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A legal update from Dechert's Business Restructuring and Reorganization Group

Pennsylvania Supreme Court Limits the Applicability of the *In Pari Delicto* Defense

In pari delicto is a common law defense against liability in circumstances where the culpability of the plaintiff is at least as great as the culpability of the defendant. The Supreme Court of Pennsylvania clarified Pennsylvania law on this on February 16, 2010, in *Official Comm. Of Unsecured Creditors of Allegheny Health, Educ. & Research Found. v. PriceWaterhouseCoopers LLP ("Allegheny III")*, 989 A.2d 313, when it answered certified questions of law from The United States Court of Appeals for the Third Circuit concerning the extent to which actions of a debtor corporation's managers can be imputed to the corporation for purposes of the *in pari delicto* defense. The Pennsylvania Supreme Court held that where an auditor colludes with officers of a corporation to perpetrate fraud, the actions of colluding officers cannot be imputed to the corporation. Based on the Supreme Court's holding, the Third Circuit remanded the case to the district court for a determination of "whether the third party [auditors] dealt with the principal in good faith." *Official Comm. of Unsecured Creditors of Allegheny Health v. PricewaterhouseCoopers, LLP*, 2010 U.S. App. LEXIS 10920 (3d Cir. 2010). As a result of *Allegheny III*, the *in pari delicto* defense is not available to third parties, including outside auditors, who collude with officers of a corporation to commit fraud.

Background

Allegheny Health, Education, and Research Foundation ("AHERF") is a nonprofit organization which operated health care facilities. AHERF aggressively acquired hospitals, medical schools, and physicians' practices as part of an integrated-delivery-system business model. To avoid disclosing the failure of that business model, AHERF officers, including the chief executive and financial officers, allegedly colluded with AHERF's auditor, Coopers and Lybrand ("C&L"), the predecessor company to PriceWaterhouseCoopers LLP ("PwC"), to fraudulently misstate AHERF's finances in 1996 and 1997.

In 1998, AHERF filed for bankruptcy. The official committee of unsecured creditors (the "Committee") thereafter asserted claims on behalf of the estate against PwC, under Pennsylvania law, for breach of contract, professional negligence, and aiding and abetting a breach of fiduciary duty. The Committee sought damages of over one billion dollars. PwC moved for summary judgment on the basis of *in pari delicto*, a common law doctrine that protects a defendant from liability where the plaintiff is equally or more culpable for the damages it suffered. PwC argued that AHERF was equally at fault because the AHERF officers provided false financial information to C&L.

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The district court issued a summary judgment in favor of PwC on the sole basis of the *in pari delicto* defense. *See AHERF Creditors' Comm. V. PwC*, No. 2:00cv684, slip op. (W.D. Pa. Jan. 17, 2007). In so ruling, the court relied on the principle of agency law that the fraudulent conduct of a corporate officer is imputed to the corporation if committed in the course of the officer's employment and for the benefit of the corporation. *Id*. at 14. The district court found that the preparation of false financial statements was in the course of the employment of AHERF management, and that the financial misstatements provided at least a short-term benefit to AHERF. *Id*. at 20.

On appeal, the Third Circuit noted variations between jurisdictions concerning the extent to which the wrongdoing of officers and directors can be imputed to a corporation in the auditor-liability setting. To clarify Pennsylvania law on the subject, the Third Circuit certified the question to the Pennsylvania Supreme Court. The Pennsylvania Supreme Court accepted certification and proceeded to develop a narrow imputation rule that is not applicable in an instance of auditor collusion with company management.

Analysis

The Seventh Circuit's influential decision in *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir. 1982) adopted a broad application of *in pari delicto* in the auditor liability context. *Cenco* held that immunizing auditors from malpractice claims, even in cases in which the auditor's malpractice was a but-for cause of damages resulting from fraud, is good policy because it prevents corporations from relying solely on auditors, and thereby preserves the incentive for corporations to monitor managerial behavior. The Pennsylvania Supreme Court noted that *Cenco* has been criticized for its "free-wheeling" reliance on pragmatic reasoning. *Cenco's* application of the *in pari delicto* defense subsequently influenced the Second Circuit, *see Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114 (2d Cir. 1991) (finding that the trustee for a bankrupt corporation does not have standing to pursue claims against those who defrauded the corporation with the cooperation of management), and the Third Circuit in applying Pennsylvania law, *see Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001).

In its February 16 opinion, the Pennsylvania Supreme Court first addressed the availability of the *in pari delicto* defense to auditors, as a class, and declined to adopt a general rule which would disable auditors from asserting this defense. As a result, the court recognized that the question of whether to impute the wrongdoing of corporate officers for purposes of the *in pari delicto* defense was the "linchpin" of the certified questions. That question turns on the degree to which a court prioritizes the policy of incentivizing internal corporate monitoring over the objectives of the traditional schemes governing liability in contract and in tort, including fair compensation and deterrence of wrongdoing. The Pennsylvania Supreme Court decided not to follow the scheme for risk-allocation adopted in *Cenco*.

The Pennsylvania Supreme Court found that in cases where the auditor colludes with management to commit fraud the traditional rationale for imputing the acts of agents to the corporation is no longer applicable. The court found that imputation rules operate to protect third parties on account of their reliance on the agent's actual or apparent authority. Such reliance does not exist where there is a secret agreement to collude and the actions of the officers are not properly sanctioned by the rules governing the corporation. Finding that, if the allegations were true, AHERF's officers had no actual or apparent authority to misrepresent corporate finances or collude with PwC to prepare a false financial statement, the Pennsylvania Supreme Court found that the officers' actions cannot be imputed to AHERF for purposes of the *in pari delicto* defense.

Conclusion

Although Pennsylvania law allows auditors to assert an *in pari delicto* defense, it does not protect third parties from liability where the third party has colluded with company management to commit fraud. The Pennsylvania Supreme Court's ruling will limit the availability of the *in pari delicto* defense in cases in which bankruptcy estates seek to recover from a third party that aided the debtor's officers in the commission of fraud.

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Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/insolvency.

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