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New York High Court Declines to Broaden Liability of Third-Party Professionals for Client Fraud

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Lawyers for the Profession® Alert

Kirschner v. KPMG LLP, ___ N.E.2d ___, 2010 WL 4116609 (N.Y. 2010)

Brief Summary
Under New York law, the fraud of corporate insiders will be imputed to the corporate entity regardless of the insiders' intent or the degree to which the corporation benefited from the fraud. There is a limited exception to this rule when the fraud is against the corporation itself. In cases where fraud is imputed, the corporation is barred by the doctrine of *in pari delicto* from shifting responsibility for the fraud to third-party agents such as law firms or accounting firms.

Complete Summary
The New York Court of Appeals, in a 4-3 decision, held that the combined principles of *in pari delicto* and imputation prevent corporations from shifting responsibility for insider fraud to third parties unless the fraud was perpetrated against the corporation itself. The Court discussed these principles in response to certified questions from two courts. The Delaware Supreme Court certified the *in pari delicto* question, and the U.S. Court of Appeals for the Second Circuit certified the imputation question.

The former case involved a shareholder derivative action based on insider fraud in which the corporation sued its outside auditor for failure to detect the fraud. The auditor raised the defense of *in pari delicto,* which precludes the court from resolving disputes between two wrongdoers.

The latter case arose on the heels of a corporate bankruptcy that was triggered by insider fraud. A litigation trustee was appointed as part of the Chapter 11 proceeding, and the trustee ultimately sued a group of the corporation's advisers, including its former law firm, alleging that they were partially responsible for the fraud. Those third parties argued that the insiders' fraud could be imputed to the corporation and asserted the rule that a corporation lacks standing to recover from third parties for a fraud that the corporation itself was involved in.

The New York high court held that so long as insider fraud can be imputed to the corporation, the corporation is barred by the doctrine of *in pari delicto* from shifting responsibility to third parties. There is a narrow exception to the

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imputation rule, the Court held, for instances in which a corporate agent totally abandons the corporation's interest and acts entirely for his or her own, or another's benefit, i.e., when the corporation is actually the victim of the fraud. The Court emphasized the narrowness of this so called "adverse interest" exception by noting that, for the exception to apply, harm to the corporation must arise from the fraud itself, rather than from discovery of the fraud.

In reaching its conclusion, the Court rejected plaintiffs' efforts to expand the adverse interest exception in the context of *in pari delicto*. For example, the Court rejected an idea derived from Second Circuit precedent in which the adverse interest exception applies so long as the insiders *intended* to, and actually did benefit themselves, and/or if the corporation only received a short-term benefit but suffered a long-term harm. The Court also rejected the approach taken by the New Jersey Supreme Court in which minor corporate shareholders who are deemed innocent and unaware of internal fraud may bring suit against a third-party auditor for negligence. The Court also discussed a similar approach taken in Pennsylvania, and, more generally, the applicability of comparative negligence in this context.

The Court rejected those equitable approaches, noting that the proper balance of equities is difficult to determine. Specifically, the Court stated: "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?" The Court further noted that as between the corporation and an outside professional entity, the corporation's agents invariably play a bigger role in the fraud and therefore are more culpable.

Three judges dissented, arguing against the majority's strict application of the imputation principle. Namely, they argued that where fraud merely prolongs the life of a corporation the corporation does not truly benefit, and therefore the adverse interest exception to imputation may apply. The dissent further questioned whether the majority's holding might remove the incentive of third-party professionals to monitor insider agents of the corporation.

Significance of Opinion

This exceptionally important opinion solidifies New York's stance on the doctrine of *in pari delicto* and clarifies the scope of the imputation rule by highlighting the narrow applicability of the adverse interest exception. This decision appears to largely insulate lawyers and other third-party professionals from liability for corporate client fraud under New York law.

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