In pari delicto: Why your choice of litigation venue matters

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Liquidators and trustees in bankruptcy of entities that have sustained losses from fraudulent schemes in which management may have been involved will be paying close attention to recent decisions of the courts in the State of New York to determine whether to choose a New York forum to assert negligence, malpractice or other tort claims against former service providers. Andrea Harris-Kellow and Margot MacInnis explain.

Historically, where a company has suffered significant losses as a result of alleged wrongdoing by its management, the strategy of a liquidator has included asserting claims against those whose negligence or complicity contributed to the losses sustained. New York has historically been a favourite jurisdiction given its position as a commercial centre, the fact that the courts are familiar and accustomed to dealing with financial and cross-border matters, and the availability of jury trials for the determination of actions. Recent decisions from the New York courts underscore the need for trustees and liquidators to be thoroughly familiar with the doctrine of *in pari delicto* before proceeding with claims against service providers seeking to hold them to account for their part in a fraudulent scheme.

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The recent decisions handed down in New York by its highest court—the New York Court of Appeals—in the matters of *Kirschner v KPMG and Teachers' Retirement System of Louisiana v PricewaterhouseCoopers LLP* have demonstrated the application of the doctrine of *in pari delicto* to bar claims by corporations, as well as those who sue standing in their shoes (such as liquidators), against third-party advisors. While these rulings may cause liquidators to re-evaluate their strategies, for those such as auditors, who often find themselves targeted in the litigation aftermath of a fraudulent scheme, these cases could be seen as welcome relief.

Put simply, *in pari delicto* is Latin for 'in equal fault'. It denies relief in civil proceedings to a plaintiff where both parties are considered to be at fault. When considering bringing a claim against auditors or other service providers that may have owed the company a duty and standard of care, a liquidator will seek legal advice on the merits of the claims, including defences available. The *in pari delicto* doctrine is an important consideration, whose application requires both a knowledge of the complexities of the doctrine and a familiarity with the facts and circumstances leading to the losses sustained.

In the context of a bankruptcy, the New York Court of Appeals has ruled that a trustee cannot ultimately pursue claims against those who acted negligently (or worse) with regard to the company where management was engaged in fraud and the company, to any degree, benefited from the fraud. The liquidator's legal counsel will want to contemplate whether there are innocent insiders, since, under some circumstances, the rule may not be applied where, had the service provider not been negligent and had detected the fraud, there is at least one decision-maker in management or a shareholder who is innocent of the fraud and could have stopped it.

This is illustrated in the *Kirschner* case, where the losses arose out of the collapse of the brokerage and clearing firm, Refco. After its initial public offering in 2005, Refco disclosed a significant fraudulent financial scheme that had been devised by its president and CEO. This disclosure ultimately caused Refco to file for Chapter 11 bankruptcy. Simultaneously, a litigation trust was established and Refco's trustee filed a complaint against Refco's former law and accounting firms, and three investment banks, making claims of malpractice, fraud and breach of fiduciary duty. The trustee alleged that these advisors assisted Refco in carrying out the fraud or, alternatively, were negligent in their failure to discover the fraud.

Another case that incorporates the *in pari delicto* doctrine is *Teachers' Retirement System of Louisiana*, a derivative lawsuit that was brought on behalf of American International Group, Inc (AIG) against PricewaterhouseCoopers LLP (PwC) in its capacity as AIG's auditor. It was alleged that PwC had failed to detect a scheme by which senior officers at AIG inflated the publicly reported financial condition of AIG and ultimately caused harm to AIG when the scheme was identified.

In both of these cases, the trial courts dismissed the claims made against the auditors (and other third-party advisors), stating that a corporate insider's conduct, even if fraudulent, is imputed to the corporation (and therefore to a liquidator standing in the shoes of the corporation) under the general principles of agency law. Accordingly, and pursuant to the *in pari delicto* doctrine, a claim by or on behalf of the corporation is blocked where the corporation receives any benefit from the wrongful conduct. This is illustrated in the landmark decision of *Wagoner*, which held that, in the context of a bankruptcy trustee, when a bankrupt corporation has joined with a third party in defrauding its creditors, a bankruptcy trustee cannot recover against the third party for the damage to the creditors.

New York law also recognises the adverse interest exception to the doctrine, but only where the insider 'totally abandons' the corporation's interest and acts for its own or another's purpose and the corporation receives no benefit from the wrongful conduct. In the wake of the *Kirschner* decision, there will no doubt be issues surrounding the interpretation of this exception by the New York courts, and this will be the subject of attention in future litigation.

The New York courts declined to follow the approach in New Jersey and Pennsylvania, where courts have carved out the *in pari delicto* doctrine to permit claims against negligent or colluding outside advisors that are alleged to share some blame for the insider's fraud.

In New Jersey, corporate shareholders may seek recovery from a negligent auditor so long as the shareholder is:

- Innocent and did not engage in the fraud
- Should not have been aware of the fraud due to their role in the company, and
- Had no ability to oversee the company's operations by virtue of stock ownership.

In Pennsylvania, where an auditor engages in 'secretive, collusive conduct' with the agent and thus 'has not proceeded in material good faith', imputation is not available.

To compare the approach of the New York courts with the position of another jurisdiction, the House of Lords in the UK has found that the conduct of a person who owns and controls a company should be treated as that of the company. Accordingly, when a claim exists against a third-party advisor, it will be struck out on the basis that the court should not assist a claimant to recover compensation for the consequences of its own illegal conduct. This is demonstrated by *Moore Stephens v Stone Rolls Ltd*, where the director and sole shareholder of a closely held private company deceived the auditors with fraudulent conduct carried out on all creditors. The creditors of the insolvent company were barred from suing the auditors for negligence pursuant to the doctrine of *ex turpi causa non oritur actio*, the principle of which is that a claimant cannot make a plea in the court whilst relying on his own illegal behaviour. This ultimately has the same effect as the *in pari delicto* doctrine.

The recent New York decisions have resolved any previous ambiguity about the broad, preclusive effect of *in pari delicto*. In considering whether to bring a claim against a third-party service provider, the liquidator should scrutinise the terms of engagement between the company and the service provider. It is this document that will normally set out the jurisdiction(s) in which any action(s) can be taken against the service provider. From the perspective of third-party advisors, New York now appears to be a favoured centre for these claims. Advisors should not, however, take comfort in assuming that using the doctrine in New York simply makes a claim null and void. Rather, a plaintiff will consider options of an alternate jurisdiction with more favourable jurisprudence before making such a claim. Should there be an opportunity to sue in a jurisdiction that holds a less strict interpretation on the *in pari delicto* doctrine, this would advantage the liquidator in bringing an action on behalf of the company.

It is also often the case that a liquidator may be quick to take action against directors, managers and officers of an incapacitated entity without regard, in some instances, to the matters pleaded or the voluminous nature of the pleadings, which often include claims for negligent conduct, collusion and fraudulent activity on behalf of the company's insiders. If in doubt, and where appropriate, a liquidator should be careful not to 'over plead' matters against the company's decision-makers, as this instantly entitles a third-party service provider to invoke the *in pari delicto* defence, which will ultimately result in dismissal against a liquidator. Accordingly, careful consideration should be given to the facts pleaded by a liquidator against a corporate insider if there is an action that should be pursued against a third-party service provider. ■

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It is important to note that the views and commentary set out in this article are those of the authors and not necessarily those of KRyS Global.

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