California Court Signals Potential In Pari Delicto Doctrine Split With New York

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The common law doctrine of *in pari delicto* bars recovery by plaintiffs who share culpability for wrongdoings alleged in a complaint. Subject to certain exceptions, a corporate plaintiff's claims are barred by the *in pari delicto* doctrine where its employees or agents participated in the alleged wrongdoing. *In pari delicto* defenses may be asserted where corporate plaintiffs assert claims against third parties that conspired with the corporation's former employees or agents to harm the corporation and its shareholders.

Different jurisdictions have applied the *in pari delicto* doctrine in a variety of different ways, and have crafted various exceptions to the general rule. For example, some jurisdictions recognize exceptions to the general rule that acts by a corporation's agents are imputed to the corporation. Recent decisions from courts in New York and California illustrate divergent approaches regarding the "imputation exception" to the *in pari delicto* defense. The New York Court Appeals (the state's highest court) has held that the *in pari delicto* doctrine may bar claims unless the wrongful acts of an employee are shown to have been beyond the scope of his authority and adverse to the plaintiff's interests. On the other hand, a recent decision from San Francisco Superior Court appears to allow such claims where at least some of the corporation's officers or directors were not complicit in the wrongful acts. This appears to contradict New York's stringent interpretation of the doctrine. Thus, practically speaking, California may be more preferable than New York for plaintiffs where some, but not all, of the plaintiff's officers or directors committed or were complicit in wrongdoing relating to the lawsuit, to the arguable benefit of the company. Several types of disputes may hinge on this forum choice, including actions against a company's auditors or financiers, and many types of litigation springing from litigation trusts in bankruptcy.

New York: The *In Pari Delicto Doctrine* After Kirschner v. KPMG
In both California and New York, courts recognize the common law *in pari delicto* doctrine, which "dictates that when a participant in illegal, fraudulent, or inequitable conduct seeks to recover from another participant in that conduct, the parties are deemed *in pari delicto*, and the law will aid neither, but rather, will leave them where it finds them." *Casey v. U.S. Bank Nat'l Ass'n,* 127 Cal. App. 4th 1138, 1143 n.1 (2005); *see also Kirschner v. KPMG LLP*, 15 N.Y.3d 446, 464 (2010) ("The doctrine of *in pari delicto* mandates that the courts will not intercede to resolve a dispute between two wrongdoers.").

A recent high profile decision from New York, *Kirschner v. KPMG LLP*, affirmed dismissal of a bankruptcy trustee's claims against the estate's outside auditors on *in pari delicto* grounds. *Kirschner* dealt with the spectacular implosion of Refco, a leading provider of brokerage and clearing services, that declared bankruptcy when it was discovered that the company's President and CEO covered up hundreds of millions of dollars in uncollectible debt for the better part of a decade. After the ensuing bankruptcy, the bankruptcy court appointed a Litigation Trustee, who brought suit in the U.S. District Court for the Southern District of New York on behalf of Refco's estate against, among others, Refco's outside auditors for their roles in the company's years-long efforts to manipulate the company's financial reporting and to hide the company's debts from the public and regulators. *Id*. at 457-59.

The auditors moved to dismiss the lawsuit on several grounds, including *in pari delicto*. The Court granted this motion because, *inter alia*, the complaint was allegedly "saturated by allegations that Refco received substantial benefits from the [Refco] insiders' alleged wrongdoing." *Kirschner v. Grant Thornton LLP*, 2009 WL 1286326, at *6 (S.D.N.Y. Apr. 14, 2009). On appeal, the U.S. Court of Appeals for the Second Circuit certified a series of questions regarding the scope of the *in pari delicto* doctrine to the New York Court of Appeals, the state's highest court.

In finding for the auditors on the Second Circuit's certified questions, the New York Court of Appeals noted that acts of a corporation's agents are traditionally imputed to the corporation itself. *See Kirschner*, 15 N.Y.3d at 465-66. Extending this precedent to the case at hand, the *Kirschner* Court found that actions taken to bolster a corporation's healthy image should be imputed to the corporation and that there were no exceptions or public policies militating against this finding. *Id*. at 466-69, 474-77. Accordingly, the Court found that the Litigation Trustee, suing on behalf of Refco, was subject to the *in pari delicto* doctrine and could not sue Refco's outside auditors for their part in its demise. *Id*. at 476-77.

California: The Apparent Rejection of *Kirschner v. KPMG* in *Paron v. RKC*

In a similar case, *Paron Capital Management, LLC, et al. v. Rothstein, Kass & Company, P.C., et al.*, CGC-11-510203 (Cal. Sup. Ct. S.F. Cty.), a California court declined to apply the standard set forth in *Kirschner*. In *Paron*, two of the plaintiff hedge fund's three partners, Peter McConnon and Timothy Lyons, hired Rothstein, Kass & Company ("RKC") to audit the trading records of their third partner, James Crombie. Investors in Paron required such an audit before they agreed to invest money in the hedge fund. RKC validated Crombie's trading records in November 2010 but, five months later, the National Futures Association ("NFA") instigated a new audit of Paron that led McConnon and Lyons to discover that Crombie had provided them with falsified records. When McConnon and Lyons reported this information to the NFA and Paron's clients, the fund experienced mounting withdrawals that led to its demise shortly thereafter. Paron, McConnon, and Lyons subsequently sued RKC and other parties in San Francisco Superior Court for the losses they sustained due to, among other things, the faulty audit of Crombie's records. RKC moved to dismiss the plaintiffs' complaint on *in pari delicto* grounds.

RKC's motion to dismiss relied heavily on the reasoning in *Kirschner* and argued that Crombie's fraud was properly imputed to Paron, which therefore barred the fund from suing RKC on *in pari delicto* grounds. Paron responded by pointing out that, "[u]nder California law, *in pari delicto* is never applied to innocent parties, and the doctrine would only be appropriate if 'the complaint alleges that every decision maker in the company was involved in the misconduct.'" As the facts demonstrated—according to Paron—the plaintiffs were the *victims* of Crombie's fraud, not its beneficiaries. Accordingly, *in pari delicto* did not apply.

The Court agreed with Paron's analysis, denied RKC's motion and reinstated claims that had previously been dismissed on *in pari delicto* grounds. Implicit in this decision was a holding that the complaint did *not* have to allege facts that "show that Crombie's conduct was completely adverse to the company's interest and outside the scope of authority," which was the basis of the prior dismissal. Paron's case thus proceeds in spite of New York's *Kirschner* opinion.

Plaintiffs should be wary of relying too heavily on the *Paron* court's decision for their forum selection analysis. At this stage, it is a trial court decision that may be subject to reversal on appeal. However, the decision is an encouraging sign for plaintiffs and may presage a split in how the *in pari delicto* doctrine is applied in New York and California.