



The Business Suit

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Imputation Doctrine No Longer Protects Auditors



The New Jersey Supreme Court recently held that the imputation doctrine does not bar a lawsuit against a negligent corporate auditor brought by a litigation trust on behalf of a debtor corporation's shareholders. According to the court's 5-2 opinion in *NCP Litigation Trust v. KPMG*, ___ A.2d ___, 2006 WL 1776178 (June 28, 2006), such a suit is allowed, regardless of whether the auditors had actively participated in or had direct knowledge of the corporation's fraud.

Factual Background

Two senior officers of Physician Computer Network ("PCN"), a public corporation, performed a series of fraudulent transactions to inflate PCN's revenues and minimize its expenses. The officers intentionally misrepresented the corporation's financial status to PCN's corporate auditors, KPMG. The auditors failed to detect those misrepresentations for several years. After subsequent audits revealed the fraud, PCN was forced to announce previously unreported losses of tens of millions of dollars.

These disclosures wrought havoc on the corporation's already worsening financial condition and pushed it into bankruptcy. This action had its genesis in PCN's confirmed bankruptcy plan, which created the NCP Litigation Trust (the "Trust") to act as the debtor corporation's successor-in-interest and to pursue the shareholders' claims.

Litigation in the Lower Courts

The Trust set its sights on KPMG, alleging negligence, negligent misrepresentation, breach of contract and breach of fiduciary duty for KPMG's failure to perform the audits according to professional guidelines. The complaint further alleged that, had KPMG's audits not been performed so negligently, the auditor would have detected PCN's fraud and prevented the losses.

KPMG moved to dismiss the complaint, arguing that the fraud of PCN's two officers -- PCN's agents -- should be imputed to the Trust. The trial court agreed with KPMG's argument, opining that to defeat the imputation defense, the Trust would have to show that there had been intentional and material participation in the fraud by the auditors. The Trust appealed the decision. The Appellate Division reversed the trial court, holding that the complaint was not barred by the imputation defense because it alleged equitable fraud independent of any legal fraud allegedly committed by PCN's officers.

The Supreme Court's Review

KPMG sought review of that decision by the New Jersey Supreme Court. It argued that the Trust should be barred by the imputation defense pursuant to *in re Integrity Insurance Company*, 240 N.J. Super. 480 (App. Div. 1990) -- New Jersey's only decision addressing this issue -- and *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir.), cert. denied, 459 U.S. 880 (1982). The imputation doctrine imputes an agent's fraud to its principal, thereby barring the principal from suing an innocent third party. KPMG claimed that the complaint should be dismissed because, pursuant to *Integrity*, the imputation doctrine bars all claims against an auditor unless the plaintiff alleges that the auditor was an active and knowing participant in the fraud, which the complaint did not. KPMG further argued that, according to *Cenco*, since the Trust represents the shareholders, tort principles require that the imputation doctrine bar the Trust's suit.

The New Jersey Supreme Court rejected KPMG's argument based on *in re Integrity Insurance Company*, 240 N.J. Super. 480 (App. Div. 1990), even though KPMG did not actively participate in the fraud or have direct knowledge of the misconduct. The Supreme Court noted that the imputation defense applies to prevent suits by a principal against a third party where an agent of the principal defrauded the third party. However, PCN's circumstances were not the usual circumstances for which the imputation doctrine was designed. The wrongdoing perpetrated by PCN's officers did not directly defraud an innocent third party; it defrauded the corporation. Thus, KPMG was not a victim of the fraud. The court also noted that KPMG had an independent contractual obligation to detect the fraud -- a duty KPMG allegedly did not perform. The court held that the Trust's suit cannot be barred "because one who contributed to the misconduct [KPMG] cannot invoke imputation."

The court also knocked down KPMG's argument that *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir.) should apply. Interpreting Illinois law more than 20 years ago, the Seventh Circuit held that negligent auditors could invoke the imputation doctrine when corporate management committed fraud that benefited the corporation. To determine the application of the imputation doctrine, the court looked to tort principles rather than agency law. The *Cenco* court also reasoned that a judgment favoring the corporation would be improper because the culpable officers owned stock and would receive a pro-rata share of compensation from the auditor. In terms of deterrence, the court held that the shareholders of a corrupt enterprise should not be afforded an opportunity to shift the entire responsibility for a fraud to auditors.

While acknowledging that shareholders should not benefit from their own wrongdoing, the New Jersey Supreme Court noted that not all shareholders are equal. The court held it would be inherently unfair to bar all shareholder suits because of the actions (or inactions) of shareholders who, as directors or officers, either did nothing to stop the fraud or contributed to the misconduct. In large corporations, only those shareholders who hold large positions can effect change to a board of directors. Given this inequity, the court held that the imputation doctrine should not bar suits by all shareholders. Tipping its hat to the dissent, the court agreed that no one should profit from fraud that he or she caused and limited its holding to the protection of only innocent shareholders.

The Supreme Court also recognized that the focus should not be merely on deterring the wrongdoing of directors and officers, but also should be on deterring the misconduct of their auditors. In the current corporate climate, the court stated, "auditors must be more alert to corporate fraud and, where appropriate, courts should take steps to protect and safeguard the public from that fraud." The court reasoned that, if imputation were allowed to shield a negligent auditor, shareholders would be forced to shoulder the complete burden of a loss -- an inequitable result. To deter future wrongdoing, the court refused to carve out a safe haven for auditors accused of unprofessional conduct. While auditors cannot be expected to locate every single instance of corporate fraud, they should be held to answer for the negligent performance of duties prescribed by their terms of engagement.

Therefore, under New Jersey law, when an auditor is negligent under the terms of its engagement, the imputation doctrine does not preclude recovery against that auditor by corporate shareholders. A limited imputation defense can properly compensate fraud victims without providing a parallel windfall to wrongdoers. When shareholders are innocent of corporate fraud, this holding allows for their just compensation.

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