Macquarie Capital (USA) Inc. v Morrison & Foerster LLP
2016 NY Slip Op 31405(U)
July 14, 2016
Supreme Court, New York County
Docket Number: 650988/2015
Judge: Saliann Scarpulla

[* 1]

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 39

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MACQUARIE CAPITAL (USA) INC.,

Plaintiff,

DECISION/ORDER

-against-

Index No. 650988/2015

MORRISON & FOERSTER LLP,

Defendant.

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HON. SALIANN SCARPULLA, J.:

In this action to recover damages for legal malpractice, defendant Morrison & Foerster LLP ("Morrison") moves to dismiss the complaint.

Puda Coal, Inc. ("Puda") was a Delaware corporation that was listed on the New York Stock Exchange, and conducted its operations in China through Shanxi Puda Coal Group Co., Ltd. ("Shanxi Coal"). Puda reported in public filings that it owned a 90 percent interest in Shanxi Coal. In the Fall of 2010, Puda hired plaintiff Macquarie Capital (USA) Inc. ("Macquarie"), an investment banking firm, as an underwriter for a public offering of stock to be conducted in December 2010. According to the allegations of the complaint, in November 2010, Macquarie hired Morrison, a law firm with "highly-promoted experience with complex China-related transactions," as its counsel, to conduct due diligence for the transaction and to gain a "full understanding of the operating and ownership structure of Puda and its subsidiaries."

Macquarie also hired international private investigation firm, Kroll Inc. ("Kroll") to investigate the character, integrity and reputation of the individuals associated with Puda. Kroll issued a report on December 2, 2010 ("the Kroll Report"), which disclosed that Puda did not own a 90 percent interest in Shanxi Coal, in contradiction to Puda's public representations and reports. In

fact, in September 2009, Puda's 90 percent ownership in Shanxi Coal had been transferred to Ming Zhao, who was Chairman of Puda's Board of Directors, a major Puda shareholder, and an 8 percent owner of Shanxi Coal.

Kroll provided the Kroll Report to Macquarie via William Fang, an associate, who, on December 2, 2010, emailed the report to several other members of the Macquarie deal team, and then forwarded it to Morrison with a cover email that indicated "no red flags were identified." Neither Macquarie nor Morrison picked up on the finding in the Kroll report that Puda did not, in fact, own a 90 percent interest in Shanxi Coal. Further, on December 13, 2010, Morrison issued an opinion letter/negative assurance letter, confirming its due diligence findings, and indicating that "nothing has come to our attention" that caused Morrison to believe that the offering documents contained false or misleading statements. Puda conducted two public offerings in 2010 without disclosing the change in ownership structure. Puda raised millions of dollars from investors selling shares in what was essentially an empty shell company.

According to the allegations of the complaint, in April 2011, Puda's fraud was uncovered and made public by the financial press. Puda was removed from the New York Stock Exchange. On April 15, 2011, a class action lawsuit was filed in the Southern District of New York, Civil Action No. 11-CIV-2598 (the "Southern District Action"). The Southern District Action included claims against Macquarie for violations of sections 11 and 12(a)(2) of the Securities Act, which claims were subsequently dismissed. Later, a claim against Macquarie for violation of section 10(b) of the Securities Exchange Act was added. The Southern District Action was later consolidated with other similar investor actions and currently is pending before the Honorable Denise Cote.[1]

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[1] At oral argument, defendant's counsel represented that Macquarie had since settled with the class plaintiffs.

The SEC also asserted claims against Macquarie in a regulatory action. Macquarie settled with the SEC and agreed to pay $3 million in civil penalties, $12 million in disgorgement and interest, and for the cost of establishing a fund to compensate investors. Macquarie did not deny or admit wrongdoing in the regulatory action. However, Macquarie agreed that it "shall not seek or accept, directly or indirectly, reimbursement or indemnification from any source . . . with regard to any civil penalty amounts" that it agreed to pay.

Macquarie commenced this action alleging a cause of action for legal malpractice against Morrison based on its failure adequately to investigate Puda's ownership in Shanxi Coal, and its failure properly to review the Kroll report. Macquarie claimed that Morrison's malpractice was compounded by its issuance of the inaccurate Opinion Letter. It alleged that its damages consisted of "costs and fees associated with defending, as well as any damages or settlement costs that may be incurred in, the Southern District Action, and costs and certain payments associated with related investigations...costs, expenses and reasonable attorneys' fees in connection with this action."

Morrison now moves to dismiss the complaint. It first argues that any conduct by Morrison was not the proximate cause of Macquarie's liability to the SEC or legal fees it incurred, because Macquarie cannot sue its lawyer for failing to inform it of information that was in its possession.

Morrison next argues that the doctrine of *in pari delicto* bars claims where the plaintiff engaged in wrongdoing, and here, Macquarie falsely represented, either through fraud or negligence, to Morrison that the Kroll Report was innocuous. The Fang email indicating "no red flags" was a misrepresentation that was reckless. Also, Morrison's opinion letter merely indicated that Morrison did not believe that the offering documents contained a misstatement of material fact. It did not purport to "confirm or establish factual matters" and it specifically stated that it did "not undertaken to verify independently the accuracy of any such factual matters."

Finally, Morrison argues is that the damages alleged are not recoverable as a matter of law. Specifically, it alleges that (1) there is no right to indemnification for amounts that are incurred under securities liability; (2) there is no right to seek contribution for securities liability pursuant to Section 12 of the Securities Act, and contribution is only permitted against those who could have been held liable in the securities action to begin with, which is not the case here; (3) Macquarie cannot seek damages for attorneys fees or other litigation expenses it incurred in connection with the securities action or the SEC investigation, because it is only another form of disguised contribution and/or indemnification, and the American Rule precludes recovery of attorneys fees and litigation expenses in instances like this; (4) the language of the consent judgment bars Macquarie from seeking damages based on the civil penalties; and (5) Macquarie may not recover the amount it paid in disgorgement of its ill-gotten gains from underwriting the Puda Offering.

In opposition, Macquarie argues that it sufficiently pled a cause of action for legal malpractice. It maintains that Morrison's responsibility as underwriter's counsel included independently investigating Puda's purported ownership in Shanxi Coal. Macquarie, a diversified financial services company, retained Morrison, an international law firm claiming to have expertise in China-related transactions, to serve as underwriter's counsel, a job that included conducting legal due diligence in connection with its underwriting of the public equity offering by Puda. As part of its legal due diligence work, Morrison was tasked with using its legal expertise and knowledge of China-based transactions to gain a full understanding of the ownership and operating structure of Puda and its subsidiaries in China, and bringing any information that was contrary to Puda's representations to Macquarie's attention. Morrison failed to do so, both before and after its receipt of the Kroll Report, which it was duty bound to review. According to the allegations of the complaint, the Kroll Report was sent to Morrison with the expectation that the firm would "review the report for any information relevant to [its] tasks."

Further, Macquarie contends that causation was adequately pled, in that had Morrison properly conducted the due diligence with which it was charged, raised the ownership issue with Macquarie and not issued the opinion letter, Macquarie would have determined that it should withdraw from the Puda deal. Morrison claims that it is not relieved of liability for its malpractice simply because Macquarie had the Kroll report. Any negligence on Macquarie's part in reviewing the Kroll Report is merely a factor to be assessed in the mitigation of damages. Even though the non-lawyers at Macquarie noted in a cover email, that "no red flags were identified" in the Report, the lawyers at Morrison were not absolved of their responsibility to read the Kroll Report that their client forwarded to them. Morrison's argument -- that its liability for its malpractice was cut off when Macquarie received the Kroll Report, no matter how egregiously Morrison failed in its duty to carry out the assigned due diligence and provide competent legal advice to Macquarie before and after that receipt -- is patently meritless and, at most, raises disputed issues of fact

Macquarie next argues that the *in pari delicto* doctrine is inapplicable because it only applies where, unlike here, intentional wrongdoers seek recovery against those who participated in a fraud.

Finally, Macquarie argues that it has properly pled damages. First, it maintains that it may receive damages for sums expended in the SEC action. While it is not seeking to recover damages based on the $3 million it paid as a civil penalty, it was not determined that all of the monies it paid out for disgorgement was for ill-gotten gains, so it could be entitled to receive some of those monies. Second, contrary to Morrison's argument, a plaintiff is permitted to seek recovery from an attorney in a legal malpractice case for damages incurred by its client through a separate securities action. Third, the American Rule does not apply here because a plaintiff is permitted to seek damages for legal costs it was compelled to expend in another litigation that results from the malpractice committed by its attorney. Finally, it is seeking restitution of legal fees paid to Morrison in connection with its retention and work as underwriter's counsel.

Macquarie additionally notes that while the Court may take judicial notice of the existence of the SEC Action complaint and Final Judgment, the factual allegations in those documents were neither admitted nor denied by Macquarie, and were not actually litigated, and accordingly do not establish any defense as a matter of law.

Discussion

Morrison first seeks dismissal of the complaint based on the *in pari delicto* doctrine. The doctrine "mandates that the courts will not intercede to resolve a dispute between two wrongdoers." *Kirschner v. KPMG LLP*, 15 N.Y.3d 446, 517 (2010). The application of the *in pari delicto* doctrine is most obvious where a willful wrongdoer is suing someone who is alleged to be merely negligent, but the principle may also be applied where both parties acted willfully. *Concord Capital Mgt., LLC v. Bank of America., N.A.,* 102 A.D.3d 406 (1st Dept. 2013). I find that the facts as presented here do not support an application of the *in pari delicto* doctrine.

Moreover, I find that the complaint must be dismissed because Macquarie has not sufficiently alleged a claim for legal malpractice, specifically, has failed sufficiently to allege proximate cause. A cause of action for legal malpractice requires "three essential elements: (1) the negligence of the attorney; (2) that the negligence was the proximate cause of the loss sustained; and (3) proof of actual damages." *Prudential Ins. Co. v. Dewey Ballantine*, 170 A.D.2d 108, 114 (1st Dept. 1991) *affd* 80 N.Y.2d 377 (1992). To establish proximate cause, a plaintiff must demonstrate that but for the attorney's negligence, he or she would have prevailed in the underlying matter or would not have sustained any ascertainable damages. The failure to establish proximate cause mandates the dismissal of a legal malpractice action, regardless of the attorney's negligence. *Brooks v. Lewin*, 21 A.D.3d 731, 734 (1st Dept. 2005).

Macquarie alleges that it hired Morrison, based on its expertise in China-related transactions, to perform due diligence for the transaction and to gain a full understanding of the operating and

ownership structure of Puda and its subsidiaries. Macquarie further alleges that Morrison egregiously failed in its duty to carry out its assigned due diligence by neglecting to uncover a crucial component of Puda's ownership structure, and also failing to pick up on the discovery made by Kroll as set forth in the Kroll Report. However, Morrison's failures cannot be deemed to have proximately caused Macquarie's damages, because Macquarie was also in possession of this critical information. *See Ableco Fin. LLC v. Hilson*, 109 A.D.3d 438 (1st Dept. 2013).

In *Ableco,* the plaintiff was in "the business of making commercial loans." Plaintiff loaned money to Bay Harbor, in order to finance Bay Harbor's purchase of assets from the bankruptcy estate of Steve & Barry's, a retail clothing chain. Plaintiff retained defendant as its counsel for the transaction. The deal closed. Without repaying the loan, Bay Harbor later filed its own bankruptcy petition. In relevant part, plaintiff claimed legal malpractice, alleging that defendant failed to "adequately advise it that its first priority security interest on Bay Harbor's assets was collateralized by only a portion of the Steve and Barry's inventory, as opposed to the entire inventory." Plaintiff maintained that it would not have made the loan had defendant provided it with the correct information that it was not acquiring a first priority lien on the entire inventory. The court held that the claim should have been dismissed "on the basis of information plaintiff indisputably possessed prior to the [] closing."

The Court also specifically referenced an email from plaintiff's senior vice president to a member of plaintiff's deal making team, which had a press release attached to the email. The press release indicated that the assets to be acquired included "all Steve & Barry's merchandise, with the exclusion of any product located at stores not purchased by [Bay Harbor]." The Court explained that the documentary evidence refuted plaintiff's "pivotal" claim that it made the loan without knowing that it was not getting a first priority lien on the entire inventory.

In light of the Court's holding in the *Ableco* case that the legal malpractice claim should have been dismissed based on the information the plaintiff "indisputably possessed," the legal malpractice claim here must be dismissed as well. The allegations of the complaint clearly state that Macquarie possessed the Kroll Report, and the crucial information contained therein, prior to the closing of the transaction. While Macquarie seeks to distinguish this case from *Ableco*, in that this case resolves a motion to dismiss and *Ableco* resolved a motion for summary judgment after the completion of discovery, the relevant evidence here was available and referenced in the complaint, specifically the Kroll Report, and was indisputably possessed by Macquarie prior to the closing.

Macquarie further argues that proximate cause may ultimately be proven because discovery would reveal that it lacked "actual knowledge" of the subject information in the Kroll Report before the closing. However, in *Ableco* the First Department dismissed plaintiff's malpractice claim based on plaintiff's possession of the information, not plaintiff's subjective understanding of the

significance of the information. As it is undisputed here that Macquarie had the information that it complains Morrison failed to uncover, the element of proximate cause cannot be proven, and the legal malpractice claim must be dismissed.

In accordance with the foregoing, it is hereby

ORDERED that defendant Morrison & Foerster LLP's motion to dismiss the complaint is granted and the complaint is dismissed; and it is further

ORDERED that the Clerk of the Court is directed to enter judgment accordingly.

This constitutes the decision and order of the court.

Dated: New York, New York
July 14, 2016

ENTER:

J.S.C.

HON. SALIANN SCARPULLA