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Supreme Court of Texas.
GRANT THORNTON LLP, Petitioner,
v.
PROSPECT HIGH INCOME FUND, ML CBO IV (Cayman), Ltd., Pamco Cayman, Ltd., and
Pam Capital Funding, L.P., Respondents.
No. 06-0975.

December 9, 2008.

Appearances:
Samara L. Kline, Baker Botts, LLP, Dallas, Texas, for Petitioner.
Paul B. Lackey, Lackey Hershman, LLP, Dallas, Texas, for Respondent.

Before:

Wallace B. Jefferson, Chief Justice, Nathan L. Hecht, Harriett O Neill, Dale Wainwright, Scott A. Brister, David Medina, Paul W. Green, Phil Johnson, and Don R. Willett, Justices.

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CHIEF JUSTICE JEFFERSON: The court will hear argument now in 06-0975, Grant and Thorton LLP v. Prospect High Income Fund and others.
SPEAKER: May it please the Court. Ms. Kline will present argument for the petitioner. Petitioner has reserved five minutes for rebuttal.

ORAL ARGUMENT OF SAMARA L. KLINE ON BEHALF OF THE PETITIONER

MS. KLINE: Good morning. May it please the Court. My name is Samara Kline and I'm here on behalf of the petitioner, Grant Thornton.
This case presents the question whether an auditor may be held liable for investment losses sustained by potential investors and holders of publicly-traded securities. The answer here is no for at least three reasons. First, the plaintiff funds are not within the scope of liability defined by this Court's decision -- decisions in McCamish and Pacific Mutual. In those decisions, the Court limited liability to only those third parties that the auditor intended to influence in a specific known transaction. Here, there's no evidence that when Grant Thornton issued its reports, it -- it intended to influence the plaintiff funds in any particular known transaction.
Second, claims by investors who merely held public securities rather than bought or sold them are inherently speculative with respect to causation and reliance. Courts across the country have rejected

these kind of holder claims, and this Court should do the same.

Finally, there is no evidence of the well-established causation requirements. When these funds bought Epic bonds, they were discounted 75% off the face value at maturity. This reflected the market's perception of a significant risk that the bonds would not be redeemed for face value at maturity. But in this case, the plaintiff funds seek to hold Grant Thornton liable for 100% of the face value at maturity and more. No witness, expert or lay witness, testified that the alleged misrepresentation caused these damages -- these claim damages or that the claim damages would not have occurred absent the alleged misrepresentation.

JUSTICE BRISTER: What was the purpose of the negative assurance?

MS. KLINE: The negative-assurance statement is part of -- well, let me start out by saying, there was only one negative-assurance statement and it was issued in 1999. And at that time, three of the four plaintiffs were not bond holders. The negative-assurance statement was issued by Grant Thornton to Epic. It was a -- a statement that the auditor had not discovered any violation of the Indenture. Three -- three particular covenants of the Indenture --

JUSTICE BRISTER: [inaudible] set aside [inaudible] -- specifically to set aside for interest payments.

MS. KLINE: Not really. I -- I mean if you look at the three covenants of the Indenture that the negative-assurance statement covered, they don't mention the Escrow -- requirement in particular. But even assuming that was the purpose, there's no evidence that the purpose of it was to advise individual bond holders with respect to any number of transactions that they may or may not enter into. And I think the important thing to look at is did Grant Thornton, at the time it issued the negative assurance statement in 1999, -- I mean in 2000 for the year and 1999 -- intend to influence the world of potential investors in these bonds?

JUSTICE BRISTER: But it couldn't -- it couldn't -- assuming again that-- it was intended to cover the -- the interest Escrow. It wouldn't have been to inform Epic of that 'cause Epic would know. So, it must have been intended to inform somebody besides Epic.

MS. KLINE: Well, U.S. Trust was the trustee, but -- U.S. Trust of course knew, because U.S. Trust was the party to the Indenture and -- and the Escrow agreement --

JUSTICE BRISTER: It must have been intended for some kind of third party 'cause otherwise, there would have been no point to it.

MS. KLINE: Well, no, there is no evidence that Grant Thornton intended to influence a world of potential investors and even if --

JUSTICE BRISTER: Not if everybody in the world. I've - - you know, they wouldn't --

MS. KLINE: -- even if --

JUSTICE BRISTER: -- I wasn't planning on to invest and therefore in -- they wouldn't have been in -- had me in mind, but they've certainly had somebody besides Epic and U.S. Trust.

MS. KLINE: Well, there is no evidence of that, but even if you assume that the negative-assurance statement was intended to influence bond holders, first of all, there's no particular transaction associated with that. And I think if you look at the case law under Section 552 and under Pacific Mutual and -- and 531 which it -- which it relied on, what you'll see is that if you separate cases where the claim survived summary judgment or survived motions to dismiss from those where it did not, all of those are characterized by a particular transaction that was contemplated by the auditor at the time the

reports were issued. For example, a merger transaction or one of the best cases on this is out of the -- the Federal Court of Appeals for the First Circuit, the LaPalm case. It's not cited in our brief, but it's discussed a lot in the Compass Bank case that we cite. Its 258 F 3d 35 --

JUSTICE BRISTER: But I'm just -- I'm just -- I'm just, why would you put -- why would you put in something assuming the negative assurances, we've got an Escrow to pay interest. It seems to me the obvious person who would -- there's only one person in the world who would care about that, is the people the interest who would be paid to and the only imaginable purpose if that's what it was at least in part for the negative assurance is 'cause people that were gonna get the interest payments might want to do something if there was no Escrow there.

MS. KLINE: Well, there are couple of problems --

JUSTICE BRISTER: What -- what other imaginable reason would there be?

MS. KLINE: Well, there are couple of problems with that theory in this case. I mean, first of all, at the time the negative-assurance statement was issued, only one of these plaintiffs was a bond holder --

JUSTICE BRISTER: [Inaudible] --

MS. KLINE: -- and they're not seeking --

JUSTICE BRISTER: Forget about your case for a minute, this is just we've got a case with somebody else --

MS. KLINE: Okay.

JUSTICE BRISTER: -- and they have to have a -- an audit firm come in and say, we've got an Escrow set aside for interest to pay bond holders. And the auditing firm says, yup that money's there. The only possible purpose with that would be to give notice to the people to whom interest payments are due.

MS. KLINE: Well, I disagree with that because the trustee itself was responsible for reporting to the bond holders. And -- and the other -- the other problem with that is, if you accept that theory in this case, you're essentially saying that every case in which the investors invested in public securities can survive summary judgment because that Indenture is not particular to this case. It's the same -- those -- those provisions of the Indenture mirror Federal law. And in every case in which you have an insurer of public securities, you're gonna have that kind of Indenture because it mirrors Federal law. And so, you really are opening the flood gates to any kind of investor in a public security who's held onto that security, seen an investment loss and then retrospectively tries to recover that investment loss from an auditor. And I think the -- the point of 552 and -- and the Pacific Mutual reasoning is that you look at what risk the auditor accepted at the time of the engagement.

Here, the engagement letter doesn't say anything about the Indenture or about the bond holders. The reports themselves were issued to Epic and don't reference the bond holders. There's --

JUSTICE GREEN: Okay, so -- so Grant Thornton was hired by Epic to do this audit report. Now, is there -- is there a requirement that that be done in Federal law or otherwise?

MS. KLINE: Yes, there's something called the --

JUSTICE GREEN: Okay, so, they didn't have any choice.

MS. KLINE: Right. There's something called the Trust Indenture Act, its 15 USC 77 AAA. And -- and that sets the requirements for publicly issued securities. And -- and it's the same when a company issues stock that's publicly-traded and audited financial statements

are prepared and they're sent to every shareholder who -- who is a -- is a shareholder in that publicly-traded stock.

JUSTICE WAINWRIGHT: You mentioned that the -- you believe the standard for holding auditors liable in a situation like this is that they intended reliance on their statements by the third parties. McCamish refers to our 1999 case intention. The Pacific Mutual case you cited says that there needs to be only a -- a special likelihood that the representation, or misrepresentation if you will, will reach the persons and will influence their conduct. There's a very recent Law Review article out of Texas Tech Law School that says, there's confusion throughout courts, commentators, the Bar, everybody about what the actual standard is. You seemed fairly confident when you said intent. Would -- do you think it is settled and why? When there appear to be different language in McCamish and Pacific Mutual about the standard.

MS. KLINE: Well, I think -- I think it's settled that under 552, we do not use a foreseeability standard. And it's settled, I mean we're talking about two causes of action; negligent misrepresentation and fraud. With respect to both of those causes of action, I think Texas Law is settled that we do not use a foreseeability standard, in other words, the auditor's liability is not defined by any foreseeable user. I think the language of -- of McCamish is different than the language of Pacific Mutual with respect to the -- the "known party." McCamish uses known party. Pacific Mutual uses a person who's especially likely to rely. But what the two standards have in common is this particular transaction requirement.

But to address your question, I think the confusion has come from the fact that some courts including the Court of Appeals in this case have used language that sounds like a foreseeability standard. And the Dallas Court of Appeals in a case that predated McCamish called Blue Bell used a foreseeability standard. So that has caused confusion and I think this case, affords the Court an opportunity to reaffirm what McCamish said with respect to claims for negligent misrepresentation which is -- it's not a foreseeability standard. You've got to have a known party and a known transaction.

JUSTICE WAINWRIGHT: So, whatever the standard is, it is -- you believe clearly higher than foreseeability

MS. KLINE: Yes, I think the Court --

JUSTICE WAINWRIGHT: And but do you see some daylight between the language of the Pacific Mutual and McCamish?

MS. KLINE: Yes and I -- I think that the Court could resolve that by -- by being more clear about the -- the degree of evidence required and especially in this case, where you're talking about a public transaction. I mean, one way to resolve the -- the confusion is what the Southern District of New York said in the Crazy Eddie case which is when you boil this all down, what really you're looking for is a private transaction.

A transaction that all the parties contemplated at the time of the engagement. I mean, this is sort of a poster child for that kind of case because the plaintiffs are trying to impose on Grant Thornton a $130 million liability. And when you look at Grant Thornton's engagement letter and its audit report and the circumstances surrounding the engagement, there's no evidence that at the time, Grant Thornton assumed that kind of risk. And when you go back and look at the reasoning underlying McCamish and the reason for putting limits on auditor liability so that auditors don't have indeterminate liability to an indeterminate group of people. I -- I think this case really

cries out for that kind of --

CHIEF JUSTICE JEFFERSON: Do -- do I understand your argument to be that -- that those who are not bond holders at the time the negative assurance was issued have no claim because they came afterwards?

MS. KLINE: That's one of the arguments is that it -- the time the negative-assurance statement was issued, three of the four plaintiffs were nothing other than potential investors indistinguishable from any other potential investors.

CHIEF JUSTICE JEFFERSON: But don't investors commonly rely on whatever financial statement is available in making their determination on whether to invest, right?

MS. KLINE: And I think that's exactly the foreseeability standard that courts across the country have rejected because it leads to indeterminate liability. And it -- and it makes it almost impossible for an auditor to accept such an engagement and to price it. And so, it -- it limits the supply of those kinds of services, which are necessary to the functioning of our public markets.

CHIEF JUSTICE JEFFERSON: Though you would ask us to say as a matter of law if you come after the statement was -- if you were not a bond holder at the time the statement was issued then as a matter of law, you'd have no claim?

MS. KLINE: Well, I think you could say that -- that as a matter of law, mere potential investors are not within the scope of liability for an audit report.

JUSTICE JOHNSON: What if -- what -- does that principle apply if for example, we have loans made where we aggregate loans and ship them down stream as we've seen nationally? How do people -- how do people who buy know whether something is sound or not if the auditors -- if the auditors don't give some kind of opinion, I know its a difficult situation, but how do -- how do investors know how to evaluate?

MS. KLINE: Well, I -- I think if you read the California Supreme Court decision in the Bailey case, it really goes into what an audit report really is and how limited the role of an auditor is and it would take me a lot more than 12 minutes to explain that but, you know, in this case we're talking about a sophisticated market investor. I mean, Highland manages hundreds of millions of dollars of investments. And -- and they have plenty of resources --

JUSTICE JOHNSON: Well, but we also got a lot of sophisticated market investors that are going bankrupt right now because somebody ship toxic, what they call toxic loans down stream and --

MS. KLINE: Well --

JUSTICE JOHNSON: -- is everybody gonna have to hire their own evaluation person before they invest in these things --

MS. KLINE: No sir, but the --

JUSTICE JOHNSON: -- and I understand the auditor's limit.

MS. KLINE: Well, the law provides a lot of different remedies. I mean, there are claims against the issuer of the --

JUSTICE JOHNSON: Right, right.

MS. KLINE: -- the securities, There are claims against the trustee, but -- but to impose that kind of liability on an auditor who -- who did not intend and had no knowledge of a -- a particular transaction is far beyond what the law and really any jurisdiction has allowed. I'd like to try --

CHIEF JUSTICE JEFFERSON: Are there any -- any further questions? Your time has expired.

MS. KLINE: I've got 49 seconds. Thank you.

CHIEF JUSTICE JEFFERSON: Thank you very much --

MS. KLINE: I'll try to address --

CHIEF JUSTICE JEFFERSON: We'll hear from you on rebuttal --

MS. KLINE: -- the other two points in my rebuttal. Thank you.

CHIEF JUSTICE JEFFERSON: Yes. Thank you. The Court is now ready to hear argument from the appellee.

SPEAKER: May it please the Court. Mr. Lackey will present argument for the respondent.

ORAL ARGUMENT OF PAUL LACKEY ON BEHALF OF THE RESPONDENT

MS. LACKEY: Thank you, your Honor. May it please the Court. My name is Paul Lackey and I represent the respondents who are four qualified investment entities that invest in high yield bonds through a single registered investment adviser. And those entities through that single registered investment adviser purchased bonds with time share company known as Epic.

Now, Epic in this case, the situation here is unique. This is not a case like other holder cases and this is not a case like others stock -- potential stock investors.

First of all, these bonds were -- are higher bonds that can only be sold to qualified investors. The baby in the E-Trade commercial can't click a link and buy these bonds. And the evidence in the Davis Deadman affidavit is that there's a limited universe of people, registered investment advisers in the U.S., that actually are qualified investors to buy these bonds and that buy high-yield bonds.

JUSTICE O'NEILL: Now you -- you've --

JUSTICE HECHT: High-yield is a -- is a euphemism for junk.

MS. LACKEY: Or junk is euphemism for high-yield. I mean, it's a -- it's a multi-billion almost trillion dollar market that -- that without, what do you call them "junk bonds" or "high-yield bonds," the U.S. economy would collapse. So, the sale, I mean, you know, people can call it junk bonds --

JUSTICE MEDINA: [inaudible] already.

MS. LACKEY: Well -- well, not with these junk bonds. But -- but perhaps because of lack of responsibility of auditors. The second thing, yeah --

JUSTICE O'NEILL: Now let me ask you a question, you sued for the face value of the bonds?

MS. LACKEY: Incorrect.

JUSTICE O'NEILL: How is the failure to set up the Escrow account that was designed to cover the interest payment affect the face value of the bonds?

MS. LACKEY: Yeah, two -- two points, first of all, your Honor, we didn't sue for the face value of the bonds. The petition and the claim for damages actually says, "for some significant amount of the face value of the bonds." Second of all, remember this is a no evidence summary judgment with regards to the damages portion. And the -- the no evidence summary judgment was not, there's no evidence that you have a particular level of damages. It was -- there's no evidence of damages.

And in response to that, we submitted evidence that if the auditors, if Grant Thornton had acted correctly and remember this is a case where Grant Thornton knew the Escrow wasn't funded from almost day one. This isn't a case where they weren't sure --

JUSTICE O'NEILL: But, okay -- but they knew they had money in other accounts to cover it. In fact, at the time of default on the interest payment, there was money there to pay it. They just chose to

pay it for operations.

MS. LACKEY: Arguably, at the time of the default, but the evidence in the record from -- from Mr. Flatley in his deposition at page 411, is that had he known earlier about the default, he would have funded the Escrow, had U.S. Trust come to him and said there was a problem, he would have funded the Escrow, and if Grant Thornton had not sent the negative reassurance letter, as part of the '99 audit to U.S. Trust, there's evidence in the record that U.S. Trust would have gone to Epic and that Flatley would have then funded the -- the Escrow account.

So, the damages and there's sort of two level of damages that we've talked about here. And the -- the first level is there's evidence that the Escrow account would have gotten funded had Grant Thornton done his job properly. The second level is if they had a -- had not sent the negative reassurance letter, if we had found out that the Escrow wasn't set up and funded and the company had refused to fund it, we could have filed it into bankruptcy earlier. And Davis Deadman in his deposition --

JUSTICE HECHT: What good would that -- what good would that have been?

MS. LACKEY: Well, Davis Deadman in his deposition at page 211 discusses this. And this is part of the unique structure -- that's actually my second part -- the unique structure of this bond deal. It was secured by a lien on real property. Unlike most bond sales, you had a lien on all the real property. It's a time share company, okay. So, you have a lien on this pie of time shares. Everyday that goes by, you sell another time share and your lien gets smaller, so the longer this company goes along, the less -- the less property you have a lien on, the less collateral you have. And so -- and this is what Davis Deadman explains in his deposition page 211 is that the earlier you put them into bankruptcy, the more of the pie you have to distribute to the creditors. And that's one of the circumstances that make this a unique factual case.

JUSTICE O'NEILL: So you didn't want the interest, in fact, you wanted to liquidate -- because you kept buying bonds after the default.

MR. LACKEY: Well, there's two reasons that we bought bonds -- that the respondents bought bonds after the default. First reason is they were trying to reach a threshold of control for the bankruptcy. If they have more than 50 percent of the bonds, you have a controlled premium where you're able to direct the trustee to take certain actions and you're able to take control in the bankruptcy process. So after the default, they paid a premium for a small amount of bonds to get over the threshold to own more than 50 percent of the bonds so that they would have some ability to control the process going forward and it's how high --

JUSTICE WAINWRIGHT: Your purpose there was not financial return then. Your purpose was something different, yet, you're suing for damages on those bonds too.

MR. LACKEY: Well -- well, two points. The -- the second point was that they also, at that time had realized that there had been significant mistakes by several professionals involved; Grant Thornton, and U.S. Trust, and -- and perhaps Prudential and they purchased or they believed they purchased at that time of the litigation rights. And so they were actually looking at those purchases, having a control premium which would allow them to maximize value.

Unlike a lot of hedge funds that invest one percent in a hundred different investments, this particular registered investment advisement takes large positions in investments because it believes if it has a

controlling position in the debt that it can maximize the value of the recovery --

JUSTICE HECHT: But after -- but after it is suing -- after it is suing for misstatements in the audit report, it's still buying bonds.

MR. LACKEY: Those claims -- Well those claims were dismissed.

JUSTICE HECHT: I know.

MR. LACKEY: [Inaudible] --

JUSTICE HECHT: They were still buying bonds.

MR. LACKEY: Well, they were buying bonds because they were trying to get to the control premium level.

JUSTICE HECHT: After the lawsuit was filed.

MR. LACKEY: Absolutely. And they were also trying to get the -- the litigation rights because they -- they believe they purchased the litigation rights. That the litigation rights travel with the bonds and those later purchases specifically addressed the litigation rights and that that was part of the ultimate recovery, was there had been significant mistakes by professionals which kind of leads me --

JUSTICE WAINWRIGHT: Let me -- I need to clear up a couple of things. First, you said U.S. Trust would have taken some action that could have averted some of these damages if the negative assurance hadn't been made and was false -- which was false, you alleged.

MR. LACKEY: Correct.

JUSTICE WAINWRIGHT: Apparently, according to the briefing, U.S. Trust was aware that these interest payments were made out of accounts or funds transferred from accounts other than this specific Escrow account and that -- that method had been used to pay this interest previously, so -- so, U.S. Trust knew that all the money didn't come from that one Escrow account.

MR. LACKEY: It's an interesting question and there's sort of several levels --

JUSTICE WAINWRIGHT: [Inaudible] what the briefing indicates, [inaudible] the record yet.

MR. LACKEY: -- There's sort of several levels. The -- the Appellate Court actually held that there was no evidence in the record to show what U.S. Trust knew about the status of -- of the Escrow account. And indeed, the evidence in the record by the representative --

JUSTICE WAINWRIGHT: That's different from my question --

MR. LACKEY: I agree.

JUSTICE WAINWRIGHT: My question is, did U.S. Trust know that prior to the default, that funds had been used to pay the interest from not just the Escrow account but from different accounts?

MR. LACKEY: There's -- there's no evidence in the record to that effect, your Honor.

JUSTICE WAINWRIGHT: It's contrary to the briefs.

MR. LACKEY: And -- well, the other point, though, is even if there were evidence, and if you're talking about an imputation, there's -- there's an adverse interest exception. And the evidence from U.S. Trust is had, for example, Grant Thornton not, in effect, lied, I mean, Grant Thornton's representative [inaudible] admits, they knew that the Escrows weren't set up and weren't funded properly and yet they sent a letter, a negative assurance letter to U.S. Trust saying it was okay. U.S. Trust says that they had relied on it and -- and that's kind of the third aspect of the Indenture that makes this unique. Unlike -- the only reason that you have an auditor is these are public bonds.

JUSTICE WAINWRIGHT: Let me be sure I understand so -- so you're saying there's no evidence in the record that U.S. Trust knew that

funds to pay the interest had come from accounts other than just the Escrow account.

MR. LACKEY: I -- I don't believe there's any evidence in the record of that [inaudible].

JUSTICE WAINWRIGHT: The -- the next thing I want to clear up. Who did U.S. Trust work for?

MR. LACKEY: That's another interesting question --

JUSTICE WAINWRIGHT: Who is responsible to -- I think part of your position is they were the funds -- U.S. Trust was the fund's agent so, information provided to Trust was the same as providing the information to the funds.

MR. LACKEY: For some purposes and -- and that's where this is actually relatively complicated when it comes to the multiple agencies. They were, first of all, an Escrow agent. And as an Escrow agent, they were an agent for both parties. And that's one of the reasons why the Court of Appeals says down below, besides the fact that the imputation argument wasn't raised until the reply brief and the summary judgment and besides the fact there's no evidence of what U.S. Trust knew and the adverse interest exception. They also say that unlike a typical situation where they're a single agent, here, U.S. Trust has multiple agency roles. One of them is as a dual agent as an Escrow agent for both parties, and then they also have a role under the Indenture that makes this unique, separate and apart from sort of Federal law on auditing public bonds which is this Escrow account.

And for purposes of determining the Escrow account, they -- they say they're allowed to under the Indenture rely on Grant Thornton's audit and their negative assurance letter that the Escrow account's being properly set up and maintained and that they send that letter to U.S. Trust as the representative for the bond holders and then U.S. Trust sends that out to all the bond holders. So, this isn't a case where you have a huge universe of potential investors that -- that have no contact with Grant Thornton. This is a case where Grant Thornton knows it's sending a letter to a representative of the bond holders as the caretaker for things like the Escrow.

JUSTICE WAINWRIGHT: Davis Deadman was Highland Capital's Senior Portfolio Manager. MR. LACKEY: Correct. JUSTICE WAINWRIGHT: Was he a -- a investment adviser to the funds? What was his role?

MR. LACKEY: Yeah. In essence, the way that these investments work is -- there's different structures that actually purchase the funds, okay and -- and there's -- a number of different structures that any particular registered investment adviser controls the investment decisions for. Davis Deadman was the individual responsible at the registered investment adviser for making the purchases for all of the funds. And that's how all of this debt sold. There's a limited number of registered investment advisers that buy high yield bonds for qualified investors and that one investment adviser makes multiple purchases.

JUSTICE WAINWRIGHT: Now, Deadman, um -- I believe, according to the briefing indicates that as you affirmed, I think, that part of the strategy was that in liquidation or in bankruptcy, a better recovery could -- could be obtained and towards the end of this transaction. Did that strategy come from Deadman or was that the fund strategy and was he more of -- was he just an agent executing transactions or was he providing investment advice?

MR. LACKEY: He -- he is the investment decision maker. The funds -- the way this is set up and that's why it's a little bit, disingenuous in my mind to say only Prospect held the funds at the time -- at time

of the first letter. Prospect is, but one of a multitude of investment vehicles for Highland Capital Management. Davis Deadman is a senior partner at Highland Capital Management. There's no one at the fund levels -- most of the funds don't have employees. The registered investment advisement -- adviser makes a 100 percent of the decisions. Davis Deadman was the sole decision maker for all of the respondents and all of their purchases. It's one registered investment adviser that analyzes the situation, determines the investment and has a 100 percent capacity to -- to make decisions on the investments.

JUSTICE WAINWRIGHT: So you say U.S. Trust should have been advised that the contrary to the actual representation made by the negative assurance, should have been advised that the funds were not in Escrow.

MR. LACKEY: Absolutely.

JUSTICE WAINWRIGHT: But the record at -- again, according to the brief -- briefing indicates that Deadman isn't even -- didn't even remember reading the -- the audit report that had the negative assurance.

MR. LACKEY: I don't believe that's true, your Honor.

JUSTICE WAINWRIGHT: I think the record indicates otherwise.

MR. LACKEY: The -- the -- well -- well, the record indicated -- Davis Deadman's deposition was a three day extravaganza involving multiple cases and a lot of questions that kind of went back over and over to him, okay. And -- and that was well in advance of -- of his affidavit. His affidavit, I think, he synthesizes much of that questioning and says that he indeed did look at all of the -- of the K's and the Q's and all of that information with regard to making any of these purchases or making decisions on the bonds and he relied on U.S. Trust and Grant Thornton as -- as he's allowed to, I believe, under the Indenture with regard to the Escrow agreement. So, he didn't separately investigate it. He said it would be a practical impossibility and not how the market works; that what you do in this situation you have the public audits which are only there because of the bonds. The only reason you have an audit is the bonds and in particular, the Indenture requires that you send a copy of that audit and this negative assurance letter to the representative of the bond holders. That's why this is a unique case.

JUSTICE O'NEILL: Would you agree with the characterization of the fund status as holders?

MR. LACKEY: No. As -- as these being holder claims? No, absolutely not, your Honor. These are not -- these are not holder claims --

JUSTICE O'NEILL: Okay, well, let me ask you this. If they were holder claims, do you think they would survive under the facts here?

MR. LACKEY: Well -- well, yes. If you look at the Charvanian case which examined Delaware law, but -- but a Texas Court of Appeals case --

CHIEF JUSTICE JEFFERSON: In which case, I'm sorry?

MR. LACKEY: Charvanian and -- and the Burrows case.

JUSTICE O'NEILL: But Charvanian involved a specific sale that was about to be made and the specific phone call that was relied on not to sell.

MR. LACKEY: And this involves a specific provision that says you will hire a nationally accredited auditing firm, Grant Thornton, and that firm will provide a negative assurance letter to the representative of the bond holders U.S. Trust that says that nothing's been violated --

JUSTICE O'NEILL: But you'd have to agree -- you'd have to agree, though that that case -- tell me Charvanian I don't know how to

pronounce it, it's a funny, so --

MR. LACKEY: However you'd pronounce it, Charvanian. I'm sure, I mispronounced it.

JUSTICE O'NEILL: I'll just call it that case --

MR. LACKEY: Okay

JUSTICE O'NEILL: -- the 14th Court of Appeals, I believe.

MR. LACKEY: Yes, we can agree on that.

JUSTICE O'NEILL: That -- that -- that case had a much higher proof threshold for a specific sale.

MR. LACKEY: Well, first of all in holder claims, if you had holder claims here with those -- there's purchase claims, there's not filing a bankruptcy claim, there's Epic claims. We've never made a claim of damages for holding on and not selling the bonds here, okay. So -- so, we don't have -- this is not a holder claim situation. And as a matter of fact, the word holder claims was not mentioned in the summary judgment briefing. The holder claims cases were not cited in the summary judgment briefing. None of this was brought up really until the Supreme Court level. This isn't a holder claims case. But if you're looking at holder claims in Texas, there's certainly a long history of fraud that causes inaction to be something that you can -- you could sue someone for and you have to prove causation and you have to prove reliance. And the issue with a lot of the holder claims cases is that, for example, if you buy stock -- so it's all investors in the world, the baby on E- Trade you buy stock and you say that you would have sold it if you had known about a misrepresentation that -- that affected the actual value of the asset. Well, if anyone had known that, the value would have been lower. And so there's a damages issues there. Whereas here we're talking about specifically funding an Escrow or putting a company that's liquidating your collateral on a daily basis into bankruptcy sooner. [Inaudible] case where we claim we would have sold it sooner.

JUSTICE HECHT: You say those are unique characteristics but it seems like they would obtain in any kind of transaction like this. You always have an auditor, you would always be required to give negative assurances and --

MR. LACKEY: It -- it's not true, your Honor. This is -- this is -- these are unique bonds. They're almost no bond sales that have Escrows and liens. Bonds are, generally, unsecured --

JUSTICE HECHT: [inaudible] something else, so, I mean, that's the only purpose of having an auditor.

MR. LACKEY: No, if you didn't have -- no -- normal -- a normal bond situation, if you have public bonds, you have to have an auditor. That part's true. But it -- it is --

JUSTICE HECHT: The auditor will make statements and if all of the investors can sue on those statements then we're right back where we started.

MR. LACKEY: But this is a different case. Because in this case --

JUSTICE HECHT: Why is it different?

MR. LACKEY: Right, because in this case, [inaudible] Escrow --

JUSTICE HECHT: -- has a different name, why is it different?

MR. LACKEY: Not -- not true, your Honor. You had an Escrow and -- and you had liens on the property.

CHIEF JUSTICE JEFFERSON: Counsel, would you let the JUSTICE finish his question?

MR. LACKEY: Oh, I'm sorry.

JUSTICE HECHT: Let me finish. You say this is a different case and it's unique, but it's not unique in the sense that an auditor has been

employed to look at the transactions and the documents and see whether they've been in compliance.

MR. LACKEY: I -- I disagree, your Honor.

JUSTICE HECHT: All right.

MR. LACKEY: Normal -- in a normal case, a normal bond case, you would start to have an auditor, audit and issue public financials. That's absolutely true. But I don't know of any other bond case that has this unique Escrow feature or -- or the lien feature. That's not -- you don't normally see that in a bond case and you don't normally have --

JUSTICE HECHT: I -- I take your point on that.

MR. LACKEY: Okay. And you don't --

JUSTICE HECHT: But I don't see how that affects the auditor's general obligation. It will just be -- take another form in another setting.

MR. LACKEY: It -- it makes it different in this case because you had to send the actual negative assurance letter to the representative for the bond holders and that's because they wanted to make sure that the Escrow was funded, and you have a unique Escrow here and you don't normally, have to send the assurance letter and in addition to sending the assurance letter, you send the audit to the representative of the bond holders which indicates that that there is -- is some evidence in the record that it's especially likely that they understood that the bond holders were going to rely on that. This isn't a case were it's just a public audit that's out on -- on Edgar They have to actually send a copy of the audit with the negative assurance letter to our representative --

JUSTICE O'NEILL: The representative in this case, you're claiming is U.S. Trust?

MR. LACKEY: Yeah, for purposes of getting the negative assurance letter.

JUSTICE O'NEILL: And U.S. Trust knew the situation?

MR. LACKEY: The evidence of the record is -- there's no evidence in the record they knew the situation.

JUSTICE HECHT: It was their account.

MR. LACKEY: It was their account. But that -- but that's what the Court of Appeals said. There's no evidence in the record that they knew, that there was anyone there that knew the situation. But perhaps more importantly is the adverse interest exception to -- to imputation and actually sort of, more importantly, they didn't raise the imputation argument until the reply brief on the summary judgment. But what the Court of Appeals says is we [inaudible] have to get to that issue. It would true that would be a problem but [inaudible] have to get there because there's a -- a multiple fact issue. One being, they were dual agent. And all those imputation cases aren't about dual agencies. They were dual agent in Escrow --

JUSTICE O'NEILL: Well okay. But -- but you would agree if they are the funds representative and their -- their agent then the -- the U.S. Trust knowledge can be -- has to be imputed to the funds, as well.

MR. LACKEY: There's a fact question is an adverse interest. And that's what the Court of Appeals held there is that if there was no adverse interest exception and if they weren't a multiple agent, if they didn't -- weren't an agent for both parties, then absolutely, that there's an imputation of -- of what they knew.

JUSTICE O'NEILL: Wait, so are -- are you telling me then because they're an agent for both parties, you only impute the misrepresentations, but you don't -- or the reliance but you don't

impute the knowledge of the -- of the agent as well?

MR. LACKEY: They wore different hats. So, they wore more -- they -- they wore a hat where they were representative of the bond holders and they made mistakes, they were sued and they made mistakes. That's absolutely true and that would be something that you have to parse out in terms of damages at the trial court level. But they -- if they have an adverse interest to you, the case -- and -- the reason they have an adverse interest is because they made mistakes in setting up the Escrow, and so the Court of Appeals said that it becomes a fact issue, the nature of that adverse interest and whether or not that adverse interest means that you don't impute it because the case law is clear that once your agent has an adverse interest on something, then you don't impute their knowledge. And so -- and then that becomes a fact question, and there's evidence in the record that they had an adverse interest.

JUSTICE O'NEILL: What created the adverse interest?

MR. LACKEY: Their failure to properly set up the Escrow account.

JUSTICE WAINWRIGHT: Going back to that point in the Petitioner's brief on the Merits page 9, it says U.S. Trust allowed Epic to maintain the interest Escrow in two different accounts. Epic periodically transferred money to U.S. Trust from another account to make interest payment. This [inaudible] situation -- this had been the situation for sometime and U.S. Trust never objected to this arrangement by [inaudible] Court order's record page number cited. Do you think that's false?

MR. LACKEY: Well, what's interesting is -- the U.S. Trust they didn't know about it.

JUSTICE WAINWRIGHT: [inaudible] isn't it -- didn't you say you thought there was no evidence that U.S. Trust knew that the funds came from different accounts to pay the interest.

MR. LACKEY: -- I don't -- I don't think there's any evidence in the record they knew about it. Maybe they should have known about it.

JUSTICE WAINWRIGHT: [Inaudible] possible you have a different interpretation of the record. Are you saying they know -- don't they?

MR. LACKEY: I think -- the -- the difference is should have known versus known. I mean, I think that points to an argument that maybe they should have known. Now, I don't believe there's any general imputation of what your agent should have known versus what your agent knew. I have not seen any case law that imputes what your agent should have known. I don't think -- and -- and this is what the Court of Appeals noted is that there -- they didn't think there was any evidence in the record about what U.S. Trust actually knew anyone at U.S. Trust what they knew. As a matter of fact, they said they were relying on Grant Thornton and these negative assurances, but that -- that goes to what they should have known.

CHIEF JUSTICE JEFFERSON: Are there further questions, Justice Wainwright? Thank you, Counsel.

REBUTTAL ARGUMENT OF SAMARA KLINE ON BEHALF OF THE PETITIONER

MS. KLINE: Let's remember what this negative assurance statement was. It was a snapshot in time. U.S. Trust, there is evidence in the record that U.S. Trust confirmed, this is at page 3211 of the record. U.S. Trust confirmed as of December 31, 1999 that the Escrow account existed and contained more than the amount of the next required interest payment. Following the negative assurance statement, Epic paid

the interest that was due, all through the year 2000. The negative assurance statement itself related only to the condition of the Escrow account as of December 31, 1999.

It is undisputed, further, that the bond holders never received, saw, or heard about the negative assurance statement. U.S. Trust maintained the account. There are records, account records in the summary judgment record here. And there is not a shred of evidence that the negative assurance statement that opined as to the condition of things at December 31, 1999 had anything to do with what happened in 2001 when the interest payment was missed. In fact, the evidence in the record is that Epic chose not to make the interest payment because of the big elephant in the room. It had lost it's critical financing, its lifeblood. It had no cash to continue operations, and it chose to use the cash that it had set aside for interest payments to, instead, fund operations.

JUSTICE WAINWRIGHT: What is -- I'm sorry.

MS. KLINE: So, -- I'm sorry.

JUSTICE WAINWRIGHT: -- let me interrupt here, what does the record shows about Deadman's knowledge of the state of the Escrow account as of December 31, 1999?

MS. KLINE: I know the record -- it's undisputed that Deadman never saw the negative assurance statement. What Deadman said with respect to well -- I -- I don't know that there's anything in terms of Deadman and the Escrow account. The record is that Deadman first said he couldn't remember if he had looked at the 10k's. And remember the 10k's is a whole bunch of information, one page of which is the audit report. He first said he couldn't remember if he'd seen it. About six months after his deposition, he filed an affidavit in connection with opposition to the summary judgment motion where he said, I relied on any 10k's that were out there before I purchased, made purchases after the 10k's. So, there's no -- there's no specific evidence that Deadman read or relied on the audit report, it's a --

JUSTICE HECHT: What is your answer to the argument that if we had known sooner, we would have taken other action?

MS. KLINE: Well, I think if you heard that the recitation of all the speculation that that depends on, I think it's inherently speculative and no evidence of causation, but at a minimum, that kind of argument would require expert testimony. A lay juror could not make an inference about complicated financial transactions and what would happen in bankruptcy and whether bankruptcy was even possible earlier. If you look at the record, and -- and we explained this in our brief, an event not maintaining the Escrow account was not a default under the Indenture for sixty days. There was a 60-day cure period. And then even after that 60 days, the bond holders had to give notice to the trustee and there was another 60-day period. So, even if in the year 2001 if the audit report on the 2000 financial statements had been different, it -- it would have been impossible to put Epic into bankruptcy any earlier than they did. But even setting all that aside, at a minimum, you would have to have some kind of expert testimony just like in other causation cases that the court has decided to support and to get pass summary judgment on -- on that kind of thing. I -- I want to just remind the Court, the concepts that we're talking about are -- are not novel. Justice Cordoza -- Cordoza explained the reasoning behind preventing indeterminate liability to auditors back in 1931. JUSTICE *Rehnquist wrote the Blue Chip Decision that -- that has the purchase and sale requirement and -- and explains why holder claims aren't viable in 1975. The Court of Appeals opinion in this case is out of

step with Texas law and law that's developed throughout the country over decades. This Court should keep Texas in the mainstream by reversing the Court of Appeal's judgment and rendering a judgment for Grant Thornton.

CHIEF JUSTICE JEFFERSON: Thank you, Counsel. The cause is submitted and the Court would take a brief recess.

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