

PENNSYLVANIA SUPREME COURT RESTRICTS USE OF *IN PARI DELICTO* DEFENSE BY OUTSIDE AUDITORS

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On February 16, 2010, the Pennsylvania Supreme Court issued an opinion of first impression under Pennsylvania law as to whether an imputation-based *in pari delicto* defense in an auditor-liability context may be asserted. According to the Court, while the defense may apply in cases of auditor negligence, it is not available where the auditor materially has not dealt in good faith with the client-principal, such as where the auditor secretly colludes with corporate officers to misstate corporate finances to the corporation's ultimate detriment. *Official Committee of Unsecured Creditors of Allegheny Health Education and Research Foundation v. PriceWaterhouse Coopers, LLP*, No. 38 WAP 2008, 2010 WL 522830 (Pa. Feb. 16, 2010). To view the full opinion, visit: <http://www.aopc.org/T/SupremeCourt/SupremePostings.htm>.

AHERF'S BANKRUPTCY AND THE COMMITTEE'S COMPLAINT AGAINST PWC

The court's decision stems from the collapse of Allegheny Health Education and Research Foundation ("AHERF"), a non-profit corporation which operated hospitals, medical schools, and physicians' practices until it filed for bankruptcy in 1998, and, addresses claims alleged against PriceWaterhouse Coopers ("PWC"), the successor to the company's auditors, by the committee of unsecured creditors (the "Committee"). The Committee's claims against PWC, for breach of contract, professional negligence, and aiding and abetting a breach of fiduciary duty under Pennsylvania law, were based on PWC's alleged collusion with AHERF officers to fraudulently misstate AHERF's finances in the years leading up to its bankruptcy. The Committee sought damages equal to the "full extent of [AHERF's] insolvency," or over one-billion dollars.

At the district court level, PWC moved for summary judgment based on the defense of *in pari delicto potior est conditio*

defendentis, which, in general terms, means that in a case of equal or mutual fault, the position of the defending party is the stronger one. In January 2007, the United States District Court for the Western District of Pennsylvania granted PWC's motion, concluding that the misconduct of AHERF's officers was imputed to AHERF (and, by extension, to the Committee, which stood in AHERF's shoes), thereby barring the Committee's claims against PWC.

The Committee appealed the district court's decision to the Third Circuit Court of Appeals, which unanimously concluded that it was unable to decide the case without guidance from the Pennsylvania Supreme Court. The Third Circuit certified, and the Pennsylvania Supreme Court accepted, the following questions:

1. What is the proper test under Pennsylvania law for determining whether an agent's fraud should be imputed to the principal when it is an allegedly non-innocent third party that seeks to invoke the law of imputation in order to shield itself from liability?
2. Does the doctrine of *in pari delicto* prevent a corporation from recovering against its accountants for breach of contract, professional negligence, or aiding and abetting a breach of fiduciary duty, if those accountants conspired with officers of the corporation to misstate the corporation's finances to the corporation's ultimate detriment?

THE PENNSYLVANIA SUPREME COURT'S DECISION

The Pennsylvania Supreme Court responded to the Third Circuit's certification petition as follows:

1. The proper test to determine the availability of defensive imputation in scenarios involving non-innocents depends on whether or not the defendant dealt with the principal

in good faith. While one of the primary justifications for imputation lies in the protection of innocents, in Pennsylvania, it may extend to scenarios involving auditor negligence, subject to an adverse-interest exception, as well as other limits arising out of the underlying justifications supporting imputation. Imputation does not apply, however, where the defendant materially has not dealt in good faith with the principal.

2. The *in pari delicto* defense may be available in its classic form in the auditor-liability setting, subject to ordinary requirements of pleading and proof (including special ones related to averments of fraud where relevant), and consideration of competing policy concerns. However,

as noted, imputation is unavailable relative to an auditor that has not dealt materially in good faith with the client-principal. This effectively forecloses an *in pari delicto* defense for scenarios involving secretive collusion between officers and auditors to misstate corporate finances to the corporation's ultimate detriment.

The case will now return to the Third Circuit Court of Appeals.

The Pennsylvania Supreme Court's decision is likely to have significant ramifications for auditor-liability cases governed by Pennsylvania law given that the *in pari delicto* defense and its imputation doctrine have frequently been used to defeat third-party claims against auditors.