

# The Refco Puzzle: When Are Complicit Third Parties Liable?

BY LAZAR EMANUEL

Ever since the Refco scandal erupted in October 2005, the federal and state courts have been struggling to answer a fundamental question of third-party liability – when is a lawyer, an accountant, a banker, a financial advisor, or a consultant who has participated in, ignored, or failed to discover, a corporate fraud – accountable in damages to third parties, e.g., a creditor of the corporation or a Trustee appointed by the bankruptcy court? But first a little history.

On August 16, 2005, Refco, Inc., one of the country's leading commodity brokers, launched its Initial Public Offering. The shares sold initially at \$22. By September 7, 2005, the stock had reached a peak of \$30.12 a share. One month later, on October 10, Refco's president, Philip Bennett, resigned after facing an internal audit that revealed he had disguised \$430 million in debts to his firm. On October 12, Bennett was charged with a criminal count of securities fraud for manipulating the firm's financial statements. On October 13, the New York Stock Exchange halted all trading in Refco's shares. On October 17, Refco filed for bankruptcy.

A total of 62 days had passed between the public offering and the bankruptcy filing. Peter Bennett pleaded guilty to the charges against him and was sentenced to 16 years in federal prison.

## A Spate of Law Suits

Unfortunately, commercial debacles lead inevitably to a spate of law suits. It was thus with Enron and thus with WorldCom. The Refco scandal has also prompted many trips to the court house.

In the June 2010 issue of NY PRR , I discussed one of the cases that sprang from Refco's demise, *Pacific Investment Company v. Mayer Brown*, (09-1619-cv, April 28, 2010). Pacific, a creditor of Refco, alleged that a senior partner at Mayer Brown had actively participated in Bennett's schemes. (The partner was later convicted of securities fraud, conspiracy and wire fraud.)

The Second Circuit drew a bright line dividing third-party "creators" – like the Mayer partner – from insiders who acted as "disseminators" of false corporate statements – like Bennett and his corporate accomplices. A "creator" might be a lawyer or an accountant (or a financial adviser) who caused the misleading statement to be conceived or drafted – or who knew of, ignored, or failed to discover its implementation – but the false statement would not be "attributed" to him if he served solely as a "secondary actor," and not as the "disseminator" of the statement.

Writing for the Court, and following the reasoning of the Supreme Court in *Stonebridge Investment Partners LLC v. Scientific Atlanta, Inc.*, 552 U.S. 148 (2008), Judge Jose A. Cabranes said:

We hold that a secondary actor can be liable for false statements in a private damages action for securities fraud only if the statements are attributable to the defendant at the time the documents are disseminated.

We further hold the plaintiff's claims that defendants participated in a scheme to defraud investors are not meaningfully distinguishable from the claim at issue in *Stonebridge* and, therefore were properly dismissed.

The creditor in *Pacific* argued that the senior partner at the Mayer firm had actively participated in drafting and distributing loan documents and an IPO Registration, all containing false statements. The law firm had also reviewed and replied to comment letters from the SEC. (The SEC filed an amicus brief in support of the creditor in *Pacific*, arguing among other points, that the adoption of "creator" liability was consistent with prior opinions of the courts, and that shielding Mayer Brown from damages caused by a partner who was convicted criminally for his acts could not be supported.)

Judge Cabranes cited the Supreme Court decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). That decision interpreted SEC Rule 10b-5 to require the element of "reliance" before those who "aid and abet" corporate malfeasance can be held liable to third parties.

In *Shapiro v. Cantor*, 123 F.3d 717 (1997), the 2nd Circuit followed *Denver* and decided for defendant Deloitte & Touche on a claim for complicity in the deceptive conduct of a limited partnership. The 2nd Circuit said:

(a)llegations of "assisting," "participating in," "complicity in" and similar synonyms used throughout the complaint all fall within the prohibition in *Central Bank*. A claim under §10(b) must allege a defendant has made a material misstatement or omission indicating an intent to deceive or defraud in connection with the purchase or sale of a security.

Then, in *Wright v. Ernst & Young, LLP*, 152 F.3d 169 (1998), the 2nd Circuit added another element to the requirements for complicit liability – *i.e.*, that *Central Bank* requires that a false statement be attributed to the third-party defendant at the time the statement is disseminated. As Judge Cabranes concluded:

Wright ... made clear that attribution is necessary to establish the reliance element of a private damages action under Rule 10b-5. Because the misrepresentations under which plaintiff's claims were based were not attributed to Ernst & Young, we held that the complaint failed to state a claim under 10b-5.

## **Bankruptcy Trustee Joins the Refco Fray**

While *Pacific* was moving through the courts, the judge in the Refco bankruptcy proceeding established a Refco Litigation Trust and appointed Marc S. Kirschner as Trustee, with authorization to pursue claims and causes of action possessed by Refco prior to its bankruptcy filing. The beneficiaries of the Trust were designated as the owners of general unsecured claims against Refco.

In August 2007, the bankruptcy Trustee filed an action in the Illinois state courts alleging fraud, breach of fiduciary duty and malpractice against a group of parties divided into Respondents and Defendants. The Respondents included Mayer Brown – the defendant in *Pacific* – PricewaterhouseCoopers, and various affiliates of banks, including Bank of America, Credit Suisse and Deutsche Bank. Among the Defendants were Ernst & Young and several principals and officers of Refco, including Philip Bennett.

In 2008, the Trustee filed an action in the Massachusetts state courts, apparently for the purpose of adding the accounting firm KPMG to his list of targets. Ultimately, both state actions were removed to the federal courts and transferred to the Southern District of New York for coordinated and consolidated proceedings. The Case was listed as *Kirschner v. KPMG LLP et al.*, Docket Nos. 09-2027-cv (CON). After the case was removed, the defendants moved to dismiss the Trustee’s complaint and the District Court granted the motion.

## **The Wagoner Rule**

The District Court relied on the decision in *Shearson Lehman Hutton v. Wagoner*, 944 F2d 114 (2d Cir 1991), which enunciated the “Wagoner rule” – i.e., that a bankruptcy trustee does not have standing to recover from third parties who are alleged to have joined with the principals of a defendant corporation in defrauding creditors; in other words, from parties who are in *pari delicto* with the corporate insiders or principals. The central question in *Wagoner* was whether the third parties had met the criteria required for the “adverse interest” exception to the Wagoner in *pari delicto* rule. That exception can be invoked only when the insiders who engaged in wrongdoing acted entirely in their own interest and not in the corporation’s interest.

The Refco Trustee appealed from the District Court ruling, and in an opinion by Judge Jon O. Newman, the 2nd Circuit disposed *seriatim* of the Trustee’s arguments. Assuming the truth of the facts recited by the Trustee and by the District Court, Judge Newman described the actions of Refco insiders as “[a] scheme which involved...both concealment of Refco’s uncollectible debt and the misappropriation of customer assets.”

Judge Newman considered the Trustee’s argument that the Refco insiders had abandoned Refco’s interest entirely, without any benefit to Refco, and had therefore made inapplicable the adverse interest exception to imputation of their misdeeds to Refco. He concluded that “the issues concerning imputation and the adverse interest exception raise questions of New York law as to which considerable uncertainty exists.” [Author’s note: The decision in *Pacific* was not invoked by Judge Newman, even though Mayer Brown was a Respondent in *Kirschner*. One is left to wonder why the *Pacific* court did not also pose a question to the Court of Appeals to clarify New York law.]

Judge Newman announced the decision of the Circuit Court to certify to New York's Court of Appeals a series of questions the answers to which would govern the 2nd Circuit's disposition of the Trustee's appeal.

Judge Newman reviewed the arguments of the Trustee and of the Appellees to show the confusion and imprecision of New York law. The arguments of both exposed several issues, all of which were certified to the New York Court of Appeals. Curiously, both the Trustee and the Appellees cited the same New York cases (four of them) in support of their arguments. This gave Judge Newman the opportunity to say:

Their differing uses of New York cases, coupled with the somewhat divergent language used by the District Court in the pending case and by our Court in *CBI*, both endeavoring to interpret New York law, make it appropriate to seek authoritative guidance from the New York Court of Appeals. Although the precise allegations in the pending case are distinctive, the recent frequency of insider misconduct in the corporate world underscores the virtue of using certification.

In consequence, the 2nd Circuit certified the following questions to the Court of Appeals: (1) the overarching question whether the allegations of the complaint in this case satisfy the "adverse interest" exception to the *Wagoner* rule of imputing insiders' misconduct to their corporation, and the following subsidiary questions subsumed within that ultimate question: (2) whether the adverse interest exception is satisfied by showing that the insiders intended to benefit themselves by their misconduct; (3) whether the exception is available only where the insiders' misconduct has harmed the corporation; (4) if harm is required, whether the analysis of such harm may include any detriment to a corporation resulting from the eventual unmasking of the misconduct; (5) if harm is required, whether such harm may be determined by considering a corporation and its related corporations as a single enterprise; (6) if harm is required and is to be determined with respect to separate though related corporations, whether the allegations of the complaint adequately allege such harm; (7) whether the exception is precluded where the misconduct conferred some benefit upon the corporation; and (8) if the adverse interest exception were otherwise available, would it be precluded by the "sole actor" rule? If the Court of Appeals is disinclined to answer or at least discuss all of these questions, we hope it will focus its attention on questions (2) and (3).

### **Court of Appeals Responds**

In her 35-page opinion, Court of Appeals Judge Susan P. Read answered only two of the 2nd Circuit's questions – "No" to Question 2 (whether the adverse interest exception is satisfied by showing that the insiders intended to benefit themselves by their misconduct); and "Yes" to Question 3 (whether the exception is available only where the insiders' misconduct has harmed the corporation). The opinion fails to answer any of the other questions, although each of them represents a central issue debated by the courts in earlier opinions.

[Judge Read's opinion also resolved a certified question in another case – *Teachers' Retirement System of Louisiana et ano. Derivatively on behalf of nominal defendant AIG, Inc. v. PricewaterhouseCoopers LLP*. In *Teachers'*, Plaintiffs alleged that AIG insiders had conspired with other companies to transfer insurance policies without transferring the risk of coverage and had created other "special purpose entities" without observing the required accounting rules. They did not allege that Pricewaterhouse had conspired with the AIG insiders, only that as AIG's independent auditor, it had neglected its responsibility to detect

and report the fraud by AIG's senior officers. Plaintiff's complaint was dismissed by the Delaware Court of Chancery and the Delaware Supreme Court certified a question to the New York Court asking whether the doctrine of *in pari delicto* covered the failure of an accounting firm to satisfy professional standards in its audits, although it had not knowingly participated in the fraud. Judge Read treated *Teachers'* as another case involving corporate and third-party malfeasance and answered the certified question "Yes", but only "assuming the adverse interest exception does not apply."]

Judge Read discussed several related issues:

**In Pari Delicto.** This is the doctrine which instructs the New York Courts not to resolve disputes between two wrongdoers. The doctrine has been followed for 200 years. "The doctrine is "so strong ...that we have said the defense applies even in difficult cases and should not be weakened by exceptions." Also, "we are applying fundamental concepts of morality and fair play and fair dealing" (quoting a 1960 New York case).

**Imputation.** We observe the fundamental principle that "the acts of agents, and the knowledge they acquire while acting within the scope of their authority are presumptively imputed to their employers." The presumption exists in every case except where the corporation is actually the agent's intended victim, principally to encourage employers "to select honest agents and delegate duties with care."

**The Adverse Interest Exception.** The exception arises only when the agent has totally abandoned his principal's interests and is acting entirely for his own interest or the interest of others. "...because the exception requires adversity, it cannot apply unless the scheme that benefitted the insider operated at the corporation's expense. The crucial distinction is between conduct that defrauds the corporation and conduct that defrauds others for the corporation's benefit.

**Decisions in New Jersey and Pennsylvania.** The New York Court rejected two views of the same issues adopted by New Jersey and by Pennsylvania. The New Jersey view would enable corporate shareholders who are "innocent" of blame to avoid the *in pari delicto* hurdle and recover – at least in proportion to their degree of complicity. In Pennsylvania, the 3rd Circuit held that when a third party colludes with a corporate insider or agent to defraud the principal, the law requires an inquiry into "whether the third party dealt with the principal in good faith."

**Comparative negligence.** The Trustee in *Refco* argued that an *in pari delicto* defense requires apportionment of fault and damages between the Trustee and the defendant. The Court answered "...comparative fault contradicts the public policy purposes at the heart of *in pari delicto* – deterrence and the unseemliness of the judiciary 'serving as paymaster of the wages of crime'" (quoting *Stone*, 298 NY at 271."

**Public Policy.** "We are ... not convinced that altering our precedent to expand remedies for these or similarly situated plaintiffs would produce an immediate additional deterrent to professional misconduct or malpractice....The principles of *in pari delicto* and imputation, with [their] narrow adverse interest exception, which are embedded in New York law, remain sound."

In a decision on November 21, 2010, following the answers to its certified questions by the Court of Appeals, the 2nd Circuit said:

The responses from the Court of Appeals have authoritatively announced New York law on the issues on which we were in doubt....With respect to all of the Trustee's contentions challenging other aspects of Judge Lynch's decision (note: Judge Lynch was the District Court judge who dismissed the Trustee's complaint), we conclude that he correctly rejected the Trustee's arguments, and we adopt his opinion as the resolution of this Appeal.

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