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OUTSIDE COUNSEL

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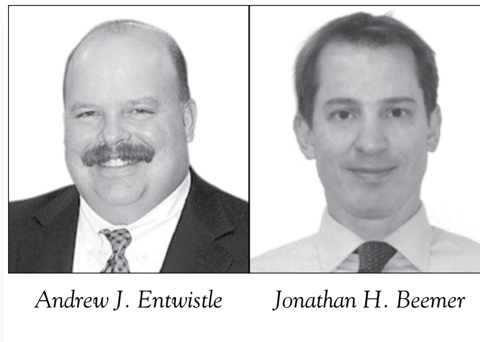
'Wagoner,' In Pari Delicto Defenses Aid Outside Auditors

The New York State Supreme Court's decision in *Bullmore v. Ernst & Young Cayman Islands*[1] provides the most recent articulation under New York law of the in pari delicto defense and the standing doctrine known as the "*Wagoner* rule."[2]

Justice Charles E. Ramos relied on both principles to grant summary judgment dismissing a negligence claim brought by court-appointed liquidators of a foreign hedge fund against its outside auditor. The *Bullmore* decision may well bolster the defenses available to accountants, and conceivably other third-party professionals, sued by liquidators for negligence under New York law.



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The Facts

The court in *Bullmore* considered a negligence claim against Ernst & Young Cayman Islands[3] (Ernst & Young) by joint official liquidators of Beacon Hill Master Ltd. (the fund), a defunct Cayman Islands hedge fund.

The fund was organized under Cayman Islands law in 1997 and invested principally in mortgage-backed securities. A related entity and its four principals served together as the fund's investment managers (the investment managers). Ernst & Young was the fund's outside auditor and issued a "clean audit report" for the fund for the first quarter of 2002.

In October 2002, the investment managers notified the two independent members of the fund's board of directors that the fund had sustained heavy trading losses and a reduction of half its net asset value (NAV). At this same time, the fund's "broker," Bear Stearns, learned of these losses and ceased its financing of the fund. Bear Stearns also alerted the Securities and Exchange Commission (SEC) of the fund's status.

Following a consent judgment with the SEC, the fund entered into official liquidation in the Cayman Islands in 2004. The Grand Court of the Cayman Islands appointed joint official liquidators (the liquidators) to pursue claims on behalf of the fund pending its wind-up. Subsequently, the liquidators commenced this action on behalf of the fund against the investment managers, Ernst & Young, and the fund's administrator. The complaint alleged that the investment managers fraudulently inflated the value of the assets held by the fund.

All defendants other than Ernst & Young settled with the liquidators. The sole remaining claim charged Ernst & Young with negligence in failing to detect the investment managers' fraudulent valuation and to alert the fund's directors of the fraud.

Summary Judgment Arguments

Ernst & Young moved for summary judgment relying on the imputation principles of the *Wagoner* rule and the in pari delicto defense. The *Wagoner* rule is a standing doctrine which prohibits a bankruptcy trustee from bringing claims on behalf of the debtor corporation against third parties who cooperate with management in committing wrongdoing against the corporation.[4] The rule is based on the basic agency principle that wrongdoing committed by corporate management within the scope of its employment will generally be imputed to the corporation.[5] In pari delicto is an equitable defense which prevents a plaintiff from recovering against a defendant where both are equally at fault for the alleged wrongdoing.

Ernst & Young asserted that the liquidators lacked standing to sue because the wrongful actions of the investment managers were imputed to the fund under *Wagoner*. Thus, standing in the shoes of a party "in equal fault" under the in pari delicto defense, the liquidators could not recover for Ernst & Young's alleged negligence.

Relying on *Willamson v. PricewaterhouseCoopers LLP*, Index No. 602106/06 (N.Y. Sup. Nov. 7, 2007), the liquidators countered that as "innocent successors-in-interest" they should be permitted to bring a claim because any recovery would benefit only the innocent fund investors, not the investment managers who perpetrated the fraud.[6]

The liquidators also argued for application of the so-called "innocent insider" exception to the *Wagoner* rule. Here, the liquidators contended that the fund directors could have stopped the investment managers' fraudulent valuation had Ernst & Young alerted them of its existence. The "innocent insider" exception may rebut the imputation of wrongdoing under *Wagoner* where management insiders were both unaware of the misconduct and had authority to stop it had they been aware.

The liquidators also urged application of the "adverse interest" exception to the *Wagoner* rule. When a corporate officer or agent's misconduct is so adverse to the corporation that such agent has "totally abandoned" the interests of the corporation for the benefit of themselves or a third party, the "adverse interest" exception can rebut imputation of wrongdoing to the corporation or parties standing in its shoes.[7] According to the liquidators, the investment managers had abandoned the fund's interest by seeking to increase their own management fees through fraudulent inflation of the fund's NAV.

The Supreme Court's Decision

Justice Ramos synthesized the leading cases in the Second Circuit on the *Wagoner* rule and the in pari delicto defense to formulate his own standard of review for the liquidators' claim. As a threshold matter, Jus-

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tice Ramos found it necessary to decide whether the investment managers whose challenged conduct would be imputed to the fund were acting within the scope of their employment. Justice Ramos used this test to decide whether the "adverse interest" exception to the *Wagoner* rule applied.

The court found nothing in the record to suggest that the investment managers were acting outside the scope of their employment, or had "totally abandoned" the fund's interests to benefit themselves. Indeed, the liquidators had alleged that the false reporting of the fund's NAV allowed the fund to attract and retain capital from investors, thereby benefiting from the investment managers' alleged wrongdoing. Notably, the court required only "some degree of financial benefit" to the fund to render inapplicable the "adverse interest" exception. The court also considered the intent of the allegedly wrongdoing agent in deciding the "total abandonment" question.[8]

Thus, it did not matter that the investment managers stood to gain increased fees from the fraud since the record also demonstrated their intent to attract capital and retain existing fund investors through manipulation of the fund's NAV.

'Innocent Insider' Exception

The "innocent insider" exception was also rejected by the court. Interestingly, Justice Ramos considered the "innocent insider" analysis not so much as an exception to the *Wagoner* rule, but as a means of determining causation for the negligence claim.[9]

In the court's view, the question of whether Ernst & Young's alleged negligence caused the fund to incur losses depended on whether the "innocent insider" directors could have prevented such losses had they been aware of the investment managers' manipulative conduct. Justice Ramos found no such causal link and was extremely skeptical of the purported innocence of the directors.

According to Justice Ramos, the factual record clearly established that the investment managers exercised complete discretion over the management of the fund and its investments. In contrast, the directors devoted only "a few hours at best" performing mainly "administrative tasks" for the fund. The directors did not investigate or seek to remove the investment managers when they learned of the fund's valuation discrepancies, and failed to alert the SEC of these conditions when they became known.

Consequently, Justice Ramos found no triable issue of fact as to whether the directors had been innocent decision makers capable of stopping the investment managers' wrongdoing had they been so informed by Ernst & Young.[10] The court viewed the directors as being indisputably passive and "at best, in delicto," with the investment managers, thereby making it appropriate to impute their conduct to the fund.

The court also found misplaced the liquidators' reliance on the *Williamson* case. In *Williamson*, a court-appointed trustee of a hedge fund was permitted to bring a negligence claim against the fund's auditor. Aside from the significant factual distinctions in *Williamson* (i.e., misconduct by a single director, fact issue on whether director acted solely to benefit himself, auditors' direct knowledge of inflated valuations over a five-year period), Justice Ramos refused to recognize the existence of an "innocent successor" exception to the *Wagoner* rule as had Justice Moskowitz in *Williamson*. Justice Ramos found that this exception would inappropriately permit the liquidators to pursue a claim for the benefit of the fund's investors, where the fund itself lacked standing. Justice Ramos further found that application of the "innocent successor" exception would ignore an established principle that negligence claims against accountants belong to the corporate client, as opposed to persons (such as investors) who lack privity with them.

Justice Ramos' rejection of the "innocent successor" exception is obviously at odds with a sister court, and the liquidators have indicated an intention to appeal the *Bullmore* ruling. While it remains an open question under New York law,[11] *Bullmore* would seem to cast doubt upon the viability of the "innocent successor" exception going forward.

Conclusion

The reach of the *Wagoner* rule and the in pari delicto defense for outside auditors are unresolved questions which different state courts are addressing with increasing frequency. Indeed, the U.S. Court of Appeals for the Third Circuit has recently certified to the Pennsylvania Supreme Court the question of the appropriate standard under Pennsylvania law for deciding whether an agent's fraud should be imputed to its principal when an allegedly culpable third-party invokes such imputation to shield itself from liability. See *Official Comm. of Unsecured Credt. of Allegheny Health Educ. and Research Found. v. PricewaterhouseCoopers LLP*, No. 07-1397 (July 1, 2008). In certifying this question, the *Allegheny* court suggested that imputation might unfairly benefit an outside auditor alleged to have contributed to misconduct at the corporation.[12] Such a holding could run counter to the law in New York as expressed in *Bullmore*.

In New York, the precise contours of the *Wagoner* and in pari delicto defenses, as well as the "innocent insider" and "innocent successor" exceptions may ultimately depend upon their consideration by the New York Court of Appeals. In the interim, the *Bullmore* decision provides practitioners with guidance on what court-appointed liquidators must demonstrate to bring negligence claims against outside auditors. *Bullmore* may seem to foreclose liability for such claims when outside auditors (and perhaps other third-party agents) can show an intentional benefit to the liquidated entity arising from management's wrongdoing.

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1. 2008 N.Y. Slip Op. 28238, 2008 WL 2572931 (N.Y. Sup. June 19, 2008).

2. The rule is derived from the Second Circuit's decision in *Shearson Lehman Hutton Inc. v. Wagoner,* 944 F.2d 114 (2d Cir. 1991) and its progeny.

3. Plaintiff originally sued both Ernst & Young Cayman Islands and Ernst & Young LLP, but Justice Ramos dismissed claims against the latter for lack of privity, which dismissal was affirmed. See *Bullmore v. Ernst & Young Cayman Islands,* 45 AD3d 461, 846 NYS2d 145 (1st Dept. 2007).

4. See *Wagoner,* 944 F.2d at 120 (finding "[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation"). While the *Wagoner* case dealt with claims by a corporation's bankruptcy trustee, Justice Ramos explicitly noted that *Wagoner* applied to joint liquidators and other analogous court-appointed representatives with authority to commence claims which the entity could have brought absent liquidation. See *Bullmore*, 2008 WL 2572931, at *2 n.3.

5. The *Wagoner* rule does not bar breach of fiduciary duty claims against a debtor corporation's fiduciaries. See *Global Crossing Estate Rep. v. Winnick,* No. 04 Civ. 2558 (GEL), 2006 WL 2212776, at *15 & n.20 (S.D.N.Y. Aug. 3, 2006) (declining to apply *Wagoner* to dismiss Estate Representative's claims against self-dealing fiduciaries) (citing cases).

6. In *Williamson,* Justice Moskowitz adopted such an "innocent successor" exception to the *Wagoner* rule, holding that a hedge fund's liquidation trustee could pursue claims against the fund's auditors where the only beneficiaries of the claim would be innocent investors, and where applying the in pari delicto defense could allow an alleged wrongdoer to escape liability.

7. See *Center v. Hampton Affiliates Inc.,* 66 NY2d 782, 784 (1985) ("when an agent is engaged in a scheme to defraud his principal, either for his own benefit or that of a third person, the presumption that knowledge held by the agent was disclosed to the principal fails because he cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose").

8. This is consistent with the standard set forth by federal and state appellate courts in New York. See, e.g., *In re CBI Holding Co.,* 529 F.3d 432, 451 (2d Cir. 2008); *Capital Wireless Corp. v. Deloitte & Touche*, 216 AD2d 663, 627 NYS2d 794 (3d Dept. 1995).

9. In this regard, Justice Ramos' interpretation appears to reinforce New York state and federal court decisions which cast doubt on the very existence of an "innocent insider" exception to the *Wagoner* rule. See, e.g., *Morgado Family Partners, L.P. v. Lipper,* 6 Misc.3d 1014(A), 800 N.Y.S.2d 350 (N.Y. Sup. Nov. 9, 2004) (refusing to endorse existence of "innocent insider" exception under New York law), aff'd, 19 A.D.3d 262, 800 N.Y.S.2d 128 (1st Dept. 2005); *In re CBI,* supra at n.8, 529 F.3d at 447 (citing with approval district court's rejection of "innocent insider" exception to *Wagoner* imputation).

10. Indeed, Justice Ramos found the directors' "willful passivity" provided Ernst & Young with a so-called "*Cenco* defense." In *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir. 1982), Judge Posner for the Seventh Circuit found that passive directors who did not directly participate in management's scheme to inflate corporate inventories were nonetheless culpable for their failure to supervise the conduct of their appointed managers.

11. See *Morgado*, 19 AD3d at 263, 800 NYS2d at 129 ("it is unsettled that in pari delicto can ever apply against an innocent, non-bankruptcy trustee").

12. See also *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 882 (N.J. 2006) (New Jersey Supreme Court holding that auditor "who contributed to the misconduct cannot invoke imputation" to avoid liability for negligence).

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