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Second Circuit Affirms S.D.N.Y. Decision Requiring High Standard of Knowledge for Aiding and Abetting of Fraud and of Breach of Fiduciary Duty

In *Krys v. Pigott*, the Second Circuit addressed the pleading requirements for a claim of aiding and abetting a fraud or breach of fiduciary duty under New York law. *Krys v. Pigott*, Nos. 12-3575, 12-3586, 2014 WL 1394940 (2d Cir. Apr. 11, 2014). It held that constructive knowledge – namely, knowledge that a defendant should have obtained in the exercise of reasonable diligence – is insufficient to state such a claim. The Court found it unnecessary to decide whether “conscious avoidance” of knowledge would suffice, since it held that plaintiffs had failed adequately to plead either actual knowledge or conscious avoidance. The Court further provided some guidance on the types of factual allegations that are required to plead the element of knowledge in an action asserting claims for aiding and abetting fraud and/or breach of fiduciary duty.

Background

This case arose from the 2005 collapse of Refco Inc., a financial services firm that filed for bankruptcy after revealing it had hidden hundreds of millions of dollars of debt. The plaintiffs were liquidators for a group of hedge fund customers of Refco (the “SPhinX funds”), whose funds had been commingled with Refco’s, causing the SPhinX funds to be vulnerable to creditors after Refco’s bankruptcy. The defendants were other Refco customers that allegedly had entered “round trip” loan transactions with Refco, in which they would borrow money from a Refco entity and lend the same amount to RGHI, a holding company, controlled by Refco’s CEO, which used that money to pay down a debt to Refco. These transactions were allegedly “unwound” after the end of each reporting period. The plaintiffs alleged that, by participating in these transactions, defendants had helped Refco conceal its losses by offloading debt from its balance sheets at the end of each reporting period. The plaintiffs claimed that the defendants knew, consciously avoided knowing, or should have known that these round trip transactions were shams intended to permit Refco to file fraudulent financial statements.

In 2012, Judge Rakoff dismissed claims against certain defendants for aiding and abetting fraud and aiding and abetting breach of fiduciary duty. *In re Refco Inc. Securities Litigation*, Nos. 07 MDL 1902, 08 Civ. 3065, 08 Civ. 3086, 2012 WL 3126834 (S.D.N.Y. July 30, 2012). The court held that the plaintiffs had failed to allege facts plausibly suggesting that these defendants had knowledge of the fraud, as required under New York law.

Second Circuit Opinion

The Second Circuit affirmed Judge Rakoff's dismissal of these claims, holding that plaintiffs' amended complaint did not contain sufficient allegations to give rise to a reasonable inference that the defendants had *actual knowledge* of Refco's fraud and breach of fiduciary duty. The Court found that the complaint did not sufficiently allege that defendants had knowledge of certain key facts, including Refco's insolvency, Refco's large trading losses, the role played by RGHI in the round-trip transactions, and the use of customer assets to fund Refco's own operations. The court held that in the absence of knowledge of these facts, the allegations that the defendants agreed to participate in Refco's fraud and breach of fiduciary duty were conclusory.

The Court confirmed that, under New York law, "constructive knowledge," *i.e.* knowledge that a party exercising reasonable care or diligence should have, is insufficient to give rise to liability for aiding and abetting fraud or breach of fiduciary duty. The court declined to address whether "conscious avoidance of knowledge" would be sufficient to support a claim of aiding and abetting, because, on the pleaded facts, the complaint would not satisfy the conscious avoidance standard either. In particular, the Court found insufficient allegations that defendants had expressed concerns about the propriety of the round trip loans and that they declined to participate in transactions with Refco due to financial disclosure concerns. The Court also found that, simply because the loans were issued in large, round dollar amounts, that fact did not suffice to demonstrate defendants' conscious avoidance, because such loans were also consistent with lawful business practices. The Court further noted that, since the defendants were customers of Refco and had their loans guaranteed by Refco, it was implausible that the defendants knew or consciously avoided knowing that the firm was insolvent. In sum, the Second Circuit refused to draw the inferences, urged by the plaintiffs, that "suspicious characteristics" of the loans, and the apparent lack of a legitimate business purpose for them, meant that the defendants knew or consciously avoided knowing about Refco's alleged fraud and breach of fiduciary duty.

While this decision is likely to have limited applicability to federal securities law, which does not permit actions for aiding and abetting securities fraud by private parties, the decision could have wide applicability for financial institutions subject to aiding and abetting claims under New York law. This decision may make it more difficult for plaintiffs to plead actual knowledge in aiding and abetting cases. The question of whether conscious avoidance can give rise to aiding and abetting liability, however, remains unanswered.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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