STATE OF MINNESOTA
IN COURT OF APPEALS
A06-1309

Julia A. Christians, Trustee for the Bankruptcy Estate of Technimar Industries, Inc.,

Appellant,

v.

Grant Thornton, LLP,

Respondent.

APPELLANT'S REPLY BRIEF

Kalina, Wills, Gisvold & Clark, P.L.L.P.
Gordon B. Conn, Jr. #18375
6160 Summit Drive, Suite 560
Minneapolis, MN 55430
Telephone: (612) 789-9000
Facsimile: (763) 503-7070
Attorneys for Appellant
Julia A. Christians, Trustee for the Bankruptcy Estate of Technimar Industries, Inc.

Oppenheimer Wolff & Donnelly LLP
Michael E. Keyes #193902
Katherine M. Wilhoit #313853
Heidi A. O. Fisher #320638
Mark P. Schneebeck #348922
3300 Plaza VII Building
45 South Seventh Street
Minneapolis, MN 55402-1609
Telephone: (612) 607-7000
Facsimile: (612) 607-7100
Attorneys for Respondent
Grant Thornton, LLP

STATE OF MINNESOTA
IN COURT OF APPEALS
A06-1309

Julia A. Christians, Trustee for the Bankruptcy
Estate of Technimar Industries, Inc.,

Appellant,

v.

Grant Thornton, LLP,

Respondent.

TABLE OF CONTENTS

Table of Authorities

Page

Other Authorities

Introduction

Contrary to the repeated assertions by its negligent auditor, Respondent Grant Thornton, LLP, Technimar Industries, Inc., was not a "fraudulent debtor." It was a legitimate business attempting to commence manufacture of a premier product, now on the market under a variety of names, including "Cambria," "Silestone," "Technistone," "Bretonstone,"and others.

An Italian company, Breton, S.p.A., ("Breton") had developed a proprietary manufacturing process for the "agglomerated stone" product, basically made from certain sands and other quartz-bearing minerals, the final product being apparently superior to natural stone, such as granite, and to synthetic products, such as DuPont "Corian." In 1994, Technimar entered into a contract with Breton whereby Technimar would have the exclusive right to manufacture the "Bretonstone" product in the United States, and would buy from Breton the necessary manufacturing equipment for approximately $16 million. Technimar paid Breton over $2 million as an initial deposit.

Technimar needed a manufacturing facility and capital. Plans were made for Technimar to move its existing stone-fabrication business from Texas to Minnesota, and to establish a manufacturing plant in Cohasset, Minnesota.

A private placement offering in early 1996 raised over $12 million for Technimar. The Minneapolis Police Relief Association ("MPRA"), was persuaded to invest $5 million of its pension fund money in Technimar stock, and also made debt investments in Technimar, with promissory notes generally due in early 1998. Other Minneapolis police and fire pension funds made similar investments in Technimar.

The debt and equity capital permitted Technimar to make substantial payments to Breton on the equipment contract, but by mid-1996, Breton was still owed approximately $8.4 million. More money was needed to bring the project to fruition. Financing arrangements were made with Heller Financial, Inc. ("Heller"), whereby the City of Cohasset would issue an industrial revenue bond for $12 million, to be assigned to Heller. A manufacturing facility would be built in Cohasset, by a partnership of Minnesota Power and Mortenson Company, to be leased to Technimar.

Heller was to obtain a first security interest in both the Breton equipment to be delivered and in Technimar's rights under the exclusive equipment contract. Heller required additional financial support for the credit facility to Technimar, and the City of Cohasset guarantied a portion of the $12 million bond obligation, as did the Iron Range Resource and Rehabilitation Board ("IRRRB"). Still more financial support was to be provided by a collateral pledge of $7.6 million by Valent Venture & Growth ("Valent"). The pledge was to be cash, invested in cash-equivalent government securities on deposit with Norwest Bank for the benefit of Heller.

In September 1996, in contemplation of a closing by October 30, 1996, Breton had agreed to invest $7.6 million of its proceeds from the Heller financing in Valent. Valent would then guarantee $7.6 million of the Heller loan obligation, and thereafter Technimar would buy $4 million of Breton's Valent shares, and Valent would buy $3.6 million from Breton (September Agreement, A. 44-47). It was understood by the City of Cohasset, the IRRRB, Minnesota Power, and Mortenson that Technimar would redeem Breton's investment in Valent. The Heller closing was delayed, and the September agreement was amended by a December 20, 1996, agreement, which linked shipment dates to payments; it also increased Technimar's share of the required redemption to $6.6 million, but extended the times for payment to Breton as follows:

$1.0 million prior to 12/30/96

$1.2 million by 1/31/97

$2.0 million by 2/28/97

$2.4 million by 3/31/97

The Heller loan closed, and Technimar commenced making the further payments to Breton, which were disclosed to Grant Thornton in connection with its audit (A. 109-111).

It is thus obvious that, despite Grant Thornton's characterizations, Technimar was not a "fraudulent debtor." The debt and equity financing it obtained was for a legitimate business purpose. It has never been alleged that the private placement offering was in any way fraudulent. Technimar was not a Ponzi scheme or a conspiracy to violate laws.

Technimar did not obtain audited financial statements for the purpose of defrauding its creditors or investors. Rather, the Heller bond financing required that Technimar provide Heller with audited financial statements subsequent to closing of the financing. Technimar shopped around, obtained several proposals, and ultimately was persuaded to retain Grant Thornton to audit its 1996 financial statements. In its engagement letter (A. 77), Grant Thornton stated that [o]ur audit will be conducted in accordance with generally accepted auditing standards . . ."

Grant Thornton began its auditing work in early 1997, and on or about May 15, 1997, issued its unqualified opinion that the audited financial statements presented "in all material respects the consolidated financial position of Technimar . . . as of December 31, 1996 . . . in conformity with generally accepted accounting principles."

The audited financial statements showed $26,260,863 in total assets and $16,255,655 in liabilities, for a net worth of just over $10 million. The Assets included a $16 million deposit on the Breton machinery and equipment, but the Liabilities did not disclose the $7.6 million obligation to Breton.

As was required under the Heller loan transaction, Grant Thornton also provided its "Debt Compliance Letter," indicating there were no defaults or events of default under the Heller security agreement, and its notes to the financial statements recite that a "security agreement between the purchaser of the bond [Heller] and the Company contains certain restrictive covenants, for which the Company is in compliance."

It is undisputed that the audited financial statements did not disclose Technimar's true financial condition. It is also beyond dispute that Grant Thornton's Debt Compliance Letter was in error, because Technimar's redemptions (disclosed to Grant Thornton) of Breton's Valent shares were prohibited investments in violation of the Heller loan covenants and constituted an event of default, such that Technimar was not in compliance with the restrictive loan covenants.

In light of the parties' experts' conflicting opinions, and in light of substantial evidence to support the trustee's claims of breach of contract and negligence (see Appellant's Brief, pp.22-24), the district court denied Grant Thornton's motion for summary judgment on the accounting malpractice claim.[1] Notwithstanding its negligence, Grant Thornton seeks affirmance of the dismissal on various issues, none of which support the granting of summary judgment in the facts of this case.

Argument

I. The doctrine of in pari delicto has no application in the facts of this case.

---

1 The Court erroneously concluded that the breach of contract issue was not addressed, and granted summary judgment on that claim. (A. 189). But breach of contract for failure to conduct the audit in conformance with generally accepted standards, and a claim for negligent failure to conduct the audit in conformance with generally accepted standards involve essentially the same elements, and were addressed as one by the trustee, both in her brief and in oral argument (Plaintiff's Memorandum, R.A. 79-83, T. 31), and summary judgment on the breach of contract claim was inappropriate for the same reasons it was denied on the malpractice claim.

Consistent with its repeated characterization of Technimar as a "fraudulent debtor," Grant Thornton seeks affirmance on grounds of the in pari delicto doctrine.

The defense of in pari delicto refers to "equal fault or guilt." Black's Law Dictionary 791 (6th ed. 1990). With the merger of law and equity, the doctrine is a "counterpart" of the equitable defense of unclean hands, which "forbade a plaintiff to recover damages if his fault was equal to the defendant's." Byron v. Clay, 867 F. 2d 1049, 1052 (7th Cir. 1989). The in pari delicto doctrine is closely related and considered a corollary of "unclean hands." 27 Am Jur. 2d, Equity §132.

The District Court correctly determined that Grant Thornton's comparative fault defense could not be decided on summary judgment (A.189), but the Court's reasoning applies with equal force to the in pari delicto defense, which also requires a comparison of fault or guilt. Instead, without having seen a single witness or heard any testimony, the District Court rendered summary judgment for Grant Thornton on this issue.

It is true that many federal courts have found the defense to be available in actions by bankruptcy trustees, with only a minority (albeit well-reasoned) holding it to be unavailable as a matter of law.[2] But it is also true that most cases in which it has been so applied against bankruptcy trustees have involved criminal

---

[2] Academic comment has been generally critical of allowing the defense in the bankruptcy context; see, e.g., Tanver Alam, *Fraudulent Advisors Exploit Confusion in The Bankruptcy Code: How In Pari Delicto Has Been Perverted to Prevent Recovery for Innocent Creditors*, 77 Am. Bankr. L. J. 305 (2003).

wrongdoing or massive frauds by the debtor prior to bankruptcy, and it is uniformly recognized that the applicability of the doctrine, even as against a federal bankruptcy trustee, is a matter of state law, hence the somewhat bewildering patchwork of federal court decisions in this area.

Minnesota law precludes its application in this case. Grant Thornton correctly asserts (Brief, pp. 22-3) that a federal bankruptcy trustee generally stands in the shoes of the debtor. But that is also true with respect to a receiver appointed under state law; the receiver likewise "stands in the shoes of the insolvent as regards the defenses . . . which the defendant may set up. Dunnell's Minnesota Digest, Receivers, §4 (d) (4th Ed. 1998).

For receivers in some states, wearing the debtor's shoes may subject the receiver to the in pari delicto defense—see Knauer v. Johnathan Roberts, Inc., 348 F. 3d 230 (7th Cir. 2003). But not in Minnesota, not under the authority of Bonhiver v. Graff, 248 N.W. 2d 291, 296 (Minn. 1976); Magnusson v. American Allied Ins. Co., 189 N.W. 2d 28, 33 (Minn. 1971); and German-Am. Finance Corp. v. Merchants & Mfgrs. Bank, 225 N.W. 891 (Minn.1929).

Grant Thornton relies upon State v. AAMCO Automatic Transmissions, Inc., 199 N.W. 2d 444 (Minn. 1972), in which the Court held that the claim against a franchisor by a damaged franchisee who had participated in illegal sales practices with the franchisor was barred on grounds of in pari delicto. But the decision was made only after a jury had assessed the relative blame of the parties, and in affirming application of the doctrine in that case, the Minnesota Supreme Court observed:

> "We do not forecast an uncritical application of this doctrine, for it is not without exception. A paramount public interest in the enforcement of some statutes may call for judicial intervention in favor of one wrongdoer against the other in order to effectuate the enforcement of a public policy which overrides considerations of a benefit inuring to a wrongdoer."

State by Head v. AAMCO Automatic Transmissions, Inc., 199 N.W.2d at 448, citing Perma Life Mufflers, Inc. v. International Parts Corp. 392 U.S. 134, 139, 88 S.Ct. 1981, 1984, 20 L.Ed.2d 982, 990 (1968).

In the present case, any recovery by the bankruptcy trustee will not benefit any person or entity whose conduct is alleged by Grant Thornton to give rise to the in pari delicto defense, but rather, as in Bonhiver v. Graff, recovery will be for the benefit of creditors. Affirming the District Court's application of the doctrine in this case will let Grant Thornton escape liability for auditor malpractice, to the detriment of Technimar's innocent creditors.

II. Evidence and fact issues should have precluded summary judgment on issues of reliance, damage, and causation.

Grant Thornton argues that the knowledge of Roberto Contreras, Sr., of the December agreement with Breton is imputed to Technimar, such that, in a massive leap of logic, Technimar therefore cannot have relied on Grant Thornton's audited financial statements. Of course, in most cases, knowledge of an officer is imputedly knowledge of the corporation; but imputing such knowledge to a corporation for purposes of liability for respondeat superior or contract enforcement is inherently different from imputing knowledge to defeat reliance on an audited financial statement.

Legal fictions aside, the fact in this case is that successor management of Technimar (Jay Salmen) did not know why Breton was withholding delivery of the remaining equipment, and even sought to engage Italian counsel to enforce Technimar's rights (Salmen Depo., S. R. 164).

Imputed knowledge of a single fact (here the December agreement) is not the same as knowledge that the audited financial statement was wrong, FDIC v. Deloitte & Touche, 834 F. Supp. 1129,1137 (E. D. Ark. 1992). Grant Thornton dismisses the Court's discussion in that case as mere dicta, which technically it may be, but it also simply reflects common sense. Technimar's Chief Financial Officer, Luis Contreras, testified in his deposition that he believed the Grant Thornton audited financial statements and subsequent internal statements to have been accurate, and that he relied on the audit report in the conduct of Technimar's business (Luis Contreras Depo., pp.12-13 and Contreras Depo Ex. 1; S.R. 137, 149). As CFO, he signed the promissory notes to the Minneapolis Police Relief Association, and provided the audited financial statements to it (Luis Contreras Depo., at p.7, S.R. 136).

Grant Thornton argues that Technimar suffered no damage because the damage was to the creditors, not Technimar, a patently erroneous contention addressed at pp. 26-30, Appellant's Brief, and not repeated here. In further support of its "no-damage" argument, Grant Thornton asserts (Brief, p. 29, n.10) that if it is held liable to Plaintiff, Plaintiff must indemnify it, stating "Inasmuch as any recovery obtained by Appellant must be returned to Respondent, there can be no damages in this case." This "Catch-22" argument is without merit, because the law does not favor indemnification for one's own negligence, and because the provision in Grant Thornton's retention letter does not provide that it applies to claims by the client, as opposed to the auditor's liability to third parties, it affords no defense to Grant Thornton. See National Hydro Systems v. M. A. Mortenson Company, 529 N.W. 2d 690, 694 (Minn.1995).

Grant Thornton also asserts (Brief, p. 31) that there is no causation, because decisions to incur more debt were made by Technimar, not Grant Thornton, and Grant Thornton had nothing to do with management's business decisions. By this argument, Grant Thornton is implicitly asking this Court to eliminate any action for auditor malpractice in this state, because auditors seldom if ever will be a participant in a client's business decisions based upon management's understanding of the audited financial statements.

It is of course true that Grant Thornton was not involved in Technimar's operations after rendering its erroneous audit, but it is also true that Technimar's Chief Financial Officer has testified that he relied on the audited financial statements in the conduct of Technimar's business, thereby providing a causal link. (Luis Contreras Depo., pp.12-13, S.R. 137).

One cannot say with absolute certainty what would have happened if the Grant Thornton audit had resulted in accurate financial statements, but at summary judgment, the non-moving party is entitled to have inferences resolved in her favor. When Technimar's true financial condition came to light after Luis Contreras had incurred significant additional debt in reliance on the audited financial statements, Technimar's management was replaced and, ultimately, a Chapter 11 case filed. At the summary judgment level, it is a fair inference that if the true financial situation had been known earlier, such steps would have been taken earlier.

Grant Thornton makes much (Brief, p.32) of the trustee's deposition testimony acknowledging "speculation" on her part as to what would have happened if the Grant Thornton opinion had been accurate, but fails to include her other testimony, as an experienced bankruptcy trustee, regarding the "what if" question:

> Q. [W]hat is it about the audit that would have stopped the debtor from accumulating the additional debt?
>
> A. For one thing, investors would not have been as anxious to invest in the company. For another, the company would likely have conducted its business in a different manner, aiming for a more positive result, which may have been sale or an earlier Chapter 11 filing to stop the bleeding, with

the potential for reorganization or, again, a sale
within the 11.

Julia Christians Depo., pp. 127-8, S.R. 436.

Grant Thornton's motion for summary judgment did not put into play the quantum of damage, but rather the fact of damage and causation of damage as an element of accountant liability (Memorandum in support of motion for summary judgment, pp. 28, 31, R. A. 38, 41). With due regard for resolving inferences in favor of the non-moving party, both elements are established in this record. But for Grant Thornton's erroneous audit, not only would Technimar not have incurred the substantial additional debt, it could not have, because the Minneapolis Police Relief Association would have cut off the funding (Berryman Depo. pp. 22-3, S.R. 284).

Conclusion

Despite Grant Thornton's efforts in this litigation to characterize Technimar as a "fraudulent debtor," it was not; at most it was guilty of optimism. It is at least a bit ironic that in this appeal from a summary judgment in an auditor malpractice action, the auditor's malpractice is not at issue. The District Court denied Grant Thornton's motion for summary judgment as to its negligence, and for good reason—Grant Thornton simply botched the job. Over a year after the audit, Grant Thornton withdrew its audit opinion (unprecedented in the Minneapolis office, according to James Ravell, the audit partner), and all members of the audit team, except for partner Ravell, are no longer with the company.

This case is important because it presents the issue of whether various artificial constructs and legal fictions should provide shelter to a negligent auditor in a case brought by a bankruptcy trustee. The Big Eight (Seven, Six, Five, Four?) accounting firms are very good and very experienced in urging such legal shelters, as is Grant Thornton, now apparently Number Five in the dwindling availability of auditor choices for business.

The defendants' assertions of concepts such as in pari delicto and imputation in auditor malpractice actions divert attention from the underlying and fundamental question of did the auditors do their job? If they did not, what should be the consequence? Under the District Court's decision, the harmful consequences of a negligent audit are borne by the audit client's innocent creditors, not by the negligent auditor.

As reflected in the sheer volume of the record submitted by the parties on this appeal, there are numerous issues of material fact relating to Grant Thornton's defenses. The District Court impermissibly drew inferences in favor of the moving party, and Appellant respectfully prays that the summary judgment be reversed.

October 16, 2006.

KALINA, WILLS, GISVOLD & CLARK, P.L.L.P.

By: ____________________

Gordon B. Conn, Jr. (#18375)
6160 Summit Drive, Suite 560
Minneapolis, MN 55430
Tel. (612) 789-9000
Fax (673) 503-7070
Attorneys for Appellant
Julia A. Christians, Trustee for the
Bankruptcy Estate of Technimar Industries, Inc.