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Expert Analysis

Court of Appeals Endorses Robust In Pari Delicto Defense

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In a much-anticipated decision, the New York Court of Appeals ruled 4-3 in *Kirschner v. KPMG LLP*[1] that the in pari delicto doctrine—the principle that courts will not intercede to resolve a dispute between wrongdoers—applies broadly to bar claims by a company against third parties who assist corporate insiders in wrongdoing, even if the outsiders knowingly participate in the fraud or other breach of duty, profit from it, and are integral to its success. The Court thus declined to follow recent rulings by the New Jersey and Pennsylvania high courts adopting less expansive versions of the defense,[2] and the decision presents a major impediment to recovery for bankruptcy trustees, derivative plaintiffs and successor corporate managers who seek to impose liability on third parties for losses in which insiders are also at fault.

Case Summary

Kirschner arrived at the Court of Appeals by way of questions certified in separate cases before the U.S. Court of Appeals for the Second Circuit and the Delaware Supreme Court.[3] The provenance of the case reflects the relative rarity of New York state court cases involving in pari delicto—most of the significant decisions have been in federal court bankruptcy matters. The Second Circuit's certified questions arose from litigation brought by the bankruptcy trustee of Refco, the financial services firm that spectacularly flamed out within months of its 2005 IPO, after disclosure that its executives had committed massive accounting fraud. The Delaware case was a derivative action by AIG stockholders, based on accounting improprieties also disclosed in 2005, resulting from use of sham transactions, "topside adjustments" by senior managers, and alleged tax evasion. Both cases named the companies' auditors; the Refco trustee also sued other third parties, including underwriters, law firms, and several Refco customers.

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The *Kirschner* majority opinion applies a straightforward legal analysis: (1) in pari delicto stands for the principle that courts do not intercede between wrongdoers, (2) under traditional agency principles, the acts of agents (here, the corporate officers) are imputed to their principals (here, the corporations in whose name the claims were brought), and (3) while the imputation rule is subject to the "adverse interest exception," the exception applies only where the agent has "totally abandoned his principal's interests," barring reliance on the exception if the misconduct "enables the business to survive—to attract investors and customers and raise funds for corporate purposes," even if the actions were "actually motivated by the agent's desire for personal gain." Further limiting the scope of the exception, the Court noted that "any harm from the discovery of the fraud—rather than from the fraud itself—does not bear on whether the adverse interest exception applies."[4]

Commentary

While the majority's logic for imputation—the "incentive for a principal to select honest agents and delegate duties with care"—makes good sense for the sole proprietor and her bookkeeper, it runs counter to a large body of scholarship, extending back to the 1932 publication of "The Modern Corporation & Private Property," recognizing that the modern public corporation is governed by professional managers and largely reallocates corporate control from shareholder "principals" to officer "agents."[5]

Even in the case of the sole proprietorship, it seems perverse that a third party such as an auditor, who is engaged by the principal to monitor for fraud, can escape liability if it is negligent or actually colludes with the agents it is charged with monitoring. The Restatement (Third) of Agency specifically rejects imputation and allows a claim to proceed in this situation,[6] but the law of New York, as announced in *Kirschner*, explicitly bars liability on these facts.

The more persuasive explanation for the majority's decision was its view, which it articulated in some detail, that spreading liability for corporate wrongdoing to third parties is not a good thing. With respect to the need for compensation, the Court explained that allowing claims against third parties "may be viewed as creating a double standard whereby the innocent stakeholders of the corporation's outside professionals are held responsible for the sins of their errant agents while the innocent stakeholders of the corporation itself are not charged with knowledge of their wrongdoing agents."[7] Likewise, the Court questioned the value of additional deterrence, citing the substantial securities fraud settlements obtained by shareholders from Refco's underwriters and AIG's auditor.[8]

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As reflected by the three-judge dissent in *Kirschner*, reasonable minds can differ regarding the fairness of particular liability allocation regimes and the correct level of deterrence. By establishing a near per se rule of non-liability, however, without regard to the third party's intent, the benefit it derived, or level of assistance it provided, the majority rule seems unlikely to achieve the appropriate level of compensation or deterrence. As Columbia Law School professor John C. Coffee, among others, has prominently observed, gatekeepers play a central role in detecting malfeasance by corporate managers, and an optimal regime should therefore impose a substantial risk of liability, subject to reasonable damages caps.[9]

A similar judge-made limitation on liability could be imposed, as the Refco trustee proposed, by adopting some form of comparative fault.[10] While the majority correctly observed that some claims—notably fraud—are asserted directly by injured stakeholders and are therefore not subject to the in pari delicto defense, the reach of the federal antifraud laws has been sharply curtailed by the U.S. Supreme Court, most recently with the rejection of "scheme" liability in 2008.[11] Thus, at least some of the "large settlements and judgments in the litigation that inevitably follows the collapse of an Enron, or a WorldCom" referenced by the majority[12] would not occur today.

While clear rules and predictable results are, of course, desirable in many situations, the value of providing blanket immunity for third parties who facilitate fraud and other wrongdoing is not so obvious. Giving due recognition to the burdens of litigation and risk of overdeterrence, the better approach would perhaps have been to require a showing of more than negligence, say, recklessness or active participation, and rely on judges to actively police weaker claims through accelerated judgment.

Planning

The hard rule of *Kirschner* notwithstanding, plaintiffs have some options. First, it may be possible to avoid New York law altogether. The relevant choice of law principles are not clearly settled and their application is often fact intensive.[13]

Second, since in pari delicto applies only to claims by or on behalf of the injured principal and the dividing line between direct and derivative claims is not clear-cut,[14] a claim might better be asserted directly by a shareholder, creditor, or other stakeholder, rather than by or on behalf of the company.

Third, there is some authority that in pari delicto does not apply if the third party masterminded the wrongdoing or is more at fault than the insider.[15]

Finally, there is the adverse interest exception. The exception will apply only if "the scheme that benefitted the insider operated at the corporation's expense," and the focus must be on whether the conduct at issue was adverse to the company "at the time it was committed"—not on harm that later resulted "from the discovery of the fraud—rather than the fraud itself…."[16] Accordingly, the focus of pleading and proof should be on the benefit to the insiders and detriment to the corporation at the time of the wrongdoing—such as the lost opportunity to address the underlying business problems concealed through the fraud.

Conclusion

In pari delicto presents a major challenge for bankruptcy trustees, shareholder derivative plaintiffs, and successor corporate managers seeking to recover against third parties who abet wrongdoing by insiders. It can best be addressed by careful litigation planning that includes scrutinizing the appropriate choice of law, evaluating the proper characterization of a claim as direct or derivative, and, where possible, pleading the third party's greater relative fault, receipt of substantial benefits by insiders from the wrongdoing, and a contemporaneous detriment to the injured corporation.

1. 15 N.Y.3d 446, 912 N.Y.S.2d 508, 938 N.E.2d 941 (2010).

2. *NCP Litig. Trust v. KPMG LLP*, 187 N.J. 353, 901 A.2d 871 (2006) and *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers, LLP*, 989 A.2d 313 (Pa. 2010).

3. *Kirschner v. KPMG LLP*, 590 F.3d 186, 191 (2d Cir. 2009), and *Teachers' Ret. Sys. of La. v. PricewaterhouseCoopers LLP*, 998 A.2d 280 (Del. 2010).

4. 15 N.Y.3d at 464-69, 912 N.Y.S.2d at 517-21, 938 N.E.2d at 950-53.

5. Adolf Berle & Gardiner Means, "The Modern Corporation & Private Property" (1932). The foundational modern article is Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976), available at http://ssrn.com/abstract=94043.

6. RESTATEMENT (THIRD) OF AGENCY §5.03 cmt. b (2006).

7. 15 N.Y.3d at 475, 912 N.Y.S.2d at 525, 938 N.E.2d at 958.

8. Id. at 476, 912 N.Y.S.2d at 525, 938 N.E.2d at 958.

9. John C. Coffee, "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms," 84 B.U. L. REV. 301, 349-50 (2004) (discussing the importance of gatekeepers in preventing corporate fraud). See also Frank Partnoy, "Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime," 79 WASH. U. L.Q. 491 (2001).

10. 15 N.Y.3d at 474, 912 N.Y.S.2d at 525, 938 N.E.2d at 958. In adopting its narrower version of in pari delicto, the New Jersey Supreme Court held that its state's statutory comparative negligence standard would apply to limit third party liability. 187 N.J. at 380, 901 A.2d at 887.

11. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148 (2008).

12. 15 N.Y.3d at 466, 912 N.Y.S.2d at 518-19, 938 N.E.2d at 951-52.

13. See, e.g., *In re Adelphia Commc'ns Corp.*, 365 B.R. 24, 46 (Bankr. S.D.N.Y. 2007), aff'd in relevant part sub nom. *Adelphia Recovery Trust v. Bank of Am., N.A.*, 390 B.R. 64 (S.D.N.Y. 2008).

14. See *In re Mediators Inc.*, 105 F.3d 822, 825 (2d Cir. 1997) (discussing "whether a right to sue belongs to the debtor or to the individual creditors"); *Tooley v. Donaldson, Lufkin & Jenrette Inc.*, 845 A.2d 1031, 1036 (Del. 2004) (reformulating the Delaware standard for distinguishing direct and derivative cases and acknowledging that "[d]etermining whether an action is derivative or direct is sometimes difficult").

15. See *Furman v. Furman*, 178 Misc. 582, 586, 34 N.Y.S.2d 699, 704 (N.Y. Sup. Ct. N.Y. County) ("where the parties are not equal in guilt (in pari delicto) but where one of them, although participating in the wrong, is less guilty than the other, the party more at fault cannot employ the doctrine of pari delicto to shield his deliberate invasion of the rights of the former"), aff'd, 262 A.D. 512, 30 N.Y.S.2d 516 (1st Dept. 1941), aff'd, 287 N.Y. 772, 40 N.E.2d 643 (1942); *Globaltex Group Ltd. v. Trends Sportswear Ltd.*, No. 09-CV-0235, 2010 WL 1633438 (E.D.N.Y. April 21, 2010) (denying summary judgment based on the in pari delicto defense where "it is possible that the defendants were more at fault").

16. Id. at 467-68, 912 N.Y.S.2d at 519-20, 938 N.E.2d at 952-53.