VOLUME 9, ISSUE 2

PROFESSIONAL LIABILITY DEFENSE QUARTERLY

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DEFENDING PROFESSIONALS WHEN SUED BY BANKRUPT ENTITIES, BY: JENNIFER BERARD, CPCU, AND DONALD PATRICK ECKLER, ESQ.

In the wake of the 2008 financial crises there was a proliferation of bankruptcies of corporate entities. Whether because of the number of filings, the depth of the crisis, or a bolt of collective creativity, the trustees and receivers of these bankrupt entities sought out any potential source of recovery. Because they are insured, this search often involved suits being filed professionals for malpractice, particularly attorneys. Though the crisis has passed the number of bankruptcies has fallen, the frequency with which such claims are being brought, relative to the number of bankruptcies, has not necessarily seen a corresponding decrease.

A combination of factors has helped produce a longer tail on these type of cases, such as statute of limitations *discovery* rules, procedural leniencies provided within the bankruptcy proceeding (if that is the venue of the case), and claims made insurance policies that often grant full prior acts coverage for professional such as lawyers, accountants, and brokers such that the insurance carriers are extending collectible coverage in these case. Furthermore, any stigma or disincentive in filing these claims against professionals, if it ever existed, appears to have worn off, as these kinds of cases have become more the norm and are considered (by the experienced Trustees who have pursued them before) as acceptable (or even honorable) deployment of the their fiduciary responsibilities. This article will discuss the peculiar challenges of defending these cases and strategies to be employed.

Standard of Care

Standard of care can be a more difficult battle ground in professional liability claims brought by a bankruptcy trustee or receiver because often the professional in some way was either 1) directly involved in whatever activities that caused the entity to fail or 2) should have discovered and advised the entity of the problems that led to the entity's demise. As brutal as this retrospectoscope can be in these cases where the business has obviously failed, all standard of care defenses related to what was known at the time, what the standards were in place at the time and what the owners and decision makers of the business entity did with that same information should be fully explored, if necessary with experts in that field who can opine as to what other professionals were doing in same or similar circumstances.

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Standing

The trustee or receiver generally stands in the shoes of the debtor, as his successor in interest. As such, standing is generally not going to be a viable defense but should be closely examined if the Trustee attempts to boost or confuse the damage picture by asserting losses from other adjacent businesses (which may not be his purview, or may be too attenuated). In all cases, the bankruptcy order that conveys upon the trustee or receiver his power should be requested and carefully reviewed for any restrictions related to time, or scope.

Unclean Hands and *In Pari Delicto*

Bankruptcy courts have repeatedly concluded that a trustee in bankruptcy takes the debtor's rights subject to all defenses and other burdens to which such rights were subject immediately prior to the commencement of the bankruptcy case. This "standing in the shoes of the debtor" principle becomes very important when considering important defenses such as *in pari delicto*/ unclean hands.

Depending on the jurisdiction, these doctrines, which apply when both the plaintiff and defendant participate in a fraudulent, illegal, or inequitable conduct, may be interchangeable. They are often affirmative defenses that must be pled. In some jurisdictions *in pari delicto* applies to complaints at law, while unclean hands applies to allegations seeking equitable relief. In such jurisdictions unclean hands will likely not be available in a professional malpractice claim.

In Ohio, which adheres to this majority position, the unclean hands defense is defined as a defense against claims in equity. *Rivers v. Otis Elevator*, 996 N.E.2d 1039, 1047 (Ohio, 8th Dist.). The unclean hands defense requires a showing that the party seeking relief engaged in reprehensible conduct with respect to the subject matter of the action. *State ex rel. Coughlin v. Summit County Bd. of Elections*, 995 N.E.2d 1194, 1197 (2013). The doctrine of unclean hands considers whether the party seeking relief has engaged in inequitable conduct that has harmed the party against whom he seeks relief. *Downie-Gombach v. Laurie*, 41 N.E. 2d 858, 865 (2015). The doctrine of unclean hands "precludes one who has defrauded his adversary in the subject matter of the action from equitable relief." *In re Dow*, 132 B.R. 853, 860 (Bankr.S.D.Ohio 1991) (the doctrine of unclean hands does not apply where there is no allegation that the plaintiffs defrauded the defendant).

With respect to *in pari delicto* the doctrine "refers to the plaintiff's participation in the same wrongdoing as the defendant." *Downie-Gombach*, 41 N.E. 2d at 865. The doctrine refers to equal fault, or equal culpability. *Id*. It is premised on the policy that "no Court will lend its aid to a man who founds his cause of action upon an immoral or illegal act." *Id.* The "doctrine is only applicable when the plaintiff bears equal fault to, or more fault than, the defendant for the alleged wrong." *Antioch Litigation Trust v. McDermott Will & Emery LLP*, 738 F.Supp.2d 758, 772 (S.D.Ohio 2010). In this way the doctrine can be part of a comparative fault analysis. *In pari delicto* is founded upon public policy, and does not depend upon the guilt or innocence of a party. *Commercial Nat'l Bank v. Wheelock*, 40 N.E. 636 (1895).

Under Illinois law no distinction between the application of these doctrines in the context of a professional malpractice action. *Lurie v. Wolin*, 2014 IL App (1st) 130661-U, ¶¶ 11-17. In Illinois, a claim for professional malpractice cannot be pursued when the plaintiff has placed himself in a questionable situation. Illinois courts have consistently found that the court is required to leave the parties where it found them and provide no remedy when such parties are before them. In *Makela v. Roach*, 142 Ill. App. 3d 827, 832 (2nd Dist. 1986) the court held:

> [w]here a party voluntarily elects to follow advice intended to extricate herself from a questionable situation, she comes to his court with unclean hands and may not seek relief from her wrongful conduct through a legal malpractice action. … We pass no judgment on the advice given by the defendant, as a refusal to aid [plaintiff] is a decision based on her attempt to evade the law.

Likewise in *Mettes v. Quinn*, 89 Ill. App. 3d 77, 80 (3rd Dist. 1980) the court held that "[i]t has been the policy of the courts to refuse their aid to anyone who seeks to found his cause of action upon an illegal or immoral act or transaction." Illinois courts will not aid plaintiffs who by their own acts create a situation and then seek unethical or illegal behavior on behalf of a licensed professional to extricate them.

More recently, in *Peterson v. McGladrey LLP*, 792 F.3d 785, 788-789 (7th Cir. 2015), in which the trustees in bankruptcy for mismanaged a investment fund brought accounting malpractice claims against the outside auditor, and the Court found that even though the auditor committed a separate error, the fund manager's own misconduct barred the claims under *in pari delicto*. The Court found no support for the argument of the trustee that the error of the professional must be the same as that of the client in order for *in pari delicto* to apply. *Peterson*, 792 F.3d at 787.

Irrespective of the manner in which these doctrines are conceived in a given state, counsel for the defendant professional should ascertain if there is a basis to claim that the plaintiff is at least in part culpable in causing the injury claimed.

Causation

As pointed out above, these entities are bankrupt or

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otherwise insolvent; getting a handle on the various (and often complex) causes for that situational and the full time line of decision making that contributed to them, can be critical to asserting important defenses related to statute of limitations or scope of involvement. Every demarcation in the professional's involvement, e.g. the timing of his various engagements and the scope of those engagements, should be examined closely alongside a broken down version of the damages model to explore fully all causation angles. At its simplest, if it can be shown that the entity would have been bankrupt or insolvent irrespective of the conduct of the professional, the plaintiff's complaint, or key parts of the damages, may be able to be defeated. This is particularly true when the professional is an outsider to the business and may not have directly participated in whatever dismal decision making or market conditions that contributed to the business's demise. Mitigation of damages defenses are often closely linked with causation,

Consider one illustrative example of the kind of case in which causation and unclean hands kinds of defenses can be found in a case stemming from a bankrupt business. Plaintiff was a business whose franchise model to sell start up software and policies that would allow small banks and other financial institutions to sell insurance on the side. The business underwent an initial honeymoon phase in the early 2000s, consistent with the rising market then, but suffered serious decline closely linked with the real estate market crash and the disappearance of smaller lending institutions. Ultimately, the franchise company was subjected to involuntary bankruptcy and its Trustee/Receiver, in an effort to increase the bankruptcy Estate, pursued claims against all of the professionals involved in any aspect of the business. Various defendant professionals were accused of failing to see and report the inevitable flaws in the business model itself and further accused of helping to sustain the unsustainable in a way that deepened the later insolvency. Despite the large damages that stemmed from the demise of the company, many different causation issues, comparative fault angles and scope of representation defenses became apparent when a deep exploration of timeline of compartmentalized legal work took place.

Damages

Closely related to the causation issues are some important damages defenses that should be considered in every complex or soft damages scenario. Insolvencies do not happen all at once, they invariably happen over time which allow for defenses (including statute of limitations) based on that break down. Trustees in bankruptcy should not be able to escape the empirical proof requirements for damages that exist in many jurisdictions, because they, again, stand only in the shoes of the debtor at the time of the bankruptcy.

Damages in professional negligence cases usually must be proved with "legal certainty" or "reasonable certainty" which is defined differently in different jurisdictions but most often means some reasonable space of time (e.g. 5 years for the "new business rule") in which empirical business data and facts support the financial conclusions. Mere conclusions without supporting data, or rank speculation (e.g. about things such as future profits) should not satisfy this proof requirement.

As an example in *Meriturn Partners, LLC v. Banner & Witcoff, Ltd.*, 31 N.E.3d 451, 459-460 (1st Dist. 2015) the court upheld a $6 million judgment (the amount of the investment by the plaintiffs) but declined to award lost profits as too speculative because of the new nature of the business at issue. The Court applied the "new business" bar applied to "unestablished ventures, unestablished products and unestablished processes" of an existing business, not just to a new "business" itself. *Meriturn Partners*, 31 N.E.3d at 459. For a full exposition of *Meriturn Partners*, see *"Just When You Thought You Knew Who You Represented: A New Decision May Upset the Law Regarding Attorney Liability to Third Parties,"* IDC Quarterly, Vol. 26, No. 2, Donald Patrick Eckler, Matt Tibble, and Adam Carter, http://www.pretzel-stouffer.com/profiles/pdf/26.2.M1.pdf

Negotiation, Resolution, and the Fiduciary Dilemma

Trustees and receivers have a fiduciary responsibility to recover as much money for the bankruptcy estate as reasonably possible; it is their obligation to the debtor and to the creditors. Depending on the trustee and the situation, this responsibility can produce inflexible or even unfair dynamics when it comes time to try to resolve the matter. Trustees often will not be shy about asserting their fiduciary duty and pragmatism as reasons why negotiations should take place early in the case (before full discovery has taken place). A trustee may then later utilize this same responsibility as an excuse for why she cannot possibly negotiate below a certain amount. Counsel for the defendant should raise issues related to the costs and risk in the case, including serious dilemmas (for both sides) caused by diminishing limits policies. Reminding the trustee that she must not only take into account whatever risk of losing that exists in that particular case, but she must act more responsibly than perhaps the business entity would have done before the insolvency -- her duty extends to achieving a reasonable result net of expenses, from her efforts. For example, spending $1 million in fees and experts to prove a questionable liability case that has a best day of $2 million in a situation involved a diminishing limits $2 million policy is a precarious scenario for a Trustee. The Trustee should be reminded that she is most certainly not fulfilling her

***PLDQ*'s Summer 2017 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:

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fiduciary duty if her inflexible negotiating produces a lengthy expensive litigation process, or an unfavorable or nonexistent net recovery.

Conclusion

The challenges of defending a case involving a bankrupt entity are unique and require a different approach than the defense of other professional malpractice actions. Conceding breach of the standard of care may be an awkward position to take, but it is often the necessary tact in such cases so that the defense of the case can focus on the other elements of the case where successful defense is much more likely to be found.

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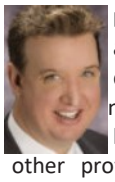

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