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## New York's Top Court Endorses Broad Scope For *In Pari Delicto* Defense When Outside Professionals Are Sued In Connection With Corporate Frauds

In a much-awaited decision, New York's highest court on October 21, 2010 gave a broad scope to the *in pari delicto* doctrine that is often used as a defense when a company's outside professionals are sued on behalf of the company for their roles in connection with management-led wrongdoing at the company. In a 4-3 ruling in two consolidated cases, *Kirschner v. KPMG LLP* and *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP* (Nos. 151 & 152, Oct. 21, 2010), the New York Court of Appeals— addressing questions certified to it by the U.S. Court of Appeals for the Second Circuit and the Delaware Supreme Court — narrowly confined the circumstances in which the company could invoke the so-called “adverse interest” exception that sometimes can block the *in pari delicto* defense. In so doing, the Court rejected a number of theories that had been embraced by other state and federal courts, both within New York State and without, as a means of limiting the scope of the *in pari delicto* defense. The result is an improved climate for outside professionals who find themselves facing claims arising from management-led frauds.

### **Background: The Nature of the *In Pari Delicto* Defense**

Under the *in pari delicto* doctrine, courts have held that outside professionals working for a company are protected against suits by bankruptcy trustees and other corporate representatives for actions those professionals may have taken in connection with management-led misconduct at the company, such as financial frauds. This defense against liability derives from the notion that misconduct by the company's managers that is within the scope of their employment will normally be imputed to the company, and that therefore a corporate representative should not be able to sue to recover for an alleged wrong that the company itself essentially took part in.

The availability of this defense has always been subject to an important exception, however. If the managers responsible for the wrongdoing at the company had “totally abandoned” the interests of the company in favor of their own personal interests, then the *in pari delicto* defense might not apply. This has been known as the “adverse interest” exception to the *in pari delicto* doctrine.

Particularly in the wake of the many financial fraud scandals and other corporate debacles in recent years, courts and litigants have had to address increasingly aggressive theories for invoking the “adverse interest” exception, as bankruptcy trustees, liquidators and other corporate representatives sought to recover from auditors, law firms, banks and other professionals who worked with corporate management during the time when challenged practices were going on. Courts have been divided on a number of the

issues arising from these theories. In its October 21 decision, New York's top court has now provided answers to many of these contested issues under New York law.

## **Resolving When Management Should Be Deemed Acting with “Adverse Interest” to the Company**

The key question that arises repeatedly in these cases is how to determine when a corporate officer has been acting with “total abandonment” of the company's interests, so as to trigger the “adverse interest” exception and make the *in pari delicto* defense unavailable to the defendant outside professionals. Perhaps most notable in the New York Court of Appeals' decision is that it rejected the view — which some have contended the Second Circuit endorsed just a few years ago — that the analysis should turn solely upon the subjective intent of the corporate managers in question as to whether they were motivated to any extent in their actions by considerations of personal gain.

### **Management's Subjective Intent Is Not Determinative**

The Court explained that using such a subjectively-oriented approach was untenable because:

“A fraud that by its nature will benefit the corporation is not ‘adverse’ to the corporation's interests, even if it was actually motivated by the agent's desire for personal gain. \* \* \* To allow a corporation to avoid the consequences of corporate acts simply because an employee performed them with his personal profit in mind would enable the corporation to disclaim, at its convenience, virtually every act its officers undertake. . . . A corporate insider's personal interests — as an officer, employee, or shareholder of the company — are often deliberately aligned with the corporation's interests by way of, for example, stock options or bonuses, the value of which depends upon the corporation's financial performance.”

Instead, for the exception to apply, the Court said:

“the scheme that benefitted the insider [must have] operated at the corporation's expense. The crucial distinction is between conduct that defrauds the corporation and conduct that defrauds others *for* the corporation's benefit. . . . [W]hen insiders defraud third parties for the corporation, the adverse interest exception is not pertinent.”

### **Corporate Harm in the Long Run Is Likewise Not Determinative**

The Court of Appeals also rejected the notion that the conduct of corporate officers could not be viewed as benefitting the company if, in the long run, it led the company to collapse once that conduct was exposed.

“So long as the corporate wrongdoer's fraudulent conduct enables the business to survive — to attract investors and customers and raise funds for corporate purposes — this [adverse interest] test is not met.”

The Court rejected the suggestion that "bankruptcy is harm enough" and that, whenever the corporation is bankrupt, "it is fair to assume" that the adverse interest exception 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." Indeed, "[e]ven where the insiders' fraud can be said to have caused the company's ultimate bankruptcy, it does not follow that the insiders 'totally abandoned' the company." Similarly:

"any harm from the discovery of the fraud — rather than from the fraud itself — does not bear on whether the adverse interest exception applies. The disclosure of corporate fraud nearly always injures the corporation. If that harm could be taken into account, a corporation would be able to invoke the adverse interest exception and disclaim virtually every corporate fraud — even a fraud undertaken for the corporation's benefit — as soon as it was discovered and no longer helping the company."

#### Exceptions in the Name of Equity or Fairness Are Not Warranted

The Court also rejected suggestions that, like courts have done in New Jersey and Pennsylvania, it should create special exceptions to these principles in corporate fraud cases brought against auditors, or that involve outside professionals who had knowingly colluded with corrupt corporate management. In addition, the Court refused to endorse what has sometimes been termed the "innocent successor" principle, which argues that even if corporate representatives "stand in the shoes of corporate malefactors, any recovery they achieve" nevertheless still should be allowed because it "will, in fact, benefit blameless unsecured creditors . . . and shareholders . . . at the expense of defendants who allegedly assisted the fraud or were negligent," a result that the proponents of this theory claim is called for "in the interests of fairness."

The Court, however, declared itself "not persuaded" that the equities in favor of creating such exceptions "are quite so obvious." It asked, "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 also rejected the suggestion that the *in pari delicto* defense should be treated like a principle of comparative fault, under which it would only mitigate to a degree, but not entirely foreclose, the imposition of liability upon a company's professionals. "It is not evident that expanding the adverse interest exception or loosening imputation principles under New York law would result in any greater disincentive for professional malfeasance or negligence than already exists." To the contrary, taking such an approach "would allow the creditors and shareholders of the company that employs miscreant agents to enjoy the benefit of their misconduct without suffering the harm."

#### Conclusions

The Court's ruling can only be described as pro-defendant in an area of litigation that has proliferated in recent years. The ruling has now swept away a number of the issues surrounding the *in pari delicto* defense on which federal and lower state courts have been divided in recent years, and which had been used to avoid or create uncertainty as to the applicability of the defense.

Notably, the Court rejected certain approaches that would make the defense turn on complex fact issues or complicated equitable calculations, thus making it easier for defendants to obtain *in pari delicto* dismissals at an early pre-discovery stage of litigation — a point that the Court in fact expressly noted in a footnote to its decision. The Court’s rejection of analyzing corporate benefit and harm in hindsight once a company has gone bankrupt also may limit plaintiffs’ ability to defeat *in pari delicto* defenses in bankruptcy contexts by using “deepening insolvency” arguments, *i.e.*, arguments that actions which at first blush seemed to benefit the company should nevertheless be considered detrimental because they ultimately left the company in an even worse position by the time the company finally had to file for bankruptcy.

The Court’s ruling will not be the last word on *in pari delicto* under New York law, as there are still a number of *in pari delicto* issues on which the courts are divided but which were not presented by this recent case. Nevertheless, the ruling should have an immediate effect on how claims and potential claims against outside professionals are viewed, evaluated and litigated when they arise from wrongdoing that was perpetrated by a company’s own management.

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