# In Seminal Decision, New York Court of Appeals Rejects Attempt to Expand Scope of Liability for Professional Service Providers

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On October 21, 2010, the New York Court of Appeals issued a critically important decision that limits the ability of corporations, as well as those who sue standing in their shoes (such as bankruptcy trustees and derivative plaintiffs), to bring claims against professional advisors and other third parties for allegedly assisting or failing to detect wrongdoing that is perpetrated by the corporation's own senior management.[1]

WilmerHale represented the prevailing investment bank defendants in one of two cases that led to the ruling (*Kirschner*), and our partner Phil Anker argued that case before the Court.

***Kirschner v. KPMG LLP* (Refco) and *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP* (AIG)**

The Court's ruling involved appeals in two cases separately certified to the Court for its guidance on questions of New York law:

- *Kirschner v. KMPG LLP*, certified by the U.S. Court of Appeals for the Second Circuit, involved claims brought by the litigation trustee for the bankrupt brokerage firm Refco Inc. against, among others, Refco's former auditor, outside counsel, and three investment banks.[2] The trustee alleged that the defendants had assisted Refco's senior management in perpetrating a scheme that allowed the company to hide its precarious financial condition from the public, but which, when revealed, resulted in the company's bankruptcy.

- *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP*, certified by the Delaware Supreme Court, involved claims brought derivatively on behalf of American International Group (AIG) against AIG's auditor, PricewaterhouseCoopers (PwC).[3] Plaintiffs alleged that PwC had failed to detect a scheme by which senior officers at AIG inflated AIG's publicly reported financial condition, ultimately causing harm to AIG when the scheme came to light.

In *Kirschner*, the district court granted our clients' motion (and those of other third-party defendants) to dismiss the complaint on *in pari delicto* and related grounds, holding that the misconduct of the company's officers was imputed to the company (and to the trustee standing in the company's shoes) and thus barred the action because the company's own principals were at least "of equal fault."[4] On appeal, the Second Circuit certified to the New York Court of Appeals a series of questions concerning the scope and application under New York law of the "adverse interest exception" to the general rule of imputation. Under that exception, an agent's misconduct may not be imputed to his principal if the agent "totally abandoned" the principal's interests. The trustee also asked the New York Court of Appeals to rule that, even if the fraudulent misconduct of Refco's corrupt insiders would otherwise be imputed to Refco and bar the action, the professional defendants, as supposed "gatekeepers," should not be able to assert an *in pari delicto* defense because of their own supposed wrongdoing or even mere negligence. In *Teachers' Retirement System*, the Delaware Supreme Court asked the Court of Appeals whether, under New York law, the doctrine of *in pari delicto* bars a derivative suit where a corporation sues its auditor for failing to detect a fraud committed by the corporation.

**Court Rejects Plaintiffs' Efforts to "Reinterpret New York Law" and Impose Liability on Third-Party Professionals for Misconduct of the Company's Own Management**

In a 4-3 opinion, the Court accepted our clients' arguments and rejected the plaintiffs' effort to "reinterpret New York law" so as "to bring about [an] expansion of third-party liability." On the question of imputation, the Court reaffirmed its holding in *Center v. Hampton Affiliates*[5] that for the adverse interest exception to apply (and thus for a principal to disclaim the acts of its agent), the agent must have "totally abandoned" the principal's interests and have acted "entirely" for his own or another's purpose. This "most narrow of exceptions," the Court held, is reserved for those cases "where the insider's misconduct benefits only himself or a third party; i.e., where the fraud is committed *against* the corporation rather than on its behalf." Moreover, the Court clarified, the dispositive question is not whether the insider intended to benefit himself, but whether the insider's conduct was adverse to the corporation.

The Court also rejected the Refco trustee's argument that, when the insider fraud is revealed and the corporation ends up in bankruptcy, the adverse interest exception automatically applies. "[T]he mere fact that a corporation is forced to file for bankruptcy does not determine whether its agents' conduct was, at the time it was committed, adverse to the company." Moreover, "any harm from the discovery of the fraud—rather than from the fraud itself—does not bear on whether the adverse interest exception applies"; otherwise, the "narrow exception" would apply in almost every case, as "disclosure of corporate fraud nearly always injures the corporation."

The Court declined the plaintiffs' request to carve away at the centuries-old *in pari delicto* doctrine, which "serves important policy purposes." The doctrine, the Court emphasized, "deters illegality" by "denying judicial relief to an admitted wrongdoer," and also "avoids entangling courts in disputes between wrongdoers." The plaintiffs' public-policy arguments did not persuade the majority. As to the plaintiffs' suggestion that it is inequitable to deny recovery to "innocent" stakeholders of Refco and AIG, the Court was "not persuaded [] that the equities are quite so obvious," asking "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?" Nor, the Court reasoned, would "expand[ing] remedies for these or similarly situated plaintiffs [] produce a meaningful additional deterrent to professional misconduct or malpractice," observing that professional service providers already face the risk of liability from suits brought by other constituents such as (in the case of Refco) corporate shareholders. "The speculative public policy benefits advanced by the [plaintiffs]," the Court concluded, "do not, in our view, outweigh the important public policies that undergird our precedents in this area or the importance of maintaining the 'stability and fair measure of certainty which are the prime requisites in any body of law.'"

The dissenting judges did not dispute the majority's analysis of the applicable provisions of agency law, instead arguing that the Court should not have applied those principles "strict[ly]" or "rigid[ly]." But, whatever its dispute with the majority's policy judgments or legal reasoning, the dissent recognized the significance of the Court's decision: "The majority opinion effectively precludes litigation by derivative corporate plaintiffs or litigation trustees to recover against negligent or complicit outside actors."

**The Bottom Line**

As the dissent suggests, this will surely prove to be a seminal decision, greatly reducing the potential for bankruptcy trustees, derivative plaintiffs and others that stand in the shoes of a company to assert claims against third-party professionals for damages resulting from the fraud or other misconduct of the company's own management. It is a counterweight to recent decisions from the highest courts of two other states that can be read, to one degree or another, to allow such plaintiffs more easily to disclaim the misconduct of their own corporate insiders in suits against professional advisors, thereby weakening in those states the *in pari delicto* doctrine.[6] The significance of the New York Court of Appeals' decision will likely be even more magnified, given the importance of New York law, particularly in the commercial context.

[1]*Kirschner v. KPMG LLP*, No. 151 (Oct. 21, 2010), uncorrected opinion available at www.courts.state.ny.us/CTAPPS/decisions/2010/oct10/151-152opn10.pdf.

[2]*Kirschner v. KPMG LLP*, 590 F.3d 186 (2d Cir. 2009).

[3]*In re Am. Int'l Group, Inc.*, 998 A.2d 280 (Del. 2010).

[4]*Kirschner v. Grant Thornton LLP*, 07 Civ. 11604, 2009 WL 1286326 (S.D.N.Y. Apr. 14, 2009) (Lynch, J.).

[5] 66 N.Y. 2d 782 (1985).

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

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