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### Imputation Doctrine No Longer A Shield for Negligent Auditors

Shareholders may sue accountants for negligent failure to detect fraud

By Stephen V. Falanga

The New Jersey Supreme Court's decision in *NCP Litigation Trust v. KPMG, LLP*, may dramatically affect the relationship between corporations and their outside auditors. The case, decided June 28, altered the legal landscape in New Jersey by holding that shareholders of defunct corporations may now pursue third party actions against the company's accountants for negligent failure to detect fraud of corporate principals.

The *NCP* decision involved the Supreme Court's interpretation of the longstanding "imputation doctrine." As the Supreme Court noted in its opinion, "[t]he imputation doctrine is derived from common law rules of agency relating to the legal relationship among principals, agents, and third parties." The imputation doctrine is grounded in the theory that a principal is deemed to know

the facts that are known to its agent. Consequently, if an agent engages in fraudulent activity, that activity and knowledge of that activity is imputed to the principal. The imputation of that knowledge results in the principal being estopped from suing a third party for damages resulting from the fraud of its agent.

Case law applying the imputation doctrine demonstrates that the concept is premised upon the rationale that when choosing between two innocent parties, it is the principal who selected the agent that should bear the loss stemming from the agent's misconduct. As the Supreme Court noted, the imputation doctrine and the imputation of the acts of an agent to the principal serve important public policy considerations. For example, attributing the risk of the agent's conduct to the principal ensures that principals will exercise due care and diligence in selecting their agents. Relying on citations to the Restatement of Agency, the Supreme Court also noted that "[b]ecause the principal cannot avoid responsibility through ignorance, imputation also 'encourages a principal to develop effective procedures for the transmission of material facts, while discouraging practices that isolate the principal or co-agents from facts known to an agent.'"

Notwithstanding the strong public policy in favor of the imputation doctrine to protect innocent third parties from lawsuits by principals relating to fraud of an agent, the Supreme Court concluded that the "rationale for imputation in a simple principal-agent relationship begins to break down in the context of a corporate audit where the allocation of risk and liability among principals, agents, and third parties becomes more complicated." Citing to a number of treatises, the Court carved a distinction in the application of the imputation doctrine, concluding that the "all or nothing approach" was too harsh an application if it absolved allegedly negligent auditors from failing to uncover financial fraud by the corporation's agents.

The case of *NCP* involved a publicly traded New Jersey corporation called Physician Computer Network, Inc. (PCN). PCN developed and marketed computer software to assist doctors in their communications with hospitals, insurers and laboratories. KPMG was engaged by PCN to serve as the company's independent outside auditor.

Beginning in the mid to late 1990s, two officers of the PCN, John Mortell, PCN's president, chief financial officer and a member of the company's directors, and Thomas Wraback, PCN's senior vice president and chief financial officer, engaged in a fraudulent scheme to inflate the revenues of PCN and to reduce its reported expenses. These two officers of PCN intentionally misrepresented the details concerning PCN's financial con-

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*Falanga is with Connell Foley of Roseland.*

dition to KPMG beginning as early as 1995.

In connection with its duties as the company's outside auditing firm, KPMG issued audit opinions with respect to PCN's financial statements. With the consent of KPMG, the audit opinions were attached to copies of PCN's SEC filings. This occurred for approximately two years until early 1998 when KPMG, during the course of its audit work for the fiscal year ending Dec. 31 1997, uncovered certain accounting irregularities and raised those concerns with PCN's legal counsel as well as with Mortell and Wraback.

As a result of KPMG's discoveries, PCN issued a press release announcing that it would restate its previously reported financial results for each of the first three quarters of 1997. Later that spring, it was announced that KPMG was withdrawing its auditor's report for 1996 and that a special committee was being appointed to conduct an investigation into KPMG's discovery of the financial irregularities. Ultimately, PCN announced that KPMG was no longer acting as an independent auditor for the corporation and PCN retained a new accounting firm to complete the audit for its 1997 financial results and to assist in the restatement of fiscal results for 1995 and 1996.

Ultimately, the disclosure of the financial misreporting that KPMG itself uncovered in early 1998 lead to the financial downfall of PCN, which filed for bankruptcy in December of 1999. Under a plan of reorganization, PCN's assets were sold to a third party and a trust was created known as the NCP Litigation Trust pursuant to the confirmed bankruptcy plan. All causes of action held by PCN were assigned to the trust to be enforced for the benefit of the holders of allowed equity interests of PCN, namely the shareholders of PCN.

In the middle of 2002, the trust commenced an action against KPMG alleging negligence, misrepresentation, breach of contract and breach of fiduciary duty in failing to uncover the fraud of PCN's officers. In connection with those allegations, the trust asserted that KPMG failed to per-

form its audits in conformity with professional guidelines. In short, the trust contended that had KPMG exercised due care, the fraud of Mortell and Wraback would have been uncovered at the time and the losses PCN suffered would have been prevented.

Relying upon the imputation doctrine, KPMG moved to dismiss the complaint, arguing that the fraudulent acts of Mortell and Wraback should be imputed to the Trust as PCN's successor-in-interest, thereby barring the trust's action against KPMG. Concluding that the prior Appellate Division decision in the case of *In re Integrity Insurance Company*, 240 N.J. Super 480 (App.Div.1990), controlled, the Law Division granted KPMG's motion.

*Integrity* involved a somewhat similar factual scenario to the matter presented in *NCP*. In *Integrity*, an insurance company was liquidated under the New Jersey Insurers Liquidation Act, and a liquidator was appointed on behalf of the insurer's policyholders and other beneficiaries. The liquidator commenced a lawsuit on behalf of Integrity, its creditors, policyholders, claimants, and beneficiaries to recover damages from Touche Ross & Company as Integrity's accountant and auditor, as well as several stockholders.

In the liquidator's complaint, the liquidator asserted various causes of action against the stockholders and directors and also Touche Ross. In particular, the liquidator contended that Touche Ross breached its contract, committed malpractice, negligence, negligent misrepresentation, gross negligence and recklessness and also further charged Touche Ross with fraud and aiding and abetting the misconduct of its co-defendants. In fact, the liquidator also alleged that Touche Ross violated New Jersey's Anti-Racketeering and Consumer Fraud Statutes.

In urging the trial court and Appellate Division to dismiss the claims against it, Touche Ross argued that the liquidator on behalf of Integrity was barred under the imputation doctrine, contending that knowledge by the individual defendants, who were officers and directors of

Integrity, must be imputed to Integrity as a corporation. However, the Appellate Division in Integrity rejected this argument, noting that although knowledge of corporate officers and agents of the corporation is regularly imputed even where the agent is committing a fraud, the doctrine is not available to one who "contributed to the misconduct sought to be imputed." In short, based on the allegations in the complaint, the Appellate Division concluded that Touche Ross' culpability, if demonstrated, would bar Touche Ross from using the imputation doctrine as a defense to liability.

As the Supreme Court noted, until the case of *NCP*, *Integrity* was the only reported New Jersey decision addressing the application of the imputation defense in the corporate auditing context. In relying on the *Integrity* decision to support its request for dismissal, KPMG interpreted the holding as requiring the third party to have "actively participated in the corporate fraud" in order to bar the application of the doctrine. However, the Supreme Court ultimately rejected this position, concluding that the Appellate Division in *Integrity* was "careful not to establish 'active participation' as the standard." Instead, the Court found that the imputation defense is not available "to one who contributed to the misconduct." In the Court's view, "contributing to the misconduct" may include negligence of the third party, as in this case, in allegedly failing to exercise proper care to uncover corporate fraud.

In vigorous dissents, Justices Jaynee LaVecchia and Roberto Rivera-Soto disagreed with the majority's holding. Justice LaVecchia concluded that the imputation defense should be available in cases of alleged negligence and that it should not be available in situations where gross negligence or recklessness contributed to the misconduct, noting that in *Integrity*, there were allegations against the auditor of more than simple negligence. Justice Rivera-Soto concurred, noting that "the majority effects a fundamental transformation of the imputation defense" transforming it from a "defense to liability" to "an item in mitigation of damages. ■"