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# NEW YORK COURT OF APPEALS ROUNDUP

## LIMITS OF 'GATEKEEPER' PROFESSIONALS' LIABILITY

ROY L. REARDON AND MARY ELIZABETH MCGARRY*
SIMPSON THACHER & BARTLETT LLP

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The Court of Appeals last month handed down a much-anticipated decision concerning the liability of third-party professionals that either fail to detect or are actively complicit in wrongdoing by officers of their corporate clients. In *Kirschner v. KPMG LLP*, the Court concluded that New York's traditional strict application of the in pari delicto doctrine, and the long-established principle under which acts of agents are imputed to their principals, remain fully intact in the corporate context. As a result, if its officer engaged in wrongdoing, a corporation will have a very difficult time recovering from its auditor or other professional advisor unless the officer acted purely in his personal interests and without any short-term benefit to the corporation.

In *Flemming v. Barnwell Nursing Home and Health Facilities Inc.*, the Court agreed with the Appellate Division that there is no basis, under CPLR 909 or otherwise, to award counsel fees to a class member who raises an objection to a proposed class action settlement.

**Third-Party Professionals**

Public policy considerations formed the basis of the Court's 4-3 decision in *Kirschner v. KPMG LLP,* in which the majority affirmed the continuing vitality of New York's precedents regarding the in pari delicto doctrine and the "adverse interest exception" to the agency principle that an employee's conduct is imputed to his employer where such conduct falls within the scope of the employee's authority. The Court declined plaintiffs' invitation in the two underlying actions to follow New Jersey and Pennsylvania in lowering the standard for holding professionals liable when a client's officer engages in misconduct.

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* **Roy L. Reardon** *and* **Mary Elizabeth McGarry** *are partners at Simpson Thacher & Bartlett LLP.*

The decision answered questions certified by the courts in two actions. First, the Delaware Supreme Court certified a question in *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP*, a derivative action brought on behalf of American International Group Inc. (AIG). This marks the first time in which the Court of Appeals answered a question from another state since the certification procedure became effective in 1986. Plaintiffs did not allege that AIG's auditor, PricewaterhouseCoopers LLP (PwC), participated in the accounting and tax fraud allegedly perpetrated by senior AIG officers. Rather, they argued that, through malpractice or negligence, PwC failed to detect or report the officers' wrongdoing. The Delaware Chancery Court, applying New York law, granted PwC's motion to dismiss based upon the in pari delicto defense.

The second action, *Kirschner*, involved Refco's collapse two months after the initial public offering of its stock. Refco filed for bankruptcy shortly after it disclosed that its CEO had long been operating a scheme to hide millions of dollars of company debt from the public and regulators. The bankruptcy Litigation Trustee sued various company insiders, IPO underwriters, a law firm and two accounting firms under an aiding and abetting theory. Relying upon the "*Wagoner* rule," the District Court for the Southern District of New York dismissed the claims against the professionals. The *Wagoner* rule bars a debtor's estate from recovering from third parties that allegedly joined the company in defrauding creditors unless the "adverse interest exception" may be invoked. The exception applies when the officers who engaged in wrongdoing acted entirely on behalf of themselves and against the corporation's interests.[1] On appeal, the U.S. Court of Appeals for the Second Circuit sought guidance from the Court of Appeals.

The Court was not called upon to answer novel questions of law, so much as to evaluate whether long-standing common law principles should be revisited on public policy grounds. However, as Judge Susan Phillips Read's opinion for the Court explained, public policy considerations are precisely what undergird New York's existing law in these areas.

The in pari delicto defense appears in New York decisions handed down over 200 years ago. It is founded on the principles that an admitted wrongdoer should be denied judicial relief and that courts should not become entangled in disputes among wrongdoers. These considerations are so strong that the defense is equally available to a defendant who was merely negligent as to one who intentionally engaged in wrongdoing with the plaintiff.

And for over 100 years, New York has recognized a presumption that officers' actions in carrying out a corporation's activities—even fraudulently—are imputed to the corporation. The policy supporting this agency principle is that "imputation fosters an incentive for a principal to select honest agents and delegate duties with care." The adverse interest exception applies to such situations as well, but as the Court emphasized, the exception is very, very narrow. Where conduct benefits both the corporation and the insider, the exception is inapplicable. It is instead reserved for instances, such as embezzlement, in which the insider "totally abandon[s]" his employer's interests, rendering the corporation the victim of conduct designed only to benefit the insider and/or a third party. The Court further held that the adverse interest exception is only available where the alleged insider's misconduct harmed the corporation.

Judge Read's opinion made clear that the Court will bridge no effort to water down the adverse interest exception. The Court rejected the argument that the corporation is the victim when insiders act for their own benefit and/or engage in a scheme that generates short-term profits for the corporation, but later causes it harm. The Court emphasized that such interpretation would render the adverse interest exception a "dead letter because it would encompass every corporate fraud prompting litigation." Thus, any harm from the "discovery of the fraud" (even when it leads to bankruptcy)—instead of the fraud itself—"does not bear on whether the adverse interest exception applies."

Plaintiffs also urged the Court to consider that innocent shareholders and creditors would bethe ultimate beneficiaries of any recovery against third-partyprofessionals that are partially responsible for the losses. The majority was not persuaded, and found no public policy basis for causing the innocent stakeholders of the third parties to suffer for the benefit of the innocent stakeholders of the entity whose agents almost invariably played a greater role in the fraud than the outside professionals.

Further, pointing to the fact that third parties often pay massive amounts to settle cases arising out of corporate scandals (for example, PwC paid $97.5 million to settle AIG's shareholders' claims), the Court was not convinced that changing New York law would provide any further deterrent to misconduct or malpractice.

Judge Carmen Beauchamp Ciparick authored the dissent in which Chief Judge Jonathan Lippman and Judge Eugene F. Pigott, Jr. concurred. Policy was again a central theme: "[T]he agency law principles upon which the majority rests its conclusions ignore complex assumptions and public policy that compel different conclusions." The dissent

argued that strict application of these principles undermined the public's interest in incentivizing "gatekeeper professionals" to "maximize diligence and thwart malfeasance." In particular, the dissenters would not have dismissed the actions at the pleading stage.

**No Counsel Fees for Objectors**

*Flemming v. Barnwell Nursing Home and Health Facilities Inc.*, as viewed by the majority in an opinion by Judge Pigott, was simply a matter of reviewing CPLR 909, finding that the statute's plain language provided that only "the representatives of the class" may be awarded attorney's fees when a judgment is entered in favor of the class, and concluding that attorney's fees may not be awarded to a class member who objected to the settlement but was not a class representative.

The underlying and hard-fought lawsuit was brought on behalf of 242 individuals who were residents of the defendant Barnwell Nursing Home and Health Facilities during a roughly one-year period. They claimed that they had been denied proper nursing care as required by New York's Public Health Law §2801-d.

Caroline Mouris was a member of the class on behalf of her mother's estate. She did not object to the settlement amount to be paid by the defendant. Rather, she challenged the amount of fees sought by class counsel, the compensation to be paid to the settlement administrator, and an "incentive award" to be made to the individual class representative. Ms. Mouris also sought counsel fees incurred in making her objections.

Neither the Court of Appeals majority nor the unanimous panel of the Appellate Division, Third Department, provided specific details of the reasons for Ms. Mouris' objections. However, the Appellate Division reduced the class counsel fees awarded by the supreme court, eliminated the incentive award to the named plaintiff, and remitted the case for further consideration of the administrator's compensation, finding the supreme court's award of such compensation was "arbitrary" and "unsupported."

While the Supreme Court had concluded in denying Ms. Mouris' application for counsel fees that her objections were of no assistance to that court or benefit to the class, the Appellate Division made no specific reference to that finding. The Third Department concluded that such finding was irrelevant in any event because, under the "American Rule," no fee shifting is allowed other than as provided by statute or contract, neither of which was implicated here (citing CPLR 909).

Underlying the Court's holding is the fact that in 1975 the Legislature enacted "comprehensive reform of the laws relating to class actions in New York," and included a provision for an award of reasonable attorney's fees for class counsel who produce a successful result. That reform did not provide for counsel fees to an objector who challenges a settlement, including a challenge that results in a benefit to the class. Such a provision, the majority said, could easily have been included in the reform legislation if that had been the Legislature's intent.

The dissent by Judge Robert S. Smith, joined in by Chief Judge Jonathan Lippman, broadly challenged the holding as bad policy, contrary to New York's common law, and not required by CPLR 909. Moreover, as the dissent shows, there is ample precedent in New York that could have been relied upon by the majority to permit an allowance of attorney's fees to successful objectors in class actions under the "common fund" doctrine. In the dissent's view, leaving counsel for a successful objector to work without compensation or seek payment from the objector will in most cases discourage the filing of objections, and thereby deny the court that must pass upon a settlement's fundamental fairness a competing view of the potential value to the class.

In *Flemming*, for example, every fee component of the settlement reached by the parties and approved by Supreme Court was rejected in the Appellate Division. After what was described as a six-year tenacious legal battle, who was likely to challenge the settlement? Certainly not the parties who had agreed to it or the court with a six-year old case on its docket and that awarded fees to class counsel in excess of the amount counsel originally requested.

As pointed out by the Appellate Division, a court reviewing fee applications in class settlements has a fiduciary duty to the settlement class. Denying such court the view of a good-faith objector whose counsel would only be paid in an amount fixed by the court consistent with the benefit such services provided to the class seems to raise a real question of state policy. At the same time, letting objectors have their counsel fees is likely to increase the filing of objections to class settlements. Do the benefits outweigh the negatives? We think so. The question is now left to the Legislature to address.

**Endnotes:**

1. See *Shearson Lehman Hutton v. Wagoner*, 944 F.2d 114 (2d Cir. 1991). As the Court of Appeals pointed out, the *Wagoner* rule is a creature of federal bankruptcy law and is generally characterized by federal courts as a matter of a debtor's standing to pursue a claim, However, to the extent it reflects the in pari delicto principle, under New York law, in pari delicto is an affirmative defense, although it may be resolved on a motion to dismiss in appropriate circumstances.

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