another case, *Senior Cottages of America, LLC* was in the business of developing senior citizen housing projects that qualified for low income housing tax credits. The company was unable to pay its debts as they became due, and – with the assistance of counsel – transferred all or substantially all of the assets to a new entity. Following its bankruptcy, *Senior Cottages'* trustee sued the former counsel for malpractice and aiding and abetting breach of fiduciary duty alleging they assisted the debtor's principal in transferring corporate assets for inadequate consideration. The bankruptcy court dismissed the trustee's claim against the attorneys, and denied leave to amend based on the doctrine of futility given the *in pari delicto* defense. *Moratzka v. Morris*, 320 B.R. 895, 901 (Bankr. D. Minn. 2005). The district court affirmed on the basis of lack of standing – *i.e.*, no injury to the company, only to the creditors. The 8th U.S. Circuit Court of Appeals reversed the district court decision, finding that the amended complaint sufficiently alleged an injury to the debtor. *In re Senior Cottages of America, LLC*, 482 F.3d 997 (8th Cir. 2007). The defense of *in pari delicto* was not raised on appeal.

The 'Citx Corp.' case

Another case involved *CitX Corp. Inc.* which proposed to create an "internet shopping mall." Would-be mall merchants invested \$18 million

in the project. Following the failure of a related business, CitX filed bankruptcy. The bankruptcy trustee filed an action against CitX's accountants for malpractice, breach of fiduciary duty, negligent misrepresentation, and "deepening insolvency" alleging that the accounting firm "missed many 'red flags'" in preparing the company's financial statements, and this inaction allowed the debtor to incur millions of additional dollars in debt. *CITX Corp.*, 448 F.3d 672, 675-76 (3d Cir. 2006). Among the "red flags": CitX's "bookkeeper" was the principal's girlfriend and a high school dropout; the company was bouncing checks and was insolvent except for a \$2.4 million receivable from an associated company that itself was "a fraudulent enterprise" and ultimately shut down by the Florida Attorney General. *CitX*, 448 F.3d at 675-76. The 3rd Circuit affirmed summary judgment in favor of the accounting firm. *Id.*

In yet another case, Lernout & Hauspie Speech Products, N.V. was involved in developing and licensing speech recognition software. After two years of reporting strong revenues and profits, it acquired two domestic companies (along with the "massive" new debt). *Baena v. KPMG, LLP*, 453 F.3d 1 (1st Cir. 2006). A subsequent audit found that revenues for the prior two years had been overstated by more than \$250 million. The company filed for bankruptcy. The bankruptcy trustee filed suit against the former accountants for breach of fiduciary duty, accounting malpractice, and unfair or deceptive trade practices alleging that the accountants wrongfully issued unqualified opinions and failed to alert the independent directors, permitting the company to incur \$340 million in new debt. The trustee alleged that the accounting firm "knowingly tolerated patently improper accounting practices . . . in order to retain a lucrative client." *Id.* at 4. The 1st U.S. Circuit Court of Appeals affirmed the dismissal of the action against the accountants based upon the *in pari delicto* defense. *Nisselson v. Lernout*, 469 F.3d 143 (1st Cir. 2006).

Two issues arise repeatedly in these matters: the application of the *in pari delicto* defense, and the

viability of "deepening insolvency," either as a theory of damages or an independent cause of action.

In many cases, the "hoary *in pari delicto* doctrine" is the greatest obstacle to a successful recovery against the debtor's professionals. See *Nisselson*, 469 F.3d at 147. The *in pari delicto* defense prohibits plaintiffs from recovering damages resulting from their own wrongdoing. See *Terlecky v. Hurd (In re Dublin Secs.)*, 133 F.3d 377, 380 (6th Cir. 1997); see also *Nisselson*, 469 F.3d at 151 (explaining the purposes of the doctrine as "courts should not lend their good offices to mediating disputes among wrongdoers" and "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality").

One observer notes of the trend: 'That's where the money is.'

The defendant typically raises the *in pari delicto* defense claiming that the misconduct of the debtor's principals is imputed to the debtor under agency principals; recovery should therefore be prohibited because the debtor was the primary wrongdoer and should not recover from others on account of its own wrongdoing. In the absence of an innocent officer, director, or shareholder, the choreographed response to a motion to dismiss is usually reference to the recognized exception to the *in pari delicto* defense: the "adverse interest exception." "The acts of the agent will not be charged to the corporation if although the agent purportedly acts for the corporation, he 'is really committing a fraud for his own benefit.'" *Bennett Funding Group, Inc. v. Kirkpatrick & Lockhart LLP*, 336 F.3d 94, 100 (2d Cir. 2003) (citation omitted).

The reply typically is to resort to an exception to the exception: the "sole actor rule" which imputes the agent's knowledge 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." *Id.*

A second issue often arising in these cases is that of "deepening insolvency," whether as a theory of damages or an independent cause of action. As a theory of damages, the first question to ask is: "Whose damages are being asserted: the debtor's or the creditors'?" A trustee can only bring those claims that are property of the estate, *i.e.*, a cause of action for damage to the debtor, as the trustee cannot bring claims solely for damages to creditors. *Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416 (1972); *In re Senior Cottages*, 482 F.3d at 1000; *Schnelling v. Thomas (In re Agribiotech, Inc.)*, 319 B.R. 216, 221 (D. Nev. 2004).

While any recovery to the estate by a trustee flows to the creditors, the mere fact that creditors will enjoy the recovery does not defeat the trustee's right to assert the debtor's claim. *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 348-49 (3d Cir. 2001); *Baena*, 453 F.3d at 5. As a theory of damages, the issue can also be characterized as an issue of standing: whether or not the corporation itself suffered harm, as opposed to merely the creditors. See, *e.g.*, *In re Greater Southeast Comm. Hosp. Corp. I*, 353 B.R. 324, 337 (Bankr. D. Colo. 2006) (stating that "the accumulation of debt by an insolvent entity could, in certain circumstances, be harmful to the corporation.") (relying on *Lafferty*, 267 F.3d 340 (3d Cir. 2001)).

As an independent cause of action, deepening insolvency has received mixed reviews with the more recent cases appearing to reject the theory. The caselaw to date has largely been by federal courts attempting to predict how state courts would rule on the issue – and not always accurately. See, *e.g.*, *In re Exide Techs., Inc.*, 299 B.R. 732 (Bankr. D. Del. 2003) (predicting Delaware would recognize); *Trenwick America Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 206 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. Supr. 2007) (holding that Delaware does not recognize the cause of action).

Protect oneself

Given the number of actions against professionals by bankruptcy trustees and the uncertainty that exists as to the viability of causes of action and affirmative defenses, what should professionals do to protect themselves from being targeted for such an action?

The Attorney's Liability Assurance Society, Inc. ("ALAS"), a leading mutual insurance company for law firms, has advised that "the key is to look for red flags" during the course of the engagement. Brian J. Redding and Deborah G. Shortridge, "The Zone of Insolvency," and Lawyer Liability – Where Are We and Where Might We Be Going?" ALAS Loss Prevention J. (Fall 2004).

For example:

- Is there anything that suggests that there might be something wrong here?
- Is this transaction with an affiliated entity
- Is the author of the appraisal or fairness opinion someone closely connected to the transferor?
- Are outdated financials being used?
- Are relevant factors not discussed in the fairness opinion?
- Is the transaction one that qualifies as self-dealing on the part of the controlling shareholder?
- Are there indications that the sale price seems to be a bargain for the purchaser?

If these or other indications of problems exist, the lawyers need to stop and ask questions, if not as a matter of law, at least as a matter of prudence and good loss prevention.¹

In short, the best protection for the professional seems to be continued ethical vigilance, and a steadfast enforced commitment to avoiding risk, even if doing so is at the cost of losing a client. Particularly in today's litigious climate and current economic downturn, losing a client because of a commitment to high, professional standards may actually benefit the law firm or accountant in the long run. Even if the professional would ultimately prevail against a claim by the trustee, the economic, business, and reputational costs of defending such a claim are likely to be significantly greater than the business of any single client.

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