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Judicial Construction in the Wake of the Nation's S & (and) L Crisis: Build a Better Status and the FDIC Will Beat a Path to Your Courtroom

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JUDICIAL CONSTRUCTION IN THE WAKE OF THE NATION'S S & L CRISIS: BUILD A BETTER STATUS AND THE FDIC WILL BEAT A PATH TO YOUR COURTROOM

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I. INTRODUCTION

In March and July of 1992, the accounting firms of Deloitte and Touche and Peat Marwick were sued for $150 million and $100 million, respectively, in connection with audits of bankrupt thrift clients.  

Arthur Andersen was recently targeted with, and is currently defending, a $400 million lawsuit involving one of its failed financial institution clients. 

1Gail D. Cox, Unlimited Liability Accountants' Legal Expense is Fuzzy, but the Bottom Line is Clear: Damages are Exploding, NAT'L J., Dec. 21, 1992, at 1, 22.

2Suit is Said to Bar Arthur Andersen from Contract Bid, N.Y. TIMES, Aug. 26, 1992, at D1. Arthur Anderson, as a result of this malpractice allegation, was barred from competing for a twenty million dollar government contract. This is another example of the adverse economic impact experienced by professional firms as a result of the current...
Ernst & Young ("E&Y") settled all of the government's claims against it arising out of the failure of several of its savings and loan institution clients for $400 million.3

Like these accounting firms, law firms similarly suffer. Early in 1992, the law firm of Kaye, Scholer, Fierman, Hays and Handler settled with government regulators for $41 million amid allegations of malpractice by their firm which had advised the failed Lincoln Savings and Loan.4 Blank, Rome, Comisky and McCauley, a Philadelphia law firm, settled with the FDIC for $61 million for alleged legal malpractice arising out of its representation of a failed thrift.5

The plaintiff initiating these lawsuits is typically the government because most of the thrift failures have resulted from misconduct by the institution's officers and/or directors. These insiders could not successfully sue the outside professionals for negligence or malpractice since the insiders' knowledge of and, in fact, perpetration of the activities that led to the thrifts' demise would be used to show lack of causation and reliance on the advice provided by outside professionals.

Typically, either the Federal Deposit Insurance Corporation ("FDIC") or Resolution Trust Corporation ("RTC") will be the particular government regulatory agency that initiates litigation. Specifically, the FDIC is responsible for pursuing claims arising from thrift failures before January 1, 1989.6 The RTC is responsible for pursuing claims against thrifts for which successors in interest were appointed between December 31, 1988 and October 1, 1993.7

3 John H. Cushman, Jr., $400 Million Paid by S & L Auditors, Settling U. S. Case, N.Y. TIMES, Nov. 24, 1992, at A1. The terms of the settlement did not include any admission of wrongdoing by Ernst & Young. Ernst & Young, however, did agree to change some of its accounting practices, and three of its partners are now prohibited from providing professional services to federally insured financial institutions.

Deloitte & Touche has been reportedly negotiating with the government to resolve approximately $1.4 billion in claims from the failure of some of its financial institution clients. Alan Breznick, Ernst's Action Presses Others to Settle Suits, CRAIN'S N.Y. BUS., Nov. 30, 1992, at 1.


7 Id. The RTC will be dissolved in 1996 and the FDIC will succeed to its claims. Id.
the sake of simplicity, "FDIC" will be used throughout the article to refer to both governmental agencies.

The enormity of verdicts and settlements does not necessarily paint a realistic picture regarding the true scope of auditors' or attorneys' culpability for the failure of this country's thrift institutions. However, in its zealous quest to make someone pay for thrift failures, the government has vigorously pursued the institutions' outside professionals. This so-called "deep pocket" phenomenon of including accounting and law firms with large revenues and insurance coverage virtually guarantees collection of immense verdicts. In view of the flood of lawsuits that have been and continue to be filed against outside professional firms, the firms' abilities to defend against the government's customary claims of negligence and professional malpractice has become a vital issue.

A common touchstone of professional firms' defensive strategies is the assertion that the culpable officers and directors of the thrift institution did not rely on the challenged information supplied by the defendant firms. Any such lack of reliance must necessarily be imputed to the thrift institution itself as the...
institution can only function through its managers. Consequently, when the governmental agency as receiver or assignee institutes negligence actions that could have been brought by the thrift against outside professional firms, it should be subject to the same defenses, namely, the negation of the reliance or causation elements, that the failed thrift would have faced.

In FDIC v. Ernst & Young12 and FDIC v. O'Melveny & Meyers,13 the United States Courts of Appeals for the Fifth Circuit and the Ninth Circuit, respectively, reached dramatically different results on these issues when faced with very similar fact scenarios.14 In Ernst & Young, the Fifth Circuit held that the FDIC, as the assignee of the defunct Western Savings Association, was unable to sustain a claim of negligence against Ernst & Young because the FDIC would be subject to the same defenses as the failed thrift, namely lack of reliance.15 In contrast, in O'Melveny the Ninth Circuit held that the FDIC, as the assignee of the defunct American Diversified Savings Bank, was able to sustain a negligence claim against O'Melveny & Meyers because the FDIC would not be subject to the same defenses as the failed thrift, including lack of reliance.16

Those courts that have barred a reliance defense where the government sues as receiver have favored a policy of compensating the government for losses by shifting losses onto innocent or marginally culpable professional firms.17 This has been accomplished by elevating the FDIC to a special status above that of an ordinary assignee.18 As a result of this classification, those courts have held that the FDIC is immune from imputation in situations where ordinary assignees would not be.19 This reluctance to hold governmental plaintiffs subject to defenses that would be valid against the thrifts, in turn, has severely crippled professional liability defendants in their efforts to defend against such claims.20

12FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir.), reh'g, en banc denied, 976 F.2d 732 (1992). See infra note 159 and accompanying text. The Fifth Circuit refused to vacate, and the decision is still good precedent.

As part of the recent $400 million settlement agreement with Ernst & Young, the FDIC required Ernst & Young to join in its petition to the Fifth Circuit to vacate the decision. The rationale behind the FDIC's approach is fairly obvious. Aside from its adversity, the decision represents a potential turning point in litigation that has overwhelmingly favored the FDIC.

13FDIC v. O'Melveny & Meyers, 969 F.2d 744 (9th Cir. 1992), rev'd and remanded, 114 S. Ct. 2048 (1994) (unanimous opinion).

14See discussion infra Part II.

15Ernst & Young, 967 F.2d at 169–72.

16O'Melveny, 969 F.2d at 748–49, 751–52.

17See discussion infra part V.A.

18See infra note 163 and accompanying text.

19See infra note 163 and accompanying text.

20See supra note 10 and accompanying text.
This note proposes that the Fifth Circuit's opinion in handling these claims provides a better rationale than the Ninth Circuit's opinion. The first factor examined is the degree of control exercised by the corporate officer(s) who had been aware of the financial woes that the outside professionals allegedly overlooked. The second factor discussed is whether the insiders' misconduct was for or against the institution. Finally, policy considerations will be evaluated to determine whether the FDIC should be accorded the special status that immunizes it from defenses which could have been asserted against the failed thrift through imputation from the thrift's internal wrongdoers. On remand from the United States Supreme Court, the Ninth Circuit should adhere to the Fifth Circuit's rationale.

II. BACKGROUND — ERNST & YOUNG AND O'MELVENY

The primary conflict between the Fifth and the Ninth Circuits arises from the FDIC's need to prove justifiable or reasonable reliance by failed institutions on audits, placement memoranda and other documents, as a component of causation in professional liability claims. Ordinarily, reasonable reliance is essential to a plaintiff's prima facie case, but the Fifth and Ninth Circuits take different views on the necessity of proving this required element when the government is the plaintiff.

In a typical professional negligence action, causation must be proved as part of a plaintiff's prima facie case. In the context of a professional negligence action, the plaintiff may state the causation component in this way: But for reliance by the institution's officers or directors on negligent professional advice, certain risky loans, investments, acquisitions, etc., would not otherwise have been undertaken by the institution. This reasonable reliance component of causation is negated, and the prima facie case is defeated, where the insiders are perpetrating their fraudulent activities with full awareness of the institution's true financial condition.

21 See infra part III discussing under what conditions knowledge of wrongdoers may be imputed to the institution under the Fifth Circuit's reasoning in FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir. 1992).

22 This factor is referred to as the "Cenco test," derived from Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.), cert. denied, 459 U.S. 880 (1982). See discussion infra part IV.

23 See discussion infra part V.

24 FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir. 1992) (stating that reliance must be shown in a negligence action brought by the FDIC to establish that alleged faulty audit was a substantial factor in bringing about the thrift's failure); FDIC v. O'Melveny, 969 F.2d 744 (9th Cir. 1992) (reasoning that lack of reliance by failed thrift's owners would not be a valid defense against FDIC in a negligence action for policy reasons), rev'd and remanded, 114 S. Ct. 2048 (1994).
A. FDIC v. Ernst & Young (The Fifth Circuit Opinion)

In Ernst & Young, the FDIC sued E&Y for alleged negligence in connection with E&Y's audits of the financial statements of Western Savings Association, a failed Dallas thrift. The theory of the FDIC's case was that Western's losses would have been avoided if E&Y had promptly detected the thrift's insolvency. According to the FDIC's complaint, for the year ended 1984, E&Y's audit showed that Western's net worth exceeded $41 million, when, in fact, the thrift was insolvent by more than $100 million. Similarly, the 1985 audit indicated a net worth of more than $49 million while, according to the FDIC's complaint, the thrift was actually insolvent by more than $200 million.

Throughout this period, the thrift was wholly owned by a sole shareholder, Jarrett E. Woods. Woods was also chairman of the board of directors, chief operating officer, and chief executive officer, in addition to holding several subordinate offices. Woods' lending and investment policies were very risky and, as a result, the thrift's financial position became increasingly unstable. Eventually, Woods' practices drove Western into insolvency.

In light of the fact that Woods was solely responsible for perpetrating the unsound lending and investment policies, he did not need, nor would he have wanted, E&Y's advice that Western was insolvent. Accordingly, Woods did not rely on the purportedly incorrect audits.

Based on Woods' extensive control status at Western, including his 100% ownership, the Fifth Circuit imputed his lack of reliance to Western. Further, the Court reasoned that the FDIC as assignee stood in Western's shoes and was, therefore, limited to instituting claims that Western could have brought and subject to the same defenses that Western would have faced. Accordingly, the Court affirmed summary judgment for E&Y on the FDIC's claims.

Aside from the Fifth Circuit's adherence to well-settled corporate law principles, its disposition of this case, on summary judgment, has important potential implications for future cases. By granting summary judgment, the Fifth Circuit established that, as a matter of law, there was no material issue of
fact, with respect to imputation or the FDIC’s status as assignee of Western.\(^{36}\) Since neither Woods, nor the thrift could have relied upon E&Y’s audit to establish causation, the FDIC, in Western’s shoes, could not establish the reliance element of its negligence claim.\(^{37}\)

**B. FDIC v. O’Melveny & Meyers (The Ninth Circuit Opinion)**

In *O’Melveny & Meyers*, the FDIC sued the Los Angeles law firm of O’Melveny & Meyers for alleged professional malpractice in connection with legal services provided to a failed savings and loan, American Diversified Savings Bank.\(^{38}\) Specifically, the FDIC alleged that O’Melveny’s assistance in preparing private placement memoranda (PPMs) and its due diligence work to confirm the accuracy of certain disclosures were the negligent cause of American Diversified’s losses.\(^{39}\) Similar to the allegations in *Ernst & Young*, the PPMs supposedly did not provide a realistic picture of the thrift’s true financial condition, which was tenuous.\(^{40}\)

The internal fraud in *O’Melveny* was perpetrated by three officers who owned all of the thrift’s stock.\(^{41}\) According to the FDIC, Ranbir Sahni, the chairman and chief executive officer of American Diversified, Lester Day, the president, and Wyn Pope, an executive vice-president, engaged in fraudulent bookkeeping to disguise their activities.\(^{42}\) Specifically, the thrift’s assets were overvalued and its profits were inflated by sham sales.\(^{43}\)

Nevertheless, the Ninth Circuit held that there was no imputation of knowledge to the thrift from the trio, since they were distinct entities from the thrift.\(^{44}\) According to the court, the three wrongdoers were *not* the thrift.\(^{45}\) *O’Melveny* further opined that even if the knowledge was imputed to the thrift

\(^{36}\)The Fifth Circuit’s disposition of this case on summary judgment demonstrates that the court discerned no material issue of fact regarding the FDIC’s status as an ordinary assignee.

That determination could be followed by other courts to prevent the FDIC from advancing its special status argument in future, similar cases. This potential for future adoption of the Fifth Circuit’s reasoning illustrates another reason why the FDIC attempted to have the decision vacated. See *supra* note 12.

\(^{37}\) *Ernst & Young*, 967 F.2d at 166.


\(^{39}\) *Id.* at 746.

\(^{40}\) *Id.* at 747.

\(^{41}\) *Id.*

\(^{42}\) *Id.* at 750.

\(^{43}\) *O’Melveny*, 969 F.2d at 750.

\(^{44}\) *Id.*

\(^{45}\) *Id.*
from the officers, the knowledge would not be imputed to the FDIC. The court examined policy reasons relating to compensating victims and punishing wrongdoers and concluded that the FDIC should be accorded special status. Because the court did not consider the FDIC to be an ordinary successor in interest, it held that the conduct of the officers could not operate to subject the FDIC to the same defenses that the thrift would be subject to if the thrift was asserting the claim of malpractice.

The remaining sections of this article will explore the reasoning of the Ernst & Young and O'Melveny opinions in greater detail. Specifically, closer analysis will reveal that the Fifth Circuit’s reasoning is sounder than the Ninth Circuit’s judicial legislation. First, the Fifth and Ninth Circuits’ approaches for determining whether knowledge should be imputed to the failed thrift will be discussed. Second, the Circuits’ different approaches to the "on the behalf" test will be analyzed. Finally, the desirability of the policies furthered by the Fifth Circuit’s approach over the policies arguably advanced under the Ninth Circuit’s approach will be examined.

III. FIRST FACTOR — WHEN SHOULD THE KNOWLEDGE OF COMPANY OFFICERS AND DIRECTORS BE IMPUTED TO THE ENTITY?

As exemplified by Ernst & Young and O'Melveny, many financial institution failures are the result of fraud perpetrated by an institution’s internal management. According to Ernst & Young, the first step for a professional firm seeking to advance a successful imputation argument is to impute knowledge of the thrift’s managers who perpetrated fraud or misappropriated funds, to the thrift. Although a corporation possesses a legal identity of its own, without its officers or directors, it cannot carry on its activities. Under certain circumstances, when the controlling shares of the institution or the bulk of the managerial activities are concentrated with one individual or a group of individuals, the perpetrators’ knowledge necessarily becomes the thrift’s knowledge. According to the Fifth Circuit, the requisite control to demonstrate this knowledge is established by demonstrating either one hundred percent ownership or a sufficient level of operational control to equate the officer’s knowledge with the institution’s. There is a divergence among courts,

46 Id. at 751.

47 Id. at 751–52. The United States Supreme Court reversed the Ninth Circuit with respect to its articulated policy of according special status to the FDIC: O'Melveny & Myers v. FDIC, 114 S. Ct. 2048, 2054 (1994).

48 O'Melveny, 969 F.2d at 752.

49 FDIC v. Ernst & Young, 967 F.2d 166, 169 (5th Cir. 1992).

50 Id. at 171. The court emphasized that Woods was the sole stockholder of Western "and, as the FDIC's complaint stated, Woods 'dominated and controlled Western's board of directors from the time he took control of Western.'" Id.
however, as to what level of control under the second approach will be sufficient to impute the wrongdoer's knowledge.\textsuperscript{51}

In \textit{Ernst \& Young}, the Fifth Circuit held that at a minimum where a sole stockholder commits fraudulent acts, the officer is, \textit{as a matter of law}, the alter ego of the entity.\textsuperscript{52} It is understandable, then, that the Fifth Circuit in \textit{Ernst \& Young} imputed Woods' knowledge to Western as he owned one hundred percent of Western's stock.\textsuperscript{53} It is far from understandable why imputation was precluded by the Ninth Circuit in \textit{O'Melveny} where the wrongdoers collectively owned one hundred percent of American Diversified. Similar to Western which could only act through its sole stockholder Woods, American Diversified could only act through its controlling shareholders.\textsuperscript{54}

Despite the similarities of ownership and control between \textit{Ernst \& Young} and \textit{O'Melveny}, the Ninth Circuit took a radically different approach to imputation from that of the Fifth Circuit.\textsuperscript{55} The ownership factor that was so integral to the Fifth Circuit's analysis was not even addressed in the Ninth Circuit opinion, even though the three individuals perpetrating the fraudulent activities owned one hundred percent of American Diversified.\textsuperscript{56} The Ninth Circuit decided that

\textsuperscript{51}The Fifth Circuit, in FDIC v. Lott, 460 F.2d 82 (1972), for example, refused to impute knowledge from the president and controlling shareholder to the failed Lorenzo State Bank. Imputation was primarily rejected for two reasons: (1) the president was not the sole stockholder; and (2) the president was not in sole control of the thrift's activities. \textit{Id.} at 87–88.

The Fifth Circuit, however, has moved away from the wooden approach used in \textit{Lott}. In \textit{Wellington v. United States Fidelity \& Guar. Co.}, 778 F.2d 1103 (5th Cir. 1985), the financial institution was precluded from recovering on a bond even though the wrongdoer was a vice–president who owned only forty percent of the thrift's outstanding stock. \textit{Id.} at 1110–11; see also FDIC v. Clark, 978 F.2d 1541, 1550 (10th Cir. 1992)(stating that "if an employee was acting within the scope of his authority then his fault would be attributed to the FDIC"); American Standard Credit v. National Cement Co., 643 F.2d 248 (5th Cir. 1981)(reasoning that knowledge of mere employee of parent corporation who was an officer of a subsidiary corporation might be sufficient to impute knowledge from subsidiary to parent).

\textsuperscript{52}For the impact that this alternative has had on various decisions considering imputation see \textit{infra} note 61 and accompanying text.

\textsuperscript{53}Other decisions that support the proposition that a sole stockholder is the institution include: FDIC v. Aetna Casualty \& Sur. Co., 947 F.2d 196 (6th Cir. 1991); Phoenix Sav. \& Loan, Inc. v. Aetna Casualty \& Sur. Co., 381 F.2d 245 (4th Cir. 1967); McKee v. American Casualty Co. of Reading, Pa., 316 F.2d 428 (5th Cir. 1963); see also \textit{3 William M. Fletcher, Cyclopedia of the Law of Private Corporations} § § 809, 814 (perm. ed. 1986).

\textsuperscript{54}FDIC v. O'Melveny \& Meyers, 969 F.2d 744, 745–46 (9th Cir. 1992), \textit{rev'd and remanded}, 114 S. Ct. 2048 (1994).

\textsuperscript{55}\textit{Id.} at 752.

\textsuperscript{56}\textit{Id. But see} California Union Ins. Co. v. American Diversified Sav. Bank, 948 F.2d 556, 565 (9th Cir. 1991) (recognizing that Sahni and Day owned all of the outstanding stock of American Diversified and that the pair "completely dominated and controlled" the bank).
where a single individual owns almost all of the stock, there should be no imputation when that person acts adversely toward the thrift.\footnote{57}{O'Melveny, 969 F.2d at 751–52.} That reasoning, however, focused the inquiry on only one of the wrongdoers instead of the trio of wrongdoers. When the inquiry is properly focused on the trio’s activities and the group’s total ownership is recognized, the Ninth Circuit’s reasoning is flawed. Its failure to even discuss the crucial ownership factor reveals a weakness in its imputation analysis. Unlike the Fifth Circuit’s reasoning in \textit{Ernst & Young}, the Ninth Circuit’s reasoning is faithful to neither settled corporate principles nor common sense.

In addition to imputing Woods’ knowledge based on his one hundred percent stock ownership, the Fifth Circuit also imputed his knowledge based on his control over Western.\footnote{58}{FDIC v. Ernst & Young, 967 F.2d 166, 171 (5th Cir. 1992).} The court recognized that Woods held all of the important positions of control and power at Western including chairman of the board, chief operating officer, chief executive officer, and various committee seats at Western and its wholly-owned subsidiaries.\footnote{59}{Id. at 168.} In view of Woods’ operational control, the Fifth Circuit concluded that "the privity and knowledge of individuals at a certain level of responsibility must be deemed the privity and knowledge of the organization . . . [and] the level of responsibility must extend at least to the sole owner who dominated the board of directors."\footnote{60}{Id. at 171 (emphasis supplied).}

This reasoning is well-taken. As previously mentioned, a corporation can only act through its individuals. This is true whether the individuals act responsibly or fraudulently. Thus, one hundred percent stock ownership should by no means be the \textit{only} basis for imputation. Otherwise, the knowledge of controlling managers could not be imputed to the institution, despite their \textit{de facto} control over the company. Many courts have adopted the alternative imputation approach suggested by the Fifth Circuit which focuses on operational control.\footnote{61}{See FDIC v. Clark, 978 F.2d 1541, 1550 (10th Cir. 1992)(stating that "if an employee was acting within the scope of his authority then his fault would be attributed to the FDIC"); American Standard Credit v. National Cement Co., 643 F.2d 248, 271 (5th Cir. 1981)(reasoning that knowledge of mere employee of parent corporation who was an officer of a subsidiary corporation might be sufficient to impute knowledge from subsidiary to parent); Phoenix Sav. & Loan, Inc. v. Aetna Casualty & Sur. Co., 381 F.2d 751–52.}
In addition to emphasizing Woods' ownership interest, the Fifth Circuit considered Woods' domination and control over Western's activities. This suggests that even if Woods was not the sole owner of the thrift, the control he exerted over Western through his various offices and other positions would have been a sufficient basis for imputation. This "operational" approach is sound because rigid formulae, which emphasize percentages or shares of stock, will not fairly or consistently inform the imputation analysis since it is rare that the culpable insiders who have de facto control over the institution will also be the sole owners of the institution. More flexible approaches that examine the realities of the internal structure of an entity are more likely to accurately reflect the extent of wrongdoers' control over the organization and lead to imputation when it is justified.

Under an operational approach, both the Ernst & Young and O'Melveny fact situations would support imputation. The officers involved in both of those cases changed investment policies, lending practices, and underwriting policies to perpetrate and perfect their fraudulent schemes. The domination of such areas by the parties rises to the level of control necessary to establish imputation to the institution.

IV. SECOND FACTOR – WERE THE ACTIONS OF THE WRONGDOERS ON BEHALF OF THE FINANCIAL INSTITUTION?

Once the Fifth Circuit court in Ernst & Young determined that the wrongdoers exercised sufficient control to justify imputation, the court assessed whether the wrongdoers' fraud was "for" or "against" the institution, a test derived from Cenco, Inc. v. Seidman & Seidman. Under Ernst & Young's approach, if the institution is the primary beneficiary of the wrongdoers' scheme, knowledge will be imputed from the wrongdoers to the institution.

In Cenco, a corporation sued its outside accounting firm, Seidman & Seidman, for professional malpractice, fraud and breach of contract. The plaintiff alleged damages resulting from managerial fraud that was not detected by Cenco's outside auditors. Specifically, the managers had

245, 250 (4th Cir. 1967)(stating that "[o]rdinarily knowledge of officers and directors having substantial control of all activities of a corporation is imputed to the corporation ... [h]owever, such is not necessarily true if [they] do not have the requisite control.").

62 Ernst & Young, 967 F.2d at 171.

63 See discussion supra parts II.A, II.B.

64 486 F.2d 449 (7th Cir. 1982), cert. denied, 459 U.S. 880 (1982), "[T]he primary costs of a fraud on the corporation's behalf are [not borne] by the stockholders ... and the stockholders should not be allowed to escape all responsibility for [fraud committed by officers]." Id. at 456.

65 Id.

66 Id. at 451.

67 Id. at 451–52.
fraudulently inflated Cenco's inventory values. As a result of the inflated inventories, Cenco presented a misleading picture of improved financial health that enabled it to command higher stock prices, acquire other companies, and borrow money at lower rates. Eventually, the fraud was revealed by a newly hired financial officer who reported Cenco to the SEC. The specific claim against the defendant—accounting firm alleged that either the auditors should have uncovered the fraud or the auditors did know of the fraud but failed to report it. Seidman & Seidman, however, showed that they had been diligent in their attempts to follow-up signs of fraud, i.e., they had satisfied their professional duty. Seidman & Seidman further showed that managers at all levels of responsibility at Cenco, who participated in the fraud, had prevented Seidman & Seidman from actually discovering the fraud.

The jury instructions in Cenco stated that "the acts of a corporation's employees are the acts of the corporation itself if the employees were acting on the corporation's behalf." Cenco argued that these instructions improperly focused the jury's attention on the actions of Cenco's managers, not Cenco's conduct. By focusing on Cenco's knowledge and existence as a separate corporate entity, the plaintiff—corporation hoped to convey the image that the corporation was innocently manipulated by the actions of its managers. Therefore, Seidman & Seidman would be unable to defend against the corporation the way it was able to defend against claims by managers, officers or directors. The court rejected Cenco's argument and held that the auditors could validly assert defenses against Cenco that were viable against Cenco's managers based on the imputation of knowledge from the wrongdoers to Cenco.

In order to arrive at its decision, the court examined state tort liability objectives and an auditor's professional duties regarding fraud detection in the context of a claim brought by a corporation where fraud was perpetrated by corporate officers. The two objectives to be served through tort liability, as stated by the Cenco court, are compensation of victims of misconduct and the

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68 Id.

69 Cenco, 686 F.2d at 451-52.

70 Id.

71 Id.

72 Id. at 456.

73 Id. at 454. Unlike Ernst & Young and O'Melveny, the wrongdoers in Cenco occupied various positions in upper-level management. Thus, the levels of responsibility were somewhat lower in Cenco as compared with Ernst & Young and O'Melveny in which the wrongdoers occupied high-level officer and director positions. The Cenco court would apparently reject a distinction based on the different levels of responsibility since the thrust of its reasoning was premised on preventing enrichment of the wrongdoers.

74 Cenco, 686 F.2d at 454.

75 Id.
deterrence of future similar misconduct.\textsuperscript{76} In the case of a corporation, a judgment for the corporation will not compensate the corporation directly.\textsuperscript{77} Rather, the judgment will be distributed among its owner(s).\textsuperscript{78} Thus, the "victim" to be compensated by a recovery for a corporation is not actually the corporation, but rather, its stockholder(s).\textsuperscript{79}

The \textit{Cenco} court considered whether recovery would be limited to the actual victims of the managers' fraud. The potential beneficiaries of any recovery consisted of several categories of stockholders, some of whom were actual participants in the fraudulent activity.\textsuperscript{80} Since a judgment would not distinguish among those categories, active participants in the fraud would also benefit.\textsuperscript{81} In the court's view, "such a judgment would be perverse from the standpoint of compensating the victims of wrongdoing."\textsuperscript{82}

With respect to the second objective of tort liability, deterrence, the \textit{Cenco} court observed that shifting the cost of the fraud from Cenco to the accounting firm would not deter the type of fraud at issue.\textsuperscript{83} The scheme was perpetrated by members of the board, vice-presidents and other top-level managers, within the corporation.\textsuperscript{84} If the company could simply shift its losses under these circumstances, the incentive to hire honest managers would be lost, as would the incentive to monitor managers' activities.\textsuperscript{85} By the same token, the court noted that the high-level pervasiveness of the fraud involved in \textit{Cenco} made it especially difficult for independent auditors to detect. In short, under \textit{Cenco}, not holding a company liable for its failure to hire honest managers and

\textsuperscript{76}Id. at 455.
\textsuperscript{77}Id.
\textsuperscript{78}Id. The court noted that the undisputed facts showed that the fraud "permeated" the top management at Cenco. Id. Under those circumstances, the court reasoned that the corporation should not be able to shift the entire responsibility for the schemes to the outside auditors. Id.

\textsuperscript{79}"Auditors are not detectives hired to ferret out fraud ..." \textit{Cenco}, 686 F.2d at 454. Though the court acknowledged the validity of Cenco's argument that the victims, in this case stockholders, should be duly compensated, it did not agree that shifting the loss, by prohibiting imputation, to the accountants would best accomplish this goal. Specifically, the court determined that Cenco could not separate itself from the internal wrongdoers. Id. at 456. "If Seidman failed to police its people, Cenco failed as or more dramatically to police its own." Id.

\textsuperscript{80}Id. at 455. "To the extent [that the corrupt officers] are still stockholders in the company, they would benefit pro rata from a judgment in favor of Cenco." Id.

\textsuperscript{81}Id .
\textsuperscript{82}Id.
\textsuperscript{83}Id.

\textsuperscript{84}Cenco, 686 F.2d at 451.
\textsuperscript{85}Id. at 455.
monitor their conduct is a less acceptable outcome than holding the auditors liable for failure to uncover such fraud.  

Another important consideration was the fact that the immediate effect of the fraud was to help, not harm, the shareholders. According to the Cenco court, "[f]raud on behalf of the corporation is not the same thing as fraud against it." As noted by the court, fraud against the corporation injures primarily the stockholders. For example, fraud against the company would include theft or embezzlement, activities that deplete the assets of the corporation. Fraud which benefits the corporation, "aggrandizes" the corporation, and primarily injures outsiders such as insurers and prospective stock purchasers. An example of this would be the creation of artificial profits or inventory values through bookkeeping entries. Nothing is being taken out of the corporation's asset pool in this example, yet the financial entries purport to convey an image of profitability or wealth that does not truly exist. Through the use of this false image, potential investors, for instance, may feel secure in purchasing stock which may later prove to be worth substantially less than the purchase price. Important to the Cenco court's analysis was the fact that the wrongdoers were not defrauding current stockholders. Since the defrauded stockholders were new purchasers, the company was receiving money from outsiders, which served—at least initially—to actually benefit or increase the monetary assets of the corporation. The court noted that, in spite of the fact that the corporation or its stockholders may not be net beneficiaries once the fraud is revealed, the fraud is nonetheless beneficial to the corporation. The participants turned the "company into an engine of theft against outsiders – creditors, prospective stockholders, insurers, etc." The Fifth Circuit in Ernst & Young applied the Cenco test to the FDIC's claim and found that Woods' fraud benefited Western. In making this distinction,
the crucial fact was that Woods was the sole stockholder and therefore, Woods was Western.\textsuperscript{95} Given this dual identity, any fraud that benefited Woods, necessarily benefited Western, albeit temporarily.\textsuperscript{96} The victims of the fraud in \textit{Ernst \& Young} were its depositors and creditors, outsiders of Western.\textsuperscript{97} Any recovery for the FDIC, as receiver standing in Western's shoes, would effectively reward Woods, the only stockholder, for his misconduct. Deterrence would not be enhanced by a recovery for the receiver because, similar to \textit{Cenco}, the outside auditors were dependent on the information provided by Woods in forming opinions about the financial health of the thrift.\textsuperscript{98} In future situations where a thrift client is wholly owned by an individual, an outside auditor will still be limited in its ability to follow up on "red flags" by the information supplied by the individual. Because Woods, and thus, Western, was fully aware of Western's deteriorating financial condition, the Fifth Circuit expressly rejected, as a matter of law, the FDIC's claim that proper performance of audits, as opposed to the allegedly improper ones prepared by Ernst \& Young, would have alerted Western to Woods' fraud.\textsuperscript{99} The court stated: "Western cannot claim it should recover from E\&Y for not being rescued by a third party for something Western was already aware of and chose to ignore."\textsuperscript{100}

The Ninth Circuit in \textit{O'Melveny}, also relied on \textit{Cenco} to inform its imputation analysis.\textsuperscript{101} The Ninth Circuit's treatment of \textit{Cenco}, however, cannot be squared with the Fifth Circuit's entirely different treatment of that case. The court did not consider that the wrongdoing trio owned one hundred percent of American Diversified's stock.\textsuperscript{102} The \textit{O'Melveny} court, instead, evaluated the trio's fraudulent activities, which consisted primarily of "cooking the books" through overvaluation of the thrift's assets.\textsuperscript{103} The Ninth Circuit then determined that these activities were against the thrift's well-being, not for it, as required for

\textsuperscript{95}Although not addressed by the court in \textit{O'Melveny}, the Ninth Circuit did consider this ownership in California Union Ins. Co. v. American Diversified Sav. Bank, 948 F.2d 556 (9th Cir. 1991). See discussion infra pp. 27–28.

\textsuperscript{96} \textit{Ernst \& Young}, 967 F.2d at 171. Ultimate success or failure, under \textit{Cenco}, is not the determinative factor for deciding whether an action is taken on behalf of an entity. \textit{Cenco}, 686 F.2d at 449.

\textsuperscript{97} \textit{Ernst \& Young}, 967 F.2d at 171.

\textsuperscript{98}Id.

\textsuperscript{99}Id.

\textsuperscript{100}Id.

\textsuperscript{101}FDIC v. \textit{O'Melveny \& Meyers}, 969 F.2d 744 (9th Cir. 1992), rev'd and remanded, 114 S. Ct. 2048 (1994).

\textsuperscript{102}Id. at 746.

\textsuperscript{103}Id.
imputation under Cenco. 104 Further, the court stated that the wrongdoers benefited from their activities. 105

The court failed to articulate, however, in what capacity, other than as owners of American Diversified, the trio benefitted. Thus, if their activities benefitted them, for example, by increasing the apparent value of their ownership shares in American Diversified, the trio’s benefit was inextricably linked with the beneficial increase in profitability that the thrift experienced as a result of the overvaluation activities. The Ninth Circuit’s emphasis was placed on the ultimate condition of the institution, insolvency and receivership, to support the conclusion against imputation. 106 The court also reasoned that even if the thrift somehow benefited, there could be no imputation since recovery would best serve tort objectives. 107 The O’Melveny court concluded, without explanation, that recovery by the FDIC "would best serve the objectives of tort liability by properly compensating the victims of the wrongdoing ..." 108

The Ninth Circuit’s Cenco application, thus, cannot be reconciled with the Fifth Circuit’s approach because on virtually identical facts, completely opposite results were achieved. Ernst & Young, for example, placed heavy emphasis on Woods’ controlling ownership share. 109 O’Melveny did not even consider the ramifications of nearly identical control interests. 110 The three inside perpetrators of the fraud in O’Melveny collectively owned all of the thrift’s stock and were controlling officers. 111 Just as Woods was Western, Sahni, Day and Pope taken together were American Diversified. Nonetheless, the O’Melveny court ignored the controlling ownership interests held by Sahni, Day and Pope in determining whether they acted on behalf of the thrift.

The Fifth Circuit, in Ernst & Young, also emphasized the extent of operational domination exercised by Woods in its decision whether to impute his knowledge to the thrift. 112 As Western’s president, chairman, chief executive officer and vice–president, Woods was necessarily acting on the thrift’s

104 Id. at 750.

105 Id.

106 O’Melveny, 969 F.2d at 750–51. See also Steve E. McConnico et al., Failed Financial Institutional Litigation: The Expanding Scope of Liability, 12 REV. LITIG. 537 (1993) (criticizing the O’Melveny court’s formulation of an imputation test which focuses on hindsight rather than the intentions of the wrongdoers).

107 Id.

108 Id. at 750.

109 FDIC v. Ernst & Young, 967 F.2d 166, 171 (5th Cir. 1992).

110 FDIC v. O’Melveny & Meyers, 969 F.2d 744, 750 (9th Cir. 1992), rev’d and remanded, 114 S. Ct. 2048 (1994).

111 “Sahni and Day owned all the stock [of American Diversified] and held key positions.” California Union Ins. Co. v. American Diversified Sav. Bank, 948 F.2d 556, 565 (9th Cir. 1992).

112 Ernst & Young, 967 F.2d at 171.
behalf.\textsuperscript{113} In contrast, \textit{O'Melveny} gave no weight to the operational domination of Sahni, Day and Pope even though they occupied essentially the same positions of authority and control as Woods.\textsuperscript{114}

Another sharp difference between the Fifth and the Ninth Circuit's treatments of \textit{Cenco} involves whether the institution's ultimate failure means that the underlying fraud was against the corporation.\textsuperscript{115} In \textit{O'Melveny}, imputation was rejected because "disaster, not benefit" accrued to the thrift as a result of Sahni, Day and Pope's activities.\textsuperscript{116} The Ninth Circuit court relied on this long-range effect in concluding that the activities were not on behalf of American Diversified.\textsuperscript{117} In contrast, despite the fact that the long-term consequence of Woods' fraud was Western's financial demise, the Fifth Circuit's \textit{Ernst & Young} decision recognized an imputation defense because in the short-term Woods had benefited and, therefore, Western had benefited.\textsuperscript{118}

The Ninth Circuit's contrasting focus on the long-term effects of the fraud is wholly inconsistent with \textit{Cenco}'s reasoning. In \textit{Cenco}, the Seventh Circuit expressly held the company was not a net beneficiary of the internal fraud. Thus, the auditor's defenses were sustained even though \textit{Cenco} ultimately failed.\textsuperscript{119} The \textit{Cenco} court held that in order to best serve tort liability objectives, the proper focus for imputation was not the net result, but rather, who was most responsible for the wrongdoing and whether they would participate in any recovery.\textsuperscript{120} Indeed, if the focus was the net result, as in \textit{O'Melveny}, knowledge could never be imputed, since it is the company's collapse into insolvency which usually precipitates these actions.\textsuperscript{121} Rather, by focusing on the wrongdoers, fault can appropriately be determined and, in the case of financial institutions where at least part of the fraud was internally perpetrated, fault will not be unfairly shifted to innocent or far less culpable parties, such

\textsuperscript{113} \textit{Id}.

\textsuperscript{114} \textit{O'Melveny}, 969 F.2d 744.

\textsuperscript{115} \textit{See supra} parts II.A, II.B.

\textsuperscript{116} \textit{O'Melveny}, 969 F.2d at 747.

\textsuperscript{117} \textit{Id.} at 750.

\textsuperscript{118} \textit{Ernst & Young}, 967 F.2d at 168.


\textsuperscript{120} \textit{Id.} The \textit{Cenco} court characterized the ultimate failure to achieve a net beneficial result as a question of damages. \textit{Id}.

\textsuperscript{121} The point is this: It is the institution's failure that serves as the triggering event in this type of litigation where the government must step in for an insolvent thrift. Thus, by focusing on the "net" result, the Ninth Circuit in \textit{O'Melveny} overlooked the obvious—the net result had to be insolvency, otherwise, there would be no litigation.
as outside auditors or attorneys, who, in fact, might have been misled by the wrongdoers themselves.\textsuperscript{122}

The foregoing analysis demonstrates the faulty rationale of \textit{O'Melveny} in light of the better reasoning of \textit{Ernst & Young}, decided on strikingly similar facts. It seems much more equitable to premise imputation from wrongdoer(s) to the institution on traditional corporate principles where the wrongdoer(s) had either the necessary ownership control or operational control to establish that the wrongdoer(s) \textit{was} the corporation. This approach avoids result-oriented holdings and represents the better application of the \textit{Cenco} test, which, as shown by the Ninth Circuit's \textit{O'Melveny} decision, may be manipulated to prevent imputation in almost any case arising from an institutional failure.\textsuperscript{123} The Ninth Circuit chose not to consider the ownership or control of the wrongdoers in \textit{O'Melveny} and interpreted \textit{Cenco} to mean that ultimate failure precluded initial imputation of knowledge. On remand, the Ninth Circuit should adopt the sounder rationale of the Fifth Circuit in connection with its consideration of the imputation issue.

In situations where the requisite basis for imputation is established either through ownership or operational control, a separate \textit{Cenco} analysis is superfluous in determining whether knowledge of fraud perpetrated by the owners or controlling individuals should be imputed to the thrift.\textsuperscript{124} Only the element of control needs to be addressed. Absent imputation under these circumstances, the result will be a distortion of corporate principles as corporations will be able to shift losses for which they are at fault to innocent or less culpable parties. Further, more plaintiff-clients who sue outside

\begin{footnotesize}
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\item \textsuperscript{122}See infra note 163 and accompanying text.
\item \textsuperscript{123}The willingness of courts to fashion new legal principles, which either lack a solid precedential basis or are based on nebulous "policy" grounds, is explored in greater depth by Philip A. Lacovara, "Follow the Money; Should Lawyers and Accountants Pay for the Sins of Their Clients?," \textit{WASH. POST}, July 21, 1992, at A19. Mr. Lacovara states in that article that "it is the naked quest for the money" which is fueling the current trend to allocate losses to accountants and attorneys, not sound policy. \textit{Id.} The manipulation of the \textit{Cenco} test represents one option for courts to facilitate this loss shifting.
\item \textsuperscript{124}In \textit{FDIC v. Clark}, 978 F.2d 1541 (10th Cir. 1992), the court affirmed the jury instruction given by the district court which stated, "if an employee was acting within the scope of his authority then his fault would be attributed to the FDIC, standing in the shoes of the bank. If the employee was not so acting, then no negligence or fault would be attributed." \textit{Id.} at 1550 (emphasis supplied). \textit{See, e.g.,} Coit Indep. Joint Venture v. FSLIC, 489 U.S. 561 (1989)(stating government agency that was appointed receiver stepped into the shoes of the insolvent thrift); Scholes v. Stone, McGuire & Benjamin, 821 F. Supp. 533, 535 (N.D. Ill. 1993)("it is a well-known legal principle that a receiver can bring only those claims belonging to the entity it represents"); Jacobson v. FDIC, 407 F. Supp. 821 (S.D. Iowa 1976)(reasoning that FDIC as receiver stood in the shoes of failed thrift and enjoyed no greater rights than the failed thrift); 2 RALPH E. CLARK, A TREATISE ON THE LAW AND PRACTICE OF RECEIVERS § 362, at 619 (3d ed. 1959)("the receiver of a bank stands in no better position than the bank stood as a going concern and when the bank was a party to an illegality, the court will leave the parties where it finds them by refusing relief to the receiver").
\end{itemize}
\end{footnotesize}
professionals will be relieved of the requirement to prove a necessary element of professional negligence actions, reasonable reliance. Once the imputation analysis has progressed beyond the first factor and requisite control has been established, the inquiry should then be complete as far as imputation to the institution from the wrongdoer(s) is concerned. This will avoid the semantics often engaged in by courts in construing Cenco. The next section addresses another major distinction between the Fifth and Ninth Circuits’ opinions, namely, policy considerations concerning the FDIC’s role as receiver or assignee of a failed thrift. The Fifth Circuit in Ernst & Young reasoned that no special policy justification warranted special treatment for the FDIC in this capacity.\textsuperscript{125} The Ninth Circuit in O’Melveny reached the opposite conclusion and extended to the FDIC, as receiver, special status.\textsuperscript{126}

V. POLICY CONSIDERATIONS — WHO SHOULD BEAR CONSEQUENCES OF THRIFT INDUSTRY FAILURES

If imputation of knowledge from the wrongdoers to the thrift has been established through ownership and/or requisite control, the FDIC or other successor in interest should be subject to imputation in the same way that successors in interest in other situations would be. The sensitive nature of the financial institution industry’s woes, however, has resulted in some courts engaging in a special brand of adjudication.\textsuperscript{127} Courts indulging in this type of

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\item\textsuperscript{125}FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir. 1992).
\item\textsuperscript{126}FDIC v. O’Melveny & Meyers, 969 F.2d 744 (9th Cir. 1992), rev’d and remanded, 114 S. Ct. 2048 (1994).
\item\textsuperscript{127}See O’Melveny, 969 F.2d 744 (reasoning that Ninth Circuit should fashion a special “federal rule of decision” for FDIC since it was an involuntary successor); Resolution Trust Corp. v. Farmer, 823 F. Supp. 302, 311 (E.D. Pa. 1993) (citing as a “significant” factor the “intricate regulatory scheme” pursuant to which a failed bank’s successor acts to protect interests of third parties); In re Sunrise Sec. Litig., 818 F. Supp. 830 (E.D. Pa. 1993)(treating FDIC as “simply another assignee” would effectively require the public to pay for wrongs which it could not have prevented); Comeau v. Rupp, 810 F. Supp. 1127 (D. Kan. 1992)(determining that FDIC represents the public and is exempt from imputation of wrongdoer’s knowledge); FSLIC v. McGinnis, Juban, Bevan, Mullins & Patterson, P.C., 808 F. Supp. 1263 (E.D. La. 1992)(stating that FDIC is exempt from imputation in the interest of equity and statutory mission).

The truly disturbing factor about these “loss-shifting” holdings based on “policy” is that they ignore the fact that in order to perfect the fraudulent, and eventually, fatal, schemes, concealment from outside professionals is often necessary. “Nothing to date supports a conclusion that auditors or lawyers were responsible for even a small percentage of the fraudulent activity.” Kolb & Carroll, supra note 8, at 19. Aside from managerial concealment, the governmental agencies themselves are responsible for the thrift failures. “In assessing who is responsible for the S & L crisis, it should also not be forgotten that after… sweeping regulatory changes of the early ’80’s Congress… failed to improve sufficiently the force of federal examiners.” Id. “The regulators alone—not the auditors and not the attorneys—had the authority to prevent S & L’s from engaging in unwise transactions.” Id. But see McCoy, supra note 11 (discussing how potentially effective counterclaims and defenses based on the government’s own inaction in the face of awareness of institutional difficulties have not been accepted by courts).
\end{enumerate}
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policy-making have demonstrated a willingness to exempt the FDIC and its sister agencies from general principles of law that require a plaintiff to prove all of the elements necessary to establish its prima facie case. A desire to pin large losses from thrift failures on defendants with financial depth and "make someone pay" has led some courts, including the Ninth Circuit in O'Melveny, to hold that even when knowledge normally would be imputed from managerial wrongdoers to the thrift, "policy" nevertheless dictates that the governmental successor in interest should not be subject to that defense. The result is that, under the guise of "policy", the FDIC, in the shoes of the failed institution, is enabled to pursue claims which would fail, due to lack of reliance, if brought by the actual thrift institution against professional firms.

A. General Policy Considerations

As the Fifth Circuit recognized in Ernst & Young, such a result would be erroneous. The Fifth Circuit held that the FDIC, as assignee, could not make a claim that the thrift could not make. In holding that the FDIC is like any other assignee or receiver, the Fifth Circuit affirmed traditional corporate law principles that an assignee obtains the rights of the assignor and nothing more.

In Ernst & Young, the FDIC as a normal assignee was subject to the same defenses as Western. The FDIC argued that its duty to enlarge the asset pool...
supplied the necessary justification for special status. But the court rejected this so-called "policy" and discerned no statutory or other policy to support a special "immunity" status for the FDIC. Alternatively, the FDIC argued that, even absent reliance on E&Y's audit by Woods or Western, the auditors should nevertheless be liable for their alleged negligence. The court rejected this argument because, as assignee of Western, the FDIC was precluded from making an argument for liability which the thrift itself could not advance. Thus, a thrift's assignee cannot create liability premised on an overriding need to recover damages. The liability of a defendant is properly determined by examining the status of the plaintiff and the legal rights that accompany that status. Rather than engage in "judicial expansion of express powers and rights granted to the FDIC" to facilitate damage recovery, the Fifth Circuit consistently applied traditional principles of corporate law in analyzing E&Y's potential liability.

A similar approach was taken in FDIC v. Cherry, Bekaert & Holland, in which the defendant-accountants urged the court to compel the FDIC to produce loan files for the loans at issue. Ordering production, the district court relied on Eleventh Circuit opinions which declined to confer special status on the FDIC where document production and debt collection were involved. The Cherry court acknowledged that while maximizing recovery by the insurance fund was important, it could not be accomplished by contravening established legal principles. Since relevant statutory authority contained no provision conferring special status on the FDIC, the court declined to inject its own ad hoc policy into the regulatory scheme.

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135Id.
136Ernst & Young, 967 F.2d at 170.
137Id. at 171.
138Id.
139Id.
141Cherry, 742 F. Supp. at 613–14.
142Id. The two Eleventh Circuit opinions analyzed were: FDIC v. Jenkins, 888 F.2d 1537 (11th Cir. 1989)(finding no absolute priority for FDIC for recovery of fund); FDIC v. Harrison, 735 F.2d 408 (11th Cir. 1984)(reasoning that FDIC subject to same defense as any other private party for debt collection).
143Cherry, 742 F. Supp. at 615.
O'Melveny, in contrast to Ernst & Young and Cherry, concluded that the FDIC occupied a special niche because its succession was involuntary. In addition, the Ninth Circuit noted that succession was "part of an intricate regulatory scheme." But, the court did not explain why the source of succession or nature of succession should operate to immunize the FDIC in its status as receiver from defenses that would be valid if asserted against the thrift itself.

As support for its special status argument, the government has called upon the courts, including the Ninth Circuit, to extend the D'Oench doctrine, codified at sections 1821(d)(9) and 1823(e) of the Federal Deposit Insurance Act, to disallow reliance defenses in professional malpractice cases. The D'Oench doctrine was formulated by the Supreme Court in D'Oench, Duhme & Co. v. FDIC. In D'Oench, the FDIC attempted to enforce a note acquired from a failed thrift. The note's maker attempted to assert, as a defense against the FDIC, that a prior oral side agreement with the failed thrift guaranteed that the note would never be called for payment. But, the Court held that federal policy of protecting the FDIC against misrepresentations about an institution's assets precluded the maker's defense that a prior oral agreement with the failed thrift guarant...
thrift had been formed. \(^{151}\) This was because the FDIC had to be able to rely on a failed institution's records in order to properly assess solvency. \(^{152}\)

A purchase and assumption agreement between the FDIC and a failed thrift similar to the one at issue in \(D'Oench\) provides an alternative to liquidation of a thrift's assets. The FDIC must be able to rely on the thrift's books when it conducts its quick review of a failed thrift's books. In addition to the immediacy of its decision, the FDIC is acting as a receiver, rather than an assignee, when it participates in a purchase and assumption agreement. The time constraints and unique status of the FDIC in the context of purchase and assumption agreements distinguish such cases from professional accounting or law firms. Further, these factors explain why the \(D'Oench\) doctrine should be limited to the context of receivership arising out of a purchase and assumption agreement.

The effect of \(D'Oench\) has been to eliminate defenses in cases brought by the government based on secret side agreements forgiving non-payment between a failed institution and the borrower. In professional negligence cases, the FDIC has argued that the special protection given to it in suits to collect on loans should be expanded to apply in situations where the FDIC steps in as receiver for a thrift rendered insolvent by secretive and fraudulent insider misconduct. \(^{153}\) However, the FDIC's argument for expansion of the statutory protection is not well-founded, as shown by \(Ernst \& Young\) and \(Cherry\). First, the \(D'Oench\) doctrine and its protection are limited to fact situations involving alleged oral side agreements between the failed institution and third parties. The reason for this is that such claims sound in contract, whereas professional malpractice claims sound in tort. Furthermore, neither the \(D'Oench\) doctrine nor its statutory counterpart suggests that the FDIC should be exempt from the application of traditional corporate principles when serving as an assignee. To extend this doctrine to professional negligence situations would effectively

\(^{151}\) Id. at 450–51.

\(^{152}\) Id.

\(^{153}\) 12 U.S.C. §§ 1821(d)(9), 1823(e)(1991). Generally, these sections list certain requirements that must be satisfied in order for agreements, purporting to reduce, limit or defeat a financial institution's interests, to be valid. To satisfy these requirements, the agreement must be:

1. in writing,
2. executed by the depository institution,
3. approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and,
4. continuously, from the time of its execution, an official record of the depository institution.

Examples of the government's attempts to extend the \(D'Oench\) doctrine to the professional malpractice context can be seen in FDIC v. O'Melveny & Meyers, 969 F.2d 744 (9th Cir. 1992), rev'd and remanded, 114 S. Ct. 2048 (1994); FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir. 1992); FDIC v. Cherry, Bekaert & Holland, 742 F. Supp. 612 (M.D. Fla. 1990).
exempt the FDIC from having to prove causation, an element of its prima facie case. There is no precedent for excusing a plaintiff from proving a longstanding element of a common-law claim simply to facilitate recovery and to do so would do incalculable violence to settled common law. In the context of a professional negligence action arising out of fraudulent activity by a failed thrift’s owners or officers, the FDIC’s knowledge of such high-level misconduct would not necessarily prevent the consummation of a purchase and assumption agreement. The decision whether to enter into such an agreement is made by examining account balances, among other bookkeeping entries, to ascertain liquidated numbers. Owners’, managers’, or officers’ fraud or other wrongful activities, even if known, cannot be similarly reduced to a liquidated figure. Thus, these activities do not produce a certain or estimated dollar amount to be considered pursuant to choosing purchase and assumption or liquidation.

Moreover, there is nothing in the statutes themselves or their comments which suggest that Congress intended the D’Oench doctrine to apply to professional malpractice actions. The policy behind the codification of the D’Oench doctrine arose out of a need to protect the reliability of the cursory inspection of a thrift’s books undertaken by a regulatory agency. In sharp contrast, the policy sought to be furthered by the government through extension of D’Oench is enlargement of its asset pool. The distinctive policy underlying the codification of the D’Oench doctrine is, therefore, demonstrative of D’Oench’s inapplicability to professional malpractice actions.

The United States Supreme Court, in O’Melveny, agreed with the Fifth Circuit’s rationale and rejected the Ninth Circuit’s position that federal policy, as embodied in the D’Oench doctrine, supported the recognition of a special status for the FDIC.154

The Court rested its decision on two distinct grounds. First, the Court admonished that the creation of federal common law, which results in a special status for the FDIC, would impermissibly alter the regulatory scheme of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA").155 As noted by the Court, several regulatory provisions expressly provide special federal rules regarding FDIC claims and defenses.156 Thus, the creation of a special status for the FDIC, in situations not specifically provided for in FIRREA, would run afoul of the regulatory framework already in place.157

The second ground for the Court’s decision involved the well-recognized rarity of cases in which special federal rules may be justifiably created by the

155 Id. at 2054.
156 Id. at 2054 (citations omitted).
157 Id. at 2054 (stating that “additional ‘federal common-law’ exceptions is not to ‘supplement’ this scheme, but to alter it”).
The Court explained that such cases are limited to situations involving significant conflict between federal policies and the application of state law.\textsuperscript{159}

In \textit{O'Melveny}, the Court found no significant conflict between federal policies concerning the failure of financial institutions and state law.\textsuperscript{160} The Court determined that both the task of conducting state-by-state research to ascertain the FDIC's rights and liabilities and the reduction of potential uncertainty as to these rights and liabilities were ordinary consequences of FDIC litigation which did not rise to the level of a federal interest, to justify a special status for the FDIC under the guise of federal common law.\textsuperscript{161}

The Court then addressed the government's contention that the federal government's interest in preventing the depletion of the federal deposit insurance fund supported the creation of a special status for the FDIC. First, the Court stated that neither the regulatory scheme nor prior law provided a definite level for the insurance fund.\textsuperscript{162} Next, the Court recognized that, in the absence of federal policy mandating that the insurance fund should always prevail in litigation, it lacked authority to create new causes of action for the purpose of enriching the fund.\textsuperscript{163} The government's argument for the creation of a special status for the FDIC would necessarily result in the creation of new causes of action to enrich the insurance fund because the FDIC would not be subject to the same defenses, nor would it bear the same burdens of proof, that generally apply in similar litigation which does not involve the FDIC.\textsuperscript{164} That is precisely the consequence sought to be avoided by the United States Supreme Court.

As demonstrated by the foregoing analysis, the rationale of the Ninth Circuit and other courts that have constructed a special status for the FDIC and other successor governmental agencies does not withstand scrutiny. The common theme among these courts to justify this status is the obvious desire to facilitate damage recovery.\textsuperscript{165} The Ninth Circuit court explained that, if settled corporate principles were applied and the FDIC was subject to the same defenses as the failed institution, the regulatory scheme would be frustrated since the asset

\textsuperscript{158}O'Melveny, 114 S. Ct. at 2055.

\textsuperscript{159}\textit{Id.}

\textsuperscript{160}\textit{Id.}

\textsuperscript{161}\textit{Id.}

\textsuperscript{162}O'Melveny, 114 S. Ct. at 2055.

\textsuperscript{163}\textit{Id.}

\textsuperscript{164}\textit{Id.} The Court compared the government's argument in \textit{O'Melveny} to other cases in which the Court rejected similar arguments, premised on an alleged "policy" to facilitate greater recoveries. \textit{Id. (citing United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979); United States v. Yazell, 382 U.S. 341 (1966)).}

\textsuperscript{165}O'Melveny, 969 F.2d at 752.
pool would be less.\textsuperscript{166} This preclusion from increasing the asset pool would, then, reduce the receiver’s discretionary powers for distribution of the total assets to interested parties.\textsuperscript{167} The fallacy of this explanation is that it presupposes a duty of receivers to maximize the total asset pool available by totally ignoring established legal defenses such as lack of reasonable reliance by the institution. The true duties of a receiver are \textit{preservation and equitable distribution}, not maximization, of the asset pool.\textsuperscript{168}

The simultaneous creation of special statuses and immunities and rejection of traditional legal principles is an inappropriate method to achieve damage recovery. The inappropriateness of this methodology has been starkly illustrated by the FDIC’s own practice of advancing inconsistent strategies in related litigation.\textsuperscript{169} The Ninth Circuit’s approach is violative of traditional corporate and receivership principles, and it serves only as an incentive for plaintiff-successors to manipulate precedent and argue inconsistent theories depending which posture is most favorable to recovery. In light of the U.S. Supreme Court’s declaration that no special status must be given to the FDIC, the Ninth Circuit on remand must look to California state law concerning imputation of knowledge, rather than judicially-created federal policy, as a

\begin{itemize}
\item \textsuperscript{166} Id.
\item \textsuperscript{167} See H.R. Rep. No. 54(1), 101st Cong., 1st Sess. 330 (1989) ("[T]he FDIC authorities and duties as . . . receiver . . . essentially parallel those heretofore exercised . . . ").
\item \textsuperscript{168} California Union Ins. Co. v. American Diversified Sav. Bank, 948 F.2d 556 (9th Cir. 1991).
\item \textsuperscript{169} The current atmosphere of record-setting judgments and settlements may be characterized as the public’s call for retribution for the huge losses suffered as a result of so many institutional failures. Two authors have addressed the current environment in this way: "If the 1980s were known as the decade of greed, it is doubtless correct that the 1990s ultimately will be known as the decade of retribution." Harvey L. Pitt & Dixie L. Johnson, \textit{The Banking Scandal: An Era of New Standards for Professionals?}, in \textit{ADVANCED SECURITIES LAW WORKSHOP 1992}, at 713, 734 (PLI Corp. L. Practice Course Handbook Series No. 784, 1992).
\end{itemize}

What is particularly disturbing is that the FDIC has alternately urged and opposed imputation depending on which approach is most beneficial to it under the circumstances. Like \textit{O’Melveny, California Union}, 948 F.2d at 565, involved the failure of American Diversified. In \textit{California Union}, the government sought to recover on insurance policies that did not provide payment unless knowledge of the fraudulent activity was obtained within a particular time frame. \textit{Id.} The government, as assignee or receiver, did not file its insurance claim until \textit{after} American Diversified’s insolvency drove it out of business. \textit{Id.} However, as assignee, the thrift’s knowledge of the fraud, imputed from Sahni, Day and Pope’s knowledge, occurred \textit{before} the expiration of the time frame for filing the claim. \textit{Id.} Thus, as assignee, the government argued for imputation of knowledge and \textit{against} special status to allow the FSLIC to recover under insurance policies.

Conversely, the government argued for special status and \textit{against} imputation in \textit{O’Melveny} to facilitate recovery against the failed thrift’s outside attorneys. \textit{O’Melveny}, 969 F.2d 744. It is difficult to discern how these contrary results, arising out of the same thrift failure, can be said to further the tort liability objectives of victim compensation and deterrence or fairness and consistency in the judicial process.
basis for determining whether the FDIC's claims against outside proof will succeed.

B. Effect on the Cost and Availability of Professional Service

Subsequent opinions that have perpetuated the O'Melveny rationale for according special status to the FDIC or other government successors in interest have done so on the basis that outside professionals, rather than the public, should bear the loss.\[170\] In FDIC v. Marsiglia, for example, the court emphasized that the FDIC owed a duty to the public at large.\[171\] The court determined that imputation would defeat the purpose of the FDIC: to protect the public against the losses which were precipitated by fraudulent activities.\[172\] But this conclusion, that shifting losses away from the insurance companies toward professional firms will somehow insulate the public from the economic impacts of the financial institution crisis, fails to consider the indirect impacts this shifting will have on the economy.\[173\] Many accounting and law firms are simply abandoning services for the banking industry altogether.\[174\] The end

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\[171\] Id. at *5.

\[172\] See supra note 193 and accompanying text.

\[173\] One commentator has stated:

In response to the FDIC's position, accountants could argue that no good public policy interest will be served by bankrupting and destroying the major accounting firms of the United States through unprecedented lawsuits and damage awards.

With few national financially solvent accounting firms remaining, accounting services will be more scarce and cost-prohibitive, resulting in fewer audits or less thorough audits, which, in turn, will create greater opportunities for fraud and corruption in corporations and financial opportunities. Thus, accountants could argue that imposing
result is that firms who are willing to service this industry will be fewer in
number and higher in price. 175

Some of these effects are already being experienced. 176 Eckert Seamans
Cherin & Mellott, a Pittsburgh law firm, recently settled with the FDIC for $24
million. 177 As a result, it has voluntarily chosen not to serve as general counsel
to savings and loans institutions nor will it represent S & L's in regulatory
matters. 178 In the future, some of the nation's accounting firms may also shy
away from perceived "high risk" industries, including financial institutions. 179

To better cope with more costly insurance, accounting and law firms alike have
been implementing "risk reduction" strategies. 180 The country's ninth largest
accounting firm, McGladrey & Pullen, has traditionally avoided thrift clients,
and in the recent past it has implemented risk reduction policies for other
industry segments identified as "high risk." 181 Those policies include a
stringent client acceptance process and annual client evaluations. 182 The

liability on accounting firms would not be in the long-term best interest
of the public.

Jan S. Blaising, Are the Accountants Accountable? Auditor Liability in the Savings and Loan

175 Three recent surveys showed that only 53% of California CPA firms will take on
audit engagements; 32% of CPA firms, in general, are discontinuing audit work in high
risk industries, and 56% of mid-size CPA firms will not become involved with clients in
high risk areas. Arthur Andersen et al., The Liability Crisis in the United States: Impact
on the Accounting Profession, A Statement of Position 5 (Aug. 6, 1992) (unpublished
manuscript, on file with the CLEVELAND STATE LAW REVIEW). Since less of the more
affordable small to mid-size alternative firms are available, there will likely be
corresponding reductions in the numbers of start-up businesses, as key professional
services will be out of reach.

176 See infra note 187 and accompanying text.

177 Larry Smith, Still Reeling in the Wake of S & L Suits, Law Firms Grope for Solutions,

178 Id.

179 See infra note 187 and accompanying text.

180 David C. Walters, Liability Crisis Threatens Auditors, CHRISTIAN SCI. MONITOR, Dec.

181 Id.

182 New York attorney, Melvyn I. Weiss has represented plaintiffs alleging claims of
negligence by auditors and he makes the following suggestions to accounting firms to
contain risk:
   — Rotate audits between firms to maintain impartiality
   — Improve training for on site auditors
   — Do not permit audit clients to hire employees from the accounting firm.

Walters, supra note 173.

Representative Edward J. Markey, chairman of the House Energy and Commerce
Committee's subcommittee on finance has urged legislation that would require auditors
to notify senior managers, or boards of directors, about improper accounting practices
within an organization. Both the organization and the outside auditor would be
required to report the improprieties to the SEC. John H. Cushman, Jr., Bank Failures Raise
segments classified as "high risk" by McGladrey & Pullen and its accounting industry peers include: financial institutions and services, insurance companies, securities brokers and dealers, real estate investment firms and high technology firms.\(^{183}\) The impact of the industry-wide risk reduction on members of "high risk" segments will likely resemble the effects felt by Americans who seek treatment for their ailments. Those most in need of professional services will simply not be able to obtain them. This problem is especially acute for companies who are just getting started and need professionals to assist with initial public offerings.

This risk reduction adversely affects the ability of many start-up companies to operate and grow, since professional services are more scarce, and where available, costly.\(^{184}\) It is the up-and-coming, untried companies which pose the greatest risk potential for professionals should the companies fail. In 1991 alone, \$477 million were expended by the six largest public accounting firms to settle and defend lawsuits.\(^{185}\) This figure was up from \$404 million in 1990, and projections for 1992 show even larger expenditure figures.\(^{186}\) The percentage of national accounting revenues represented by these figures is 9 percent and 7.7 percent respectively.\(^{187}\) With accounting firms facing litigation expenses approaching one-tenth of overall income, the nation will likely

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a Question: Who Does the Final Audit?, N.Y. TIMES, Dec. 6, 1992, at 6E. Currently, auditors need only notify management of improper accounting practices. Lee Berton, Holding Accountants Accountable, WALL ST. J., Sept. 22, 1992, at A18. The proposed whistle-blower legislation could have serious ramifications for firms seeking to retain and solicit new clients. It is unclear whether this legislation would apply only to financial institutions or whether its application would extend to all companies.

\(^{183}\)Walters, supra note 173; see also Arthur Andersen, supra note 168.

\(^{184}\)The effects of the so-called "scapegoat litigation" were measured in a study by the American Tort Reform Association. Mark A. Hofman, Study Says Joint and Several Liability to Hurt Economy; Report Blasts S & L Litigation, BUS. INS., Aug. 17, 1992, at 2. The following results of the study show the far reaching economic effects of this litigation:

- An increase in the cost of raising equity capital by as much as 1.3% over the next five years due to increased costs of legal, audit and investment banking services.
- Increase in the cost of capital varying considerably according to the amount raised.
- Average annual decline of \$6 billion in business' fixed investment — during five-year period.
- Concurrent decline in labor productivity.
- Increased inflation due to drop in investment and productivity.
- Drop in GNP of an average of \$17.8 billion in 1991 dollars per year during five-year period.
- Loss of as many as 224,000 jobs over the period.

Id. For specific effects on the accounting industry see supra text accompanying notes 170-98.

\(^{185}\)See Arthur Andersen, supra note 168.

\(^{186}\)Id.

\(^{187}\)Id.
experience professional firm failures and audits clearly will become more costly.188

C. Insurance Costs and Related Effects on Professional Firms

It has become obvious, in the wake of monumental verdicts, claims and settlements against professional firms, that a substantial motivator for according government regulators "special status" is the potentially greener pastures that these firms represent.189 It has become commonplace to include accounting and law firms as defendants in lawsuits, since the firms often are the only entities left with sufficient financial resources or insurance policies to pay for recovery.190 Because these firms represent the most realistic sources for enlarging the asset pool of the bankrupt entity, it is not surprising that some courts are tempted to facilitate that recovery under the guise of equity, policy and fairness.191

Those firms that remain viable will still experience the economic impact of the mounting litigation, primarily in the form of higher liability premiums.192

188 See Breznick, supra note 3, noting that Ernst & Young's record settlement occurred almost exactly two years after Laventhol & Horwath collapsed, at least in part, under the pressure of pending litigation.

189 Accountants are currently facing more than $9 billion in claims, while major law firms face multi-million dollar claims. Lacovara, supra note 123. "The search is on for other 'deep pockets' who can help defray the cost." Id. at 9. Jon Madonna, Chairman of KPMG Peat Marwick stated, "Ambulance chasers used to be confined to automobile accidents...[n]ow... business accidents are a lot more valuable." Walters, supra note 173, at 9.

Many in the accounting industry feel that the reason for the tremendous lawsuits is the government's need to do "anything they can to replenish the [insurance] fund regardless of the source." Barbara Rehm, Suits Target Deep Pockets of Accountants, AM. BANKER, Mar. 13, 1990, at 1.

190 One commentator has suggested, however, that the existing collective insurance coverage of the larger accounting firms will be insufficient to cover the total value of estimated claims. Jeff Dash, The S & L Crisis: Should Accountants Be Accountable?, 17 S. ILL. U.L.J. 365 (1993). Another reason for including professional firms as defendants is the likelihood of settlement as sheer volume of litigation makes defending an uneconomical prospect for many firms. Ray J. Groves, Chairman of Ernst & Young, had this to say about the firm's recent $400 million settlement: "It is the only realistic solution to an endless stream of lawsuits that would have been even more expensive to defend." Coyle, supra note 130, at 5. In another article, Mr. Groves also stated that "[c]ontesting each lawsuit would have meant many years of almost continuous litigation — and an unacceptable drain of the firm's time and resources." Mark A. Hofman & Gavin Souter, Ernst & Young Settlement Praised: Pact Called 'Fabulous Deal' for Accountant, Insurers, BUS. Ins., Nov. 30, 1992, at 1. The message is clear. With the firms' defensive arsenal greatly depleted, the prospect of continuing legal battles is too costly to justify. Professional firms are either faced with enormous litigation costs and a small chance of vindication or a quick resolution in the form of a settlement.

191 See Walters, supra note 173.

192 Three hundred million dollars of E & Y's recent four hundred million dollar settlement was paid by insurance companies. Hofman & Souter, supra note 183; see also
Ninety-six percent of accounting firms with more than fifty certified public accountants have experienced at least a three hundred percent increase in liability insurance premiums between 1985 and 1991.\textsuperscript{193} In some cases, however, accounting firms have opted to "go bare" because new, higher insurance premiums and higher deductible amounts are simply not affordable.\textsuperscript{194} Of course, the danger in "going bare" is that a firm may be completely wiped out financially by one lawsuit. As already indicated, the price of defending or settling a specious claim for a professional firm may be too high, and, as a result, the business may be forced to close its doors.\textsuperscript{195}

Under the rule of joint and several liability, professional firms are especially vulnerable to attack.\textsuperscript{196} Even assuming a firm is only marginally culpable, under joint and several liability, that firm can be held responsible for an entire judgment.\textsuperscript{197} In certain jurisdictions, if a firm is found by a jury to be only one percent responsible for an institution's failure, it may have to pay one hundred percent of the judgment if, as is usually the case, the other parties at fault, such as directors and officers, are judgment-proof.\textsuperscript{198} Such a result is clearly inequitable.

\textbf{D. Public Misunderstanding of the Auditor's Role}

The courts' construction of a special status to avoid the operation of traditional legal principles is deemed acceptable not only because recovery is

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\textit{Christine Woolsey, Large Accounting and Law Firms See E & O Rate Increases, BUS. INS., Apr. 27, 1992, at 52 (stating that "S & L settlements have pushed [premium] trends along swiftly"). One expert's estimate has predicted that Ernst & Young will immediately experience a twenty-five percent increase in its insurance premiums as a result of its settlement. Breznick, supra note 3.}
\end{center}

\textsuperscript{193}\textit{See Arthur Andersen, supra note 168.}

\textsuperscript{194}Professional firms with potential liability for financial institution clients are having particular difficulty obtaining maximum coverage or, in some cases, any coverage. Woolsey, supra note 185. A once-prominent underwriter, National Union Fire Insurance Co., ceased underwriting Big Six accounting firms, and it has restricted its underwriting for law firms. Id. National Union will issue coverage to law firms with financial institution clients after securing higher deductibles from the firms. Id.}

\textsuperscript{195}\textit{See supra note 182.}

\textsuperscript{196}Many in the accounting and law professions have advocated proportionate liability, so firms will only be liable for amounts of damages "directly attributable" to their actions. Walters, supra note 173; see also Arthur Andersen, supra note 168, at 6 ("[P]roportionate liability will help restore balance and equity to the liability system by discouraging specious suits and giving blameless defendants the incentive to prove their case in court rather than settle.").

\textsuperscript{197}Hofman & Souter, supra note 183, at 1. Under joint and several liability, "all defendants found to be liable may have to pay for the full amount of damages, no matter what portion of the harm their misconduct actually caused." Id.

\textsuperscript{198}\textit{See supra note 183 and accompanying text.}
facilitated, but also because the general public misperceives the responsibility undertaken by outside professionals, especially auditors.\textsuperscript{199}

The public misconception about accounting firms' responsibilities, even before the S & L crisis, was a belief that a firm's audit opinion constituted a "clean bill of health" for the entity audited.\textsuperscript{200} Thus, the misguided rationale of O'Melveny and courts that have followed O'Melveny is understandably appealing to the poorly-informed, general public, many of whom were customers damaged by thrift failures.

Contrary to popular belief, however, the true objectives of an audit are to detect inadvertent mistakes made by management in their financial records and to give an opinion on the reasonableness of figures reported.\textsuperscript{201} An audit is by no means a guarantee, nor are auditors insurers against managerial fraud or other internal treachery.\textsuperscript{202} This concept was aptly summed up by Chief Justice Malcolm Lucas of the California Supreme Court in this way: "An auditor is a watchdog, not a bloodhound."\textsuperscript{203}

VI. CONCLUSION

Three hundred million dollars, four hundred million dollars, five hundred million dollars . . . enormous claims and settlements like these are projected to continue for at least several more years.\textsuperscript{204} One managing partner in an accounting firm summarized the liability crisis facing firms in this way: "There

\textsuperscript{199}It should be noted that a professional's responsibility may be expanded or contracted by the terms of an express contract.

\textsuperscript{200}See Travis M. Dodd, Accounting Malpractice and Contributory Negligence: Justifying Disparate Treatment Based Upon the Auditor's Unique Role, 80 GEO. L. J. 909, 915 (1992)(discussing the fact that unqualified audit reports only show an auditor's belief that financials are "fairly presented", not that the entity has a "clean bill of health"). The author states that the "expectation gap" between the public's perceptions of the auditors' responsibilities and the auditors' own perceptions is widest in the area of detection of management fraud or theft. \textit{Id.} at 916. Recent, well-publicized settlements and claims have apparently widened the chasm, rather than contracting it. See supra notes 1-4 and accompanying text.

\textsuperscript{201}See Robert B. Hale, Auditor Liability Under the DTPA: Can It Get Any Worse for Accountants?, 44 BAYLOR L. REV. 313 (1992)(noting that role of independent auditor is to express an opinion); Dodd, supra note 192 (stating that auditor has duty to detect items which result in material misstatements in financials); see also Oberly & Morris, supra note 6 (explaining that audits must be in compliance with Generally Accepted Accounting Standards and Principles, and that auditor responsibility does not include a guarantee of accuracy).

\textsuperscript{202}Dodd, supra note 192, at 919 ("[A]s a general proposition '[a]uditors do not cause business failures, nor can they prevent them from happening.").


\textsuperscript{204}See supra notes 1-6 and accompanying text.
may be a settlement or lawsuit out there that could kill any one of us." Accounting and law firms that are sued by the FDIC and other regulatory agencies for professional malpractice have two options, either to defend their actions in court or reach a settlement. The former has proven far less viable in the past two years as some courts have become far more willing to exempt the FDIC from the plaintiff's usual burden to prove all of the elements of a professional negligence claim, including reasonable reliance.

It is true that the thrift disasters of the last decade have been costly. It is also true that those who bear responsibility should be made to answer for their culpability. However, the allure of achieving these goals, as well as deterring similar future conduct, have no validity when innocent or marginally culpable parties are hampered in their ability to defend themselves. A balance must be struck in the context of well-settled legal principles.

In the eyes of some courts, the search for a scapegoat to shoulder the losses experienced as a result of many failed savings and loan and thrift institutions seems to be over. The "deep-pocketed" professional firms have filled that role quite nicely. Stripped of their ability to formulate a strong defense and exposed to potential financial ruin from rising insurance costs and a continuing barrage of lawsuits, these scapegoats may soon become endangered or extinct. These are consequences that our national economy can ill afford to suffer.

ALISON L. DRAKE

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205 Walters, supra note 173, at 9 (quoting LeRoy E. Martin, national managing partner of McGladrey & Patten).

206 See supra note 124 and accompanying text. For an excellent discussion about the failure of deterrence and loss spreading policies as justifications for shifting losses to accountants, see John A. Siliciano, Negligent Accounting and the Limits of Instrumental Tort Reform, 86 Mich. L. Rev. 1929 (1988).