Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Defending Malpractice Claims Against A Trustee Or Receiver

Law360, New York (November 25, 2015, 11:00 AM ET) --

Thomas G. Ward

Defending a law firm, accounting firm or other professional against a malpractice suit can be complicated enough, but when a former client is insolvent or has declared bankruptcy and is under the control of a receiver or trustee, there are a number of substantive and procedural wrinkles that may further complicate the defense. If the bankruptcy is a Chapter 7 filing, a trustee will be appointed. If the bankruptcy is a Chapter 11 filing, a trustee may be appointed or the company may continue to operate as a debtor in possession. In other circumstances, a receiver may be appointed.[1] The type of proceeding can affect the course of the litigation and the defenses that are available.

Discovery in the Bankruptcy Context

Litigators who are called upon to defend a professional in a malpractice case involving a client in bankruptcy should be cognizant that the professional may be subject to discovery more than once. Most notably, Rule 2004 of the Bankruptcy Code authorizes pre-lawsuit discovery to be taken from practically any party with a connection to the bankrupt entity. Rule 2004 allows any interested party, including the debtor, trustee or creditors committee, to issue subpoenas for documents and oral testimony.[2] As long as the Rule 2004 examination request relates to the property, liabilities or financial condition of the debtor, it is likely to be allowed.[3] In a Chapter 11 case where the claims and dollar amounts at issue may be substantial, the bankruptcy court can also appoint an examiner to take evidence and identify potential claims. If fraud played a part in the downfall of the client, professionals who provided services to the now-bankrupt entity are likely to come under scrutiny during this process as potential sources of recovery.

Adversary Proceedings and Other Actions

Following Rule 2004 discovery or the issuance by an examiner of a report detailing the results of its investigation and identifying potential targets for future litigation, former professionals who represented the bankrupt entity may find themselves on the receiving end of adversary proceedings in bankruptcy court or other state or federal litigation outside of the bankruptcy court.

Such claims are often brought by litigation trusts, which may be set up in the bankruptcy plan of liquidation or reorganization to pursue claims that were owned by the estate for the benefit of creditors. The bankruptcy plan, implementing documents (such as litigation trust agreements) and confirmation order generally provide the authority for the litigation trust to pursue claims formerly held by the debtor, including against professionals. It is important to carefully review those documents to understand the powers and standing of a trust to pursue such claims, who is controlling the trust, and who the beneficiaries of the trust will be.

There are considerations specific to the receivership or trustee contexts that make defending professionals more difficult. First, if the company's management has been replaced by a receiver or trustee, any goodwill that existed during the course of the professional relationship almost certainly will be gone. The receiver or trustee will view himself as responsible for maximizing the recovery on any claims, not for maintaining good relationships with the company's former professionals, especially if the company is to be liquidated.[4]

Second, in the case of law firm defendants, the receiver or trustee steps into the shoes of the client and therefore controls the attorney-client privilege, at least for pre-bankruptcy communications.[5] A receiver or trustee may have little incentive to protect the attorney-client privilege and may not hesitate to affirmatively and publicly quote statements by its former professionals that it will seek to spin to its advantage. The potential privilege-waiver consequences that may ordinarily deter a client from suing its lawyers are much less relevant once the claims are owned by a receiver or trustee.

The In Pari Delicto Defense in the Insolvency Context

In defending against a trustee or receiver claim, a number of defenses may be investigated, including in pari delicto, contributory fault, statutes of limitations and causation.

The application of in pari delicto in the receiver or trustee context is particularly important to understand as professional defendants rely heavily on that defense to resist claims brought by a former client — or by a litigation trust to whom the former client's claims have been assigned. In pari delicto means, in short, that one cannot recover from another when one is equally or more at fault. Thus, if the former client is alleged to have engaged in fraud, in pari delicto can be a powerful defense for the professional.

Receivers — as opposed to bankruptcy trustees — have sometimes succeeded in defeating the imposition of in pari delicto by arguing that they are "innocent successors," especially when pursuing actions for fraudulent or preferential transfers, and so should not be bound by the prior wrongdoing of the defunct corporation. For example, in Scholes v. Lehmann, 56 F.3d 750, 754-55 (7th Cir. 1995), the Seventh Circuit held in a fraudulent transfer case that "the defense of in pari delicto loses its sting when the person who is in pari delicto is eliminated." The Scholes court colorfully compared corporations engaged in malfeasance to "evil zombies," as to whom in pari delicto no longer should apply once the corporation is "[f]reed from [the] spell" of the wrongdoers in management. Id. at 754.

Likewise, in another receiver case, Janvey v. Democratic Senatorial Campaign Committee Inc., 712 F.3d 185, 190–92 (5th Cir. 2013), the Fifth Circuit, applying Scholes, held that the conduct of the wrongdoers would not be attributed to the company, freeing the receiver to pursue alleged fraudulent transfers without being subject to in pari delicto. In these cases, courts expressed reluctance to hold a corporate entity responsible for the wrongdoing of its former management when doing so would harm creditors who had not engaged in such conduct.[6]

Notably, some courts — including the Seventh Circuit — have held or suggested that the "innocent successor" exception in the receivership context should be applied only to claims involving fraudulent transfers. Peterson v. McGladrey & Pullen LLP, 676 F.3d 594, 596 (7th Cir. 2012). Other courts, however, have suggested that in pari delicto does not apply to receivers as a general matter, even outside the fraudulent or preferential transfer context.[7]

In the bankruptcy trustee context, in contrast, courts have widely accepted the in pari delicto defense, and rejected the innocent successor argument, at least where the claims at issue are state law tort claims where in pari delicto ordinarily would apply.[8] Courts frequently reason that because, under § 541 of the Bankruptcy Code, the bankruptcy estate owns the property (including claims) of the debtor, those claims in the hands of a trustee are coextensive with the claims that the debtor corporation could have pursued. As such, courts find such claims to be subject to defenses such as in pari delicto. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 355-58 (3d Cir. 2001) (rejecting "innocent successor" argument pursuant to Bankruptcy Code § 541).

Even the Seventh Circuit, which decided the leading innocent successor case in the receivership context, found that claims by bankruptcy trustees are different and that in pari delicto is available in response to such claims to the extent available under state law for state law tort claims. Peterson, 676 F.3d at 599. Note, however, that where the bankruptcy trustee is pursuing fraudulent transfer, preference or other claims created by the Bankruptcy Code, a number of courts have held that in pari delicto does not apply.[9]

A number of courts have expressly distinguished between receivers and bankruptcy trustees in terms of the applicability of the innocent successor rule.[10] However, practitioners should be aware that there are some cases that tend to lump together the two categories of successor entities in a way that may result in uncertainty as to the availability of the in pari delicto defense.[11]

Thus, in evaluating the availability of the important in pari delicto defense, practitioners should be aware of the distinction that courts draw (or don't) between receivership and trustee cases, and also that courts may distinguish between claims based on state tort law, as opposed to claims created by the Bankruptcy Code or that implicate preferential distributions among creditors.

Defenses Specific to the Bankruptcy Context

In addition to the in pari delicto defense, practitioners should also know that there are a number of potential defenses with unique application in the bankruptcy context that may help their clients.

First, the doctrine of judicial estoppel may bar pursuit of unscheduled or undisclosed claims. As part of a bankruptcy case, a debtor must file a "schedule of assets and liabilities."[12] Claims against third parties must be listed on the schedule.[13] In addition, debtors in Chapter 11 bankruptcy cases are required to file a "disclosure statement" that describes the estate's assets.[14] The schedule and disclosure statement are representations to the court that certain assets do and do not exist. The debtor obtains a discharge in bankruptcy or confirmation of a plan based in part on those representations. Thus, if the debtor, trustee or post-confirmation entity (such as a reorganized debtor or liquidating trust) brings a claim that was not properly scheduled and disclosed, the court may find that claim barred by judicial estoppel.[15]

Second, there may be defenses based on res judicata. A Chapter 11 bankruptcy ultimately results in the bankruptcy court's confirmation of a plan of reorganization or a plan of liquidation. That plan binds interested parties to the bankruptcy.[16] Courts have held that if a matter is settled in the plan, a party to the bankruptcy is barred from subsequently relitigating those matters.[17] Therefore, in defending against suits following the confirmation of a bankruptcy plan, it is important to read the plan carefully to see if an action or claim conflicts with the plan or another court order, was properly assigned to the trust or other entity bringing it, or has been brought in the correct forum.[18]

Finally, bankruptcy plans may contain releases or exculpation provisions to facilitate confirmation of a plan. Such provisions may run to the benefit of the professionals and provide finality. Plan exculpation provisions are often included to protect the professionals retained to serve the bankruptcy estate and successor entities, and thus may be limited to decisions or conduct occurring during the bankruptcy. Release provisions, however, often sweep more broadly. These provisions should be reviewed carefully to determine whether they provide defenses because they may be binding against the party pursuing the claim.[19]

Conclusion

Litigating against receivers and trustees involves consideration of issues different from those in a standard professional liability case. For example, there are lines of cases that may limit the availability of certain defenses like in pari delicto, particularly in the receivership context. And practitioners should be alert to the fact that there are other defenses — such as those provided in and arising from the bankruptcy plan and disclosure schedules — that are unique when dealing with bankrupt or insolvent entities. In defending against malpractice claims in the bankruptcy and receivership contexts, it is thus important to research and review the availability and limitations on these types of defenses.

—By Thomas G. Ward, Ellen Oberwetter and Craig D. Singer, Williams & Connolly LLP

Thomas Ward is partner in Williams & Connolly's Washington, D.C., office and co-head of the firm's bankruptcy litigation group. His practice focuses on professional liability defense, financial and securities litigation, and bankruptcy litigation.

Ellen Oberwetter is a partner in the firm's Washington office and co-head of the bankruptcy litigation practice. Her practice focuses on professional liability defense, bankruptcy litigation and patent litigation.

Craig Singer, also a partner in Washington, has represented numerous lawyers and law firms in federal and state courts, government investigations and arbitration proceedings in jurisdictions throughout the country. He is the author of the book, "Professionals, Firms and Fraud: Defending Professionals Against Liability for Client Fraud," which was published by the ABA in 2015.

[1] Federal and state courts have jurisdiction to appoint a receiver to oversee the affairs of a company upon a clear showing that an emergency exists and that a receiver is necessary to protect property interests. See, e.g., Fed. R. Civ. P. 66; 16 William Meade Fletcher et al., Fletcher Cyclopedia of the Law of Private Corporations § 7709 (rev. vol. 2015) (Receivers); Consol. Rail Corp. v. Fore River Ry. Co., 861 F.2d 322, 326 (1st Cir. 1988); Tate v. Phila. Transp. Co., 190 A.2d 316, 321 (Pa. 1963); 28 U.S.C. § 959(b) (2012).

[2] Fed. R. Bankr. P. 2004.

[3] Rule 2004 examinations, while broad, do have some limits. For example, the “pending proceeding doctrine” typically precludes the use of Rule 2004 examinations to obtain discovery in lieu of using Federal Bankruptcy Procedure Rule 7026. See, e.g., In re Glitnir banki hf., No. 08-14757, 2011 WL 3652764, at *3 (Bankr. S.D.N.Y. Aug. 19, 2011) (outlining pending proceeding test); In re Wash. Mut. Inc., 408 B.R. 45, 50 (Bankr. D. Del. 2009).

[4] See Maxwell v. KPMG LLP, 520 F.3d 713, 718 (7th Cir. 2008).

[5] See Commodity Futures Trading Commision v. Weintraub, 471 U.S. 343 (1985).

[6] See also Edgewater Med. Ctr. v. Rogan (In re Edgewater Med. Ctr.), 332 B.R. 166, 177 (Bankr. N.D. Ill. 2005) (“The appointment of a receiver alters the defenses to which a corporation is subject by removing the wrongdoer from the scene for purposes of in pari delicto.”).

[7] See FDIC v. O’Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) (per curiam); Jones v. Wells Fargo Bank NA, 666 F.3d 955, 966 (5th Cir. 2012) (per curiam).

[8] See Official Comm. of Unsecured Creditors of PSA Inc. v. Edwards, 437 F.3d 1145, 1152 (11th Cir. 2006); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 355-58 (3d Cir. 2001); Nisselson v. Lernout, 469 F.3d 143, 155-56 (1st Cir. 2006) (“Here, of course, the fraud that underpins the trustee’s claims was complete at the moment the companies merged. Therefore, any post-merger changes in ... governance or management are beside the point.”); Sender v. Buchanan (In re Hedged-Invs. Assocs. Inc.), 84 F.3d 1281, 1285 (10th Cir. 1996); Kirschner v. KPMG LLP, 938 N.E.2d 941, 957-59 (N.Y. 2010) (rejecting litigation trustee’s arguments for innocent successor immunity under New York law); Unencumbered Assets Tr. v. JP Morgan Chase Bank (In re Nat’l Century Fin. Enters., Inc. Inv. Litig.), 604 F. Supp. 2d 1128, 1142-43 (S.D. Ohio 2009) (rejecting argument that removal of wrongdoer prior to bankruptcy filing nullifies in pari delicto argument).

[9] E.g., Kapila v. Bennett (In re Pearlman), 472 B.R. 115, 122-23 (Bankr. M.D. Fla. 2012) (avoidance and fraudulent conveyance actions not barred); Notinger v. Migliaccio (In re Fin. Res. Mortg. Inc.), 454 B.R. 6, 24 (Bankr. D.N.H. 2011) (same). This is consistent with the position a number of courts have taken that various equitable defenses are not available as defenses to statutory bankruptcy claims. See Sterling Die Casting v. Local 365 UAW Welfare & Pension Fund (In re Sterling Die Casting, Co.), 118 B.R. 205, 207 (Bankr. E.D.N.Y. 1990) (rejecting unenumerated defense to preference action); Guinn v. Irwin Mortg. Corp. (In re Patterson), 330 B.R. 631, 642-43 (Bankr. E.D. Tenn. 2005) (defenses to preference actions are limited by statute); Gecker v. Goldman Sachs & Co. (In re Auto. Prof’ls, Inc.), 398 B.R. 256, 262 (Bankr. N.D. Ill. 2008) (usually cannot have a common law equitable defense to statutory bankruptcy causes of action).

[10] R.F. Lafferty & Co., 267 F.3d at 355-58 (explaining the difference due to Bankruptcy Code § 541).

[11] O’Melveny & Myers, 61 F.3d at 19 (noting in rejecting the innocent successor argument that “*A receiver, like a bankruptcy trustee* and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank; it is thrust into those shoes.” (emphasis added)(internal quotation marks omitted)); but see In re Crown Vantage Inc., No. 02-3836 MMC, 2003 WL 25257821, *6–7 (N.D. Cal. Sept. 25, 2003), aff’d sub nom. Crown Paper Liquidating Tr. v. PricewaterhouseCoopers LLP, 198 F. App’x 597 (distinguishing O’Melveny and explaining that under § 541 the rule may be different in bankruptcy cases) (9th Cir.2006).

[12] 11 U.S.C. § 521; 11 U.S.C. § 1141 ("[T]he provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan.")

[13] See USinternetworking Inc. v. Gen. Growth Mgmt. Inc. (In re USinternetworking Inc.), 310 B.R. 274, 281 (Bankr. D. Md. 2004).

[14] 11 U.S.C. § 1125(b).

[15] See Rosenshein v. Kleban, 918 F. Supp. 98, 104 (S.D.N.Y. 1996) ("[T]he integrity of the bankruptcy system depends on full and honest disclosure by debtors of all of their assets. ... The interests of both the creditors, who plan their actions in the bankruptcy proceeding on the basis of information supplied in the disclosure statements, and the bankruptcy court, which must decide whether to approve the plan of reorganization on the same basis, are impaired when the disclosure provided by the debtor is incomplete.").

[16] 11 U.S.C. § 1141.

[17] See, e.g., Russell v. Transp. Funding LLC (In re Russell), 386 B.R. 229, 231 (B.A.P. 8th Cir. 2008) ("An unappealed, confirmed plan is res judicata, and its terms are not subject to collateral attack."); First Union Commercial Corp. v. Nelson, Mullins, Riley & Scarborough (In re Varat Enters. Inc.), 81 F.3d 1310, 1315 (4th Cir. 1996) ("[F]ederal courts have consistently applied res judicata principles to bar a party from asserting a legal position after failing, without reason, to object to the relevant proposed plan of reorganization or to appeal the confirmation order."); In re Residential Capital LLC, 508 B.R. 838, 846 (Bankr. S.D.N.Y. 2014) ("Confirmation of a plan operates as a final judgment for res judicata purposes.").

[18] See Grausz v. Englander, 321 F.3d 467, 475 (4th Cir. 2003) (res judicata barred claims based on work in the bankruptcy where fees had been approved); Frazin v. Haynes & Boone LLP. (In re Frazin), 732 F.3d 313, 321 (5th Cir. 2013), cert. denied, 134 S. Ct. 1770 (2014).

[19] See FDIC v. O'Donnell, 136 B.R. 585, 589 & n.6 (D.D.C. 1991); Corbett v. MacDonald Moving Servs. Inc., 124 F.3d 82, 88–89 (2d Cir. 1997).