Who's At Fault?

NY COURT RULING SHELTERS AUDITORS

By Barry Jay Epstein, Ph.D., CPA, CFF
Partner, Litigation Consulting Services, Russell Novak & Company LLP

As 2010 comes to a close, a recent NY court ruling may have set the stage for greater auditor protection, following a stricter interpretation of the *in pari delicto* doctrine in situations in which undetected accounting frauds have resulted in corporate failure.

Accounting frauds have brought many corporations to ruin over the years, and indeed the occurrence of such fraud is a reliable indicator of near-term bankruptcy risk. In most such cases, assuming the company's financial statements had been subject to an audit, there would be a plausible argument that there had been "audit failure" of some magnitude, else the fraud would have been discovered in its early, less virulent stages. It has therefore been common for bankruptcy trustees, among many others, to seek recovery from outside auditors in such circumstances.

Unlike creditors of the bankrupt entity, which also commonly and successfully seek recovery from the former auditors, trustees arguably "stand in the shoes" of the former management of defunct enterprises. This position generally limits the trustee's ability to pursue litigation against others, such as professional assistance providers to the former company, who may have failed in performing their services.

Under the principle of imputation, the actions of the officers (agents for their corporations, which as artificial persons are the respective principals) are attributed to the company. Unless it can be shown that a disloyal agent acted in a manner adverse to the principal (e.g., when the action is pilferage from inventory – the *adverse interest exception* to the *in pari delicto* defense), it will be concluded that the corporation was the beneficiary of the agent's actions. In most financial reporting frauds, the proximate impact is to report higher earnings, which may provide such salutary effects as higher market price for its stock, improved credit ratings resulting in lower borrowing costs, and extended existence before its inevitable demise.

The Bible offers conflicting declarations regarding whether the sins of the father are to be visited upon the sons. By contrast, under the law as most often interpreted, the sins of the former corporation will definitely be visited upon the trustee in bankruptcy, limiting his/her ability to assert claims against other wrongdoers, thanks to the doctrine of *in pari delicto*. The recent ruling by the New York State Court of Appeals will further restrict the ability to seek recompense from auditors, regardless of the egregiousness of their failures in conducting financial statement examinations.

In *Marc S. Kirschner, as Trustee of Refco Litigation Trust v. KPMG, LLP et al*., the Court grappled with the oft-debated question of whether the doctrine of *in pari delicto* is an absolute bar to recovery against service providers (in this case, several accounting and law firms, among others). Simply put, the plaintiff argued that a *comparative fault* concept should have been applied, as there were (to plaintiff, at least) rather obvious flaws in the quality of services they provided, which enabled the former management of Refco (a provider of brokerage and clearing services in the derivatives, currency, and futures markets) to engage in large-scale fraud, which, *inter alia*, concealed hundreds of millions of dollars of debt. When these acts were ultimately revealed, Refco collapsed.

Reprinted with the permission of the Law Bulletin Publishing Company®

Under a comparative fault approach, the relative responsibilities of a company and its auditors (and, here, also its outside counsel) would guide the apportionment of damages. Had this doctrine been adopted, it is likely that the several audit firms and law firms named in the suit would have had to shoulder a good share of the losses suffered. The Court, however, rejected this, holding that "the effect . . . would be to marginalize the adverse interest exception." It also found that "comparative fault contradicts the public policy purposes at the heart of *in pari delicto* -- deterrence and the unseemliness of the judiciary 'serv[ing] as paymaster of the wages of crime'."

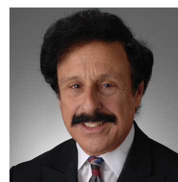
Both the AICPA and NYSSCPA (respectively, the national and the New York state associations of CPAs) filed *amicus curiae* briefs supporting the defendants, arguing that the *in pari delicto* doctrine bars recovery by a wrongdoing corporation against its auditors regardless of the nature of the auditors' alleged conduct; that the *adverse interest exception* is satisfied only where the agent has "totally abandoned his principal's interests and cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal; and that the *adverse interest exception* is precluded where the corporation benefited in any way from the fraud.

The ruling will likely chill the enthusiasm that bankruptcy trustees often exhibit for pursuing outside auditors following financial reporting fraud-induced business failures. From the service providers' perspective, this is a good result, as they often see themselves (with good reason, to be sure) as the "deep pockets" targets in situations in which they in fact (in their minds, at least) were victims, not perpetrators. From others' perspectives, however, the fear of such consequences served a socially useful purpose of keeping auditors and others "on their toes" in providing high quality services, particularly benefiting shareholders, creditors, and others (taxpayers, in the case of failures that ultimately become wards of the state, as has recently become common), who are the true victims of such frauds.

Other cases, in other jurisdictions, may reverse this trend, but for now, recoveries from service providers that fail to detect fraud seem less likely to be forthcoming. The game will continue, no doubt. ■

Barry Jay Epstein, Ph.D., CPA, CFF (bepstein@RNCO.com) is a Partner in the Chicago, Illinois firm, Russell Novak & Company, LLP, where his practice is concentrated on technical consultations on GAAP and IFRS, and as a consulting and testifying expert on civil and white collar criminal litigation matters. Dr. Epstein is the co-author of Wiley GAAP 2010, Wiley IFRS 2010, Wiley IFRS Policies and Procedures, and other books.

Russell Novak & Company LLP
225 W. Illinois Street, Suite 300
Chicago IL 60654
312-464-3520
BEpstein@RNCO.com



Barry Jay Epstein

Reprinted with the permission of the Law Bulletin Publishing Company®