

Seventh Circuit Applies Principle of “Loss Causation” in the Context of Negligence Claim Against Accounting Firm, Issues Warning to Bankruptcy Trustees

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In an important ruling issued on March 21, 2008, Maxwell v. KPMG LLP, No. 07-2819, 2008 WL 746849 (7th Cir. 2007), the U.S. Court of Appeals for the Seventh Circuit drew on the concept of “loss causation” from securities law to illustrate why an accounting firm’s alleged malpractice was not the legal “cause” of financial losses claimed by the plaintiff.

The plaintiff, a trustee in bankruptcy of a company called marchFirst, brought suit against the accounting firm, KPMG, alleging that the firm’s negligent performance of its auditing services caused marchFirst’s demise. The trustee alleged that, in March 2000, marchFirst, under its predecessor name Whittman-Hart, acquired a “dot.com” company called US Web/CKS for more than \$7 billion, paying entirely with stock and renaming the combined company marchFirst. The acquisition proved to be ill-fated: US Web/CKS’s business collapsed and the former Whittman-Hart shareholders were left with a minority interest in a company that was forced to declare Chapter 7 bankruptcy in 2001. marchFirst’s trustee in bankruptcy brought suit against Whittman-Hart’s auditor, KPMG, under Illinois tort law, alleging that KPMG was negligent in approving Whittman-Hart’s third-quarter earning report because KPMG should have known that the report significantly overstated the company’s earnings. The trustee argued that KPMG’s alleged negligence “caused” marchFirst’s demise because, if the earnings had been accurately stated, US Web/CKS would have lost interest in being acquired and, if Whittman-Hart had not been “chained to a drowning US Web,” then it would not have perished in the burst of the dot.com bubble and marchFirst would not have filed for bankruptcy.

In an important ruling regarding proximate cause or “legal cause,” the Seventh Circuit affirmed the district court’s grant of summary judgment in favor of KPMG. The Court found that the necessary conditions of Whittman-Hart’s demise were its decision to buy US Web/CKS and the failures of the dot.com market, and that KPMG had not caused either event through its prior audit of Whittman-Hart. Moreover, the Court noted that even if US Web/CKS’ agreement to be acquired had been influenced by KPMG’s audit work, it was irrelevant because, under the plaintiff’s own argument, “US Web was doomed by the coming collapse of its market and so was not harmed by the advice.” Therefore, any

negligence on the part of KPMG could not be deemed the legal “cause” of marchFirst’s bankruptcy. In so doing, the Court analogized to the similar distinction in securities law between “transaction causation” and “loss causation.” Similarly, KPMG did not assume any duty to give Whittman-Hart business advice, including whether to acquire another company, and therefore the Court concluded that Whittman-Hart cannot make KPMG “the insurer against the folly (as it later turned out) of a business decision (the decision to try to acquire US Web) unrelated to what an auditor is hired to do.”

The Court concluded its opinion with an equally important admonition. Judge Posner observed that trustees in bankruptcy do not operate within the same incentive structure as the officers of the corporation for which they act as trustee: “The filing of lawsuits by a going concern is properly inhibited by concern for future relations with suppliers, customers, creditors, and other persons with whom the firm deals (including the government) and by the cost of litigation. The trustee of a defunct enterprise does not have the same inhibitions.” The Court was particularly concerned by the potential leverage created by the filing of a frivolous suit where significant damages (in this case \$ 626 million) are asserted. As a result, the Court concluded: “Judges must be vigilant in policing the litigation judgment exercised by trustees in bankruptcy, and in an appropriate case must give consideration to imposing sanctions for the filing of frivolous suits.”

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