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IN THE SUPREME COURT OF FLORIDA

CASE NO. 82,365

ALLAN GEE, as Official Liquidator of
UNIVERSAL CASUALTY & SURETY COMPANY, LTD. (in liquidation),
Petitioner,

vs.

SEIDMAN & SEIDMAN and
BINDER DIJKE OTTE & CO., *et al.*,
Respondents.

On Discretionary Review
from the
Third District Court of Appeal

BRIEF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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BRIEF OF THE
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

The American Institute of Certified Public Accountants (the "Institute") respectfully submits this brief as amicus curiae pursuant to Rule 9.370 of the Florida Rules of Appellate Procedure in support of respondents Seidman & Seidman and Binder Dijke Otte & Co. (collectively "Seidman") and in opposition to petitioner Allan Gee, as liquidator (the "Liquidator") of Universal Casualty & Surety Company, Ltd. ("Universal").

PRELIMINARY STATEMENT

There are two aspects of the Liquidator's brief which, the Institute believes, warrant emphasis at the outset. The first is that the Liquidator fails to make clear the precise claim for relief on which he seeks to recover. The second is that the Liquidator fails to make clear precisely on whose behalf that claim is being asserted.

These two issues are central to this appeal, because the precise claim is for professional negligence, which requires proof of justifiable reliance on the audit report at issue; and that claim is being asserted on behalf of Universal -- the wrongdoing corporation which, through its senior management, engineered the fraud -- and not being asserted on behalf of Universal's creditors or policyholders, whose claims have been voluntarily dismissed. The basic question, should this Court grant review, therefore, is whether a wrongdoing corporation whose senior management has engineered a fraud should be able to assert "justifiable reliance" on an otherwise innocent accounting firm which failed to discover and expose it. This is not, as the Liquidator tries to argue, an issue of "equitable estoppel" or any equitable remedy at all. The issue is whether the Liquidator can, as a matter of law, prove the elements of his negligence claim.

The district court of appeal below, consistent with the leading case on this issue, the most recent case on this issue, and any number of cases in between, held that a wrongdoing corporation cannot prove justifiable reliance on an accounting firm that failed to discover and reveal to the wrongdoer what the wrongdoer already knew. The district court also recognized that, to prove professional negligence based upon audit malpractice, a corporation, like any other litigant, must prove all of the requisite elements, including the element of justifiable reliance. The Institute believes that the district court's resolution of the issues was correct, and respectfully submits that this Court should reach the same conclusion.[1]

INTEREST OF THE INSTITUTE AS AMICUS CURIAE

The Institute is the national professional accounting organization, all of whose more than 312,000 members are certified public accountants ("CPAs"), approximately 16,000 of whom reside in Florida. The Institute's service to the public spans more than one hundred years and extends to CPAs who provide accounting services to the public through firms of all sizes and as sole practitioners.

Among the Institute's purposes are the promotion and maintenance of high professional standards of practice. Over the years, the Institute has been a principal force in developing accounting and auditing standards, sponsoring educational programs, and issuing professional publications to improve the quality of services provided by CPAs. In particular, the Institute develops the standards that, after due process and formal adoption, govern the conduct of the various types of services CPAs provide with respect to financial statements, such

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[1] This brief uses the following abbreviations: "Liq. Br." for the Petitioner's Initial Brief on the Merits (dated Dec. 20, 1993); "Ins. Dep't Br." for the Brief of Amicus Curiae the State of Florida Department of Insurance (dated Dec. 10, 1993); "Ins. Ass'n Br." for the Brief of Amicus Curiae the National Association of Insurance Commissioners (dated Dec. 20, 1993); and "Foster Aff." for the Affidavit of Angus J.E. Foster on Cayman Islands Law (dated Nov. 30, 1990). References to "T" are to the trial transcript; to "R" are to other portions of the record on appeal.

as audits, reviews and compilations, and the reports issued thereon. The Institute consequently has a strong interest in the decision of the district court, which clarifies the scope and basis of accountants' civil liability for damages arising from actions for the negligent performance of accounting services.

This interest is particularly present in the circumstances of the instant case, in which an entity, whose dominating and controlling owner/manager has committed a fraud, becomes insolvent and the successor in interest sues the associated professionals for failing to detect the fraud. If the successor is able always to avoid the consequences of the entity's prior acts, already beleaguered professionals will have to withstand a plethora of new litigation from a wholly unlikely source -- the entity that committed the underlying fraud. The Institute believes that a rule that would permit such an untoward result would depart from traditional law and be inherently unjust.

SUMMARY OF ARGUMENT

This brief makes four points. First, the Liquidator stands in the shoes of the corporation he succeeds and may assert only, and has asserted only, a claim which the corporation itself possesses. Second, in light of the corporation's knowledge through the knowledge of its wrongdoing management, the corporation cannot prove justifiable reliance upon, and therefore cannot prove its claim for professional negligence against, Seidman. Third, there is no basis, in law or logic, for the creation of a special rule eliminating the element of causation for the insurance industry. Fourth, the district court's decision should be approved because it is consistent with good policy.

ARGUMENT

I. THE LIQUIDATOR POSSESSES ONLY THE CLAIM OF THE CORPORATION.

The Liquidator, as statutory successor to an insurance company, "steps into the shoes" of the corporation and possesses no claim that the corporation itself does not possess. As the leading commentators on insurance law and practice have stated:

> Since a receiver derives his authority from statute, and cannot act in contravention of or beyond the statute . . . the order [directing liquidation] confers no additional authority. His authority does not extend beyond that of the property, contracts, and rights of action of the company as of the date of the order directing liquidation. Accordingly, . . . [a] receiver . . . [stands] in the shoes of the company with the same rights and obligations with respect to assets and property of the company that it had at the inception of the receivership. The insolvency of an insurance company does not enable its receiver to maintain actions which the company could not.

19 John A. Appleman & Jean Appleman, Insurance Law and Practice § 10682 (1982). Both the law of the Cayman Islands and of the State of Florida are in accord. See The Companies L. (rev.), ch. 22, pt. V § 108(a), reprinted in, Commercial Laws of the World-Cayman Islands (Foreign Tax L. Publishers March 1993); FDIC v.

Cherry, Bekaert & Holland, 742 F. Supp. 612, 615 (M.D. Fla. 1990); Young v. Victory, 150 So. 624 (Fla. 1933).

As recognized by the court below, the Liquidator tried his case in full recognition of the fact that he was asserting the claim of Universal, and only Universal. Seidman & Seidman v. Gee, 625 So.2d 1, 4 (Fla. 3d DCA 1993). The Liquidator stated, "the Liquidator brings only the claims of Universal itself." Id. The Liquidator emphasized that he was "not seeking to bring the creditors['] claims."[2] Id. On appeal, the Liquidator argued that he was bringing a claim that "belongs to Universal itself" which existed "separate and apart from any cause of action that might be brought by creditors." Id. The Liquidator stated: "The fact that [Universal] is insolvent, and thus its recovery from BDO Seidman will be used to retire its debts, does not . . . convert Universal's own cause of action against its accountants into a piggyback cause of action by a liquidator asserting creditors' claims." Id. Before this Court, the Liquidator

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[2] The National Association of Insurance Commissioners (the "Insurance Association") attempts to obfuscate this point when it asserts that the Liquidator was acting "on behalf of the policyholders and creditors." (Ins. Ass'n Br. at 5.) In fact, the Liquidator was not stating the claims of policyholders or creditors per se, and to the extent they had any claims they were free to assert those claims themselves -- as they did, though they thereafter elected to take voluntary dismissals. (See infra at 7.) To the extent the Insurance Association's point is that the Liquidator desires to distribute any recovery to policyholders and creditors, the issue is not what the Liquidator intends to do with the money, but who owns the claim the Liquidator seeks to assert. The only answer to the latter question is Universal.

characterizes his claim as "a cause of action belonging to Universal." (Liq. Br. at 24.)

The Liquidator's assertion of only the corporation's claim, moreover, was manifestly (in the words of the court below) "a calculated tactic to avoid one or more obvious bars to recovery upon the theory that the action was brought on behalf of corporate creditors." 625 So.2d at 4. The Liquidator's apparent recognition of the impediments to noncorporate claims was well placed. The record shows that seventeen of Universal's creditors initially joined the Liquidator as plaintiffs, fifteen of whom found it appropriate to take voluntary dismissals during discovery. The remaining two voluntarily dismissed their claims at the close of the Liquidator's case. (R. 35, 257-59, 66; T. 1695.) It may be surmised that, had these creditors possessed viable claims against Seidman, they would not have voluntarily dismissed them.

As amicus, the State of Florida Department of Insurance (the "Insurance Department") submits the position, rejected below, that "the statutory powers given to the Liquidator are very broad" and, in substance, that the "purposes" of insurance company statutes "require the Liquidator to have substantially 'bigger shoes' than the company's former management could have worn."[3] (Ins. Dep't Br. at 5, 7.) But the Insurance Department

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[3] The Insurance Department encountered the same "justifiable reliance" issue on which the court ruled here in <u>State of Fla. Dep't of Ins. v. Touche Ross</u>, No. 89-18003 (11th Cir. Dade Co.
(continued...)

has cited no law, either from the Cayman Islands or the State of Florida, in support of its position that the Liquidator may assert a claim for professional negligence which the predecessor company could not assert.[4] Nor is there any. (Foster Aff. ¶ 7 -- "There is no special law of the Cayman Islands dealing with the liquidation (bankruptcy) of an insurance company.") The law applicable to the insurance company here, whether it be the law of the Cayman Islands or the law of the State of Florida, is that the receiver/liquidator suing on behalf of the corporation gets nothing more than the claim the corporation itself possessed. See The Companies L. (rev.), ch. 22, pt. V § 108(a), reprinted in, Commercial Laws of the World-Cayman Islands (Foreign Tax L. Publishers March 1993) ("An official liquidator shall have power . . . to bring or defend any action, suit, prosecution or other legal proceedings, whether civil or criminal, in the name and on

[3](...continued)
Fla.) (Repleaded and Amended Complaint; Answer ¶ 81).

[4] The Insurance Department, together with the Liquidator, has cited a number of cases from other jurisdictions for the proposition that certain other state statutes empower a receiver to pursue claims on behalf of creditors or other third parties. See Corcoran v. Frank B. Hall & Co., 545 N.Y.S.2d 278 (App. Div. 1st Dep't 1989) (New York statute); Foster v. Peat Marwick Main & Co., 587 A.2d 382 (Pa. Commw. Ct. 1991) (Pennsylvania statute); Merin v. Yegen Holdings Corp. (In re Integrity Ins. Co.), 573 A.2d 928 (N.J. Super. Ct. App. Div. 1990) (New Jersey statute). Those cases do not address Cayman Islands or Florida law, and in any event have nothing to do with the situation here, where the Liquidator has denied that he is exercising any such power. (R. at 843.)

behalf of the company"); FDIC v. Cherry, Bekaert & Holland, 742 F. Supp. 612, 613-15 (M.D. Fla. 1990) ("this Court declines to speculate that Congress contemplated that negligence suits against third party defendants are a necessary part of the recovery of the insurance fund"); *see generally* 16 Charles R.P. Keating & Charity R. Miller, Fletcher Cyclopedia of the Law of Private Corporations § 7847, at 542 (perm. ed. rev. vol. 1989 & Supp. 1992) ("the receiver takes only such rights as were vested in the corporation and the receiver cannot maintain an action unless the corporation could have maintained it before the receivership").

But regardless of what the law might be if the receiver chose to sue on behalf of creditors, the point is that he did not. Thus, this situation does not involve questions of whether the Liquidator's powers are "very broad" or whether the Liquidator is empowered to stand in "bigger shoes." The issue here is whether the Liquidator has *chosen* to exercise any such power. In this case, he has not. The only question, therefore, is whether Universal itself possesses a claim against Seidman under the circumstances of this case.

II. THE CORPORATION POSSESSES NO CLAIM AGAINST SEIDMAN.

A. An Officer's or Director's Knowledge of the True Financial Condition of a Corporation Precludes the Corporation From Suing Its Auditor for Malpractice.

It is telling that, in a fifty-page brief, the Liquidator waits until page 32 to begin its discussion of what is universally recognized to be the leading case on the question certified by the district court. That case is Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.), cert. denied, 459 U.S. 880 (1982). In Cenco, the Seventh Circuit imputed the knowledge of "top management" to a corporation and observed that "a participant in a fraud cannot also be a victim entitled to recover damages, for he cannot have relied on the truth of the fraudulent representations, and such reliance is an essential element in a case of fraud." Id. at 454.

Cenco involved a corporation, some of whose senior management and directors were aware of inflated inventory, the effect of which was to increase artificially the corporation's stock price and thereby to permit the corporation to "buy up other companies on the cheap," borrow money at lower rates, and obtain inflated insurance recoveries for inventory that was lost or destroyed. Id. at 449. When a new chief financial officer discovered the fraud and reported it to the Securities and Exchange Commission, the corporation -- now under new management -- filed a claim against its accounting firm for audit malpractice and fraud. Id. at 451, 453. The corporation argued that it had been harmed by the accounting firm's failure to discover the misconduct.

The Seventh Circuit held that the corporation's own knowledge of the wrongdoing, through the knowledge of its officers and directors, constituted an impediment to the corporation's claims. In particular, the Seventh Circuit held that the knowledge of its officers and directors would preclude the corporation from proving justifiable reliance upon its accounting firm, insofar as a participant in a fraud "cannot have relied on the truth of the fraudulent representations." Id. at 454. Putting aside the situation of deception aimed at the corporation itself, as where top management may be "stealing from the company," the court held that "turning the company into an engine of theft against outsiders" would preclude a claim. Id. On the facts at issue there, the use of inflated stock to "buy up other companies on the cheap," to borrow money at lower rates, and to cause insurers to pay inflated claims for inventory lost or destroyed, showed that management was "not stealing from the company" but was "instead aggrandizing the company . . . at the expense of outsiders." Id. at 451.

The present case, as the district court recognized, involves exactly that situation. It is conceded that wrongdoer Vishwa Shah dominated and controlled Universal.[5] It is similarly conceded that he was cognizant of -- indeed, that he deliberately manipulated -- Universal's underlying financial condition by "creating" a nonexistent CD without which Universal could not be

[5] The Liquidator has described Shah as "the only stockholder ever individually identified" (Liq. Br. at 9), and the Liquidator's expert testified that "Shah was the management" and "clearly Shah had control." (T. at 1406, 1474.) A board resolution, dated August 2, 1978, gave Shah "sole and total responsibility for the management of the company" and, "in respect of the financial and investment management of the company," authorized him to act "without reference to the other directors." (T. at 3659; Defendants' Exhibit RR.)

operated. Under those circumstances, Shah cannot prove that he justifiably relied upon the audited financial statements, the underlying misstatement of which he engineered through the vehicle of the fictitious CD. And if he cannot prove it, then the corporation that he dominated and controlled cannot prove it either.

The district court's opinion is, in fact, quite unremarkable: it is nothing more than the logical application of the most basic principles of tort law to a corporate entity. A corporation is an artificial person which can act only through the actions of its directors and agents. Kent Ins. Co. v. Schroeder, 469 So. 2d 209, 210 (Fla. 5th DCA 1985); In re Advisory Opinion to the Governor, 243 So. 2d 573 (Fla. 1971). A corporation therefore can only prove justifiable reliance -- a critical element of an audit malpractice claim -- through the justifiable reliance of its directors and agents.[6] Where the

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[6] Courts have repeatedly held that a claim based upon audit malpractice requires causation, and causation requires justifiable reliance. See FDIC v. Ernst & Young, 967 F.2d 166, 170 (5th Cir. 1992) ("a claim that reliance is not a component of causation strains credulity"); Smolen v. Deloitte, Haskins & Sells, 921 F.2d 959, 964 (9th Cir. 1990) ("Appellants must present some evidence establishing the element of causation, in the sense of actual and justifiable reliance . . . to avoid summary judgment on their professional negligence . . . [claim]"); E.F. Hutton Mortgage Corp. v. Pappas, 690 F. Supp. 1465, 1475 (D. Md. 1988); Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992); Eldred v. McGladrey, Hendrickson & Pullen, 468 N.W.2d 218, 219-20 (Iowa 1991) ("[the theory of negligent misrepresentation] requires that the plaintiffs justifiably rely to their detriment on some misrepresentation"); Delmar Vineyard v. Timmons, 486 S.W.2d 914, 919 (Tenn. Ct. App. 1972). The Insurance Association's whole brief is based upon
(continued...)

directors/agents know the truth -- indeed, have engineered its distortion -- they cannot claim to be deceived. And the corporation, which knows what they know, cannot claim to be deceived either.

In so holding, the district court came to a conclusion identical to any number of other courts. In FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir. 1992), for example, the Fifth Circuit held that the knowledge of fraud by the dominating and controlling officer and owner of a savings and loan association should be imputed to the corporation, thereby precluding the corporation, as well as its assignee the FDIC, from stating a claim against its auditor. 967 F.2d 166 (5th Cir. 1992). The court explained: "The issue, therefore, is whether either [the manager or the corporation] relied upon Arthur Young's audit to cause injury to [the corporation]." Id. at 170. Since the manager "was cognizant of the financial condition" of the corporation, the manager, and therefore the corporation, could not have justifiably relied on the audited financial information and had no claim against its auditor. Id. The court reasoned: "Because a corporation operates through individuals, the privity and knowledge of individuals at a certain level of responsibility

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[6](...continued)
an erroneous statement to the contrary, for which it cites no authority. (Ins. Ass'n Br. at 5.)

must be deemed the privity and knowledge of the organization, 'else it could always limit its liability'. . . ."[7] Id. at 171.

A number of other cases, also applying well recognized and developed tort and agency rules in similar situations, have reached the same conclusion. See FDIC v. Shrader & York, 991 F.2d 216, 221-27 (5th Cir.), petition for cert. filed (U.S. Oct. 26, 1993) (No. 93-651); FDIC v. Deloitte & Touche, 834 F. Supp. 1129 (E.D. Ark. 1992); FDIC v. Reigier, Carr & Monroe, No. CIV-92-075-S, 1993 U.S. Dist. LEXIS 14546 (E.D. Okla. Aug. 17, 1992), aff'd, 996 F.2d 222 (10th Cir. 1993); CEPA Consulting, Ltd. v. KMG Main Hurdman (In re Wedtech Sec. Litig.), 138 B.R. 5, 9 (S.D.N.Y. 1992); Feltman v. Prudential Bache Sec., 122 B.R. 466, 474 n.9 (S.D. Fla. 1990); Security Am. Corp. v. Schacht, No. 82-C-2132 (N.D. Ill. Jan. 31, 1983).[8]

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7 The FDIC went to great lengths to try to do away with the Fifth Circuit's decision in Ernst & Young, moving for a rehearing (denied), and then entering into a settlement that constrained Ernst & Young from opposing a motion to vacate the opinion and affirmatively required Ernst & Young to join in the motion to vacate. The Fifth Circuit nonetheless refused to enter the requested vacatur. (Notice of Counter Development dtd. Dec. 1, 1992.) The Fifth Circuit ruled that, motion and settlement notwithstanding, its decision would stand. (Final Resolution Order dtd. Dec. 8, 1992.)

8 These cases -- all of which involved the critical element of justifiable reliance -- are distinguishable from the Ninth Circuit's recent decision in FDIC v. O'Melveny & Meyers, 969 F.2d 744 (9th Cir. 1992), cert. granted, 62 U.S.L.W. 3375 (U.S. Nov. 29, 1993). In the former, the knowledge of the wrongdoer, imputed to the corporation, precluded the corporation from proving justifiable reliance on the accounting firm's alleged misrepresentation of a material fact. In O'Melveny, in contrast, liability was not premised upon the law firm's alleged misrepresentation of a material fact upon which the corporation was alleged to have relied.

B. The "Adverse Interest Exception"

All of this the Liquidator cannot refute. Instead, the Liquidator submits that the "adverse interest exception," which precludes the imputation of knowledge of directors or agents acting adversely to the corporation, should apply.[9] (Liq. Br. at 25-26.) In support, the Liquidator asserts that Universal was not an "engine of theft" against outsiders because, the Liquidator argues, it was primarily an insurance company which wrongdoing owner Shah looted into insolvency by receiving dividends. (Liq. Br. at 9.) The fact that Universal was an

[9] There is an alternate basis upon which the district court could have concluded that the knowledge of wrongdoer Shah should be imputed to Universal. The Liquidator has pointed to no owners of Universal other than Shah, and the Liquidator appears to concede the absence of any other shareholders, large or small. (Liq. Br. at 9.) As a matter of law, the sole owner of a corporation who dominates and controls its affairs cannot be considered to have acted adversely to his or her own interests. See 3 Lenore M. Zajdel, Fletcher Cyclopedia of the Law of Private Corporations § 809, at 76-77 (perm. ed. rev. vol. 1986) ("Where the officer to whom notice is given or by whom knowledge is acquired is in effect the corporation, the notice is generally imputed to the corporation. . . . So, the rule that a corporation is not charged with the knowledge of an officer acting adversely to it does not apply where an officer is also the sole stockholder. . . ."); see also id. § 814, at 96. This exception to the adverse interest exception is well established and has been widely followed. See FDIC v. Shrader & York, 991 F.2d 216, 221 (5th Cir.), petition for cert. filed (U.S. Oct. 26, 1993) (No. 93-651); FDIC v. Ernst & Young, 967 F.2d 166, 171 (5th Cir. 1992); Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 120 (2d Cir. 1991); Loftin & Woodard, Inc. v. United States, 577 F.2d 1206, 1244 (5th Cir. 1978); McKee v. American Casualty Co., 316 F.2d 428, 430 (5th Cir. 1963); Federal Land Value Ins. Co. v. Taylor, 56 F.2d 351, 354 (9th Cir. 1932); Blau-Par Corp. v. Reliance Chem. Corp., 565 N.Y.S.2d 910 (App. Div. 3d Dep't 1991); Richmond Hill Realty Co. v. East Richmond Hill Land Co., 285 N.Y.S. 424, 428 (App. Div. 1st Dep't 1936).

insurance company in particular, the Liquidator argues, is of "pivotal significance." (Liq. Br. at 27.)

The truth of the matter is that whether Universal was an insurance company (actually, it was primarily a reinsurance company with other insurance companies as "policyholders") and whether Universal was rendered insolvent (actually, the Liquidator elsewhere says his theory is that it was never solvent to begin with), have nothing to do with whether the corporation was used as an engine of theft against outsiders, as in Cenco. (Liq. Br. at 7-10, 20.) Whether the corporation was used as an engine of theft involves who was deceived into losing money. Thus, the district court, quoting Cenco, was careful to distinguish between fraud against outsiders "on behalf of the corporation" and fraud where the corporation itself is deceived:

> Fraud on behalf of a corporation is not the same thing as fraud against it. Fraud against the corporation usually hurts just the corporation; the stockholders are the principal if not only victims; their equities vis-a-vis a careless or reckless auditor are therefore strong. But the stockholders of a corporation whose officers commit fraud for the benefit of the corporation are beneficiaries of the fraud.

Id. (quoting Cenco, 686 F.2d at 456).

Here, as the district court recognized, it was not the corporation that was the defrauded victim; those deceived were outsiders -- the creditors of the company. Indeed, a fundamental theme of the Liquidator's case is that wrongdoer Shah fabricated from the beginning the existence of a "non-existent" certificate of deposit to obtain insurance premiums from outsiders, which flowed into the corporation, and were then, in large part, paid to owner Shah as dividends. (Liq. Br. at 7-10.) As presented by the Liquidator, it was Universal (and its owner) which benefited from the fraud, and outsiders who suffered, for it is the corporation that obtained money from outsiders who lost it. It is, not coincidentally, only the money the corporation owed to outsiders that the Liquidator now seeks to get back.

This is not, therefore, a case where the corporation was a deceived victim through an employee's unexposed theft of a corporate asset. That the owner took dividends, a fact upon which the Liquidator focuses at length, does nothing to refute the corporation's function as an "engine of theft" against outsiders. Indeed, in this respect, too, the case is analogous to Cenco; in Cenco the Seventh Circuit explicitly recognized that the wrongdoing officers and directors, as money moved from the corporation to their own pockets, were "aggrandizing themselves." 686 F.2d at 451. The corporation here was used as a classic engine of theft, for, according to the Liquidator, it was used exclusively and completely to defraud outsiders into giving money to the corporation and, thereby, to owner Shah.[10]

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[10] The Liquidator also tries to distinguish Cenco based on the Liquidator's role and the fact that the Liquidator would not pay any claims submitted by wrongdoer Shah from any recovery to Universal. (Liq. Br. at 37.) Thus, according to the Liquidator, a policy of Cenco -- that only true victims of fraud should be compensated -- would not be frustrated here. The problem with this argument is that the manner in which the (continued...)

In any event, although the Liquidator refers to the payment of dividends as "looting," the Liquidator is hard pressed to point to evidence that any such "looting" occurred. The Liquidator can show only that Shah engineered a fraud upon outsiders, using Universal as his device, and kept the proceeds of the fraud for himself. In fact, not only is there no evidence of looting; there is no evidence that Universal was ever solvent to begin with. Not having any assets, Universal could not have been looted. It could only have been used as a conduit to steal from others. See Security Am. Corp. v. Schacht, No. 82-C-2132 (N.D. Ill. Jan. 31, 1983) (an alleged fraud, involving the misrepresentation of the assets and liabilities of the company, was not designed to loot the company because the company "had no assets except those it acquired along the way, pursuant to the fraudulent plan"). In any event, the mere payment of dividends does not constitute looting, particularly in the absence of

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[10](...continued)
Liquidator intends to distribute any recovery is utterly irrelevant to whether the corporation has a cause of action against Seidman. The fact that the Liquidator here has determined not to make any payments to Shah has nothing to do with whether the corporation -- which must be viewed independent of the Liquidator's involvement -- has a claim.

The Liquidator also states that he personally "disagrees with Cenco" and the other authorities "insofar as they suggest that it is ever appropriate to consider fraud a 'benefit' to any corporation." (Liq. Br. at 34.) Under the Liquidator's moral scheme, "any dishonest or less than honorable purposes" should always be deemed "detrimental" to the company. (Liq. Br. at 34.) A more realistic view would suggest that, at least in the short run, a corporation can be aggrandized at the expense of outsiders.

owners who do not share in the dividends -- precisely the case here.

The Liquidator places great emphasis on Schacht v. Brown, 711 F.2d 1343 (7th Cir.), cert. denied, 464 U.S. 1002 (1983). In essence, the Liquidator's argument is that the Seventh Circuit, having painstakingly worked through these issues in Cenco in what the Seventh Circuit plainly intended to be a seminal decision, several months later "discarded" Cenco in the insurance company/insolvency context and adopted a completely different analysis in Schacht. (Liq. Br. at 32-38.) The Liquidator argues that Schacht not only demonstrates the Seventh Circuit's rejection of Cenco under the circumstances here, but carves out an exception to the Cenco "engine of theft" analysis in the context of insurance company insolvency cases. (Liq. Br. at 36-38.)

In fact, Schacht is a very different case, both from Cenco and from the present one, and the distinction has nothing to do with insurance company insolvencies. The difference is that Schacht involved wrongdoers who in fact stole from the corporation: they "systematically looted" the corporation of "its most profitable and least risky business and more than $3,000,000 in income" -- actions that "in no way" could be described as beneficial to the corporation. Id. at 1348. Cenco still very much applied, the court made clear, where "the managers are not stealing from the company . . . but instead are turning the company into an engine of theft against outsiders."

Id. Subsequent cases have explicitly recognized the Cenco/Schacht "engine of theft" distinction. See Diamond Mortgage Corp. v. Sugar, 913 F.2d 1233, 1248 n.14 (7th Cir. 1990), cert. denied, 498 U.S. 1089 (1991); Feltman v. Prudential Bache Sec., 122 B.R. 466, 473-74 & n.9 (S.D. Fla. 1990); Wedtech Corp. v. KMG Main Hurdman (In re Wedtech Corp.), 81 B.R. 240, 242 (S.D.N.Y. 1987).

The principles of Cenco, moreover, have been routinely applied where the corporation was driven into insolvency or some form of reorganization.[11] For example, the United States District Court for the Southern District of Florida applied Cenco in an insolvency, finding the "Cenco 'engine of theft' theory . . . is wholly consistent with existing [Florida] law." Feltman v. Prudential Bache Sec., 122 B.R. 466, 473-74 & n.9 (S.D. Fla. 1990). In Feltman, the court faced a corporation that was driven into bankruptcy by a corporate officer who "defrauded investors out of at least $9.7 million." Id. at 468. As here, a trustee tried to assert claims against the corporation's accounting firm.

[11] FDIC v. Shrader & York, 991 F.2d 216, 221-27 (5th Cir.), petition for cert. filed (U.S. Oct. 26, 1993) (No. 93-651); FDIC v. Ernst & Young, 967 F.2d 166, 170-72 (5th Cir. 1992); Drexel Burnham Lambert Group Inc. v. Vigilant Ins. Co., 595 N.Y.S.2d 999, 1009 (N.Y. Sup. Ct. 1993); FDIC v. Deloitte & Touche, 834 F. Supp. 1129 (E.D. Ark. 1992); FDIC v. Reigier, Carr & Monroe, No. CIV-92-075-S, 1993 U.S. Dist. LEXIS 14546 (E.D. Okla. Aug. 17, 1992), aff'd, 996 F.2d 222 (10th Cir. 1993); Feltman v. Prudential Bache Sec., 122 B.R. 466, 473-74 & n.9 (S.D. Fla. 1990); Wedtech Corp. v. KMG Main Hurdman (In re Wedtech Corp.), 81 B.R. 240, 242 (S.D.N.Y. 1987); Stratton v. Sacks, 99 B.R. 686, 696 (D. Md. 1989), aff'd, 900 F.2d 255 (4th Cir. 1990).

The court held that, under Florida law, no such claim would be permitted. Employing the "engine of theft" analysis, the court stated: "The debtors' status as sham corporations created to steal from their customers . . . would bar them from suing on other grounds. [The corporation] was clearly 'an engine of theft,' unentitled to recovery from its cohorts." Id. at 474 n.9.

More recently, the "engine of theft" analysis was relied upon in the insolvency of Drexel Burnham Lambert Group to deny it a recovery against its insurers because corporate managers "stole for the company and not from it":[12]

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[12] Courts have also imputed knowledge where a fraud is so widespread among the company's senior management that there is virtually no one in control of the company who could have been deceived. J.J. McCaskill Co. v. United States, 216 U.S. 504, 515 (1910) (refusing to apply adverse interest exception to corporate officers who "own[ed] a large majority of the stock of said corporation, with the entire management and control of the business and affairs," because the "interest of the corporators and the corporation [was] thus shown to be identical, not adverse"); Phoenix Sav. & Loan, Inc. v. Aetna Casualty & Sur. Co., 381 F.2d 245, 250 (4th Cir. 1967) (stating rule but declining to impute knowledge because not clear that wrongdoers had control of company while frauds were in process); Hartford Accident & Indem. Co. v. Hartley, 275 F. Supp. 610, 617-18 (M.D. Ga. 1967) (imputing knowledge of bank officer's misappropriations to bank, where such officer had sole and complete control of bank), aff'd, 389 F.2d 91 (5th Cir. 1968); Austin v. Hallmark Oil Co., 134 P.2d 777, 784 (Cal. 1943) (majority stockholders, who named dummy directors, generally and ordinarily directed and managed the affairs of the corporation such that their knowledge was knowledge to the corporation and disclosure to them was disclosure to the corporation); West Am. Fin. Co. v. Pacific Indem. Co., 61 P.2d 963, 969 (Cal. Dist. Ct. App. 1936) (in light of control exercised by individuals who both constitute a majority of the board of directors and held a majority of the stock, their knowledge should be imputed to the corporation).

> [Drexel] is hardly in a position now to complain about its losses because of the activities of the individuals who stole for the company and not _from_ it. There are no defalcations, thefts, or embezzlements here involved. There were questionable securities transactions and improprieties in financial arrangements with customers, illegal enterprises which brought it millions in profits. Drexel acknowledged that it participated fully, either heartily approving, or pretending to look the other way with sly winks. _It cannot now disclaim corporate responsibility and point to some scoundrelly individuals shouting, "He did it, not us!"_

Drexel Burnham Lambert Group Inc. v. Vigilant Ins. Co., 595 N.Y.S.2d 999, 1009 (N.Y. App. Div. 1993) (emphasis added).

Unable to prevail in the face of traditional principles of agency, the Liquidator tries to recast his claim as "a cause of action . . . for artificial prolongation of [Universal's] corporate existence past insolvency." (Liq. Br. at 1.) Such an attempt is futile. First, there is no separate claim of "artificial prolongation of corporate existence"; and the cases cited by the Liquidator only refer to "artificial prolongation" in the context of a plaintiff who can otherwise state a proper claim. (Liq. Br. at 30 n.20.) Second, the Liquidator's cause of action is not for "artificial prolongation" of Universal's life; it is for negligence. Third, the Liquidator's theory is not that Universal's life was prolonged "past insolvency," for there is no evidence that Universal was ever solvent to begin with. It is the Liquidator's explicit theory that Universal under Shah could not have existed or done business without a certificate of deposit which, the Liquidator contends, never existed. (Liq. Br. at 9.) There was, therefore, no corporate life to be prolonged -

- other than a life created and sustained, according to the Liquidator, solely and completely through the initial fraud. This is not the situation of a wholesome corporation whose underlying value dissipated over time, even if that would make a difference under Cenco, which it would not. This corporation under Shah, according to the Liquidator's proof, was always an engine of theft and never had any underlying value at all.

Beyond his "insurance company/insolvency" argument, the Liquidator also tries to escape Cenco by arguing flatly that he "disagrees with Cenco" and that "Cenco has been sharply criticized." (Liq. Br. at 34, 36.) For support, the Liquidator relies on a Practicing Law Institute article by M. Rosner and J. Squire. See M. Rosner & J. Squire, The Cenco Defense, Accountants' Liability 1988, at 396 (PLI Corp. Law & Practice Course Handbook Series No. 383). (Liq. Br. at 36.)

In fact, Cenco has been and remains -- in precisely the manner applied by the district court here -- the most vigorously endorsed and consistently used analysis to date.[13] As one of the

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[13] See, e.g., FDIC v. Shrader & York, 991 F.2d 216, 221-27 (5th Cir.), petition for cert. filed (U.S. Oct. 26, 1993) (No. 93-651); FDIC v. Ernst & Young, 967 F.2d 166, 170-71 (5th Cir. 1992); Drexel Burnham Lambert Group Inc. v. Vigilant Ins. Co., 595 N.Y.S.2d 999, 1007, 1009-10 (N.Y. App. Div. 1993); FDIC v. Deloitte & Touche, 834 F. Supp. 1129, 1139 (E.D. Ark. 1992); In re Crazy Eddie Sec. Litig., 802 F. Supp. 804, 817-18 (E.D.N.Y. 1992); FDIC v. Reigier, Carr & Monroe, No. CIV-92-075-S, 1993 U.S. Dist. LEXIS 14546 (E.D. Okla. Aug. 17, 1992), aff'd, 996 F.2d 222 (10th Cir. 1993); CEPA Consulting, Ltd. v. KMG Main Hurdman (In re Wedtech Sec. Litig.), 138 B.R. 5, 9 (S.D.N.Y. 1992); Feltman v. Prudential Bache Sec., 122 B.R. 466, 473-74 & n.9 (S.D. Fla. 1990); Stratton v. Sacks, 99 B.R. 686, 696 (D. Md. 1989), aff'd, 900 F.2d 255 (4th Cir. 1990); Robertson v. White, 633 F. Supp. 954, 975-76 (W.D. Ark. 1986); Security Am. Corp. v. Schacht, No. 82-C-2132 (N.D. Ill. Jan. 31, 1983).

more recent decisions has stated, "Cenco's popularity in other jurisdictions is not surprising." FDIC v. Deloitte & Touche, 834 F. Supp. 1129, 1139 (E.D. Ark. 1992). As to the Practicing Law Institute article on which the Liquidator relies, that article is far from an objective and disinterested analysis of the issue. It was written by counsel for certain plaintiffs in the Wedtech securities litigation in the Southern District of New York, prior to a much anticipated ruling on the imputation issue by Judge Sand. When Judge Sand ruled, the position advocated in the article was rejected.[14] CEPA Consulting, Ltd. v. KMG Main Hurdman (In re Wedtech Sec. Litig.), 138 B.R. 5, 9 (S.D.N.Y. 1992).

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[14] The Liquidator also argues that the district court improperly focused upon the short-term effects of Shah's fraud in assessing whether Universal was used as an engine of theft against outsiders; the Liquidator argues that the focus should be on the long term, and asserts that the long-term effect was to render Universal more insolvent. That argument makes no sense. In the long term, fraud on behalf of a corporation will always harm the corporation because no massive fraud can continue forever. In focusing on the short-term benefit or detriment to the corporation, the court's analysis was identical to that of any number of cases addressing that issue. See Cenco, 686 F.2d at 456 ("[the detriment to the corporation] after the fraud is unmasked and the corporation is sued is a question of damages, and is not before us"); Security Am. Corp. v. Schacht, No. 82-C-2132 (N.D. Ill. Jan. 31, 1983) ("Whether liability ultimately may fall on Security America, once the fraud has been unmasked, is not the relevant inquiry"); FDIC v. Deloitte & Touche, 834 F. Supp. 1129, 1137-40 (E.D. Ark. 1992) ("If the only facts supporting an adverse interest argument are that FirstSouth ultimately failed, and that controlling officers engaging in wrongful conduct continued to draw their salaries, the plaintiff's position will be a difficult one to maintain"); CEPA Consulting, Ltd. v. KMG Main Hurdman (In re Wedtech Sec. Litig.), 138 B.R. 5, 9 (S.D.N.Y. 1992) ("The relevant issue is short term benefit or detriment to the corporation, not any detriment to the corporation resulting from the unmasking of the fraud").

The Liquidator also draws attention to the Ninth Circuit's decision in FDIC v. O'Melveny & Meyers, 969 F.2d 744 (9th Cir. 1992), cert. granted, 62 U.S.L.W. 3375 (U.S. Nov. 29, 1993) (No. 93-489), in which a law firm sought to raise an "unclean hands" defense against the FDIC. The Liquidator suggests that O'Melveny illustrates a "split" in the federal circuits on the issue of imputing knowledge and that O'Melveny represents the "better reasoned" view. (Liq. Br. at 41-42.) In fact, O'Melveny involved whether a law firm could raise an equitable defense against the FDIC -- not whether, as is the issue here, there existed the elements of a claim to begin with. As stated in FDIC v. Deloitte & Touche, 834 F. Supp. 1129 (E.D. Ark. 1992):

> O'Melveny, however, is a decision about equitable estoppel. Its tone reflects the Ninth Circuit's assessment of the parties' ethical positions. The FDIC had done nothing wrong, whereas the law firm had (at least allegedly) breached fundamental professional duties. Those are appropriate concerns for a Court "sitting in equity." In this case, however, Deloitte has not attempted to assert an equitable defense.

834 F. Supp. 1129, 1143 n.21 (E.D. Ark. 1992). Further, the O'Melveny court did not reject Cenco by any means; rather, it rejected the application of state law -- under which the successor to a corporation is plainly susceptible to the same defenses, and must affirmatively prove the same elements, as the predecessor corporation itself -- in favor of the creation of new federal law regulating the assertion of an equitable defense against the FDIC. 969 F.2d at 751. The Supreme Court has granted certiorari. 62 U.S.L.W. 3375 (U.S. Nov. 29, 1993).

The Liquidator's other cases are both distinguishable and unpersuasive. In a number of them, imputation of knowledge was not at issue because the receivers brought actions on behalf of third parties in addition to or instead of the companies themselves. See, e.g., FDIC v. Nathan, 804 F. Supp. 888, 893 (S.D. Tex. 1992) (suit on behalf of thrift, depositors, shareholders and creditors); Foster v. Peat Marwick Main & Co., 587 A.2d 382, 384 (Pa. Commw. Ct. 1991); Corcoran v. Frank B. Hall & Co., 545 N.Y.S.2d 278, 279 (App. Div. 1st Dep't 1989); Bonhiver v. Graff, 248 N.W.2d 291, 296 (Minn. 1976). The others involve situations plainly distinguishable from the situation here.[15]

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[15] See FDIC v. Clark, 978 F.2d 1541, 1545, 1549 n.7 (10th Cir. 1992) (explicitly distinguishing the case from the situation of FDIC v. Ernst & Young because in Clark the FDIC was suing in its corporate capacity, thereby obtaining powers under federal law broader than in Ernst & Young, in which the FDIC "sued only on behalf of the institution"); Kempe v. Monitor Intermediaries Inc., 785 F.2d 1443 (9th Cir. 1986) (case did not address claims for audit malpractice); FDIC v. Niblo, 821 F. Supp. 441, 449 (N.D. Tex. 1993) (suit against former officers and directors); FDIC v. Thompson & Knight, 816 F. Supp. 1123, 1132 (N.D. Tex. 1993) (claims asserted by FDIC against law firm were dismissed); FDIC v. Benjes, 815 F. Supp. 1415 (D. Kan. 1993) (court examined only affirmative defenses; it did not deal with reliance and causation); FDIC v. Gantenbein, 811 F. Supp. 593, 596 (D. Kan. 1992) (court acknowledged that fraud committed by corporate officer would be imputed to the company if the officer's conduct was for the benefit of the corporation); Tew v. Chase Manhattan Bank, N.A., 728 F. Supp. 1551, 1560-61 (Bankr. S.D. Fla. 1990) (claims not against an outside accounting firm but against a bank, in which the court was careful to distinguish the case from the situation in which a corporation benefits "monetarily at the expense of" outsiders), modified, 741 F. Supp. 220 (S.D. Fla. 1990); McHale v. Huff (In re Huff), 109 B.R. 506 (Bankr. S.D. Fla. 1989) (involving claims not against an outside accounting firm, but against the inside directors and officers themselves); Wedtech Corp. v. KMG Main Hurdman (In re Wedtech Corp.), 81 B.R. 240 (Bankr. S.D.N.Y. 1987) (court
(continued...)

Nor does the district court's decision constitute "a significant departure from present universally accepted principles governing auditor liability." (Liq. Br. at 45.) If anything, it is the position of the Liquidator that constitutes "a significant departure" from presently accepted principles, in at least two important respects. First, the present state of the law is that a corporate successor must prove each element of a professional negligence claim that the corporation itself had to prove. Second, permitting the Liquidator to recover from an accounting firm for the supposed losses of outside creditors would circumvent the very plain holding of this Court as to when accountants are liable to outsiders not in privity with them. See First Florida Bank, N.A. v. Max Mitchell & Co., 558 So. 2d 9, 14-15 (Fla. 1990); see also Liq. Br. at 46 n.37 ("Third party rights to sue are still very limited"). The Liquidator has cited no evidence that the creditors, on whose behalf he says he seeks a recovery, could satisfy this Court's privity requirements and

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[15](...continued)
denied motions to dismiss based on the undeveloped record and stated, "It is possible . . . that management was indeed acting in whole or in part for the benefit of [the company], in which case the adverse interest exception would not apply"); Holland v. Alexander Grant & Co. (In re American Reserve Corp.), 70 B.R. 729, 735 (Bankr. N.D. Ill. 1987) (court denied motion to dismiss because the complaint failed to allege that management acted on behalf of company); Robertson v. White, 633 F. Supp. 954, 959 (W.D. Ark. 1986), (court only considered "whether the various counts can possibly state causes of action against the defendants under any view of the complaint"); Bloor v. Dansker (In re Investors Funding Corp.), 523 F. Supp. 533, 541 (S.D.N.Y. 1980) (involving a claim of "plundering" the corporation); Merin v. Yegen Holdings Corp. (In re Integrity Ins. Co.), 573 A.2d 928, 941-42 (N.J. Super. Ct. App. Div. 1990) (observing that, under the New Jersey law at issue, the doctrine of "constructive notice to the principal" did not apply).

assert a claim against Seidman. The creditors' voluntary defection from this case suggests they could not. (See supra at 7.) To permit a recovery here would eviscerate this Court's Max Mitchell privity requirement to the extent he is suing on behalf of creditors.

III. A SPECIAL EXCEPTION FROM "GENERAL CORPORATE LAW" NEITHER EXISTS, NOR SHOULD BE CREATED, FOR CLAIMS BY INSURANCE COMPANIES.

The Insurance Department, satisfied with neither the decision of the district court nor with the question that court has certified, devotes the bulk of its amicus brief to the proposition that, for purposes of a Cenco analysis, insurance companies are not, or should not be, subject to "general corporate law" and that a special exception from Cenco exists, or should be created, for the insurance industry. (Ins. Dep't Br. at 9, 15-18.) The principal authority cited for the proposition that insurance companies are entitled to a special exception from Cenco is Schacht v. Brown, 711 F.2d 1343 (7th Cir.), cert. denied, 464 U.S. 1002 (1983). The Insurance Department argues that "Schac[h]t represents the clearest possible statement that the Cenco rationale was never intended to be applied in the insurance-insolvency context." (Ins. Dep't Br. at 17.)

The most obvious response is that none of the existing cases, Schacht included, recognizes a distinction between insurance companies and other companies as to the applicability of a Cenco analysis. The distinction involves whether money is being stolen on behalf of the corporation or from it. It is quite true that Schacht by coincidence happened to involve an insurance company; it is equally true that, as shown above, that coincidence played absolutely no role in the Schacht court's decision. None of the other cases cited by either the Insurance Department or the Liquidator recognizes a distinction between insurance and other companies for purpose of a Cenco analysis.[16] Indeed, most of them do not involve a Cenco analysis at all.

Nor does there exist a distinction between insurance companies and others that would justify the creation of a special rule by this Court. The Insurance Department seeks to offer a number of such distinctions -- such as that the business of insurance has its "origins in antiquity"; that the "government's interest in the law of insurance is intense"; that the failure of an insurance company is "detrimental to the public"; that states "extensively regulate the types of investments in which insurers may engage"; and that shareholders in an insurance company

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[16] The Insurance Department also refers to Bonhiver v. Graff, 248 N.W.2d 291, 296 (Minn. 1976), for the proposition that an insurance company receiver is not subject to the causation requirement of Cenco. In fact, Bonhiver involved a case in which the receiver was pursuing the claims of creditors, so that the issue of imputation of knowledge to the corporation did not arise. Id. at 296. The Insurance Department and the Liquidator both cite a number of additional cases for the proposition that, under the laws of New Jersey, Pennsylvania, and New York, an insurance company receiver is empowered to pursue the claims of creditors and others. (See Ins. Dep't Br. at 15-17; Liq. Br. at 29.) As discussed above (see note 4 supra), those cases do not address Cayman Islands or Florida law; in any event, the Liquidator has elected to pursue only the claim of the corporation here. See Corcoran v. Frank B. Hall & Co., 545 N.Y.S.2d 278, 279-80 (App. Div. 1st Dep't 1989); Foster v. Peat Marwick Main & Co., 587 A.2d 382, 384 (Pa. Commw. Ct. 1991); Merin v. Yegen Holdings Corp. (In re Integrity Ins. Co.), 573 A.2d 928, 931 (N.J. Super. Ct. App. Div. 1990).

insolvency have "the lowest possible priority." (Ins. Dep't Br. at 9-12.)

But none of these characteristics is unique to an insurance company: many or all of them apply to any number of regulated industries, particularly regulated industries involving financial services. Banking, to name just one example, has its "origins in antiquity"; the government's interest in the law of banking is "intense"; the failure of a bank is "detrimental to the public"; the states "extensively regulate the types of investments in which" banks may engage; and, in a liquidation, the shareholders of a bank have "the lowest possible priority."

Of course, the law is clear that a receiver/liquidator, standing in the shoes of a failed bank, may assert only the claims the bank had available to it. See, e.g., Coit Independence Joint Venture v. FSLIC, 489 U.S. 561, 571 (1989); FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir. 1992); FDIC v. Harrison, 735 F.2d 408, 412 (11th Cir. 1984) ("stands in the shoes of the insolvent bank"). And the law is equally clear that a Cenco analysis can preclude recovery by a bank receiver which has stepped into the bank's shoes. One of the clearest decisions on this issue is, again, FDIC v. Ernst & Young, in which the Fifth Circuit applied a Cenco analysis to relegate the biggest insurance company of them all -- the FDIC[17] -- to a position no

[17] The FDIC's report for the year ending December 31, 1991 shows that it insured deposits of $1,957,722,000,000. See 1991 FDIC Ann. Rep. 134.

better than the failed bank would have occupied in asserting its claim:

> The most significant factor in the present case's outcome is the FDIC's decision to sue only as Western's assignee. The FDIC did not sue on its own behalf or on Western's creditors' behalf. Essentially, therefore, this is a client case in which a client is suing its auditor. Consequently, the effect of the auditor's alleged negligence on third parties is legally irrelevant to the determination of the present case. 'An assignee obtains only the right, title, and interest of his assignor at the time of his assignment, and no more. Accordingly, an assignee may recover only those damages potentially available to his assignor.'

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

The fact is that an insurance company is a type of financial services company which, while of great importance, is no different in this context than any other highly regulated financial services concern, including banks, savings and loans, brokerage firms, and other similar institutions. There is no basis for the creation of a special rule for the insurance industry.[18]

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[18] The Insurance Department argues that, under New Jersey law, "the liquidator of an insolvent insurer can pursue an action for wrongful continuation of corporate existence" on behalf of others beside the company, such as creditors and policyholders. (Ins. Dep't Br. at 15-16.) The main problems with that argument are: (1) New Jersey law does not apply to this case; (2) even under New Jersey law there is no separate claim for "wrongful continuation of corporate existence"; (3) the claim here is not for wrongful continuation of corporate existence, but for negligence; and (4) regardless of whether the Liquidator would have the power to pursue claims of others aside from the company, the Liquidator has chosen to pursue only the claim of the company itself.

IV. THE DISTRICT COURT'S DECISION IS CONSISTENT WITH GOOD POLICY.

The Liquidator also argues that the district court's decision is contrary to good policy and principles of equity. He asserts that the court's decision creates a rule whereby supposedly "auditors will have no liability" for failing to detect fraud. (Liq. Br. at 46.) Moreover, the Liquidator asserts, the district court's decision "was based solely on equity, thus completely upending equity's intent to protect the innocent and to promote justice." (Liq. Br. at 42.) For its part, the Insurance Department calls upon this Court to invoke "the police power of the state" and counsels that the Court "need not worry about an explosion of litigation or serious damage to the accounting profession" thereafter. (Ins. Br. at 18-19.)

The truth of the matter is that the district court's decision in no way affects the auditor's duty to detect fraud. It merely follows existing law in setting forth who can sue for a failure to detect fraud and who cannot. The district court confirmed that the wrongdoer who benefited from the fraud cannot sue.

Further, to increase the liability of the outside auditor to include liability to the wrongdoing corporation arising out of the misdeeds of its officers and directors is to completely disregard the basic truths of corporate governance and the outside audit process. Auditors are not the guarantors of the financial statements they audit. Bily v. Arthur Young & Co., 834 P.2d 745, 779 (Cal. 1992). A corporation's financial reporting, like all aspects of corporate governance, are under the effective control of management, for the commercial reality is that financial reporting takes place in a client-controlled environment. As the California Supreme Court has recently observed:

> As a matter of commercial reality, audits are performed in a client-controlled environment. The client typically prepares its own financial statements; it has direct control over and assumes primary responsibility for their contents. The client engages the auditor, pays for the audit, and communicates with audit personnel throughout the engagement. Because the auditor cannot in the time available become an expert in the client's business and record-keeping systems, the client necessarily furnishes the information base for the audit.
>
> Thus, regardless of the efforts of the auditor, the client retains effective primary control of the financial reporting process.

Bily v. Arthur Young & Co., 834 P.2d 745, 762 (Cal. 1992).

It is the management of a company -- not the outside auditors -- who are the stewards of the business and who establish the all-important culture and environment of the company and its commitment to ethical conduct. See Committee of Sponsoring Organizations of the Treadway Commission, Internal Control -- Integrated Framework, Ch. 8 at 82 (Sept. 1992) ("By selecting management, the board [of directors] has a major role in defining what it expects in integrity and ethical values, and can confirm its expectations through its oversight activities"). It is bad policy to shift liability for management misconduct to the once-a-year auditors, whose principal responsibility consists of rendering an opinion based upon an annual test of the accounts. The audit process is simply no substitute for the unrelenting supervision of attentive corporate management.

In addition, moving responsibility from the directors to the auditors unfairly harms the users of professional services. Where professionals face 100 percent exposure for their clients' misconduct, some will stop practicing in the field, and the survivors will raise their rates to cover the increased risk. Bily v. Arthur Young & Co., 834 P.2d 745, 766 (Cal. 1992). The phenomenon of accounting firms withdrawing from entire industries, and the inability of some companies to obtain audits at all, is being increasingly reported in the financial press. See Kelley Holland and Larry Light, Big Six Firms are Firing Clients: Huge Lawsuits Make Them Choosy About Whom They'll Audit, Business Week, Mar. 1, 1993, at 76. As one publication has described:

> With growing regularity, major public accounting firms are turning their backs on many smaller banks, thrifts, and fledgling companies. Deloitte & Touche, for one, declined to audit about 60 companies trying to go public last year, more than half the 103 initial public offerings they actually evaluated.

Id.

Statistical data, gathered by the profession, demonstrate the point. A recent survey of mid-sized and smaller firms revealed that one-fifth of the firms responding said they would "discontinue providing or performing certain types of services." Hearings on Private Litigation under the Federal Securities Laws Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 103d Cong., 1st Sess. (1993) (responses of Jake L. Netterville to questions submitted by Senator Pete Domenici). A separate study found that mid-sized firms are limiting their client base to reduce liability exposure. Id. Of the firms surveyed (the six largest firms were not included), 56% said they would not do business with clients involved in industries they considered to be high risk. Id. Still another survey of small CPA firms found that only 53% are willing to undertake audit work, while, of those, 32% are discontinuing audits in what they consider to be high-risk economic sectors. Id. A Special Report by the Public Oversight Board reports instances of students who are potentially dissuaded from entering public accounting by the threat of liability; young managers refusing partnership in accounting firms because of concern about their personal assets; and the decision of existing partners to leave public accounting for corporate positions in order to avoid potential liability. Public Oversite Board, In The Public Interest: Issues Confronting The Accounting Profession at 9 (1993).

These concerns appear to be justified. Data from the profession show that, during the years 1990, 1991, and 1992 alone, the handful of accounting firms was required to expend in judgments, settlements, and defense costs more than $1.6 billion.[19] An article last month reports that claims against the Big Six accounting firms "total $30 billion, or far more than the accounting partners' capital." Michael Siconolf & Lee

[19] The Insurance Department also argues that "suits against insurance-company auditors are fairly rare," using as its only evidence the fact that it is pursuing "only five suits" against auditors at the moment. (Ins. Dep't Br. at 19). Assuming that each state is pursuing "only five suits" against auditors, that constitutes 250 suits. And this is just litigation as to insurance companies, before the expansion of liability that the Insurance Department proposes on this appeal.

Burton, Andersen, Deloitte Are Named in Suit Over Partnerships, Wall St. J., Jan. 11, 1994, at C17, col. 12.

Ultimately, it is the public that will have to pay the price. As the Seventh Circuit recognized in DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir.), cert. denied, 498 U.S. 941 (1990), an overbroad extension of accountants' liability necessarily increases the costs of accounting services and thereby decreases their availability. Id. at 629. Clients who are unable to afford the increased cost of liability-driven accounting services may turn to accounting firms that are less responsible, but cheaper. See Brian K. Kirby & Thomas L. Davies, Accountant Liability: New Exposure for an Old Profession, 36 S.D. L. Rev. 576, 595 n.200 (1991).

Finally, the Institute takes issue with the Liquidator's premise that a court decision is almost by definition "inequitable" if the accounting firm does not have to pay. (See Liq. Br.at 44.) To the contrary, the Institute submits that it is inherently inequitable to permit a corporation, acting through wrongdoing officers and directors put in place by the corporation's owners, to conspire to defraud and, once caught, to turn around and sue the auditors for failing to discover and expose their wrongdoing. The proposition that the corporation should be able to prove that the corporation itself, through its wrongdoing officers and directors, "justifiably relied" upon the accounting firm they were undertaking to deceive exceeds the bounds of reason, let alone equity.

In any event, while courts sometimes speak in terms of "estoppel" or other equitable concepts, they are not equitable principles that preclude recovery here, but principles as basic as the need to plead and prove the elements of a claim -- including the element of justifiable reliance. Where those elements cannot be pleaded and proved -- and they cannot be here -- there is no claim, and principles of "equitable estoppel" or other aspects of equity do not even enter into it.

The district court has chosen the appropriate rule to apply where the successor in interest seeks to blame others for the entity's wrongdoing. The Institute submits that it is inequitable to choose a regime where the associated professionals are always liable to the fraudfeasor or his successor because of the fraud -- the reality of the legal position asserted by the Liquidator. It is just as inequitable to choose a regime where the professional is never liable, and the Institute does not advocate that position. The proper result is achieved through the application of basic principles of tort law, as the district court accomplished.

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CONCLUSION

The American Institute of Certified Public Accountants respectfully requests that the decision of the Third District Court of Appeal be approved.

Dated: New York, New York
February 14, 1994

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that true and correct copies of the foregoing Brief of the American Institute of Certified Public Accountants as *Amicus Curiae* in Support of Respondents, together with the Appendix, were mailed this 10th day of February, 1994, to:

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