No. 10-1306

IN THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

GRANT THORNTON LLP,
Appellant – Cross-Appellee,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION,
Appellee – Cross-Appellant.

On Appeal from the United States District Court
for the Southern District of West Virginia

Honorable Judge David A. Faber, District Judge
Case Nos. 1:00-cv-00655 & 1:03-cv-02129

REDACTED OPENING PROOF BRIEF FOR GRANT THORNTON LLP

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Fed. R. App. P. 26.1 and Local Rule 26.1, Appellant – Cross-Appellee Grant Thornton LLP (the "party") makes the following disclosure:

(i) The party is not a publicly held corporation or other publicly held entity;

(ii) The party does not have any parent corporations;

(iii) No publicly held corporation or other publicly held entity owns 10% or more of the stock of the party;

(iv) No other publicly held corporation or other publicly held entity has a direct financial interest in the outcome of the litigation;

(v) The party is not a trade association;

(vi) This case does not arise out of a bankruptcy proceeding.

Dated: June 9, 2010

By: /s Stanley J. Parzen

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JURISDICTIONAL STATEMENT

The district court's jurisdiction over this action by the Federal Deposit Insurance Corporation ("FDIC") as receiver for the First National Bank of Keystone ("Keystone" or "the Bank") was predicated on 28 U.S.C. § 1345. The district court entered final judgment on March 10, 2010. Dkt. 646. Grant Thornton filed a notice of appeal on March 15, 2010. Dkt. 647. The FDIC cross-appealed on March 19, 2010. Dkt. 652. This Court's jurisdiction rests on 28 U.S.C. § 1291.

ISSUES PRESENTED FOR REVIEW

This appeal arises from the insolvency and eventual closing of Keystone. Keystone became insolvent because of unprofitable securitization transactions, but its officers and directors disguised its financial condition by falsifying its books and records. The FDIC and Office of the Comptroller of the Currency ("OCC") failed to discover the fraud despite multiple investigations and intensive oversight. Grant Thornton LLP ("Grant Thornton") audited Keystone's last set of financial statements but also failed to uncover management's fraud. After regulators finally learned that the Bank had been insolvent for years, they closed it. The FDIC then sued Grant Thornton, claiming that the Bank would have been closed earlier but for Grant Thornton's negligent failure to discover the fraud.

This appeal presents the following issues:

1. Whether the trial court erred in (a) ruling that Grant Thornton's failure to detect the fraud proximately caused Keystone's operating losses, including interest paid to depositors, from the audit's completion until the Bank closed; and (b) refusing to consider Grant Thornton's argument that post-audit misconduct by Keystone management was an intervening cause that cut off Grant Thornton's liability.

2. Whether the trial court erred in precluding Grant Thornton from raising defenses or counterclaims based on Keystone management's conduct, including its interference with the audit, on the ground that the actions and knowledge of the Bank's officers and directors could not be imputed to the FDIC.

3. Whether, under West Virginia law, Grant Thornton was entitled to a credit reflecting the full face amount of the FDIC's $22 million settlement with a joint tortfeasor.

STATEMENT OF THE CASE

Grant Thornton was retained by Keystone about a year before the Bank closed, when the fraud had been ongoing for years and the Bank was already deeply insolvent. After the Bank closed, the FDIC, as Receiver for Keystone, sued Grant Thornton for professional malpractice, contending that it had negligently "failed to discover that Keystone was overstating its loans by $500 million." Dkt.

12, ¶ 116.[1]

Holding that the actions of Keystone management could not be imputed to the FDIC, the trial court struck Grant Thornton's affirmative defenses and dismissed its counterclaims asserting breach of contract, negligence, negligent mispresentation, and fraud by Keystone management. Dkts. 1044 and 1060 in 2:99-0992. It also refused to allow Grant Thornton to seek contribution from Keystone's outside counsel Kutak Rock, LLP ("Kutak"), holding that the FDIC's $22 million settlement with Kutak extinguished Grant Thornton's contribution claim. Dkt. 288 at 3.

In 2004, the district court conducted a bench trial addressing the claims of both the FDIC and Gary Ellis, who contended that he had relied on the audit report in accepting employment as Keystone's President. In March 2007, the district court held Grant Thornton liable to the FDIC and Ellis for $25,080,777 and $2,419,233, respectively. Dkt. 540. This Court reversed the judgment for Ellis, concluding that Grant Thornton did not owe him any duty. *See Ellis v. Grant Thornton LLP*, 530 F.3d 280 (4th Cir. 2008).

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[1] The FDIC asserted its claims against Grant Thornton by filing counterclaims in *Grant Thornton v. FDIC*, No. 1:00-0655, and a complaint in intervention in *Gariety v. Grant Thornton, LLP*, No. 2:99-0992. The court subsequently severed the FDIC's claims against Grant Thornton from the other claims in *Gariety*, assigned a new case number to those claims (No. 1:03-2129); and consolidated them for trial with the FDIC's claims in No. 1:00-0655. *See* Dkt. 1 in 1:03:2129. Unless otherwise indicated, the docket numbers referenced herein are in No. 1:00-0655.

The district court delayed entry of judgment on the FDIC's claims pending determination of the amount, if any, of the credit to be provided to Grant Thornton for the Kutak settlement. Dkt. 541. After conducting an evidentiary hearing on that issue in November 2007 (Dkt. 615, 617-18, 626), the district court on March 10, 2010, held that Grant Thornton was entitled to a settlement credit of $1,343,750 plus 8.563% of any future payments from Kutak. Dkt. 645–46.

STATEMENT OF FACTS

A. The Fraud at Keystone

Keystone was a small community bank until 1992, when it began securitizing high loan-to-value mortgage loans. Dkt. 540 ¶ 5. Keystone would acquire and pool the loans, sell interests in the pool to investors, and retain a subordinated residual interest. *Id*. These transactions "proved highly unprofitable" due to the risky nature of the underlying loans and their high default rate. *Id.* ¶ 7. According to an FDIC expert, the Bank was hundreds of millions of dollars insolvent by December 1996, several years before Grant Thornton's appearance. 5/27/04 Tr. 40-41.

The Bank's managers "concealed the failure of the securitizations by falsifying the Bank's books." Dkt. 540 ¶ 7. They made "[b]ogus entries" in the bank's financial records, prepared "bogus documents" such as "false remittance reports," "booked false credits to interest income," and "booked false debits to

loans to fraudulently inflate assets and capital." *Id.* ¶¶ 7-8. They created "fraudulent entries" to carry more than $500 million of loans on the Bank's books that should have been removed after they were securitized and sold. *Id.* ¶ 9. And they "embezzled large sums from the Bank, covering their theft with other false entries in the Bank's books." *Id.* ¶ 7.

The fraud at Keystone remained hidden for years despite intense regulatory oversight. From 1992 through 1999, the OCC conducted eight safety and soundness examinations and one FHA Title I mortgage examination at Keystone. The FDIC participated in three of those examinations. GT Ex. 22 at 6-12. In 1997, the OCC took a "hard look" at the Bank, deploying a highly experienced 15-member team of examiners, including a fraud specialist, and certified public accountants, to work on the Keystone examination. 6/4/04 Tr. 131-32. They did not find the fraud.

B. Grant Thornton's Audit of Keystone[2]

1. The Keystone Engagement

In May 1998, the OCC required Keystone to "take specific steps to improve its regulatory and financial condition," including "retaining a nationally recognized independent accounting firm." Dkt. 540 ¶ 12; FDIC Ex. 64. On September 10,

---

[2] Grant Thornton submits that, in light of the pervasive fraud and wholesale efforts by management to conceal the fraud, the lower court's finding of negligence was wholly unwarranted. Nevertheless, we do not ask this Court to set aside that finding.

1998, Grant Thornton agreed to audit the Bank's financial statements as of December 31, 1998. The engagement letter stated:

> [A]n audit is not a special examination designed to detect defalcations or fraud, nor a guarantee of the accuracy of the consolidated financial statements and is subject to the inherent risk that errors, irregularities, or other illegal acts, if they exist, might not be detected. However, if you wish us to direct special auditing procedures to such matters, we would be pleased to work with you to develop a separate engagement for that purpose.

FDIC Ex. 96 at 2. Neither Keystone nor the OCC asked Grant Thornton to conduct a fraud audit.

On October 22, 1998, Grant Thornton separately agreed to undertake certain "agreed upon procedures" at the Bank. FDIC Ex. 101. The OCC finally approved this undertaking only three weeks before the Bank closed. GT Ex. 741 at 111-12, 131-32. The district court imposed no liability for this engagement.

2. The Keystone Audit

Grant Thornton began field work for the Keystone audit late in 1998 and issued its audit report in April 1999. During the audit, Keystone provided Grant Thornton with numerous documents that misstated Keystone's loan balances (*see* Dkt. 540 ¶¶ 25, 29-31); and the Bank indisputably lied in its management representation letter to Grant Thornton (GT Ex. 1.G). In concluding that Grant Thornton should have discovered the fraud despite this interference, the court focused principally on two decisions that, according to the FDIC, led the auditors

to miss that Keystone was overstating its assets.

First, the court criticized Grant Thornton employee Susan Buenger (who along with Grant Thornton partner Stanley Quay performed most of the work on the audit) for performing an "analytic test" of Keystone's interest income rather than a "test of details." Dkt. 540 ¶¶ 26-28. Buenger compared Keystone's reported interest income to its reported average balance of outstanding loans, calculated an annual yield, and then compared it to the industry yield on similar loans. *Id.* ¶ 28. Some of the Keystone documents upon which Buenger relied in performing her analysis were inaccurate. *Id. ¶¶* 29-31. The district court found that Buenger instead "should have tested Keystone's interest income for 1998 by reviewing the remittance records of interest income for 1998*.*" *Id.* ¶ 39. Had she done so, the court concluded, "it is more likely than not she would have discovered the loan inventory fraud in March, 1999," leading to the Bank's earlier closing. *Id.* ¶ 40.

Second, the court focused on Buenger's efforts to obtain confirmation of Keystone's loan portfolio from the Bank's third-party loan servicers. At the end of 1998, most of Keystone's loans were serviced by Compu-Link Loan Service ("Compu-Link") and Advanta Mortgage Corp. USA ("Advanta"). Keystone's records indicated that, as of December 31, 1998, Compu-Link and Advanta were servicing Keystone-owned loans totaling approximately $227.2 million and $242.6

million, respectively. GT Ex. 1.D. Keystone provided extensive documentation indicating that it owned these loans. *See, e.g.,* FDIC Ex. 230; FDIC Ex. 165 at 3; GT Ex. 1.D; 6/2/04 Tr. 23-24; 6/8/04 Tr. 189-90. In fact, however, Compu-Link and Advanta together were servicing only approximately $20 million in Keystone loans; United National Bank actually owned the other loans claimed by Keystone. 5/21/04 Tr. 21; Dkt. 540 ¶ 50.

Buenger sent confirmation requests to Keystone's servicers, including Compu-Link and Advanta. 6/2/04 Tr. 7-10. The requests clearly indicated that they were for an audit of Keystone, and instructed each servicer to provide Grant Thornton with the balances of loans that it was servicing as of December 31, 1998. GT Ex. 1.E & 1.F.

Compu-Link was servicing approximately $14 million of Keystone loans but confirmed in response to Buenger's inquiry that "the total balance of Keystone loans serviced by Compu-Link Loan Service as of December 31, 1998 was $227,168,296." FDIC Ex. 647. That figure precisely matched the false Compu-Link balance that Keystone was reporting in its financial records. 6/2/04 Tr. 13-16; GT Ex. 1.D. The FDIC largely ignored this confirmation response at trial, as did the district court in its Findings of Fact and Conclusions of Law.

With respect to the Advanta confirmation response, there was no dispute at trial that Advanta provided Buenger with two loan balances which totaled $242.6

million, identical to the fraudulent number shown on Keystone's books. The parties disputed, however, whether Advanta had represented that the larger of the loan balances belonged to Keystone.

On March 15, 1999, Buenger contacted Patricia Ramirez of Advanta, the Investor Reporting Manager for the Keystone account, to request a confirmation response. Dkt. 540 ¶ 51; 6/2/04 Tr. 18-19; GT Ex. 1.C. Ramirez arranged for Buenger to be sent a statement indicating that Advanta was servicing approximately $6.3 million of loans for Keystone. Dkt. 540 ¶ 50; 6/2/04 Tr. 21;GT Ex 1.B at 2. Noting the discrepancy between what Keystone was reporting and the Advanta statement, Buenger called Ramirez to ask if there was "anything else." 6/2/04 Tr. 27.

Ramirez then sent Buenger an e-mail indicating that Advanta was servicing approximately $236.2 million of additional loans—a sum that corresponded to the difference between the $242.6 million that Keystone was reporting and the $6.3 million that Advanta had confirmed initially. Dkt. 540 ¶ 61; GT Ex. 1.B. at 2; 6/2/04 Tr. 28-29. The e-mail listed the "Investor Name" as "United National Bank." Dkt. 540 ¶ 61; GT Ex. 1.B. at 2. Buenger testified that Ramirez had told her during their telephone conversation that "the loans coded under the 'United' name actually belonged to Keystone as of December 31, 1998." GT Ex. 1.B at 1; 6/2/04 Tr. 28-29, 32-34. And, as noted above, other information (fraudulently)

provided by the Bank to Grant Thornton supported Keystone's ownership of these loans.

Ramirez did not recall the conversation with Buenger but claimed that she "never would have made the remarks Buenger has attributed to her" (Dkt. 540 ¶ 71) because she knew that the loans belonged to United, not Keystone (*id.* ¶ 71). Other Advanta employees, however, admittedly *were* confused about the ownership of these loans. 5/18/04 Tr. 32-34. Furthermore, it was undisputed that it violated industry practice and Advanta policy to respond to a confirmation request from one bank with loan balance information for another bank (6/2/04 Tr. 32; FDIC Ex. 896 at 98-100), yet Ramirez could not explain why she would have sent United information to Keystone's auditor. *See id.* at 224 (testimony of Ramirez that "[y]our speculation is as good as mine" about why she sent her e-mail to Buenger). Tellingly, the trial court made no factual findings on this issue.

According to the trial court, however, "Buenger should have called Ramirez back after receipt of the e-mail to determine why the e-mail reflected that the loans were owned by United and requested that Ramirez confirm in writing that the $236 million in loans were owned by Keystone." Dkt. 540 ¶ 64. In the court's view, "[i]f Buenger had followed GAAS and promptly investigated the $236 million discrepancy, she would have discovered the fraud, which would have led to the closure of the Bank." *Id.* ¶ 58.

In April 1999, Grant Thornton issued and delivered to Keystone's Board of Directors its audit report stating that Keystone's financial statements were fairly stated in accordance with GAAP. *Id.* ¶ 82.

C. The Discovery of the Fraud and Closure of Keystone

In late June/early July of 1999, the OCC began an examination of Keystone. Dkt. 540 ¶ 97. During the examination, the Bank's managers "made several efforts to have Advanta and Compu-Link respond to the OCC with information on loans owned by United as well as Keystone, in order to keep the fraud concealed." *Id.* ¶ 99. Bank examiners also learned "that Keystone had the ability to manipulate servicer data and servicer reports that, while appearing to come directly from the servicers, were actually prepared by the Bank." *Id.* ¶ 101. In late August 1999, the examiners finally learned from Compu-Link and Advanta that they were servicing only about $36 million in Keystone loans. *Id.* ¶¶ 102-04. Examiners thus concluded that "the Bank's books overstated the loans it owned by approximately $515 million." *Id.* ¶ 104. On September 1, 1999, the Bank was closed. *Id.* ¶ 129.

D. Proceedings Below

1. Liability and Damages

In response to the FDIC's complaint, Grant Thornton raised multiple affirmative defenses—including contributory negligence, *in pari delicto*, fraud and

breach of contract—based upon the misconduct of Keystone's officers and directors and their direct interference with the audit. Dkt. 766 in 2:99-0992. It also asserted counterclaims against the FDIC for breach of contract, negligence, fraud, and negligent misrepresentation. Dkt. 767 in 2:99-0992. The FDIC moved to strike Keystone's affirmative defenses and to dismiss its counterclaims, arguing that such defenses cannot be asserted against the FDIC when it sues as receiver for a failed bank. Dkts. 803 and 822 in 2:99-0992. The trial court granted both motions (Dkts. 1044 and 1060 in 2:99-0992), holding that Grant Thornton "may not impute to the FDIC the knowledge or conduct of Keystone Bank's officers" for the purpose of asserting these claims or defenses (Dkt. 1060 at 2-3 (quoting Dkt. 880 in 2:99-0992, at 13)).

At trial, the FDIC contended that Grant Thornton should have discovered the fraud by October 31, 1998, and was liable for Keystone's net expenditures from that date until the Bank closed, which totaled $62 million. Much of that sum ($47 million) was interest on the Bank's deposits (GT Ex. 700-A; 5/24/04 Tr. 68); the remainder included salaries, retirement plan contributions, advertising, professional fees, dividends, and routine expenses such as office supplies, telephone services, and postage (*id.* at 58-64). The FDIC's damages expert conceded that Grant Thornton had no role in accepting deposits, setting salaries, establishing professional fees, awarding dividends, or determining the Bank's other

expenditures. *Id.* at 63-64, 71, 81-82. The FDIC claimed damages solely on the ground that the discovery of the fraud would have led the Bank to close before the expenditures were made.

The trial court found "no factual basis" for the FDIC's contention that Grant Thornton should "have uncovered the fraud" by October 31, 1998. Dkt. 540 ¶ 165. It concluded, however, that Grant Thornton should have discovered the fraud and insolvency by April 19, 1999 (the date of its audit report), and that, had it done so, the bank would have closed two days later. *Id.* at 82. Thus, Grant Thornton was liable for all "expenses [of the Bank] that would not have been incurred if the Bank had been closed as of April 21, 1999, offset by revenues and appropriate credits received during the same period." *Id.* Rejecting Grant Thornton's arguments that it had not proximately caused these expenditures, the court held that "'but for' Grant Thornton's gross negligence, the FDIC would have avoided $25,080,777 in losses." *Id.* That figure included approximately $20 million in interest paid to the Bank's depositors. GT Ex. 700-A; 5/27/04 Tr. 68.

2. Settlement Credit

Before the trial, Grant Thornton sought leave to file a contribution claim against Kutak. Dkt. 645 ¶ 22. On May 20, 2003, however, the FDIC and Kutak settled all Keystone-related claims, stipulating that they had "a total settlement value of at least $22 million." GT Ex. 507 ¶ 29; Dkt. 645 ¶ 15. The trial court

subsequently held that "Grant Thornton's contribution claims against Kutak Rock have been extinguished" by the settlement. Dkt. 288 at 3.

Grant Thornton argued that, under West Virginia law, it was entitled to a $22 million settlement credit because (1) Kutak was jointly responsible for the operating losses for which Grant Thornton had been held liable and (2) the settlement agreement did not allocate the proceeds among joint and alleged non-joint claims. *See*, *e.g.*, Dkt. 565 at 2-3, 9-11. The FDIC insisted that *no* settlement credit was appropriate because it had planned to sue Kutak only for damages associated with Keystone's securitizations, for which Grant Thornton was not jointly liable. *See, e.g.*, Dkt. 560 at 25; Dkt. 576 at 3.

As a fallback, the FDIC argued that "the court [sh]ould, through independent allocation, determine the amount actually paid for overlapping damages." Dkt. 576 at 12. The FDIC also insisted that any credit should be based on "the amount actually recovered" from Kutak, rather than the full value of the agreed settlement. *Id*. at 13–14. Over Grant Thornton's objections, the district court ordered "a hearing of not more than four days" to "determin[e] … the credit to be given Grant Thornton for the FDIC's settlement with Kutak Rock." Dkt. 563.

During the discovery that preceded the settlement credit trial, the FDIC maintained that it had "not even considered a claim … for the operating losses" against Kutak. Dkt. 560 at 25. The FDIC completely reversed course after the

court ordered it to produce *in camera* its July 3, 2002 Authority to Sue Memorandum and draft complaint against Kutak. Dkt. 616 (sealed). When it turned over the documents, the FDIC filed a "Notice of Corrected Testimony" admitting that it "did consider claims against Kutak for $91 million in operating losses (including the $25 million for which Grant Thornton has been found liable) and that those operating loss claims were in fact recommended and approved by the FDIC for filing." Dkt 610 at 1.

[REDACTED]

During the hearing regarding the allocation of the Kutak settlement, the FDIC contended that Kutak's liability greatly exceeded Grant Thornton's and that only 6.9% of the $22 million settlement should be allocated to the overlapping damages. Dkt. 623 ¶¶ 53, 55. Grant Thornton argued that the FDIC had failed to sufficiently establish its claim against Kutak for damages arising from the securitizations and that the entire $22 million settlement should be allocated to the overlapping operating expense damages.

More than two years later, the district court issued supplemental findings and conclusions granting Grant Thornton a $1.3 million settlement credit. Dkt. 645. The court made detailed findings with respect to Kutak's critical role in Keystone's unprofitable securitization program and its repeated failures over several years to disclose to Keystone's Board of Directors or to regulators evidence of management misdeeds. The court concluded that (i) "Kutak is responsible for $292,899,685.20 in damages" to the FDIC, including operating losses (*id*. at 41); (ii) Kutak's liability for operating losses "includes the $25,080,777 in operating losses that the court calculated as damages against Grant Thornton" (*id.* at 40); and (iii) "in determining a settlement credit to be given to Grant Thornton, the FDIC/Kutak settlement should thus be allocated proportionally to such damages" (*id.* at 41). Dividing 292,899,685 by 25,080,777, the court held that Grant Thornton was entitled to a 8.563% settlement credit. *Id.* at 61.

The court calculated the settlement credit based upon the funds actually received by the FDIC ($15,692,521), rather than the higher amount stipulated under the settlement agreement. The court held that Grant Thornton should receive an additional credit equal to 8.563% of any future payments made by Kutak to the FDIC under the agreement.

SUMMARY OF ARGUMENT

This case concerns an accounting firm that was engaged to audit a federally-insured bank that had been the subject of intense regulatory scrutiny for many years. Unbeknownst to the regulators who ordered Keystone to replace its prior auditors, Keystone senior management had long pursued a massive fraud. Bogus bookkeeping entries and wholesale falsification of bank records "hid the true financial condition of the Bank from the Bank's directors, shareholders, depositors, and regulators." Dkt. 540 ¶ 7. Government investigators later concluded that "[a]lleged fraudulent accounting practices, uncooperative bank management and reported high profitability may all have served to mask the bank's true financial condition from OCC examiners." *Gariety v. Grant Thornton LLP*, 368 F.3d 356, 360 (4th Cir. 2004).

The FDIC, which participated in overseeing Keystone, sought to impose on Grant Thornton massive liability for Keystone's losses. As Keystone's receiver, the FDIC "stands in the shoes" of the Bank in pursuing claims against Grant Thornton. Yet, at every turn, the district court stripped Grant Thornton of the fundamental protections that plainly would bar or limit the claims of any other West Virginia plaintiff. It adopted a "but for" causation theory that made Grant Thornton liable for every expenditure made by the Bank after Grant Thornton "should have" discovered the fraud. It held that the misconduct, negligence and

contractual breaches by Keystone's officers and directors, including their direct interference with the audit, are irrelevant when the FDIC sues, notwithstanding the critical role played by the doctrines of comparative negligence and *in pari delicto* under West Virginia law. And although Grant Thorton's contribution claim was extinguished by the FDIC's agreement to settle its claims against the law firm that later was found to have played a key role in the events at Keystone, the district court disregarded black-letter West Virginia law to deny Grant Thornton all but a miniscule settlement credit.

The trial court's rulings create a legal landscape for the FDIC that gives the agency immense power but bears little resemblance to West Virginia law. These rulings maximized the FDIC's recovery in this case, but did so at the cost of exposing auditors and others who serve federally-insured institutions to potentially limitless liability that is unbounded by ordinary principles of proximate causation and proportionate fault. If upheld, the judgment will discourage prudent service providers from future dealings with federally-insured institutions—particularly those most in need of audit services.

1. In ruling that Grant Thornton's auditing mistakes caused all of Keystone's losses until the Bank closed, the trial court jettisoned the proximate causation principles that ordinarily circumscribe negligence liability. The court found that the Bank's operating losses—mostly comprising interest paid to

Keystone's depositors—would not have occurred "but for" Grant Thornton's failure to discover the Bank's fraud and insolvency. But such "but for" causation—which suggests at most that Grant Thornton's conduct helped produce the occasion for the Bank's injury by allowing it to continue operating—does not create liability for damages under West Virginia law.

In short, the FDIC failed to establish that Grant Thornton's negligence *proximately* caused harm to Keystone. There was no relationship—much less the required direct relationship—between the audit report and Keystone's injuries. Keystone was *already* insolvent as a result of securitization losses and *already* held deposits on which it owed interest. The audit report neither caused the Bank's poor financial condition nor caused any expenditures to be made. The FDIC's novel causation theory effectively makes the auditor an insurer for a bank's future financial performance if it fails to recognize that the bank should close. The trial court's adoption of this theory—which would impose arbitrary and potentially breathtaking liability on auditors—violates West Virginia law and should be reversed.

Even if the FDIC's causation theory were accepted, however, the intentional misconduct of Keystone's managers *after* the audit severed the causal connection between the audit and Keystone's damages. Most notably, Keystone's management interfered with the OCC's efforts to obtain loan balance information

from the Bank's third-party loan servicers, delaying the Bank's closing by months. Contrary to the trial court's flawed rationale for rejecting Grant Thorton's intervening cause defense, such actions may defeat proximate causation even if they are not imputed to the plaintiff. Because the trial court erred in refusing to consider that Keystone management, not Grant Thornton, was responsible for keeping the bank open, the judgment must be reversed.

2. The trial court also erred in precluding Grant Thornton from raising affirmative defenses or counterclaims based on the conduct or negligence of Keystone's management. It was undisputed that Keystone's officers and directors repeatedly lied to Grant Thornton and otherwise interfered with the audit. Grant Thornton therefore had strong arguments for reducing or avoiding liability via the application of comparative negligence, *in pari delicto*, or similar doctrines. The trial court, however, held that Grant Thornton was barred from asserting any claims or defenses that involved the imputation of Keystone management's knowledge or actions to the FDIC.

The court was mistaken. The Supreme Court has made clear that the FDIC, when it sues as receiver, stands in the shoes of the failed entity. West Virginia law does not hold otherwise. Grant Thornton was therefore entitled to raise all defenses that could have been raised in a suit by Keystone itself—including

defenses, like comparative negligence, that would have assigned to Keystone its appropriate share of fault for the failure of the audit to detect the fraud.

3. The trial court also erred in deciding that Grant Thornton should receive a credit of only $1.3 million (plus a small percentage of any additional recovery) for the FDIC's $22 million settlement with Kutak. The FDIC ultimately conceded that Kutak jointly caused the $25 million in damages for which Grant Thornton was held liable. Under West Virginia law, "a prior settlement by one joint tortfeasor" extinguishes other tortfeasors' contribution claims, but also reduces the plaintiff's remaining claims "to the extent of *any amount stipulated by the release or the covenant*, or in the amount of the consideration paid for it, *whichever is the greater*." *Bd. of Educ. of McDowell County v. Zando, Martin & Milstead, Inc.,* 390 S.E.2d 796, 805 (W. Va. 1990) (emphasis added). That rule mandated that Grant Thornton be afforded a $22 million credit.

The FDIC contended that the settlement credit should be much smaller than $22 million because Kutak caused *greater* harm to the Bank than Grant Thornton did. The settlement agreement, however, failed to allocate between the damages for which Kutak alone allegedly was responsible and the joint damages for which Grant Thornton was later held liable. Under these circumstances, the non-settling defendant is entitled to a full credit, because it is neither feasible nor fair to the nonsettling defendant to allocate the settlement after the fact.

Moreover, the settlement credit should be based on the amount stipulated in the settlement agreement, not on the amount ultimately collected by the FDIC. Although Kutak settled for $22 million, the trial court calculated the credit as a percentage of the $15 million paid to date, and held that Grant Thornton would receive an additional credit only if and when additional payments were made. Under West Virginia law, however, a nonsettling joint tortfeasor is entitled to a credit equal to the "amount stipulated by the release or the covenant," or the "consideration paid," "whichever is the *greater*." *Zando*, 390 S.E.2d at 805 (emphasis added). The court's failure to apply West Virginia's clear rule necessitates reversal.

STANDARD OF REVIEW

This Court "review[s] the district court's legal determinations de novo and its factual determinations for clear error." *United States v. Kelly*, 592 F.3d 586, 589 (4th Cir. 2010). "Appellate review of a district court's interpretation or application of state law is *de novo*." *Bryte ex rel. Bryte v. American Household, Inc.*, 429 F.3d 469, 475 (4th Cir. 2005).

"Ordinarily, questions of negligence including proximate cause" are reviewed for clear error, but "where all the evidence relied on by a party is undisputed and susceptible of only one inference, the question of proximate cause becomes a question of law." *Harbaugh v. Coffinbarger*, 543 S.E.2d 338, 346

(W.Va. 2000); *see also Costello v. City of Wheeling*, 117 S.E.2d 513, 520 (W.Va. 1960) (same). In addition, this Court "review[s] *de novo* the district court's legal conclusions regarding the correct standard of proof for proximate cause." *Murray v. United States*, 215 F.3d 460, 463 (4th Cir. 2000).

A district court's decision to strike a defendant's affirmative defenses or dismiss its counterclaims is a purely legal issue that is reviewed *de novo.* *Kelly*, 592 F.3d at 589.

A district court's interpretation of state law regarding the calculation of a settlement credit is reviewed *de novo.* *See Nebraska Plastics v. Holland Colors America, Inc.*, 408 F.3d 410, 419 (8th Cir. 2005).

ARGUMENT

I. THE TRIAL COURT ERRED IN RULING THAT GRANT THORNTON PROXIMATELY CAUSED THE DAMAGES CLAIMED BY THE FDIC

The district court held that, because Grant Thornton failed to recognize the Bank's insolvency, it was liable for Keystone's net expenditures from two days after the audit was completed until the Bank closed. Dkt. 540 at 82. If accepted, the notion that the failure to discover a bank's pre-existing insolvency makes an auditor responsible for all future losses would represent a massive expansion of liability that would "ultimately result in more harm than good." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 n.32 (1976). In fact, the FDIC's causation theory

violates basic principles governing the scope of negligence liability. Under West Virginia law, the fact that a negligent act is a "cause-in-fact" of an injury "alone does not suffice" to establish liability. *Perry v. Melton*, 299 S.E.2d 8, 11 (W. Va. 1982). The plaintiff's injury must be a "direct and proximate result" of the defendant's breach of duty. *Keister v. Talbott*, 391 S.E.2d 895, 896, Syl. pt. 2 (W. Va. 1990).

Here, the Bank's losses were not caused by the audit, but were the result of its prior engagement in unprofitable securitizations and the imbalance between the Bank's income and its interest obligations. Moreover, any causal link between the audit and the Bank's losses was severed by Keystone management's subsequent affirmative actions to prevent others from discovering the fraud. Because Grant Thornton did not proximately cause the $25 million in damages attributed to it, the judgment must be reversed.

A. The FDIC's Claimed Damages Lack A Direct Relationship To, And Were Not The Foreseeable Result Of, Grant Thornton's Audit Report.

Under West Virginia law, there is a "clear distinction between the proximate cause of an injury and the condition or occasion of the injury." *Perry*, 299 S.E.2d at 11; *accord Wehner v. Weinstein*, 444 S.E.2d 27, 35 (W. Va. 1994). "[A] proximate cause of injury is a cause which, in a natural and continuous sequence, produces foreseeable injury and without which the injury would not have

occurred." *Hudnall v. Mate Creek Trucking, Inc.*, 490 S.E.2d 56, 61 (W. Va. 1997). By contrast, "[a]n act which merely furnishes the condition or occasion upon which injuries are received, but which does not put in motion the agency by or through which the injuries are inflicted, does not constitute the proximate cause of the harm." *Ente Nazionale Per L'Engergia v. Baliwag Navigation, Inc.*, 774 F.2d 648, 655-56 (4th Cir. 1985).

Further, the "injury suffered" must be "directly related" to the "claims … asserted against the defendants." *Lively v. Rufus*, 533 S.E.2d 662, 668 n.ll (W. Va. 2000). If the "kind of loss that occurred was not the kind" that the duty alleged to have been violated "was intended to prevent," there is no proximate causation. *Movitz v. First Nat'l Bank of Chicago*, 148 F.3d 760, 763 (7th Cir. 1998); *see also Matthews v. Cumberland & Allegheny Gas Co.*, 77 S.E.2d 180 (W. Va. 1953) (no proximate causation where plaintiff ran across road in effort to avoid injury from defendant's operations and was hit by a car).

1. The Bank's losses were not directly related to Grant Thornton's error.

a. The FDIC contended that "[i]f Keystone had been closed by April 21, 1999, the Bank could have avoided incurring $25,397,693 in expenses and operating losses … which would not have been incurred if the bank had been closed." Dkt. 493 ¶ 172. To derive that figure, the FDIC's damages expert Harry Potter used a "cash-out-the-door" methodology that he had never before employed

in a bank failure case. 5/27/2004 Tr. 97-99. Potter simply added up the Bank's outlays during the relevant period and subtracted income that would not have been earned had the Bank been closed. *Id.* at 40. "[S]ubstantially all" of "the bank's ordinary operating expenses"—including such mundane items as postage, office supplies, and phone calls—"were included in the calculations." 5/27/04 Tr. 58.

Potter conceded that "Grant Thornton had no role" in advising the Bank to make these payments. 5/27/04 Tr. 63-64; *see also id.* at 67 (Potter "didn't identify Grant Thornton conduct specific to a particular damage item."). Although interest on deposits made up the bulk of the damages, Potter acknowledged that most of the deposits were accepted before the audit (*id.* at 69) and that "Grant Thornton didn't have anything to do with" Keystone's acceptance of deposits (*id.* at 71). He also admitted that the Bank's insolvency pre-dated Grant Thornton's arrival (*id.* at 37-38) and that no embezzlement occurred during the audit or after the audit report was delivered (*id.* at 46-47).

Thus, there was no relationship, much less a direct one, between the alleged breach of duty by Grant Thornton—the failure to discover that Keystone's financial statements were inaccurate—and the alleged injuries. Keystone did not rely on the audit report to take deposits and then pay interest on those deposits; that obligation clearly predated the audit report. *See Lively,* 533 S.E.2d at 669 ("debts which the plaintiff was already responsible for regardless of the defendant's

actions" cannot be the "basis of recovery" from the defendant). Furthermore, the audit report did not facilitate any embezzlement or any transactions that harmed the Bank. Because Grant Thornton's audit report did not "put in motion the agency by or through which" the alleged damages were incurred (*Ente Nazionale*, 774 F.2d at 655-656), it is not liable for those damages.

The FDIC failed below to identify a single case that holds an auditor liable for a bank's ordinary operating losses on the basis that the bank would have closed had its insolvency been revealed. This is not surprising, because adoption of the FDIC's novel theory would expose auditors to unpredictable and potentially breathtaking liability. Under the FDIC's approach, any mistake by an auditor that prolongs a bank's life exposes the auditor to liability for all deposit interest, as well as every other expense, paid during the bank's continued existence. The magnitude of that exposure would be entirely arbitrary, varying according to the size of the bank, the time elapsing between the date when the insolvency should have been discovered and when it ultimately was discovered, and the bank's financial performance during that period. That liability might be crushing; but, if the bank profited because of a fortuitous change in its circumstances, there might be *no* damages. The arbitrary and uncontrollable exposure created by the FDIC's approach would make it difficult if not impossible for banks experiencing regulatory difficulties to obtain services from large accounting firms. *C.f.*, *e.g.*,

Central Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164, 189 (1994) (explaining that expansion of Section 10b-5 liability to professional service providers would may make it "difficult" for "newer and smaller companies" to "obtain advice from professionals").

b. In analogous contexts, courts have refused to hold auditors liable on the theory that a negligent audit was the "but for" cause of subsequent losses unrelated to the auditor's work. In *Askanase v. Fatjo*, 130 F.3d 657, 676 (5th Cir. 1997), for example, the court held that Ernst & Young did not proximately cause a corporation's losses even though it assumed that, but for the auditor's misrepresentations, the corporation "would not have continued to exist, could not have incurred more debt, and would not have lost more money." *Id.* Accordingly, the "alleged conduct did no more than furnish the condition that made the plaintiff's injury possible" (*id.*), and could not be used to "make Ernst & Young an insurer of [the audited corporation]." *Id.*

Proximate causation is also absent when the plaintiff claims that the auditor's negligence allowed an unprofitable transaction to occur, but does not demonstrate a relationship between the loss and the auditor's error. In *Maxwell v. KPMG LLP*, 520 F.3d 713, 716 (7th Cir. 2008), for example, the Seventh Circuit refused to hold an auditor liable for an unprofitable purchase, even though the transaction would not have occurred but for the auditor's negligence in auditing the

acquiring company's financial statements. As Judge Posner explained, the plaintiff could not "make its auditor the insurer against the folly (as it later turned out) of a business decision … unrelated to what an auditor is hired to do." *Id*. at 717; *see also*, *e.g.*, *Gasner v. Board of Supervisors*, 103 F.3d 351, 360 (4th Cir. 1996) (defendants entitled to summary judgment where plaintiffs alleged that they purchased bonds as a result of defendants' misrepresentations but failed to establish that there was "direct or proximate relationship between the loss and the misrepresentation").

In *Bloor v. Carro, Spandock, Londin, Rodman & Fass*, 754 F.2d 57,61-62 (2d Cir. 1985), the Second Circuit rejected the theory that a law firm was liable for losses caused by "mismanagement" and "looting" where "without [the law firm's] participation," the corporation "would have been unable to acquire the large amounts of money necessary to perpetrate and maintain the [f]raud." *Id*. at 62 (internal quotations omitted). The complaint was deficient because it "allege[d] only 'but for' causation and fail[ed] to show that [the corporation's] subsequent losses were caused by [the law firm's] actions." *Id.* Similarly, in *In re Parmalat Securities Litigation*, 421 F. Supp. 2d 703 (S.D.N.Y. 2006), the court rejected the theory that "because Deloitte USA did not correctly audit Parmalat USA's financial statements, the subsidiary was not subjected to further scrutiny and, in turn, broader attention was not brought to bear upon the (different) fraudulent

schemes taking place at [the parent]." *Id*. at 722. As it held, "[c]onduct that merely creates a condition that made the resulting injury possible is too remote to constitute legal cause." *Id.*

Here, too, the Bank's losses were totally unrelated to Grant Thornton's conduct. Grant Thornton did not undertake a duty to advise Keystone whether to close the bank or keep it open. *Maxwell*, 520 F.3d at 716. There was no evidence that the Bank "chang[ed] its position based on the incorrect financial statements." *Parmalat*, 421 F. Supp. 2d at 722. Grant Thornton had no role in the decisions and events (both before and after issuance of the audit report) that produced the Bank's net expenditures during the months in question. And it had nothing to do with creating the conditions underlying the Bank's precarious financial state. It simply failed to find a long-entrenched fraud, and thus the Bank remained open. "[W]hen one party's negligence simply furnishes a condition by which an injury is made possible, and that condition leads to an injury due to the later independent act of another party, the creation of the condition is held not to be the proximate cause of the injury." *Trustees of AFTRA Health Fund v. Biondi*, 303 F.3d 765, 783 (7th Cir. 2002).

In particular, Grant Thornton should not be required to reimburse the FDIC for interest paid to depositors prior to the Bank's closing. Most of the deposits were accepted before the audit; and the Bank received the use of the depositor's

funds in exchange for its interest payments. Under federal law, the interest obligation ceased once the FDIC closed the Bank; but the fact that the FDIC has the power to seize a bank, nullify its interest obligations, and return deposits does not mean that an auditor *causes* interest payments when it fails to trigger that dramatic event.

2. The Bank's losses were not foreseeable.

Under West Virginia law, a tortfeasor may be held liable only for the *foreseeable* harm that results from its conduct. *See Matthews*, 77 S.E.2d at 189 ("it must appear that the injury was the natural and probable consequence of the negligent act and that ought to have been foreseen in light of the attendant circumstances"). The district court found it "foreseeable to a reasonably prudent auditor that the failure to discover that the Bank has lost hundreds of millions of dollars and is hopelessly insolvent will result in a continuation of those losses." Dkt. 540 at 82-83.

The trial court employed the wrong analysis. In this context, whether the claimed injury was reasonably foreseeable to the auditor must be determined by examining the auditor's reasonable expectations at the time of the engagement. *Cf. Ellis*, 530 F.3d at 291 (auditor's liability to third parties determined by examining, "from the accountant's standpoint, what risks he reasonably perceived he was undertaking when he delivered the challenged report or financial statement");

North American Specialty Ins. Co. v. LaPalme, 258 F.3d 35, 41 (1st Cir. 2001) ("[T]he risk perceived by the accountant at the time of the engagement cabins the extent of the duty he owes to known third parties."). Grant Thornton was not asked to render an opinion on the Bank's solvency or provide advice on whether the Bank should continue in business. In fact, auditors may not give solvency opinions. *See* American Institute of Certified Public Accountants, *AT Section 9101: Attest Engagements Interpretations of Section 101*, 2.24-2.25. Therefore, a reasonable auditor in Grant Thornton's position would not have anticipated that the Bank's managers would rely upon the audit report as the basis for paying interest on deposits or incurring the routine expenses associated with keeping the Bank open.

Had either the Board or the regulators asked Grant Thornton to assist them in determining whether to shut the Bank, it could have negotiated appropriate liability limitations and proceeded with a full understanding of the risks. Instead, Grant Thornton was retained for the defined purpose of determining the accuracy of the Bank's financial statements. It was not foreseeable that a mistake in performing that task would make Grant Thornton the insurer for all of the Bank's future expenditures (including interest on pre-existing deposits) until the Bank closed.

3. The cases cited by the district court do not support finding proximate causation here.

In finding proximate causation, the trial court relied on *Lincoln Grain, Inc. v. Coopers & Lybrand*, 345 N.W.2d 300, 308-09 (Neb. 1984), and *Comeau v. Rapp*, 810 F. Supp. 1172 (D. Kan. 1992). Neither case supports the FDIC's causation theory.

In *Lincoln Grain*, the auditors investigated the accuracy of the valuations placed upon the inventory of Lincoln Grain's Iowa division. After the auditors signed off on the valuations, the company learned that an employee had falsified the valuations, and continued to do so after the audit, resulting in damages. The court found it to be "foreseeable that the negligent failure to detect falsifications will likely result in continued falsifications." 345 N.W.2d at 308-309. Thus, there was a direct relationship between the auditor's mistake and the resulting damages: the falsifications that the auditor missed led to further falsifications. Here, by contrast, the FDIC does not allege that the failure to detect the loan balance misstatements led to new frauds or that any embezzlement or other improper transactions occurred during the damages period (5/27/004 Tr. 46-47); the losses resulted strictly from the Bank's routine operations.

In *Comeau*, the FDIC alleged that an auditor failed to identify problems with loans purchased by a savings and loan from the Halle Mortgage Corporation. 810 F. Supp. at 1176. New purchases from Halle followed, causing additional losses.

As the court explained, "the inquiry is whether it was reasonably foreseeable to the Accountants that lending and or loan servicing practices of RCSA, if unchecked, could be expected to result in loan losses of the type sustained by RCSA." *Id.* at 1178. As with *Lincoln Grain*, the court's affirmative answer to that question in *Comeau* does not support the conclusion that the damages attributed to Grant Thornton were reasonably foreseeable here. Indeed, the court acknowledged that the "[a]ccountants would have a better argument if the loans for which the FDIC seeks recovery were purchased from someone other than Halle," because that would not be foreseeable. *Id*. at 1178 n.3. Here, the Bank's interest obligations and operating expenses were totally unrelated to the loan balance confirmation process, and it was not foreseeable that an error in that process would make Grant Thornton liable for all future Bank expenditures.

The trial court worried that, "[u]nder Grant Thornton's theory, an auditor would never be liable for performing a negligent audit." Dkt. 540 at 86. That is not so. For example, if Grant Thornton had wrongly stated that a particular transaction was profitable, and Keystone had subsequently engaged in similar transactions in reliance on the statements, then Grant Thornton might be liable for the related losses. *See*, *e.g.*, *Comeau*, 810 F. Supp. at 1178. Because the FDIC made no attempt to show that anything like this happened here, however, the judgment against Grant Thornton must be reversed.

B. The Misconduct Of Keystone's Management Was An Intervening Cause That Severed The Causal Connection Between The Audit And The FDIC's Damages.

Even if the FDIC's causation theory were otherwise plausible (and it is not), the judgment would have to be reversed because the trial court erroneously rejected Grant Thornton's intervening cause defense. Under West Virginia law, "a person charged with negligence in connection with an injury" is relieved of liability by "a negligent act, or omission, which constitutes a new effective cause and operates independently of any other act, making it and it only, the proximate cause of the injury." *Sydenstricker v. Mohan*, 618 S.E.2d 561, 568 (W. Va. 2005) (internal quotation marks omitted); *see also, e.g., Sergent v. City of Charleston,* 549 S.E.2d 311, 320 (W. Va. 2001) ("The proximate cause of the injury is the last negligent act contributing to the injury and without which the injury would not have occurred."). "Generally, a willful, malicious or criminal act" also "breaks the chain of causation" and functions as an intervening cause. *Id.* at 320.

Grant Thornton argued below that the willful acts of the Bank's corrupt managers broke any causal connection between the audit report and Keystone's subsequent operating expenses. *See* Dkt. 494 at 94-95. The district court rejected this intervening cause defense on the basis that, under *Cordial v. Ernst & Young*, 483 S.E.2d 248 (W. Va. 1996), management's actions could not be imputed to the FDIC. Dkt. 540 at 92-103. As we discuss below (at 41-42), the district court

misapplied *Cordial.* More importantly here, however, an intervening cause can be established by evidence "that shows the negligence of another party *or a nonparty.*" *Sydenstricker*, 618 S.E.2d at 568. Thus, actions need not be imputed to the Bank or the FDIC for them to defeat proximate causation. *See Mid-State Surely Corp. v. Thrasher Eng'g, Inc.*, 2006 WL 1390430, at *11 (S.D.W. Va. 2006) (defendant may "introduce evidence of [third party's] fraud … to demonstrate that the fraud served as an intervening cause of [plaintiff's] loss" even if any argument that this "fraud may be imputed to [plaintiff] to defeat or offset [plaintiff's] claim against [defendant]" is "without merit"); *Comeau v. Rupp*, 810 F. Supp. 1127, 1142 (D. Kan. 1992) (allowing auditor defense that bank management's conduct was "the legal cause of plaintiff's losses" despite having held that the conduct was not imputable to the FDIC).

The trial court's erroneous refusal to consider Grant Thornton's intervening cause defense was highly prejudicial, because there was undisputed evidence that Keystone's managers took affirmative steps *after the audit* to keep the Bank open and prevent regulators from discovering the fraud. First, Keystone's managers were well aware that "Keystone's deposit (liability) balance" was "nearly ten times larger than its loan (asset) balance" (Dkt. 540 at 88), but they continued to operate the Bank while hiding its financial condition from regulators and the Board.

Second, after Grant Thornton issued the audit report, Keystone's corrupt managers took affirmative steps to block regulators from discovering the Bank's true loan balances during their examination in the Summer of 1999. *See* Dkt. 540 ¶¶ 97-102. OCC examiners prepared confirmation requests for Advanta and Compu-Link on or about June 30, 1999. FDIC Ex. 413 at 1; 5/18/04 Tr. 37-40. The Bank's managers, however, staved off discovery of the fraud for weeks by (1) convincing examiners to allow the Bank to send the confirmation requests; (2) rewording the confirmation letters so that they requested information on United loans as well as Keystone loans; and (3) intercepting the responses. FDIC Ex. 364; 6/4/04 Tr. 160; 5/18/04 37-40, 43-44, 50-51, 227-28. In other words, after the audit, Bank management prevented regulators from uncovering the same information the court held Grant Thornton should have uncovered. As a direct result of this interference, the OCC did not obtain accurate loan balance information until August 23, 1999—nearly two months after they first prepared the confirmation requests. Dkt. 540 ¶ 102.

It is beyond serious argument that, had Keystone's management not interfered with the OCC's examination, the Bank would have closed much earlier. Accordingly, that interference was "a new effective cause" of the Bank's continuing expenditures (*Sydenstricker*, 618 SE.2d at 568), breaking any causal connection between Grant Thornton's actions and the FDIC's harm by no later

than June 30, 1999. If the Court does not enter judgment for Grant Thornton on proximate cause grounds, therefore, it should hold that Grant Thornton is not liable for losses incurred after June 30, 1999 and should remand for the trial court to consider the remainder of Grant Thornton's intervening cause defense under the correct legal standard.

II. THE TRIAL COURT ERRED IN STRIKING GRANT THORNTON'S AFFIRMATIVE DEFENSES AND DISMISSING ITS COUNTERCLAIMS

Judge Posner has observed that when fraud "permeat[es] the top management" of a corporation, the corporation "should not be allowed to shift the entire responsibility for the fraud to its auditors." *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982). Here, however, the district court erroneously concluded that the conduct of Keystone's officers and directors could not be imputed to the FDIC. Accordingly, it wrongly precluded Grant Thornton from asserting the defenses and counterclaims ordinarily available when an auditor is sued for negligence by a client that interfered with the audit. *See* Dkts. 880, 1044, and 1060 in 2:99-0992; *see also* Dkt. 540 at 93-101. This sweeping legal error necessitates reversal.

Keystone's management interfered with the audit by lying to Grant Thornton and supplying it with numerous false documents. That interference provided Grant Thornton with a strong basis to reduce or avoid any liability. The FDIC itself

acknowledged that "the contributory negligence of a client may be a defense to a claim for accounting malpractice" when "it has contributed to the accountant's failure to perform his contract and report the truth." Dkt. 803 in 2:99-0992 at 15 & n.4 (internal quotation marks omitted) (citing cases); *see also id.* at 15 ("[I]n certain limited instances the client's damages in an accounting malpractice action should be reduced to the extent his losses are his own fault."). Under West Virginia's comparative negligence doctrine, a plaintiff's recovery is reduced by its share of fault, and a plaintiff who is 50% responsible may not recover. *See Bradley v. Appalachian Power Co.*, 256 S.E.2d 879, 885-86 (W. Va. 1979). Grant Thornton also had strong defenses based on the doctrine of *in pari delicto* and the fraud of Keystone's officers and directors. *See, e.g., Cenco*, 686 F.2d at 453-54; *Ladd Furniture, Inc. v. Ernst & Young*, 1998 WL 1093901, at *4 (M.D.N.C. Aug. 27, 1998); *In re Leslie Fay Cos. Sec. Litig.*, 918 F. Supp. 749, 765 (S.D.N.Y. 1996).

The district court disallowed these defenses and claims, however, based on its conclusion that the West Virginia Supreme Court of Appeals ("WVSCA") would not "hold the public responsible for the patently illegal acts of the Keystone officers." Dkt. 880 in 2:99-00992, at 13. Citing *O'Melveny & Myers v. FDIC*, 512 U.S. 79 (1994), the district court first posited that "[i]n an action brought by the FDIC as receiver, state law governs the imputation of knowledge of the failed

institution's management to the receiver." Dkt. 880 in 2:99-cv-00992, at 5; *see also* Dkt. 540 at 93 (same). It then "attempt[ed] to predict" whether the WVSCA would hold that "the FDIC as Receiver for a failed bank is not liable for the misconduct of bank management." Dkt. 880 in 2:99-00992, at 8.

In *O'Melveny*, the Supreme Court courts may not employ "federal common law" to determine "the law of imputation … to the FDIC suing as receiver." 512 U.S. at 85. It explained that the federal statutory provisions that define the powers and duties of the FDIC as receiver "indicate that the FDIC as receiver 'steps into the shoes' of the failed S & L, obtaining the rights '*of* the insured depository institution' that existed prior to receivership." *Id.* at 86 (internal citation omitted); *see* 12 U.S.C. § 1821(d)(2)(A)(i) (stating that "the [FDIC] shall, ... by operation of law, succeed to all rights, titles, powers, and privileges of the insured depository institution"). According to the Court, "it is hard to avoid the conclusion that § 1821(d)(2)(A)(i) places the FDIC in the shoes of the insolvent S&L, to work out its claims under state law." *Id.* at 86-87. Thus, the Court stated, when the FDIC "assert[s] the claims *of* the [failed institution]" under state law, "any defense good against the original party is good against the receiver." *Id.* at 86 (internal quotation marks omitted); *see also*, *e.g.*, *FDIC v. Ernst & Young*, *LLP*, 374 F.3d 579, 581 (7th Cir. 2004) (Easterbrook, J.) ("FDIC-Receiver steps into the shoes of the failed bank and is bound by the rules the bank itself would encounter in litigation.");

FDIC v. Ernst & Young, 967 F.2d 166, 170 (5th Cir. 1992) ("the FDIC is not entitled to special protection when it brings a tort claim against a third party on behalf of a defunct financial entity"); *Resolution Trust Corp. v. Everhart*, 37 F.3d 151, 154 (4th Cir. 1994) (FDIC "exercis[es] not the rights of the government, but rather the rights of the failed institution").

In "predict[ing]" West Virginia law, the district court did what *O'Melveny* forbids: it created a special rule that broadly immunizes the FDIC from state-law defenses on the basis that "[a]ny recovery by the FDIC will ultimately inure to the benefit of the public." Dkt. 540 at 100; *see also id.* at 101. But the FDIC does *not* represent the public; as *O'Melveny* recognizes, it vindicates the interests of an insurance fund maintained through assessments paid to the FDIC by banks. As the Supreme Court explained in *O'Melveny*, "there is no federal policy that the fund should always win." 512 U.S. at 88.

The district court found support for its decision in a footnote in *Cordial v. Ernst & Young*, 483 S.E.2d 248 (W. Va. 1996). In *Cordial*, the issue was whether the insurance commissioner, acting as receiver for an insolvent insurer, had standing to sue the insurer's auditor on behalf of creditors and policy holders. In dictum in the footnote, the court (in the context of discussing the insurance commissioner's standing) noted that certain unspecified complete defenses would be unavailable to the auditor because the commissioner "vindicate[es] the rights of

the public." *Id.* at 257 n.9. Because federal law surely governs the *FDIC's* standing, this dictum is irrelevant.

But even if the *Cordial* dictum is deemed relevant to the imputation doctrine, it does not suggest that the WVSCA would absolve bank receivers from all defenses involving the imputation of bank management's conduct to the failed entity. The WVSCA in *Cordial* addressed equitable defenses, not those based on comparative fault or audit interference. Moreover, it expressly relied on West Virginia's insurance statute, which stated that the insurance commissioner as receiver acts for "the public." *Id.* at 256-257. The court cited that statute to distinguish the case from *Wheeling Dollar Savings & Trust Co. v. Hoffman*, 35 S.E.2d 84, 88 (W. Va. 1945), which holds that the rights of *banking* receivers rise no higher than those of the failed bank. *Id.* at 257 n.9; *see also* W. Va. Code § 31A-7-4 (listing the powers of banking receivers without immunizing them from any claims or defenses). There is therefore no reason to doubt that the WVSCA would treat the FDIC as "standing in the shoes" of Keystone, as *O'Melveny* and § 1821(d)(2)(A)(i) direct, particularly for purposes of evaluating defenses involving comparative negligence and audit interference.

Conceding that *Cordial* did not answer the question before it (Dkt. 540 at 95), the trial court said that it also found *Comeau v. Rupp.*, 810 F. Supp. 1127 (D. Kan. 1992), to be "persuasive." Dkt. 540 at 97. But that decision explicitly relied

on the federal common law that the Supreme Court later invalidated. *See* 810 F. Supp. at 1140 (citing *FDIC v. O'Melveny & Myers*, 969 F.2d 744 (9th Cir. 1992) ("*O'Melveny I*"), for the proposition "that federal common law rather than state law determines the defenses available against the FDIC"). The trial court also noted *Cordial*'s citation to *RTC v. KPMG Peat Marwick*, 845 F. Supp. 621 (N.D. Ill. 1994) (Dkt. 540 at 94), but that case also pre-dated *O'Melveny*. *See* 845 F. Supp. at 622-23 ("the question before the court … is whether to treat the RTC as a normal receiver … or to instead consider the RTC exempt from these defenses due to its special nature as an instrumentality of the United States").

The district court also cited *FDIC v. O'Melveny & Myers*, 61 F.3d 17 (9th Cir. 1995) ("*O'Melveny II*"), in which the Ninth Circuit, on remand, reinstated its earlier holding that "a bank's inequitable conduct is not imputed to [the FDIC]." *Id*. at 19. In our view, the Ninth Circuit both failed to follow the Supreme Court's directive and misapplied California law. *See FDIC v. Refco Group, Ltd.,* 989 F. Supp. 1052, 1088 (D. Colo. 1997) (criticizing *O'Melveny II*). But even if the Ninth Circuit's decision is correct, it has little relevance here, because the court purported to apply California law and did not address audit interference. *O'Melveny II,* 61 F.3d at 18.

In short, the FDIC should have been subjected to the defenses and counterclaims that could have been asserted against Keystone.[3] If the court declines to enter judgment for Grant Thornton on proximate cause grounds, then Grant Thornton is entitled to a new trial in which it may attempt to establish these defenses and counterclaims.

III. THE DISTRICT COURT ERRED IN GRANTING A SETTLEMENT CREDIT OF JUST $1.3 MILLION FOR KUTAK'S $22 MILLION SETTLEMENT WITH THE FDIC

After much wrangling, the FDIC ultimately reversed course and conceded that Kutak was jointly responsible for the same $25 million in operating losses for which Grant Thornton was held liable. Because Kutak settled with the FDIC, however, Grant Thornton's contribution claim against Kutak was extinguished. This was no small blow to Grant Thornton, which might have been able to shift its

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[3] The district court asserted, without elaboration or analysis, that the knowledge and conduct of Keystone's managers could not be imputed to the corporation because "management had abandoned the interest of Keystone and was acting adversely to Keystone's interest for their own personal gain." Dkt. 540 at 101. But a principal cannot escape responsibility for an agent's fraud unless the interests of the agent are "*completely* adverse to those of his principal." *Martin Marietta Corp. v. Gould, Inc.*, 70 F.3d 768, 773 (4th Cir. 1995); *see also, e.g., FDIC v. Schrader & York*, 991 F.2d 216, 225 (5th Cir. 1993) ("fraudulently inflated profits" are benefits to the company). And the adverse-interest exception does not apply at all "if the agent acts with apparent authority." *In re Crazy Eddie Sec. Litig.*, 802 F. Supp. 804, 818 (E.D.N.Y. 1992); *see also Hartmann v. Prudential Ins. Co.*, 9 F.3d 1207, 1212 (7th Cir. 1993) (same). At the very least, therefore, Keystone's submission of a false management representation letter—without which the audit report could not have been issued—may be imputed to the FDIC.

entire liability to Kutak had it been allowed to proceed with a contribution claim. Under West Virginia law, Grant Thornton was entitled to a dollar-for-dollar credit equal to the stipulated settlement amount. *Zando*, 390 S.E.2d at 805. The court nevertheless gave Grant Thornton a credit of only $1.3 million of the $22 million to which Grant Thornton was entitled.

A. The District Court Erred In Conducting A Post-Hoc Allocation Hearing Rather Than Affording Grant Thornton A Full Credit.

1. Under West Virginia law, a nonsettling defendant is entitled to a dollar-for-dollar credit for any settlement by a joint tortfeasor.

To promote "the strong public policy favoring out-of-court resolution of disputes," West Virginia law provides that "one who settles with the plaintiff prior to verdict is discharged from any liability for contribution." *Zando,* 390 S.E.2d at 803. West Virginia law protects nonsettling defendants in two ways, however. First, contribution claims are extinguished only if the settlement was made in good faith. *Zando*, 390 S.E.2d at 804-805; *see also Smith v. Monanghela Power Co.*, 429 S.E.2d 643 (W. Va. 1993). Second, West Virginia "counterbalances the loss of the right of contribution" by giving nonsettling defendants "the benefit of the settlement" as a "reduction of the verdict." *Id.*; *see also Hardin v. NY Cent. R.R. Co.*, 116 S.E.2d 697, 701 (1960).

In West Virginia, "practice with regard to verdict reduction … comports with" Section 4 of the Uniform Contribution Among Tortfeasors Act ("UCATA"),

which "states that a prior settlement by one joint tortfeasor 'reduces the claim against the others to the extent of any amount stipulated by the release or the covenant, or in the amount of the consideration paid for it, whichever is the greater.'" *Zando,* 390 S.E.2d at 805 (quoting UCATA § 4, 12 U.L.A. 98 (1975)). When one defendant settles with a plaintiff, "nonsettling defendant[s]" receive "a *pro tanto*, or dollar-for-dollar, credit … against any verdict ultimately rendered for the plaintiff." *Id*.

2. Because the FDIC and Kutak did not allocate their settlement between joint and non-joint claims, Grant Thornton is entitled to a full credit.

a. The FDIC settled with Kutak shortly after Grant Thornton sought leave to sue Kutak for contribution. Dkt. 1069 in No. 2:99-cv-992, at 2. The FDIC elected not to allocate the settlement between joint damages and alleged nonjoint damages, maintaining, contrary to its internal analysis, that the overlap between Grant Thornton's and Kutak's liability was minimal or nonexistent. *See, e.g.,* Dkt. 576 at 3. When the FDIC later conceded, in response to the district court's *in camera* production order, that its claims against Kutak completely subsumed "the $25 million for which Grant Thornton had been found liable" (Dkt. 610 at 1), only one result was possible under West Virginia law: *The trial court should have awarded Grant Thornton a credit for the entire $22 million settlement*. This is true for several reasons.

First, West Virginia law requires payment of a full credit. *See Hardin*, 116 S.E. at 701. The UCATA's language provides unconditionally that "a prior settlement by one joint tortfeasor 'reduces the claim against the others to the extent of any amount stipulated by the release or covenant, or in the amount of consideration paid for it, which ever is the greater." *Zando*, 390 S.E.2d at 805 (quoting the UCATA rule). Interpreting the same language, the Alaska Supreme Court has held that it "calls for a reduction [of the verdict] in the amount of the total consideration paid for the release, not merely the consideration which can be allocated to common liability." *Navistar Int'l Transp. Corp. v. Pleasant*, 887 P.2d 951, 958 (Alaska 1995) (superseded by statute). The court explained that, "[i]f the rule were otherwise," the settling parties "could easily avoid the impact" of the settlement-credit rule by "allocating some part of the consideration paid for a release to punitive damages or some other item of damages for which other tortfeasors would not be liable." *Id.*

Second, West Virginia's standards for approval of settlements in multi-party cases can be meaningfully applied only if the allocation is included in the settlement agreement. Two factors "that may be relevant to determining whether a settlement lacks good faith" are "the amount of the settlement in comparison to the potential liability of the settling tortfeasor *at the time of the settlement*" and "whether the motivation of the settling plaintiff and settling tortfeasor was to single

out a non-settling defendant or defendants for wrongful tactical gain." *Smith*, 429 S.E.2d at 652 (emphasis in original). Neither factor can be evaluated reliably without knowing what settlement funds have been allocated to joint and non-joint claims. *See, e.g., Erreca's v. Superior Court*, 24 Cal. Rptr. 2d 156, 173 n.7 (Cal. Ct. App. 1993) ("Determination of the credit issue to the extent possible cannot be deferred until after any eventual jury verdict, because the entire settlement must be determined to be in good faith as to both settling and non-settling defendants.").

Third, "settlements are favored under the laws of [West Virginia]" because they "promot[e] judicial economy." *Horace Mann Ins. Co. v. Adkins*, 599 S.E.2d 720, 726 (W. Va. 2004). But "the benefits typically realized by the court system from a settlement are significantly vitiated" by ancillary, "post hoc … litigation" after settlement. *Charleston Area Medical Center, Inc. v. Parke-Davis*, 614 S.E.2d 15, 24 (W. Va. 2005). West Virginia cases construing the settlement credit rule have repeatedly emphasized that any method for applying a settlement credit that "encourage[s] … protracted proceedings," rather than "contributing to the laudable objective of judicial economy," is strongly disfavored. *Id.*; *see also McDermott, Inc. v. AmClyde*, 511 U.S. 202, 211 (1994) (method of determining a settlement credit that "leads to unnecessary ancillary litigation" is "clearly inferior").

b. The post-hoc allocation procedure adopted by the district court here perpetuated contentious and expensive litigation between the parties for three years

past the initial judgment of liability, yet it had no hope of either producing a fair valuation of the FDIC's claims against Kutak or replicating the allocation that the settling parties would have made contemporaneously. To the contrary, it allowed the FDIC to manipulate the evidence to give Grant Thornton a tiny credit in exchange for the loss of its contribution claim. Such an allocation procedure has no place in West Virginia's settlement/credit regime, which is designed to promote judicial economy by encouraging settlements while preserving fairness to non-settling joint tortfeasors.

For such reasons, Texas courts have held that, when a settlement covers both joint and non-joint liabilities and does not allocate among joint and nonjoint claims, "the nonsettling party is entitled to a credit equaling the entire settlement amount." *Cohen v. Arthur Andersen LLP,* 106 S.W.3d 304, 310 (Tex. Ct. App. 2003) (citing *Mobil Oil Corp. v. Ellender,* 968 S.W.2d 917, 928 (Tex. 1998)). They have recognized that "[w]hen the settlement agreement does not allocate" among the various claims settled, conducting a protracted allocation hearing "to prove the agreement's allocation" would impose an "unfair[] penal[ty]" on "the nonsettling party," who was not a party to the agreement. *Ellender*, 968 S.W.2d at 928. "The better rule," they have concluded, "is to require a settling party to tender … a settlement agreement allocating" among claims, or otherwise to grant a

credit for the entire settlement without "limit[ation]." *See also In re Enron Corp. Securities, Derivative & ERISA Litig.*, 623 F. Supp. 2d 798, 839 (S.D. Tex 2009).

Courts in multiple jurisdictions have similarly held that when a settlement agreement fails to allocate among various theories of liability, the court will not allocate for the parties. The Superior Court of Delaware, for example, has explained that when a plaintiff does not "mak[e] an allocation as part of the settlement," the court will not "judicially rearrang[e] the settlement" but will "appl[y] the full settlement amount against the jury's award to the plaintiff." *Farrall v. A. C. & S. Co., Inc.*, 586 A.2d 662, 667 (Del. Super. Ct. 1990). Florida courts have held that a "trial court err[s]" when it "attempt[s] to determine, after the trial and without the participation of the settling defendant, exactly how the settling parties intended the settlement to be applied to the plaintiff's causes of action." *Nauman v. Eason*, 572 So.2d 982, 985 (Fla. Ct. App. 1990) (remanding with instruction to enter "a final judgment which reflects the setoff of the entire settlement amount against the total jury verdict"); *see also Ass'n for Retarded Citizens, Dade County, Inc. v. Dep't of Health and Rehab. Servs.*, 619 So.2d 452, 454 (Fla. Ct. App. 1993) ("an agreement to apportion the proceeds of a settlement agreement must be found on the face of the settlement agreement and agreed to by all of the parties involved in the settlement").

Likewise, the Tenth Circuit recently concluded that when a settlement agreement is "silen[t] … regarding allocation," extrinsic evidence of allocation is generally "too speculative" to allow the court to allocate on the parties' behalves. *Friedland v. TIC-The Indus. Co.*, 566 F.3d 1203, 1211 (10th Cir. 2009); *see also Eastridge Dev. Co. v. Halpert Assocs., Inc.*, 853 F.2d 772, 782–783 (10th Cir. 1988) (same). Thus, if a party "want[s] … any particular application of its settlement with the settling defendants" allocated to joint liabilities, it must "specifically stipulate[] in the settlement documents what allocations of damages [are] applicable to each cause of action." *Hess Oil Virgin Island Corp. v. UOP, Inc.*, 861 F.2d 1197, 1209 (10th Cir. 1988). *See also Lard v. AM/FM Ohio, Inc.*, 901 N.E.2d 1006, 1018 (Ill. App. Ct. 2009) (when settling parties fail to "allocate the settlement, the nonsettling defendants [are] entitled to setoff the entire amount of the prior settlements"); *Hogan v. Armstrong World Indus., Inc.*, 840 S.W.2d 230, 238 (Mo. Ct. App. 1992) ("The absence of an allocation" among claims in a settlement agreement "indicates the intention of treating them as indivisible.").

3. The district court's post-hoc allocation procedure was unfair to Grant Thornton and violated West Virginia law.

a. The district court's post-hoc allocation of the settlement amount undermined West Virginia's careful tradeoff between encouraging settlement and preserving fairness to nonsettling defendants. As an initial matter, in undertaking to determine the settlement credit by evaluating the extent of Kutak's potential

liability, the trial court was attempting to answer the wrong question. In West Virginia, "verdict reduction does not take into account the settling party's *actual* degree of fault" but instead concerns only the terms agreed to by the settling parties. *Zando*, 390 S.E.2d at 805 (emphasis added). A settlement credit thus should be determined by the allocation intended by the parties to the agreement, not by a factfinder's post-hoc determination of the settling defendant's actual degree of fault.

Indeed, as the WVSCA noted in *Zando*, "any analysis [of a settlement] based on the subsequent verdict necessarily relies on hindsight." 390 S.E.2d at 804 (quoting *Jachera v. Blake-Lamb Funeral Homes, Inc.*, 545 N.E.2d 314, 319 (Ill. App. 1989)). Such hindsight bias clearly distorted the analysis here: The court compared the verdict that the FDIC *actually won* against Grant Thornton ($25 million) with the amount that the court believed the FDIC *could have obtained* from Kutak Rock ($292,899,685.20). At that time, however, the FDIC was claiming at least $149 million in damages from Grant Thornton. Dkt. 12 at 53. Had the FDIC included an allocation in the settlement agreement and submitted it contemporaneously for the court's approval, it could never have defended an allocation of only 8.563% of the settlement to the joint claims. That minuscule percentage resulted from comparing the court's valuation of the FDIC's *untested*

claims against Kutak with its finding of damages against Grant Thornton following a full trial.

It is no surprise that the settlement credit hearing resulted in an inflated assessment of Kutak's liability. To minimize the settlement credit, the FDIC claimed that the evidence showed Kutak to have caused a whopping $361,637,236.78 in damages. Dkt. 623 ¶ 53. To counter the FDIC's argument that Kutak's liability for non-joint claims dwarfed its liability for joint claims, Grant Thornton was placed in the untenable position of having to defend Kutak with respect to the non-joint claims. Even setting aside whether a $361 million claim against Kutak could be evaluated with limited discovery and a trial of less than a week, Grant Thornton had no first-hand knowledge of Kutak's conduct with respect to Keystone's securitization program. Moreover, it was not a party to the settlement agreement between Kutak and the FDIC and therefore was not in a position to prove how the parties would have allocated the settlement amount had they decided to do so. And Kutak itself was not a party to the proceeding and had no incentive to assist Grant Thornton.

Indeed, Grant Thornton and Kutak in no way had similar interests in this matter. "A court should hesitate to [require] a litigant [to] serve as a proxy for an absent party unless the interests of the two are *identical*." *Nat'l Union Fire Ins. Co. of Pittsburgh v. Rite Aid of S.C., Inc.*, 210 F.3d 246, 251 (4th Cir. 2000) (emphasis

added). Because Grant Thornton's and Kutak's interests clearly were not aligned, the allocation hearing was not remotely conducive to the sort of "adversarial testing [that] 'beats and bolts out the Truth.'" *Crawford v. Washington*, 541 U.S. 36, 62 (2004) (quoting Matthew Hale, *History and Analysis of the Common Law of England* 258 (1713)).

The West Virginia courts disapprove of proceedings in which "the settling party, who is out of the case, is not present to defend himself, " recognizing that, under such circumstances, both the "importance and accuracy" of any factual findings are "necessarily undermined." *Zando*, 390 S.E.2d at 806; *see also Ellender*, 968 S.W.2d at 928 ("Without an allocation, [the nonsettling defendant], who was not a party to the settlement, ha[s] almost no ability to prove which part of the settlement amount represented [joint] damages."); *Nauman*, 572 So.2d at 985 (allocation "after the trial and without the participation of the settling defendant" is error). The West Virginia courts thus undoubtedly would reject the approach adopted by the district court in this case.

b. In reaching a contrary decision, the district court relied heavily on three federal bankruptcy cases. First, it cited *Bowers v. Kuse*, No. 97-2583, 1998 WL 957455 (4th Cir., Sept. 22 1998) (unpublished), for the proposition that, in determining settlement credits, courts "'must undertake an independent allocation of the settlement.'" Dkt. 645 at 48 (quoting *Bowers*, 1998 WL 957455, at *7). The

quoted language was taken from this Court's description of the Ninth Circuit's holding in *In re Lendvest Mortgage, Inc.*, 42 F.3d 1181 (9th Cir. 1994). *See Bowers*, 1998 WL 957455, at *7 ("The Ninth Circuit … held [that] 'the bankruptcy court must undertake an independent allocation of the settlement … '" (quoting *Lendvest*, 42 F.3d at 1185)). *Bowers* itself concerned whether a settlement agreement encompassed the claims being litigated. The bankruptcy court did not hold an "allocation hearing" (Dkt. 645), but simply "concluded as a matter of fact that the … claim [being litigated] was not part of the settlement." *Bowers*, 1998 WL 957455, at *7. The case thus does not address question presented here.

The other bankruptcy cases relied on by the district court provide no better support for its decision. The courts in *Lendvest* and *In re Prudential of Florida Leasing, Inc.*, 478 F.3d 1291 (11th Cir. 2007), addressed "the operation of federal bankruptcy courts," where state law "is of relatively little import." *Lendvest*, 42 F.3d at 1183. Their holdings thus shed little light on the application of the settlement credit rule under West Virginia law.

B. The Settlement Credit Should Have Been Based on the Stated Value of the Settlement Agreement And Not On The Lesser Amount the FDIC Ultimately Received.

1. In *Zando*, the WVSCA held that West Virginia's "practice with regard to verdict reduction" follows "Section 4 of the UCATA, which states that a prior settlement by one joint tortfeasor 'reduces the claim against the others to the extent

of *any amount stipulated by the release or the covenant*, or in the amount of the consideration paid for it, *whichever is the greater*.'" 390 S.E.2d at 805 (emphasis added) (quoting UCATA § 4). The meaning of Section 4 is "unambiguous" and "clear": when the amount paid is less than the stipulated settlement value, the judgment must be "reduced by the amount stipulated." *Tommy's Elbow Room, Inc. v. Kavorkian*, 754 P.2d 243, 246 (Alaska 1988). The district court's "predict[ion] that West Virginia's highest court would follow the approach taken" by *other* state courts (Dkt. 645 at 59), is thus plainly wrong: *Zando* (which cited *Tommy's Elbow Room*) adopted Section 4, and Section 4 unambiguously requires a credit for the amount stipulated in the agreement if that amount is greater than the consideration paid.

Here, the settlement agreement stipulated that "Kutak Rock and the FDIC have concluded independently that the FDIC Claims against Kutak Rock and Lambert have a *total settlement value* of at least $22 million." GT Ex. 507 ¶ 29 (emphasis added). The agreement expressly contemplated insurance proceeds of as much as $20 million; Kutak also agreed to execute two conditional promissory notes worth between $4 million and $10.75 million, depending on the insurance proceeds actually collected. (The insurer was in liquidation proceedings at the time of the settlement.) GT Ex. 507, Ex. A-B. Because the stipulated "settlement

value" of $22 million is obviously "greater" than the $15.7 million that the FDIC has collected to date, *Zando* requires an offset of $22 million. 390 S.E.2d at 805.

The district court's conclusion to the contrary is also squarely at odds with West Virginia's public policy promoting judicial efficiency. Granting a settlement credit for consideration paid requires the "trial court [to] retain[] continuing jurisdiction to ensure defendants receive an offset from any future settlement monies received in satisfaction of this action." *Garcia v. Duro Dyne Corp.*, 67 Cal. Rptr. 3d 100, 106 (Cal. Ct. App. 2007) (alterations omitted). Here, the district court will require Grant Thornton to apply for ongoing credits "[i]f and when the FDIC receives additional payments under the FDIC/Kutak settlement." Dkt. 645 at 60. The district court's approach thus not only ignores *Zando*'s adoption of Section 4 of the UCATA, but also threatens further to "ero[de]" the settlement credit rule's promotion of judicial economy. *Horace Mann*, 599 S.E.2d at 726..

2. The out-of-state case law relied upon by the district court cannot overcome the unavoidable conclusion that, under West Virginia law, the settlement credit must be based on the $22 million stipulated settlement value.

Garcia, for example, suggested that, although California law codifying Section 4 of the UCATA "requires an offset in the greater of the 'amount stipulated by the release' or the 'amount of the consideration paid,'" the statute "does not specify *when* the defendant is entitled to receive the offset credit." 67

Cal. Rptr. 3d at 106 (emphasis added). The court in *Garcia* reasoned that it "need not decide" the meaning of Section 4 because, in its view, nonsettling defendants are not entitled to a settlement credit "until the settlement monies have been paid." *Id*.

But *Garcia* unmistakably did decide the meaning of Section 4, and in a way that strikes the words "amount stipulated … whichever is greater" out of the statute altogether. After all, if nonsettling defendants are not entitled to a credit "until" a settlement amount is paid, and are then entitled to a credit only in proportion *to* the amount paid, they will never receive "the amount stipulated by the release" unless and until the amount stipulated *equals* "the amount of the consideration paid." 67 Cal. Rptr. 3d at 105.

In *Fibreboard Corp. v. Fenton*, 845 P.2d 1168 (Colo. 1993), the Colorado court concluded that actual collection of settlement proceeds is required before a settlement credit can be granted, *id*. at 1176–1177; yet it reached that conclusion *despite* the plain language of Section 4 of the UCATA. As Chief Justice Rovira explained, "the plain language of [Section 4] provides sufficient grounds" to reject "the majority's 'actual collection' rule." *Id*. at 1178–1179 (Rovira, C.J., dissenting in part and concurring in part). The "plain language" of Section 4 sufficient to reject the "actual collection" rules is, of course, the same plain language adopted by the West Virginia court in *Zando*.

The decision in *Federal Sav. & Loan Ins. Corp. v. Butler*, 904 F.2d 505 (9th Cir. 1990), is even less helpful. It involved a settlement agreement that "stipulat[ed]" to "*liability*" for "$165.5 million" in damages, but required the settling defendant to pay only $8.4 million for a release of that liability. *Id*. at 508–09 (emphasis added). Because there was never any expectation that the settling defendant would pay more than $8.4 million, the court rightly concluded that "Butler's admitted liability of $165.5 million … is not a stipulation to an amount to reduce the claims against the other defendants." *Id*. at 514. Unlike *Butler*, the parties here stipulated to a "settlement value" that the FDIC could receive—$22 million—and Grant Thornton is entitled to a credit in that amount.

CONCLUSION

Because Grant Thornton's conduct did not proximately cause the damages sought by the FDIC, the decision below should be vacated and judgment entered in favor of Grant Thornton. If the Court does not enter judgment for Grant Thornton, it should reverse and remand with instructions that the trial court should (1) grant Grant Thornton a new trial at which it may present its defenses and counterclaims based on Keystone management's misconduct (2) award Grant Thornton a $22 million settlement credit against any future judgment favoring the FDIC.

REQUEST FOR ORAL ARGUMENT

Grant Thornton respectfully requests that the Court hold oral argument in this case.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 32(a)(7)(C), the undersigned counsel for Appellant – Cross-Appellee Grant Thornton LLP certifies that this brief:

(i) complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because it contains 13,991 words, including footnotes and excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii); and

(ii) complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because it has been prepared using Microsoft Office Word 2007 and is set in 14-point sized Times New Roman font.

Dated: June 9, 2010

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CERTIFICATE OF SERVICE

The undersigned counsel for Appellant – Cross-Appellee Grant Thornton LLP certifies that on June 9, 2010, the foregoing Redacted Opening Proof Brief for Grant Thornton LLP was served on all parties or their counsel of record through the CM/ECF system if they are registered users or, if they are not, by serving a true and correct copy at the addressee listed below:

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