PRESIDENT'S LETTER

BY: JONATHAN S. ZISS, ESQ.

How ever did it become December?

I am pleased to report that PLDF heads into 2016 in better shape than ever. Our membership continues to grow and to diversify. Several of our committees are becoming very active, recruiting new members and putting them to work to the common good.

For example, in this issue, you will find a very instructive piece about the powerful equitable defense known as *in pari delicto.* This tactic, which happens to be near and dear to my heart, can fell giants under the right circumstances. The piece was researched and written by members Bryan Paul and Bob Girardeau, with the assistance of Brent Almond. Also in this issue is an excellent addition to your toolbox, courtesy of David Anderson: "Defending Professional Liability Claims in Bankruptcy Court".

The Accountants Professional Liability and Lawyers Professional Liability Committees are hard at work on 50-State surveys of the law. Keep your eyes on these pages and on the website for more information. This is only the beginning of our efforts to make PLDF a go-to resource for the professional liability claims specialist and defense practitioner. Personally, I find it inspiring to see our member firms and organizations pulling together to collaborate on projects of this kind.

Our Board meets early in the year to set our priorities for the year and to plan projects large and small. Please be sure to share your suggestions during the next 60 days so that we can have the benefit of our community's collective best thinking when we convene.

From all of us at PLDF, have a peaceful and happy Holiday season! We'll see you in 2016.

Warm regards,

Jonathan

MANAGING DIRECTOR'S MESSAGE

BY: CHRISTINE S. JENSEN

Greetings to all PLDF Members and Other Friends!

I look back on another successful year for PLDF. In 2015 we advocated successfully in a state supreme court as an amicus, our sixth annual meeting featured our new "field trip" concept that will be repeated next year, we are underway in the preparation of a 50-State compendium of authorities on the subject of the privity defense, our LinkedIn and PLDF website messaging volumes continue to rise, and we've named a Director of Membership Development to assist the Board of Directors in searching for ways to grow our ranks and to ensure our membership proposition is valuable. Look for new ideas as we begin our new year which leads off with our semi-annual Board meeting at the end of January in Santa Monica, California.

The new year also brings opportunities for members to provide leadership to PLDF's committees. Both Chair and Vice Chair positions are available on our Real Estate E&O Claims Committee, our Insurance Producer E&O Claims Committee, and our Other Healthcare Malpractice Claims Committee. Vice Chair openings are available on our Construction Design E&O Claims Committee, our Miscellaneous Professional Liability Claims Committee, and our Investment Professional E&O Claims Committee. Please email me if you are interested and I will share with you a summary of the leadership responsibilities.

I will sincerely welcome your inputs about ways in which we can look for new innovations to bring greater value to your practices or careers with industry. We know the members of the plaintiffs' bar are testing new claims approaches in concert with the widespread information-sharing they are known for. Are we doing all that we can to assist our members and the PL defense community generally in challenging the plaintiffs' bar? My goal for 2016 is to re-double efforts—as per our Mission Statement—to enhance the stature and effectiveness of professional liability professionals through education, training, and the exchange of information. Thank you and best wishes! Chris

Google Analytics, PLDF Website Data, October 2015

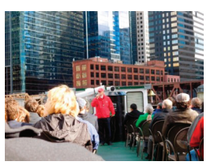
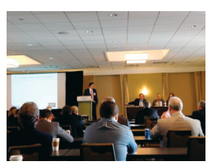
Sessions: 539, **Users**: 564, **Page Views**: 2,760, **Visit Duration** (mins:secs): 3:37, **Pages/Visit**: 3.73, % **New Visits**: 63.73%

A Few Scenes From PLDF's Sixth Annual Meeting!







An Association of Malpractice Defense Professionals™

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VOLUME 7, ISSUE 4

PROFESSIONAL LIABILITY DEFENSE QUARTERLY

FALL 2015

INSIDE THIS ISSUE:

SPECIAL POINTS OF INTEREST:

- Committee Leadership Positions Open (See Page 8)
- 50-State Privity Law Compendium Project Underway
- New Directors Elected at Annual Meeting
- Director of Membership Development Named

THE *IN PARI DELICTO* DEFENSE TO ACCOUNTING E&O CLAIMS,

BY: ERIS BRYAN PAUL, ESQ., ROBERT M. GIRARDEAU, ESQ., AND BRENT ALMOND, ESQ.

Accounting firms, especially those who provide audit services, often find themselves being forced to defend litigation brought by a plaintiff or plaintiffs who stands in the shoes of a former audit client. Often times, these plaintiffs are shareholders, receivers, litigation trustees or bankruptcy trustees. The plaintiffs often allege that the accounting firm failed to discover some fraud or other wrongdoing within the client corporation or worse, that the accounting firm was even complicit in that fraud or wrongdoing. If the corporate client itself was involved in some type of fraud or misconduct, a powerful defense to all of claims brought by the plaintiff includes the defense of *in pari delicto*.[1]

Imagine the following: between 2008 and 2012, managerial employees with Acme Incorporated engaged in a massive fraud. The fraud began in Acme's sales division, but eventually spread to the very top management of Acme, and by the time the fraud was uncovered, the Chairman and President of Acme, including a number of Vice Presidents and other type managers were deeply involved. Not all management of Acme was corrupt, however, and several of the Board of Directors were not in on the fraud, although there may be evidence that they were negligent in allowing it to flourish undetected. In these cases, the fraud is often eventually discovered by a newly hired financial officer beginning their employment with the company or a whistleblower. Often the fraud is discovered by new management put into place by an out of state private equity firm that recently bought the company. In our example, Acme's independent auditor through the period of the fraud, never discovered the fraud; or if it did discover the fraud, it failed to report it.

The fraud in our example involved inflating the company's sales figures and certain accounts receivable far above their actual value. Specifically, the fraud consisted of the company selling its inventory to the government on a cost plus basis but falsely reporting to the government the actual cost involved. Obviously, this increased the apparent worth of Acme and greatly increased the market price of its stock.[2] When the fraud was uncovered, the market price plummeted over 80%. Moreover, the inflated stock price was used as leverage to expand Acme's footprint throughout the southeastern United States and Acme also benefited from the fraud by being able to borrow money at lower rates than if its sales had

Continued on page 2

DEFENDING PROFESSIONAL LIABILITY CLAIMS IN BANKRUPTCY COURT,

BY: DAVID C. ANDERSON, ESQ.

Strangers in a strange land. That's how many defense lawyers and claims examiners feel when defending an insured lawyer in bankruptcy court after the client has filed for bankruptcy. Bankruptcy trustees, creditors' committees and liquidating trusts make very dangerous plaintiffs. And many defense lawyers feel like they have been dragged into bankruptcy court "separated from their wallets without any concern for proximate cause or liability issues."

That was the sentiment of Johannes Kingma, a partner at Carlock, Copeland & Stair LLP in Atlanta, who moderated a panel discussion on defending legal malpractice claims in bankruptcy court. Kingma was joined by Allison McCabe, a senior claims examiner at Aspen Insurance in New York, and Rob Charles, a bankruptcy lawyer and partner at Lewis Roca Rothgerber in Tucson, Arizona. Together, they revealed some of the inner workings of professional malpractice claims in bankruptcy court.

Square Deal in Bankruptcy Court?

Kingma queried whether a defendant lawyer could ever get a "square deal" in bankruptcy court given that it seems as

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IN PARI DELICTO DEFENSE IN APL CLAIMS, CONT'D

been stated honestly. As a result, those involved in the fraud were not stealing from the company, as in the usual case, but instead the fraudsters were increasing both the power of perceived wealth of the company and themselves, at the expense of others.

Once the fraud is discovered, litigation surely follows. In some cases stock purchasers bring class actions against the corporation and its independent auditors, alleging violations of various securities laws and fraud. Moreover, the corporation, under new management, may file cross claims against the auditors for breach of contract, professional malpractice and fraud. Or yet still, should Acme be driven into bankruptcy various creditors and shareholders of the company may see an attempt by the bankruptcy trustee to recover losses from an auditor through an Adversary Proceeding in the United States Bankruptcy Courts.

When such lawsuits arise, defendant auditors should consider the *in pari delicto* defense, in addition, of course, to any other common law or statutory defenses which may be available.

In Pari Delicto Defined

In its simplest form, *in pari delicto* is a tribute to the oft-cited adage, "you've dug your own grave, now lie in it." Derived from the Latin phrase, *in pari delicto potior est conditio defendentis*, the defense provides that, in the case of equal or mutual fault, the position of the defending party is the better one. *Bateman Eichler, Hill Richards v. Berner*, 472 U.S. 299, 306 (1985); *Official Comm. of Unsecured Creditors of PSA v. Edwards*, 437 F.3d 1145, 1152 (11th Cir. 2006). Put another way, "the general rule is that if parties to a fraud are *in pari delicto,* the law will leave them where it finds them." *Knox-Tenn Rental Co., v. Jenkins Ins., Inc.*, 755 S.W.2d 33, 39 (Tenn. Ct. App. 1988). As Judge Desmond more eloquently stated:

> For no court should be required to serve as paymaster of the wages of crime, or referee between thieves. Therefore, the law will not extend its aid to either of the parties or listen to their complaints against each other, but will leave them where their own acts have placed them.

Stone v. Freeman, 298 N.Y. 268, 271 (1948); consequently, the intended purpose of the *in pari delicto* doctrine is readily apparent. First, it works to ensure that courts do not lend their "good offices" to mediating disputes among wrongdoers. *Edwards*, 437 F.3d at 1152. Second, the defense deters wrongdoing by denying judicial relief to an admitted wrongdoer. *Id*.

Utilization of *In Pari Delicto* by an Auditor Defendant

As illustrated in the above hypothetical, the corporation's claim against the auditor arises out of the alleged negligent failure of the auditor to detect the company's fraud, or possibly his active participation in the fraud. In other words, the corporation in the above scenario is forced to concede the presence of fraudulent activity within the company. Such cases are fundamentally distinct from derivative suits, in which the plaintiff is often an innocent party altogether. This distinction is an important one because derivative suits are generally immune to an *in pari delicto* defense. *See American Int'l Group, Inc. v. Greenberg*, 976 A.2d 872, 889 (Del. Ch. Ct. 2009) ("it is generally accepted that a derivative suit may be asserted by an innocent stockholder on behalf of a corporation…"); *Trenwick Am. Litig. Trust v. Ernst & Young*, LLP, 996 A.2d 168, 212 n. 132 (Del.Ch. Ct. 2006)("the doctrine of *in pari delicto* has never operated in Delaware as a bar to providing relief to the innocent by way of a derivative suit").

By contrast, the managerial misdeeds in the above hypothetical will be imputed to the corporation by way of agency law. This imputation makes the corporation legally responsible for the fraudulent activities of its officers, thus giving rise to an *in pari delicto* defense. The rationale was explained by the New York Court of Appeals in *Kirschner v. KPMG, LLP*, 15 N.Y.3d 446 (2010). The *Kirschner* court reasoned that "the risk of loss from the unauthorized acts of a dishonest agent falls on the principal that selected the agent . . . after all, the principal is generally better suited than a third party to control the agent's conduct, which at least in part explains why the common law has traditionally placed the risk on the principal." *Kirschner* 15 N.Y.3d at 465. The court went on to state that such is the case "even where the agent acts less than admirably, exhibits poor business judgment, or commits fraud… [because] like a natural person, a corporation must bear the consequences when it comments fraud . . ." *Id.*

Adverse Interests Exception and Relevant Impact of *In Pari Delicto* Defense as to Auditor

An exception to the general rule of imputation does exist, however. Assume that in the above hypothetical, the fraudsters were acting entirely adverse to Acme and solely for their own benefit. In such a case, their conduct would arguably not be imputed to Acme under the so-called "adverse interests" exception. Practically, this would mean that the auditor would be unable to rely on the *in pari delicto* defense to defend against the claims of the innocent corporation. *See Kirschner,* 15 N.Y.3d at 466. As a corollary to this point, the auditor's own culpability may affect the applicability of the *in pari delicto* defense (i.e., failed to satisfy professional standards in auditing company as opposed to aiding or abetting fraud).

Though widely accepted, the "adverse interests" exception to the general rule of imputation has not been applied consistently in state and federal courts. Most often, the various applications of the exception turn on

PLDF COMMITTEES

Professional Liability Defense Federation's 12 substantive committees include:

- **Medical**
- **Other Healthcare**
- **Legal**
- **Accounting**
- **Investment**
- **Corporate Governance**
- **Insurance**
- **Real Estate**
- **Construction Design**
- **Cyber**
- **Employment Practices**
- **Miscellaneous PL**

> ""[T]he general rule is that if parties to a fraud are *in pari delicto*, the law will leave them where it finds them."

PL CLAIMS IN BANKRUPTCY, CONT'D

quite different.

- Your case, while in bankruptcy court, may be tried before the federal district court anyway.
- Bankruptcy judges may be less busy than state court judges and maybe you want a trial quickly.
- If you have a complex commercial case, a bankruptcy judge may be more adept at handling it.
- You may think the bankruptcy judge will be more helpful on pretrial issues.

Trustee Conflicts and the 'Multi-Party Mess'

Trustees must attest that they have no conflicts in connection with the bankruptcy matters they handle. "The trustee and the trustee's lawyers should be disinterested," Charles said. If a trustee fails to reveal a conflict that is subsequently discovered, he said, it may lead to the disgorgement of the trustee's fees. "And it's a crime," Charles added. "Everything that is done in a bankruptcy is filed under penalty of perjury and there is a criminal statute, 28 U.S.C. § 152, that makes a lot of things criminal that you might think were just stupid or negligent."

Kingma said he has been able to strategically take advantage of the rule against conflicts in the past. He explained that the bankruptcy bar is "pretty small and when there's a big case, there's lots of phone calls flying around before bankruptcy is filed and then thereafter." Sometimes, bankruptcy trustees and lawyers will forget that they were part of the information "swirling around," he said. And if you can document their involvement, "that could give you a lot of leverage and that's something to think about," Kingma advised.

McCabe agreed and described her experience where a lawyer who represented a legal malpractice plaintiff was later disqualified from representing the trustee after the plaintiff filed for bankruptcy. Where the plaintiff-debtor and trustee's views on settlement diverge, a conflict is created that likely disqualifies the lawyer from continuing his representation, she said.

Creditor's Committee

A creditor's committee is made up of 20 of the largest unsecured creditors in a Chapter 11 reorganization. They are fiduciaries for all of the creditors, not just their individual interests, and the committee may retain counsel at the expense of the bankruptcy estate. Kingma likened creditors' committees to the "mob with pitch forks and torches circling the castle." Sometimes, he said, the creditors' committee will seek permission from the court to pursue claims, perhaps against a professional, if the debtor in possession chooses to abandon it. If allowed, then a professional may have to defend against the committee, which acts much the same way a trustee would if appointed.

Liquidating Trusts

Liquidating trusts receive the rights and causes of action of the debtor post-Chapter 11 plan confirmation. So, a professional may find himself sued by a liquidating trust in bankruptcy court. When defending such a claim, Charles advised "doing your homework" and reviewing the disclosure statement that is supposed to disclose assets.

"It's frightening how often causes of action are brought post-confirmation that were not disclosed in the disclosure statement," Charles told the audience. Just like when a debtor fails to identify a cause of action in her bankruptcy schedules, if a cause of action is not disclosed in the disclosure statement, judicial estoppel (or a similar concept) may apply to preclude the claim, he said.

In Pari Delicto—a Great Tool

While successful use of the *in pari delicto* (at equal fault) defense varies from jurisdiction to jurisdiction, the panel agreed that it can be a great tool in this context. "The notion is, under state law or federal common law, that management is *in pari delicto* with the alleged tortious professional and the trustee can't pretend like management wasn't making those decisions," Charles explained. The company acts through its management, it's bound by the decisions of management, and it can't then turn around and sue its lawyer for decisions it intentionally made, he said. Kingma cautioned that factual issues may preclude the application of the *in pari delicto* defense, but defense lawyers would be wise to develop such a defense if possible.

Opportunity and Optimism

The panel summed up by encouraging defense counsel to be optimistic that the bankruptcy trustee will make a better adversary than the typical professional liability plaintiff. They also said there's a lot more opportunity if defense counsel is informed about the bankruptcy process and perhaps consults with a bankruptcy lawyer along the way. Even Kingma ultimately conceded that bankruptcy court is "a good place to get cases resolved, one way or another."

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> "[T]he creditors committee will seek permission from the court to pursue claims, perhaps against a professional, if the debtor … chooses to abandon it."

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not normally transcribed.

Anyone can attend a 341 meeting, but it's unclear whether a non-creditor may ask questions, he said. Charles added, however, that there's a lot of flexibility because a judge does not preside over the 341 meeting and the pool of creditors is not clearly defined at the beginning of a bankruptcy.

Proofs of Claim for Fees

Lawyers who are owed fees by clients that go bankrupt often file proofs of claim in bankruptcy court. The only way to share in the distribution of assets in a Chapter 7 bankruptcy case is through the filing of a proof of claim. A proof of claim is unnecessary in a Chapter 11 bankruptcy case provided your claim is properly scheduled.

The panel considered whether it is wise for a lawyer to file a proof of claim for unpaid fees when a client files for bankruptcy. Charles indicated that the analysis is not unlike that undertaken when deciding whether to sue a client directly for unpaid fees. Counsel should assess the probability of being counter-sued for professional negligence and determine whether the risk outweighs the potential reward, he said.

Paying a Trustee or Trustee's Lawyer

Kingma asked how trustees and their lawyers are paid in bankruptcy court and how the way in which they are paid may impact settlement of claims. Charles explained that trustees are paid reasonable compensation, which typically is based on some kind of hourly accounting but capped by a schedule based on assets distributed. In a Chapter 7 case where there are no assets, he said, the trustee gets a fee of $100 to administer the case. That, he said, tells you the trustee who owns the debtor's claim for alleged professional liability is paid based upon a percentage of what he recovers. "So, the trustee has an economic incentive to find money to pay creditors because without that the trustee does work but won't get paid for it," Charles said.

Charles also explained that the lawyers in a Chapter 11 case representing the debtor or the trustee are paid upon court approval after a fee application is filed to the extent there are unencumbered assets available to pay claims, or they can be retained as special counsel. The trustee can hire a lawyer on a contingent fee basis with court approval and then they are paid the way a plaintiff's lawyer is typically paid outside of the bankruptcy context, he said.

The panel agreed that it is often more beneficial to attempt to resolve a case with a trustee than it would be with the classic professional malpractice plaintiff. While the plaintiff may be angry or simply "making it up," a trustee is solely economically motivated, they explained.

There isn't any magical time to approach the trustee regarding settlement, panelists agreed. However, in a Chapter 7 case, you probably want to do that shortly before the initial meeting of creditors because that is when the trustee will likely first pay attention to the matter. In a Chapter 11 case, defense counsel will need to find a way to get the trustee's attention over that of others who are also trying to get her attention regarding the issues they believe are important.

Bar Orders (Not the Alcoholic Kind)

Bar orders, after a period of time set by the court, preclude claims brought by those who are not the settling plaintiff, such as a trustee or debtor in possession. The panel said such orders are useful to professional liability defendants that agree to settle claims brought by the trustee or debtor in possession but are concerned that similar claims might be brought by others.

A bar order allows a settling plaintiff to "give defendant and the insurance company a release in a way that is much more comforting," Charles said, as it allows a defendant to settle without having to be concerned that others will bring similar claims.

Eroding Limits Policies

McCabe asked her fellow panelists about their experience with bankruptcy lawyers and trustees when the issue of eroding policy limits in the professional liability context arises—i.e., when defense costs eat away at the amount available for payment of claims. Kingma said his experience has been that bankruptcy lawyers and trustees care less about eroding policy limits than do typical professional liability plaintiffs. He said he often discusses the eroding limits issue with trustees early in the process in an effort to explain to them that an early agreement to settle is to their benefit. But many trustees are interested in learning about the defendant's personal assets and will often require a defendant to execute an affidavit attesting to his assets before any settlement can be reached, Kingma said.

"It really depends on the sophistication of the trustee and the trustee's counsel," Charles offered. Charles said that many times when he is representing a creditor in bankruptcy he will inquire of the trustee as to the insurance situation. "So, there can be a lot of voices who speak to that topic," he stated.

Bankruptcy Court vs. State Court

Kingma segued into the next section of the discussion by asking Charles, "If you were a defendant, would you rather be in bankruptcy court?" Charles's response was "It depends." It's a more difficult question to determine whether you'd prefer federal district court over bankruptcy court, he said. But if you are comparing bankruptcy court to state court, he continued, here are some things to consider:

- Many defense lawyers routinely remove cases from state court to federal court.
- Depending on your state, a unanimous verdict might only be required in federal court, and the jury venire process could be

"The panel agreed that it is often more beneficial to attempt to resolve a case with a trustee that it would be with the classic professional malpractice plaintiff."

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IN PARI DELICTO DEFENSE IN APL CLAIMS, CONT'D

the court's view of adversity. Courts evaluate the issue of adversity by examining the extent of the agent's personal benefit as well as the extent of adversity to the corporation. Some states interpret the exception narrowly, in which case the agent's actions or inactions will not be imputed to the principal only when the agent has "totally abandoned" the principal's interest. Courts following this approach are not concerned with the agent's motivation for the wrongdoing; instead, the focus is on the benefit to the corporation, no matter how short-lived the benefit may have been. For example, Alabama courts state that:

> Under the "adverse interests" exception to the [*in pari delicto*] doctrine, the imputation of wrongdoing by an agent . . . to the debtor corporation will not occur if the agent was engaged in fraud or self-dealing *entirely* adverse to the corporate principal. However, the exception is *narrow* and only applies when an individual wrongdoer or agent has *wholly* abandoned *any* corporate purpose, even if the agent's purpose is misguided or even fraudulent to the point of ultimately causing the company's failure. (emphasis added) (internal footnote omitted).

In re Verilink Corp., 2009 WL 4609308 *23 (emphasis added); *see also, e.g.*, *SouthTrust Bank*, 939 So. 2d at 905-06 (explaining that the adverse interests exception only applies if the agent's intentional actions were "*wholly* for the gratification of the agent's personal objectives") (emphasis added).

Likewise, the New York Court of Appeals recently reaffirmed New York's very narrow application of the "adverse interest" exception to *in pari delicto*, by stating that:

> We articulated the adverse interest exception in *Center [v. Hampton Affiliates*, 66 N.Y.2d 782 (1985)] as follows: "To come within the exception, the agent must have *totally abandoned* his principal's interests and be acting entirely for his own or another's purposes. It cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal" . . . This rule avoids ambiguity *where there is a benefit to both the insider and the corporation*, and reserves this most narrow of exceptions for those cases - - outright theft or looting or embezzlement - - where the insider's misconduct benefits only himself or a third party; i.e., where the fraud is committed against a corporation rather than on its behalf.

Kirschner, 15 N.Y.3d at 466-67 (emphasis added). The court further reasoned that "a fraud that by its nature will benefit the corporation is not "adverse" to the corporation's interests, even if it was actually motivated by the agent's desire for personal gain. . . . Thus, "[s]hould the 'agent act[ ] both for himself and for the principal,' . . . application of the exception would be precluded" . . . *Id.* The court's rationale for this extremely strict interpretation of the exception was simple. According to the court, to allow a corporation to avoid the consequences of corporate acts simply because an employee performed them with his personal profit in mind would enable the corporation to disclaim, at its convenience, virtually every act its officers undertake. . . . "A corporate insider's personal interests - - as an officer, employee, or shareholder of the company - - are often deliberately aligned with the corporation's interests by way of, for example, stock options or bonuses, the value of which depends upon the corporation's financial performance." *Id.*

Other states take a more liberal approach and preclude imputation when the agent's wrongdoing is done primarily for his benefit, while others go a step further and preclude imputation when the agent's wrongdoing is merely incompatible with the principal's interests. As is often the case, a particular court's view of adversity is often grounded in the state's common law agency jurisprudence. Despite these differences, courts are generally unified in their adverse interest analysis when the agent is the sole actor or shareholder for the corporation. *See FDIC v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992); *Thabault v. Chait*, 541 F.3d 512, 527 (3d Cir. 2008); *Ash v. Georgia-Pacific Corp.*, 957 F.2d 432 (7th Cir. 1992).

Jurisdictional differences aside, the wrongdoing by the managerial officers in the above hypothetical would almost assuredly be imputed to Acme. Thus, the auditor *would* have a strong *in pari delicto* defense relative to claims filed on behalf of the corporation.

Additional Considerations: *In Pari Delicto* Defense as Applied to Trustees or Receivers

As noted in the above hypothetical, a potential plaintiff could include a bankruptcy trustee or receiver. The question often arises as to whether or not these otherwise innocent parties are subject to an *in pari delicto* defense. Until recently, some courts held that bankruptcy trustees were immune from an *in pari delicto* defense. Courts rationalized that any recovery would benefit innocent third parties as opposed to the fraudulent corporation; however, the more recent trend is to allow an *in pari delicto* defense against the trustee.

This approach is more closely aligned to 11 U.S.C. § 541 (a) of the Bankruptcy Code, which states in pertinent part that the bankruptcy estate includes "all legal and equitable interests of the debtor in property as of the commencement of bankruptcy." It follows then that entities bringing claims on behalf of the estate, be

"Other states take a more liberal approach and preclude imputation when the agent's wrongdoing is done primarily for his benefit … ."

***PLDQ*'s Winter 2016 Issue**

We encourage member submission of articles pertinent to professional liability claims administration, defense trial advocacy, or professional liability substantive law. The manuscript deadline for the next issue is: **February 1, 2016**.

IN PARI DELICTO DEFENSE IN APL CLAIMS, CONT'D

it a trustee or a committee of creditors, would stand in the shoes of the debtor. *See also Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001) (explaining that a trustee stands in the shoes of the debtor and could only assert those causes of action available to the debtor and was likewise subject to the same defenses that could have been asserted by the defendant had the action been instituted by the debtor).

Relationship Between Company's Fraudulent Acts and Misconduct Alleged Against Defendant Auditor

As shown, for *in pari delicto* to apply, the plaintiff must be at least equally at fault in causing the harm alleged against the defendant. But was exactly does that mean? In a recent federal case pending in Illinois, plaintiff argued that the auditor defendants could not establish their *in pari delicto* defense by proving plaintiffs participated in a different fraud, but, instead, must prove that the plaintiffs participated specifically in the fraud at issue because that is the fraud the auditor failed to detect. The court refused to adopt such a narrow and restrictive approach, stating instead that the defendant need prove only that the plaintiff "bears equal fault for the alleged injury." *See Peterson v. McGladrey and Pullen, LLC*; 2014 WL 1389478 (N.D. Ill. 2014); *see also Peterson v. McGladrey LLP,* 792 F.3d 785 (7th Cir. 2015).

Conclusion

When an auditor is alleged to have negligently failed to detect or actively participated in fraud relative to a corporate client, an *in pari delicto* defense should be considered. As shown, the wrongdoings of the corporate officers will be imputed to the corporation in most jurisdictions, except in the narrowest of circumstances. Because the corporation itself is guilty of fraud, the defense of *in pari delicto* will bar claims against the negligent auditor.

Endnotes

1.Black's Law Dictionary 794 (7th ed. 1999) states that the phrase "*in pari delicto*" means "equally at fault."
2. This could hold true whether the company is publically traded, or is closely-held.

PLDF AND DIVERSITY

Professional Liability Defense Federation supports diversity in our member recruitment efforts, in our committee and association leadership positions, and in the choices of counsel, expert witnesses and mediators involved in professional liability claims.

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though the deck is stacked against him because the trustees are interested in pursuing everyone in the neighborhood of a failed enterprise. Charles explained that generally the bankruptcy process focuses mainly on economics, particularly when there is a trustee assigned. While notions of liability are not irrelevant, he said, they are less relevant, particularly in circumstances where there is little in the way of funds available to pay creditors' claims.

Panelists also discussed the "strange anomaly" in bankruptcy court where in many cases professionals charge $700 or $800 per hour until all the money is bled out of the bankruptcy estate and then they just close the case. "It is true that bankruptcy is expensive," Charles said. "But with the decline in bankruptcy cases filed," he said, "such aggressive billing is also on the decline. In the average case where the stakes are important, but there isn't sufficient money available to pay for the trustee or his counsel to 'bill like a drunken sailor,' defense counsel may have a better opportunity to obtain a favorable result for her client," Charles added.

The panel agreed that defense lawyers can be successful in bankruptcy court if they have a sense of the players, understand that they are no longer in the trial court to which they've become accustomed and, as McCabe noted, they familiarize themselves with the bankruptcy rules so they can "play in the bankruptcy club where everyone seems to know each other already."

Sanctions Against Bankruptcy Trustees

Kingma followed up by asking, with a degree of sarcasm, whether "in the history of federal jurisprudence, a bankruptcy judge has ever assessed sanctions against

"[F]or *in pari delicto* to apply, the plaintiff must be at least equally at fault in causing the harm alleged against the defendant."

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a trustee" for abusively pursuing claims. Charles indicated that he had to do some research to discover that such sanctions have, in fact, been assessed in the past. But they are rare, he noted. Just like persuading a federal district judge to award sanctions under Fed. R. Civ. P. 11 is an infrequent event, persuading a bankruptcy judge to award sanctions under Bankruptcy Rule 9011 is also an infrequent event, he said. "You can demand them all you want, but they're hard to get," Charles told the audience.

Right to a Jury Trial

Many defense lawyers like to have a jury, if necessary, ultimately decide the issues of a professional malpractice case because they know how to communicate to a jury. But to many defense lawyers, bankruptcy court seems to be set up to prevent a jury from deciding claims; instead, a bankruptcy judge, who may appear to rely a bit too much on the trustee, makes all of the decisions. Kingma grilled Charles as to how such a scenario can be constitutional.

Charles responded, "The layers of misinformation in that question are mind boggling," causing the audience to chuckle. He then listed what he sees as those layers of misinformation:

- Very few of his partners who are defense lawyers say they want a state court jury going after their profession.
- A bankruptcy judge is like a magistrate. The judge may not conduct a jury trial absent consent.
- "Only an idiot would ask a bankruptcy judge to conduct a jury trial" because that's not what she does. Managing juries takes skill, and bankruptcy judges just don't have that skill.
- If you're in a bankruptcy-related case and you need a jury trial, you're going to ask the federal district judge to withdraw the reference and conduct a jury trial.
- After the reference is withdrawn, the frustration will continue when you are sent back to the bankruptcy judge who will act like a pretrial magistrate and decide discovery issues.

McCabe said malpractice insurers do not have a standard policy regarding whether to proceed in bankruptcy court. Instead, she said, they consider each matter on a case-by-case basis and take defense counsel's recommendation into consideration.

2004 Examinations: Fishing Expedition?

Bankruptcy Rule 2004 essentially says that the court can authorize anyone to examine anyone about anything related to a debtor, assets, liabilities, the possibility of reorganization, and so on. In the context of a potential claim against a professional, that rule allows a trustee or his lawyer to essentially conduct pre-litigation discovery and presents an opportunity for a fishing expedition that can be frustrating for the professional, speakers said. Many times, no litigation is pending and no issues have been framed when the 2004 examination takes place.

McCabe said an insurance carrier often gets involved upon notice of a 2004 examination because it is usually the first sign of trouble. And the insurer will often get defense counsel involved at that point as well, she said. Rule 2004 examinations are public unless a protective order is obtained. Charles pointed out, however, that if a debtor claims professional malpractice, the attorney-client privilege may be held by the trustee depending on whether the debtor is an entity or an individual. Therefore, he said, you may not have grounds to seek a protective order on that basis because the privilege may have been transferred to the trustee per U.S. Supreme Court precedent.

An Arrow for Defense Counsel's Quiver

Kingma advised that if you learn of a 2004 examination notice, review the bankruptcy schedules early. "There's all sorts of good information in the bankruptcy schedules," he said. Charles added that if a debtor fails to identify his professional malpractice claim as an asset in the bankruptcy schedules, the defendant professional will have a relatively strong defense based on judicial estoppel. "The number of debtors who don't tell their bankruptcy lawyer or trustee about pending causes of action, not just professional liability, but ordinary personal injury, any number of causes of action, would stagger you," Charles stated.

On the other hand, he said, if the cause of action has, in fact, been listed in the schedules, defense counsel can learn a lot about the debtor's income, expenses, real estate values and what the trustee estimates the professional malpractice claim may be worth, which all aid in conducting a damage analysis.

341 Meetings

In every bankruptcy case there is an initial meeting of creditors, and that meeting is sometimes called a 341 meeting after the section of the Bankruptcy Code that authorizes it, 11 U.S.C. § 341. At that public meeting, trustees and creditors ask questions of the debtor regarding the schedules and statements. It is typically short in duration, lasting no more than an hour and sometimes far less time. Charles explained, "It can be a place to get information. Not a great place unless you have one or two questions that need to be answered in order to file a dispositive motion. The typical bankruptcy lawyer doesn't prepare his client for a 341 meeting as he would a deposition." If you pursue that strategy, he said, you may want to bring a court reporter with you because a 341 meeting is recorded, but

"[I]f a debtor claims professional malpractice, the attorney-client privilege may be held by the trustee depending on whether the debtor is an entity or an individual."

PLDF Amicus Program

Please let us know of appeals in your jurisdictions implicating important professional liability issues that might have national significance.