

Imputation And The *In Pari Delicto* Defense In Auditor-Liability Cases: Pennsylvania Declines To Abolish The Traditional Defense, But Limits It As Well

Bankrupt companies regularly sue their outside professionals for contributing to the bankruptcy. These cases can turn on a single question: To defend itself, can a professional firm point out that the plaintiff's own officers committed fraud that figured in the bankruptcy? The answer is "yes," according to the Pennsylvania Supreme Court. In reaching this conclusion, the court specifically declined to follow the lead of New Jersey's highest court, which recently answered "no" (with some qualifications). The Pennsylvania case is *Allegheny Health*—fully titled *Official Committee of Unsecured Creditors of Allegheny Health Education and Research Foundation v. PriceWaterhouseCoopers, LLP*.¹

Although the *Allegheny Health* court permitted this defense, it also acknowledged a "collusion exception" to it. Depending on its development in future cases, this exception could give plaintiffs a route around an otherwise imposing defensive barrier. At least in Pennsylvania, the next likely battle is over the future of this collusion exception.

The *In Pari Delicto* Defense

Corporations regularly go bankrupt in the wake of fraud committed by their officers. Bankruptcy and fraud often go together, in particular because management can be tempted to engage in fraud precisely to hide a company's financial woes. Whatever the explanation for specific frauds, failed companies regularly sue their outside auditors for failing to detect them. The stakes in these cases can be huge; the plaintiff in *Allegheny Health* sued the auditor for more than a billion dollars.²

These cases raise the question whether the officers' wrongful conduct should defeat the corporation's claims. This is the doctrine of *in pari delicto*: that in "a case of equal or mutual fault the position of the defending party is the stronger one."³ Where the plaintiff is a corporation, the predicate for this defense is imputation: holding the corporation responsible for the acts of its officers. Together, imputation and *in pari delicto* form a powerful all-or-nothing defense, even in liability schemes that otherwise apply comparative negligence.

The leading authority is *Cenco, Inc. v. Seidman & Seidman*, a 1982 case decided under Illinois law.⁴ There, the United States Court of Appeals for the Seventh Circuit permitted an auditor to invoke the *in pari delicto* doctrine to defeat a claim against it for failing to detect fraud by the management of an audit client.⁵ Since *Cenco*, numerous courts have permitted auditors to defeat claims by asserting the *in pari delicto* defense. At the same time, plaintiffs suing auditors have persistently worked to lower, punch holes in, or outright eliminate the defense.

Plaintiffs made their furthest advance toward eliminating the defense in a 2006 decision of the New Jersey Supreme Court, *NCP Litigation Trust v. KPMG LLP*.⁶ The *NCP* court ruled

¹ 989 A.2d 313 (Pa. 2010).

² *The Official Comm. of Unsecured Creditors of Allegheny Health, Educ. and Research Found. v. PriceWaterhouseCoopers, LLP*, 2007 WL 141059 (W.D. Pa. Jan. 17, 2007) at *4.

³ *Allegheny Health*, 989 A.2d at 315.

⁴ 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

⁵ 686 F.2d at 545-57.

⁶ 901 A.2d 871 (N.J. 2006).

(with exceptions not relevant here) that an auditor cannot benefit from imputation if the auditor was at fault in any way, even if only negligent. The court held that “the imputation doctrine does not bar corporate shareholders from recovering . . . against an auditor who was negligent within the scope of its engagement by failing to uncover or report the fraud of corporate officers and directors.”⁷ The court reasoned that imputation should not be available to a defendant who had “contributed to the misconduct”—in *NCP*, by negligently failing to detect it.⁸

Allegheny Health Education and Research Foundation v. PriceWaterhouseCoopers

1. Background

The latest decision to address these issues is *Allegheny Health*. The facts of the case follow the familiar pattern. *Allegheny Health* was a large health-care system that failed and filed for relief under the Bankruptcy Code. It came to light that, while the corporation’s financial health was fading, the corporation’s senior management had engaged in fraud to present a falsely positive financial picture. A committee of creditors—referred to in the opinion as the Committee—stepped into *Allegheny Health*’s shoes and sued the corporation’s auditor, PriceWaterhouseCoopers (“PwC”).⁹ The Committee alleged that PwC had “colluded” with senior management by issuing a clean audit opinion even though the auditor knew about the management fraud.¹⁰ The Committee asserted claims of breach of contract, negligence, and aiding and abetting the breach of fiduciary duty, all under Pennsylvania law.¹¹

PwC moved for summary judgment. It argued that the conduct of *Allegheny Health*’s management should be imputed to *Allegheny Health* and that, based on this imputation, the creditors’ claims were barred by the *in pari delicto* doctrine. The district court granted PwC’s motion.¹² The court applied the general rule 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,” and found no applicable exceptions.¹³

On appeal, the Third Circuit focused on the fact that the auditor allegedly was worse than negligent—that it allegedly had actual knowledge of the fraud. The court therefore certified two questions of state law to the Pennsylvania Supreme Court: the “proper test” for imputation when the defendant is “non-innocent” because it had colluded with *Allegheny Health*’s officers, and whether the *in pari delicto* defense is available to auditors who “conspired with officers of the corporation.”¹⁴

⁷ 901 A.2d at 873.

⁸ *Id.* at 882.

⁹ *Id.* at 315. (The auditor actually had been a predecessor of PwC, Coopers & Lybrand. *Id.* at 315.)

¹⁰ *Id.* at 315-17.

¹¹ *Id.* at 316.

¹² *Id.*

¹³ *Id.* (citing district court opinion).

¹⁴ *Id.* at 318.

2. The Parties' Arguments

In the Pennsylvania Supreme Court, the Committee advocated the elimination of imputation and *in pari delicto* in all claims against auditors, including claims based on mere negligence. It argued that any auditor that was negligent or worse was “non-innocent” and had “unclean hands” and, as a result, was ineligible to assert the *in pari delicto* defense or its predicate, imputation.¹⁵ In the alternative, the Committee advocated a significant expansion of the adverse-interest exception to imputation. That exception traditionally has absolved a principal of responsibility for an agent only when the agent’s actions conferred no benefit at all on the principal. The Committee sought to shift the focus of the exception to the subjective motivation of the agent. It argued that the exception should apply whenever wrongdoer agents act with the intention to benefit themselves, even if only by “preserving their positions and personally profiting from their extended tenure.”¹⁶ The Committee also argued that, in any event, the traditional “benefit” test for the exception was met here because the corporation had not benefited from wrongdoing that had the effect of extending the corporation’s life beyond solvency.¹⁷ Finally, the Committee argued for the application of a “collusion” exception to imputation, which it contended was already recognized by Pennsylvania law.¹⁸

PwC made various counter-arguments, generally defending the traditional rules of imputation and *in pari delicto*.¹⁹ PwC did not dispute the existence of a collusion exception to imputation, but did try to avoid its application in this case by limiting it to “circumstances where an agent and the third party conspire to commit a fraud against the principal” rather than against third parties,²⁰ apparently because in those cases the corporation would benefit from the fraud.²¹

3. The Court’s Decision

In its opinion, the Pennsylvania Supreme Court began by addressing the *in pari delicto* defense in isolation, apart from its predicate in imputation. The court reaffirmed the defense’s validity in auditor-liability cases. The court then turned to imputation and reached three important conclusions, the first two helpful to auditor defendants and the third helpful to plaintiffs, including the plaintiffs in *Allegheny Health*. The court first reaffirmed the validity of traditional imputation principles, and therefore the *in pari delicto* defense, where a corporation charges an auditor with negligence but nothing worse. Second, the court refused to abolish imputation in negligent-auditor cases through the alternate route of broadening the adverse-interest exception. Third, however, the court acknowledged a collusion exception to imputation and gave it a potentially broad reading. The court also expressed views on a number of matters that do not appear to figure in its holdings, thus leaving a treasure trove of dicta for litigants to cite in future cases.

a. The *In Pari Delicto* Doctrine

¹⁵ *Id.* at 319.

¹⁶ *Id.*

¹⁷ *Id.* at 319-20.

¹⁸ *Id.* at 321.

¹⁹ *Id.* at 323-25.

²⁰ *Id.* at 324 (emphasis removed).

²¹ *Id.* at 334.

Beginning with the *in pari delicto* doctrine, the court separated this defense from the underlying question of imputation by assuming that the plaintiff was “a corporation controlled by a single individual.”²² The court explained that the very purpose of the *in pari delicto* doctrine was to provide a defense when both sides are to some degree “culpable.”²³ It then held that the defense is available “in the auditor-liability setting,”²⁴ including in cases of “intentional auditor misrepresentation” as long as that misrepresentation was “at the behest of the owner.”²⁵

b. Imputation

Imputation in negligence cases. This left the question of imputation. Turning to that issue, the court held that imputation is generally available in cases where the auditor is negligent. It thus declined the Committee’s invitation to eliminate imputation in all auditor cases, and it expressly refused to follow the New Jersey Supreme Court’s decision in *NCP*.²⁶

The adverse-interest exception. The court next addressed the adverse-interest exception, refusing to broaden the exception beyond its previous scope.²⁷ It declined to base the exception on a subjective test of the agent’s intent.²⁸ Instead, it reaffirmed the traditional focus on benefit to the corporation, reasoning that this objective test protects third parties who rely in good faith on the apparent authority of the corporation’s agents.²⁹ The court also indicated that virtually any benefit to the corporation warrants imputation.³⁰ The assumption appears to be that the presence of benefit to the corporation tends to align with the appearance that the agent is acting with the corporation’s authority,

The collusion exception. Next, the court discussed a second possible route around imputation, the collusion exception. Where the adverse-interest exception focuses on benefit to the principal, the collusion exception focuses on the knowledge of the third party who interacts with the agent.³¹ If this third party has “collude[d]” with the agent, the court ruled, imputation is “unavailable.”³² The court explained that the rationale for imputation is that a third party is entitled to rely on the “agent’s actual or apparent authority,”³³ but that this rationale “breaks

²² *Id.* at 331.

²³ *Id.*

²⁴ *Id.* at 339.

²⁵ *Id.* at 331. The court relied heavily on the Delaware Chancery Court’s opinion in a case addressing claims brought against AIG. *Id.* at 331 (discussing *In re Am. Intern. Group, Inc., Consol. Deriv. Litig.*, 976 A.2d 872 (Del. Ch. 2009)).

²⁶ *Allegheny Health* at 334.

²⁷ *Id.* at 333-35.

²⁸ *Id.*

²⁹ *Id.* at 335.

³⁰ *Id.*

³¹ *Id.*

³² *Id.* at 337. Here the Pennsylvania Supreme Court parted company with the district court that had granted summary judgment for the auditor.

³³ *Id.* at 336 (citation omitted).

down completely” where the third party has colluded with the agent,³⁴ particularly where the purpose of the collusion is “to withhold information” from others in the corporation.³⁵ If the third party *knows* that the agent is acting improperly, the court explained, “the agent’s authority is neither actual nor apparent.”³⁶ The court noted that other courts have recognized this exception as well.³⁷

The court rejected PwC’s effort to limit the exception to cases where the fraud is against the corporation itself. Even in frauds against third parties, the court reasoned, the auditor knows that the agent lacked authority for the conduct at issue.³⁸

4. The Implications Of *Allegheny Health*

The Allegheny Court thus closed the door on the plaintiff’s effort to wipe out the imputation and *in pari delicto* defense altogether. It opened a window for plaintiffs, however, by acknowledging the collusion exception and basing that exception entirely on the rationale of apparent authority. How much that exception helps plaintiffs will be the subject of future disputes. In fact, to the extent that this discussion shifts the basis of imputation solely to the presence of apparent authority, it could narrow the scope of the imputation doctrine itself.

a. The court preserved the *in pari delicto* defense in cases alleging auditor negligence

Probably the most important element of *Allegheny Health* is the court’s refusal to eliminate the basic rule of imputation in cases brought against auditors.³⁹ As the court pointed out, its preservation of the basic imputation rule also preserves other features of Pennsylvania

³⁴ *Id.*

³⁵ *Id.* at 337.

³⁶ *Id.* at 336 (citation omitted).

³⁷ *Id.* at 336 (citing *In re Am. Intern. Group, Inc.*, 965 A.2d 763, 807 (Del. Ch. 2009)). The court again leaned heavily on the Delaware Chancery Court’s analysis in *AIG*.

³⁸ *Allegheny Health* at 321 n.7, 324 n.11, 336-37.

³⁹ The court did not follow the plaintiff’s invitation to focus its analysis on questions such as whether the auditor had “clean hands” or was “innocent,” *id.* at *4-*5. This was wise. Trying to resolve imputation and *in pari delicto* issues by debating who is “innocent” leads to circularity, strategic imprecision in the use of the words, and similar dead ends. For example, in *Allegheny Health*, “the Committee stresse[d] the grounding of imputation doctrine in the protection of innocents,” *id.* at *5, using “innocent” to mean “not even negligent.” That cannot be what innocence means in the context of imputation, however, because if only non-negligent defendants could assert imputation, then no party that needed an imputation-based defense could assert one. The same is true of the *in pari delicto* defense. A requirement that a defendant must be without legal fault to assert the defense would eliminate the defense.

An example of question begging is the Committee’s assertion that directors or officers who lack actual knowledge of fraud are “innocent” within the meaning of the traditional imputation rule. This contention assumes an answer to the very question at issue, which is whether the corporation’s monitors should have done a better job of monitoring and therefore should be held responsible (*vis-à-vis* third parties) for the agents they selected. (For an example of a good discussion of terms such as “innocent,” see *Cenco*, 686 F.2d 449, 455-56.)

law, including the existence of a contributory negligence scheme in professional liability cases,⁴⁰ and the specific defense of audit interference.⁴¹ *Allegheny Health* also preserves the ability of auditors to use imputation offensively, as a basis for claims against their clients for injuries that an auditor suffers because of the wrongdoing of employees of an audit client.

The *Allegheny Health* court also expressed its views about “the complexity of doctrine-setting social-policy judgments in this area.”⁴² In this vein, it acknowledged the importance both of corporations’ monitoring their own agents and of auditors’ meeting their obligations as well.⁴³ This discussion displayed some acceptance of the view—long advocated by the accounting profession—that the auditor’s role is limited and “depend[s] on the terms of the retention.”⁴⁴ Future auditor defendants might quote this discussion when fighting what auditors see as the “expectancy gap.”

As this discussion illustrates, *Allegheny Court* emphasizes the case-by-case complexity of the imputation and *in pari delicto* issues. The decision appears, nonetheless, to permit auditors to continue to assert imputation defenses on dispositive motions, at least in many cases. The real battle in the future will be over the exceptions.

b. The court refused the invitation to eliminate the *in pari delicto* defense by broadening the adverse-interest exception to imputation

The court generally stood with the traditional view of the adverse-interest exception. The Committee’s position would have, in effect, expanded that exception until it swallowed the basic imputation rule. By rejecting the proposed expansion, the court preserved the ability of defendants, in many cases, to defeat this exception on motions.

The court may have given future defendants some other help as well, on the important question whether wrongdoing that extends a company’s life past the point of insolvency constitutes a benefit to the corporation. While the court did not specifically resolve the question, it did note that the Committee had criticized the district court for accepting that the extension of corporate life is a benefit to the corporation.⁴⁵ The court later rejected the Committee’s view of the adverse-interest exception, affirmed the benefit-based test for the exception, and endorsed a “liberal” test for benefit.⁴⁶ A liberal test sets a lower threshold for what counts as a benefit. This choice of a more liberal category of “benefit” limits the scope of the adverse-interest exception. The court’s endorsement of the more “liberal” test for benefit, and apparent acceptance of the view that extending a corporation’s life is a benefit to the corporation, also could play an important role in deepening-insolvency matters. This more liberal view of benefit undermines deepening-insolvency theories of injury and damages.

c. The “collusion” exception is limited in theory, but presents a possible road map for future plaintiffs

⁴⁰ *Allegheny Health* at 335 n.31 (citing cases).

⁴¹ *Id.* at 335 (citing cases).

⁴² *Id.* at 335.

⁴³ *Id.* at 333-38.

⁴⁴ *Id.* at 332.

⁴⁵ *Id.* at 319-20.

⁴⁶ *Id.* at 336.

The collusion exception might show more promise for future plaintiffs. This exception arises from the court's effort to reconcile, however imperfectly, the multiple rationales underlying the agency-based doctrine of imputation and the equitably-oriented doctrine of *in pari delicto*. These rationales include holding principals responsible for the conduct of their agents; considering whether an agent acted for the benefit of the principal; and the principle of apparent authority, which protects third parties who reasonably rely on the appearance that an agent is acting with authority.

As the court explained, because the collusion exception arises where the third party knows that the agent is misleading the principal, the third party does not merit the protection of the principle of apparent authority.⁴⁷ As long as the collusion exception is limited to collusion *against* the principal, and presumably to the principal's detriment as well, the exception does not run afoul of the other goals of imputation, such as encouraging principals to monitor properly and matching benefits from agent conduct with responsibility for that same conduct. The concern that a broader collusion exception could conflict with these other goals was the apparent basis of PwC's argument that the exception should not apply to frauds against third parties.⁴⁸ The same concerns appear to explain the court's own earlier statement that, assuming a sole-shareholder corporation, the *in pari delicto* defense should apply even in cases of "intentional auditor misrepresentation"—that is, collusion—if the auditor misrepresentation were made "at the behest of the owner."⁴⁹ An even broader concern arises here: If analysis of the collusion exception is limited to the apparent-authority issue, and does not also address benefit to the principal and related considerations, then the analysis could limit imputation by limiting its justification to protecting apparent authority. In short, the application of *in pari delicto* where a third-party commits fraud but the owner knows about it suggests that the collusion exception should be limited to fraud against the principal.

In any event, although auditor defendants will dispute the scope of the collusion exception, they may take some comfort in the perception that the exception is limited to cases where the third party has actual knowledge of fraud. But the exception may be so limited only in theory; future plaintiffs inevitably will work to broaden it in practice. They will plead collusion, or similar intentional conduct, in an effort to craft claims that can survive dispositive motions. These complaints also will raise new questions about the outer limits of the collusion exception, such as whether its knowledge requirement is met by some degree of recklessness. Another battleground will be whether plaintiffs that plead collusion can satisfy the stricter pleading standards that govern claims sounding in fraud. Future decisions will reveal the extent to which plaintiffs will succeed in invoking this exception to plead claims against third-party professionals to avoid the powerful effect of imputation and *in pari delicto*.

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If *Allegheny Health* is an indication of the direction of the law, then the New Jersey Supreme Court's decision in *NCP* was a high-water mark for plaintiffs, not the leading edge of a rising tide.⁵⁰ The next decisions will tell, and highest court of New York may be next to consider

⁴⁷ *Id.* at 337.

⁴⁸ See *id.* at 337.

⁴⁹ *Id.* at 331.

⁵⁰ This would not be the first time New Jersey has taken the lead in expanding the liability of accountants. In *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 146-47 (N.J. 1983), that court significantly expanded accountants' liability to third parties. Few states followed suit, however.

the issue. On March 10, 2010, the Delaware Chancery Court certified to the New York Court of Appeals the question whether, under New York law, an allegedly negligent auditor can assert the *in pari delicto* defense. That case involves a failure to detect management fraud at AIG, and again the auditor defendant is PwC. If the Court of Appeals takes on the matter, it will issue the next important opinion on the place of imputation and the *in pari delicto* defense in claims against outside professionals.⁵¹

The New Jersey legislature ultimately reversed the decision, returning accountants' liability to the scope recognized in other states. See N.J. Stat. Ann. § 2A:53A-25 (Thomson Reuters).

⁵¹ *Teachers' Retirement System of Louisiana v. PriceWaterhouseCoopers LLP*, No. 454, 2009, slip op. (Del. Mar. 3, 2010).