No. 06-0975

IN THE SUPREME COURT OF TEXAS

GRANT THORNTON LLP,
Petitioner,

v.

PROSPECT HIGH INCOME FUND, ML CBO IV (CAYMAN), LTD., PAMCO CAYMAN, LTD., PAM CAPITAL FUNDING, L.P., HIGHLAND CRUSADER FUND, LTD., AND PCMG TRADING PARTNERS VII, L.P.,
Respondents.

On Appeal from the
Fifth Court of Appeals at Dallas, Texas

BRIEF OF AMICI CURIAE TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS AND AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN SUPPORT OF PETITIONER'S MOTION FOR REHEARING

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TO THE HONORABLE SUPREME COURT OF TEXAS:

Amici Curiae the Texas Society of Certified Public Accountants and the American Institute of Certified Public Accountants submit this Amici brief in support of Petitioner's Motion for Rehearing. The fees for the preparation of this brief are being paid by these Amici. *See* TEX. R. CIV. P. 11(c). Amici urge this Court to grant review to clarify the circumstances under which an accounting firm can be held liable to a nonclient for alleged misrepresentations in an audit report under Texas law. This case presents several jurisprudentially important legal issues pertinent to an accounting firm's potential liability. Allowing the court of appeals' decision to stand would establish deleterious precedent outside the mainstream of nationwide jurisprudence in this hotly litigated area of professional liability law, and may expose Texas courts to a plethora of non-meritorious lawsuits.

STATEMENT OF INTEREST OF AMICI CURIAE

The **Texas Society of Certified Public Accountants** (TSCPA) is a nonprofit professional organization of CPAs. It has the largest in-state membership of any voluntary CPA organization in the country, with 20 local chapters and more than 27,000 members. TSCPA's mission is to promote the highest standards of ethics and professionalism in public accounting through a variety of services, including professional education, peer review and participation in the public policy process on issues of importance to its members.

The **American Institute of Certified Public Accountants** (AICPA) is the national organization of the certified public accounting profession, all of whose more than 340,000 members are certified public accountants. Among the AICPA's purposes are the promotion

and maintenance of high professional standards of practice. In pursuit of these ends, the AICPA has been a principal force in developing accounting and auditing standards, drafting model legislation, sponsoring educational programs, and issuing professional publications to improve the quality of services provided by CPAs. Because of its historical role in formulating standards relating to audits, reviews, and compilations, and the reports issued thereon, the AICPA maintains a strong interest in the scope and bases of civil liability sought to be imposed on auditors pursuant to those standards.

Neither the TSCPA nor the AICPA has an interest in the particular dispute at issue. However, because of their (1) extensive understanding of the accounting profession and, in particular, the role of an independent auditor, and (2) commitment to the public interest, these state and national organizations of CPAs are deeply concerned about the court of appeals' decision in this case inasmuch as it threatens to broaden, without any basis, the circumstances under which an accounting firm may be liable to nonclients for alleged misrepresentations in an audit report.

This is of particular concern to certified public accountants because accounting firms have increasingly become "deep pocket" target defendants in suits by disgruntled investors. When investors lose money in an entity whose fortunes subsequently fade, it is not uncommon for those investors to cast about for someone to blame and to resort to the courthouse to try to recoup those losses. And, particularly when other potential defendants prove insolvent, plaintiffs-investors sue the accounting firm that audited the failing or failed entity. As the U.S. Chamber of Commerce has observed, "the [accounting] profession finds

itself the target of a difficult litigation and regulatory enforcement environment, where business losses by a client can result in lawsuits . . . ." U.S. Chamber of Commerce, *Auditing: A Profession at Risk* at 4 (January 2006).

In addition to the obvious financial and reputational exposure caused by the mere filing of lawsuits, increased litigation risk affects the ability of the profession to recruit and retain highly qualified personnel. *See id.* at 8. ("Qualified auditors face ever-growing incentives to exercise their professional options and may opt to leave the profession altogether."). This, in turn, may further reduce the availability, and therefore increase the cost, of accounting services. In sum, it is important that the potential liability of an accounting firm to nonclients for alleged misrepresentation in an audit report be governed by a predictable set of standards so that non-meritorious claims can be disposed of at the outset of litigation. This will greatly reduce the burdensome costs of protracted litigation in cases that should be resolved at the summary judgment stage or earlier.

Finally, even where an audit report is issued outside of Texas (as it was in this case), creative plaintiff's counsel can push for the application of a state's law perceived to favor them or attempt to create a basis for Texas jurisdiction in multi-state transactions. This makes the court of appeals' decision of interest to accounting professionals both within and outside Texas.

ARGUMENT

I. This Court should grant review and conclude that "holder" claims cannot be pursued under Texas law.

The court of appeals agreed with the Funds that a so-called "holder" claim could be pursued under Texas law:

> *Appellants argue that even after purchasing the bonds, they relied on Grant Thornton's representations in deciding whether to* ***continue holding the bonds***. Absent their reliance upon Grant Thornton's misrepresentations, appellants contend, they would have forced Epic to comply with its loan covenants or forced it into bankruptcy, as stated in Deadman's affidavit. *We agree with appellants that there are genuine issues of material fact regarding whether Prospect's post-purchase reliance was justified.*

Prospect High Income Fund v. Grant Thornton, LLP, 203 S.W.3d 602, 612-13 (Tex. App.—Dallas 2006, pet. denied) (emphasis added). Notably, the court of appeals' decision cites no Texas authority in support of this holding, *id.*, and there is none applicable to this set of facts.[1] Thus, the decision by the court of appeals in this case is quite literally the first to recognize, without restriction, a "holder" claim under Texas law.

Not only is this holding unprecedented in Texas, but it is also contrary to federal law and to the law in nearly every other state that has considered the issue. *See, e.g., In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, Nos. H-01-3624, G-02-0299, 2007 WL 789141, at *11 (S.D. Tex. Mar. 12, 2007). The United States Supreme Court, rejecting

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[1] One Texas appellate court decision, subsequently vacated on other grounds, gave "limited" recognition to a "holder" claim in the "narrow" setting where there were "direct, face-to-face or telephone" conversations between the parties, and the defendant induced the plaintiffs to abandon "a specific plan to sell their shares at a date certain." *Shirvanian v. DeFrates*, No. 14-02-00447-CV, 2004 Tex. App. LEXIS 182, at *57-59 (Tex. App.—Houston [14th Dist.] 2004), *op. withdrawn*, 161 S.W.3d 102, 105, 110 (Tex. App—Houston [14th Dist.] 2004, pet. denied). The case before the Court here does not involve remotely comparable facts.

holder claims under federal securities laws, has stressed the inherently speculative nature of such claims, and the serious problems of proof they present. The Court rejected liability attaching under the very circumstances presented here—if such claims were permissible, "bystanders to the securities marketing process could await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused nonselling in a falling market . . . ." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 747 (1975). Holder claims are virtually impossible to corroborate—they usually depend on self-serving, subjective, after-the-fact testimony that the plaintiff held an investment that went bad based on the alleged misrepresentation: "the door will be open to recovery of substantial damages on the part of one who offers only his testimony to prove" his claim. *Id*. at 746. Individual plaintiffs have frequently attempted to pursue holder claims under state law. A number of courts have rejected such claims based on the policy reasons articulated above. *See, e.g., In re WorldCom, Inc. Sec. Litig*., 336 F.Supp.2d 310, 319 (S.D.N.Y. 2004) (rejecting holder claims under Georgia law and citing additional cases from other jurisdictions). In the very few cases where holder claims were allowed to proceed, there was specific and independent evidence that the plaintiff had either determined to sell the stock but changed the decision based on alleged misrepresentation, or had received personal, one-on-one misrepresentations directly from the defendants, as in *Shirvanian*. *See WorldCom*, 336 F.Supp.2d at 320.

Without such requirements at the pleading stage, let alone as an evidentiary matter, there will be a proliferation of baseless suits by disappointed investors, placing accounting firms, as well as issuers, underwriters, and even lenders, in the cross-hairs of suits based on

subjective, unverifiable claims. This will disrupt businesses, increase transaction costs, and lead to coercive settlements. As the Supreme Court observed, a complaint of this type "which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment." *Blue Chip*, 421 U.S. at 740. Because of this heightened, yet baseless, "value," "[t]he very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit." *Id.*

In short, the court of appeals' decision, which substantially expands the circumstances under which an accounting firm can be dragged into court, may have a profound impact on accounting professionals, among others. If Texas is to stake out a position on "holder" claims that is contrary to the majority rule and inconsistent with sound policy concerns articulated by the U.S. Supreme Court, such a momentous decision should come from this Court only after full consideration of the competing policy concerns. Amici therefore urge this Court to grant review and issue a decision that a "holder" claim cannot be pursued under Texas law.

II. This Court should grant review to reject the "vicarious reliance" theory.

The court of appeals accepted another argument by the Funds that has been rejected elsewhere. The Funds premised their claims, in part, on the 1999 negative-assurance statement that Grant Thornton provided to Epic in April 2000. It is undisputed, however, that none of the Funds ever received or relied upon that statement. Undaunted, the Funds contend

that they can pursue their claims because a **third party**, U.S. Trust, purportedly relied upon the negative-assurance statement, despite the absence of any evidence that U.S. Trust passed along the information to them. CR 9/3251.

Until the court of appeals' decision in this case, no court in Texas has ever accepted such a "vicarious reliance" theory. Another Texas court has rejected it. *See Hendricks v. Thornton*, 973 S.W.2d 348, 361-63 (Tex. App.—Beaumont 1998, pet. denied) (affirming summary judgment against plaintiffs who premised fraud and misrepresentation claims on information they obtained about an auditor from their investment advisor). Courts elsewhere have also rejected the theory. *See, e.g., Eldred v. McGladrey, Hendrickson & Pullen*, 468 N.W.2d 218, 220 (Iowa 1991) (affirming judgment for accounting firm, holding that "vicarious reliance is too weak to support a finding of tortious misrepresentation.").[2]

Texas should not embrace a theory of reliance rejected elsewhere without full consideration by this Court. Permitting "vicarious" reliance without clear explication of the relationship between the actual recipient and plaintiff that must be pleaded and proved to support such a possibility—if it should be permitted at all—creates an end-run around a fundamental element of tort claims. The theories that plaintiffs can create as to how they "relied" on the actual recipient's "reliance" are limited only by the imagination. Such a holding also effectively eliminates the privity required for nonclient negligent

[2] *See also White v. BDO Seidman, LLP*, 549 S.E.2d 490, 493 (Ga. Ct. App. 2001) ("we cannot agree that Georgia law permits such indirect reliance to substitute for proof of actual reliance in a negligent misrepresentation case."); *Secs. Investor Prot. Corp. v. BDO Seidman, L.L.P.*, 746 N.E.2d 1042, 1047 (N.Y. 2001) (plaintiffs' "reliance on silence from [another] party cannot be equated" with its own reliance on the auditor's report).

misrepresentation claims, discussed below, and no doubt will be relied upon to support claims well beyond auditor liability, such as legal malpractice, or any other tort claim in which reliance is an element. Amici urge this Court to grant review and expressly reject the "vicarious reliance" theory.

III. This Court should grant review to reaffirm the narrow circumstances under which nonclients can sue an accounting firm.

By two separate decisions, this Court has made clear the restricted scope of a professional's liability to a nonclient who alleges negligent or fraudulent misrepresentations. *See McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*, 991 S.W.2d 787 (Tex. 1999) (addressing *negligent* misrepresentation); *Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co.*, 51 S.W.3d 573, 574 (Tex. 2001) (addressing *fraudulent* misrepresentation). The manner in which the court of appeals applied these clear standards to the undisputed facts is disturbing and merits review by this Court.

In *McCamish*, this Court addressed the scope of a professional's liability to a nonclient for the tort of *negligent* misrepresentation, as defined by the RESTATEMENT (SECOND) OF TORTS § 552 (1997). *See McCamish*, 991 S.W.2d at 787. The Court recognized that the Restatement "*narrow[s]* the class of potential claimants" by limiting liability to a loss suffered by "a *limited group* of persons for whose benefit and guidance [one] intends to supply the information or knows that the recipient intends to supply it . . . ." *Id.* at 793-94 (emphasis added). Under this formulation, an action for negligent misrepresentation lies "only when information is transferred by a[] [professional] to a *known party* for a *known purpose*." *Id.* at 794.

In *Pacific Mutual*, this Court addressed "the scope of an accounting firm's liability for making *fraudulent* misrepresentations in an audit report." *Pacific Mutual*, 51 S.W.3d at 574 (emphasis added). The Court adopted the "especial likelihood" restriction set forth in a comment to the Restatement. The Court held: "To prove that an alleged fraudfeasor had reason to expect reliance,

> [t]he maker of the misrepresentation *must have information* that would lead a reasonable man to conclude that there is an *especial likelihood* that it will reach those persons and will influence their conduct. There must be something in the situation *known to the maker* that would lead a reasonable man to govern his conduct on the assumption that this will occur. *If he has the information*, the maker is subject to liability under the rule stated here."

Id. at 581 (quoting RESTATEMENT (SECOND) OF TORTS § 531 cmt. d (1977)) (emphasis supplied by Court).

Although the restrictions adopted by this Court in *McCamish* and *Pacific Mutual* were designed to *narrow* the class of potential claimants, the court of appeals undermined the force of those decisions by failing to properly apply them to a fact-setting that is likely to recur. To illustrate, here the Funds were unknown to Grant Thornton. The bulk of the claims in this case are asserted by investment funds that, when the 1999 audit report was issued, were nothing more than unidentified, potential investors in the open market about whom the auditor, Grant Thornton, had no specific information and to whom it *never* provided its audit report. Under these circumstances, as regards the Funds, it cannot be said that Grant Thornton transferred the information in the audit report "to a *known party* for a *known purpose*." *McCamish*, 991 S.W.2d at 794 (emphasis added). Thus, as a matter of law, an action for *negligent* misrepresentation based on the 1999 report cannot lie for these

claimants. Similarly, without possessing specific information about the Funds, there is no evidence that Grant Thornton had reason to know that its audit report would influence the Funds' conduct, much less that it "ha[d] information" that would "lead a reasonable man to conclude" that there was an "*especial likelihood*" that the Funds' conduct would be influenced by the audit report. *Pacific Mutual*, 51 S.W.3d at 581 (emphasis added). Thus, as a matter of law, an action for *fraudulent* misrepresentation cannot lie. And, as explained in Grant Thornton's Brief on the Merits, the same basic reasoning precludes liability for the 2000 audit report. *See* Pet. BOM at 46-48.

The court of appeals' decision establishes disturbing precedent that will no doubt be relied upon in numerous cases with facts similar to those here, notwithstanding the clear intent of *McCamish* and *Pacific Mutual* that more was required. Such a result will make many lawsuits that should not survive summary disposition at the outset of litigation virtually impossible to resolve without trial.

CONCLUSION

This case involves tort-law issues of significant interest to a critical profession—the accounting profession. Further, the legal issues presented here affect all sorts of commercial claims in which alleged damages may be substantial, and may make Texas a target forum for such litigation. Accordingly, this Court should grant Petitioner's Motion for Rehearing and review the decision of the court of appeals.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served in accordance with the Texas Rules of Appellate Procedure upon the following counsel of record via United States mail, on this the 21st day of March, 2008.

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