AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Feature

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# Limits of Expansive Protection of New York's *In Pari Delicto* Defense

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Whenever a company tumbles into bankruptcy following the discovery of its management's financial misdeeds, firms that provided the company with accounting, legal, banking and financial advisory services should prepare to defend themselves against malpractice claims by a bankruptcy trustee or other estate representative, who may seek to hold them responsible for the collapse. These claims often allege that the professionals participated in, aided and abetted, or negligently failed to detect and stop the fraudulent acts and breaches of duty perpetrated by management.

Fortunately for these defendants, courts interpreting New York law have repeatedly recognized a powerful defense that can eliminate such claims at an early stage of the litigation. The common law doctrine of *in pari delicto* bars a plaintiff from recovering against a third party for a fraud or other misconduct in which the plaintiff participated.[1] Applying this doctrine in the bankruptcy context, the Second Circuit has firmly held that a "claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not the guilty corporation."[2] Thus, under the so-called "*Wagoner* Rule," since a bankruptcy trustee stands in the shoes of the corporation (not its creditors), he/she lacks standing to recover from third parties for participating in fraud or other misconduct perpetrated by the corporation.[3]

Moreover, the highest appellate court in New York has ruled that the "adverse-interest exception" to the *in pari delicto* defense — which applies when the corporate misfeasor has "totally abandoned" the company's interests in favor of his/her own — only limits application of *in pari delicto* in very narrow circumstances.[4] Simply put, New York's version of the *in pari delicto* defense is among the most protective to professionals in the nation.

The strength of this defense has been on display in recent years. Banks, accounting firms and law firms have all successfully used the *in pari delicto* defense and the *Wagoner* Rule to shield themselves from lawsuits by representatives of companies accused of large-scale financial frauds, such as *Bernard L. Madoff Investment Securities*,[5] *Refco Inc.*[6] and *MF Global Holdings Ltd.*[7] In a July 9, 2014, decision, however, the New York district court overseeing litigation stemming from the collapse of MF Global Holdings Ltd. halted this trend of *in pari delicto* dismissals.[8] The court instead allowed the bankruptcy estate to pursue claims seeking more than $1 billion of damages against MF Global's accounting firm for professional malpractice and negligence in connection with allegedly faulty accounting advice given with respect to MF Global's investment strategy.

In so holding, the court drew a fine — but important — distinction between claims that a professional helped or negligently failed to stop an unlawful act (barred by *in pari delicto*) and claims that a professional gave improper advice that caused the

1 *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 950 (N.Y. 2010) ("*Kirschner*").
2 *Shearson Lehman Hutton Inc. v. Wagoner*, 944 F.2d 114, 120 (2d Cir. 1991).
3 *Id.*; *Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC)*, 721 F.3d 54, 64 (2d Cir. 2013) ("*Madoff*") ("These claims fall squarely within the rule of *Wagoner* and the ensuing cases: [Trustee **Irving**] **Picard** stands in the shoes of BLMIS [the debtor] and may not assert claims against third parties for participating in a fraud that BLMIS orchestrated.").
4 *Kirschner*, 938 N.E.2d at 950 ("[T]he principle that a wrongdoer should not profit from his own misconduct is so strong in New York that we have said [that] the defense applies even in difficult cases and should not be 'weakened by exceptions.'") (citation omitted).
5 *See, e.g., Madoff*, 721 F.3d at 58, 64 (affirming district court's dismissal of trustee's unjust enrichment, breach of fiduciary duty, aiding and abetting fraud, and negligence claims against several banks that did business with Madoff on *in pari delicto*/*Wagoner* grounds).
6 *See Kirschner*, 938 N.E.2d at 946, 949, 959 (holding that *in pari delicto* defense bars a litigation trustee's claims against various third parties for aiding and abetting Refco insiders in committing fraud or for negligently failing to discover such fraud).
7 *In re MF Global Holdings Ltd. Inv. Litig.*, No. 11-CV-7866, 2014 WL 667481, *23-25 (S.D.N.Y. Feb. 11, 2014) ("*MF Global II*") (dismissing on *in pari delicto* grounds claims against debtor's auditing firm for its alleged failure to ensure that proper controls existed at company to safeguard customer funds).
8 *MF Global Holdings Ltd. v. PricewaterhouseCoopers LLP*, No. 14-CV-2197, 2014 WL 3402602 (S.D.N.Y. July 9, 2014) ("*MF Global III*").

company's financial failure (not barred by *in pari delicto*). This decision provides much food for thought with respect to how to plead and defend professional malpractice lawsuits stemming from the bankruptcy of an entity felled by its management's or employees' misconduct.

## Factual Background

Prior to its bankruptcy, MF Global operated a commodities brokerage business through its subsidiary, MF Global Inc. (MFGI), a registered futures commission merchant. In an attempt to stem a three-year streak of losses, in 2010 MF Global's management — led by its newly appointed chief executive officer, former New Jersey governor and U.S. Sen. Jon Corzine — undertook a new strategy to convert the firm into an investment bank. As part of this plan, MF Global began making large and risky investments in European sovereign debt, which it implemented through "repurchase-to-maturity" (RTM) transactions. Simplified, these transactions worked as follows: (1) MF Global U.K. Limited (MFG-UK) — MF Global's London-based subsidiary — would purchase European sovereign debt securities through a London exchange and sell that debt to MFGI; (2) MFGI would then sell the debt back to MFG-UK and enter into a repo contract under which MFGI agreed to repurchase the securities on the maturity date at the same price plus interest; and (3) MFG-UK (now the owner of the securities) would then enter into a repo contract to sell the debt to a third party and to repurchase the debt two days prior to its maturity. Essentially, these RTM transactions resulted in MFGI being "long" on European sovereign debt.

In addition to the hopes that this strategy would yield investment gains, the manner in which MF Global accounted for these trades on its books provided the company with several benefits. Specifically, the company treated these RTM transactions as debt "sales" rather than "loans," notwithstanding the fact that MFGI and MFG-UK were contractually obligated to repurchase the debt securities from their respective RTM counterparties. In other words, at the time of entering into an RTM transaction, MF Global did not report the obligation to repurchase the securities as a liability on its balance sheet. Upon the completion of the RTM transaction, MF Global would instead account for a "purchase" by the appropriate entity, which allowed MF Global to recognize upfront gains at the time of entering into the RTM transaction and avoided including these transactions in the "value-at-risk" calculations included in its financial statements.

The RTM strategy proved to be disastrous and was one of the key factors precipitating MF Global's demise. As the European sovereign debt market experienced a significant decline in late 2010 and throughout 2011, MF Global eventually disclosed in its filings with the Securities and Exchange Commission (SEC) more than $7.5 billion of RTM transactions. This led the Financial Industry Regulatory Authority and SEC to require MF Global to reserve significant capital to cover these transactions. This requirement put tremendous strain on the company's liquidity. As alleged in the subsequent litigation, at several points during 2011, management used intra-company transfers to meet the reserve requirement, including transfers from accounts holding its customers' funds that were required to be segregated and secured.

In October 2011, the company reported a massive loss associated with writing down the value of its deferred tax assets. MF Global filed its chapter 11 petition about one week later, and liquidation proceedings under the Securities Investor Protection Act (SIPA) were commenced for MFGI. As of the bankruptcy filing, approximately $1.6 billion of customer funds were missing.[9]

Unsurprisingly, a raft of litigation ensued. Among the defendants sought to be held liable for the fallout was MF Global's outside accountant and auditor, PricewaterhouseCoopers LLP (PwC). Customers (both individually and as assignees of the SIPA trustee's claims on behalf of MFGI) sued to hold PwC liable for failing to ensure that MF Global had sufficient controls in place to safeguard customer funds.

In his Feb. 11, 2014, *MF Global II* decision, Judge Marrero granted PwC's motion to dismiss these claims at the pleading stage on the following grounds. On one hand, the customers' individual claims for professional negligence were dismissed for a lack of privity between the customer plaintiffs and PwC. On the other hand, claims brought on behalf of the SIPA estate were dismissed pursuant to the doctrine of *in pari delicto*. Specifically, since MFGI employees clearly participated in the misuse of its customers' funds and because the trustee stepped into MFGI's shoes, *in pari delicto* barred the SIPA trustee and his assignees from holding PwC responsible for the customer's losses on a negligence theory.[10]

## *MF Global III*

Following Judge Marrero's dismissal of the customers' and the SIPA trustee's claims against PwC, on March 28, 2014, MF Global (under new management and in its capacity as the plan administrator for its confirmed chapter 11 plan) commenced a lawsuit against PwC in district court, seeking at least $1 billion of damages for PwC's allegedly "extraordinary and egregious professional negligence."[11] The complaint alleged that MF Global suffered damages as a direct result of relying on faulty advice from PwC with respect to (1) "count[ing] the RTM transactions as sales" and "derecogniz[ing] them from MF Global's balance sheet," (2) the company's capital reserve requirements and (3) accounting for deferred tax assets.[12]

PwC quickly moved to dismiss the complaint on several grounds, including *in pari delicto*. Tackling *in pari delicto* first as a threshold issue, the court denied PwC's request to apply that doctrine and directed the parties to brief the other aspects of PwC's motion to dismiss. In so holding, Judge Marrero distinguished his dismissal of the customers' claims against PwC in *MF Global II* because that complaint alleged that PwC's violations of

9 The foregoing factual background was derived primarily from Hon. Victor Marrero's initial written decision in the *MF Global* litigation. *See In re MF Global Holdings Ltd. Sec. Litig.*, 982 F. Supp. 2d 277 (S.D.N.Y. 2013) ("*MF Global I*"). In *MF Global I*, Judge Marrero analogized the collapse of MF Global to "a massive train wreck in which thousands of people — passengers, crew, bystanders, and others — were seriously injured upon sudden impact with a force [that] the victims could not see coming." *Id.* at 288-89.

10 *MF Global II*, 2014 WL 667481, *22-23. Judge Marrero later denied reconsideration of his order dismissing the claims against PwC, and the plaintiffs have appealed his order to the Second Circuit. *See MF Global III*, 2014 WL 3402602, at *3 n.2.

11 *MF Global III*, 2014 WL 3402602, at *1, *2.

12 *Id.* at *2.

law "resulted only because MF Global employees violated statutory and common law by transferring customer funds out of secured and segregated accounts."[13] In other words, absent MF Global misusing customer funds, the customers would have no claims against PwC for failing to prevent the misuse. In *MF Global III*, the plaintiff alleged that PwC's advice regarding the RTM transactions and other accounting matters caused the company to fail. Since there was no allegation or suggestion that MF Global "participated in PwC's formulation of its professional opinions other than to give PwC the information it requested to formulate those opinions," *in pari delicto* did not apply to bar these claims against PwC.[14]

## Conclusion

Without any evidence that MF Global acted improperly with respect to the accounting advice that it received and relied upon, the court was unwilling to use the strong medicine of *in pari delicto* to shut down this lawsuit before it got off the ground. Judge Marrero expressed serious concern over the implications of dismissing these malpractice claims against MF Global's accountant at such an early stage of the litigation (notwithstanding his prior *in pari delicto* ruling protecting PwC from different claims by different plaintiffs). In denying PwC's motion to dismiss in *MF Global III*, the court wrote:

> Under PwC's reasoning, the *in pari delicto* doctrine would insulate an auditor from liability whenever a company pursues a failed investment strategy after receiving wrongful advice from an accountant. Such a broad reading of the doctrine would effectively put an end to all professional malpractice actions against accountants — an outcome not in line with *Kirschner* or the New York courts' interpretation of it.[15]

Thus, this ruling is not about an exception to *in pari delicto* — such as the often-debated adverse-interest exception. Instead, *MF Global III* is about whether *in pari delicto* even applies in a situation where a professional is not being sued for its participation in or failure to stop a company's fraud or other wrongful conduct.

*MF Global III* provides an excellent example of a plaintiff and its counsel being rewarded for learning from others' past mistakes before the same court in the same overarching case. Rather than focusing on wrongful conduct by MF Global employees that PwC failed to detect and stop (as in *MF Global II*), the complaint at issue in *MF Global III* focused on PwC's accounting advice and its harm to the company. In other words, rather than running directly into the brick wall of *in pari delicto*, MF Global creatively pled around the issue.

That is not to say that this litigation against PwC has been won, not by a long shot. As Judge Marrero makes clear in his opinion, the plaintiff will have to prove that "MF Global … innocently accepted PwC's negligent advice in carrying out the RTM Strategy, and its doing so caused the damages it claims."[16] Proving that PwC's accounting advice caused the estate's damages, not MF Global's risky and highly leveraged investment strategy, will be extraordinarily difficult. That being said, the plaintiff lives to fight another day. In light of the expansive application of *in pari delicto* under New York law, this is a commendable accomplishment for an estate representative suing for accountancy malpractice after a major financial collapse. abi

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13 *Id.* at *3.
14 *Id.* at *4.
15 *Id.* at *5.
16 *Id.*