Kirschner v. KPMG LLP: New York Court of Appeals Reaffirms Broad Scope of *In Pari Delicto* Defense for Professional Service Providers and Rejects Attempt to Expand Scope of Liability

On October 21, 2010, the New York Court of Appeals reaffirmed the broad scope of the *in pari delicto* defense for investment banks, auditors, law firms and other professional service providers in cases brought by companies (or those suing on their behalf, such as bankruptcy trustees and litigation trusts) in two cases that had been certified to it from the United States Court of Appeals for the Second Circuit and the Supreme Court of Delaware. The *in pari delicto* doctrine has been interpreted to preclude actions by or on behalf of a corporation against its professionals because a corporate insider's misconduct is imputed to the company. Notwithstanding the general rule, courts have allowed an "adverse interest" exception to the *in pari delicto* defense where the insider "totally abandoned" the company's interests. The Court of Appeals in *Kirschner v. KPMG LLP* concluded that the adverse interest exception is reserved for cases of "outright theft or looting or embezzlement" where the agent's misconduct benefits only himself or a third party. *Kirschner v. KPMG LLP*, No. 151, 2010 N.Y. LEXIS 2959 (*Kirschner*).

Background: *Kirschner v. KPMG LLP* and *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP*

In *Kirschner v. KPMG LLP*, certified by the U.S. Court of Appeals for the Second Circuit, Refco's litigation trustee brought claims against the company's outside auditor, as well as its law firm and investment banks, after the company's president and CEO hid hundreds of millions of dollars of Refco's uncollectible debt. *Kirschner v. KPMG LLP*, 590 F.3d 186 (2d Cir. 2009). The revelation of the fraud led to the company's bankruptcy. The District Court for the Southern District of New York dismissed the litigation trustee's claims against Refco's professional service providers, imputing the president and CEO's conduct to the company and applying the *in pari delicto* doctrine.

Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP, certified by the Supreme Court of Delaware, involved derivative claims brought on behalf of American International Group ("AIG") against AIG's auditor after the auditor allegedly failed to detect a scheme by AIG officers to fraudulently inflate the company's financial performance. *In re Am. Int'l Group, Inc.*, 998 A.2d 280 (Del. 2010). The Delaware Court of Chancery concluded that the officers' fraudulent acts were imputable to AIG under New York agency law. The *in pari delicto* doctrine therefore barred AIG's claims against the auditor.

The New York Court of Appeals Narrowly Construes the Adverse Interest Exception to the *In Pari Delicto* Defense

The New York Court of Appeals, in a 4-3 opinion, refused to diminish the scope of the *in pari delicto* doctrine by reinterpreting the adverse interest exception. It held that the adverse interest exception applies only where the agent has "totally abandoned" its principal's interests and acts "entirely" for its own or another's benefit. In particular, the adverse interest exception does not apply where both the insider and

corporation derive a benefit from the insider's fraud. Total abandonment occurs only "where the fraud is committed *against* a corporation," not on its behalf.

The Court of Appeals clarified that even when the motive behind the agent's fraud is personal gain, the agent might not totally abandon the principal's interests.

The Court of Appeals found strong public policy considerations underlying the rule that all corporate acts by an agent, including fraudulent ones, are presumptively imputed to the principal. The presumption of imputation "reflects the recognition that principals, rather than third parties, are best-suited to police their chosen agents and to make sure they do not take actions that ultimately do more harm than good." The Court of Appeals noted that the *in pari delicto* doctrine has survived for more than 200 years, and serves important policy functions by deterring wrongdoing and avoiding court entanglement in disputes between wrongdoers.

This decision by the New York Court of Appeals is a strong counterweight to recent decisions from the highest courts of New Jersey and Pennsylvania, both of which weakened the scope of the *in pari delicto* doctrine to allow plaintiffs to bring suits more easily against professional service providers in cases of corporate misconduct. Given the prevalence of New York law in commercial transactions, the *Kirschner* decision will likely have a limiting effect on suits by bankruptcy trustees and derivative plaintiffs against auditors, lawyers, investment banks and other professionals for damages resulting from corporate misconduct.

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