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Claims by Corporate Successor: 'In Pari Delicto' Still Applies
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The Appellate Division, First Department, recently affirmed the dismissal of various claims brought by New Greenwich Litigation Trustee, successor to the claims of two feeder funds in the Bernard Madoff affair, against various third-party fund administrators, accountants and auditors. In New Greenwich Litigation Trustee, LLC v. Citco Fund Services (Europe) B.V.,1 the court relied on the Court of Appeals' decision in Kirschner v. KPMG LLP,2 to reaffirm the broad application of the in pari delicto doctrine to all situations involving equal or mutual fault, and to construe narrowly the recognized exceptions to this doctrine. It thus held that, even when a successor trustee is asserting the interests of innocent creditors when prior management has acted wrongfully, the court will impute prior management's wrongful acts to the company.

The in pari delicto doctrine—"in pari delicto potior est conditio defendentis" means "In a case of equal or mutual fault, the position of the [defending party] is the better one,"—precludes the courts from interceding to resolve a dispute between two wrongdoers. It is a longstanding common law doctrine that serves the public policy aims of deterring illegal conduct by denying wrongdoers judicial relief and preventing the waste of public resources should the courts become entangled in disputes between wrongdoers. In New York, the principle underlying the doctrine is so strong courts have held that it should be applied even in difficult cases, and should not be "weakened by exceptions."3

While the justice of the doctrine is obvious in cases involving natural persons, it becomes less clear in matters involving corporate persons acting through dishonest agents, especially where an otherwise

innocent party becomes the successor to a legal claim of a corporation. The doctrine thus poses a particular challenge for trustees in bankruptcy who are faced with recovering assets to pay innocent creditors of companies that were previously tainted by fraud or other wrongdoing. In effect, creditors victimized by corrupt prior management acting in concert with third parties are precluded from recovering from those parties precisely because prior management was corrupt.

Claims by Successor

In Kirschner, dealing with similar circumstances to New Greenwich, the Court of Appeals resolved what was at the time a "significant and unsettled [question] of New York Law," namely, whether in pari delicto barred derivative claims by a corporation's successor against third-party professionals for negligence and malpractice in failing to detect or prevent fraudulent activity perpetrated by the corporation and its insiders.

The Court of Appeals held that agency law required that the acts of the fraudulent insiders be imputed to the corporation and, in bankruptcy, the successor to the corporation's claims. As such, the court ruled that the successor trustee was barred from making claims for negligence or malpractice against the third parties. The court was not blind to the ramifications of its decision and in particular the fact that it would shield third parties from liability for their own wrongful actions against the interests of innocent creditors. Judge Carmen Beauchamp Ciparick in dissent criticized the majority decision on exactly this ground, noting that it would "effectively [preclude] litigation by derivative corporate plaintiffs or litigation trustees to recover against negligent or complicit outside actors."4

In New Greenwich, the trustee sued the defendants, GlobeOp Financial Services LLC, Citco Fund Services (Europe) BV, Citco (Canada) Inc., and a number of Pricewaterhouse Coopers entities, which were at various times fund administrators, sub-administrators, external accountants and auditors of the two feeder funds. The trustee alleged that the defendants, charged with conducting due diligence regarding the Madoff funds, failed to do their jobs, all the while receiving millions in fees from the funds. The complaint alleged claims for breach of fiduciary duty, negligent misrepresentation, professional and gross negligence, breach of contract, common-law fraud, unjust enrichment and aiding and abetting breach of fiduciary duties.

In the Supreme Court, Justice Marcy Friedman invoked Kirschner's strict application of the in pari delicto doctrine and dismissed all claims against the third parties.5 In doing so, the court observed that plaintiffs had pleaded in previous derivative actions that prior management had acted wrongfully, which the court found were "informal judicial admissions" binding on the funds. The court also rejected the trustee's claim that it was an "innocent successor" to the company and therefore not bound by the bad conduct of its former officers.

Justice Friedman held that, pursuant to Section 541 of the Bankruptcy Code, the trustee stood "in the shoes" of the funds in respect of its claims, and was precluded from bringing any action that the funds could not have brought. The court noted the trustee's argument, based on cases outside of New York, that certain non-bankruptcy receivers and trustees had been held to not be subject to in pari delicto dismissal, but rejected the application of such cases to the trustee because Section 541 clearly applied and precluded the claims.

The Appellate Division affirmed the Supreme Court, rejecting the trustee's arguments that its claims fell within exceptions to the in pari delicto doctrine. The court refused to apply the "adverse interest" exception, which prevents an agent's conduct being imputed to the principal where the agent has "totally abandoned" the principal's interests and is acting "entirely" to benefit himself or a third party.6 The exception is often invoked in cases involving wrongdoing by insiders, and the courts have wrestled with the question of whether conduct that benefits a corporation in the short term, but harms it in the longer term represents a "total abandonment" of the corporation's interests.

In Kirschner, the Court of Appeals applied a strict version of the "adverse interest" exception, noting that even a short-term benefit represents some advancement of the principal's interest and precludes a finding that the manager was acting "entirely" adverse to the company. In doing so, the court expressly refused

to follow New Jersey and Pennsylvania courts in denying culpable third parties the protection of in pari delicto by adopting a carve-out from traditional agency law in cases of corporate fraud. In New Greenwich, the First Department also refused to apply this "most narrow of exceptions."7

Both the Supreme Court and the Appellate Division held that even where funds' agents were personally profiting from the lack of due diligence, any conceivable benefit to the funds, even keeping them operational despite their losses and thus potentially attracting new investors, was sufficient to refute that the agents' interests were "adverse."

Both courts also adopted a narrow application of the "insider" exception to in pari delicto. This exception ordinarily permits the corporation or its successor to sue former "insiders" who perpetrated the fraud. In pari delicto only bars a wrongdoer corporation from suing third parties, not the very agents whose wrongdoing has been imputed to the corporation. Here the trustee had argued that, given that one managing partner of a Citco affiliate had previously also been a director of one of the funds' general partners, Citco was an insider, so in pari delicto was inapplicable and claims by the trustee should be permitted to go forward. The Appellate Division affirmed the Supreme Court's ruling that this overlap of management was an insufficient basis to attribute insider status to Citco.

The court further held that in pari delicto applied even in cases of negligence, the test being whether the third parties were at equal or greater fault than the corporation. The Appellate Division also rejected the trustee's argument that it was an "innocent successor" to the funds, affirming the Supreme Court's application of Section 541 to preclude the trustee's claims.

Considering Strategy

Ultimately, this case demonstrates the challenges bankruptcy trustees will face under New York law going forward. Often, the conduct of former officers and directors of bankrupt companies (particularly those that collapse because of fraud or wrongdoing) will be relevant and even necessary to claims against third parties. But the pleading of such conduct will be considered admissions by the company and serve to bar the case altogether. Nor is omitting the wrongdoing from the complaint likely to be a successful strategy, given that the defendants will surely raise it in any event, although in that case, plaintiff will not be doomed by its own admissions in the pleadings.

The New Greenwich case highlights the importance of carefully considering litigation strategy, including whether litigating in New York where New York law is likely to be applied is a good idea, potentially even prior to Chapter 11 reorganization and appointment of a litigation trustee. The viability of any successful action may therefore depend on how parties conduct themselves at the earliest stages of litigation, making careful planning and evaluation of the available options essential to any recovery against those third parties that were complicit in the entity's misdeeds.

Endnotes:
1. No. 600469/09, 2016 WL 6086111, at * (1st Dept. Oct. 18, 2016).
2. 15 N.Y.3d 446, 938 N.E.2d 941, 950 (2010).
3. McConnell v. Commonwealth Pictures Corp., 7 N.Y.2d 465, 470, 166 N.E.2d 494, 497 (1960).
4. Kirschner, supra n. 2 at 477, 959.
5. Walker, Truesdell, Roth & Associates, Inc. v. Globeop Fin. Servs. LLC, 43 Misc.3d 1230(A), 993 N.Y.S.2d 647 (Sup. Ct. 2013).
6. Kirschner, supra n. 2 at 466.
7. Id at 466.

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