CLEARY GOTTLIEB Alert Memo

NOVEMBER 5, 2010

www.clearygottlieb.com

New York Court of Appeals Reaffirms In Pari Delicto Defense for Outside Professionals

When corporate fraud or other misdeeds are disclosed, investment banks, auditors and other outside professionals are often faced with claims that they allegedly assisted or failed to detect the wrongdoing of the corporation's management. The *in pari delicto* defense, a doctrine under which courts will not intercede to resolve a dispute between two wrongdoers, can provide a strong defense to such claims. In a divided opinion in *Kirschner v. KPMG*,[1] New York's highest court recently reaffirmed its robust interpretation of that doctrine, interpreting narrowly the "adverse interest" exception to application of *in pari delicto*, which renders the defense unavailable where management's wrongdoing was adverse to the interests of the corporation.

Specifically, the Court limited the adverse interest exception to cases where management totally abandons the corporation's interests, as in cases of looting or embezzlement. The Court also rejected arguments that the adverse interest exception should apply if disclosure of the fraud ultimately harmed the corporation, and that the subjective intent of management controls whether the defense applies, focusing instead on the short-term benefits of the wrongdoing for the corporation prior to disclosure. The decision also rejects policy-based arguments for equitable exceptions to the *in pari delicto* defense where outside professionals knowingly colluded with corporate management, discrediting the notion that without such exceptions, outside firms would have insufficient incentives against malfeasance.

Kirschner marks a contrast with recent decisions in a few other states that have eroded the *in pari delicto* doctrine, and ensures that the doctrine will continue to provide outside professionals with a powerful defense under New York law, even at the dismissal motion stage.

The Kirschner and PWC Disputes

The Court's opinion involves appeals from two cases separately certified to the Court on questions of New York law.

[1] Kirschner v. KPMG LLP, No. 151 (N.Y. Oct. 21, 2010), uncorrected opinion available at http://www.nycourts.gov/ctapps/decisions/2010/oct10/151-152opn10.pdf.

© Cleary Gottlieb Steen & Hamilton LLP, 2010. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

First, *Kirschner v. KPMG LLP* arises from the collapse of the bankrupt brokerage Refco Inc. The case was filed in the U.S. District Court for the Southern District of New York by a litigation trust formed by Refco against Refco's former auditor, outside counsel and investment banks, all of whom were alleged to have assisted a management-led fraud that created a falsely positive picture of Refco's financial condition. After that fraud was disclosed, the company ultimately filed for bankruptcy protection. The district court dismissed the claims against the outside professionals on *in pari delicto* grounds, holding that management acts should be imputed to the corporation.[2] On appeal, the U.S. Court of Appeals for the Second Circuit certified several questions to the New York Court of Appeals concerning the scope of New York's adverse interest exception.[3]

Second, *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP* stems from allegations that senior management at American International Group, Inc. ("AIG") fraudulently inflated the company's publicly-reported financials, ultimately damaging AIG when the scheme was disclosed. The case was brought derivatively by shareholders who alleged that AIG's outside auditor was negligent in failing to detect the wrongdoing. The Delaware Chancery Court held that New York's *in pari delicto* doctrine barred the claims, imputing the wrongdoing of management to the corporation (and in turn to its shareholder plaintiffs).[4] On appeal, the Delaware Supreme Court asked the New York Court of Appeals to clarify whether *in pari delicto* bars a derivative suit where a corporation sues its auditor for failure to detect corporate fraud.[5]

The Adverse Interest Exception is Exceedingly Narrow

Most importantly, the Court reaffirmed that under New York law the scope of the "adverse interest" exception to the *in pari delicto* doctrine is very narrow. Under that exception, management's wrongdoing is not imputed to the corporation – and the *in pari delicto* doctrine does not apply – where the relevant officers abandon the interests of the corporation and act for their own interest. While lower courts have differed in applying this exception, *Kirschner* unambiguously reiterates that it applies only where management has acted in "total abandonment" of the company's interests, acting "entirely" for their own or another's benefit. The Court thus held that this exception must be reserved for 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." The decision states that to give any

[2] See Kirschner v. Grant Thornton LLP, No. 07 Civ. 11604(GEL), 2009 WL 1286326 (S.D.N.Y. Apr. 14, 2009).

[3] Kirschner v. Grant Thornton LLP, 590 F.3d 186, 191 (2d Cir. 2009).

[4] In re Am. Int'l Group Inc., 965 A.2d 763 (Del. Ch. 2009).

[5] Teachers' Ret. Sys. of La. v. PricewaterhouseCoopers, LLP, 998 A.2d 280 (Del. 2010).

broader scope to the exception would permit a corporation (or plaintiffs standing in its shoes) to avoid the consequences of corporate acts nearly any time an employee acted to some extent with personal profit in mind, which would vitiate the basic purpose of the doctrine.

Inquiries Into Harm from Disclosure of Fraud, or Subjective Intent of Management Are Irrelevant

Kirschner also rejected plaintiffs' arguments that, where the company ultimately sought bankruptcy protection as a result of the disclosure of the fraud, the adverse interest exception applies as a matter of law. The Court rejected the relevance of this inquiry altogether, holding that "any harm from the discovery of the fraud – rather than the fraud itself – does not bear on whether the adverse interest exception applies." Instead, the inquiry must focus on the consequences of the wrongdoing at the time it was perpetrated, as any contrary rule would allow a corporation to disclaim nearly any act of fraud – even those undertaken to the benefit of the company – as soon as the fraud was discovered and no longer of benefit.

Of arguably greater importance, the Court resolved a growing division among lower courts on the import of the subjective intent of management in determining the application of the adverse interest exception. The Court rejected the view that the *in pari delicto* analysis should turn on the subjective question of whether managers were motivated to any extent in their actions by personal gain. Notably, the Court disagreed with plaintiffs' arguments that the Second Circuit had already endorsed such a view in its 2008 In re CBI decision.[6] Accordingly, in the absence of an inquiry into the subjective intent of management, the *in pari delicto* defense is far more likely to be applied in support of a dismissal motion, thereby sparing defendants the burdens of discovery; indeed, the opinion notes that the availability of the *in pari delicto* defense can continue to be resolved on a motion to dismiss in appropriate cases.

Public Policy Does not Justify Exceptions for "Innocent Successors"

Kirschner also rejects policy-based arguments that, because suits against outside professionals seek to vindicate the rights of innocent unsecured creditors or shareholders, the *in pari delicto* doctrine should not apply to them. The Court found any public policy benefits "speculative," reasoning that insiders are best positioned to police their agents to "ensure that they do not take actions that ultimately do more harm than good." Moreover, the Court was unpersuaded that it was "quite so obvious" that the "interests of innocent stakeholders of corporate fraudsters [should] trump those of innocent stakeholders of outside professionals who are the defendants in these cases." In doing so, the Court expressly declined to adopt exceptions for outside professionals who colluded with fraudulent management.

[6] In re CBI Holding Co., 529 F.3d 432, 438 (2d. Cir. 2008).

In Practice: Implications for Outside Professional Defendants

Kirschner reaffirms the practical availability of the *in pari delicto* defense to auditors, investment banks and other outside professionals faced with damages claims resulting from the wrongdoing of a company's own management. By emphasizing the narrow scope of the adverse interest exception, and eliminating any inquiry into the subjective intent of management, the decision also makes the *in pari delicto* defense more readily susceptible to determination on a dismissal motion, without the need for discovery. Notably, the Court of Appeals' decision parts ways with approaches recently taken by courts in New Jersey and Pennsylvania, which had the effect of limiting or qualifying the *in pari delicto* defense.[7] As the dissent recognized, "the majority opinion effectively precludes litigation by derivative corporate plaintiffs or litigation trustees in order to recover against negligent or complicit outside actors."

* * * * * * * * * * *

Questions concerning the *Kirschner* decision may be addressed to Lindsee P. Granfield or Luke A. Barefoot in the New York office, or any of your other contacts within the Firm.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

[7] See, e.g., NCP Litig. Trust v. KPMG LLP, 187 N.J. 353 (2006) (requiring fact-finder to assess the relative fault of the company and its shareholders in comparison to the outside-professional defendants, as matters of comparative negligence and apportionment); Official Comm. of Unsecured Creditors of Allegheny Health Education & Research Found. v. PricewaterhouseCoopers, LLP, 989 A.2d 313, 339 (Penn. 2010) (requiring an inquiry into whether the outside professional "dealt with the principal in good faith," rendering the *in pari delicto* defense unavailable in cases of collusion with management).

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax