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Further Perspectives on Corporate Wrongdoing, In Pari Delicto, and Auditor Malpractice

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Further Perspectives on Corporate Wrongdoing, *In Pari Delicto*, and Auditor Malpractice

Deborah A. DeMott*

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I. Introduction

By specifying when one person is subject to the legal consequences of another's conduct, the common law of agency serves as a bridge to the application of other legal doctrines, including the defense of *in pari delicto*.[1] Its bridging function implicates agency law in a wide range of disputes involving disparate bodies of primary law, including the tort and contract doctrines relevant to professional malpractice cases. Christine Shepard's Note, *Corporate Wrongdoing and the* In Pari Delicto *Defense in Auditor Malpractice Cases: A New Approach*[2] ably

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1. This is shorthand for the Latin maxim, *in pari delicto potior est condition defendentis*, translated as "[w]here both parties are equally in the wrong, the position of the defendant is stronger." BLACK'S LAW DICTIONARY, app. B, at 1838 (9th ed. 2009).

2. Christine M. Shepard, *Corporate Wrongdoing and the* In Pari Delicto *Defense in Auditor Malpractice Cases*: *A New Approach*, 69 WASH. & LEE L. REV.

examines several recent cases that are sharply divided on the implications of agency doctrine for defenses available in such cases, in particular when auditors are defendants.[3] Shepard focuses on recent cases stemming from auditors' failure to detect or report fraud perpetrated by a corporation's agents, typically, but not necessarily, situated high within the corporation's management hierarchy, through manipulation of the corporation's financial records. She argues that courts should decouple the operation of agency doctrines that charge a corporation with the legal consequences of its agents' wrongdoing, including their knowledge of their own fraud, from a separate determination of whether the doctrine of *in pari delicto* should bar recovery, whether by the corporation itself, its shareholders suing derivatively on its behalf, a trustee in bankruptcy, or a litigation trust or committee created to pursue claims following bankruptcy. Only when a corporation is itself directly at fault should *in pari delicto* apply. Shepard's proposal is grounded in the insight—with which I agree—that the broad reach of agency doctrine does not mean that it necessarily answers all questions arising from a dispute. Moreover, as Shepard explains, agency doctrines of attribution and imputation operate on an all-or-nothing basis that disallows consideration of relative fault or responsibility. I begin with some background and then turn to questions beyond those examined in Shepard's Note. These include the functions served by auditors, in particular in companies with public shareholders, and the significance of choice of law. I conclude with some reservations about implementing the approach Shepard recommends and about the capacity of private law to resolve the underlying issues.

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275 (2012).

3. Although Shepard's Note is focused on auditors as defendants, the question is salient for other categories of external providers of professional services, including lawyers. *See* Henry S. Bryans, *Claims Against Lawyers By Bankruptcy Trustees—A First Course on the* In Pari Delicto *Defense*, 66 BUS. LAW. 587 (2011) (discussing lawyers' use of the *in pari delicto* defense when trustees bring claims against them based on legal services provided to a debtor prior to bankruptcy).

II. Agency Law and Defenses to Professional Malpractice

Agency law and the legal doctrines applicable to professional malpractice intersect in several ways. For starters, agency law defines when the relationship between two persons situates one as an agent and the other as the principal.[4] In the corporate context, a corporation's agents include its officers and managerial employees. Agency doctrines of general applicability also specify when the legal consequences of an agent's conduct may be attributed to the principal. When an agent makes a contract purportedly on behalf of the corporation, attribution turns in most cases on whether the agent acted with actual and/or apparent authority.[5] An agent's tortious conduct may also be attributed to a corporate principal with the result that it becomes vicariously liable to the victim; when the agent is an employee, the long-established doctrine of respondeat superior determines whether the principal is vicariously liable.[6] When the agent is not an employee (or is an employee acting outside the scope of employment for purposes of respondeat superior), the principal's vicarious liability for unauthorized tortious conduct turns on whether the agent's conduct appeared to be authorized, bringing the issue within the ambit of the doctrine of apparent authority.[7]

It's helpful to distinguish, as do many but not all cases, attribution of conduct from imputing an agent's knowledge to the principal. Whether a principal is charged with knowledge of a fact known to an agent may carry consequences different from those that follow attributing the agent's conduct to the principal. For example, knowledge imputed from an agent to the principal may prove beneficial to the principal by establishing that action was taken reasonably when the law requires reasonable action. Or the consequences for the principal may lead to the imposition of liability, for example for fraud committed by an agent against a third party when the underlying definition of the tort—fraudulent

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4. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).
5. *Id.* §§ 2.01, 2.03.
6. *Id.* § 7.07.
7. *Id.* § 7.08.

misrepresentation—requires that the defendant have acted with scienter.[8]

In contrast, Shepard's Note tackles imputation's less intuitive consequences. Imputing its agents' knowledge of their fraudulent conduct to a corporation may bar claims it may assert against third parties who, by failing to detect or by colluding in the agents' misconduct, breached duties owed to the corporation—duties that stemmed from either the third party's undertaking to render professional services or its active collusion in the agents' fraudulent conduct. Such claims would be barred via *in pari delicto* when the court treats the corporation's imputed knowledge as establishing fault that is substantially the same as the fault of the third-party service-provider.[9]

In the assessment of an experienced observer, the application of *in pari delicto* in this context represents "the product of very skilled advocacy,"[10] especially when the plaintiff who seeks to impose liability is a bankruptcy trustee. This is because the history of *in pari delicto* marks it as a doctrine intended to deter wrongdoing and to guard against the jeopardy to judicial integrity were a court "required to serve as paymaster of the wages of crime, or referee between thieves."[11] In contrast, a bankruptcy trustee is innocent, not a potential wrongdoer to be deterred, who pursues recovery on behalf of innocent creditors. Only through a rigid application of the "alchemy of imputation"[12] could *in pari delicto* morph into an affirmative defense—or a matter of standing[13]—to

8. RESTATEMENT (SECOND) OF TORTS § 526 (1977) (defining fraudulent misrepresentation). One who makes a false statement of fact, opinion, intention or law does so fraudulently when the maker knows or believes that the matter is not as represented, lacks confidence in the accuracy of the express or implied representation, or knows that the representation lacks the stated or implied basis. *Id.*

9. *See* Pinter v. Dahl, 486 U.S. 622, 632 (1988) (defining the *in pari delicto* defense).

10. Bryans, *supra* note 3, at 618.

11. Stone v. Freeman, 82 N.E.2d 571, 572 (N.Y. 1948), *quoted in* Kirschner v. KPMG LLP, 938 N.E.2d 941, 950 (N.Y. 2010).

12. Bryans, *supra* note 3, at 619; *see also* Shepard, *supra* note 2, at 294 ("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.").

13. *See* Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 120 (2d Cir. 1991) (holding that a bankruptcy trustee lacks standing to pursue claims

be asserted by defendants as of right.[14] This alchemical transformation may rely on another general characteristic of agency doctrine, which is its binary or "all-or-nothing" quality that is mirrored by *in pari delicto* itself. That is, agency doctrines—including those governing a principal's vicarious liability—either do or do not result in attribution or imputation, but they do not turn on the relative culpability of a principal and a third-party plaintiff or defendant. As Shepard emphasizes, applying *in pari delicto* via imputed knowledge ignores the requirement of personal wrongdoing on which courts long premised the availability of *in pari delicto*.[15]

Additionally, omissions are crucial to the alchemy's success. Imputation is often justified on the basis that it creates incentives for principals to exercise care in choosing and monitoring the agents who represent them in interactions external to the principal-agent relationship.[16] Otherwise, the principal might be tempted to choose less than scrupulous agents, gambling that their misconduct against third parties may benefit the principal but that direct fault on the principal's part will be difficult for a third-party victim to prove. However, third-party providers of professional services often are themselves agents of a firm because they are the firm's employees or (however designated) its owners as partner/shareholders. A service firm's incentives to exercise care in choosing and monitoring agents seem as relevant as comparable incentives within the client's organization.[17]

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against third parties alleged to have assisted insiders of debtor in damaging it). No other federal circuit followed *Wagoner* in treating *in pari delicto* as a standing doctrine; although *Wagoner* stated that it applied New York law, the New York Court of Appeals has clarified that *Wagoner* is not a part of New York law, in which *in pari delicto* is an affirmative defense. *See Kirschner*, 938 N.E.2d at 946 n.3 ("[I]n New York, in pari delicto is an affirmative defense, not a matter of standing.").

14. *See* Bryans, *supra* note 3, at 619 (noting that the judge-made doctrine of *in pari delicto* which was created to "preserve the integrity of the . . . courts" has been converted to a defense as of right).

15. *See* Shepard, *supra* note 2, at 296 ("[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.").

16. *See* RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b (2006) ("Imputation creates incentives for a principal to choose agents carefully and to use care in delegating functions to them.").

17. This is not a point addressed in my earlier article on imputation. *See*

If ignored, the inescapable fact that most who furnish professional services in this context are themselves agents of firms can lead to odd results. In the most recent of the cases that Shepard discusses, *Kirschner v. KPMG LLP*,[18] the New York Court of Appeals justified applying *in pari delicto* to bar claims against, *inter alia*, audit firms and a law firm because "why should the interests of innocent stakeholders of corporate fraudsters trump those of innocent stakeholders of the outside professionals who are the defendants"?[19] And why depart from the "recognition that principals, rather than third parties, are best-suited to police their chosen agents and to make sure that they do not take actions that ultimately do more harm than good"?[20] As it happens, in *Kirschner*, the law firm partner who had lead responsibility for the client was himself so implicated in senior management's fraud that he was convicted of federal felonies and sentenced to seven years in prison.[21] *In pari delicto* insulated his former law firm from liability to the trustee of the defunct client's litigation trust, which excluded the firm's assets (including its insurance resources) from the pool of assets potentially available to compensate innocent creditors, notwithstanding the firm's receipt of fees paid by the client during the fraud and the far-from-inconceivable prospect that lapses occurred in the law firm's supervision of its partner's work and clientele.[22]

Additionally, it is well established that a client's own negligence is not a defense to an auditor's negligence unless the

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Deborah A. DeMott, *When Is a Principal Charged with an Agent's Knowledge,* 13 DUKE J. COMP. & INT'L L. 291 (2003) (exploring the basics of how the imputation doctrine operates, discussing the traditional justifications for imputation, and offering alternate justifications).

18. Kirschner v. KPMG LLP, 938 N.E.2d 941 (N.Y. 2010).

19. *Id.* at 958.

20. *Id.* at 953.

21. Debra Cassens Weiss, *Sentence 'Quite Harsh' for Ex-Mayer Brown Partner in Refco Fraud,* A.B.A. J., Jan. 15, 2010.

22. Nor were the firm and the incarcerated partner subject to liability to the client's defrauded shareholders because they did not make false statements directly to shareholders as required for liability under the federal securities laws. *See* Pacific Inv. Mgmt. Co. v. Mayer Brown LLP, 603 F.3d 144, 148 (2d Cir. 2010), *cert. denied*, 131 S. Ct. 3021 (2011) ("We hold that a secondary actor[, such as a lawyer or accountant,] can be held liable in a private damages action brought pursuant to Rule 10b-5(b) only for false statements attributed to the secondary-actor defendant at the time of dissemination.").

client's negligence contributed to the auditor's failure to perform its duties. For example, in *National Surety Co. v. Lybrand*[23] the defendant auditors failed to detect defalcations by the client's cashier, allegedly because the auditors did not perform the examinations—such as comparing bank deposit slips with deposit entries to verify the client's cash position—that would have detected the cashier's practice of embezzling from petty cash.[24] The defendants argued that their client itself was contributorily negligent because the cashier had charge of banking transactions as well as custody of clients' checks and that the combination enabled the cashier to disguise his cash thefts. Replied the court, "[a]ccountants, as we know, are commonly employed for the very purpose of detecting defalcations which the employer's negligence has made possible."[25] Additionally, the client's allegedly negligent practices prompted no caution—no warnings—from its auditors.[26]

The auditors' failure to caution their client in *Lybrand* implicates a long-standing expectation and duty of external auditors to call known deficiencies in internal controls to the client's attention.[27] Auditors also assess the effectiveness of the client's own internal controls over financial reporting.[28] Since the preparation of financial statements is management's responsibility (and routine audits are not forensic exercises), an auditor's representation that financial statements conform to accounting principles requires comfort with the client's own internal controls and practices that affect the reliability of its financial reporting and preparation of financial statements. Modern regulatory

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23. Nat'l Sur. Co. v. Lybrand, 9 N.Y.S.2d 554 (N.Y. App. Div. 1939).

24. *Id.* at 555–57.

25. *Id.* at 563.

26. *Id.* at 559–60 (noting that auditors had not "made any suggestion to [client] as to their methods relative to cash, yet charge [client] with negligence in the failure to make investigations which are within the ordinary realm of professional accountants").

27. *See* SEC Codification of Financial Reporting Policies § 601.01, Fed. Sec. L. Rep. ¶ 73,251, at 62,896 (CCH 2009) [hereinafter SEC Codification] ("[G]enerally accepted audit standards require auditors to report to their clients all material weaknesses in internal accounting controls that come to their attention during an examination of financial statements in accordance with such standards.").

28. SEC Reg. §210.2-02(f), Fed. Sec. L. Rep. ¶ 69,126, at 61,020–21 (CCH 2011) (requiring auditors' attestation on internal control over financial reporting).

concern with internal controls was sparked by the Foreign Corrupt Practices Act,[29] which required public companies to "devise and maintain a system of internal accounting controls" sufficient, *inter alia*, to "maintain accountability for assets."[30] The concern intensified in 2002 when Section 404 of the Sarbanes–Oxley Act[31] required certification by senior management of the effectiveness of internal controls over financial reporting,[32] augmenting the already extensive presence of accounting and auditing matters within federal securities regulation. Thus, although internal controls are situated within an audit client's organization, external auditors often design them[33] and assess their effectiveness.[34] Put differently, a client's system of internal controls pertinent to the accuracy of its financial reporting often stems from an interactive process that engages the client's organization at many levels, including the board of directors and its audit committee, with active involvement from the client's external auditor. And, as noted above, an auditor has long had a duty to bring known discrepancies in internal controls to the client's attention. For an audit firm, work focused on designing and testing internal controls, as opposed to ferreting out fraud, has been characterized as "intellectually stimulating and lucrative work,"[35] which, for our purposes, imposes duties on an auditor concerning the client's internal processes and controls.

The cases discussed by Shepard differ from *Lybrand* in both the hierarchical position of the wrongdoer within the firm (cashier-employee in broker-dealer versus senior management of corporation) and the consequences or nature of the agent's

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29. Foreign Corrupt Practices Act, Pub. L. No. 95-213, 91 Stat. 1494 (1977).

30. *Id.*; *see also* Securities Exchange Act § 13(b)(2), 15 U.S.C. § 78m(b)(2)(B) (2006).

31. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2006).

32. 15 U.S.C. § 7262 (2006) (stating the requirement for management assessment of internal controls).

33. JOHN C. COFFEE JR., GATEKEEPERS 143–45 (2006).

34. *See, e.g.*, *PCAOB Auditing Standard No. 5*, http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5.aspx#introduction (last visited Jan. 26, 2012) (effective pursuant to SEC Release No. 34-56152 (July 27, 1007)) (on file with the Washington and Lee Law Review). This standard governs an external audit of management's assessment of the effectiveness of internal controls.

35. COFFEE, *supra* note 33, at 145.

wrongdoing. Although agency doctrine generally imputes an agent's knowledge to the principal when it concerns information related to the agent's duties to the principal, imputation is subject to an exception when the agent acted "adversely" to the principal.[36] Agents who steal from the principal, as did the cashier in *Lybrand*, act beyond the bounds of the agency relationship.[37] Whether an agent's fraud should be characterized as sufficiently adverse to the principal for purposes of imputing the agent's knowledge is a vexed question that cases do not answer consistently. In the interests of clarity, however, whether an agent acted adversely to the principal is best treated as a step toward determining whether the agent's knowledge should be imputed to the principal, not as an exception to the availability of *in pari delicto* as a defense.[38]

III. The Sharp Bite of Choice of Law

A remarkable feature of the cases Shepard discusses is that, within a short period of time, three important jurisdictions—New Jersey,[39] New York,[40] and Pennsylvania[41]—adopted three very different rules. Moreover, a lengthy dictum from Delaware's Court

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

37. *Id.* cmt. c (discussing when an agent acts adversely to a principal).

38. *Accord*, *In re* AMERCO Derivative Litig., 252 P.3d 681, 695 n.5 (Nev. 2011) ("[W]e conclude that the appropriate analysis requires courts to consider the adverse interest exception as a means of rebutting the presumption that an agent's acts are imputed to the corporation."); Shepard, *supra* note 2, at 316. *But see* Am. Int'l Grp. Consol. Derivative Litig., 976 A.2d 872, 891 n.50 (Del. Ch. 2009) ("[R]egardless of whether the adverse interest exception is seen as an exception to in pari delicto or to imputation, the effect is the same.").

39. *See* 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).

40. *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 when a corporation sues its outside auditor for professional malpractice or negligence in failing to detect fraud committed by the corporation).

41. *See* Official Comm. of Unsecured Creditors of Allegheny Health, Educ. & Research Found. v. PricewaterhouseCoopers, LLP, 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).

of Chancery in a case governed by New York law recommends yet another approach.[42] Beyond the fact that all four jurisdictions share geographical proximity, such striking diversity in recently articulated rules seems unusual. One explanation may be not just high stakes for the parties, but the fact that plausible policy arguments do not all point in the same direction. Audit firms confront potentially crippling monetary liability in amounts disproportionate to fees that clients pay for audit services. On the other hand, compensating innocent creditors and equity investors is a worthy goal, especially given their inability to bring to bear the professional expertise for which auditors are engaged. And the stakes associated with the quality of financial reporting, at least in the context of public companies, extend broadly across capital markets, well beyond the bounds of any particular client's relationship with its auditor. Effective implementation of federal securities laws has long been associated with auditors' independence and objectivity; these qualities, quintessential requisites for appropriate work, may be undermined by inadequate incentives.[43]

Regardless of the explanation, an intriguing consequence of these inter-jurisdictional differences is the stress they place on determining which jurisdiction's law applies to auditors' acts of alleged malpractice. Just why this is so becomes evident from the rules adopted in the cases themselves, fully detailed in Shepard's Note. *Kirschner*, the New York case discussed above, makes the availability of *in pari delicto* turn solely and dispositively on imputation.[44] Shepard fairly characterizes this outcome as conferring a form of immunity on auditors that is available regardless of whether an audit failure stemmed from non-negligent mishap, negligence, or active collusion with fraud-feasors within the client's organization.[45] *Kirschner* also ignores a

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42. *See In re* Am. Int'l Grp., Inc., 965 A.2d 763, 831 n.246 (Del. Ch. 2009) (presenting seven reasons why the Delaware Court of Chancery would be "chary about following the New York approach").

43. *See* SEC Codification, *supra* note 27, § 601.01, ¶ 73,251, at 62,894 ("The Commission has historically considered the independence of the auditors who examine financial statements filed with the Commission as central to the effective implementation of the federal securities laws.").

44. *See Kirschner*, 938 N.E.2d at 950–52.

45. *See* Shepard, *supra* note 2, at 278.

central insight reflected in *Lybrand*, which is the efficiency of contracting for expert monitoring services that shareholders and directors lack expertise to provide[46] through a corporate-level engagement that spreads the costs. In contrast, the New Jersey case, *NCP Litigation Trust v. KPMG LLP*[47] decouples the duties an auditor owes its client from imputation to the client of its agents' guilty knowledge, holding that negligent (as well as collusive) failures within the scope of an audit engagement subject the auditor to liability; imputation would be operative against the client in suits brought by third-party victims of its agents' misconduct. Additionally, under *NCP*, claims against auditors would be barred when made by shareholders who engaged in the fraud, knew or should have known of it, or held stock in blocks of such size to enable them to oversee the firm's operations.[48] Juxtaposed with *NCP* and *Kirschner*, the holding in the Pennsylvania case turns on another facet of agency doctrine, which is whether the auditor dealt in material good faith with its client through the client's agents. In *Official Committee of Unsecured Creditors of Allegheny Health, Education & Research Foundation v. PricewaterhouseCoopers LLC* (*AHERF*),[49] the court held that an auditor who knows or has reason to know that the financial statements prepared by the client's management are false also knows or has reason to know that the corporation did not authorize management's conduct.[50] Thus, an auditor who knows management's conduct to be unauthorized does not deal in good faith with the client and may not benefit from imputing management's guilty knowledge to the corporation. However, the *AHERF* court equates the position of a negligent auditor who fails to detect fraud to the position of any third party who deals in

46. Note, *Recent Case*, 124 HARV. L. REV. 1797, 1802 (2011) ("[A]rguably one of the major reasons that a corporation would contract for the monitoring services of outside professional specialists is to exploit their expertise on issues about which ordinary investors and non-expert directors would otherwise have neither the requisite knowledge nor resources to make an informed judgment.").

47. NCP Litig. Trust v. KPMG LLP, 901 A.2d 871 (N.J. 2006).

48. *Id.* at 885–86.

49. *See* Official Comm. of Unsecured Creditors of Allegheny Health, Educ. & Research Found. v. PricewaterhouseCoopers, LLP, 989 A.2d 313 (Pa. 2010).

50. *Id.* at 336.

good faith with a principal through agents reasonably believed to have authority to act on the principal's behalf.[51]

Thus, much turns on which jurisdiction's law applies,[52] a question addressed extensively by the Delaware Court of Chancery in *American International Group, Inc. v. Greenberg*.[53] As Shepard notes, the *Greenberg* court observed that a corporation's external auditors are not comparable to "genuine third-parties,"[54] implying that auditors should for this purpose be

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51. *Id.* at 335.

52. These stark differences may make it attractive to auditors (and perhaps law firms) to consider contractual specifications of the law to be applied to disputes arising out of an engagement. The effectiveness of contractual choice of law in this context appears to be untested. In general, jurisdictions vary in the issues that may be governed by a contractual choice of law. *See* Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 64 BUS. LAW. 999, 1029–31 (2009). Additionally, conventional principles dictate disregarding the state chosen contractually when the issue is not one the parties could have resolved contractually when the state chosen lacks any substantial relationship to the parties or the transaction, or when its application would contravene "a fundamental policy of a state which has a materially greater interest . . . in the determination of the particular issue" and which, but for the contractual choice of law, would be the state of the applicable law. RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 187(2)(b) (1971). Perhaps also relevant are limitations on the effectiveness of agreements that prospectively limit liability for malpractice in the case of lawyers. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 54 (2000) (stating that such an agreement is unenforceable). To be sure, contractual choice of a jurisdiction that confers effective immunity is technically not identical to a contractual release of liability or to an indemnity agreement, but the practical consequences may be the same. Separately, provisions in engagement letters that limit an auditor's liability to the client may call its independence into question, and thus run counter to the SEC requirement that an auditor be independent. In the SEC's view, a client's agreement to indemnify its auditor against loss stemming from the auditor's own negligence means that the auditor cannot be viewed as independent. SEC Codification, *supra* note 27, § 602.02.f.i, ¶ 73,274, at 62,968 (observing that "[s]uch condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies . . . existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed"). The prospect of liability, that is, constitutes "one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement." *Id.*

53. *In re* Am. Int'l Grp., Inc., 965 A.2d 763 (Del. Ch. 2009), *question certified by* Teachers' Ret. Sys. of La. v. PricewaterhouseCoopers, LLP, 998 A.2d 280 (Del. 2010), *question answered by* Kirschner v. KPMG LLP, 938 N.E.2d 941 (N.Y. 2010), *judgment aff'd*, 11 A.3d 228 (Del. 2011).

54. *Id.* at 831 n.246; *see also* Shepard, *supra* note 2, at 315.

deemed to be among the corporation's own agents, who of course may not rely on imputation as a basis to defeat their liability to the corporation.[55] If auditors are repositioned as corporate actors comparable to directors and officers, and the issue is whether they breached governance-related duties owed to the corporation, then the applicable law would typically be that of the state of incorporation, often Delaware in the case of corporations with public shareholders. To be sure, deeming a corporation's external auditor to be its agent seems inconsistent with the requirement that the auditor be independent from the client, but this is not the focus of the court's analysis. Moreover, although the court applied settled choice of law principles applicable to tort and breach of contract claims—which emphasize the physical location where work was performed—it also noted that, had the plaintiffs alleged conduct by the auditor-defendant that aided and abetted breaches of fiduciary duty by corporate insiders, "Delaware's policy interest would . . . be paramount" in applying its law to a "knowing accomplice" in a scheme to injure a Delaware corporation by acting in cahoots with the corporation's own agents.[56] Likewise, to the extent a corporation's external auditors participate in designing its internal control systems, at least that portion of their work, if adopted by the client, becomes part of the client's internal mechanisms of accountability and arguably may implicate policy interests of the state of incorporation.

IV. Determining When a Corporation Is Itself at Fault

As noted above, Shepard advocates decoupling the availability of the defense of *in pari delicto* from imputation. Additionally, she proposes that *in pari delicto* be limited to situations in which a corporation itself is at fault for failing to detect managerial financial fraud. To make this assessment, a court would focus on whether the corporation's directors failed to

55. RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006) (stating that imputation is operative "[f]or purposes of determining a principal's legal relations with a third party").

56. *In re Am. Int'l Grp., Inc.*, 965 A.2d at 822. This creates the possibility of dépeçage, that is, the application of multiple jurisdictions' law to different issues arising out of the same matter.

implement adequate information-gathering and reporting systems; failing to do so would breach the directors' duties to the corporation.[57] The proposal does not take into account the fact that a board's failure on this score may often, in the context of internal systems relevant to financial accounting, be preceded by prior work to design such systems rendered by the corporation's auditor. This fact differentiates these cases from the *Caremark*[58] precedent on which Shepard relies. In *Caremark,* the control systems in question concerned compliance with federal regulations applicable to providers of health care services[59]; auditors, who may design internal controls applicable to financial reporting, are not the focus of the reporting systems required by *Caremark.* Moreover, if directors reasonably believe that an auditor has the requisite expertise to design an internal control system, corporate law protects their good faith reliance on the auditor's report, opinion, or statement.[60] Additionally, *Lybrand*, like more recent authority, defines an auditor's responsibilities to encompass reporting known deficiencies in internal control systems.[61]

For these reasons, it may be difficult to unscramble the strands of multi-party responsibility when managerial fraud goes undetected, perhaps sorting the consequences of a design flaw in an internal control system from subsequent flaws in audit procedures and distinguishing both from errors made by the client's directors. To be sure, an externally imposed requirement that severely restricts the functions that a single audit firm may serve for any particular client would simplify the sorting, but such a restriction could also add to costs and complexity and reduce the fit between a control system and the risks associated with any particular client if its designer is less informed about the client. On the other hand, when a client's board (or its audit committee) disregards an auditor's recommendations concerning the design of internal systems or the auditor's report of observed

57. *See* Shepard, *supra* note 2, at 279, 327–33.

58. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

59. *Id.* at 970.

60. DEL. CODE ANN. tit. 8, § 141(e) (2011).

61. *See* Nat'l Sur. Corp. v. Lybrand, 9 N.Y.S.2d 554, 563 (N.Y. App. Div. 1939).

deficiencies in internal controls, it is more plausible that the directors should bear responsibility for managerial fraud that subsequently eludes negligent auditors. But even then, the corporation's shareholders, like its creditors, may not be especially blameworthy, relying as they did on the auditor's work.

Perhaps adequate responses to auditor malpractice in the public company context lie beyond the capacity of private law. In *Greenberg,* the Delaware court noted that one might both disapprove of judicial grants of immunity to auditors "while still having doubt about the public policy utility of exposing audit firms to uncapped liability for their negligent failure to detect financial fraud by corporate managers."[62] As a more direct response, the court suggested legislation that couples caps on auditor liability with indemnity rights that negligent auditors may pursue against insiders who acted with scienter.[63] More generally, the doctrinal solutions possible through private law seem likely to be overwhelmed, both by inter-jurisdictional differences and by the practical consequences of visiting massive financial liability on an auditor out of proportion to fees charged (and fees that could plausibly be charged) for audits of public-company clients. Even were other jurisdictions persuaded by the argument in *Greenberg* that the equivocal role of auditors should be resolved by deeming them the client's agents who owe it duties governed by the law of the client's state of incorporation, jurisdictions might well differ on the circumstances under which those duties are enforceable (and by whom). Thus, perhaps circumstances have outrun the capacity of private law. A uniform federal response through *ex ante* legislation or regulation may be better suited to the national scope on which major audit firms and capital markets operate and may better serve the systemic objective of furthering the integrity of financial reporting, central

62. *In re* Am. Int'l Grp., Inc., 965 A.2d 763, 831 n.246 (Del. Ch. 2009).

63. *Id.* The SEC appears to disapprove of engagement terms that grant such indemnity rights. *See* SEC Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence: Frequently Asked Questions, Question 4 (Dec. 13, 2004), http://www.sec.gov/info/accountants/ocafaqaudind121304.htm (last visited Jan. 26, 2012) (noting that the clause "other matters" in engagement letters stating that the SEC registrant would release, indemnify, or hold harmless from liability or costs resulting from knowing misrepresentations by management would impair the audit firm's independence) (on file with the Washington and Lee Law Review).

as that is to the operation of information-driven markets for investment securities. A uniform federal response might also focus on remedying any problematic features in the structure of audit firms and the services they offer that compromise the efficacy of auditing and thus the integrity of financial reporting. Just as federal securities law and regulation occupy much legal space surrounding public companies, so might these additional issues underlying auditors' accountability be brought into the fold.

Displacing the operation of private law doctrines through regulation is far from unprecedented. In what now may feel like the distant past, prior to the enactment of the Securities Act of 1933,[64] the private law of contract and tort did not "condone misrepresentation in the sale of securities."[65] However, the fit was not optimal because "the common-law liability was not consciously and especially moulded for the flotation of securities," developed as it was "largely in connection with other transactions" and then "applied piecemeal to securities cases as they came before the courts."[66] Only rarely did courts articulate any underlying rationale or policy[67] and often factual variations overcame any policy underlying liability.[68] Among the accomplishments of the Securities Act was a regulatory design (including civil liability provisions) that stemmed from focused consideration of the requisites of protecting investors in public corporations. The Act, as federal legislation that preempted state law, also replaced jurisdiction-by-jurisdiction legal diversity with uniformity.[69] Likewise, in the context of public companies, the import of managerial fraud when an auditor is also at fault warrants a uniform answer.

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64. *See* Securities Act of 1933, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

65. Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 227 (1933).

66. *Id.*

67. *Id.*

68. *Id.* at 228.

69. *See* LOUIS LOSS & JOEL SELIGMAN, 1 FUNDAMENTALS OF SECURITIES REGULATION 41 (2000) ("It would be difficult to think of any area of the law where uniformity is so essential.").