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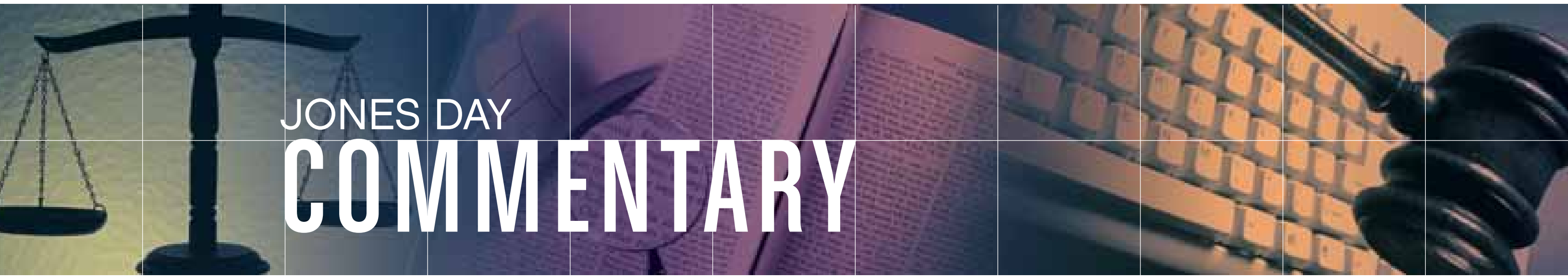

THABAULT V. CHAIT: COMPLETING THE THIRD CIRCUIT'S DEEPENING INSOLVENCY TRILOGY

When the United States Court of Appeals for the Third Circuit decided *Thabault v. Chait*, 541 F.3d 512 (3d Cir. 2008), in September 2008, it was the most significant accounting malpractice decision of last year and perhaps the most significant damages case in the last 20 years. Why? Accounting malpractice cases are filled with pitfalls for unsuspecting plaintiffs. Moreover, accounting firms tend to settle cases in which the plaintiffs survive motions predicated on tried-and-true legal defenses and factual hurdles. The result is that few auditing malpractice cases are tried. *Thabault*, then, is an exception for that reason alone. But it was different for other reasons, as well. *Thabault* involved a negligently performed audit of an insolvent insurance company. The accounting firm—PricewaterhouseCoopers—not only pursued a trial rather than settlement, it vigorously advanced many of the industry's favorite legal and factual defenses throughout pre- and post-trial motions and on appeal. Damages awarded by the jury were significant (in excess of $100 million) and PwC's attacks on the calculations and the requisite evidence of causation were myriad and aggressive. The result is a rich body of thoughtful trial court decisions, culminating in the Third Circuit's opinion that provides articulate jurisprudence on issues that are certain to arise with increasing frequency as failed company litigation becomes more prevalent.

BACKGROUND

Thabault v. Chait was federal litigation initiated by the state receiver of Ambassador Insurance Company against the company's former management and auditors. Ambassador was a surplus lines insurance company, headquartered in New Jersey and domiciled in Vermont, which fell victim to gross mismanagement in the soft insurance market that dominated the early 1980s. Coopers & Lybrand audited Ambassador's financial statements, including its loss reserves from 1979 through 1982. In its year-end 1981 audit, Coopers & Lybrand's loss reserve analysis showed that Ambassador was insolvent, but the auditors allowed themselves to be talked out of their own calculations, in favor of management's overly optimistic—and unrealistic—assumptions about Ambassador's practices and the insurance markets. Coopers & Lybrand opined that Ambassador's rosy financials fairly represented the company's financial condition. The loss reserves presented in those financials were relied upon by the Vermont Insurance Department, which allowed Ambassador to continue writing new insurance policies.

In 1983, Ambassador's true financial condition was revealed, and the Vermont Insurance Department immediately placed Ambassador into rehabilitation and ultimately liquidation. In 1985, the Vermont Commissioner of Insurance, acting as Ambassador's receiver and on Ambassador's behalf, filed suit against Ambassador's president, chief financial officer, treasurer, parent company, and auditor in the United States District Court for the District of New Jersey. The complaint alleged that Ambassador's former management had grossly mismanaged Ambassador, the auditors had negligently conducted the audit, and the parent company had unlawfully accepted dividends when Ambassador was insolvent.

Ambassador's failure was, at the time, one of the largest insurance failures in history, and a large portion of policyholder losses were not covered by a guaranty fund (because surplus lines insurance rarely is), which meant that the policyholders whose claims could not be paid had no alternative source of recovery. (New Jersey subsequently enacted legislation that provided guaranty fund coverage for surplus lines insurance policyholders, specifically to address the uncovered Ambassador claims, but that fund only applied to New Jersey residents and only covered claims up to a fixed amount.) Other related litigation surfaced—most notably litigation filed on behalf of Ambassador's subsidiary, Horizon Insurance Company, by its receiver, the New York Superintendent of Insurance, and a shareholder suit against Ambassador's parent, Ambassador Group. The multiple suits were consolidated in New York federal court as "multidistrict litigation," and the complexities of the MDL slowed the litigation considerably.

On motion by the Receiver, the Ambassador case was ultimately remanded from the MDL and returned to its home forum in New Jersey, where fact discovery was concluded, expert discovery took place, dispositive motions were considered and rejected, and the case was prepared for trial. In May 2005, 20 years to the month after being filed, the Ambassador case proceeded to trial. By that point, the only remaining defendants were PricewaterhouseCoopers, the successor by merger to Coopers & Lybrand, and the estate of Ambassador's former president and CEO. After a three-month trial, the jury found against PwC, finding that Coopers & Lybrand had been negligent and that its negligence resulted in $119.9 million in damages to Ambassador. In both post-trial motions and on appeal, PwC asserted a number of defenses to liability and damages commonly raised by auditors in cases of this kind. The resolution of those issues in the Third Circuit in September creates strong precedent that will shape distressed company litigation for years to come.

THE APPEAL

PwC pursued seven issues on appeal, none successfully. Three of those issues gave the Third Circuit an opportunity to speak to significant questions that arise in failed company litigation.

Deepening Insolvency. More than a decade after the Ambassador complaint had been filed, the Third Circuit decided *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 347 (3d Cir. 2001). *Lafferty* held that the Pennsylvania Supreme Court would recognize an independent cause of action for "deepening insolvency" where a defendant caused an injury to a debtor's corporate property "from the fraudulent expansion of corporate debt and prolongation of corporate life." *Id.* at 347, 351. The Third Circuit revisited the issue in *In re CitX*, 448 F.3d 672 (3d Cir. 2006), moving from consideration of the "deepening insolvency cause of action" to limiting the availability of "deepening insolvency damages" in a state law negligence case.

On appeal in *Thabault*, PwC argued that (1) *CitX* barred a plaintiff's recovery for negligence (as in an accounting malpractice case) when the plaintiff's losses either created or "deepened" insolvency; and (2) only the individual creditors, and not the insolvent company, suffer a compensable harm when the corporation becomes insolvent. The Third Circuit rejected both arguments.

With regard to *CitX*, the Third Circuit reiterated that *Lafferty* did not create a new theory of damages for a state law negligence claim that would allow a plaintiff to simply compare two balance sheets to determine the amount by which the insolvency had increased. The court, however, specifically analyzed the components of Ambassador's damages calculation and concluded that the damages proven to the jury consisted of "itemized, specific, and avoidable losses that Ambassador incurred by continuing its operations beyond the date of PwC's negligent audits." *Thabault*, 541 F.3d at 519. Even though those damages had an "impact on Ambassador's solvency" (*i.e.*, deepened the insolvency), the calculation measured the specific losses that were proximately caused by PwC's negligence, not simply the amount by which Ambassador became more insolvent. Thus, these were not the deepening insolvency damages criticized in *CitX*. These damages were traditional tort damages, recoverable under New Jersey state tort law.

The Third Circuit also quickly disposed of PwC's argument that corporate losses below the solvency threshold belong only to the company's creditors, and not the company itself. The court succinctly stated: "Today we hold that an increase in liabilities is a harm to the company and the law provides a remedy when a plaintiff proves a negligence cause of action." *Thabault*, 541 F.3d at 523.

Proximate Cause. Proximate cause frequently is a difficult element to prove in an accounting malpractice case because the plaintiff must show that the damages sought actually resulted from the negligence and not other, concurrent events. Where an audit is involved, the plaintiff generally must show that, but for the negligently performed audit, the damages would not have arisen. To contest proximate cause in *Thabault*, PwC relied on *FDIC v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992), an accounting malpractice case in which the Fifth Circuit opined that "[i]f nobody relied on the audit, then the audit could not have been a substantial factor in bringing about the injury." *Id.* at 170. This language has appeared in countless briefs filed by accounting firms and their trade group over the years to support the argument that a plaintiff must establish "eyeball reliance" on the audited financial statements, and it has dissuaded many plaintiffs from pursuing their cases to judgment.

The Third Circuit distinguished *FDIC v. Ernst & Young*, however, concluding that a causative chain like the one established in *Thabault* was sufficient to establish legal causation. In *Thabault*, the jury was presented with evidence that (1) Coopers & Lybrand's audit had produced materially misstated loss reserves, which were incorporated in the required filing (the statutory annual statement) Ambassador made with the Vermont Department of Insurance; (2) had the statutory annual statement been accurate, it would have shown Ambassador was insolvent or nearly so; (3) faced with an accurate statutory annual statement showing Ambassador's hazardous financial condition and decline in surplus, the Vermont Department of Insurance would have immediately stopped Ambassador from writing new insurance policies; and (4) the insurance policies Ambassador wrote after the point at which the Department would have prohibited further new business (if Coopers & Lybrand had done its job) resulted in net losses of $119.9 million. There was no need for the Insurance Department to have received and relied on the actual audited financial statements because the evidence showed that an intervention would have taken place had the audit work produced reasonable loss reserves. Thus, even without eyeball reliance, proximate cause was sufficiently established. *Thabault*, 541 F.3d at 524.

***In Pari Delicto*.** The doctrines of *in pari delicto* and imputation are invoked in nearly every accounting malpractice case. Accounting firms routinely argue that corporate management's bad conduct should be imputed to the corporation, thereby barring the corporation from recovering against the allegedly negligent accountants because the plaintiff corporation cannot assert a claim against a defendant when the plaintiff itself bears fault for the claim. On appeal, PwC argued that Ambassador's CEO's bad conduct (gross negligence and breach of fiduciary duty) should have been imputed to Ambassador and its Receiver, barring recovery against PwC for Coopers & Lybrand's negligent audit.

The Third Circuit disposed of PwC's argument on two bases. First, the court upheld and applied the common law rule that bad conduct will not be imputed when the bad actor is acting adversely to the corporation. The Third Circuit held that the CEO's conduct did not benefit Ambassador because that conduct "allowed Ambassador to continue past the point of insolvency." *Thabault*, 541 F.3d at 529. Second, the court determined that New Jersey's recently announced "auditor negligence" exception to imputation applied: "PwC was not a victim of [the CEO's] fraud and allowing it to avoid liability by invoking the in pari delicto doctrine would not serve the purpose of the doctrine—to protect the innocent." *Id.* The auditor negligence exception applied regardless of the CEO's ownership interests in the corporation.

CONCLUSION

It is frequently said by the accounting industry that bankruptcy trustees, creditors committees, and insurance receivers often pursue the outside auditors simply because they are "deep pocket defendants." In fact, the accounting firm can, in certain cases, bear an equal responsibility for the losses occasioned by a company's failure. Such was the case in *Ambassador*, where the auditor abandoned its required duty of independence and allowed its better judgment to be overridden by a strong-willed CEO. Although the case is not unique for that, it is unique for the defendant firm's willingness to pursue its defense all the way through a trial and on to an appellate decision. The legacy of that strategic choice is the Third Circuit's expansive decision in *Thabault v. Chait*, in which the court disposes fairly readily of some of the auditing industry's most sturdy bastions: *in pari delicto*, causation, standing, and deepening insolvency damages. Although one can argue that the Third Circuit did not break new ground in its holdings in *Thabault*, it is certainly the case that the court was more clear and more emphatic than predecessor courts facing these same issues. And, of course, its opinion is the most recent major opinion in this field, completing the Third Circuit's deepening insolvency trilogy (*Lafferty*, *CitX*, and now *Thabault*). Coming from this respected court, we expect to see its holdings influence the shape of the law in this area for years to come.

Postscript: With pre- and post-judgment interest, the judgment totaled $205.3 million, which was paid by PwC to the Estate of Ambassador Insurance Company in October 2008. PwC did not file a petition for writ of certiorari with the United States Supreme Court.

LAWYER CONTACTS

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