When the Client Is a Fraud

Defending Professionals and Firms Following a Client's Misconduct

CRAIG D. SINGER

The author is a partner with Williams & Connolly LLP, Washington, DC.

Suppose you are the general counsel of a law firm. One morning, you open your newspaper and read shocking revelations about a long-standing client of the firm. The client, it turns out, was much less than it appeared. All or much of the client's business was a fiction, existing only in a false trail of paper or electronic book entries. The clients' executives cleverly concealed this state of affairs from the world.

Business lawyers at your firm have represented the client for years, including in connection with its securities offerings and significant transactions. You believe those lawyers had no idea that the client was engaged in fraud; they too were fooled by the client's executives. Nonetheless, you should prepare for your firm to be sued—indeed, you may be in for an onslaught of lawsuits and investigations. This article describes some of the types of claims that commonly arise in this situation, along with several key defenses. The subject is treated at greater length in my book, *Professionals, Firms, and Fraud: Defending Professionals Against Client Fraud* (ABA 2015).

Not much imagination is necessary to construct the frightening scenario described above because it happens with some frequency—not just to lawyers but also accountants, bankers, and other professionals surprised to learn that a client they believed was running a legitimate business was actually engaged in massive fraud. Maybe there was no real business at all, as in the case of a pure Ponzi scheme, which takes in cash from investors only to pay it to prior investors as fake "returns." Or maybe the client had a real business but a far less successful one than its managers represented. In either case, the fraudsters deceived those who invested, lent, or did business with the company in order to obtain cash—whether to line their own pockets, live high on the hog for as long as the scheme lasted, or to prop up their failing company in an effort to save it.

While the natural life of such frauds would appear to be short, they can actually endure for many years, as in the famous case of Bernard Madoff's Ponzi scheme. That is true of many client frauds that spawn claims against professional firms. Professionals sometimes represent a company over an extended time period, in many different matters, only to find out later with the rest of the world that their long-trusted client has been perpetrating a long-running fraud.

Large financial frauds can have a devastating impact on investors, lenders, and innocent company employees. Less publicized but no less real is the impact of a client's fraudulent scheme on the professionals who represented the fraudulent entity. Frauds of any magnitude and duration require the perpetrators to retain lawyers, accountants, and bankers to allow the business both

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DAILY GAZETTE
CEO INDICTED ON FRAUD CHARGES
VANDALAY INDUSTRIES
ACCUSED OF CRIMINAL ACTS
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Dear Counselor,
We are very
here at

to raise cash and to present an appearance of regularity. When the fraud collapses, the professionals often find themselves in the crosshairs of litigation.

Claims against the professionals can come in a variety of forms depending on the circumstances. On some occasions, the professionals themselves are accused of intentionally participating in the fraud. More commonly, the professionals allegedly failed to discover the fraud in the face of alleged warning signs or red flags. The impact of such lawsuits will be felt not only by the individual professionals who represented the fraudulent client but also by their firms—that is, their partners and coworkers who may have had nothing to do with the representation.

Claims like these against professionals have become the rule rather than the exception. Examine any significant fraud that has received public attention in recent years and you will find claims—sometimes ruinous, always expensive—against the professionals who represented or were associated with the enterprise. In the past 15 years, I personally have represented professionals or firms in at least 10 separate matters like this. The scale of these frauds appears to be increasing, and the amount of claimed damages in such cases is correspondingly larger too. Recent years have seen damages claims in the billions or hundreds of millions of dollars—amounts that dwarf most professionals' insurance policies or reserves.

A professional firm that represented a fraudulent enterprise is likely to face a multifront war.

Litigators are hardly surprised to hear that professional firms often find themselves sued whether or not they are actually at fault or believe themselves to be. The reality is that professionals often do not uncover client fraud, even over a period of years representing the crooked (as it turns out) client. This does not mean the professionals were complicit in the fraud or even that they were negligent. Even in the context of a long-term client relationship, professionals are often engaged for discrete tasks or perform services that do not expose the inner workings of the client's business. Lawyers typically perform legal services and do not examine the client's finances. Auditors are on site for a limited period, and the fraudsters may intentionally set out to deceive them with false documents or incomplete information in order to obtain an unqualified audit. Yet, the professional firms are ready targets for litigants seeking to recoup some of their losses when the client company turns out to be insolvent.

Claims by Clients

When a client's fraud is revealed, professionals may anticipate lawsuits from a variety of sources. One common plaintiff, in some ways the most dangerous, is the client itself or the client's trustee or receiver. The fraudsters who ran the company ordinarily lose power upon the fraud's exposure, to be replaced by new management. More often than not, at least in my experience, the company that committed a major fraud is insolvent and soon is forced into bankruptcy or receivership. In that circumstance, the trustee, receiver, debtor-in-possession, creditors' committee, or other successor-in-interest to the client company will take ownership of the client's claims and can sue the professionals. Bankruptcy plans often provide for the creation of "litigation trusts" with no purpose other than to assert the estate's claims against professionals and other third parties.

Because the successor usually stands in the client company's shoes, it will assert that it is in privity with the professionals who represented the client and has standing to sue the professionals for negligence, breach of fiduciary duty to the client, or similar claims. Trustees and receivers are increasingly aggressive in asserting such claims against the professionals who represented the insolvent company. They portray themselves as acting in the interest of the innocent creditors. Trustees' or receivers' ability to assert negligence-based and fraudulent conveyance–type claims makes them particularly dangerous plaintiffs. They may assert claims as adversary proceedings in bankruptcy court, sue in state or federal court, or initiate arbitration in the event the professional and the client had an agreement to arbitrate disputes.

Trustees often claim enormous sums as damages based on a controversial theory of "deepening insolvency"—that is, the corporation was "damaged" when it incurred debt to third parties that it could not repay because of the corporate executives' fraud, which the professionals allegedly failed to prevent. On this theory, the trustee will seek to hold the professionals liable for the client corporation's entire "deepened" indebtedness, which can run to the hundreds of millions or billions of dollars.

Damages theories like this are often deeply flawed, not least because the corporation's indebtedness does not damage the corporation that owes the money; it damages the creditor who is out the money. For this reason and others, the notion of "deepening insolvency" has been roundly criticized in recent years, and a number of courts have rejected such damages claims, but they continue to be asserted. And the threat of such a large claim makes it of paramount importance for the defendant to look for a way to defeat the trustee's case at an early stage.

Illustration by Darren Gygi

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In Pari Delicto Defense

One way an early dismissal can sometimes be achieved in client-fraud cases brought by the client or its bankruptcy representative is the defense of *in pari delicto*. In its classic form, this doctrine holds that a plaintiff who is at fault cannot recover against another alleged wrongdoer as long as the plaintiff's fault is at least as severe as the defendant's. In many client-fraud cases brought by the client, the professional will have a strong *in pari delicto* defense on the ground that the corporate client—the plaintiff—is charged with the wrongdoing of its executives and employees who committed fraud. Thus, a corporation charged with primary responsibility for fraud should not be permitted to recover against another party—the professional defendant—for damages caused by the professional's failure to stop the corporation's own fraud. When its elements are established, *in pari delicto* typically defeats all of the plaintiff's claims in their entirety, whether couched in tort or contract and whether the professional defendant's wrongdoing was negligent or intentional.

The same *in pari delicto* defense usually applies against a bankruptcy trustee or receiver who tries to assert tort claims against the professional. That is because the trustee or receiver ordinarily stands in the shoes of the insolvent client for purposes of tort claims and so has no greater rights to avoid the defense than would the client itself. Trustees and receivers have long sought exemptions from *in pari delicto* on the theory that they are "innocent successors" to the guilty corporation. For the most part, these efforts have been unsuccessful—most prominently in the New York case of *Kirschner v. KPMG LLP,* which reaffirmed a strong view of *in pari delicto* in that state and soundly rejected the innocent successor theory. 938 N.E.2d 941 (N.Y. 2010). Trustees and receivers have had better luck avoiding a traditional application of *in pari delicto* and similar defenses available against the corporation when they assert claims based on fraudulent transfer—claims often characterized as benefiting creditors as opposed to the guilty corporation and its shareholders.

In the usual client-fraud case, the plaintiff corporation or trustee will concede that corporate executives or employees committed a fraud—after all, that is why the professional defendants are allegedly liable, for assisting or failing to prevent that very misconduct. The more commonly litigated question is whether the employees' fraud is imputed to the corporation. Common-law principles of agency govern such imputation, and applying those principles to the facts of the case will determine whether the plaintiff company (and, in turn, its trustee) is a wrongdoer who is subject to an *in pari delicto* defense.

Most recent corporate *in pari delicto* cases focus on the "adverse interest exception" to imputation. This exception is part of common-law agency doctrine; it is not specific to *in pari delicto*. It holds that an agent's conduct is not imputed to the principal if the agent acted for the agent's own benefit and contrary to the interests of the principal. In most jurisdictions, this is a narrow exception. It is not enough, for example, that the agent's actions ultimately turned out to be bad for the company—that is true of any fraud that is eventually disclosed. Nor is it enough that the insider's fraud benefited the insider as well as the corporation. The exception applies only if, at the time the agent was committing the fraud, the agent's actions by their nature were entirely adverse to the interests of the company and not for its benefit.

Beyond pure embezzlement or theft from corporate coffers, the contours of the adverse interest exception are murky and can vary dramatically from state to state. Courts usually express adverse interest in restrictive terms. In the *Kirschner* case, New York's highest court described it as the "most narrow of exceptions," reserved for cases of outright looting or fraud against the company. *Id.* at 952. Many formulations recite language to the effect that, to qualify for the exception, the agent must have "totally abandoned" the interest of the principal or the fraud must have conferred no "benefit" on the company. In practice, however, some courts have applied the exception more broadly than others.

The adverse interest exception to imputation is confusing enough in its own right, but there is yet another layer of complexity. The adverse interest exception is itself subject to an exception, known as the "sole actor rule." It provides that, even if an agent's wrongdoing is "adverse" to the principal and would otherwise qualify for the adverse interest exception, the agent's conduct nonetheless is imputed to the principal if the wrongdoing agent, or agents, dominated the corporation. Some courts have applied an "innocent decisionmaker" test to define what it means for wrongdoers to "dominate" a company. As described in the Second Circuit's much-cited *Bennett Funding* case, the sole actor rule applies unless "at least one decisionmaker in a management role or amongst the shareholders is innocent and could have stopped the fraud." *Breeden v. Kirkpatrick & Lockhart LLP (In re Bennett Funding Grp., Inc.)*, 336 F.3d 94, 101 (2d Cir. 2003)

In pari delicto often is one of the earliest and most significant battlegrounds in a client-fraud case against a professional defendant. Because it is a complete bar to the plaintiff's recovery in most states, defendants often press the issue at the earliest reasonable opportunity. Although *in pari delicto* is usually described as an affirmative defense that the defendant bears the burden to prove, a case may be dismissed at the pleading stage on *in pari delicto* grounds if the complaint on its face sets forth the basis for the defense.

That scenario is not unusual. Despite plaintiffs' best efforts to plead around *in pari delicto*, many complaints unavoidably reveal a basis for the defense. In explaining that the professional negligently failed to detect fraud at the company, the complaint

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must explain that fraud occurred at the company—and, of course, the plaintiff is the company or a trustee that stands in the company's shoes. For these reasons, some of the most significant *in pari delicto* decisions have arisen at the pleading stage.

Claims by Non-Clients

In addition to the client or its representative, claims against professionals also may come from non-client third parties, including investors, note holders, lenders, and other transaction counterparties of the bankrupt entity. These may take the form of class actions, large consolidated actions, or individual proceedings. Substantial frauds usually spawn many such claims, often in different forums, often brought by multiple plaintiffs' law firms.

Claims by non-clients brought under common-law principles confront the significant obstacle that professional negligence claims ordinarily are reserved to the client. This principle is sometimes called the "Ultramares rule," after its most famous expression, Chief Judge Cardozo's decision in *Ultramares Corp. v. Touche Niven & Co.*, 174 N.E. 441 (N.Y. 1931). The *Ultramares* court held that a non-client could not sue a company's accountants for negligently certifying its client's financial statements. Depending on the jurisdiction, the rule is described alternatively in terms of "privity" or "duty" or "standing" or "immunity."

The publicity of a fraud-based claim may be devastating to a professional firm that trades on its good name.

Whatever the courts may call it (I'll refer to it as "privity" for short), the rule usually means pretty much the same thing: Non-clients can't sue the professional for negligently representing the client. Whatever the rule's precise legal formulation, its most compelling justification is that a professional needs to owe undivided loyalty to the client. A second powerful justification is that professionals' liability must be cabined to reasonable limits, lest the threat of lawsuits by non-clients restrict the availability of professional services to those clients who need them.

There are exceptions to the privity rule, which different states may apply in different ways. For example, non-clients sometimes can sue the professional for negligent misrepresentation if the professional gave negligent advice directly to the non-client—such as in the case of a lawyer's opinion letter addressed to the non-client. Non-clients also can sometimes sue the professional if, rather than being negligent, the professional actually intentionally aided and abetted the client's fraud. Aiding and abetting claims like this are often alleged, but they are rarely proven. Most of the time, professionals do not intentionally help their clients commit fraud.

Defenses in Private Securities Cases

Historically, non-client securities investors often brought claims against professionals under the federal securities laws. Recent securities law developments have made it more difficult for investors to bring such cases.

One of the most significant defenses for professional firms in private securities fraud cases is the rule of *Central Bank of Denver v. First Interstate Bank of Denver*, which eliminated aiding and abetting liability in private civil actions under section 10(b) of the Securities Exchange Act and Securities and Exchange Commission (SEC) Rule 10b-5. 511 U.S. 164 (1994). After *Central Bank*, 10b-5 liability in a private civil action reaches only the maker of a false or misleading statement, not one who aids and abets it. In the wake of *Central Bank*, Congress amended the securities laws, as part of the Private Securities Litigation Reform Act of 1995, to clarify that the SEC may bring an action under section 10(b) for aiding and abetting. As applied to private litigants, however, Congress let the rule of *Central Bank* stand.

In two cases since *Central Bank*, the Supreme Court has clarified the narrow contours of primary liability as opposed to aiding and abetting. In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, purchasers of stock in cable operator Charter Communications alleged that Charter had fraudulently manipulated its financial reporting through transactions with defendants Scientific-Atlanta and Motorola, whereby Charter would overpay for equipment and the defendants would return the overpayment by purchasing advertising from Charter. 552 U.S. 148 (2008). The Supreme Court held that Scientific-Atlanta and Motorola could not be liable because their "acts or statements were not relied upon by the investors;" accordingly, they were at most aiders and abettors. *Id.* at 159.

Most recently, in *Janus Capital Group, Inc. v. First Derivative Traders,* the Court addressed what it means for a defendant to "make" an untrue or misleading statement under Rule 10b-5(b). 131 S. Ct. 2296 (2011). Rule 10b-5(b) makes it unlawful for any person "[t]o make any untrue statement of a material fact." A class of investors in Janus Investment Fund sued the fund's affiliated investment advisor, Janus Capital Management LLC (JCM), under Rule 10b-5 for false statements. In a decision with

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substantial implications for claims against professionals, the Court held that JCM did not "make" the statements in the fund's prospectuses and could not be liable for them under Rule 10b-5. Rather, only Janus Investment Fund itself was the "maker" of the statement, though JCM "was significantly involved in preparing the prospectuses." *Id.* at 2304–05.

The *Central Bank, Stoneridge*, and *Janus* cases provide a strong defense for professionals in many securities fraud cases. Most such cases are based on false statements in SEC filings, prospectuses, or other offering materials. Those are the client company's statements, not the professionals' statements. A theory that the professional knowingly helped the client make the false statements, by drafting them or otherwise, is a claim for aiding and abetting, which is not actionable by a private securities plaintiff. Only when the plaintiff can point to a fraudulent statement made by the professional can this defense be overcome.

The *Central Bank* rule and other limitations on federal securities fraud claims take on added importance because federal causes of action are often the exclusive remedy for claims alleging misrepresentations in connection with a security. The Securities Litigation Uniform Standards Act of 1997 (SLUSA) forbids any state law claim brought on behalf of a class alleging a misrepresentation in connection with a security of a type that is covered by the statute. 15 U.S.C. § 78bb(f)(1). A full discussion of SLUSA is outside the scope of this article, but the statute has been broadly construed, and litigators should be aware of it when considering or defending claims against professionals.

Other Sources of Claims

A third source of claims against professionals is other accused parties, often codefendants, who may seek to bring claims for contribution or indemnification, or claims by other names that seek to recoup the damages or expenses they had to pay as a result of being sued themselves. Sometimes the plaintiffs bringing these contribution-type claims against professionals are other professionals. While perhaps a questionable strategy in many cases, it is not unheard of for professional firms to sue other professional firms for, in effect, helping the client company to mislead them. In addition, corporate insiders who are accused of committing the fraud sometimes choose to sue the professionals who represented the corporation, whether it is because they think the claims are independently justified or as a strategy to deflect attention from their own conduct (or both).

Contribution claims typically require the contribution plaintiff to show that it and the contribution defendant were "joint tortfeasors" who proximately caused the same injury to the original plaintiff and that the contribution plaintiff paid more than its fair share of the damages to the original plaintiff. Some states' laws of comparative fault make contribution claims unnecessary because no defendant can be required to pay more than its proportionate share of the injury to the original plaintiff in the first place. In some states, contribution is unavailable to intentional tortfeasors. In many states, a defendant who settled with the original plaintiff cannot be sued for contribution by another defendant.

Litigants sometimes seek to avoid the restrictions on contribution claims by styling their claims as "implied indemnification" claims or as independent tort claims that seek as damages the amount the defendant-turned-plaintiff paid to the original plaintiff. Courts usually are unsympathetic to such claims, but claims like this can sometimes prolong and complicate a professional firm's defense of litigation.

Finally, the professional firm may face claims or scrutiny from government regulators, professional disciplinary bodies, and criminal authorities. In the best-case scenario, the professional firms will be asked to provide documents to assist the authorities, and individual professionals may be approached for interviews or testimony as witnesses against the wrongdoers. In other cases, the professionals themselves may be investigated or charged.

In short, a professional firm that represented a fraudulent enterprise is likely to face a multifront war. If the fraud is large enough, this will be a war for the firm's very survival, irrespective of the actual degree of the professionals' fault. As every professional firm's general counsel knows, lawsuits can be ruinous even if they are never reduced to judgment. The publicity of a fraud-based claim may be devastating to a professional firm that trades on its good name. The expense of litigating multiple complex claims can be overwhelming, whatever the result. Thus, professional firms often choose to settle large claims that cannot be dismissed on a motion rather than opting to try a case that could destroy the firm. Sophisticated plaintiffs' lawyers and trustees understand this dynamic and will exploit it. It is imperative, therefore, for a professional firm that learns of fraud implicating a client to develop a strategy to defend itself against the many claims and threats that will arise. ■

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