New York Court Reaffirms Strong *In Pari Delicto* Defense

In a decision of significance for any professional service firm, the New York Court of Appeals forcefully reaffirmed the common-law doctrine of *in pari delicto* as a bar against claims by corporate representatives against outside auditors who fail to uncover the corporation's own wrongdoing.

On October 21, 2010, a 4-3 majority of the Court rejected calls that it join with the high courts of New Jersey and Pennsylvania in limiting the applicability of the doctrine, which mandates that "courts will not intercede to resolve a dispute between two wrongdoers." The New York Court instead held that *in pari delicto* prevented corporate stakeholders from seeking redress against third-party auditors in situations where an alleged fraud has served to benefit the stakeholders' corporation—even in those instances where the temporary benefit is followed by other negative consequences.

The Court had been asked to answer certified questions in two cases—*Kirschner v. KPMG LLP*, and *Teachers' Retirement System of Louisiana v. Pricewaterhouse Coopers LLP*—dealing with the scope of the doctrine, which acts as an affirmative defense under New York law. Both *Kirschner*, an action brought by the Refco litigation trust, and *Pricewaterhouse*, a derivative action, involved allegations that outside auditors had either failed to prevent, or had actively facilitated, fraudulent practices by senior corporate executives.

The *in pari delicto* doctrine exists primarily to deter wrongdoing and to prevent courts from becoming entangled in disputes between culpable parties. In light of this purpose, the Court explained, the doctrine will typically bar suits by corporate stakeholders based on allegations of fraud within their own company. This is because traditional principles of agency law require that "the acts of agents, and the knowledge they acquire while acting within the scope of their authority[,] are presumptively imputed to their principals."

"Like a natural person, a corporation must bear the consequences when it commits fraud," the Court said. "[W]e have held for over a century that all corporate acts—including fraudulent ones—are subject to the presumption of imputation .... [P]rincipals, rather than third parties, are best-suited to police their chosen agents and to make sure that they do not take actions that ultimately do more harm than good."

New York law recognizes an "adverse interest" exception to the *in pari delicto* doctrine where the corporate agent acts adversely to the corporation. The adverse interest exception represents the "most narrow of exceptions" to this general rule. It applies only when an agent has "totally abandoned his principal's interest" and is acting "entirely for his own or another's purposes." This exception, the Court explained, requires *total* adversity between the corporation and its agent as a prerequisite to any claim by a corporate stakeholder. "[The adverse interest exception] cannot apply unless the scheme that benefitted the insider operated at the corporation's expense," the Court said. "So long as the corporate wrongdoer's fraudulent conduct enables the business to survive—to attract investors and raise funds for corporate purposes—this test is not met."

In reaffirming these long-standing doctrines, the Court rebuffed the plaintiffs' attempts "to broaden the adverse interest exception or revise New York precedents relating to *in pari delicto* or imputation for reasons of public policy." The plaintiffs had urged the Court to change existing doctrine to allow for auditor liability by taking greater account of a corporate agent's intent in committing a fraud and by considering the extent to which a corporation may ultimately suffer when an agent's misdeeds come to light. In the Court's view, however, these proposals went too far.

According to the Court, "[t]o 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." Likewise, the mere fact that a corporation might suffer harm when an agent's misdeeds are ultimately discovered did not bear on the applicability of the adverse interest exception. "The disclosure of corporate fraud nearly always injures the corporation," the Court explained. "If that harm could be taken into account, a corporation would be able to invoke the adverse interest exception and disclaim virtually every corporate fraud—even a fraud undertaken for the corporation's benefit—as soon as it was discovered and no longer helping the company."

The plaintiffs had argued that public policy concerns and a balancing of the equities in fraud cases favored corporate stakeholders over third-party auditors. In support, the plaintiffs relied on two recent cases from the high courts of New Jersey and Pennsylvania. The first–*NCP Litig. Trust v. KPMG LLP*—is a 2006 ruling, in which the Supreme Court of New Jersey held that neither the imputation doctrine nor *in pari delicto* precluded all efforts by shareholders to recover against auditors accused of negligence or active participation in corporate fraud. The New Jersey court reasoned that corporate shareholders who lack knowledge of fraud are "innocent" and, therefore, less culpable than auditors who either negligently overlook or actively assist wrongdoing.

In the second case—*Official Comm. of Unsecured Creditors of Allegheny Health Educ. and Research Found. v. PricewaterhouseCoopers LLP*—the Pennsylvania Supreme Court elected to adopt New Jersey's approach with respect to auditors who actively engage in misconduct, but stopped short of stripping the defense from auditors who are merely negligent. Thus, under Pennsylvania law, the *in pari delicto* defense remains available to professional service providers who are accused of negligence, but it is unavailable where a plaintiff can show that an auditor failed to act in material good faith.

Ultimately, the New York Court of Appeals declined to follow either the New Jersey or Pennsylvania approaches, opting instead to retain undiminished *in pari delicto* protections in cases involving either auditor negligence or active misconduct. The Court pointed to public policy considerations that militated against loosening principles of imputation by expanding the adverse interest exception.

Specifically, the Court posited that changes in the law were unnecessary to ensure that outside auditors would be sufficiently deterred from engaging in professional misconduct. "[A]n outside professional (and especially an auditor) whose corporate client experiences a rapid or disastrous decline in fortune precipitated by insider fraud does not skate away unscathed." On the contrary, the Court stated, outside professionals "already are at risk for large settlements and judgments in the litigation that inevitably follows the collapse of an Enron, or a Worldcom or a Refco or an AIG-type scandal." As a matter of public policy, "why should the interests of innocent stakeholders of corporate fraudsters trump those of innocent stakeholders of the outside professionals who are the defendants in these cases?"

In contrast, the Court recognized great risk in tampering with the adverse interest exception. "[T]he approach advocated by the [plaintiffs]," the Court said, "would allow creditors and shareholders of the company that employs miscreant agents to enjoy the benefit of their misconduct without suffering the harm." In order to avoid this result, the Court concluded: "The principles of *in pari delicto* and imputation, with its narrow adverse interest exception, remain sound .... [T]o the extent our law had become ambiguous, today's decision should remove any lingering confusion."

For more information about the Kirschner *and* Pricewaterhouse *cases, or any other matter raised in this Legal Update, please contact any of the following lawyers.*

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