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NOTES

Are the Accountants Accountable? Auditor Liability in the Savings and Loan Crisis

Introduction

From 1980 to 1988, over 500 savings associations failed throughout the United States, more than three-and-a-half times the number of savings associations that had failed in the previous forty-five years combined.[1] As a result of the federal government's bailout of failed thrifts, the savings and loan (S&L) crisis could ultimately cost American taxpayers one trillion dollars, amounting to thirty dollars a month for every household over the next four decades (roughly equivalent to twice the cost of the Vietnam War or four times the cost of the Korean conflict).[2] Even under more conservative estimates, industry analysts warn that the S&L debacle could cost American taxpayers $500 to $700 billion[3] and

1. S. Rep. No. 19, 101st Cong., 1st Sess. 2 (1989). *See also* Clark, Murtagh, & Corcoran, *Regulation of Savings Associations Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 Bus. Law. 1013, 1013 (1990).

2. Greenwald, *S&L Hot Seat: Thrift Honchos Squirm and Politicians Dither as the Economy Slides*, Time, Oct. 1, 1990, at 34.

3. The estimates for the ultimate cost of the S&L bailout continue to increase. In October 1990, William Seidman, Chairman of the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) estimated that the cost of the S&L bailout, including interest, could reach $600 billion. Reuters, *Cost of S&L Bailout May Reach $600 Billion*, Christian Science Monitor, Oct. 1, 1990, at 9, col. 2. Other estimates suggested that the bailout would cost $500 billion. Garsson, *Half the Public Never Heard of Thrift Crisis or Costly Bailout*, Am. Banker, Oct. 3, 1990, at 7. By mid-1991, Chairman Seidman raised his estimate and predicted that the cost of the S&L bailout could reach $700 billion — $225 to $250 billion plus interest over 30 to 40 years. *Frontline: The Great American Bailout* (PBS television broadcast, Oct. 22, 1991) (transcript available from Journal Graphics, 1535 Grant Street, Denver, Colorado, 80203). To indicate the magnitude of a $250 billion bailout (excluding interest), in 1990, the federal government spent less than half of this amount on NASA, the FBI, the EPA, the Veterans Administration, the War on Drugs, Headstart, Prenatal Health Care, AIDS research, and the entire Persian Gulf War ($61 billion) combined. *Id.*

could cost each American household $5,000.[4]

As the Federal Deposit Insurance Corporation (FDIC) seeks to recover failed thrift losses and as public pressure mounts to identify, prosecute, and punish the individuals involved, attention is increasingly focusing on the liability of accountants and other professionals for their roles in the savings and loan crisis. Judge Sporkin recently observed in *Lincoln Savings and Loan Association v. Wall:*[5]

> Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?
>
> Why didn't any of them speak up or disassociate themselves from the transactions?
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> Where also were the outside accountants and attorneys when these transactions were effectuated?
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> What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.[6]

Before examining the liability of certified public accountants for their audits of now-failed savings and loan institutions, it should be noted that this topic has several different dimensions (legal, economic, administrative, and political), each individually of incredible magnitude, yet all closely interconnected. First, as for its legal dimension, the applicable area of accountant liability law is currently in a state of transition (as evidenced by the recent developments in accountants' liability to third parties).[7] Second, this topic's economic dimension involves nothing less than one of the major financial crises of the century.[8] Third, as for its administrative dimension, because accountants audited governmentally regulated entities —S&Ls— there is the added element of federal regulation and recently reorganized governmental structures. Finally, as for its political dimension, this topic must also be approached with an understanding of the influence of political philosophies and

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4. Francis, *S&L Cleanup Avoids Cause of Crisis*, CHRISTIAN SCIENCE MONITOR, Sept. 28, 1990, at 8, col. 2.

5. Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901 (D.D.C. 1990) (suit brought by Lincoln Savings and Loan Association against the director of the Office of Thrift Supervision, M. Danny Wall, for the federal regulators' take-over of Lincoln).

6. *Id.* at 920.

7. *See, e.g.*, Bagby & Ruhnka, *The Controversy Over Third Party Rights: Toward More Predictable Parameters of Auditor Liability*, 22 GA. L. REV. 149 (1987).

8. P. PILZER & R. DEITZ, OTHER PEOPLE'S MONEY: THE INSIDE STORY OF THE S&L MESS 15 (1989).

actions, both past and present. Moreover, an analysis of accountants' liability for audits of S&Ls also has implications for accountants' liability for audits of other financial institutions (such as audits for the Bank of Credit and Commerce International (BCCI), other failed banks, corporations, and insurance companies).

With such a perspective, this Note examines the liability of independent certified public accountants (CPAs) for their role as auditors of savings and loan institutions declared insolvent during the S&L crisis. Part I traces the development of the savings and loan crisis. Part II discusses the auditing process and examines the role of accountants in auditing savings and loan institutions. Part III summarizes the congressional responses to alleged accountant misconduct in the savings and loan crisis. Part IV analyzes potential lawsuits against accounting firms for their audits of now-failed S&Ls, focusing on potential parties, causes of action, arguments, and legal defenses. Finally, Part V concludes the analysis of accountants' liability in the savings and loan crisis.

I. History of the Savings and Loan Crisis

A. *Deregulation of "Sleepy" Savings and Loan Institutions*

Savings and loan institutions were originally established in the 1930s to offer home loans for Americans seeking the "American dream" of home ownership.[9] During the period between the Great Depression and the 1960's, these institutions were profitable because they offered traditional low-risk, long-term home loans and paid low interest rates on savings deposits.[10] In 1966, Congress enacted legislation which, for the first time, set a ceiling on the interest rates that S&Ls could pay depositors.[11] During the 1970's, when higher oil prices caused double-digit inflation and rapidly escalating interest rates, S&Ls became less

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9. Goldwasser, *The Liability Ramifications of the S&L Crisis*, 60 CPA J., 20, 22 (1990). For general background reading on the savings and loan crisis, see J. Adams, The Big Fix: Inside the S&L Scandal (1990); M. Mayer, The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry (1990); P. Pilzer & R. Deitz, *supra* note 8; S. Pizzo, M. Fricker, & P. Muolo, Inside Job: The Looting of America's Savings and Loans (1989); M. Waldman, Who Robbed America?: A Citizen's Guide to the Savings & Loan Scandal (1990). *See also* Wayne, *Where Were the Accountants?*, N.Y. Times, Mar. 12, 1989, § 3, at 1, col. 2.

10. Clark, Murtagh, & Corcoran, *supra* note 1, at 1019. *See also* Roberts & Cohen, *Villains of the S&L Crisis*, U.S. News & World Report, Oct. 1, 1990, at 53, 54.

11. Pub. L. No. 89-597, 80 Stat. 823 (1966). *See also* Clark, Murtagh, & Corcoran, *supra* note 1, at 1019 (S&L interest rate ceilings were codified in the Federal Reserve System's Regulation Q).

competitive because they were limited by federal regulations to paying only 5.5% interest.[12] Consequently, many depositors shifted their assets from low interest S&Ls to higher return investments (such as money market mutual funds), causing S&Ls to lose deposits rapidly.[13]

In March of 1980, in an attempt to make S&Ls more competitive, Congress passed (and Jimmy Carter signed) the Depository Institutions Deregulation and Monetary Control Act,[14] which raised the interest rate ceiling for S&Ls, lowered the capital reserves thrifts were required to keep on hand (from five percent to four percent), and with virtually no analysis or scrutiny, raised the amount of federal deposit insurance for S&Ls, banks, and credit unions from $40,000 to $100,000 per account.[15] As a result, the legislation increased the government's exposure to risk by 250% in the event of financial institution failure.[16]

When thrifts began paying more competitive interest rates on such "risk-free" deposits, Wall Street brokers were attracted by these lucrative opportunities and began packaging their own investments into insurable $100,000 chunks, shopping around the country for the highest interest rates, and dispatching deposits to S&Ls through a network of computerized transfers.[17] The ensuing war among institutions to raise interest rates in order to attract these "brokered deposits" severely strained many S&Ls. Even though S&Ls could now pay any rate to attract depositors (nearly twenty percent in some cases), they were receiving less than a ten percent return on their long-term home loans, which constituted the bulk of their assets.[18] According to one estimate, by 1981, eighty-five percent of thrifts were on the brink of collapse.[19]

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12. Moore, *The Bust of '89*, U.S. NEWS & WORLD REPORT, Jan. 23, 1989, at 36, 38.

13. Roberts & Cohen, *supra* note 10, at 54. *See also* Moore, *supra* note 12, at 38.

14. Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132.

15. Gail & Norton, *A Decade's Journey From "Deregulation" to "Supervisory Reregulation": The Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 BUS. LAW., 1103, 1104 (1990). *See also* Roberts & Cohen, *supra* note 10, at 54.

16. Moore, *supra* note 12, at 38. Such extended government liability has been widely criticized. *See* Kane, *Proposals to Reduce FDIC and FSLIC Subsidies to Deposit-Institution Risk-Taking*, 8 ISSUES IN BANK REG. 24, 31 (1985). *See also* Richter, *A Risky System for Deposits,* L.A. Times, Sept. 9, 1990, p. 1, col. 1 ("[A] family of four can legally open fourteen insured accounts worth $1.4 million at a single institution.").

17. Roberts & Cohen, *supra* note 10, at 55. *See also* Moore, *supra* note 12, at 38; Richter, *supra* note 16, at 1.

18. Richter, *supra* note 16, at 1. *See also* Clark, Murtagh, & Corcoran, *supra* note 1, at 1020; Moore, *supra* note 13, at 38.

19. Cope, *Did Pratt's Piloting Sink S&L Industry?*, AM. BANKER, Oct. 1, 1990, at 1. *See also* Roberts & Cohen, *supra* note 13, at 54 (Only two years after the 1980 bill, the capital reserves of the thrift industry plunged from $31 billion to $4 billion.).

In 1981, Ronald Reagan assumed the Presidency, and in keeping with his devotion to the principles of deregulation, he led the move to deregulate the thrift industry even further.[20] As a result, the Federal Home Loan Bank Board (FHLBB) permitted S&Ls to make accounting changes which masked their growing insolvency.[21]

In addition to federal deregulation efforts, some states, particularly Texas, California, and Florida, enacted laws deregulating state-chartered S&Ls.[22] State-chartered S&L owners could now choose to operate under either federal or state restrictions which, for practical purposes, meant many selected the most lenient restrictions.[23]

In 1982, Congress passed (and President Reagan signed) the Garn-St Germain Act.[24] This deregulation law expanded the powers of federally chartered thrifts, allowed S&Ls to invest in high-risk, high-return ventures, and gave thrifts lending powers not granted to even more so-

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20. Roberts & Cohen, *supra* note 10, at 55.

21. *Id. See also* Cope, *supra* note 19, at 2. Under Richard Pratt, head of the FHLBB, relief measures were taken with the following results:

> a. capital requirements were cut further from 4% to 3% of assets;
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> b. S&Ls were allowed to count intangible capital such as "goodwill"; thus when stronger thrifts merged with insolvent thrifts, the stronger thrifts were allowed to count the insolvent's intangible capital ("goodwill") which inflated the acquirer's "paper assets";
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> c. S&Ls were permitted to exclude subordinated debt from their liabilities in calculating regulatory net worth and the exposure of the insurance fund. Similarly, S&Ls were also permitted to increase their assets and thus their regulatory net worth (which measures the exposure of the insurance fund) by the unrealized appreciation in value of land and buildings;
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> d. S&Ls deferred loan losses, postponing the recognition of those losses;
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> e. S&Ls kept even less than the required 3% of assets on hand by adjusting the way in which capital requirements were determined; they calculated capital requirements against the average asset balance of the past five years to arrive at higher capital assets.

Cope, *supra*, at 55.

22. *Failure of Independent CPA's to Identify Fraud, Waste and Mismanagement and Assure Accurate Financial Position of Troubled S&Ls: Hearings Before the Committee on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess., 30 (1989) [hereinafter *CPA Hearing*] (statement of John J. LaFalce, member of the House of Representatives). *See also* Roberts & Cohen, *supra* note 10, at 55.

23. Roberts & Cohen, *supra* note 10, at 55 (two-thirds of the industry's losses can be attributed to state-chartered thrift failures). *See also* Clark, Murtagh, & Corcoran, *supra* note 1, at 1021 ("In particular, several states granted state-chartered savings associations the authority to invest in equity securities, unrated corporate debt securities, and real estate development projects of a type, or in an amount, that would have been impermissible for federal savings associations.").

24. Garn-St Germain Depository Institutions Act of 1982, Pub. L. 97-320, 96 Stat. 1469.

phisticated commercial banks.[25] In addition, regulators' changes in the loan-to-value regulations enabled S&Ls to lend up to 100% of the appraised value of a commercial real estate development project, even if the actual purchase price was much smaller.[26] Consequently, a real estate developer could now purchase property, secure an inflated appraisal stating that the property was worth 150% of the purchase price, then easily borrow the full inflated amount from an S&L.[27] Under such conditions, inflated appraisals were not difficult for developers to obtain.[28]

Federal officials continued to deregulate the thrift industry by removing other "safety nets." Rules requiring S&Ls to be owned by multiple shareholders, living in geographical proximity to the S&L, were abandoned, thus allowing S&Ls to be owned by single investors.[29] Meanwhile, federal examiners cut back significantly on policing the S&L industry.[30]

B. Speculation and Unscrupulous Transactions

The effect of deregulation was that thrifts could be owned by single investors who could loan money at higher interest rates and invest in speculative ventures with less regulatory supervision, yet such owners were backed with government-guaranteed federal deposit insurance.[31] In this "no-lose" situation, some S&Ls were purchased by aggressive entrepreneurs who used S&L funds to finance their own ventures, and in

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25. Moore, *supra* note 12, at 38 (S&Ls were permitted to make "high-risk acquisition, development and construction loans [ADC loans], to form development subsidiaries and make direct investments").

26. 48 Fed. Reg. 23032, 23037 (1983). *See, e.g.*, Complaint of Plaintiff at 14, Sunbelt Sav. Ass'n of Texas v. McBirney, No. 88-6955 (N.D. Tex. filed June 2, 1988) [hereinafter Complaint, Sunbelt v. McBirney] (pending $200 million suit against accounting firm Grant Thornton for its audits of Sunbelt Savings Association and Sunbelt Service Corp. in Dallas, Texas); Complaint of Plaintiff at 14, FDIC v. Schoenberger, No. 89-2756 (E.D. La. filed June 19, 1989) [hereinafter Complaint, FDIC v. Schoenberger] (pending $40 million suit against accounting firm J. K. Byrne & Co. for its audits of Crescent Federal Savings Bank in New Orleans, Louisiana). *See also* Moore, *supra* note 12, at 38.

27. Moore, *supra* note 12, at 38. *See also CPA Hearing, supra* note 22, at 85-86 (statement of Mr. Thomas Myers, President of T.A. Myers & Co.) ("The joke was that you drive into the drive-up window at Sunrise Savings and Loan, they would throw a bag of money and a loan application.").

28. Moore, *supra* note 12, at 38.

29. Roberts & Cohen, *supra* note 10, at 55.

30. Clark, Murtagh, & Corcoran, *supra* note 1, at 1022 ("In some instances, this reduction in regulatory scrutiny was the result of a conscious effort to deregulate; other times it was the result of inadequate staffing at both the federal and state levels."). *See also* Roberts & Cohen, *supra* note 10, at 55.

31. Roberts & Cohen, *supra* note 10, at 55.

some cases, ignored the rules that remained after deregulation.[32] These circumstances were summarized in their popular motto "Heads, I win; tails, FSLIC loses," because they were assured that the Federal Savings and Loan Insurance Corporation would underwrite their losses in the event of the thrift's failure.[33]

Consequently, some S&L operators ran their institutions more like speculative real estate investment companies than federally insured financial institutions.[34] Although some of these aggressive new operators made speculative acquisition development and construction loans (ADC loans)[35] and invested in highly speculative ventures (spanning a range from junk bonds to bull-sperm banks and shopping centers in the desert),[36] the most unscrupulous operators developed schemes to inflate the S&L's net worth artificially. Some of the more common transactions were "land-flips" in which worthless parcels of land were traded back and forth, increasing in value with each exchange,[37] "tax-sharing

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32. Goldwasser, *supra* note 9, at 23.

33. *CPA Hearing*, *supra* note 22, at 60. *See also* Moore, *supra* note 12, at 38.

34. *E.g.*, Complaint, Sunbelt v. McBirney, *supra* note 26.

35. *E.g.*, Complaint, FDLIC v. Schoenberger, *supra* note 26.

36. Roberts & Cohen, *supra* note 10, at 55. *See also* First Amended Complaint of FSLIC at 25, FSLIC v. Fitzpatrick, No. 86-6780 RMT (Tx) (C.D. Cal. filed Mar. 13, 1987) [hereinafter Complaint, FSLIC v. Fitzpatrick] (settled suit against accounting firm Touche Ross & Co. for its audits of Beverly Hills Savings and Loan in Beverly Hills, California).

37. Under the "land flip" scheme, S&L operators would sell seemingly worthless land back and forth to each other, each time inflating the price. It has been reported that during a "land flip," one speculator

> would line up his cronies and take a piece of vacant land worth maybe $125,000. A first set of buyers would pay $200,000 and then turn around and sell it for $400,000. The second buyer would immediately resell for $600,000, and so on until, by the end of the day, the parcel may have gone through six sales and wind up with a 'market' value, supported by courthouse records, of $2 million or so.

J. Adams, The Big Fix: Inside the S&L Scandal 205 (1990). *See also CPA Hearing*, *supra* note 22, at 19; First Amended Complaint of Plaintiff at 31, FSLIC v. Jacoby, No. 86-1894, (S.D. Fla. filed Dec. 6, 1988) [hereinafter Complaint, FSLIC v. Jacoby] (pending $250 million suit against accounting firm Deloitte, Haskins & Sells for its audits of Sunrise Savings and Loan in West Palm Beach, Florida).

In *Who Robbed America: A Citizen's Guide to the Savings and Loan Scandal*, the author described the recollections of a real estate salesperson who later pleaded guilty to criminal charges in the S&L probe. The "land-flip" participant stated:

> I remember one closing we had, ... It was in the hall of an office building. The tables were lined all the way down the hall. The investors were lined up in front of the tables. The loan officers would close one sale and pass the papers to the next guy. It looked like kids registering for college. If any investor raised a question, someone would come over and tell them to leave, they were out of the deal.

M. Waldman, *supra* note 9, at 35-36.

schemes" in which an S&L was deliberately pillaged for the benefit of a parent holding company,[38] or "cash for trash" transactions in which an S&L eliminated worthless real estate from its financial records to avoid a reduction in the institution's net worth.[39] These unscrupulous S&L owners often lived in opulence,[40] and were generous contributors to political campaigns.[41]

In 1984, oil prices fell dramatically, leading to an economic downturn in the oil-producing states of the Southwest.[42] As a result, the real estate

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38. *E.g.*, Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 909 (D.D.C. 1990). This "tax-sharing" scheme was used by S&L owners who also owned other parent companies. They looted the S&L by transferring cash to the parent company, ostensibly to help the parent company meet its payments to the IRS. In fact, the cash was kept by the parent company for other purposes. In *Lincoln*, it was found that from 1984-1987, Lincoln sent $94 million to its parent company American Continental Corporation (ACC). Judge Sporkin wrote that "[t]his so-called tax sharing agreement was nothing more than a clever but impermissible way of looting Lincoln by upstreaming funds from Lincoln to ACC." *Id.*

39. Wayne, *Showdown at "Gunbelt" Savings*, N.Y. Times, Mar. 12, 1989, § 3, at 1-2, col. 2. In *Inside Job: The Looting of America's Savings and Loans*, "cash-for-trash" deals are described as follows:

> In a cash-for-trash transaction, a thrift officer said, in effect, "We'll make you the loan you want, on the condition that you use the extra money we loan you to buy a piece of repossessed real estate we have on our books." Cash-for-trash schemes were popular among poorly run and crooked savings and loans because as long as the thrift could keep reselling repossessed properties to phony buyers (thereby hiding their past mistakes), and collect phony fees and make a phony profit, it could hold off suspicious federal auditors.

S. Pizzo, M. Fricker, & P. Muolo, *supra* note 9, at 353. *See also* Complaint, Sunbelt v. McBirney, *supra* note 26, at 19; M. Waldman, *supra* note 9, at 37.

40. One of the most notorious S&L owners was Edwin T. McBirney III, Chairman of Sunbelt Savings Association, who owned a fleet of seven aircraft, bought 84 Rolls-Royces from Bhagwan Shree Rajneesh (an Indian guru in Oregon), and built a "gleaming moonscape skyscraper" known as Sunbelt's "intergalactic headquarters." McBirney also earned a reputation for throwing extravagant parties, spending $1.3 million for Halloween and Christmas parties in 1984-1985. Moore, *supra* note 12, at 40.

Another notorious S&L operator, Don Ray Dixon, owner of Vernon Savings and Loan in Vernon, Texas, liked exotic cars and $2 million beach houses, and went on an 1983 "eating trip" through Europe in which Dixon conducted a "market study" of world-class restaurants, all paid for by Vernon Savings and Loan. J. Adams, *supra* note 37, at 218. *See also CPA Hearing*, *supra* note 22, at 69.

41. Roberts & Cohen, *supra* note 10, at 58. *See also* M. Waldman, *supra* note 10, at 60-82. Charles Keating of Lincoln Savings and Loan made generous contributions to politicians and expected his employees to do the same. As stated in the *Chicago Tribune*, "Politicians would visit Lincoln Savings and Loan, and the next day a stack of checks would be forwarded . . . . Arizona senator John McCain received 51 donations from Keating family members and employees all on the same day." Lavin, *Charlie's Web*, Chicago Tribune, Jan. 14, 1990, at C1. It is also interesting to note that Charles Keating donated over one million dollars to Mother Teresa. *Id.* at C9.

42. Goldwasser, *supra* note 9, at 23.

boom in the Southwest ended, foreclosures increased, and approximately 200 S&Ls failed and were taken over by the Federal Savings and Loan Insurance Corporation (FSLIC).[43]

C. *Reregulation of Savings and Loan Institutions*

In 1985, the Federal Home Loan Bank Board (FHLBB), led by Edwin Gray, began to "reregulate" S&Ls. The FHLBB hired hundreds of new examiners, increased capital requirements of S&Ls, established growth limitations, attempted to limit brokered deposits, and banned inflated appraisals.[44] When property was reappraised at current depressed market values, foreclosures increased, and even more S&Ls were declared insolvent.[45]

Due to the high number of S&L insolvencies, the FSLIC's funds were depleted by 1986, rendering it unable to close troubled S&Ls or to reimburse depositors.[46] As a result, hundreds of insolvent and nearly insolvent S&Ls continued to operate and incur losses estimated at over twenty million dollars per day.[47]

II. The Role of Accountants in the Savings and Loan Crisis

A. *The Auditing Process*

During these dramatic changes in the thrift industry, the Federal Home Loan Bank Board continued to require annual audits of S&Ls by independent certified public accountants.[48] Traditionally, an audit constituted "a verification of the financial statements of the institution through an examination of the underlying accounting records and sup-

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43. *Id.*

44. Moore, *supra* note 12, at 41.

45. *Id.*

46. The FSLIC had a negative net worth of approximately $6.3 billion in December 31, 1986, which dropped to a negative $13.7 billion in December 31, 1987. *Condition of the Federal Deposit Insurance Funds Before the House of Representatives Comm. on Banking, Finance and Urban Affairs*, 100th Cong., 2nd Sess. 185 (1988) (statement of M. Danny Wall, Chairman, Federal Home Loan Bank Board).

47. Clark, Murtagh, & Corcoran, *supra* note 1, at 1014. However, even when FSLIC did not liquidate ailing thrifts, it usually replaced S&L management, and regulators placed thrifts under tight supervisory controls. Telephone interviews with Anne Buxton Sobol, former Assistant General Counsel of the Federal Deposit Insurance Corporation (Oct. 18, 1990, Nov. 2, 1990, Nov. 15, 1990, Nov. 20, 1990, Aug. 22, 1991, Oct. 6-7, 1991).

48. 12 C.F.R. § 571.2 (1991).

porting evidence."[49] During an audit, accountants agree to examine the institution's financial statements in accordance with the Generally Accepted Auditing Standards (GAAS) and Generally Accepted Accounting Principles (GAAP).[50] One of four types of audit reports may be issued

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49. Hagen, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65, 66 (1987). An audit typically consists of the following five stages:

> (1) planning the audit;
> (2) making a preliminary evaluation of the institution's internal control system;
> (3) conducting compliance tests to determine whether the institution's internal control system functions properly;
> (4) adjusting the audit program to conform with the results of the compliance tests; and
> (5) issuing a written report in which the auditor evaluates whether or not the institution's statements fairly reflect its financial condition.

Id. at 67-68.

50. The AICPA has issued Generally Accepted Auditing Standards (GAAS) that are standard auditing methods and procedures which govern audits conducted by CPAs. These standards also include Statements on Auditing Standards which interpret the Generally Accepted Auditing Standards (GAAS). *Id.* at 72-73. The Generally Accepted Auditing Standards are as follows:

> *General Standards*
> 1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
> 2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
> 3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.
> *Standards of Field Work*
> 1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
> 2. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
> 3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.
> *Standards of Reporting*
> 1. The report shall state whether the financial statements are presented in accordance with the generally accepted accounting principles.
> 2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
> 3. Information disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
> 4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where the auditor's name is associated

at the conclusion of the audit: (1) an unqualified opinion ("clean audit"); (2) a qualified opinion; (3) an adverse opinion; or (4) a disclaimer opinion.[51] An unqualified opinion is an accountant's opinion without any exceptions, reservations, or qualifications that the financial statements of the institution fairly represent its financial position.[52] A qualified opinion and an adverse opinion are those given when the institution has used an improper accounting treatment for one or more items, and thus its financial statements do not comply with Generally Accepted Accounting Principles (GAAP).[53] Finally, a disclaimer is the harshest judgment, indicating that the institution's financial records are so inadequate that the auditors cannot render an opinion.[54]

In spite of widespread agreement on the mechanics of an audit, there is, however, considerable disagreement concerning the proper role of an independent certified public accountant. Essentially, there is disagreement as to whether an accountant owes ultimate allegiance to the public or to the client and disagreement as to whether an audit can be expected to reasonably assure that the financial statements are accurate. Accountants frequently refer to this as the "expectation gap" between public perceptions and the realities of an auditor's role.[55]

Traditionally, in planning, conducting, and reporting audits, accountants have been expected to adhere to the principles of "conservatism, skepticism, and independence."[56] In *United States v. Arthur Young & Co.*,[57] the United States Supreme Court stated that an auditor's responsibility to the public transcends an auditor's employment relationship with the client, thus requiring an auditor to maintain total independence from the client.[58] In *Arthur Young*, Chief Justice Burger described this "public watchdog" role:

> with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

Silver, *Compilations, Reviews, and Audits/The Audit Process*, ACCOUNTANTS' LIABILITY: A.L.I.-A.B.A. COURSE OF STUDY MATERIALS 51, 59-60 (Jan. 31 - Feb. 1, 1991).

51. Hagen, *supra* note 49, at 69-71.

52. *Id.* at 69.

53. The difference between a qualified opinion and an adverse opinion is "the degree of materiality of the deficiency in the financial statements." *Id.* at 70.

54. Wayne, *supra* note 9, at 1. *See also* Hagen, *supra* note 49, at 71.

55. *See CPA Hearing*, *supra* note 22, at 79. *See also* Morrison, *The Difficulties Facing Today's Bank and Savings and Loan Association Auditor: An Auditor's Perspective*, 653 PRAC. L. INST. 135 (1989); Neebes, Guy, & Whittington, *Illegal Acts: What are the Auditors' Responsibilities?*, 171 J. OF ACCT. 89 (1991).

56. *See CPA Hearing*, *supra* note 22, at 58 (statement of Thomas Bloom, former chief accountant for the Federal Home Loan Bank Board).

57. 465 U.S. 805 (1984).

58. *Id.* at 817.

> An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to [the] investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[59]

However, even if accountants accept this "public watchdog" role and accept ultimate allegiance to the public, accountants still caution against complete or unreasonable reliance upon audits, arguing that an audit cannot guarantee that an institution's financial records are accurate. As expressed by the Commission on Fraudulent Financial Reporting in its 1987 report:

> [A]n audit cannot and does not guarantee or provide absolute assurance that the financial statements are reliable and accurate. These clarifications will help to confirm to all concerned that management has primary responsibility for the financial statements and to protect users of financial statements from placing more reliance on the audit process than is reasonable.[60]

Thus, there is a tension at the heart of the auditing process between an accountant's ultimate allegiance to the public or to the client. Moreover, regardless of the primary allegiance owed by the auditor, there remains an unresolved issue of just how accurate the audit is purporting to be, and therefore, what degree of reliance on the audit is reasonable.

B. *Indications of Accountant Misconduct in Auditing S&Ls*

Throughout the evolution of the S&L crisis, some S&Ls were audited by accounting firms and were given "clean audits" only to be declared insolvent shortly thereafter.[61] In California, for example, twenty-nine of thirty-one insolvent S&Ls were given "clean audits" by their accounting firms.[62] Similarly, in the FDIC's suit against accounting firm Ernst & Young (formerly Arthur Young) for the accountants' audits of Western

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59. *Id.* at 817-18.

60. *CPA Hearing*, *supra* note 22, at 162 (written statement of William L. Gladstone, Chairman of Arthur Young & Company, quoting The Report of the National Commission on Fraudulent Financial Reporting, Oct. 1987).

61. Wayne, *supra* note 9, at 12.

62. Roberts & Cohen, *supra* note 10, at 59.

Savings & Loan in Dallas, Texas, the FDIC alleges that Western's financial statements should have shown that Western had a negative net worth of at least $100,000,000 at the end of 1984 and a negative net worth of at least $200,000,000 at the end of 1985, yet Arthur Young gave "clean," unqualified opinions on the 1984 and 1985 financial statements to both Western's directors and to the FSLIC.[63]

As more S&Ls were declared insolvent, questions began to be raised about the auditors' methods, and allegations of accountant impropriety continued to surface. For example, in a shareholder's suit against Charles Keating, a memo surfaced which allegedly was circulated among the partners at the accounting firm Touche & Ross which stated: "[A]ccountants will probably soon run out of ways under GAAP to postpone the recognition of losses in a business having long-term, low-earning assets and capitalized with short-term, high-cost obligations."[64]

Some S&Ls engaged in questionable hiring practices and became known for their "accountant shopping."[65] Charles Keating's Lincoln Savings and Loan, for example, hired four accounting firms in five years, prompting some to accuse Lincoln of shopping for auditors to get the "treatment" it wanted.[66] It was also disclosed that in some situations, once independent accountants had audited the S&L, those same accountants were then hired by the S&L after issuing favorable audit opinions. For example, in the Lincoln Savings and Loan case, it was revealed that Jack Atchison, a lead auditor with Arthur Young, allegedly wrote letters to several senators discouraging regulatory take-over of Lincoln, and that one month after Atchison signed Arthur Young's "clean audit," he was hired by Charles Keating at four times his former salary (from a previous salary of $225,000 a year to over $900,000 a year).[67] Astonishingly, it was also reported that Charles

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63. Complaint of FDIC at 27, FDIC v. Ernst & Young and Arthur Young & Company, No. CA3-90-0490-H, (N.D. Tex. filed Mar. 1, 1990) [hereinafter Complaint, FDIC v. Ernst & Young]. This suit seeks $560 million in damages from the Big Six accounting firm, Ernst & Young. *Id.* It is the largest suit ever brought against an accounting firm. Waldman, *The Other S&L Culprits*, TIME, Oct. 29, 1990, at 54. *See also* Wayne, *supra* note 9.

64. Moore, *Cash Call*, 22 NAT'L J. 2244 (1990).

65. *CPA Hearing*, *supra* note 22, at 22. *See also* McTague, *Accountants Shy of Weak Thrifts in Lincoln Wake*, AM. BANKER, Dec. 22, 1989, at 11. William Black of the Office of Thrift Supervision testified that "[i]n the trade, it was called 'accountant shopping,' and the K Mart blue light special among accountants was Arthur Young's Dallas office." *Id.*

66. *CPA Hearing*, *supra* note 22, at 22.

67. Lavin, *supra* note 41, at 9. Atchison wrote letters to several Senators on March 17, 1987, stating that Lincoln was a "strong and viable financial entity" and suggesting that federal thrift regulators were harassing Lincoln. Parloff, *The Banking Crisis: Wheel

Keating and his son admitted that Atchison was only one of approximately fifty accountants who had worked on independent audits of Lincoln Savings and Loan and later had been hired by Lincoln and its affiliates.[68]

Another example of possible auditor misconduct was exposed when Crescent Federal Savings & Loan Association dismissed the accounting firm of J.K. Byrne and retained Price Waterhouse & Co. to audit the S&L. During its examinations, Price Waterhouse discovered over 1,000 accounting errors in Crescent's financial records that were not reported earlier.[69]

Thus, evidence of "clean" S&L audits shortly before insolvency, balance sheet manipulations, questionable accountant hiring practices, and substantial accounting errors resulted in a call for congressional inquiry into the role of accountants in the emerging S&L crisis.

III. The Congressional Response to Accountants' Liability in the Savings and Loan Crisis

A. *The GAO Report*

Prompted by the number of failures in the thrift industry and the failure of independent accountants' audits to reveal the extent of those financial problems, the House Committee on Banking, Finance and Urban Affairs requested that the United States General Accounting Office (GAO) review the quality of S&L audits in the Dallas Federal Home Loan Bank District.[70] The GAO's study focused on eleven of the twenty-nine S&Ls that had failed in the district between January 1, 1985 and September

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of Fortune, Am. Law., Mar. 1991, at 60, 64 (1991). *See also CPA Hearing*, *supra* note 22, at 67; Chadwick, *Big Suits*, Am. Law., Sept. 1991, at 38, 39; McCoy, Schmitt, & Bailey, *Hall of Shame: Besides S&L Owners, Host of Professionals Paved Way for Crisis*, Wall Street J., Nov. 2, 1990, at A9, col. 5.

68. Lavin, *supra* note 41, at 9 ("Atchison was only one of many accountants on the staff. At one time, Keating bragged that he hired 50 away from his auditors. Regulators have noted that that was one way to ensure a friendly audit."). *See also* Williamson, *Keating's Influence in High Places*, San Francisco Chronicle, Nov. 20, 1989, at A4.

69. Complaint, FDIC v. Schoenberger, *supra* note 26, at 21. It is interesting to note, however, that Price Waterhouse has not escaped criticism for its audits of financial institutions. Price Waterhouse has been criticized for its reports issued for the Bank of Credit and Commerce International (BCCI). Sly, *Tales of Massive Deceit Emerge in BCLI Scandal*, N.Y. Times, Aug. 18, 1991, § C, at 1, col. 1 ("A 1990 investigation by Price Waterhouse into the shaky state of BCCI's balance sheet catalogs loan after loan made with virtually no documentation. . . . Even after the 1990 report, Price Waterhouse certified BCCI's accounts as fair and accurate.").

70. United States General Accounting Office, CPA Audit Quality: Failures of CPA Audits to Identify and Report Significant Savings and Loan Problems 2 (1989) [hereinafter GAO Report] (Pub. No. AFMD-89-45).

30, 1987.[71] In February 1989, the GAO issued a report finding that in six of the eleven S&L audits it examined, the independent certified public accountants did not "adequately audit and/or report the S&Ls' financial or internal control problems in accordance with professional standards."[72] The study found that accountants did not adequately report significant problems such as: (1) S&L accounting practices which were not in conformity with standard accounting principles; (2) regulatory violations (*i.e.*, excessive loans to related parties or single borrowers); (3) formal regulatory actions; (4) concentrations of high-risk loans within restricted geographic areas; and (5) serious internal control weaknesses.[73]

The GAO report stated that accurate CPA audits of S&Ls were vitally necessary to enable federal officials to regulate the S&L industry effectively and that significant improvements were needed in the quality of S&L audits.[74] The report recommended that the American Institute of Certified Public Accountants (AICPA) revise its 1979 audit guide for S&Ls, inform its members of the contents of the GAO report, and instruct them on the particular problems that might occur when auditing S&Ls.[75] After conducting its study and finding significant audit and reporting problems in six of the eleven S&Ls studied, the officials at the GAO referred the CPA firms performing the audits to the appropriate regulatory and professional bodies for disciplinary action.[76]

B. Hearing Before the House Committee on Banking, Finance and Urban Affairs

In response to the GAO Report, the House Committee on Banking, Finance and Urban Affairs conducted a hearing on February 21, 1989, in which prominent members in the accounting field testified and responded to the critical GAO Report.[77] The representatives from the accounting field asserted that the GAO Report was misleading because only six of twenty-nine S&L audits in the Dallas district were criticized

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71. *Id.* at 1. *See also* Kheel & Sohmer, *The GAO's Report to the House Banking, Finance and Urban Affairs Committee: CPA Audit Quality*, 653 PRAC. L. INST. 113 (1989); Kolins, *Accounting & Auditing Report*, 22 PRAC. ACCT. 102 (1989).

72. GAO REPORT, *supra* note 70, at 1. The GAO report found that, before the 11 S&Ls failed, their latest audit reports showed a combined positive net worth of $44 million, yet 5 to 17 months later when the S&Ls failed, the 11 S&Ls had a combined negative net worth of $1.5 billion. *Id.*

73. *Id.* at 5.

74. *Id.* at 10.

75. *Id.* at 10-11.

76. *Id.* at 1.

77. *CPA Hearing*, *supra* note 22, at 1.

and that twenty-seven of twenty-nine audit reports included qualifications.[78]

The accounting representatives and several congressional participants cited numerous other causes of S&L insolvencies and inaccurate S&L audits. They noted the following causes: (1) fraud by S&L management (arguing CPAs could conduct an audit according to GAAP and still be victims of fraud);[79] (2) faulty examinations by federal regulators and regulators' failure to quickly close insolvent thrifts;[80] (3) ambiguous accounting standards (both AICPA and federal regulators' standards);[81] (4) inherent limitations of the audit process (arguing accountants could not look at every transaction because they must contain the costs of the audit);[82] (5) federal and state deregulation (extended in some states and unaccompanied by increased oversight);[83] (6) faulty appraisals (upon which audit opinions were based);[84] and (7) congressional authorization of deviations from GAAP despite warnings from the AICPA to Congress not to weaken accounting standards during deregulation.[85] In fact, Mr. Philip Chenok, President of the AICPA, testified as follows:

> The profession has done a great deal over the years to warn about those activities which weakened the S&L accounting disciplines. . . .
>
> As far back as 1981, when the Federal Home Loan Bank Board allowed savings and loan associations to defer losses from the sale of assets with below-market yields, the profession warned that such treatment was inconsistent with generally accepted accounting principles.
>
> In 1982, when Congress passed the Garn-St Germain Depository Institutions Act, which allowed qualifying subordinated

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78. *Id.* at 23-24. Members of the accounting profession have also criticized the GAO Report for its limited time frame and scope. They argue that the S&L selection process predetermined the report's outcome (because of the eleven audits studied, nine were selected due to their "clean opinions"), and that the subsequent "6 of 11" or "more than half" statistic is therefore misleading. *See* Goldwasser, *supra* note 9, at 24-25.

79. *CPA Hearing*, *supra* note 22, at 28.

80. *Id.* at 5, 21, 65. Accountants offered as an example the fact that in 1986, Arthur Young made a heavily qualified audit report of Western Savings and Loan, but federal regulators did not close Western until May 1987, a year later. *Id.* at 65.

81. *Id.* at 25.

82. *Id.* at 5.

83. *Id.* at 28, 30, 31, 65.

84. *Id.* at 34-35.

85. *Id.* at 15. *See also Statement of Philip B. Chenok, President, American Institute of Certified Public Accountants Before the Committee on Banking, Finance and Urban Affairs, United States House of Representatives*, 167 J. Acct. 143, 144 (1989); *Warnings Unheeded in S&L Crisis, Says AICPA in Testimony*, 167 J. Acct. 15 (1989).

> debentures, appraised equity capital and net worth certificates to be included in net worth for regulatory purposes, it was warned that such differences between regulatory accounting principles and generally accepted accounting principles could lead to confusion and misleading financial reports.
>
> When regulators appeared to be allowing excessive up-front income recognition for loan origination and commitment fees, the profession warned against inconsistency with generally accepted accounting principles.
>
> Again, when proposals to permit the deferral and amortization of loan losses in a manner inconsistent with sound accounting procedure emerged, the profession warned against such actions.
>
> As recently as last year, when the Federal Home Loan Bank Board sought to have withdrawn AICPA guidance requiring disclosure of certain loss possibilities in FSLIC assisted mergers, the profession held firm.[86]

The AICPA President submitted an extensive list which documented AICPA's professional education programs and summarized the organization's pronouncements, comment letters, and congressional testimony.[87]

C. FIRREA: The Financial Institutions Reform, Recovery and Enforcement Act of 1989

After numerous congressional hearings on the S&L crisis, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).[88] FIRREA completely reorganized the supervisory structures of thrift institutions[89] and restricted the investment activities of thrifts.[90] The law also abolished the FSLIC[91] and gave the FDIC the responsibility of insuring both S&L and bank deposits.[92]

FIRREA's most important impact on accountants is that it increased the enforcement authority of banking agencies.[93] Under FIRREA, an

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86. *CPA Hearing*, *supra* note 22, at 16-17.

87. *Id.* at 115-45.

88. Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (codified at scattered sections of 12 and 15 U.S.C.). *See also* Gail & Norton, *supra* note 15, at 1106.

89. Gail & Norton, *supra* note 15, at 1108.

90. *Id.* at 1153-87.

91. 12 U.S.C. § 1821a (Supp. I 1989). *See also* Gail & Norton, *supra* note 15, at 1109.

92. 12 U.S.C. § 1814(a) (Supp. I 1989). *See also* Gail & Norton, *supra* note 15, at 1108.

93. Gail & Norton, *supra* note 15, at 1188. *See also* Clark, Murtagh, & Corcoran,

independent accountant is considered an "institution-affiliated party" if the accountant "knowingly or recklessly participates in (a) any violation of law or regulation; (b) any breach of fiduciary duty; or (c) any unsafe or unsound practice, which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution."[94] Under expanded civil and criminal penalties, as an institution affiliated party, an accountant could be fined up to one million dollars per day for FIRREA violations.[95]

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supra note 1, at 1028. *See generally* Malloy, *Nothing to Fear But FIRREA Itself: Revising and Reshaping the Enforcement Process of Federal Bank Regulation*, 50 Ohio St. L.J. 1117 (1989); *Enforcement Provisions of Financial Institutions Reform, Recovery and Enforcement Act of 1989*, 36 Fed. B. News J. 481 (1989); Comment, *Civil Money Penalties in the Financial Institutions Reform, Recovery and Enforcement Act of 1989*, 12 Geo. Mason U.L. Rev. 289 (1990).

94. 12 U.S.C. § 1813(u) (Supp. I 1989). *See also* Gail & Norton, *supra* note 15, at 1188. The "knowing" and "reckless" standards of conduct have been defined in criminal law and tort law. *See, e.g.*, Model Penal Code § 2.02 (Official Draft 1985) which states:

> (b) Knowingly.
> A person acts knowingly with respect to a material element of an offense when:
> (i) if the element involves the nature of [her] conduct or the attendant circumstances, she is aware that [her] conduct is of that nature that such circumstances exist; and
> (ii) if the element involves a result of [her] conduct, she is aware that it is practically certain that [her] conduct will cause such a result.
> (c) Recklessly.
> A person acts recklessly with respect to a material element of an offense when he consciously disregards a substantial and unjustifiable risk that the material element exists or will result from his conduct. The risk must be of such nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation.

See also W. Keeton, D. Dobbs, R. Keeton, & D. Owen, Prosser and Keeton on the Law of Torts 213 (5th ed. 1984) [hereinafter Prosser and Keeton] (footnotes omitted).

> The usual meaning assigned to . . . "reckless" . . . is that the actor has intentionally done an act of an unreasonable character in disregard of a known or obvious risk that was so great as to make it highly probable that harm would follow, and which thus is usually accompanied by a conscious indifference to the consequences.

Id. See also Kawasaki, *Liability of Attorneys, Accountants, Appraisers, and Other Independent Contractors Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 42 Hastings L.J. 249, 274 (1990).

95. 12 U.S.C. § 1818(i)(2) (1988 & Supp. I 1989). As "institution-affiliated parties," accountants could be fined the following civil money penalties:

(a) Tier One: An accountant may be fined up to $5,000 per day for violations of any law, regulation, final regulatory agency order, condition or written condition or agreement with regulatory agencies. 12 U.S.C. § 1818(i)(2)(A)

FIRREA also authorizes federal regulators to take action against affiliated parties (such as accountants) even before the S&L fails,[96] to issue a cease-and-desist order to terminate an affiliated party's contract with the savings and loan,[97] and to issue an industry-wide prohibition against an accounting firm or an individual accountant.[98] Finally, FIRREA sets a six-year statute of limitations for commencement of civil and criminal actions from the time an accountant ceases to be affiliated with the institution.[99]

Thus, through its GAO Report, congressional hearing, and statutory enforcement provisions, Congress has responded in some measure to the allegations of S&L accountant impropriety. However, the courts have not yet made their determinations as suits against accounting firms for S&L audits have only been recently filed. The sequence of events which led to hundreds of S&L insolvencies, the differing expectations of an auditor's role, the evidence of possible auditor misconduct in S&L audits, and the congressional responses to the S&L audit issue have set the stage for present and future litigation of the issue of accountants' liability in the S&L crisis.

IV. Claims Against Accountants for Their Audits of Failed S&Ls

A. *Parties Who May Assert Claims Against Accountants*

Once a savings and loan institution has been declared insolvent (or

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(Supp. I 1989).

(b) Tier Two: An accountant may be fined up to $25,000 per day for any tier one violations, for reckless engagement in an unsafe or unsound practice in conducting the affairs of the institution, or for a breach of a fiduciary duty. The violation must involve a pattern of misconduct resulting in personal gain and cause more than minimal loss to the financial institution. *Id.* § 1818(i)(2)(B).

(c) Tier Three: An accountant may be fined up to $1,000,000 per day if the accountant knowingly or recklessly causes substantial loss to a financial institution or receives substantial personal gain as a result of her or his activity. *Id.* § 1818(1)(2)(C), (D).

Under FIRREA's criminal penalties, an accountant could also be fined up to $1,000,000, imprisoned for up to five years, or both if convicted for knowingly participating in a financial institution's affairs while subject to an order. *Id.* § 1818(j). *See also* Gail & Norton, *supra* note 15, at 1193; Kawasaki, *supra* note 94, at 263-64; Murphy, *Claims Against Accountants, Attorneys, and Appraisers*, Failing Financial Institutions: A.L.I. - A.B.A. Course of Study Materials, 101, 104-05 (Oct. 11-12, 1990).

96. 12 U.S.C. § 1818(b) (1988 & Supp. I 1989). *See also* Hirschberg & Univer, *Accountants' Liability in Connection with Failed Financial Institutions*, Failing Financial Institutions: A.L.I. - A.B.A. Course of Study Materials, 119, 130 (Oct. 11-12, 1990).

97. 12 U.S.C. § 1818(b) (1988 & Supp. I 1989). *See also* Hirschberg & Univer, *supra* note 96, at 130.

98. 12 U.S.C. § 1818(e)(7) (1988 & Supp. I 1989). *See also* Hirschberg & Univer, *supra* note 96, at 130.

99. 12 U.S.C. § 1818(i)(3) (1988 & Supp. I 1989). *See also* Hirschberg & Univer, *supra* note 96, at 130.

is in danger of insolvency), the Federal Deposit Insurance Corporation (FDIC) or the Resolution Trust Corporation (RTC) has authority to take over the institution as either a receiver or a conservator of the failed S&L.[100] As receiver or conservator, the FDIC or RTC succeeds to "all rights, titles, powers, and privileges" of the S&L[101] and thereby legally "stands in the shoes" of the S&L.[102] Because the S&L could have sued the accountants based upon the parties' prior contractual relationship,[103] the FDIC, now "standing in the shoes" of the S&L, may also bring a direct claim against the S&L auditors.[104] The FDIC may also assert a claim against the S&L's auditors in its corporate capacity as assignee of claims owned by the S&L.[105]

As the primary party in suits against accounting firms, the FDIC is currently pursuing lawsuits against accounting firms for their audits of S&Ls, but none of these cases has yet proceeded to trial.[106] Presently, the FDIC and the RTC have eighteen lawsuits pending against accounting

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100. 12 U.S.C. § 1821(c) (1988 & Supp. I 1989). *See also* Gail & Norton, *supra* note 15, at 1132. In distinguishing between a conservator and a receiver,

> [a] conservator is appointed to operate or dispose of the association as a going concern and is specifically empowered to take any necessary steps to put the association in a sound and solvent condition, to carry on the business of the association, and to preserve and conserve the assets and property of the association. A receiver is appointed to liquidate the assets and to resolve the affairs of a failed savings association.

Tucker, Meire, & Rubinstein, *The RTC: A Practical Guide to the Receivership/Conservatorship Process and the Resolution of Failed Thrifts*, 25 U. RICH. L. REV. 1, 24 (1990). In determining whether the RTC or the FDIC is appointed as receiver or conservator,

> [t]he OTS [Office of Thrift Supervision] must appoint the RTC as receiver in the case of any savings association whose deposits were insured by the FSLIC prior to enactment of FIRREA and for which a receiver or conservator had been or is appointed during the period beginning January 1, 1989 and August 9, 1992. The FDIC must be appointed the receiver by the OTS in all other cases. Either the FDIC or the RTC may serve as conservator for a federal or state savings association.

Id. at 10. *See also* 12 U.S.C. § 1464(d)(2)(H)(ii) (Supp. I 1989).

101. 12 U.S.C. § 1821(d)(2)(A)(i) (1988 & Supp. I 1989). *See also* Gail & Norton, *supra* note 15, at 1135; Tucker, Meire, & Rubinstein, *supra* note 100, at 24.

102. Tucker & Eisenhofer, *Accountants' Liability: Negligent Representation Suits Multiply in Wake of S&L Crisis*, NAT'L L.J., June 25, 1990, at 18. *See also* Dilloff, *Banking Reform Act Advances: Thrifts Crisis*, NAT'L L.J., Sept. 4, 1989, at 15.

103. *See* Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931).

104. Gail & Norton, *supra* note 15, at 1135; Tucker & Eisenhofer, *supra* note 102, at 18.

105. Hirschberg & Univer, *supra* note 96, at 122-23.

106. Telephone interviews with Anne Buxton Sobol, former Assistant General Counsel of the Federal Deposit Insurance Corporation (Oct. 18, 1990, Nov. 2, 1990, Nov. 15, 1990, Nov. 20, 1990, Aug. 22, 1991, Oct. 6-7, 1991).

firms for the firms' audits of S&Ls.[107] In addition to these eighteen pending suits, the FDIC and RTC have settled an additional eleven lawsuits totalling more than forty million dollars.[108] As revealed in Appendix A and the list of the settled lawsuits below, the FDIC and RTC have filed suit against all of the "Big Six" accounting firms except Price Waterhouse & Co. for audits of now-failed S&Ls.[109]

It is likely that many of the FDIC's pending accountant suits will be settled out of court because accounting firms want to avoid the negative publicity of prolonged lawsuits as well as possible adverse court opinions that would seriously damage the public trust inherent in the auditing process.[110] Further, the FDIC is also motivated to settle its S&L

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107. *Id.* See Appendix A for pending FDIC and RTC suits against accounting firms for audits of failed S&Ls.

108. *Id.* Telephone interviews with J.P. Monahan, Federal Deposit Insurance Corporation Legal Division, Professional Liabilities Section, Washington, D.C. (Aug. 22, 1991, Sept. 28, 1991). As of October 7, 1991, the FDIC has settled the following suits against accounting firms for the firms' audits of failed S&Ls:

(a) *FSLIC v. Greenstein Logan & Co.* (for audit of Ben Milam S&L in Cameron, Texas and Mercury Savings Association in Witchita Falls, Texas; settled for $400,000);

(b) *FSLIC v. McGladrey Hendrickson* (for audit of San Marino S&L in San Marino, California; settlement undisclosed);

(c) *FSLIC v. Coopers & Lybrand* (for audit of First Federal S&L in Niles, Michigan; settlement undisclosed);

(d) *FSLIC v. Laventhol Horwath* (for audit of Pittston S&L in Pennsylvania; settlement undisclosed);

(e) *FSLIC v. Warner Phillips* (for audit of State Federal S&L Assoc. in Corvallis, Oregon; settlement undisclosed);

(f) *FSLIC v. Regier, Carr Monroe* (for audit of Oklahoma Federal S&L in El Reno, Oklahoma; settled for $1,500,000);

(g) *FDIC v. Armbrister* (for audit of Mountain Security Savings Bank in Wytheville, Virginia; settled for $1,440,452);

(h) *FSLIC v. Anders* (for Peat Marwick's audit of Farmers Savings Bank in Davis, California; settled for $11.3 million);

(i) *FSLIC v. Fitzpatrick* (for Touche Ross's audit of Beverly Hills S&L in Mission Viejo, California; settlement undisclosed) (The FDIC and Touche Ross both agree that the case has been settled, but there is continuing litigation over the nonmonetary terms of the settlement).

As of September 26, 1991, the RTC has settled the following suits against accounting firms for the firms' audits of failed S&Ls: (a) *RTC v. Frost & Co.* (for audit of Madison Guaranty S&L in Augusta, Arkansas; settlement undisclosed) and (b) *RTC v. Regier, Carr & Monroe* (for audit of Great Plains S&L in Weatherford, Oklahoma; settlement undisclosed). Telephone interview with Felicia Neuringer, Resolution Trust Corporation, RTC Communications Director, Washington, D.C. (Sept. 26, 1991).

109. Rehm, *Suits Target Deep Pockets of Accountants*, AM. BANKER, Mar. 13, 1990, at 7, col. 1.

110. *Banking Reform Act Advances: Thrift Crisis*, NAT'L L.J., Sept. 4, 1989, at

accountant claims due to the fact that accountants' malpractice insurance policies are often "self-liquidating," thus requiring defense costs to be charged against the malpractice insurance policy limits.[111]

Besides the FDIC, other parties such as state regulatory agencies or state appointed receivers may assert direct claims against accounting firms for S&L audits.[112] For example, in *Maryland Deposit Insurance Fund Corporation v. Grant Thornton*,[113] Maryland savings and loan authorities sued an insolvent thrift's accountants for their alleged inadequate financial reporting (although the case was settled without determining the validity of the claim).[114]

Nonclient third parties who claim to have suffered financial losses due to their reliance upon S&L auditors' reports may also have standing to bring claims against accounting firms for the accountants' S&L audits.[115] Potential third party plaintiffs could be S&L depositors,[116] S&L creditors,[117] S&L shareholders or investors,[118] purchasers of S&L loans and certificates of deposit,[119] parties who made loans to S&L purchasers

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15. *See also* Rozen, *Gladiator Among the Green Eyeshades*, AM. LAW., May 1991, at 40. However, if these suits are not settled, and a judgment is entered against an accounting firm, recent changes by accounting firms to reorganize as corporations instead of partnerships (to reduce liability) would not shield firms because an accounting firm's new corporate status would not be retroactive to the events in question in these suits. *See* Dawson, *Comptroller Wants Tougher Laws for Accountants*, REUTER BUS. REP., Aug. 2, 1990; Cowan, *C.P.A.'s to Sell Stock in Practice*, N.Y. Times, June 14, 1990, at 1, col. 3. Also, if liable, accounting firms will have to pay damages from their insurance coverage, but such coverage is significantly less than many of the damages alleged in the suits against accounting firms. *See* Schachner, *S&L Litigation Won't Ruin Accountant E&O Market*, BUS. INS., March 20, 1989 at 2 (It is estimated that the largest accounting firms purchase only $50 million to $100 million in professional liability coverage worldwide.).

111. Sontag, *Soured Deals Snag More Professionals: Lawyers, Accountants and Others Often Are the Only Deep Pockets*, NAT'L L.J., Feb. 4, 1991, at 1.

112. Hirschberg & Univer, *supra* note 96, at 123.

113. No. 87062047-CL62242 (Baltimore Cir. Ct. 1985).

114. *Id. See also* Hirschberg & Univer, *supra* note 96, at 123.

115. Hirschberg & Univer, *supra* note 96, at 123-24. *See also* Tucker & Eisenhofer, *supra* note 102, at 17.

116. *E.g.*, Popkin v. Jacoby, No. 88-1713 (E.D. Pa. 1989) (class action brought by depositors at Sunrise Savings and Loan Association against S&L directors and officers and against accounting firm Deloitte, Haskins & Sells).

117. *E.g.*, Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390 (Ala. 1989).

118. *E.g.*, Blake v. Dierdorff, 856 F.2d 1365 (9th Cir. 1988); Bedevian v. Ernst & Whinney, No. 89 CIV 6541 (RJW) (S.D.N.Y. 1989).

119. *E.g.*, E.F. Hutton Mortgage Corp. v. Pappas, 690 F. Supp. 1465 (D. Md. 1988) (purchaser of loans); Brockton Sav. Bank v. Peat, Marwick, Mitchell & Co., 577 F. Supp. 1281 (D. Mass. 1983) (purchaser of certificates of deposit).

that later became insolvent,[120] and even accountants who sue their predecessor auditors.[121]

Currently, jurisdictions have adopted three different approaches to determining whether a nonclient third party has standing to sue an auditor for negligence.[122] The three basic approaches — established by the strict privity rule, the Restatement rule, and the liberal foreseeability rule — differ essentially as to the number of potential plaintiffs that may bring suit against the accounting firm.[123] Thus, the ability of a third party to bring a claim against an accounting firm for S&L audits is therefore determined by the status of accountants' liability law in that jurisdiction.

In jurisdictions following the traditional privity rule of *Ultramares Corp. v. Touche*,[124] accountants are liable only to parties with whom they are in privity of contract.[125] Therefore, under the strict privity rule, a third party does not have standing to sue an accountant because the contract was between the auditor and the institution, not the auditor and the third party.[126] Interestingly, the New York Court of Appeals recently modified the strict privity rule in *Credit Alliance Corp. v. Arthur Andersen & Co.*[127] and held that accountants are liable to parties with whom they are in privity, and to those in a relationship "sufficiently

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120. *E.g.*, Idaho Bank & Trust Co. v. First Bancorp of Idaho, 115 Idaho 1082, 772 P.2d 720 (1989).

121. *See* Hirschberg & Univer, *supra* note 96, at 130.

122. Tucker & Eisenhofer, *supra* note 102, at 17. *See generally* Bagby & Ruhnka, *supra* note 7, at 149; Elliott, *Expanding Third Party Liability for Accountants: Finding a Middle Ground: Blue Bell v. Peat, Marwick, Mitchell & Co.*, 19 Tex. Tech L. Rev. 171 (1988); Hawkins, *Professional Negligence Liability of Public Accountants*, 12 Vand. L. Rev. 797 (1959); Marinelli, *Accountants' Liability to Third Parties*, 16 Ohio. N.U.L. Rev. 1 (1989); Millian, *An Accountant's Liability to Third Parties: A Continued Assault on the Citadel of Privity*, 19 Stetson L. Rev. 711 (1990); Brodsky, *Accountant Liability to Non-Clients*, N.Y.L.J. Dec. 18, 1990, at 3; Cooper, *Accountants' Liability: Privity Rule Is Necessary in Today's Marketplace*, N.Y.L.J., Apr. 9, 1990, at 1; Annotation, *Liability of Public Accountants to Third Parties*, 46 A.L.R.3rd 979 (1985).

123. Tucker & Eisenhofer, *supra* note 102, at 18.

124. 255 N.Y. 170, 174 N.E.2d 441 (1931).

125. *Id.*

126. *Id. See also* Koch Indus. v. Vosko, 494 F.2d 713 (10th Cir. 1974); Stephens Indus. v. Haskins & Sells, 438 F.2d 357 (10th Cir. 1971); Hartford Accident & Indem. Co. v. Parente, Randolph, Orlando, Carey & Assoc., 642 F. Supp. 38 (M.D. Pa. 1985); Safeco Ins. Co. of Am. v. Stockton Bates Co., No. 83-6207 (E.D. Pa. 1985); Shofstall v. Allied Van Lines, 455 F. Supp. 351 (N.D. Ill. 1978); Canaveral Capital Corp. v. Bruce, 214 So. 2d 505 (Fla. App. 1968); McDonald, *Accountants' Liability to Third Parties: Unmanageable Risks of Foreseeability*, 57 Def. Couns. J. 194, 195; Tucker & Eisenhofer, *supra* note 102, at 17.

127. 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985).

approaching privity" (the "near privity rule").[128] Although several states have codified some variation of the privity rule,[129] the trend is toward more expanded liability.[130]

In jurisdictions following the Restatement approach, courts have extended accountants' liability for negligence not only to those with whom the accountant is in contractual privity, but also to particular parties whom the accountant anticipated would receive and rely upon the audit report.[131] The Restatement (Second) of Torts states that an accountant is liable to:

> a) the person or one of a limited group of persons for whose benefit and guidance [the accountant] intends to supply the information or knows that the recipient intends to supply it; and
> b) through reliance upon it in a transaction that [the accountant] intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.[132]

Finally, a few jurisdictions have recently adopted a more liberal foreseeability rule which significantly expands an accountant's liability for an inadequate audit.[133] In a movement from contract law toward tort law, the foreseeability rule provides that accountants are potentially

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128. *Id. See also* Toro Co. v. Krouse, Kern & Co., 827 F.2d 155, 161 (7th Cir. 1987) (accounting firm and individual accountants not liable for negligence to third party who relied on audit report unless accountant's conduct reveals accountant had actual knowledge that "the particular person or entity bringing the law suit would rely on the information given"); Brodsky, *supra* note 122, at 3.

129. Ark. Stat. Ann. § 16-114-302 (1987); Ill. Rev. Stat. ch. 111, para. 5535.1 (1986); Kan. Stat. Ann. § 1-402 (1990).

130. Marinelli, *supra* note 122, at 9.

131. *See, e.g.*, Briggs v. Sterner, 529 F. Supp. 1155 (S.D. Iowa 1981); Ingram Indus. v. Nowicki, 527 F. Supp. 683 (E.D. Ky. 1981); Bonhiver v. Graff, 248 N.W.2d 291 (Minn. 1976); Aluma Kraft Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo. Ct. App. 1973); Spherex Inc. v. Alexander Grant & Co., 122 N.H. 898, 451 A.2d 1308 (1982); Haddon View Inv. Co. v. Coopers & Lybrand, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982); Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Civ. App. 1971). *See also* Gossman, *IMC v. Butler: A Case for Expanded Professional Liability for Negligent Misrepresentation?*, 26 Am. Bus. L.J. 99, 103 (1988); Hirschberg & Univer, *supra* note 96, at 131.

132. Restatement (Second) of Torts § 552 (1977). *See also* Marinelli, *supra* note 122, at 5.

133. *E.g.*, International Mortgage Co. v. John P. Butler Accountancy Corp., 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986), Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987); H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 461 A.2d 138 (1983); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 335 N.W.2d 361 (1983). *See also* Hirschberg & Univer, *supra* note 96, at 125; Gossman, *supra* note 132, at 99.

liable to "all persons injured by reliance on a negligent audit report, so long as their reliance was reasonably foreseeable."[134]

Because few states still adhere to a strict or modified privity rule[135] and only a minority of states have adopted the foreseeability rule,[136] most third party suits brought against accountants will be governed by the moderate Restatement approach. Therefore, most third parties would have standing to sue an accounting firm for the firm's audits of an S&L if the third parties were part of a limited group whom the accountants intended to receive and rely on the report.[137]

Considering that the law on accountants' liability to third parties varies dramatically from state to state, the choice of law decision will often be crucial to the outcome of these third party suits.[138] Interestingly, the issue of which state's law should be applied in accountants' liability cases involving nationwide accounting firms has not often been litigated.[139] Therefore, it is likely that conflict of law questions will receive more attention in accountants' liability cases in the future.[140]

B. *Causes of Action Against Accountants for S&L Audits*

Parties bringing suits against accountants for S&L audits have proceeded upon the following legal theories: (1) negligence and professional negligence (malpractice);[141] (2) negligent misrepresentation;[142] (3) breach of written and oral contracts and breach of implied covenants;[143] (4) federal and state regulatory violations;[144] (5) deceit or fraud;[145] (6) failure

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134. Gossman, *supra* note 132, at 104.

135. Tucker & Eisenhofer, *supra* note 102, at 17.

136. *Id.*

137. *See* RESTATEMENT (SECOND) OF TORTS § 552 (1977).

138. Swanson, *Accountants' Liability — Recent Developments*, ACCOUNTANTS' LIABILITY: A.L.I. - A.B.A. COURSE OF STUDY MATERIALS 379, 384 (Jan. 31 - Feb. 1, 1991).

139. *Id.*

140. *Id.*

141. *E.g.*, Complaint of Plaintiff at 54, FDIC v. Deloitte & Touche and Deloitte, Haskins & Sells, No. LR-C-90-520, (E.D. Ark. filed July 25, 1990) (pending $480 million suit against accounting firm Deloitte & Touche and former partnership Deloitte, Haskins & Sells for its audits of FirstSouth in Pine Bluff, Arkansas); Complaint, FDIC v. Ernst & Young, *supra* note 63, at 30; Complaint, FSLIC v. Jacoby, *supra* note 37, at 123.

142. *E.g.*, Complaint of Plaintiff at 16, FSLIC v. Jeffery, Palazzola & Co., No. 88-01242 (C.D. Cal. filed Mar. 8, 1988) [hereinafter Complaint, FSLIC v. Jeffery, Palazzola & Co.] (former suit against accounting firm Jeffery, Palazzola & Co. for its audits of North America Savings and Loan Association in Santa Ana, California).

143. *E.g.*, Complaint, FDIC v. Schoenberger, *supra* note 26, at 70; Complaint, FSLIC v. Fitzpatrick, *supra* note 36, at 38.

144. *E.g.*, Complaint, FSLIC v. Jeffery, Palazzola & Co., *supra* note 142, at 13.

145. *Id.* at 15; Complaint of Plaintiff at 18, FSLIC v. Buceta, No. 86-3445 ER (C.D. Cal. filed May 29, 1986) [hereinafter Complaint, FSLIC v. Buceta] (former suit against firm Anderson, Alford & Ritter for its audits of State Savings and Loan Association in Salt Lake City, Utah).

to disclose or correct audits;[146] (7) violation of Rule 10b-5 securities laws;[147] and (8) violations of the Racketeer Influenced and Corrupt Organizations Act (RICO).[148] In spite of the various causes of action available in accountants' liability cases, plaintiffs' preferred cause of action is common-law negligence.[149]

C. FDIC's Negligence Claim Against S&L Auditors

Given the FDIC's position as the most prominent plaintiff in lawsuits for thrift audit failure due to its multi-million dollar suits against accounting firms,[150] this section focuses on the *FDIC*'s suits against accounting firms for the accountants' audits of failed S&Ls. Specifically, this section will analyze an FDIC negligence claim against accountants by examining the issues involved, exploring parties' arguments, and predicting the manner in which these issues might be resolved.[151]

1. Duty and Standard of Care.—In the FDIC's negligence action against an accounting firm for its audits of an S&L, the FDIC must establish the elements of negligence by first demonstrating that the accounting firm owed a duty of care in conducting its audits of the S&L.[152] In determining the proper standard of care required by ac-

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146. *E.g.*, Complaint of Plaintiff at 12, FSLIC v. Regier Carr & Monroe, No. 88-C-1437B (N.D. Okla. filed Oct. 17, 1988) (settled suit against accounting firm Regier Carr & Monroe for its audits of Oklahoma Federal Bank in El Reno, Okla.).

147. *E.g.*, DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir. 1990) (class of investors' suit against accounting firm Ernst & Young for audits of Continental Illinois Bank). *See also* Brodsky, *Accountants' Liability in the Savings and Loan Crisis*, N.Y.L.J., Aug. 1, 1990, at 3.

148. *E.g.*, Complaint, FSLIC v. Buceta, *supra* note 145, at 25.

149. Hendricks, *Pleadings and Discovery Devices*, ACCOUNTANTS' LIABILITY: A.L.I. - A.B.A. COURSE OF STUDY MATERIALS 191, 193 (Jan. 31 - Feb. 1, 1991); Kiernan, *Defending an Accountant's Liability Suit*, ACCOUNTANTS' LIABILITY: A.L.I.- A.B.A. COURSE OF STUDY Materials 243, 249 (Jan. 31 - Feb. 1, 1991).

150. The FDIC has a separate professional liability section which is dedicated to pursuing claims against professionals such as accountants who provided services to seized thrifts and banks. This FDIC professional liability group is involved in investigations surrounding 1,000 financial institutions, and as a result of these investigations, the FDIC expects to collect more than $370 million in settlements in 1990. Telephone interviews with Anne Buxton Sobol, former Assistant General Counsel of the Federal Deposit Insurance Corporation (Oct. 18, 1990, Nov. 2, 1990, Nov. 15, 1990, Nov. 20, 1990, Aug. 22, 1991, Oct. 6-7, 1991).

151. For this discussion, it will be assumed that the FDIC or RTC has brought suit against an accounting firm for the firm's S&L audits, but similar issues and arguments could be raised in suits brought by other plaintiffs against accounting firms for their S&L audits.

152. The plaintiff must establish the following traditional elements in a negligence suit:

countants, accountants may argue that the standard should be whether the accountants conducted their audit in conformity with GAAS and produced their opinion in conformity with GAAP.[153] However, in recent accountants' liability cases, courts have found that the duty of care required of accountants encompasses more than mere adherence to the GAAS and GAAP standards developed by AICPA.[154] Rather, courts have held that accountants have a duty to use reasonable professional care and that the GAAS and GAAP standards are merely evidence of reasonable professional care.[155] For example, in *Mishkin v. Peat, Marwick, Mitchell & Co.*,[156] the court defined the standard of care required of accountants as follows: "[An accountant] does undertake to use skill and due professional care and to exercise good faith and to observe

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> (1) duty — the defendant must have had a duty or obligation recognized by law "requiring the person to conform to a certain standard of conduct, for the protection of others against unreasonable risks";
> (2) breach of duty — the defendant must have failed to conform to the standard required;
> (3) causation — there must be a reasonably close causal connection between the defendant's conduct and the plaintiff's resulting injury;
> (4) damage — the plaintiff (or the plaintiff's interests) must have experienced actual loss, damage, or injury.

See Prosser and Keeton, *supra* note 94, at § 30 (5th ed. 1984).

Negligence lawsuits brought against accountants have no different elements than the elements of the traditional common-law negligence action. *See generally* FDIC's Brief in Opposition to Defendant's Motion for Summary Judgment, FDIC v. Ernst & Young and Arthur Young and Company, No. CA3-90-0490-H (D.C. Tex. filed Mar. 29, 1991) [hereinafter FDIC's Brief in Opposition, FDIC v. Ernst & Young]. *See also* G. Spellmire, W. Baliga, & D. Winiarski, Accountant's Legal Liability Guide 10.03 (1990).

153. Eickemeyer, *Audit Issues in Litigation*, Accountants' Liability: A.L.I. - A.B.A Course of Study Materials 89, 115 (Jan. 31 - Feb. 1, 1991); Hirschberg & Univer, *supra* note 96, at 122.

154. *See* Bily v. Arthur Young & Co., 230 Cal. App. 3d 835, 271 Cal. Rptr. 470, *superseded*, 274 Cal. Rptr. 371, 798 P.2d 1214 (1990); Maduff Mortgage Corp. v. Deloitte, Haskins & Sells, 98 Or. App. 497, 779 P.2d 1083 (1989). *See also* Eickemeyer, *supra* note 153, at 110-16.

155. *Bily*, 230 Cal. App. 3d at 846, 271 Cal. Rptr. at 475 (1990) (accountant's obligation is to "use professional care" because GAAS and GAAP are not so comprehensive as to address every conceivable situation presented in an audit). In *Maduff Mortgage Corp. v. Deloitte, Haskins & Sells*, the Oregon appellate court discussed the role of GAAS and GAAP standards in determining the scope of an accountant's duty and stated:

> The AICPA standards are only evidentiary. . . . [The standards] are principles and procedures developed by the accounting profession itself, not by the courts or the legislature. They may be useful to a jury in determining the standard of care for an auditor, but they are not controlling. The amount of care, skill and diligence to be used by defendant in conducting an audit is a question of fact for the jury, just as it is in other fields for other professionals.

Maduff Mortgage Corp., 918 Or. App. at 502, 779 P.2d at 1086.

156. 744 F. Supp. 531 (S.D.N.Y. 1990).

generally accepted auditing standards and professional guidelines, with the appropriate reasonable, honest judgment that a reasonably skillful and prudent auditor would use under the same or similar circumstances."[157] In the FDIC's suits against accountants for their audits of S&Ls, the FDIC could most likely establish that the accountants had a duty to use reasonable professional care in their audits, using the GAAS and GAAP standards as evidence of reasonable professional care, but not as the sole yardstick by which the standard of care is measured.

2. Breach of Duty.—As for the breach of duty element, the FDIC would be required to demonstrate that S&L accountants failed to use reasonable professional care in their audits of the S&Ls. The FDIC could offer evidence of accountants' failure to conform to GAAS and GAAP as well as evidence of specific circumstances in which the accountants failed to use reasonable professional care in planning, staffing, conducting, or reporting the S&L audits.[158]

3. Causation.—If the FDIC is able to establish the duty and breach of duty elements in a negligence action against accountants, the causation element would probably be the crucial element of the claim. The FDIC

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157. *Id.* at 538. *See also* FDIC's Brief in Opposition, FDIC v. Ernst & Young, *supra* note 152, at 6 ("In its conduct of the audits, AY [Arthur Young] was obligated to exercise independent judgment and apply the level of care, diligence and prudence expected of professional accountants in the conduct of such audits."); Kiernan, *supra* note 149, at 254.

158. *E.g.*, Complaint, FDIC v. Ernst & Young, *supra* note 63, at 17-20. In *FDIC v. Ernst & Young and Arthur Young & Co.*, the FDIC's Complaint alleges that Ernst & Young breached its duty and failed to plan and conduct their audits in accordance with GAAS because the accounting firm:

(a) conducted inadequate evaluation of audit risks;
(b) provided deficient technical training and proficiency of personnel;
(c) lacked independent mental attitude;
(d) failed to exercise due professional care in performance of audits;
(e) violated standards of field work; and
(f) failed to follow the Industry Guide.

Id. The FDIC alleges that "AY [Arthur Young], however, did not perform its audits in accordance with GAAS and did not exercise the due care required of it." FDIC's Brief in Opposition, FDIC v. Ernst & Young, *supra* note 152, at 6.

The FDIC's Complaint also alleges that Ernst & Young breached its duty by improperly certifying Western Savings' financial statements as consistent with GAAP when, in fact, the statements violated GAAP in the following respects:

(a) improper recognition of profit from sales of real estate investments
(b) improper recognition of profit from sales of real estate owned
(c) improper recognition of income from net profit interests
(d) failure to recognize losses as a result of troubled debt restructures
(e) inadequate provisions for loan and investment losses
(f) inappropriate recognition of fee income
(g) inappropriate recognition of interest income.

Id. at 20-26.

would have to show that the accountants' breach of their duty caused the S&L's losses (cause-in-fact).[159] To establish the causal connection between an accounting firm's audits and the S&L's losses, the FDIC could assert a "but for causation" argument: but for the accountants' faulty audits, the S&L would have suffered no losses because proper audits would have alerted S&L management and federal regulators to the thrift's insolvent condition.[160] Thus, the audits were *the* cause of the S&L's losses.[161] However, in cases of misconduct by S&L management, the FDIC could instead employ a "substantial factor" argument: that the accountants' flawed audits were a substantial factor in the S&L's losses. Thus, the audits were *one* of the causes of the S&L's losses.[162]

In either a "but for" or "substantial factor" causation argument, the FDIC could assert that the accountants' audits caused the S&Ls' losses due to one or more of the following facts: (1) had the auditors accurately audited the S&L, the Board of Directors (or at least a few of them) would have recognized that the S&L's loan programs were a failure and would have discontinued substandard lending practices;[163] (2) had the auditors correctly audited the S&Ls, regulations (such as the loan-to-one-borrower rule) would have limited the amount of loans that S&Ls could have made;[164] or (3) had the auditors correctly audited the S&L, regulators would have realized that the S&L was insolvent and would have taken steps to close the S&L much sooner.[165]

Thus, in proving the causation element, the FDIC could most persuasively argue that the accountants' audits were a "substantial factor" in the causation of the S&Ls' losses because both the Board of Directors and the regulators relied upon the accountants' audits of the S&L, and due to their reliance, the directors and regulators failed to take remedial actions (such as restricting S&L loans or placing the S&L into receivership), and as a result, S&L losses mounted.[166]

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159. *See, e.g.*, Complaint, FDIC v. Ernst & Young, *supra* note 63, at 26-29.

160. *See* Prosser and Keeton, *supra* note 94, at § 41.

161. *Id.*

162. *Id.*

163. *E.g.*, Complaint, FSLIC v. Fitzpatrick, *supra* note 36, at 45 ("[h]ad BHSL known the true facts, it would not have continued the business practices that resulted in its financial ruin").

164. 12 C.F.R. § 563.90 (1991). *See also* Complaint, FDIC v. Ernst & Young, *supra* note 63, at 28; FDIC Brief in Opposition, FDIC v. Ernst & Young, *supra* note 152, at 22 ("If Western had been reported to be insolvent, it would have been subject to immediate supervisory action and legally incapacitated from making any commercial loans or residential loans larger than $500,000 — cutting off the type of speculative lending that led to its spectacular losses."); Norton, *Lending Limitations and National Banks under the 1982 Banking Act*, 101 Banking L.J. 122 (1984).

165. *See, e.g.*, Complaint, FDIC v. Ernst & Young, *supra* note 63, at 28.

166. *E.g.*, Complaint, FSLIC v. Fitzpatrick, *supra* note 36, at 45 ("BHSL [Beverly

As a rebuttal to the FDIC's causation argument, accountants could assert that their audits did not *cause* the S&L's losses because even if the audits were faulty, corrupt S&L directors did not rely upon the audit reports because they knew about the S&L's true insolvent condition.[167] Accountants could also argue that the FDIC did not rely upon

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Hills Savings and Loan] and the regulatory agencies were unaware of the true facts . . . had the regulatory agencies known the true facts, they would not have permitted BHSL to continue such business practices.").

167. *See, e.g.*, Defendants' Memorandum in Support of Their Motion for Summary Judgment at 19-29, FDIC v. Ernst & Young, No. CA3-90-0490-H (N.D. Tex. filed Feb. 19, 1991) [hereinafter Defendant's Memo, FDIC v. Ernst & Young] (accountants' breach of duty in performing audits could not have caused S&L's losses if S&L chairman of the Board had committed fraud, knew the true state of the S&L's financial condition, and thus did not rely on faulty audits).

In the first written opinion in the FDIC's suits against accounting firms for S&L audits, the district court in *FDIC v. Ernst & Young* granted the defendant accounting firm's motion for summary judgment. Memorandum and Order, FDIC v. Ernst & Young and Arthur Young and Company, No. CA3-90-0490-H (N.D. Tex. dismissed Sept. 30, 1991). *See also* Blumenthal & Moses, *Judge Blocks Regulators' Attempt to Tie Accountant to S&L Failure*, Wall. St. J., Oct. 2, 1991, § B, at 4, col. 2.

The court held that the FDIC did not establish the causation element of its negligence claim — that the Ernst and Young 1984 and 1985 audits caused Western Savings Association's losses. In its analysis of the causation element, the court stated that due to the nature of accounting negligence claims, a plaintiff must establish causation by showing that there was reliance on the audit and that such reliance caused the institution's losses. *Id.* at 7-8. In determining reliance, the court stated that in this case, because Western's fraudulent CEO, Board chairperson, and 100% owner, Jarrett E. Woods, Jr., knew the true state of Western's financial condition, he could not have relied on the faulty audits. Moreover, the court found that because Woods's knowledge was imputable to Western (because Woods's acts were made on behalf of Western), Western therefore knew of its true financial condition, and thus Western did not rely upon the accountants' faulty audits, so the audits did not cause the S&L's losses. *Id.* at 11. Thus, in its multi-layered analysis of the causation element, the district court's opinion focused on the subissue of reliance on the audits, the reliance subissue of the imputation doctrine, and the imputation subissue of benefit to the S&L.

However, it would appear that the district court incorrectly analyzed the imputation sub-issue in this case. The district court stated that the general rule is that if an officer's fraudulent acts were made on behalf of the S&L (or bank), then the officer's knowledge is imputed to the S&L (or bank). *Id.* at 10. However, having stated the rule, the court determined that because Woods's fraudulent acts were made on behalf of Woods (because as sole shareholder, he benefited from his fraud), Woods's knowledge of Western's true financial condition could be imputed to Western. It would appear that the district court did not follow the rule that it declared. The test, as described by this court, for imputing Woods's knowledge to Western is whether Woods's acts benefited the S&L, not whether Woods's acts benefited Woods. Just because Woods, as sole shareholder, benefited by his fraudulent acts, does not mean that Western benefited. Rather, because Woods's fraudulent acts were not made on behalf of the S&L, his knowledge should not be imputed to the S&L, and therefore the S&L did not know of its true financial condition, and upon receiving the accountants' audits, did rely upon the audits, and such reliance would the accountants' report either because the FDIC made an independent assessment of the S&L's financial statements in its own examinations, or because the S&L still would not have closed due to lack of the FDIC's personnel, funds, or political interference, despite the results of an adequate audit report.[168]

Even if it is established that the accountants' audits were one of the causes of the S&Ls' losses, the FDIC must prove that the accounting firm was the proximate cause of the S&L's losses, thus making it legally responsible for the losses.[169] An accounting firm could argue that other intervening, superseding causes precipitated the S&L's losses, thereby relieving them of liability. These superseding causes would include: (1) economic conditions (the drop in the real estate market and the drop in oil prices); (2) bad loans made prior to the audit which would have resulted in losses regardless of the audit; (3) management fraud which hid the institution's true financial picture from the auditors; (4) failure by federal examiners to examine S&Ls adequately; (5) negligence by both regulators and politicians in failing to close down S&Ls sooner; or (6) management negligence after the S&L take-over.[170]

In traditional tort analysis, intervening causes become superseding causes (thus relieving the defendant of responsibility) only if the intervening causes were unforeseeable.[171] Therefore, accountants could argue that it was unforeseeable that real estate and oil prices would drop, that S&L management would commit fraud against the auditors by "hiding the real books," or that regulators or politicians would be negligent. From an auditor's viewpoint, these superseding causes would be the proximate cause of S&L losses, not the accountant's audit.

Clearly, the causation element will be a battleground in the FDIC's suits against accounting firms for their audits of S&Ls. Causation is a "fact-sensitive" element, and facts such as the timing of loans in relation to the state of the economy and corrective regulatory action, as well as the extent of management misconduct and possible regulator negligence, will determine the success of the accountants' argument that superseding causes were to blame for S&L losses.

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appear to have caused the S&L's losses. Upon the FDIC's appeal of *FDIC v. Ernst & Young*, it will be interesting to discover the appellate court's resolution of this pivotal imputation subissue. It should also be noted that a similar imputation subissue arises in an accounting firm's contributing negligence defense. *See infra* notes 185-89 and accompanying text.

168. Hirschberg & Univer, *supra* note 96, at 128.

169. Prosser and Keeton, *supra* note 94, at § 92.

170. Telephone interviews with D. Jeffrey Hirschberg, Associate General Counsel of Ernst & Young (Nov. 8, 1990, Nov. 16, 1990).

171. Prosser and Keeton, *supra* note 94, § 44.

4. Injury or Damage.—As the final element of a negligence claim, the FDIC must also establish the damage or injury caused by the accountants' audits. Given the stratospheric losses of many failed S&Ls, this final element should not be difficult for the FDIC to prove in its actions against S&L accountants.[172]

5. Public Policy.—In addition to establishing the elements of negligence, the FDIC could also argue that public policy favors holding negligent accounting firms liable for their audits of failed savings and loan institutions. The FDIC will argue that it is "good public policy" to encourage public confidence in financial institutions and that for nearly sixty years, this public policy has been furthered by federally insured deposits. The FDIC could argue that the policy of encouraging public confidence in financial institutions will be greatly undermined if the public perceives that the financial institutions that are entrusted to insure deposits, instead, merely insure that unscrupulous professionals will prosper and that the taxpayers will foot the bill.

In response, 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.[173] 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 institutions.[174] Thus, accountants could argue that imposing liability on accounting firms would not be in the long-term best interest of the public.

D. Affirmative Defense of Contributory Negligence in Suits Against Accountants for S&L Audits

In the FDIC's cases against accounting firms, even if the FDIC established the elements of a negligence claim, accounting firms might

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172. *E.g.*, Complaint, FDIC v. Ernst & Young, *supra* note 63, at 28 (FDIC's complaint alleges that due to Ernst & Young's 1984 audit, Western Savings and Loan Association suffered damages in excess of $450 million and that as a result of Ernst & Young's 1985 audit, Western suffered damages in excess of $110 million).

173. Marcotte, *Accountants Under Seige: Fourteen of Biggest Firms Endangered by S&L Suits, Lawyer Warns*, 77 A.B.A. J. 20, 20 (Jan. 1991).

174. Accountants could argue that expansive liability for the major national accounting firms will result in a shortage of the most sophisticated national accounting firms. Accountants could cite as an example the FDIC's problems employing accounting firms with the requisite sophistication for its suits while avoiding using firms it is currently suing. In light of this shortage, the FDIC has hired four of the same accounting firms that it is currently suing for the firms' S&L audits. Himmelstein, *RTC Officials Eye 140 Suits Against Lawyers*, N.Y.L.J., Nov. 29, 1990, at 4.

be able to assert the affirmative defense of contributory negligence.[175]

First, the availability of this defense will depend upon a court's interpretation of contributory or comparative negligence in the context of accountants' liability cases. Some courts (usually operating under an absolute contributory negligence rule) have only permitted accountants to assert the contributory negligence defense when the client's negligence was great enough to have contributed to the accountant's failure to perform a proper audit.[176] Recently, other courts (usually relying on comparative negligence statutes) have permitted accountants to assert the client's negligence as a defense without any proof that the client's negligence interfered with the accountant's ability to perform the audit.[177] Thus, in FDIC's suits against accounting firms, if the suit is brought in a contributory negligence jurisdiction, courts might only permit an accounting firm to assert the S&L management's contributory negligence as a defense when the management's own

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175. Although the contributory negligence defense would be the most common defense asserted by accounting firms sued by the FDIC, an accounting firm might also make use of the "informational tort" defense, failure to mitigate damages defense, assumption of risk defense, failure to warn defense, "equitable immunity set-off" defense, or estoppel. *E.g.*, Reply Memorandum for Plaintiff at 31-36, 61-67, FDIC v. Ernst & Whinney, No. CIV-3-87-364, (E.D. Tenn filed June 11, 1990). *See also* Kolb, *Defending Accountants in Bank Failure Litigation*, FAILING FINANCIAL INSTITUTIONS: A.L.I. - A.B.A. COURSE OF STUDY MATERIALS 135, 141 (Oct. 11-12, 1990).

176. Fullmer v. Wohlfeiler & Beck, 905 F.2d 1394 (10th Cir. 1990) (accountant cannot use comparative negligence as a defense unless the client's negligence contributed to the accountant's inability to perform work or to furnish accurate accounting information). *E.g.*, National Surety Corp. v. Lybrand, 256 A.D. 226, 9 N.Y.S.2d 554 (1939) (accountant may use contributory negligence as a defense only when the client's negligence contributed to the accountant's failure to perform the contract and to report the truth). *Accord* Shapiro v. Glekel, 380 F.Supp. 1053, 1058 (S.D.N.Y. 1974); Cereal Byproducts Co. v. Hall, 132 N.E.2d 27, 29 (Ill. App. Ct. 1956) (accountant may use contributory negligence as a defense only when there is evidence that the client's conduct contributed to the negligence of the accountant's audit); Lincoln Grain Inc. v. Coopers & Lybrand, 216 Neb. 433, 345 N.W. 2d 300 (1984). *See also* Hawkins, *supra* note 122, at 797; Leibensperger & Wood, *Defenses of Accountants Based on Client's Negligence or Intentional Wrongdoing*, IIIB ABA SECTION OF LITIGATION 1 (Oct. 1990); Menzel, *The Defense of Contributory Negligence in Accountant's Malpractice Actions*, 13 SETON HALL L. REV. 292 (1983); Note, *The Peculiar Treatment of Contributory Negligence in Accountants' Liability Cases*, 65 N.Y.U.L. REV. 329; Tucker & Eisenhofer, *supra* note 102, at 18.

177. *E.g.*, Devco Premium Fin. Co. v. North River Ins. Co., 450 So. 2d 1216 (Fla. Dist. Ct. App. 1984), *review denied*, 458 So. 2d 272 (Fla. 1984) (accountant may assert comparative negligence as a defense regardless of whether client's negligence impaired accountant's audit); Capital Mortgage Corp. v. Coopers & Lybrand, 142 Mich. App. 531, 369 N.W.2d 922, 925 (1985) (accountant may assert comparative negligence as a defense to claim audit failed to detect embezzlement without having to show that client's negligence affected accountant's ability to audit). *See also* Leibensperger & Wood, *supra* note 176, at 6-8.

negligence was so substantial that it interfered with the accountants' ability to audit the S&L. However, if the suit is brought in a comparative negligence jurisdiction, courts will most likely allow an accounting firm to assert the S&L management's negligence as a defense regardless of whether the management's negligence interfered with the accounting firm's ability to perform a proper audit.

If the contributory negligence defense in accountants' liability cases is recognized in a given jurisdiction, the second issue will be which type of contributory negligence defense may be asserted by an accounting firm. An accounting firm might assert two different contributory negligence defenses: (1) a *direct* contributory negligence defense — that the FDIC was contributorily negligent based upon the *FDIC's* conduct as regulator or (2) a *derivative* contributory negligence defense — that the FDIC was contributorily negligent based upon the *S&L management's* conduct that is imputed to the FDIC because it "stands in the shoes" of the failed S&L.[178]

As for the *direct* contributory negligence defense, an accounting firm might argue that the *FDIC*, in its capacity as regulator and insurer, was contributorily negligent in its regulation of the S&L, and thus the FDIC should not be allowed to recover damages[179] (or in a comparative negligence jurisdiction, that the FDIC's damages should be reduced in proportion to its own fault).[180] However, because the FDIC operates in two separate legal capacities — in a "corporate" capacity as regulator and insurer and in a "trustee" capacity as receiver, conservator, or assignee — courts have held that a party may not assert affirmative defenses which arise out of the FDIC's actions as regulator or insurer in an action in which the FDIC is a receiver, conservator, or assignee.[181] Thus, in the FDIC's suits against accounting firms for their S&L audits, the accounting firms may not assert a contributory negligence defense against the FDIC in its capacity as receiver, conservator, or assignee on the basis of possible FDIC negligent acts in its capacity as regulator and insurer.

However, even if accountants could establish the FDIC's negligence as regulator as an affirmative defense, it is unlikely that they would do so. Rather, accountants would argue that both independent ac-

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178. Kolb, *supra* note 175, at 138-41. *See also* Hirschberg & Univer, *supra* note 96, at 128-29.

179. Hirschberg & Univer, *supra* note 96, at 128-29.

180. Prosser and Keeton, *supra* note 94, § 67.

181. *See* Murphy, *FDIC, FSLIC, and Claims Against Other Than Directors and Officers*, Failing Financial Institutions: A.L.I. - A.B.A. Course of Study Materials 203, 208 (Nov. 5-6, 1987); Note, *FDIC and FSLIC Pursuit of Claims Against Officers, Directors, and Others Involved With Failed Thrifts*, 58 Miss. L.J. 89, 119 (1988).

countants and regulator auditors properly performed their audits, and the regulators' failure to detect the S&L's problems is evidence that the independent accountants could not have detected the problems either.[182] Moreover, even if the contributory negligence of the FDIC as regulator was asserted, due to the special legal status given to the FDIC as a regulatory governmental agency, such a defense would be unsuccessful.[183]

As for the *derivative* contributory negligence defense, accountants might argue that the FDIC was contributorily negligent due to the *S&L management's* misconduct which may be imputed to the FDIC. Courts have established the general rule that the knowledge or wrongdoing of an institution's agent may be imputed to the institution.[184] However, courts have made a further distinction by stating that the wrongdoing of a corporation's management can only be imputed to the corporation when the management acts on *behalf* of the corporation,[185] or expressed conversely in what is called the "adverse interest exception," the wrongdoing of a corporation's management cannot be imputed to the corporation when the management acts to the *detriment* of the corporation.[186] Thus, the FDIC could respond that

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182. Kolb, *supra* note 175, at 141.

183. Hirschberg & Univer, *supra* note 96, at 129. *E.g.*, Emch v. United States, 630 F.2d 523 (7th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981) (government has not waived sovereign immunity in regulation of financial institutions because it is engaged in discretionary activity); FDIC v. Ernst & Whinney, No. CIV-3-87-364 (E.D. Tenn. Dec. 15, 1987) (FDIC's pre-closing activities not subject to ordinary tort affirmative defenses).

184. Restatement (Second) of Agency § 219 (1969). *See also* Prosser & Keeton, *supra* note 94, §§ 69-70; Defendants' Memo, FDIC v. Ernst & Young, *supra* note 167, at 19-29; Defendants' Reply Brief in Support of Their Motion for Summary Judgment at 2, FDIC v. Ernst & Young & Arthur Young & Co., No. CA3-90-0490 (N.D. Tex. filed Apr. 19, 1991) [hereinafter Defendants' Reply Brief, FDIC v. Ernst & Young]; FDIC's Brief in Opposition, FDIC v. Ernst & Young, *supra* note 152, at 8.

185. Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982). In *Cenco, Inc. v. Seidman & Seidman*, a company sued its auditors, and the auditors asserted the wrongdoing of the company's management as a defense. The Seventh Circuit Court of Appeals held that because the company's managers were acting for the benefit of the company, their wrongdoing could be imputed to the company, and thus the auditors could use the wrongdoing of the company's managers as a defense. *Id.* at 456. The court reasoned that a judgment for the company would have had the effect of rewarding the managers for their misconduct because they were also shareholders in the company. *Id.* at 455.

186. Schacht v. Brown, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983). In *Schacht v. Brown*, the Seventh Circuit Court of Appeals held that management misconduct could not be imputed to the corporation when the management's actions were adverse to the corporation. In *Schacht*, the state of Illinois (as the receiver of an insurance company) sued the insurance company's auditors, and the auditors asserted the wrongdoing of the insurance company's management as a defense. The court held that because the

the FDIC is not contributorily negligent due to the wrongdoing of S&L management because under the "adverse interest exception," the wrongdoing of the S&L's management cannot be imputed to the S&L and subsequently to the FDIC because the S&L managers acted to the detriment of the S&L.[187] Therefore, an accounting firm most likely could not succeed on the derivative contributory negligence defense.[188]

Another FDIC argument against the imputation of the S&L management's misconduct to the S&L and subsequently to the FDIC is to distinguish between the S&L management and the S&L institution. The FDIC could argue that because the FDIC could sue the S&L management if it desired, S&L management and the S&L institution/FDIC are not one in the same. Thus, the misconduct of the S&L management should not be imputed to the S&L institution and subsequently to the FDIC in a contributory negligence defense.[189] However, an accounting firm might respond that, if the FDIC is allowed to divorce itself from S&L management, so too should an accounting firm be allowed to divorce itself from its few incompetent auditors.[190]

In summary, in the FDIC's suits against accounting firms for the accountants' audits of failed S&Ls, the FDIC may have difficulty

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insurance company's management had acted to the detriment of the company, the wrongdoing of management could not be imputed to the company or subsequently to the receiver. Therefore, the auditors could not use the wrongdoing of the company's managers as a defense. *Id.* at 1347. *Accord* Tew v. Chase Manhattan Bank, N.A., 728 F. Supp. 1551, 1560 (S.D. Fla. 1990); *In re* Wedtech, 81 Bankr. 240, 241 (S.D.N.Y. Bankr. 1987); *In re* Investors Funding Corp. Sec. Litig., 523 F. Supp. 533 (S.D.N.Y. 1980); Holland v. Arthur Andersen & Co., 127 Ill. App. 3d 854, 469 N.E.2d 419 (1984); Bonhiver v. Graff, 248 N.W.2d 291 (Minn. 1976). *See also* Tucker & Eisenhofer, *supra* note 102, at 18-19.

187. *See, e.g.*, Defendant's Memo, FDIC v. Ernst & Young, *supra* note 167, at 19-29; FDIC's Brief in Opposition, FDIC v. Ernst & Young, *supra* note 152, at 8-17; Tucker and Eisenhofer, *supra* note 102, at 18.

188. It should be noted that in *FDIC v. Ernst & Young and Arthur Young & Co.*, the accountants argued an exception to the "adverse interest exception" — the "sole representative exception." Defendants' Reply Brief, FDIC v. Ernst & Young, *supra* note 184, at 2-8. In their brief, the accountants asserted that even though under the "adverse interest exception" the management's wrongdoing cannot be imputed to the corporation if the management acted to the detriment of the corporation, under the "sole representative doctrine," if the manager is a "sole owner, sole representative, or alter ego of the corporation" and acts to the detriment of the corporation, then the manager's wrongdoing may be imputed to the corporation. *Id.* In its responding brief, the FDIC argued that the "sole representative doctrine" had never been rigidly applied in Texas courts (the applicable law of the case) and charged Ernst & Young with misstating the "sole representative doctrine." FDIC's Surreply and Supporting Brief to Defendants' Motion for Summary Judgment at 1-9, FDIC v. Ernst & Young and Arthur Young and Co., No. CA3-90-0490-H (N.D. Tex. filed Apr. 26, 1991).

189. *See, e.g.*, FDIC's Brief in Opposition, FDIC v. Ernst & Young, *supra* note 152, at 8-17.

190. Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449, 456 (7th Cir. 1982).

establishing the causation element of its negligence claims due to the possibility that corrupt S&L management did not rely on the faulty audits or due to other superseding causes. However, it would appear that the FDIC might be able to establish causation nevertheless, and if the FDIC is able to "jump the causation hurdle," could most likely also defeat a contributory negligence claim offered by an accounting firm — either a direct contributory negligence defense or a derivative contributory negligence defense.

V. Conclusion

Although the precise causes of the savings and loan crisis will be debated for years to come, there are indications that some accountants' S&L audits were a contributing factor in the culmination of that crisis. Although determinations of liability may only be made in a court of law after careful scrutiny of the facts in each case,[191] the evidence suggests that accountant behavior during the savings and loan crisis could be placed on a continuum. In some cases, ethical accountants may have stood firm, in spite of pressure from their S&L clients to adjust accounting procedures or to issue unqualified audit opinions.[192] In other cases, diligent accountants may have failed to detect well-concealed fraud and may have been the victims of fraud and deceptive S&L management tactics. In other situations, some accountants may have been unable to keep pace with the rapid changes in the S&L industry following federal and state deregulation. However, it would appear that in some circumstances, S&L accountants sacrificed traditional values of the accounting profession — conservatism, skepticism, objectivity, and independence — and either "looked the other way" in order to retain S&L auditing business, or deliberately participated in and benefited from the pillaging of S&Ls.

Clearly, the wrongdoing of some accountants should not implicate all S&L auditors, nor should accountants be used as "deep pockets" to pay for the wrongful acts of others in the S&L crisis. To the extent that accounting firms' financial positions attract unwarranted suits, they should remain immune.

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191. Audits are fact intensive exercises, and litigation concerning those audits is fact intensive as well. Kiernan, *supra* note 149, at 247.

192. Not to be forgotten are accountants who, in the face of misconduct by S&L directors and officers, stood firm and refused management's efforts to modify audit reports. As Judge Sporkin wrote in *Lincoln Savings & Loan Association v. Wall*, "While there are few heroes in this saga, Ms. Vincent must be commended for standing firm on the proper accounting for this transaction. Indeed, she maintained her position despite attempts made by Keating to have her removed from the audit." Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 941 (D.D.C. 1990).

However, the S&L accountants who "looked the other way" as thrift management drove S&Ls into insolvency, or who actively participated in concealing institutional losses from FDIC regulators and trusting depositors, should receive severe penalties and be assessed substantial damages. Those accountants must be held accountable for their role in one of the largest financial disasters in our nation's history.[193]

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193. Rosenbaum, *As Session Winds Up, G.O.P. Plans for TV Time*, N.Y. Times, Nov. 24, 1991, § 1, at 34, col. 1 (the savings and loan debacle is "the biggest disaster in public finance in American history").

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APPENDIX A
FDIC AND RTC LAWSUITS AGAINST ACCOUNTING FIRMS FOR ACCOUNTANTS' AUDITS OF FAILED S&LS

The FDIC and RTC have the following lawsuits pending against accounting firms for their audits of failed savings and loan associations (as of October 7, 1991):

STATE	SAVINGS & LOAN	SUIT, DOCKET#, COURT	DAMAGES*
AR	FirstSouth, FA	*FDIC v. Deloitte & Touche and Deloitte, Haskins & Sells* LR-C-90-520 (USDC ED AR)	$480 million
CA	Homestate S&LA	*FSLIC v. Bitticks & Co.* C-88-3756-WWS (USDC ND CA)	$4 million
CA	Imperial Savings Association	*RTC as Conservator for Imperial Savings v. Ernst & Whinney, Union Bank, Victor Sy, and Ernst & Young* 90-0374-JLI (USDC SD CA)	$26 million
FL	Amerifirst FS&LA	*Amerifirst FS&LA and Amerifirst Development Corp. v. Thomas R. Bomar* et al. (Deloitte, Haskins & Sells and Ernst & Whinney) 90-0429-CIV (USDC SD FL)	$75 million
FL	Commonwealth FS&LA	*RTC as Conservator for Commonwealth FS&LA v. Jason Chapnick, Deloitte, Haskins & Sells, et al.* 89-6572-CIV-JCP (USDC SD FL)	$50 million
FL	Duvall FS&LA	*RTC as Conservator for Duvall FS&LS v. Peat Marwick* 89-085-48 CA (4th Jud. Cir. Ct.)	$16.6 million
FL	Royal Palm FS&L	*RTC as Conservator for Royal Palm FS&L v. Deloitte, Haskins & Sells* 89-8039-CIV-PAINE (USDC SD FL)	Amount undetermined

* Approximate figures

FL	Sunrise S&LA	*FDIC v. Jacoby, et al.* (Deloitte Haskins & Sells) MDL 655 (USDC ED PA)	$250 million
KS	Rooks County FS&LA	*Roger Comeau, et al. v. Terry Rupp, et al.* (Grant Thornton) 86-1531-T (USDC KS)	$15 million
KY	Henderson Bank Home S&LA	*RTC v. Logan Campbell* 89-CI-1-89 (USDC WD KY)	Amount undetermined
LA	Crescent FSB	*FDIC v. Kevin C. Schoenberger, et al.* (J.K. Byrne & Co.) 89-2756S-L/M-2 (USDC ED LA)	$40 million
MN	Midwest Federal S&L	*Midwest Federal S&LA v. Greentree Acceptance, Inc., et al.* (Touche, Ross & Co.) 3-88-669 (USDC MN)	$192 million
OK	People's Federal	*RTC as Conservator for People's Federal v. Touche, Ross & Co., et al.* 90-C-221-B (USDC ND OK)	$467,000
OK	Territory S&LA	*FSLIC v. Futures, Inc. Regier, Carr & Monroe* 88 CIV 0906 PNL (USDC SD NY)	$12 million
PA	Atlantic Financial FS&LA	*RTC as Conservator for Atlantic Financial FS&LA v. Laventhol & Horwath* 90-4113 (USDC ED PA)	$3 million
TN	Century FSB	*RTC as Receiver for Century FSB v. Arnold Spain & Co.* 89-1065-TUB (USDC WD TN)	$5.2 million
TX	Sunbelt SA of TX	*FDIC v. Edwin McBirney* (Grant Thornton) 3-89-2295-R (USDC ND TX)	$200 million
TX	Western Savings Association	*FDIC v. Ernst & Young & Arthur Young & Co.* CA-3-90-0490-H (USDC ND TX)	$560 million