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For a late breaking development on the Refco litigation described in this article, see the text box on p. 52.

Litigating Financial Losses Under State Law: Defenses and Issues to Consider

State law has often been considered "plaintiff-friendly," but there are important and potentially powerful defenses available to defendants against state law claims.

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Recent months have witnessed a staggering loss of wealth across virtually every asset class. Not unexpectedly, litigation seeking recovery for such losses has followed and is expected to increase. While "traditional" class action claims continue to be brought under the federal securities laws, procedural and substantive impediments to such litigation may push some plaintiffs in the direction of individual (non-class) state law litigation. In fact, substantial, high-stakes cases are increasingly being pursued under state law.[1] Theories of recovery range from breach of contract to fraud.

While state law is often viewed favorably by plaintiffs and with great trepidation by defendants, both sides to state law litigation should be aware of potential defenses that can substantially alter the presumed balance of risks. This article highlights a number of such defenses.

FEDERAL VERSUS STATE LAW

Defendants have long believed that state law – and state courts – favors plaintiffs. Indeed, that sentiment was part of what motivated the Class Action Fairness Act of 2005 ("CAFA");[2] the Private Securities Law Reform Act (the "PSLRA"); and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[3]

[1] See, e.g., M&T Bank v. Gemstone CDO VII, Ltd., et al. (New York State Supreme Court) (claim by a CDO investor against entities that "marketed" the investment); UBS Securities LLC v. Highland Capital Management, L.P., et al. (New York State Supreme Court) (indemnification and breach of contract action arising out of failed CDO); City and County of San Francisco v. Ambac Financial Group Inc., et al. (Superior Court of the State of California, San Francisco County) (state law claims relating to alleged improprieties in the municipal bond insurance industry); and HSH Nordbank AG v. UBS AG and UBS Securities LLC (New York State Supreme Court) (state law claims arising out of plaintiff's purchase of CDO investment).

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[2] PL 109-2 (2005). CAFA expanded federal jurisdiction over class action lawsuits in order to cut back on what Congress perceived to be "forum shopping" by plaintiffs in pro-plaintiff state courts. See 151 Cong. Rec. S1076 (daily ed. February 8, 2005) (statement of Sen. Specter explaining that "[t]he class action bill has as its central focus to prevent judge shopping to various States and even counties where courts and judges have a prejudicial predisposition on cases."); id. at S1081 (statement of Sen. Lott addressing "a dramatic rise in the number of interstate class actions being filed in State courts, particularly in what are called magnet jurisdictions"); and 151 Cong. Rec. H748 (daily ed. February 17, 2005) (statement of Rep. Blunt arguing that "[l]awyers who now manipulate this system often do anything to stay out of Federal court"). See also 151 Cong. Rec. H.726 (daily ed. February 17, 2005) (statement of Rep. Sensenbrenner observing that "certain favored judges" in state courts were "hearing nationwide cases and setting policy for the entire country").

[3] In 1995, Congress enacted the PSLRA, PL 104-67, which stiffened the pleading requirements on federal securities claims and imposed certain procedural hurdles on such litigation (at least claims brought under the 1934 Act). The goal of the legislation was largely to cut back on frivolous litigation and reduce the cost to business of such claims. After the adoption of the PSLRA, Congress became concerned that plaintiffs could easily evade the protections provided by the PSLRA by filing actions under state law and/or in state court. See H.R. Rep. No. 105-803, at 14-15 (1998) (Conf. Rep.) (observing that plaintiffs' lawyers have evaded the PSLRA's provisions that protect against exploitative suits by filing "frivolous and speculative suits in State court, where essentially none of the [PSLRA]'s procedural or substantive protections against abusive suits are available"). SLUSA, PL 105-353, was enacted to

A number of recent decisions have confirmed the limitations imposed by the PSLRA. For instance, in *Tellabs*, the Supreme Court instructed that in order to satisfy the heightened pleading requirements of the PSLRA, a plaintiff must plead facts giving rise to an inference of *scienter* that is "cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[4] Facts from which an inference of *scienter* is merely "plausible" or "reasonable" are inadequate.[5] Then in *Stoneridge*, the Supreme Court held that private plaintiff claims for securities fraud under section 10(b) do not extend to third parties who neither make alleged misstatements nor engage in deceptive conduct on which investors relied.[6]

There are many potential defendants in an asset-back securities case: the seller, the rater of its credit quality, and the party that "independently valued" the collateral in connection with its selection for the transaction.

Two recent decisions in the Refco litigation illustrate the potential difference between claims under the federal securities laws versus state law. In an opinion dated March 17, 2009, Judge Lynch dismissed section 10(b) claims brought by investors against Mayer Brown LLP ("Mayer Brown"), which had served as counsel to Refco prior to its collapse. Investors alleged that Mayer Brown was a central participant in a fraudulent scheme to conceal Refco's true financial condition from investors. Writing that "[a]t most, the Mayer Brown Defendants were culpable aiders and abettors," Judge Lynch concluded that *Stoneridge* and *Central Bank* precluded 10(b) claims against the law firm.[7] Judge Lynch reflected on his ruling:

> It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of the fraud. However, as the Court noted in *Stoneridge*, the fact that the plaintiff-investors have no claim is the result of a policy choice by Congress. 128 S. Ct. at 769. In 1995, in reaction to the Supreme Court's decision in *Central Bank*, Congress authorized the SEC – but not private parties – to bring enforcement actions against those who "knowingly provide . . . substantial assistance to another person" in violation of the federal securities laws. *See* PSLRA, Pub. L. No. 104-67, § 104, 109 Sta. 737, 757, codified in 15 U.S.C. 78t(f). This choice may be ripe for legislative re-examination. While the impulse to protect professionals and other marginal actors who may too easily be drawn into securities litigation may well be sound, a bright line between principals and accomplices may not be appropriate. There are accomplices and there are accomplices: after all, in the criminal context when the Godfather orders a hit, he is only an accomplice to murder – one who "counsels, commands, induces or procures" but he is nonetheless liable as a principal for the commission of the crime. 18 U.S.C. 2(a). Likewise, some civil accomplices are deeply and indispensably implicated in wrongful conduct. Perhaps a provision authorizing the SEC not only to bring actions in its own right but also to permit private plaintiffs to proceed against accomplices after some form of agency review would

address the problem. 15 U.S.C. 77p(b)-(c), 78bb(b)-(c) (2000) (class actions "based upon the statutory or common law of any State" subject to removal to federal court and preemption by federal law). Notably, neither the PSLRA nor SLUSA applies to claims brought under the 1933 Act, such that a plaintiff may be able to avoid the restrictions Congress sought to impose by pursuing a state court strategy under the 1933 Act. See, e.g., In re WorldCom, Inc. Sec. Litig., No. Civ. 02-3288, 2003 WL 22701241, at *5 n.1 (S.D.N.Y. November 17, 2003).

[4] Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2510 (2007). Following Tellabs, a number of federal courts have dismissed so-called "subprime" class actions for failure to meet the pleading requirements laid out by the Supreme Court. See In re Downey Sec. Litig., No. CV 08-3261-JFW, 2009 WL 736802, *8 (C.D. Cal. March 18, 2009); In re Radian Sec. Litig., No. 07-3375, 2009 WL 974324, *11-12. *26 (E.D. Pa. April 9, 2009); and Pittleman v. Impac Mortgage Holdings, Inc., No. 07-0970, 2009 WL 648983, *2 (C.D. Cal. March 9, 2009).

[5] On remand from the Supreme Court, the Seventh Circuit concluded that the facts in Tellabs met the "cogent" and "compelling" standard. Makor v. Tellabs, 513 F.3d 702, 709 (7th Cir. 2008) (finding that the allegedly false statements concerned the defendant's "most important products," making it "exceedingly unlikely" that they were the "result of merely careless mistakes at the management level based on false information fed it from below, rather than an intent to deceive or a reckless indifference to whether the statements were misleading"). Courts are also beginning to foreclose use of the "collective scienter" doctrine, which permits the aggregation of the states of mind of more than one corporate employee to satisfy the pleading and proof burden established by Tellabs. See Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital, 531 F.3d 190, 195 (2d Cir. 2008) ("To prove liability against a corporation, of course, a plaintiff must prove that an agent of the corporation committed a culpable act with the requisite scienter, and that the act (and accompanying mental state) are attributable to the corporation.").

[6] Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008) (rejecting "scheme liability" in place of showing reliance on alleged misstatements or deceptive conduct). The Court's ruling on "scheme liability" blocked an avenue for avoiding its prior ruling that there is no private right of action for aiding and abetting liability under the securities laws. See Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A., 511 U.S. 164, 177 (1994).

[7] In re Refco, Inc. sec. Litig., No. 05 Civ. 8626, 2009 WL 724378, at *13 (SDNY, March 17, 2009).

provide the necessary flexibility without involving the courts in standardless and difficult-to-administer line-drawing exercises.[8]

One week later, Judge Lynch ruled on motions to dismiss in the separate case against Mayer Brown brought by the Thomas H. Lee Equity Fund ("THL Partners"). THL Partners invested more than $450 million in Refco and acquired the majority of Refco's stock through a leveraged buy-out in August 2004. THL Partners contends it lost more than $245 million in the wake of Refco's collapse. It brought claims against Mayer Brown under the federal securities laws and under state law. In an opinion dated March 23, 2009, Judge Lynch dismissed the federal claims on the same basis and for the same reason he dismissed the plaintiff shareholder claims in his earlier decision. Finding that New York law applied to the common law claims for negligent misrepresentation and fraud, Judge Lynch dismissed the negligent misrepresentation claim, but upheld the fraud claim.[9] Notably, the facts supporting the state law fraud claim were identical to those underlying the federal claim. The difference? New York state law recognizes aiding and abetting liability.[10]

ISSUES UNDER STATE LAW

As high stakes litigation is brought under state law, the nuances and potential defenses to such claims become increasingly important. In order to consider a number of the potentially more relevant defenses, it is useful to consider a hypothetical: plaintiff is an investor in, or guarantor of, some form of asset-backed security that has declined substantially in value. There are many potential defendants: one "sold" the investment at issue; another rated its credit quality; and yet a third "independently valued" the collateral in connection with its selection for the transaction. The plaintiff – which may be either an individual or an institution – argues that defendants misrepresented the underlying collateral at the time of the sale. The defendants argue that its representations were truthful and accurate and further contend that any misunderstanding regarding the quality and specific nature of the collateral was due to a failure in plaintiffs' due diligence for which the plaintiff is at fault. Some amount of the decline in value of the investment is almost certainly allocable to a change in market conditions, but the parties disagree on how much.

This discussion focuses on: (1) imputation; (2) comparative fault; (3) relative causation; (4) *in pari delicto*; and (5) reliance and related defenses that apply in non-class state law claims.

Imputation. Imputation is the legal theory by which the conduct or knowledge of an individual is attributed to an institution. State law controls the question.[11] The general rule is that a principal is liable for the conduct of its agent while acting within the scope of his employment.[12] Imputation is both a potential defense in its own right,[13] and the basis for other potential defenses such as comparative fault, *in pari delicto,* and arguments concerning reliance.

Whether conduct is imputable turns on whether the agent's action was intended to benefit the principal, even if the action was tortious or illegal.

Whether conduct is imputable turns on whether the agent's action was intended to benefit the principal, even if the action was tortious or illegal.[14] The ultimate effect of an agent's acts on his principal – which may be harmful – should not override the agent's

[8] Id. at n.15.

[9] The parties disagreed whether New York law applied to the state law claims. THL Partners argued for the application of Massachusetts law. New York law requires a plaintiff to plead and prove privity or near-privity with the defendant to establish a negligent misrepresentation claim. Massachusetts law does not. Concluding that New York governed, Judge Lynch dismissed the claim for failure to meet this requirement. Thomas H. Lee Equity Fund V., L.P. v. Mayer Brown, Rowe & Maw LLP, No. 07 Civ. 6767, 2009 WL 762512, at *12-16 (S.D.N.Y. March 23, 2009).

[10] Id. at 16-18 (Mayer Brown's substantial and knowing participation in perpetrating the Refco fraud – if proven as alleged – including its help effectuating the round-trip loans that transformed Refco's uncollectible losses into receivables owed to Refco by third-parties its statements and its assistance of Refco's misconduct throughout the due diligence process, all aided and abetted the fraud on which the THL Funds relied).

[11] See O'Melveny & Meyers v. FDIC, 512 U.S. 79, 84-85 (1994) ("the short of the matter is that [state] law, not federal law, governs the imputation of knowledge to corporate victims of alleged negligence. . . .").

[12] See, e.g., A-G Foods, Inc. v. Pepperidge Farm, Inc., 579 A.2d 69, 73 (Conn. 1990); McAndrew v. Mularchuk, 162 A.2d 820, 830 (N.J. 1960); and Losito v. Kruse, 29 N.E.2d 705, 70 (Ohio 1940).

[13] Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449, 455 (7th Cir. 1982).

[14] See Pelletier v. Bilbiles, 227 A.2d 251, 253 (Conn. 1967) ("If an agent intends to benefit its principal, the "fact that the specific method a servant employs to accomplish his master's orders is not authorized does not relieve the master from liability."); Son v. The Hartford Ice Cream Company, 129 A. 778, 780 (Conn. 1925)

contemporaneous intent to benefit his principal. Thus, in its simplest terms, conduct intended to benefit the principal should be imputed. In contrast, where the *sole intent* of an agent's conduct is to harm the principal – embezzlement is the most oft-cited example – the agent is said to be adverse to his principal and the conduct is not imputed.[15] Counsel should thus focus on the development of a factual record regarding whether the agent intended to benefit his principal through his actions or whether he intended solely to benefit himself.[16]

Because 51 Percent Rules can potentially limit or eliminate any plaintiff recovery, parties to state law litigation should consider early on whether and how comparative fault comes into play.

Comparative Fault. Most, although not all, states have abandoned strict contributory fault in favor of comparative fault schemes.[17] As a general matter, comparative fault limits a plaintiff's recovery to such of its damage that does not result from its own conduct. In contrast, contributory fault bars any recovery where the plaintiff is at all responsible for its losses. Under the tort reform laws of many – but by no means all – states, a plaintiff recovers nothing if, including any imputed conduct, it is more than 50% at fault for its own damage (the "51 Percent Rule").[18]

In the hypothetical above, for instance, the defendants may argue that the collateral and valuation failings to which the plaintiff attributes its losses either were apparent to it through its due diligence or would have been had it conducted adequate due diligence.[19] The question thus arises whether the knowledge and conduct of the individuals responsible for the plaintiff's due diligence should be imputed to it. Posit a circumstance in which the individual's personal compensation turned on the volume and magnitude of transactions completed during the year. He thus benefitted from the "failed" transaction at issue. Should his knowledge of potential problems be imputed to his employer, including for purposes of determining comparative fault? As discussed above, the question turns on the employee's intent at the time of the conduct in issue.

Importantly, however, there are material differences even within those states that have adopted a 51 Percent Rule. For instance, a threshold question concerns the range of claims to which the rule applies. Some states limit the rule's application to

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("When the servant is doing or attempting to do the very thing which he was directed to do, the master is liable, though the servant's method of doing it be wholly unauthorized or forbidden."); Butler v. The Hyperion Theater Company, 124 A. 220, 221 (Conn. 1924) ("the intent of an [agent] in following a certain course of conduct, even if disobedient, is a material element in determining whether or not his conduct was in the execution of the master's business within the scope of his employment or was conducted indulged in contrary to his duty and solely for a purpose of his own."); and Di Cosala v. Kay, 450 A.2d 508, 513 (N.J. 1982) (holding that an agent's negligence in shooting the plaintiff could not be imputed to the principal because the agent's interactions with the plaintiff were socially motivated). See also GNOC Corp. v. Aboud, 715 F. Supp. 644, 650 (D.N.J. 1989) (under New Jersey law, "when the conduct is activated by a purpose to serve the master, the fact that the act is prohibited by the employer is not determinative of the issue").

[15] See Wight v. BankAmerica Corp., 219 F.3d 79, 87 (2d Cir. 2000) (finding that under the New York adverse interest exception to imputation "management conduct will not be imputed to the corporation if the officer acted entirely in his own interests and adversely to the interests of the corporation"); Center v. Hampton Affiliates, Inc. 66 N.Y. 2d 782, 784-85 (1985) ("when an agent is engaged in a scheme to defraud his principal, either for his own benefit or that of a third person, . . . he cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose" and cautioning that the agent "must have totally abandoned" his employer's interests for the exception to apply); First Nat'l Bank of New Bremen v. Burns, 88 Ohio St. 434, 438-9 (Ohio 1913) (an exception to imputation exists if the agent acted adversely to the principal and entirely for his own or another's purpose) (Ohio law); Pelletier, 227 A.2d at 253 ("the fact that the battery by [the agent] may have been motivated by personal animosity as well as by an overzealous regard for his duties as an employee does not exonerate the [principal].") (Connecticut law); Donio v. U.S., 746 F. Supp. 500, 505 (D.N.J. 1990) ("[s]o long as the employee is not motivated by purely personal reasons, his or her acts may be within the scope of employment, though 'quite improper'") (New Jersey law).

[16] See, e.g., Cenco, Inc., 686 F.2d at 455 (applying Illinois law, holding that a jury could have reasonably found that the mangers intended to benefit the corporation by inflating inventories, which boosted the price of the company's stock and allowed it to engage in stock-based merger transactions and to borrow funds at favorable rates); MCA Financial Corp. v. Grant Thornton, L.L.P., 687 N.W.2d 850 (Mich. Ct. App. 2004) (applying Michigan's "wrongful-conduct rule" to bar a corporation from recovering from its auditors where the corporation could point to no evidence that the fraudfeasors did not act to benefit the corporation by keeping it afloat); and Miller v. Ernst & Young, 938 S.W.2d 313 (Mo. Ct. App. 1997) (applying Missouri law and holding that fraud benefited the company where it enabled the company to obtain lines of credit and temporarily continue its business even though the discovery of the fraud led the corporation to file for bankruptcy).

[17] Four states – Alabama, Maryland, North Carolina and Virginia – have retained common law contributory negligence schemes. The District of Columbia also maintains a contributory negligence defense.

[18] By way of example, New Jersey and Connecticut both include a 51 Percent Rule in their comparative fault schemes. In contrast, New York and California are pure comparative fault states.

[19] Failure to conduct adequate due diligence can, in certain circumstances, be an outright defense to liability. See DDJ Mgmt., LLC v. Rhome Group, L.L.C., 2009 WL 537535 (N.Y.A.D. 1 Dept. March 5, 2009).

claims sounding in negligence.[20] Other states permit application of the statute to any claim.[21] It is thus potentially relevant whether the claims brought on the stated hypothetical are stated as breach of contract (failure to comply with contractually-specified warranties regarding the underlying collateral), fraud (misrepresentations regarding the subordination levels embedded in the security) or negligence (a failure by the defendants to comply with professional standards). State schemes also differ on the question of to whom fault can apportioned. Some permit allocation of fault only to parties to the litigation, where others permit allocation of fault to non-parties.[22] Issues arise regarding what conduct may be considered for purposes of fault allocation. For instance, to the extent an auditor is involved as a defendant, may it allocate fault to the plaintiff based on conduct that did not directly interfere with its audit (due diligence failures do not typically amount to audit interference)?[23] Another potentially important difference concerns the treatment of judgment proof defendants.[24]

Because 51 Percent Rules can potentially limit or eliminate any plaintiff recovery, parties to state law litigation should consider early on whether and how comparative fault comes into play. Part of such an analysis should include choice-of-law determinations that may give rise to the application of a 51 Percent Rule, including whether the case can or should be positioned for an early ruling on choice of law.

Where comparative fault allocates responsibility for a single source of harm between culpable persons, principles of relative causation permit a defendant to demonstrate that discrete portions of the plaintiff's damage are attributable to *causes* other than the defendant's conduct and thereby limit the portion of plaintiff's total damages for which the defendant can be held responsible.

Relative Causation. Principles of relative causation, which allow the finder of fact to divide a plaintiff's damage among various causes, should also be considered by parties to state law litigation.[25] Where comparative fault allocates responsibility for a single source of harm between culpable persons, relative causation permits a defendant to demonstrate that discrete portions of the plaintiff's damage are attributable to *causes* other than the defendant's conduct in order to limit the portion of plaintiff's total damages for which the defendant can be held responsible.

[20] See, e.g., Conn. Gen. State. § 52-572h(b) (limiting the Connecticut comparative fault scheme to "causes of action based on negligence"). See also id. § 52-572h(k) (expressly excluding causes of action sounding in breach of fiduciary duty or fraud from the statute's reach); Electroformers, Inc. v. Richter, 2002 WL 442287, at *2 (Conn. Super. 2002) (striking defendant's comparative negligence defense to action for breach of fiduciary duty); and Town of Monroe v. Underground Constr. & Survey, Inc., 2004 WL 1193962 (Conn. Super. 2004) (rejecting defense of comparative negligence to breach of contract claim because "by its own terms, the comparative negligence statute applies only to causes of action based on negligence").

[21] See, e.g., N.J. Stat. Ann. § 2A: 15-5.2(c)(1) (Statute applies to "negligence actions," which is defined to "include[], but is not limited to, civil actions for damages based upon theories of negligence, products liability, professional malpractice whether couched in terms of contract and like theories. In determining whether a case falls within the term 'negligence actions,' the court shall look to the substance of the action and not the conclusory terms used by the parties.").

[22] See McKenna v. New York, 492 N.Y.S.2d 805 (2d Dept. 1985); Scibelli v. Herman, 856 N.Y.S. 2d 126 (2d Dept. 2008).

[23] The audit interference doctrine, established in National Surety Corp. v. Lybrand, 9 N.Y.S.2d 554, 563 (N.Y. App. Div. 1st Dep't 1939), limited the availability of an auditor's contributory negligence defense to conduct that interfered with the audit itself. As the National Surety court stated: "We are, therefore, not prepared to admit that accountants are immune from the consequences of their negligence because those who employ them have conducted their own business negligently . . . . Negligence of the employer is a defense only when it has contributed to the accountant's failure to perform his contract and to report the truth." Id. The rule was adopted to "soften what was then the 'harsh rule' of negligence which barred recovery of damages if there was any contributory negligence on the part of the plaintiff." Scioto Mem'l Hosp. Ass'n v. Price Waterhouse, 659 N.E.2d 1268, 1272 (Ohio 1996). With the advent of comparative fault, however, many jurisdictions have abandoned the audit interference rule as a relic of the old contributory negligence regime. See id.; see also Halla Nursery, Inc. v. Baumann-Furrie & Co., 454 N.W.2d 905, 909 (Minn. 1990); FDIC v. Deloitte & Touche, 834 F. Supp. 1129, 1145 (E.D. Ark. 1992); Devco Premium Fin. Co. v. North River Ins. Co., 450 So.2d 1216 (Fla. Dist. Ct. App. 1984); Capital Mortgage Corp. v. Coopers & Lybrand, 369 N.W.2d 922, 925 (Mich. Ct. App. 1985); Standard Chartered PLC v. Price Waterhouse, 945 P.2d 317, 352-53 (Ariz. Ct. App. 1996). However, a number of other courts have retained the audit interference rule despite the move from contributory fault to comparative fault regimes. See Stroud v. Arthur Andersen & Co., 37 P.3d 783, 790 (Okla. 2001); Fullmer v. Wohlfeiler & Beck, 905 F.2d 1394, 1396-98 (10th Cir. 1990) (applying Utah law); Bd. of Tr. of Cmty. Coll. Dist. No. 508 v. Coopers v. Lybrand, 803 N.E.2d 460, 466 (Ill. 2003).

[24] For example, Connecticut's comparative fault statute directs that if any liable defendant is judgment-proof, that defendant's share of the judgment will be reapportioned to the other liable defendants based on their respective share of fault. See Conn. Gen. Stat. § 52-572h(g). In contrast, the comparative fault schemes of New York and New Jersey do not distinguish between judgment proof and non-judgment proof defendants. However, under the New Jersey comparative fault statute, any defendant at fault for at least 60 percent of the total damages is jointly and severally liable for the damage award. N.J. Stat. Ann. § 2A: 15-5.3(a).

[25] See, e.g., Restatement (Third) of Torts: Apportionment of Liability § 26 and Restatement (Second) of Torts § 433A.

While the goal of both relative causation and comparative fault is to allocate responsibility for the plaintiff's damage to multiple sources, there are several important distinctions between the two doctrines:

- *First*, relative causation focuses exclusively on the cause of the harm, not the culpability or fault of the parties.
- *Second*, unlike comparative fault, which under the law of some states can only apportion fault amongst parties to the action, relative causation is not limited by the four corners of the complaint.
- *Third*, relative causation may be applied to all claims, where the law of some states restricts the application of comparative fault as discussed above.
- *Finally,* relative causation is applicable no matter the nature of the underlying conduct, whereas some states do not permit the application of comparative fault to intentional conduct.

The application of relative causation principles in a particular case depends on whether the causes of the alleged harm are divisible or indivisible. In the fist instance, it is preferable to "apportion the damages to the distinct causes without resorting to comparative fault."[26] Defendants seeking to divide damages by cause must provide a "reasonable basis" for doing so.[27]

While relative causation and comparative fault principles may be applied separately, they are not mutually exclusive.[28] In the circumstance in which damages are indivisible or have been divided by cause into such component pieces as far as reasonable, the fact finder then applies principles of comparative fault, including any applicable 51 Percent Rule, to the indivisible whole or to each component part of damage. The interaction of these two doctrines – relative causation and comparative fault – and their potential implication for damages raises important strategic considerations for parties to any litigation in which they apply.

On the hypothetical stated above, how should the parties deal with that portion of plaintiff's loss caused by a change in market conditions? Should either side attempt to isolate that component of loss, thereby effectively removing it from the dispute? Such an approach reduces a defendant's overall exposure, but potentially isolates a component of damage with respect to which it has a lesser ability to invoke comparative fault, including – where available – the 51 Percent Rule. In states that do not have a 51 Percent Rule, this calculus may be of little import. However, in states that have adopted such a rule, the more damage that is "backed out" that could otherwise arguably have been characterized as allocable to plaintiff's fault, the less conduct there is to count toward the 51 percent and the less likely a zero damages verdict.

A variety of factors implicate whether it is more advantageous – for either party – to separate out and isolate the effect of the allegedly wrongful conduct versus treating the plaintiff's claimed damages as incapable of separation by cause. While the answer will vary from case to case, the following should be considered: (1) the size of the total damage claim; (2) the size of the damage claim that can safely be isolated as allocable to the alleged wrongdoing; (3) the clarity of the line between the allegedly wrongful conduct on the one hand and innocent causal factors on the other; and (4) the nature of the applicable comparative fault scheme.

Where the size of the total damage claim is unmanageably large, the defendant may want to consider an approach to damage that seeks to take portions of it "off the table" through arguments of relative causation. Although this may isolate a portion of damage as to which the defendant has less remaining opportunity to reduce its exposure, including to a zero damages result through an applicable 51 Percent Rule, such an approach may be preferable to a high stakes gamble on the entire claim. To the extent the litigation is governed by a pure comparative fault regime (i.e., one that does not contain a 51 Percent Rule), removing damage through relative causation almost certainly makes sense. Even where a 51 Percent Rule is available, however, where the isolated component of damage is itself unmanageable, or, alternatively, the damage claim in full is manageable, a defendant may prefer to pursue the higher risk, but higher reward approach of foregoing any arguments of divisibility. In reverse, a plaintiff may want to consider whether to concede that some limited portion of its losses was caused by market forces or non-actionable conduct, in an effort to negate a central element of defendant's comparative fault defense, particularly in a 51 Percent regime in which a zero damages result is possible.

Another factor to consider in analyzing whether to argue for a causal divide – or which divides to argue for – is the clarity of the proposed division (the "firewall" between the actionable and non-actionable components of loss). Any decision to pursue causal divides should take account of the extent the firewall

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[26] Owens Corning Fiberglass Corp. v. Parrish, 58 S.W.3d 467, 479 (Ky. 2001). See also Kalland v. North American Van Lines, 716 F.2d 570, 573 (9th Cir. 1983) ("Where injuries can properly be apportioned to separate causes based on evidence in the record, there is no occasion to invoke the doctrine of comparative negligence. . . . ").

[27] See, e.g., Dafler v. Raymark Industries, Inc., 611 A.2d 136 (N.J. Super. ct. App. Div. 1992) (defendant sought to establish that plaintiff's injuries were caused by cigarette smoking).

[28] See Restatement (Third) of Torts: Apportionment of Liability § 26.

between the potential divides is porous. In theory, if there truly are no defensible causal divides, the ultimate damage award should be unaffected by the decision to pursue an indivisible versus divisible approach to damage. In practice, however, firewall problems may play less of a role in a damage award under an indivisible damage approach insofar as the defendant may be able to use the 51% Rule to its advantage simply by including such issues as part of the overall mix of factors that go into the fault determination. A divisible approach, in contrast, permits a plaintiff to argue that defendant is at fault even for components of damage it seeks to entirely remove from the case.

In Pari Delicto. Another potentially important defense at state law is *in pari delicto*. Under this doctrine, neither a court of law nor a court of equity will provide a remedy to a fraudulent or illegal transaction for an injury stemming from that transaction where the parties are shown to be equally responsible for the illegality. *In pari delicto* is a potentially powerful state law defense, including to claims brought by failed financial institutions – or their successors in interest such as conservators or trustees – against its service providers (e.g., its auditors and investment bankers). While there is common ground on the basic elements of an *in pari delicto* defense under state law: (1) the plaintiff is substantially equally responsible for (2) the harm it seeks to redress and (3) whether allowing the defense would contravene public policy, the application of these principles differs among states.[29]

Reliance and Related Defenses. Under the fraud-on-the-market doctrine, class adjudication under the securities laws absolves individual investors from having to establish personal reliance on specific, allegedly false statements in purchase or sale decisions.[30] Where claims are brought under state law, however, individual reliance is in play and provides a potentially powerful defense for defendants of which both parties should be aware. Developing a fact record on the circumstances surrounding the failed investment is essential to pursuing such a defense.[31] Conversely, it is important for plaintiffs to carefully define the allegedly actionable misrepresentations or misconduct in light of the need of each plaintiff to affirmatively demonstrate reliance.

Under the doctrine of *in pari delicto*, neither a court of law nor a court of equity will provide a remedy to a fraudulent or illegal transaction for an injury stemming from that transaction where the parties are shown to be equally responsible for the illegality.

To the extent the allegedly fraudulent statements or conduct postdates a plaintiff's purchase decision, that plaintiff may have "holder" claims under state law. Such claims do not exist under federal law.[32] Holder claims may be susceptible of damage defenses to the effect that plaintiffs' losses would have been the same – or greater – had the fraud been revealed at some earlier date (such as the date of the plaintiff's initial investment).[33]

CONCLUSION

While state law has historically been considered by litigants to be "plaintiff-friendly," there are important and potentially powerful defenses available to defendants to such litigation. Plaintiffs and defendants alike should be aware of the availability of such defenses and how they apply in individual litigation so that they might shape the factual record and focus on material choice of law determinations.

[29] For instance, the New Jersey Supreme Court has held that the defense of imputation – and thus the *in pari delicto* doctrine – does not bar claims by the trustee of a bankrupt audit client against its auditor. NCP Litigation Trust v. KPMG LLP, 901 A.2d 871 (NJ 2006). See also Sunpoint Securities, Inc. v. Cheshier & Fuller, 377 B.R. 515 (Bankr. E.D. Tex. 2007) (Texas law precludes imputation of the wrongdoing of a dominant shareholder to the trustee of a bankrupt corporation; trustee permitted to recover damages from the corporation's outside auditors for negligently failing to detect the insider's wrongdoing). But see Baena v. KPMG LLP, 389 F. Supp. 2d 112, 121 (D. Mass. 2005) (dismissing state law claims against auditor, noting that "[i]n sum, the complaint alleges that because the Defendants failed to expose the fraud by those controlling the Plaintiff corporation, and the fraud succeeded, the Defendants should bear responsibility for the Breaching Managers' fraud. Such a result is inconsistent with the doctrine of *in pari delicto*."); Official Comm. Of Unsecured Creditors v. Shapiro, No. 99-526 1999 U.S. Dist. LEXIS 14517, at * 17 (E.D. Pa. 1999) (dismissing state law claims based on *in pari delicto* when the complaint alleged that auditor knowingly or recklessly issued inaccurate audit reports); and MCA Fin. Corp., 687 N.W.2d 850, 854 (Mich. Ct. App. 2004) (affirming dismissal of claim against auditor, noting "[a]t most, the complaint alleges that defendants failed to detect the defects in the financial statements and, therefore, erroneously put their seal of approval on the financial statements as being acceptable.").

[30] See Basic Inc. v. Levinson, 485 U.S. 224 (1988).

[31] See, Pension Comm. of the Univ. of Montreal Pension Plan, et al. v. Banc of America Sec., LLC, 592 F. Supp.2d 608, 639 (S.D.N.Y. 2009) (summary judgment granted on fraud claims where plaintiffs invested prior to receiving the net asset value calculations – the documents containing the alleged misrepresentations).

[32] Merrill Lynch v. Dabit, 547 U.S. 71 (2006) (SLUSA preempts state-law securities fraud class actions filed by those who claim to have merely held – as opposed to purchased or sold – the defendant company's shares).

[33] See Pension Comm., 592 F. Supp. 2d at 637-639.

businesses about their rights and responsibilities. The Bureau also collects fraud complaints and makes them available to law enforcement agencies. There are no identification or suspicious activity reporting requirements on commercial websites.[10] Internet payment service providers may be licensed as money services businesses.[11]

The Study describes specific issues in the United Kingdom, Luxembourg, The Netherlands, Singapore, China (with variations for Hong Kong) and Australia.

[10] There are such requirements in The Netherlands.

[11] Internet payment service providers are licensed in Australia.

CONCLUSION

The FATF provides a list of mechanisms that amount to best practices for internet payment service providers. The degree to which these items are actually implemented will vary considerably from site to site. Although vigilance on the part of banks will make up for some deficiencies, but international cooperation will be key to limiting the use of the internet by criminal enterprises.

Late Breaking Development

As this issue was going to press, Judge Lynch granted motions to dismiss the state law claims brought by the trustee of the Refco Litigation Trust against various advisors—investment banks and accounting firms—involved in a set of transactions referred to as the round-trip loans.[1] See *Kirschner v. Grant Thornton LLP*, No. 07 CIV 11604, 2009 WL 996417 (S.D.N.Y. April 14, 2009). The court held that "[b]ecause a trustee cannot sue to recover for a wrong undertaken by the debtor itself, the motions to dismiss will be granted in their entirety." The bulk of the opinion addressed whether the conduct of the individual corporate officers who actually committed the wrongful acts at issue could be imputed to the corporation. The Trustee argued that the adverse interest exception barred the imputation of the individuals' conduct. The court rejected that position and dismissed the complaint.

As is often the case, the corporate officers profited from the apparent but illusory success of the corporation. Id. at * 7 (the insiders enriched themselves by "'sell[ing] their interests in Refco at a fraudulently inflated price.'"). The complaint itself, however, laid out the "substantial benefits [to the firm] from the insiders' alleged wrongdoing." Indeed, Judge Lynch reflects that the "gravamen of the Trustee's allegations is not that the insiders stole assets from Refco, but rather that the insiders' fraudulent scheme was to steal *for* Refco—to inflate the value of Refco's interests on behalf of Refco itself by maintaining the illusion that Refco was 'fast-growing, highly profitable, and able to satisfy its substantial working capital needs without having to borrow money.'" The court thus concluded that the individuals could not be said to have "totally abandoned" their principal's interests as would be required to apply the adverse interest exception to imputation. Id. at * 7.[2]

[1] The Trustee originally filed the case in the Circuit Court of Cook County, Illinois, asserting claims under Illinois state law. The case was removed to federal court and transferred to New York by the Panel on Multidistrict Litigation. The motions to dismiss either expressly or impliedly argued for the application of New York law and the court decided the case on that basis. Id. at * 1.

[2] Judge Lynch seemingly rejected the Trustee's position that the intent of the individual actor is relevant to the question of imputation (id. at * 7), preferring instead a standard that looks to whether the corporation was—in fact—harmed by the scheme. Id. at * 8. Observing that it "is a basic principle of corporate finance that extending credit to a distressed entity itself does the entity no harm," id. (citation omitted), Judge Lynch concluded that Refco suffered no harm. While the imputation question here may have resolved in the same manner no matter which standard applies, that may not always be the case. Take, for instance, the case of a foreign currency trader who undertakes to hedge trades of the company for which he works. Despite his best efforts, he fails to put on a proper hedge and, instead, puts on a purely directional (losing) position. Margin calls are made on his employer. Can his employer take the position that it is not responsible for the acts of its trader on the ground that it was harmed by the employee's conduct?

While Judge Lynch's opinion discusses imputation at some length, it appears in the end to have turned on the question of whether Refco suffered any harm from the alleged conduct. If there was no harm—an element of the claim itself—then the Trustee, which stood in Refco's shoes and had no greater claim than the company, was similarly without a cause of action. Id. at * 7. Judge Lynch ultimately concluded that Refco had suffered no harm.