Articles

Auditors' failure to issue going-concern opinion not liable for damages under 'deepening insolvency' theory

In *Fehribach v. Ernst & Young LLP*, 493 F. 3d 905 (7th Cir. 2007), the 7th Circuit Court of Appeals affirmed the district court's rejection of a bankruptcy trustee's claim that the auditing firm for the bankrupt business was liable under the theory of "deepening insolvency" for failing to issue a going-concern qualification in its annual report of the company.

The trustee in *Fehribach* presented expert evidence that Ernst & Young LLP (E&Y) was negligent in failing to include a going-concern qualification in its 1995 audit report of the then financially troubled company, Taurus Foods, Inc. (Taurus). Some months after Taurus received the audit report, the company's bank became alarmed at its financial condition and imposed restrictions that further exacerbated its problems.

In an unsuccessful attempt to keep the company afloat, Taurus' chief financial officer began to illegally inflate the company's daily reports. The trustee argued that if E&Y had properly issued a going-concern qualification in its 1995 report, the owner-managers would have immediately liquidated, averting costs of an additional $3 million that the company incurred before three of its creditors forced it into bankruptcy two years later.

The theory of deepening insolvency is based on the premise that a company inevitably causes harm to its shareholders through increased exposure to creditor liability if it continues to borrow funds after becoming insolvent. *Fehribach*, 493 F. 3d at 908.

Some jurisdictions have awarded damages under this theory to a bankrupt company which, by delaying liquidation, ran up additional debts that would not have been incurred had the plug been pulled sooner. *See id.* (citing *In re Global Service Group, LLC,* 316 B.R. 451, 456-59 (Bankr. S.D.N.Y. 2004)).

In considering the validity of this controversial theory, the *Fehribach* court noted that the shareholders of an already-insolvent company have nothing further to lose from any deepening insolvency resulting from management’s attempt to turn the company around with borrowed funds. *Fehribach,* 493 F. 3d

at 908.

The court recognized, however, that an insolvent company could be worth more liquidated than the sum of its liabilities, potentially leaving at least something of value to inure to the benefit of the shareholders. *Id.* (*citing Schacht v. Brown,* 711 F. 2d 1343, 1348 (7th Cir. 1983))

The court also found that the theory could be properly invoked when "management in cahoots with an auditor or other outsider concealed the corporation's perilous state which, if disclosed earlier, would have enabled the corporation to survive in recognized form." *Fehribach,* 493 F. 3d at 908. The court cautioned, however, that in the absence of fraud, breach of fiduciary duty or other conventional wrongdoing, it makes no sense to use the theory to "punish corporate management for trying in the exercise of its business judgment to stave off a declaration of bankruptcy . . . " *Id.* Here, there was no suggestion that the auditor was involved in the CEO's fraud, which in any event did not occur until after the auditor’s financial report was issued.

However, the owners of Taurus lost their entire investment when the company became insolvent. They had nothing more to lose and thus had no damages to support a claim under the theory of deepening insolvency. *Id*. at 909.

The court then considered whether damage to the *creditors* – who were the "only possible losers from the prolongation of the corporation’s miserable existence" – could support an award under the deepening insolvency theory. *Id.* The court noted that the creditors – who would be the beneficiary of any award to the bankruptcy trustee – were not parties to the contract between Taurus and E&Y and thus had no direct claim against the auditor under Indiana's version of the *Ultramares* doctrine. *Id.* (citing *Ultramares Corp. v. Touche*, 255 N.Y. 170 (1931)). The court concluded that the trustee did have standing because E&Y had a duty to Taurus, and this duty "does not evaporate just because the client is bankrupt and any benefits from suing will accrue to its creditors." *Id.*

The court nonetheless ruled against the trustee on the merits. The court noted that an audited firm should usually recognize its own financial peril, regardless of the auditor's going-concern qualification, since the company supplies the financial information on which the audit is based. *Id.* at 911. The purpose of an audit report is to make sure that the audited company's financial statements – which are prepared by the company, not by the auditor – correspond to reality, lest they either have been doctored by a defalcating employee or innocently misrepresent the company's financial situation. *Id.* The auditor is required to "state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles and to identify those circumstances in which such principles have not been consistently observed in the preparation of the financial statements of the current period in relation to those of the preceding period." *Id.* at 910.

Here, there was no contention that E&Y failed to notice any discrepancies between the company's statements and its actual financial condition. Nothing that was in or should have been in the audit report indicated that Taurus could not survive another year. To the contrary, the report reflected positive though slight net income and no sign of an obligation that would mature in the next year and drive the firm under.

The court recognized that generally accepted accounting standards also require the auditor to be on the lookout for "certain conditions or events that, when

considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time." *Id.* at 910-911. Such "conditions or events" include: negative trends; other indications of possible financial difficulties, such as a loan default; internal matters, such as the need to significantly revise operations; and external matters that have occurred, such as a natural disaster or "loss of a principal customer or supplier." *Id.* at 911. These accounting standards also require the auditor to have "an appropriate understanding of the entity *and its environment*." *Id.* (emphasis in original). The report did fail to tell Taurus of ominous trends in its industry. *Id*. However, an auditor is not required to *investigate* external factors, as distinct from *discovering* them in the course of the audit. *Id.* As the court reasoned, the auditor should not be expected to duplicate the expertise assumed to reside in the firms themselves or in management consultants specializing in the firm's industry.

Although *Fehribach* does not hold auditors liable for failing to *investigate* external factors, the case nevertheless underscores the importance of recognizing certain conditions or events *discovered* during the course of an audit as indicative of going-concern issues.

Generally accepted accounting principles provide examples of such conditions and events, including: recurring operating losses; working capital deficiencies; negative cash flows from operating activities; adverse key financial ratios; loan defaults; arrearages in dividends; denial of usual trade credit from suppliers; restructuring of debt; work stoppages or other labor disputes; legal proceedings; legislation with negative impacts; or loss of a key franchise, license, patent or customer. *Id.* at *911. As the credit crunch continues to spread throughout the economy, more bankrupt companies and their shareholders and creditors may seek damages against their auditors under the theory of deepening solvency. It is thus more imperative than ever for an auditor to recognize the signs that its audited client may be facing going-concern issues that require a qualification in the audit report.

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