COMMONWEALTH OF MASSACHUSETTS

APPEALS COURT

FOR THE COMMONWEALTH

No. **2017-P-1208**

MERRIMACK COLLEGE
PLAINTIFF-APPELLANT

v.

KPMG, LLP.,
DEFENDANT-APPELLEE

ON APPEAL FROM A JUDGMENT
OF THE SUPERIOR COURT

BRIEF OF PLAINTIFF-APPELLANT, MERRIMACK COLLEGE

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MERRIMACK COLLEGE CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 1:21 of the Rules of the Supreme Judicial Court, Plaintiff-Appellant Merrimack College hereby states that it has no parent corporation, and that no publicly held corporation owns 10% or more of its stock.

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STATEMENT OF ISSUES

1. Did the trial court err in ruling as a matter of law that the subjective intent of an employee is irrelevant in determining whether the wrongdoer "intended, at least in part" to benefit the employer for purposes of determining whether the employee's wrongful conduct is attributable to the employer and thus bars recovery against the employer's accountant under the doctrine of *in pari delicto*?

2. Should an independent auditing firm be immunized from liability for negligent performance of professional services involving the detection of fraud or misconduct by a client's employee?

3. Did the trial court err in allowing the defendant to amend its answer to add a new affirmative defense, which then served as an asserted ground for summary judgment, after the principal summary judgment briefs had already been served?

STATEMENT OF THE CASE

The complaint in this case was filed on June 30, 2014, alleging negligence on the part of the defendant KPMG, LLP, which served as the independent auditor for the plaintiff, Merrimack College until 2011 (Record Appendix, Vol. 1, 012-023).[1] Merrimack alleges that, during the years 1999 through 2004,[2] KPMG negligently failed to investigate irregularities in the College's financial aid office, and therefore failed to discover that the financial aid director, Christine Mordach, had issued millions of dollars of student loans without the knowledge of either Merrimack or the student borrowers. KPMG filed a motion to compel arbitration, which was denied by the Superior Court (Sanders, J.), and affirmed by the Appeals Court, Merrimack College v. KPMG, LLP, 88 Mass. App. Ct. 803 (2016) (R.A. VoL. 1, 004, ¶10).

KPMG filed a motion for summary judgment on March 24, 2017, claiming that 1) Merrimack's claims are barred by the doctrine of *in pari delicto;* 2) Merrimack's claims

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[1] All references to the Record-Appendix are abbreviated "R.A.").

[2]Due to a change in the language of the KPMG engagement letter for services to Merrimack, KPMG's auditing services rendered from 2005 through 2011 are the subject of a separate arbitration proceeding between the parties.

are barred by a purported release in the engagement letter; 3) Merrimack's claims are barred by the statute of limitations; and 4) Merrimack has raised no valid claim under G.L. c.93A (R.A. Vol. 1, 034-059). KPMG also filed a motion for leave to file an amended answer, seeking to add as an affirmative defense the release language that formed the basis for its summary judgment motion (R.A., Vol. 4, 295-329). Merrimack opposed the summary judgment motion on all grounds, and opposed the motion for leave to amend (R.A. Vol. 1, 060-062; Vol. 4, 330-332). The Superior Court (Salinger, J.) heard oral argument from the parties on April 6, 2017, and entered summary judgment on May 17, 2017 (R.A. Vol 1, 010, ¶42). Merrimack's Notice of Appeal was filed on June 13, 2017. (R.A. Vol. 1, 010, ¶43). The record was assembled in the Superior Court on September 6, 2017, and the appeal was docketed in the Appeals Court on September 14, 2017 (R.A., Vol 1, 011, ¶47). The plaintiff filed an application for direct appellate review on October 2, 2017.

STATEMENT OF FACTS

From 1998 through 2011, the defendant, KPMG, LLP, a multinational accounting and audit firm, served as the independent auditor for Merrimack College, a small, pri-

vate Catholic institution in North Andover, Massachusetts (R.A. Vol. 1, 075, ¶1; Vol. 1, 076, ¶3). During this time, KPMG conducted annual audits of Merrimack's business and financial aid operations, and each year, issued an unqualified opinion that Merrimack's financial statements were free from material misrepresentation (R.A. Vol. 1, 134, ¶188; Vol. 2, 104; Vol. 4, 143; Vol. 4, 167; Vol. 4, 195; Vol. 4, 232; Vol. 3, 057; Vol. 3, 024).

In fact, KPMG's stated opinion was incorrect (R.A. Vol. 1, 076, ¶5; Vol. 1, 137, ¶199). Unbeknownst to anyone else at Merrimack, and undetected by KPMG, the College's financial aid director, Christine Mordach, was creating hundreds of Perkins loans[3] without the consent or knowledge of the student borrowers (R.A. Vol. 1, 077, ¶6). Mordach caused these undocumented and invalid loans to be entered on Merrimack's books with the result that the College's financial statements, as audited and certified by KPMG, reflected the non-existent student

[3] A Perkins loan is processed and issued by the educational institution and funded by a combination of federal and institutional funds. The College would withdraw the appropriate monies from the fund at the beginning of each semester, replenishing the fund with repayments received for past loans (R.A. Vol. 3, 190-193).

loans as assets of the College, thus overstating the College's financial position (R.A. Vol. 3, 187-189).

For years, Mordach evaded detection, often making false entries in the records of the College's loan processor to reflect payments that had not occurred, to indicate a deferral, or to provide incorrect demographic information so that the student would not receive a bill. Id. Any student complaints about loan irregularities were handled by Mordach herself, and she successfully deflected concerns, at times even making loan payments with her own money to conceal her activities (R.A. Vol. 1, 137, ¶198; Vol. 3, 127, 98:3-99:17).

KPMG conducted an annual audit each fiscal year, which consisted of two parts: preparing financial statements, and conducting a so-called A-133 audit, which is a legal requirement for organizations receiving substantial federal funds (R.A. Vol. 1, 076, ¶3). As part of its work, KPMG examined the operations of the financial aid office Vol. 2, 104; Vol. 4, 143; Vol. 4, 167; Vol. 4, 195; Vol 4, 232; Vol. 3, 057; Vol. 3, 024). Although KPMG frequently noted irregularities in the records of the financial aid office, it nevertheless issued unqualified opinions each year. Id. KPMG never reported to Merrimack that these irregularities raised any doubts

about the validity of any loans or receivables; instead, the concern was expressed in terms of disorganization and untimely record-keeping (R.A. Vol. 3, 339-342).

Far from representing disorganization and tardiness—which were not new issues, and which Merrimack was aware had plagued Mordach throughout her career—many of the irregularities identified by KPMG were actually evidence of Mordach's creation of invalid, unauthorized loans (R.A. Vol 1, 112, ¶107). These include such things as students receiving more loan distributions than permitted by federal law, unexplained fluctuations in the outstanding loan balance, unexplained reconciliations and variances in the loan amounts, and irregularities in the promissory notes. Id. As a result of KPMG's continued issuance of unqualified opinions through 2010, Mordach's activities went undetected, and she continued to create and conceal the invalid loans thus increasing the amount by which assets were overstated (R.A. Vol. 3, 187-189).

In 2011, Merrimack instituted a new borrower tracing system, and many students who had never been billed for the Mordach-created loans suddenly received bills for loans they never incurred (R.A. Vol. 3, 198). The volume of complaints escalated, and Merrimack hired a

forensic accounting team to determine what had happened in the financial aid office. Id. The investigation revealed more than 1200 "irregular" student loans (R.A. Vol. 1, 137, ¶199; Vol. 3, 188).[4] Merrimack wrote off the uncollectible loans and repaid students who had made payments on loans they had incurred, at a total cost for repayments, write-offs and investigation and administrative fees of more than $6 million (R.A. Vol. 1, 138, ¶202; Vol. 4, 264-267). This action seeks to recover those losses.

After these revelations, Mordach pleaded guilty to certain federal charges, served a term in federal prison, and was ordered to pay restitution in the amount of $1.5 million (R.A. Vol.1, 078, ¶8). Yet the resolution of the criminal charges provides little insight regarding the larger questions surrounding Mordach's intentions. Mordach's actions, and the motivation behind them, are critical to the resolution of the central issue on appeal, the application of the doctrine of *in pari delicto*.

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[4] The term "irregular loan" was coined by Grant Thornton, the forensic auditor retained by Merrimack in fall 2011 to examine the operations of the financial aid office, to describe potentially uncollectible or invalid loans that bore specified indicia of Mordach's activities (R.A. Vol. 3, 187, n. 1).

Mordach, who had attended Merrimack and began to work in its financial aid office immediately upon her graduation in 1973, has a checkered employment history. Despite devoting her life to her work, Mordach was not particularly qualified or adept at her job, and had received performance warnings and been placed on probation (R.A. Vol. 1, 118, ¶130; Vol. 1, 119, ¶¶131-132). She was under pressure from the College administration to balance her office's budget, and feared she might be fired if she did not succeed (R.A. Vol. 1, 117, ¶¶123,124). By entering loans as receivables due to the College, Mordach caused the financial aid budget to appear balanced and in good order, when in fact, she was creating a deeper deficit every year (R.A. Vol. 1, 264). Mordach, who is single and lived with her elderly mother, had every reason to be concerned about the security of the only job she had ever known. Thus, while Mordach did not pocket the proceeds of these loans, and in fact, apparently expended her own funds to make repayments on behalf of some students in order to avoid detection, there is a clear inference that she feared losing her job, and attempted to make her office's budget appear balanced by issuing unauthorized loans (R.A. Vol. 1,

137, ¶198). For purposes of summary judgment, this inference must be drawn in favor of Merrimack.

SUMMARY OF ARGUMENT

KPMG has failed to establish as a matter of law that Mordach intended, at least in part, to benefit Merrimack College by her creation of invalid and unauthorized student loans. It was clear that, from the beginning, her actions caused financial harm to Merrimack, both in the form of creating invalid and unenforceable loan obligations, and in committing Merrimack to spend additional funds that were not in the budget, and were not intended to be spent for student aid. Mordach's own testimony and employment history would permit a jury to find that she intended not to benefit Merrimack, but to conceal her performance deficiencies and save her job. In the absence of proof that Mordach intended to benefit Merrimack, her conduct may not be imputed to the College (pages 11 to 32).

The application of *in pari delicto* to bar Merrimack's claims would leave small businesses and nonprofit organizations unable to protect themselves from dishonest or incompetent employees. As part of its engagement letter, KPMG undertook to perform an audit using reasonable professional standards, including efforts

to detect misstatements in the financial statements, whether due to fraud or error (R.A. Vol. 1, 341; Vol. 1, 0348; Vol. 2, 002; Vol. 4, 323). Merrimack quite reasonably believed that, in retaining an internationally renowned auditing firm, it would receive the benefit of the firm's expertise and knowledge, and that this would provide a level of protection against fraud and error not otherwise available to the College. Further, because of the differing factual inferences that can be drawn about Mordach's conduct, a jury could find that the parties were not *in pari delicto* (pages 32 to 47).

KPMG's affirmative defense of release was not raised in its answer as required by Rule 8(c), Mass. R. Civ. P. KPMG has never explained its delay in raising this defense, and it was an abuse of discretion for the trial court to permit KPMG to amend its answer in the absence of such an excuse (pages 47 to 50).

ARGUMENT

I. KPMG HAS FAILED TO ESTABLISH THE ESSENTIAL REQUIREMENTS FOR APPLICATION OF THE DOCTRINE OF *IN PARI DELICTO*

A. THE DOCTRINE OF *IN PARI DELICTO* DOES NOT APPLY UNLESS CHRISTINE MORDACH'S WRONGFUL CONDUCT IS IMPUTED TO MERRIMACK COLLEGE.

The doctrine of *in pari delicto* is an equitable concept, originally applied to relieve the courts of the unseemly task of enforcing an illegal contract. Atwood v. Fish, 101 Mass. 63 (1869). Thus, Massachusetts courts have refused to enforce contracts where the performance involves some illegal action. See, e.g., Arcidi v. National Ass'n of Government Employees, Inc., 447 Mass. 616 (2006) (illegal "consulting agreement making payment contingent upon a decision of a governmental authority); Connecticut Nat. Bank of Hartford v. Kommit, 31 Mass. App. Ct. 348 (1991) (enforcement of credit card debt incurred for gambling); Hastings Assocs., Inc. v. Local 369 Bldg. Fund, Inc., 42 Mass. App. Ct. 162 (1997) (refusal to enforce contract based on illegal transfer of liquor license). Compare Berman v. Coakley, 243 Mass. 348 (1923) (illegal contract to suppress criminal prosecution could be enforced by client, who was not *in pari delicto* with attorney).

While the scope of the doctrine has been expanded beyond its origins, the fundamental equitable principles remain intact. In its modern formulation, the doctrine "bars a plaintiff who has participated in wrongdoing from recovering damages for loss resulting from the wrongdoing." Choquette v. Isacoff, 65 Mass. App. Ct. 1, 3 (2005). However, the mere presence of unlawful conduct does not automatically result in the application of the doctrine; the court must examine the overall circumstances of the transaction. Fine *v.* Sovereign Bank, 634 F. Supp. 126 (D. Mass. 2008).

Where the plaintiff is the individual who is guilty of the misconduct, the application of the *in pari delicto* doctrine is straightforward, as there is no question that the plaintiff is responsible for his own actions. However, when the misconduct is committed by an employee or agent of a corporate plaintiff, the defendant cannot invoke the defense against the employer/plaintiff without first proving that the employee's misconduct is imputed to the employer. Because there is no evidence that anyone else at Merrimack was complicit in Mordach's wrongdoing, the legal imputation of Mordach's actions and knowledge to Merrimack is the *sine qua non* of KPMG's successful establishment of the *in pari delicto* defense.

The Supreme Judicial Court in Wang Laboratories, Inc. v. Business Incentives, Inc., 398 Mass. 854, 859 (1986), established a three-part test for determining whether an agent's wrongful conduct is within the scope of his employment, and thus will be attributed to the principal. The first two prongs, whether the conduct was of the kind to be performed for the employer, and whether the conduct occurred substantially within the authorized time and space limits, are not at issue here. The third prong, the intent to benefit the employer is the subject of this appeal. Therefore, to benefit from the imputation of Mordach's misconduct to Merrimack, KPMG must prove that Mordach intended, at least in part, to benefit the College by her wrongdoing. Id. at 860.

The third prong of the Wang test encompasses the so-called "adverse interest exception," which precludes the imputation of knowledge from an agent to his principal where the agent is acting against the interests of the principal. Sunrise Props. v. Bacon, Wilson, Ratner, Cohen, Salvage, Fialky & Fitzgerald, P.C., 425 Mass. 63, 66-67 (1997). In an ordinary agency relationship, it is presumed that the agent will not conceal information or knowledge from the principal, and thus the principal is deemed to have constructive knowledge of facts known to

the agent and to be responsible for the agent's conduct. DeVaux v. American Home Assur. Co., 387 Mass. 814, 818 (1983). However, where the agent's interest is adverse to the principal, this underlying rationale for imputation of conduct or knowledge does not apply. With respect to a "faithless agent," the Appeals Court has noted:

> A long-standing principle in our jurisprudence holds that we will not impute to the principal notice to an agent regarding a fraudulent act in which the agent is engaged against the principal. The presumption is that, in circumstances such as these, where it was in [the agent's] interest to keep the information from [the principal], the agent would suppress the information.

Lawrence Sav. Bank v. Levenson, 59 Mass. App. Ct. 699, 705 (2003) [internal citation omitted]. See Sperry Rand Corp. v. Hill, 356 F.2d 181, 187 (1st Cir. 1966) (agent's knowledge of his own unauthorized acts is not imputed to the principal).

The logic of the faithless agent rule is sound: if the agent truly intends to benefit the principal, then it is reasonable to expect that the principal will be informed of the agent's actions and knowledge. If on the other hand, the agent is acting in a manner that will harm the principal, it is equally reasonable to expect that the agent will take steps to prevent the

principal from learning of his actions. Mordach's conduct in this case exemplifies the "faithless agent" principle in action. Part of Mordach's activities involved a so-called "swap program," where Mordach would promise students who had been awarded financial aid grants that they would receive a multiple of the grant amount in the following year if they agreed to exchange the grant for a Perkins loan in the current year (R.A. Vol. 1, 136, ¶193; Vol. 3, 127, 101:1-16). Others at the College were aware of the "swap program," which was not in itself illegal. Some students agreed to the exchange, executed appropriate supporting paperwork, and their loans were not designated as irregular or invalid. Others did not agree or did not know, and Mordach, without telling anyone at Merrimack, created the exchange on paper without the student borrowers' authorizations, resulting in irregular, invalid and uncollectible loans (R.A. Vol. 1, 077, ¶6; Vol. 1, 135, ¶191). Simply put, Mordach kept her superiors informed of her actions when they were appropriate and benefitted the College, while concealing the actions which were inappropriate and resulted in a loss to the College. This secretive conduct is entirely in accord with the reasoning in Lawrence Savings Bank, supra, and establishes that the rationale

for imputation of an agent's knowledge to the principal is absent in this case.

B. Whether Christine Mordach Intended to Benefit Merrimack College is a Factual Issue that Cannot be Decided as a Matter of Law on Summary Judgment.

In order to satisfy the third prong of the Wang test, and thus attribute Mordach's knowledge to Merrimack, KPMG faces a significant hurdle at this summary judgment stage, because Mordach's intent is the type of issue that can rarely be established as a matter of law. Quincy Mut. Fire Ins. Co. v. Abernathy, 393 Mass. 81, 86-88 (1984). See also, Flesner v. Technical Communications Corp., 410 Mass. 805, 809 (1991) (motive); Riley v. Presnell, 409 Mass. 239, 247 (1991) (knowledge); Pederson v. Time, Inc., 404 Mass. 14, 17 (1989) (insanity). Compare Liberty Mutual Ins. Co. v. Casey, 91 Mass. App. Ct. 243, 246-247 (2017) (intent to injure inferred as a matter of law where assailant punched victim multiple times and kicked him once in face). The factual record in this case reveals two competing narratives about Mordach's motivation and intent. While many of the facts themselves are undisputed, the inferences that may be drawn from those facts are quite different, factually

and legally. The drawing of these inferences is a function for the factfinder. Flesner, 410 Mass. at 811–812.

KPMG argues, and the trial court found as a matter of law, that "Mordach's scheme *was devised to benefit* a financially struggling Merrimack in the late 1990's and early 2000's" (R.A. Vol. 1, 112-114, ¶108, ¶110 [emphasis added]). The cited paragraphs, while perhaps permitting a factfinder to draw such an inference, certainly do not compel it—a consequential distinction for purposes of summary judgment. The sole evidence on which the defendant relies to prove the critical issue of Mordach's intent is Mordach's own testimony that she believed the College benefitted from her activities in creating irregular loans (R.A. Vol. 1, 275-276; Vol. 3, 120, 58:8-20). Ignoring for a moment whether this belief is either well-founded or true, see infra at 27-32, Mordach's testimony fails to satisfy the defendant's burden to establish her actual intent as a matter of law. Although there can be no direct evidence to contradict Mordach's testimony about her subjective intent, that testimony—coming from a convicted felon and vulnerable, as discussed below, to impeachment by her other testimony—need not be believed by a jury, and cannot serve as the basis for summary judgment on an issue as to which the

defendant bears the burden of proof. Wilmington Trust Co. v. Manufacturers Life Ins. Co., 624 F.2d 707, 708-709 (5th Cir. 1980); Guardian Life Ins. Co. of America v. Grant, 22 Mass. L. Rptr. 157 (Mass. Super. 2007). See Irwin v. United States, 558 F.2d 249, 252 (5th Cir. 1977) (where taxpayer had burden of proof on motive, his uncontradicted testimony was insufficient to sustain grant of summary judgment); White v. Taylor Distributing Co., 739 N.W.2d 132, 138-139 (Mich. App. 2007) (subjective testimony of defendant, even though uncontradicted by documentary evidence, could not establish sudden emergency defense as a matter of law); see also, Flesner v. Technical Communications Corp., 410 Mass. at 809 (where "much depends upon the credibility of witnesses testifying as to their own states of mind… the jury should be given an opportunity to observe the[ir] demeanor, during direct and cross-examination").

Other evidence, including Mordach's own testimony, creates a far more compelling inference that Mordach's motivation was not to benefit the College, but to avoid the consequences of her own professional shortcomings. Mordach testified that, although she believed that it was common and without consequence for non-profit in-

stitution to run a deficit, the then-president of Merrimack, Richard Santagati, had made it clear that he would not tolerate budget deficits (R.A. Vol. 1, 117, ¶¶120,121,123; Vol. 3, 128, 185:10-13). With this directive in mind, Mordach testified that, despite her belief that there would be no adverse consequences to the College from a deficit, she believed that such a deficit in her office's budget would put her job at risk (R.A. Vol. 1, 117, ¶124; Vol. 3, 128, 182:10-15).

Indeed, there is much to suggest that Mordach's concern for her job was well-founded. Mordach was originally hired by Merrimack upon her graduation from the College in 1973 (R.A. Vol. 1, 116, ¶117; Vol. 3, 116, 24:17-24). She worked in the financial aid office continuously until 1989-1990, when she asked for a one-year leave of absence (R.A. Vol. 1, 117-119, ¶125; Vol. 3, 137). Although her stated reason at the time was to obtain additional education and training to improve her job performance, she testified at her deposition that she felt she needed the leave because of the pressure of her job, including pressure to balance the financial aid budget (R.A. Vol. 1, 117-118, ¶¶125,127; Vol. 3, 134, 137). In fact, Mordach admitted that she took no coursework during her leave, but instead, she spent the year

cleaning houses and stringing racquets at a health club (R.A. Vol. 1, 118, ¶128; Vol. 3 133-134).

When she returned from her leave, Mordach felt that the pressure had increased (R.A. Vol. 1, 118, ¶129; Vol. 3, 134). Several months later, she was informed that her employment contract would not be renewed, and that she would be terminated at the end of the school year 1990-1991 (R.A. Vol. 1, 118, ¶130). At the time of that termination notice, Mordach was facing a large budget deficit (R.A. Vol. 1, 119, ¶131). Confronted with the prospect of losing the only real job she had ever held, Mordach successfully fought termination on the grounds that her office was complying with all requirements (R.A. Vol. 1, 119, ¶132). Although permitted to keep her job, Mordach was placed on probation and given a lengthy written summary of various deficiencies in her performance (R.A. Vol. 1, 119, ¶133). This warning caused Mordach to have additional concerns about her job security (R.A. Vol. 1, 119, ¶134).

With this history, it is clear that Mordach was eager to avoid a second—and perhaps irreversible—notice of termination. President Santagati arrived in 1994, bringing with him his insistence on a balanced budget. (R.A. Vol. 117, ¶¶122,123). It was around this time that

Mordach began to create irregular loans.[5] Mordach has testified that she believed she would probably be fired, reprimanded or warned if the financial aid office budget ran a deficit. Id. at ¶124. Over the next several years, KPMG reported multiple concerns about the operation of the financial aid office (R.A. Vol. 1, 103, ¶79; Vol. 1, 105, ¶85; Vol. 1, 106, ¶¶88,89; Vol. 1, 107, ¶90; Vol. 1, 120, ¶136; Vol. 1, 123, ¶¶148, 149, 150; Vol. 1, 125, ¶157; Vol. 1, 126, ¶158; Vol. 1, 128, ¶¶165,166,167; Vol. 1, 129, ¶¶168-170; Vol. 2, 106; Vol. 3, 057-063; Vol. 3, 112; Vol. 4, 144; Vol. 4, 195-198; Vol. 4, 232-234). As a result of these concerns, Merrimack in fact placed Mordach on probation in January 2003. (R.A. Vol. 1, 119, ¶134.)

Mordach's conflicting testimony about her motives, combined with her checkered employment record, create a factual dispute that cannot properly be decided on summary judgment. In GTE Products Corp. v. Broadway Elec. Supply Co., Inc., 42 Mass. App. Ct. 293 (1997), the Appeals Court considered the defendant's claim that the

[5] It is unclear exactly when the first irregular loans were created. There is evidence of irregularities dating back to 1999, but records from earlier years were unavailable, making any determination about the origins of the problem impossible. (R.A. Vol. 1, 137, ¶200.)

actions of a "faithless agent" should be imputed to his principal, and held that that the jury was correctly permitted to decide whether the agent had acted against the interests of the plaintiff-principal. Id. at 299-300. The court noted that there was evidence that the agent's "actions were largely motivated by his personal desire to hold on to his job and to receive commissions on orders placed by the defendants." Id. at 300. See also Berish v. Bornstein, 71 Mass. App. Ct. 1101 (2007) (evidence supported judge's factual finding that defendant's position was adverse to the board of trustees of which he was a member); Cheng v. Sunoco, Inc. 2010 WL 5437235 (D. Mass. 2010) (whether agent acted on her own is a question of fact); Cannonball Fund, Ltd. v. Dutchess Capital Management, LLC., 33 Mass. L. Rptr. 623 (Mass. Super. 2016) (summary judgment record raised factual question concerning whether the investments were principally intended to benefit limited partnership, either in short or long term, as opposed to serving as a means for agents' personal profit). Compare Newton v. Krasignor, 404 Mass. 682, 687-688 (1989) (as a matter of law, insured's intentional setting of fire inside school, *absent evidence of any other motive* such as need for warmth or light, implied intent to cause some property damage).

Based on Mordach's own testimony, it is very plausible that a jury would find that her intent was not to benefit Merrimack, but to save her job, and that she was willing to go to extraordinary lengths to do so. Mordach's concealment of the problem loans—by creating false addresses and Social Security numbers, using her own funds to make payments, and committing mail and wire fraud—underscore the lengths to which she was willing to go to prevent Merrimack's management from learning what she had done. These elaborate attempts at concealment are completely at odds with the proposition advanced by the defendant, that Mordach intended her actions to benefit Merrimack.

The motion judge's initial error stems from his reliance on Kirschner v. KPMG, LLP, 938 N.E.2d 941, 950-952(N.Y. 2010), a case applying New York law. Citing Kirschner, the court wrote:

> This exception [adverse interest] applies only where the agent has "totally abandoned his principal's interests and [is] acting entirely for his own or another's purposes. It cannot be involved merely because he has a conflict of interest or because he is not acting primarily for his principal." This "most narrow of exceptions" is reserved for cases such as *"outright theft or looting or embezzlement"* where a "fraud is committed against a corporation rather than on its behalf."

(R.A. Vol. 4, 429; [citations omitted, emphasis added].) In contrast, Massachusetts law recognizes that an employee may intend to benefit himself other than by direct illegal financial gain. See, e.g., GTE Products Corp. v. Broadway Elec. Supply Co., Inc., 42 Mass. App. Ct. 293, 300 (1997) (evidence that the agent's "actions were largely motivated by his personal desire to hold on to his job and to receive commissions on orders placed by the defendants"); Sperry Rand Corp., supra, at 187, fn. 11 (agent's conduct was "doubtless self-interested; at the least to reduce his own work, at worst to fabricate an article which he could persuade defendant to pay him to circulate"). Further, Massachusetts law specifically recognizes that an agent's conflict of interest may prevent imputation of knowledge or conduct. See, J.C. Penney Co., Inc. v. Schulte Real Estate Co., Inc., 292 Mass. 42, 45 (1935) (agent with conflict of interest was "shorn of authority" to bind the principal); Chan v. Chen, 70 Mass. App. Ct. 79, 85 (2007) ("violation of agent's duty against surreptitious self-dealing, regardless of whether the agent intends to harm the principal, is a breach of the agency relationship").

The motion judge's opinion reflects both an overly narrow view of what constitutes profit or benefit to the

employee and an impermissible factual finding as to Mordach's intent. While this case does not present the typical scenario of theft or defalcation in which the employee directly receives illegal financial gains from his fraud, there is nonetheless substantial evidence of a continuing benefit to Mordach in the form of retaining her employment. The Appeals Court in GTE Products has recognized that such an intent may be sufficient to prevent the imputation of the employee's wrongful conduct to the employer. Id. at 300. See In re CBI Holding Co., Inc., 529 F.3d 432, 449 (2008) (upholding bankruptcy court's factual finding that manager was acting for his own interest where fraud perpetrated so that he would receive a bigger bonus and to "preserve [his] personal control over the company").

The trial court erroneously disregarded the evidence of Mordach's subjective intent, focusing instead on whether Merrimack College in its opinion benefited from her actions. The court conflated the first and third prongs of the Wang Laboratories test for imputed conduct: whether the misconduct was "kind of conduct" she was employed to perform, and whether the employee's motive was to benefit the employer. The court wrote:

> Merrimack's assertion that Mordach's subjective intent was to protect her own job, not to help Merrimack, is also unavailing. Even if Mordach's "predominant motive" was to benefit herself, Merrimack is still responsible for Mordach's misconduct as long as her actions were undertaken within the scope of her authority as financial aid director. As in *Wang*, "[t]here can be no serious claim" that Mordach's approval of Perkins loans "was not the kind of conduct [she] was employed to perform. As a result, Mordach's misconduct must be imputed to Merrimack.
>
> This is not a case in which an employee engaged in fraud against her employer with the intent to profit personally at the employer's expense.

(R.A. Vol. 4, p. 428; [citations omitted].)

This statement reflects a misapplication of Massachusetts law in two respects. The "kind of conduct" test is a separate prong of the Wang Laboratories rubric, which, even if satisfied, does not eliminate the need to consider the employee's intent. Further, as set forth in Wang, and contrary to the court's view that Mordach's subjective intent does not matter, Massachusetts case law contemplates a test of intent that is subjective, and therefore not properly resolved on summary judgment. See GTE Products Corp., supra at 299-300. Instead, the last quoted sentence of the Superior Court's opinion reflects an improper factual determination about Mordach's motive.

In addition to its resolution of disputed inferences regarding Mordach's intent, the trial court also accepted as fact that Merrimack College benefitted from her misconduct. The court apparently reasoned that, since Mordach did not personally pocket the proceeds of the loan, she was, as a matter of law, acting for the benefit of the College and not for herself. This reasoning is erroneous both in its failure to recognize a benefit to Mordach beyond the direct receipt of the loan proceeds and in its determination that a lack of benefit to Mordach necessarily and as a matter of law implies a benefit to Merrimack.

In discussing the third prong of the Wang criteria, the trial court opined:

> Furthermore, the factual record makes clear that Mordach approved fraudulent Perkins loans in order to improve Merrimack's finances by allowing it to spend additional federal Perkins funds on its operations. Mordach did not perpetrate this fraud in order to profit from it personally; none of the funds that Mordach improperly released by approving false loans without a student's consent went into her pocket or bank account.

(R.A. Vol. 4, p. 427). The court's assertion contains an impermissible factual finding about Mordach's intent: specifically that she "approved fraudulent loans in order to improve Merrimack's finances." This is, quite

simply, a wholesale adoption of KPMG's argument that completely overlooks the competing inference that may be drawn from Mordach's employment history and her concerns about her job security.

In essence, the court reasoned as follows: 1) Mordach did not personally profit from her activities, in the sense that she received none of the money obtained through the unauthorized loans, and 2) since she did not personally profit from the loan proceeds, she therefore as a matter of law could not have intended to benefit herself, and 3) since she did not intend to benefit herself, she must have intended to benefit the College, and 4) since she intended to benefit the College, her misconduct is imputable to Merrimack. The error of this analysis is demonstrated by one of the cases cited by the motion judge, which rejects the notion that benefit to the corporation automatically requires imputation, and notes the importance of the employee's subjective intent. Grede v. McGladrey & Pullen LLP, 421 B.R. 879, 886 (N.D. Ill. 2009).

The notion of the employee's intent and the purported benefit to the employer are to some extent inextricably intertwined. If Merrimack College would in fact benefit from Mordach's misconduct, that fact might

support the argument that Mordach intended to create that benefit. But far from benefitting the College, Mordach's activities resulted in significant financial damage to Merrimack. While Mordach's entry of invalid loans on the College's books made the budget appear to be in balance, the "benefit" was illusory, because the listed obligations were non-existent. Compare Grede at 888-889 (factual question whether benefits were real or illusory, "meant to conceal benefits solely for those who controlled" the corporation). Merrimack did not benefit even in the short term, as most of the invalid Perkins loans created by Mordach resulted in a grant of additional unfunded scholarship monies in subsequent years, thus creating greater expense and budget overruns to Merrimack than if the previous year's exchange of a loan for a grant had not occurred. Even if the loans had been valid assets—which they were not, this exchange would have only provided a temporary (one year or less) budget relief. An exchange that resulted in an increased scholarship expense *and* an invalid loan was *a fortiori* financially disastrous for Merrimack. See Schacht v. Brown, 711 F.2d. 1343, 1348 (7th Cir. 1983) (managing directors inflicted "real damage" on the corporation by allegedly diminishing its assets and income).

KPMG's "factual" statement that "Mordach's scheme enabled Merrimack *to retain and attract students*, while improving Merrimack's overall financial position by increasing tuition revenue and creating the appearance of a balanced budget," finds at best possible—not indisputable—inferential support in the cited paragraphs (R.A. Vol. 1, 76, ¶5; Vol. 1, 112, ¶106; Vol. 1, 113-114, ¶110; Vol. 1, 43 [emphasis added]). The suggestion that Merrimack benefited from an ability to attract and retain students is purely speculative and unsupported by any facts of record. There were multiple other funding sources that might have been available (including *valid* Perkins loans), as well as the Merrimack unfunded grants, so there is no competent evidence that Mordach's activities allowed Merrimack to retain any identifiable student or students. Further, this argument is indistinguishable from that rejected in GTE Products, where the defendant argued that the plaintiff benefitted because, despite its employee's fraud, it received the profits from sales it would not otherwise have made, even if those profits were less than they should have been. 42 Mass. App. Ct. at 299. See also, Sperry, 356 F.2d at 185-187(defendant who benefited from advertising campaign based on agent's fraudulent representations

about medical study was not liable for agent's conduct). Compare Wang Laboratories, 398 Mass. at 860 (agent's misconduct intended to obtain benefits of defendant's services for his employer without payment).

This is not a case where simply "'in retrospect,' the employee's actions 'were ill-advised' and actually hurt the employer's interests." Slip opinion at 5, citing Kourouvacilis v. American Fed'n of State, Cty. & Mun. Employees, 65 Mass. App. Ct. 521, 534 (2006). Even prospectively, there is little evidence that Mordach truly believed that the creation of invalid loans would inure to the benefit the College, or that committing the College to far more in grants than it had budgeted or than it could afford was a benefit. Mordach's activities essentially resulted in a Ponzi scheme, where she was continually creating new invalid loans to cover up the shortfall created by the old invalid loans, and thus postpone the day of reckoning. Mordach's ongoing effort to cover her tracks is further evidence that her intent was not to benefit Merrimack, but to maintain her employment. In any event, there is insufficient evidence of benefit to Merrimack to warrant summary judgment. See GTE Products Corp. v. Broadway Elec. Supply Co., Inc., 42 Mass. App. Ct. 293, 300 (1997) (that plaintiff

may have benefited in some small way in spite of the agent's fraudulent acts insufficient to establish by directed verdict standard that agent's actions were not adverse to his employer's interests.

C. Even if Mordach's Conduct is Imputed to Merrimack College, Equitable Considerations Preclude the Application of the *In Pari Delicto* Doctrine.

Even if Mordach's conduct is attributed to Merrimack College, the doctrine of *in pari delicto* does not automatically bar the plaintiff's claims. As the Appeals Court has noted:

> "[o]ur cases warn against the sentimental fallacy of piling on sanctions unthinkingly once an illegality is found."… " '[C]ourts do not go out of their way to discover some illegal element in a contract or to impose hardship upon the parties beyond that which is necessary to uphold the policy of the law[.]' "… We must examine and weigh all of the circumstances: "what was the nature of the subject matter of the contract; what was the extent of the illegal behavior; was that behavior a material or only an incidental part of the performance of the contract...; what was the strength of the public policy underlying the prohibition; how far would effectuation of the policy be defeated by denial of an added sanction; how serious or deserved would be the forfeiture suffered by the plaintiff, how gross or undeserved the defendant's windfall."

Hastings Assocs., Inc. v. Local 369 Bldg. Fund, Inc., 42 Mass. App. Ct. at 175 [internal citations omitted]. A careful consideration of the many unusual circumstances

in this case leads to the conclusion that it would be inequitable to place the burden of this loss on Merrimack, an otherwise innocent employer with a rogue employee, rather than on KPMG, a firm of trained audit professionals who failed to perform what they had contracted to do.

As its name implies, application of the *in pari delicto* rule requires that the parties be at least at equal fault. Council v. Cohen, 303 Mass. 348, 354 (1939). The conduct on the part of the plaintiff required to permit a defendant to invoke the doctrine must be deliberately or intentionally wrong, rather than merely negligent or the result of innocent mistake or error. Baena v. KPMG LLP., 453 F.3d 1, 6 (1st Cir. 2006). See MF Global Holdings, Ltd. v. Pricewaterhouse-Coopers LLP., 199 F.Supp.3d 818,835 (S.D.N.Y. 2016) (accountant cannot show that plaintiff "was an intentional wrongdoer" which "intentionally provided inaccurate financial statements to PwC").

KPMG asserts that "Merrimack launched an investigation in August 2011 into the activities of its Financial Aid Office and concluded that Mordach had engaged in a *fraudulent scheme* to issue Perkins loans to certain students in place of previously granted scholarships"

(R.A. Vol. 1, 079, ¶9; Vol. 1, 042)[emphasis added]). In fact, paragraphs 5 and 9 of the SOMF simply refer to "irregular" loans and "widespread problems," and do not support KPMG's allegation of a fraudulent scheme (R.A. Vol. 1, 76, 79, ¶¶5, 9). As argued infra at pages 38-40, the difference is consequential. KPMG has acknowledged that whatever illegal conduct occurred was limited to Mordach herself, and was unknown to Merrimack's management (R.A. Vol. 1, 116, ¶116). Indeed, even as the investigation of the financial aid office began, both Merrimack and KPMG were unsure whether the irregularities were anything more than poor record-keeping (R.A. Vol. 1, 115, ¶115). Thus, once again the focus is squarely on the various possible inferences surrounding Mordach's intent and wrongdoing. The evidence that Mordach's intent in creating and concealing the irregular loans was to commit a deliberate fraud is far from overwhelming and certainly not undisputed.

Mordach's testimony supports a finding that she did not deliberately set out to create fraudulent loans, but rather became overwhelmed by a combination of factors, including financial pressures, antiquated manual systems, and her own professional shortcomings. In that vein, she testified that sometimes the exchange of a

scholarship for a Perkins loan "just slipped by" without the student's knowledge (R.A Vol. 1, 136, ¶194; Vol. 3, 123, 80:2-22). Mordach further testified that, when students questioned their Perkins loans, she used incorrect Social Security numbers and other personal information in the computer records to help the student avoid credit problems while she worked to resolve the issue (R.A. Vol. 1, 137, ¶197; Vol. 3, 125, 88:17-89:5). She has consistently resisted the proposition that she acted with fraudulent intent in *creating* the irregular loans; her guilty plea involved three counts of mail and wire fraud related only to her later attempts to cover up the unauthorized loans, not to the loans themselves (R.A. Vol. 1, 136, ¶196; Vol. 3, 119, 54:5-16). This testimony, along with Mordach's lack of financial gain, raises a reasonable inference that the situation was the unfortunate result of poor record-keeping spun out of control.

KPMG's assertion that Merrimack is bound by the facts recited by the United States Attorney during Mordach's plea colloquy is legally incorrect (R.A. Vol. 1, 064-067). The law is clear that, while a guilty plea may be offered as evidence in a civil action against the former criminal defendant, it has no preclusive effect,

and the defendant is entitled to explain the facts and his reasons for entering the plea. Metropolitan Prop. & Cas. Ins. Co. v. Morrison, 460 Mass. 352, 364 (2011). However, this case is yet one step removed from that principle since Mordach is not a party to this action. Her simple confirmatory response to the U.S. Attorney's factual recitation would at most be admissible to impeach her testimony, and would have no substantive effect against Merrimack College. See Mass. G. Evid., Section 613 and Mass. G. Evid., Section 801(d)(1)(A)(iv). Thus, KPMG's reliance on Mordach's guilty plea to supply undisputed evidence of her fraudulent intent is unavailing, both because it is not binding on either Mordach or Merrimack, and because it is hearsay.

While correctly rejecting KPMG's argument that Merrimack is bound by Mordach's guilty plea, the trial court erred in drawing impermissible factual inferences to establish Mordach's fraudulent intent (R.A. Vol. 4, 431, n. 2). The trial court's statement that "Merrimack is bound by its own, detailed allegations that Mordach engaged in intentional fraud," while legally sound, is factually unsupported, as Merrimack has never alleged that Mordach engaged in intentional fraud (R.A. Vol. 4,

431). The judge's untenable leap in reasoning is demonstrated in his explanation:

> In its complaint, Merrimack alleges that Mordach approved Perkins loans "for imaginary students who never existed," for current students who never signed any promissory notes, for prior students who had graduated or died and thus were not eligible for a Perkins loan, using fake social security numbers, or listing Mordach's own home address as the address for the purported loan application.[6]
>
> When it responded to KPMG's statement of undisputed material facts Merrimack understandably admitted that these facts demonstrate that Mordach had engaged in deliberate fraud.[7] More specifically, Merrimack admitted that Mordach "created false paperwork and issued Perkins loans to students without the students' knowledge or consent." *Deliberately processing and approving loans for dead or otherwise departed students, using made up social security numbers, putting down Mordach's own address in lieu of the students['], approving loans for students who never signed any promissory note, and otherwise obligating current and former students to repay a loan they never knew about is fraudulent.*

(R.A., Vol. 4, pp. 430-431; [emphasis added].)

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[6] The actual allegations summarized by the judge are contained in paragraph 13 of the Complaint (R.A. Vol. 1, 014-016). Nowhere in the Complaint does Merrimack allege that Mordach acted with fraudulent intent.

[7] Nowhere in the Statement of Material Facts did Merrimack make such an admission of deliberate fraud. Merrimack admitted only that Mordach took certain actions as alleged in the Complaint (R.A. Vol. 1, 077, ¶¶6,7).

The judge's error lies in his conclusion that "false" is the legal equivalent of "fraudulent," a proposition that overlooks the mental state that distinguishes the two. While a "false" statement is simply one that is untrue, a "fraudulent" statement is one made with intent to deceive. See Cumis Ins. Society, Inc. v. BJ's Wholesale Club, Inc., 455 Mass. 458, 472 (2009); Sound Techniques, Inc. v. Hoffman, 50 Mass. App Ct. 425, 432-433 (2000). Thus, while Merrimack agrees that Mordach took various actions that created false loans and records, the question of whether she did so with intent to defraud, as KPMG claims, or simply, as Mordach has testified, either intending to help students or because errors "slipped by," or even without fraudulent intent, but out of desperation to save her job, precludes the entry of summary judgment. See Robinson v. Prudential Ins. Co. of America, 56 Mass. App. Ct. 244, 251-251 (2002) (whether statement was "willfully false, fraudulent or misleading" not determined on summary judgment as "incorrect statement does not necessarily indicate actual intent to defraud").

KPMG's inability to establish Mordach's fraudulent intent as a matter of law precludes the application of

in pari delicto at the summary judgment stage. In contrast to Mordach's disorganized and careless errors, which according to her resulted from various less-than-ideal working conditions, KPMG actually identified a number of discrepancies that were the result of the irregular loans, and chose either to dismiss them without further investigation or to accept Mordach's inconsistent and illogical explanations (R.A. Vol. 1, 103, ¶79; Vol. 1, 105, ¶85; Vol. 1, 106, ¶¶88,89; Vol. 1, 107, ¶90; Vol. 1, 120, ¶136; Vol. 1, 123, ¶¶148, 149, 150; Vol. 1, 125, ¶157; Vol. 1, 126, ¶158; Vol. 1, 128, ¶¶165,166,167; Vol. 1, 129, ¶¶168-170; Vol. 2, 106; Vol. 3, 057-063; Vol. 3, 112; Vol. 4, 144; Vol. 4, 195-198; Vol. 4, 232-234). This view of the evidence does not support, let alone compel, a finding that Mordach's fault was equal to that of KPMG. See Scola v. Constantino Richards Rizzo LLP., 31 Mass. L. Rptr. 33 (Mass. Super. 2013) (denying judgment on the pleadings where unsophisticated plaintiffs alleged that they believed, based on accountants' advice, that their actions were not illegal); George v. Whitman, 2009 WL 4894364 at *1 (Mass. Super. 2009) (material issues of fact as to whether client engaged in intentional misconduct precluded summary judgment for lawyer); MF Global Holdings,

Ltd. v. PricewaterhouseCoopers LLP., 199 F.Supp.3d 818,835 (S.D.N.Y. 2016) (accountant cannot show that plaintiff "was an intentional wrongdoer" which "intentionally provided inaccurate financial statements to PwC").

The inequity in applying the *in pari delicto* doctrine in this case is further apparent from the position and conduct of the various actors. KPMG finds itself in this case not because it was an innocent victim of Mordach's activities, but because of its own undertaking to conduct an audit using reasonable efforts to detect both fraud and error, and its subsequent failure to investigate and recognize the significance of the irregularities that it repeatedly noted. Courts have recognized that a defendant in this status is not entitled to the same protection afforded an innocent third party. The First Circuit has noted, "Where a principal is attempting to avoid liability to an innocent party, a greater adverse interest on the agent's part might well be required before insulating the principal from his agent's knowledge." Sperry Rand Corp. v. Hill, 356 F.2d 181, 186 (1966). See National Credit Union Admin. v. Ticor Title Ins. Co., 873 F. Supp. 718, 726 (D. Mass. 1995)

(inequitable to allow principal to disclaim responsibility for agent's knowledge while acquiring a benefit from an innocent third party). Compare Bockser v. Dorchester Mutual Fire Ins. Co., 327 Mass. 473 (1951) (principal liable for agent's fraud perpetrated on innocent third party). In contrast, GTE Products did not concern an innocent third party who was seeking to hold a principal liable for the fraudulent acts of its agent, but rather a situation where the agent and the third party both had knowledge of the fraud. Thus, the GTE court noted, "[t]he rationale for imputing an agent's knowledge to his principal in order to do justice to an innocent third-party is totally lacking here." Id. at 300.

Because of an auditor's important role in identifying irregularities in financial documents, some courts have recognized an "auditor exception" to the doctrine of *in pari delicto*. The Third Circuit noted in Thabault v. Chait, 541 F.3d 512 (3d Cir. 2008):

> We also deem applicable the "auditor negligence" exception recognized by the New Jersey Supreme Court in *NCP*, which explained "that a claim for negligence may be brought on behalf of a corporation against the corporation's allegedly negligent third-party auditors for damages proximately caused by that negligence." Similar to the fact pattern in *NCP*, PwC was not a victim of Chait's

> fraud and allowing it to avoid liability by invoking the *in pari delicto* doctrine would not serve the purpose of the doctrine—to protect the innocent.

541 F.3d 512, 529 (3d Cir. 2008). See, NCP v. KPMG LLP., 187 N.J. 353, 901 A.2d 871 (N.J. 2006) (auditor not a "victim of the fraud in need of protection"). Regardless of the conduct of the audited organization, its auditors have an independent contractual duty to comply with professional standards regarding the detection of misstatements due to fraud or error. Id. at 372, 901 A.2d at 882. See, Lawrence Sav. Bank v. Levenson, 59 Mass. App. Ct. 699, 706 (2003) (law firm had independent duty to report bank officer's wrongdoing to its bank client).

This holding is in keeping with other situations where one party's specific responsibility is to prevent, reduce or avoid harm to another. See, e.g., McNamara v. Honeyman, 406 Mass. 43, 55 (1989) (no comparative negligence where the defendant's duty of care includes preventing the self-abusive or self-destructive acts that caused the plaintiff's injury); Pierce v. Cunard Steamship Co., 153 Mass. 87 (1891) "(plaintiff's previous negligence is not a sufficient excuse for knowingly inflicting an injury upon him, or, short of that, for omitting the use of such care as is reasonable under the

circumstances to avoid injuring him"). While it will fall to the jury to determine the ultimate allocation of responsibility between the parties, KPMG cannot be said as a matter of law to be blameless in failing to follow accepted professional standards. To hold that KPMG cannot be liable for failing to detect fraud or error "would render meaningless" KPMG's contractual obligation to do just that. McNamara, 406 Mass. at 55.

This case differs from the usual situation in which the *in pari delicto* defense is applied in three important respects. First, such cases almost invariably involve either an individual plaintiff who is himself the actual wrongdoer, or a corporate plaintiff whose controlling managers have committed the wrong. Second, where an entity is involved, it is a for-profit, money-making enterprise attempting to benefit directly from the fraud. And finally, the parties whose fault are at issue were usually engaged in joint wrongdoing, either contractually or otherwise. See, e.g, Fine v. Sovereign Bank, 634 F. Supp.2d 126 (2008) (adverse interest exception subject to further exception where wrongdoer is sole director and shareholder); Baena v. KPMG, LLP., 453 F.3d 1 (chairman of the board, CEO and managing directors

deliberately overstated revenue); AGM Marine Contractors, Inc. v. Canby, Maloney & Co., Inc., 71 Mass. App. Ct. 1119 (2008); (sole shareholder, officer and director filed false income tax returns prepared by defendant accounting firm); Choquette v. Isacoff, 65 Mass. App. Ct. 1 (2005) (individual plaintiff signed false bankruptcy schedules prepared by defendant attorney); Kirschner v. KPMG LLP., 938 N.E. 2d at 946 (corporate president and CEO concealed uncollectible debt from public and regulators).

In contrast, Mordach, the only wrongdoer at Merrimack, was not an executive or controlling manager at the College, and the College itself is not a profit-seeking business but a non-profit educational institution. Further, there is no suggestion that Mordach colluded with anyone at KPMG to achieve an illegal goal; rather, she and the College's auditors engaged in separate acts of wrongdoing more appropriately addressed through the doctrine of comparative negligence.

The trial court dismissed these considerations, once again citing Kirschner:

> "To allow a corporation to avoid the consequences of corporate acts simply because an employee performed them with his personal profit in mind would enable the corporation to disclaim, at its convenience, virtually every

> action its officers undertake. '[C]orporate officers, even in the most upright enterprises, can always be said, in some meaningful sense, to act for their own interests.'" Id [*Kirschner v, KPMG*, LLP], quoting *Grede v. McGladrey & Pullen LLP*, 421 B.R. 879, 886 (N.D. Ill. 2009).

(R.A. Vol. 4, 429). However, while the judge accurately quoted the Kirschner court, that court omitted two critical phrases as it quoted the Grede court's opinion, as shown in bold below:

> **The reason one must carefully examine what benefit accrued to the corporation is that** corporate officers, even in the most upright enterprises, can always be said, in some meaningful sense, to act for their own interests, **particularly when those officers own all or a very large piece of the business and control it.** The adverse interest exception swallows the rule if all that is required to invoke it is a secondary, or indirect benefit of keeping the enterprise alive to preserve their jobs or increase the paper value of their ownership shares.

Grede v. McGladrey & Pullen LLP., 421 B.R. 879, 886 (N.D. Ill. 2009). As aptly noted in Grede, the position of the wrongdoer and the nature of the alleged benefit are factors to be considered.

If Merrimack is barred from recovery against its negligent auditors, the result will be inequitable in

two respects. First, KPMG's failure to perform its contractual undertaking[8] to apply reasonable standards to identify fraud or error will be completely without consequence. KPMG should not be permitted to avoid responsibility for its failure when the misconduct by Mordach is precisely the type of irregularity it undertook to locate. Second, small organizations like Merrimack depend on professional auditors to help them identify fraud and error. An organization that lacks the in-house expertise to supervise all of its own financial operations should be able to rely on a professional it retains to audit those operations, and should have recourse against that professional when it performs negligently. Merrimack did everything right: it hired a large, international audit firm to audit its finances, paid more than $1 million for those services over the years, and yet, according to KPMG, is now without remedy for its $6 million loss. KPMG was in the best position to recognize and mitigate that loss, and in fact, had been retained in part for that specific purpose. It is difficult to conceive of how small organizations can

[8] This language appears in each annual engagement letter with minor stylistic changes (R.A. Vol. 1, 341; Vol. 1, 348; Vo. 2, 002; Vol. 4, 323).

protect themselves from rogue employees if KPMG's position is upheld.

II. THE TRIAL COURT ERRED IN PERMITTING KPMG TO AMEND ITS ANSWER AFTER SERVING ITS SUMMARY JUDGMENT MOTION AND AFTER THE PLAINTIFF HAD RESPONDED.

On March 23, 2017, the same day that it filed with the court a summary judgment motion relying on a defense of release, the defendant, KPMG LLP, served a motion to amend its answer to include the affirmative defense on which it seeks to rely. To this day, KPMG has never offered an excuse for its failure to plead this allegedly case-dispositive affirmative defense until the very day its summary judgment package was filed with the court.

Massachusetts law is clear that "the defense of a release must be raised as an affirmative defense and that the omission of an affirmative defense from an answer generally constitutes a waiver of that defense." Sharon v. Newton, 437 Mass. 99, 102 (2002); Mass. R. Civ. P., Rule 8(c). Although KPMG correctly notes that the court has discretion to allow the filing of an amended answer, it has provided no basis whatsoever that would justify the exercise of that discretion.

One of the principal reasons for the denial of a motion to amend is undue delay. In Castellucci *v.* United States Fid. & Guar. Co., the Supreme Judicial Court held

that, "[a]mong the good reasons, however, for which a motion to amend may be denied are that no justification for the lateness of the motion is apparent (beyond counsel for the moving party having had a late dawning idea) and that one or more of the nonmoving parties would be caught off balance by the proffered amendment." 372 Mass. 288, 292 (1977). The chronology of this case demonstrates repeated junctures at which the defendant could and should logically have raised this defense, which is based on a series of letters KPMG sent annually to Merrimack each year from 1999 through 2011:

- KPMG filed a notice of intent to file a motion to dismiss on August 15, 2014, relying on arbitration language that appears in the very same letters;

- KPMG filed its answer on November 10, 2014, omitting any defense of release;

- KPMG participated in multiple Rule 16 conferences and amended scheduling orders, never once seeking to extend the Rule 15 deadline;

- KPMG served its motion for summary judgment on January 27, 2017 relying on a defense of release, but still making no attempt to amend its answer to include that defense;

- KPMG finally served a motion to amend its answer on March 23, 2017, two weeks after Merrimack had served its summary judgment reply brief, and concurrently with filing its summary judgment motion in court.

The Supreme Judicial Court has recently emphasized that repose of discretion in a trial court is not a grant of unfettered license to make any decision that the court desires. Commonwealth v. Veiovis, 477 Mass. 472, 482 (2017), citing L.L. v. Commonwealth, 470 Mass. 169, 185, n. 27 (2014). Rather, discretion must be exercised with due consideration to the appropriate factors, and a court's ruling will be reversed upon a finding of "a clear error in judgment in weighing relevant to the decision. Id. See Long v. Wickett, 50 Mass. App. Ct. 380, 386, n.8 (2000) (abuse of discretion where "decision making process… did not take into account all the proper factors identified by relevant case law").

It is axiomatic that first inquiry when a party seeks to take an action for which the deadline has long since passed should be the reason for the delay. The defendant has yet to offer such an explanation in any form or forum. Without any proffered excuse, the trial court obviously did not consider the reason for the delay, and thus abused its discretion by failing to consider the most relevant of all factors. KPMG's sole response to its unexplained lapse has been to attempt to shift to the plaintiff the burden to justify its opposition to the motion to amend. To impose any burden on

the opposing party in this situation, before the moving party has proffered even the first excuse for its lapse, would make a complete mockery of the Rules of Civil Procedure and the Superior Court Rules. The lack of excuse, standing alone, is a sound basis for denial of the defendant's motion. Barbosa v. Hopper Feeds, Inc., 404 Mass. 610, 621-622 (1989; Libby v. Comm'r of Correction, 385 Mass. 421 (1982).

CONCLUSION

The plaintiff, Merrimack College, respectfully requests this Honorable Court to vacate the order of the Superior Court granting summary judgment and to remand the case for trial. The plaintiff further requests that order of the Superior Court granting the defendant's motion to amend its answer be vacated, and that an order denying the motion to amend enter from this court.

The plaintiff,
By its Attorney,

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ADDENDUM

COMMONWEALTH OF MASSACHUSETTS

SUFFOLK, ss.

SUPERIOR COURT.
1484CV02098-BLS2

MERRIMACK COLLEGE

v.

KPMG LLP

MEMORANDUM AND ORDER ALLOWING DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

Merrimack College incurred substantial financial losses because its former financial aid director, Christine Mordach, deliberately approved fake Perkins loans for many students without their knowledge.[1] For years Mordach awarded far more financial aid than she was authorized to spend. She made the college's financial aid budget appear balanced by replacing grants and scholarships with fake Perkins loans, the proceeds of which were used to pay tuition owed to Merrimack. Ms. Mordach pleaded guilty to federal criminal charges of mail and wire fraud.

Merrimack seeks to recover its losses from its former auditor, KPMG LLP. Merrimack claims that KPMG noticed but did not follow up on discrepancies in some student loan accounting and deficiencies in internal controls for such loans, and as a result failed to discover Mordach's fraud. Merrimack asserts that KPMG was negligent, breached its contract, and violated G.L. c. 93A.

KPMG has moved for summary judgment on several grounds, including that Merrimack's claims are barred under the equitable doctrine known as *in pari delicto* because Mordach committed fraud to benefit her employer and her deliberate wrongdoing on behalf of Merrimack was far worse than KPMG's alleged negligence.

The Court agrees that, in light of the undisputed material facts, Merrimack's claims are barred by the *in pari delicto* doctrine. Under these circumstances, Merrimack is legally responsible for Mordach's misconduct. Merrimack is also

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[1] The Perkins Loan program provides "low-interest loans to financially needy students" at institutions of higher education that are funded with federal monies, matching contributions by each participating school, and repayment of prior loans. *De La Mota* v. *United States Dept. of Educ.*, 412 F.3d 71, 74 (2d Cir. 2005). "The schools independently determine eligibility, advance funds, collect payments[,] and make decisions concerning loan forgiveness." *Id.*; see also 20 U.S.C. §§ 1070 et seq.

bound by the allegations in its complaint that Mordach engaged in intentional fraud. That deliberate misconduct by Merrimack's employee was far more serious than KPMG's purported negligence. Finally, the Court is not persuaded that Massachusetts should recognize, on public policy grounds, an exception to this doctrine for claims against an allegedly negligent outside auditor. The Court will therefore allow KPMG's motion and dismiss this action.

1. Legal Background. "The doctrine of in pari delicto bars a plaintiff who has participated in wrongdoing from recovering damages for any loss resulting from the wrongdoing." *Choquette* v. *Isacoff*, 65 Mass. App. Ct. 1, 3 (2005). It reflects an equitable and policy judgment that courts should "not lend aid to parties who base their cause of action on their own immoral or illegal acts." *Id.* at 4. This doctrine does not create an absolute bar to recovery. If both sides may have engaged in misconduct, the "less guilty" party may be able to recover damages or obtain equitable relief, notwithstanding its own misconduct. *Id.*, quoting *Council* v. *Cohen*, 303 Mass. 348, 354 (1939), and *Berman* v. *Coakley*, 243 Mass. 348, 350 (1923).

"*In pari delicto*" is a phrase of legal Latin that "means 'in equal fault.' " *Baena* v. *KPMG LLP*, 453 F.3d 1, 6 (1st Cir. 2006), quoting *Black's Law Dictionary* 791 (6th ed. 1990). It comes from a long-standing equitable maxim, "*in pari delicto potior est conditio defendentis*," that can be translated as "[i]n a case of equal or mutual fault, the position of the [defending party] is the better one." *Id.* n.5, quoting *Black's Law Dictionary*.

The practical import of this principle, where it applies, "is simply that the law leaves the parties exactly where they stand; not that it prefers the defendant to the plaintiff, but that it will not recognize a right of action" based on inequitable conduct. *Atwood* v. *Fisk*, 101 Mass. 363, 364 (1869).

This principle was developed and originally applied to bar a plaintiff who engaged in wrongdoing from obtaining purely equitable relief (such as an order that someone specifically perform a contract or some other injunctive relief) to remedy its own misconduct (such as entering into an illegal contract or engaging in fraud). *Choquette*, 65 Mass. App. Ct. at 4.

More recently, this doctrine has also been applied to bar a plaintiff from asserting legal claims seeking monetary compensation for an injury that was in part self-inflicted. In *Choquette*, for example, the plaintiff filed a bankruptcy petition and was then sued by the bankruptcy trustee for fraudulently conveying property and filing a false statement of his assets. The plaintiff turned around and sued his attorney for legal malpractice on the theory that the lawyer had prepared the false schedule of assets. The Appeals Court affirmed summary judgment in favor of the defendant lawyer on the ground that the *in pari delicto* doctrine barred all claims because the plaintiff had knowingly signed the false asset schedule and then lied about it under oath during his bankruptcy hearing. *Id.* at 3-8.

The *in pari delicto* doctrine applies with full force against a corporation or other legal entity, such as Merrimack College, that has been injured as a result of misconduct by an employee or other agent acting on its behalf and then seeks compensation from some third party for that injury. *Arcidi* v. *National Association of Government Employees, Inc.*, 447 Mass. 616, 621-62 (2006).

2. Application to the Undisputed Facts. Whether particular claims are barred because the plaintiff is at least as culpable as, and thus *in pari delicto* with, the defendant can be resolved on a motion for summary judgment where the material facts are not in dispute. See *Choquette*, 65 Mass. App. Ct. at 2-8.

2.1. Imputing Misconduct to Merrimack. Under the circumstances of this case, Mordach's fraudulent conduct must be imputed to Merrimack, meaning that Merrimack is legally responsible for Mordach's fraud.

The rules describing when an employer is responsible for wrongdoing by its employee can be summarized as follows. Any misconduct by employee that is "committed within the scope of his employment" is imputed to the employer, which is "vicariously liable" for the employee's misdeeds. E.g., *Kourouvacilis* v. *American Fed'n of State, Cty. & Mun. Employees*, 65 Mass. App. Ct. 521, 534 (2006). Conduct by an employee is deemed to be "within the scope of employment if it is of the kind he [or she] is employed to perform, ... if it occurs substantially within the authorized time and space limits, ... and if it is motivated, at least in part, by a purpose to serve the employer" (citations omitted). *Wang Laboratories, Inc.* v.

Business Incentives, Inc., 398 Mass. 854, 859 (1986). "[A]n employer need not control the details of an employee's tasks in order to be held liable [or responsible] for the employee's tortious acts." *Dias* v. *Brigham Med. Assocs., Inc.*, 438 Mass. 317, 320 (2002).

These same "agency-based imputation rules" for deciding whether an employer will be held vicariously liable for its employee's wrongdoing apply with full force in this case, because they also determine whether an employee's misconduct is imputed to the employer when applying the *in pari delicto* doctrine. *Baena*, 453 F.3d at 8 (applying Massachusetts law); accord *Kirschner* v. *KPMG LLP*, 938 N.E.2d 941, 950-952 (N.Y. 2010) (applying New York law).

All three prongs of the test reiterated in *Wang Laboratories* are satisfied here, which means that Mordach's fraud must be imputed or attributed to Merrimack. Mordach served as Merrimack's Director of Financial Aid. She was responsible for approving all Perkins loans awarded to Merrimack students. Doling out Perkins loan funds was part of Mordach's job, something that Merrimack paid her to do, and something she did during regular working hours and using Merrimack's facilities and equipment. Furthermore, the factual record makes clear that Mordach approved fraudulent Perkins loans in order to improve Merrimack's finances by allowing it to spend additional federal Perkins funds on its operations. Mordach did not perpetrate this fraud in order to profit from it personally; none of the funds that Mordach improperly released by approving false loans without a student's consent went into her pocket or bank account.

Merrimack makes several arguments as to why, in its view, the imputation of Mordach's misconduct to Merrimack turns on disputed issues of fact and thus cannot be resolved on a motion for summary judgment. None has merit.

First, the argument that Merrimack should not be held to account for misdeeds by a lower-level employee has no basis in law and cannot be squared with the facts.

There is no "low-level employee" exception to the legal rule that an employer is vicariously liable for misconduct committed by employee within the scope of her employment. What matters is whether an employee's negligent or intentional

misconduct involved something within the scope of their employment responsibilities, not whether they are a senior executive or a junior staffer. See generally *Wang Laboratories*, *supra*.

In any case, the undisputed facts show that Mordach was a relatively high-level staffer. She was responsible for managing Merrimack's entire financial aid program, including the award of Perkins loans. As Director of Financial Aid, from 1999 to 2004 Mordach oversaw the award and distribution of almost $150 million in financial aid. For eight different years Mordach, together with the other members of Merrimack's senior management, signed management representation letters to KPMG. Merrimack points to no appellate decision in which a corporate entity was not held responsible for misconduct committed within the scope of employment by someone with similar management responsibilities.

Second, Merrimack's further argument that in the long run the college was hurt, not helped, by Mordach's fraud also misses the point. Whether an employer is vicariously liable for an employee's misconduct turns on whether the employee's actions were motivated at least in part by a desire to benefit her employer. See *Wang Laboratories*, 398 Mass. 859. It is irrelevant whether "in retrospect" the employee's actions "were ill-advised" and actually hurt the employer's interests. *Kourouvacilis*, 65 Mass. App. Ct. at 535.

Third, Merrimack's assertion that Mordach's subjective intent was to protect her own job, not to help Merrimack, is also unavailing. Even if Mordach's "predominant motive" was to benefit herself, Merrimack is still responsible for Mordach's misconduct so long as her actions were undertaken within the scope of her authority as financial aid director. See *Wang Laboratories*, 398 Mass. at 859-860. As in *Wang*, "[t]here can be no serious claim" that Mordach's approval of Perkins loans "was not the kind of conduct [she] was employed to perform." *Id.* at 860. As a result, Mordach's misconduct must be imputed to Merrimack.

This is not a case in which an employee engaged in fraud against her employer with the intent to profit personally at the employer's expense.

Merrimack correctly notes that an employer or other principal is not responsible for misconduct by or credited as having knowledge of an agent that "has

acted fraudulently toward the principal and is engaged in an independent fraudulent act from which the principal does not benefit." *Sunrise Properties, Inc.* v. *Bacon, Wilson, Ratner, Cohen, Salvage, Fialky & Fitzgerald, P.C.*, 425 Mass. 63, 67 (1997). An agent who commits a "fraudulent act ... against the principal" is sometimes called a "faithless agent;" since such a person is not working on behalf of the principal, but instead is trying to harm the principal, it would not be appropriate to impute their knowledge or misconduct to the principal. See *Lawrence Sav. Bank* v. *Levenson*, 59 Mass. App. Ct. 699, 705-706 (2003).

In the context of the *in pari delicto* doctrine, this same concept is referred to as an "adverse interest" exception to the doctrine. See, e.g., *Baena*, 453 F.3d at 7. This exception only applies where the agent has "totally abandoned his principal's interests and [is] acting entirely for his own or another's purposes. It cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal." *Kirschner*, 938 N.E.2d at 952, quoting *Center* v. *Hampton Affiliates, Inc.*, 488 N.E.2d 898, 900 (N.Y. 1985). This "most narrow of exceptions" is reserved for cases such as "outright theft or looting or embezzlement" where a "fraud is committed against a corporation rather than on its behalf." *Id.*

The adverse interest exception to the *in pari delicto* doctrine does not apply here because Mordach was approving false Perkins loans in order to allow Merrimack to spend additional federal monies, not in order to profit personally at Merrimack's expense. "A fraud that by its nature will benefit the corporation," at least in the short run, "is not 'adverse' to the corporation's interests, even if it was actually motivated by the agent's desire for personal gain." *Kirschner*, *supra* at 952. "To allow a corporation to avoid the consequences of corporate acts simply because an employee performed them with his personal profit in mind would enable the corporation to disclaim, at its convenience, virtually every act its officers undertake. '[C]orporate officers, even in the most upright enterprises, can always be said, in some meaningful sense, to act for their own interests.'" *Id.*, quoting *Grede* v. *McGladrey & Pullen LLP*, 421 B.R. 879, 886 (N.D.Ill. 2009).

The fact that Mordach concealed her misconduct from others at the college does not insulate Merrimack from responsibility for her wrongdoing. Concealment

does not implicate a "faithless agent" or "adverse interest" exception to the normal imputation rules in the absence of proof that the agent was acting completely against the interests of its principal. *GTE Products Corp.* v. *Broadway Elec. Supply Co., Inc.*, 42 Mass. App. Ct. 293, 299-300 (1997); *National Credit Union Admin.* v. *Ticor Title Ins. Co.*, 873 F.Supp. 718, 726-727 (D.Mass. 1995) (applying Massachusetts law). As one commentator has explained:

> A principal is liable for many frauds by the agent, although committed for the agent's own purposes. In fact, most unauthorized frauds by agents are committed because of the strong conflicting interests of the agent. In such cases, the innocent principal is liable because the agent has knowledge which makes his representations deceitful. The fact that the agent has every reason to conceal the facts from the principal is immaterial....

W.A. Seavey, Agency § 102, at 185-186 (1964).

In sum, in deciding whether the *in pari delicto* doctrine applies, the Court must treat Mordach's fraud as misconduct committed by and for Merrimack.

2.2. Mordach's Fraud Outweighs KPMG's Alleged Negligence. The intentional misconduct by Merrimack's agent in authorizing fraudulent Perkins loans is far more serious than KPMG's failure to ferret out that fraud when auditing Merrimack's finances. Merrimack's claims against KPMG are therefore barred by the doctrine of *in pari delicto*. See, e,g., *Baena* v. *KPMG, supra* (applying Massachusetts law); *Peterson* v. *McGladrey LLP*, 792 F.3d 785, 788 (7th Cir. 2015) (applying Illinois law); *Christians* v. *Grant Thornton, LLP*, 733 N.W.2d 803, 814-815 (Minn. Ct. App. 2007); *Kirschner* v. *KPMG, supra* (applying New York law).

Merrimack cannot avoid summary judgment on the ground that there is a disputed issue as to whether Mordach committed intentional fraud. Merrimack points to deposition testimony in which Mordach insisted that although improper loans sometimes just "slipped by," she did not intentionally approve fraudulent loans. This testimony cannot be squared with Merrimack's own binding allegations.

In its complaint, Merrimack alleges that Mordach approved Perkins loans "for imaginary students who never existed," for current students who never signed any promissory notes, for prior students who had graduated or died and thus were not eligible for a Perkins loan, using fake social security numbers, or listing Mordach's own home address as the address for the purported loan application.

When it responded to KPMG's statement of undisputed material facts, Merrimack understandably admitted that these facts demonstrate that Mordach had engaged in deliberate fraud. More specifically, Merrimack admitted that Mordach "created false paperwork and issued Perkins loans to students without the students' knowledge or consent." Deliberately processing and approving loans for dead or otherwise departed students, using made up social security numbers, putting down Mordach's own address in lieu of the students, approving loans for students who never signed any promissory note, and otherwise obligating current and former students to repay a loan they never knew about is fraudulent.

Merrimack cannot avoid summary judgment on the ground that facts admitted by Merrimack in its complaint have arguably been contradicted by Mordach's deposition testimony.[2] To the contrary, Merrimack is bound by its own, detailed allegations that Mordach engaged in intentional fraud. See G.L. c. 231, § 87 (allegations "[i]n any civil action pleadings ... shall bind the party marking them"). This statute provides that "facts admitted in pleadings" are "conclusive upon" the party making them. *Adiletto* v. *Brockton Cut Sole Corp.*, 322 Mass. 110, 112 (1947). Since no "[f]indings contrary to facts admitted in pleadings" may be made, judgment should be entered against a party if the facts admitted in its pleading demonstrate that it cannot prevail as a matter of law. *Id.*

2.3. No Auditor Exception. Merrimack urges the Court to recognize an exception to the *in pari delicto* doctrine, on public policy grounds, for claims that an auditor of an organization's finances negligently failed to discover that an employee had engaged in fraud.

Since this doctrine is equitable in nature, considerations of public policy are always relevant. See generally *Arcidi*, 447 Mass. at 620. Courts should not dismiss claims on *in pari delicto* grounds "where the public interest requires" that a party

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[2] KPMG's further argument that Mordach's guilty plea in federal court conclusively establishes that she engaged in fraud is without merit. Under Massachusetts law guilty pleas may be evidence of wrongdoing, but they "are not conclusive of the underlying facts." *Costa* v. *Fall River Housing Auth.*, 453 Mass. 614, 632 (2009). Mordach's plea would not bar Merrimack from offering evidence at trial in an attempt to explain away the plea. *Id.* n.27; accord *Aetna Cas. & Sur. Co.* v. *Niziolek*, 395 Mass. 737, 747-750 (1985).

be allowed to enforce an illegal contract or seek compensation for some injury. *Choquette*, 65 Mass. App. Ct. at 4, quoting *Berman*, 243 Mass. at 354; accord *Bernhardt* v. *Atlantic Finance Corp.*, 311 Mass. 183, 188 (1942).

The public policy exception sought by Merrimack, however, would be inconsistent with existing Massachusetts law. In *Choquette*, the Appeals Court was asked to exempt legal malpractice claims from the doctrine of *in pari delicto* on the ground that the public policy of holding lawyers accountable for giving "competent legal advice" concerning "complex areas of the law" should outweigh any equitable concern about a client seeking be compensated by someone else for injuries caused by the client's own wrongdoing. See 65 Mass. App. Ct. 7-8. The Appeals Court rejected that argument.

This case is indistinguishable from *Choquette*. Merrimack argues that "an auditor's important role in identifying irregularities in financial documents" should outweigh the equitable concerns underlying the *in pari delicto* doctrine. But there is no good reason why the public interest in holding independent auditors like KPMG responsible for their negligence is any stronger than the very similar public interest at stake in *Choquette* in holding attorneys responsible for any legal malpractice.

New Jersey appears to be the only state that has recognized an "auditor exemption" to the doctrine of *in pari delicto*. See *NCP* v. *KPMG LLP*, 901 A.2d 871, 882 (N.J. 2006); *Thabault* v. *Chait*, 541 F.3d 512, 526-529 (3d Cir. 2008) (applying New Jersey law).

Every other court to consider the issue has rejected the New Jersey approach and declined to create a blanket "auditor exception" to the doctrine of *in pari delicto*. See *Official Committee of Unsecured Creditors of Allegheny Health Educ. and Research Foundation* v. *PriceWaterhouseCoopers LLP*, 989 A.2d 313, 325-335 (Pa. 2010) ("*AHERF*"); *Kirschner*, 938 N.E.2d at 955-959 (N.Y. 2010); *Stewart* v. *Wilmington Trust SP Svcs., Inc.*, 112 A.3d 271, 315-318 (Del. Ct. Chancery), aff'd, 126 A.3d 1115 (Del. 2015).

Other courts have instead held that the doctrine of *in pari delicto* bars a corporation from suing its outside auditor for professional malpractice based on the auditor's failure to detect fraud committed by a corporate officer, where the fraud

benefited the corporation at least in part and auditor is not accused of aiding or participating in the fraud. See *Baena* v. *KPMG*, 453 F.3d 1 (1st Cir. 2006) (applying Massachusetts law); *Peterson* v. *McGladrey LLP*, 792 F.3d 785, 788 (7th Cir. 2015) (applying Illinois law); *Christians* v. *Grant Thornton, LLP*, 733 N.W.2d 803, 814-815 (Minn. Ct. App. 2007); *USACM Liquidating Trust* v. *Deloitte & Touche LLP*, 764 F.Supp.2d 1210, 1222-1223 (D.Nev. 2011) (applying Nevada law); (applying Minnesota law); *Kirschner*, *supra* (applying New York law); *AHERF*, *supra*, at 335-336 (applying Pennsylvania law).[3] Those decisions are consistent with Massachusetts law.

The Court is compelled by *Choquette* to reject Merrimack's advocacy for an auditor exemption to *in pari delicto*. If *Choquette* did not control, then the Court would be convinced by the New York Court of Appeals' thoughtful explanation of why it would not be appropriate to recognize such an exemption. Merrimack's proposal would "creat[e] a double standard whereby the innocent stakeholders" of the outside auditor "are held responsible for the sins of their errant agents while the innocent stakeholders of" the entity injured by its employee's fraud "are not charged with knowledge of their wrongdoing agents." *Kirschner*, 938 N.E.2d at 958. As in *Kirschner*, Merrimack has not shown that there is a compelling public policy justification for letting entities that were injured by the deliberate fraud of their employees sidestep the *in pari delicto* doctrine and shift responsibility to an independent auditor that negligently failed to discover the fraud.

ORDER

Defendant's motion for summary judgment is ALLOWED. Final judgment dismissing all claims with prejudice shall enter forthwith.

May 15, 2017

Kenneth W. Salinger
Justice of the Superior Court

[3] In contrast, several courts have held that an auditor that actively participates in an alleged fraud is not protected by the *in pari delicto* doctrine. See *AHERF*, 989 A.2d at 336-339; *Stewart*, 112 A.3d at 319-320. There is no evidence in this case that KPMG knowingly aided or abetted Mordach's fraudulent scheme.

KeyCite Yellow Flag - Negative Treatment
Distinguished by Scola v. Constantino Richards Rizzo, LLP, Mass.Super., March 28, 2013

71 Mass.App.Ct. 1119
Unpublished Disposition
NOTICE: THIS IS AN UNPUBLISHED OPINION.
Appeals Court of Massachusetts.

AGM MARINE CONTRACTORS, INC., & others [1]
v.
CANBY, MALONEY & CO., INC.

No. 07-P-616.
|
April 14, 2008.

West KeySummary

1 **Action**
Illegal or Immoral Transactions

The in pari delicto doctrine barred a business owner's claim that an accounting firm failed to prepare proper tax returns for him, resulting in the business owner's criminal tax convictions. The doctrine was properly applied to prevent the business owner from recovering damages resulting from the wrongdoing in which he was fully engaged.

Cases that cite this headnote

By the Court (KAFKER, DREBEN & WOLOHOJIAN, JJ.).

MEMORANDUM AND ORDER
PURSUANT TO RULE 1:28

***1** The plaintiffs, John Mikutowicz, AGM Marine Contractors, Inc. (AGM), and Felix Management Inc. (Felix), contend that the motion judge erred in allowing a motion to amend and in granting summary judgment to the defendant, Canby, Maloney & Co. (CMC), on the basis of the in pari delicto doctrine. The in pari delicto doctrine "bars a plaintiff who has participated in wrongdoing from recovering damages for loss resulting from the wrongdoing." *Choquette v. Isacoff,* 65 Mass.App.Ct. 1, 3, 836 N.E.2d 329 (2005). We affirm as the judge (1) did not abuse his discretion in allowing CMC's motion to amend its answer to include a defense based on the in pari delicto doctrine; and (2) properly allowed summary judgment for CMC based on the doctrine.

John Mikutowicz, the sole shareholder and officer of AGM and Felix, was indicted in September, 2001, on counts of conspiracy to defraud the United States taxing authorities, filing false income tax returns, and tax evasion. 18 U.S.C. § 371 (2000); 26 U.S.C. § 7206(1)(2000); 26 U.S.C. § 7201 (2000). In December, 2001, after the indictments had been returned, Mikutowicz, AGM, and Felix commenced an action against CMC, an accounting firm, in Superior Court. It was alleged that CMC had been aware, at all times, of the material facts surrounding the tax returns in question, and had failed to prepare proper tax returns, in light of the information known to CMC. CMC filed an answer in January, 2002. [2]

In the Federal criminal trial, Mikutowicz was convicted on all counts on June 28, 2002. The United States Court of Appeals for the First Circuit affirmed his conviction on April 22, 2004. *United States v. Mikutowicz,* 365 F.3d 65 (1st Cir.2004). In order to convict Mikutowicz of a criminal tax violation, the government had to prove beyond a reasonable doubt that the tax laws "imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty." *Cheek v. United States,* 498 U.S. 192, 201, 111 S.Ct. 604, 112 L.Ed.2d 617 (1991). In the criminal case, Mikutowicz had sought to shift the blame for his tax filings onto others, including CMC.

On December 28, 2005, CMC moved to amend its answer in the civil suit to assert a defense based on the in pari delicto doctrine. The motion to amend was allowed, as was CMC's motion for summary judgment, based on that doctrine. See R.A. at 48-49. A separate and final judgment pursuant to Mass.R.Civ.P. 54(b), 365 Mass. 820 (1974), issued in favor of CMC, followed by this appeal. R.A. at 613.

We conclude that the judge did not abuse his discretion in allowing the motion to amend. The in pari delicto defense

became more viable once Mikutowicz was convicted and his conviction was affirmed on appeal. At that point Mikutowicz's intentional violation of the tax laws had been established beyond a reasonable doubt and his defense based on blaming the accountants and consultants had been rejected. The civil case also had not advanced to the point where the plaintiffs were unduly prejudiced by the amended answer. A few days before the motion to amend was filed, the plaintiffs had moved to postpone the trial date until on or after August 7, 2006. As "a motion to amend should be allowed unless some good reason appears for denying it," *Doe v. Senechal,* 66 Mass.App.Ct. 68, 77, 845 N.E.2d 418 (2006), quoting from *Castellucci v. United States Fid. & Guar. Co.,* 372 Mass. 288, 289, 361 N.E.2d 1264 (1977), and "it is well-settled that prejudice to the non-moving party is the touchstone for the denial of an amendment," *ibid.,* quoting from *Hamed v. Fadili,* 408 Mass. 100, 105, 556 N.E.2d 1020 (1990), there was no abuse of discretion in allowing the motion to amend.

***2** The motion judge properly allowed summary judgment based on the in pari delicto doctrine. Mikutowicz's Federal tax convictions unequivocally establish his illegal behavior. They likewise establish that he is in "pari delicto" as it cannot be shown that "his guilt may be far less in degree than that of his associate [i.e., CMC] in the offence." *Choquette,* 65 Mass.App.Ct. at 5, 836 N.E.2d 329, quoting from 1 Story, Commentaries on Equity Jurisprudence § 423, at 399-400 (14th ed.1918). See *Berman v. Coakley,* 243 Mass. 348, 350, 137 N.E. 667 (1923). This is particularly clear given the failure of his defense based on *Cheek v. United States, supra.* Finally, we discern no overriding public policy interests at stake that require an exception to the general rule here. *Choquette,* 65 Mass.App.Ct. at 6, 836 N.E.2d 329. Consequently, the doctrine was properly applied to prevent Mikutowicz from recovering damages resulting from the wrongdoing in which he was fully engaged. See *Atwood v. Fisk,* 101 Mass. 363, 364 (1869); *Choquette,* 65 Mass.App.Ct. at 5, 836 N.E.2d 329. As Mikutowicz was the sole officer, director, and shareholder of AGM, his actions were also imputed to the corporations and their claims were properly barred by the doctrine as well. See *Demoulas v. Demoulas,* 428 Mass. 555, 584-585, 703 N.E.2d 1149 (1998).

Judgment affirmed.

All Citations

71 Mass.App.Ct. 1119, 884 N.E.2d 551 (Table), 2008 WL 1700120

Footnotes

1 Felix Management Inc., and John Mikutowicz.

2 CMC thereafter sought a stay of discovery pending resolution of the criminal case, which was allowed on April 23, 2002. A scheduling order issued on January 22, 2003, lifted the stay and called for discovery to be completed by February 16, 2004, submission of motions pursuant to Mass.R.Civ.P. 56, 365 Mass. 824 (1974), by April 16, 2004 and a pretrial conference on August 14, 2004. We note that defense counsel's representation at oral argument concerning the duration of the stay was not therefore fully accurate. Discovery was thereafter extended to May 15, 2004 and submission of rule 56 motions to June 15, 2004. CMC's first summary judgment motion was denied on April 8, 2005. On December 22, 2005, the plaintiffs filed an assented-to motion to postpone the trial until after August 6, 2006. As grounds for the motion, the plaintiffs stated that they had to replace their expert witness and both sides had to depose the expert witnesses. Another reason given to postpone the trial was to address CMC's second motion for summary judgment, which included the in pari delicto defense.

71 Mass.App.Ct. 1101
Unpublished Disposition
NOTICE: THIS IS AN UNPUBLISHED OPINION.
Appeals Court of Massachusetts.

Stephen BERISH & others, [1] trustees, [2]
v.
Stuart BORNSTEIN, individually
and as trustee, [3] & another. [4]

No. 06-P-1404.
|
Dec. 28, 2007.

MEMORANDUM AND ORDER PURSUANT TO RULE 1:28

***1** In these cross appeals, we address the implied warranty of habitability and negligence claims as applied to construction of a residential condominium development and, in so doing, attempt to avoid prolonging this twenty-year dispute between the condominium unit owners and the developer. The plaintiffs, trustees of the Cotuit Bay Condominium Trust, appeal from the trial judge's rulings that faulty window installation in the units was not a latent defect and that faulty chimney attachments were not a safety threat to the condominium unit inhabitants. The plaintiffs also challenge the judge's findings regarding the condominium's bathroom ventilation and his dismissal of certain other claims as time-barred.

The defendants, who include Stuart Bornstein, the condominium developer and an original trustee of the Cotuit Bay Condominium Trust, along with Cotuit Bay Condominium, Inc., the general contractor, cross-appealed primarily from the judge's rulings on the timeliness of the plaintiffs' claims for breach of the implied warranty of habitability and for negligence, and from the award of prejudgment interest, particularly in conjunction with repair costs calculated as of the time of trial. The defendants also appeal from the judge's determination that the condition of the fire walls and the fire stops constituted a breach of the implied warranty of habitability.

We hold that the judge erred in his application of the law of implied warranty of habitability to the faulty window installation and chimney attachments, but we remand solely for a determination of damages for chimney repairs, which may be readily ascertained from uncontested facts in the record. We otherwise affirm the amended judgment.

The procedural and factual history is set out in *Berish v. Bornstein,* 437 Mass. 252 (2002). In that matter, the Supreme Judicial Court remanded for trial the plaintiffs' claims for breach of the implied warranty of habitability and for negligence, both of which had been dismissed before trial. The case on remand was heard by a judge over the course of seventeen days. The judge made detailed findings of fact bearing on the plaintiffs' claims of breach of the implied warranty of habitability and negligence stemming from the manner in which the defendants installed windows, bathroom and attic ventilation, fire walls and fire stops, and chimneys in the condominium buildings. [5] These appeals followed.

We summarize the judge's findings, pertinent to this appeal, from the judge's May 22, 2006, "Findings of Fact, Rulings of Law and Order for Judgment," which we augment somewhat in our discussion of the issues.

We begin with the windows. The plaintiffs sought damages for problems arising from the improper installation of the windows throughout the development. The judge found that the defendants failed to install some of the windows with the proper flashing and then failed to caulk the windows, allowing moisture and drafts to infiltrate the units. Burt Kaplan, who moved into a unit in June, 1983, and served as a Cotuit Bay Condominium trustee from July, 1984, through July, 1986, discovered the lack of flashing during his first winter in the unit. At that time, he noticed cold drafts coming through the windows and attempted to caulk the windows to correct the problem. This proving unsuccessful, he inserted a knife into the sides of the window frames to determine the draft's source. The judge concluded that the lack of flashing was an observable defect rather than a latent one, but that it constituted negligence, for which damages were warranted.

***2** The judge found that repair of the damaged areas around the windows necessitated removing portions of the wall surrounding each window, then the window itself, and any rotted sheathing. The window would then be

reframed and reinstalled, with the appropriate flashing and caulking. The cost of those repairs was set at $2,064, per window. From the plaintiffs' evidence, the judge found that twenty-two percent of the windows in the condominium buildings were negligently installed. On that basis, the judge awarded the plaintiffs $358,274.62, which represents twenty-two percent of the $1,628,531 sought by the plaintiffs for all 429 of the windows installed by the defendants.

The plaintiffs also claimed that the chimneys atop the condominium buildings were not properly attached to the roofs. Two chimneys fell from the roofs during a hurricane in 1985, at which time Burt Kaplan discovered that the chimneys had been attached to the roofs only by "16 penny nails," and two-inch by four-inch frames, nailed to the roof sheathing. Nine more chimneys fell off the roofs during a hurricane in 1991. The judge found the defendants' method of attaching the chimneys to be insufficient to withstand the level of anticipated wind pressure for the condominiums. Though noting that nineteen units required chimney repairs in order to strengthen their attachments, the judge ultimately concluded that the chimneys posed a risk to the general public outside the units, rather than to the individual occupants of the units, and so did not fall within the implied warranty of habitability. He awarded no damages for chimney repairs.

The plaintiffs additionally claimed that the defendants installed faulty ventilation in the bathrooms, causing air from the bathrooms to exhaust either between the ceilings and the floors above, or, in the upper-level bathrooms, into the attics. The judge agreed that the bathroom vents were improperly installed, but he was unconvinced that the faulty installation caused harm to the building structure, as alleged, or that it caused the growth of mold in the units. Rather, he inferred that the lack of a routine maintenance program for the condominium's ventilation systems caused the mold odors inside the units, and that, as such, the plaintiffs had not met their burden of proving a causal connection between the defendants' defective installation of the vents and the alleged harm.

The trial judge found that the fire walls and fire stops breached the implied warranty of habitability.

Discussion. Despite the parties' detailed accounts of the evidence favorable to their respective positions, our review of the trial judge's findings of fact is confined to the clearly erroneous standard set out in Mass.R.Civ.P. 52(a), as amended, 423 Mass. 1408 (1996). See *Starr v. Fordham,* 420 Mass. 178, 186 (1995). We will not disturb the judge's findings on appeal, "where such findings are supported 'on any reasonable view of the evidence, including all rational inferences of which it is susceptible." ' *Judge Rotenberg Educ. Center, Inc. v. Commissioner of the Dept. of Mental Retardation,* 424 Mass. 430, 452 (1997), quoting from *First Pa. Mort. Trust v. Dorchester Sav. Bank,* 395 Mass. 614, 624 (1985). "The inquiry is not whether we would have reached the same result as the judge but rather whether, on the entire evidence, we are 'left with the definite and firm conviction that a mistake has been committed." ' *Commonwealth v. Source One Assocs.,* 436 Mass. 118, 124 (2002), quoting from *Starr v. Fordham,* 420 Mass. at 186.

***3** The same does not hold true with regard to the judge's conclusions of law, as "we must ensure that the judge's ultimate findings and conclusions are consistent with relevant legal standards." *Demoulas v. Demoulas Super Mkts., Inc.,* 424 Mass. 501, 510 (1997). "Thus, the 'clearly erroneous' standard of appellate review does not protect findings of fact or conclusions based on incorrect legal standards." *Kendall v. Selvaggio,* 413 Mass. 619, 621 (1992).

While the parties have failed to persuade us that the challenged findings were clearly erroneous, see *Buster v. Moore,* 438 Mass. 635, 643 (2003), we do take issue with certain legal conclusions reached by the judge in applying the law of implied warranty of habitability to newly constructed condominiums. "[T]o ensure that the ultimate findings and conclusions are consistent with the law, we scrutinize without deference the legal standard that the judge applied to the facts." *Kendall v. Selvaggio, supra. Silvestris v. Tantasqua Regional Sch. Dist.,* 446 Mass. 756, 771 (2006). See *Bui v. Ma,* 62 Mass.App.Ct. 553, 565 (2004).

1. *Implied warranty of habitability.* In *Berish v. Bornstein,* 437 Mass. at 265-266, the Supreme Judicial Court set out the elements of a claim for breach of the implied warranty of habitability brought by an organization of unit owners for latent defects in the condominium's common areas that affect the habitability of individual units:

"To establish such a claim, the organization of unit owners must demonstrate that (1) it is an organization of unit owners as defined by G.L. c. 183A, § 1; (2) the common area of the condominium development contains a latent defect; (3) the latent defect manifested itself after construction of the common areas was substantially completed; (4) the defect was caused by the builder's improper design, material, or workmanship; and (5) the defect created a substantial question of safety as to one or more individual units, or made such units unfit for human habitation." [6]

One caveat: we note that in determining whether a defect is latent, the Supreme Judicial Court explained that while claims brought by an individual unit owner required that the defect manifest itself only after the time of purchase, an organization of unit owners does not actually purchase the common areas. Therefore, for claims brought by an organization of unit owners, the court set substantial completion, rather than date of purchase, as the point after which the defect, to be considered latent, must become apparent. *Id.* at 266 n. 28.

a. *Windows.* The judge found that the defendants installed certain windows in the condominium development without the proper flashing and caulking to protect the units from infiltration of moisture and cold air. To recap, Burt Kaplan was first alerted to the problem with the onset of winter, having moved in to his unit in the summer of 1983. The draft prompted Kaplan to apply caulk around the exterior of the window frames several times in an attempt to stop the draft. He discovered the lack of flashing when he inserted a knife through the sides of the window frames and was able to probe all the way to the interior of the wall. Yet the judge concluded from these findings that the lack of flashing was not a latent defect, because it was capable of observation without removing any shingles or performing any other "destructive testing."

***4** "Latent defects are conditions that are hidden or concealed, and are not discoverable by reasonable and customary observation or inspection." *Albrecht v. Clifford,* 436 Mass. 706, 713 (2002), citing Black's Law Dictionary 429, 887 (7th ed.1999). It is apparent that the trial judge here focused on the court's observation in *Albrecht* that the Albrechts' expert did not have to dismantle the allegedly defective fireplaces and chimneys in order to see the defect. *Ibid.* But we do not construe the court's definition or subsequent discussion as making destructive testing the touchstone for latency. To do so would place too heavy a burden on an ordinary home owner in making a reasonable and customary observation or inspection of new construction after it has been substantially completed. Significant to the policy that imposes an implied warranty of habitability on the builder is that the burden be placed on the party who is in the best position to observe and correct the defect during the construction process, before it is hidden beneath finished surfaces. *Id.* at 710. *Berish v. Bornstein,* 437 Mass. at 263. Thus, fairness dictates that the burden on the condominium unit owners in this case should be limited to observation of materials and components that were "readily accessible," without the need to dig and probe beneath finished surfaces in the common areas to uncover shoddy workmanship. *Albrecht v. Clifford, supra* at 713. [7]

While sticking a knife into the edge of a window frame and poking through to the interior wall may not constitute actual dismantling or destruction of the window frame, we think it sufficiently intrusive to exemplify the hidden character of a defect that was not otherwise "readily accessible" to the ordinary unit owner. In our view, digging beneath finished surfaces with a knife to discover the absence of flashing is not consistent with the "readily accessible" materials and components referenced in *Albrecht v. Clifford,* 436 Mass. at 713, and far exceeds what should be considered the reasonable and customary observation or inspection required by an organization of unit owners upon occupying a newly constructed condominium.

In *Albrecht v. Clifford, supra,* the Supreme Judicial Court characterized as close the question whether the use of video equipment to observe interior chimney measurements was a reasonable expectation to place on purchasers, once they had been alerted to the problem by related defects that were more obvious. Here, by contrast, there was nothing more blatant, at the time of substantial completion and Kaplan's initial occupancy, to alert him that the windows in his unit required intrusive, below-the-surface investigation to determine whether they were properly installed.

The timing of Kaplan's discovery is further confirmation of its latent character. The discovery occurred many months after construction was completed and only when the onset of colder weather caused a noticeable draft to

the unit's occupant. As such, the defect was one that manifested itself only after construction was substantially completed. See *Berish v. Bornstein,* 437 Mass. at 266 & n. 28. Accordingly, we conclude that the lack of window flashing fully comported with the criteria established for latency for purposes of the implied warranty of habitability, and recovery should not have been denied on that basis.

***5** The judge's additional findings, regarding the infiltration and damage caused by moisture and cold air seeping through the defectively installed windows, satisfy us that the plaintiffs established the remaining elements of their claim and are entitled to recover their costs of repair for the defendants' breach. See, e.g., *Albrecht v. Clifford,* 436 Mass. at 711; *Berish v. Bornstein, supra,* at 265-266. Moreover, further findings are not necessary to establish damages, since the judge ruled in the plaintiffs' favor on their negligence claim for the faulty window installation and awarded damages in the amount of $2,064 per window. This resulted in an award in the amount of $358,274.62, the cost of repairs for the windows that "experienced some difficulty."

The amount awarded for window repairs under the plaintiffs' negligence claim brings us to another issue raised by the plaintiffs on appeal, that is, whether the judge improperly limited the recovery for window repairs to the ninety-five windows that "experienced difficulty," rather than awarding damages for all 429 windows installed by the defendants. (The judge's award for the windows was on a negligence theory rather than on a breach of the implied warranty of habitability.) We are not persuaded that, as a remedy for breach of the implied warranty of habitability with respect to the windows or as a remedy for negligence, the plaintiffs were entitled to recover for repairs to all of the windows in the buildings constructed by the defendants, regardless of proof of damages. The judge specifically found that only "[twenty-two] percent of the windows experienced some difficulty, be it water leaks or drafts." The question, on our review under the clearly erroneous standard, is not whether the judge reasonably might have inferred, from the evidence presented that ninety-five windows installed by the defendants "experienced difficulty" that the installation of all of the windows was faulty, but whether such inference was compelled. See, e.g., *Witteveld v. Haverhill,* 12 Mass.App.Ct. 876, 877 (1981). On this record, it was not. [8] [9]

Because the record indicates that recovery to correct the defective window installation under the plaintiffs' claim for breach of the implied warranty of habitability would be duplicative of the damages awarded for negligence, [10] no remand for further findings on damages is warranted. See *Linkage Corp. v. Trustees of Boston Univ.,* 425 Mass. 1, 20 (1997).

b. *Chimneys.* The judge determined that nineteen of the chimneys were not properly attached to the roofs in accordance with the applicable building code. But while the judge found that the defect satisfied the latency elements of the claim, the judge ruled that it did not come within the implied warranty of habitability because any safety concerns posed by the inadequate chimney attachments related not to the individual occupants of the units, but rather to the general public outside the units. [11]

***6** We return to the basic premise: "[A]n organization of unit owners may bring a claim for breach of the implied warranty of habitability when there are latent defects in the common areas that implicate the habitability of the individual units." *Berish v. Bornstein,* 437 Mass. at 265. With respect to the habitability of the individual units, we think the judge's conclusion that the threat posed by falling chimneys was only to the general public outside the units did not take into account the necessity that, in order to inhabit the individual units, occupants must first be able to get inside the units; habitability presupposes access. See generally *Lynch v. James,* 44 Mass.App.Ct. 448, 450 (1998).

Passing the question whether the judge was correct that safety of the general public does not implicate habitability, negligence, here implication of the defect on the individual units themselves, was apparent from the record. According to the site plans and unit deeds, the individual unit owners entered and exited their units directly from the outside, rather than through interior, common hallways. Based on the judge's finding that the inadequately attached chimneys posed a danger to people on the ground outside the condominium units, it must follow that the chimneys posed a danger to the individual units and their owners. See, e.g., *Bui v. Ma,* 62 Mass.App.Ct. at 565 (trial judge's ultimate finding set aside as both inconsistent with the law and with the judge's own subsidiary findings). As such, the habitability of the individual units was implicated when the units could not

be accessed, and thereby inhabited, without substantial safety concerns. We thus conclude that the threat of falling chimneys to the safety of the condominium's inhabitants, in the course of entering or exiting their individual units, created a substantial question of safety regarding those individual units, so as to constitute a breach of the implied warranty of habitability.

In order to set the damages for the nineteen chimneys identified by the judge, the judge's findings make clear that the faulty chimney connections required repair, rather than replacement. [12] Specifically, he found that "the reasonable and necessary repair to these chimneys is to install steel angles or a carriage bolt directly from the base of the chimney enclosure to the rafters" and "to install headers in each of the chimneys, and in some instances it would become necessary to install headers in the process of fastening external portions of the chimneys." But the judge did not reach the issue of the cost to repair the chimney attachments.

Nevertheless, the record permits the calculation of the cost of repairs, based on uncontested testimony and documentary evidence. One of the plaintiffs' witnesses, Robert Brandon, an architect for SEA Consultants, Inc., testified that the cost for repair was $1,200 per chimney. [13] The defendants' expert opined only that the chimney attachments conformed to the applicable building code. The defendants neither challenged, nor presented evidence to dispute, the plaintiffs' $1,200 per chimney estimate for the cost of fixing the chimney attachments.

***7** In these rare circumstances, in order to avoid the additional time and expense of the parties and the courts on an issue fully vetted at trial, we remand for further findings on damages for chimney repairs, but direct that the judge derive such findings from the existing trial record. Compare *McKenna v. Begin,* 5 Mass.App.Ct. 304, 311-312 (1977) (while the judge, on remand, was free to hear additional evidence, the Appeals Court opined that damages fairly could be computed "upon consideration of the evidence already before him"). We observe that the undisputed evidence would support an award in the amount of $1,200 per chimney, to brace the nineteen chimneys identified by the judge as improperly attached. Under the formula employed by the plaintiffs' expert, and utilized by the judge elsewhere in his findings, the record would permit an award for repairs, in 2005 dollars, based on the $1,200 per chimney figure in 1987 dollars, to be $2,207 ($1,200 + [.8392 x $1,200]), per chimney, for a total award of $41,933, consistent with the judge's general ruling that damages should be valued as of the time of trial.

c. *Ventilation.* The judge found that the bathroom ventilation systems were not installed correctly and constituted latent defects. Nevertheless, he found that these defects did not raise a question of substantial safety, because the plaintiffs failed to prove that the improper bathroom ventilation caused the mold found within the units. The judge further found that any "mold growth was insignificant as it related to the health and safety of the occupants." There was evidence to support that view, and the judge was free to draw the inference, from the evidence, that the plaintiffs' failure to service the ventilation system, rather than the builder's improper installation of the ventilation, caused the presence of mold in the units. See *Judge Rotenberg Educ. Center, Inc. v. Commissioner of the Dept. of Mental Retardation,* 424 Mass. at 452. As trier of fact, the judge was entitled to believe the defendants' expert that lack of maintenance caused the mold, and we cannot say his findings were clearly erroneous. See *Buster v. George W. Moore, Inc.,* 438 Mass. 635, 644 (2003).

The plaintiffs seem to suggest that their claim for breach of the implied warranty of habitability required no proof of a causal connection between the builder's defect, here the lack of proper bathroom ventilation, and the unsafe or unfit living condition in the unit, here the presence of mold. As we understand the cause of action as set forth by the Supreme Judicial Court, the defendants' failure to comply with the applicable building code does not, in itself, establish a right to recovery without proof that "the defect *created* a substantial question of safety, or *made* such units unfit for human habitation" (emphasis added). *Berish v.. Bornstein,* 437 Mass. at 266. Because the judge found that the unit owners' lack of maintenance of the ventilation system, rather than the builder's faulty installation, caused the presence of mold in the units, the plaintiffs did not establish the necessary causal link to the unsafe condition so as to entitle them to a remedy from the defendants. See *id.* at 265-266 (ensuring a remedy for unit owners against a builder "whose improper design, material, or workmanship is *responsible* for a defect in a common area that *causes* units to be uninhabitable or unsafe" [emphasis added]).

***8** 2. *Statute of limitations.* The plaintiffs appeal from the judge's ruling that two of their claims were time-barred: one, arising from the defendant's failure to apply a weather-resistant wrap on the building exteriors, and the second, from faulty chimney height and framing. The judge correctly applied the three-year limitations period set out in G.L. c. 260, § 2B, [14] for the plaintiffs' negligence claims and for their breach of the implied warranty of habitability claims.

As to the weather-resistant wrap, the judge found that the plaintiffs learned of the missing or defective wrap in 1986-1987, but failed to raise the claim in their three amended complaints and did not assert the claim in a timely manner before the master. Because the claim was raised for the first time at the 2005 trial, the judge ruled that it was time-barred.

The plaintiffs argue that under the liberal rules of pleading, the allegations in their first amended complaint, concerning defects in the condominium buildings' exterior finish, put the defendants on notice that their claim included damages for the lack of a weather-resistant wrap on several of the buildings. They rely on the principle that the complaint need not identify the exact substantive theory in order to state a claim. It is necessary, however, that the complaint identify the basic facts underlying the plaintiffs' claim. See *Kurker v. Hill,* 44 Mass.App.Ct. 184, 193 (1998) (plaintiff's complaint recited the elements of the claim but lacked factual support for his conclusory allegations). Here, general allegations concerning problems with the exterior finish of the buildings did not set forth sufficient facts to put the defendants on notice of a claim stemming from the absence of the weather-resistant wrap. See also *Multi Technology, Inc. v. Mitchell Mgmt. Sys., Inc.,* 25 Mass.App.Ct. 333, 335 (1988) ("complaint's sufficiency turns on whether it provides enough information to give the defendant notice of what the dispute is about ...").

The same reasoning applied to the plaintiffs' claim for defects in connection with chimney framing and chimney height. The plaintiffs concede in their brief on appeal that these claims first were raised prior to the second trial in 2005, and we find nothing in the amended complaint that would put the defendants on notice that claims were being asserted for defects in chimney framing and height.

3. *Cross appeal.* The defendants' cross appeal principally concerns the judge's rulings on the statute of limitations and accrual dates pertaining to certain of the plaintiffs' claims for breach of the implied warranty of habitability and for negligence. The plaintiffs filed their complaint on January 28, 1987.

For the common area claims alleging breach of the implied warranty of habitability, the defendants argue that only claims in connection with units completed on February 21, 1984, and additional units completed on December 20, 1984, were timely brought. According to the defendants, the undisputed fact that the other seven buildings constructed by the defendants were substantially completed more than three years before this action was filed renders claims related to those buildings time-barred.

***9** To the extent we understand their argument, the defendants appear to press an overly simplified reading of language in *Berish v. Bornstein,* 437 Mass. at 262-266, as rendering the discovery rule inapplicable to a claim for breach of the implied warranty of habitability. See generally *Bowen v. Eli Lilly & Co.,* 408 Mass. 204, 205 (1990) (discovery rule established for the purpose of determining when the statute of limitations will start to run). We will not infer an intent to abandon the discovery rule for a particular cause of action without the court's clear directive. Moreover, the judge here properly relied on the Supreme Judicial Court's reference in *Berish v. Bornstein,* 437 Mass. at 264 n. 25, in utilizing the discovery rule for claims for breach of the implied warranty of habitability.

The judge in this case devoted considerable attention to the facts bearing on the plaintiffs' discovery of the various defects alleged in their complaint and concluded that defects related to window flashing, bathroom ventilation, fire walls and fire stops, and chimney fastenings were first discovered within the limitations period. The defendants have not demonstrated that the findings were clearly erroneous, and the judge's conclusion that these claims were timely comports with his findings and the applicable law.

Turning to the plaintiffs' negligence claims, to which the defendants appear to concede applicability of the discovery rule, the defendants argue that "widespread knowledge among individual unit owners of widespread water infiltration prior to January 28, 1984," rendered

claims for negligent installation of windows in buildings occupied prior to January 28, 1984, time-barred. We do not read the passing reference in *Cigal v. Leader Dev. Corp.,* 408 Mass. 212, 218 n. 10 (1990), to the individual owners' right to bring a derivative action, under Mass.R.Civ.P. 23.1, 365 Mass. 768 (1974), as meaning that the accrual date for the trustees' lawsuit should be measured from the time when individual owners first discovered problems with their units.

The defendants also maintain that knowledge among certain unit owners, prior to January 28, 1984, of leaking windows in their units should have placed the trustees on notice of the defective window installation sooner. The judge found that while the defendant, Bornstein, had notice of leaking skylights and sliders in 1983, based upon unit owners' complaints made directly to him, notice to Bornstein did not constitute notice to the board of trustees because Bornstein's interest was adverse to the board. For this, the judge appropriately relied on basic agency principles, taking into account Bornstein's position as developer and as majority shareholder of Conduit Bay Condominium, Inc., the general contractor for the condominium units.[15] See, e.g., *GTE Prods. Corp. v. Broadway Elec. Supply Co.,* 42 Mass.App.Ct. 293, 299-300 (1997) (agent's knowledge is not imputed to his principal if he acted on his own, adversely to the principal). As a consequence, the judge found that the board of trustees did not have notice of the leaking windows until 1984. As there was ample evidence to support the judge's findings in this regard, the defendants have not met their burden of showing that the judge's findings were clearly erroneous.

***10** The remaining issues raised by the defendants' cross appeal require little discussion. We touch on them briefly:

The defendants' argument that the judge should not have permitted new evidence in the second trial is without merit. Nothing in the Supreme Judicial Court's remand order narrowed the scope of the evidence. Compare *Rzeznik v. Chief of Police of Southampton,* 10 Mass.App.Ct. 335, 337-338 (1980).

The defendants also claim error in the judge's conclusion that the condominium's inadequate fire walls and fire stops were latent defects under the implied warranty of habitability. The judge, citing *Albrecht v. Clifford,* 436 Mass. at 713, found that inspecting the fire walls and fire stops was not a matter of reasonable and customary observation, due to the difficulty and danger posed in accessing the attic areas from which the defects could be observed. Again, the defendants have not met their burden of showing that the judge's findings in this regard were clearly erroneous or that his conclusions were at odds with his subsidiary findings or the law.

Next, the defendants contend that the economic loss doctrine barred the award for repairs to the defective windows and surrounding structures on the plaintiffs' negligence claim. In accordance with *Berish v. Bornstein,* 437 Mass. at 268, the judge characterized the damages awarded as being for repair of water damage to the condominium units, rather than for repair of the defective windows themselves.[16] While discussing the economic loss doctrine in connection with the plaintiffs' other negligence claims, the judge did not address the doctrine in connection the defective windows, explaining that the point was not argued. The defendants' proposed findings of fact and conclusions of law confirm that view. The defendants, on appeal, point to their motion to amend the judgment as preserving the issue, but their citation to the trial court docket is insufficient for our review. See Mass.R.A.P. 16(a)(4), as amended, 367 Mass. 921 (1974).[17]

As a final matter, the defendants argue that the combination of the award of prejudgment interest, dating from the time the action was originally filed some twenty years ago, and the award for the cost of repairs as of the date of trial, is punitive and constitutes a windfall for the plaintiffs. We see no windfall here nor any other reason not to apply the applicable prejudgment interest statute, c. 231, § 6B.[18] As to recovery for the costs of repairs as of the time of trial, the cases cited by the defendants addressed interest and present value in the context of future damages and are accordingly not applicable here. See generally *Commonwealth v. Johnson Insulation,* 425 Mass 650, 665 (1997) (distinguishing an estimate for future repairs for property damage that has already occurred, from "future damages," for which prejudgment interest was not appropriate). The defendants cite to no pertinent authority that required the judge, in circumstances such as these, to choose between the two.

***11** The defendants' argument that the judge erred in awarding costs to the plaintiffs is unpersuasive.

We remand for further findings on the repair costs for the chimney attachments, consistent with this memorandum and order. After those findings are entered, the amended judgment shall be modified to include the additional damages and any accompanying interest award. In all remaining respects, the amended judgment is affirmed.

So ordered.

All Citations

71 Mass.App.Ct. 1101, 878 N.E.2d 581 (Table), 2007 WL 4563493

Footnotes

1 Rita Reisner, Anthi Tsamtsouris, Sidney Parlow, Irving Lyon, and Angelo Massa.

2 Of the trust of the Cotuit Bay Condominium (unit owners' association).

3 Of the Cotuit Bay Condominium Trust (nominee trust).

4 Cotuit Bay Condominium, Inc.

5 The judge also ruled against certain individual unit holders who had assigned their claims pertaining to inadequate headroom clearance to the plaintiffs. There has been no appeal from that determination.

6 General Laws c. 183A, § 1, defines an organization of unit owners as "the corporation, trust or association owned by the unit owners and used by them to manage and regulate the condominium."

7 The trial judge here may have placed too much emphasis on language cited in *Albrecht v. Clifford,* 436 Mass. at 710, taken from *Christensen v. R.D. Sell Constr. Co.,* 774 S.W.2d 535, 538 (Mo.Ct.1989), that the implied warranty of habitability "protects purchasers from structural defects that are nearly impossible to ascertain by inspection after the home is built." The passage reflects one of several important policy considerations taken into account by the Supreme Judicial Court in deciding to adopt the implied warranty for our jurisdiction. We rely on the court's subsequent discussion of latency. *Albrecht v. Clifford,* 436 Mass. at 713.

8 Moreover, the judge noted that there was insufficient proof that all remaining windows suffered drafts or leaks as a result of improper installation. To recover damages under a claim for a breach of the implied warranty of habitability, there must be a showing that "(5) the defect created a substantial question of safety as to one or more individual units, or made such units unfit for human habitation." *Berish v. Bornstein,supra* at 266. There was no showing that any windows in addition to those for which the judge awarded damages for negligence either created safety issues or rendered a unit uninhabitable.

9 The plaintiffs argue that the cost of examining all the windows in all the condominiums was excessive. But they point to no proof that examining all the windows would cost one million dollars, as they now assert, nor do they cite authority for the proposition that the expense of procuring evidence of damages excuses the degree of proof ordinarily required. The case of *National Merchandising Corp. v. Leyden,* 370 Mass. 425, 430 (1976), upon which the plaintiffs rely, dealt with the difficulty of proving lost profits in the face of defendants who obstructed access to the very records upon which those damages would be based. See *Our Lady of the Sea Corp. v. Borges,* 40 Mass.App.Ct. 484, 488 (1996) (estimated damages for recovery of lost profits permissible where misappropriation of fish was carried out in secret and relevant documents likely destroyed).

10 The plaintiffs sought the same amount for repairs, $2,064 per window, under both their implied warranty claim and their negligence claim.

11 In addition, though not mentioned by the judge, a 2003 report prepared by SEA Consultants, Inc., for the trustees, and admitted in evidence, indicated that the improperly attached chimneys posed a hazard to the decks below. It is undisputed that each of the condominium units had at least one outdoor deck attached to it. From this evidence we could infer, as an alternative basis for our holding here, that the danger of falling chimneys created a substantial question of safety and habitability to individual unit owners using the decks attached to their units. See generally *Demoulas v. Demoulas Super Mkts., Inc.,* 424 Mass. at 510 ("inferences from the basic facts ... are open for our decision ...").

12 The plaintiffs seek damages that would cover the replacement of thirty-eight chimneys, but do not point to evidence that would render clearly erroneous the judge's finding that witnesses had identified only nineteen chimneys as improperly attached and in need of repair.

13 Brandon's total estimate for damages included the cost of replacing some thirty-eight chimneys, as well as repairing sixteen chimneys, for a total of $154,142, in 1987 costs, or $283,498 in 2005 costs. Because of the judge's finding, we focus only on the evidence of repair costs.

14 General Laws c. 260, § 2B, as appearing in St.1984, c. 484, § 53, provides, in relevant part, that an "[a]ction of tort for damages arising out of any deficiency or neglect in the design, planning, construction or general administration of an improvement to real property ... shall be commenced only within three years next after the cause of action accrues...."

15 See *Berish v. Bornstein,* 437 Mass. at 254 n. 8.

16 The uncontested evidence showed that the damages awarded for the defective windows were based on estimates for repairing and replacing the damaged structures surrounding the windows, and that the windows themselves, which the judge found were not "self-flashing," as the defendants claimed, were to be removed, stored, and then reinstalled, once the damage to the walls was remedied.

17 Because we have ruled that the plaintiffs were entitled to recover the same amount for the improper window installation on their implied warranty of habitability claim, the outcome, in terms of dollar amount, would be the same, regardless.

18 General Laws c. 231, § 6B, as amended through St.1982, c. 183, § 2, provides: "In any action in which a verdict is rendered or a finding made or an order for judgment made for pecuniary damages for personal injuries to the plaintiff or for consequential damages, or for damage to property, there shall be added by the clerk of court to the amount of damages interest thereon at a rate of twelve percent per annum from the date of commencement of the action even though such interest brings the amount of the verdict or finding beyond the maximum liability imposed by law."

Civil Procedure Rule 8: General Rules of Pleading

(a) Claims for Relief. A pleading which sets forth a claim for relief, whether an original claim, counterclaim, cross-claim, or third-party claim shall contain (1) a short and plain statement of the claim showing that the pleader is entitled to relief, and (2) a demand for judgment for the relief to which he deems himself entitled. Relief in the alternative or of several different types may be demanded.

(b) Defenses: Form of Denials. A party shall state in short and plain terms his defenses to such claim asserted and shall admit or deny the averments upon which the adverse party relies. If he is without knowledge or information sufficient to form a belief as to the truth of an averment, he shall so state and this has the effect of a denial. Denials shall fairly meet the substance of the averments denied. When a pleader intends in good faith to deny only a part or a qualification of an averment, he shall specify so much of it as is true and material and shall deny only the remainder. Unless the pleader intends in good faith to controvert all the averments of the preceding pleading, he may make his denials as specific denials of designated averments or paragraphs, or he may generally deny all the averments except such designated averments or paragraphs as he expressly admits; but, when he does so intend to controvert all its averments, he may do so by general denial subject to the obligations set forth in Rule 11. The signature to an instrument set forth in any pleading shall be taken as admitted unless a party specifically denies its genuineness. An allegation in any pleading that a place is a public way shall be taken as admitted unless a party specifically denies such allegation.

(c) Affirmative Defenses. In pleading to a preceding pleading, a party shall set forth affirmatively accord and satisfaction, arbitration and award, assumption of risk, contributory negligence, discharge in bankruptcy, duress, estoppel, failure of consideration, fraud, illegality, injury by fellow servant, laches, license, payment, release, res judicata, statute of frauds, statute of limitations, waiver, and any other matter constituting an avoidance or affirmative defense. When a party has mistakenly designated a defense as a counterclaim or a counterclaim as a defense, the court on terms, if justice so requires, shall treat the pleading as if there had been a proper designation.

(d) Effect of Failure to Deny. Averments in a pleading to which a responsive pleading is required, other than those as to the amount of damage, are admitted when not denied in the responsive pleading. Averments in a pleading to which no responsive pleading is required or permitted shall be taken as denied or avoided.

(e) Pleading to Be Concise and Direct; Consistency.

(1) Each averment of a pleading shall be simple, concise, and direct. No technical forms of pleading or motions are required.

(2) A party may set forth two or more statements of a claim or defense alternatively or hypothetically, either in one count or defense or in separate counts

or defenses. When two or more statements are made in the alternative and one of them if made independently would be sufficient, the pleading is not made insufficient by the insufficiency of one or more of the alternative statements. A party may also state as many separate claims or defenses as he has regardless of consistency and whether based on legal or equitable grounds. All statements shall be made subject to the obligations set forth in Rule 11.

(f) Construction of Pleadings. All pleadings shall be so construed as to do substantial justice.

Effective July 1, 1974.

CERTIFICATE OF COMPLIANCE

I, Elizabeth N. Mulvey, hereby certify that the within Brief for Appellant, Merrimack College, complies with the rules of court that pertain to the filing of briefs, including but not limited to: Mass R. App. P. 16(a)(6), (e), (f), (h), 18 and 20.

/s/Elizabeth N. Mulvey

_____

ELIZABETH N. MULVEY

Appeals Court No.: 2017-P-1208

Certificate of Service

I HEREBY CERTIFY that a true and correct copy of foregoing document

BRIEF OF PLAINTIFF-APPELLANT, MERRIMACK COLLEGE
and,
APPENDIX VOLUMES 1 - IV

was sent by email to the following parties on this 24th day of October, 2017.

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