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Litigation

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New York's Highest Court Declines to Expand Liability of Third-Party Professionals

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On October 21, 2010, the New York Court of Appeals ruled on certified questions in two cases: Kirschner v. KPMG LLP *("Kirschner"), certified by the United States Court of Appeals for the Second Circuit, and* Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers *LLP ("Teachers' Retirement"), certified by the Delaware Supreme Court, reiterating and strengthening the* in pari delicto *defense. That defense is available to third-party professionals, such as accountants or attorneys, who are accused by corporations, and those who sue on their behalf, of colluding with, or negligently failing to detect the wrongdoing of, a company's own management.*

Suits by Post-Bankruptcy Litigation Trustees and Derivative Actions

In *Kirschner*, a post-bankruptcy litigation trustee brought claims on behalf of Refco, a bankrupt brokerage firm, against Refco's outside auditors, its law firm, and three of its investment banks. According to the trustee, Refco's senior management participated in a fraudulent scheme to make the company's financials appear much more robust, and the defendants failed to detect this fraud, which ultimately resulted in Refco's bankruptcy.

Teachers' Retirement is a derivative action brought on behalf of American International Group (AIG) against AIG's auditors, PricewaterhouseCoopers ("PwC"), for allegedly failing to detect that AIG's senior officers were also fraudulently inflating that company's financials.

The *In Pari Delicto* Defense

Under the doctrine of *in pari delicto*, courts will not intervene to resolve a dispute between two wrongdoers. When determining whether a corporation itself is a wrongdoer and therefore barred from bringing a lawsuit against other alleged wrongdoers, courts resort to basic agency principles. Specifically, "the acts of agents,

and the knowledge they acquire while acting within the scope of their authority, are presumptively imputed to their principals." Indeed, it is well-settled New York law that corporate acts, even fraudulent ones, fall within the scope of the agents' authority, and are thereby imputed to the corporation, making it liable for the agents' conduct.

Application of the Adverse Interest Exception

There is, however, an adverse interest exception to this general rule of imputation. For the exception to apply, "the agent must have *totally abandoned* his principal's interests and be acting entirely for his own or another's purposes." The Court reaffirmed that this exception is a very narrow one, applicable only in those cases of "outright theft or looting or embezzlement—where the insider's misconduct benefits only himself or a third party; *i.e.*, where the fraud is committed against a corporation rather than on its behalf."

The Court provided additional guidance insofar as determining whether the exception applies, making clear that the self-motivation of the agent alone is not sufficient to invoke the exception. This is because the interests of the corporate officer and corporation are typically aligned; therefore, the self-interest of the officer alone does not trigger the adverse interest exception. Indeed, while the officer is often motivated to overstate a corporation's financial performance to maximize his own compensation, the corporation simultaneously benefits by attracting additional customers and investors. Therefore, "[t]o allow a corporation to avoid 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."

Moreover, the Court rejected the plaintiffs' argument that the adverse interest exception applies when the corporation is harmed by the discovery of the fraud, such as when the company is forced to file for bankruptcy protection as a result of the fraud. As the Court explained, the discovery of fraud, as opposed to the fraud itself, nearly always causes injury to a corporation. Therefore, harm from its discovery "does not bear on whether the adverse interest exception applies." Otherwise, "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."

Policy Arguments in Favor of Watering Down Defense Rejected

The Court refused to chip away at the *in pari delicto* doctrine, which "serves important policy purposes" and encourages "principal[s] to select honest agents and delegate duties with care." The Court disagreed with the litigation trustee's argument in *Kirschner* that, in the interest of fairness, suits brought by litigation trusts or derivative plaintiffs should be allowed because recoveries in these cases would benefit the "innocent stakeholders of corporate fraudsters." The Court noted that the stakeholders of outside professionals are likewise innocent, and nevertheless those professionals are already subject to liability to other parties arising out of the corporation's fraud. Ultimately, "the corporation's agents would almost invariably play the dominant role in the fraud and therefore would be more culpable than the outside professional's agents who allegedly aided and abetted the insiders or did not detect the fraud at all or soon enough." The Court explicitly rejected recent decisions of the highest courts of Pennsylvania and New Jersey which adopted these "fairness" arguments, thereby weakening the *in pari delicto* doctrine.

Importance of Decision in Actions by Receivers and Litigation Trustees

This decision is particularly important in those cases where, for example, a receiver, who “steps into the shoes” of the receivership entity, is appointed to run the company and oftentimes asserts claims against third-party professionals in an attempt to recover sums for investors and/or creditors. The same is true with respect to the recent trend of setting up post-bankruptcy litigation trusts—armed with war chests from the debtor’s remaining assets—for the sole purpose of pursuing the bankrupt company’s claims against third-party professionals. In such cases, New York’s highest court has made it clear that the *in pari delicto* defense remains viable. Conversely, given that the highest courts of Pennsylvania and New Jersey have decided to weaken the *in pari delicto* defense as discussed above, the rulings of those two courts may lead to increased litigation by those suing on behalf of corporations that have gone through bankruptcy reorganizations (e.g., by bringing derivative claims against the former professionals of the reorganized company). In view of the disparity between New York and those jurisdictions, choice of law will be a significant issue that may well impact the outcome of those lawsuits.

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