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Avoiding Professional Liability: Aiding and Abetting Client Wrongdoing and Other Liability Risks

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Introduction

This presentation is a discussion of the ethical issues facing attorneys, financial advisors, and other professionals engaged by insolvent (or allegedly insolvent) clients, and the creditors and other parties who deal with them. In particular, we will discuss the merits of various theories under which parties have attempted to impose liability on such professionals.

A similar presentation, entitled "If you Can't Do the Time …" – Bankruptcy Crimes and Fraud," was made at the American Bankruptcy Institute's Mid-Atlantic Bankruptcy Workshop held August 3-5, 2006 in Cambridge, Maryland, and with the gracious consent of the panelists for that presentation[1], the written materials from that presentation are included herewith in their entirety (the "Mid-States Materials"). The materials included provide an excellent backdrop for the present discussion. Specifically, they provide an overview of the criminal enforcement efforts of the offices of the United States Trustee, as prosecuted by the Department of Justice, and various statutory provisions relative to bankruptcy crimes. They stop with an overview of ethical considerations for attorneys generally and speak to the ethical parameters set forth in the Model Rules, the bankruptcy code, and the separate but related fiduciary obligations.

[1] The panelists included: Kelly Beaudin Stapleton, U.S. Trustee for Region 3, Philadelphia, PA; Richard E. Byrne, Chief of the Criminal Enforcement Unit for the U.S. Department of Justice, Washington, D.C.; Stephen A. Donato, Bond Schoeneck & King PLLC, Syracuse, NY; Ronald S. Gellert, Eckert Seamans Cherin & Mellott, LLC, Wilmington, DE; and Richard M. Kremen, DLA Piper Rudnick Gray Cary US LLP, Baltimore, MD.

I. Overview of Ethical Considerations.

Avoiding malpractice claims by bankruptcy and restructuring practitioners involves much more than an intimate knowledge of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure. Such practitioners also must prepare and timely file pleadings, UCC financing statements, mortgages and related documents. In making these filings, a practitioner must know and comply with a myriad of local jurisdictions' rules and procedures, in addition to rules relating to the filing of paper and electronic documents. Lawyers practicing in this field must be diligent about discovering and appropriately addressing potential conflicts of interest arising in connection with their past, present and prospective representations. A bankruptcy or restructuring attorney must be familiar with the parameters of new laws, such as the Sarbanes-Oxley Act of 2002[2], and various theories of liability to his/her client (and himself/herself), such as deepening insolvency , that are rapidly changing and may have an impact on his/her practice.

Below is a discussion of certain of these aspects.

a. Conflicts of Interest for Debtors' Counsel.

In addition to rules defining and prohibiting impermissible conflicts of interest provided in each virtually every lawyer's state rules of professional conduct, bankruptcy practitioners also must abide by the "disinterestedness" rules set forth in the Bankruptcy

[2] Although not discussed herein in detail, various provisions of the Sarbanes-Oxley Act of 2002 (the "SOX Act") must be familiar to bankruptcy practitioners. For example, the SOX Act adds Section 523(a)(19) to the Bankruptcy Code, which renders a debt nondischargeable in bankruptcy to the extent the debt results from a judgment for violation of any federal or state securities law, or common law fraud or other acts in conjunction with the sale of a security. Additionally, the SOX Act also added a new criminal law provision at 18 U.S.C. § 1519, provides for fines and imprisonment for anyone who knowingly alters, destroys, mutilates, etc. any record, document, or tangible object with the intent to impede, obstruct or influence the investigation or proper administration of any matter within an department or agency of the United States *or any case filed under title 11, or in relation to or contemplation of any such matter or case*.

Code. Although this issue is addressed in the Mid-States' Materials, it is worth repeating that a lawyer's prepetition employment by a debtor alone will not disqualify him or her from future employment as debtor's counsel for the same client in that client's bankruptcy case.[3] So long as a lawyer or other professional discloses such prior engagement, is a "disinterested person" as required by 11 U.S.C. § 327(a)[4], and does not hold or represent an interest adverse to the estate (such as the interests of another adverse client or a claim for fees), the professional typically may be employed.

It is worth noting in this regard that the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") substantially loosened the disinterestedness test as applicable to financial advisors and their counsel. Prior to BAPCPA, a financial advisor was not disinterested if it had been an underwriter of any of the debtor's outstanding securities or any securities issued within three years before bankruptcy, whether or not such securities were still outstanding, and a law firm was not disinterested if it had acted as counsel for the underwriter in any such transaction. Both of these automatic disqualification provisions were repealed by BAPCPA, thereby potentially opening-up the number of investment banks eligible to compete for employment as financial advisors in chapter 11 cases. However, while the disinterestedness standard in this regard was relaxed, it was not eliminated, so that if a current or former financial advisor cannot fit within the new disinterestedness definition

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[3] United States Trustee v. Price Waterhouse, 19 F.3d 138, 141-42 (3d Cir. 1994).

[4] "The term 'disinterested person' means a person that –
(A) is not a creditor, an equity security holder, or an insider;
(B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
(C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason." 11 U.S.C. §101(14).

set forth in 11 U.S.C. §101(14), it still may be disqualified from employment in a particular case.

Further, Section 327(e) of the Bankruptcy Code permits employment of a professional as "special counsel" in circumstances where the attorney might not otherwise be employable. Specifically, subsection (e) loosens the disinterestedness standard to be applicable only to the matter for which the attorney is being employed as special counsel.

A creditor is not a disinterested person.[5] Thus, if a firm or an individual lawyer is a prepetition creditor of a debtor, and such position presents an actual conflict of interest for the lawyer or firm as counsel to debtor, the bankruptcy court may not permit such representation.

A lawyer or firm who received an allegedly avoidable transfer may be prohibited from representing the debtor in the case in which such transfer may be adjudicated (i.e., as debtor's counsel in debtor's case).

b. Conflicts of Interest for Counsel to Creditors and Creditors' Committees.

Obligations to former or current clients can present conflicts of interest precluding representation of creditors. For example, a secured creditor often will be directly adverse to both the debtor and general unsecured creditors. General unsecured creditors will be adverse to the debtor and may oftentimes be adverse to each other. Attorneys for any of these parties therefore are encouraged to explore the past and current engagements of his/her firm to determine the extent to which its clients are adverse to each other and thus prohibiting engagement of one or more lawyers.

[5] Id.

Concurrent representation of a secured creditor and one or more unsecured creditor is permissible provided no actual conflict exists. Lawyers must abide by their local rules of professional conduct concerning when a client but be advised and consent to the potential or real conflicts.

The standards for engagement of committee counsel vary somewhat from employment of debtor's counsel. Recall that employment of debtor's counsel requires a finding by the bankruptcy court that prospective counsel does not hold or represent an interest adverse to the bankruptcy estate, and is disinterested. Significantly, Section 1103(b) of the Bankruptcy Code, which is applicable to the employment of Committee counsel, does not provide a disinterestedness standard.

A lawyer or firm wishing to represent one or more creditors, but which does not represent the Committee, is not subject to Section 1103(b) with respect to these representations. The professional must comply with Bankruptcy Rule 2019 to disclose representation of multiple creditors, but otherwise such retention is outside the parameters of the Bankruptcy Code, and is subject only to the applicable provisions of the Rules of Professional Conduct.

c. Consequences for Failing to Resolve Conflicts.

Section 328(c) of the Bankruptcy Code authorizes a court to deny compensation for services and reimbursement of a lawyer who, at any time during such person's employment, is not interested, or represents or holds an adverse interest with respect to the matter on which the lawyer is employed. Courts have recognized that lawyers who fail to meet the standards of disinterestedness and lack of adversity, or who make inadequate disclosures, "may be penalized in a variety of ways, including disqualification

or removal from the case, total or partial denial of compensation, or disgorgement of fees and expenses."[6] Thus if counsel has or develops a conflict of interest at any time in the case, the court may deny counsel some or all compensation.[7]

Sanctions under the Bankruptcy Code or Bankruptcy Rules may consist of directives of a nonmonetary nature (such as denial or representation or termination of representation), directives of a monetary nature (such as denial of future payment of fees or disgorgement of some or all fees already paid), or bankruptcy court disqualification orders. Sanctions under the state versions of the Model Rules of Professional Conduct also may include public reprimand, suspension from practice, and disbarment.

The recent decision in In re eToys, Inc., 331 B.R. 176 (Bankr. D. Del. 2005), in which Debtor's counsel was ordered to disgorge fees for nondisclosure of counsel's prior representation of two creditors, and Committee counsel agreed to disgorge $750,000 for failing to disclose its connections with one of the debtor's officers, is noteworthy in this regard. In the course of its analysis, the eToys court noted that "[h]arm to the estate is not necessary to a decision to order disgorgement of fees where there is a conflict of interest." Id., 331 B.R. at 193. Interestingly, the court also noted that while "an officer [of a debtor] is not a professional who needs to be retained by the debtor under section 327(a) [, n]onetheless, the Court does have the power to supervise and deny compensation to officers of a debtor in appropriate circumstances," including circumstances involving "relationships that might affect an officer's loyalty (and the failure to disclose those relationships)." Id., 331 B.R. at 202. eToys emphasizes the importance to professionals seeking employment by the bankruptcy estate of a thorough

[6] In re El San Juan Hotel Corp., 239 B.R. 635, 647 (BAP 1st Cir. 1999).

[7] 11 U.S.C. § 328(c).

conflicts-check investigation, and of immediate disclosure of any relationships that may give rise to an actual or potential conflict of interest.

II. Aiding and Abetting.

a. The Basics of the Claim.

In the typical aiding and abetting claim, the client is the primary wrongdoer and is often accused of fraud, misrepresentation, and/or breach of fiduciary obligations. The lawyer is sued for having assisted the client's fraud, such as by documenting the transaction but failing to prevent the client from harming third parties.

b. The Lawyer's Defenses.

A professional's primary defense to aiding and abetting claims is lack of scienter. That is, the professional typically asserts that "the client fooled me, too" and that "I didn't know about the fraud." These cases become ones of identifying "red flags" – what the lawyer did or should have known in terms of the client's fraudulent or circumstances – and the relative importance and contribution of such conduct or circumstances to the plaintiffs' damages.

Plaintiffs' counsel, with the benefit of hindsight, may argue that the professional conveniently "looked the other way" while the client defrauded its creditors. The motivation often suggested by plaintiffs is the fees generated by the work for the client.

c. Crown Vantage – A "Real Life" Example.

For an example of the scenarios played out in aiding and abetting cases, consider the case of Crown Paper Liquidating Trust v. Pricewaterhousecoopers LLP (In re Crown Vantage, Inc.), 2003 WL 25257821 (N.D.Cal. Sept. 25, 2003), aff'd, 198 Fed.Appx. 597 (9th Cir. Aug. 9, 2006) (a not-for-publication decision), cert. denied, ___U.S.___, 127

S.Ct. 1381, (Feb. 26, 2007)[8]. Boiled to its essence, this case involved a transaction (later pejoratively described as the "Spin") in which a parent corporation, James River Corporation ("JRC"), created a subsidiary, Crown Vantage, Inc. ("Crown"), and in the words of the District Court, "unload[ed] vastly over-valued but under-performing assets onto Crown, and … cause[ed] Crown to borrow well over half a billion dollars, all of which monies were then taken by [JRC], while Crown remained obligated to pay on the loans," all to the detriment of Crown's creditors. Crown, 2003 WL 25257821. Eventually Crown collapsed under the weight of its debt, filed a Chapter 11 petition in the Bankruptcy Court for the Northern District of California, Oakland Division (Newsome, J.), and confirmed a plan of liquidation under which Crown Paper Liquidating Trust ("the Liquidating Trust") became the successor-in-interest to Crown.

The Liquidating Trust then filed a lawsuit against 15 defendants, including PricewaterhouseCoopers LLP, f/k/a Coopers & Lybrand ("PWC"), Ernst & Young LLP ("E & Y"), McGuireWoods LLP, as successor to McGuire Woods Battle & Boothe, LLP ("McGuire Woods"), Merrill Lynch & Co., Merrill Lynch Pierce Fenner & Smith, (collectively, "Merrill Lynch"), Salomon Brothers ("Salomon"), Credit Suisse First Boston Corporation, as successor to Donaldson, Lufkin & Jenrette ("DLJ"), and Houlihan Lokey Howard & Zukin ("Houlihan Lokey"), claiming they had participated in JRC's wrongful conduct, aided and abetted JRC and each other, or otherwise breached independent duties owed to Crown with respect to the "Spin" and its aftermath.

Specifically, the Liquidating Trust alleged that McGuire Woods, which continued to represent Crown after the Spin, concealed from Crown after the Spin "all documents

[8] A copy of the District Court opinion, which was adopted by the Ninth Circuit in its not-for-publication affirmance, is included herewith.

and information related to the Spin," Merrill Lynch and Houlihan Lokey, after the transfers, provided "false and misleading opinions" that the Spin had been "fair and equitable and not a fraudulent transfer," PWC prepared and disseminated "false and misleading financial statements" to assist JRC in "the perpetuation of the illusion of growth and prosperity and artificially prolonging Crown's life," Salomon, which "conducted due diligence regarding Crown's post-Spin operations," did not advise Crown of "the true nature of the assets," and Credit Suisse First Boston Corporation's predecessor, DLJ (which worked for Crown as a financial advisor pursuant) did not advise Crown of the true value of its assets and should have advised Crown to file for bankruptcy, rather than to continue as a "going concern."

PWC and the other defendants successfully defeated the Liquidating Trust's liability claims by arguing that Crown had acted *in pari delicto* with JRC in the allegedly wrongful conduct:

> **First**, for the doctrine to apply, agents of the plaintiff corporation must have participated in the wrongdoing for which the corporation seeks to recover. See Mediators. Inc. v. Manney (In re Mediators), 105 F.3d 822, 826-27 (2nd Cir.1997) (holding where agents of corporation participated in fraudulent scheme with defendant, corporation was barred from asserting claim against defendant, unless exception to doctrine of in pari delicto applied). **Second**, if such agents, at the time of such participation, were acting in a manner adverse to the interests of the corporation, the so-called "adverse interest exception" applies, with the result that the actions of the agents are not imputed to the corporation. See, e.g., Bankruptcy Services, Inc. v. Ernst & Young (In re CBI Holding Co.), 247 B.R. 341, 365 (Bankr.S.D.N.Y.2000) (holding where "segment of management involved in the fraud was acting for its own interest and not that of [the corporation]," their participation in accounting fraud was not imputed to corporation, and corporation's claim against defendant accounting firm was not barred). **Third**, even if the agents of the corporation were acting in a manner adverse to the interests of the corporation, where the agents and the corporation are "one and the same," the "sole actor exception" applies to the "adverse interest exception," with the result that *in pari delicto* will bar the claim. See, e.g., Lafferty, 267 F.3d at 359 (holding

> "sole actor exception" applied to bar corporation from suing its underwriters for participating with agents of corporation in fraudulent scheme, where such agents "clearly dominated" corporation and one of the agents was the "sole shareholder" of corporation).

Crown, 2003 WL 25257821 (emphasis added, footnotes omitted).

Accordingly, the Court held that since JRC, as Crown's sole shareholder, exercised dominion and control over Crown as to the Spin and had sole and complete decision-making during those transactions, the adverse interest exception to the presumption of knowledge could not apply, and barred the Liquidating Trust's claim against the professionals for allegedly assisting JRC in stripping Crown of its assets. Crown, 2003 WL 25257821 (citing Mediators. Inc. v. Manney (In re Mediators), 105 F.3d 822, 827 (2nd Cir.1997).

Undeterred, the Liquidating Trust next argued that the professionals could be held liable "for aiding and abetting fraudulent transfers of assets from Crown to [JRC]." Crown, 2003 WL 25257821. The court, noting that the "dismissal of certain claims based on *in pari delicto* [also] dismissed any claim based on the theory that [the professional] defendants … aided and abetted JRC in effectuating the transactions comprising the Spin," limited its consideration of the Liquidating Trust's "aiding and abetting fraudulent transfer claims" to a certain 1998 settlement agreement between Crown and JRC, which agreement the Liquidating Trust also claimed to be a fraudulent transfer."

The Crown court noted that under traditional fraudulent transfer analysis, "'recovery may be had only against persons who have received the property in question,'" and not against others, citing Elliott v. Glushon, 390 F.2d 514, 514, 517 (9th Cir.1967) (holding trustee seeking relief from fraudulent conveyance may only recover

from transferee; affirming dismissal of claim for damages against attorney who allegedly conspired with debtor to fraudulently convey estate's property to third party), and FDIC v. Porco, 75 N.Y.2d 840, 552 N.Y.S.2d 910, 552 N.E.2d 158, 159 (N.Y.1990) (holding trial court erred by not dismissing claim for damages based on allegation defendants "assisted" debtor in transferring debtor's assets outside of country; reaffirming "traditional rule in this State reject[ing] any cause of action for mere participation in the transfer of a debtor's property prior to the creditor's obtaining a judgment"). Moreover, the Court noted that the applicable state law at issue – Virginia and New York – contemplated no cause of action for "aiding and abetting" a fraudulent transfer:

> See Efessiou [v. Efessiou, 41 Va. Cir. 142,] 1996 WL 1065637 [, *4-5 (1996)] (dismissing claim for conspiracy to effect fraudulent conveyance because, under Virginia law, "there can be no civil action for conspiracy where the unlawful act underlying the conspiracy claim does not allow for a damage award," and Virginia does not permit damage award as remedy for fraudulent conveyance); Porco, 552 N.Y.S.2d 910, 552 N.E.2d at 159 ("Nor is there merit to plaintiff's argument that [a New York statute] creates a creditor's cause of action in conspiracy, assertable against nontransferees or nonbeneficiaries solely for assisting in the conveyance of a debtor's assets.")

Crown, 2003 WL 25257821. Accordingly, the Crown court held that the Liquidating Trust "cannot state a claim for relief under either bankruptcy law, Virginia law, or New York law for aiding and abetting fraudulent transfers," and dismissed such claims without leave to amend.

If Crown's approach is followed by other courts examining the potential liability of professionals in having "aided and abetted" the allegedly wrongful conduct of their clients, this decision should afford some comfort to such professionals that their engagement letters are not the functional equivalent of a guaranty of their client's good faith and honesty – so long as the professionals are, themselves, acting with integrity.

III. Other Theories for Imposing Liability (International Strategies Group, Ltd.).

The U.S. Court of Appeals for the First Circuit's recent decision in International Strategies Group, Ltd. V. Greenberg Traurig, LLP, et al.[9], a copy of which is included with these materials, highlights a number of theories for recovery against bankruptcy and restructuring professionals.

a. Factual Background.

International Strategies Group ("ISG") invested $4 million with Corporation of the BankHouse ("COB") in April 1998. COB promised investors substantial profits, along with a guarantee of non-depletion of the investor's original investment. Soon thereafter, in May, 1998, COB made two unauthorized transfers of ISG's investment, both of which violated the non-depletion guarantee, and one of which was made to one of the defendant law firm's account. COB then allegedly engaged in a Ponzi scheme, using funds from new investors to cover the depletion of funds provided by previous investors.

In June, 1998, ISG sought assurances from COB that its funds were intact. ISG soon learned that that COB had mishandled the funds and of certain specified transfers of its funds.

In July, 1999, an attorney (and an individual defendant in the lawsuit) with one of the defendant law firms began representing COB. In August, 1999, an executive of COB sent ISG an e-mail outlining COB's "options for retrieval" of the lost funds, and advised ISG that it had engaged the two defendant law firms to pursue COB's civil and criminal remedies against ISG. Soon thereafter, during a meeting of ISG and COB, the individual

[9] USCA 1 Opinion 06-1790 (March 30, 2007).

lawyer advised ISG that he (the lawyer) had been retained by COB, that COB was also a victim of fraudulent activities, and that any independent action by ISG against COB or other parties would jeopardize the lawyer's negotiations to recover the missing funds.

When COB had neither recovered the funds nor filed a complaint in over two years, ISG engaged independent counsel in 2001 and filed a lawsuit against COB and its executive in early 2002. ISG obtained a $10 million judgment, but the judgment is uncollectible.

b. Claims Against the Professionals and the Trial Court's Ruling.

ISG filed suit against the two law firms and the individual lawyer seeking damages for malpractice, misrepresentation, and violation of a state consumer protection law. Additionally, ISG included claims against the individual lawyer for breach of fiduciary duty and breach of express and implied contract, and claims against the lawyer's law firm for conversion and aiding and abetting fraud and breach of fiduciary duty, based on the May, 1998 fund transfer to the law firm's account.

Defendants moved for summary judgment on all counts. The trial court refused to grant the defendants' request for a finding that no attorney-client relationship existed between ISG and the defendants. However, the court did enter summary judgment in favor of the defendants on the basis that ISG failed to establish a viable cause of action as to most of ISG's claims, including negligence, misrepresentation, the state-law consumer protection law, breach of fiduciary duty and breach of contract. The trial court also granted summary judgment as to claims based on conversion and aiding and abetting fraud and breach of fiduciary duty, concluding that the statute of limitations had expired.

c. <u>The Appellate Court's Decision</u>.

The Appellate Court's disposition of ISG's claims against the defendant law firm is relevant to this discussion. The claims were based on COB's transfer of funds to the law firm's account. Both claims were tort claims which, under applicable state law, were subject to a three year statute of limitations. Massachusetts common law has established that a tort claim accrues when the plaintiff knew or should have known of the alleged injury.

The law firm asserted that the limitations period began to run in April, 2000, when ISG learned of COB's transfer of funds to the law firm. ISG, however, asserted the doctrine of "continuous representation" (which provides that any period of limitations should be equitably tolled for malpractice claims where the attorney continues to represent the plaintiff's interests in the matter in question.) to argue that the limitations period did not begin to run until October 2001, when ISG finally engaged independent counsel. The appellate court determined that because it found no attorney-client relationship between ISG and the defendants, the continuous representation doctrine was inapplicable and thus reaffirmed the trial court's summary judgment in favor of defendants on the basis of an expired statute of limitations.

Query: *What would have resulted from a consideration of the claims for conversion and aiding and abetting fraud and breach of fiduciary duty had the defendant law firm not succeeded on its limitations defense?*

ABI 2006

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"If You Can't Do the Time . . ." -- Bankruptcy Crimes and Fraud

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ABI CAMBRIDGE
Bankruptcy Crimes and Fraud

I. Overview of USTP/DOJ Criminal Enforcement Efforts[1]

A. Statutory Obligations to Refer -- 28 U.S.C. ' 586 & 18 U.S.C. ' 3057

The United States Trustee Program (AUSTP@) has a statutory obligation to refer matters to the appropriate United States attorney that relate to the occurrence of any action which may constitute a crime, and at the request of the United States attorney, to assist the United States attorney in carrying out prosecutions based on such action.[2] If bankruptcy judges or private trustees have reasonable grounds to believe that a violation of law relating to bankruptcy has occurred or that an investigation should be initiated, then they shall report the underlying facts and circumstances to the appropriate United States attorney, including the names of all the witnesses and the offenses suspected.[3] Upon receipt of this information, the United States attorney shall inquire into the facts and present the matter to the grand jury if it appears probable that any such offense has been committed, unless upon inquiry and examination the United States attorney decides that the ends of public justice do not require investigation or prosecution, in which case he shall report the facts to the Attorney General for his direction.[4]

B. USTP=s Criminal Enforcement Unit

To assist with the USTP's mission to protect the integrity of the bankruptcy system, in 2003 the Executive Office for United States Trustees ("EOUST") established a Criminal Enforcement Unit ("CREU"), which consists of experienced former federal prosecutors. CREU's mission includes working with Program staff to identify and refer possible criminal conduct and to assist federal law enforcement agencies and United States attorney offices ("USAOs") with bankruptcy-related investigations and prosecutions, and to conduct training for Program personnel, private trustees, prosecutors, and law enforcement agents. Last year alone, members of CREU trained approximately 1,500 people in various training programs around the country.

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[1] Written by Richard E. Byrne, Chief, Criminal Enforcement Unit, United States Department of Justice, Executive Office for United States Trustees. Additional thanks to Joseph J. McMahon, Jr., Trial Attorney, Office of the United States Trustee, Wilmington, Delaware for his edits of the entire document.

Please note that the views expressed in this document are not the views of the United States Trustee for Region 3, the Executive Office for United States Trustees, the United States Trustee Program, and/or the United States Department of Justice.

[2] *See* 28 U.S.C. ' 586(a)(3)(F) (2005).
[3] *See* 18 U.S.C. ' 3057(a) (2005).
[4] *See* 18 U.S.C. ' 3057(b).

C. Bankruptcy Abuse Prevention and Consumer Protection Act (the "BAPCPA") Designation Requirements

Every USAO and every Federal Bureau of Investigation field office must designate one prosecutor and one special agent, respectively, to investigate and prosecute violations of 18 U.S.C. '' 152 and 157, relating to materially false statements made in bankruptcy schedules and abusive reaffirmations of debt.[5] Each United States attorney who is designated shall, in addition to any other responsibilities, have primary responsibility for carrying out the duties of a United States attorney under section 3057.[6] In addition, the bankruptcy court is required to establish procedures for referring any case that may contain a materially fraudulent statement in a bankruptcy schedule to the appropriate United States attorney or special agent.[7]

D. The BAPCPA=s New Debtor Audits

The United States trustee for each district is authorized to contract with auditors to perform audits in cases designated by the United States trustee, in accordance with the procedures established under section 603(a) of the BAPCPA.[8] The report of each audit is to be filed with the court and transmitted to the United States trustee. Each report shall clearly and conspicuously specify any material misstatement of income or expenditures or of assets identified by the person performing the audit. Where a material misstatement of income, expenditures, or assets is reported, the clerk of the district court shall give notice of the misstatement to the creditors in the case.[9] If a material misstatement is reported, the United States trustee shall report it to the designated United States attorney and take appropriate action, including but not limited to commencing an adversary proceeding to revoke the debtor's discharge.[10]

E. Bankruptcy Fraud Working Groups

To better facilitate coordination between the USTP, USAOs, and federal law enforcement agencies relating to bankruptcy investigations and prosecutions, the Department of Justice utilizes local bankruptcy fraud working groups. A representative of the USTP, USAO, and several federal law enforcement agencies typically make up a working group, which meets periodically to discuss ongoing bankruptcy fraud investigations and pending criminal referrals.

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[5] *See* 18 U.S.C. ' 158(a).
[6] *See* 18 U.S.C. ' 158(c).
[7] *See* 18 U.S.C. ' 158(d).
[8] *See* 28 U.S.C. ' 586 (f)(1).
[9] *See* 28 U.S.C. ' 586 (f)(2)(a).
[10] *See* 28 U.S.C. ' 586 (f)(2)(b).

Additionally, there is a National Bankruptcy Fraud Working Group ("NBFWG"), which consists of a representative from the USTP, USAOs, the Department's Criminal Division, FBI, Internal Revenue Service-Criminal Investigation, Postal Inspection Service, United States Secret Service, Housing and Urban Development Office of Inspector General, Social Security Administration Office of Inspector General, Federal Trade Commission, and Executive Office for United States Attorneys, as well as other agencies. The NBFWG, which meets approximately once a year, helps coordinate a national response to bankruptcy fraud issues.

F. Summary of National Criminal Enforcement Efforts

In October, 2004, the USTP announced "Operation SILVER SCREEN," which highlighted the indictment of twenty-one individuals in seventeen separate prosecutions and demonstrated the breadth of enforcement actions taken by the Department of Justice in combating bankruptcy fraud and protecting the integrity of the bankruptcy system. The press release issued by the Program relating to Operation SILVER SCREEN can be found at http://www.usdoj.gov/ust/eo/public_affairs/press/docs/silver_screen_final_10-28-04.htm. The cases collectively involved the concealment of more than $7 million in assets, illegal conduct by professionals, use of false Social Security numbers and false identities, submission of forged documents, false statements, and various fraudulent acts. As of this writing, the coordinated effort, dubbed "Operation SILVER SCREEN" in recognition of the USTP's enhanced screening of bankruptcy cases to identify fraud and abuse, has resulted in twelve defendants being convicted of, or pleading guilty to, bankruptcy-related crimes.

II. The United States Trustee's Mandatory Obligation to Move for Appointment of a Chapter 11 Trustee – 11 U.S.C. § 1104(e)[11]

A. Background and History of the Subsection

During the bankruptcy cases of Enron and WorldCom, examiners were appointed to investigate the much-publicized scandals affecting their businesses. The fraud-laden schemes engaged in by corporate officers and directors that were uncovered in these investigations not only attracted headlines, but also the attention of Congress. While the Bankruptcy Code has long permitted the appointment of a trustee or examiner in chapter 11 cases, the U.S. Trustee was not required to move for the appointment of a trustee or examiner in such cases. Seizing the opportunity, Congress amended the Bankruptcy Code in an effort to provide a more assertive means by which to investigate a debtor's affairs where actual fraudulent or dishonest behavior is

11 Written by Stephen A. Donato, Esquire, Bond, Schoeneck & King PLLC. Syracuse, New York. The author refers the reader to the excellent article entitled, "Zero Tolerance for Commercial Bankruptcy Fraud: Bankruptcy Metrics Dictate Forewarned is Forearmed" published in the December/January 2006 ABI Journal and presented at the December 2005 ABI Winter Leadership Conference, Educational Session of the Commercial Fraud Task Force Committee by the co-authors, Daniel A. Austin, Esq., Pennsylvania, Robert J. Musso, Esq., and Ch. 7 panel trustee Eastern District of New York, Rosenberg, Musso & Weiner, New York, Jack Seward, Jack Seward & Associates, LLC New York, and Bruce Weiner, Esq., Rosenberg, Musso & Weiner, New York for an in depth and thorough discussion of bankruptcy fraud topics.

suspected. The amendment, part of the BAPCPA, is found at 11 U.S.C. 1104(e).[12] This subsection provides that:

> The United States Trustee shall move for the appointment of a trustee under subsection (a) if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.

Since 11 U.S.C. § 1104(e) is relatively new, there are currently no reported cases concerning this subsection.

B. Zero Tolerance for Fraud and Abuse

Section 1104(e), which mandates that the United States trustee file a motion for the appointment of a chapter 11 trustee in certain circumstances, ensures that an increased number of bankruptcy debtors will be scrutinized by appointed trustees. This powerful mandate adds sharper teeth to the Bankruptcy Code and augments the likelihood that those engaged in actual fraudulent or dishonest conduct will be uncovered, removed and possibly subjected to criminal sanctions. Now that the United States trustee is compelled to move for the appointment of a trustee, it is possible that the United States trustee will act at an early stage of the proceedings when the facts and circumstances concerning the alleged fraudulent conduct have not been fully and thoroughly investigated. So long as the United States trustee has reasonable grounds to suspect criminal conduct, she will move quickly to appoint a trustee to intercede and investigate a debtor suspected of wrongdoing.

C. Opportunity for Greater Creditor Participation

Since section 1104(e) mandates that the United States trustee move for the appointment of a chapter 11 trustee where the trustee has reasonable grounds to suspect actual fraudulent conduct, dishonest conduct, or criminal activity, creditors now have a greater opportunity to participate in the proceedings of a chapter 11 case. While this new section was enacted in response to alleged fraudulent conduct in larger chapter 11 cases such as Enron and WordCom, it is apparent that this section will also benefit creditors in smaller cases by providing them the opportunity to submit information and evidence to the United States trustee. Unlike before, if the information provided by the creditor creates "reasonable grounds" of suspicion, the United States trustee is now obligated to take action and move for the appointment of a trustee. In order to impact the proceedings in this way, the creditor should, immediately upon the debtor's filing,

12 The BAPCPA was signed into law on April 20, 2005. Certain sections of the BAPCPA (including 11 U.S.C. § 1104(e)) became effective immediately. Such sections apply to all cases filed on or after that date.

collect relevant information of actual fraudulent or criminal behavior on the part of the debtor or its constituent members, officers or directors. This information should be passed on to the creditor's attorney for review and ultimately forwarded to the Office of the United States Trustee. The Office of the United States Trustee will determine whether reasonable grounds exist to appoint a chapter 11 trustee.

The appointed chapter 11 trustee will then review the information provided by the creditor, which information will form the basis for a more thorough and expedited investigation of the debtor. Since this information will allow the appointed trustee to become more knowledgeable about the debtor in a shorter period of time, the trustee can rapidly move, for example, to protect the computing systems of the debtor, the primary source of financial and other information about the debtor. If the debtor did engage in accounting improprieties or bankruptcy fraud, the information contained on the computer devices would more than likely disclose such conduct.

It is readily apparent, therefore, that creditors will now play a much more prominent role in chapter 11 cases by assembling information and forwarding it to the United States trustee for consideration in the appointment of a chapter 11 trustee.

D. What Does "Information About the Debtor" Mean?

Unsupported accusations about the debtor will not compel the United States trustee to move for the appointment of a chapter 11 trustee. Instead, if a creditor seeks to successfully compel the United States trustee to move for the appointment of a chapter 11 trustee, the information provided about the debtor must be sufficient to create reasonable grounds to suspect that the governing agents of the debtor engaged in some type of villainous behavior in managing the commercial debtor or in its public financial reporting. To this end, the information presented should be in the form of hard evidence. In other words, the creditor seeking to impact a chapter 11 case by causing the appointment of a chapter 11 trustee should submit hard copies of documents, including hard copy and electronic documents substantiating the claimed dishonest or actual fraudulent conduct at issue.

E. What are "Reasonable Grounds to Suspect?"

The phrase "reasonable grounds to suspect" is one of the many interpretation issues left unresolved by section 1104(e).[13] Since this phrase is not defined in the statute itself, an examination of the jurisprudential usage of the phrase is in order. The standard of "reasonable grounds to suspect" appears to have been most commonly utilized in Fourth Amendment cases involving the stopping, detaining and questioning of those suspected of criminal activity. The "reasonable grounds to suspect" evidentiary standard, in this context, has been described as something less than probable cause. More specifically, the United States Supreme Court has

13 As an aside, a possible explanation for the numerous unanswered issues presented by this section is that it was added to the BAPCPA during Senate Judiciary Committee mark-up only two months prior to being signed into law.

defined the phrase to mean that an officer who conducts an investigatory stop must articulate "a particularized and objective basis for suspecting the particular person stopped of criminal activity."[14] This definition requires that the officer identify a specific objective basis to confirm any hunch or gut-feeling before detaining a suspect. A stop that does not meet the "reasonable grounds to suspect" standard would be unreasonable under Fourth Amendment law.

Based on the foregoing, it appears that the interpretation of "reasonable grounds to suspect" under section 1104(e) would be similar. In other words, this standard would appear to require the United States trustee to have more than a hunch that wrongdoing has occurred. Instead, the United States trustee's suspicion of actual fraudulent, dishonest or criminal conduct must be grounded on objective evidence. This underscores the importance of a creditor seeking to affect the proceedings by providing hard evidence to the United States trustee. At the same time, however, "reasonable grounds to suspect" is not an onerous standard, and is likely to be met in cases where limited evidence exists.

F. The United States Trustee's Role

Section 1104(e), while mandating that the United States trustee move for the appointment of a trustee in certain circumstances, does not speak to the role or level of involvement the United States trustee is to play in a chapter 11 case. Should the United States trustee be passive and patiently await the presentation of evidence and materials before investigating a chapter 11 debtor, or should the United States trustee actively inquire into the dealings of each debtor? Not only does section 1104(e) fail to address the role the United States trustee is to play, but 28 U.S.C. § 586, which sets forth the duties of United States trustees, was not amended to account for the newly-added section 1104(e).

In addition, section 1104(e) does not provide a remedy in the event that the United States trustee fails to move for the appointment of a chapter 11 trustee. A private party may well be able to move to compel the chapter 11 trustee to act pursuant to section 1104(e). However, if that private party is an interested party, it may be simpler to move directly for the appointment of a trustee or examiner by motion to the court under 11 U.S.C. § 1104(a).[15]

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14 *Illinois v. Wardlow*, 528 U.S. 119, 128 (2000); *United States v. Cortez*, 449 U.S. 411, 417-418 (1981).

15 11 U.S.C. § 1104(a) provides:

> At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee
>
> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor;
>
> (2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or
>
> (3) if grounds exist to convert or dismiss the case under section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate.

G. Conclusion

Section 1104(e) was introduced in response to large-scale fraud and criminal conduct. However, this section is framed in a manner that permits creditors to benefit in much smaller and lower-profile cases. While the impact of this section on creditors and the United States trustee remains uncertain, it is clear that section 1104(e) has introduced many interpretive challenges and uncertainties to chapter 11 cases. Although the courts have not yet been summoned to provide guidance with regard to this section, courts will likely have opportunities to interpret section 1104(e) and the United States trustee's duties thereunder in the near future.

III. Potential Creditor Pitfalls -- From the Obvious to the Bizarre[16]

It is particularly important to note that bankruptcy crimes are not limited to debtor/principal constituents only. There are a number of acts that creditors may employ to attempt to obtain a greater recovery than would ordinarily be received in a particular bankruptcy case. While it is clear that creditors are entitled to take all necessary steps, within the scope of the law, to protect their pecuniary interests, oftentimes creditors take additional steps that run afoul of the law. This section is dedicated to illuminating those acts that may not be taken in advancing creditors' rights.

A. Concealment of Assets, False Oaths and Claims; Bribery – 18 U.S.C. § 152

Title 18 of the United States Code governs "Crimes and Criminal Procedure." Specifically, those crimes relating to bankruptcy matters (Title 11) are enumerated in 18 U.S.C. § 152. The crimes enumerated in 18 U.S.C. § 152 are applicable to, and indeed have been applied against, creditors performing the acts identified in this section. The criminal acts enumerated in 18 U.S.C. § 152 are:

> §152. Concealment of assets, false oaths and claims, bribery
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> A person who—
>
> (1) knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States Trustee, any property belonging to the estate of a debtor;
>
> (2) knowingly and fraudulently makes a false oath or account in or in relation to any case under title 11;

16 Written by Ronald S. Gellert, Esquire, Member, Eckert Seamans Cherin & Mellott, LLC, Wilmington, Delaware. Special thanks to Diane Sirull, Esquire and Erin Pearson for their research and writing assistance.

(3) knowingly and fraudulently makes a false declaration, certificate, verification, or statement under penalty of perjury as permitted under section 1746 of title 28, in or in relation to any case under title 11;

(4) knowingly and fraudulently presents any false claim for proof against the estate of a debtor, or uses any such claim in any case under title 11, in a personal capacity or as or through an agent, proxy, or attorney;

(5) knowingly and fraudulently receives any material amount of property from a debtor after the filing of a case under title 11, with intent to defeat the provisions of title 11;

(6) knowingly and fraudulently gives, offers, receives, or attempts to obtain any money or property, remuneration, compensation, reward, advantage, or promise thereof for acting or forbearing to act in any case under title 11;

(7) in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation;

(8) after the filing of a case under title 11 or in contemplation thereof, knowingly and fraudulently conceals, destroys, mutilates, falsifies, or makes a false entry in any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor; or

(9) after the filing of a case under title 11, knowingly and fraudulently withholds from a custodian, trustee, marshal, or other officer of the court or a United States Trustee entitled to its possession, any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor,

shall be fined under this title, imprisoned not more than 5 years, or both.[17]

17 18 U.S.C. § 152 (2005).

Clearly, several of these provisions, such as subsections four (knowing presentment of false claim against estate) and five (knowing and fraudulent post-petition receipt of estate property to avoid provisions of Title 11) are aimed directly at creditors and their acts during a bankruptcy proceeding. Other subsections are generally applicable to parties involved in a bankruptcy proceeding, including creditors.

1. Filing False Claims – 18 U.S.C. § 152(4)

This subsection is straightforward. When a creditor knowingly and fraudulent submits a false proof of claim, the creditor is going to be subject to criminal liability. In fact, the penalties for such acts are relatively serious, including a fine (previously capped at $500,000) and/or imprisonment for up to five years.[18] Such penalties are purposefully severe so as to apply a distinct deterrent: "[t]hese criminal sanctions . . . are the proper remedies to be applied to creditors . . . who routinely file unlawful claims . . . . [C]reditors . . . filing overstated claims in the expectation that the claims will not be scrutinized or that their amendment when they are caught will remedy any problems that are discovered do so at their peril."[19]

2. Receipt of Estate Assets – 18 U.S.C. § 152(5)

18 U.S.C. § 152(5) describes the crime of receiving any material amount of property post-petition from the debtor with the intent to circumvent title 11. While "material" is undefined, it is clear that courts have interpreted this subsection of 18 U.S.C. § 152 broadly.[20] Further, even where the property was not technically held by a debtor at the time of transfer, to the extent that the debtor retained a property interest that could be deemed within the broad scope of 11 U.S.C. § 541, the transferee may be found criminally liable. [21] Moreover, and albeit not surprising, a court may find a creditor to be criminally liable for participating in a clandestine arrangement whereby the creditor received payment from the debtor in return for accepting the plan and influencing similarly-situated creditors to accept the plan.[22]

3. Bribery – 18 U.S.C. § 152(6)

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18 *See In re Burkett*, 329 B.R. 820, 830 n.7 (Bankr. S.D. Ohio 2005) (recognizing stiff deterrent to filing false claims).

19 *In re Shank*, 315 B.R. 799, 815−16 (Bankr. N.D. Ga. 2004).

20 *See United States v. Wernikove*, 206 F. Supp. 407, 409 (E.D. Pa. 1962) (interpreting statute broadly so as to include all forms of property received with intent to defeat the provisions of Title 11).

21 *See United States v. Cardall*, 885 F.2d 656, 676−77 (10th Cir. 1989) (upholding lower court's conviction of defendant under 18 U.S.C. § 152(5) for receiving a transfer from non-debtor account where evidence demonstrated that transferee was particularly knowledgeable of inter-company transactions and ownership rights of the funds received).

22 *See Lurie v. United States*, 20 F.2d 589, 590 (6th Cir. 1927) (noting that the creditors' plan would not have worked "without intentional and express deception of the judge of the bankruptcy court").

In addition, a creditor who receives a transfer from the debtor in return for a favorable vote on a plan may also be criminally liable for bribery under 18 U.S.C. § 152(6).[23] An offer to settle a suit pre-petition such that the creditor's settlement would not be listed on the debtor's bankruptcy schedules and/or other disclosures, with the intent to avoid a discharge of the settlement, may be deemed bribery and/or extortion that would give rise to criminal liability under 18 U.S.C. § 152(6).[24]

4. "Take Your Pick" – Conduct Which Violates Multiple Subsections Under 18 U.S.C. § 152

The United States Court of Appeals for the Seventh Circuit case titled *United States v. Knox*[25] details everything that a creditor should not do. *Knox* involved a creditor who had previously been awarded a default judgment in a civil matter prior to the debtor's bankruptcy. The creditor took extraordinary steps to attempt to recover on the judgment. Upon discovering that the debtor filed its chapter 11 petition prior to the default judgment becoming final, the creditor hired two men in the "collection" business to recover the debt. The two collection agents employed verbal threats and physical intimidation in their collection efforts; the agents "staked out" the home of the debtor's president and made multiple, unannounced visits to the debtor's offices. Cooperating with Federal Bureau of Investigation agents, the debtor's president advised the collection agents on multiple occasions that the company was in bankruptcy, that the claim would be processed in the course of the case, and that any payment outside of the case would be a criminal act for both debtor and creditor. Undeterred, the collection agents pressed for payment. Eventually, the FBI (with assistance from the debtor's president) carried out a "sting" whereby the collection agents were to have received their money, at which point the collection agents (and later the creditor) were arrested and subsequently convicted under, *inter alia*, the bankruptcy fraud provisions of 18 U.S.C. § 152.

5. Other Crimes Under 18 U.S.C. § 152

a. Bid-Rigging

In *United States v. Zehrbach*, the potential purchaser was convicted of bankruptcy fraud and conspiracy to commit bankruptcy fraud for paying other potential bidders to withdraw their bids for debtors' assets, thereby enabling purchaser to submit the sole bid at a lower value.[26]

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23 *See id.* at 590 ("Private and special payments to a creditor to induce him to vote for a composition are not in terms here forbidden, but it cannot be the intent that the minority of creditors may be coerced by a majority secured by bribery.").

24 *See Christenson v. Aiken (In re Aiken)*, 80 B.R. 971, 973 (Bankr. E.D .Mo. 1988) (noting the possibility of criminal liability; court found that debtor whose actions "amount[ed] to sketchy offers to settle the debt" was not criminally liable for bribery or extortion).

25 68 F.3d 990 (7th Cir. 1995).

26 *See United States v. Zehrbach*, 47 F.3d 1252, 1267 (3d Cir. 1995) (affirming the conviction).

b. Pre-Petition Removal of Assets

In *United States v. Sabbeth*, the debtor's principal, who questionably determined that he was owed funds from a debtor, removed assets of the debtor for his personal use prior to the company's filing chapter 11.[27] Not only did this give rise to fraudulent transfer and preference liability, but the principal was convicted of bankruptcy fraud under 18 U.S.C. § 152 as well as money laundering under 18 U.S.C. § 1956.[28]

B. Involuntary Cases – 11 U.S.C. § 303

Prior to the 2005 BAPCPA amendments, the issue of whether the filing of an involuntary case for an improper purpose gave rise to criminal liability under 18 U.S.C. § 151 *et seq.* was an open question. For instance, it had been previously suggested that "a creditor [who] initiates an involuntary petition against a debtor for the sole purpose of pressuring a debtor into paying a disputed claim" may face criminal liability.[29] On the other hand, some courts specifically noted that the sanction provisions of § 303(i) are the sole remedy for an improper involuntary filing and that there is no explicit statutory authority to impose penalties under 18 U.S.C. § 151 *et eq*.[30]

The BAPCPA amendments (18 U.S.C § 157) helped clarify the question of whether criminal liability may be imputed to a creditor who improperly brings an involuntary case.[31] This section provides:

> A person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so –
>
> (1) files a petition under title 11, <u>including a fraudulent involuntary bankruptcy petition under section 303 of such title</u>,
>
> … shall be fined under this title, imprisoned not more than 5 years, or both.[32]

Thus, while the statute remains unclear as to what amounts to a fraudulent involuntary bankruptcy petition, a creditor must be cognizant not only of the court's authority to issue civil sanctions under § 303(i), but also of the criminal liability which may follow. As such, the threat

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27 *See United States v. Sabbeth,* 125 F. Supp. 2d 33, 37−39 (E.D.N.Y. 2000) (concluding that criminal act was complete upon the transfer from the corporation to the principal and rejecting defendant's assertion that the transferred monies were his property until the trustee recovered them).

28 *See id.* (listing counts of conviction).

29 ROSEMARY WILLIAMS, 1 BANKRUPTCY PRACTICE HANDBOOK § 6:49 (2d ed.),.

30 *In re Schloss*, 262 B.R. 111, 118 (Bankr. M.D. Fla. 2000) (awarding sanctions under §303 but rejecting imposition of criminal sanctions).

31 *See* 18 U.S.C. § 157(1) (setting forth sanctions for bankruptcy fraud).

32 18 U.S.C. § 157 (emphasis added).

of criminal liability should remain a distinct factor for consideration when evaluating whether to file an involuntary case under § 303.

C. Abusive Reaffirmations – 18 U.S.C. § 158

11 U.S.C. § 158 was enacted as part of the BAPCPA amendments and specifically grants the Attorney General the responsibility of designating those individuals who will have "primary responsibility in carrying out enforcement activities in addressing violations of section 152 or 157 relating to abusive reaffirmations of debt."[33] This section specifies that the individuals with such responsibility shall be (1) "the United States attorney for each judicial district of the United States" and (2) "an agent of the Federal Bureau of Investigation for each field office of the Federal Bureau of Investigation."[34]

Courts view reaffirmation agreements as "the creditor's playthings."[35] Therefore, creditors must be cognizant of this fact and take the necessary steps to ensure that any reaffirmation agreement they propose to a debtor complies with all requirements, especially in light of 18 U.S.C. § 158. One requirement that creditors commonly do not comply with is the requirement that the reaffirmation agreement be filed with the court.[36]

Prior to the enactment of section 158, courts were split over whether 11 U.S.C. § 524 contains a private right of action for a violation of that section. In those courts that did not recognize such a private right of action, refusal to enforce the reaffirmation agreement was the only remedy available to "punish" a creditor who did not comply with applicable requirements.

In *Bessette v. Avco Financial Services., Inc.*, the United States Court of Appeals for the First Circuit was faced with a reaffirmation agreement that did not comply with the necessary conditions of 11 U.S.C. § 524.[37] Specifically, the creditor did not file the reaffirmation agreement with the court, and the reaffirmation agreement did not "advise the debtor[38] that the agreement may be rescinded within sixty days of the date of the filing with the court."[39] The First Circuit held that 11 U.S.C. § 105 "provides a bankruptcy court with statutory contempt powers" and that "[t]hose contempt powers inherently include the ability to sanction a party."[40] As such, the Court held that courts may use their contempt powers to award monetary relief to a

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33 18 U.S.C. § 158.
34 *Id.*
35 *See Sears, Roebuck & Co. v. Spivey*, 265 B.R. 357, 366 (E.D.N.Y. 2001) (stating that because reaffirmation agreements require creditor consent, they are regarded as "creditor's playthings").
36 *See* 11 U.S.C. § 524(c)(3) (2001) (stating that reaffirmation agreements need to be filed with the court to be enforceable).
37 *See Bessette v. Avco Fin. Servs., Inc*., 230 F.3d 439, 444 (1st Cir. 2000) (stating that "[t]here is no dispute that the reaffirmation agreement involved in this case falls short of the § 524 criteria").
38 While 11 U.S.C. § 524(c) previously required that a reaffirmation agreement contain language advising the debtor that it could be rescinded at any time prior to discharge or within sixty days after the agreement was filed with the court, under BAPCPA, this is no longer a requirement.
39 *Id.*
40 *Id.* at 444−48.

debtor.[41] However, in *Pertuso v. Ford Motor Credit Co.*[42], the United States Court of Appeals for the Sixth Circuit addressed a situation similar to the one described in *Bessette* (i.e., a reaffirmation agreement that was not filed with the court). The Sixth Circuit held that 11 U.S.C. § 105 does not grant the court the power to sanction a party in that context.[43]

Despite the split in authority over whether a creditor that violates 11 U.S.C. § 524 can be civilly sanctioned, 18 U.S.C. § 158 makes it clear that a creditor who abuses reaffirmation of debt will face criminal prosecution. Therefore, creditors must be careful not to violate sections 152 and 157.

D. Actions to Force Settlement – 11 U.S.C. § 727

In addition to the foregoing concerns, creditors who wish to extract some benefit or leverage from bringing an action for denial of discharge pursuant to 11 U.S.C. § 727 need to be particularly careful when contemplating a settlement of that action with the debtor. In essence, the creditor who brings such an action is viewed as a trustee with an obligation to ensure that the bad acts of a debtor prohibit the discharge of all debts (as opposed to an action arising under section 523 where the non-dischargeability results in the denial of discharge as to one specific claim).

Thus, where a creditor/plaintiff in a section 727 action reaches a settlement which, in return for dismissing the action, benefits only that creditor (as opposed to the entire creditor body), such action may be contrary to public policy and possibly could be referred for further criminal investigation under 18 U.S.C. § 152(5, 6).[44]

IV. Ethical Considerations for Attorneys[45]

Today's bankruptcy attorneys face a multitude of ethical responsibilities when representing their clients. Indeed, bankruptcy attorneys representing an entity in the zone of

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41 *See id.* at 445 (finding that courts have the power to award monetary relief).

42 233 F.3d 417 (6th Cir. 2000).

43 *See id.* at 423 (rejecting the argument that "§ 105 could . . . be invoked to remedy breaches of § 363 . . .").

44 *See* 18 U.S.C. § 152 (5, 6) (creating sanctions for receipt of value outside of Title 11 provisions or for advantage for forbearance); *Burns v. Hassan (In re Hassan)*, 2005 Bankr. Lexis 2168, *2 (Bankr. N.D. Ga.) ("Discharge is not a commodity subject to negotiation. Such an exchange may be grounds for a criminal action."); *Royal Bank of Pa. v. Grosse (In re Grosse)*, 1997 Bankr. Lexis 2351*14−16 (Bankr. E.D. Pa.) (citing cases finding that negotiated discharges are against public policy); *Moister v. Vickers (In re Vickers)*, 176 B.R. 287, 290 n. 10 (Bankr. N.D. Ga. 1994) (stating that "[d]ischarges are not property of the estate and are not for sale"); *In re Moore*, 50 B.R. 661, 664 (Bankr. E.D. Tenn. 1985) (noting that, because of the influence of public policy upon discharges, discharges cannot be part of contract negotiations); *see also In re Levy*, 127 F.2d 62, 63 (3d Cir. 1942) (deeming illegal cash offer from third party to creditors committee to drop turnover proceeding in exchange for committee's agreement not to contest debtor's discharge).

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insolvency, the debtor-in-possession, a trustee, a creditor, or an official creditors' committee owe extensive ethical and fiduciary duties to their clients, as defined by the Bankruptcy Code, applicable bankruptcy case law, the American Bar Association's Model Rules of Professional Conduct, and applicable state law. For example, one of the greatest professional nightmares a chapter 11 debtor's attorney can face is discovering, during a bankruptcy case, that the people running the debtor are crooks. Such a discovery should immediately cause the attorney to seriously consider whether he should withdraw from representing the debtor (assuming that the individuals acting as debtors-in-possession do not take steps to rectify their improper actions, this action is probably inevitable). All too often, even seasoned bankruptcy attorneys fail to recognize these ethical pitfalls when they surface during the course of the representation. The failure of counsel to behave prudently can lead to dire consequences, including ethics complaints and disbarment proceedings. To be sure, a number of high-visibility, adverse decisions resulting in disqualification of counsel, denial of compensation, and disgorgement of fees have made bankruptcy attorneys more cautious than ever in the way they approach new engagements. Consequently, bankruptcy attorneys must educate themselves about the scope of their ethical duties and the types of issues that are likely to face during the engagement.

ETHICAL OBLIGATIONS OF ATTORNEYS

A. Ethical Duties Under The Model Rules

1. Duty of Competent Representation

MRPC 1.1 provides that a lawyer shall provide competent representation to a client. This requires legal knowledge, skill, thoroughness, and preparation reasonably necessary to handle the representation. In the bankruptcy context, a lawyer who is unfamiliar with the Bankruptcy Code would likely be breaching his duty of representation if he was to undertake the representation, as bankruptcy counsel, of a corporation who is preparing to, or has, filed for bankruptcy protection.

2. Duty of Diligence

MRPC 1.3 requires that a "lawyer act with reasonable diligence and promptness in representing a client."

3. Duty of Communication

MRPC 1.4 requires a lawyer to maintain contact with the client. The lawyer must obtain the client's consent when necessary, discuss the objectives of the representation and how they are to be accomplished, and inform the client about the status of the matter. The attorney must keep the client *reasonably* informed of the status of the case. Also, an attorney must return telephone calls or emails from his client and respond to requests for information from the client.

4. Duty to Maintain Attorney-Client Privilege / Confidentiality

MRPC 1.6 requires that a lawyer not disclose any information relating to the representation of a client without the client's consent, implied authorization in order to carry out the representation or the disclosure is permitted to, *inter alia*, "prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; . . . prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services; . . . to secure legal advice about the lawyer's compliance with these Rules; . . . to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or . . . to comply with other law or a court order." *See generally Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. at 454 (counsel for debtors in possession owe a duty to maintain client confidentiality).

5. Duty to Abstain from Conflicts of Interest (MRPC 1.7, 1.8, 1.9 and 1.10)

B. Duties Arising Under the Bankruptcy Code

1. Debtor's Retention of Professionals Under 11 U.S.C. § 327(a): Duties of "Disinterestedness" and "No Adverse Interest."

To establish eligibility for retention under section 327, the professional: (1) must be "disinterested"; and (2) must not hold or represent any interest adverse to the estate.

Under amended section 101(14), the term "disinterested person" means a person that (a) is not a creditor, an equity security holder, or an insider; (b) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and (c) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, in connection with, or interest in, the debtor, or for any other reason. (Note that the BAPCPA has deleted all prior references to investment bankers for purposes of the "disinterested" standard). An attorney for a debtor-in-possession or creditors' committee must be disinterested and not hold any interest adverse to the bankruptcy estate in order to ensure that the lawyers provide undivided loyalty and untainted advice and assistance in furtherance of their fiduciaries responsibilities. *See In re EZ Links Golf, LLC,* 317 B.R. 858, 862 (Bankr.D.Colo. 2004) (debtor's counsel); *In re Greystone Holdings, LLC*, 305 B.R. 456, 460 (Bank.N.D.Ohio 2003) (citing *Kravit, Gass & Weber, S.C. v. Michel (In re Crivello)*, 134 F.3d 831, 836 (7th Cir. 1998) (counsel for creditors' committee).

"Adverse interest" has been defined as either: (i) the possession or assertion of any economic interest that would tend to lessen the value of the bankruptcy estate or create an actual or potential dispute with the estate as a rival claimant; or (ii) a predisposition of bias against the estate. *See In re Granite Partners, L.P.*, 219 B.R. 22, 23 (Bankr. S.D.N.Y. 1998).

Under Federal Rule of Bankruptcy Procedure 2014(a), the employment application and the accompanying verified statement must disclose any potential conflicts of interest. Professionals should err on the side of full disclosure since the sanctions for failing to disclose fully and properly all connections include disqualification from representation and denial of compensation. *See In re Granite Sheet Metal Works, Inc.*, 159 B.R. 840, 847-48 (Bankr. S.D. Ill. 1993) (disqualification of counsel and disgorgement of fees were appropriate where attorneys failed to disclose the extent of their pre-petition representation of the debtor).

2. Official Committee's Retention of Professionals Under 11 U.S.C. § 1103

Section 1103 authorizes an official creditors' committee to employ counsel and other professionals provided that the professionals who are employed may not, while employed by the committee, "represent any other entity having an adverse interest in connection with the case."

Section 1103(b) does not disqualify a professional person from representing a committee appointed under section 1102 solely because the professional holds an interest adverse to the estate or is not disinterested under section 101(14). *See In re Enron Corp.*, 2002 WL 32034346 (Bankr. S.D.N.Y. 2002).

3. Counsel's Solicitation of Unsecured Creditors Committee Representation

The appointment as counsel to the official committee of unsecured creditors brings with it many ethical concerns. However, these concerns are not just limited to post-retention matters; the conduct of the lawyer or law firm must be considered from the moment that the decision is made for the firm or lawyer to pursue the representation of the particular committee. Attorneys must consider the rules of ethics when soliciting potential members of the committee for retention as counsel, or risk facing disciplinary action.

- **QUERY**: Can counsel seeking to be engaged by the committee (i) "cold call" committee members?; (ii) advertise directly to committee members?; (iii) take committee members to dinner?; or (iv) otherwise court the committee to obtain the engagement?

MRPC 7.1 through 7.4 are implicated when considering solicitation or advertising by an attorney. While the Model Rules do not prohibit solicitation or advertising through written, recorded or electronic communication, s*ee* Model Rule 7.2(a), lawyers are specifically prohibited from making a pitch to a potential client in person, over the telephone, or through e-mail unless certain exceptions apply. *See* Model Rule 7.3. The exceptions are: (i) the person contacted is a

lawyer; OR (ii) the person contacted has a family, close personal, or prior professional relationship with the lawyer.

Based on the Model Rules, contacting a former client to express an interest in being appointed as counsel would not constitute an ethical violation; however, under the Model Rules, "cold-calling" a prospective committee member may constitute an ethical violation, for which the lawyer/law firm may be held accountable.

If Model Rule 7.3(a) is read literally, it could provide a way around the prohibition against contacting non-clients because the prospective committee member is not itself the prospective client. A literal reading of Model Rule 7.3 could be used to argue that a lawyer could make a written "pitch" for professional employment to a potential committee member that is not a client or former client (so long as there is no material misrepresentation or materially misleading information).

Model Rule 7.2(b) provides that "[a] lawyer shall not give anything of value to a person for recommending the lawyer's legal services." Thus, a lawyers are probably violating Model Rule 7.2(b) when they buy dinner or drinks or provide free seminars and/or advice to a potential committee member for the sole purpose of having the person recommend them for the position of committee counsel.

C. Fiduciary Duties of Debtor's Counsel

Counsel to an entity in the zone of insolvency, the debtor in possession ("DIP"), or a trustee owe extensive fiduciary duties to their clients, as defined by the Bankruptcy Code (and related case law), the Model Rules of Professional Responsibility, and applicable state law. *See ICM Notes, Ltd. v. Andrews & Kurth, LLP*, 278 B.R. 117, 126 (S.D. Tex. 2002); *Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. 434, 465 (D. Utah 1998); *In re Sidco, Inc.*, 173 B.R. 194, 196 (E.D. Cal. 1994).

Debtor's counsel has extensive duties, including (but not limited to): (i) Duty of Loyalty - *In re R&R Associates of Hampton,* 402 F.3d 257, 266 (1st Cir. 2005) (This duty is also owed to a creditors' committee by a lawyer retained to represent the committee); *Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. 434, 454 (D. Utah 1998) (The duty of loyalty includes the duty to maintain the confidentiality of the client and the duty to prevent any conflict of interest.); (ii) Duty to Inform of DIP's Violation of its Fiduciary Duty to Estate and Beneficiaries – *In re JLM, Inc.*, 210 B.R. 19, 26 (2d Cir. BAP 1997); *In re Sky Valley Inc.*, 135 B.R. 925, 937-38 (Bankr. N.D. Ga. 1992) (duty to disclose DIP's unauthorized use of estate funds); (iii) Duty to "Police" the Debtor – *In re Dieringer*, 132 B.R. 34 (Bankr. N.D. Cal. 1991); (iv) Duty to Maximize Estate Assets – *In re Keene Corp*., 205 B.R. 690, 691 (Bankr. S.D.N.Y. 1997).

D. Fiduciary Duties of Committee Counsel

1. Scope of Fiduciary Duty

Counsel for an creditors committee of unsecured creditors owes a fiduciary duty to all unsecured creditors. *In re General Homes Corp.*, 181 B.R. 87 (Bankr. S.D. Tex. 1994).

2. Duties of Access to Information and Solicitation of Comments

The BAPCPA amended 11 U.S.C. § 1102(b)(3) to provide:

> A committee appointed under subsection (a) shall-
>
> (A) provide access to information for creditors who-
>
> (i) hold claims of the kind represented by that committee; and
>
> (ii) are not appointed to the committee;
>
> (B) solicit and receive comments from the creditors described in subparagraph (A); and
>
> (C) be subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).

Prior to the BAPCPA, it was established that the appointed creditors' committee held an attorney-client privilege with its attorney. *See*, *e.g.*, *In re Subpoenas Duces Tecum Dated March 16, 1992*, 978 F. 2d 1159 (9th Cir. 1992); *In re JMP Newcor Intern. Inc.*, 204 B.R. 963 (Bankr. N.D. Ill. 1997); *Matter of Baldwin United Corp.*, 38 B.R. 802 (Bankr. S.D. Ohio 1984).

3. Effect of the BAPCPA

The committee is now required to provide all non-committee member constituents with access to information.

The committee is now required to solicit and receive comments from their non-committee member constituents.

The committee may now be subject to a court order that compels additional reports or disclosures to creditors represented by the Committee, but are not members of the Committee.

The flow of information and discovery between a debtor and the creditors' committee may be stalled as a result of the committee's requirement to provide information to its non-committee member constituents. Committees may not be as willing to enter into confidentiality

agreements with a debtor because they cannot guarantee that the information received from the debtor will remain confidential if a non-committee member creditor seeks information from the committee. As a result of the disclosure requirement, debtors may choose not to participate in an open exchange of information with the committee until such time as the court has entered an order stating that the committee is not required to provide confidential information to its non-member constituents, or another agreement has been reached that is acceptable to both the debtor and the committee.

Courts will be required to address the competing policy interests in terms of the disclosure of the information to those creditors who are not on the creditors' committee.

- *In re REFCO, Inc.*, 336 B.R. 187 (Bankr. S.D.N.Y. 2006)

The United States Bankruptcy Court for the Southern District of New York issued an opinion regarding the requirement of the committee to disclose information to its non-member constituents pursuant to 11 U.S.C. § 1102(b)(3). The court held that the committee would not be required to disclose confidential and non-public, proprietary, privileged, and other protected information, without further court order; *however*, with respect to all other information, the committee would be required to proactively provide specified types of information on a committee-run website. The court also established a protocol for handling disputes between the committee and its non-member constituents regarding information requested by the non-member creditor.

- *In re FLYi, Inc., et al.*, Case No. 05-20011 (Bankr. D. Del. 2005)

In the Independence Air bankruptcy case, the Debtors proactively filed a motion seeking the entry of an order providing that any creditors' committee appointed pursuant to 11 U.S.C. § 1102 is not authorized or required pursuant to 11 U.S.C. § 1103(b)(3)(A) to provide access to the debtors' confidential information or to provide privileged information to any creditor that the committee represents. Only after the United States trustee had appointed an official committee did the court grant the motion, defining confidential information and privileged information (for the purposes of the order) and expressly stating what did not constitute "confidential information" under the order. The court specifically held that the committee was not required to utilize a website to disseminate information to its constituency or to respond to inquiries and comments received from them. The court also stated that the committee was to use its "reasonable business judgment" in responding to such inquiries and comments.

APPLICABILITY OF ATTORNEY-CLIENT PRIVILEGE

A. "Noisy" Withdrawal - Is Counsel for the Debtor In Possession Required to Inform the Court of Misbehavior by Management?

An attorney may not reveal the client's confidential information, and certainly must prevent disclosure of matters within the attorney-client privilege. *See* ABA Model Rules of Professional Conduct ("MRPC") 1.6. Moreover, the duty of undivided loyalty is part of the fiduciary duties owed by attorneys to the clients. As a result, professionals face an ethical dilemma when the officers running the debtor are corrupt.

There are certain exceptions to the rules of confidentiality and the attorney-client privilege, which may alleviate ethical problems posed by a misbehaving client.

- In a non-litigation context, if the client requests the lawyer to disclose confidential information that the lawyer knows is false, the lawyer is required to advise the client that the representation will be terminated if the client further insists upon the lawyer's using the false information. *See* MRPC 1.16 (authorizing withdrawal of counsel where counsel knows client is contemplating criminal activity). If the client proceeds with committing the fraud, the lawyer must terminate the representation, but cannot disclose the confidential information. If the lawyer believes that the client is continuing to perpetuate a fraud, counsel may additionally need to disavow any opinions or other documents he may have provided to third parties. The scope of the withdrawal and disavowal is subject to various interpretations. *See, e.g., In re O.P.M. Leasing Servs., Inc.*, 13 B.R. 64 (S.D.N.Y. 1981).

- In a litigation matter, counsel also has options to overcome ethical issues when they arise. The attorney is prohibited from: (1) making a false statement of material fact or law to a tribunal; (2) failing to disclose a material fact to a tribunal when disclosure is necessary to avoid assisting a criminal or fraudulent act by the client; (3) offering evidence that the attorney knows to be false. *See* MRPC 3.3. Thus, where the client does not take steps to rectify its improper actions, the attorney may withdraw from the representation. *See* MRPC 1.16(a)(1) (requiring an attorney to withdraw from representing a client "if the representation will result in violation of the Rules of Professional Conduct or other law"). If the prospective ethical issue involves perjury or a fraud on the court, the attorney has an obligation to "rat" on his client. *See Nix v. Whiteside*, 475 U.S. 157, 168-69 (1986) ("[There is a] special duty of an attorney to prevent and disclose frauds upon the court.").

Where a client refuses to correct the false testimony or disclose the fraud, a "noisy" withdrawal may be permitted. A noisy withdrawal is a withdrawal from the representation of a client accomplished by a disavow of work product provided by the attorney. *See* ABA Formal Opinion 92-366. An attorney can make a noisy withdrawal only if the attorney's work product is being used or is intended to be used in a *future* fraud or future criminal activity. Counsel may accomplish a noisy withdrawal by immediately moving to withdraw from the representation upon the discovery of the fraud and the failure of the debtor to rectify such fraud.

After withdrawing from a case, a lawyer is required to take reasonable steps to protect the client's interests, including (a) giving the client reasonable notice of withdrawal; (b) allowing the client time to employ replacement counsel; (c) cooperating with replacement counsel; (d) returning property and papers that belong to the client; and (e) refunding any unearned advance fees. *See* MRPC 1.16(d).

- *In re The Phoenix Group Corp.*, 305 B.R. 447 (Bankr. N.D. Tex. 2003)

Chapter 11 debtors' counsel represented the debtors in a hotly-contested chapter 11 proceeding. Counsel for the debtors moved twice to be permitted to withdraw for ethical reasons. In one of the motions counsel noted that the debtors' principal was demanding that debtors' counsel take actions and pursues strategies that counsel found to be "legally and ethically improper. The second motion to withdraw was granted. Counsel ultimately filed a final fee application and the principals of their former client, allegedly on behalf of the debtors, objected arguing (1) the debtors' counsel failed to properly object to the plan of another related chapter 11 debtor (the "Related Case"); and (2) the debtors' counsel failed to pursue the appointment of a trustee in the Related Case. The court overruled the objection after finding that: (i) the debtors could not get along with any attorney, as six of its 20 largest creditors were law firms; (ii) the debtors did in fact attempt to require their counsel take improper actions; and (iii) the debtors' counsel properly exercised its professional judgment in deciding not to pursue the actions which were the basis of objection to the fee application.

B. Difficult "Noisy" Withdrawal Questions

When misbehavior by management of the debtor is more subtle, such as questionable expenditures, counsel's decision whether to inform is more difficult. In a chapter 11 case the debtor in possession's attorney represents a client that has attributes of both a fiduciary (a trustee) and a self-interested litigant (a debtor and a party in interest). The common law fiduciary duties of care and loyalty impose standards of conduct on all agents for the debtor. Attorneys are included in the list of agents having fiduciary duties. As such, one of the fiduciary duties that estate counsel has in a bankruptcy case is the duty to report improper conduct by the DIP and its management to the Bankruptcy Court or other authorities. *See Zeisler & Zeisler v. Prudential Ins. Co. (In re JLM, Inc.)*, 210 B.R. 19, 26 (2d Cir. 1997); *In re Bonneville Pacific Corp.*, 196 B.R. 868, 886-88 (Bankr. D. Utah 1996); *Coldwell Banker Residential Real Estate v. Berner*, 609 N.Y.S.2d 948, 951 (N.Y. App. Div. 1994) (an agent breaches his fiduciary duty of loyalty "by failing to disclose information obtained during the period of engagement which affects a transaction in which the agent is engaged, so that the principal may take steps to protect his or her interests."); *see also In re Brennan*, 187 B.R. 135, 150 (Bankr. D.N.J. 1995) (noting that professionals will be obligated to report Debtor's breach); *In re Fivers*, 167 B.R. 288, 301 (Bankr. N.D. Ga. 1994) (noting that attorney, as fiduciary of estate, must further estate's interest); *In re Barrie Reed Buick-GMC Inc.*, 164 B.R. 378, 381 (Bankr. S.D. Fla. 1984) (noting the duty of debtor's counsel to bring breaches

of fiduciary to attention of court). *See generally In re Love*, 163 B.R. 164 (Bankr. D. Mont. 1993); *In re Granite Sheet Metal Works Inc.*, 159 B.R. 840 (Bankr. S.D. Ill. 1993); *In re United Utensils Corp.*, 141 B.R. 306 (Bankr. W.D. Pa. 1992); *In re Wilde Horse Enterprises Inc.*, 136 B.R. 830 (Bankr. C.D. Cal. 1991); *In re Sky Valley Inc.*, 135 B.R. 925 (Bankr. N.D. Ga. 1992); *In re Rusty Jones Inc.*, 134 B.R. 321 (Bankr. N.D. Ill. 1991).

One of the first cases to discuss estate counsel's duty to report wrongdoing on the part of the DIP was *In re Rusty Jones Inc.*, 134 B.R. 321 (Bankr. N.D. Ill. 1991) where the court denied 60% of the requested fees of estate counsel due to numerous violations of counsel's fiduciary duty, including counsel's failure to inform the court of clear insider misconduct relating to the post-petition operation of the estate's business. Since *Rusty Jones*, opinions have considered this question and have held that estate counsel has breached, or would breach, the fiduciary duty by failure to disclose.

Estate counsel could make a noisy withdrawal in cases involving serious client misconduct. But what if the judge doesn't permit the withdrawal of representation? Or what if the judge asks “why”?

Requiring attorneys for debtors in possession to inform on their clients raises several issues. The first issue is whether the attorney has any discretion to determine the seriousness of the misconduct. The second issue concerns disagreements over estate administration. A decision to sell or retain business assets is affected by whether the person making the decision believes in the viability of the business. Is a debtor in possession who believes, despite continuing losses, that a business can be turned around, breaching a fiduciary duty, thus triggering counsel's obligation to inform the court? A third issue concerns the adversarial process itself. All other parties in the adversarial process are entitled to rely on their counsel's protecting their confidential information.

BAPCPA’S NEW DRA DISCLOSURE REQUIREMENTS: 11 U.S.C. § 527(a)(2)

A. Overview

BAPCPA has established considerable restrictions on the activities of debt relief agencies (“DRA”). *See* 11 U.S.C. §§ 526, 527 and 528. It requires DRAs who render "bankruptcy assistance" to enter written contracts with "assisted persons," disclose the extent of services provided and fees charged, and disclose clearly and conspicuously in all advertising that their services contemplate bankruptcy. *See* 11 U.S.C. § 528. It also requires DRAs to provide a detailed written notice to all "assisted persons" of the disclosure requirements of the Bankruptcy Code, the obligation of accuracy and truthfulness on those disclosures, and that failure to comply with those requirements carries potential civil and criminal sanctions. *See* 11 U.S.C. § 527. DRAs are prohibited from failing to provide the services they contracted to provide, counseling any person to make false statements, or advising the person "to incur more debt in contemplation

of such person filing a case under this title or to pay an attorney or bankruptcy petition preparer[.]" *See* 11 U.S.C. § 526(a)(4).

The disclosures under section 527 appear to be required in consumer cases only (rather than in business cases). "Debt relief agency" is defined in section 101(12A) as "any person who provides any 'bankruptcy assistance' to an assisted person in return for the payment of money or other valuable consideration or who is a bankruptcy petition preparer." "Assisted person" is defined in new section 101(3) as "any person whose debts consist primarily of consumer debts and the value of whose nonexempt property is less than $150,000." Therefore, DRAs who represent owners of businesses and individuals whose nonexempt property is greater than $150,000 would not be covered.

- **QUERY**: Is a bankruptcy lawyer a debt relief agency under BAPCPA? The definition in section 101 seems broad enough to include attorneys; however, at least one court has issued a *sua sponte* ruling determining that attorneys are not "debt relief agencies" as that term is used in BAPCPA. *See In re Attorneys at Law and Debt Relief Agencies*, 332 B.R. 66 (Bankr. S.D. Ga. 2005). *But see In re McCartney*, 336 B.R. 588 (Bankr. M.D. Ga. 2006) (Attorney moved for determination that attorneys practicing before bankruptcy court were not "debt relief agencies," and were not subject to obligations imposed on debt relief agencies under BAPCPA; however, bankruptcy court held that motion did not present live "case or controversy," over which it could exercise jurisdiction.).

B. DRA Disclosure Requirements -- 11 U.S.C. § 527

1. Statutory Text

Section 527(a)(2) requires DRAs to tell their clients about the dangers of bankruptcy and to explain bankruptcy alternatives. These disclosures must be made no later than three days after bankruptcy assistance is first offered to the debtor. Specifically, section 527(a)(2) sets forth a series of "disclosures" which DRAs must provide to all assisted persons being provided bankruptcy assistance (which would include creditors). Significantly, section 526(c) authorizes the Court to impose civil liability for violation of duties imposed upon debt relief agencies.

11 U.S.C. § 527 provides (emphasis added):

> (a) A debt relief agency providing bankruptcy assistance to an assisted person shall provide—
>
> (1) the written notice required under section 342(b)(1) [11 USC § 342(b)(1)]; and

(2) to the extent not covered in the written notice described in paragraph (1), and not later than 3 business days after the first date on which a debt relief agency first offers to provide any bankruptcy assistance services to an assisted person, a clear and conspicuous written notice advising assisted persons that—

(A) all information that the assisted person is required to provide with a petition and thereafter during a case under this title is required to be complete, accurate, and truthful;

(B) all assets and all liabilities are required to be completely and accurately disclosed in the documents filed to commence the case, and the replacement value of each asset as defined in section 506 [11 USC § 506] must be stated in those documents where requested after reasonable inquiry to establish such value;

(C) current monthly income, the amounts specified in section 707(b)(2) [11 USC § 707(b)(2)], and, in a case under chapter 13 of this title [11 USC §§ 1301 et seq.], disposable income (determined in accordance with section 707(b)(2) [11 USCS § 707(b)(2)]), are required to be stated after reasonable inquiry; and

(D) information that an assisted person provides during their case may be audited pursuant to this title, and that failure to provide such information may result in dismissal of the case under this title or other sanction, including a criminal sanction.

(b) A debt relief agency providing bankruptcy assistance to an assisted person shall provide each assisted person at the same time as the notices required under subsection (a)(1) the following statement, to the extent applicable, or one substantially similar. The statement shall be clear and conspicuous and shall be in a single document separate from other documents or notices provided to the assisted person:

"IMPORTANT INFORMATION ABOUT BANKRUPTCY ASSISTANCE SERVICES FROM AN ATTORNEY OR BANKRUPTCY PETITION PREPARER.

"If you decide to seek bankruptcy relief, you can represent yourself, you can hire an attorney to represent you, or you can get

help in some localities from a bankruptcy petition preparer who is not an attorney. THE LAW REQUIRES AN ATTORNEY OR BANKRUPTCY PETITION PREPARER TO GIVE YOU A WRITTEN CONTRACT SPECIFYING WHAT THE ATTORNEY OR BANKRUPTCY PETITION PREPARER WILL DO FOR YOU AND HOW MUCH IT WILL COST. Ask to see the contract before you hire anyone.

"The following information helps you understand what must be done in a routine bankruptcy case to help you evaluate how much service you need. Although bankruptcy can be complex, many cases are routine.

"Before filing a bankruptcy case, either you or your attorney should analyze your eligibility for different forms of debt relief available under the Bankruptcy Code and which form of relief is most likely to be beneficial for you. Be sure you understand the relief you can obtain and its limitations. To file a bankruptcy case, documents called a Petition, Schedules and Statement of Financial Affairs, as well as in some cases a Statement of Intention need to be prepared correctly and filed with the bankruptcy court. You will have to pay a filing fee to the bankruptcy court. Once your case starts, you will have to attend the required first meeting of creditors where you may be questioned by a court official called a 'trustee' and by creditors.

"If you choose to file a chapter 7 case, you may be asked by a creditor to reaffirm a debt. You may want help deciding whether to do so. A creditor is not permitted to coerce you into reaffirming your debts.

"If you choose to file a chapter 13 case in which you repay your creditors what you can afford over 3 to 5 years, you may also want help with preparing your chapter 13 plan and with the confirmation hearing on your plan which will be before a bankruptcy judge.

"If you select another type of relief under the Bankruptcy Code other than chapter 7 or chapter 13, you will want to find out what should be done from someone familiar with that type of relief.

"Your bankruptcy case may also involve litigation. You are generally permitted to represent yourself in litigation in bankruptcy

court, but only attorneys, not bankruptcy petition preparers, can give you legal advice.".

(c) Except to the extent the debt relief agency provides the required information itself after reasonably diligent inquiry of the assisted person or others so as to obtain such information reasonably accurately for inclusion on the petition, schedules or statement of financial affairs, a debt relief agency providing bankruptcy assistance to an assisted person, to the extent permitted by nonbankruptcy law, shall provide each assisted person at the time required for the notice required under subsection (a)(1) reasonably sufficient information (which shall be provided in a clear and conspicuous writing) to the assisted person on how to provide all the information the assisted person is required to provide under this title pursuant to section 521 [11 USC § 521], including—

(1) how to value assets at replacement value, determine current monthly income, the amounts specified in section 707(b)(2) [11 USC § 707(b)(2)] and, in a chapter 13 case, how to determine disposable income in accordance with section 707(b)(2) [11 USC § 707(b)(2)] and related calculations;

(2) how to complete the list of creditors, including how to determine what amount is owed and what address for the creditor should be shown; and

(3) how to determine what property is exempt and how to value exempt property at replacement value as defined in section 506 [11 USC § 506].

(d) A debt relief agency shall maintain a copy of the notices required under subsection (a) of this section for 2 years after the date on which the notice is given the assisted person.

2. Analysis of DRA Disclosure Requirements

First, under section 527(a)(1), the assisted person must be given the written notice required under section 342(b)(1) (despite the fact that section 342 requires this notice to be given by the clerk of the court). Section 527 only mentions a portion of the notice required under section 342 (evidently omitting the portion required by section 342(b)(2)).

Second, section 527(a)(2) provides that to the extent not covered by the section 342(b)(1) notice, and within 3 days of when the DRA first offers to provide bankruptcy assistance services

to an assisted person (including a creditor or landlord) a clear and conspicuous notice containing various other pieces of information (which is reprinted in section 527) must also be provided. For example, the notice is to inform the debtor that replacement value of each asset as defined in section 506 must be stated where requested in the "documents filed to commence the case" after reasonable inquiry to establish that value. Note however that the document filed to commence the case is the petition, which requires no property valuation; consequently, the required statement may be misleading.

Third, section 527(b) states that a DRA must provide the assisted person a statement about "bankruptcy assistance services." This statement must be provided at the time of notice under section 527(a)(1) (but no time requirement is set in section 527(a)(1), which refers to the clerk's notice under section 342(b)(1)). Under section 342, the clerk is required to give its notice before commencement of the case.

- **QUERY:** If a creditor who is an assisted person first consults an attorney after the commencement of the case, is it impossible for the attorney to give timely notice to the creditor? Could this cause attorneys to refuse to accept an engagement because they cannot comply with the provision?

Thus, it appears that the following disclosures/notices must be given to all assisted persons being provided bankruptcy assistance under BAPCPA:

- Notice mandated by section 342(b)(1) and section 527(a)(1) – purposes, benefits and costs of bankruptcy.

- Notice mandated by section 527(a)(2) – notice of mandatory disclosure to consumers who contemplate filing bankruptcy.

- Notice mandated by section 342(b)(2) – notice that fraud and concealment are prohibited.

- Notice mandated by section 527(b) – information about bankruptcy assistance services.

H

In re Crown Vantage, Inc.
N.D.Cal.,2003.
Only the Westlaw citation is currently available.
United States District Court,N.D. California.
In re: CROWN VANTAGE, INC., Debtor.
No. 02-3836 MMC.

Sept. 25, 2003.

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Randall J. Newsome, Oakland, CA, pro se.
USBC Manager, Oakland, CA, pro se.

ORDER GRANTING IN PART AND DENYING IN PART DEFENDANTS' MOTIONS TO DISMISS; DEFERRING RULING ON CERTAIN ISSUES
MAXINE M. CHESNEY, J.

(Docket Nos. 83, 84, 86, 89, 90, 96, 97)

***1** The above-titled consolidated proceeding consists of three matters that previously were pending in the United States Bankruptcy Court for the Northern District of California, as part of *In re Crown Vantage, Inc.*, a Chapter 11 proceeding filed by Crown Vantage, Inc. ("Crown Vantage") and Crown Paper Company ("Crown Paper").[FN1] The three matters are: (1) *Fort James Corporation v. Crown Vantage, Inc., et al.*, C 02-3838 ("the Fort James case"); (2) *Crown Paper Co., et al., v. Fort James Corp., et al.*, C 02-3839 MMC ("the Crown Vantage case"); and (3) *Crown Paper Liquidating Trust v. PricewaterhouseCoopers, et al.*, C 02-3836 MMC ("the Liquidating Trust case").

FN1. By orders filed April 23, 2002 and August 8, 2002, the bankruptcy court certified the three matters to the District Court for withdrawal of the reference pursuant to Bankruptcy Local Rule 9015-2, and on April 16, 2003, the consolidated proceeding was reassigned to the undersigned.

Before the Court is the motion of defendants Fort James Corporation, Fort James Operating Company, Fort James Fiber Company, and Fort James International Holdings, Ltd. (collectively, "Fort James") to dismiss the First Amended Complaint in the Crown Vantage case ("the FJ FAC"). Also before the Court are nine motions to dismiss the First Amended Complaint in the Liquidating Trust case ("the PWC FAC"), filed, respectively, by the following defendants: (1) PricewaterhouseCoopers LLP, f/k/a Coopers & Lybrand ("PWC"); (2) Ernst & Young LLP ("E & Y"); (3) McGuireWoods LLP, as successor to McGuire Woods Battle & Boothe, LLP ("McGuire Woods"); (4) Merrill Lynch & Co., Merrill Lynch Pierce Fenner & Smith, (collectively, "Merrill Lynch") and Salomon Brothers ("Salomon"); (5) Credit Suisse First Boston Corporation, as successor to Donaldson, Lufkin & Jenrette ("DLJ"); (6) Houlihan Lokey Howard & Zukin ("Houlihan Lokey"); (7) Ernest Leopold ("Leopold"); (8) Clifford Cutchins ("Cutchins"), Stephen Hare ("Hare"), and Robert C. Williams ("Williams"); and (9) William Daniel ("Daniel"), Joseph T. Piemont ("Piemont"), and E. Lee Showalter ("Showalter").

On August 15, 2003, the motions came on regularly for hearing, at which time all parties appeared through their counsel of record. Having considered the papers filed in support and in opposition to the motions, and the arguments of counsel, the Court rules as follows.

FACTUAL BACKGROUND

Crown's [FN2] claims arise out of a series of transactions, which Crown refers to as the "Spin," and from the aftermath of those transactions. In the pleadings, Crown defines the "Spin" as "a scheme by Fort James [ ] to unload vastly over-valued but under-performing assets onto Crown, and to cause Crown to borrow well over half a billion dollars, all of which monies were then taken by Fort James, while Crown remained obligated to pay on the loans." (*See* FJ FAC ¶ 627; *see also* PWC FAC ¶¶ 12-17.) [FN3]

FN2. Plaintiffs refer to Crown Vantage and Crown Paper "interchangeably" and "collectively" as "Crown," except where necessary to differentiate between them. (*See* FJ FAC ¶ 4; PWC FAC ¶ 21.) For the purposes of this order, the Court will refer to plaintiffs as "Crown," except where necessary to differentiate between them.

FN3. At the hearing, Crown expanded on its definition of the "Spin" by explaining that, in its view, the "Spin" consisted of four transactions, occurring when: (1) Fort James predecessor, James River Corporation, transferred assets and liabilities to Crown Paper, in exchange for Crown Paper stock; (2) Crown Paper borrowed money from third parties; (3) James River Corporation obtained from Crown Vantage pay-in-kind notes; and (4) Crown transferred cash to James River Corporation.

The following facts, taken from the FJ FAC and from the PWC FAC, are assumed true solely for the purposes of the motions to dismiss.

In 1994, defendant Fort James' predecessor, James River Corporation ("JRC"), was "on the brink of insolvency." (FJ FAC ¶¶ 5, 101; PWC FAC ¶¶ 2, 106.) In March 1995, defendant McGuire Woods, a law firm whose clients included JRC and Crown, formed Crown Vantage and Crown Paper as Virginia corporations, being aware of JRC's financial situation and intending that Crown would be "the dumping ground of JRC's unwanted assets and liabilities." (FJ FAC ¶¶ 21, 131; PWC FAC ¶¶ 24, 136.) Crown Vantage was a "publicly traded holding company owning 100% of Crown Paper's outstanding stock" (PWC ¶ 3), and JRC became the "sole shareholder" of Crown Vantage. (FJ FAC ¶¶ 260(a), 630; PWC FAC ¶¶ 265(a).) JRC elected insiders of JRC to the Crown Board of Directors, and those "insider directors" were under control of, and acted for the benefit of, JRC. (FJ FAC ¶ 133; PWC FAC ¶ 138.) Additionally, three "independent" directors were appointed to the Crown Board. (FJ FAC ¶ 167; PWC FAC ¶ 172.) On August 15, 1995, the Crown Board of Directors, including the "independent" directors, voted to enter into transactions "related to the Spin," (FJ FAC ¶¶ 208, 242; PWC FAC ¶¶ 213, 247) and, on August 25, 1995, the "spin-off" of Crown from JRC occurred. (FJ FAC ¶ 696.)

***2** In planning and executing the Spin, JRC had "sole and complete decision-making power." (FJ FAC ¶ 134; PWC FAC ¶ 139.) Under the transactions comprising the Spin, JRC transferred to Crown assets that were "depleted" and "extremely overvalued." (FJ FAC ¶¶ 159(a), 400; PWC FAC ¶¶ 164(a), 405.) JRC also caused Crown to transfer to JRC $551,200,000 in cash,[FN4] (FJ FAC ¶ 252; PWC FAC ¶ 257), caused Crown to issue $100 million in "Senior Pay-in-Kind" ("PIK") Notes to JRC, (*id.*), and caused Crown to enter into an agreement under which Crown became liable for "numerous contractual and other liabilities" of JRC. (FJ FAC ¶ 254; PWC FAC ¶ 259.) [FN5] Crown alleges these transfers of cash, notes and liability constituted "fraudulent transfers." (*See* FJ FAC ¶ 254; PWC FAC ¶ 259.) The "fraudulent transfers" rendered Crown "insolvent, in that its liabilities, including future probable liabilities, exceeded its assets. (FJ FAC ¶ 260(m); PWC FAC ¶ 265(m).)

FN4. As a result of alleged misrepresentations made by JRC to a group of banks, Crown had obtained a "credit facility," comprising two "terms loans," and a "revolving line of credit." (FJ FAC ¶ 166; PWC FAC ¶ 171.)

FN5. Many of the transferred liabilities were not associated with any of the transferred assets. (FJ FAC ¶ 159(b); PWC FAC ¶ 164(b).)

In order to persuade the "independent" Crown directors to approve the "Spin," JRC hired defendant Houlihan Lokey, an investment banking firm, to render a "solvency opinion" to be presented to Crown. (FJ FAC ¶ ¶ 25, 169-70; PWC FAC ¶ ¶ 28, 174-75.) JRC provided Houlihan Lokey with "inflated projections" that had been created by defendant Williams, the President of JRC, who was "directly involved in each aspect of structuring and planning of the Spin," and by defendant Merrill Lynch, an underwriter serving as Crown's investment adviser and which "was primarily responsible for structuring the Spin." (FJ FAC ¶ ¶ 22, 33, 173, 205, 278, 286, 446; PWC FAC ¶ ¶ 25, 36, 178, 210, 283, 291, 451.) In its opinion, Houlihan Lokey "rubber-stamp[ed]" JRC's projections, although Houlihan Lokey knew it could not justifiably rely on the projections, and advised the Crown directors that Crown "would go forward as a solvent business." (FJ FAC ¶ ¶ 204, 207, 437; PWC FAC ¶ ¶ 209, 212, 442.)

Williams concealed from Crown the fact that the value of the assets JRC transferred to Crown was "substantially overstated on financial statements," that the transferred liabilities were "severely understated," and that "Crown was insolvent." (FJ FAC ¶ 449; PWC FAC ¶ 454.) Just prior to the Spin, defendant PWC, an accounting firm, prepared an audit report for the Crown directors containing falsehoods by the persons who prepared Crown's financial statements; PWC "turned a blind eye to the material misrepresentations." (FJ FAC ¶ ¶ 19, 245-47, 455, 463-64; PWC FAC ¶ ¶ 22, 250-52, 460, 468-69.) Had PWC prepared a proper accounting, "Crown would have been deemed insolvent from the date of the spin." (FJ FAC ¶ 464; PWC FAC ¶ 469.) Defendant McGuire Woods, who provided legal advice to Crown with respect to the Spin, failed to advise Crown that McGuire Woods knew Crown would not have adequate capital to survive if Crown approved the Spin. (FJ FAC ¶ 213; PWC FAC ¶ 218.) Defendant Salomon, an underwriter, prepared a prospectus containing false information provided by JRC concerning the assets to be transferred by JRC to Crown, and failed to advise Crown of the falsehoods. (FJ FAC ¶ ¶ 23, 309, 318; PWC FAC ¶ ¶ 26, 314, 323.)

***3** Defendants Cutchins and Hare were Crown directors just prior to the Spin. (FJ FAC ¶ ¶ 398, 403; PWC FAC ¶ ¶ 403, 408.) During such time as Cutchins and Hare served as Crown directors, they worked to "construe all arrangements between JRC and Crown in favor of JRC," and hired Merrill Lynch to work for Crown because they knew Merrill Lynch would "go along with JRC's inflated valuation" of the assets that were to be transferred in the Spin. (FJ FAC ¶ ¶ 400, 402; PWC FAC ¶ ¶ 405, 407.) Defendants Daniel and Piemont, two of Crown's directors, both of whom were also directors of JRC, approved the Spin even though they knew at the time that the assets transferred from JRC to Crown were "over-valued," knew that Crown was "insolvent," and knew that "the Spin was structured to only benefit JRC." (FJ FAC ¶ ¶ 412, 439, 442; PWC FAC ¶ ¶ 417, 442, 447.) Defendant Leopold, chosen by Williams to be Chairman of the Crown Board of Directors, knew "at the time of the Spin" that the assets transferred from JRC to Crown were "significantly overvalued and insufficient collateral to the subordinated debt offering." (FJ FAC ¶ ¶ 419, 421, 423; PWC FAC ¶ ¶ 424, 426, 428.) Defendant Showalter, a Crown director who had been an employee of JRC, knew the "true condition" of assets transferred from JRC to Crown and worked closely with PWC to "hide the fact that Crown's assets were overvalued." (FJ FAC ¶ ¶ 434-35; PWC FAC ¶ ¶ 439-40.)

After the transfers, JRC distributed "all of the outstanding shares of Crown Vantage to the JRC shareholders." (FJ FAC ¶ 257; PWC FAC ¶ 262, 265(o).) [FN6] JRC continued to "exercise[ ] adverse dominion and control" over the Crown directors, and the "vestiges of JRC's control of Crown continued through and up to the time Crown filed for bankruptcy." (FJ FAC ¶ ¶ 346, 389; PWC FAC ¶ ¶ 351, 394.) JRC, assisted by the other defendants, "continued to misrepresent and/or conceal Crown's true financial condition ... long after Crown became insolvent." (FJ FAC ¶ 389; PWC FAC ¶ 394.) The "concealment of Crown's true financial condition artificially prolonged the life of Crown while giving the illusion ... that Crown's business was prosperous when, in fact, it was not." (FJ FAC ¶ 393; PWC FAC ¶ 398.)

FN6. Although the FACs do not state on what date this occurred, Crown reported to the SEC in 1997 in a Form 10-K that "[a] total of 8,446,362 shares of [Crown Vantage]'s common stock were issued and began trading on NASDAQ on August 28, 1995." (*See* Hibbard Decl. Ex. G at 4.) Defendants' request, unopposed by Crown, that the Court take judicial notice of the Form 10-K is hereby GRANTED.

McGuire Woods, who continued to represent Crown, concealed from Crown after the Spin "all documents and information related to the Spin." (FJ FAC ¶ 350; PWC FAC ¶ 355.) Merrill Lynch and Houlihan Lokey, after the transfers, provided "false and misleading opinions" that the Spin had been "fair and equitable and not a fraudulent transfer." (FJ FAC ¶ 351; PWC FAC ¶ 356.) PWC prepared and disseminated "false and misleading financial statements" to assist JRC in "the perpetuation of the illusion of growth and prosperity and artificially prolonging Crown's life." (FJ FAC ¶ 489; PWC FAC ¶ 494.) Salomon, who "conducted due diligence regarding Crown's post-Spin operations," did not advise Crown of "the true nature of the assets." (FJ FAC ¶ ¶ 357-58; PWC FAC ¶ ¶ 362-63.) Defendant Credit Suisse First Boston Corporation's predecessor, DLJ, which beginning in 1997 worked for Crown as a financial advisor pursuant to the terms of an "engagement letter," did not advise Crown of the true value of its assets and should have advised Crown to file for bankruptcy, rather than to continue as a "going concern." (FJ FAC ¶ ¶ 360, 379-80; PWC FAC ¶ ¶ 365, 384-85.)

***4** Defendant E & Y, an accounting firm that began performing services for Crown after the Spin, prepared audits for Crown that falsely represented Crown's financial position. (FJ FAC ¶ ¶ 20, 538; PWC FAC ¶ ¶ 23, 543.) In particular, E & Y "intended to hide the fact" that other defendants had "failed to properly write-down" the value of certain assets. (FJ FAC ¶ 608; PWC FAC ¶ 612.) Showalter worked with E & Y to approve each of E & Y's audits of Crown so as "to conceal Crown's deepening insolvency, to hide the over-valuing of the transferred assets and to conceal his wrongdoing and that of [the other] Defendants." (FJ FAC ¶ 436; PWC FAC ¶ 441.) Williams, Cutchins, Hare, and Leopold also were aware of, but failed to disclose, Crown's insolvency after the Spin. (FJ FAC ¶ ¶ 341-42; PWC FAC ¶ ¶ 346-47.) Daniel and Piemont, after the Spin, failed to take any step to "remedy the Spin." (FJ FAC ¶ 443; PWC FAC ¶ 448.)

On March 18, 1998, JRC and Crown entered into a settlement agreement, under which Crown's obligations to JRC under the PIK Notes were modified and Crown released any "potential claims arising out of the Spin" that Crown had against JRC and certain "generically described parties." (FJ FAC ¶ ¶ 323-24, 333; PWC FAC ¶ ¶ 328-29, 338.) Crown alleges that the release was a "fraudulent conveyance" because "Crown received nothing in return for the release of claims." (*See* FJ FAC ¶ 335; PWC FAC ¶ 340.)

Showalter, in his capacity as a Crown director but acting in the best interest of JRC, voted to approve the settlement agreement. (FJ FAC ¶ 438; PWC FAC ¶ 443.) Piemont and Daniel voted to approve the settlement agreement even though it provided no benefit to Crown. (FJ FAC ¶ 443; PWC FAC ¶ 448.) Leopold signed the settlement agreement on behalf of Crown, thereby "potentially absolv[ing] JRC of any liability for certain prior wrongful acts done to Crown," even though Leopold had, four months earlier, stated to JRC that one of the Spin transactions had been "a one-sided deal, drafted only in favor of JRC." (FJ FAC ¶ ¶ 431-32; PWC FAC ¶ ¶ 436-37.) E & Y, knowing there was "no economic justification" for the settlement agreement, failed to disclose that the settlement agreement was "absent arms length fairness or proper consideration." (FJ FAC ¶ ¶ 517-18; PWC FAC ¶ ¶ 522-23.) DLJ advised Crown to enter into the settlement agreement in order to "protect" JRC and other defendants from liability as a result of the Spin. (FJ FAC ¶ ¶ 386-87; PWC FAC ¶ ¶ 391-92.)

On March 15, 2000, Crown, having "become insolvent by well in excess of $1 Billion," filed for bankruptcy protection. (FJ FAC ¶ 13.)

PROCEDURAL BACKGROUND

As noted, on March 15, 2000, Crown filed for bankruptcy protection. During the course of the bankruptcy proceedings, Fort James filed proofs of claims against the bankruptcy estate. (*See* Coyne Decl., filed November 1, 2002, Exs. C-1.) On April 13, 2001, Fort James filed in the bankruptcy court the Fort James case, by which Fort James seeks, *inter alia*, a declaration that the "Transaction" [FN7] was not a "fraudulent transfer" and that any claim by Crown against Fort James arising out of the "Transaction" has been "waived, barred and precluded by, among other things, the doctrines of waiver, unclean hands, laches, estoppel, and any and all statutes of limitations." (*See* Compl. For Declaratory J., prayer for relief.)

FN7. The Transaction" to which Fort James refers in the Fort James case is the "Spin." or at least some of the transfers Crown alleges constituted the "Spin."

***5** On September 26, 2001, Crown filed in the

bankruptcy court the Crown Vantage case, by which Crown asserts against Fort James claims for fraudulent transfer, breach of fiduciary trust, and related causes of action. By order filed November 19, 2001, the bankruptcy court, upon stipulation of the parties, deemed the Fort James case to be a counter-claim to the Crown Vantage case. On April 23, 2002, in light of Crown's jury demand in the Crown Vantage case and Fort James' lack of consent to a jury trial before the bankruptcy court, the bankruptcy court certified the Crown Vantage and Fort James cases for withdrawal of the reference.

Meanwhile, on November 19, 2001, the bankruptcy court confirmed Crown's proposed plan. Under the confirmed plan, Crown Paper Liquidating Trust ("the Liquidating Trust") became the successor-in-interest to Crown. On March 14, 2002, the Liquidating Trust filed in state court the Liquidating Trust case, alleging therein that 15 defendants participated in Fort James's wrongful conduct, aided and abetted Fort James and each other, or otherwise breached independent duties owed to Crown with respect to the "Spin" and its aftermath. E & Y removed the Liquidating Trust case to bankruptcy court. On August 8, 2002, in light of Crown's jury demand in the Liquidating Trust case and E & Y's lack of consent to a jury trial before the bankruptcy court, the bankruptcy court certified the Liquidating Trust case to the District Court for withdrawal of the reference.

On September 20, 2002, the Honorable William H. Alsup, to whom the matters were then assigned, consolidated the Crown Vantage case, the Fort James case, and the Liquidating Trust case for all pre-trial purposes. On October 31, 2002, plaintiffs filed FACs in both the Crown Vantage and Liquidating Trust cases.

DISCUSSION

Defendants argues that Crown's claims in the FACs should be dismissed on numerous grounds. The Court will first address the arguments made by defendants in the Omnibus Memorandum of Points and Authorities in Support of Motions to Dismiss ("Omnibus Memorandum"), to which all defendants in the Liquidating Trust case and Fort James, the only defendant in the Crown Vantage case, have joined. The Court will then consider additional arguments made in the separately filed motions to dismiss.

A. Omnibus Memorandum Issues

1. Standing

As a threshold issue, defendants argue that Crown lacks standing to assert the claims made against them.[FN8] Defendants observe that the pleadings contain many allegations that defendants, or some of them, have misled Crown's creditors, (*see, e.g.*, PWC FAC ¶ 159 (alleging Merrill Lynch was aware statements made by certain defendants to "potential creditors" of Crown were false)), and argue that Crown is attempting to seek relief for injuries to the creditors.

> FN8. Fort James has joined in this argument to the extent that Crown has asserted claims on behalf of Crown itself, specifically Counts 3 through 13 asserted in the Crown Vantage case, as opposed to the two claims brought on behalf of Crown's creditors, specifically Counts 1 and 2 asserted in the Crown Vantage case. (*See* Fort James' Official Response to Court's Question Re Joinder, filed September 9, 2003.)

The claims that Crown asserts against defendants arise from the following allegations: (1) defendants were responsible for the alleged "fraudulent transfers" occurring during the Spin, whereby, *inter alia*, Crown paid over $550,000,000 to JRC, as well as other consideration, in exchange for worthless assets; (2) defendants were aware at all times prior to Crown's filing for bankruptcy that Crown was insolvent, but failed to advise Crown of that fact and took steps to artificially prolong Crown's existence; and (3) defendants caused Crown to enter into an agreement releasing claims Crown had against JRC and others arising out of the Spin, as well as modifying other obligations Crown had to JRC, but failed to advise Crown that Crown was not receiving any valid consideration in return from JRC. Such allegations adequately allege that defendants caused injury to Crown. Consequently, Crown has standing to allege claims based on such conduct. *See National Organization for Women v. Scheidler*, 510 U.S. 249, 256, 114 S.Ct. 798, 127 L.Ed.2d 99 (1994) (holding to establish standing, plaintiff, at pleading stage, need only allege some injury to itself "fairly traceable to the defendant's allegedly unlawful conduct").

***6** Accordingly, defendants are not entitled to dismissal on the ground that Crown has not alleged the requisite injury to itself for purposes of standing.

2. In Pari Delicto

Defendants argue that Crown is barred from asserting the claims made against them under the doctrine of in pari delicto.[FN9] The doctrine of in pari delicto bars a participant in an unlawful act from recovering damages from another participant in the unlawful act. *See, e.g.*, *Terlecky v. Hurd (In re Dublin Sec., Inc.)*, 133 F.3d 377, 380 (6th Cir.1998). Where a plaintiff is a corporation, the doctrine applies if, under agency principles, the unlawful actions of an agent of the corporation are imputed to the corporation. *See id.*

FN9. Fort James has joined in this argument to the extent that Crown has asserted claims on behalf of Crown itself, specifically Counts 3 through 13 asserted in the Crown Vantage case, as opposed to the two claims brought on behalf of Crown's creditors, specifically Counts 1 and 2 asserted in the Crown Vantage case. (*See* Fort James' Official Response to Court's Question Re Joinder, filed September 9, 2003.)

a. Invoking In Pari Delicto Against Bankruptcy Trustee

Crown argues that the doctrine of in pari delicto cannot be invoked against a bankruptcy trustee, irrespective of whether it could have been invoked against the debtor corporation. Although the Ninth Circuit has not had occasion to directly address the issue, every Circuit to have considered the question has held that in pari delicto can be asserted against a trustee bringing a claim on behalf of a debtor in bankruptcy. *See Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 356-58 (3rd Cir.2001); *Terlecky*, 133 F.3d 377, 381 (6th Cir.1998); *Sender v. Buchanan (In re Hedged-Investments Associates, Inc.)*, 84 F.3d 1281, 1284-86 (10th Cir.1996); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1093 (2nd Cir.1995). As explained in *Sender*, when a trustee asserts a claim on behalf of a debtor, the trustee proceeds under 11 U.S.C. § 541(a)(1), which defines the property of the estate as "all legal or equitable interests of the debtor in property as of the commencement of the case." *See Sender*, 84 F.3d at 1285 (citing 11 U.S.C. § 541(a)(1)). *Sender* concluded that § 541(a)(1) "establishes the estate's rights as no stronger than they were when actually held by the debtor," and thus in pari delicto, or any other defense available as against the debtor, can be asserted against the trustee. *See id.*

The legislative history of § 541 lends support for this conclusion:
Though this paragraph [§ 541(a)(1)] will include choses in action and claims by the debtor against others, it is not intended to expand the debtor's rights against others more than they exist at the commencement of the case. For example, if the debtor has a claim that is barred at the time of the commencement of the case by the statute of limitations, then the trustee would not be able to purse that claim, because he too would be barred.

See H.R. Rep. 95-595, at 367-68, reprinted in 1978 U.S.C.C.A.N. 5963, 6323.

Relying on *Federal Deposit Ins. Corp. v. O'Melveny & Myers*, 61 F.3d 17 (9th Cir.1995), Crown argues that a different result should pertain in the Ninth Circuit. In *O'Melveny*, the Ninth Circuit, applying California law, held that "defenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver." *See id.* at 19. As the Third Circuit observed in *Lafferty*, however, *O'Melveny* is distinguishable, as that case involved a receiver, a party not subject to the restrictions of § 541(a)(1). *See Lafferty*, 267 F.3d at 358 (distinguishing *O'Melveny* from action brought by bankruptcy trustee; noting "unlike bankruptcy trustees, receivers are not subject to the limits of section 541"). Where, as here, a bankruptcy trustee files claims on behalf of the bankruptcy estate, § 541(a)(1), as discussed above, provides that the trustee's rights are no greater than the rights of the debtor. Indeed, even before the enactment of § 541(a)(1),[FN10] the Ninth Circuit had observed, "It is elemental that the trustee stands in the shoes of the bankrupt ... and can assert no greater rights against the [defendant] than could have been asserted by the bankrupt in the absence of bankruptcy proceedings." *See Schultz v. England*, 106 F.2d 764, 768 (9th Cir.1939) (holding resolution of trustee's claim to equipment in building leased by landlord to debtor was dependent on whether debtor had right to possess equipment as against landlord); *see also Pellerin v. Stuhley (In re Destro)*, 675 F.2d 1037, 1040 (9th Cir.1982) (holding, in context of adversary proceeding against debtor, that bankruptcy trustee "succeeds only to such rights as the bankrupt possessed; and the trustee is subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition").

FN10. Section 541 was enacted in November 1978.

***7** Consequently, defendants may assert in pari delicto as a defense.

b. Application of In Pari Delicto Defense

Because defendants raise the defense of in pari delicto on a motion to dismiss, defendants are entitled to dismissal only if the defense is established on the face of the complaints, specifically, the FJ FAC and the PWC FAC. *See, e.g., Official Committee of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, 322 F.2d 147, 163-166 (2nd Cir.2003) (affirming dismissal of claims filed on behalf of debtor where applicability of defense of in pari delicto was established in complaint). Because Crown's claims arise under state law, the issue of whether Crown's claims are barred by in pari delicto is governed by state law. *See id.* (holding where Texas law applied to state law claims filed on behalf of debtor, dismissal was appropriate where, under Texas law, defense of in pari delicto was established on face of complaint).

Here, all defendants, with the exception of E & Y and DLJ as discussed below, argue that Virginia law applies to the claims asserted against them. In large part, these defendants rely on the bankruptcy court's ruling in the Crown Vantage case that Virginia law applies to Crown's claims against Fort James. (*See* Order, filed April 23, 2002, in Crown Vantage case).[FN11] In its opposition, Crown has not requested reconsideration of this ruling, and, indeed, cites Virginia law as supportive of Crown's argument that Crown has stated valid claims. (*See, e.g.*, Pls.' Consolidated Response to Defs.' Mots. To Dismiss at 56:6-9, 68:22-7.) Consequently, the Court will apply Virginia law to Crown's claims against defendants Fort James, PWC, McGuire Woods, Merrill Lynch, Salomon, DLJ, Leopold, Cutchins, Hare, Williams, Daniel, Piemont, Showalter, and, with one exception discussed *infra*, Houlihan Lokey.

FN11. The bankruptcy court reached this result after applying the tests set forth in the Restatement (Second) of Conflict of Laws. (*See id.* at 4-7.)

As discussed in more detail below, E & Y argues that the claims against it are governed by California law and DLJ argues that the claims against it are governed by New York law. For the purposes of the doctrine of in pari delicto, however, no party argues that the law of the three potentially relevant states, namely Virginia, California, and New York, differs in any respect with regard to the doctrine of in pari delicto. Rather, the parties agree that the analysis of the applicability of that doctrine proceeds in three specific steps. [FN12] First, for the doctrine to apply, agents of the plaintiff corporation must have participated in the wrongdoing for which the corporation seeks to recover. *See Mediators, Inc. v. Manney (In re Mediators)*, 105 F.3d 822, 826-27 (2nd Cir.1997) (holding where agents of corporation participated in fraudulent scheme with defendant, corporation was barred from asserting claim against defendant, unless exception to doctrine of in pari delicto applied). [FN13] Second, if such agents, at the time of such participation, were acting in a manner adverse to the interests of the corporation, the so-called "adverse interest exception" applies, with the result that the actions of the agents are not imputed to the corporation. *See, e.g., Bankruptcy Services, Inc. v. Ernst & Young (In re CBI Holding Co.)*, 247 B.R. 341, 365 (Bankr.S.D.N.Y.2000) (holding where "segment of management involved in the fraud was acting for its own interest and not that of [the corporation]," their participation in accounting fraud was not imputed to corporation, and corporation's claim against defendant accounting firm was not barred). Third, even if the agents of the corporation were acting in a manner adverse to the interests of the corporation, where the agents and the corporation are "one and the same," the "sole actor exception" applies to the "adverse interest exception," with the result that in pari delicto will bar the claim. *See, e.g., Lafferty*, 267 F.3d at 359 (holding "sole actor exception" applied to bar corporation from suing its underwriters for participating with agents of corporation in fraudulent scheme, where such agents "clearly dominated" corporation and one of the agents was the "sole shareholder" of corporation).

FN12. No party cites any case applying either Virginia or California law in which the doctrine of in pari delicto was applied in a case similar to the instant action. No party, however, argues that Virginia or California would apply the doctrine in a manner different from that set forth in the decisions from other jurisdictions on which all parties have relied.

FN13. Although the Second Circuit in

> *Mediators* did not specifically identify the applicable doctrine, a later decision of the Second Circuit clarified that the doctrine in question was in pari delicto. *See Coopers & Lybrand*, 322 F.3d at 164 (describing *Mediators* as case where Second Circuit affirmed dismissal "upon findings that in pan delicto had been established in the complaints").

***8** Here, according to the FACs, the majority of Crown's directors, along with JRC, participated in all of the allegedly wrongful acts. As discussed above, those acts are alleged to have caused injury to Crown, thus bringing into play the "adverse interest exception." [FN14] As a consequence, unless the applicability of the "sole actor exception" is apparent from the face of the complaints, defendants are not entitled to dismissal based on the doctrine of in pari delicto.

> FN14. Defendants, relying on Crown's allegation that some defendants defrauded banks into loaning Crown large sums of money, argue that JRC and certain of the other defendants in fact provided benefits to Crown. (*See* Defs.' Omnibus Reply at 13.) As noted above, however, Crown also alleges that after Crown received those funds, the Crown directors voted to transfer the funds to JRC in exchange for JRC's worthless assets. When viewed in the light most favorable to Crown, these allegations cannot be read as a concession that JRC or any other defendant acted for the benefit of Crown.

Defendants argue that the sole actor exception applies in light of Crown's allegation that "JRC, as the sole shareholder of Crown Vantage, exercised dominion and control over Crown as to the Spin," (*see* FJ FAC ¶ 260(a); PWC FAC ¶ 265(a)), and that JRC had "sole and complete decision-making" during those transactions. (*See* FJ FAC ¶ 134; PWC FAC ¶ 139.) In support of this argument, defendants rely on cases applying the sole actor exception where the sole shareholder of the plaintiff corporation participated in the alleged wrongdoing. *See, e.g.*, *Mediators*, 105 F.3d at 827 (holding where sole shareholder "is alleged to have stripped the corporation of assets, the adverse interest exception to the presumption of knowledge cannot apply"; barring corporation's claim against bank and law firm for allegedly assisting shareholder in stripping corporation of its assets). In explaining the basis for this result, the Second Circuit has stated: "This rule imputes the agent's knowledge to the principal notwithstanding the agent's self-dealing because the party that should have been informed was the agent itself albeit in its capacity as principal. Where, as here, a sole shareholder is alleged to have stripped the corporation of assets, the adverse interest exception to the presumption of knowledge cannot apply." *See id.*

In response, Crown relies on its allegations that Crown had "independent" directors who did not participate in, and were unaware of, the wrongdoing, (*see, e.g.*, FJ FAC ¶ ¶ 167-69; PWC FAC ¶ ¶ 172-74), as well as its allegations that the independent directors "could have taken steps to prevent the damages and losses [Crown] incurred as a result of the wrongful conduct" had they known of the conduct. (*See* FJ FAC ¶ 346; PWC FAC ¶ 351.) Crown cites several cases holding that the doctrine of in pari delicto does not apply where independent directors could have prevented or stopped the wrongful conduct had they been made aware of it. *See, e.g.*, *Sharp Int'l Corp. v. KPMG LLP (In re Sharp Int'l Corp.)*, 278 B.R. 28, 37-39 (Bankr.E.D.N.Y.2002) (holding plaintiff's allegation that "innocent" director would have had ability to "bring an end to the fraudulent activity" was sufficient to withstand motion to dismiss based on in pari delicto); *Smith v. Arthur Andersen L.L.P.*, 175 F.Supp.2d 1180, 1198-1200 (D.Ariz.2001) (holding plaintiff's allegation that there were "innocent members on [plaintiff's] Board and Audit Committee who were unaware of the wrongdoing" was sufficient to withstand motion to dismiss based on in pari delicto); *CBI Holding*, 247 B.R. at 365 (holding evidence that one of plaintiff's directors "had he known of the fraud, would have taken steps to stop it" was sufficient to defeat defendant's argument that fraud committed by certain of plaintiff's officers and managers was imputed to plaintiff); *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P.*, 212 B.R. 34,45-46 (S.D.N.Y.1997) (dismissing complaint with leave to amend to allege "innocent member" of plaintiff's management would have had ability to stop CEO's fraudulent activity had such person known of it). In none of the cases on which Crown relies, however, was the plaintiff a corporation owned by a sole shareholder who participated in the wrongdoing for which the plaintiff sought relief. *See, e.g.*, *Sharp*, 278 B.R. at 37-39 (observing corporation had "innocent 13% shareholder" at all times); *Smith*, 175 F.Supp.2d at 1187, 1199 (noting plaintiff corporation argued that sole actor exception did not apply because case did not involve allegation that sole

shareholder engaged in wrongdoing; observing corporation had alleged defendants, former officers and directors, had concealed material information from corporation's shareholders); *CBI Holding*, 247 B.R. at 365 (observing plaintiff's 48% shareholder "was innocent of the fraud"); *Wechsler*, 212 B.R. at 35 (observing alleged wrongdoers were not sole shareholders of plaintiff).

***9** Although Crown argues that the sole actor exception is inapplicable unless all shareholders and directors participate in the fraud, Crown cites no case in which the sole actor exception was held inapplicable where a sole shareholder participated in the fraud. Rather, irrespective of whether all or some of the directors also participated, the courts have held that where a sole shareholder is a participant in the wrongdoing, an allegation that independent or innocent directors could have taken steps to stop the wrongful conduct is insufficient to avoid the bar of in pari delicto. *See, e.g.*, *Lafferty*, 267 F.3d at 360 (affirming dismissal based on in pari delicto where sole shareholder participated in alleged wrongful conduct for which plaintiff sought relief; holding plaintiff's allegation that some directors did not perpetrate fraud insufficient to avoid application of in pari delicto); *FDIC v. Ernst & Young*, 967 F.2d 166, 171-72 and n. 2 (5th Cir.1992) (affirming grant of summary judgment against plaintiff corporation where "sole owner" of corporation engaged in accounting fraud and "dominated the board of directors"; holding evidence that "three outside directors" would have acted differently had they known of fraud insufficient to create triable issue of fact). Under the law of Virginia, the state in which Crown was incorporated, such a result follows from the fact that a sole shareholder has the right to remove directors. *See* Va.Code Ann. § 13.1-680 (affording shareholders right to remove directors). Consequently, to the extent Crown's claims are based on conduct occurring while JRC was Crown's sole shareholder, Crown's "independent" director allegations do not assist Crown in avoiding dismissal based on in pari delicto.

Relying on principles of comparative fault as recognized in California and New York, Crown argues that even if the bar of in pari delicto is apparent from the face of the complaints, the Court, at the pleading stage, should not determine that the bar is complete as to any claims governed by the law of those states, because a jury might conclude that defendants' wrongdoing exceeded that of Crown. None of the claims as to which in pari delicto is applicable, however, is governed by the law of any state other than Virginia.[FN15] Under Virginia law, negligence on the part of a plaintiff, if concurrent with that of a defendant, is a complete bar to any recovery on a negligence claim. *See* *Ponirakis v. Choi*, 262 Va. 119, 546 S.E.2d 707, 711 (Va.2001). Although, "[g]enerally, an issue whether a plaintiff is guilty of contributory negligence is a question of fact to be decided by the trier of fact," *see id.*, here, as discussed above, the alleged wrongful acts of JRC, when it was Crown's sole shareholder, are imputed as a matter of law to Crown as a result of the applicability of the doctrine of in part delicto. In other words, there is no triable issue of material fact with respect to contributory negligence.

> FN15. The parties agree that the claims based on conduct occurring while JRC was Crown's sole shareholder are subject to Virginia law. The agreement on which DLJ relies in support of its argument that New York law applies was not executed until 1997, well after Crown's stock became available to the public. All of the claims against E & Y, who argues California law governs the claims against it, arise from conduct occurring after Crown's stock became available to the public.

***10** Accordingly, defendants are entitled to dismissal of Crown's claims to the extent the claims are based on conduct occurring while JRC was Crown's sole shareholder. Because Crown has alleged that all of the transactions comprising the Spin occurred while JRC was Crown's sole shareholder, (*see, e.g.*, PWC FAC ¶ 265(a)), Crown's claims based on such transactions are barred by the doctrine of in pari delicto.[FN16] In light of Crown's allegations that JRC was not Crown's sole shareholder after the completion of the transactions that comprised the Spin, however, and the allegations that the independent board members could have taken steps to remedy the alleged wrongdoing by defendants, defendants are not entitled to dismissal of Crown's claims to the extent the claims are based on conduct occurring after JRC was no longer Crown's sole shareholder.

> FN16. In the Omnibus Memorandum, defendants also argue that Crown's claims based on the transactions comprising the Spin are subject to dismissal on the grounds that Crown has failed to adequately allege the element of causation, has failed to

adequately allege a basis for finding defendants owed Crown fiduciary duties with respect to such transactions, and has pleaded facts establishing the bar of the statute of limitations. In light of the Court's finding with respect to the doctrine of in pari delicto, the Court need not decide these issues.

3. Aiding and Abetting Fraudulent Transfers

Crown alleges that defendants in the Liquidating Trust case, with the exception of E & Y, are liable for aiding and abetting fraudulent transfers of assets from Crown to Fort James.[FN17] (*See* PWC FAC ¶ ¶ 329, 333-340 (alleging Fort James was sole transferee of certain property of Crown); PWC FAC Counts 2, 12, 23, 40, 45, 50, 58, 63, 68, 73, 78, 83.) Defendants argue that such claims are subject to dismissal because no such claim is cognizable under bankruptcy law, Virginia law, or New York law.

FN17. As a result of the Court's dismissal of certain claims based on in pari delicto, the Court has dismissed any claim based on the theory that defendants in the Liquidating Trust case aided and abetted JRC in effectuating the transactions comprising the Spin. Consequently, the Court will address the propriety of Crown's aiding and abetting fraudulent transfer claims only to the extent such claims are based on Crown's 1998 settlement agreement with Fort James, which agreement Crown also alleges to be a fraudulent conveyance.

Under bankruptcy law pertaining to recovery for a fraudulent conveyance, "recovery may be had only against persons who have received the property in question." *See* *Elliott v. Glushon*, 390 F.2d 514, 514, 517 (9th Cir.1967) (holding trustee seeking relief from fraudulent conveyance may only recover from transferee; affirming dismissal of claim for damages against attorney who allegedly conspired with debtor to fraudulently convey estate's property to third party). Likewise, under Virginia law, a plaintiff seeking recovery for a fraudulent conveyance may only seek recovery of the property, or under limited circumstances the value of the property, from the transferee. *See* *Efessiou v. Efessiou*, 41 Va. Cir. 142, 1996 WL 1065637, *4 (1996) (citing Supreme Court of Virginia decisions so holding). Similarly, under New York law, a plaintiff who seeks recovery for a fraudulent conveyance may "obtain a nullification of the conveyance" and/or "secure the assets in satisfaction of the debt," remedies which by definition are available only from the transferee. *See* *FDIC v. Porco*, 75 N.Y.2d 840, 552 N.Y.S.2d 910, 552 N.E.2d 158, 159 (N.Y.1990) (holding trial court erred by not dismissing claim for damages based on allegation defendants "assisted" debtor in transferring debtor's assets outside of country; reaffirming "traditional rule in this State reject[ing] any cause of action for mere participation in the transfer of a debtor's property prior to the creditor's obtaining a judgment"). Consequently, Crown cannot state a claim for relief under either bankruptcy law, Virginia law, or New York law for aiding and abetting fraudulent transfers.

***11** Crown argues that, in the event its claims for aiding and abetting a fraudulent transfer are not cognizable, such claims should be construed as claims for aiding and abetting a breach of fiduciary duty or for common law conspiracy to commit a fraudulent act. Crown, however, has alleged claims for aiding and abetting breach of fiduciary duty against each defendant against whom it has alleged a claim for aiding and abetting fraudulent transfers. Further, neither Virginia nor New York recognizes a claim for conspiracy to effect a fraudulent conveyance. *See* *Efessiou*, 41 Va. Cir. 142, 1996 WL 1065637, *4-5 (dismissing claim for conspiracy to effect fraudulent conveyance because, under Virginia law, "there can be no civil action for conspiracy where the unlawful act underlying the conspiracy claim does not allow for a damage award," and Virginia does not permit damage award as remedy for fraudulent conveyance); *Porco*, 552 N.Y.S.2d 910, 552 N.E.2d at 159 ("Nor is there merit to plaintiff's argument that [a New York statute] creates a creditor's cause of action in conspiracy, assertable against nontransferees or nonbeneficiaries solely for assisting in the conveyance of a debtor's assets.")

Accordingly, Crown's claims for aiding and abetting fraudulent transfers, specifically Counts 2, 12, 23, 40, 45, 50, 58, 63, 68, 73, 78, 83 in the Liquidating Trust case, are subject to dismissal, without leave to amend.

4. Negligent Misrepresentation Claims

Crown alleges claims for negligent misrepresentation against some of the defendants. Fort James, Houlihan Lokey, McGuire Woods, PWC, Merrill Lynch, and Salomon argue that the claims for negligent misrepresentation asserted against them are governed

by Virginia law,[FN18] and that such claims are not cognizable because Virginia law does not recognize a tort of negligent misrepresentation. *See* *Bentley v. Legent Corp.*, 849 F.Supp. 429, 434 (E.D.Va.1994) ("Virginia does not recognize any tort of negligent misrepresentation.") In response, Crown does not offer any contrary authority recognizing such claims under Virginia law. Consequently, the negligent misrepresentation claims asserted under Virginia law are subject to dismissal.

FN18. Crown also alleges claims for negligent misrepresentation against E & Y and DLJ. These claims arise from conduct allegedly occurring after JRC was no longer Crown's sole shareholder. The parties to such claims agree that the law of states other than Virginia governs such claims.

Houlihan Lokey, however, has not shown that Crown's claim for negligent misrepresentation against it is subject to Virginia law. To the extent that claim is not subject to dismissal pursuant to the doctrine of in pari delicto, the claim for negligent misrepresentation against Houlihan Lokey appears to be based solely on alleged statements made by Houlihan Lokey in an opinion letter to Crown dated July 8, 1999. (*See* PWC FAC ¶ 360.) Crown alleges that such opinion letter was issued as a result of a June 1, 1999 agreement, which, Crown states, the parties agreed would be governed by California law. (*See* PWC FAC ¶ ¶ 360-61.) [FN19] Under California law, a claim for negligent misrepresentation is cognizable. *See* *Bily v. Arthur Young & Co.*, 3 Cal.4th 370, 408, 11 Cal.Rptr.2d 51, 834 P.2d 745 (1992) ("Where the defendant makes false statements, honestly believing that they are true, but without reasonable ground for such belief, he may be liable for negligent misrepresentation, a form of deceit.") Consequently, given the potential for application of California law to Crown's claim for negligent misrepresentation as based on the opinion letter, Houlihan Lokey has not shown that such claim is subject to dismissal.

FN19. Both Houlihan Lokey and Crown only address Crown's allegation that Houlihan Lokey made misrepresentations during the time JRC was Crown's sole shareholder. Consequently, neither party has addressed the effect of the choice of law provision allegedly included in the parties' June 1999 agreement.

***12** Crown argues that, as to those defendants subject to Virginia law, its claims for negligent misrepresentation should be construed as claims for constructive fraud. In support thereof, Crown cites *Hitachi Credit America Corp. v. Signet Bank*, 166 F.3d 614 (4th Cir.1999), in which the Fourth Circuit observed that a claim for constructive fraud under Virginia law can be based on a false statement that is made negligently: "Constructive fraud differs [from actual fraud] only in that the misrepresentation of fact is not made with the intent to mislead, but is made innocently or negligently; the plaintiff must still prove the other elements of actual fraud-reliance and detriment-by clear and convincing evidence." *See* *id.* at 628. Crown, however, has separately alleged constructive fraud claims against McGuire Woods and PWC and, consequently, leave to amend to allege constructive fraud against those defendants is unnecessary.

Accordingly, Crown's claims titled "negligent misrepresentation" against Fort James (Count 7 in the Crown Vantage case), McGuire Woods (Count 7 in the Liquidating Trust case), PWC (Count 18 in the Liquidating Trust case), Merrill Lynch (Count 39 in the Liquidating Trust case), and Salomon (Count 44 in the Liquidating Trust case), are subject to dismissal for failure to state a claim under Virginia law. Crown will, however, be afforded leave to amend to allege claims for constructive fraud against Fort James, Merrill Lynch and Salomon, to the extent Crown bases such claims on conduct occurring after Fort James no longer was Crown's sole shareholder.

5. Breach of the Duty of Good Faith and Fair Dealing Claims

Crown alleges claims for tortious breach of the duty of good faith and fair dealing against defendants Fort James, McGuire Woods, PWC, E & Y, and DLJ. Defendants argue that such claims are not cognizable.

Virginia law governs the claims against Fort James, McGuire Woods and PWC. Virginia does not recognize a cause of action for tortious breach of the duty of good faith and fair dealing. *See* *Charles E. Brauer Co. v. Nationsbank*, 251 Va. 28, 466 S.E.2d 382, 385 (Va.1996) (holding breach of implied covenant of good faith and fair dealing does not constitute a tort, but gives rise only to a claim for breach of contract.) New York law governs the claim against DLJ. [FN20] New York does not recognize a cause of action for tortious breach of the duty of good

faith and fair dealing. *See Harris v. Provident Life Accident Ins. Co.*, 310 F.3d 73, 80 (2nd Cir.2002) ("Under New York law, parties to an express contract are bound by an implied duty of good faith, but breach of that duty is merely a breach of the underlying agreement.") California law governs the claim against E & Y.[FN21] California, with limited exceptions not applicable to the instant action, does not recognize a cause of action for tortious breach of the duty of good faith and fair dealing. *See Kransco v. American Empire Surplus Lines Ins. Co.*, 23 Cal. 4th 390, 400 (2000) (holding plaintiff alleging breach of covenant of good faith and fair dealing is, outside of context of insurance contracts, "limited to contract rather than tort remedies").

FN20. DLJ argues that all of the claims asserted against it are governed by New York law. At the hearing conducted August 15, 2003, Crown stated that it does not dispute DLJ's argument, to the extent Crown's claims are based on conduct arising out of the performance of DLJ's contractual duties.

FN21. E & Y argues that all of the claims asserted against it are governed by California law. At the hearing conducted August 15, 2003, Crown stated that it does not dispute E & Y's argument, to the extent Crown's claims are based on conduct arising out of the performance of E & Y's contractual duties.

***13** Crown argues that its claims for tortious breach of the covenant should be allowed to proceed as claims for breach of fiduciary duty. Crown, however, has alleged claims for breach of fiduciary duty against Fort James, McGuire Woods, PWC, E & Y, and DLJ.

Accordingly, Crown's claims for tortious breach of the duty of good faith and fair dealing, specifically, Count 13 in the Crown Vantage case and Counts 16, 27, 37, and 54 in the Liquidating Trust case are subject to dismissal, without leave to amend.

6. Deepening Insolvency Claims

In the Omnibus Memorandum, defendants do not specifically address Crown's claims for damages based on a "deepening insolvency" theory. (*See* PWC FAC Prayer for Relief ¶ A.) Crown bases such claims on conduct occurring after JRC was no longer Crown's sole shareholder. (*See, e.g.*, PWC FAC ¶ ¶ 494 (alleging PWC prepared and disseminated "false and misleading financial statements" after transactions comprising Spin had occurred in order to assist JRC in "the perpetuation of the illusion of growth and prosperity and artificially prolonging Crown's life").) In their reply offered in support of the Omnibus Memorandum, defendants address the "deepening insolvency" claims, arguing therein that such claims are not cognizable because Crown alleges it was insolvent at the time the transactions comprising the Spin were effectuated. (*See, e.g.*, PWC FAC ¶ 236 (alleging "[a]t the time of the Spin and thereafter, Crown was insolvent").) Although not clearly expressed, it appears defendants are arguing that a "deepening insolvency" claim is cognizable only where the plaintiff corporation was initially solvent and later became insolvent, after which time a defendant took action to cause the corporation's insolvency to deepen. Defendants cite no authority in support of this proposition, either as a matter of Virginia law or otherwise. For this reason, and because defendants have raised this argument for the first time in their reply, the Court will not further address the argument at this time. As the Court indicated at the hearing conducted August 15, 2003, however, the Court will not preclude defendants from filing a second motion to dismiss to specifically address Crown's claims based on conduct occurring after JRC was no longer Crown's sole shareholder.

B. Motion to Dismiss Claims in Crown Vantage Case

Fort James, in addition to relying on the arguments made in the Omnibus Memorandum, makes additional arguments in support of dismissal. With respect to the claims brought by Crown on its own behalf, Fort James has specifically addressed only Crown's claims based on conduct occurring during such time as JRC was Crown's sole shareholder. In light of the Court's ruling as to in pari delicto, the Court finds it unnecessary to address the separate arguments made by Fort James in support of dismissal of such claims.

The Court will, however, address Fort James's arguments in support of dismissal of Crown's claims brought on behalf of creditors.[FN22]

FN22. These claims are not addressed in the Omnibus Memorandum.

1. Count One

***14** Count One, brought by Crown on behalf of its creditors, alleges that the transfers of property from Crown to JRC under the "Spin" constituted fraudulent conveyances under 11 U.S.C. § 544(b).

"[T]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor." 11 U.S.C. § 544(b). "Applicable law" within the meaning of § 544(b) includes state law. *See Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589, 593 (9th Cir.1991). Crown and Fort James agree that the "applicable law" as to Count 1 is the law of Virginia. Fort James does not argue that Crown fails to state a claim for fraudulent conveyance under Virginia law; [FN23] rather, Fort James argues that the claim, which it asserts accrued in August 1995 when the subject transfers occurred, is barred by a four-year statute of limitations applicable under California law. Crown, in opposition, argues that Virginia law as to the statute of limitations should apply.

FN23. Under Virginia law, a transfer "given with intent to delay, hinder or defraud creditors, purchasers or other persons of or from what they are or may be lawfully entitled to shall, as to such creditors, purchasers or other persons, their representatives or assigns, be void," *see* Va.Code Ann. § 55-80, and a transfer "which is not upon consideration deemed valuable in law ... by a transferor who is thereby rendered insolvent, shall be void as to creditors whose debts shall have been contracted at the time it was made...." *See* Va.Code Ann. § 55-81.

Fort James cites no case in which a bankruptcy court applying the law of one state for purposes of assessing the merits of a fraudulent conveyance claim has applied the law of a different state for purposes of the statute of limitations. By contrast, numerous cases, when applying a given state's law as to a claim for fraudulent conveyance under § 544(b), have applied that same state's statute of limitations. *See, e.g., Dietz v. St. Edward's Catholic Church (In re Bargfrede)*, 117 F.3d 1078, 1080 (8th Cir.1997) (holding trustee's claim under § 544(b) subject to Iowa law, both as to elements of claim and statute of limitations); *Womack v. Eggebrecht (In re Demis)*, 191 B.R. 851, 856 (Bankr.D.Mont.1996) (holding where trustee sought to set aside transfer under Montana law pursuant to § 544(b), "Montana law determines the limitations period"); *Mahoney, Trocki & Assocs. v. Kunzman (In re Mahoney, Trocki & Assocs.)*, 111 B.R. 914, 917 (Bankr.S.D.Cal.1990) (holding, as to claim under § 544(b), where "California law on fraudulent conveyances is being utilized, California statute of limitations must be applied as well"; citing cases in support thereof).

Consequently, the Court will apply Virginia law to determine the applicable statute of limitations. In that respect, as Fort James acknowledges, the Supreme Court of Virginia has held that an action to set aside a conveyance of the ground of actual fraud is not subject to any statute of limitations. *See Flook v. Armentrout's Adm'r*, 100 Va. 638, 42 S.E. 686, 687 (Va.1902) (holding no statute of limitations barred claim to set aside fraudulent conveyance "upon the ground of actual fraud"; considering merits of claim brought ten years after subject conveyance occurred).[FN24] Here, Crown alleges that the conveyances "were made with the actual intent to hinder, delay and defraud Crown's creditors." (*See* FJ FAC ¶ 723.)

FN24. At least one bankruptcy court, sitting in Virginia, has held that such a claim is subject to the equitable doctrine of laches. *See In re Massey*, 225 B.R. 887, 891 (Bankr.E.D.Va.1998). Because Fort James does not argue that Count 1 is barred by laches, the Court need not decide whether laches is a cognizable defense to a claim for fraudulent conveyance under Virginia law.

***15** Accordingly, Fort James is not entitled to dismissal of Count 1 based on the statute of limitations.[FN25]

FN25. Crown alternatively argues that because it has alleged that one of the creditors is the United States, the trustee, standing in the shoes of the United States, is not bound by any state statute of limitations. In light of the Court's finding with respect to the applicability of Virginia law as to the statute of limitations, the Court need not address Crown's alternative argument.

2. Count Two

In Count Two, also brought by Crown on behalf of its

creditors, Crown alleges that the settlement agreement Crown entered into with Fort James in 1998 was a fraudulent conveyance that should be set aside under § 544(b). Crown alleges that because the settlement agreement was a fraudulent conveyance, the release therein is "ineffective to release the claims held by any creditors of Crown." (*See* FJ FAC ¶ 753.)

Fort James argues that if Count One is dismissed, Count Two is moot. Assuming, *arguendo*, Fort James' assertion is correct, Fort James is not entitled to dismissal of Count Two as Count One is not subject to dismissal.

C. Motion to Dismiss Claims in Liquidating Trust Case

All defendants in the Liquidating Trust case, in addition to seeking dismissal for the reasons stated in the Omnibus Memorandum, seek dismissal of the claims asserted against them for reasons set forth in their separate motions to dismiss.

The separate motions filed on behalf of defendants Houlihan Lokey, McGuire Woods, Merrill Lynch, Salomon, Leopold, Cutchins, Hare, Williams, Daniel, Piemont, and Showalter specifically address only Crown's claims based on conduct occurring during such time as JRC was Crown's sole shareholder. [FN26] In light of the Court's ruling as to in pari delicto, it is unnecessary to address the separate arguments made by these defendants.

> FN26. Each defendant in the Liquidating Trust case is alleged to have participated in some type of wrongful conduct after the time JRC ceased to be Crown's sole shareholder, as well as to have aided and abetted wrongful conduct of other defendants and to have participated in a conspiracy during such time.

The motions filed by PWC, E & Y and DLJ do specifically address Crown's claims based on conduct occurring after JRC was no longer Crown's sole shareholder. In the interests of judicial economy, however, the Court will defer ruling on those portions of the motions filed by PWC, E & Y, and DLJ until such time as all defendants have had the opportunity to specifically address such claims.

CONCLUSION

For the reasons discussed, defendants' motions to dismiss are GRANTED in part and DENIED in part, as follows.

1. In the Crown Vantage case,

a. Counts 3 to 12 are hereby DISMISSED without leave to amend, to the extent the claims are based on conduct occurring while JRC was Crown's sole shareholder;

b. Count 7 is hereby DISMISSED with leave to amend; [FN27]

> FN27. The Court, after addressing any motions seeking dismissal of claims based on conduct occurring after JRC was no longer Crown's sole shareholder, will provide a deadline by which Crown may amend.

c. Count 13 is hereby DISMISSED without leave to amend; and

d. in all other respects, the motion filed by Fort James is hereby DENIED.

2. In the Liquidating Trust case,

a. all claims are hereby DISMISSED without leave to amend, to the extent the claims are based on conduct occurring while JRC was Crown's sole shareholder;

b. Counts 2, 7, 12, 16, 18, 23, 27, 37, 40, 45, 50, 54, 58, 63, 68, 73, 78, 83 are hereby DISMISSED without leave to amend;

c. Counts 39 and 44 are hereby DISMISSED with leave to amend;

d. in all other respects, the motions filed by Houlihan Lokey, McGuire Woods, Merrill Lynch, Salomon, Cutchins, Hare, Leopold, Showalter, Daniel, Piemont, and Williams are hereby DENIED; and

***16** e. ruling on the motions to dismiss filed by PWC, E & Y, and DLJ, to the extent such motions address conduct occurring after JRC was no longer Crown's sole shareholder, is hereby DEFERRED.

3. Fort James, Houlihan Lokey, McGuire Woods, Merrill Lynch, Salomon, Cutchins, Hare, Leopold,

Showalter, Daniel, Piemont, and Williams may, no later than 30 days from the date of this order, file motions to dismiss, addressing claims based on conduct occurring after JRC was no longer Crown's sole shareholder. At the hearing on any such motions, the Court will also address the remaining arguments in the motions filed by PWC, E & Y, and DLJ.

This order closes Docket Numbers 83, 84, 86, 89, 90, 96, and 97.

IT IS SO ORDERED.

N.D.Cal.,2003.
In re Crown Vantage, Inc.
Slip Copy, 2003 WL 25257821 (N.D.Cal.)

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United States Court of Appeals
For the First Circuit

No. 06-1790

INTERNATIONAL STRATEGIES GROUP, LTD.,

Plaintiff, Appellant,

v.

GREENBERG TRAURIG, LLP, A. JOHN PAPPALARDO, AND ECKERT, SEAMANS, CHERIN & MELLOTT, LLC,

Defendants, Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

[Hon. Rya W. Zobel, U.S. District Judge]

Before

Selya, Circuit Judge,
Stahl, Senior Circuit Judge,
and Howard, Circuit Judge.

Jessica Block with whom Block & Roos, LLP, was on brief for appellant.

Paul B. Galvani with whom Matthew P. Garvey and Ropes & Gray, LLP, were on brief for appellees Greenberg Traurig, LLP, and Pappalardo.

Martha Born with whom William B. Mallin, Timothy S. Coon, Holland & Knight, LLP, and Eckert Seamans Cherin & Mellott, LLC, were on brief for Eckert, Seamans, Cherin & Mellott, LLC.

March 30, 2007

STAHL, Senior Circuit Judge. Plaintiff International Strategies Group, Ltd. ("ISG") brought suit against attorney A. John Pappalardo and two law firms, Greenburg Traurig, LLP ("GT"), Pappalardo's current firm, and Eckert, Seamans, Cherin & Mellott, LLC ("ESCM"), Pappalardo's former firm. ISG's claims against defendants arose from the loss of roughly $4 million, which it invested with Corporation of the BankHouse ("COB"), a Boston-based investment firm. Attorney Pappalardo represented COB as it sought to recover about $19 million, including ISG's funds, that COB had lost through a series of fraudulent transfers.

The district court granted summary judgment as to all of ISG's claims against the three defendants, finding a failure to demonstrate causation and to file within the statute of limitations. We affirm, concluding that summary judgment was appropriate as to ISG's negligence, misrepresentation, breach of fiduciary duty, breach of contract, and 93A unfair trade practices claims because no attorney-client relationship was formed between ISG and any of the defendants. Further, we hold that ISG's remaining two claims, for

conversion, and aiding and abetting fraud and breach of fiduciary duty, fail because they were not filed within the statutory period. We also affirm the district court's denial of ISG's motion for reconsideration or relief from judgment.

I. Background This case involves a complex set of financial transactions involving numerous individuals and entities. We do not delve into every nuance in our recitation of the facts below, but only those necessary to explain our decision. Because we are reviewing a grant of summary judgment, we draw all reasonable inferences in favor of the non-moving party, ISG. Maldonado-Denis v. Castillo-Rodriguez, 23 F.3d 576, 581 (1st Cir. 1994).

A. The Scheme

ISG, a Hong Kong-based company, invested $4 million with COB in April 1998, through COB's so-called "Federal Reserve Guarantee Program." COB told potential investors that this program generated profits by controlling the circulation of U.S. dollars. COB promised investors substantial profits, along with a guarantee of non-depletion of their original investment. Having been essentially promised profit at zero risk, ISG transferred its $4 million investment to a COB account at ABN Amro Bank in Belgium on May 15,

1998. Two weeks later, on May 29, 1998, COB made unauthorized transfers of $821,500 of ISG's investment into an ESCM bank account in Pennsylvania, and $328,500 into a COB bank account in Boston. Both transactions violated the non-depletion agreement, and were made without ISG's permission or knowledge.

COB then engaged in a Ponzi scheme, according to ISG's allegations, using funds from new investors to cover the depletion of funds provided by previous investors, amounting to millions of dollars in ill-gotten gains by COB and a variety of individuals and entities not involved in this suit. ISG estimates that COB amassed about $19 million dollars through this scheme, and then transferred these funds in November 1998, without the permission of any investor, to an entity called Swan Trust. Henry Pearlberg, the trustee of Swan Trust, then depleted the Swan Trust account through a series of transactions in late 1998 and early 1999, depositing most of the money ($16.7 million) in an account held by First Merchant Bank ("FMB"), which ISG characterizes as a "rogue Northern Cyprus bank." Pearlberg also appropriated about $2.3 million for his own use. ISG alleges that FMB dissipated the $16.7 million account through yet another series of fraudulent transactions from February to May 1999.

In April 1999, COB and its CEO, James Pomeroy, persuaded Pearlberg to execute a Deed of Assignment, which assigned to Pomeroy,

as agent for COB, all rights to the misappropriated funds held by FMB, Swan Trust, and Pearlberg. In July 1999, Pomeroy received a disbursement of $1.2 million from FMB based on this assignment. These recovered funds were not passed on to the investors, but were retained by COB or Pomeroy and are now dissipated.

B. Attempts to Recover Dissipated Funds

In June 1998, ISG had become concerned that COB was not honoring the non-depletion agreement and unsuccessfully sought assurance from COB that its funds were intact. By mid-1999 ISG's director, Phillip Clark, a Hong Kong attorney, was actively investigating COB's handling of ISG's investment. By then, ISG knew that COB had transferred funds to Swan Trust, and that Pearlberg had subsequently transferred the majority of those funds to the FMB account. By this time, ISG also had learned of Pearlberg's assignment to Pomeroy and Pomeroy's recovery of $1.2 million based on the assignment. By April 2000, ISG had learned of COB's initial depletion of its investment -- the May 1998 transfers to the ESCM and COB accounts in the United States.

In July 1999, Pappalardo, then an attorney with ESCM, began representing COB. On August 11, 1999, COB's Pomeroy sent ISG an email detailing COB's "options for retrieval" of the lost funds. Pomeroy

also informed ISG that, "I have chosen to move to prepare litigation against the parties utilizing the law firm of Greenberg & Traurig. I have utilized the law firm of Seamin Cherin & Melott [sic] for the criminal assistance against the parties."

During this same period, ISG's Clark flew to Boston to confront COB over the missing funds. When the parties met in Boston, Pappalardo told Clark that he had been retained by COB; that COB was also a victim of the fraudulent scheme; that all necessary steps, including litigation, would be taken to recover the funds; and that any independent action by ISG against COB, Pomeroy, or other parties would jeopardize Pappalardo's negotiations to recover the missing funds. ISG alleges that these representations, and other events that we detail below, led it to believe that Pappalardo was ISG's legal representative and that an attorney-client relationship had been formed.

Pappalardo informed ISG on several occasions that a negotiated recovery of the funds was imminent, as was COB's filing of a civil complaint against the perpetrators of the fraud. When Pappalardo had neither recovered the funds nor filed a complaint in over two years, ISG finally retained outside counsel on November 7, 2001. Through counsel, ISG filed suit against COB and Pomeroy in March 2002. ISG obtained a $10 million judgment in that suit, but the award has proven uncollectible. ISG also filed suit against ABN Amro

Bank, FMB, and two individuals associated with COB's scheme. Those suits are currently pending.

C. Proceedings Below

ISG brought three claims against all three defendants: negligence, in the form of legal malpractice; misrepresentation; and violation of Chapter 93A, the Massachusetts consumer protection law, see Mass. Gen. Laws ch. 93A, § 1 et seq. ISG brought two additional claims against Pappalardo alone, for breach of fiduciary duty and breach of express and implied contract. Finally, ISG brought two claims against ESCM alone, for conversion, and aiding and abetting fraud and breach of fiduciary duty, based on the May 1998 transfer of funds to ESCM's escrow account.

Defendants moved for summary judgment on all counts. The district court declined the defendants' request to grant summary judgment on the ground that no attorney-client relationship was formed. However, holding that ISG had failed to establish a viable theory of causation, the court granted summary judgment as to most of ISG's claims, including negligence, misrepresentation, violation of Chapter 93A, breach of fiduciary duty, and breach of contract. The court also granted summary judgment as to the remaining two claims -- conversion, and aiding and abetting fraud and breach of fiduciary duty -- concluding that the statute of limitations had expired.

ISG filed a motion for reconsideration or relief from judgment, which the district court denied. ISG timely appealed the district court's grant of summary judgment and denial of its motion for reconsideration.

II. Analysis

A. Standard of Review

On appeal, we review a district court's grant of summary judgment de novo, viewing the facts in the light most favorable to the nonmoving party. See Fontánez-Núñez v. Janssen Ortho LLC, 447 F.3d 50, 54 (1st Cir. 2006). Summary judgment is appropriate where there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. See Fed. R. Civ. P. 56(c). An appellate court is not "tied to the district court's rationale," but may affirm a grant of summary judgment "on any ground revealed by the record." Iverson v. City of Boston, 452 F.3d 94, 98 (1st Cir. 2006).

We review a district court's denial of a motion for reconsideration or relief from judgment for abuse of discretion. See Ruíz-Rivera v. Riley, 209 F.3d 24, 27 (1st Cir. 2000). "To obtain relief, the movant must demonstrate either that newly discovered evidence (not previously available) has come to light or that the rendering court committed a manifest error of law." Palmer v.

Champion Mortgage, 465 F.3d 24, 30 (1st Cir. 2006).

B. Duty of Care

Most of ISG's claims against defendants are predicated on establishing the existence of an attorney-client relationship or other duty of care between ISG and the defendants, including the claims of negligence, misrepresentation, and violation of Chapter 93A. In addition, ISG's claims against Pappalardo, for breach of fiduciary duty and breach of contract, are also predicated on the existence of an attorney-client relationship or other duty of care between Pappalardo and ISG.

ISG puts forth two theories for the existence of a duty of care by defendants. First, ISG argues that an attorney-client relationship was in fact formed. Second, ISG avers that "the forbearance of ISG induced by Pappalardo while at GT and ESCM, created a duty of care." This second argument is an invocation of the foreseeable reliance exception that, under Massachusetts law, creates a duty of care toward nonclients. See Sheinkopf v. Stone, 927 F.2d 1259, 1268 (1st Cir. 1991). Thus, we first examine whether an attorney-client relationship was created in fact; if not, we then consider whether the foreseeable reliance exception for nonclients applies in this case.

1. Attorney-Client Relationship

Under Massachusetts law, an attorney-client relationship may

be shown by an express contract, see Miller, 725 N.E.2d at 549, or may be implied "when (1) a person seeks advice or assistance from an attorney, (2) the advice or assistance sought pertains to matters within the attorney's professional competence, and (3) the attorney expressly or impliedly agrees to give or actually gives the advice or assistance," DeVaux v. Am. Home Assurance Co., 387 Mass. 814, 444 N.E.2d 355, 357 (1983) (quoting Kurtenback v. TeKippe, 260 N.W.2d 53, 56 (Iowa 1977)). The third prong of the DeVaux test may be established "by proof of detrimental reliance, when the person seeking legal services reasonably relies on the attorney to provide them, and the attorney, aware of such reliance, does nothing to negate it." Id.

It is not entirely clear whether ISG alleges that an express attorney-client relationship was formed. Nonetheless, we can easily conclude that this is not the case. There is no evidence here of a retainer agreement or other contract for legal services between ISG and any of the defendants; nor is there evidence of billing or remittances for such services.

ISG points to the power of attorney that it executed in favor of Pappalardo in July 2000, authorizing him to transfer to an interest bearing escrow account any funds belonging to ISG that he succeeded in recovering from Swan Trust. However, by executing the

power of attorney, ISG granted only a circumscribed agency power to Pappalardo in order to facilitate the physical return of the missing funds. While the power of attorney may have some impact on our analysis of whether an implied attorney-client relationship was formed, it is certain that such a limited power of attorney did not create an express attorney-client relationship. See Williams v. Dugan, 217 Mass. 526, 528, 105 N.E. 615 (1914) (noting that a power of attorney creates limited agency relationship as to expressly enumerated powers and no additional powers may be inferred); see also Bachner v. Air Line Pilots Ass'n, 113 F.R.D. 644, 649 (D. Alaska 1987) ("A power of attorney establishes the relationship of attorney-in-fact, which is an agency relationship different from the relationship of an attorney-at-law.").

We turn next to ISG's contention that an attorney-client relationship was created by implication, under the DeVaux three-part test. On appeal, ISG contends that, based on Pappalardo's assurance that he represented the interests of the investors and his warnings that filing independent charges would jeopardize his attempts to negotiate a recovery of the funds, ISG reasonably believed that Pappalardo was its attorney and forebore from pursuing independent legal action on that basis. In contrast, the defendants maintain that Pappalardo made clear that he only represented COB, and ISG

demonstrated an understanding of this fact; that ISG never relied on Pappalardo for legal services; and that ISG, as a sophisticated, represented entity, understood that its position was potentially adverse to Pappalardo's client, and indeed threatened suit against COB on this basis several times.

Our analysis of whether an implied relationship was created must start with the conjunctive, three-part DeVaux test. Under part one of the test, we ask whether ISG sought legal advice or assistance from Pappalardo. See DeVaux, 444 N.E.2d at 357. Courts interpreting DeVaux have understood this first prong to require concrete communication by the plaintiff requesting that the attorney represent him, or explicitly seeking individualized legal advisement. For example, in Robertson v. Gaston Snow & Ely Bartlett, 404 Mass. 515, 536 N.E.2d 344, 351 (1989), the Massachusetts Supreme Judicial Court ("SJC") found no implied attorney-client relationship between a corporate officer and a law firm representing the corporation, where the officer never explicitly requested that the firm represent him regarding his employment status at the corporation after a reorganization. The SJC reached this conclusion even though the officer had previously been a client of the firm in regard to other matters, had numerous discussions with the firm about the corporate reorganization and his future employment with the corporation, and

had requested and received a sample employment agreement from the firm. Id. The SJC concluded that an implied relationship cannot be formed without active communication from the plaintiff to the lawyer requesting legal representation or legal advice:

> In spite of several written and many oral communications between the plaintiff and the other participants, the plaintiff introduced no evidence of a specific reference to [the firm] as his personal counsel. His claim is essentially, therefore, that he thought that [the firm] represented him but that he failed to communicate his thought to anyone.

Id. at 349.

Similarly, in Sheinkopf v. Stone, 927 F.2d 1259, 1266-67 (1st Cir. 1991), this court held that no implied attorney-client relationship arose under Massachusetts law between an attorney and an investor, where the investor bought into a joint investment venture managed by the attorney. We reached this result even though the attorney prepared various legal documents for the investor's signature and requested that he sign them; promised to "protect" the investor; told the investor that "other clients of [the firm]" were also investing in the venture; listed the firm's address on the joint venture's legal documents; and transacted joint venture business out of his law firm office and with the assistance of his law firm secretary. Id. at 1265-66. This court found particularly persuasive that the investor "never explicitly requested [the attorney] or [the law firm] to represent him, never sought any legal advice from them,

and was never billed for services." Id. at 1268.

Here, ISG's claim is in some ways weaker than those of plaintiffs in Robertson and Sheinkopf. Not only is there no evidence or allegation that ISG explicitly requested legal representation from Pappalardo, but on at least two occasions ISG acknowledged that it was not Pappalardo's client. First, in a March 30, 2000, letter, Clark wrote to Pappalardo:

> While I appreciate that you act for Corporation of the Bankhouse (COB), I find that your failure to respond to any of our correspondence insulting and unprofessional. It is not beyond the parameters of your ethical requirements for you to correspond with International Strategies Group (ISG) on COB's instruction.(emphasis added). Second, on August 15, 2001, having grown more frustrated at Pappalardo's lack of communication and failure to recover the funds through negotiation, C.M. Barber, another ISG director, wrote to Pappalardo:
>
> John, you seem to be testing our resolve to take [independent] action. How do we respond? . . . We can prepare a comprehensive complaint to the Massachusetts State Bar with respect to your treatment of us as third parties, particularly in the circumstances of the Power of Attorney.

(emphasis added). These acknowledgments that Pappalardo did not represent ISG were consistent with Pappalardo's advisement to ISG on at least two occasions that he represented COB alone. Following Pappalardo's first meeting with ISG, he wrote to Clark on August 20, 1999:

> As you know, I am counsel along with others, for Societè Bank House ("C.O.B.") and represent that entity and its employees in connection with certain matters arising from their relationship with Swan Trust and its successors.

Three months later, Pappalardo began a letter to ISG's Barber with a similar notification: "I am writing to you at the request of my client, Corporation of the BankHouse, Incorporated ('COB') in connection with the recovery of funds from the transactions involving the Swan Trust."

In addition, there is no evidence that ISG requested legal advice from Pappalardo respecting ISG's potential individual claims. Such a request would have raised a serious ethical dilemma for Pappalardo, as one of ISG's foremost claims would have been against COB, Pappalardo's client. Indeed, in a March 23, 2000, letter to COB, ISG's Clark acknowledged that ISG did not have an attorney-client relationship with COB's attorneys, and therefore prodded COB to consult with its own attorneys regarding the prospects for a COB civil suit:

> [W]e are of the view that the urgent instigation of civil proceedings against Swan Trust, May Davis and others is now a priority. May we seek your consultation with your civil attorneys as to the process and timing of implementing same. It is our view that there will be economies in process and costs through the various investors and/or their fiduciary proceeding in concert and together with Corporation of the BankHouse ("CoB") in its separate function as fiduciary to such parties. There would be a requirement for all such parties to be privy to the benefits of a client relationship with your appointed attorneys.

(emphasis added). Though ISG here proposed a joint representation of all the investors by COB's attorneys, there is no evidence or even allegation that COB responded to this proposal or took any action to implement it.

In sum, the record indicates that ISG did not explicitly

request legal representation from Pappalardo, nor did it seek advice regarding its own legal position vis-à-vis the entities implicated in the fraud. Therefore, we conclude that ISG has set forth insufficient facts to support its claim of an implied relationship under part one of the DeVaux test.

We turn next to the third prong of the DeVaux test, and ask whether Pappalardo expressly or impliedly agreed to give or actually gave the requested advice or assistance. See DeVaux, 444 N.E.2d at 357. This prong may be satisfied if ISG reasonably relied on Pappalardo to provide legal services, and Pappalardo, aware of such reliance, did nothing to negate it. Id.

The reasonable reliance test captures the essence of ISG's allegation that an implied relationship was created. ISG argues that Pappalardo urged it not to proceed on its own, but rather to wait for Pappalardo to orchestrate a negotiated return of the missing funds on behalf of the "team" of investors; therefore, the argument goes, ISG reasonably relied on Pappalardo to provide legal services, and Pappalardo, aware of this reliance, did nothing to negate the impression that he was acting as ISG's attorney. However, the facts before us do not support this account.

The problem with ISG's allegation here is that no evidence suggests that ISG was relying on Pappalardo to provide ISG with legal services. Instead, all the evidence suggests that ISG was relying on Pappalardo to recover the funds for COB, with the expectation that ISG would be an eventual financial beneficiary of such a recovery.

Pappalardo told ISG that, in his opinion, his negotiations were more likely to lead to a recovery of the missing funds if ISG refrained from filing its own charges. This was a strategic opinion from the attorney of a potential adversary, which ISG was free to accept at face value, ignore, or seek legal advice regarding. ISG chose to forego its own action, expecting to benefit financially from a successful COB recovery. However, ISG's anticipated financial benefit does not transform Pappalardo's legal work on behalf of COB into a duty to ISG. Nor does ISG's expectation of an eventual financial recovery support the notion that it was reasonable for ISG to rely on Pappalardo for legal services.

This situation is analogous to one the SJC confronted in Spinner v. Nutt, 417 Mass. 549, 631 N.E.2d 542 (1994). There, trust beneficiaries brought suit against the attorneys for the estate's trustees. The SJC found no duty of care as between the estate's attorneys and the estate's beneficiaries: "The fact that third parties are thus benefitted, or damaged, by the attorney's performance does not give rise to a duty by the attorney to such third parties, and hence cannot be the basis for a cause of action by the third parties for the attorney's negligence." Id. at 546 (quoting Goldberg v. Frye, 266 Cal. Rptr. 483, 489 (Cal. Ct. App. 1990)). The SJC concluded that, "In these cases the third parties are incidental

beneficiaries, and '[a]n incidental benefit does not suffice to impose a duty upon the attorney.'" Id. (quoting Ronald E. Mallen and Jeffrey M. Smith, 1 Legal Malpractice § 7.11 (3d ed. 1989)). Similarly here, where ISG relied on Pappalardo to recover the missing money on behalf of COB, rather than to provide ISG directly with legal counsel, ISG put itself in the position of an incidental third-party financial beneficiary, and therefore no implied attorney-client relationship was established. ISG relied on Pappalardo only to recover the missing funds for COB, not to provide ISG with legal services.

Furthermore, assuming arguendo that ISG did rely on Pappalardo to provide direct legal services, no reasonable factfinder could conclude that ISG's reliance in this regard was reasonable. ISG attempts to rebut this conclusion by pointing to several pieces of evidence, including three statements made by Pappalardo. ISG notes that: (1) Pappalardo sent ISG an "action plan" for recovery of the funds which noted that he "represent[ed] the team," comprised of the investors and COB; (2) Pappalardo told ISG that COB and ISG's interests were "one and the same"; and (3) Pappalardo told ISG that he was preparing a civil suit against the fraudulent parties "to protect [ISG's] interest."

However, these comments must be analyzed in the broader

context of the parties' course of dealing. As discussed above, Pappalardo had told ISG on several occasions that he represented COB alone, and ISG made several statements which indicated its understanding of this arrangement. Also, ISG had chosen to forebear in bringing its own legal action, hoping instead that Pappalardo's negotiations on behalf of COB would succeed, resulting in an eventual financial benefit to ISG. Finally, ISG was aware of its ability to bring suit against COB and Pomeroy, and reminded Pappalardo and COB of this fact on several occasions.

Evaluating the three statements cited by ISG in this larger context, we conclude that ISG's alleged reliance was not reasonable. First, Pappalardo's statement in the "action plan" that he represented the investors as a team simply reflected the reality that ISG had chosen to coordinate its strategy with COB by deferring individual action in favor of Pappalardo's efforts to recover the funds for COB. Pappalardo's statement that he represented the team is even less problematic than that made by the attorney in Sheinkopf, who told an investor that "other clients of [the firm]" were also investing in the attorney's venture. 927 F.2d at 1265. We were unpersuaded in Sheinkopf that that statement was a reasonable basis for an implied relationship. In this case, Pappalardo's statement accurately reflected a choice made by ISG to forebear in favor of

Pappalardo's efforts on COB's behalf.

Second, Pappalardo's statement that the interests of his client and ISG were one and the same also did not form a reasonable basis for ISG's reliance on Pappalardo for legal services. As discussed above, ISG had threatened to sue COB and Pomeroy on several occasions, indicating that it was well aware that their interests were not fully aligned.

Third, when read in the context of the entire letter, Pappalardo's statement that he was preparing a civil suit on behalf of COB in order to "protect [ISG's] interest" also does not provide a reasonable basis for ISG's reliance. ISG highlights just one sentence in the October 22, 1999, letter from Pappalardo to ISG: "To also protect your interest and as part of pursuing our position for collection, COB has been preparing its own civil fraud case against the US based parties." It is a sign of the tenuousness of ISG's claim that the sentence it chose to highlight contains a clear statement by Pappalardo that the civil suit would be brought solely on behalf of his client, COB. Further, because ISG knew that the suit would be brought on behalf of COB alone, it is clear that the "interest" that Pappalardo referred to was simply ISG's recovery of its investment funds as an incidental beneficiary of the lawsuit. This is particularly so given that the same letter began, "I am writing to

you at the request of my client, Corporation of the BankHouse Incorporated ("COB") . . ." and the second paragraph stated:

> As our client is bound by confidentiality agreements, I am reluctant to share specifics of the details or process, for fear of jeopardizing the sensitive arrangements involved or breaching specific confidentiality agreements that are integral to the matters involved. However, I want to provide you with an understanding of the actions that are being taken on behalf of COB. (emphasis added).

ISG also points to the power of attorney and accompanying "side letter" as grounds for its alleged reasonable reliance on Pappalardo for legal services. As discussed above, the power of attorney granted to Pappalardo the limited agency right to transfer any recovered ISG funds to an interest-bearing escrow account. The "side letter" was drafted by ISG and given to Pappalardo along with the signed power of attorney. It read:

> The Directors of ISG seek to . . . clarify . . . that the captioned Power of Attorney is given to [ESCM and Pappalardo] upon the understanding that it will be actioned by the attorney with the utmost good faith and due care having regard to the interests of ISG.

The "side letter" simply reiterated the duty of care that accompanies any agency relationship and did not expand the very limited grant of authority contained in the power of attorney. No reasonable factfinder could conclude that ISG, a sophisticated entity, was reasonable to rely on Pappalardo to provide broad legal services simply because it appointed him attorney-in-fact for the limited

purpose of transferring funds. Indeed, in an August 2001 letter to Pappalardo, ISG acknowledged that it remained a nonclient third party even after the power of attorney was signed.

Therefore, we hold that ISG's claim fails the third prong of DeVaux because ISG did not rely on Pappalardo for legal services, but merely for incidental financial benefit. Further, we conclude that even if ISG did rely on Pappalardo for legal services, such reliance was not reasonable given the parties' course of dealings.

We also briefly note that these conclusions are fatal to ISG's claim under prong two of DeVaux, which requires the plaintiff to have sought advice or assistance on a matter within the attorney's professional legal competence. See DeVaux, 444 N.E.2d at 357. As we noted in Sheinkopf, attorneys "routinely wear a multitude of hats," 927 F.2d at 1265, and mere interaction with an attorney for assistance of any kind is not enough under DeVaux. The assistance sought must be legal in nature. The facts here show that ISG relied on Pappalardo only for a financial benefit. ISG having failed all three prongs of the DeVaux test, we conclude that no implied attorney-client relationship was created.

2. Foreseeable Reliance Exception for Nonclients

Generally, under Massachusetts law, an attorney only owes a duty of care to clients. See One Nat'l Bank v. Antonellis, 80 F.3d 606, 609 (1st Cir. 1996) ("'[A]n attorney's liability for negligence

arises out of a duty owed to a client.'") (quoting Norman v. Brown, Todd & Heyburn, 693 F.Supp. 1259, 1265 (D. Mass. 1988)). However, Massachusetts courts have carved out a limited "foreseeable reliance" exception to this rule, which creates a duty to nonclients where the attorney knew, or should have reasonably foreseen, that the nonclient would rely on his services. See Antonellis, 80 F.3d at 609; Sheinkopf, 927 F.2d at 1268. Nonetheless, this duty will not be imposed if "such an independent duty would potentially conflict with the duty the attorney owes to his or her client." Antonellis, 80 F.3d at 609 (quoting Lamare v. Basbanes, 418 Mass. 274, 636 N.E.2d 218, 219 (1994)).

ISG invokes this nonclient exception to no avail, for the simple reason that ISG and COB were potentially adverse parties. Imposing on Pappalardo a duty to ISG would create a potential conflict with Pappalardo's preexisting duty to COB, his client. See id. ("Massachusetts and federal case law has consistently found that a potential conflict between an attorney's duty to his or her client and the alleged duty to the nonclient is sufficient to defeat the nonclient's malpractice claim.").

ISG and COB were potentially adverse parties since ISG invested in COB's scheme. ISG became aware of an actual conflict with COB when it began investigating the fraudulent transfers in early

1999. In a letter to COB sent in early 1999, before Pappalardo was hired, ISG bitterly complained that COB was not keeping ISG apprised of its account positions, and threatened to pursue legal actions if COB "had been in any way misleading or inaccurate" regarding the funds:

> You seem to be under the mistaken impression that I am posturing with respect to the need for ISG to consider it's [sic] legal options. I should clarify perhaps that [ISG directors] could well be taken to task with regard to our failure to take local state legal advice.

Given this very real conflict between ISG and COB, we decline to impose on Pappalardo a duty to ISG as a nonclient.

Therefore, because we have determined that no reasonable factfinder could conclude that an attorney-client relationship was created, either expressly or by implication, and that no duty of care was owed to ISG as a nonclient, we conclude that summary judgment was appropriate as to the five counts predicated upon the existence of such a duty.

C. The Remaining Claims

Two claims remain -- conversion, and aiding and abetting fraud and breach of fiduciary duty, both brought against ESCM alone. ISG bases these claims on COB's unauthorized transfer of $821,500 of ISG's investment to an ESCM account on May 29, 1998. Both claims against ESCM sound in tort, see Gallagher v. R.E. Cunniff, Inc., 314

Mass. 7, 49 N.E.2d 448, 449 (1943) (conversion); Arcidi v. Nat'l Ass'n of Gov't Employees, Inc., 447 Mass. 616, 856 N.E.2d 167, 173 (2006) (aiding and abetting breach of fiduciary duty), meaning the claims are subject to a three-year statute of limitations, see Mass. Gen. Laws ch. 260, § 2A ("Except as otherwise provided, actions of tort, actions of contract to recover for personal injuries, and actions of replevin, shall be commenced only within three years next after the cause of action accrues.").

Massachusetts courts have said that a tort claim accrues when the plaintiff knew or should have known of the alleged injury. See Joseph A. Fortin Constr., Inc. v. Mass. Hous. Fin. Agency, 392 Mass. 440, 466 N.E.2d 514, 516 (1984) ("[I]t is a well-settled rule that causes of action in tort generally accrue under G.L. c. 260, § 2A, at the time the plaintiff is injured."); Hendrickson v. Sears, 365 Mass. 83, 310 N.E.2d 131, 135 (1974) ("[A] cause of action accrues on the happening of an event likely to put the plaintiff on notice.").

The defendants assert that the limitations period began to run in April 2000, when ISG learned of the transfer of funds to ESCM's account. 💬 Citing the doctrine of continuous representation, ISG argues that the limitations period should be equitably tolled during the period that ISG was allegedly represented by Pappalardo. See Murphy v. Smith, 411 Mass. 133, 579 N.E.2d 165, 167 (1991) (the continuing representation doctrine "tolls the statute of limitations in legal malpractice actions where the attorney in question continues to represent the plaintiff's interests in the matter in question"). Thus, ISG suggests that the statutory period did not begin to run

until October 2001, when ISG "disengaged entirely from its relationship with Pappalardo and his firms."

Because we have determined that no attorney-client relationship existed between ISG and Pappalardo, the continuous representation doctrine clearly is not applicable here. Therefore, ISG's claims accrued in April 2000, when it first learned of its injury. Because more than three years elapsed between April 2000 and the filing of this action on June 30, 2004, ISG's claims were not timely filed, and the district court correctly granted summary judgment on this basis.

D. Motion for Reconsideration or Relief from Judgment

We also affirm the district court's rejection of ISG's motion for reconsideration or relief from judgment. ISG's motion for reconsideration, which we review for abuse of discretion, see Barrett v. Lombardi, 239 F.3d 23, 28 (1st Cir. 2001), consisted only of "theories previously advanced and rejected," Palmer v. Champion Mortgage, 465 F.3d 24, 30 (1st Cir. 2006), and arguments unrelated to the grounds upon which we found summary judgment to be appropriate.

III. Conclusion

For the foregoing reasons we affirm the district court's grant of summary judgment in favor of defendants as to all of ISG's claims. Costs to appellees.