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KD Alert: NY Court Of Appeals Declines To Expand Liabilities For Accountants, Lawyers, Bankers & Other Professionals

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On October 21, 2010, New York's highest state court "decline[d] to alter our precedent … to bring about the expansion of third-party liability" in a decision offering a sigh of relief to myriad professionals and their insurers. Although there is no limit to plaintiffs' creativity when seeking deep-pocketed sources to recoup investment losses, this decision could provide a useful shield from liability for professionals, such as accountants, auditors, lawyers, investment bankers, and financial advisers.

Issues Certified to the New York Court of Appeals

In *Kirschner v. KPMG, et al., the New York Court of Appeals was asked to "certify" or give clear guidance on, the question of whether New York law bars creditors and shareholders from pursuing a company's third-party professional service providers. The Court was asked to re-visit common law notions of "imputation"—i.e., where a corporation is deemed responsible for the wrongful actions or fraud of its agents and executives, unless the executives acted with an "adverse interest" to the company that was solely for the executive's benefit—and "in pari delicto," i.e., the principle that "mandates that the courts will not intercede to resolve a dispute between two wrongdoers." (Op., at 12). Where concurrently applied, these judicial precepts dictate that where corporate executives orchestrate a fraud, the fraud is imputed to the corporation, and thus is imputed to its shareholders and creditors who then "stand is the shoes" of the company; then, under in pari delicto, the courts will refuse to get involved in a dispute with the imputed "wrongdoers" (the shareholders and creditors) and their "coconspirators" (the third-party professionals).*

The request to certify came from two separate courts presiding over derivative-type actions brought by creditors and shareholders of companies whose executives allegedly committed fraud: the first was a New York federal court case involving defunct commodities broker Refco, whose Liquidation Trustee sued the investment banks, lawyers and accountants that helped underwrite Refco's leveraged buyout and IPOs; and the second was a shareholder derivative action in Delaware state court where AIG shareholders sued PricewaterhouseCoopers, AIG's independent auditors, for failing to uncover an alleged 2005 accounting fraud purportedly costing the shareholders $3.5 billion in equity.

The Court of Appeals' Decision

The Refco Liquidation Trust and AIG derivative plaintiffs chiefly challenged application of the imputation and in pari delicto doctrines on public policy grounds, asserting that the doctrines should be laid to rest in order to "recompense the innocent and make outside professionals (especially accountants) responsible for their negligence and misconduct in cases of corporate fraud." (Op. at 22). Plaintiffs contended that New York law should take into account the agent's intent or comparative negligence and that decisions from other jurisdictions should guide the Court to disregard the long-standing doctrines in these kinds of cases. The Court rejected all of these arguments.

In declining to expand third-party liabilities, the Court reasoned:

We are also not convinced that altering our precedent to expand remedies for these or similarly situated plaintiffs would produce a meaningful additional deterrent to professional misconduct or malpractice. The derivative plaintiffs caution against dealing accounting firms a "get-out-of-jail-free" card. But as any former partner at Arthur Andersen LLP — once one of the "Big Five" accounting firms — could attest, an outside professional (and especially an auditor) whose corporate client experiences a rapid or disastrous decline in

fortune precipitated by insider fraud does not skate away unscathed. In short, outside professionals — underwriters, law firms and especially accounting firms — already are at risk for large settlements and judgments in the litigation that inevitably follows the collapse of an Enron, or a Worldcom or a Refco or an AIG-type scandal.

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.

Our read of the Kirschner decision is that it will provide a useful tool to protect third-party professionals from derivative liability claims in the event the corporations they service wind up in serious trouble. But it also seems fair to say that this may not be the end of the story, given the potential for other direct actions under state and federal securities laws. Nevertheless, from Stoneridge several years ago to Kirschner today, it appears that third-party professionals are holding the levy of flooding litigation for the time being.