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FRANK J. GEBHARDT (WSBA No. 4854)
FELTMAN, GEBHARDT, GREER & ZEIMANTZ, P.S.
14th Floor Paulsen Center
421 West Riverside Avenue
Spokane, WA 99201-0495
Telephone: (509) 838-6800
Facsimile: (509) 744-3436

ROBERT P. VARIAN (*pro hac vice*)
KENNETH P. HERZINGER (*pro hac vice*)
ORRICK, HERRINGTON & SUTCLIFFE LLP
The Orrick Building
405 Howard Street
San Francisco, CA 94105-2669
Telephone: (415) 773-5700
Facsimile: (415)773-5759

Attorneys for Defendant
PricewaterhouseCoopers LLP

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF WASHINGTON

METROPOLITAN MORTGAGE & SECURITIES CO., INC. and SUMMIT SECURITIES, INC.,

Plaintiffs,

v.

PRICEWATERHOUSECOOPERS, LLP,

Defendant.

Case No. CV-05-0290-FVS

MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF PRICEWATERHOUSECOOPERS LLP'S MOTION TO DISMISS COMPLAINT FOR PROFESSIONAL NEGLIGENCE, NEGLIGENT MISREPRESENTATION, AND BREACH OF CONTRACT

(ORAL ARGUMENT REQUESTED)

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ORRICK, HERRINGTON & SUTCLIFFE LLP
405 HOWARD STREET
SAN FRANCISCO, CALIFORNIA 94105
TELEPHONE (415) 773-5700

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ORRICK, HERRINGTON & SUTCLIFFE LLP
405 HOWARD STREET
SAN FRANCISCO, CALIFORNIA 94105
TELEPHONE (415) 773-5700

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STATUTES

TREATISES

Defendant PricewaterhouseCoopers LLP ("PwC") respectfully submits this memorandum in support of its motion to dismiss Metropolitan Mortgage & Securities Co., Inc. ("Metropolitan") and Summit Securities, Inc.'s ("Summit") (collectively, "Plaintiffs") Complaint for Professional Negligence, Negligent Misrepresentation, and Breach of Contract (the "Complaint") pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure.

I. INTRODUCTION

Metropolitan and Summit bring this action on the theory that PwC failed to detect and expose misconduct allegedly undertaken by Plaintiffs at the direction of their owner, C. Paul Sandifur. The Complaint is doomed by its own allegations. It asserts – and can only assert – claims that belong to Metropolitan and Summit, not creditors or investors. At the same time, Plaintiffs' allegations make unmistakably clear that, if the financial irregularities that are the linchpin of their claims in fact occurred, Metropolitan and Summit were the primary wrongdoers. Their claims are thus barred under the doctrine of *in pari delicto*. Moreover, the fact that Plaintiffs would have been aware of the conduct they allege PwC failed to detect the moment it occurred renders their claims untimely under the applicable statute of limitations, and bars any claim (i) that Plaintffs relied on PwC to advise them of their purported misconduct, or (ii) that they were injured by PwC's failure to do so.

PwC audited the financial statements that Metropolitan and Summit prepared and issued for fiscal years ended September 30, 1999 and 2000. Plaintiffs terminated and replaced PwC in June of 2001.[1] After terminating PwC, Plaintiffs continued to operate their business, issued financial statements audited by Ernst &

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[1] Although the Complaint (¶9) alleges that PwC resigned as Plaintiffs' auditor, the judicially noticeable facts demonstrate that Metropolitan and Summit terminated PwC. *See* Metropolitan and Summit's June 18, 2001 Form 8-Ks, attached as Exs. A & B to PwC's Request for Judicial Notice ("RJN") filed herewith.

ORRICK, HERRINGTON & SUTCLIFFE LLP
405 HOWARD STREET
SAN FRANCISCO, CALIFORNIA 94105
TELEPHONE (415) 773-5700

Young, LLP, and filed for bankruptcy protection in 2004. Now, nearly five years after PwC issued its last audit report, Plaintiffs assert for the first time that their 1999 and 2000 financial statements violated Generally Accepted Accounting Principles ("GAAP"), and seek to hold PwC responsible for that supposed transgression.

Notwithstanding Plaintiffs' assertions, the 1999 and 2000 financial statements that form the basis of their claims have never been restated. Nor have the financial statements at issue been determined by Ernst & Young, or any court or agency, to have been materially inaccurate. To the contrary, the complaint filed by the SEC against Mr. Sandifur and members of his management team fails to take issue with them, and alleges that Sandifur and Plaintiffs committed fraud after they replaced PwC, because they could not countenance the mounting losses that were reported in the financial statements that PwC had audited.[2] Despite ample opportunity to investigate the circumstances surrounding their demise, Plaintiffs are able to identify only two isolated transactions (out of the multitude included in the financial statements audited by PwC) that they claim were not accounted for in conformance with GAAP.

These core facts, the conclusions reached by the SEC, and Plaintiffs' anemic effort to plead accounting violations severely undermine the foundation upon which Plaintiffs' claims are built. In any event, accepting Plaintiffs' allegations that there were problems with the 1999 or 2000 financial statements as true, the fact that Plaintiffs' own allegations place the blame on Sandifur and his senior management

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[2] As noted in the SEC complaint, Metropolitan reported a $7.6 million loss in the last financial statement audited by PwC. A true and correct copy of the complaint filed by the SEC, which is judicially noticeable pursuant to Fed. R. Evid. 201 and *Burbank Glendale-Pasadena Airport Auth. v. City of Burbank*, 136 F.3d 1360, 1364 (9th Cir. 1998), is attached to the RJN as Ex. C.

team is dispositive. The Complaint explicitly alleges that Metropolitan and Summit were owned, managed and controlled by Sandifur, and that Sandifur concealed Plaintiffs' true financial condition. Accordingly, Plaintiffs are reduced to taking PwC to task for failing to advise them of their own alleged wrongdoing. Under settled law, such allegations can provide no basis for any claim against PwC.

The Complaint's assertions that Plaintiffs were injured by PwC's alleged negligence and breaches of contract fail as a matter of law, on multiple grounds:

First, accepting Plaintiffs' allegations as true, their claims for professional negligence, negligent misrepresentation and breach of contract are barred by the doctrines of *in pari delicto* and imputation because Plaintiffs clearly were the primary wrongdoers.

Second, each of Plaintiffs' claims is further barred by Washington's three-year statute of limitations. By definition, Plaintiffs would have been aware of the alleged misconduct at the time it occurred, and the Complaint was filed almost five years after PwC issued its audit reports on the 2000 financial statements.

Third, Plaintiffs' claims fail because they cannot establish causation, damages or injury. Taking Plaintiffs' allegations as true, Sandifur, Metropolitan and Summit could not have been injured by PwC's alleged failure to notify them that they were concealing Plaintiffs' true financial condition. Plaintiffs are the source of their own troubles, and they cannot assert claims on behalf of third parties.

Finally, Plaintiffs' negligent misrepresentation claim must be dismissed because Plaintiffs cannot establish that they reasonably relied on PwC's audits or reports.

II. FACTUAL BACKGROUND

PwC served as Plaintiffs' auditor in connection with the financial statements that Metropolitan and Summit prepared and issued for fiscal years ended

September 30, 1999 and 2000.[3] Plaintiffs terminated PwC, and hired Ernst & Young as their new auditor, on June 12, 2001. Compl. ¶ 9; (Metropolitan and Summit's June 18, 2001 Form 8-Ks), RJN, Exs. A & B. Long after they terminated their relationship with PwC, and after Metropolitan and Summit issued three additional financial statements audited by Ernst & Young, Plaintiffs filed for bankruptcy protection. Compl. ¶ 10. Sandifur and the balance of Plaintiffs' senior management resigned their positions early in 2004. *Id.* Plaintiffs filed this action on September 21, 2005.

The Complaint asserts professional negligence, negligent misrepresentation and breach of contract claims arising out of PwC's audits of financial statements that were prepared and issued by Metropolitan and Summit under Sandifur's control. Compl. ¶¶ 2-3. Plaintiffs allege that they were injured because PwC's purported negligence "gave C. Paul Sandifur . . . as Met's CEO and Chairman of the Board, and as controlling common shareholder of both Met and Summit, the latitude he needed" to engage in the alleged misconduct. Compl. ¶ 4. Although the Complaint proclaims that "the PwC audits failed to detect violations of applicable accounting principles and to disclose significant and material accounting departures and internal control deficiencies" (¶ 3), Plaintiffs do not – and cannot – allege that

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[3] The facts recited in this Memorandum are derived from the factual allegations set forth in the Complaint, which must be taken as true for purposes of this motion, and on documents that are referred to or relied upon in the Complaint, filed by Plaintiffs with the SEC, or otherwise subject to judicial notice or consideration on a motion to dismiss. Fed. R. Evid. 201; *Parrino v. FHP, Inc.*, 146 F.3d 699, 705-06 (9th Cir. 1998) (courts may consider documents that are attached to the complaint, explicitly or implicitly incorporated by reference in the complaint, or that are capable of accurate and ready determination and not reasonably subject to dispute on a motion to dismiss).

their 1999 or 2000 financial statements were ever restated, or that Ernst & Young, the SEC, the Washington Department of Financial Institutions ("DFI"), or any other regulatory body ever determined that they were false or misleading.

Indeed, after an extensive investigation of the facts leading up to the collapse of Metropolitan and Summit, the SEC concluded that Sandifur and three former officers of the company engaged in a fraud that commenced nearly two years after the period covered by the financial statements at issue in this case, and after Plaintiffs terminated PwC as their auditor. *See* Complaint filed in *S.E.C. v. C. Paul Sandifur Jr., et al.*, Case No. 2:05-CV-01631-JCC, W.D. Wash. Sept. 22, 2005 ("SEC Compl."), RJN, Ex. C. The SEC Complaint alleges that "[i]n an effort to hide the company's deteriorating financial condition from investors, from at least June 2002 through September of 2002, these Metropolitan executives engineered a series of complex real estate sales designed to boost the company's reported earnings." (SEC Compl. ¶ 2), RJN, Ex. C.

Nor did the SEC criticize or take issue with Plaintiffs' 1999 or 2000 financial statements. Rather, the SEC Complaint notes that "[i]n its Form 10-K filed with the Commission for the fiscal year ended September 30, 1999, Metropolitan disclosed that it would have to rely, in part, on future sales of its securities simply to repay its current indebtedness," and that Metropolitan "reported a loss of $7.6 million for the fiscal year ended September 30, 2000." (SEC Compl. ¶ 21), RJN, Ex. C. According to the SEC, it was difficulties in repaying current indebtedness and mounting losses – both of which were disclosed when PwC was Plaintiffs' auditor – that prompted Plaintiffs to engage in purportedly fraudulent transactions. (SEC Compl. ¶ 22), RJN, Ex. C.

The SEC does not criticize, or even mention, the two isolated transactions – referred to in the Complaint as the "Koa Timber Transaction" and the "FLIP Tax Shelter" – that Plaintiffs cite as the sole "examples" of purported GAAP violations. *See* Compl. ¶¶ 21-29. While the Complaint attempts to describe those transactions

in pejorative terms, it fails to identify any GAAP provision allegedly violated, and does not state what the "correct" accounting should have been. The Complaint further fails to acknowledge that Plaintiffs derived $6 million of benefit from the "FLIP" transaction, even after it was challenged by the IRS.[4]

Not only does the SEC assert no claims relating either to the 1999 or 2000 financial statements audited by PwC, or the "Koa" or "FLIP" transactions referred to in the Complaint, it alleges no wrongdoing by the auditors who replaced PwC and audited Plaintiffs' 2001, 2002 and 2003 financial statements. Rather than finding fault with Ernst & Young, the SEC charged Sandifur and Metropolitan's senior management with making false and misleading statements to Ernst & Young in connection with its audits, and that Sandifur and his controller certified the accuracy of Metropolitan's financial statements knowing that they were false. (SEC Compl. ¶¶ 92, 95), RJN, Ex. C.

The 1999 and 2000 financial statements that PwC audited several years prior to the wrongful conduct alleged in the SEC complaint were also prepared under the direction and control of Sandifur and, if Plaintiffs' allegations are correct, Sandifur deceived PwC as well. As the audit opinions upon which Plaintiffs rely make explicitly clear, each of the 1999 and 2000 financial statements was "the responsibility of the Company's management." (Metropolitan and Summit's 1999 and 2000 Form 10-Ks at F-1), RJN, Exs. E-H. PwC's responsibility was to "plan

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[4] On February 23, 2005, Metropolitan filed a motion for entry of an order approving a compromise and settlement with the IRS regarding the FLIP transaction in the U.S. Bankruptcy Court for the Eastern District of Washington. *See* RJN, Ex. D. Under the terms of the settlement, the IRS agreed to permit Metropolitan to retain 20% of its claimed loss on the transactions. At a 35% effective tax rate, the loss allowed under the IRS settlement is worth $5,919,973 to Metropolitan.

and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." *Id.* Accepting Plaintiffs' assertion that those financial statements were materially misstated as true, Plaintiffs' own allegations lay primary blame for the defects squarely at the feet of Sandifur.

According to the Complaint, Sandifur was the personification of Metropolitan and Summit – at both the shareholder and management levels. Plaintiffs allege that "Sandifur inherited control of [Metropolitan] from his father," and ran both companies as Metropolitan's "President, CEO, and Chairman of the Board." Compl. ¶ 10. Plaintiffs further allege that "Sandifur and his family directly and indirectly own *all* of Met's and Summit's common stock," and that Sandifur was the "controlling common shareholder of both Met and Summit." Compl. ¶¶ 4, 10 (emphasis added). The Complaint therefore refers to Metropolitan and Summit (and their respective affiliates) collectively as "the Met/Summit Group." Compl. ¶ 8.

Plaintiffs acknowledge that the actions that Metropolitan and Summit undertook while PwC served as their auditor were executed at Sandifur's direction and under his control: "Under Sandifur's control, Met and Summit raised capital and managed investments for all of the companies in the Met/Summit Group." Compl. ¶ 11. More to the point, the Complaint specifically alleges that Sandifur "conceal[ed] the financial performance of the Met/Summit Group." Compl. ¶ 57. It also refers, for example, to "regular overrides by Sandifur of internal controls." Compl. ¶ 36. Plaintiffs further allege that "Sandifur contrived to preempt the DFI from regulating Met by depriving it of jurisdiction to do so," and that he obtained listings for Metropolitan debentures and preferred stock on the Pacific and American Stock Exchanges. Compl. ¶¶ 36, 49-51.

The Complaint further alleges that Sandifur and his companies used their purported concealment of Plaintiffs' true financial condition to issue debt that was never repaid. Compl. ¶¶ 13, 14. Thus, on Plaintiffs' allegations, Sandifur,

Metropolitan and Summit benefited from their misconduct at the expense of the outsiders who provided them with millions of dollars in capital. The third parties who purportedly were injured in this fashion have filed a separate action in this Court asserting their own claims on their own behalf. *See In re Metropolitan Securities Litigation*, Case No. CV-04-0025-FVS. Plaintiffs were on the receiving end of the money that was lost. They do not purport to assert claims on behalf of their alleged victims (and are not permitted to do so).

III. STANDARD FOR MOTION TO DISMISS

To survive a motion to dismiss, Plaintiffs must allege facts that, if proven, would entitle them to relief on their cause of action. Fed. R. Civ. P. 12(b)(6). Although the court must accept a plaintiff's well pleaded factual allegations as true for purposes of evaluating a motion to dismiss, it is not required to accept as true unreasonable inferences, conclusory assertions, unwarranted deductions of fact or conclusory allegations that are contradicted by documents referred to in the complaint. *See Steckman v. Hart Brewing Inc.*, 143 F.3d 1293, 1295 (9th Cir. 1998); *Miranda v. Clark Cty., Nev.*, 279 F.3d 1102, 1106 (9th Cir. 2002), *rev'd in part on other grounds*, 319 F. 3d 465; *In re Stac Elec. Sec. Litig.*, 89 F.3d 1399, 1403 (9th Cir. 1996).

IV. ARGUMENT

A. Plaintiffs' Claims Are Barred by The Doctrines of *In Pari Delicto* and Imputation

A multitude of decisions have consistently held that claims for negligence and breach of contract against accountants and other professionals cannot be asserted by those who orchestrated, knew of or participated in the alleged wrongdoing. This rule is fully applicable to corporations in bankruptcy. *In re Mediators, Inc.*, 105 F.3d 822, 827 (2d Cir. 1997) (affirming dismissal of claims against debtor's accountant for aiding and abetting debtor's sole shareholder in breach of fiduciary duty); *F.D.I.C. v. Ernst & Young*, 967 F.2d 166, 171 (5th Cir.

1992) (finding accountants could not be held liable for negligence because owner's knowledge of association's risky lending practices and its precarious financial condition could be imputed to association and its board of directors); *In re Dublin Sec., Inc.*, 133 F.3d 377, 380 (6th Cir. 1997) (affirming dismissal of trustee's claims against law firm based on *in pari delicto* doctrine).[5] Plaintiffs' claims are thus

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[5] *Accord, Shearson Lehman Hutton v. Wagoner*, 944 F.2d 114, 119-20 (2d Cir. 1991) (trustee's fraud claim was barred because sole stockholder, director and president who committed fraud "not only knew of the bad investments, but actively forwarded them"); *Hirsch v. Arthur Anderson & Co.*, 72 F.3d 1085, 1094-95 (2d Cir. 1995) (affirming dismissal of trustee's malpractice claims against accounting firm because debtors had participated with the accounting firm in the alleged wrongdoing); *Official Committee of the Unsecured Creditors of Color Tile, Inc.*, 322 F.3d 147, 158-66 (2d Cir. 2003) (affirming dismissal of claims against accountants under Rule 12(b)(6) because the affirmative defense of *in pari delicto* was established as a matter of law by the facts pled in the complaint); *In re Bennett Funding Group*, 336 F.3d 94, 101-102 (2d Cir. 2003) (management's conduct imputed to debtor barred trustee's claims against debtor's accountants for alleged malpractice and breach of fiduciary duty); *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 359-60 (3d Cir. 2001) (affirming dismissal of claims by Chapter 11 trustee because alleged wrongdoer dominated and controlled debtor corporations); *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449, 456-57 (7th Cir. 1982) (finding that auditors could use wrongdoing of corporation's managers as a defense against charges of professional malpractice, breach of contract and fraud); *In re Hedged-Investments Associates*, 84 F.3d 1281, 1284-85 (10th Cir. 1996) (affirming judgment against bankruptcy trustee based on *in pari delicto* doctrine); *In re Agribiotech, Inc.*, 2005 U.S. Dist. LEXIS 6466, *21-

barred by the doctrine of *in pari delicto*, i.e., that "courts should not mediate disputes between wrongdoers." *See Pinter v. Dahl*, 486 U.S. 622, 635-36 (1988). The doctrine bars claims of a plaintiff who is "an active, voluntary participant in the unlawful activity that is the subject of the suit." *Id.*

The *in pari delicto* doctrine has long been recognized in Washington. As the Washington Supreme Court emphasized more than half a century ago: "The complainant ought not to be the transgressor himself, and then complain that by chance he has been injured on account of his own wrongful misconduct. When, as is sometimes the fact, the original wrong-doer is the party who sustains the greater injury by reason of his inequitable scheme or plan, he ought to bear the burden and the consequences of his own folly . . . ." *J.L. Cooper & Co. v. Anchor Sec. Co.*, 9 Wash. 2d 45, 72 (1941). Moreover, under long-settled law (in Washington and all other jurisdictions), an agent's knowledge and acts will be imputed to a corporation. *See, e.g., Post v. Maryland Cas. Co.*, 2 Wash. 2d 21, 26 (Wash. 1939); *Hitt Fireworks Co. v. Scandinavian American Bank*, 114 Wash. 167 (1921); *Hedrick v. Washington Nat'l Ins. Co.*, 186 Wash. 263 (1936).

This case presents a paradigm example of the circumstances in which these doctrines apply, and the reasons that they exist. As noted at pages 3-8, above, Plaintiffs themselves allege that their President, CEO, Chairman of the Board and sole shareholder was the central player in the alleged deceptive and fraudulent activities for which Plaintiffs seek to hold PwC liable. Compl. ¶¶ 4, 10, 37, 57, 64. Not surprisingly, the law does not permit a company – even in bankruptcy – to evade the consequences of its actions in the circumstances presented here.

Plaintiffs cannot distance themselves from the wrongful conduct that they

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(footnote continued...)

48 (D. Nev. April 1, 2005) (rejecting bankruptcy trustee's claims for professional negligence, breach of fiduciary duty and fraud based on *in pari delicto* doctrine).

allege was directed, controlled and undertaken by Sandifur and his management team on the theory that they were unauthorized activities by agents. Their allegations eclipse traditional notions of principal and agency. As the courts have recognized, imputation is required when, as in this case, the agents are also the principals, and there is no meaningful basis separating them from the company. *See, e.g., In re Dublin*, 133 F.3d at 380 ("the officers and directors were the 'alter egos' of the debtor corporations and any malfeasance on their parts is directly attributable to the debtors themselves"); *Color Tile, Inc.*, 322 F.3d at 164-65 ("the principal and agent are one and the same"); *In re Mediators*, 105 F.3d at 827 ("the party that should have been informed was the agent itself albeit in its capacity as principal"); *Ernst & Young*, 967 F.2d at 171 ("responsibility . . . must extend at least to the sole owner who dominated the board of directors").

Although Washington courts have recognized a narrow exception to the rule that the actions of an agent bind the principal, i.e., when the "interests of the agent and the corporation [are] really adverse," *Maryland Cas. Co.*, 2 Wash. 2d at 26, this exception does not apply here. First, Plaintiffs' allegations, including that Sandifur owned and controlled Metropolitan and Summit, demonstrate that his interest was not adverse for purposes of the controlling case law. Second, even if the interests were adverse, the exception would be inapplicable under the "sole representative" or "sole actor" doctrine.

The Complaint refutes, rather than supports, any suggestion that Sandifur (or anyone on his management team) was acting on the basis of an interest that was adverse to the companies he owned and controlled. Plaintiffs do not allege that Sandifur looted Metropolitan or Summit, or embezzled from the corporations. Rather, the Complaint asserts that Sandifur, Metropolitan and Summit used the alleged fraud to boost their earnings, bolster their balance sheet and to issue more debt. Compl. ¶¶ 4, 11, 12, 13, 21-26, 58. These allegations dispose of the claims they seek to assert against PwC as a matter of law. *See, e.g., Cenco,* 686 F.2d at

451-56 (when fraud involves scheme to increase the apparent worth of the company, which enabled the company to obtain certain benefits, the acts of the company's corrupt managers could properly be imputed to the company, even if it ultimately causes the corporation's insolvency); *Young v. Deloitte & Touche*, No. 040807 BLS, 2004 WL 2341344, at *10 (Mass. Super. Sept. 20, 2004).

The court in *Young v. Deloitte & Touche* explained: "The complaint does not allege that the Officers [falsified the company's financial statements] for their own personal purposes, however, but rather 'in order to meet earnings expectations and fraudulently to maintain the Company's access to debt financing by falsifying base reports . . .' These are allegations of fact which are binding on the Trustee . . ., these allegations are also imputed to and binding upon [the company] as knowledge of officers and directors having substantial control of the activities of the corporation." 2004 WL 2341344, at *10 (citations omitted). That holding, and the underlying rationale, are directly applicable here.

Even if Sandifur had been acting to further an interest that was adverse to his companies, however, the *in pari delicto* doctrine would still bar Plaintiffs' claims. Under controlling case law, Sandifur and the other members of Plaintiffs' senior management alleged to have committed the wrongdoing were the sole representatives of Metropolitan and Summit. As the Washington Supreme Court held more than sixty years ago, "if the agent is the sole representative of the principal, or the only person or means by which the principal acts, then the knowledge of the agent will be imputed to the principal, and the general rule applies, and not the exception thereto." *Higgins v. Daniel*, 5 Wash. 2d 134, 139 (1940). *See, e.g., Puget Sound Nat'l Bank v. St. Paul Fire and Marine Ins. Co.*, 32 Wash. App. 32, 41 (1982) ("Even if the agent's interest is adverse to that of his principal, knowledge will be imputed if the agent is the 'sole representative' of the principal."); *Plywood Marketing Assoc. v. Astroia Plywood Corp.*, 16 Wash. App. 566, 575 (1976) ("[E]ven if the agent conceals knowledge from his principal,

contrary to its best interest, the knowledge will be imputed to the principal as against third parties if the agent is the sole representative or executive official of the principal[s]").

The sole representative/actor doctrine has been broadly applied by federal courts throughout the United States, including when the affairs of the corporation are dominated by more than one actor or representative. *See, e.g., In re Dublin Sec.*, 133 F.3d at 380 (affirming dismissal because officers and directors were the "alter egos" of the debtor corporations); *Color Tile, Inc.*, 322 F.3d at 164-65 (the sole actor doctrine "negates the adverse interest exception"); *In re Mediators*, 105 F.3d at 827 (the sole actor rule "imputes the agent's knowledge to the principal notwithstanding the agent's self-dealing"); *Ernst & Young*, 967 F.2d at 171 ("responsibility must extend at least to the sole owner who dominated the board of directors."); *Lafferty*, 267 F.3d at 359-60 (dismissing case because alleged wrongdoer dominated and controlled the corporation); *Demoulas v. Demoulas*, 428 Mass. 555, 584-85 (1998) ("knowledge of officers and directors having substantial control of all activities of a corporation is imputed to the corporation") (citation omitted).

As noted above, Plaintiffs do not merely allege that Sandifur was a corporate manager who engaged in misconduct while performing his duties, or that he dominated Plaintiffs' affairs. They allege that he was the sole owner of the corporations, and that he controlled and directed their actions – including the alleged concealment of Plaintiffs' true financial condition – from beginning to end. *See* pp. 3-8, *supra*.

The Complaint's attempt (¶ 4) to rely on the "innocent decision-maker" doctrine adopted by a few courts as an exception to the imputation rules falls utterly flat. No such exception has ever been accepted by any court in Washington. The

theory has been roundly rejected by courts throughout the country.[6] Accordingly, as a matter of law, the misconduct and knowledge that Plaintiffs attribute to Sandifur throughout the Complaint must be imputed to Plaintiffs.

B. Plaintiffs' Claims Based On The 1999 and 2000 Audits Are Barred By Washington's Three-Year Statute of Limitations

Each of Plaintiffs' claims sounds in tort and, accordingly, is governed by Washington's three-year statute of limitations. *See* RCW § 4.16.080. These claims began to accrue for purposes of the statute of limitations on the dates that PwC issued the audit reports that are the subject of Plaintiffs' claims (November 19, 1999 and December 28, 2000) because knowledge of all the relevant facts can be imputed to Plaintiffs on those dates. Thus, Plaintiffs asserted each of these claims more than three years after the claim had accrued. The claims are time-barred.[7]

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[6] *See In re Bennett Funding Group, Inc.*, 336 F.3d at 101 (rejecting the "innocent decision-maker" doctrine as an exception to imputation because the "so-called independent" directors were "impotent to actually do anything," and such a "would-a, could-a, should-a test" is insufficient to defeat imputation.); *Color Tile, Inc.*, 322 F.3d at 165-66 (affirming dismissal of plaintiffs' claims because allegations that company's creditors or underwriter would have "rescued" the company if informed of its true financial condition was irrelevant since the company's management and directors were well aware of its condition); *Ernst & Young*, 967 F.2d at 171 (rejecting argument that company's creditors or government regulators would have "rescued" company because company cannot recover from accountant for something it was already aware of); *In re Agribiotech*, 2005 U.S. Dist. LEXIS 6466 at *39-41 (rejecting "innocent decision-maker" rule).

[7] Although Plaintiffs have not pled that they are entitled to rely on the extension to the limitation period under Section 108(a) of the Bankruptcy Code, Plaintiffs'

1. The Applicable Statute of Limitations For All of Plaintiffs' Claims is Three Years

Although Plaintiffs style one of their claims as a breach of contract, it is really nothing more than a reiteration of their negligence claims under a different name. The Complaint asserts claims against PwC for professional negligence and negligent misrepresentation on the grounds that PwC's audits of Metropolitan and Summit's 1999 and 2000 financial statements allegedly did not comply with professional standards (Compl. ¶¶ 63, 64, 67), and for breach of contract, alleging that PwC breached the terms of its engagement letters with Plaintiffs to conduct its audits in accordance with such standards (Compl. ¶ 79).

Section 4.16.080 of the Washington State Code prescribes a three year limitation on tort claims (i.e., professional negligence and negligent misrepresentation). *See Hunter v. Knight, Vale & Gregory*, 18 Wash. App. 640, 641-643 (1977). An action for negligence begins to run when "the plaintiff knows or, through the exercise of due diligence, should have known all facts necessary to establish a legal claim." RCW 4.16.080; *Crisman v. Crisman*, 85 Wash. App. 15, 20 (1997); *Hunter*, 18 Wash. App. 642-643 (applying discovery rule in accountant malpractice action). Actual knowledge of the fraud will be inferred if the aggrieved party, by the exercise of due diligence, could have discovered it. *Strong v. Clark*, 56 Wash. 2d 230, 232, (1960).

Washington law is clear that if the gravamen of Plaintiffs' breach of contract claim is PwC's purported negligence, the three-year statute of limitations for tort actions applies. *See, e.g., Davis v. Davis Wright Tremaine, LLP*, 103 Wash. App. 638, 654 (2000) (despite written agreement between lawyer and client, legal

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(footnote continued...)

claims would not be saved even if they had, because all of Plaintiffs' claims accrued before the February 4, 2004 bankruptcy filings.

malpractice claim was based on violation of standard of care, which is governed by three-year statute). Plaintiffs make no attempt to distinguish their negligence and breach of contract causes of action, and in the Third Cause of Action for breach of contract, do little more than incorporate and repeat the allegations in the preceding portions of the Complaint. Compl. ¶ 71-79. It is thus readily apparent that each of these causes of action is based on the same alleged departures by PwC from GAAP and GAAS in connection with its audits of Metropolitan and Summit's financial statements. *Compare* Compl. ¶ 64 *and* ¶ 79.

Similarly, Plaintiffs' negligent misrepresentation and breach of contract claims are nearly identical. *Compare* Compl. ¶ 67 *and* ¶ 79. The fact that the breach of contract claim is merely a reiteration of Plaintiffs' claims for professional negligence and negligent misrepresentation is underscored by the fact that Plaintiffs' compensatory damages items set forth in their Prayer for Relief are claimed in respect to each cause of action enumerated in the Complaint. Because Plaintiffs base their professional negligence, negligent misrepresentation and breach of contract claims on PwC's alleged failure to comply with professional standards in conducting its engagements, each of Plaintiffs' claims is governed by the three-year statute of limitations in RCW Section 4.16.080.

2. All of Plaintiffs' Claims Are Time-Barred Because Their Claims Began To Accrue When PwC Issued Its 1999 and 2000 Audit Options

Accepting Plaintiffs' allegations as true, they knew or should have known the facts necessary to establish a claim at the time that PwC's audit reports were issued. As stated above, Sandifur and the companies he owned, directed and controlled were aware of their own alleged misconduct and PwC's purported failure to detect that misconduct at the time that it occurred. *See, e.g., Gevaart v. Metco Const., Inc.*, 111 Wash. 2d 499 (1988) (The statute of limitations begins to run when the plaintiff knows or should know the relevant *facts*, regardless of whether or not the

plaintiff also knows that these are facts are enough to establish a legal cause of action).

Metropolitan and Summit's management were responsible for preparing – and in fact prepared – the financial statements that PwC audited. They were responsible for ensuring that those financial statements conformed with GAAP. *See* Compl. ¶ 36; (Metropolitan and Summit's 1999 and 2000 Form 10-Ks at F-1), RJN, Exs. E-H. To the extent there were "red flags," Plaintiffs were not merely aware of them – they created the warning signals themselves. *See* Compl. ¶¶ 23, 36.

Based on the facts alleged in the Complaint, it is clear that Plaintiffs' claims began to run no later than November 19, 1999 and December 28, 2000 respectively, the dates of PwC's audit opinions. Therefore, Plaintiffs' claims accrued by November 19, 2002 and December 28, 2003, respectively. Since Plaintiffs' claims accrued prior to February 4, 2004, the date that Metropolitan and Summit filed for bankruptcy, each of Plaintiffs' claims are time-barred and should be dismissed for failure to state a claim under RCW Section 4.16.080 and Rule 12(b)(6).

C. Plaintiffs' Claims Must Be Dismissed Because They Cannot Establish Causation, Damage Or Injury

The facts, circumstances and allegations that require dismissal of Plaintiffs' claims under the doctrine of *in pari delicto*, and on statute of limitations grounds, also mandate dismissal because Plaintiffs cannot allege that they were injured by PwC's failure to detect their alleged misconduct. Any losses suffered by Plaintiffs were directly attributable to actions undertaken by Metropolitan and Summit under the direction and control of Sandifur. Sandifur and his companies were well aware of their alleged misconduct and were not damaged by PwC's purported failure to detect and advise them of it. Moreover, the assertion that some unknown "independent director," the SEC or some other regulatory body would have stepped

in to save Plaintiffs from themselves is both irrelevant and refuted by the Complaint. *See* Compl. ¶¶ 13, 44-57.

In order to prevail on any of their claims, Plaintiffs must establish that PwC was the proximate cause of a compensable injury to Metropolitan and Summit. *See e.g., Swartz v. KPMG LLC*, No. C03-1252, 2004 U.S. Dist. LEXIS 22757 (E.D. Wash. Feb. 13, 2004) (professional negligence); *ESCA Corp. v. KPMG Peat Marwick*, 135 Wash. 2d 820 (1998) (negligent misrepresentation); *Seabed Harvesting Inc. v. Dept. of Natural Resources*, 114 Wash. App. 791, 797 (2002) (breach of contract). Washington's model jury instructions describe proximate cause as "a cause which, in a direct sequence, unbroken by any new independent cause, produces the injury complained of an without which such injury would not have happened." WPI § 15.01.

As established in the Complaint, the claimed injuries were self-inflicted. That is the end of the relevant analysis. *See, e.g., Cenco*, 686 F.2d at 454-56 (Holding that a participant in a fraud cannot also be a victim entitled to recover damages). It is also clear that because the only allegation that PwC's negligence proximately caused injury to Plaintiffs is that Plaintiffs "could have taken steps" to salvage the company, Plaintiffs' proximate causation allegations fail as a matter of law. *Ernst & Young*, 967 F.2d at 171 (A plaintiff "cannot claim it should recover from [its auditor] for not being rescued by a third party for something [it] was already aware and chose to ignore."); *Color Tile v. Investcorp.*, 80 F. Supp. 2d 129, 131 (S.D.N.Y. 1999) Plaintiff's own compliant established lack of causation because of plaintiff's own wrongdoing, *aff'd,* 322 F.3d 147 (2nd Cir. 2003). Because PwC's "place on the causal chain consists simply of its alleged failure to raise the alarm," the claims against it must be dismissed. *Drabkin v. Alexander Grant & Co.*, 905 F.2d 453 (D.C. Cir. 1990) (finding lack of causal connection between alleged audit deficiencies and corporation's financial problems).

In addition, Plaintiffs' after-the-fact assertions of what their Board of

Directors would have done if faced with unprofitable business or control deficiencies are discredited by what was actually done. As the financial statements and other documents referenced in the Complaint establish, the companies suffered significant losses that were reported in the financial statements audited by PwC. *See e.g., Drabkin*, 905 F.2d at 456 (director's self-serving, after-the-fact speculation that he would have changed business plan or pressed for an earlier bankruptcy was unreliable, in light of entire board's failure to respond to earlier warnings). Similarly, according to the Complaint, the DFI, and the SEC were well aware of the fact that Metropolitan had violated its memorandum of understanding with the DFI in 1998 (Compl. ¶ 47), and the Washington Office of the Insurance Commissioner were aware that Plaintiffs' insurance subsidiary had violated the insurance laws in 1999. Compl. ¶ 53.

Even if there were a scintilla of factual support for Plaintiffs' supposition of corporate injury, a speculative theory as to how PwC might have helped save the company from itself cannot satisfy Plaintiffs' pleading burden with respect to proximate causation. Where a company fails because of mismanagement and management fraud, third-party professionals do not become liable for the company's losses merely because they were a "but for" condition of management's schemes. *See, e.g., Bergeson v. Life Ins. Corp.*, 265 F.2d 227, 233-34 (10th Cir. 1959); *RTC v. Azevedo*, No. C-92-1304, 1993 U.S. Dist. LEXIS 20233, *12 (N.D. Cal. Oct. 4, 1993) (the theory of "'I did wrong, but you should have stopped me' and 'If you didn't stop me, you're liable for everything I did wrong' . . . just doesn't go'"); *Stratton v. Sacks*, 99 B.R. 686, 969 (D. Md. 1989), *aff'd*, 900 F.2d 255 (4th Cir. 1990) (rejecting speculative the theory that "had the other stockholders and directors known of [management] misconduct, they would have prevented the diversions which resulted in the loss in question"). As Justice Souter noted in *Holmes v. SIPC*, proximate causation requires, at a minimum, some "direct relation between the injury asserted and the injurious conduct alleged." 503 U.S. 258, 268

(1992).

D. Plaintiffs' Negligent Misrepresentation Claim Also Fails Because Plaintiffs Cannot Demonstrate Reliance

To state a claim for negligent misrepresentation Plaintiffs must plead facts that could establish a reasonable basis for relying on the purportedly misstated information – i.e., they "must prove [they] justifiably relied upon the information negligently supplied by defendant." *ESCA*, 135 Wash. 2d at 826 (*citing Condor Enters., Inc. v. Boise Cascade Corp.*, 71 Wash. App. 48, 52 (Wash. 1993)). *See also* Restatement (Second) of Torts § 552 (1977) (negligent misrepresentation requires actual and justifiable reliance). Reliance is not justified where plaintiffs had "sufficient [prior] notice" that the information relied upon was incorrect. *Smolen v. Deloitte, Haskins & Sells,* 921 F.2d 959, 965 (9th Cir. 1990).

Here, Plaintiffs set forth no facts that would show they justifiably relied on the purported misstatements. Compl. ¶¶ 66-70. To the contrary, the Complaint incontrovertibly shows that Plaintiffs were the source of any misstatements contained in their financial statements, and that, if anything, *PwC* "over-relied" on management's misrepresentations in certifying those financial statements. Compl. ¶ 37. The Complaint alleges that Plaintiffs implemented internal controls that were "grossly deficient" (Compl. ¶ 37), regularly overrode such controls (Compl. ¶ 36), used "improper accounting" to falsely recognize gain on sham transactions (Compl. ¶ 26), and otherwise "concealed [their] financial performance." Compl. ¶ 56.[8]

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[8] The Complaint also refers to a "review of commercial real estate lending processes" allegedly undertaken by PwC in February 2001 (Compl. ¶¶ 39-42), and mentions the purported review in the negligent misrepresentation claim. Compl. ¶ 67. Plaintiffs do not, however, allege facts concerning the source, nature, basis or scope of any duties purportedly undertaken by PwC in connection with the review, the manner in which such duties were breached, or the manner in which Plaintiffs

Plaintiffs' intentional misstatements of their financial statements completely bar them from now claiming they relied on PwC's audit opinions to conclude that there were no misstatements. *See, e.g., ESCA*, 125 Wash. 2d at 827-830; *Smolen*, 921 F. 2d at 965.

Smolen is on all fours with the present case. In *Smolen*, the sellers of a business brought suit against their auditors for negligent misrepresentation after the company adjusted its financial statements to account for grossly overstated inventory. 921 F.2d at 961-63. The plaintiffs argued that because they relied on the financial misstatements in connection with selling the company, they were entitled to recover the value lost on the company's sale price after the adjustment to inventory. *Id.* at 963. The Ninth Circuit flatly rejected this argument, holding that plaintiffs' prior knowledge of the overstatements gave them "sufficient notice" of the misstatements in their financial statements "and thus made any reliance by appellants unreasonable." *Id.* at 964-65.

Accepting their own allegations as true, Plaintiffs likewise had "sufficient notice" of the alleged misstatements long before any reliance on PwC's audit opinions or other alleged misstatements could have been detrimental. For example, Plaintiffs were aware that the obligors on the Koa Timber Harvesting Agreement had purportedly defaulted on their payments shortly after the deal closed. Compl. ¶¶ 23-24. Similarly, Plaintiffs were aware of the purported fraudulent business

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(footnote continued...)

relied upon or might have been damaged by the supposed review. Moreover, Plaintiffs do not, because they cannot, allege that these purported misstatements are based on PwC's audits or that PwC had a duty to make these statements. To the extent conclusory allegations regarding the review are intended to serve as part of the basis of the negligent misrepresentation claim, they suffer from the same defects that require dismissal of all of Plaintiffs' claims.

activities that they were engaged in, including the "overstatement of assets, masking of joint ventures as lending transactions, and booking large, year-end inter-company transactions that lacked economic substance," before PwC audited their financial statements. Compl. ¶ 38. As in *Smolen*, Plaintiffs here knew of the allegedly improper accounting prior to their supposed reliance and therefore cannot argue that their reliance was justified. Hence, their claim of negligent misrepresentation should be dismissed for this additional reason.

V. CONCLUSION

The defects outlined above are both fatal and irremediable. Accordingly, defendant PwC respectfully requests that the Court dismiss Metropolitan and Summit's Complaint for Professional Negligence, Negligent Misrepresentation, and Breach of Contract in its entirety, and with prejudice.

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Respectfully submitted,

ORRICK, HERRINGTON & SUTCLIFFE LLP

/s/
Robert P. Varian, *pro hac vice*

FELTMAN, GEBHARDT, GREER & ZEIMANTZ, P.S.

/s/
Frank J. Gebhardt, WSBA #4854

Attorneys for Defendant
PricewaterhouseCoopers LLP