IN THE

Supreme Court Of Pennsylvania

38 WAP 2008

**The Official Committee Of Unsecured Creditors Of
Allegheny Health, Education And Research Foundation,**

Plaintiff - Appellant,

v.

PricewaterhouseCoopers LLP,

Defendant - Appellee.

BRIEF OF *AMICUS CURIAE*
CENTER FOR AUDIT QUALITY
IN SUPPORT OF APPELLEE

ON CERTIFIED QUESTIONS OF LAW FROM THE
UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT
IN DOCKET NO. 07-1397

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November 5, 2008

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The Center For Audit Quality respectfully submits this brief as *amicus curiae*, pursuant to Rule 531, in support of defendant-appellee PricewaterhouseCoopers LLP ("PwC").

INTEREST OF THE CENTER FOR AUDIT QUALITY AS *AMICUS CURIAE*

The Center for Audit Quality ("CAQ") is a public policy organization that seeks to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change, rooted in the audit and accounting profession's core values of integrity, objectivity, honesty, and trust. The CAQ also seeks to improve the reliability of public company audits and to enhance their relevance for investors in this time of increasing financial complexity and globalization. To accomplish its mission, the CAQ offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and fosters and participates in the public discussion about financial reporting. Any U.S. accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") may join the CAQ. The CAQ is affiliated with the American Institute of Certified Public Accountants ("AICPA"), and has approximately 800 U.S. public company auditing firms (including PwC) as members, representing tens of thousands of professionals dedicated to audit quality.

Accordingly, the CAQ has a keen interest in cases, such as this one, concerning the legal rules that affect auditors and the audit process, and their broader impact on investors and the capital markets.

BACKGROUND

The Allegheny Health, Education and Research Foundation ("AHERF") is in bankruptcy. This case involves a suit by The Official Committee of Unsecured Creditors of the Allegheny Health, Education and Research Foundation (the "Committee") in which the Committee pursues

AHERF's claims against AHERF's auditor, PwC, for breach of contract, professional negligence, and aiding and abetting a breach of fiduciary duty. These claims stem from an accounting fraud that, all parties agree, was orchestrated and concealed by AHERF's senior management. The district court for the Western District of Pennsylvania dismissed the suit under the doctrine of *in pari delicto*, literally meaning "in equal fault," which provides that a plaintiff may not assert a claim against a defendant if the plaintiff bears "substantially equal responsibility for his injury." *Pinter v. Dahl*, 486 U.S. 622, 632 (1988) (internal quotation marks omitted). In reaching this decision, the district court held that the wrongful acts of AHERF's officers are imputed to AHERF, and thus the *in pari delicto* doctrine bars AHERF's claims, and the Committee's attempt to recover on AHERF's claims. On appeal, the Court of Appeals for the Third Circuit certified two questions to this Court:

> 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?

SUMMARY OF ARGUMENT

The district court correctly held that under Pennsylvania law, AHERF would be culpable for the fraudulent acts instigated and orchestrated by its senior management, and as a result, the Committee's suit is barred, because the Committee stands in AHERF's shoes.

The Committee, apparently conceding that its suit cannot succeed under the traditional legal rule, urges this Court to adopt one of a number of exceptions. As demonstrated below, the proposed exceptions are not supported by the law, and would have serious consequences for the

sustainability of the audit profession, the public markets, and investors. The Committee's proposed doctrinal innovations should be rejected.

ARGUMENT

I. Under Pennsylvania Law, Acts Committed By An Agent In The Course Of Employment Are Imputed To A Principal Who Benefits From Them

This Court has long recognized that "'[a]cts of fraud by an agent, committed in the course of his employment, are binding on the principal even though the principal did not know of or authorize'" them. *Bachman v. Monte*, 326 Pa. 289, 295, 192 A. 485, 487 (1937) (citation omitted). As the district court correctly held, under Pennsylvania law, a corporation that benefits from an agent's acts performed within the scope of employment is responsible for those acts. *Official Committee of Unsecured Creditors of Allegheny Health, Educ. and Research Foundation v. PricewaterhouseCoopers LLP*, No. 2:00cv684, 2007 WL 141059, at *11 (W.D. Pa. Jan. 17, 2007) ("Op."); *see also Aiello v. Ed Saxe Real Estate, Inc.*, 508 Pa. 553, 499 A.2d 282 (1985).

The Committee offers this Court no reason to depart from this well-established rule. The Committee argues, for instance, that a corporation should be able to avoid an agent's conduct—even if it benefited from that conduct—depending solely on the subjective motivation of the agent. But as this Court suggested in *Aiello*, when a principal benefits from an agent's misconduct, imputation is proper even if the agent did not intend to benefit the principal, because it would be inequitable to let a principal benefit from the misconduct and "at the same time" take no responsibility for it. 508 Pa. at 559, 499 A.2d at 285. Rather, a principal who benefits from misconduct must take the benefit "subject to his agent's fraud." *Id*. at 559, 499 A.2d at 286.

Todd v. Skelly, 384 Pa. 423, 428-29, 120 A.2d 906, 909 (1956), also makes clear that objective consideration of the benefit received by the principal is central to the imputation

inquiry. If there is an actual benefit, imputation is proper (*Aiello*); if there is no benefit, it is not (*Todd*).

Pennsylvania is not alone in following such a rule. Cases hold a principal responsible for misconduct from which it has actually benefited, even if the agent's subjective motivation may be adverse to the principal. *See, e.g., FDIC v. Shrader & York*, 991 F.2d 216, 223-24 (5th Cir. 1993) ("knowledge is imputed in a case of 'joint' interests *even though the agent's primary interest is inimical* to that of the principal") (emphasis added; internal quotation marks omitted). Imputation does not apply only when the agent acts entirely for his own purposes, *and* the principal receives no benefit. *Beck v. Deloitte & Touche*, 144 F.3d 732, 736 (11th Cir. 1998) (Florida law does not impute an officer's misconduct when his actions "neither [are] intended to benefit the corporation, *nor actually cause short- or long-term benefit* to the corporation") (emphasis added).

Under this test, imputation applies here. Because AHERF actually benefited from the misconduct, that is the end of the inquiry.

But imputation also applies for the additional reason that there is no evidence that management's "subjective motivation" was adverse to AHERF. This case does not involve self-dealing or looting or any other conduct that would justify the Committee's assertion that management's interests were necessarily adverse to AHERF. The fact that management acted to further its own compensation and reputation does not support this conclusion, either. To the contrary, management's actions, which permitted AHERF to continue its corporate expansion and prolonged its viability, furthered both AHERF's interests, and those of management, whose compensation package and prestige were tied to the fate of AHERF. In addition, as the district court reasoned, the "contention that imputation is improper where the jury could infer that

management acted to preserve their own 'employment, salaries, emoluments and reputations . . .' is illogical as it would discharge corporations from liability for the misdeeds of its officers or directors *in almost every instance*." Op. at *13 (emphasis added). As almost all corporate officers act to preserve their own employment, salaries, and reputations, the Committee's proposed test would essentially eliminate corporate liability for misconduct of corporate officers.

The Committee also argues that under Pennsylvania law, the conduct of a corporate agent within the scope of his or her employment is not imputed to the corporation unless the person seeking imputation was "innocent." Br. at 17. But the Committee fails to cite a single case in which this Court has refused imputation because a third party was purportedly not "innocent." Indeed, in *Aiello*, cited by the Committee (Br. at 17), this Court *allowed* imputation. While the innocence of the third parties there was mentioned as a fact favoring imputation, this Court did not *require* that third parties be innocent as a prerequisite to imputation. To the contrary, the Court stated that "[t]his result [*i.e.*, imputation] can be reached similarly on the familiar ground that when an agent exceeds his authority, his principal cannot benefit of his act and at the same time repudiate his authority." *Aiello*, 508 Pa. at 559, 499 A.2d at 285.

This is precisely the ground on which the district court applied imputation here. And, consistent with this ground, this Court has permitted imputation in numerous cases in which the third parties seeking imputation were not innocent. *See, e.g., Corn Exch. Nat'l Bank & Trust Co. v. Burkhart*, 401 Pa. 535, 538-40, 545, 165 A.2d 612, 613-14, 616 (1960) (imputing conduct to the corporation even where the third party seeking imputation fraudulently executed documents at issue in the lawsuit). Imputation thus does not turn on the chance that some third-party may or may not be "innocent."

*   *   *

The district court's "benefit" test is correct and consistent with Pennsylvania law, and provides the answer to Question 1. This Court should reject the Committee's attempts to create either a "subjective motivation" exception, or a "non-innocent" third party exception, and confirm that it meant what it said in *Aiello*: A principal who benefits from improper conduct must take the benefit "subject to his agent's fraud." *Aiello*, 508 Pa. at 559, 499 A.2d 285. That rule bars the Committee's suit.

II. Even Assuming PwC Is At Fault, The *In Pari Delicto* Doctrine Bars The Committee's Suit Because AHERF Bears At Least Equal Fault

As the district court correctly held, the *in pari delicto* doctrine applies in all cases of equal fault. Even assuming that PwC "aided and abetted" the financial statement fraud committed and concealed by AHERF's management, the *in pari delicto* doctrine bars the Committee's suit, because AHERF bears at least equal fault for the fraud committed by its management. Indeed, as discussed in Part III below, AHERF bears greater fault because it is *primarily* responsible for the accuracy of the financial statements and for policing corporate fraud. *See also Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982) (Posner, J.) ("If [the auditor] failed to police its people, [the audited corporation] failed as or more dramatically to police its own.").

In its certification order, however, the Third Circuit inquired whether this rule should apply "against a party that has not personally engaged in inequitable conduct, but rather has that conduct imputed through agency law." Certification Order at 13. As the Third Circuit implicitly recognized, Pennsylvania law does not prevent the application of the *in pari delicto* doctrine when fault is sought to be established through imputation. Nor is that the law elsewhere. The Restatement of Agency expressly recognizes that a culpable defendant may invoke imputation to

establish an *in pari delicto* defense: "Imputation may provide the basis for a defense that may be asserted by third parties when sued by or on behalf of a principal. Defenses such as *in pari delicto* may bar a plaintiff from recovering from a defendant whose conduct was also seriously culpable." Restatement (Third) of Agency § 5.03 cmt. b (2006); *see also id.* ("The agents' conduct may provide a defense to the service provider . . . on the basis that the agents' knowledge, imputed to the principal, defeats a claim that the principal relied on the accuracy of the work done by the service provider.").

Moreover, because corporations can only act through agents, imputation is a prerequisite to establishing "equal fault" by a corporation. Rejecting the application of the *in pari delicto* defense in cases involving imputed conduct would accordingly have the perverse result of eliminating the application of the defense against a corporation. Departure from the traditional rule is thus particularly unwarranted.

A. The Committee's Novel "Independent Decision-Maker" Exception Deviates From Traditional Agency Doctrine, And Would Eliminate The *In Pari Delicto* Doctrine

The Committee seeks to evade the *in pari delicto* doctrine by asking this Court to recognize another exception, the "independent decision-maker" exception. The proposed exception should not be recognized as part of Pennsylvania law.

Under traditional agency principles, "a company president who engages in [improper conduct] leaves his corporation liable even if the board of directors, had it known, would have stopped him." *Baena v. KPMG LLP*, 453 F.3d 1, 8 (1st Cir. 2006). The Committee's proposed "independent decision-maker" exception, however, would discharge the corporation from liability whenever independent board members declare, after the fact, that they would have stopped improper conduct by corporate officers had they known of it. The overwhelming majority of courts have rejected this proposed exception as a "radical alteration" in traditional

agency and *in pari delicto* principles. *E.g., Baena*, 453 F.3d at 8. The Committee cites a few lower federal court decisions from New York, but those decisions have been repudiated by the Second Circuit. *In re CBI Holding Co.*, 529 F.3d 432, 447 n.5 (2d Cir. 2008) (agreeing with the district court's rejection of the "independent decision-maker" exception).

Independent members of the board of directors will almost always declare, as in this case, that they would have prevented or stopped the illegal conduct had they known of it. After all, preventing improper conduct is one of their responsibilities. Thus, were the exception incorporated into the law, corporate liability for acts of senior officers would only attach in the extremely unusual instances in which it is shown that the board members knew of the improper conduct, or sanctioned it.

But this proposed rule—that a principal is only liable for its agent's fraud when the principal knows of it, or authorizes it—has already been flatly rejected by this Court in *Aiello.* In that case, this Court held that "a principal *is* liable . . . [for the conduct] of his agent committed within the scope of his employment *even though the principal did not authorize*, justify, participate in *or know of such conduct* or even if he forbade the acts or disapproved of them." 508 Pa. at 559, 499 A.2d 285 (emphases added).[1] This Court should re-affirm *Aiello* and reject the "independent decision-maker" exception.

B. A Rule That Treats The "Innocence" Of Bankruptcy Creditors As A Bar To The Application Of The *In Pari Delicto* Doctrine Would Be Preempted By Federal Law

The Committee's final proposed exception—under which the "innocence" of bankruptcy creditors would bar the application of the *in pari delicto* doctrine—is preempted by Section 541

[1] The "independent decision-maker" exception would also create anomalies for the imputation doctrine by essentially leaving only third parties liable for corporate fraud.

of the Bankruptcy Code. The Third Circuit did not certify this question to the Court, suggesting instead that this is an issue of federal bankruptcy law. *See* Certification Order at 12 (recognizing that innocent creditors can receive no greater rights than the debtor, and that this federal question is distinct from the certified question "of how Pennsylvania law weighs the equities of the various parties in applying the *in pari delicto* doctrine"). The equities that the Third Circuit wished this Court to consider do not include the "innocence" of the bankruptcy creditors, but the two other considerations discussed above: Whether the *in pari delicto* doctrine should apply against a party that has the misconduct "imputed through agency law," or when the doctrine is asserted by a collusive actor. *Id*. at 12-15. Nonetheless, the effect of the Bankruptcy Code is at issue here, given the Committee's arguments before this Court.

Section 541 expressly limits the property of the estate to those interests of the debtor that would have existed "as of the commencement of the [bankruptcy] case." 11 U.S.C. § 541(a).[2] This means that a cause of action belonging to the debtor that could not have been viable before the "commencement" of bankruptcy is also not viable when asserted by creditors after the bankruptcy. A rule of Pennsylvania law, which, on account of the "innocence" of the creditors, would allow the opposite result—*i.e.*, would allow a claim that would not have been viable before bankruptcy to be viable thereafter—would thus directly conflict with federal law. Under the Supremacy Clause of the Constitution of the United States, any such rule of state law would be preempted, as state law that conflicts with a federal statute is without effect. *Crosby v. Nat'l*

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[2] Under 11 U.S.C. § 541(a), the bankruptcy estate includes, except as otherwise provided, "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a). These "interests" include legal claims. *In re Nejberger*, 934 F.2d 1300, 1301-02 (3d Cir. 1991).

Foreign Trade Council, 530 U.S. 363, 372-73 (2000); *Geier v. Am. Honda Motor Co.*, 529 U.S. 861 (2000).

For these reasons, even a rule of general applicability that would prevent application of the doctrine whenever the beneficiaries of any recovery are innocent is preempted when applied in the bankruptcy context. Such an application would violate Section 541 because it would allow a claim that would not have been viable when asserted by the debtor before bankruptcy, when there are no innocent beneficiaries, to be viable thereafter.

That the debtor's estate cannot be enlarged by its creditors post-bankruptcy is made plain not only by the clear temporal limitation in the text of Section 541 ("as of the commencement of the case"), but also by its legislative history. Both the Senate and House Reports emphatically state that Congress intended that the creditors "can take no greater rights than the debtor." S. Rep. No. 95-989, at 82 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5868; *see also* H.R. Rep. No. 95-595, *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6323. The estate "succeeds only to such rights as the bankrupt possessed" pre-bankruptcy, not more. *Bank of Marin v. England*, 385 U.S. 99, 101 (1966).[3] Accordingly, an interpretation of Pennsylvania law that treats the debtor's property—including the form of property embodied in legal claims—as greater post-bankruptcy than pre-bankruptcy "directly conflicts" with federal law, and is preempted.

Creditors thus take the debtor's property "subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition." *Bank of Marin,* 385 U.S. at 101. Otherwise, the creditor could succeed on a claim on which the debtor would not

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[3] *Bank of Marin* was decided under Section 70(a) of the Bankruptcy Act of 1898. Although the Bankruptcy Code was enacted in 1978, Section 70(a) was retained without substantive change and recodified at 11 U.S.C. § 541. *Compare* Bankruptcy Act of 1898, § 70, ch. 541, 30 Stat. 544, 565-66 (1898) (codified at 11 U.S.C § 110), *with* 11 U.S.C. § 541(a).

have succeeded, and the creditor would thus take "greater rights than the debtor," in violation of Section 541. Indeed, several courts have held, on facts virtually identical to those presented here, that Section 541 subjects "innocent" third parties such as a trustee or creditors to an *in pari delicto* defense where that defense could have been asserted against the debtors under state law. *See*, *e.g., In re Dublin Secs., Inc. v. Hurd*, 133 F.3d 377, 380 (6th Cir. 1997) (applying doctrine of *in pari delicto* to bar suit by trustee against law firms); *In re Mediators, Inc.*, 105 F.3d 822, 826 (2d Cir. 1997) ("[T]he Mediators has no standing to assert aiding-and-abetting claims against third parties for cooperating in the very misconduct that *it* had initiated") (emphasis added); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1092 (2d Cir. 1995) (applying doctrine of *in pari delicto* to bar trustee suit against accounting firm); *FDIC v. Ernst & Young*, 967 F.2d 166, 171 (5th Cir. 1992) (same).

Universal Builders, Inc. v. Moon Motor Lodge, Inc., 430 Pa. 550, 555, 244 A.2d 10, 14 (1968), cited by the Committee, Br. at 17, is not to the contrary. *Universal Builders* did not involve the *in pari delicto* doctrine, nor did it consider Section 541. And if *Universal Builders* were read to hold that the *in pari delicto* doctrine does not apply to innocent third parties such as trustees in bankruptcy, that holding would be preempted.

Precedent derived from insurance receiver cases such as *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995), is also inapposite because those receivership cases do not involve Section 541. *See In re Hedged-Investments Assocs., Inc.*, 84 F.3d 1281 (10th Cir. 1996) (holding that the Seventh Circuit's reasoning in *Scholes* did not comport with the plain language of section 541); *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 358 (3d Cir. 2001) (distinguishing *Scholes* because, "unlike bankruptcy trustees, receivers are not subject to the limits of section 541"). And to the extent that there are a handful of bankruptcy

cases supporting an "innocent" successor-in-interest rule, they contravene Section 541 and established Supreme Court precedent such as *Bank of Marin*. *See also Zartman v. First Nat'l Bank of New York*, 216 U.S. 134, 135 (1910) (bankruptcy trustee or creditor "takes the property of the bankrupt, *not as an innocent* purchaser, but as the debtor had it at the time of the petition, subject to all valid claims, liens and equities") (emphasis added).

* * *

Section 541 mandates that where the debtor's claims would have been barred by an equitable defense, the creditors—standing in the debtor's shoes in seeking to enforce these claims—are barred as well. The Committee's purported "independent decision-maker" exception is not well-founded in the law, and has been rejected by other courts. Accordingly, where, as here, the claims would have been dismissed on *in pari delicto* grounds had they been brought by AHERF, the Committee's claims also must be dismissed on that ground. Thus, the answer to Question 2 is "yes."

III . Changing The Law To Extend Liability In This Context Would Not Serve The Public Interest

A. Broader Liability For Auditors Would Not Reduce Corporate Fraud, Improve Audit Quality, Increase Deterrence, Or Punish "Wrongdoers"

Recognizing the Committee's proposed exceptions would not serve the dual purposes of the litigation system—deterrence and compensation of innocent victims.

The deterrence justification for restricting application of the *in pari delicto* defense in cases involving auditors is particularly dubious, because substantial deterrents already exist. *See Cenco*, 686 F.2d at 455 (rejecting the deterrence justification). Auditors belong to a profession that values and encourages high professional standards, has robust and well-funded systems in place to encourage ethical behavior, and is subject to extensive, multi-tiered regulatory oversight. Indeed, auditors have little to gain but much to lose by not exposing a client's fraud—*i.e.*, by

issuing a misleading audit report. "An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work." *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990). "It is highly improbable that an accountant would risk surrendering a valuable reputation for honesty and careful work by participating in a fraud merely to obtain increased fees." *In re Worlds of Wonder Secs. Litig.*, 35 F.3d 1407, 1427 n.7 (9th Cir. 1994) (citation and internal quotation marks omitted). While auditors are often sued based on the mere presence of an accounting mistake and an allegation that the mistake must have been made collusively because of the desire for continued audit fees, that allegation is economically "irrational." *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) (rejecting as "irrational" plaintiff's proposed scienter inference based on accounting firm's purported motive to garner fees). For these reasons, and because auditors face significant sanctions at the hands of regulators charged with protecting the public interest (including the SEC, the PCAOB, and state regulators), auditors already have "a great deal of incentive to ensure accurate reporting." *Baena*, 453 F.3d at 9.

Increasing auditor liability also would have the unwanted and undesirable effect of *reducing* the incentive of the board of directors—the duly selected representatives of shareholders, charged with the governance of the entity—to police and deter fraud. *Cenco*, 686 F.2d at 455 ("But if the owners of the corrupt enterprise are allowed to shift the costs of its wrongdoing entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced."). The board, in its oversight role, appoints, supervises, and can replace management. Management, in turn, is better-equipped to prevent fraud than outside auditors, and is primarily responsible for doing so. *See also* pp. 15-16, below. And "[m]anagement, along with those charged with governance, should set the proper tone; create

and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud." Statement on Auditing Standards ("SAS") 99 (AU § 316.04). Reducing the incentive for boards of directors, through management, to detect and prevent fraud would be detrimental to deterrence goals and to audit quality.

Furthermore, restricting the availability of the *in pari delicto* defense would not necessarily help punish "wrongdoers." That an audit has failed to detect fraud does not mean that the auditors have departed from the requisite standard of care, much less that they have done so intentionally or collusively. *See* Final Report Of Advisory Committee On The Auditing Profession To the Department of Treasury ("Final Report") VII: 15-18 (Oct. 2008) (recognizing the inherent limitations in the ability of a properly-conducted audit to detect fraud, and recommending that these limitations be better communicated to investors and the general public, in order to close the "expectations gap" between those limitations and the general public's mistaken belief that the failure to detect fraud is conclusive evidence of wrongdoing on the part of the auditor).

"For practical reasons of time and cost, an audit rarely, if ever, examines every accounting transaction in the records of a business." *Bily v. Arthur Young & Co.*, 834 P.2d 745, 749 (Cal. 1992). Due to the sampling nature of an audit and the necessity to rely on information received from the client, "even a properly planned and performed audit may not detect a material misstatement resulting from fraud." SAS 99 (AU § 316.12); *see also In re IKON Office Solutions, Inc.,* 277 F.3d 658, 673 (3d Cir. 2002) ("[E]ven an audit conducted in strict accordance with professional standards countenances some degree of calibration for tolerable error which, on occasion, may result in a failure to detect a material omission or misstatement").

B. Broader Liability For Auditors Would Not Compensate "Innocent" Parties

Nor would the proposed exceptions compensate "innocent parties." Even assuming that PwC departed (knowingly or not) from the requisite standard of care, AHERF (and hence the Committee standing in its shoes) is at least as culpable as PwC is asserted to be. *Cenco*, 686 F.2d at 456 ("If [the auditor] failed to police its people, [the audited corporation] failed as or more dramatically to police its own.").

Both the law and facts show that AHERF was primarily responsible for the company's financial statements, and therefore primarily responsible for any misstatements. "According to existing auditing standards and SEC rules, management prepares and has the primary responsibility for the accuracy of financial statements and for prevention and identification of fraud and the auditor's role is to provide reasonable assurance that the financial statements are free of material misstatement." Final Report at VII: 15; *see also* SAS 99 ("it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud"); National Commission on Fraudulent Financial Report, Report of the National Commission On Fraudulent Financial Reporting (Oct. 1987), *cited in* SAS 99 (AU § 316.04) ("The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management, starting with the chief executive officers, sets the tone and establishes the financial reporting environment."). Because AHERP's owners failed in their oversight of management, they are responsible for the fraud that PwC also failed to detect. *See Cenco*, 686 F.2d at 456 ("the honest owners, and their delegates—a board of directors on which dishonesty and carelessness were well represented—were slipshod in their oversight and so share responsibility for the fraud that [the auditor] also failed to detect").

The undisputed facts here show that AHERF's management knew of, instigated, orchestrated, and concealed the fraud. Because the approval and oversight of financial

statements "is an ordinary function of management that is done on the company's behalf, [this] is typically enough to attribute management's actions to the company itself." *Baena*, 453 F.3d at 7.

AHERF's culpability is further evinced by its violations of contractual responsibilities requiring it to disclose to PwC "irregularities involving management," Op. at 3, and its hindrance of PwC's audit through provision of deliberately false information. As courts have recognized, receipt of accurate, non-falsified information from the client is essential to the performance of an accurate audit, because "audits are performed in a client-controlled environment" and "the client necessarily furnishes the information base for the audit." *Bily*, 834 P.2d at 762 (citations omitted). Intentional misrepresentations made to the auditors and other deceptive conduct can thus interfere with the ability of a properly-conducted audit to detect fraud, by "caus[ing] the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false." SAS 99 (AU § 316.10); *see also* SAS 99 (AU § 316.08-10) (recognizing that fraud by management interferes with the detection of material misstatements because management can override control procedures designed to prevent similar frauds and "frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information").

C. Broader Liability For Auditors Would Disserve Investors And The Public Interest, And Would Threaten The Sustainability Of The Auditing Profession

Broader liability for auditors also would disserve the public interest because "increased civil exposure [for accountants] must ultimately raise the price of accounting services," burdening companies listed on the U.S. markets—and, ultimately, their investors and customers. *Baena*, 453 F.3d at 9. "If there is excessive . . . litigation, too many resources will be spent on litigation and on litigation avoidance. The cost of capital will then increase just as if a wasteful

tax had been imposed on capital formation." Joseph A. Grundfest, *Why Disimply?*, 108 Harv. L. Rev. 727, 732 (1995) (emphasis omitted).

In addition to increasing costs for investors and corporations, expanding auditor liability would give rise to serious systemic risks that could have a profound impact on the sustainability of the auditing profession, with serious consequences for our public markets and investors. The "profession faces catastrophic litigation risk different from that of other businesses." Final Report VII: 27. This is because, among other reasons, the fees received from an audit are disproportionately small relative to the auditor's potential liability for that audit—*i.e.*, the decline in value caused by the undetected fraud. When the liability exposure is compared to the combined partner capital retained by the firms, the threat that catastrophic litigation poses to the viability of accounting firms is simply undeniable. *See* Interim Report of the Committee on Capital Markets Regulation ("Interim Report") 87 (2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (the liability exposure of accounting firms "exceeds the combined partner capital of the Big Four firms."); Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 Colum. L. Rev. 1641, 1642 (2006) ("[a]uditors now face enhanced vulnerability to liability risks that—at least according to some—threaten the very viability of the industry as we know it.").

These risks have rendered third-party insurance largely unavailable, further compounding the professions' risks. Accordingly, broadening auditor liability "would only aggravate the exposure problem." Interim Report at 87. And, more fundamentally, expanding liability "could bankrupt another Big Four firm, with disastrous consequences for corporate governance worldwide," and for the availability of audit services. *Id.* at 86. *See also* Final Report VII: 26 ("Data provided by the accounting profession and testimony from academics, legal, and

insurance experts make clear that the threat of the loss of a major auditing firm due to litigation is real.").

This combination of catastrophic litigation risk and difficulty obtaining third party insurance further impacts the sustainability of the profession by exacerbating concentration in the profession, as smaller auditing firms are reluctant to pursue large clients to increase their market share given the dramatic increase in potential loss exposure that could result. Final Report VII: 28. This, in turn, decreases customer choice, lessens the expertise available in the market, and undercuts the benefits that flow from competition.

Significantly, the threat of disproportionate liability can further "harm audit quality by discouraging the best and brightest from entering and remaining" in the profession, "inhibiting the use of professional judgment, impeding the evolution of more useful audit reports, and causing overly cautious audits or 'defensive' auditing." Final Report VII: 28. Decreased talent retention would also significantly reduce audit capacity for the thousands of companies requiring audit services.

* * *

Any additional monitoring of corporate fraud that the Committee's proposed exceptions might prompt would not benefit investors, would not increase audit quality, and would not create net benefits in excess of costs. Because "[t]he threat of disproportionate, catastrophic liability is not necessary to preserve or enhance audit quality," Final Report at VII: 27, and such liability would have the perverse effect of reducing the incentives of those charged with the governance of the entity to police or deter fraud, the Committee's proposed departure from the agency and *in pari delicto* doctrines is particularly unwarranted, and unjustifiable.

CONCLUSION

For the foregoing reasons, this Court should answer the two certified questions as follows:

Question 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?

Answer: The district court correctly applied the "benefit" test, under which imputation is proper whenever a corporation benefits from an agent's act performed within the scope of employment.

Question 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?

Answer: Yes.

Respectfully submitted,

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