Nos. 60 and 119

Court of Appeals
of the
State of New York

TEACHERS' RETIREMENT SYSTEM OF LOUISIANA and CITY OF NEW ORLEANS EMPLOYEES' RETIREMENT SYSTEM, derivatively on behalf of Nominal Defendant American International Group, Inc.,

Plaintiffs-Appellants,

—against—

PRICEWATERHOUSECOOPERS LLP,

Defendant-Respondent.

MARC S. KIRSCHNER, as TRUSTEE OF THE REFCO LITIGATION TRUST,

Plaintiff-Appellant,

—against—

KPMG LLP, GRANT THORNTON LLP, MAYER BROWN LLP, INGRAM MICRO INC., CIM VENTURES INC., WILLIAM T. PIGOTT, MAYER BROWN INTERNATIONAL LLP, PRICEWATERHOUSECOOPERS LLP, LIBERTY CORNER CAPITAL STRATEGIES, LLC, BANC OF AMERICA SECURITIES, LLC, CREDIT SUISSE SECURITIES (USA) LLC, DEUTSCHE BANK SECURITIES, INC.,

Defendants-Respondents,

BECKENHAM TRADING COMPANY, INC., ANDREW KRIEGER, ERNST & YOUNG LLP, TONE N. GRANT, ROBERT C. TROSTEN, REFCO GROUP HOLDINGS, INC., PHILLIP R. BENNETT, SANTO C. MAGGIO, EMF FINANCIAL PRODUCTS, DELTA FLYER FUND, LLC, and ERIC M. FLANAGAN,

Defendants.

ON QUESTIONS CERTIFIED BY
THE U.S. COURT OF APPEALS FOR THE SECOND CIRCUIT
AND THE SUPREME COURT OF THE STATE OF DELAWARE

BRIEF OF *AMICUS CURIAE* THE CENTER FOR AUDIT QUALITY IN SUPPORT OF DEFENDANTS-RESPONDENTS

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DISCLOSURE STATEMENT

Amicus Curiae The Center for Audit Quality is not organized as a corporation and has no parent corporation or subsidiaries. It is affiliated with the American Institute of Certified Public Accountants and has approximately 750 U.S. public company accounting firms as members.

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The Center for Audit Quality respectfully submits this brief as *amicus curiae*, pursuant to Rule 500.23, in support of Grant Thornton LLP, KPMG LLP, and PricewaterhouseCoopers LLP, (collectively "Respondents").

INTEREST OF THE CENTER FOR AUDIT QUALITY AS *AMICUS CURIAE*

The Center for Audit Quality ("CAQ") is a public policy organization that seeks to aid investors and the capital markets by advancing constructive suggestions for change rooted in the audit and accounting profession's core values of integrity, objectivity, honesty, and trust. Any U.S. accounting firm registered with the Public Company Accounting Oversight Board may join the CAQ. The CAQ is affiliated with the American Institute of Certified Public Accountants ("AICPA"), and has approximately 750 U.S. public company accounting firms as members (including Respondents), representing tens of thousands of professionals dedicated to audit quality.

The CAQ seeks to improve the reliability of public company audits and to enhance their relevance for investors, particularly in this time of growing financial complexity and globalization. The CAQ is dedicated to helping increase public confidence in the auditing process and to maintaining high standards in the accounting profession. To fulfill its mission, the CAQ offers recommendations to policymakers, issues technical support for public company auditing professionals, and participates in the public discussion about financial reporting. For example,

among many other activities, in the last year alone, the CAQ has filed *amicus* briefs in cases concerning the constitutionality of the Public Company Accounting Oversight Board ("PCAOB"), the distinction between primary and secondary liability under Section 10(b) of the Securities Exchange Act of 1934, and the confidentiality of documents, communications and information regarding or relating to a PCAOB inspection.[1]

Accordingly, the CAQ has a keen interest in cases, such as this one, concerning legal rules that affect auditors and the audit process, and their broader impact on investors and the capital markets.

BACKGROUND

This Court has accepted certification of related questions of law in two separate cases. In both cases, the Court will answer important questions affecting whether the *in pari delicto* doctrine bars claims brought by or on behalf of a corporation against its auditor.

1. *Teachers' Retirement System of Louisiana, et al. v. PricewaterhouseCoopers LLP*. In this case, shareholder plaintiffs ("Derivative Plaintiffs") filed a derivative action purportedly on behalf of American International Group, Inc. ("AIG") in the Delaware Court of Chancery, claiming

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[1] *See Free Enter. Fund v. PCAOB*, No. 08-861 (U.S.) (filed Oct. 20, 2009); *SEC v. Tambone*, No. 07-1384 (1st Cir.) (filed Sept. 30, 2009); *Silverman v. Motorola, Inc.*, 1:07-cv-04507 (N.D. Ill.) (filed May 12, 2010).

that AIG incurred damages as a result of errors in its financial statements. Derivative Plaintiffs allege that AIG's financial misstatements, which overstated the company's value by billions of dollars, resulted from the intentional misconduct of AIG's top managers ("AIG Insiders"). They also claim that AIG's auditor is liable to AIG because it failed to perform its audits in accordance with professional standards and was negligent under New York law in failing to uncover AIG's fraud.

Applying New York law, the Chancery Court held that the claims against the audit firm were barred under the doctrine of *in pari delicto*, which "bars one tortfeasor from suing another tortfeasor for harm the first tortfeasor suffered because of their joint wrongdoing." *Am. Int'l Group, Inc. v. Greenberg*, C.A. No. 769-VCS, slip op. at 92 (Del. Ch. Feb. 10, 2009). The court held that the claims were also barred by the related "*Wagoner*" rule, which provides that a corporation lacks standing to assert "'[a] claim against a third party for defrauding [the] corporation with the cooperation of management.'" *Id*. at 94 (quoting *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 120 (2d Cir. 1991) (applying New York law)). The Chancery Court concluded that the alleged wrongful acts of the AIG Insiders were properly imputed to AIG. *Id.* at 100.

The court also rejected Derivative Plaintiffs' argument that those acts fall within the "adverse interest exception" to imputation, which provides that

companies are not responsible for the acts of their employees in certain limited circumstances in which the employees have abandoned the interests of their companies. Adhering to New York law, the court held that the adverse-interest exception was inapplicable because AIG Insiders did not "totally abandon" AIG's interests. *Id.* at 98-100.

On appeal, the Supreme Court of Delaware certified the following question to this Court:

> Would the doctrine of *in pari delicto* bar a derivative claim under New York law where a corporation sues its outside auditor for professional malpractice or negligence 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 of the corporation's financial statements?

As explained below, the correct answer to this question is "yes."

2. *Kirschner v. KPMG LLP.* In this case, Refco, Inc. and certain of its direct and indirect subsidiaries (collectively, "Refco") filed for bankruptcy following the public disclosure of a fraudulent scheme in which Refco's insiders artificially enhanced Refco's financial performance and concealed its true financial condition. Marc Kirschner, as Trustee of the Refco Litigation Trust ("Trustee"), filed suit in United States District Court for the Southern District of New York against several third-party professionals, including Refco's auditor. The Trustee asserted numerous claims under New York law, including aiding and abetting

fraud, aiding and abetting breach of fiduciary duty, breach of fiduciary duty, malpractice, and negligent misrepresentation. The claims arise from the fraud of Refco's agents, including repeated misrepresentations about Refco's financial condition and fraudulent solicitation of billions of dollars in new capital from its lenders and investors.

The district court granted the third-party defendants' motions to dismiss, holding that the Trustee lacks standing under the *Wagoner* rule because the Trustee was asserting claims based on misconduct by Refco's controlling managers. Because Refco received substantial benefits from the actions of those managers, the court also rejected the Trustee's argument that the narrow "adverse interest exception" to the *Wagoner* rule should apply. *Kirschner v. KPMG LLP*, No. 08-Civ.-8784, 2009 WL 1010060, at *1 (S.D.N.Y. Apr. 14, 2009).

On appeal, the United States Court of Appeals for the Second Circuit certified numerous questions of New York law to this Court, the following of which are addressed in this brief:

> (2) whether the adverse interest exception is satisfied by showing that the insiders intended to benefit themselves by their conduct; [and]
>
> (7) whether the exception is precluded where the misconduct conferred some benefit upon the corporation.[2]

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[2] The Second Circuit certified additional questions, as set forth in the parties' briefs. *See, e.g.*, Kirschner Op. Br. 4-5.

As explained below, the correct answers to these related questions are "no" and "yes," respectively.

SUMMARY OF ARGUMENT

The doctrine of *in pari delicto* bars a plaintiff from obtaining damages from a defendant when the plaintiff is equally at fault for the harms underlying the claims. The doctrine also applies to bar claims brought by or on behalf of a corporation when the corporation is at fault for the underlying claim due to the actions of its employees. Under settled agency principles of imputation, the wrongdoing of a corporation's employees is attributed to the corporation when the employees act within the scope of their employment.

The doctrine of *in pari delicto* and related imputation principles are of exceptional importance to the auditing profession, which must rely on the integrity of the management of public companies as part of the audit process, and which is frequently targeted in lawsuits when those companies incur losses.

In keeping with the principles of *stare decisis*, this Court should adhere to its well-established precedent, which recognizes only one exception to imputation—the adverse interest exception. The exception is a narrow one, and this Court has ruled that it applies only when the agent-employee has *totally abandoned* the corporation's interests.

Appellants, apparently recognizing that their suits cannot succeed under New York law, urge this Court to adopt a number of new exceptions to the imputation principle that would limit the availability of the *in pari delicto* defense against corporations engaged in misconduct (and other plaintiffs suing on behalf of those corporations). Their proposal to expand the adverse interest exception beyond the established boundaries of New York law—thus increasing liability for auditors—would not serve the public interest. First, applying a broad adverse interest exception based on management's "subjective intent" would encourage abusive litigation and burden courts. Second, broadening the adverse interest exception would reduce the incentive of public companies' owners and boards of directors to select honest management and to delegate duties with care. Third, broadening the adverse interest exception would not punish wrongdoers, compensate innocent parties, or improve deterrence of auditor misconduct. Fourth, expanding auditor liability would give rise to serious systemic risks that could impact the sustainability of the auditing profession and erode the competitiveness of the U.S. capital markets.

Accordingly, Appellants' attempts to curtail imputation, weaken the *in pari delicto* doctrine, and expand auditor liability should be rejected.

ARGUMENT

I. Under Settled Law, A Company May Not Sue Its Auditor For Claims Arising From The Company's Wrongdoing

A. The *In Pari Delicto* Doctrine Correctly Bars Claims By Plaintiffs Who Are At Fault For The Alleged Wrong

The doctrine of *in pari delicto* precludes a plaintiff from obtaining damages from an alleged wrongdoer when the plaintiff itself is at least equally at fault for the wrongs underlying the claims. *See Bullmore v. Ernst & Young Cayman Islands*, 20 Misc. 3d 667, 670 (N.Y. Sup. Ct. 2008). The related *Wagoner* rule holds that a bankruptcy trustee lacks standing to assert a claim against a third party where the misconduct at issue occurred with the cooperation of the company's management. *Wagoner*, 944 F.2d at 120.[3]

Appellants erroneously contend that the *in pari delicto* doctrine was replaced by comparative negligence as a result of the enactment of N.Y. C.P.L.R. § 1411 ("comparative negligence statute") in 1975. Kirschner Op. Br. 95-98; TRSLA Op.

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[3] Appellants now contend that *Wagoner* "is not and never has been New York law." Kirschner Op. Br. 4. In fact, *Wagoner* has been approvingly cited and applied by New York courts repeatedly. *See, e.g.*, *Buechner v. Avery*, 38 A.D.3d 443, 443-44 (1st Dep't 2007). If this Court accepts Appellants' apparently belated invitation to review the *Wagoner* rule now (*but see* KPMG Br. 65-68), it should affirm it. The standing doctrine provides an essential tool for screening out claims for which there can be no redress. The need for a screening mechanism is amplified in the context of actions by bankruptcy trustees, who are insensitive to, if not immune from, litigation costs and have incentives to pursue even the weakest claims tenaciously. *See, e.g.*, *Maxwell v. KPMG LLP*, 520 F.3d 713, 718 (7th Cir. 2008) ("Judges must . . . be vigilant in policing the litigation judgment exercised by trustees in bankruptcy" because "the trustee of a defunct business has little to do besides filing claims that if resisted he may decide to sue to enforce.").

Br. 17-21. The comparative negligence statute provides that a plaintiff's culpable conduct does not bar recovery of damages, but that the damages are reduced in proportion to the plaintiff's fault. N.Y. C.P.L.R. § 1411.

This Court has made clear, however, that the comparative negligence statute "has no application" when a plaintiff seeks to "recover[] for injuries sustained as a direct result of his own illegal conduct." *Barker v. Kallash*, 63 N.Y.2d 19, 28 (1984); *see also id.* at 24-25, 29 (recognizing that this principle applies generally, beyond the risk of physical injury). Indeed, it has been the settled law of New York for more than a century that "[n]o one shall be permitted to profit by his own fraud, or to take advantage of his own wrong, or to found any claim upon his own iniquity, or to acquire property by his own crime." *Riggs v. Palmer*, 115 N.Y. 506, 511 (1889); *see also Long Island Sav. Bank, FSB v. Bigman*, No. CV-89-0927, 1991 WL 144224, at *6 (E.D.N.Y. June 25, 1991).[4] Although the comparative negligence statute superseded the common law rule that contributory negligence bars a plaintiff's claim completely, it did not disturb the longstanding doctrine of *in pari delicto*, which bars the claims of a plaintiff who is equally at fault in the

[4] Appellants' reliance on *Alami v. Volkswagen of America, Inc.*, 97 N.Y.2d 281 (2002), is misplaced. Kirschner Reply Br. 51. Even after the enactment of the comparative negligence statute, this Court has squarely held that "the courts will not entertain the suit" if the alleged injuries "were the *direct result* of" the plaintiff's serious violations of law. *Barker*, 63 N.Y.2d at 24 (emphasis added). The plaintiff in *Alami* alleged that her husband's injuries were the direct result of a defect in his automobile, not of his intoxication. 97 N.Y.2d at 286. In these cases, by contrast, Appellants assert that the corporations' alleged injuries resulted directly from the revelation of their own agents' fraud.

alleged wrongdoing as a result of its own illegal conduct and might otherwise benefit from that conduct. As this Court explained, the *in pari delicto* doctrine "has always existed independently from the rule of contributory negligence and its successor, comparative negligence." *Barker*, 63 N.Y.2d at 29. "The policy on which [the *in pari delicto* doctrine] rests has not diminished with time," and has not been affected by the comparative negligence statute. *Id*.

The Derivative Plaintiffs further attempt to evade the *in pari delicto* defense by arguing that auditors may invoke the defense only if they "served as co-conspirators or accomplices in the same alleged wrongdoing." TRSLA Op. Br. 13. This argument is contrary to logic. If this argument were accepted, the *in pari delicto* defense would be available to auditors who actually conspired to engage in fraud, but not those who were negligent in failing to uncover it. That is not and should not be the law of New York.

Moreover, the Second Circuit has rejected this precise argument that a plaintiff may evade the *in pari delicto* doctrine by attempting to make fine distinctions between the alleged wrongs committed by the plaintiff and defendant. *See Peltz v. SHB Commodities, Inc.*, 115 F.3d 1082, 1090-91 (2d Cir. 1997). In *Peltz*, the plaintiff argued that the *in pari delicto* doctrine did not apply because his participation in a market manipulation was not the same wrongdoing as defendant's alleged violation of the Commodities Exchange Act. The court

disagreed, explaining that the plaintiff's "hypertechnical interpretation of the *in pari delicto* doctrine is outdated" and that "although the alleged violation[s]" were of a "different quality . . . *the lack of an identical nature does not destroy the [in pari delicto] defense*." *Id.* (emphasis added).

Tellingly, the position taken by the Refco Trustee is exactly opposite of that taken by the Derivative Plaintiffs: that knowing participation in the company's misconduct bars the *in pari delicto* defense. Kirschner Op. Br. 84. The Refco Trustee invites this Court to adopt a version of the Pennsylvania Supreme Court's novel rule that an agent's misconduct is not imputed to its principal when the *third-party* defendant knowingly participated or acquiesced in the corporation's fraud. *See Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers, LLP*, 989 A.2d 313, 336-38 (Pa. 2010) ("*AHERF*").

That rule, however, is at odds with New York law, which recognizes that the *in pari delicto* defense applies even when a third party participated in the alleged wrongdoing so long as the plaintiff is at least "equally at fault." *Bullmore*, 20 Misc. 3d at 670. That doctrine is firmly rooted in two important public policy rationales: (1) "that courts should not lend their good offices to mediating disputes among wrongdoers;" and (2) "that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality." *Bateman Eichler, Hill Richards, Inc.*

v. Berner, 472 U.S. 299, 306 (1985). Appellants have presented no justification for rewriting New York law in contravention of these important policy considerations.[5]

Where, as here, the corporations on whose behalf the claims are asserted are alleged by Appellants themselves to have engaged in *fraudulent* conduct that benefits those corporations, the corporations will always be at least equally at fault with their auditors—and at far greater fault than auditors who have been sued only for negligence. *See, e.g.*, *Terlecky v. Hurd* (*In re Dublin Sec., Inc.*), 133 F.3d 377, 380 (6th Cir. 1997) (wherever the plaintiffs or their agents intentionally defrauded the company's investors, the plaintiffs will be at least as culpable as any third-party defendant). Therefore, the *in pari delicto* defense necessarily applies.[6]

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[5] The *AHERF* decision also misconstrues settled principles of agency law. Whether an agent's knowledge or conduct is imputed to its principal turns entirely on the relationship between the principal and agent; the conduct or intent of third parties is, and should be, irrelevant. *See* Section I.B, below; *see also* KPMG Br. 85-86.

[6] This Court should not follow the New Jersey Supreme Court's decision in *NCP Litigation Trust v. KPMG LLP*, 901 A.2d 871 (N.J. 2006), which held that the "imputation doctrine does not prevent corporate shareholders from seeking to recover" from a negligent auditor. *Id.* at 890. Courts in New York and elsewhere have consistently held that the *in pari delicto* doctrine bars negligence claims against outside professionals based on the fraudulent schemes of their client company. *See, e.g.*, *Bullmore*, 20 Misc. 3d at 670-71. Moreover, it is significant that the *AHERF* decision, on which Appellants otherwise rely, recognized that the *in pari delicto* defense is available in the negligent auditor context. *AHERF*, 989 A.2d at 335-36; *accord, e.g.*, *Miller v. Ernst & Young*, 938 S.W.2d 313, 316 (Mo. Ct. App. 1997); *Seidman & Seidman v. Gee*, 625 So. 2d 1, 3 (Fla. Dist. Ct. App. 1992).

B. This Court's Rule That Corporate Agents' Actions Are Imputed To The Corporation Is Both Logical And Workable

Agency principles of imputation refer "to the attribution of one person's wrongdoing to another person." *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 355 (3d Cir. 2001). "If wrongdoing is imputed, then the *in pari delicto* doctrine comes into play and bars a suit." *Id.* This Court has long recognized that the actions of a corporation's agents are imputed to the corporation under general principles of agency law. Those principles recognize that "[a] legal entity . . . necessarily functions through human actors—its officers, agents and employees—whose knowledge and conduct may be imputed to the entity under the doctrine of respondeat superior." *Prudential-Bache Sec., Inc. v. Citibank, N.A.*, 73 N.Y.2d 263, 276 (1989). Thus, "knowledge acquired by an agent acting within the scope of his agency is imputed to his principal and the latter is bound by such knowledge although the information is never actually communicated to it." *Ctr. v. Hampton Affiliates, Inc.*, 66 N.Y.2d 782, 784 (1985). This principle is based on the "presumption that an agent [will normally] discharge . . . his duty to disclose to his principal all the material facts coming to his knowledge with reference to the subject of his agency," and therefore any misconduct engaged in by an agent occurs—at a minimum—with his corporation's tacit consent. *Id*. (internal quotation marks omitted). "Imputation creates

incentives for a principal to choose agents carefully and to use care in delegating functions to them." Restatement (Third) of Agency § 5.03 cmt. b (2006).

This Court has recognized only one exception to the rule of imputation—the adverse interest exception. The adverse interest exception applies only when "the agent [has] *totally abandoned* his principal's interests and [is] acting *entirely* for his own or another's purposes." *Hampton Affiliates, Inc.*, 66 N.Y.2d at 784-85 (emphases added). Courts apply an objective test to determine whether an agent has totally abandoned the interests of his or her company: "[W]here a corporation benefits *to any extent* from the alleged wrongful acts of its agents, the agents cannot be said to have 'totally' abandoned the corporation's interests." *Bullmore*, 20 Misc. 3d at 67 (emphasis added).

The total abandonment test allows courts to determine the applicability of the adverse interest exception, and therefore the *in pari delicto* defense, at the pleadings stage. For example, in *546-522 W. 146th St. LLC v. Arfa*, 54 A.D.3d 543 (1st Dep't 2008), the court dismissed the plaintiffs' claims based on the "content of the pleading," explaining that the complaint did not allege that the agents had totally abandoned the company's interests because the agents' wrongdoing accomplished the company's main business purpose and did not merely prolong its existence. *Id.* at 544; *see also Symbol Techs., Inc. v. Deloitte & Touche, LLP*, No. 33150/2006, 2008 WL 4103244 (N.Y. Sup. Ct. June 16, 2008) (holding that the

adverse interest exception did not apply and granting defendant auditor's motion to dismiss); *Baena v. KPMG LLP*, 453 F.3d 1, 9 (1st Cir. 2006) (affirming dismissal based on the *in pari delicto* doctrine); *In re Mediators, Inc.*, 105 F.3d 822, 826 (2d Cir. 1997) (affirming dismissal based on *Wagoner* rule); *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P.*, 212 B.R. 34, 36 (S.D.N.Y. 1997) (dismissing under the *Wagoner* rule based on the "allegation[s] in the Complaint"). By looking at whether the corporation benefited from the agent's actions, courts can determine whether the adverse interest exception applies based on the pleadings without subjecting potentially innocent parties to protracted and costly discovery and the *in terrorem* effect of unmeritorious claims.

Accordingly, the answer to "whether the [adverse interest] exception is precluded where the [agent's] misconduct conferred some benefit upon the corporation" is *yes*. (Certified Question 7, *Kirschner v. KPMG*).

Under New York's test, imputation would apply in both of the pending cases because Refco and AIG benefited from their insiders' misconduct. That is the end of the inquiry.

Appellants ask the Court to depart from the "total abandonment" test in favor of a subjective, intent-based test that can never be applied before trial. *E.g.*, Kirschner Op. Br. 53-58. This Court has ruled, however, that the adverse interest exception "cannot be invoked merely because [the agent] has a conflict of interest

or because he is not acting primarily for his principal." *Hampton Affiliates, Inc.*, 66 N.Y.2d at 785; *see also Farr v. Newman*, 14 N.Y.2d 183, 190 (1964) ("A conflict of interest does not avoid the imputation of knowledge."); *In re Crazy Eddie Sec. Litig.*, 802 F. Supp. 804, 817 (E.D.N.Y. 1992) ("Th[e] 'adverse interest' exception is not applicable when the agent acts both for himself and for the principal, though his primary interest is inimical to the principal."). Appellants' proposed test is thus foreclosed by settled law, and the answer to "whether the adverse interest exception is satisfied by showing that the insiders intended to benefit themselves by their conduct" is a clear-cut *no*. (Certified Question 2, *Kirschner v. KPMG*).[7]

New York is not alone in following such a rule. Numerous cases throughout the country hold a principal responsible for misconduct from which it has actually benefited, even if the agent's subjective motivation may be adverse to the principal. *See, e.g., FDIC v. Shrader & York*, 991 F.2d 216, 223-24 (5th Cir. 1993) ("[K]nowledge is imputed in a case of 'joint' interests *even though the agent's primary interest is inimical* to that of the principal.") (emphasis added);

[7] Even if this Court departed from the objective test, there remains serious doubt whether the culpable insiders' "subjective motivation" was adverse to their respective companies. The absence of such adverse motivation would compel imputation even under a subjective test. Although the outcome would be the same under either test in *these* cases, this Court should nonetheless reaffirm that the subjective test is not the law of New York. *See also* Section II.B, below.

Beck v. Deloitte & Touche, 144 F.3d 732, 736 (11th Cir. 1998) (Florida law does not impute an officer's misconduct when his actions "neither [are] intended to benefit the corporation, *nor actually cause short- or long-term benefit* to the corporation") (emphasis added); *Bock v. Am. Growth Fund Sponsors, Inc.*, 904 P.2d 1381, 1385 (Colo. App. 1995) (the adverse interest exception "is not triggered where the individual is also acting for the principal's benefit, even though the agent's primary interest is inimical to that of the principal"); *Mid-Continent Paper Converters, Inc. v. Brady, Ware & Schoenfeld, Inc.*, 715 N.E.2d 906, 911 (Ind. Ct. App. 1999) (same) (citing *In re Crazy Eddie Sec. Litig.*, 802 F. Supp. at 817).

II. Appellants' Efforts To Craft Novel Exceptions To Imputation Are Unsupported By Law And Contrary To The Public Interest

Recognizing that they cannot prevail under controlling New York precedent, Appellants ask this Court to rewrite the law to expand the adverse interest exception. However, that exception has repeatedly been described as *narrow*, consistent with this Court's recognition that the *in pari delicto* doctrine involves "fundamental concepts of morality and fair dealing *not to be weakened by exceptions*." *McConnell v. Commonwealth Pictures Corp.*, 7 N.Y.2d 465, 470 (1960) (emphasis added). Therefore, this Court should reject Appellants' invitation to upset the settled law of New York in favor of the principles of *stare decisis* and the public policy interests in which this Court's precedents are grounded.

A. This Court Should Uphold Its Precedent To Promote The Predictable And Consistent Development Of The Law

The doctrine of *stare decisis* represents "the obligation of courts to adhere to the results of decided cases and to refrain from disturbing general principles which have been established by judicial determination." *In re Estate of Herle*, 165 Misc. 46, 49 (N.Y. Sur. Ct. 1937). It is well settled that "*[s]tare decisis* is the preferred course because it promotes the evenhanded, predictable, and consistent development of legal principles, fosters reliance on judicial decisions, and contributes to the actual and perceived integrity of the judicial process." *People v. Taylor*, 9 N.Y.3d 129, 148 (2007) (quoting *Payne v. Tennessee,* 501 U.S. 808, 827 (1991)) (alteration in original).

This Court therefore departs from its precedent only in "exceptional cases." *Taylor*, 9 N.Y.3d at 149 (internal quotation marks omitted). Among the factors this Court considers when deciding whether to overrule precedent are: (1) "the nature of the rights and interests at stake"; (2) "the extent and degree to which action may justifiably have been taken in reliance on the precedent"; and (3) the "relative ease or difficulty of modification or change in the precedent." *Higby v. Mahoney*, 48 N.Y.2d 15, 18 (1979). This Court also considers the source of the rule of law. It is typically more willing to revisit constitutional issues "because of the very great difficulty of effecting change by constitutional amendment" through

the legislative process. *Id.* On the other hand, this Court is less likely to overrule common law rules when "change by legislative action is available." *Id.* at 19.

None of these factors weighs in favor of departing from this Court's precedent here. The purported rights at stake are claims by a *culpable* party, and particularly one that is (at least) equally at fault for the wrongdoing it alleges. The policies underlying the *in pari delicto* doctrine make clear that these rights do not hold a favored position in the law. Furthermore, auditors necessarily rely heavily on the existing rule of law, including principles of agency by which the representations of management are imputed to their company, in order to perform audits and other professional services of value to investors. Changing those principles under the law of the Nation's foremost economic center would have a dramatic and immediate impact on countless public companies and their relationships with their auditors, and would have other, far-reaching effects on the law of agency beyond the context of auditor liability and the *in pari delicto* doctrine. Finally, this case raises no issue of constitutional law, but rather addresses the common law of imputation—the very sort of law this Court

expressed special hesitancy to overturn. *Id.*[8] Appellants have therefore presented no basis to justify an exceptional departure from precedent here.

Furthermore, as explained below, the legal innovations Appellants propose would disserve the public policy interests on which that precedent was based. Maintaining consistency in the law is particularly important here, where a departure would pose undue risks to a profession that performs a vital public function. Therefore, this Court should adhere to its precedent, which has recognized for more than twenty-five years that the bright-line "total abandonment" test is the *only* exception to imputation.

B. The Proposed "Subjective Intent" Test For Imputation Would Encourage Abusive Litigation And Burden Courts

Appellants do not attempt to conceal their motive in seeking to change established New York law: they admit that their proposed "subjective intent" test for the adverse interest exception is designed to preclude defendants from ever prevailing at the pleadings stage. *See, e.g.*, Kirschner Op. Br. 54 ("[T]he adverse interest exception cannot and should not be decided before trial."). Thus, Appellants seek to establish a new rule under which auditors are likely to be ensnared in lawsuits every time a company incurs losses after errors in its financial

[8] This Court is similarly reluctant to revisit its interpretations of statutes. *See Higby*, 48 N.Y.2d at 19. For that reason, the Court should not disturb its interpretation of N.Y. C.P.L.R. § 1411 as having "no application" when a plaintiff seeks to "recover[] for injuries sustained as a direct result of his own illegal conduct." *Barker*, 63 N.Y.2d at 28; *see also* Section I.A.

statements are revealed, even where the complaint is brought by a party standing in the shoes of the corporation and where it alleges that those errors resulted from the fraud of the corporation's management. In every such case, tactical pleading would create an unduly high barrier for dismissal; the plaintiff invariably could—and would—seek to allege that the agents of the faltering company engaged in misconduct for subjectively selfish reasons. Therefore, in each of the multitude of such lawsuits, the auditor—however innocent and careful it had been, and however deceptive the management of its client had been—could be propelled into costly, distracting and ultimately meritless litigation. Without a predictable, objective test that could screen out meritless claims at the pleadings stage (such as the test that now controls under New York law), auditors would face two options: pay a ransom to settle or commit to a vigorous defense, which often requires protracted discovery. The latter option would come at great expense to auditors and consume precious judicial resources, even in cases that lack merit.

State law claims against auditors could be artfully pleaded to circumvent the deliberate limitations on liability that exist under the federal securities laws. Abusive litigation, along with the resulting concern that innocent defendants would be coerced into settlements, have prompted repeated reforms to the federal securities laws. *See* H.R. Rep. No. 105-803, at 13 (1998) (Conf. Rep.) (explaining that the Securities Litigation Uniform Standards Act of 1998 was "designed" to

reduce "'strike' suits" filed "to extract a sizeable settlement from companies that are forced to settle, regardless of the lack of merits of the suit"); H.R. Rep. No. 104-369, at 31 (1995) (explaining that Private Securities Litigation Reform Act of 1995 was prompted, in part, by "the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle"). Although private claims for aiding and abetting violations of the federal securities laws are forbidden because of concerns regarding abusive litigation, *see* H.R. Rep. No. 104-369, at 31, plaintiffs could repackage similar allegations as derivative claims for professional malpractice that enabled (or in effect, *aided*) the commission of securities fraud by officers of a public company.[9] If New York law is revised to arm plaintiffs with a new arsenal of derivative claims that are increasingly difficult to dismiss at the pleadings stage, then plaintiffs will plead around the efforts of the United States Congress to curb the abusive "targeting of deep pocket defendants, including accountants . . . without regard to their actual culpability." *Id.* This Court should not overturn its precedent to allow such circumvention of federal policy.

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[9] Indeed, counsel for the Refco Trustee recently stated in an interview with *The American Lawyer* that they are "trying to change rules of agency and tort law by which professional service providers that aid and abet financial fraud at companies that go bankrupt can be held liable. That's making policy." Michael D. Goldhaber, *What's In a Name?*, The American Lawyer, Spring 2010, at 62.

C. Eroding The Imputation Doctrine Would Reduce The Incentive Of Boards Of Directors To Oversee Management

Limiting the responsibility of companies for the actions of their employees also would have the undesirable effect of *reducing* the incentive of the board of directors—the duly selected representatives of shareholders, charged with the governance of the entity—to police and deter fraud. *See Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 455 (7th Cir. 1982) ("But if the owners of the corrupt enterprise are allowed to shift the costs of its wrongdoing entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced."). The board, in its oversight role, appoints, supervises, and can replace management. Just as "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality," *Berner*, 472 U.S. at 306, it is also an effective means of encouraging the responsible selection and oversight of management. *See* Restatement (Third) of Agency § 5.03 cmt. b (2006).

Management, in turn, is better equipped to prevent fraud than outside auditors because it generates and prepares the financial statement information that is the starting point for any audit. Thus, management is primarily responsible for its own financial statements, as well as any misstatements. "According to existing auditing standards and SEC rules, management prepares and has the primary responsibility for the accuracy of financial statements and for prevention and identification of fraud and the auditor's role is to provide reasonable assurance that

the financial statements are free of material misstatement." Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of Treasury ("Final Report") VII:15 (2008); *see also* Statement on Auditing Standards No. 99 ("SAS 99"), Codification of Statements on Auditing Standards AU § 314.04 ("it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud"). Indeed, "[t]he responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management, starting with the chief executive officers, sets the tone and establishes the financial reporting environment." Report of the National Commission On Fraudulent Financial Reporting (Oct. 1987), *cited in* SAS 99 (AU § 316.04).

Appellants attempt to shift primary responsibility for a company's financial statements from the company itself to the auditor. But the very standards that Appellants cite for the proposition that auditors have an "affirmative obligation . . . to detect fraudulent acts" (TRSLA Op. Br. 39) provide that "because of the characteristics of illegal acts [such as fraud], an audit made in accordance with generally accepted auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed." Statement on Auditing Standards No. 54 ("SAS 54"), Codification of Statements on Auditing Standards AU § 317.07. These standards make clear that auditors

cannot be expected to detect all of the errors that may arise when a company's management defies its obligation to work with its auditors honestly and lawfully.

Reducing the incentive for boards of directors to oversee management responsibly would be detrimental to audit quality and to the interests of investors more generally.

D. Broadening The Adverse Interest Exception Would Not Punish Wrongdoers, Compensate Innocent Parties, Or Improve Deterrence Of Auditor Misconduct

Expanding auditor liability to an audit client by broadening the adverse interest exception would, in many cases, impose extensive liability on well-intentioned auditors who were lied to by their own clients. Such liability would not serve the policy purpose of punishing wrongdoers. To the contrary, it would enable wrongdoers to avoid the negative consequences of their wrongdoing by shifting the costs to third parties.

That an audit has failed to detect fraud does not mean that the auditors have departed from the requisite standard of care, much less that they have done so intentionally or collusively. Indeed, the Advisory Committee on the Auditing Profession to the Department of Treasury has recognized the inherent limitations in the ability of a properly-conducted audit to detect fraud, noting that "there are

difficulties of detecting fraud, especially before it has resulted in a material misstatement." *See* Final Report VII:15.[10]

"For practical reasons of time and cost, an audit rarely, if ever, examines every accounting transaction in the records of a business." *Bily v. Arthur Young & Co.*, 834 P.2d 745, 749 (Cal. 1992). "[E]ven a properly planned and performed audit may not detect a material misstatement resulting from fraud." SAS 99 (AU § 316.12) (AICPA 2002). As courts have recognized, receipt of accurate, non-falsified information from the client is essential to the performance of an accurate audit, because "audits are performed in a client-controlled environment" and "the client necessarily furnishes the information base for the audit." *Bily*, 834 P.2d at 762 (citations omitted). Intentional misrepresentations made to the auditors and other deceptive conduct can thus interfere with the ability of a properly-conducted audit to detect fraud, by "caus[ing] the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false." SAS 99 (AU § 316.10); *see also* SAS 99 (AU § 316.08-10) (recognizing that fraud by management interferes with the detection of material misstatements because management can override controls designed to prevent similar frauds and

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[10] The Committee recommended that these limitations be better communicated to investors and the general public, in order to close the "expectations gap" between those limitations and the general public's mistaken belief that the failure to detect fraud is evidence of wrongdoing on the part of the auditor. Final Report VII:15-18.

"frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information").

According to Appellants' own version of the facts, the culpable insiders at Refco and AIG knew of, instigated, orchestrated, and concealed the frauds, including concealing them from their auditors. That misconduct not only interfered with their audits, but it also independently violated federal law. The Sarbanes-Oxley Act makes it unlawful for a company's officer or director, or any other person acting under their direction, "to take any action to fraudulently influence, coerce, manipulate, or mislead" an auditor performing an audit of the company's financial statements. 15 U.S.C. § 7242(a). Therefore, Appellants' proposed expansion of liability cannot be rationalized as serving the interest of compensating "innocent parties."[11]

Deterrence of misconduct by auditors is a particularly dubious justification for expanding the adverse interest exception because substantial deterrents already exist. *See Cenco Inc.*, 686 F.2d at 453 (rejecting the deterrence justification). Auditors belong to a profession that values and encourages high professional

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[11] To the extent that there are innocent shareholders or creditors, they are not precluded from seeking to recover against auditors through applicable direct claims. For example, shareholders who purchased shares in an offering in reliance on a misleading registration statement may assert claims against an auditor who prepared or certified part of the registration statement under Section 11 of the Securities Act of 1933. 15 U.S.C. § 77k. Similarly, innocent creditors can also attempt to recover directly against auditors in certain circumstances. *See, e.g.*, *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 551 (1985).

standards, has robust and well-funded systems in place to encourage ethical behavior, and is subject to extensive, multi-tiered regulatory oversight. "An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work." *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990). Auditors have little to gain but much to lose by not exposing a client's fraud. "It is highly improbable that an accountant would risk surrendering a valuable reputation for honesty and careful work by participating in a fraud merely to obtain increased fees." *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1427 n.7 (9th Cir. 1994) (citation and internal quotation marks omitted).

While auditors are often sued based on the mere presence of an accounting mistake and an allegation that the mistake must have been made collusively because of the desire for continued audit fees, that allegation is economically "irrational." *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) (rejecting as "irrational" plaintiff's proposed scienter inference based on accounting firm's purported motive to garner fees).

Furthermore, auditor misconduct is amply deterred by existing regulatory and civil liability. Auditors face significant sanctions at the hands of regulators charged with protecting the public interest (including the SEC, the PCAOB, and state regulators). For example, the PCAOB "initiates formal investigations and disciplinary proceedings[, . . . and] [t]he willful violation of any Board rule is

treated as a willful violation of the Securities Exchange Act of 1934, 48 Stat. 881, 15 U. S. C. § 78a *et seq.*—a federal crime punishable by up to 20 years' imprisonment or $25 million in fines ($5 million for a natural person)." *Free Enter. Fund v. PCAOB*, No. 08-861, 561 U.S. __, 2010 WL 2555191, at *7 (June 28, 2010) (citing 15 U.S.C. §§ 78ff(a), 7202(b)(1) (2006 ed.)). Moreover, the PCAOB "can issue severe sanctions in its disciplinary proceedings, up to and including the permanent revocation of a firm's registration, a permanent ban on a person's associating with any registered firm, and money penalties of $15 million ($750,000 for a natural person)." *Id.* (citing 15 U.S.C. § 7215(c)(4)). As explained above, auditors are also subject to civil liability in actions brought against them directly by investors. *See* note 11. Auditors therefore face extensive deterrence from misconduct, even absent the groundbreaking expansions of derivative liability Appellants seek here, and have "a great deal of incentive to ensure accurate reporting." *Baena*, 453 F.3d at 9.

E. Expanding Auditor Liability Would Disserve Investors And Threaten The Sustainability Of The Auditing Profession

In addition to increasing costs for investors and corporations, expanding auditor liability would give rise to serious systemic risks that could have a profound impact on the sustainability of the auditing profession, with serious consequences for our public markets and investors, as well as capital markets. Indeed, the unique regulatory and litigation burdens on U.S. auditors have already

been identified as a factor contributing to the decline in the competitiveness of U.S. capital markets in recent years. Interim Report of the Committee on Capital Markets Regulation ("Interim Report") 4-5, 88-89 (2006). Further expanding auditor liability would only exacerbate this problem.

Broader liability for auditors would disserve the public interest because "increased civil exposure [for accountants] must ultimately raise the price of accounting services," burdening companies listed on the U.S. markets—and, ultimately, their investors and customers. *Baena*, 453 F.3d at 9. "If there is excessive . . . litigation, too many resources will be spent on litigation and on litigation avoidance. The cost of capital will then increase just as if a wasteful tax had been imposed on capital formation." Joseph A. Grundfest, *Why Disimply?*, 108 Harv. L. Rev. 727, 732 (1995) (emphasis omitted). *See also* Irwin J. Sugarman, *Lawyers & Accountants Liability After* Central Bank, 1998 A.B.A. Sec. Litig. & Arbitration G-79, at *G-79 (observing that extending the reach of civil liability under the federal securities laws "might, in fact, *harm investors*").

In addition, the accounting "profession faces catastrophic litigation risk different from that of other businesses." Final Report VII:27. That is because, among other reasons, the fees received from an audit are disproportionately small relative to the auditor's potential liability for that audit, which in some cases could amount to as much as the decline in a public company's value resulting from

revelation of the undetected fraud. When the liability exposure is compared to the combined partner capital retained by the firms, the threat that catastrophic litigation poses to the viability of accounting firms is simply undeniable. *See* Interim Report at 87 (the liability exposure of accounting firms "exceeds the combined partner capital" of the largest firms); Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 Colum. L. Rev. 1641, 1642 (2006) ("Auditors now face enhanced vulnerability to liability risks that—at least according to some—threaten the very viability of the industry as we know it.").

These risks have rendered third-party insurance for large company audits generally unavailable, further compounding the profession's risks. Moreover, expanding liability could bankrupt another major firm "with disastrous consequences for corporate governance worldwide," and for the availability of audit services. Interim Report at 86; *see also* Final Report VII:26 ("Data provided by the accounting profession and testimony from academics, legal, and insurance experts make clear that the threat of the loss of a major auditing firm due to litigation is real.").

This combination of catastrophic litigation risk and difficulty obtaining third-party insurance further impacts the sustainability of the profession by increasing concentration in the profession; this is because smaller auditing firms are reluctant to pursue large clients whose massive market caps could spell

enterprise-threatening liability in the event of a stock drop. Final Report VII:28. This concentration decreases customer choice and undercuts the benefits that flow from competition.

Significantly, the threat of disproportionate liability can further "harm audit quality by discouraging the best and brightest from entering and remaining" in the profession, "inhibiting the use of professional judgment, impeding the evolution of more useful audit reports, and causing overly cautious audits or 'defensive' auditing." *Id.* Decreased talent retention would also significantly reduce audit capacity for the thousands of companies requiring audit services.

* * *

For all these reasons, Appellants' proposed exceptions and changes to the doctrines of *in pari delicto* and imputation would have a negative impact on investor protection and audit quality, and, thus, should be rejected.

CONCLUSION

For the foregoing reasons, this Court should answer these certified questions as follows:

Question, *Teachers' Retirement System of Louisiana, et al. v. PricewaterhouseCoopers LLP*. Would the doctrine of *in pari delicto* bar a derivative claim under New York law where a corporation sues its outside auditor for professional malpractice or negligence 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 of the corporation's financial statements?

Answer. Yes. The Chancery Court correctly held that the *in pari delicto* doctrine bars Derivative Plaintiffs' claims against the audit firm because the wrongdoing of AIG's insiders is imputed to AIG and the adverse interest exception does not apply.

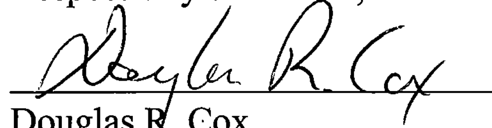
Question 2, *Kirschner v. KPMG LLP*. Whether the adverse interest exception is satisfied by showing that the insiders intended to benefit themselves by their conduct.

Answer. No. The adverse interest exception is satisfied not by showing that the agent's subjective intent was to benefit himself in some way, but only by showing that the agent "totally abandoned" the corporation's interests.

Question 7, *Kirschner v. KPMG LLP*. Whether the [adverse interest] exception is precluded where the misconduct conferred some benefit upon the corporation.

Answer. Yes. Where a corporation benefits to any extent from the insider's wrongful acts, the agents have not "totally abandoned" the corporation's interests.

Respectfully submitted,



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AFFIRMATION OF SERVICE

I, the undersigned attorney duly admitted to practice law in the Courts of this State, do hereby affirm, under penalty of perjury pursuant to CPLR § 2106, that on the 22nd day of July 2010, the foregoing Brief of *Amicus Curiae* The Center for Audit Quality in Support of Defendants-Respondents was served by overnight delivery on the following.

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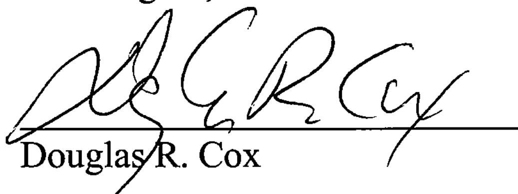

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