Introduction

Client Fraud and Its Consequences for Professionals and Their Firms

With increasing frequency, professionals and their firms are facing some variant of a nightmarish scenario that, if not handled correctly, threatens the professionals' livelihood and the firms' very existence. The classic fact pattern is this: A significant client of the firm, apparently a prosperous business offering valuable products or services, collapses overnight. 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 for years.

Perhaps 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 their fictitious "returns."[1] Or, perhaps the client had a real business, but a far less successful business than its managers had represented. In either event, the goal of such schemes typically is to deceive those who

1. The Ponzi scheme is named for Charles Ponzi, who beginning in 1919 perpetrated a fraud in which he promised large returns to investors based on buying international postal coupons, redeeming them for stamps, and selling them at a profit. In fact, Ponzi paid old investors "profits" from money invested by new investors. *See* Ron Chernow, *Madoff and His Models*, New Yorker, Mar. 23, 2009, at 28.

invest, lend, or do business with the company, so that the fraudsters may obtain cash—whether to line their own pockets, or to live "high on the hog" for as long as the scheme lasts, or to prop up their failing company in an effort to save it.

While such schemes would appear to be naturally short lived, in fact they can endure for many years. The much-publicized Madoff fraud has shown the world that a skillful and unscrupulous fraud-feasor can maintain an illusory or inflated business for years, escaping detection even by sophisticated observers.[2] And in fact, that is true of many client frauds that spawn claims against professional firms. Thus, professionals sometimes find that a long-trusted client has been perpetrating a long-running fraud.

The destructiveness of large financial frauds would be difficult to overstate. Their devastating impact on investors, lenders, and innocent company employees is obvious and well documented. In addition, fraudulent schemes victimize 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 to raise cash and to present the appearance of regularity on which the business depends. When the fraud collapses, the professionals often find themselves in the crosshairs of litigation.

On rare occasions, the professionals are accused of intentionally helping their clients to perpetrate the fraud. More commonly, the professionals allegedly failed to discover the fraud in the face of alleged warning signs or "red flags." In all such cases, the professionals' firms can expect to face large lawsuits, burdening not only the individual professionals alleged to be at fault but their entirely innocent partners and colleagues who never personally did any work for the fraudulent client.

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2. *See* David Gelles & Gillian Tett, *From Behind Bars, Madoff Spins His Story*, Fin. Times, Apr. 8, 2011, *available at* http://www.ft.com/intl/cms/s/2/a29d2b4a-60b7-11e0-a182-00144feab49a.html ("Over at least 16 years, Madoff deceived investors, regulators, banks and associates. His Ponzi scheme—a fraud which involves paying old investors with funds from new ones—made him extraordinarily wealthy. He took in $20bn in capital from investors including European nobility, average American workers, worthy charities and his own close-knit family and Jewish community. Madoff's scheme was the largest in history."); Dana Henriques, *Madoff Scheme Kept Rippling Outward, Across Borders*, N.Y. Times, Dec. 19, 2008. *See also* Chernow, *supra* note 1, discussing long-running 1920s fraud by Ivar Kreuger, the "Match King."

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 fifteen years, I personally have represented professionals or firms in at least ten separate matters of this nature. The scale of these frauds appears to be increasing, and the amount of damages sought against professional firms in such cases is correspondingly larger as well. Recent years have seen damage estimates in the hundreds of millions and billions of dollars—amounts that dwarf most professionals' insurance policies or reserves.

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. Professionals often must rely on the client to supply accurate information. 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 become ready targets for litigants seeking to recoup some of their losses when the client company proves insolvent.

When a fraud is revealed, professionals may anticipate lawsuits from a variety of sources. One common source, in some ways the most dangerous, is the client itself or the client's representative. 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 create "litigation trusts" or the like 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 have become increasingly aggressive in asserting such claims against the professionals who represented the insolvent company.[3] They portray themselves as acting in the interest of the innocent creditors. Trustees' or receivers' ability to assert negligence-based claims makes them particularly dangerous plaintiffs. They may assert claims as adversary proceedings in bankruptcy court, or sue in state or federal court, or in arbitration in the event the professional and the client had an agreement to arbitrate disputes.

In addition to the client or its representative, claims against professionals also may come from nonclient third parties, including investors, noteholders, lenders, and other transaction counterparties of the bankrupt entity. Such claims 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 plaintiff law firms. Recent developments under the federal securities laws have made it more difficult for investors to bring cases against professionals when the claim is in connection with a security;[4] and many states' laws also prohibit nonclients from asserting negligence-based claims in most instances. Yet, avenues remain for third parties to sue professionals, particularly when the claimants can plausibly aver that the professionals made direct false statements to them and when they can allege the requisite intent for an aiding and abetting claim under state law.

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3. *See Maxwell v. KPMG LLP*, 520 F.3d 713, 718 (7th Cir. 2008) (discussing the incentives of bankruptcy trustees to bring lawsuits, uninhibited "by concern for future relations with suppliers, customers, creditors, and other persons with whom the firm deals (including government) and by the cost of litigation"); *id.* ("A related point is that while the management of a going concern has many other duties besides bringing lawsuits, the trustee of a defunct business has little to do besides filing claims that if resisted he may decide to sue to enforce.").

4. *See Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008); and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver,* 511 U.S. 164 (1994), all discussed in chapter 4, *infra*.

A third source of claims is 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. A law firm, for example, may provide an opinion letter to an investment bank in connection with the transaction; or the bank may rely on the auditors' opinion on the company's financial statements.

A fourth source is the wrongdoers themselves, or other corporate insiders. Those accused of wrongdoing sometimes choose to sue others, whether because they think the claims are independently justified, or as a strategy to deflect attention from their own conduct (or both). Commonly, the plaintiff wrongdoers will claim that the professionals represented them personally or helped to mislead them.

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 fault of the professionals. As every professional firm's general counsel knows, lawsuits can be ruinous without being 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. And, professional firms often choose to settle large claims that cannot be dismissed on a motion, rather than taking a case to trial 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 firm client to develop a strategy to defend itself against the many claims and threats that will arise.

The purpose of this book is to survey the law regarding claims and defenses that commonly arise in a client-fraud scenario. Its particular focus

is identifying some of the most promising defenses and other strategies to help professional firms minimize the fallout from such events. Each of the chapters that follows is devoted to claims against professionals of a discrete type or from a distinct source.

We begin, in chapter 1, with claims by the professional's client. Such claims usually seek damages for professional malpractice, or negligence. The client has replaced its executives who allegedly committed the fraud, and it sues its lawyers, accountants, and other advisers for negligently failing to discover the fraud. The client, unlike other victims of the fraud, typically has standing to sue its professionals for malpractice, but the professionals usually will have substantial defenses, including defenses based on the client's own responsibility for the underlying fraud.

Chapter 2 discusses the common circumstance where the client is insolvent, usually as a result of the fraud or its revelation, and where "the client's" claims are asserted by a trustee, receiver, or similar representative. While the claims may be the same ones a solvent client would bring, insolvency adds many additional wrinkles, including issues of standing to sue, the trustee's claimed immunity from certain defenses, and "deepening insolvency" damages.

The next two chapters address claims that commonly are brought by nonclients who were victimized by the client's fraud—typically investors, noteholders, lenders, or other transaction counterparties who claim to have been defrauded. Nonclients usually lack standing to sue professionals for malpractice, but they often seek to assert other types of claims. In chapter 3, we address statutory claims under the securities and racketeering laws, with a particular focus on the *Central Bank* rule that bars most federal securities fraud lawsuits against professionals. Chapter 4 discusses common-law claims, including aiding and abetting, negligent misrepresentation, and conspiracy. Professionals typically have significant defenses to such nonclient claims, whether based on the lack of privity or the limitations inherent in those causes of action—for example, the requirement in an aiding and abetting case that the plaintiff prove the professional's actual knowledge of fraud.

Chapter 5 concerns claims against professionals by other allegedly responsible parties, including sometimes by other professionals. These

may take the form of claims for contribution and indemnification, or in some unusual instances direct tort claims.

Finally, chapter 6 briefly discusses certain other consequences for professionals of a client's fraud: criminal, regulatory, and disciplinary proceedings. Most of the time, governmental authorities (rightfully) will focus on the actions of the client's insiders who committed the fraud, as opposed to the professionals who failed to apprehend it. In rare cases, however, the professionals may be investigated or prosecuted, which is a game-changing proposition.

This book touches on many areas of law practice and of substantive law. Its goal is not to cover any of them exhaustively or to substitute for the many excellent treatises that do. Rather, this book attempts to bring together these many areas into a primer on client-fraud cases against professionals, in the hope that it may assist professionals faced with such claims, and the professionals' lawyers, to identify available defenses and strategies.