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Expert Analysis

Defeating In Pari Delicto On a Motion to Dismiss

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The defense of in pari delicto is often invoked by auditors, banks, law firms, and other defendants to avoid liability for their alleged participation in corporate malfeasance. The doctrine, derived from the Latin for "equally at fault," provides a complete defense where the plaintiff, either directly or through its agents, was at least equally at fault for the claimed wrongdoing. Two principles of agency law give the doctrine its teeth. First, a corporate plaintiff is deemed responsible for the acts of its employees and other agents, including fraud and criminal wrongdoing, in all but the most exceptional cases. Second, a corporate successor such as a receiver or bankruptcy trustee generally "stands in the shoes" of the malfeasant corporation, and is charged with its wrongdoing as well. As a result, employee or agent wrongdoing is commonly imputed to corporate and successor plaintiffs, triggering the application of in pari delicto.

New York law applies a particularly stringent version of the doctrine. Even though in pari delicto is an affirmative defense, and case law suggests that a balancing of the parties' relative fault is required, New York courts often dismiss plaintiffs' claims on the face of the pleadings, without balancing and without discovery. The frequency of such dismissals has only increased since 2010, when the New York Court of Appeals held in *Kirschner v. KPMG*, 938 N.E.2d 941, 946 n.3 (N.Y. 2010), that in pari delicto "may be resolved on the pleadings … in an appropriate case."

Given this trend, surviving a motion to dismiss can significantly enhance a plaintiff's leverage. If a plaintiff can persuade a court that in pari delicto presents issues of fact, the plaintiff can open the door to discovery and trial, or a more favorable settlement. This article identifies several strategies that may be useful to plaintiffs' counsel in drafting a complaint to withstand an anticipated motion to dismiss on in pari delicto grounds.

Pleading Employee Wrongdoing

Ordinarily, a complaint based on allegations of wrongdoing will include as much detail about the bad actors as possible. Where in pari delicto is in play, however, there is a competing imperative for the plaintiff: Although such allegations can help to state a cause of action, they can also be used against the plaintiff as judicial admissions of imputed misconduct. Accordingly, to the extent feasible, allegations about wrongdoing by present or former employees should be minimized.

Similarly, allegations going to the parties' state of mind may prove crucial. The *Kirschner* court held that the in pari delicto doctrine is at its strongest when a plaintiff acted intentionally, but the defendant was merely negligent. Where the plaintiff did not commit any wrongdoing, or at most acted negligently, dismissal is less likely. For pleading purposes, if allegations of misconduct by plaintiff or its agents are unavoidable, plaintiff's counsel should if possible avoid characterizing that wrongdoing as intentional. Such pleading, particularly if coupled with allegations that the defendant's own wrongdoing was intentional, will improve the odds of persuading a court that the parties' relative fault presents an issue of fact.

> New York courts remain relatively strict in their application of in pari delicto.

Rethinking 'Benefits'

The central premise of in pari delicto is imputation, which is the principle of agency law that holds corporations

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responsible for their agents' conduct. Under *Kirschner*, even unauthorized or fraudulent acts are imputed. The sole exception is where—as in the case of embezzlement or looting—"the corporation is actually the agent's intended victim," and "the fraud [was] committed *against* a corporation rather than on its behalf." *Kirschner*, 938 N.E.2d at 951, 952. If the plaintiff corporation received any benefit at all, even if the wrongdoing harmed the corporation in the long run and led to its bankruptcy, then the case will likely be dismissed.

Attempts to invoke this "most narrow of exceptions," id. at 952, are almost always rejected. New York courts have consistently rejected the argument that "net benefits"—where short-term benefits are outweighed by long-term costs—can defeat imputation. However, one potentially viable strategy is to allege that the actions of plaintiff's agents yielded *less of a benefit* than plaintiff otherwise would have received. Plaintiff did just that—and successfully avoided imputation—in *In re Refco Secs. Litig.*, 779 F. Supp. 2d 372 (S.D.N.Y. 2011). There, Judge Jed Rakoff found that even though the plaintiff whose funds were wrongfully transferred to unsegregated accounts received a benefit in the form of interest payments, those payments were actually "detrimental"—the company would have received greater interest payments if its funds had been left in the proper account. In other words, the diminished interest payments were not a benefit at all.

Isolating Defendants' Wrongdoing

Because in pari delicto applies where the plaintiff or its agent was an active, voluntary participant in the wrongdoing at issue, plaintiff's counsel should focus carefully on whether the complaint can distinguish between harm caused by plaintiff's agents, and harm caused by the defendants, with only the latter giving rise to damages. Well-counseled plaintiffs may be able to survive an in pari delicto defense if they can de-couple their own agents' alleged wrongdoing from the wrongdoing by defendants for which they seek redress. Indeed, plaintiff invoked this strategy successfully in *MF Global Holdings v. PricewaterhouseCoopers*, 57 F. Supp. 3d 206 (S.D.N.Y. 2014), following the prior dismissal of all claims on in pari delicto grounds in a related action.

In the original case, MF Global's former customers on behalf of its trustee asserted claims against the company's auditor, PwC, for professional negligence and breach of fiduciary duty, claiming that PwC had failed to detect material inadequacies in internal policies and procedures. Applying *Kirschner*, the court imputed the activities of MF Global's directors and officers to the company, and dismissed the claims based on in pari delicto. One month later, MF Global, in its capacity as Plan Administrator, filed a complaint asserting claims against PwC for professional malpractice and negligence. The Plan Administrator based its claims on PwC's advice about MF Global's accounting, alleging that *the advice itself* was erroneous and led to damages. Importantly, the Plan Administrator alleged that MF Global had no role in that incorrect advice, as MF Global gave PwC accurate information. Based on these pleadings, the court found that MF Global was not an active, voluntary participant in the allegedly improper accounting advice, and denied a motion to dismiss.

Choice of Law

Finally, plaintiffs should also pay close attention to the applicable law, and to pleading facts that might affect a choice-of-law analysis. For example, both New Jersey and Pennsylvania have adopted more plaintiff-friendly exceptions to in pari delicto. Though *Kirschner* declined to adopt those changes as a matter of New York law, 938 N.E.2d at 958, New York courts remain willing to apply other jurisdictions' in pari delicto doctrines where appropriate. See, e.g., *FIA Leveraged Fund v. Grant Thornton*, 150 A.D.3d 492, 496-97 (1st Dep't 2017).

Similarly, although most courts—like New York—treat a successor as "standing in the shoes" of the original wrongdoer, and thus equally subject to in pari delicto, some courts outside the bankruptcy context have permitted recovery by a successor on behalf of innocent creditors. See, e.g., *Scholes v. Leman*, 56 F.3d 750, 754-55 (7th Cir. 1995) ("[T]he defense of in pari delicto loses its sting when the person who is in pari delicto is eliminated."); *F.D.I.C. v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir. 1995) ("While a party may itself be denied a right or defense on account of its misdeeds, there is little reason to impose the same punishment on a trustee, receiver or similar innocent entity that steps into the party's shoes pursuant to court order or operation of law."). Here too, it is prudent for plaintiffs to be attentive to what law might apply.

Conclusion

New York courts remain relatively strict in their application of in pari delicto. Though the facts of each case are obviously unique, well-counseled plaintiffs have a number of tools at their disposal to defeat a motion to dismiss and carry a case through to discovery and beyond.

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