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New York's High Court Rejects Attempts To Expand Liability Of Outside Professional Service Providers For Failing To Detect Corporate Fraud

In *Kirschner v. KPMG LLP*, 2010 NY Slip Op. 07415, 2010 WL 4116609 (N.Y. Oct. 21, 2010), a majority of the New York Court of Appeals declined to expand liability of outside professional service providers who allegedly failed to detect or stop corporate wrongdoing. Through the interplay of two legal principles soundly "embedded in New York law" — namely, the "*in pari delicto*" defense and the "adverse interest" exception to the general rule that corporate executives' wrongdoing is imputed to the corporation — the Court rejected attempts by investors to recoup some of their investment losses from the issuers' outside auditors. If the dissent is to be believed, this decision "effectively immunizes auditors and other outside professionals from liability wherever any corporate insider engages in fraud."

The Court of Appeals was asked to rule on questions of New York law certified and submitted by the United States Court of Appeals for the Second Circuit and the Delaware Court of Chancery in the cases of *Kirschner v. KPMG LLP* and *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP*. Plaintiffs in each case sought to hold outside auditors liable for assisting or failing to detect and stop, either knowingly or merely negligently, fraudulent acts committed by executives at the corporations whose financial statements they were auditing.

In *Kirschner*, shortly after going public in 2005, the derivatives brokerage firm Refco announced that its president and CEO had been engaging in a scheme that hid hundreds of millions of dollars of debt from public statements, thus creating a fictional picture of the health of the company. After disclosure of the fraud, Refco filed for Chapter 11 bankruptcy. In its plan of reorganization, Refco established a Litigation Trust which would pay out ongoing claims against Refco. In addition to direct claims against Refco's President & CEO, the Litigation Trustee initiated actions against investment banks that served as underwriters as well as two accounting firms that had audited Refco's financial statements.

In *Teachers' Retirement System of Louisiana*, shareholders of American International Group ("AIG") initiated a derivative action on behalf of AIG against certain of its senior officers. Plaintiffs alleged that the corporation's financial statements were materially misleading, overstating its value by billions of dollars to create an illusion of profitability. Although plaintiffs made no allegation that PricewaterhouseCoopers, the auditing firm certifying AIG's financial statements, was knowingly complicit in the corporation's fraud, the complaint nevertheless claimed that the failure to detect or report the fraud fell below "professional standards of conduct."

Under traditional agency principles, New York courts ascribe liability for illegal acts committed by an agent against its principal. The principal — in both cases, the corporation — is presumed to have approved the acts of its agent — here, the corporate officers — by selecting and granting authority to such agents. Accordingly, the acts committed by officers are imputed to the corporation. One exception to this rule is the "adverse interest" exception. This exception applies when the agent's acts are deemed wholly adverse to the interests of its principal. If, and only if, such conflicting interests constitute a "total abandonment" of the corporation, the corporation may escape liability for the agents' underlying acts.

Noting that a corporate insider's personal interests are often "deliberately aligned with the corporation's interests," the Court of Appeals explained that, under New York law, the "adverse interest" exception is a narrow one: it would be recognized only if an agent's malfeasance confers no benefit whatsoever on the principal.

The majority also made clear that the officers' intent in committing the acts is irrelevant. On the contrary, if selfish motives contributed a collateral benefit to the corporation, even one that was short-lived, the "adverse interest" exception would not apply. The Court reasoned that a fraudster's motives are rarely magnanimous; if intent were deemed a dispositive factor, the insiders' inherently selfish motives would render the exception moot "because it would encompass every corporate fraud prompting litigation." Because the officers' efforts to profit — *e.g.*, by avoiding taxes or selling fictitious insurance policies — created a financial, albeit temporary, benefit to the corporation as a whole, an essential component of the defense is absent. The fact that, for example, disclosure of the fraud ultimately forced Refco into bankruptcy also was irrelevant: the Court of Appeals made clear that Refco had received enough of a benefit before its bankruptcy to defeat the claim that the fraudsters' interests were adverse to that of the corporation.

In so ruling, the corporations themselves were deemed to be complicit in the fraudulent scheme, and thus barred from suing outside auditors under the principle of "*in pari delicto*." The Latin maxim, which means "in a case of equal or mutual fault, the position of the defending party is the better one," requires that courts avoid adjudicating a dispute in which both parties enter the case with "unclean hands." Imputing liability to the corporations through the acts of its agent, the "unclean" corporations here were thus barred from bringing a claim against an allegedly "unclean" third party, even if the third party acted knowingly.

The Court explained that its rationale was twofold: first, notions of public policy would so dictate; and second, ruling otherwise would not likely provide a meaningful deterrent. If, for example, an accounting firm were held liable for the fraudulent acts of corporate officers, the result would amount to a mere shifting of responsibility among innocent parties. As Judge Read observed, "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?" Ultimately, the costs of litigation, as well as any damages resulting from that litigation, are borne by those with ownership interests over those entities. Warning of an anomalous "double standard", the Court refused to impute responsibility to the stakeholders of the outsider entity for "the sins of their errant agents," "while the innocent stakeholders of the corporation itself are not charged with knowledge of their wrongdoing agents."

Finally, the Court believed that imputing liability would not necessarily create any additional safeguard against professional misconduct. Noting that there are federal measures in place to guard against egregious violations of accounting fraud (*e.g.*, the Sarbanes-Oxley Act), the Court discounted any need for further measures under state law.

Under this decision, accounting firms, investment banks, attorneys and other "gatekeeper" professionals remain largely shielded from liability for misdeeds of a corporation's management under New York state law. Although the dissenting opinion observes that the agency principles on which the decision rests are well-grounded, public policy demands a less "rigid application." On the other hand, the imposition of additional liability on third-party professional service providers might have had troubling consequences on New York's financial service market. Ultimately, as the majority illustrates, liability-shifting among innocent stakeholders hardly yields a result that is fair or equitable.

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