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## Corporate Wrongdoing and the In Pari Delicto Defense in Auditor Malpractice Cases: A New Approach

Christine M. Shepard

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# Corporate Wrongdoing and the *In Pari Delicto* Defense in Auditor Malpractice Cases: A New Approach<sup>†</sup>

Christine M. Shepard\*

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### I. Introduction

Consider the following not-uncommon scenario: High-level employees of a public corporation fraudulently misstate the corporation's financials to make the company appear profitable and attractive to investors and lenders. The financial (mis)statements are certified by an outside auditor who failed to follow professional standards in performing the audit. Eventually, the fraud is uncovered and the true state of the company's dismal financial situation is revealed. The corporation's stock price plummets and it goes bankrupt. Creditors and shareholders of the company want to recover their losses from, *inter alios*, the auditor who negligently performed its audit. The failure, they allege, harmed them because the negligent audit allowed the fraud to continue longer than it would have if the auditor had met its duty under the engagement.<sup>1</sup> The auditor in this scenario has a powerful defense in its corner: *in pari delicto*.

Under accepted agency principles, the knowledge of a corporate officer is imputed to the corporation and the corporation is deemed to have that knowledge.<sup>2</sup> Likewise, imputation makes the corporation legally responsible for an officer's fraud.<sup>3</sup> The officer's fraud is, in law, the corporation's fraud which makes the corporation a wrongdoer in front of the court.<sup>4</sup> The defense of *in*

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1. The auditor's duty is not to uncover fraud; its duty is to perform in accordance with applicable professional standards and with the agreement between the parties. *See* Official Comm. of Unsecured Creditors of Allegheny Health, Educ. & Research Found. v. PricewaterhouseCoopers, LLP (AHERF), 989 A.2d 313, 332 (Pa. 2010) (“[T]here are multiple levels of auditor review, and the specific responsibility of the auditor in any given undertaking generally will depend on the terms of the retention.”); *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 882 (N.J. 2006) (“KPMG had an independent contractual obligation, *at a level defined by its agreement with PCN*, to detect the fraud, which it allegedly failed to do.” (emphasis added)).

2. *See* RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006) (“[N]otice of a fact that an agent knows or has reason to know is imputed to the principal if knowledge of the fact is material to the agent's duties to the principal . . .”).

3. *See id.* (stating that an agent's knowledge of a fact is imputed to her principal “[f]or purposes of determining a principal's legal relations with a third party”).

4. *See Kirschner v. KPMG LLP*, 938 N.E.2d 941, 951 (N.Y. 2010) (“[A] corporation is represented by its officers and agents, and their fraud in the course of the corporate dealings is in law the fraud of the corporation.” (citations and

*pari delicto*<sup>5</sup> prevents a wrongdoer from seeking redress against another alleged wrongdoer.<sup>6</sup> Because the corporation's creditors or shareholders bring their claim on behalf of the corporation, they "step into the shoes" of the corporation and any defense that can be asserted against the corporation may be asserted against them.<sup>7</sup> In the corporate fraud context, then, these doctrines work together to immunize auditors from liability.

This Note argues that auditors should *not* be immune from suit by or on behalf of a corporation imputed with its agent's fraud. Strong policy reasons exist both for protecting auditors from these lawsuits and for leaving open the possibility of a lawsuit for auditor malpractice.<sup>8</sup> One factor that weighs strongly against insulating auditors as a group is the way in which auditors have used the *in pari delicto* defense to achieve immunity. Before a court allows the defense—and stops a plaintiff from presenting its case no matter how strong—it must be satisfied that the plaintiff is a wrongdoer seeking to

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alterations omitted)).

5. See, e.g., *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985) (citing BLACK'S LAW DICTIONARY to define *in pari delicto*). The common law defense of *in pari delicto* comes from the Latin, *in pari delicto potior est conditio defendentis*: "In a case of equal or mutual fault . . . the position of the [defending] party . . . is the better one." *Id.*

6. See *id.* at 307 (noting that the classic formulation of the defense was narrowly limited to situations where the plaintiff was at least equally responsible, but that many courts have given the defense broader application to bar actions by plaintiffs involved generally in the wrongdoing (citing *Perma Life Mufflers, Inc. v. Int'l Parts Corp.*, 392 U.S. 134, 138 (1968))).

7. See, e.g., 11 U.S.C. § 541(a) (2006) (stating that a bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case"); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356 (3d Cir. 2001) (noting in the bankruptcy setting that the "trustee stands in the shoes of the debtor and can only assert those causes of action possessed by the debtor"); *Wight v. BankAmerica Corp.*, 219 F.3d 79, 87 (2d Cir. 2000) (holding that because management's misconduct is imputed to the corporation and a trustee stands in the shoes of the corporation, the trustee is barred from bringing suit that he himself essentially took part in); *Kirschner*, 938 N.E.2d at 959 (holding that the doctrine of *in pari delicto* will bar a derivative claim under New York law where a corporation sues its outside auditor for professional malpractice or negligence in failing to detect fraud committed by the corporation). *But see* *F.D.I.C. v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir. 1985) (finding that defenses based on unclean hands or inequitable conduct do not generally apply against a party's receiver because the receiver does not step into the parties shoes but "is thrust into those shoes").

8. See *infra* Part III.C (presenting competing policy rationales for and against auditor liability).

recover for harm caused by its own misconduct.<sup>9</sup> Courts should reconsider whether a corporation imputed with its agent's fraud satisfies this element of the *in pari delicto* defense.<sup>10</sup>

Imputation is not fault-based, and *in pari delicto* requires a showing of fault.<sup>11</sup> A better approach would attempt to establish if the corporation itself can fairly be deemed to be at fault for failing to detect the agent's fraud.<sup>12</sup> This could be achieved by judging a corporation based on the adequacy of its information gathering and reporting systems.<sup>13</sup> The systems implemented by the board of directors and carried out by corporate employees to deter and detect fraud would seem to offer a better measure of a corporation's fault and would provide a more sound basis for an auditor's use of the *in pari delicto* defense.<sup>14</sup>

Part II of this Note provides background information on (1) imputation, including the adverse interest exception; (2) the *in pari delicto* doctrine; and (3) case law addressing imputation and *in pari delicto* in corporate fraud cases. Part III suggests why— notwithstanding case law directly on point—this issue presents a

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9. See, e.g., *Bateman Eichler*, 472 U.S. at 306 (noting that “[i]n a case of equal or mutual fault . . . the position of the [defending] party . . . is the better one” (emphasis added)); *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 950 (N.Y. 2010) (defining *in pari delicto* as a mandate that “courts will not intercede to resolve a dispute between two wrongdoers”).

10. See *Art Metal Works v. Abraham & Straus*, 70 F.2d 641, 646 (2d Cir. 1934) (Hand, J., dissenting), *adopted as opinion of the court on r’hrng*, 107 F.2d 944, 944 (2d Cir. 1934) (“Whenever the question has come up, it has been held that immoral conduct to be relevant, must touch and taint the plaintiff personally; that the acts of his agents, though imputed to him legally, do not impugn his conscience vicariously.”); see also *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995) (“[T]he defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated.”); *infra* Part IV (arguing that imputation is not relevant to the determination of a plaintiff's wrongdoing as it relates to the defense of *in pari delicto*).

11. See Deborah A. DeMott, *When Is a Principal Charged with an Agent's Knowledge?*, 13 DUKE J. COMP. & INT'L L. 291, 319 (2003) (“Basic agency doctrines are not fault-based . . .”).

12. See *infra* Part IV.A (arguing that *in pari delicto* should only be available in those cases where the corporation bears actual fault).

13. The author thanks Washington and Lee School of Law Professor David Millon for suggesting consideration of a corporation's information gathering and reporting systems as an effective measure for corporate action.

14. See *infra* Part IV.B (suggesting that a corporation's information gathering and reporting systems provide the best measure of the corporation's fault in failing to detect fraud).

problem and provides an opportunity to do better in future controversies. Part IV suggests an approach that rejects the use of imputation to satisfy the elements of the *in pari delicto* defense and argues instead for a plaintiff corporation to be judged based on the adequacy of its corporate systems.

## II. Background

### A. Imputation

A discussion of imputation and the adverse interest exception is a necessary starting point to understanding the approach courts have traditionally taken to analyzing auditor liability in corporate fraud cases. When an agency relationship exists,<sup>15</sup> the rule of imputation instructs that a principal is deemed to know facts that are known by its agent.<sup>16</sup> The main purpose advanced to justify the fiction of imputation<sup>17</sup> is proper risk allocation.<sup>18</sup> As between a principal and a third party, the principal is in a better position to bear the risk that his agent will act in a way that is not sanctioned by him or will not convey knowledge the agent receives on his behalf.<sup>19</sup> The principal is better able to bear this

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15. See RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) (“Agency is the fiduciary relationship that arises when one person (a ‘principal’) manifests assent to another person (an ‘agent’) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.”).

16. See *id.* § 5.03 (“[N]otice of a fact that an agent knows or has reason to know is imputed to the principal if knowledge of the fact is material to the agent’s duties to the principal . . .”).

17. See DeMott, *supra* note 11, at 292 (“Imputing one person’s knowledge to another could be characterized as a quintessential legal fiction.”).

18. See, e.g., AHERF, 989 A.2d 313, 335 (Pa. 2010) (tagging the underlying purpose of imputation to be “fair risk allocation, including the affordance of appropriate protection to those who transact business with corporations”).

19. See, e.g., RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (2006) (“Imputation thus reduces the risk that a principal may deploy agents as a shield against the legal consequences of facts the principal would prefer not to know.”); Martin R. Scordato, *Evidentiary Surrogacy and Risk Allocation: Understanding Imputed Knowledge and Notice in Modern Agency Law*, 10 FORDHAM J. CORP. & FIN. L. 129, 155 (2004) (“[F]rom a risk allocation perspective, the possibility of an adverse agent failing to transmit successfully to the principal important knowledge or notice is a problem far better managed by the principal than by the third party.”).

risk because of the internal relationship between principal and agent.<sup>20</sup> The principal selects, monitors, and controls his agents.<sup>21</sup> And imputation destroys a principal's incentive to deploy agents as a filter to receiving "bad" information.<sup>22</sup> By holding the principal legally responsible for his agent's knowledge, the principal has strong incentive to receive that knowledge.<sup>23</sup>

### 1. Adverse Interest Exception

In some cases, the justification for imputation is outweighed by other considerations. Imputation does not apply when "the agent acts adversely to the principal in a transaction or matter, intending to act solely for the agent's own purposes or those of another person."<sup>24</sup> This exception addresses the reality that when an agent has abandoned his principal's interest, the presumption that he will fulfill his duty to relay information to his principal fails. While it is clear that the presumption fails, it is less clear

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20. See DeMott, *supra* note 11, at 315 (suggesting treatment of imputation "as a recognition of the fact that, when an agent interacts with third parties on behalf of a principal, the internal relationship between principal and agent shapes many dimensions of the agent's interaction with the third party"); see also *id.* at 317 ("Imputation may also be justified on the basis of its impact on behavior.").

21. RESTATEMENT (THIRD) OF AGENCY § 5.03 illus. 8 (2006) ("Imputation creates strong incentives for principals to design and implement effective systems through which agents handle and report information.").

22. See DeMott, *supra* note 11, at 315–16 ("Imputation responds to the evident temptation for agents to be reticent in sharing 'bad facts' with their principals."). Imputation reduces the temptation of those in control of an organization to create a structure which isolates "bad facts" in the hands of few agents. See *id.* at 317–18 (noting that without imputation such a structure would deflect the organization's accountability to those with whom its agent dealt).

23. RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (2006) ("By charging a principal with notice of material facts that an agent knows or has reason to know, imputation reduces incentives to deal through agents as a way to avoid the legal consequences of facts that a principal might prefer not to know."); see also DeMott, *supra* note 11, at 317 ("[F]rom a principal's standpoint, it is preferable that an agent transmit 'bad facts' so that the principal may determine how to react as opposed to proceeding with a transaction in the absence of actual knowledge.").

24. RESTATEMENT (THIRD) OF AGENCY § 5.04 (2006).



why it matters.<sup>25</sup> In other contexts, when the presumption is proven false, it is still maintained.<sup>26</sup> Addressing this conflict, the Restatement (Third) of Agency sets out an exception to the exception. Notice *will* be imputed when an agent acts adversely to her principal “when necessary to protect the rights of a third party who dealt with the principal in good faith.”<sup>27</sup>

The third-party-protection exception to the adverse interest exception demonstrates agency law’s goal of protecting good-faith third parties.<sup>28</sup> It also shows an attempt to modulate the “unduly severe” results that arise from agency law’s “all-or-nothing” basis.<sup>29</sup> Courts have adopted further exceptions to avoid strict

25. See Scordato, *supra* note 19, at 155 (“[T]he existence of the adverse agent exception to the imputed knowledge rule is not supported by the risk allocation rationale.”); see also *Goldstein v. Union Nat’l Bank*, 213 S.W. 584, 590–91 (Tex. 1919) (offering an “incompatibility test” for the adverse interest exception met when “the agent’s interests are so incompatible with the interests of his principal . . . to render it reasonably probable that an ordinary person . . . will [not] act in behalf of his principal” (emphasis added)); *McRaith v. BDO Seidman, LLP*, 909 N.E.2d 310, 331 (Ill. App. Ct. 2009) (explaining that the exception “suspends the operation of the general rule when the circumstances are such as to raise a clear presumption that the agent will not perform [his] duty, and thus that the principal will not in fact receive and have the benefit of the agent’s knowledge”). *But see In re CBI Holding Co.*, 311 B.R. 350, 369–70 (S.D.N.Y. 2004) (finding the adverse interest exception to be “entirely consistent with the principles of agency law” because when the agent has totally abandoned the interests of his principal the fiction of imputation is untenable).

26. See, e.g., *DeMott*, *supra* note 11, at 315 (noting that “[i]t is not a defense to a principal that an agent breached the agent’s duty to transmit relevant information, even when the principal can establish that the agent withheld the information” (emphasis added)); see also Andrew J. Morris, *Clarifying the Imputation Doctrine: Charging Audit Clients with Responsibility for Unauthorized Audit Interference*, 2001 COLUM. BUS. L. REV. 339, 350 (2001) (noting that imputation’s primary purpose is to protect innocent third parties). *But see DeMott*, *supra* note 11, at 316–17 (suggesting that imputation is justified because “the internal relationship between the principal and the agent shapes many dimensions of the agent’s interaction with the third party,” and when the agent’s actions place him “outside the control structures put in place by the principal,” the adverse interest exception makes sense).

27. RESTATEMENT (THIRD) OF AGENCY § 5.04(a) (2006). A second exception to the adverse interest exception calls for imputation “when the principal has ratified or knowingly retained a benefit from the agent’s action.” *Id.* § 5.04(b).

28. See Scordato, *supra* note 19, at 163 (noting that the extremely narrow version of the adverse interest exception set out in the Restatement (Third) of Agency is “as close to consistent with the risk allocation rationale as is possible while still retaining an adverse agent exception”).

29. *DeMott*, *supra* note 11, at 319.

application of the adverse interest exception when it would lead to an unjust result.<sup>30</sup> These court-fashioned exceptions reveal that imputation and the adverse interest exception are the wrong tools for the job of addressing auditor liability.

*a. The Sole Actor and Innocent Decision-Maker Exceptions*

The two court-fashioned exceptions to the adverse interest exception used in corporate fraud cases are the sole actor exception and the innocent decision-maker exception. The sole actor exception was created to defeat the adverse interest exception when the agent is the sole representative of the principal.<sup>31</sup> It provides that “if an agent is the sole representative of a principal, then that agent’s fraudulent conduct is imputable to the principal regardless of whether the agent’s conduct was adverse to the principal’s interests.”<sup>32</sup> Courts reason that if the corporation and the agent are one and the same, the agent has no one to whom the agent can communicate knowledge, and the adverse interest exception should not block imputation.<sup>33</sup>

The innocent decision-maker exception carves back the sole actor exception and prevents imputation when the corporation has innocent decision-makers who could have stopped the fraud

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30. See, e.g., *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 359 (3d Cir. 2001) (finding that the court need not address the adverse interest exception “because the ‘adverse interest exception’ is itself subject to an exception—the ‘sole actor’ exception”); *In re CBI Holding Co.*, 311 B.R. 350, 372 (S.D.N.Y. 2004) (defining the innocent insider, or innocent decision-maker, exception).

31. See *In re Jack Greenberg, Inc.*, 212 B.R. 76, 86 (E.D. Pa. 1997) (“Where the officer in question is the sole representative of the corporation, there is no one to whom to impart his or her knowledge and no one from whom to conceal it.”).

32. *Lafferty*, 267 F.3d at 359; see also *In re Norvergence, Inc.*, 405 B.R. 709, 748 (D.N.J. 2009) (describing the sole actor exception to the adverse interest exception).

33. See *Thabault v. Chait*, 541 F.3d 512, 528–29 (3d Cir. 2008) (recognizing the sole actor exception but refusing to apply it when the plaintiffs owned only 65% of the corporation’s stock); *In re CBI Holding Co.*, 311 B.R. at 373 (“[I]t would be nonsensical to refrain from imputing the agent’s acts of fraud to the corporation, despite the agent’s total abandonment of the corporation’s interests, [when] the agent is identical to the corporation.”).

had they discovered it.<sup>34</sup> The rationale behind this exception is that

where only some members of management are guilty of the misconduct, and the innocent members could and would have prevented the misconduct had they known of it, the culpability of the malefactors should not be imputed to the company because that imputation would punish innocent insiders (e.g., non-culpable shareholders) unfairly.<sup>35</sup>

These court-fashioned exceptions are not universally recognized but have become part of the arsenal advocates use when arguing for or against imputation.<sup>36</sup>

*b. Tests for the Adverse Interest Exception Vary by State*

State law governs the common law of agency.<sup>37</sup> States have widely accepted the adverse interest exception but articulate the test for adverse action differently.<sup>38</sup> New York, for example, has adopted a very narrow construction.<sup>39</sup> In New York, an agent must “have *totally abandoned* his principal’s interests and be

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34. See *In re CBI Holding Co.*, 311 B.R. at 372 (defining the innocent insider, or innocent decision-maker, exception); see also *In re Am. Int’l Grp., Inc.*, Consol. Derivative Litig. (AIG II), 976 A.2d 872, 893 n.56 (Del. Ch. 2009) (noting that in New York “there never actually was a freestanding innocent insider exception, it was simply an exception to the so-called ‘sole actor rule’ which is itself an exception to the adverse interest exception”).

35. *In re CBI Holding Co.*, 311 B.R. at 372.

36. See, e.g., Amelia Toy Rudolph, *Invoking In Pari Delicto to Bar Accountant Liability Actions Brought by Trustees and Receivers*, SS009 ALI-ABA 547, 574 & 579 (2010) (noting that the sole actor exception has been widely accepted but that more courts reject than accept the innocent decision-maker exception).

37. See, e.g., *O’Melveny & Myers v. F.D.I.C.*, 512 U.S. 79, 84–85 (1994) (holding that in the FDIC receivership context “[state] law, not federal law, governs the imputation of knowledge to corporate victims of alleged negligence”).

38. See Rudolph, *supra* note 36, at 574–75 (citing fifty-four state and federal cases applying the exception).

39. See, e.g., *In re Am. Int’l Grp., Inc.* (AIG I), 965 A.2d 763, 824 (Del. Ch. 2009) (noting that the adverse interest exception under New York law is “an extremely narrow one”); see also *id.* at 825 (declining to adopt the innocent insider exception in applying New York law because “the recent trend of New York law has been strongly against [its] adoption”).

acting *entirely* for his own or another's purposes."<sup>40</sup> The New York Court of Appeals takes the position that "[s]o 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 test is not met."<sup>41</sup> By contrast, Pennsylvania takes a less-restrictive approach and articulates its test this way:

Where an agent acts in his own interest which is antagonistic to that of his principal, or commits a fraud for his own benefit in a matter which is beyond the scope of his actual or apparent authority or employment, the principal who has received no benefit therefrom will not be liable for the agent's tortious act.<sup>42</sup>

While Pennsylvania's test is similar, Pennsylvania courts use a different measure to determine whether a "benefit" has been received by the principal.<sup>43</sup>

What distinguishes the tests for the adverse interest exception is the "degree of self-interest required, or, conversely, the quantum of benefit to the corporation necessary to avoid the exception's application (where self-interest is evident)."<sup>44</sup> In allowing *any* short-term benefit to defeat the exception, New York has created a clear rule where virtually all corporate fraud will be

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40. *Center v. Hampton Affiliates, Inc.*, 488 N.E.2d 828, 900 (N.Y. 1985) (emphasis added); *see also Kirschner v. KPMG LLP*, 938 N.E.2d 941, 952 (N.Y. 2010) (noting that New York's narrow scope for the adverse interest exception defeats the presumption of communication when the corporation is "actually the victim of a scheme undertaken by the agent to benefit himself" and is consistent with fundamental principles of agency law).

41. *Kirschner*, 938 N.E.2d at 953 (citing *Baena v. KPMG LLP*, 453 F.3d 1, 7 (1st Cir. 2006)).

42. *Todd v. Skelly*, 120 A.2d 906, 909 (Pa. 1956); *see also AHERF*, 989 A.2d 313, 336 (Pa. 2010) (citing *Todd* to provide Pennsylvania's "traditional, liberal test for corporate benefit").

43. *AHERF*, 989 A.2d at 334 ("[W]e believe there is . . . difficulty with applying too liberal a litmus for benefit, particularly in a paradigm involving alleged collusion between the agent and the defendant.").

44. *Id.*; *see also Rudolph, supra* note 36, at 564 (noting that courts articulate the test for the adverse interest exception in various ways "with the variations generally appearing to be the extent of the agent's personal benefit or motivation and the extent of the adversity to the corporation"). Rudolph further notes that "the battleground is often whether the benefit from the alleged wrongdoing must be *exclusively* for the agent (*e.g.*, embezzlement) for the . . . exception to apply." *Id.*

imputed to the corporation.<sup>45</sup> Other states have taken a harder look at what constitutes a benefit and have refused to find one where the corporation's existence is "artificially prolonged" through its officers' fraud.<sup>46</sup>

The adverse interest exception has the difficult charge of avoiding the harsh result of imputation while not creating an equally unjust outcome through its application. When a corporation is tainted with fraud, imputation is essential to protecting innocent third parties who were harmed by their dealings with the corporation.<sup>47</sup> The adverse interest exception, then, should not apply in most instances of corporate fraud.<sup>48</sup>

Because imputation is essential to protecting those who transact business with corporations, reliance on the adverse interest exception by those attempting to defeat the *in pari delicto* defense is misplaced. The exception's failure in this context is evidenced by (1) the court-fashioned exceptions to the adverse interest exception—created to address the ever-present case where strictly applying the adverse interest exception would produce undesirable results<sup>49</sup>—and (2) by the differing standards

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45. *Kirschner*, 938 N.E.2d at 952 (noting that the exception is reserved for cases of "outright theft or looting or embezzlement").

46. *See* *Schacht v. Brown*, 711 F.2d 1343, 1348 (7th Cir. 1983) (finding that "prolonged artificial insolvency" is a "Pyrrhic benefit" which should not block the adverse interest exception); *In re Adelpia Commc'ns Corp.*, 365 B.R. 24, 56 (S.D.N.Y. 2007) ("This Court is not of a mind to hold at this point in time, on motion, that even a peppercorn of benefit to a corporation from the wrongful conduct would provide total dispensation to defendants knowingly and substantially assisting insider misconduct that is overwhelmingly adverse to the corporation."). The Seventh Circuit's position in *Schacht* has been termed the "deepening insolvency" rationale for finding an adverse interest. *See, e.g.*, Matthew G. Dore, *Presumed Innocent? Financial Institutions, Professional Malpractice Claims, and Defenses Based on Management Misconduct*, 1995 COLUM. BUS. L. REV. 127, 156 (1995) (discussing the deepening insolvency rationale).

47. *See, e.g.*, *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 954 (N.Y. 2010) ("No one disputes that traditional imputation principles, including a narrowly confined adverse interest exception, should remain unchanged—indeed, are essential—in other contexts.").

48. *See id.* (refusing to apply the adverse interest exception); *see also* *AHERF*, 989 A.2d 313, 333 (Pa. 2010) (noting that it would be a mistake to apply the adverse interest exception too broadly in part because "[i]mputation . . . serves to protect those who transact business with a corporation through its agents").

49. *See, e.g.*, *AIG II*, 976 A.2d 872, 884 (Del. Ch. 2009) (noting the "squishy

of corporate benefit and self-interest that courts have created to determine if the exception applies.<sup>50</sup>

The adverse interest exception addresses a narrow set of circumstances in which an agent's acts are so contrary to her proper role in the agency relationship that it would be manifestly unfair to hold the principal responsible for them.<sup>51</sup> In the case of corporate fraud, the fraudulent acts are contrary to the agent's duty to perform according to the law.<sup>52</sup> But they are not so far removed from the agent's role in the agency relationship that it would be unfair to hold the corporation responsible to third parties injured by their dealings with the agent.<sup>53</sup> The facts relevant to determining if the adverse interest exception should apply address the suitability of holding a principal legally responsible for its agent's dealings with third parties. These facts do not inform whether a corporation should be permitted to recover from its auditor for malpractice. This divergence has historically been addressed through exceptions to a rule that does not reach the underlying issue.<sup>54</sup> A better approach would directly address whether the corporation should be able to recover from its auditor for malpractice.<sup>55</sup>

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manner in which some courts have employed the *in pari delicto* doctrine" and chiding the plaintiffs for asking the court to "find that th[e] case falls within some 'exception' to the traditional application of the doctrine"); *see also supra* Part II.A.1 (discussing the adverse interest exception, the sole actor exception, and the innocent decision-maker exception).

50. *See supra* Part II.A.1.b (discussing the benefit and self-interest analysis employed to determine applicability of the adverse interest exception).

51. *See, e.g., In re CBI Holding Co., Inc.*, 311 B.R. 350, 369 (S.D.N.Y. 2004) (noting that "agency would fall into desuetude if imputation had no bounds").

52. *See* *AIG I*, 965 A.2d 763, 827 (Del. Ch. 2009) ("[A]ny conscious act of a fiduciary causing a corporation to break the law is against the corporation's charter and best interests.>").

53. *See, e.g., Kirschner v. KPMG LLP*, 938 N.E.2d 941, 951 (N.Y. 2010) (discussing the importance of holding corporations responsible for the acts of their agents and noting that "[a]gency law presumes imputation even where the agent acts less than admirably, exhibits poor business judgment, or commits fraud").

54. *See, e.g., id.* at 954 (noting that the plaintiffs request that the adverse interest exception be altered for purposes of the *in pari delicto* defense only because a narrowly confined adverse interest exception is essential in other contexts).

55. *See infra* Part IV (arguing that the availability of the *in pari delicto* defense should not turn on imputation but that it should be available only if the

## 2. Third Parties Not Acting in Good Faith

In addition to using the adverse interest exception, courts have defeated the *in pari delicto* defense by finding that when an auditor is charged with fraud, agency law does not support imputation.<sup>56</sup> There are two main reasons that an auditor should not be permitted to invoke imputation when the third party does not deal with the principal in good faith. First, when a third party colludes with an agent who acts adversely to his principal, the law does not maintain the presumption that the agent will communicate his knowledge to the principal.<sup>57</sup> This is the adverse interest exception to imputation discussed previously.<sup>58</sup> But consider this scenario: an agent secretly colludes with a third party to perform an act that is not deemed “adverse” to his organizational principal. For example, when an officer secretly misstates the financials of a corporation, this fraud may be considered a benefit to the corporation rather than an adverse act.<sup>59</sup> The adverse interest exception will not apply, but its rationale operates with equal force to vitiate the presumption that the agent will communicate with his principal.<sup>60</sup> When the agent and the third party are colluding in a way that is kept secret from the principal—even though the act is not considered “adverse” under applicable state law—the third party is certain

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corporation can meaningfully be deemed a wrongdoer).

56. See, e.g., RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b (2006) (“If the third party colludes with the agent against the principal or otherwise knows or has reason to know that the agent is acting adversely to the principal, the third party should not expect that the agent will fulfill duties of disclosure owed to the principal.”).

57. See *id.* § 5.03 cmt. b (noting that notwithstanding the adverse interest exception to imputation, an agent’s knowledge is imputed “when necessary to protect the rights of a third party *who dealt with the principal in good faith*”) (emphasis added).

58. See *supra* Part II.A.1 for more detail on the adverse interest exception.

59. See, e.g., *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 953 (N.Y. 2010) (“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 test [for adverse action rather than corporate benefit] is not met.”).

60. But see *supra* note 25 and accompanying text (discussing the divergence of the adverse interest expectation from the rationale for imputation).

the agent will not communicate the knowledge to the principal and the fiction of imputation should not be maintained.<sup>61</sup>

Second, for an agency relationship to exist the agent must have authority to bind the principal.<sup>62</sup> This comes in the form of actual authority or apparent authority.<sup>63</sup> An agent has actual authority when the principal has expressly given the agent authority to act on its behalf, or when the agent reasonably believes that he has authority to act on its behalf.<sup>64</sup> Apparent authority exists when a third party reasonably believes the agent has the authority to act on behalf of the principal.<sup>65</sup>

An agent who colludes with a third party to secretly commit fraud—even for the benefit of his principal—acts with neither actual nor apparent authority.<sup>66</sup> The agent himself does not believe that “the principal wishes [him] so to act.”<sup>67</sup> This is evidenced by the secretive nature of his actions.<sup>68</sup> Similarly, no apparent authority exists because the collusive third party knows

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61. See RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b (2006) (“[I]mputation protects innocent third parties but not those who know or have reason to know that an agent is not likely to transmit material information to the principal.”).

62. See *id.* intro. note (“[T]he three distinct bases on which the common law of agency attributes the legal consequences of one person’s action to another person . . . are actual authority, apparent authority, and respondeat superior.”).

63. *Id.*

64. See *id.* § 2.01 (“An agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal’s manifestations to the agent, that the principal wishes the agent so to act.”); see also *id.* cmt b (defining express actual authority and implied actual authority).

65. See *id.* § 2.03 (“Apparent authority is the power held by an agent or other actor to affect a principal’s legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal’s manifestations.”).

66. See, e.g., *AHERF*, 989 A.2d 313, 336 (Pa. 2010) (noting that, when an agent and third party collude, “the agent’s authority is neither actual nor apparent” because “both the agent and the third party know very well that the agent’s conduct goes unsanctioned by one or more of the tiers of corporate governance”); cf. Leo E. Strine, Jr. et al., *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 650 (2010) (“For a corporate director knowingly to cause the corporation to engage in unlawful acts or activities or enter an unlawful business is disloyal in the most fundamental of senses.”).

67. RESTATEMENT (THIRD) OF AGENCY § 2.01 (2006).

68. See, e.g., *AHERF*, 989 A.2d at 337 (“Imputation is not justified in scenarios involving secretive, collusive activity . . .”).



that the secretive actions are not authorized.<sup>69</sup> Imputation, which only applies to an agency relationship, is not applicable when one of “the three distinct bases on which the common law of agency attributes the legal consequences of one person’s action to another person” is not present.<sup>70</sup>

Understanding when imputation and the adverse exception apply is essential to examining how courts have traditionally approached auditor liability in corporate fraud cases.<sup>71</sup> These principles may also be important to other defenses an auditor can raise such as inability to prove causation in a fraud claim.<sup>72</sup> The role that imputation may play in other contexts, and the desirability of precluding auditors as a class from invoking imputation, however, are beyond the scope of this Note.<sup>73</sup> Here,

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69. *Id.*

70. RESTATEMENT (THIRD) OF AGENCY intro. note (2006).

71. *See, e.g., AHERF*, 989 A.2d at 333 (noting that “agency law plays a pivotal role in the [*in pari delicto*] defense’s practical availability” because attribution of the officers’ misconduct to the corporation is a linchpin to the defendant auditor’s ability to raise the defense).

72. *See Schacht v. Brown*, 711 F.2d 1343, 1346 n.2 (7th Cir. 1983) (noting that a defendant can use imputation for a claim of estoppel or the inability to prove causation in a fraud claim). For example, in *Cenco Inc. v. Seidman & Seidman*, discussed *infra* Part II.C.1, the plaintiffs brought claims against the corporation’s auditor for breach of contract, professional malpractice, and fraud. The court analyzed the three claims as a “single form of wrongdoing under different names.” *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 453 (7th Cir. 1982). The court noted that “a participant in a fraud cannot also be a victim entitled to recover damages, for he cannot have relied on the truth of the fraudulent representations, and such reliance is an essential element in a case of fraud.” *Id.* at 454. This approach is arguably incorrect. *See* *AIG I*, 965 A.2d 763, 826 (Del. Ch. 2009) (criticizing *Cenco* for “blithely” taking the same position as to claims for negligent conduct and intentional conduct and for finding that all claims were governed by one defense). The approach to each claim should be distinct: An auditor (1) may not invoke imputation when charged with fraud but may seek to prove that the corporation itself was at fault and invoke the *in pari delicto* defense, and (2) may impute a fraudulent agent’s knowledge to the corporation when faced with a claim of breach of contract or negligence but imputation would not necessarily be relevant to the auditor’s defense against these claims. *See infra* Part IV (arguing that a plaintiff corporation’s actions should be judged by the acts of the corporation, not simply by imputing the wrongdoing of one agent to the corporation).

73. But see *infra* Part II.C.5.b for a brief discussion of Chancellor Strine’s argument that auditors should be treated like corporate insiders and precluded from invoking imputation when the corporation brings suit against them for their wrongdoing.

the focus rests on considering how courts' traditional approach to auditor malpractice—combining imputation with the *in pari delicto* defense to bar suit—may be flawed.

## B. In Pari Delicto

### 1. Defined

*In pari delicto* is an affirmative defense<sup>74</sup> which provides that when a plaintiff and defendant stand in a position of equal or mutual fault, the position of the defendant is the better one.<sup>75</sup> The defense is the “counterpart legal doctrine to [the equitable defense] of unclean hands.”<sup>76</sup> Some courts have used the legal and equitable doctrines “interchangeably without discussion of any difference between them,”<sup>77</sup> while others have drawn a distinction between the defense brought at law and in equity.<sup>78</sup> Beyond the

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74. See, e.g., Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 354 (3d Cir. 2001) (classifying *in pari delicto* as an affirmative defense). The Second Circuit characterizes *in pari delicto* as a matter of standing. See, e.g., Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 120 (2d Cir. 1991) (holding that the bankruptcy trustee lacked standing because a “claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation”); see also Wight v. BankAmerica Corp., 219 F.3d 79, 87 (2d Cir. 2000) (noting that in the corporate fraud context where the “trustee stands in the shoes of the corporation, the *Wagoner* rule bars a trustee from suing to recover for a wrong that he himself essentially took part in”). This outlier position, known as the *Wagoner* Rule, does not change the analysis here and will not be mentioned further in this Note.

75. See, e.g., Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 306 (1985) (“In a case of equal or mutual fault . . . the position of the [defending] party . . . is the better one.”).

76. Byron v. Clay, 867 F.2d 1049, 1052 (7th Cir. 1989).

77. See, e.g., T. Leigh Anenson, *Treating Equity Like Law: A Post-Merger Justification of Unclean Hands*, 45 AM. BUS. L.J. 455, 482–83 (2008) (citing New York and Maryland cases); see also *id.* at 468–74 (surveying the different uses of the doctrines among states and in federal courts and arguing for the death of the distinction between the legal and equitable defenses).

78. See AHERF, 989 A.2d 313, 328 n.16 (Pa. 2010) (noting that a previous Pennsylvania Supreme Court decision which applied the unclean hands doctrine to a case brought in equity could not “fully answer the question of how *in pari delicto* should function with regard to claims substantively grounded at law”). But see *id.* at 328 (recognizing that *in pari delicto* has “surmounted its moorings in strict equity jurisprudence and transitioned into a defense in actions at law”

law–equity distinction, the defense is complicated by different standards under federal law and state law—where the standards further diverge by state.<sup>79</sup>

From this background, however, the doctrine can be presented in three general principles. First, the plaintiff's responsibility must be substantially equal to or greater than the defendant's.<sup>80</sup> Second, the illegal activity that the plaintiff engaged in must be the subject of the lawsuit.<sup>81</sup> And third, even where these conditions are present, public policy considerations can defeat the defense.<sup>82</sup> Unavoidable, then, is the recognition that the defense is “judicial implementation of social policy.”<sup>83</sup>

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in many jurisdictions including Pennsylvania).

79. See, e.g., Rudolph, *supra* note 36, at 574–77 (presenting different articulations of the standard under federal law and state law).

80. See, e.g., *AHERF*, 989 A.2d at 329 n.19 (noting that for the defense to apply in Pennsylvania the parties must either have relatively equal degrees of fault or the plaintiff's fault must be clearly greater). *But see Bateman*, 472 U.S. at 307 (noting that “many courts have given the *in pari delicto* defense a broad application to bar actions where plaintiffs simply have been involved generally in the same sort of wrong-doing as defendants” (citations omitted)); *AIG II*, 976 A.2d 872, 883–84 (Del. Ch. 2009) (“Although the literal translation of *in pari delicto* is ‘in equal fault,’ the doctrine does not require that a court engage in the type of accounting that *in pari delicto* is meant to avoid . . .”).

81. See, e.g., *McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750, 757 (3d Cir. 1990) (“[I]n order to bar recovery, the plaintiff must be an active, voluntary participant in the unlawful activity that is the *subject of the suit*.”).

82. See, e.g., *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 307 (1985) (“In addition, the public policy considerations that undergirded the *in pari delicto* defense were frequently construed as precluding the defense even where the plaintiff bore substantial fault for his injury.” (citations omitted)); *AHERF*, 989 A.2d at 330 (“[T]he roots of the defense in equity jurisprudence . . . undermines [defendant's] contention that *in pari delicto* is to be woodenly applied . . .”); *cf.* *Schacht v. Brown*, 711 F.2d 1343, 1349 (7th Cir. 1983) (reaching its conclusion in part because “permitting recovery in this case would not send unqualified signals to shareholders that they need not be alert to managerial fraud since they may later recover full indemnification for that fraud” (emphasis added)); *id.* at 1349 n.5 (referring to the outcome in *Cenco* as “the deterrence policy of *Cenco*”); *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 881 (N.J. 2006) (“[An] auditor should not be able to avoid responsibility for its own misdeeds because imputation is invocable to protect the innocent, never to promote an injustice.” (quoting *Nischne v. Firestone Tire & Rubber Co.*, 173 A.341, 342 (N.J. Ch. 1934))).

83. *AHERF*, 989 A.2d at 331.

Judicial discretion, though, is consistent with *in pari delicto*'s roots in equity.<sup>84</sup> Courts should not apply the defense “woodenly” when other considerations trump the policy basis for the doctrine itself.<sup>85</sup> And it follows that the doctrine should not be used in a way that does not promote the policy considerations for which it was created. *In pari delicto* is intended to prevent a wrongdoer from profiting from his own misconduct.<sup>86</sup> The plaintiff must be a wrongdoer to achieve the “important public policy purposes” that have placed the doctrine “in the inmost texture of our common law for at least two centuries.”<sup>87</sup> Courts should reconsider if imputation carries the burden of making the corporation a wrongdoer. In fact, persuasive case law cautions against combining imputation with *in pari delicto* to bar a claim.<sup>88</sup>

## 2. In Pari Delicto Applied in Conjunction with Imputation

In applying *in pari delicto*, recent cases have glossed over the doctrine as well-settled law that does not require close examination.<sup>89</sup> But the application of *in pari delicto* in

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84. See, e.g., Anenson, *supra* note 77, at 482 (noting that “the doctrine of *in pari delicto* serves such diverse purposes as preserving the dignity of the courts, expressing a moral principle, and enforcing public policy”); see also *id.* (noting that *in pari delicto* was first applied by Lord Mansfield who was overheard commenting that he “never liked law so much as when it resembled equity” (citations omitted)). But see Piper Aircraft Corp. v. Wag-Aero, Inc., 741 F.2d 925, 939 (7th Cir. 1984) (Posner, J., concurring) (“The time when equity relief really was discretionary—a judgment committed to the conscience of the chancellor—is past, the law of equity having long ago crystallized in a system of rules similar in basic character to the rules of the common law, though perhaps marginally more flexible.”).

85. AHERF, 989 A.2d 313, 330 (Pa. 2010).

86. See, e.g., Kirschner v. KPMG LLP, 938 N.E.2d 941, 950 (N.Y. 2010) (“[T]he principle that a wrongdoer should not profit from his own misconduct is so strong in New York that we have said the defense applies even in difficult cases . . .”).

87. *Id.* (noting that *in pari delicto* serves the purposes of denying judicial relief to an admitted wrongdoer and avoiding entangling courts in disputes between wrongdoers).

88. See, e.g., cases cited *supra* note 10 (citing opinions by Judge Learned Hand and Judge Richard Posner that decline to apply *in pari delicto*).

89. See, e.g., AHERF, 989 A.2d at 328 (“The Latin derivation and equitable origins of the underlying common-law maxim [of *in pari delicto*] have been well traveled and need not be revisited at length here.”); see also cases discussed

conjunction with imputation against corporate plaintiffs is fundamentally different than its application against the actual wrongdoer.<sup>90</sup> There is a leap in logic from holding a corporation legally responsible for the acts of its agent through imputation to classifying it as a wrongdoer who may not bring a claim before the court.<sup>91</sup>

Consider the case of a plaintiff who is a natural person. If a defendant wishes to raise the defense of *in pari delicto*, he bears the burden of proving that the plaintiff bears substantially equal or greater responsibility for the underlying illegality.<sup>92</sup> When that plaintiff is a principal in an agency relationship, the acts of an agent will not satisfy this requirement. This is because, as Judge Learned Hand declared, “immoral conduct[,] to be relevant, must touch and taint the plaintiff personally; . . . the acts of his agents, though imputed to him legally, do not impugn his conscience vicariously.”<sup>93</sup>

In other contexts, courts have set a high standard for a defendant to show that the plaintiff was at equal fault. For example, the Supreme Court, in a securities fraud case, held that a tippee, while guilty of fraud, is not culpable *enough* for a tipper broker-dealer to raise the *in pari delicto* defense.<sup>94</sup>

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*infra* Part II.C (discussing three recent influential cases which apply *in pari delicto* with little discussion of the defense).

90. See *Universal Builders, Inc. v. Moon Motor Lodge, Inc.*, 244 A.2d 10, 13 (Pa. 1968) (finding that a corporate plaintiff was not barred from bringing suit when its officer had committed a wrong because “attribution of one party’s unclean hands to another party is not based on simple agency principles”).

91. See, e.g., RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006) (“*For purposes of determining a principal’s legal relations with a third party, notice of a fact that an agent knows or has reason to know is imputed to the principal . . .*” (emphasis added)).

92. See, e.g., *AHERF*, 989 A.2d 313, 329 n.19 (Pa. 2010) (noting that some courts have dispensed with the strict requirement that the plaintiff bear equal or greater responsibility for the harm).

93. *Art Metal Works v. Abraham & Straus*, 70 F.2d 641, 646 (2d Cir. 1934) (Hand, J., dissenting), *adopted as opinion of the court on r’hrg*, 107 F.2d 944, 944 (2d Cir. 1934).

94. See *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 314 (1985) (“Absent other culpable actions by a tippee that can fairly be said to outweigh these violations by insiders and broker-dealers, we do not believe that the tippee properly can be characterized as being of substantially equal culpability as his tippers.”).

This issue is illuminated in the corporate fraud context where the plaintiff is a bankruptcy trustee<sup>95</sup> or receiver.<sup>96</sup> Here, the wrongdoer has been removed from the scene and the plaintiff before the court is an innocent party.<sup>97</sup> In these cases, courts often deny use of the defense because it leads to an unjust result.<sup>98</sup> Courts that allow the defense are more likely to do so against a bankruptcy trustee.<sup>99</sup> This is because they feel bound by federal bankruptcy law<sup>100</sup> to apply any defense that would have been available against the bankrupt party to the trustee.<sup>101</sup>

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95. See, e.g., Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 358 (3d Cir. 2001) (joining the Second, Sixth, and Tenth Circuits in applying *in pari delicto* to bar claims of a bankruptcy trustee without regard to the trustee's status as an innocent successor).

96. See F.D.I.C. v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) (noting that "defenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver"). The Ninth Circuit would also deny *in pari delicto* against a bankruptcy trustee. See *id.* (noting that a bankruptcy trustee is one category of receiver against whom *in pari delicto* would not apply); see also *Lafferty*, 267 F.3d at 358 (distinguishing prior cases that declined to apply *in pari delicto* in the receivership context from the present case, which involved a bankruptcy trustee, because "unlike bankruptcy trustees, receivers are not subject of the limits of section 541").

97. See, e.g., Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995) ("The appointment of the receiver removed the wrongdoer from the scene. The corporations were no more Douglas's evil zombies. Freed from his spell they became entitled to the return of the moneys—for the benefit not of Douglas but of innocent investors . . .").

98. See, e.g., McRaith v. BDO Seidman, LLP, 909 N.E.2d 310, 336 (Ill. App. Ct. 2009) (finding defendant's attempt to equate the liquidator of an insolvent insurance company with the company's wrongdoing officer to be "illogical and unavailing" because "the Liquidator, by statutory definition, is not the wrongdoer").

99. See *Lafferty*, 267 F.3d at 358 (noting that "[w]hile bankruptcy law mandates that the trustee step into the shoes of the debtor when asserting causes of action, state law generally provides the substantive law governing imputation for state law claims").

100. See 11 U.S.C. § 541(a) (2006) (stating that a bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case").

101. See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 357 (3d Cir. 2001) ("The plain language of section 541, however, prevents courts from taking into account events that occur after the commencement of the bankruptcy case. As a result, we must evaluate the *in pari delicto* defense without regard to whether the Committee is an innocent successor."); see also *In re the Pers. and Bus. Ins. Agency*, 334 F.3d 239, 246 (3d Cir. 2003) (finding that because "[t]here is no limiting language in § 548 similar to that in § 541," there is no reason not to follow the "better rule" *not* to impute

But *in pari delicto* should not, in the first instance, be an available defense against a corporation based solely on the corporation being imputed with the wrongful acts of its agents.<sup>102</sup> Whether federal or state law applies, a corporation's legal responsibility for the acts of its agents is not identical to the label of "wrongdoer" which would invite the *in pari delicto* defense.<sup>103</sup>

### C. Case Law

#### 1. Cenco Inc. v. Seidman & Seidman

Several courts have recently considered how to address auditor liability in corporate fraud cases using the principles of imputation and *in pari delicto*. Before turning to recent cases, it will be informative to first consider the case that provides the foundation for auditor liability in corporate fraud cases. The Seventh Circuit case *Cenco Inc. v. Seidman & Seidman*<sup>104</sup> led to a "pioneering decision" in the area of corporate auditor liability.<sup>105</sup>

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the agent's conduct when it would lead to an inequitable result). *But see In re Adelphia Commc'ns Corp.*, 365 B.R. 24, 51 (S.D.N.Y. 2007) (criticizing *Lafferty's* analysis of § 541 and suggesting that § 541 is only relevant to *ownership* of a cause of action and standing to assert it, not to defenses that can properly be asserted against those causes of action).

102. *See infra* Part IV (arguing that a plaintiff corporation's actions should be judged by the acts of the corporation, not simply by imputing the wrongdoing of one agent to the corporation).

103. *See Art Metal Works v. Abraham & Straus*, 70 F.2d 641, 646 (2d Cir. 1934) (Hand, J., dissenting), *adopted as opinion of the court on r'hrng*, 107 F.2d 944, 944 (2d Cir. 1934) ("It would be monstrous that a man's conscience should bear the sins of those he employs, however liable he may be for their acts, and a doctrine which stands upon moral wrongdoing must clear itself of that confusion, or adopt another form."); *see also Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995) (stating that "the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated"); *Universal Builders, Inc. v. Moon Motor Lodge, Inc.*, 244 A.2d 10, 13 (Pa. 1968) (declining to apply *in pari delicto* when the wrongdoing was done by an officer of the now-bankrupt plaintiff corporation because "[t]he attribution of one party's clean hands to another party is not based on simple agency principles").

104. *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982) (holding that the allegedly negligent auditors could invoke imputation as a defense when corporate management committed fraud on behalf of the corporation).

105. *AHERF*, 989 A.2d 313, 331 (Pa. 2010).

It set the stage for a strict application of the *in pari delicto* defense and has served as the foundation for many similar outcomes.<sup>106</sup> *Cenco* has, however, been criticized for its simplistic approach to the complex intersection of law, policy, and equity.<sup>107</sup> It was undoubtedly a decision (1) highly driven by the specific facts before the court<sup>108</sup> and (2) reached by a court with specific policy goals in mind.<sup>109</sup> The Seventh Circuit's decision one year later in *Schacht v. Brown*<sup>110</sup> clarifies how these factors limit the holding in *Cenco*.

First, a brief look at the facts of *Cenco*. Over the course of five years, *Cenco* managers inflated inventory values to make the company appear more valuable, which in turn increased the price of its stock.<sup>111</sup> The company's apparently strong position allowed it to buy up other companies "on the cheap" and borrow money at

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106. See, e.g., Dore, *supra* note 46, at 161 (noting the courts that have expressly or implicitly followed *Cenco*); see also *In re CBI Holding Co., Inc.*, 311 B.R. 350, 370 n.12 (S.D.N.Y. 2004) ("*Cenco* suggests that courts should focus on who bore the 'primary costs' of the fraud—stockholders, or outsiders to the corporation—rather than on the purpose behind the fraud."); Kirschner v. KPMG LLP, 938 N.E.2d 941, 952 (N.Y. 2010) (noting that the Second Circuit's approach to *in pari delicto* is "heavily influenced by" *Cenco*).

107. See AIG I, 965 A.2d 763, 826 & n.241 (Del. Ch. 2009) (finding that *Cenco* simplifies complexities with "articulation[s] [that] ignore[] all nuance and several alternatives to avoiding an unreasonably harsh treatment of the auditors"); *AHERF*, 989 A.2d at 331–32 (discussing critique of *Cenco* and holding that Pennsylvania law does not accord with the notion that incentivizing internal corporate monitoring should take priority "over the objectives of the traditional schemes governing liability in contract and in tort"); Andrew J. Morris, *Some Challenges for Legal Pragmatism*, 28 N. ILL. U. L. REV. 1, 18–41 (criticizing *Cenco* for its reliance on highly abstract principles and pragmatic reasoning to create new law after being hasty in its determination that no existing case law provided guidance).

108. See *Cenco*, 686 F.2d at 456 (declining to rule that an auditor is never liable for the frauds of its employees, but finding that on the uncontested facts of this case the corporation should not be allowed to shift the entire responsibility for the fraud to its auditors).

109. See *id.* at 455 ("In predicting how the Illinois courts might decide the present case, we assume they would be guided by the underlying objectives of tort liability. Those objectives are to compensate the victims of wrongdoing and to deter future wrongdoing.")

110. See *Schacht v. Brown*, 711 F.2d 1343, 1347 (7th Cir. 1983) (holding that plaintiff's complaint adequately stated a claim under the Racketeer Influenced and Corrupt Organizations Act and that the claim was not defeated by *Cenco*).

111. See *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 451 (7th Cir. 1982) (presenting the facts of the case).



low rates.<sup>112</sup> The fraud was eventually discovered and led to a class action suit by Cenco stockholders against Cenco, its corrupt managers, and its auditor Seidman & Seidman (Seidman).<sup>113</sup> The class of stock purchasers settled with Seidman, leaving before the court the cross-claims by Cenco and Seidman.<sup>114</sup> Cenco alleged that Seidman was liable to it for failing to prevent the fraud, and Seidman alleged that it was a victim of the fraud and thus entitled to damages.<sup>115</sup>

The court found for Seidman because the fraudulent acts of Cenco's managers, which were done on behalf of the corporation, were attributable to Cenco.<sup>116</sup> Judge Posner declared: "Fraud on behalf of a corporation is not the same thing as fraud against it."<sup>117</sup> In this case, the stockholders had received a benefit from the fraud and outsiders had borne the primary costs. Judge Posner was not willing to allow stockholders to escape all responsibility for the fraud.<sup>118</sup>

This famous language from *Cenco* has been used to foreclose suits against an auditor brought by or on behalf of a fraudulent corporation.<sup>119</sup> But the decision is not always considered in light of the Seventh Circuit's clarification in *Schacht*.<sup>120</sup> The *Schacht* court advised that three important factors existed in *Cenco*: (1) the shareholders who would benefit from a successful recovery were the corrupt officers themselves,<sup>121</sup> (2) the plaintiffs would possibly receive a double recovery after a previous successful recovery in a direct suit against the defendants,<sup>122</sup> and (3) deterrence would not be furthered by a holding for the

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112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. *See id.* at 456.

117. *Id.*

118. *Id.*

119. *See* cases cited *supra* note 106 (citing cases that have followed *Cenco* to prevent plaintiffs' recovery from the corporation's auditor).

120. *See* *Schacht v. Brown*, 711 F.2d 1343, 1347 (7th Cir. 1983) (finding that *Cenco's* "underlying policy [does not] forbid[] the Director from maintaining the present action" (emphasis added)).

121. *Id.* at 1348.

122. *Id.* at 1349.

plaintiffs because (i) the directors would recover as shareholders and (ii) large corporate shareholders had been in a position to police the plaintiff's corrupt officers.<sup>123</sup>

Without facts that would lead to compensating wrongdoers,<sup>124</sup> and when deterring wrongdoing required the opposite result,<sup>125</sup> the *Schacht* court adhered to the guiding principles of tort liability to abandon the outcome that had furthered these principles under the facts of *Cenco*.<sup>126</sup> Different facts required a different result.

Of course, different law applied as well.<sup>127</sup> In *Cenco*, the court was predicting how Illinois courts would decide the issue under Illinois common law and in *Schacht* the court applied a federal statute and was able to "bring to bear federal policies in deciding the estoppel question."<sup>128</sup> But no federal policies were advanced to justify a different outcome. In fact, the court proceeded by

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123. *Id.*

124. *See id.* at 1348. Unlike the wrongdoing-shareholder plaintiffs in *Cenco*, the plaintiffs first in line to recover in *Schacht* were policyholders and creditors; shareholders were last in line to recover. *See id.* (noting that "under the distribution provisions of the governing liquidation statute, it is the policyholders and creditors who have first claim").

125. *See id.* at 1349 ("There is also no evidence here of the existence of large corporate shareholders capable of conducting an independent audit, as in *Cenco*, and whose lack of investigatory zeal would be rewarded by a decision favorable to the [plaintiff].")

126. *See id.* at 1348 (finding that a "*Cenco*-type analysis" would not yield the results defendants urged).

127. *See id.* at 1347 (noting that the *Cenco* court was "merely . . . attempt[ing] to divine how Illinois courts would decide th[e] issue," but that the present cause of action arose under a federal statute giving the court a clean slate on which to write).

128. *Id.* The court addressed the issue as one of estoppel. *See id.* at 1346 (presenting defendants' argument that plaintiff should be estopped from proceeding because he stood in the shoes of a corporation imputed with its officers' and directors' illegal conduct); *see also* Integrity Ins. Co. v. Yegen Holdings Corp. (*In re Integrity*), 573 A.2d 928, 941–42 (N.J. Super. Ct. App. Div. 1990) ("[E]ven though an agent (the directors and officers) of a principal (Integrity) may be responsible for falsity, the third party's ([the auditor]) culpability, if established, would estop it from raising the defense of imputation."). While this Note focuses on the defense of *in pari delicto*, a plaintiff imputed with the fraud of corporate officers invites other defenses such as estoppel, or inability to prove causation under a fraud claim. *See Schacht v. Brown*, 711 F.2d 1343, 1346 n.2 (7th Cir. 1983) (noting that an estoppel defense or the inability to prove causation in a fraud claim "raise the same issue"). *See supra* note 72 for further discussion on this point.

analyzing the issue “[as] if the estoppel holding in *Cenco* were relevant.”<sup>129</sup>

The distinction between the fraudulent acts in *Schacht* and those in *Cenco* is a thin one. In *Cenco*, “those involved in the fraud were not stealing from the company, as in the usual corporate fraud case, but were instead aggrandizing the company (and themselves) at the expense of outsiders.”<sup>130</sup> This was fraud on behalf of the corporation. In *Schacht*, by contrast, the directors’ fraudulent action pushed the corporation past its point of insolvency and systematically looted its most profitable business, aggravating its insolvency.<sup>131</sup> This, according to the court, is not a benefit to the corporation.<sup>132</sup> The court found that “it defies common sense to suggest that a parent corporation’s shareholders are not injured when their directors fraudulently prop up, drain, and thereby deepen the insolvency of a subsidiary for whose liabilities the shareholders will eventually be liable.”<sup>133</sup>

The difference seems slight—as the shareholders in both instances will ultimately suffer<sup>134</sup>—and not one on which the decision to insulate auditors from liability should turn. The key to reconciling the two cases and, more importantly, to gleaning a rule from them, is to recognize that the *Cenco* decision was driven by the court’s desire to effectuate the two underlying objectives of tort liability: (1) to compensate victims and (2) to deter future wrongdoing.<sup>135</sup>

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129. *Id.* at 1348 (“[E]ven if a *Cenco*-type analysis were applied to the instant case . . . it would not yield the result that defendants urge, *i.e.*, estoppel of the Director based on the imputation to Reserve of the directors’ knowledge of fraud.”).

130. *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 451 (7th Cir. 1982).

131. *See Schacht*, 711 F.2d at 1347–48 (contrasting the *Cenco* facts to those of the instant case).

132. *See id.* at 1348 (“In no way can these results be described as beneficial to Reserve.”).

133. *Id.* at 1348 n.4.

134. *See, e.g., Kirschner v. KPMG LLP*, 938 N.E.2d 941, 955 (N.Y. 2010) (noting that “a company victimized by fraud is *always* likely to suffer long-term harm once the fraud becomes known” (emphasis added)).

135. *See Cenco*, 686 F.2d at 455 (“Th[e] objectives [of tort liability] are to compensate the victims of wrongdoing and to deter future wrongdoing.”); *see also Schacht v. Brown*, 711 F.2d 1343, 1348 (7th Cir. 1983) (“In *Cenco* we undertook a two-pronged analysis to determine whether such imputation should occur: whether a judgment in favor of the plaintiff corporation would properly

This is important for two reasons. First, to the extent a court follows *Cenco* and strives to compensate victims and deter future wrongdoing, its outcome will be uniquely fact dependent.<sup>136</sup> And second, courts have failed to apply this *Cenco* “approach” to the facts at hand but rather have broadly applied its holding without the underlying tort-liability-objectives analysis.<sup>137</sup> In many cases, this has led to auditors being insulated from liability.<sup>138</sup> Assuredly not all of these cases produced the wrong result, but to the extent that the *Cenco* decision created a monster, its actual lesson should be reconsidered.

## 2. New Jersey

The New Jersey Supreme Court did just that in *NCP Litigation Trust v. KPMG*.<sup>139</sup> Here, a trust, on behalf of NCP creditors and shareholders, brought a negligence claim against KPMG for failure to perform its audits in conformity with GAAS and GAAP<sup>140</sup> standards.<sup>141</sup> The court held that the *in pari delicto* defense<sup>142</sup> is not available to one who “contributed to” the

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compensate the victims of the wrongdoing, and whether such recovery would deter future wrongdoing.”).

136. See, e.g., *Schacht*, 711 F.2d at 1348–49 (allowing the plaintiff’s claim to proceed under slightly different facts than *Cenco* because application of the compensation and deterrence principles did not bar suit).

137. See, e.g., Dore, *supra* note 46, at 143 (noting that the Fifth Circuit in *F.D.I.C. v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992), “adopts *Cenco*’s benefit test to resolve imputation and adverse interest problems without evaluating Judge Posner’s underlying rationale for the test: its alleged consistency with tort law’s twin goals of compensation and deterrence”); see also cases cited *supra* note 106 (citing cases that have followed *Cenco*).

138. See, e.g., *AIG I*, 965 A.2d 763, 779 (Del. Ch. 2009) (noting that New York law immunizes auditors from suit).

139. *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 873 (N.J. 2006) (holding that the imputation doctrine does not bar corporate shareholders from recovering through a litigation trust against an auditor who was negligent in failing to uncover the fraud of corporate officers or directors).

140. See *id.* at 876 (defining GAAS (General Accepted Auditing Standards) and GAAP (Generally Accepted Accounting Principles) as the professional guidelines that auditors must adhere to while conducting an audit).

141. See *id.* (presenting the allegations).

142. See *id.* at 879–80 (presenting the imputation doctrine and its rationale). The New Jersey Supreme Court does not use the term *in pari delicto* but refers to the defense as the “imputation defense.” *Id.* The court’s analysis of whether

fraud.<sup>143</sup> Because the auditor in the case at bar was allegedly negligent, it met this standard and was precluded from imputing to the corporation (on whose behalf the plaintiffs brought suit) the fraudulent acts of the corporation's agents.<sup>144</sup>

In reaching this decision, the court declined to follow *Cenco* for three main reasons. First, *Cenco* applied Illinois law so the court was "writ[ing] on a clean slate in addressing the issue under New Jersey law."<sup>145</sup> Second, the court considered how *Schacht* narrowed *Cenco*'s holding.<sup>146</sup> Lastly, the court found that barring all shareholders from recovery for the impropriety of some shareholders is "unfair and improper."<sup>147</sup>

There are three groups of plaintiffs for whom the court found that barring suit would not be unfair: (1) those shareholders who engaged in the fraud, (2) those shareholders who knew or should have known fraud was taking place, and (3) those who own large blocks of stock and therefore arguably possess the ability to oversee the company operations.<sup>148</sup> For these plaintiffs, imputation should be applied and suit against an outside auditor should be barred.<sup>149</sup>

The court supplied two reasons why innocent shareholders should be allowed to bring suit against negligent auditors. First,

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the defendant may invoke imputation tracks an analysis of when to apply *in pari delicto* and has been cited in this context. *See, e.g.*, AHERF, 989 A.2d 313, 335 (Pa. 2010) (noting that the New Jersey Supreme Court's decision in NCP "effectively negat[ed] imputation (and thus barr[ed] the *in pari delicto* defense)" in the negligent-auditor context); *see also* Thabault v. Chait, 541 F.3d 512, 528 (3d Cir. 2008) (equating New Jersey's "imputation defense" with *in pari delicto*); *In re Norvergence, Inc.*, 405 B.R. 709, 745–46 (D.N.J. 2009) (noting plaintiff's argument that under New Jersey law "the imputation defense (and therefore the *in pari delicto* defense) cannot be asserted by the [defendant auditors]").

143. *See NCP Litig. Trust*, 901 A.2d at 882 ("In sum, we hold that the Trust's suit is not barred because one who contributed to the misconduct cannot invoke imputation.").

144. *See id.* at 881–82 (noting that the New Jersey decision which articulated the "contributed to" standard "drew no distinction between negligent conduct on the one hand and fraudulent conduct on the other").

145. *Id.* at 885.

146. *Id.* at 884–85.

147. *Id.*

148. *Id.* at 885–86.

149. *See id.* at 886 (stating that the holding with these limitations "properly effectuate[s] the tort principle of compensating the victims of wrongdoing by allowing only 'innocent' shareholders to recover").

“the nature of today’s corporations” makes it unlikely that the shareholders of large corporations are in a position to monitor the actions of corporate officials.<sup>150</sup> Second, auditors are specifically retained to monitor corporate activity and the law must seek to deter auditor wrongdoing.<sup>151</sup>

The court also addressed the distinction between an agent’s act which is “adverse to” or “for the benefit of” the corporation. The court noted that “there can be difficulty in differentiating between whether the malfeasant conduct benefits or harms the corporation.”<sup>152</sup> But the court found that fraudulent acts of high-ranking officers which carry the business past the point of insolvency cannot be considered a benefit to the corporation.<sup>153</sup> Lastly, the court noted that New Jersey is a comparative negligence state so the corporation and its shareholders retain good reason to carefully monitor the transactions of the corporation and its management.<sup>154</sup>

### 3. Pennsylvania

The Supreme Court of Pennsylvania addressed the intersection of imputation and the *in pari delicto* defense in the context of a claim by a committee of creditors (the Committee) against a bankrupt corporation’s auditor.<sup>155</sup> The Committee

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150. See *id.* (disagreeing with *Cenco* that imputation must be applied to deter future wrongdoing).

151. See *id.* (“[O]ur focus cannot be limited only to deterring wrongdoing on the part of corporate shareholders.”).

152. See *id.* at 887–88 (citing Debra A. Winiarsky, *Litigating an Accountant’s Liability Suit—Contributory Negligence and Third Party Practice*, SC46 A.L.I.-A.B.A 315, 326 (1998), who proposes that “almost any situation involving management fraud can be seen as either aimed at harming or benefitting the company”).

153. *Id.*

154. *Id.* The court suggests that any benefit the corporation received from its agent’s fraud should not be a complete bar to liability but “only a factor in apportioning damages.” *Id.*

155. See AHERF, 989 A.2d 313, 339 (Pa. 2010) (holding that Pennsylvania will recognize the *in pari delicto* defense in the negligent-auditor context, but that imputation is unavailable to an auditor who has not proceeded in material good faith by colluding with the agent to fraudulently misstate corporate finances).

alleged that the auditors colluded with company officials to fraudulently misstate financials.<sup>156</sup> Specifically, the court addressed the following issue certified to it by the Third Circuit: should corporate officers' knowledge of alleged fraud and complicity be imputed to the corporation, "thereby exposing it to an application of the *in pari delicto* doctrine and/or other defenses which might arise . . . against an active wrongdoer proceeding volitionally."<sup>157</sup>

In analyzing whether the officers' knowledge should be imputed to the corporation, the court examined the adverse interest exception. It noted that the controversy surrounding the appropriate application of the adverse interest exception has focused on either (1) the degree of self-interest required, or (2) the quantum of benefit to the corporation necessary to avoid the exception's application (where self-interest is evident).<sup>158</sup> The court rejected these approaches and instead found that the appropriate approach to benefit and self-interest is to consider them in relation to the underlying purpose of imputation—fair risk allocation.<sup>159</sup> The corporation should initially bear the risk of any wrongdoing by its agents because it selects the agents and implements procedures for monitoring them.<sup>160</sup> Innocent third parties must be protected when they deal with a corporation's agent.<sup>161</sup>

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156. See *id.* at 315 (presenting the allegations against PricewaterhouseCooper).

157. *Id.* at 333.

158. *Id.* at 334.

159. See *id.* at 335 ("In light of the competing concerns, the appropriate approach to benefit and self-interest is best related back to the underlying purpose of imputation which is fair risk-allocation . . ."); see also RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c (2006) ("It is helpful to view questions about imputation from the perspective of risk assumption, taking into account the posture of the third party whose legal relations with the principal are at issue.").

160. See *AHERF*, 989 A.2d at 333 ("[I]t is the principal who has selected and delegated responsibility to . . . agents; accordingly, the [imputation] doctrine creates incentives for the principal to do so carefully and responsibly."); *id.* at 336 ("[I]mputation rules justly operate to protect third parties on account of their reliance on an agent's actual or apparent authority.").

161. See *id.* at 333 ("Imputation . . . serves to protect those who transact business with a corporation through its agents believing the agent's conduct is with the authority of the principal.").

But when the third party is on notice that the agent is acting adversely to the corporation and will not share his knowledge with the corporation, the third party no longer merits the protection that imputation provides.<sup>162</sup> In this regard, the court found that the appropriate distinction is between those who dealt with the company in material good faith and those who did not.<sup>163</sup>

*a. Those Who Proceed in Good Faith*

The court held that the *in pari delicto* defense is available in the negligent-auditor context—that is, when the corporate plaintiff is at least equally culpable relative to the subject of its lawsuit.<sup>164</sup> Because Pennsylvania law already applied contributory negligence in the accounting context, the court found that allowing the *in pari delicto* defense “dovetail[ed] with other defenses which may be available to a negligent auditor.”<sup>165</sup> The court noted that the adverse interest exception is applicable to determine if the agent’s acts will be imputed to the corporation and that the determination will turn on the “traditional, liberal test for corporate benefit.”<sup>166</sup>

A benefit to the corporation should be evaluated “in light of the reasonable perspective of a third party in its dealing with the agent.”<sup>167</sup> The question to ask is: “[W]hether there is sufficient lack of benefit (or apparent adversity) such that it is fair to charge the third party with notice that the agent is not acting with the principal’s authority.”<sup>168</sup> The court found this approach

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162. See *id.* at 336 (“[Imputation] principles do not (and should not) apply in circumstances in which the agent’s authority is neither actual nor apparent, as where both the agent and the third party know very well that the agent’s conduct goes unsanctioned by one or more of the tiers of corporate governance.”).

163. See *id.* at 335 (drawing a “sharp distinction between those who deal in good faith with the principal-corporation in material matters and those who do not”).

164. *Id.* at 330.

165. *Id.* at 335; see also *id.* at 335 n.31 (“[U]nder prevailing Pennsylvania law as presently established by the Superior Court, contributory negligence in the accounting context . . . continues to function as a complete bar to recovery under negligence theory.”).

166. *Id.* at 336.

167. *Id.* at 338.

168. *Id.* On this point, see also *McRaith v. BDO Seidman, LLP*, 909 N.E.2d



to be consistent with the core concept of apparent authority in the first instance.<sup>169</sup>

Because the court combined the benefit analysis with the risk-allocation purpose of imputation, it applied a different benefit test in the collusive-auditor context.<sup>170</sup> In a setting involving auditors who have not proceeded in material good faith, the court held that a “knowing, secretive, fraudulent misstatement of corporate financial information” will never be a benefit to a corporation.<sup>171</sup> But this type of misstatement could provide a benefit to the corporation in the negligent-auditor context which would foreclose the adverse interest exception, permit imputation, and allow the *in pari delicto* defense.<sup>172</sup>

*b. Those Who Do Not Proceed in Good Faith*

When outsiders are “in” on the fraud, the court found that the “ordinary rationale for imputation breaks down completely.”<sup>173</sup> The agent’s authority in this case is neither actual nor apparent.<sup>174</sup> Both the agent and the third party “know very well that the agent’s conduct goes unsanctioned by one or more of the tiers of corporate governance.”<sup>175</sup> To impute the agent’s knowledge to the corporation in this case would be to charge the

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310, 331 (Ill. App. Ct. 2009) (explaining that the adverse interest exception “suspends the operation of the general rule when the circumstances are such as to raise a clear presumption that the agent will not perform [his] duty, and thus that the principal will not in fact receive and have the benefit of the agent’s knowledge”).

169. See AHERF, 989 A.2d 313, 338 (Pa. 2010) (“Notably, such approach dovetails with the core concept of apparent authority in the first instance.”).

170. See *id.* at 336, 338 (providing different tests for corporate benefit in the negligent-auditor and collusive-auditor contexts).

171. *Id.* at 338.

172. See *id.* at 335 (“On balance, we believe the best course is for Pennsylvania common law to continue to recognize the availability of the *in pari delicto* defense (upon appropriate and sufficient pleadings and proffers), via the necessary imputation, in the negligent-auditor context.”).

173. *Id.* at 336.

174. See *supra* Part II.A.2 (discussing the rule that an agent has no authority to bind her principal when the third party with whom she deals knows her acts go unsanctioned).

175. AHERF, 989 A.2d 313, 336 (Pa. 2010).

corporation with knowledge “as against a third party whose agents actively and intentionally prevented those in [the] governing structure who were non-participants in the fraud from acquiring such knowledge.”<sup>176</sup> The Pennsylvania Supreme Court found that “[s]uch an application of the imputation doctrine seems ill-advised, if not perverse.”<sup>177</sup>

In relation to the public policy reasons for the *in pari delicto* defense, the court disagreed with the Seventh Circuit’s conclusion in *Cenco*.<sup>178</sup> The court found that the importance of a policy that incentivizes internal corporate monitoring is trumped by “objectives of the traditional schemes of governing liability in contract and in tort, including fair compensation and deterrence of wrongdoing.”<sup>179</sup>

#### 4. New York

##### a. Majority Opinion

The New York Court of Appeals considered two separate disputes in its *Kirschner v. KPMG LLP*<sup>180</sup> decision: (1) a litigation trust bringing suit against many defendants on behalf of the now-bankrupt corporation’s unsecured creditors alleging that the defendants either aided and abetted the corporate insiders in carrying out the fraud, or were negligent in not discovering it,<sup>181</sup> and (2) a derivative action against an auditor alleging that the auditor’s performance was not in accordance with professional standards.<sup>182</sup> The court began by affirming its commitment to the

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176. *Id.*

177. *Id.*

178. *See id.* at 332 (“Pennsylvania law does not accord with *Cenco* in terms of the degree to which the decision, in an auditor-liability context, prioritizes the policy of incentivizing the internal corporate monitoring over the objectives of the traditional schemes governing liability in contract and in tort . . .”).

179. *Id.*

180. *See Kirschner v. KPMG LLP*, 938 N.E.2d 941, 959 (N.Y. 2010) (holding that the doctrine of *in pari delicto* will bar a derivative claim under New York law where a corporation sues its outside auditor for professional malpractice or negligence in failing to detect fraud committed by the corporation).

181. *See id.* at 946 (considering questions certified from the Second Circuit).

182. *See id.* at 949 (considering a question certified by the Delaware Supreme Court).

*in pari delicto* doctrine, which is grounded in “fundamental concept[s] of morality and fair dealings.”<sup>183</sup>

The court used agency principles to find that the corporate officers’ acts were imputed to the principal in these cases because they were acting within the scope of their corporate authority.<sup>184</sup> It recognized that the adverse interest exception to imputation would be available if the agent had “*totally abandoned* his principal’s interests and [was] acting *entirely* for his own or another’s purpose.”<sup>185</sup> But where, as here, both the agent and the principal realized a benefit, the agent’s act was imputed to the principal.<sup>186</sup> The time at which to consider whether or not the agent’s act is adverse to the principal is the time at which the act was committed.<sup>187</sup> Therefore, a corporation’s ultimate demise is not evidence of an adverse act by the agent.<sup>188</sup> If the agent’s act was designed to enhance the corporation’s financial performance at the time, the agent was not acting adversely to the interests of the principal.<sup>189</sup>

The court noted the strong policy reasons for leaving the imputation principles untouched by exception, most importantly that “imputation fosters an incentive for a principal to select honest agents and delegate duties with care.”<sup>190</sup> The court pointed out that the adverse interest exception has a narrow

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183. *Id.* at 950.

184. *See id.* at 951 (noting that everyday activities central to a company’s operations and well-being such as “issuing financial statements, accessing capital markets, handling customer accounts, moving assets between corporate entities, and entering into contracts” fall within the scope of corporate officers’ authority).

185. *See id.* at 952 (citing *Center v. Hampton Affiliates*, 488 N.E.2d 828, 829–30 (N.Y. 1985) and adding emphasis).

186. *See id.* (noting that New York’s formulation of the adverse interest exception avoids ambiguity where there is a benefit to both the insider and the corporation).

187. *See id.* at 953 (noting that “the 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”).

188. *Id.*

189. *See id.* (“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—th[e] test [for the adverse interest exception] is not met.”).

190. *Id.* at 951–52.

scope.<sup>191</sup> If the disclosure of corporate fraud were to trigger the application of the exception then “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.”<sup>192</sup>

The court noted that no one contests that traditional imputation principles are essential in other contexts.<sup>193</sup> The plaintiffs here, it noted, were only suggesting the rules be revised in the *in pari delicto* context.<sup>194</sup> The court rejected this suggestion; it found its current rules in this context to be workable and anchored in sound public policy.<sup>195</sup> Why, for instance, should the innocent shareholders of the auditing or accounting firms be “held responsible for the sins of their errant agents while the innocent stakeholders of the corporation itself are not charged with knowledge of their wrongdoing agents”?<sup>196</sup> The court concluded that the doctrine of *in pari delicto* will bar a derivative claim where a corporation attempts to sue its outside auditor for failure to detect fraud committed by the corporation.<sup>197</sup>

### *b. Dissenting Opinion*

Three judges of seven disagreed that the *in pari delicto* doctrine supports such a hard-line stance.<sup>198</sup> The doctrine, they argued, is premised on “concepts of morality, fair dealings, and

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191. *See id.* at 952 (“The rationale for the adverse interest exception illustrates its narrow scope.”).

192. *Id.* at 953.

193. *See id.* at 954 (“No one disputes that traditional imputation principles, including a narrowly confined adverse interest exception, should remain unchanged—indeed, are essential—in other contexts.”).

194. *See id.* (“Although they do not stress the point, [plaintiffs’] proposals to revise imputation rules are limited to *in pari delicto* cases.”).

195. *See id.* at 959 (“The principles of *in pari delicto* and imputation, . . . which are embedded in New York law, remain sound.”).

196. *Id.* at 958.

197. *Id.* at 959.

198. *See id.* at 960 (“The principles underlying [agency law and the *in pari delicto*] doctrine do not support such a hard-line stance.”).

justice,” which should be shaped to the particulars of an individual case.<sup>199</sup> The adverse interest exception was created because, when an “agent is engaged in a scheme to defraud his principal,” the presumption of agency law—that the knowledge held by the agent was disclosed to the principal—fails.<sup>200</sup> The dissent agreed that the exception requires a showing of harm to the principal, but it found that harm in insider fraud.<sup>201</sup> It reasoned that giving the corporation longer life through fraud is “not a true benefit.”<sup>202</sup>

The dissent expressed concern that the public interest is not served by immunizing gatekeeper professionals.<sup>203</sup> It approved of the exceptions to imputation and *in pari delicto* recognized by New Jersey and Pennsylvania.<sup>204</sup> Specifically, the dissent would “recognize a carve-out or exception to the *in pari delicto* doctrine for cases involving corporate insider fraud enabled by complicit or negligent outside gatekeeper professionals.”<sup>205</sup>

### 5. Delaware

The Delaware Court of Chancery has not directly addressed, under Delaware law, whether an auditor may raise the *in pari delicto* defense against a plaintiff suing on behalf of a corporation imputed with its agents’ fraud. But it has considered imputation and the *in pari delicto* defense separately under Delaware law and together applying New York law.<sup>206</sup>

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199. *Id.* at 961.

200. *Id.* (citing *Center v. Hampton Affiliates, Inc.*, 488 N.E.2d 828, 829 (N.Y. 1985)).

201. *See id.* at 962 (“It is axiomatic that the adverse interest exception requires a showing of harm to the principal . . .”).

202. *See id.* (“[I]nsider fraud that merely gives the corporation life longer than it would naturally have is not a true benefit to the corporation but can be considered a harm.”).

203. *See id.* (“Important policy concerns militate against the strict application of these agency principles.”).

204. *See id.* at 963 (“For these and other reasons, our sister courts in New Jersey and Pennsylvania have carved out exceptions or limitations to the imputation and *in pari delicto* rules.”).

205. *Id.* at 964.

206. *See generally* *AIG II*, 976 A.2d 872 (Del. Ch. 2009) (addressing *in pari delicto* raised by co-conspirators who were not auditors and the adverse interest

First, in *In re American International Group, Inc., Consolidated Derivative Litigation (AIG I)*,<sup>207</sup> derivative plaintiffs brought suit against AIG's auditor PricewaterhouseCooper for malpractice and breach of contract.<sup>208</sup> Then-Vice Chancellor, now Chancellor Strine, writing for the Court of Chancery, held that New York law applied and required dismissal because "New York law immunizes an auditor's breach of its professional duty of care where it fails to discover a fraud committed by a corporation's top insiders."<sup>209</sup> In so holding, Strine was clear that Delaware law would not necessarily reach a similar outcome.<sup>210</sup>

Second, in the identically titled *In re American International Group, Inc., Consolidated Derivative Litigation (AIG II)*,<sup>211</sup> the court considered the derivative plaintiffs' claim against non-auditor co-conspirators.<sup>212</sup> Here, Delaware law applied and the Court of Chancery, again through Chancellor Strine, dismissed the claim because *in pari delicto* barred the plaintiffs—acting on behalf of the corporation—from recovering from third-party co-conspirators. In these recent cases, Delaware's Court of Chancery presents its position in support of a strong *in pari delicto* defense, but not to immunize auditors.<sup>213</sup> These cases offer helpful critique of New York's extreme position—to immunize auditors in all cases—and offer suggestions on how the law could do better.

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exception under Delaware law); AIG I, 965 A.2d 763 (Del. Ch. 2009) (addressing imputation, the adverse interest exception, and *in pari delicto* applying New York law).

207. See AIG I, 965 A.2d at 831 (holding that under New York law *in pari delicto* barred the shareholder derivative claims against AIG's auditor).

208. See *id.* at 776 (presenting plaintiffs' claim against PricewaterhouseCooper).

209. *Id.* at 779.

210. See *id.* at 828 & n.246 (presenting seven reasons why Chancellor Strine would be "chary about following the New York approach").

211. See AIG II, 976 A.2d at 877 (holding that a corporation may not recover against its third-party co-conspirators).

212. See *id.* at 875–77 (presenting the derivative plaintiffs' claims against an insurance broker, an insurer, a reinsurance corporation, and their subsidiaries).

213. See *id.* at 895 & n.60 (finding that *in pari delicto* should bar a corporation's suit against its co-conspirators but that the corporation "is free to go after its own directors, officers, and employees," and including outside auditors in the group of "corporate insiders" from whom the corporation can recover).

*a. The Adverse Interest Exception and In Pari Delicto*

The Court of Chancery's application of the adverse interest exception highlights the exception's inadequacy in the corporate fraud context. In *AIG I*, Chancellor Strine held that, under New York law, the adverse interest exception could not apply because the directors and officers acted, in part, to benefit the corporation.<sup>214</sup> In so finding, the Chancellor was critical of New York's approach to the exception:

In reaching this conclusion, I note that in applying the in pari delicto doctrine, New York law does not embrace the notion that any conscious act of a fiduciary causing a corporation to break the law is against the corporation's charter and best interests. In the in pari delicto context, what the adverse interest test is directed to is whether the insider is essentially stealing from the corporation as opposed to engaging in improper acts that, even if also self-interested, have the effect of benefiting the corporation financially, even if that benefit rested on illegal accounting or other illicit conduct.<sup>215</sup>

This passage conveys the court's disagreement with a test for the adverse interest exception—in the specific case of applying the exception to prevent the *in pari delicto* defense—that focuses on corporate benefit. The court seems to suggest that when an agent “engag[ed] in improper acts,” which are contrary to the corporation's charter and best interest,<sup>216</sup> the corporation should not be barred from recovery by the *in pari delicto* defense.<sup>217</sup> This point illustrates that imputation and the adverse interest exception are inadequate tools for measuring corporate fault as an element of the *in pari delicto* defense. They do not take into account that the agent's fraud—which should not be deemed “adverse” because it is the very act that imputation is designed to

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214. *AIG I*, 965 A.2d 763, 827 (Del. Ch. 2009).

215. *Id.*

216. See, e.g., MODEL BUS. CORP. ACT § 3.01 (2007) (“Every corporation incorporated under this Act has the purpose of engaging in any lawful business . . . .”); DEL. CODE ANN. tit. 8, § 101(b) (2011) (“A corporation may be incorporated or organized under this chapter to conduct or promote any lawful business or purposes . . . .”).

217. See *AIG II*, 976 A.2d 872, 891 (Del. Ch. 2009) (providing an example to illustrate that *in pari delicto* should give way to allow recovery when a corporation is suing a third party who helped an agent harm the corporation).

protect third parties against—is contrary to the corporation’s interest, lawful purpose, and long-term health.<sup>218</sup> This inadequacy is further highlighted by the court’s application of the exception in *AIG II*.

Despite the court’s criticism of New York’s approach in *AIG I*, in *AIG II*—applying Delaware law—the court followed New York’s approach to find that the *in pari delicto* defense applied. In this case, the court did not clearly articulate the rule for the adverse interest exception under Delaware law.<sup>219</sup> Indeed, the court cited to *Cenco*, a decision that it criticized in *AIG I* as “free-wheeling.”<sup>220</sup> The *AIG II* court required, and did not find, “total abandonment of the corporation’s interests” for the adverse interest exception to apply.<sup>221</sup>

This approach is not consistent with prior Delaware law on the adverse interest exception.<sup>222</sup> Chancellor Strine recently

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218. Cf. Strine et al., *supra* note 66, at 650 (“When directors knowingly cause the corporation to . . . engage in unlawful acts . . . they are disloyal to the corporation’s essential nature. By causing the corporation to become a lawless rogue, they make the corporation untrue to itself and to the promise underlying its own societally authorized birth.”).

219. See *AIG II*, 976 A.2d 872, 891 (Del. Ch. 2009) (“Many courts have recognized the so-called ‘adverse-interest exception,’ which permits a corporation to sue its co-conspirators when the corporate agent responsible for the wrongdoing was acting solely to advance his own personal financial interest, rather than that of the corporation itself.” (emphasis added) (citing authority from the Second Circuit which applied New York law)).

220. *AIG I*, 965 A.2d 763, 826 (Del. Ch. 2009).

221. *AIG II*, 976 A.2d at 891. The court hinted that a corporation “should be able to sue the third party that helped the fiduciary harm the corporation,” but apparently did not find sufficient “harm” to the corporation for that to be relevant here. *Id.* Using a circular justification, the court indicated that to prevent a complicit third party from raising the *in pari delicto* defense, the conspirators would have to be “harming” the corporation such that the adverse interest exception would apply, which itself would preclude use of *in pari delicto*. See *id.* (finding that the corporation here could *not* sue the third party which helped its fiduciaries harm it because the fiduciaries were not alleged to have totally abandoned the corporation’s interests as would be necessary to invoke the adverse interest exception). This may be explained by the court’s position in a footnote that the adverse interest exception can be seen as an exception either to *in pari delicto* or to imputation with the same effect. *Id.* at 891 n.50.

222. See *In re HealthSouth Corp. S’holders Litig.*, 845 A.2d 1096, 1108 n.22 (Del. Ch. 2003) (“When corporate fiduciaries—such as [the corporation’s] managers—have a self-interest in concealing information—such as the falsity of the financial statements that they had helped prepare—their knowledge cannot



stated: “When corporate fiduciaries—such as [the corporation’s] managers—have a self-interest in concealing information—such as the falsity of the financial statements that they had helped prepare—their knowledge cannot be imputed to the corporation.”<sup>223</sup> If Delaware applied this rule in all corporate fraud cases, the corporate insiders’ fraud would rarely if ever impute to the corporation.

But Delaware did not adhere to this rule in *AIG II* for three possible reasons. First, the identity of the defendant altered the court’s willingness to foreclose plaintiff’s recovery. In *AIG I*, when plaintiffs brought suit against AIG’s auditor, the court was highly critical of New York’s rule which “immunizes auditors.”<sup>224</sup> And on the facts of a 2003 case<sup>225</sup> when recovery by the plaintiff would have been absurd, the court articulated a low standard for the adverse interest exception to avoid imputation.<sup>226</sup> But in *AIG II*, plaintiffs sought to recover from non-auditor co-conspirators. Here, the court favored application of New York’s hard-to-attain adverse interest exception and rigid *in pari delicto* doctrine because it sought to avoid helping the corporation shift costs to its “partners in crime.”<sup>227</sup>

A second reason the court may have applied the adverse interest exception differently is that the court is limited by the

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be imputed to the corporation.”); *Holley v. Jackson*, 158 A.2d 803, 808 (Del. Ch. 1959) (“Ordinarily the knowledge of an agent is imputed to his principal . . . [but] where an agent is interested in the result of a transaction adversely to the interest of his principal, the rule of imputed knowledge on the part of the principal no longer obtains.” (citation omitted)).

223. *In re HealthSouth Corp.*, 845 A.2d at 1108 n.22.

224. *See, e.g., AIG I*, 965 A.2d at 779 (holding that the claim must be dismissed despite pleading which suggest that the auditor did not live up to its responsibilities).

225. *See In re HealthSouth Corp.*, 845 A.2d at 1107 (holding that defendant’s argument “lack[ed] logical force” when he attempted to invoke the *in pari delicto* defense by imputing his wrongdoing as CEO, and the wrongdoing of his subordinates, to the corporation attempting to recover from him).

226. *See id.* (finding that imputing to the corporation the conduct of managers to allow the CEO defendant, to whom the managers reported, to raise *in pari delicto* would be “silly”).

227. *See AIG II*, 976 A.2d 872, 894 (Del. Ch. 2009) (finding that as between derivative plaintiffs and non-auditor co-conspirators, “[a]dhering to a more traditional approach to *in pari delicto* yields a more productive and efficient result”).

advocacy of the parties before it.<sup>228</sup> The *AIG II* court was unimpressed with the plaintiffs' arguments against *in pari delicto* which included advancing new exceptions to the doctrine.<sup>229</sup> Lastly, the adverse interest exception and *in pari delicto* are alterable doctrines which have been subject to results-driven application.<sup>230</sup> Courts apply the adverse interest exception inconsistently because it does not address the core issue—the corporation's blameworthiness and the suitability of foreclosing its ability to sue a third party.<sup>231</sup>

### *b. Auditors as Defendants*

In dicta, the Court of Chancery in *AIG I* and *AIG II* presented a clear position on auditor liability in the corporate fraud context.<sup>232</sup> It found that auditors are more like corporate-insider agents than outside third parties.<sup>233</sup> And because “imputation does not furnish a basis on which an agent may defend against a claim by the principal,” an auditor likewise

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228. See, e.g., *AHERF*, 989 A.2d 313, 333 (Pa. 2010) (“Common-law decision-making is subject to inherent limitations, as it is grounded in records of individual cases and the advocacy by the parties shaped by those records.”); *AIG II*, 976 A.2d at 884 (admonishing plaintiffs for advancing “several hard to distinguish arguments”).

229. See *AIG II*, 976 A.2d at 884 (“[P]laintiffs seek to exploit the squishy manner in which some courts have employed the *in pari delicto* doctrine and to avoid dismissal by having this court find that this case falls within some ‘exception’ to the traditional application of the doctrine.”).

230. See *supra* Part II.A.1 (discussing courts’ use of the adverse interest exception including carve-outs to the rule created to achieve a just result); see also *AIG I*, 965 A.2d 763, 826–27 (Del. Ch. 2009) (noting that “some courts applying New York law have arguably strained logic and linguistics to avoid applying the adverse interest exception faithfully”).

231. See *infra* Part IV.A (arguing that *in pari delicto* should only be available in those cases where the corporation bears actual fault).

232. See *AIG II*, 976 A.2d at 895 n.60 (“Suits against corporate agents like outside auditors are best conceived of as also within the confines of a single corporate conspirator and are consistent with the traditional acceptance of derivative suits against corporate insiders.”).

233. See *AIG I*, 965 A.2d at 828 n.246 (“Immunizing the auditor does not aid *genuine* third-parties, as such immunity is not necessary for the corporation to be held responsible to third-parties for the insiders’ official wrongdoing.” (emphasis added)).

should not be permitted to invoke imputation.<sup>234</sup> Without imputation, the court found that an auditor has no basis for an *in pari delicto* defense because “the corporation did not know of the illegal conduct and was not at equal fault.”<sup>235</sup>

Delaware takes the position that “regardless of whether the adverse interest exception is seen as an exception to *in pari delicto* or to imputation, the effect is the same.”<sup>236</sup> It is useful, however, to keep the agency law principle of imputation distinct from the *in pari delicto* doctrine. The adverse interest exception applies only to imputation. And accordingly, asking if a corporation knew of the illegal conduct *through imputation* is distinct from asking if the corporation was at equal fault under *in pari delicto*.<sup>237</sup> Courts’ use of imputation to find “fault” as an element of the *in pari delicto* defense is misplaced. Separating the two doctrines is essential to bringing the right issue—the corporation’s wrongdoing—into focus. The questions then become whose acts can best capture the acts of “the corporation,” and what constitutes wrongdoing?<sup>238</sup>

### III. Current Law Does Not Adequately Address the Issue

#### A. Where the Law Stands at Present: Imputation Sometimes

While many courts have considered auditor liability in the corporate fraud context, their approaches to the issue are varied. Some courts have followed the pioneering case of *Cenco* to rely on

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234. RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b (2006); *see also* AIG II, 976 A.2d 872, 890 n.49 (Del. Ch. 2009) (using the term “corporate agents” to encompass both auditors and corporate insiders and noting that “the policy basis for allowing . . . derivative suits can easily be seen as justifying claims against corporate agents like outside auditors”).

235. AIG II, 976 A.2d at 891 n.50.

236. *Id.*

237. *See infra* Part IV (arguing that a corporation’s fault should be measured based on the actions of the board, not based on imputation principles intended for a different purpose—that of protecting third parties with a claim against the corporation).

238. *See infra* Part IV.B (arguing that a corporation should be judged by the adequacy of the information gathering and reporting systems implemented by the board of directors and carried out by corporate employees).

tort-liability objectives.<sup>239</sup> These courts will impute the corporate officers' fraud to the corporation if the fraud led to any short-term benefit and will rely on this imputation to prevent a party acting on behalf of the corporation from pursuing a claim against the corporation's auditor.<sup>240</sup> Others have attacked the problem focusing primarily on agency law principles.<sup>241</sup> This mode of analysis will preclude a collusive auditor but not a negligent auditor from raising the *in pari delicto* defense. Because a third party who does not deal with a principal in good faith has no basis in agency law to invoke imputation, the argument goes, it has no basis for the *in pari delicto* defense.<sup>242</sup> Still others have used some combination of both or have simply held that, as a policy matter, auditors may not invoke imputation.<sup>243</sup> Because imputation and the adverse interest exception do not squarely address the problem, these courts have used policy and fairness arguments to conclude that auditors should not be immune from liability.<sup>244</sup> One commonality among all approaches is a focus on

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239. See, e.g., *In re Jack Greenberg*, 212 B.R. 76, 90 (E.D. Pa. 1997) (“[I]t appears that what the *Cenco* line of cases adds to the jurisprudence is an express recognition, implicit in the earlier imputation cases, that the objectives of tort liability are to be the touchstone by which a court should consider the invocation of the doctrine.”).

240. See, e.g., *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 952 (N.Y. 2010) (relying on *Cenco* to find that the adverse interest exception should not apply, and *in pari delicto* should bar the claim, when the officers' conduct defrauds others for the corporation's benefit rather than defrauding the corporation itself).

241. See generally *AHERF*, 989 A.2d 313 (Pa. 2010) (noting that agency law plays a pivotal role in the availability of the *in pari delicto* defense and concluding that auditors accused of fraud may not raise the defense because agency law does not allow a complicit third party to invoke imputation).

242. See RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b (2006) (“[I]mputation protects innocent third parties but not those who know or have reason to know that an agent is not likely to transmit material information to the principal.”).

243. See, e.g., *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 888 (N.J. 2006) (“[Tort] principles, applied in light of the nature of today's corporations, require that [shareholder] suits be permitted and that negligent auditors be held responsible for their wrongdoing.”).

244. See *id.* at 885, 888 (discussing the unfairness of “punish[ing] the many for the faults of the few,” and explaining that tort principles applied in light of the nature of today's corporation require that auditor malpractice suits be permitted).

imputation and the adverse interest exception rather than on the *in pari delicto* defense.<sup>245</sup>

The use of the *in pari delicto* defense—an absolute defense that precludes the plaintiff from reaching the merits of its case and insulates auditors as a group from liability—deserves more thoughtful consideration. Notwithstanding Judge Posner’s famous declaration that “fraud on behalf of a corporation is not the same thing as fraud against it,”<sup>246</sup>—which led courts and advocates to focus on imputation and the adverse interest exception—one agent’s fraud should not be the touchstone of an analysis into whether the corporation is a wrongdoer in the pertinent sense. Imputation and the adverse interest exception will be relevant to some claims and defenses in corporate fraud cases, but they should not be determinative of allowing or disallowing the *in pari delicto* defense.<sup>247</sup> Imputation does not carry the burden of showing that a corporate plaintiff is at fault for the underlying illegality, which is a necessary element of the *in pari delicto* defense.<sup>248</sup>

### *B. The Direction the Law Should Travel: Imputation Should Apply*

#### *1. The Adverse Interest Exception Should Not Apply*

A corporation should be imputed with the knowledge of its agents.<sup>249</sup> The adverse interest exception to imputation addresses a specific, limited set of circumstances.<sup>250</sup> It will not and should

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245. See, e.g., *AHERF*, 989 A.2d at 328 (“The Latin derivation and equitable origins of the underlying common-law maxim [of *in pari delicto*] have been well traveled and need not be revisited at length here.”).

246. *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982).

247. See *supra* note 72 (discussing imputation’s role in other defenses).

248. See *AIG I*, 965 A.2d 763, 828 n.246 (Del. Ch. 2009) (finding that New York’s approach to imputation and *in pari delicto* “addresses the issue by rote, applying agency principles developed for other purposes”).

249. See *supra* Part II.A (discussing imputation).

250. See, e.g., *DeMott*, *supra* note 11, at 309 (noting that the adverse interest exception addresses the narrow range of cases where the conduct by an agent “is so wholly antagonistic to the principal’s interests that the relationship between principal and agent could be viewed as severed”).

not apply to the vast majority of cases dealing with auditor liability in the corporate fraud context.<sup>251</sup> Trying to shove the square peg of auditor liability into the round hole of the adverse interest exception has led to confused rules governing imputation.<sup>252</sup>

The law should probe why an auditor should or should not be permitted to invoke the absolute defense of *in pari delicto* when it is charged with failure to comply with professional standards in effectuating its engagement when that compliance is most critical.<sup>253</sup> Asking whether the corporation retained a short-term benefit from its agent's fraud to trigger the adverse interest exception and defeat imputation simply does not get us there.

## *2. Imputation Should Not Turn on Whether Auditors Were Negligent or Collusive*

Just as inquiries into corporate benefit or an agent's intent do not target the crux of the issue, neither does an approach that bifurcates the issue based on whether the auditor was negligent or complicit in the fraud.<sup>254</sup> As determined in Part II, agency principles should defeat imputation against a collusive auditor but not against a negligent auditor.<sup>255</sup> From a policy standpoint,

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251. See *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 954 (N.Y. 2010) (noting that “[n]o one disputes that traditional imputation principles, including a narrowly confined adverse interest exception, should remain unchanged—indeed, are essential—in other contexts”); see also *id.* (noting that plaintiffs’ proposed formulation of the adverse interest exception would push it “up to if not beyond the point of extinction”).

252. See, e.g., discussion *supra* Part II.A.1.a (presenting the court-fashioned exceptions to the adverse interest exception).

253. See *AIG I*, 965 A.2d at 828 n.246 (praising the New Jersey Supreme Court’s approach which treats “*in pari delicto* differently as to auditors precisely because auditors are employed in part as a safeguard against managerial financial fraud”).

254. See *AHERF*, 989 A.2d 313, 335–36 (Pa. 2010) (holding that, in light of the competing concerns at stake, the best course for Pennsylvania is to recognize the availability of the *in pari delicto* defense, via the necessary imputation, in the negligent-auditor context but not in the collusive-auditor context).

255. See *supra* Part II.A.2 (determining that *in pari delicto* should not be available to a third party who secretly colluded with the principal’s agent to commit fraud—even if the fraud isn’t “adverse” as the term is defined by state law); see also *AHERF*, 989 A.2d at 336 (“[T]he ordinary rationale supporting

though, there is no basis for the distinction.<sup>256</sup> Fraud is a more egregious act, but an unsound audit flawed by negligence is equally harmful to the public. And a rule that encourages auditors “not to investigate too closely” does not address the need for sound audits that help to deter corporate fraud.<sup>257</sup>

*C. What Is at Stake in Allowing Claims to Proceed  
Against Auditors*

The importance of how courts apply the *in pari delicto* defense in corporate fraud cases is underscored by the general debate over whether it is desirable to allow suit against auditors.<sup>258</sup> An auditor’s role in corporate monitoring is becoming increasingly important; it has been the subject of recent legislation such as the Sarbanes–Oxley Act of 2002<sup>259</sup> and the 2010 Dodd–Frank Act.<sup>260</sup> The divergent opinions regarding the wisdom of allowing or prohibiting suit against auditors are surveyed briefly below.

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imputation breaks down completely in scenarios involving secretive, collusive conduct between corporate agents and third parties.”).

256. See, e.g., *supra* Part III.C.2.a1 (discussing the important role auditors play in informing investors).

257. See John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 345 (2004) (“[P]ublic policy must seek to minimize the perverse incentives that induce the gatekeeper not to investigate too closely.”).

258. See, e.g., *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994) (discussing secondary liability and holding that a private plaintiff may not maintain an aiding and abetting suit under § 10(b) of the Securities Exchange Act of 1934 because the text does not prohibit aiding and abetting); see also *Stoneridge Inv. Partners, LLC v. Scientific Atlanta, Inc.*, 552 U.S. 148, 153 (2008) (holding that investors do not have a private right of action under § 10(b) of the Securities Exchange Act of 1934 against customer and supplier companies who participated in the investors’ company’s fraud because the investors did not rely upon their statements or representations).

259. Sarbanes–Oxley Act of 2002, 15 U.S.C. § 7201 (2006).

260. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

*1. Why the Law Should Insulate Auditors**a. Current Law Should Not Be “Weakened by Exception”*

Application of simple agency principles to the chain of events in corporate fraud cases—the existence of an agency relationship, an agent’s fraud imputed to the principal corporation, the corporation then being blocked from bringing a grievance to court—ends the legal issue under one point of view.<sup>261</sup> The New York Court of Appeals finds that existing law addresses the issue squarely and finds no reason that existing law should be “weakened by exception.”<sup>262</sup> Especially when “there are strong considerations of public policy underlying this precedent: imputation fosters an incentive for a principal to select honest agents and delegate duties with care.”<sup>263</sup>

*b. The Public Is Best Served by Protecting Auditors*

Proponents of auditor protection also argue that allowing fraudulent corporations to shift responsibility to an outside auditor will lead to a misallocation of responsibilities.<sup>264</sup> A corporation will

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261. See *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 959 (N.Y. 2010) (“[T]he principles of in pari delicto and imputation, with its narrow adverse interest exception, which are embedded in New York law, remain sound.”).

262. *Id.* at 950 (citing *McConnell v. Commonwealth Pictures Corp.*, 166 N.E.2d 494 (N.Y. 1960)).

263. *Id.* at 951–52; see also *id.* at 953 (noting that the presumption of imputation reflects the recognition that principals are best suited to police their agents); *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 904 (N.J. 2006) (Rivera-Soto, J., dissenting) (noting that allowing a company to shift the consequences of its own fraud may diminish management’s incentive to exercise due care in its own responsibilities); *AHERF*, 989 A.2d 313, 322 (Pa. 2010) (presenting defendants’ argument that allowing a corporation to sue its auditor would unwisely reduce incentives for corporations in selecting and monitoring their agents). *But see* *AIG I*, 965 A.2d 763, 828 n.246 (Del. Ch. 2009) (“I do not understand how immunizing the auditors employed to help the independent directors monitor will make either stockholders or independent directors better monitors. I really do not get that.”).

264. See, e.g., *Kirschner*, 938 N.E.2d at 957 (framing the issue before the court as whether a corporation should be permitted to shift responsibility for their own agents’ misconduct to third parties); see also *NCP Litig. Trust*, 901 A.2d at 904 (Rivera-Soto, J., dissenting) (noting the argument presented by the American Institute of Certified Public Accountants); *AHERF*, 989 A.2d at 334



inevitably be the primary wrongdoer;<sup>265</sup> the auditor's role is limited and secondary.<sup>266</sup> Further, to punish the auditor's innocent shareholders rather than the fraudulent corporation's innocent shareholders creates a double standard.<sup>267</sup>

Forcing auditors to defend their actions in court could lead to "legal extortion."<sup>268</sup> And the fear of liability will change the way audits are performed. Audits will become more expensive<sup>269</sup> and inaccessible to riskier clients such as small businesses with less sophisticated internal controls.<sup>270</sup>

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(citing *AIG II*, 976 A.2d 872, 889 (Del. Ch. 2009)).

265. See *Kirschner*, 938 N.E.2d at 958 (noting that "the corporation's agents would almost invariably play the dominant role"); see also *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982) ("If [the auditor] failed to police its people, [the corporation] failed as or more dramatically to police its own.").

266. See *NCP Litig. Trust*, 901 A.2d at 904 (Rivera-Soto, J., dissenting) (noting that the "auditor's role in the accurate presentation of a client's financial statement is limited, and most importantly, secondary to that of the client"). But see *AIG I*, 965 A.2d at 828 n.246 ("I question the soundness of premising a legal rule on the belief that, in a simplistic binary choice, independent directors are better equipped to detect high-level fraud than a company's auditor.").

267. See *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 958 (N.Y. 2010) (stating that allowing corporations to shift responsibility for their own agents' misconduct would create a double standard by which the innocent shareholders of the outside professional are held responsible for the sins of their errant agents but those of the corporation are not).

268. See *NCP Litig. Trust*, 901 A.2d at 903 n.14 (Rivera-Soto, J., dissenting) (finding that the majority's rule "merely sanctions what is referred to as nothing more than legal extortion: seeking a settlement simply because the costs of defense are prohibitive"); cf. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 163 (2008) (fearing in the securities fraud context that expanding the cause of action available under § 10(b) would "allow plaintiffs with weak claims to extort settlements from innocent companies").

269. See *AHERF*, 989 A.2d 313, 326 (Pa. 2010) (noting the argument of the Accountant Institute that allowing the corporation to shift responsibility for its wrongdoing would "result in prohibitively expensive audits").

270. See *id.* at 327 ("[A]ccountants will be forced to be more selective about the clients they serve, choosing only those with 'blue ribbon' risk management and oversight systems, and rejecting those with less sophisticated internal controls to minimize the accountant's litigation risk.").

## 2. *Why the Law Should Not Insulate Auditors*

### a. *Auditors Should Be Held Accountable for Their Work*

The arguments against isolating auditors from liability turn on their role as a gatekeeper. Shareholders rely on third-party professionals to monitor the officers and directors of the companies in which they invest.<sup>271</sup> In reality, most shareholders have no control over management and should not be saddled with the unrealistic expectation of selecting honest agents.<sup>272</sup> And just as the law must seek to deter wrongdoing within corporations, it must seek to deter auditor wrongdoing.<sup>273</sup> To completely isolate such a group from the possibility of liability for negligent or fraudulent work would be inequitable.<sup>274</sup>

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271. See *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 886 (N.J. 2006) (“[M]any investors play a passive role in the oversight of a firm’s day-to-day operations, relying instead on third-party professionals to assist in monitoring the corporation’s officers and directors.”); *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 962 (N.Y. 2010) (Ciparick, J., dissenting) (“Investors rely heavily on information prepared by or approved by auditors, accountants, and other gatekeeper professionals.”).

272. See *NCP Litig. Trust*, 901 A.2d at 886 (“[T]he nature of today’s corporation makes it increasingly unlikely that shareholders of large corporations have the ability to effectively monitor the actions of corporate officials.”).

273. See *id.* (“[O]ur focus cannot be limited only to deterring wrongdoing on the part of corporate shareholders. We must seek to deter wrongdoing on the part of corporate auditors.”); Coffee, *supra* note 257, at 345 (“[P]ublic policy must seek to minimize the perverse incentives that induce the gatekeeper not to investigate too closely.”).

274. See *NCP Litig. Trust*, 901 A.2d at 890 (“A limited imputation defense will properly compensate the victims of corporate fraud without indemnifying wrongdoers for their fraudulent activities.”); *AHERF*, 989 A.2d at 332 (“[W]e are cognizant of the special—and crucial—role assumed by independent auditors as a check against potential management abuses.”); *Kirschner*, 938 N.E.2d at 962 (Ciparick, J., dissenting) (“Indeed, these simplistic agency principles as applied by the majority serve to effectively immunize auditors and other outside professionals from liability wherever any corporate insider engages in fraud.”); see also *id.* at 963 (Ciparick, J., dissenting) (“[S]trict imputation rules merely invite gatekeeper professionals to neglect their duty to ferret out fraud by corporate insiders because even if they are negligent, there will be no damages assessed against them for their malfeasance.” (citations omitted)).

*b. Auditor Liability Need Not Be Uncapped*

Opening auditors to the possibility of liability does not require that they be exposed to “uncapped liability” for their negligent failure to detect financial fraud by corporate managers.<sup>275</sup> This concern over keeping the auditor industry healthy can be addressed in ways other than complete immunity, such as by capping liability at some multiple of audit fees and allowing audit firms full indemnification rights against any insider who acted with scienter.<sup>276</sup>

*IV. Proposed Solution*

This Note argues that auditors should *not* be immune from liability for negligent work simply because they performed that work for a corporation whose insider directors or officers committed fraud. This is not because those fraudulent acts are not imputed to the corporation. They are. It is because imputation should not be determinative of whether a defendant may successfully invoke the *in pari delicto* defense. Imputation requires a court to ask if an agent’s acts were sufficient to ascribe legal responsibility to the principal; *in pari delicto* requires a court to ask if the plaintiff bears substantially equal fault for the harm it suffered for which it seeks redress.<sup>277</sup> These are not the same question.

Imputation plays a different role (1) when the corporation defends against suit by a third party, and (2) when it attacks a third party, as a plaintiff, for the third party’s wrongdoing that harmed the corporation.<sup>278</sup> In the first case, imputation ends the

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275. AIG I, 965 A.2d 763, 828 n.246 (Del. Ch. 2009).

276. See *id.* (noting that the New York approach does not address possible solutions to the fear of uncapped liability in a direct or thoughtful way).

277. See, e.g., Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 307 (1985) (defining the classic formulation of *in pari delicto* to include situations “where the plaintiff truly bore at least substantially equal responsibility for his injury”).

278. See AIG I, 965 A.2d at 828 n.246 (criticizing the New York rule which combines imputation and *in pari delicto* to bar claims against an auditor because the rule “conflates, in a simplistic way, related, but separate, questions of agency”); see also *id.* (“It is a policy judgment, not some rote conflation of contextually different questions of agency, that must determine whether, [like

inquiry. It is for this case that agency principles were developed and function properly.<sup>279</sup> It is also here that the “severe” results of imputation are supportable: as between a third party and a corporation, the corporation should be held responsible for its agent’s acts regardless of fault.<sup>280</sup> But in the second case, a determination of fault is required and demands a more thoughtful analysis than simple agency principles are designed to provide.<sup>281</sup> Imputation—or, more precisely, the fraud committed by the corporation’s agents—will play a role in this analysis, but not a determinative one.

*A. In Pari Delicto Should Apply Only if the Corporation Is a Wrongdoer*

Auditors use the *in pari delicto* defense to block suit brought on behalf of a corporation imputed with its agents’ fraud. *In pari delicto* literally means “in equal fault,” and is intended to prevent a “deliberate wrongdoer from recovering from a co-conspirator or accomplice.”<sup>282</sup> An element of the defense, then, is that the corporate plaintiff be a wrongdoer.<sup>283</sup>

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an inside director accused of negligence], an auditor should face liability for professional negligence to its client corporation in similar circumstances.”); RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (2006) (“Knowledge, including imputed knowledge, is not always determinative of, and sometimes is not even relevant to, certain claims and defenses.”).

279. See DeMott, *supra* note 11, at 292–93 (“Treating nations and corporations as legally consequential persons necessitates doctrines—like imputation and other agency-law doctrines—that explain how such persons may take action in the physical world with legal consequences.”).

280. See *id.* at 319 (noting that a principal should be liable to third parties “even when the principal was without fault in selecting or monitoring the agent”).

281. See, e.g., RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (2006) (stating that a principal’s claim against an auditor “should not be defeated by imputing to the principal its agents’ knowledge of deficiencies in the processes under scrutiny”); see also AIG I, 965 A.2d 763, 828 n.246 (Del. Ch. 2009) (finding that New York’s approach to imputation and *in pari delicto* “addresses the issue by rote, applying agency principles developed for other purposes”).

282. *Baena v. KPMG LLP*, 453 F.3d 1, 10 (1st Cir. 2006) (applying *in pari delicto* to bar plaintiff’s claim under Massachusetts law).

283. See, e.g., *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 307 (1985) (defining the classic formulation of *in pari delicto* to include situations “where the plaintiff truly bore at least substantially equal

Only if the corporation is at fault in a meaningful sense of the term should the corporation be deemed a wrongdoer, and only then should the defense of *in pari delicto* apply.<sup>284</sup> Imputing the act of an agent should not be enough. Fault is not necessary, nor even relevant to, the process of imputation.<sup>285</sup> Agency doctrines are “not fault-based; the legal consequences of an agent’s actions are attributable to a principal even when the principal was without fault in selecting or monitoring the agent.”<sup>286</sup>

That the corporation may not be at fault even though an agent committed fraudulent acts becomes especially apparent when one considers that an auditor, *who was retained for the very purpose of monitoring corporate activity*, failed to meet its professional standards.<sup>287</sup> What is more, it is only in those cases where the very thing auditors are retained to help guard against—fraud—exists that the *in pari delicto* defense has worked to immunize auditors from answering for their own potential wrongdoing.<sup>288</sup> A corporation doing everything right should not be barred from seeking redress for harm that it

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responsibility for his injury”).

284. *Cf.* F.D.I.C. v. O’Melveny & Myers, 969 F.2d 744, 751 (9th Cir. 1992) (“We conclude that ADSB has a corporate identity distinct from that of its wrongdoing officers.”).

285. *See, e.g.*, DeMott, *supra* note 11, at 319 (“Basic agency doctrines are not fault-based . . .”).

286. *Id.*

287. *See* AIG I, 965 A.2d 763, 828 n.246 (Del. Ch. 2009) (“[A]lthough auditors give no warranty that they can detect fraud, the requirement for public companies to employ auditors is in large measure inspired by the recognition that corporate insiders have more than rarely been known to engage in financial shenanigans.”); *see also* NCP Litig. Trust v. KPMG LLP, 901 A.2d 871, 886 (N.J. 2006) (“[T]hird-party auditors are specifically retained for the task of monitoring corporate activity.”).

288. *See* AIG I, 965 A.2d at 828 n.246 (“[I]mmunizing auditors in situations when, but for the auditor’s professional negligence, wrongful managerial behavior may have been stopped before it resulted in grievous harm relieves the audit firm of any responsibility in one of the circumstances when the auditor’s compliance with its professional standard of care is most critical.”); AIG II, 976 A.2d 872, 890 n.49 (Del. Ch. 2009) (“[T]here is a strong argument to be made that [gatekeeper professionals like auditors] ought to be accountable for their malpractice and not be immunized by the very actions that were not discovered due to their failure to meet expected professional standards.”).

suffered based solely on the existence of a fraudulent agent somewhere in its ranks.<sup>289</sup>

Not every corporation, perhaps not most, will fit this mold. In *Cenco*, for example, the massive fraud involved the chairman and president, a number of vice presidents, and other top management; and the evidence suggested that those directors not involved were “negligent in allowing [the fraud] to flourish undetected beneath their noses.”<sup>290</sup> This was not a case of one or several rogue agents committing fraud. Many parties with control used the corporation to engage in massive fraud. Here, it would be fair to consider the corporation a wrongdoer and bar it from bringing a claim before the court. Relying on simple imputation principles to reach this result, however, “conflates, in a simplistic way, related, but separate, questions of agency.”<sup>291</sup> To determine a corporation’s fault, then, the law can and should look elsewhere.

### *B. Measuring Fault to Determine if the Corporation Is a Wrongdoer*

A corporation can only act through its agents.<sup>292</sup> Any attempt to judge a corporation will be limited by this reality. But this limitation should not be fatal to an attempt at better measuring a corporation’s actions than through simple agency principles.<sup>293</sup> One possible solution is to assess a corporation’s fault based on the information gathering and reporting systems that the board of directors has in place to deter and detect fraud. Corporate law

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289. See, e.g., *In re NM Holdings Co., LLC*, 411 B.R. 542, 550 (E.D. Mich. 2009) (“The rationale for applying the sole actor exception [and imputing the agent’s fraud] is much weaker where the wrongdoer is not the sole shareholder because the identity between the corporation and the wrongdoer is more attenuated in such cases.”).

290. *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 451 (7th Cir. 1982).

291. *AIG I*, 965 A.2d at 828 n.246.

292. See, e.g., *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 950 (N.Y. 2010) (“Corporations are not natural persons. Of necessity, they must act solely through the instrumentality of their officers or other duly authorized agents.” (citations omitted)).

293. See *AIG I*, 965 A.2d 763, 828 n.246 (Del. Ch. 2009) (finding that auditor liability should be addressed in a “direct or thoughtful way,” not “by rote, applying agency principles developed for other purposes”).

supports the proposition that the policies implemented by the board of directors are a good measure of a corporation's acts.

Upon incorporation, every corporation will create articles of incorporation, adopt bylaws, and elect a board of directors.<sup>294</sup> The board of directors will then appoint officers to function in the capacity set forth in the bylaws, generally management of the day-to-day operations.<sup>295</sup> The officers remain under the direction, and subject to the oversight, of the board of directors.<sup>296</sup> In addition to selecting corporate management, the board of directors must implement information gathering and reporting systems to keep informed.<sup>297</sup> These systems must monitor the activities of both high-level managers and lower-level employees to allow the board and senior management to "reach informed judgments concerning . . . the corporation's compliance with law."<sup>298</sup> Failure to assure that such systems exist would be a breach of the board's fiduciary duty to shareholders and could render directors personally liable to shareholders for harm caused by the failure.<sup>299</sup>

Through this structure, all corporate activity and corporate policy originates from the board of directors. The systems put in place and implemented by the board of directors, then, may provide the best yardstick by which to measure a corporation's acts.<sup>300</sup> If the corporation's reporting systems are inadequate to

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294. MODEL BUS. CORP. ACT §§ 2.02, 2.05, 2.06 (2007).

295. See, e.g., *id.* § 8.41 ("Each officer has the authority and shall perform the functions set forth in the bylaws, or to the extent consistent with the bylaws, the functions prescribed by the board of directors . . .").

296. See *id.* § 8.01 ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors . . .").

297. See, e.g., *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) ("[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so . . . may . . . render a director liable for losses caused by non-compliance . . .").

298. *Stone v. Ritter*, 911 A.2d 362, 368 (Del. 2006) (citing *Caremark*, 698 A.2d at 967).

299. See, e.g., *Caremark*, 698 A.2d at 970 (noting that a failure may render directors liable for losses caused by noncompliance); see also MODEL BUS. CORP. ACT § 8.31 (presenting the standards of liability for directors).

300. Cf. *Morris v. Union Pac. R.R.*, 373 F.3d 896, 902 (8th Cir. 2004) ("When

the goal of detecting and deterring insider fraud, the corporation can fairly be deemed a “knowing and substantial participant” in the fraud.<sup>301</sup> And it can fairly be precluded by the *in pari delicto* defense from recovering from others who were part of the illegality.

The question of by what standard the adequacy of corporate systems should be measured remains. The line separating adequate from inadequate systems would attempt to identify when the corporation can be equated with being a knowing participant in the fraud.<sup>302</sup> Once that line is crossed—and the corporation is deemed to be a “knowing and substantial participant” in the fraud—the corporation would be at equal fault such that the *in pari delicto* defense would be successful against it.

While this suggested approach to measuring corporate fault draws from the systems that directors are required to implement, the standard to find corporate fault would not necessarily track the standard for director liability in this context. For director liability, Delaware courts have set a high hurdle for plaintiffs seeking to recover from individual directors.<sup>303</sup> Only upon an “utter failure to attempt to assure a reasonable information and reporting system exists” will the necessary condition to liability be established.<sup>304</sup> Essentially, any system will do to relieve directors of liability. To relieve a corporation of a finding of fault for failing to detect fraud, however, evidence of more than the mere existence of systems may be desirable.

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a corporation is involved, the inquiry [into intent] depends in part on corporate policies . . . .”); *Baker v. Westinghouse Elec. Co.*, 637 N.E.2d 1271, 1277 (Ind. 1994) (finding no corporate intent because of “the sheer improbability that a corporate employer would adopt policies through its regular decision-making channels” sanctioning the behavior at issue).

301. *AIG II*, 976 A.2d 872, 883–84 (Del. Ch. 2009).

302. *See id.* at 884 (noting that *in pari delicto* “requires the court to determine that each party acted with scienter in the sense that it was a knowing and substantial participant in the wrongful scheme”).

303. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) (“Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high.”).

304. *Id.*



*1. Federal Organizational Sentencing Guidelines as a Standard  
for Adequate Systems*

For this determination, it may be useful to refer, as Chancellor Allen did in his *Caremark* opinion, to the Federal Organizational Sentencing Guidelines.<sup>305</sup> As part of an effort to ensure corporate compliance with external legal requirements, the Guidelines set forth a uniform sentencing structure for organizations that violate criminal law.<sup>306</sup> Its goal is to “provide just punishment, adequate deterrence, and incentives for organizations to maintain internal mechanisms for preventing, detecting, and reporting criminal conduct.”<sup>307</sup> In determining an organization’s culpability, the Guidelines use as one mitigating factor the existence of an effective compliance and ethics program.<sup>308</sup> Because of this, Chancellor Allen concluded that “[a]ny rational person” attempting to meet her responsibility as a member of the board of directors must implement such a system to take advantage of the reduced sanction in the event the organization is convicted of a crime.<sup>309</sup>

The *Caremark* opinion used the Guidelines only to conclude that directors must implement such systems to avoid personal liability. In the context of examining corporate acts to determine if a corporation can meaningfully be considered a wrongdoer, however, the Guidelines may provide additional assistance. The mitigating factor of whether a corporation has an “effective compliance and ethics program” targets acts by a corporation that would render it less culpable for the underlying illegality.<sup>310</sup> The idea of culpability under the Guidelines transfers effectively to measure the corporation’s wrongdoing in failing to detect an agent’s fraud.<sup>311</sup>

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305. U.S. SENTENCING GUIDELINES MANUAL ch. 8 (2011) [hereinafter GUIDELINES].

306. *Caremark*, 698 A.2d at 969.

307. GUIDELINES, *supra* note 305, intro. commentary.

308. *Id.*

309. *Caremark*, 698 A.2d at 970.

310. See GUIDELINES, *supra* note 305, § 8B2.1 (describing how an organization can have an effective compliance and ethics program which would reduce its culpability score).

311. The author thanks Washington and Lee University School of Law Professor Christopher M. Bruner for suggesting the Guidelines as a helpful tool

The standard laid out in the Guidelines for an effective compliance and ethics program is straightforward. To have an effective program, the organization must do two things: First, it must exercise due diligence to prevent and detect criminal conduct.<sup>312</sup> Second, it must promote “an organizational culture that encourages ethical conduct and a commitment to compliance with the law.”<sup>313</sup> The Guidelines offer details on how a corporation can meet these two requirements. The corporation should establish standards and procedures to detect and prevent criminal conduct. The organization’s governing authority, high-level personnel, and specific individuals within the organization should all have a role to play in implementing these procedures. An organization should take steps not to hire individuals known to have engaged in illegal activities. It should have training programs in place. The effectiveness of the program should be periodically evaluated. The program should be promoted with appropriate incentives for compliance and appropriate disciplinary measures for noncompliance.

The Guidelines also offer factors to consider when evaluating the adequacy of a corporation’s program. It enumerates relevant factors: the applicable industry practice or government standards, the size of the organization, and whether the organization has engaged in similar misconduct in the past. Notably, the Guidelines state that the failure to detect the instant case of fraud does not necessarily mean that the program is ineffective.<sup>314</sup>

## *2. Applying the Guidelines as the Measure of Corporate Wrongdoing*

To measure corporate wrongdoing using this guide, a threshold question would be, did the board implement adequate systems? If the answer is yes, then the directors would not face personal liability under *Caremark*. But the corporation may still

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to evaluate a corporation’s acts in an effort to determine at what point a corporation can be considered a wrongdoer.

312. GUIDELINES, *supra* note 305, § 8B2.1.

313. *Id.*

314. *Id.* § 8B2.1(a).

be answerable for wrongdoing if officers and employees did not use due diligence to implement the systems.

By judging a corporation based on its corporate systems, corporate actors have an incentive to create and implement sound systems—an incentive that parallels a director’s incentive to implement these systems to avoid personal liability under *Caremark*—that will protect the corporation’s ability to recover from outsiders in the event that insiders are engaged in a fraudulent scheme. Because no system will detect all fraud, a rule that can strip a corporation of its cause of action based on the fraudulent act of one agent disincentivizes the corporation from pursuing rigorous anti-fraud policies. Measuring corporate wrongdoing using corporate systems—for the purpose of satisfying an element of the *in pari delicto* defense—would create an incentive to create adequate systems and would result in a corporation being judged by acts that can more fairly be characterized as those of the corporation as a whole.

This suggestion speaks directly to the problem courts have been circling by using exceptions to apply or not apply imputation and *in pari delicto*.<sup>315</sup> For example, when there is no distinction between the fault of the corporation and that of the agent—the sole-actor exception—imputation is justified and should apply regardless of an adverse interest.<sup>316</sup> But when the majority of the board is honest and one among them is committing fraud—the innocent decision-maker exception—imputation seems unwarranted and has been discarded.<sup>317</sup>

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315. See, e.g., *In re CBI Holding Co.*, 311 B.R. 350, 371 (S.D.N.Y. 2004) (noting that the innocent insider exception seeks to prevent unfair punishment of innocent members of management who would have prevented the misconduct of the guilty had they known of it).

316. See, e.g., *Thabault v. Chait*, 541 F.3d 512, 527 (3d Cir. 2008) (stating that under the sole actor exception an “agent’s fraudulent conduct will be imputed to the principal regardless of whether the agent’s conduct was adverse to the principal’s interests”); *AHERF*, 989 A.2d 313, 331 (Pa. 2010) (noting that when an “action [is] between a corporation controlled by a single individual and a sole-proprietor auditor, there would be a good case to be made that *in pari delicto* should apply to negate all causes of action” because any auditor misrepresentation would have “full corporate complicity”).

317. See, e.g., *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, LLP*, 212 B.R. 34, 36 (S.D.N.Y. 1997) (stating that absent a finding that “all relevant shareholders and/or decision-makers are involved in the fraud,” the fraud cannot be imputed to the corporation for purposes of *in pari delicto*). *But see*

Similarly, the idea of fault drives courts' uncertainty over allowing the defense when the appointment of a receiver or bankruptcy trustee "removed the wrongdoer from the scene."<sup>318</sup> Although this does not present an identical issue, it is another instance where courts have struggled with applying *in pari delicto* when the actual party before the court is not a wrongdoer. This discomfort is warranted because the policy justifications for *in pari delicto*—denying an admitted wrongdoer access to the courts to deter illegality and prevent a waste of judicial resources<sup>319</sup>—are not advanced when the plaintiff has done no wrong. Instead, the defendant unjustly uses an equitable doctrine to skirt liability.

*C. A Limited Application of In Pari Delicto Adheres to  
Policy Objectives*

Measuring fault based on corporate systems would require a fact-intensive inquiry into the corporation's policies to determine if it could fairly be deemed a "knowing and substantial participant in the wrongful scheme."<sup>320</sup> This process may be more demanding than simply imputing a fraudulent agent's acts to the corporation. On the other hand, with the current inquiries into corporate benefit and the agent's self-interest to determine if the adverse interest exception applies, perhaps analyzing a corporation's fault would be less demanding. Notably, this inquiry would not encompass the weighing of faults that *in pari delicto* is calculated to avoid.<sup>321</sup> In fact, determining if a plaintiff has itself

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Rudolph, *supra* note 36, at 580 (noting that "more courts have rejected, rather than accepted, the 'innocent decision-maker' doctrine").

318. *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995).

319. *See, e.g., Kirschner v. KPMG LLP*, 938 N.E.2d 941, 950 (N.Y. 2010) (describing the policy justifications which have supported the doctrine for two centuries).

320. *AIG II*, 976 A.2d 872, 883–84 (Del. Ch. 2009) (noting that *in pari delicto* "requires the court to determine that each party acted with scienter in the sense that it was a knowing and substantial participant in the wrongful scheme").

321. *See id.* at 894 (applying the *in pari delicto* defense to bar suit by the plaintiff corporation against its non-auditor co-conspirators because "the *in pari delicto* doctrine has long acted as a bar to the[] ponderous inquiries" of who was more harmed by the parties' illegal conduct); *id.* at 883–84 ("Although the literal translation of *in pari delicto* is 'in equal fault,' the doctrine does not require that

acted wrongly is necessary to the *in pari delicto* defense. Every defendant who institutes the defense raises this issue for determination. Just as human plaintiffs deserve an inquiry into their behavior, corporate plaintiffs should be judged by theirs.

After such a determination, if the corporation is found responsible for the fraud and the *in pari delicto* defense applies, the auditor has a complete defense and will not have to answer for any wrongdoing. This solution seems identical to the use of *in pari delicto* and imputation to bar the claim and does not seem to answer the important underlying question: should auditors as a group be insulated from liability for professional malpractice? This result is not identical, however, and answers the underlying question in the negative while allowing for an exception only when the doctrine of *in pari delicto* so requires.

Application of the *in pari delicto* defense only in those cases where the plaintiff corporation is meaningfully at fault creates a fair and workable result for three reasons. First, this is not a blanket rule that immunizes auditors in all cases. The auditor will skirt liability in some cases where its performance fell short of the professional mark. But this is consistent with the policy judgment that *in pari delicto* represents. Society is comfortable not punishing a defendant when his accuser bears equal fault.<sup>322</sup>

Second, this outcome is consistent with agency law while furthering tort-liability objectives. This approach leaves imputation untouched. It recognizes, however, that imputation functions differently when raised as part of a defense.<sup>323</sup> Limiting imputation to its proper function furthers the tort-liability objectives of deterring wrongdoing and compensating victims. Preventing a corporation from recovering from third-parties when its policies are deficient incentivizes those with the ability to monitor the corporation—the directors and officers—to create and

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a court engage in the type of accounting that *in pari delicto* is meant to avoid . . .”).

322. See, e.g., *AHERF*, 989 A.2d 313, 329 (Pa. 2010) (“[I]n *pari delicto* serves the public interest by relieving courts from lending their offices to mediating disputes among wrongdoers, as well as by deterring illegal conduct.”).

323. See RESTATEMENT (THIRD) OF AGENCY § 5.03(b) (2006) (stating that a principal’s claim against an auditor “should not be defeated by imputing to the principal its agents’ knowledge of deficiencies in the processes under scrutiny”).

implement proper procedures.<sup>324</sup> Even shareholders, who are not realistically in a position to monitor management,<sup>325</sup> can inform themselves of such policies and determine if they are sufficient. If a shareholder finds corporate policies deficient or questionable, the shareholder can move on to a less risky investment. It may be unrealistic to expect shareholders of large corporations to investigate and monitor corporate fraud-detection systems.<sup>326</sup> But evaluating corporate fault in a way that *could* be monitored empowers shareholders and diminishes the risk that the fraud of one insider could undermine the entire value of their investment. By affording shareholders the opportunity to monitor and control their investment, application of the *in pari delicto* defense seems less harsh.<sup>327</sup>

Third, this approach addresses the concern that auditors will necessarily be less culpable than the corporation's fraudulent agents.<sup>328</sup> Even if this is so, when the acts of the auditor are properly measured against the corporation rather than the agent, the balance might shift. If it does not, *in pari delicto* would apply.<sup>329</sup> If it does—that is, if the fraudulently prepared financial statement was unsanctioned and undetected by a corporation

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324. Cf. *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 887 (N.J. 2006) (finding that, to deter future wrongdoing, courts should “not indiscriminately provide a safe haven for [auditors’] allegedly negligent conduct”).

325. See, e.g., *id.* at 886 (noting that “the nature of today’s corporation makes it increasingly unlikely that shareholders of large corporations have the ability to effectively monitor the actions of corporate officials”).

326. But see *id.* at 885 (noting that “shareholders with a substantial ownership of stock may have the ability to affect board elections” which gives them some measure of control and access to information).

327. Cf. *id.* (“Allowing the impropriety of some shareholders—who, as directors and officers, perpetrated or did not prevent the fraud—to bar all shareholders from recovery is unfair and improper.”).

328. See, e.g., *id.* at 904 (Rivera-Soto, J., dissenting) (noting that the “auditor’s role in the accurate presentation of a client’s financial statement is limited, and most importantly, secondary to that of the client”).

329. But see *AIG I*, 965 A.2d 763, 828 n.246 (Del. Ch. 2009) (suggesting that *in pari delicto* should never be an available defense against an auditor because of an auditor’s distinct role); RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (2006) (taking the position that a “principal’s claim against the service provider [retained to assess the accuracy of its financial reporting] should not be defeated by imputing to the principal its agents’ knowledge of deficiencies in the processes under scrutiny”).

with sound systems—the auditor will be responsible to the corporation for its negligent work.

Another concern, expressed by the New York Court of Appeals, is that a double standard is created when you hold the auditor responsible for its agent's acts and you do not hold the corporation responsible for its agent's acts.<sup>330</sup> This posture, however, is consistent with agency law and is especially warranted against auditors because their work has effects beyond their relationship with the corporation. This is consistent with agency law because, as discussed at the beginning of this Part, imputation functions properly when a principal defends against a claim based on its agent's wrongdoing.<sup>331</sup> A corporation acting as a plaintiff acts as a distinct entity and imputation should not be the only relevant factor in determining whether the plaintiff may pursue a claim against its auditor for professional malpractice.<sup>332</sup> This approach should not require the auditor defendant to face uncapped liability for the losses arising from the corporate fraud. Rather, the auditor should be liable for damages proximately caused by its negligent performance under the scope of its engagement with the corporation.<sup>333</sup>

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330. See *Kirschner v. KPMG LLP*, 938 N.E.2d 941, 958 (N.Y. 2010) (finding that to allow suit by creditors and shareholders merely because they are innocent parties would “creat[e] a double standard whereby the innocent stakeholders of the corporation’s outside professionals are held responsible for the sins of their errant agents while the innocent stakeholders of the corporation itself are not”).

331. See *id.* at 953 (“[P]rincipals, rather than third parties, are best-suited to police their chosen agents . . .”); RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. c (2006) (“It is helpful to view questions about imputation from the perspective of risk assumption, taking into account the posture of the third party whose legal relations with the principal are at issue.”); *cf.* Securities and Exchange Act of 1934 § 21D, 15 U.S.C. § 78u-4(f) (2006) (requiring proportionate liability in private securities litigation).

332. See RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (2006) (“Knowledge, including imputed knowledge, is not always determinative of, and sometimes is not even relevant to, certain claims and defenses.”).

333. See *AIG I*, 965 A.2d at 828 n. 246 (suggesting “a more thoughtful tact” to auditor liability such as “the use of heightened pleading standards, standards of liability (e.g. gross negligence), proof (e.g. clear and convincing evidence), and measures designed to address liability” such as capping liability at some multiple of audit fees); *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 889 (N.J. 2006) (finding that the auditor should be judged based on whether it “was negligent in performing its agreed duties and to what extent such negligence proximately contributed to the damages suffered by plaintiff”).

Holding an auditor accountable for its work is also desirable because an auditor's role is unique and has implications beyond its performance under the contract with the corporation. Auditors "have duties not just to management, but to the public at large."<sup>334</sup> Auditors are hired in part because of the potential that corporate officers will "misuse their powers and commit acts of financial wrongdoing."<sup>335</sup> To limit auditors' accountability for their performance as it relates to the very thing they were hired to help monitor eliminates a large incentive to do a good job. At the outset of an engagement, an auditor would know that the likelihood of ever being held accountable for its work under the agreement is minimal. In the only situation where its work is likely to be scrutinized—the discovery of the corporation's fraud—it is immune from suit.

Further, if during the engagement the auditor suspects or discovers fraud, it has two choices: (1) reveal the fraud or investigate further, and risk harming its relationship with the corporate officers whom it has just accused of fraud; or (2) ignore the warning signals and continue the relationship. Knowing auditors will face this choice, the law should take a firm position that an auditor must choose to investigate and reveal fraud. The threat of liability will incentivize the auditor to maintain sound policies to monitor its individual agents, and individual agents will be aware that the auditor may seek indemnification from them upon a judgment against the auditor.

### V. Conclusion

The *in pari delicto* defense is only available when a plaintiff bears equal fault for the illegality at issue. Imputing a corporate plaintiff with an agent's fraud is an inadequate measure of fault for this purpose. Imputation functions properly to allow third parties to rely on their dealings with a principal's agent.<sup>336</sup> It is

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334. AIG I, 965 A.2d 763, 828 n.246 (Del. Ch. 2009).

335. *Id.*; see also AIG II, 976 A.2d 872, 890 n.49 (Del. Ch. 2009) (finding that policy justifies claims against auditors for malpractice because they are "employed by a corporation's outside directors to help them ensure the lawful operation of the corporation").

336. See DeMott, *supra* note 11, at 291 (noting that imputation functions to "determin[e] a principal's legal rights and obligations as between the principal



not proper for the task of assigning fault to a corporation when the corporation, as a plaintiff, seeks to recover from a third party who harmed it. In this case, the corporation's blameworthiness deserves a more holistic assessment.

Evaluating the corporation's information gathering and reporting systems for this purpose would provide a measure of the corporation which (1) better captures the acts of the corporation as a whole, (2) allows the corporation to retain its ability to sue its auditor for malpractice by implementing adequate systems, (3) incentivizes corporations to pursue rigorous anti-fraud systems, and (4) relieves auditors of liability for malpractice only when the policy justifications for *in pari delicto* are present. The historical approach to *in pari delicto* in corporate auditor malpractice cases has proven inadequate. A new approach is available and overdue.