
RECENT CASES

CORPORATE LAW — PRINCIPAL'S LIABILITY FOR AGENT'S CONDUCT — NEW YORK COURT OF APPEALS CLARIFIES STANDARD FOR IMPUTABILITY OF AN AGENT'S FRAUDULENT CONDUCT TO ITS PRINCIPAL IN THE CONTEXT OF AN *IN PARI DELICTO* DEFENSE. — *Kirschner v. KPMG LLP*, 938 N.E.2d 941 (N.Y. 2010).

The common law of agency has long played a fundamental role in a wide range of business transactions. However, in the era of complex organizational structures and the outsourcing of core operations, the adaptability of that law to modern corporate realities is being put to the test. Doctrines like imputation, which under certain circumstances attributes the actions of an agent to its principal,¹ and *in pari delicto*, an equitable defense that prevents recovery by one party against another where both bear responsibility for the wrongdoing at issue,² can now combine to produce undesirable results. Accounting firms, law firms, and other providers of professional services — often referred to as “gatekeepers”³ — have employed these principles in tandem to defend against suits by their corporate clients. Typically gatekeepers raise such a defense against claims that they either conspired to commit fraud with or negligently failed to discover fraud by a client to the detriment of that client's shareholders, creditors, or both.⁴ Recently, in *Kirschner v. KPMG LLP*⁵ (*Kirschner*), the New York Court of Appeals determined that, as a matter of New York law, a corporation defrauded by its managers may not recover from its gatekeepers who either participated in the fraud or negligently failed to detect it.⁶ While the Court of Appeals was correct to consider how its decision

¹ See, e.g., RESTATEMENT (THIRD) OF AGENCY intro. at 4 (2006) (“The common law of agency . . . makes a[] . . . principal who has the right to direct another's actions[] vicariously liable for torts committed by an . . . agent while acting within the scope of employment or other engagement.”).

² See, e.g., *In re Verestar, Inc.*, 343 B.R. 444, 478 (Bankr. S.D.N.Y. 2006) (“[T]he common law defense of *in pari delicto*[] . . . prohibits a party from recovering damages arising from misconduct for which the party bears responsibility.”).

³ See, e.g., John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308 (2004) (“First, the gatekeeper is a person who has significant reputational capital . . . which it pledges to assure the accuracy of statements or representations that it either makes or verifies. Second, the gatekeeper receives a far smaller benefit or payoff for its role . . . in approving, certifying, or verifying information than does the principal from the transaction that the gatekeeper facilitates or enables.”).

⁴ See, e.g., *Chaikovska v. Ernst & Young, LLP*, 913 N.Y.S.2d 449 (N.Y. App. Div. 2010) (finding that *in pari delicto* barred both the corporation's principal shareholder and its assignee from sustaining an accounting malpractice claim against the corporation's auditor where plaintiffs alleged that the auditor failed to discover fraud perpetrated by the corporation's management).

⁵ 938 N.E.2d 941 (N.Y. 2010).

⁶ See *id.* at 945, 959.

would influence the incentives of corporate actors and deter wrongdoing generally, it failed to account adequately for how these considerations might differ when applied in the context of a large, publicly traded corporation.

Kirschner disposed of questions of state law certified to the New York Court of Appeals with respect to two underlying cases: *Kirschner v. KPMG LLP*⁷ (*Kirschner II*), and *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP*.⁸ In *Kirschner II*, Refco, a publicly traded financial services firm, declared bankruptcy after disclosing that its controlling shareholder-officers had concealed Refco's uncollectible receivables by fraudulently manipulating the firm's balance sheet for several years.⁹ A court-established litigation trust subsequently sued several parties on Refco's behalf, including the firm's senior management, as well as a law firm and three accounting firms that allegedly had either assisted Refco managers in perpetrating the fraud or negligently failed to uncover it.¹⁰ In *Teachers' Retirement System*, two stockholders of insurance and financial services giant AIG brought a derivative action against the company's independent auditor. The derivative plaintiffs alleged that, among other illegal actions, senior AIG officials fraudulently misled investors into believing that the corporation was worth billions of dollars more than it actually was worth at the time.¹¹ As for PricewaterhouseCoopers's role in the fraud, the plaintiffs claimed that the firm would have detected the scheme but for its negligent "fail[ure] to perform its auditing responsibilities in accordance with professional standards of conduct."¹²

In both underlying cases, the trial courts determined that, under New York law,¹³ *in pari delicto* barred the plaintiffs' claims against both corporations' gatekeepers. Both courts noted — without dispute from the litigants — the general presumption that the actions and knowledge of an agent within the scope of the agency relationship are imputed to the principal.¹⁴ Thus, if the fraudulent acts of Refco's and AIG's officers were attributable to their respective employers, *in pari delicto* would prohibit recovery. However, the *Teachers' Retirement*

⁷ 590 F.3d 186 (2d Cir. 2009); see also *Kirschner*, 938 N.E.2d at 948.

⁸ 998 A.2d 280 (Del. 2010); see also *Kirschner*, 938 N.E.2d at 948–50.

⁹ *Kirschner II*, 590 F.3d at 188.

¹⁰ *Kirschner*, 938 N.E.2d at 945–46.

¹¹ *Teachers' Ret. Sys. of La.*, 998 A.2d at 281.

¹² *Id.* at 282.

¹³ Both trial courts determined that, as a threshold choice-of-law matter, New York law applied. See *Kirschner v. KPMG LLP (Kirschner I)*, No. 08 Civ. 8784 (GEL), 2009 WL 1010060, at *1 n.2 (S.D.N.Y. Apr. 14, 2009) (finding that the parties had consented to the application of New York law); *In re Am. Int'l Grp., Inc.*, 965 A.2d 763, 817–22 (Del. Ch. 2009) (holding that New York had the "most significant relationship," *id.* at 818, to the controversy). The Second Circuit and the Delaware Supreme Court did not reconsider these findings on appeal.

¹⁴ See *Kirschner I*, 2009 WL 1010060, at *1; *In re Am. Int'l Grp.*, 965 A.2d at 823–24.

System plaintiffs argued that imputation should not apply because they had established the applicability of New York's "adverse interest" exception to imputation — an exception that applies when "the agent [has] totally abandoned his principal's interests and [is] acting entirely for his own or another's purposes."¹⁵ Both trial courts found that the exception did not apply,¹⁶ and the plaintiffs appealed. On appeal, both the Second Circuit and the Delaware Supreme Court declined to decide the underlying cases on the merits¹⁷ and instead chose to certify questions of law to New York's highest state court, seeking to clarify the scope of both *in pari delicto* and the adverse interest exception to imputation.¹⁸

The Court of Appeals answered the certified questions by concluding that neither set of facts met the requirements of the adverse interest exception, and as a result, that imputation and *in pari delicto* applied to both cases.¹⁹ Therefore, the court concluded that New York common law provided the defendants with an affirmative defense to the plaintiffs' claims. Writing for the court, Judge Read²⁰ determined that the disposition of the certified questions turned on whether, and to what extent, the court should reinterpret existing New York common law to allow corporations to shift liability for their agents' fraud to third parties that either took part in the fraud or negligently failed to uncover it.²¹ In the court's view, the public policy in favor of maintaining a strong presumption of imputation and *in pari delicto* outweighed the plaintiffs' arguments that fairness and deterrence considerations supported limiting the defense in their cases.²² In permitting

¹⁵ *In re Am. Int'l Grp.*, 965 A.2d at 824 (alterations in original) (emphasis omitted) (quoting *Center v. Hampton Affiliates, Inc.*, 488 N.E.2d 828, 830 (N.Y. 1985)) (internal quotation marks omitted); see also *Kirschner*, 938 N.E.2d at 947–49.

¹⁶ See *Kirschner I*, 2009 WL 1010060, at *1; *In re Am. Int'l Grp.*, 965 A.2d at 826–27.

¹⁷ Following the *Kirschner* decision, both the Second Circuit and the Delaware Supreme Court affirmed the judgments of the lower courts in the underlying cases. See *Kirschner v. KPMG LLP*, 626 F.3d 673, 677–78 (2d Cir. 2010); *Teachers' Ret. Sys. of La. v. PricewaterhouseCoopers LLP*, No. 454, 2009, 2011 WL 13545, at *1 (Del. Jan. 3, 2011).

¹⁸ The Delaware Supreme Court asked:

Would . . . *in pari delicto* bar a derivative claim . . . where a corporation sues its outside auditor . . . based on the auditor's failure to detect fraud committed by the corporation; and, the outside auditor did not knowingly participate in the corporation's fraud, but instead, failed to satisfy professional standards in its audits . . . ?

Teachers' Ret. Sys. of La. v. PricewaterhouseCoopers LLP, 998 A.2d 280, 282–83 (Del. 2010). The Second Circuit certified eight questions but invited the Court of Appeals to focus on two in particular: "whether the adverse interest exception [to imputation] is satisfied by showing that [a corporation's] insiders intended to benefit themselves by their misconduct" and "whether the exception is available only where the insiders' misconduct has harmed the corporation." *Kirschner II*, 590 F.3d 186, 194–95 (2d Cir. 2009).

¹⁹ See *Kirschner*, 938 N.E.2d at 959.

²⁰ Judge Read was joined by Judges Graffeo, Smith, and Jones.

²¹ See *Kirschner*, 938 N.E.2d at 957.

²² See *id.* at 958–59.

the defendants to elude liability, the court argued that its decision optimized the incentives of principals in two main ways. First, strictly applying imputation and *in pari delicto* deters illegal conduct because a corporation that cannot recover against a third party for its agents' wrongdoing will take greater care in selecting and monitoring its agents.²³ Second, plaintiff corporations in cases like *Kirschner* are usually the least cost avoiders in preventing illegal conduct: in the court's estimation, the principal is "generally" better positioned to control the conduct of its own agents than outside parties.²⁴

The court rejected the plaintiffs' claim that applying imputation and *in pari delicto* would unfairly punish investors for the fraudulent conduct of the agents, permitting negligent or even fraudulent gatekeepers to escape liability.²⁵ In the majority's view, the plaintiffs' approach would simply shift the burden of fraud from the innocent claimants of the defrauded firm's assets to the innocent claimants of the gatekeeper firm.²⁶ The court also rejected the contention that the plaintiffs' approach "would produce a meaningful additional deterrent to professional misconduct or malpractice."²⁷ Noting that gatekeepers already bear significant risks of liability under existing statutory and regulatory frameworks,²⁸ the court concluded that "[i]t is not evident that . . . loosening imputation principles under New York law would result in any greater disincentive for professional malfeasance or negligence than already exists."²⁹ Therefore, in the court's assessment, the plaintiffs' fairness and deterrence concerns in these specific cases did not outweigh the underlying public policy rationales in support of stricter applications of *in pari delicto* and imputation.

In dissent, Judge Ciparick³⁰ argued that the majority's approach failed to give adequate weight to public policy considerations that supported a less "hard-line stance" in the application of *in pari delicto*.³¹ Describing the defense as a flexible one,³² the dissent argued that the majority's application of traditional agency principles was overly harsh and simplistic. This would be particularly so, the dissent continued, if a gatekeeper were to bear some fault for the fraud, and if the

²³ *Id.* at 951-52.

²⁴ *See id.* at 951, 953.

²⁵ *Id.* at 958-59.

²⁶ *Id.* at 958.

²⁷ *Id.*

²⁸ *Id.* at 958-59 & n.6. Specifically, the court made mention of the 2002 Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of the U.S. Code), and subsequent rulemaking under that Act by the SEC. *Kirschner*, 938 N.E.2d at 959 n.6.

²⁹ *Kirschner*, 938 N.E.2d at 958-59.

³⁰ Judge Ciparick was joined by Chief Judge Lippman and Judge Pigott.

³¹ *Kirschner*, 938 N.E.2d at 960 (Ciparick, J., dissenting).

³² *See id.* ("[T]he concept of *in pari delicto* is not a rigid concept, incapable of shaping itself to the particulars of an individual case.").

corporation's "illusory" benefit from the fraud were, in fact, incidental to a sustained, long-term harm.³³ The dissent further contended that gatekeeper professionals — especially auditors — serve a particular public interest in certifying information upon which the investing public may rely, and that the majority's approach "merely invite[s] gatekeeper professionals 'to neglect their duty to ferret out fraud by corporate insiders'" by effectively immunizing them from liability.³⁴ Thus the dissent, citing to New Jersey and Pennsylvania law,³⁵ would have accepted the plaintiffs' arguments that the appropriate outcome would be to "recognize a carve-out" from *in pari delicto* in cases such as *Kirschner II* and *Teachers' Retirement System*.³⁶

Although the Court of Appeals was correct to consider how its decision would affect the incentives of the business community, the court failed to consider adequately how the particulars of the corporate form affect these incentives. That is, while the *Kirschner* majority suggested that its approach optimally deters wrongdoing,³⁷ it adopted an simplistic approach — one that did not account for how modern corporate realities bear on the worthwhile values the court sought to uphold.

A primary characteristic of many corporations — particularly those that are large and publicly traded — is the separation of ownership and control.³⁸ While such a structure yields clear benefits for investors,³⁹ it also comes with concomitant "agency costs" — for example, the costs of monitoring an agent's conduct to ensure compliance with the principal's directives — that arise from decoupling the incentives

³³ *Id.* at 961–62.

³⁴ *Id.* at 963 (quoting A.C. Pritchard, O'Melveny & Meyers v. FDIC: *Imputation of Fraud and Optimal Monitoring*, 4 SUP. CT. ECON. REV. 179, 192 (1994–1995)).

³⁵ See NCP Litig. Trust v. KPMG LLP, 901 A.2d 871, 890 (N.J. 2006) (declining to apply imputation to bar claims by a corporation's bankruptcy litigation trust against an outside auditor for negligently failing to uncover fraud committed by the corporation's officers); Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers, LLP, 989 A.2d 313, 335–36 (Pa. 2010) (requiring that, in order for the general rules of imputation and *in pari delicto* to bar claims against an auditor, the auditor must have dealt with the corporation's fraudulent agents in "material good faith," *id.* at 335).

³⁶ See *Kirschner*, 938 N.E.2d at 964 (Ciparick, J., dissenting).

³⁷ *Id.* at 958–59 (majority opinion). Of course, other policy rationales animated the *Kirschner* opinion — primarily, the court noted that its decision both protected the reliance interests of litigants generally via stare decisis, *see id.* at 959, and conserved valuable judicial resources for cases where the plaintiff comes before the court with the proverbial "clean hands," *see id.* at 950. While those factors are certainly relevant to evaluating the ultimate merits of the court's holding, they are beyond the scope of this discussion, which focuses narrowly on the court's policy analysis regarding effective deterrence and its conclusion that, of the possible regimes the court considered, its holding best furthered that objective.

³⁸ See generally Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

³⁹ See, e.g., Daniel F. Spulber, *Discovering the Role of the Firm: The Separation Criterion and Corporate Law*, 6 BERKELEY BUS. L.J. 298, 315 (2009).

of a business's owners from those of its managers.⁴⁰ Although such costs exist in many agency relationships, they are arguably exacerbated in publicly held corporations such as Refco and AIG. The separation of ownership and control is augmented by the presence of innumerable and frequently changing shareholders, some of whom may own as little as a single share of the corporation's stock. Such a scenario is ripe for collective action problems: no one individual may have the incentive — or the ability, for that matter — to absorb the agency costs of adequately monitoring the corporation's employees.⁴¹ And although a corporation's board of directors is charged with protecting shareholder interests, even an active and engaged board likely will not catch every instance of corporate malfeasance, particularly in cases where a certain level of expertise is necessary for such detection.⁴² Thus, in contrast to the *Kirschner* majority's claim, the shareholders and the directors that they elect do not seem particularly well suited to monitor and detect fraud perpetrated by their agents.

Indeed, arguably one of the major reasons that a corporation would contract for the monitoring services of outside professional specialists is to exploit their expertise on issues about which ordinary investors and non-expert directors would otherwise have neither the requisite knowledge nor resources to make an informed judgment.⁴³ This understanding of the auditor's function renders suspect the role of the "critical[]" claim in the *Kirschner* majority's analysis that "principals, rather than third parties, are best-suited to police their chosen agents"⁴⁴ First, the auditor's relative expertise in detecting fraud undercuts the New York Court of Appeals's "least cost avoider" argument because, again, it seems quite unlikely that investors or a board of directors would be able to detect a complex series of fraudulent balance sheet maneuvers such as those perpetrated by Refco management.⁴⁵ Second, the very point of incurring these external monitoring

⁴⁰ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308–09 (1976).

⁴¹ See Cathy A. Gay, Note, *Cenco, Inc. v. Seidman & Seidman: A Futile Attempt to Deter Management Fraud*, 1984 DUKE L.J. 141, 149 (quoting RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 301 (2d ed. 1977)). Of course, such a claim arguably does not hold in situations where the company is closely held, owned primarily by management, or both. Cf. Sharon Tomkins, Note, *Tightening Gatekeeper Liability: Should Officers' and Directors' Wrongdoing Be Imputed to the Corporation in Suits Against Third-Party Professionals?*, 69 S. CAL. L. REV. 1883, 1918–19 (1996).

⁴² See Coffee, *supra* note 3, at 304 ("[I]n most cases, boards cannot detect earnings manipulation in the absence of warnings from their professional gatekeepers.").

⁴³ See, e.g., Mark Klock, *Lessons Learned From Bernard Madoff: Why We Should Partially Privatize the Barney Fife at the SEC*, 42 ARIZ. ST. L.J. 783, 817 (2010) ("Investors do not have full access to the facts themselves, and must rely on . . . assurances given by auditors.").

⁴⁴ *Kirschner*, 938 N.E.2d at 953.

⁴⁵ See Coffee, *supra* note 3.

expenses — aside from compliance with various statutory and regulatory requirements — is to serve the policing function that the majority was so insistent that principal corporations undertake.⁴⁶ Thus, a clearer understanding of the roles and abilities of auditors and investors suggests that the majority's approach — denying recovery by those who took reasonable steps to ensure legal compliance, while immunizing the party that was actually in the position to uncover the information — will likely fail to prevent wrongdoing.

The preceding discussion may appear to suggest that a corporation's investors, while potentially large in number, are largely equivalent to one another vis-à-vis the corporation and its hired outside professionals. Of course, this is not necessarily the case. Hypothetical scenarios wherein three wholly segregated groups — ineffectual shareholders, managerial malfeasants, and asleep-at-the-wheel auditors — all work against each other may not reflect corporate realities. Indeed, while the separation of ownership and control is often viewed as a fundamental marker of the modern corporation, in the age of equity-based executive compensation,⁴⁷ a substantial percentage of a firm's outstanding shares may rest in the hands of those in charge of a firm's day-to-day affairs and corporate policy. Thus, the actual wrongdoers may very well be members of the class seeking recovery against the corporation's allegedly negligent gatekeepers.⁴⁸

In terms of deterrence considerations, lack of segregation between managers and shareholders certainly validates the Court of Appeals's concern that relaxing *in pari delicto* and imputation would require the judiciary to “serve as paymaster of the wages of crime”⁴⁹ by allowing wrongdoing managers to participate in a shareholder recovery. However, this difficulty is not insurmountable: for example, at least one other jurisdiction has ameliorated this concern by permitting an imputation-based *in pari delicto* defense only against those shareholders who either participated in management's fraud or had active or constructive knowledge of it, while allowing all other shareholders to recover to the extent the plaintiffs can prove their claims at trial.⁵⁰ This approach would of course implicate other policy values — for exam-

⁴⁶ See Lauren Colasacco, Note, *Where Were the Accountants? Deepening Insolvency as a Means of Ensuring Accountants' Presence when Corporate Turmoil Materializes*, 78 FORDHAM L. REV. 793, 796 (2009) (noting that the role of accountants is to “monitor, advise, and screen,” as well as to “take steps to prevent managerial fraud from bankrupting companies”).

⁴⁷ See generally Kevin J. Murphy, *Stock-Based Pay in New Economy Firms*, 34 J. ACCT. & ECON. 129 (2003).

⁴⁸ Indeed, in the case of the Refco fraud, chief executive officer Phillip R. Bennett sold some seven million shares of Refco stock for \$146 million following the firm's initial public offering in 2005. See *Kirschner v. KPMG LLP*, 590 F.3d 186, 190 (2d Cir. 2009).

⁴⁹ *Kirschner*, 938 N.E.2d at 950 (quoting *Stone v. Freeman*, 82 N.E.2d 571, 572 (N.Y. 1948)).

⁵⁰ See *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 885–86 (N.J. 2006).

ple, judicial efficiency.⁵¹ However, it nevertheless demonstrates that the majority's concern that allowing any recovery would underdeter wrongdoing is at least theoretically surmountable.

Although *Kirschner*'s analysis of deterrence and incentives betrays a failure to account sufficiently for the relevance of the corporate form, it does not necessarily follow that applying the reasoning suggested herein should compel the court to reach an alternative disposition. Deterrence and incentives are not the only relevant considerations at issue in such cases.⁵² Indeed, a court hearing a case like *Kirschner* could adopt a comprehensive incentives-based analysis and still reach the same legal conclusion as the New York Court of Appeals in light of the policy tradeoffs that likely inhere in any approach. Moreover, alternative legal regimes — ex ante regulation, for example — could be a superior option.⁵³ Nevertheless, a more rigorous understanding of the incentives at work among investors, employees, and third-party gatekeepers would at least provide for clearer, more thorough consideration of the public policy concerns that arise when applying *in pari delicto* and imputation.

⁵¹ See, e.g., *id.* at 886 n.3 (noting that determining the shareholders against whom the defendants could assert an imputation defense would “generally [be] a question of fact” and assessed “on a case-by-case basis”).

⁵² See *supra* note 37.

⁵³ See, e.g., Amy Shapiro, *Who Pays the Auditor Calls the Tune?: Auditing Regulation and Clients' Incentives*, 35 SETON HALL L. REV. 1029, 1085–95 (2005) (arguing in favor of mandatory “financial statement insurance” for auditors).