

The Blame Game

A company's management commits fraud, but auditors fail to spot it. So where do you point the finger?

By Brian J. Hunt, J.D.



We know that auditors make every effort to ensure a company's financial statements accurately and fairly present an organization's transactions. And we know that auditors can be held liable for losses caused by their oversight or negligence. However, what if a company's very own management is involved in fraud against the company? Well, this is where things get interesting.

If auditors do have the misfortune of finding themselves deceived by company managers, they may find salvation in the form of the *in pari delicto* defense, meaning "equally in fault." Under this defense, responsibility for the losses brought about by the fraud falls to the company versus the unsuspecting auditors.

For a brief background, consider the seminal case of *Cenco v. Seidman & Seidman* (1982). Here, corrupt managers fraudulently inflated the price of inventory and used the increased stock prices to purchase companies, borrow money and file exaggerated insurance claims. A newly hired financial officer eventually discovered the fraud.

Seidman & Seidman were Cenco's auditors throughout this period, but failed to perceive and uncover the fraud. The Seventh Circuit Court of Appeals held that Illinois tort law would apply the doctrine of *in pari delicto*, and began by noting that fraud on "behalf of" a corporation is not the same as fraud "against" the corporation.

The Court went on to explain that fraud against the corporation usually only harms the corporation, with the stockholders being the principal—if not the only—victims. On the other hand, when officers commit fraud on behalf of the corporation, outsiders rather than stockholders are the primary victims. The Court reasoned that, in such cases, the stockholders shouldn't escape responsibility for the fraud.

What's more, the Court reasoned that allowing the corporation to shift responsibility to the auditors wouldn't promote the objectives of tort liability, which include compensating the victims and deterring future wrongdoing. With respect to the latter, the Court stated that the incentive for corporations to hire honest managers and monitor their behavior would be reduced if the shareholders of a corrupt corporation were allowed to simply lay the blame at the auditors' door.

More recently, *Parmalat Capital Finance Ltd. v. Grant Thornton International* (2014) provides an illuminating discussion of the *in pari delicto* defense. Parmalat started life as an Italian dairy operation and grew into a multinational food company. In the late 1980s, when Parmalat began experiencing financial difficulties, company insiders chose to concoct schemes and transactions to create the appearance of financial health. They obtained loans based on these

transactions, which were used to service company debt and obtain more loans.

Parmalat's directors hid these schemes in false financial statements, which were later approved by their auditors, Grant Thornton. The fraud continued until the company's massive collapse a decade later. Parmalat then filed suit against Grant Thornton, alleging that the firm contributed to the collapse by conducting inadequate audits of the books in violation of Illinois tort law. In response, Grant Thornton asserted the *in pari delicto* defense.

A prior federal court concluded that the application of this defense was a state law issue. The Seventh Circuit then ordered the case to be sent to Cook County, since it was uncertain that Illinois would follow the *Cenco* decision. The Court explained that *Cenco* was not based on Illinois statutory or case law; instead, the federal court predicted how the Illinois Supreme Court would decide such a case.

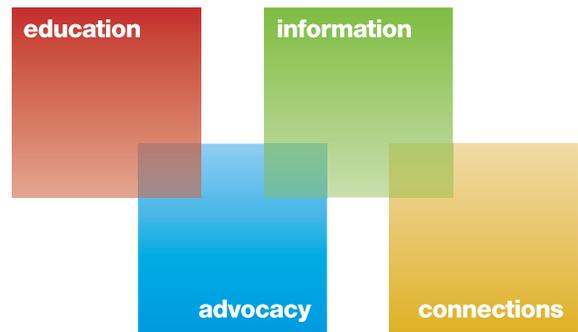
Truthfully, the practical application of the *in pari delicto* defense is complicated. In particular, discerning whether a manager is committing fraud for the benefit versus the detriment of the corporation can be extremely difficult to assess. For example, evidence that management received higher bonuses because of increased stock prices and profits may show that the fraud was committed against the corporation. On the other hand, if the managers believed their conduct to be a short-term fix to solve the company's financial problems, the court may decide that their actions benefited the corporation.

The *in pari delicto* defense has been widely, but not universally, accepted. The defense is recognized in California, Delaware, New York and Pennsylvania, for example, but was rejected by New Jersey. The recent remand of *Parmalat* to Illinois state court provides Illinois jurists with the opportunity to cement the defense into Illinois law, and therefore further protect auditors unfortunate enough to perform audits on companies whose managers have committed fraud. Stay tuned! □

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