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## **Second Circuit Update**

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- **Computer Hacker Can Be Sued for Securities Fraud, Second Circuit Rules**
- **New York Appellate Court Reinstates Complaint Based on Adverse Interest Exception to *In Pari Delicto* Doctrine**



### **Computer Hacker Can Be Sued for Securities Fraud, Second Circuit Rules** *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009)

The Second Circuit recently held that a computer hacker may be liable for fraud under the Securities Exchange Act, even though he owed no fiduciary duty to the company whose shares he traded.

In *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009), the SEC brought a civil enforcement action under Section 10(b) of the Securities Exchange Act of 1934. The SEC alleged that defendant gained unauthorized access to IMS Health, Inc.'s ("IMS") earnings report minutes after the data was received on IMS's secure server and several hours before the company's earnings per share -- which were 28 percent below the expectations of Wall Street analysts -- were announced. Within an hour of receiving the earnings data, defendant purchased "put" options that would expire the following week, betting that IMS's stock price would drop precipitously and significantly. He sold all of his options within six minutes of the market opening the next morning, realizing a net profit of \$286,456.00 overnight.

The SEC sought and received a temporary restraining order from the Southern District of New York freezing defendant's trading gains. However, the trial court later denied the SEC's request for a preliminary injunction because the SEC had not shown a likelihood of success on the merits. The court reasoned that computer hacking was not "deceptive" within the meaning of Section 10(b) because defendant, a corporate outsider who owed no fiduciary duties to IMS or to its web host, had not breached any fiduciary duty of disclosure. Such a breach was a required element of a "deceptive device" under Section 10(b), the trial court held, relying on U.S. Supreme Court precedent.

The Second Circuit disagreed. The appellate court acknowledged that the SEC's claim here is not based on either the traditional theory involving a corporate insider or the misappropriation theory of insider trading -- both of which involve breach of a fiduciary duty to the source of the non-public information. Nonetheless, the court found that computer hacking could constitute use of a "deceptive device" under Section 10(b) without the need for breach of a fiduciary duty to the source, and that the Supreme Court had not held otherwise.

The theory of fraud in the three Supreme Court cases cited by the trial court was silence or nondisclosure, not an affirmative misrepresentation, the Second Circuit noted. These cases all held that remaining silent where there was a fiduciary duty to speak satisfied the act's requirement of a "deceptive device or contrivance." "However, what is sufficient is not always what is necessary, and none of the Supreme Court opinions considered by the District Court *require* a fiduciary relationship as an element of an actionable securities claim under Section 10(b)," the court held. Since "an affirmative misrepresentation is a distinct species of fraud" and the SEC alleged that defendant affirmatively misrepresented himself to gain access to material, nonpublic information that he then used to trade, the Second Circuit saw no reason to prohibit this "straightforward theory of fraud."

However, the trial court had not decided whether the computer hacking in this case fell within the ordinary meaning of the word "deceptive." Therefore, the Second Circuit remanded the case to the Southern District to determine whether the hacker had gained access through a fraudulent misrepresentation that would constitute a "deceptive device or contrivance" prohibited by Section 10(b).

This decision may significantly broaden the SEC's enforcement power in the area of insider trading such that more cases will rely on the theory of affirmative misrepresentation rather than nondisclosure in breach of a fiduciary duty.

## **New York Appellate Court Reinstates Claim Based on Adverse Interest Exception to *In Pari Delicto* Doctrine**

Symbol Techs., Inc. v. Deloitte & Touche, LLP, 2009 WL 3486378 (2d Dep't Oct. 27, 2009)

An intermediate New York appellate court recently reinstated an accounting malpractice claim, finding that plaintiff had pled sufficient facts to overcome the applicable statute of limitations and *in pari delicto* defenses.

Plaintiff sued its auditor for accounting malpractice in connection with audits performed for four fiscal years. Plaintiff contended that defendant had failed to discover a fraud perpetrated by several members of plaintiff's senior management team. The fraud caused plaintiff to pay more than \$100 million in unearned compensation to senior management, to restate its earnings and to become the target of investigations by the SEC and the U.S. Attorney's Office for the Eastern District of New York.

Defendant performed the audits at issue for plaintiff for fiscal years 1998 through 2001. The action, which commenced on November 11, 2005, was subject to the three-year statute of limitations for malpractice claims. However, the court held that the continuous representation exception to the statute of limitations applied. Plaintiff alleged that the parties had mutually contemplated that defendant's representation would continue after it issued an audit report or opinion, as defendant had a continuing obligation to remedy defects found in the audits and did so. Further, while each year's engagement letter addressed the scope of fees for services, no separate agreement covered the remedial accounting services that defendant performed until the end of 2003. Therefore, the appellate court held that the trial court had improperly determined that the malpractice action was barred as untimely.

The appellate court next turned to the equitable defense of *in pari delicto*, which bars a plaintiff from recovery in situations where the plaintiff itself is at fault. This doctrine recognizes that, in general, the actions of an agent can be imputed to the corporation where that agent is acting within the scope of his or her employment.

New York law recognizes an adverse interest exception to this doctrine. The exception "is a method by which a plaintiff corporation can demonstrate that its agent's actions should not be imputed to it" because the agent's fraud was entirely self-interested and the corporation did not benefit from it in any way, the court explained. This exception is narrowly defined to prevent the imputation of manager misconduct where an officer acts entirely for his own or another's purposes and against the corporation's interests.

Recognizing that plaintiff had pled facts sufficient to overcome the *in pari delicto* defense, the court highlighted those allegations that established the adverse interest exception:

1) the managers' actions to inflate revenues and manipulate earnings were taken solely to advance their personal interests and for their personal benefit; 2) the managers' misconduct was entirely outside the scope of their employment and represented a total abandonment of the corporation; and 3) the managers' misconduct did not inure to the benefit of, and instead harmed, the corporation.

Defendant countered by pointing to a non-prosecution agreement between plaintiff and the SEC to refute the application of the exception. In the non-prosecution agreement, plaintiff acknowledged that as a result of certain improper management conduct, the corporation had violated federal criminal law. The court found that such statements did not conclusively foreclose the use of the exception because plaintiff never admitted that the fraud was done for its benefit. The court therefore reinstated the accounting malpractice claim.

This case can serve as a roadmap for parties to determine whether exceptions to the statute of limitations and *in pari delicto* defenses are adequately pled in the context of an accounting malpractice claim.

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