

THIRD CIRCUIT REMANDS CASE INVOLVING USE OF *IN PARI DELICTO* DEFENSE BY OUTSIDE AUDITORS, AFTER RECEIVING PENNSYLVANIA SUPREME COURT'S GUIDANCE

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In a February 19, 2010 Alert, we reported on an opinion of the Pennsylvania Supreme Court regarding the use of an imputation-based *in pari delicto* defense in an auditor-liability context, an issue of first impression under Pennsylvania law. *Off. Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Fund v. PricewaterhouseCoopers, LLP* (“Allegheny III”), 989 A.2d 313 (Pa. 2010). Specifically, we reported that while the Pennsylvania Supreme Court preserved the availability of this defense in cases of auditor negligence, it conditioned the defense’s availability on the auditor dealing materially in good faith with the client-principal. The Pennsylvania Supreme Court in Allegheny III expressly found that collusion between an officer-agent and the auditor does not permit imputation of the agents’ conduct to its corporate principal because the auditor has not proceeded in material good faith, and the auditor under such circumstance is on notice that the officer-agent will withhold information from the corporate principal.

Based on the Pennsylvania Supreme Court’s opinion in Allegheny III, the U.S. Court of Appeals for the Third Circuit, on May 28, 2010, vacated and remanded the district court’s grant of summary judgment in favor of PricewaterhouseCoopers (“PWC”) in an adversary proceeding brought against it by the committee of unsecured creditors (the “Committee”) of Allegheny Health Education and Research Foundation (“AHERF”) (“Allegheny IV”). Significantly, the Third Circuit directed the district court to inquire into whether PWC dealt with AHERF in good faith, an issue the district court had not analyzed when it granted PWC’s motion for summary judgment, but is now required to under Pennsylvania law, as instructed by Allegheny III.

BACKGROUND OF THE DECISION

As we noted in our February 2010 Alert, the Pennsylvania Supreme Court’s opinion was issued in response to questions certified to it by the Third Circuit in the context of AHERF’s bankruptcy proceeding and, in particular, an adversary proceeding brought by the Committee against PWC, the successor to the company’s auditors. The Committee’s complaint alleged claims against PWC for breach of contract, professional negligence, and aiding and abetting a breach of fiduciary duty under Pennsylvania law, based on PWC’s alleged collusion with AHERF officers to fraudulently misstate AHERF’s finances in the years leading up to its bankruptcy.

The district court had granted PWC’s motion 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. The Committee appealed the district court’s decision to the Third Circuit, which unanimously concluded that it was unable to decide the case without guidance from the Pennsylvania Supreme Court and, as such, certified to the Pennsylvania Supreme Court questions regarding the application of an *in pari delicto* defense in an auditor-liability context under Pennsylvania law.

SIGNIFICANCE OF THE DECISION

As noted, the case will now be remanded to the district court to consider whether PWC acted in good faith with AHERF’s officers and, as such, whether PWC may assert the *in pari delicto* defense. The Third Circuit in Allegheny IV specifically recognized that the Pennsylvania Supreme Court effectively foreclosed an *in pari delicto* defense by auditors where there

was secretive collusion between officers and auditors to misstate finances to a corporation's ultimate detriment.

The district court's analysis of PWC's conduct will provide direction as to what type of conduct constitutes "good faith" or, by contrast, what type of conduct fails to satisfy that

requirement. As the *in pari delicto* defense and its imputation doctrine have frequently been used to defeat third-party claims against auditors, this precedent is likely to have significant ramifications for auditor-liability cases governed by Pennsylvania law and may influence similar litigation in other states.