Maxwell v. KPMG: TRUSTEE BEWARE!

By David P. Leibowitz

It's not easy being a chapter 7 trustee. Trustees have myriad mandatory tasks and duties for which trustees are paid the munificent sum of $60 per case. Asset estates represent the sole source of significant compensation within the trustee practice. This alone creates a strong incentive for trustees to pursue assets or causes of action which might generate assets in chapter 7 estates.

While trustees have the obligation and incentive to pursue assets and claims, that duty is balanced by the obligation of a trustee to exercise business judgment in doing so. The recent case of *Maxwell v. KPMG*[1] provides a dramatic reminder to trustees that our work not only offers high stakes but also imposes high risks.

Defendant KPMG, one of the largest accounting firms in the world, had performed an audit of Whittman-Hart in 1999. Maxwell sued KPMG, alleging that it had acted negligently and in breach of contract in many respects in performing its audit of Whittman-Hart. As a result, Maxwell alleged that Whittman-Hart was able to use its stock to acquire USWeb even though its stock was not all it was cracked up to be. Maxwell concluded that had Whittman-Hart not acquired USWeb, it would have avoided bankruptcy and a myriad of shareholder suits.

The Case

Debtor, marchFIRST, was the product of a merger of information technology consulting firm Whittman-Hart and internet sales consulting firm USWeb/CKS. The merger was priced at $7 billion. USWeb was substantially larger than Whittman-Hart; Whittman-Hart paid USWebs shareholders entirely with Whittman-Hart stock.

The merger took place in March 2000. In April, 2001, marchFIRST filed its chapter 11 bankruptcy case in Delaware. Within a few days, the case was converted to a chapter 7 case. By July, marchFIRST was transferred to the bankruptcy court in Chicago. Andrew Maxwell, a highly experienced and well-respected trustee and attorney, was appointed trustee.[2] He retained Williams Montgomery & John,[3] attorneys with recognized success pursuing audit malpractice claims, to represent him in the adversary proceeding against KPMG.

Defendant KPMG, one of the largest accounting firms in the world, had performed an audit of Whittman-Hart in 1999. Maxwell sued KPMG, alleging that it had acted negligently and in breach of contract in many respects in performing its audit of Whittman-Hart. As a result, Maxwell alleged that Whittman-Hart was able to use its stock to acquire USWeb even though its stock was not all it was cracked up to be. Maxwell concluded that had Whittman-Hart not acquired USWeb, it would have avoided bankruptcy and a myriad of shareholder suits. The original complaint sought damages in excess of $75,000 but no specific dollar amount. KPMG answered and sought a jury trial. As a result, it was successful in having the reference withdrawn.[4]

The trustee sought damages from KPMG in an amount equal to the difference between the value of a hypothetical stand-alone Whittman-Hart on April 12, 2001, and the purported negative value of marchFIRST on April 12, 2001. He asserted that had KPMG pointed out the problems with the 1999 Earnings Release, the merger would not have happened.[5] The measure of damages sought by the trustee was such that it would have not only paid creditors of Whittman-Hart in full, it also would have resulted in close to $500 million being available to the stockholders of marchFIRST, 57% of which was held by former shareholders of USWeb.

Ultimately, the district court granted summary judgment in favor of KPMG. District Judge Joan Gottschall analyzed the facts carefully and clinically. She noted that:

> There is no statement by KPMG associated with the financial informationcontained in the unaudited 1999 Earnings Release. Indeed, KPMG did not issue its audit report on Whittman-Harts 1999 financial statements until March 27, 2000, well after the merger had closed. Further, Whittman-Hart did not file its Form 10-K for the period ended December 31, 1999, until March 30, 2000.

Judge Gottschall concluded that the evidence before her established that the failure of marchFIRST was not proximately caused by any accounting failures of KPMG. She stated that proximate causation required more than a "but for" analysis. Instead, there had to be a showing that there was a "natural and continuous chain of events unbroken by any intervening cause" in order to establish liability for negligence. The district court saw this case as one where the loss was caused not by KPMGs negligence but by subsequent events over which it had no control.

On appeal the Seventh Circuit unanimously affirmed the district courts summary judgment in favor of KPMG. Writing for the court, Judge Richard A. Posner was particularly concerned that the measure of damages sought by the trustee exceeded the claims of unsecured creditors by $500 million. The fact that 57% of the stock of marchFIRST (the entity resulting from the merger of Whittman-Hart and USWeb) was owned by former shareholders of USWeb gave the court pause. Judge Posner wrote: "USWeb cannot at once be the cause of the bankruptcy and its principal beneficiary."

After analyzing and concurring with Judge Gottschalls analysis of proximate causation, the court stated:

> The failure to state Whittman-Harts fourth-quarter earnings accurately, insofar as it was due to KPMG, may as we said have been a wrong to US Web (though a wrong that did no harm if indeed that firm was doomed), but it was not a wrong to Whittman-Hart, as the auditor neither was asked to nor did advise Whittman-Hart to buy US Web. By swallowing a larger company, and one concentrated in the dot.com business, Whittman-Hart assumed the risk of being injured, fatally as it turned out, by a downturn in that business. It wants to make its auditor the insurer against the folly (as it later turned out)

About the Author

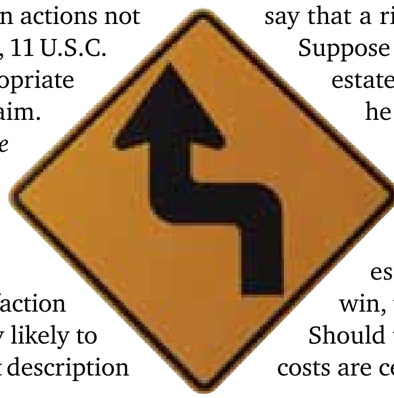
David P. Leibowitz has been a panel trustee in Chicago since 1991. He is board certified as both a business and consumer bankruptcy attorney and practices in Illinois and Wisconsin. The subject of this case, Andrew Maxwell, also is a panel trustee in Chicago, Illinois. Mr. Leibowitz and Mr. Maxwell have worked together on numerous cases, both as adversaries and collaborators.

of a business decision (the decision to try to acquire US Web) unrelated to what an auditor is hired to do.

Had the court left the matter rest at this point, this case would be of much less interest to trustees. However, Judge Posner and the court were very concerned about the evidence proffered by the trustee in support of his motion for summary judgment. He characterized an element of the trustees evidence in support of his motion for summary judgment, an expert report presented by Paul Marcus, as "outlandish." The court considered the trustees case to be extremely weak, not only on liability but also on damages. As a result, the court expressed the need to consider not only the litigation judgment of Maxwell, as trustee in this case, but of chapter 7 trustees generally.

Judge Posner wrote that chapter 7 trustees have "little to do besides filing claims that if resisted he may decide to sue to enforce." In this context, Judge Posner opined that:

> Judges must therefore 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 a frivolous suit. The Bankruptcy Code forbids reimbursing trustees for expenses incurred in actions not reasonably likely to benefit the debtors estate, 11 U.S.C. 330(a)(4)(A)(ii)(I), and authorizes an appropriate sanction against parties who file such a claim. Bankruptcy Rule 9011(b)(2), (c)(1)(B); *In re Bryson*, 131 F.3d 601, 603-04 (7th Cir. 1997); *In re Cohoes Industrial Terminal, Inc.*, 931 F.2d 222, 227 (2d Cir. 1991).



Judge Posner expressed his apparent dissatisfaction with the instant case, stating: "Not 'reasonably likely to benefit the debtors estate' may well be a correct description of this suit."

The ink on the courts opinion of March 21, 2008 was still damp when on April 4, 2008, KPMG filed its motion for sanctions in the Seventh Circuit. By April 8, 2008, Maxwell was ordered to respond. And on April 9, 2008, KPMG filed its motion for leave to file a motion for sanctions in the district court. It is difficult to evaluate the record in the district court since much of it is maintained under seal.

***Taxman Clothing* is highly pertinent not only because of Judge Posners risk-reward theory of bankruptcy litigation, but also because of his analysis of the trustee-attorney relationship.**

The Judge

Some context here is appropriate. Judge Richard Posner has served on the Seventh Circuit Court of Appeals in Chicago since 1981, and written several thousand opinions during that time.[6] Judge Posner has previously weighed in on his view of bankruptcy proceedings and bankruptcy trustees in *In re Taxman Clothing Corp.*[7] There, the Court had the unpleasant task of addressing a request for fees by an attorney who had previously sought and received $85,000 in interim compensation while on a quest to recover $61,000 in preferences.

Taxman Clothing is highly pertinent not only because of Judge Posners risk-reward theory of bankruptcy litigation, but also because of his analysis of the trustee-attorney relationship. Of initial interest here is Judge Posners game-theory analysis of litigation. He states:

> Litigation is a gamble, and a failed gamble can often produce a large net loss even if it was a good gamble when it was made. Suppose that Aimen had been seeking to recover not $ 33,000 but $330,000 and that he had had a 90 percent chance of winning a judgment for that amount and successfully defending the judgment in this court. An expenditure of $85,000 in attorney's fees would not be unreasonable when the expected benefit was $297,000 ($ 330,000 x .9), so if the attorney performed competently but simply was unlucky and lost he would have a good claim for his fees, just as if he had been hired on a noncontingent basis to handle a comparable litigation outside of bankruptcy. See generally *In re Central Ice Cream Co.*, 841 F.2d 732 (7th Cir. 1988).
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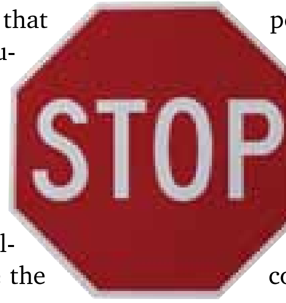
> Indeed, one can imagine a case in which the total attorney's fees would at the end of the day exceed the potential gain from the suit yet have been reasonably incurred. This is just to say that a risk prudently incurred may still turn out badly. Suppose in our hypothetical case that the attorney for the estate was on the verge of winning the $330,000 that he sought, having incurred $60,000 in attorney's fees so far. Unexpectedly the defendants produce surprise witnesses whose testimony threatens to demolish the estate's case unless countered at great expense. It will cost the estate $280,000 in additional attorney's fees to win, though if it incurs those costs victory is assured. Should the attorney abandon the suit because the total costs are certain to exceed the gain? He should not. If he abandons the suit, the estate will have incurred a net loss of $60,000, the costs incurred to date. If he incurs the additional costs required for victory, the net loss will be reduced to $10,000 ($280,000 + $60,000 - $330,000).

In *Taxman Clothing Corp.* Judge Posner expressed no criticism of the trustee, Eugene Crane. Rather, he focused his concern upon the trustees attorney, Philip Aimen:

> Aimen was not a wind-up toy set in motion by the trustee. He had an independent fiduciary duty to the estate. As soon as it became clear that the preference suit could not yield the estate a net gain, he should have taken the necessary steps to drop it. We need not speculate about what he should have done if he had tried to stop and the trustee had ordered him to continue, *In re Drexel Burnham Lambert Group, Inc.*, 133 Bankr. 13, 23 (Bankr. S.D. N.Y. 1991), or if he had been acting under a court's order. See *Yadkin Valley Bank & Trust Co. v. McGee,* 819 F.2d 74, 76 (4th Cir. 1987).

Judge Posner in *Maxwell v. KPMG* again utilized his game-theory analysis of litigation, this time, to demonstrate that trustees have to consider the consequences of pursuing high-risk but high-reward litigation, stating:

> We are particularly disturbed by the damages claim. It is not only groundless, as we have seen; it is intimidating, because of its size. Nor is it a good plea that yes, the damages claim of $626 million is preposterous, but suppose that therefore the probability of its succeeding is only 1 in 1000; well, .001 $626 million is $626,000, and that expected value of suing may exceed the cost of the suit to the bankrupt estate. There is something wrong with this reasoning. For if .001 is too high an estimate, the trustee can up his damages claim to $6.26 billionthe probability of success will be even lower, but even if it is only 1 in 10,000 (and how exactly would one demonstrate that it is less?), the expected value of suing will still be $626,000. A frivolous appeal has some chance of success: lightning may strike, or the law may change while the appeal is pending; and a trustee who succeeds in obtaining a judgment will share in it. 11 U.S.C. 326(a), 330.



The Maxwell court, at least in dictum, distinguishes the role of the bankruptcy trustee from the role of others exercising normal business judgment. Since the trustee is a liquidator, the trustee has no interest in on-going business relations or dealings with potential defendants. Accordingly, the trustee must have particularly sound reasons for suing anyone.

So if the probability of success is too low, then the suit is, *a fortiori* frivolous. And since frivolous suits are forbidden, frivolous suits invite sanction.

In contrast to his opinion in *Taxman Clothing Corp.*, where Judge Posners displeasure was directed to the trustees attorney, in *Maxwell* it seems to be directed to the trustee. In *Maxwell*, Judge Posner concluded:

> We note, therefore, that the defendant can file a motion in the district court for an award of reasonable attorneys fees, *In re Roete*, 936 F.2d 963, 966-67 (7th Cir. 1991) (of course to be paid by the trustee personally, not by the bankrupt estate), and a corresponding motion in this court under Fed. R. App. P. 38. *We do not, however, prejudge the outcome of either type of motion*. (emphasis added).

It would seem that in *Maxwell*, Judge Posner has diverged from his prior opinion in *Taxman Clothing Corp.* where he held that the trustees attorney was not a wind-up toy set into motion by the trustee but rather an independent fiduciary of the estate. In *Maxwell,* the court invited KPMG to sue Maxwell, and not the lawyers who pursued the claim for the trustee, notwithstanding the fact that under *Taxman Clothing Corp.,* the firm had an independent fiduciary obligation to the estate of marchFIRST, and as soon as it became clear that the adversary proceeding had no net benefit to the estate, was obligated to drop it.

Implications for Trustees

The *Maxwell* court, at least in dictum, distinguishes the role of the bankruptcy trustee from the role of others exercising normal business judgment. Since the trustee is a liquidator, the trustee has no interest in on-going business relations or dealings with potential defendants. Accordingly, the trustee must have particularly sound reasons for suing anyone.

But bankruptcy litigation is often contingent and risky. Bankruptcy trustees do not often have much in the way of assets with which to pursue litigation. The liquidation of a distressed debtor requires as much, if not more, creativity and risk-taking as the management of a healthy entity. Bankruptcy courts should be no more willing to second guess competent, disinterested trustees and debtors-in possession than other courts are willing to second guess competent, disinterested directors.

Bankruptcy trustees, like corporate directors, are fiduciaries. Fiduciaries owe three basic duties to their constituents: the duty of care (*i.e.*, the obligation not to act negligently), the duty of loyalty (*i.e.*, the obligation not to act in the fiduciarys own interests), and the duty of obedience (*i.e.*, the obligation not to act outside of the fiduciarys permitted authority). Whether these three duties have been met is the essence of any inquiry concerning the propriety of a fiduciarys actions.

The Sixth Circuit Court of Appeals, in *Ford Motor Credit Company v. Weaver*, 680 F.2d 451 (6th Cir. 1982), set forth the circumstances under which a trustee may be held accountable:

> A trustee in bankruptcy may be liable for violations of his fiduciary duties. A trustee in bankruptcy can be liable in his official capacity or individually. A bankruptcy trustee is liable in his official capacity for acts of negligence. The applicable standard is the exercise of due care, diligence and skill both as to affirmative and negative duties. The measure of care, diligence and skill required of a trustee is that of an ordinarily prudent man in the conduct of his private affairs under similar circumstances and with a similar object and view. Mistakes in judgment cannot be the basis of a trustees liability in his official capacity. The failure to meet the standard of care, however, subjects the trustee to liability in his official capacity. *Id.* at 461-2 (citations omitted). *Cf. In re Cochise College Park, Inc.*, 703 F.2d 1339 (9th Cir. 1983) (holding that a trustee is also personally liable for negligent conduct).

Trustees naturally rely upon professionals, such as attorneys, accountants and financial advisors in order to help them determine whether to pursue litigation. Trustees, therefore, should view themselves as clients in this context. If trustees are pursuing litigation, they must be aware of the provisions of Bankruptcy Rule 9011, not in the context of attorney liability, but in the context of client liability.[8] Best practice would suggest that the extent of due diligence in compliance with Bankruptcy Rule 9011 by a trustee will vary from case to case. However, best practice would also suggest that a Rule 9011 analysis ought to be performed prior to commencement of any adversary proceeding.

In big litigation, where the trustee is represented by outside counsel, the Trustee would be well served by a memorandum from counsel as to the legal basis for any claims as well as the evidentiary support for any factual allegations. The trustee, whether acting alone or through counsel, has a real advantage in having the ability to investigate with Rule 2004 examinations prior to commencing any adversary proceeding and so should have a good opportunity to develop sufficient evidentiary support prior to commencing any adversary case.

In light of the harsh consequences suggested by the Seventh Circuit in *Maxwell v KPMG,* a trustee who considers pursuing substantial but risky litigation ought to be confident that he has had competent counsel willing to vouch for the merit of the claim and substantial evidence to support the claim. In so doing, the trustee will have made reasonable inquiry under the circumstances and will have gone a long way to protect himself or herself against the potential for substantial personal liability.

Editor's Note: *On April 22, 2008, Ron Peterson and Jenner and Block were employed as special counsel to Andrew Maxwell in this case to respond to the various motions for sanctions in the Seventh Circuit. In addition, Steven Towbin and two of his partners from Shaw Gussis filed appearances for Mr. Maxwell personally in the bankruptcy case on April 23, 2008.*

Footnotes:

1 —F 3rd — , 2008 WL 746849, 49 Bankr.Ct.Dec. (7th Cir. 2008).

2 Andrew Maxwell has been an attorney for 31 years and a trustee for 23 years. Just prior to his appointment as Trustee in marchFIRST, he had served with distinction as Products Liability Trustee in *Pettibone* where the bankruptcy judge recognized the excellent results he had achieved in that case. *In re Pettibone Corp.* 244 B.R. 906, 910 (Bankr. N. D. IL 2000).

3 The firm of Williams Montgomery & John focuses on litigation. The attorney who led the litigation in *Maxwell v. KPMG*, Steven Roeder, was co-lead counsel in an auditing malpractice claim against Pricewatershouse Coopers, LLP and Arthur Andersen, LLP, on behalf of the City Colleges of Chicago. *See* http://www.willmont.com/bio/StevenRoeder.asp. While Andersen settled before trial for a confidential amount, the jury awarded more than $13 million in damages against PricewaterhouseCoopers, at that time the largest reported audit malpractice jury verdict in Illinois. Ultimately, that judgment was affirmed by the Illinois Supreme Court.

4 28 USC 157(d); and Fed. R. Bankr. Pro. 5011.

5 The damage calculation is explained in the district courts opinion granting summary judgment in favor of KPMG as follows:

The Trustees damages expert calculates damages as follows.

Maxwell, as Trustee, offers the value of marchFIRST on April 12, 2001 (the date of bankruptcy), based on his estimates of what the liabilities and assets of the company were on that date. Maxwell asserts that the fair value of the debtors business on the date of bankruptcy was negative $93.6 million. Marcus, the Trustees damages expert, offers two figures. First, he estimates the value of Whittman-Harts stock on the day before the merger (February 29, 2000 valuation) had the accounting malpractice not occurred. Based on this value, he created a peer group stock index, using eight comparable companies, to estimate the value of Whittman-Hart had it not merged with USWeb and continued instead as a stand alone company (April 12, 2001 valuation). Marcuss index shows that comparable companies declined 70% in stock value over the observed time. Thus, he concludes that the stock market value of a hypothetical stand alone Whittman-Hart on April 12, 2001, (the date of bankruptcy) would have been $535 million. The total damages in this case are estimated to be the difference between this number and negative $93.6 million, the number that Maxwell opines is the value of marchFIRST on April 12, 2001. This leaves KPMG responsible for the $628.6 million difference that was caused by the merger.

6 http://www.projectposner.org/ about/posner.

7 49 F.3d 310 (7th Cir. 1995).

8 Bankruptcy Rule 9011 provides:

By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances,

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;

(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;

(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and

(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

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