Professional Liability

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Defending Claims for Malpractice Brought by Bankruptcy Trustees

Practitioners who defend legal and accounting malpractice claims undoubtedly have observed the proliferation of actions filed by bankruptcy trustees against attorneys and accountants. Such actions have been filed throughout the United States, including Illinois. These suits can be extremely expensive to defend, and the bankruptcy trustees typically seek outlandish damages. These actions led Seventh Circuit Court of Appeals Judge Richard Posner to comment that “[j]udges must therefore be vigilant in policing the litigation judgment exercised by trustees in bankruptcy, and in imposing sanctions for the filing of a frivolous suit.” Maxwell v. KPMG LLP, 520 F.3d 713, 718 (7th Cir. 2008). Therefore, defense attorneys must be cognizant of certain legal theories that can be effective in such cases.

To place context on this issue, the fact pattern in many of the cases is similar. Typically, there has been fraud committed by an insider or insiders of a corporation. At some point, the fraud is revealed and the corporation is forced to file for bankruptcy. A bankruptcy trustee or liquidation trustee will file a negligence claim against a professional alleging that the professional either conspired with the insiders to carry out the fraud, or failed to detect the fraud that was committed.

In such cases, a bankruptcy trustee stands in the shoes of the company in pursuing the claim. Official Committee of Unsecured Creditors of PSA, Inc., 437 F.3d 1145, 1150 (11th Cir. 2006) (“A bankruptcy trustee stands in the shoes of the debtor and has standing to bring any suit that the debtor could have instituted when the debtor filed for bankruptcy, and there is no suggestion in the text of the Bankruptcy Code that the trustee acquires rights and interests greater than those of the debtor.”). Therefore, the claim actually involves the company whose insider committed the fraud suing the professional that had been retained by the company. The question thus becomes whether the company that committed the wrongdoing through its agent may recover for damages that it suffered as a result of the wrongdoing, or whether the company is precluded from recovering because it was itself the wrongdoer through its agent.

The answer to these questions lies in the concepts of in pari delicto and imputation. In pari delicto is a Latin phrase meaning “[e]qually at fault.” BLACK’S LAW DICTIONARY, Eighth Edition, p. 1248. The principle behind the pari delicto doctrine is that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing. Id. Imputation is a concept in agency whereby a corporation will be charged with the knowledge of its agent. In essence, when the two doctrines are put together, they stand for the proposition that a company who suffered damages as a result of the wrongdoing of its agent cannot recover from a third party for damages caused by the agent’s wrongdoing. Thus, in cases where a bankruptcy trustee for a corporation sues a third party professional for damages caused by the wrongdoing of an agent of the corporation, the professional very often defends the claim based on the in pari delicto doctrine and imputation.

However, there is an important exception to the concept of imputation; namely, the adverse interest exception. The adverse interest exception applies where the agent is found to have totally abandoned the interests of the company in committing the wrongdoing. Importantly, as discussed below, total abandonment
means just what it says—total abandonment. If the company benefitted to some extent, even if the benefit was short term, the adverse interest exception does not apply.

A very recent decision by the Court of Appeals of New York addressed these important concepts in the context of a professional negligence claim brought by a liquidation trustee against KPMG. *Kirschner v. KPMG, LLP,* 2010 WL 4116609 (N.Y. Oct. 21, 2010). The court’s holding in *Kirschner* is very helpful for attorneys defending similar claims as the court there addressed and rejected many arguments that are often raised by bankruptcy trustees to avoid the in pari delicto doctrine and imputation.

*Kirschner* arose from the collapse of Refco, once a leading provider of brokerage and clearing services. After becoming a public company in 2004, Refco disclosed that its president and chief executive officer had orchestrated a succession of loans which hid hundreds of millions of dollars of Refco’s uncollectible debt from the public and regulators. This in turn created a falsely positive picture of Refco’s financial condition. However, the false picture allowed Refco to stay in operation and raise additional capital for the operations of the company. Following the disclosure of the fraud, Refco filed for bankruptcy protection in the United States Bankruptcy Court for the Southern District of New York.

The bankruptcy court ultimately confirmed Refco’s Chapter 11 bankruptcy plan. Among other things, the plan established a Litigation Trust, which authorized Marc Kirschner as Litigation Trustee to pursue claims and causes of action possessed by Refco prior to its bankruptcy filing. Among other suits, Kirschner brought an action against KPMG alleging that as Refco’s accounting firm, KPMG was negligent in failing to discover the scheme orchestrated by Refco’s president and CEO. The suit against KPMG was transferred with other suits brought by Kirschner to the Southern District of New York.

KPMG moved to dismiss the complaint asserting that the Trustee could not prevail on a claim against KPMG when insiders of Refco engaged in the fraudulent conduct that caused the damage. The District Court agreed, finding that, under New York law, the Trustee’s claims were precluded because his complaint alleged that Refco received substantial benefits from the agents’ wrongdoing. The Trustee’s claims essentially alleged that the wrongdoers stole for Refco and not from Refco. Specifically, the District Court held that “the burden of the [Refco] insiders’ fraud was not borne by Refco or its then-current shareholders who were themselves the [Refco] insiders—but rather by outside parties, including Refco’s customers, creditors, and third parties who acquired shares through the IPO.” *Id.* The District Court thus dismissed the claims against KPMG.

On appeal, the United States Court of Appeals for the Second Circuit certified a series of questions to the Court of Appeals of New York relating to whether New York law supported the decision of the District Court. In response, the *Kirschner* court answered the questions by engaging in a substantive analysis of the law relating to the in pari delicto doctrine, imputation and the adverse interest exception. The *Kirschner* court began its analysis by discussing the doctrine of in pari delicto. The court stated that the doctrine “mandates that the courts will not intercede to resolve a dispute between two wrongdoers.” *Id.* The court noted that the doctrine remains in effect because denying judicial relief to an admitted wrongdoer deters illegality, and because it avoids entangling courts in disputes between wrongdoers.

The *Kirschner* court then discussed the concept of imputation. The court recognized the fundamental principle that “the acts of agents, and the knowledge they acquire while acting within the scope of their authority are presumptively imputed to their principals.” *Id.* The law presumes imputation even where the agent exhibits poor business judgment or commits fraud. Therefore, fraud by officers and agents in the course of the corporate dealings is considered in the law to be the fraud of the corporation.

However, the court also recognized that there is an important exception to imputation; namely, the adverse interest exception. The adverse interest exception applies where the agent has totally abandoned his principal’s interests for his own or another’s purposes. Where the agent is perpetrating a fraud that is intended to benefit the agent exclusively, and in the process harm the corporation itself, the concept behind imputation fails. Under such circumstances, the agent is not acting on behalf of the corporation. Conversely, the court found that where the corporate wrongdoer’s fraudulent conduct “enables the business to survive—to attract investors and customers and raise funds for corporate purposes—[the total abandonment] test is not met,” and the adverse interest exception does not apply. *Id.*
In arguing that the adverse interest exception applied to the claims against KPMG, the Trustee contended that the fact that Refco was forced to file for bankruptcy demonstrated that Refco was harmed by the wrongdoers’ conduct. The Kirschner court rejected this argument, finding that the mere fact that an entity is forced to file for bankruptcy does not determine whether its agent’s conduct was adverse to the company at the time the conduct was committed. Likewise, the court held that any harm resulting from the discovery of the fraud—rather than the fraud itself—is not relevant to whether the adverse interest exception applies. “If that harm could be taken into account, a corporation would be able to invoke the adverse interest exception and disclaim virtually every corporate fraud—even a fraud undertaken for the corporation’s benefit—as soon as it was discovered and no longer helping the company.” Id.

The Kirschner court likewise rejected the Trustee’s argument that the adverse interest exception should apply where the wrongdoers intended to benefit themselves at the corporation’s expense, and the corporation received only a short term benefit. The court found that adopting the Trustee’s argument would mean the demise of imputation. The court explained as follows: “This is so because fraudsters are presumably not, as a general rule, motivated by charitable impulses, and a company victimized by fraud is always likely to suffer long-term harm once the fraud becomes known.” Id.

The court additionally rejected the Trustee’s assertion that the in pari delicto defense should not be a total bar to recovery, but rather should be akin to a comparative negligence analysis between the defendant professional and the company. The court held that such a change would “marginalize the adverse interest exception.” Id. The court also held that “comparative fault contradicts the public policy purposes at the heart of in pari delicto—deterrence and the unseemliness of the judiciary serving as paymaster of the wages of crime.” Id.

It would appear clear that based on the Kirschner decision, the Second Circuit will affirm the dismissal of the Trustee’s claims against KPMG. As a result, KPMG will avoid liability based on the legal theories that it presented, rather than having to engage in fact discovery surrounding its actions. While KPMG undoubtedly will expend a significant amount of money in achieving the dismissal, that will be a small fraction of what it would cost to take the case to trial.

As stated above, Kirschner is important for all of us practitioners because it provides strong responses to many of the arguments that are raised by bankruptcy trustees to avoid the application of the in pari delicto doctrine and imputation. However, the most important thing to take away from Kirschner is that it is incumbent on defense counsel to focus on the benefits that the company received as result of the wrongful conduct. Kirschner makes clear that such benefits need not have been long term benefits, nor must they have been the intended consequence of the wrongdoers’ actions. As long as some cognizable benefit to the company was achieved as a result of the wrongdoing, the bankruptcy trustee will be precluded as a matter of law from pursuing professional negligence claims against the attorneys or accountants who performed services for the company prior to the bankruptcy. Once the benefit is identified, the attorney must aggressively pursue the in pari delicto and imputation defenses through a motion to dismiss or a motion for summary judgment. This will allow the attorney to focus the case on the legal issues, rather than the factual issues framed by the bankruptcy trustee’s allegations, and allow the attorney to obtain a resolution of the case strictly on the legal issues.

About the Author

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