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The Adverse Interest Exception to the *In Pari Delicto* Defense

Thomas J. Hall and Judith A. Archer, *New York Law Journal – December 19, 2019*

In pari delicto is a centuries-old doctrine that prevents courts from intervening to resolve disputes between two wrongdoers. Rooted in principles of equity, *in pari delicto* acts as an affirmative defense to deny relief to an injured party where both parties are equally at fault. As explained by the Court of Appeals, the doctrine serves two important public policy purposes: (1) deterring illegality by denying judicial relief to an admitted wrongdoer and (2) deterring courts from involving themselves in cases between two wrongdoers. *Kirschner v. KPMG LLP*, 15 N.Y.3d 446, 464 (2010).

New York courts are often tasked with determining the application of the *in pari delicto* defense to acts committed by a corporation's agent. Corporations act through their officers and agents and, when those agents commit bad acts or fraud, those bad acts can be imputed to the corporation, regardless of whether those acts are authorized or known by the corporation. *See id.* at 465-66. The adverse interest exception to this fundamental agency principle prevents an agent's acts from being imputed to the corporation and, thus, bars the application of the *in pari delicto* defense.

Following Court of Appeals precedent, the Commercial Division has consistently maintained the narrow scope of the adverse interest exception to the *in pari delicto* defense. In a recent reversal of a Commercial Division decision, however, the First Department in *Conway v. Marcum & Kliegman LLP*, 176 A.D.3d 477 (1st Dep't Oct. 10, 2019), signaled a widening of the adverse interest exception. In contrast to prior Commercial Division holdings, the First Department concluded that the continued existence of a corporate entity does not *per se* constitute a benefit precluding the application of the adverse interest exception.

Court of Appeals Precedent

In *Kirschner v. KPMG LLP*, 15 N.Y.3d 446 (2010), the Second Circuit and the Delaware Supreme Court asked the New York Court of Appeals to evaluate the extent to which the adverse interest exception can be applied to defeat an *in pari delicto* defense. In the Second Circuit case, a litigation trustee of a bankruptcy firm had brought suit against the firm's former executives, law firms, and accounting firm alleging fraud, breach of fiduciary duty, and malpractice. In the Delaware case, stockholders brought a derivative action against a corporation's outside auditors, alleging the auditors had failed to detect fraud by the corporation's officials. In both instances, the Court of Appeals determined that the agents' misconduct was properly imputed to the corporation and *in pari delicto* barred both plaintiffs' claims.

In reaffirming the narrow scope of the adverse interest exception, the Court of Appeals first noted that under well-settled precedent, for the exception to apply "the agent must have totally abandoned" the principal's interests and acted entirely in the agent's own interest. *Id.* at 466. Describing the adverse interest exception as the "most narrow of exceptions," the Court of Appeals instructed that use of the exception is limited to cases in which the agent's conduct equates to "outright theft or looting or embezzlement … where the fraud is committed *against* a corporation rather than on its behalf." *Id.* at 466-67 (emphasis in original).

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According to the Court of Appeals, the key question is whether the agent's conduct harmed the corporation or whether the conduct harmed "others for the corporation's benefit." If the agent's conduct benefitted the corporation, even if the conduct was not authorized, the adverse interest exception may not bar imputation to the corporation. Thus, "[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" the adverse interest exception will not apply.

Commercial Division Application

Following *Kirschner*, the Commercial Division has narrowly applied the adverse interest exception. As illustrated by *Mashreqbank PSC v. Ahmad Hamad Algosaibi & Bros. Co.*, 40 Misc. 3d 1214(A) (N.Y. Co. 2013), the Commercial Division has been reluctant to apply the adverse interest exception when the "harm" is not sufficiently pled. In *Mashreqbank*, defendant, a partnership organized under the laws of Saudi Arabia, filed a cross-claim against plaintiff, a banking corporation, alleging that plaintiff aided and abetted defendant's former manager's fraudulent schemes. Invoking the *in pari delicto* defense, plaintiff argued that the former manager's conduct could be imputed to the defendant even if the defendant had not known of or sanctioned the conduct. Justice Melvin L. Schweitzer of the New York County Commercial Division held that defendant's assertion that its former manager harmed the corporation was conclusory and, in the absence of any evidence of harm, inferred that defendant received a benefit from the fraud. The Commercial Division therefore concluded that the adverse interest exception did not apply and granted plaintiff's motion to dismiss.

In *Walker Truesdell Roth and Assocs. Inc. v. Globeop Fin. Servs. LLC*, 43 Misc. 3d 1230(A) (N.Y. Co. 2013), the Commercial Division examined the adverse interest exception in the context of a lawsuit that arose out of the Bernard Madoff Ponzi scheme. Plaintiff, a hedge fund litigation trustee, sued the auditors of the hedge fund for failure to conduct adequate due diligence, negligent misrepresentation, and common law fraud. Defendants argued that *in pari delicto* barred the claims because the fraud was perpetrated by the manager of the funds and, thus, the manager's conduct should be imputed to the plaintiff. Plaintiff argued, however, that because the manager received incentive-based compensation based on the performance of the fund, the manager was acting for his own interest and not in the interest of the fund. The court rejected this argument, noting that although the officers and agents of the funds were compensated, their fraud allowed the fund to remain "unchecked," and to continue to attract new investors. *Id.* Justice Marcy S. Friedman of the New York County Commercial Division further noted that the "pleading of conduct that enabled the Funds, at least for a time, to survive and attract investors is [] inconsistent with the adverse interest exception." Because the adverse interest exception and other exceptions to *in pari delicto* did not apply, the court granted defendants' motion to dismiss.

Similarly, in *FIA Leveraged Fund, Ltd. v. Grant Thornton LLP*, two hedge funds sued their auditors alleging that the auditors did not comply with U.S. auditing standards. 50 Misc. 3d 1213(A) (N.Y. Co. 2016). The auditor defendants argued that *in pari delicto* applied because the managers of the funds had committed fraud to keep the funds afloat. The manager's alleged fraudulent acts included overstating the value of the funds, failing to disclose transactions, and "misusing investor funds." The Commercial Division held that *in pari delicto* applied because plaintiffs were authorized agents of the funds "and as such, the aforementioned misconduct—the very same misconduct defendants are charged with failing to detect—may be imputed" to plaintiffs. As to the adverse interest exception, Justice Eileen Bransten of the New York County Commercial Division reasoned that the exception could not apply because the managers' actions were undertaken, in part, to benefit the two funds. The alleged fraud committed by the managers allowed the funds to survive and hid lost profits from various investors. Citing *Kirschner*, the Commercial Division reasoned that the adverse interest exception cannot be met when the alleged misconduct allowed the business to survive.

The *Conway* Decision

Recently, the First Department reversed a decision from the New York County Commercial Division, signaling that New York appellate courts may be widening the scope of the historically narrow adverse interest exception. In *Conway v. Marcum & Kliegman LLP*, 176 A.D.3d 477 (1st Dep't Oct. 10, 2019), plaintiffs, liquidators of hedge funds, sued an outside accounting firm for failing to detect fraudulent activity by the funds' managers. Justice Charles E. Ramos of the New York County Commercial Division granted defendants' motion for summary judgment on the basis of *in pari delicto*, but the First Department reversed this decision, holding that "plaintiffs raised issues of fact as to the adverse nature of their interests vis-à-vis those of their agents, the funds' investment managers, that preclude summary dismissal of the complaint on the ground of the in pari delicto defense." In contrast to *Walker and FIA Leveraged Fund*, the First Department

concluded that, "the mere continuation of a corporate entity does not per se constitute a benefit that precludes application of the adverse interest exception."

In broadening the scope of the adverse interest exception, the First Department reasoned that "reliance on speculation about the benefits to be derived from the continued existence of an entity is inconsistent with the analysis of the adverse interest exception in *Kirschner*." The court continued, stating that "an ongoing fraud and a continued corporate existence may harm a corporate entity: The agent may prolong the company's legal existence so that he can continue to loot from it." This reasoning by the First Department represents a departure from how previous Commercial Division decisions have viewed the "survival" of a corporate entity in the context of the adverse interest exception.

Conclusion

Nearly ten years ago, *Kirschner* reaffirmed the narrow scope of the adverse interest exception and the Commercial Division has decided cases accordingly. *Conway*'s reversal represents a departure from the narrow exception articulated in *Kirscher* and appears to mark a new approach to how New York courts analyze the benefits a corporation may receive in considering application of the exception. Until the Court of Appeals provides further guidance, however, the adverse interest exception may continue to be a rarely applied exception and *in pari delicto* may remain a broad defense grounded in important public policy principles.

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