

Outside Counsel

Law vs. Equity: Second and Third Circuits Diverge on 'In Pari Delicto'

The increased numbers of bankruptcies and securities debacles in recent years, where the primary wrongdoers lack the resources to remedy all those who claimed to be injured, have led to increased efforts to hold more secondary parties—such as accountants, bankers and lawyers—responsible. These efforts, though, frequently have run into difficulties.

In many situations, creative efforts to extend liability to such additional parties have been stymied by restrictions imposed by developments under the securities laws.¹ More generally, though, another stumbling block has been the “in pari delicto” doctrine, which itself has been the subject of much litigation in recent years, with courts in different jurisdictions taking different approaches.

A May 28, 2010, Third Circuit decision, *Official Committee of Unsecured Creditors of Allegheny Health, Education, and Research Foundation v. PricewaterhouseCoopers*,² helps illustrate a divide that has emerged between courts within the U.S. Court of Appeals for the Second and Third circuits on this issue. This divide turns mostly on whether the doctrine is treated by the courts as one of law or one of equity.

Basics of Doctrine

The “in pari delicto” doctrine—also known as the imputation principle and in some jurisdictions as the “Wagoner Rule,” after a leading Second Circuit case³—bars companies and their bankruptcy representatives from recovering from the company’s professional advisors for actions those advisors may have taken in connection with management-led misconduct, on the theory that the management’s wrongdoing should be imputed to the corporate

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entity on whose behalf suit is now being brought against the advisors.

However, the doctrine can be undercut by its “adverse interest” exception, which provides that the doctrine may not apply (i.e., management’s wrongdoing will not be imputed to the company) if the guilty corporate manager has completely foregone the interests of the company in favor of his or her own personal interests. This exception is usually construed narrowly, though. Because it is held to apply only if the manager has “totally” abandoned the company’s interest, the exception typically is not available if the manager’s actions could be said to have provided any benefit at all to the company.

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In pari delicto doctrines typically arise from underlying state law. Cases in state and federal courts within the Second Circuit frequently involve application of New York law, whereas within the territory of the Third Circuit the issue may arise under New Jersey, Pennsylvania or Delaware law. New York law tends to treat the doctrine as a purely legal application of common-law agency principles, whereas in the states of the Third Circuit it is viewed more as an equitable doctrine. The result of this distinction has been a noticeable difference in outcomes in

certain familiar situations, such as suits against allegedly negligent auditors, as illustrated by the Third Circuit’s recent *Allegheny* decision.

The ‘Allegheny’ Case

Allegheny involved allegations that a group of high-level officers of a health care provider knowingly misstated the company’s finances in connection with the defendant’s audits of the company, in order to conceal the company’s precarious financial position. The result allegedly was that the company’s board allowed management to continue in its failing business strategy, until ultimately the company was forced to file for bankruptcy. The company’s creditors’ committee then filed adversary proceeding claims against the auditors for breach of contract, negligence and aiding and abetting management’s breach of fiduciary duty.

Citing the in pari delicto doctrine, the auditors moved for summary judgment, which the district court granted. On appeal, the Third Circuit certified two questions regarding the in pari delicto doctrine under Pennsylvania law to the Pennsylvania Supreme Court. The Third Circuit termed in pari delicto “a murky area of the law” involving “an ill-defined group of doctrines that prevents courts from finding for a plaintiff equally at fault as the defendant,” and noted that Pennsylvania courts “have not been of one mind as to whether the doctrine is legal or equitable.”⁴

Upon receiving the Pennsylvania Supreme Court’s ruling,⁵ which provided clarification on some of the inquiries relevant to the in pari delicto doctrine, the Third Circuit remanded the case back to the district court for further proceedings to address the factors that the Pennsylvania Supreme Court had identified as relevant.

One of these inquiries was whether the auditor defendant had dealt “in good faith” with the company “in material matters,” or whether there had been “secretive, collusive conduct between corporate agents” and the defendant.⁶ This inquiry was needed, according to the court, “[b]ecause

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the underlying purpose of imputation is fair risk-allocation, including the affordance of appropriate protection to those who transact business with corporations.⁷ Even when there may be some corporate benefit, if there is collusion then the “rationale supporting imputation breaks down” because “there can be no justifiable reliance” by the outside advisor on the manager’s authority when the advisor knows the manager’s “conduct goes unsanctioned by one or more tiers of corporate governance.”⁸

Such knowledge on the part of the outside advisor may be deemed to arise based on what a reasonable person in that position “should glean from its dealings with a corporate agent,” with the court indicating that a “sufficient lack of benefit (or apparent adversity)” may make it “fair to charge” the advisor “with notice” that management “is not acting with [the company’s] authority.”⁹

The court explained that “although in pari delicto has been imported from equity and recast as an at-law defense, its origins in equity mean that it is subject to appropriate and necessary limits”; “matters of public policy are to be taken into consideration” and the in pari delicto doctrine “is not to be woodenly applied.”¹⁰ Under this inquiry, auditors who negligently failed to uncover management financial fraud could be entitled under Pennsylvania law to protection under the in pari delicto doctrine, depending on the facts.¹¹

The Third Circuit noted that Pennsylvania approach was more flexible than that taken by New Jersey law, which on policy grounds effectively refuses to allow negligent auditors any protection at all under the in pari delicto doctrine, even in the absence of collusion with guilty management.¹²

Pennsylvania’s rule, said the court, sought to balance the need to incentivize corporate owners to hire honest managers and monitor their behavior against the important role played by auditors as a check against management abuses.¹³ The court further observed that the law of another Third Circuit jurisdiction, Delaware, similarly attempts to “balance[] the allocation of risk” under the in pari delicto doctrine, though noting that while Delaware law favors “strong imputation rules, including a low threshold for benefit,” it has not specifically addressed the balancing of interests in the context of a suit against negligent auditors who failed to uncover a corporate conspiracy.¹⁴

Contrasting Approach

Second Circuit courts applying New York law have largely eschewed addressing the in pari delicto doctrine as a matter of equity, or as involving the balancing of competing policy interests. Rather, they tend to have approached

the doctrine as a purely legal issue simply involving application of common-law agency principles.¹⁵

In notable contrast to the laws of the states within the Third Circuit, courts that apply New York law have not invoked the balancing of competing policy considerations as the basis for determining whether an allegedly negligent auditor can claim protection under the in pari delicto doctrine. Rather than debate what risks or burdens it is fair to ask auditors (as opposed to other parties) to assume in the management fraud context, these courts mostly have focused on a more formalistic approach, in which they point out that the agency-law principles of imputing management wrongdoing to the corporate entity fatally undermine the plaintiff’s ability to show reliance upon or causation arising from the auditor’s conduct.

This approach is well illustrated in a decision by Judge Shira Scheindlin in the Southern District, in which she explained that when the corporation “accuses [its auditor] of dereliction with respect to the very financial statements that [the corporation’s] officers and directors manipulated,” it “cannot now be heard to claim that it was duped into believing those financials were accurate simply because [the auditor] certified them.”¹⁶

Similarly, Justice Ramos in the New York County Commercial Division has pointed out that when all members of management with authority to stop the wrongdoing were complicit in that wrongdoing, “then the accountant’s failure to alert management could not have caused the entity’s loss,” because “a claim for negligence in this context relies upon a causal link between the accountant’s alleged negligence, e.g., failure to alert management, and the corporation’s ultimate loss.”¹⁷

Conclusion

The New York courts within the Second Circuit thus have not taken the approach exemplified by the Third Circuit’s recent *Allegheny* decision of focusing on whether the defendant was justified in relying on management’s seeming authority, and/or on what the resulting policy implications might be, in determining whether the defendant (particularly an auditor defendant) should be able to invoke the in pari delicto defense.

Instead, these courts have focused more on the fact that imputing management’s misconduct to the company (or its current litigation representatives) undercuts the company’s ability to show the causation or reliance element that is necessary to make out the company’s own prima facie case against the auditor or other third-party advisor. Policy arguments about the role that society should ask auditors and other third-party advisors to play

in order to deter and prevent corporate fraud and misconduct are not the principal issue.

From the defendant’s standpoint, litigating within the Second Circuit, or otherwise being able to secure the application of New York law, may therefore offer much greater certainty and likelihood of success with respect to an in pari delicto defense than does the approach of *Allegheny* or other case law from within the states of the Third Circuit, where the availability of the defense is explicitly conditioned on equitable and policy factors.



1. See, e.g., *Stoneridge Inv. Partners v. Scientific-Atlanta Inc.*, 552 U.S. 148 (2008); *SEC v. Tambone*, 597 F.3d 436 (1st Cir. 2010); *Pac. Inv. Mgmt. Co. v. Mayer Brown*, 603 F.3d 144 (2d Cir. 2010).

2. 2010 WL 2134619 (3d Cir. May 28, 2010).

3. *Shearson Lehman Hutton Inc. v. Wagoner*, 944 F.2d 114 (2d Cir. 1991).

4. *Allegheny*, 2010 WL 2134619, at 2 n.2.

5. 989 A.2d 313 (Pa. 2010).

6. See *Allegheny*, 2010 WL 2134619, at 4-5.

7. See id. at 4 (internal quotations omitted).

8. See id. at 5 (internal quotations omitted).

9. See id. at 6 (internal quotations omitted).

10. See id. (internal quotations omitted).

11. See id. at 5-6 & n.5.

12. See id. at 5 n.5 (citing *NCP Litig. Trust v. KPMG*, 901 A.2d 871, 888-90 (N.J. 2006)).

13. See *Allegheny*, 2010 WL 2134619, at 7 & n.6.

14. See id. at 4 n.4 (citing *Am. Int’l Group Inc. Consol. Derivative Litig.*, 976 A.2d 872, 889 (Del. Ch. 2009)) (internal quotations omitted).

15. *Wight v. BankAmerica Corp.*, 219 F.3d 79, 86-87 (2d Cir. 2000); see also *In re CBI Holding Co.*, 529 F.3d 432, 448 (2d Cir. 2008); *In re Bennett Funding Group Inc.*, 336 F.3d 94, 100 (2d Cir. 2003); *In re The Mediators Inc.*, 105 F.3d 822, 826 (2d Cir. 1997); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1094 (2d Cir. 1995).

16. *Am. Tissue Inc. v. Arthur Andersen*, 275 F. Supp. 2d 398, 405 (S.D.N.Y. 2003).

17. *Bullmore v. Ernst & Young Cayman Islands*, 20 Misc.3d 667, 673, 861 N.Y.S.2d 578, 583 (Sup. Ct. N.Y. Co. 2008).