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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,

v.

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

Respondents.

ON DISCRETIONARY REVIEW FROM THE THIRD DISTRICT COURT OF APPEAL

PETITIONER'S INITIAL BRIEF ON THE MERITS

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OVERVIEW

This case is about an insurance company's right to recover when it has been tortiously driven into insolvency. The right arises from what has become an all-too recurrent scenario: the acts of a corrupt officer in the company combine with those of malpracticing auditors to present a false picture of the insurance company's assets over an extended period of time. The company is forced to continue in business selling insurance coverage and acquiring attendant coverage obligations, when in reality it is insolvent. Pressed deeper and deeper into debt by the tandem tortious activities of its officer and auditors, the company's dire condition eventually becomes manifest to some outsider (*e.g.*, an unpaid policyholder or an insurance commissioner), the abuse of the corporate entity is called to a halt, and a liquidator is appointed as a court-supervised fiduciary to try to bring the company to an honorable end.

Accounting malpractice has contributed to this scenario with such unfortunate frequency that a specific body of law has developed to provide redress. The debt-ridden insurance company has a cause of action against its malpracticing accountants and/or its abusive officers for artificial prolongation of its corporate existence past insolvency. The cause of action permits the company, through its liquidator, to recover its wrongfully acquired net deficit, to repay the innocent policyholders and creditors to whom it became indebted, and thereafter to be brought by its liquidator to an honorable termination. The financial toll for the wrongdoing is thus levied on the wrongdoers, not on the victims.

The victim insurance company here is Universal Casualty and Surety Co., and its Liquidator is Petitioner in these proceedings. The malpracticing auditors are Respondents BDO

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Seidman,[1] and the corrupt officer in the company was one of its managing directors, a man named Vishwa Shah. The Liquidator sued BDO Seidman and recovered the jury verdict and judgment which is the subject of these appellate proceedings. The judgment in favor of the Liquidator is for payment into Universal's estate to be distributed pursuant to liquidation law. No wrongdoers stand to benefit from the distribution.

In the Third District, BDO Seidman did not deny its malpractice, or that as a result of the malpractice Universal ended up saddled with a multi-million dollar net deficit. The Third District itself accepted the jury's findings on negligence and damages. However, the Third District reversed based on "equitable" grounds, holding that the Liquidator was estopped to recover from the wrongdoing auditors because of Shah's misconduct. The end result of the Third District's "equity" decision is that innocent tort victims are left uncompensated while tortfeasor BDO Seidman gets off scot-free. The decision not only produced the wrong result in this case, but stands as dangerous precedent for shielding other malpracticing auditors from liability in the future. The Third District's decision should be vacated, and the BDO Seidman auditors — like other tortfeasors — should be required to pay for the damages caused by their negligence.

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[1]Respondent was known at one time as Seidman & Seidman in the USA and Binder Dijke Otte in Europe and international circles. More recently, it has used a combined version — BDO Seidman. Petitioner simply makes reference to "BDO Seidman" or "Seidman" throughout.

STATEMENT OF THE CASE AND FACTS

A. Statement of the case[2]

1. The lawsuit

Cayman insurance company Universal Casualty and Surety Company ("Universal") was placed in liquidation under the supervision of the Cayman Grand Court in September of 1984. (T. 722).[3] Allan Gee, an English chartered accountant with the Cayman office of Ernst & Young, was appointed Liquidator of Universal. (T. 677, 683; Plaintiff's Exhibit #2). While reviewing Universal's books and records, collecting its assets, and putting its affairs in order, the Liquidator discovered evidence that Universal's assets were not as represented in its audited financial statements, thus indicating, *inter alia*, malpractice on the part of Universal's auditors, BDO Seidman. (T. 388-400; 691-712). The Liquidator therefore sought and obtained an order from the Cayman Grand Court authorizing the Liquidator to bring this action for accounting malpractice against BDO Seidman. (R. 200-201, 714).[4]

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[2]The record references herein are made as follows. The original record from the trial court and the Third District is referred to as R. ___. The trial transcript is referred to as T. ___. The supplemental record consisting of additional materials from the Florida Third District Court of Appeal, and added by stipulation of the parties, is referred to as SR. ___. All emphasis in this brief is supplied unless otherwise stated.

[3]A United States bankruptcy court, which issued rulings on certain early discovery efforts by the Liquidator, discussed at length the Cayman Island liquidation laws and court procedures and determined that they are much the same as those in the United States and comport with United States due process requirements. *In re Gee,* 53 B.R. 891, 901-904 (Bankr. S.D.N.Y. 1985).

[4]It is undisputed that the Liquidator has standing to bring all claims belonging to Universal, including this claim against its former auditors. (R. 200-201).

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2. The trial, verdict and judgment

The suit was filed in 1987 and proceeded through three years of discovery and procedural skirmishing. (R. 2-856). At the end of a month long jury trial beginning in November, 1990, the jury found, simply enough, that there was negligence on the part of the BDO Seidman auditors which was a legal cause of damage to Universal Casualty and that the damage caused by such negligence was $15.7 million. (R. 1098-1099).

3. The appeal to the Third District

BDO Seidman appealed to the Third District raising a variety of evidentiary and legal issues. (SR. 1-43). Significantly, BDO Seidman did not contend on appeal that the negligence and damages findings were against the manifest weight of the evidence. (R. and SR. *passim*).[5] The Third District's decision also found no error in connection with the jury's findings on negligence and damages, and assumes that those findings were sufficiently supported by the evidence to have passed beyond appellate interference. (R. 2080-2086). Nonetheless, the Third District reversed, not because of any trial error or lack of evidentiary support for the jury verdict, but on a theory of an *equitable* defense of estoppel, which the Third District decided should be

[5]Seidman specifically conceded on appeal that its negligence was no longer an issue. (SR. 11, 115). As to damages, Seidman had two arguments. Seidman disagreed with the Liquidator's claims processing methodology. (SR. 12-13). Seidman also argued that the damages sought were really the creditors' damages, ignoring the case law cited in the argument section below that a company itself is damaged by an artificial prolongation of its corporate life beyond insolvency and, if such a prolongation is *tortiously* caused, the company may recover its net deficit from the tortfeasors. Seidman's "heads I win, tails you lose" argument in this regard was that *no one* could recover for the damages caused by Seidman's now conceded negligence. Seidman contended that the creditors could not recover because they were not in privity with Seidman and that Universal, which *did* have privity, could not recover because it was really creditors' rights and damages which were involved. (*See, e.g.*, R. 234-235, 770, 1954-1965, 1686; SR. 14).

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extended to relieve the wrongdoing auditors from the obligation to pay for the damages caused by their tortious conduct. (SR. 2082-2086).

Specifically, the Third District held on an estoppel theory that the auditors *would not have to pay for* the damages caused to their client Universal Casualty by their negligence because there was a manager within Universal committing fraud and this fraud should be imputed to the company as a "benefit" defeating the Liquidator's recovery from the negligent auditors. (SR. 2082-2086).

The Petitioner/Liquidator moved for rehearing, certification and rehearing *en banc.* (SR. 133-211). The Third District denied the rehearing motions, but certified the case as passing upon a question of great public importance. (SR. 2091-2092).[6] This Court thereafter issued an order which directed the parties to proceed with briefing the merits, and which carried the jurisdictional issue with the case. (Florida Supreme Court Order dated November 2, 1993).

B. Statement of the facts

The following is provided as an overview of the record facts pertinent to consideration of these review proceedings.

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[6]Because the Third District did not rule upon the Petitioner's request for certification at the time that the order was issued denying rehearing and rehearing *en banc*, Petitioner filed a notice to invoke this Court's jurisdiction on grounds of express and direct conflict. Petitioner also submitted his jurisdictional brief. Thereafter the Third District issued its order of certification, and this Court directed the parties to proceed with briefs on the merits, carrying the jurisdictional question with the case.

1. **Trial evidence supporting the jury's verdict**

a. **Liability**

In the summer of 1978, Universal Casualty — through one of its managing directors, Vishwah Shah — retained BDO Seidman to audit its company records. (T. 562-563). The audit work, as it turned out, consisted of little more than auditing one item, since Universal had only one substantial asset to speak of, a $10 million certificate of deposit from Merchant & Shipowners Bank, a 'bank' purportedly located on the small Caribbean island of St. Vincent. (T. 2540, 3152, 3197, 3152, 3157). This 'bank' was nothing but a phony shell bank that was the subject of a variety of fraud investigations in the United States. (T. 292-293, 299-317, 1429-1430) A Banking Circular issued by the Chief of Fraud of the U.S. Office of the Comptroller stated: "It is suggested that extreme caution be exercised in conducting any transactions involving this bank", which meant that the Comptroller had "substantial evidence that [Merchants & Shipowners] was an illegal corporation." (T. 316, 318-325; Plaintiff's Composite Trial Exhibit #1). The most routine — and required — audit procedures would immediately have led to this circular and the information about Merchants' & Shipowners' illegal status, and thus to the information that Merchants & Shipowners certainly had no $10 million of Universal's. (T. 454-458; 1429-1430, 1462; Shockey Depo. 312).

Trial testimony also established that any accounting firm performing an audit in a Caribbean setting was required to know that the St. Vincent locale of Merchants & Shipowners was a red flag of the first-order, since St. Vincent's was a notorious home for fraudulent shell banks in the mid and late 1970's. (T. 454, 679, 1430). Standard audit procedures required BDO Seidman to visit the home office of Merchants & Shipowners in St. Vincent's, where the auditors

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would *immediately* have discovered that Merchants & Shipowners never did any banking and never even had an office. (T. 472, 485). Worse, BDO Seidman knew Merchants & Shipowners had common ownership with Universal which relationship necessitated even more intense scrutiny under accepted auditing standards. (T. 1417-1418, 1467-68, 3152).

Despite the easily visible storm warnings about Merchants & Shipowners, BDO Seidman never bothered to call or visit the bank, although the most basic audit procedures absolutely required them to do so. (T. 459, 487, 1420-1421, 1428-1429, 1455, 1659, 1664, 1667-1668). Doing either would readily have revealed that the only substantial asset BDO Seidman was auditing was phony, and that no $10 million dollars ever existed as a Universal asset. (T. 459, 487, 1420-1421, 1428-1429, 1455, 1659, 1664, 1667-1668).

Other red flags surrounded the Universal audit assignment. Two reputable accounting firms — Coopers & Lybrand and Touche Ross — had previously withdrawn and refused to perform Universal's audits precisely because of the Merchants & Shipowners CD, and BDO Seidman knew this before taking the Universal engagement. (T. 1483, 1499-1500, 2272, 2485-2491, 2584-2599; Kremer Depo. 147-150, 160, 175). In addition to the two Big Eight accounting firms' refusal to take on the Universal audit, BDO Seidman also knew that attorneys had refused to act for Universal because of concerns about the unverified $10 million CD. (T. 1528).

Notwithstanding the warning signals which should have led BDO Seidman to decline the audit work or, having accepted, to exercise all professional auditing care for Universal as its client, BDO Seidman took on the work but performed it so negligently that for *years* it issued grossly inaccurate audit reports for Universal. (Plaintiff's Composite Trial Exhibit No. 13). The first Seidman audit report for Universal was issued in June of 1978. Additional reports were issued thereafter for the years ending December 31, 1978, 1979, 1980, and 1981. (Plaintiff's

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Composite Trial Exhibit No. 13). In each audit, BDO Seidman affirmatively — and without qualification — verified the existence of the non-existent $10 million "asset". (Plaintiff's Composite Exhibit 13; T. 1410, 1585-1586).

BDO Seidman's failures to discover the easily detectable problem with the St. Vincent's shell bank and its non-existent CD for the first years of the audits were followed by a commensurately egregious auditing error. (T. 1433-1461). The Merchants & Shipowners CD was eventually replaced with a $10 million "rent-a-CD", an ephemeral 'asset' that exists for only 24 hours, and may be had for the price of a few thousand dollars in rental fees — as BDO Seidman could and should have easily ascertained, but did not. (T. 1433-1461; Kaltman Depo. 8-15).[7]

Notwithstanding Universal's lack of any substantial capitalization, the BDO Seidman audits — affirming that there *was* such capitalization — enabled Universal to get into business on an international scale as an insurer and reinsurer. (See, e.g., T. 721; Plaintiff's Trial Exhibit No. 14). During the period covered by the Seidman audits from 1978 through the end of 1982, Universal took in total premiums of approximately $16 million. (Plaintiffs' Trial Exhibit No. 13, BDO Seidman Audit Reports for Universal 1978-1982). Universal also paid out policyholder losses as they arose and came due — over $6.5 million was paid on policyholder

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[7]BDO Seidman had also specifically committed to perform the Universal audits under the stringent New York statutory accounting principles for insurance companies, which prescribe a conservative approach to ensure that funds will be available to pay policyholders. (T. 1178-1181, 2531-36; Plaintiff's Composite Trial Exhibit 13). As it turned out, Dennis Kremer — the assigned audit partner — did *not* perform the audits under New York statutory accounting principles, and ***did not even know what they prescribed***. (T. 2531-2553). This dereliction was significant because the statutory accounting principles prohibit more than 10% of an insurance company's assets from being deposited with any one U.S. bank — even a solid domestic bank like Chase Manhattan — and prohibit more than 1% from being kept in a foreign bank. (T. 1178-1181). The $10 million in CD's — representing 96% of Universal's assets — was a clear violation of these statutory accounting principles, and resulted in just the problem those principles were designed to prevent — unavailability of funds to pay policyholders' losses. (T. 1178-1181, 2543).

losses. (*Id.*). During that same period, millions of dollars were being taken out of Universal reported as 'dividends' to stockholders, Shah being the only stockholder ever individually identified.[8]

However, because — as Seidman should readily have discovered — the company did not have the $10 million in capitalization, Seidman should also have recognized that the 'dividends' Shah was taking were not legitimate dividends at all but rather a flat-out looting of the company's available cash. (T. 1656). The following comparison of net income and "dividends" from 1979 to 1982 charts the thefts by Shah which cumulatively contributed to Universal's deepening insolvency and ultimate inability to pay the claims of its insureds.

	Net Income	**'Dividends'**
1979	$1,078,867	$ 713,000
1980	$1,866,871	$1,780,000
1981	$1,204,611	$2,103,150
1982	$ 293,815	$1,305,556

(Plaintiff's Trial Exhibit No. 13).

Had BDO Seidman properly discharged their auditing duties, they would have immediately discovered that no $10 million in assets existed for Universal, would have withdrawn

[8]As the bankruptcy court in New York noted in issuing an early opinion concerning the Liquidator's right to search for Universal records, the ownership of Universal was a hazy subject: "The record contains contradictory evidence of [Universal's] holding company's immediate and beneficial ownership. [Liquidator] Gee has apparently not yet unraveled that small mystery." *In re Gee*, 53 B.R. 891 n. 1 (Bankr. S.D.N.Y. 1985). Subsequent discovery and the evidence at trial did not dispel the clouds (Kremer Depo. 273-283), and BDO Seidman certainly never bothered to pin down the facts on Universal's ownership, notwithstanding their auditing duty to do so. (*See, e.g.*, T. 1418-1419). Because it was Seidman's affirmative defense that Shah's conduct should be imputed to the Liquidator since it "benefitted" Universal, if the identity of, or amounts received by, other stockholders, if any, is material, Seidman had the burden of proof on the subject.

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from the audit and the client, and would never have issued the unqualified audit statements which launched Universal's international business, artificially kept it afloat for years, and allowed Shah to bleed it dry by letting him take out Universal's cash in the guise of 'dividends.' (T. 459, 471, 487, 508, 1428-1429, 1585, 1586, 1659). BDO Seidman's audit work alone stood to shield Universal and its policyholders from financial disaster, but because Seidman did not perform Universal's audits with the requisite auditing care, disaster followed as the night the day. (*Id.*)

b. Causation and damages

The manifest weight of the evidence introduced at trial demonstrated that it was BDO Seidman's audit reports which caused Universal to acquire ever deepening indebtedness to its policyholders, and BDO Seidman's negligent auditing which allowed Shah to loot Universal. (*See, e.g.*, T. 1118-1125, 1121, 1232-1233, 1503, 2995; Kramer Depo. 528-529; Haggerty Depo. 98; Butterworth Depo. 9, 14-15). The evidence showed that without the BDO Seidman audits Universal would not have been able to operate as an international reinsurer and collect the premiums it did (substantial portions of which were looted out by Shah, as detailed above), or acquire the insurance obligations it did. (*Id.*).

The words of BDO Seidman's own John Abernathy, who in 1978 was the managing partner of BDO Seidman's New York office and reviewing partner on the Universal audits (T. 562), offered the most graphic articulation of the significance of certified financial statements for Universal: "The company is in need of certified financial statements immediately, as they are turning down business until such certification can be obtained". (Memorandum dated May 2, 1978, Plaintiffs' Composite Exhibit 12, No. 21).

Trial witnesses for both parties who had experience or expertise in the reinsurance market were also in agreement on the necessity of audited financial statements for Universal to transact business in that market. (T. 1118-1125, 1221, 2995, Haggerty Depo. 24). As explained by one of BDO Seidman's own experts, insurance companies base decisions to buy reinsurance coverage on the financial stability of the company they are considering doing business with, and they look at the financial statement to determine this stability. (T. 2995). For companies such as Universal, which were not listed in the standard industry reference books, "the only other way to do business is to have an audit." (Haggerty Depo. 24). BDO Seidman certainly knew that *its* audited statements for Universal were being disseminated by the hundreds. (Kremer Depo., 527-529).[9]

BDO Seidman and its audits also became critical to Universal's existence on other fronts. (Butterworth Depo. 9, 17-18). First, Cayman insurance laws passed in 1979 and effective in 1980 required all Cayman insurance companies to be licensed by the Cayman Superintendent of Insurance. (Butterworth Depo., 9, 14-15). Audited financial statements were required for licensing, and the superintendent's office specifically relied on the BDO Seidman audits to issue Universal's license. (Butterworth Depo., 6-7, 43-44). Universal would not have been able to write insurance business without the license. (Butterworth Depo. 44). In addition, and as referenced above, the prospective attorneys for Universal had stated in writing (and BDO Seidman had a contemporaneous copy) that they would take no further action on behalf of Universal until the accountants certified the $10 million CD, so Universal needed BDO Seidman's audit to get legal

[9]BDO Seidman itself initially gave Universal 60 copies of its printed report, and BDO Seidman eventually provided Shah with 300 copies of the December 31, 1978 BDO Seidman audit. (Plaintiffs' Composite Exhibit 26, No.1, July 21, 1978 letter from BDO Seidman to Vishwa Shah; Kremer Depo. 527; Plaintiff's Composite Trial Exhibit 26, Tab 37).

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representation. (Plaintiffs' Exhibit 12, No.14). Finally, BDO Seidman served as a reference for Universal. (T. 2659).[10]

In fact, the Seidman audits enabled Universal to sell insurance quite successfully. (T. 721). When the Cayman Superintendent of Insurance finally suspended Universal's license in 1983, it turned out that one hundred and nineteen international reinsurance policyholders from all corners of the earth had coverage with Universal and had claims totalling $33,088,844.06. (T. 721-22; Butterworth Depo., 10-11; Plaintiff's Trial Exhibit 14).

Of the total, the Liquidator admitted claims in the amount of $16,236,969.94 and rejected $16,851,874.12. (Plaintiff's Trial Exhibit 14). The claims rejected were mainly for lack of supporting documentation. (T. 739-742, 817, 876, 877, 883). The Liquidator was able to realize $440,000 as an asset of Universal's in settlement as approved by the Cayman Grand Court. (T. 957, 1009, 1015). Thus, when the Liquidator had completed the claims process and the settlement, the Company's net deficit was $15,796,969.94. (T. 722, 1015, 3694).

2. BDO Seidman's defenses and trial decisions on presentation of same

At trial, BDO Seidman factually contested the liability and damages issues on the Liquidator's negligence claim with witnesses and evidence, but the jury ultimately resolved these factual issues against BDO Seidman. (R. 1098-1099).

BDO Seidman also raised various affirmative defenses. (R. 234-238). Seidman presented those affirmative defenses pertinent here *solely* on the basis of legal arguments, not disputed facts. (R. *passim*; T. *passim*). Specifically, the most significant of Seidman's defenses for

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[10]For example, in 1980 one of Universal's biggest clients became concerned about the $10 million capitalization, and called BDO Seidman. (T. 2659). BDO Seidman affirmatively — and completely inaccurately — told the caller that there was no reason to be concerned. (T. 2659).

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purposes of these review proceedings was an equitable defense of estoppel in which Seidman argued that misconduct by Shah should be imputed to Universal's Liquidator to defeat any recovery from BDO Seidman for its malpractice. (R. 737, p. 24; 1088-1089). BDO Seidman advanced this theory purely on case law arguments, asserting that if a corporate insider's misconduct works a short-term benefit to the corporation, the misconduct should be imputed to the corporation. (R. 1088-1089).

As discussed more fully below, it is significant that in connection with its estoppel defense BDO Seidman never offered any factual proof or requested any jury findings by special interrogatory verdict that: (1) Shah's fraud was a benefit to Universal; (2) Universal was an "engine of theft"; or (3) that Shah was the sole managing director of Universal. (R. *passim*, T. *passim*). If Seidman needed factual proof on any of these matters in connection with its affirmative defenses, the time to present that proof was at trial.[11] However, BDO Seidman presented no such proof, and, in fact, the evidence in the record detailed in the next section — from Seidman's own witnesses and documents — shows the factual opposites: (1) Shah's fraud did not benefit Universal; (2) Universal was not an 'engine of theft'; and (3) for whatever relevance it has, Shah was not the sole managing director of Universal.

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[11]BDO Seidman was well aware of its burden of proof in this regard as evidenced, for example, by its own requested jury instructions: "Seidman has the burden of proving by the greater weight of the evidence *all of the facts necessary to establish its affirmative defenses.*" (R. 996).

3. The Third District's decision

a. **The reversal of the jury verdict on the basis of a legally inapplicable — and factually unproven — equitable defense**

The Third District's decision reached the conclusion that the auditors would be absolved from all liability in the case despite the fact that the Petitioner/Liquidator's case of auditor negligence and resulting damages was supported by the manifest weight of the evidence. (R. 2080-2086). The basis for this holding of non-liability was stated to be — *not* any trial error or any failure in the Petitioner/Liquidator's proof— but that *equity* would relieve these conceded wrongdoers of liability for the damages they caused. (R. 2080-2086).

The entire basis for this conclusion on the equities was a factual 'finding' ***by the Third District panel*** — a factual finding which was never proven or requested by BDO Seidman, never made by the court or jury at the trial level, and which is in fact directly contradicted by the record evidence — that Universal *benefitted* from management fraud. (R. 2080-2086). As set forth below, the facts show precisely the opposite. Manager Shah consistently acted to the detriment of Universal and looted millions of dollars from the company.

b. **Factual inaccuracies in the Third District's decision**

i. **Uncontradicted record evidence that Shah looted Universal, bled it of its assets, and drove it ever deeper into insolvency**

The Third District reversed the jury verdict only on the basis of its own factual determination — *not* made by the jury or supported by the record — that Shah's conduct "benefitted" Universal, stating peremptorily: "It is a critical *fact* that Vishwa Shah's fraudulent act was committed for the benefit of the corporation". (R. 2085). The decision also states (inaccurately) that: "[T]he fraud committed by the managing director was not intended to loot

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the corporation[.]" (R. 2085) Finally, the opinion recites that "*without dispute* . . . [the] corporate officer's fraud intended to and did benefit the corporation[.]" (R. 2086). The Petitioner/Liquidator— and the entire record — not only dispute, but belie the Third District's "finding" that the corporate officer's fraud was a benefit to Universal, and thus the actual record facts are set out.[12]

A brief chronology of Universal's corporate existence is provided as background to detailing Shah's detrimental activities towards Universal. Universal already existed as a company before Shah came on the scene. (*See, e.g.,* Haggerty Depo. 10-11). Universal was actually started in July of 1977 by Owen Haggerty, an established reinsurance broker, well before Shah became involved with Universal about March of 1978. (Plaintiffs' Trial Exhibit 13, BDO Seidman Audit Report of June 30, 1978; Haggerty Depo., 10-11). Shah and Llewellyn Jones were the joint managing directors of Universal from mid-1978 until Shah became ill with heart problems in 1982 and 1983. (T. 2367, 2501, 2796, 2806, 2042-2043). Shah eventually resigned from Universal in late 1983, and one Pringle Reddy took over in his place. (T. 2042-2043).

During the course of Shah's tenure at Universal, the per annum premium income ranged from $400,000 to $7 million over that period of time, with total premiums of approximately $16 million for the 1978-1982 period. (Plaintiffs' Trial Exhibit No. 13, BDO Seidman Audit Reports for Universal 1978-1982). The net income of the company was $5,176,526.00. (*Id.*). As an insurance company, Universal needed to maintain a certain premium to net worth ratio to operate legally within the rules established by the Cayman Superintendent of Insurance to ensure

[12]As indicated above in this brief, BDO Seidman presented its imputation defense both at trial and on appeal as a purely legal argument. At no time did BDO Seidman present any *factual* evidence of — or arguments about — any benefits Universal allegedly received from Shah's activities.

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that the company had sufficient capitalization to pay policyholder losses. (Butterworth Depo. 23, 28, 43). The requirements are based on a 3:1 premium to capital ratio, which based on Universal's premiums resulted in a capitalization requirement of $1 million to $2 million per annum. (*Id.*)

Since $10 million in capitalization was more than adequate for the Cayman Insurance Superintendent's requirements, BDO Seidman's audit report "verifying" that figure was the reason Universal was licensed. (Butterworth Depo., pp. 6-7, 43-44). However, because the $10 million was non-existent, Universal did not, in fact, have adequate capitalization for the Cayman Insurance requirements. (T. 1659).

Given Universal's non-existent $10 million asset for capital, the "dividends" to Shah[13] were nothing more than thefts of corporate assets that could and should have been available to pay the claims of Universal's insureds. Shah was just bleeding the Company by looting it of the assets it did have in the form of cash received as premiums. As set out previously, a comparison of Universal's net income to Shah's 'dividend' takings from 1978 through 1982 shows that he was stripping Universal of as much available cash as he could. (Plaintiffs' Trial Exhibit No. 13). For example, in 1987, Universal's net income was $1.2 million and Shah took out $2.1 million. (*Id.*) Seidman legitimized Shah's looting by reporting it as 'dividends', which allowed a continual draining of the cash Universal could have used to honor its insuring obligations.

Not only was Shah looting all the cash out of Universal after it came in, but he had also made a deal to skim "commissions" out of the premiums due to Universal before they even came in: Shah set up Meridian, a brokerage company in Bermuda, in a fifty/fifty ownership

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[13]*See* note 8, *supra*.

deal with one Maurice Rutty. (T. 2075-2076, 2167, 2206). Although he did not perform any brokering, Shah — in complete breach of his fiduciary duty to Universal — shared in the commissions earned by Meridian. (T. 2167).

Furthermore, the $10 million CD Shah was 'providing' for the Company's capitalization — under the Third District opinion's "benefit" characterization — was an asset that owed interest income to Universal, and even at the lowest possible interest rates would have provided Universal in excess of a half a million dollars a year in income (T. 1659). Instead of Universal getting the interest, there was a cover-up and the interest was also reported/diverted as "dividends" to stockholders (T. 1660), i.e., Shah.[14]

Shah's activities continued to be detrimental to Universal to the end. Towards the latter part of 1983, Rutty advised Shah — as Shah was contemplating closing down Universal's business — that if Shah made $2.5 million available to Universal (Shah had by that time looted almost $6 million out of the company) then Universal could obtain enough reinsurance to pay all the claims which would arise against Universal. (T. 2089). Shah — acting adversely to Universal's interests — never did so. (R. *passim*).

Finally, BDO Seidman's own counsel contended at trial that Shah stole money from Universal. (T. 2070-2073). Counsel for BDO Seidman stated: "We have the right to assume he took the money out of Universal . . . ". (T. 2073). The only direct testimony on the subject of whether Shah's activities benefitted Universal was: "The purpose of the fraud was to line *Shah's* pockets." (T. 1656). In short, from start to finish Shah's activities were detrimental to Universal and illegally stripped it of its necessary cash and capital.

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[14]*See* note 8, *supra*.

ii. BDO Seidman's misstatements, *not* Shah's, caused the damages in this case

The Third District's opinion contains an additional significant factual inaccuracy. Specifically, the decision states that: "***Shah's*** fraudulent misrepresentation benefitted Universal as it was the prerequisite to the corporation's approval to continue in business, and was integral to its marketing program." (R. 2086).[15] This is not true. It was ***BDO Seidman's*** misrepresentations in its audit reports ***alone*** which were "the prerequisite to the corporation's approval to continue in business" and were "integral to Universal's marketing program." The facts of record show that neither the Cayman Superintendent of Insurance nor the policyholders who bought insurance from Universal would have or did take any action based on Shah's representations about the $10 million — it was *exclusively* BDO Seidman's representations in the audit reports that mattered. (Butterworth Depo., 6-7, 43-44; T. 1118-1125, 1221, 2995, Haggerty Depo. 24). The distinction was the perfectly obvious one between relying on an individual's remarks about what his company is worth, and what the certified public accountants say it is worth. (T. 1115-1116, 1118-1125, 1129, 2299).

The witnesses' comments on this subject were succinct and unequivocal. Universal was a fairly new company with no track record, and "any prudent insurance person would need to know Universal's financial stability before doing business with it." (T. 1115-1116). Prospective policyholders would certainly not take Vishwa Shah's word that Universal had $10 million. (T. 1118-1121). He was simply an individual and an unknown. (T. 1118-1121). BDO Seidman, on the other hand, by its own considerable promotional efforts was an internationally known auditing

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[15]This statement by the Third District — insofar as it suggests that it was beneficial to Universal to continue in business when it was insolvent — also runs directly counter to the case law on this point, as discussed in the argument section below.

firm whose verification of a $10 million asset meant that the asset in fact existed,[16] and it was the BDO Seidman audit reports alone which got Universal its business and its license. (T. 1118-1125, 1221, 2295; Haggerty Depo. p. 24; Butterworth Depo. 6-7, 43-44).

Petitioner believes the true facts on causation are significant because Shah's fraudulent representations by themselves had no capacity to cause and did not cause the damages in this case. Regardless of the relative degrees of culpability of Shah and BDO Seidman, it was BDO Seidman's tortiously issued audit reports alone which were causally linked to Universal's damages.

iii. The facts about Universal do not comport with the "engine of theft" characterization

The Third District decision characterizes Universal as an "engine of theft", although neither the decision nor the few cases which have used that catchphrase define what exactly an "engine of theft" is. Petitioner here responds by citing to the testimony and evidence from BDO Seidman's ***own partners*** on the Universal account, given during the litigation, and their own audit reports which distinctly contradict the "engine of theft" factual determination the Third District made.

John Abernathy, managing partner on the Universal account, testified as follows:

> *I am absolutely certain that this organization was set up as a legitimate enterprise* . . . There is no doubt in my mind that that is the way the company started and that is the way it operated for a number of years.

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[16]Or should have meant that the asset in fact existed.

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(T. 2414). Abernathy and audit partner Dennis Kremer both testified in their depositions in 1989 that they did not believe there was fraud in the company, or that they had ever been misled or deceived in the course of their audit work. (T. 586-587; Kremer Depo. p. 90).

It is also significant to note that Universal — presumably unlike an "engine of theft" — in fact operated properly as a reinsurance company and *paid out* policyholder losses for some years. (Plaintiffs' Trial Exhibit 13). The BDO Seidman audit reports show over $6.5 million paid to policyholders for losses covered by Universal insurance during the period from 1978 to 1982. (*Id.*). Furthermore, had BDO Seidman properly ascertained the undercapitalization, they would not have been able to report Shah's lootings as dividends, and Universal would have had more funds to pay on its policyholder loss obligations on which it was making substantial payments anyway. (*Id.*)

The "engine of theft" phrase is used in connection with the *Cenco* estoppel defense[17] cited in the Third District's decision and discussed in the argument section below, an affirmative defense on which BDO Seidman had the burden of proof. The Petitioner/Liquidator's evidence and the favorable inferences therefrom certainly do not support the characterization of Universal as an "engine of theft", but rather show Universal as an operating insurance company abused and looted by Shah.

Seidman itself certainly asked for no jury finding on this issue at trial, and for deliberate, strategic reasons. Seidman's defense at trial was that Universal was a legitimate company until the very end at which time Shah stole its money. Seidman advanced this position in order to support its arguments that its auditors had not been negligent at all, i.e., that the $10

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[17]*See, Cenco v. Seidman & Seidman*, 686 F.2d 449 (7th Cir. 1982), *cert. denied*, 459 U.S. 880 (1982), discussed in detail in the argument section below.

million was there all along so the Seidman audits were properly performed and accurate. For that strategic reason, the Seidman auditors' *own trial evidence and testimony* contradicts the "engine of theft" characterization.

The Third District accordingly had no record basis for introducing an 'engine of theft' characterization into the case, and certainly not where the party that stood to benefit was Seidman itself which spent the whole trial testifying to the contrary.

iv. Evidence relating to Universal's management

Since on appeal the Third District and Seidman are referring to Shah as the sole managing director of Universal, the Petitioner here points out the actual record facts.

BDO Seidman dealt with *two* managing directors of Universal as reflected throughout their testimony and workpapers and documentation. (T. 2367, 2501, 2796, 2806, Plaintiffs' Exhibits 12, 13, 26). BDO Seidman's managing partner Abernathy and audit partner Kremer both recognized that Llewellyn Jones was a managing director of Universal, separate and apart from Vishwa Shah. (T. 2367, 2501). BDO Seidman workpapers and other documents in their files confirm Llewellyn Jones as chairman of various Universal meetings, President of Universal, and as the "individual in the Cayman Islands in charge of the operations." (Plaintiff's Exhibit 12, Ex. 11, Ex. 21, Ex. 46, Plaintiff's Exhibit 13, Plaintiff's Exhibit 26). In fact, BDO Seidman approved Universal's internal controls on the basis of the divided responsibilities:

> We found the [internal control system] to be adequate because the President either performs or reviews all functions in addition to the Managing Directors.

(Plaintiff's Exhibit #26 - Ex. 47 (Tab 29) — Abernathy Engagement Partner's Memorandum).

* * *

In sum, the uncontradicted record evidence amply and unequivocally demonstrates that Shah's fraudulent acts did not benefit Universal, as the Third District's decision erroneously determined, but in fact looted what had been a legitimate insurance company, bled it of its assets and drove it ever deeper into insolvency. But for BDO Seidman's auditing negligence, these fraudulent actions would have been revealed — or perhaps never occurred — long before Universal's insolvency rendered it unable to meet its obligations to its insureds.

SUMMARY OF ARGUMENT

Tortious conduct by accountants in disseminating misleading audit reports for insurance companies has all too frequently been the legal cause of the artificial prolongation of insurance companies' corporate lives beyond insolvency. Invariably in such cases, tortious conduct by the insurance company's management will parallel that of the auditors. *Id.* Sooner or later, the insolvency comes to light and a liquidator or receiver is appointed.

The liquidator may then decide to sue either the auditors or management or both. When the auditors are sued, they inevitably defend by claiming — as BDO Seidman did here — that the fraud of management *benefitted* the company and thus should be imputed to the company, in whose shoes the liquidator stands, and therefore the liquidator should be estopped from recovering from the auditors notwithstanding their negligence.

A variety of cases have considered imputation defenses in a variety of contexts with differing results. However, *all* of the cases involving liquidators of insurance companies driven into insolvency by management fraud and auditor malpractice reject the imputation defense as a bar to recovery. Such cases — informed by the public need to protect the solvency of insurance companies — hold that being driven into insolvency is *not* a benefit to an insurance company and thus no estoppel defense will be heard to defeat recovery from auditors whose malpractice occasioned the insolvency or degree of insolvency. The Third District's decision stands alone in holding to the contrary. The Third District's decision is at odds with the other authorities, reaches a wholly inequitable result, and establishes disturbing legal precedent which runs counter to any public goals or policies which Florida should approve. This Court should adopt the law which protects insurance companies from insolvency, and which requires auditors whose negligence causes or contributes substantially to such insolvency to answer for their fault.

ARGUMENT

POINT I

THE LIQUIDATOR PROPERLY BROUGHT A CAUSE OF ACTION BELONGING TO UNIVERSAL AGAINST BDO SEIDMAN FOR ARTIFICIAL PROLONGATION OF UNIVERSAL'S CORPORATE EXISTENCE TO WHICH ESTOPPEL WAS NOT A DEFENSE

A. The verdict and its reversal

The evidence in the trial of this case showed that BDO Seidman is a firm of auditors which engaged in international promotional efforts in order to court clients world-wide and in order to induce the public at large to think of BDO Seidman as a prominent, reliable auditing firm. One of the clients BDO Seidman obtained was Universal Casualty & Surety, a Cayman Island insurance company whose insurance and reinsurance — thanks only to BDO Seidman — would come to be purchased throughout the world.

BDO Seidman owed its client Universal a duty to exercise professional care in performing Universal's audits so that Universal's audited financial assets would fairly reflect Universal's financial status. Had BDO Seidman exercised *any* care at all in performing its audits for Universal — had it picked up the telephone to make the most basic of required telephone calls — BDO Seidman would immediately have determined that the only asset of Universal's upon which company director Shah hoped to expand Universal into a major international reinsurance business was *non-existent*, a phony $10 million CD from a sham bank in a known hotbed of sham banks.

BDO Seidman's ineptitude and slothfulness in performing audits for its client Universal were little short of incredible. Year after year, Seidman issued certified 'audited' financial statements affirming the existence of $10 million dollars in assets which transparently

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were not there, and allowing manager Shah to steal millions of dollars of the company's operating capital. So egregious and so pathetic was the negligence that (1) it took the jury only 90 minutes after a five week trial to return a verdict finding BDO Seidman's negligence as well as the $15.7 million in damages it caused to Universal; (2) BDO Seidman has conceded its negligence at the appellate level since there was absolutely no way to argue that the jury's negligence finding was against the manifest weight of the evidence (SR. *passim*); and (3) the Third District itself acknowledged the negligence as a given: "BDO Seidman, the accounting firm hired by Universal to provide financial reports for dissemination to prospective policy holders, negligently failed to discover that the $10 million CD was non-existent." (R. 2081). The fact — and jury finding — that BDO Seidman's extended negligence caused Universal's damages is also accepted as a given by the Third District. (R. 2081).

In short, we come before this Court on an appellate record in which it is effectively uncontested that BDO Seidman is a tortfeasor whose negligence caused millions of dollars of damages to its client Universal Casualty. Nonetheless, using an *equity* principle — imputation of knowledge to create an estoppel — the Third District handed the malpracticing auditors a get-out-of-jail-free card and reversed the judgment on the jury's verdict. In these review proceedings, this Court can determine whether equity should countenance such a result and whether it represents sound precedent for the courts of this state.

B. The Third District's decision — inappropriate application of an imputation defense

The imputation issue on which the Third District decided the case arises from commonplace agency principles, as summarized, for example, in *Tew As Trustee for the Estate of E.S.M. v. Chase Manhattan Bank*, 728 F. Supp. 1551 (S.D. Fla. 1990):

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> Normally, the acts and knowledge of an agent are imputed to the principal. In the case of a corporation, it can only act through its agents. Therefore, the rule is that actions of corporate directors and officers are attributable to the corporate entity. . . .
>
> * * *
>
> As with almost all rules, there is at least one exception. ***If the agent is acting adversely to the principal's interests, the knowledge and misconduct of the agent are not imputed.***

728 F. Supp. at 1560.

Under these imputation principles, the question is whether Shah's activities were a benefit to Universal or were adverse to Universal's interests. As set forth above, the *facts* in the record from Seidman's own audit reports uncontrovertedly show that Shah was looting and cheating the company. Thus, there is no *factual* showing of benefit to Universal.

It is also undisputed that Universal was driven ever deeper into insolvency as the Seidman audit reports were used to incur further and further insuring obligations for Universal while Shah looted out its cash. The issue before this Court as a matter of law, therefore, is whether tortious activities which lead to ever greater insolvency for an insurance company should be treated as beneficial to the company or as detrimental.

1. Background principles of corporate and insurance law

Certain basic principles of corporate and insurance law — overlooked or ignored by the Third District — are initially set out as background for answering the imputation question.

Firstly, it is "elemental jurisprudence that a corporation is a creature of the law, endowed with a personality separate and distinct from that of its owners[.]" *Berger v. Columbia Broadcasting System, Inc.*, 453 F.2d 991, 992 (5th Cir. 1972), *cert. denied*, 409 U.S. 848 (1972). As this Court has stated: "The corporate entity is an accepted, well used and highly regarded

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form of organization in the economic life of our state and nation." *Robert's Fish Farm v. Spencer*, 153 So. 2d 718, 721 (Fla. 1963).

The law protects the *separate* identity of the corporation with the corollary principle of corporate law that officers, directors and dominant stockholders owe fiduciary duties to the company.

> A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders.
>
> * * *
>
> Their dealings with the corporation are subjected to rigorous scrutiny . . . . for that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation — creditors as well as stockholders.

Pepper v. Litton, 308 U.S. 295, 306-307 (1939). Professionals performing services for the corporation, of course, owe a duty *to the corporation* to use the requisite professional care.

The significant point to note is that Universal here had its own separate entity and existence, apart from any shareholders, officers, directors, or creditors. Corporate manager Shah owed Universal a fiduciary duty to protect and promote its corporate interests so that it could operate appropriately and fairly as an insurance company. Corporate auditors BDO Seidman owed Universal a duty to use professional auditors' care in performing Universal's audits so that Universal could honorably conduct business with a true depiction of its financial condition. Both Shah and BDO Seidman breached their duties to the corporation, and it was the corporation which was damaged by the torts of its officers and auditors.

The fact that Universal was an insurance company is also of pivotal significance to the determination of the issues in this case. Insurance is a specialized and highly regulated

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industry in modern economic life which has a profound impact on public interests in almost all phases of life.

> Perhaps no other business affects the public so intimately as does the insurance business. It is entirely clear that the business of insurance is affected with a public interest.

VANCE ON INSURANCE (West 1951), p. 36. *See also, e.g., Springer v. Colburn*, 162 So. 2d 513 (Fla. 1964). This Court so recognized in *Feller v. Equitable Life Assurance Co.*, 57 So. 2d 581, 586 (Fla. 1952):

> The business of insurance has become one of the dominating businesses of the world . . . [and] the business of insurance is affected with a public interest as much as any other business in the United States.

Precisely because the insurance industry so vitally affects the public's interests — and because the public is so dependent on insurance company solvency to pay losses when the need is activated by catastrophe or otherwise — insurance companies are highly regulated. VANCE, *supra; Springer, supra; Feller, supra. See also, e.g.*, 30 Fla. Jur. 22 Insurance §14. Under both Florida and Cayman law, insurance companies must submit annual audited financial statements to the Insurance Commissioners in order to become and remain licensed. The reason for the requirement is that it is critical for regulators and policyholders to have access to independently verified information about an insurance company's financial condition, i.e., audited financial statements from an independent firm of certified public accountants.

2. The imputation defense is inapplicable in cases involving insolvent insurance companies

Against these background principles, we turn to a discussion of the body of law which has developed to provide answerability and redress when the misconduct of an insurance

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company insider combines with the malpractice of its auditors to present a false surface picture of financial well-being, when in fact the insurance company is being driven ever deeper into insolvency.[18] Of pivotal significance is the point — overlooked by the Third District — that this body of law specifically rejects the proposition that an artificially prolonged corporate existence masking an underlying insolvency is *beneficial* to the insurance company. Thus, no estoppel defense will be permitted to defeat recovery against the auditor and corporate officer tortfeasors.

Under this body of law — the leading case of which is *Schacht v. Brown*, 711 F.2d 1343 (7th Cir. 1982), *cert. denied*, 464 U.S. 1002 (1983) — Universal had a claim, properly brought by the Liquidator against BDO Seidman, for the artificial and tortious prolongation of Universal's corporate life which caused Universal to be saddled with additional liabilities and be driven deeper into insolvency. *See also, e.g., Foster as Rehabilitator of Mutual Fire, Marine & Inland Insurance Co. v. Peat Marwick Main & Co.*, 587 A.2d 382 (Pa. Commw. Ct. 1991); *In re Liquidation of Integrity Insurance Co.*, 573 A.2d 928 (N.J. Super. Ct. App. Div. 1990); *Corcoran as Liquidator of Union Indemnity Insurance Co. v. Hall & Co.*, 545 N.Y.S.2d 278, 149 A.D.2d 165 (App. Div. 1989); *Holland v. Alexander Grant & Co.*, 70 B.R. 729 (Bankr. N.D. Ill. 1987); *Bonhiver v. Graff*, 248 N.W.2d 291 (Minn. 1976).[19] These cases — all of which involve insurance companies in liquidation — stand for the proposition that mounting debts after insolvency cause

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[18] *See generally* D. Howard, *Making Accountants Account for Themselves When an Insurance Company Has No Tomorrows*, 40 FED'N OF INS. CORP. COUNS. Q. 342 (1990).

[19] The principle has also been acknowledged in non-insurance company cases on the *Schacht* rationale. *See, e.g., Tew as Trustee for the Estate of E.S.M. v. Chase Manhattan Bank*, 728 F. Supp. 1551 (S.D. Fla. 1990); *Feltman as Trustee for First Financial Planning v. Prudential Bache Securities*, 122 B.R. 466 (S.D. Fla. 1990); *In re Huff*, 109 B.R. 506 (Bankr. S.D. Fla. 1989); *Robertson as Trustee of the Farmer's Co-Op v. White*, 633 F. Supp. 954 (W.D. Ark. 1986).

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injury to the insurance company itself for which the company's liquidator may sue its former auditors whose inaccurate audit reports caused an illusion of continuing economic viability.

The rationale behind the cases derives from the basic proposition of corporate law referenced above, i.e., that a corporation is a separate entity with its own rights, including (1) the right to be free from management abuse and auditor malpractice, and (2) the right to maintain its honor, so to speak, by not being caused through tortious conduct to acquire debts it cannot discharge. Those whose tortious conduct causes the company to wrongfully acquire debts it cannot repay will be required to restore to the company its net deficit for distribution to creditors so it may discharge its obligations and retire with a clean slate.

Auditors inevitably argue, as Seidman did here (in arguments adopted and expanded by the Third District), that the management's misconduct *benefitted* the company as a basis for advancing an imputation defense, relying on *Cenco* and other non-insurance company cases discussed below. The point sufficient to note here is that whatever the holdings in other contexts — and however wise or unwise they may be — the cases on point involving insurance companies are clear that the separate corporate existence is *not* benefitted by artificial prolongation through false depiction of its true financial position. *Schacht, supra.*[20] "A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." *In re Investors Funding Corp.*, 523 F. Supp. 533, 541 (S.D.N.Y. 1980). "[T]he

[20]A liquidator specifically has standing to bring an insurance company's artificial prolongation of life suit against its former auditors for falsely representing the company's financial position. *Schacht, supra; Corcoran, supra.* The injury is to the insurance company itself, and *not* just to the company's policyholders and creditors although naturally they are derivatively injured also. *Schacht, supra, Corcoran, supra.* The measure of damages to the insurance company is the net deficit it ended up with as a result of the artificial prolongation. *Bonhiver, supra.*

artificial financial picture of [the company] which prolongs [its] existence several years beyond [its] actual insolvency [is not a benefit to the company]." *Id.* As the *Schacht* court said:

> [C]ases [which] suggest that a corporation may not sue to recover damages resulting from the fraudulent prolongation of its life past insolvency . . . ***rest upon a seriously flawed assumption, i.e., that the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests.*** [cites omitted].
>
> ***This premise collides with common sense, for the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability.***

Schacht v. Brown, 711 F.2d at 1350.

In *Corcoran, supra,* the court also succinctly stated the principle:

> Misrepresentations as to Union [Indemnity Insurance Co.'s] true financial condition concealed Union's financial condition and its eventual insolvency, and caused Union to assume additional risks and thereby increase the extent of its exposure to creditors.
>
> . . .
>
> ***Contrary to the defendants' [including auditors] contention that such conduct injured only Union's creditors, . . . failure to disclose the insolvency of an insurance company is an injury to that corporation for which [the liquidator] may institute an action.***

545 N.Y.S.2d at 283, 149 A.D. 2d at 175.

The *Schacht* court directly rejected the defendant auditors' arguments that continuing the insurance company's active corporate existence during deepening insolvency was a benefit:

> [T]he fact that Reserve's existence may have been artificially prolonged pales in comparison with the real damage inflicted by the diminution of its assets and income.
>
> . . .

> [I]f defendant's position were accepted, the possession of such "friends" as Reserve had would certainly obviate the need for enemies.

711 F.2d at 1348. The notion that being continued in existence only to acquire ever-more indebtedness is beneficial to the company was discarded as fatuous (a "pyrrhic benefit" as the *Schacht* court put it); the corporate officers were clearly acting adversely to the company's interests and therefore their actions would not be imputed to the company or the Liquidator acting on its behalf. (*Id.*).[21]

3. The Third District's misplaced reliance on inapposite cases and inequitable result

The Third District ignored the *Schacht* rule that artificial prolongation of an insurance company's life into insolvency is *not* to be deemed a benefit.[22] Instead, the Third District relied primarily on two inapposite pre-*Schacht* decisions *from the same Circuit as Schacht*, both of which were distinguished in *Schacht* for precisely the same reasons they are distinguishable here.

a. *Cenco*

The Third District's main reliance was placed on the decision in *Cenco v. Seidman & Seidman*, 686 F.2d 449 (7th Cir. 1982), *cert. denied*, 459 U.S. 880 (1982), which was issued by the Seventh Circuit about a year before that same court decided *Schacht*. The most significant

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[21]*See also, e.g.*, *Kempe as Liquidator of Dover Insurance Co. v. Monitor Intermediaries, Inc.*, 785 F.2d 1443 (9th Cir. 1986); *In re Liquidation of Integrity Insurance Co.*, 573 A.2d 928 (N.J. Super. Ct. App. Div. 1990); *Corcoran, supra.*

[22]The Third District referenced *Schacht*, but 'distinguished' it on grounds that the corporate officers in *Schacht* were looting the insurance company. Of course, as shown in the recitation of the facts above, looting by corporate officer Shah was precisely what was occurring in this case as well, which fact mandates application of *Schacht* under the Third District's own reasoning.

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distinguishing features of *Cenco* are (1) that *Cenco* did not involve an insurance company, and more critically, (2) *that Cenco did not involve a corporation which had been driven into insolvency* by its officers' looting and accountants' negligence, but rather an ongoing business which had directly been *aggrandized* by the fraudulent schemes in which management was involved. Thus, the issue of whether tortiously-induced insolvency is beneficial or not — which is the only issue in the instant case — *was never presented in Cenco.*

Because *Schacht* and *Cenco* are the main authorities considered in cases throughout the country when dealing with potential imputation/estoppel defenses, it is worth setting out the *Cenco* facts which graphically demonstrate why the *Schacht* court a year later determined that the *Cenco* estoppel holding does not apply to the insurance-company-driven-into-insolvency cases.

Cenco was a publicly held corporation that sold medical supplies. For a period of five years, some, but not all, of Cenco's top management were engaged in a massive fraud which involved misrepresenting certain inventories far above their actual value. 686 F.2d at 451. At all times, however, the fraud in Cenco was being committed on behalf of the company — there was no looting or stealing by the fraudulent manager/shareholders. *Id.* Rather, the value and assets of the corporation in Cenco were *increased* by the fraud. *Id.* For example, the fraud (1) greatly inflated the value of Cenco's stock which was used to buy up other companies at bargain prices, (2) allowed Cenco to borrow money at lower rates, and (3) enabled Cenco to get its insurers to pay inflated claims for inventory lost or destroyed since Cenco's insurance claims were based on inflated rather than actual inventory values. Under these factual circumstances, the *Cenco* court determined that the fraud was for the benefit of the company:

> Thus, ***those involved in the fraud were not stealing from the company, as in the usual corporate fraud case***, but instead were aggrandizing the company (and themselves) at the expense of outsiders, such as the

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> owners of the companies that *Cenco* bought with its inflated stock, the banks that loaned *Cenco* money and the insurance companies that insured its inventories.

686 F.2d at 451. It was also these facts which led the *Cenco* court to characterize the company as having been turned into an 'engine of theft' against outsiders. 686 F.2d at 454.[23] *Id.*

Throughout the five-year period that the fraud in connection with Cenco's inventories continued, Cenco's independent auditor was none other than BDO Seidman, which "either never discovered the fraud or if it did failed to report it." 686 F.2d at 451. When the fraud was eventually discovered by a new corporate financial officer, a class action against Cenco, the corrupt managers, and Seidman, was brought by the Cenco stockholders who purchased stock during the fraud. Cenco filed a cross-claim against Seidman, and Seidman cross-claimed against Cenco.

Prior to trial, both Cenco and Seidman settled with the class. The claims between Cenco and Seidman remained pending. The trial court directed a verdict for Cenco on Seidman's cross-claim and the jury found for Seidman on all three of Cenco's common law claims. On appeal, the issue concerned the propriety of a jury instruction which permitted the imputation of management's fraud to Cenco as a complete estoppel defense for Seidman. The *Cenco* court decided that an estoppel was appropriate in that case because the fraud had actually benefitted the company. In reaching its conclusion, the Cenco court noted that all tort decisions should be

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[23]Petitioner disagrees with *Cenco* and other authorities insofar as they suggest that it is ever appropriate to consider fraud a 'benefit' to any corporation. Petitioner submits that such thinking disregards the law establishing and protecting the separate corporate entity. *Any* actions by corporate officers or employees which use the company for *any* dishonest or less than honorable purposes are — and should always be deemed by the law to be — *detrimental* to the company. Only in that way can the law protect corporate entities and attempt to ensure that they are put only to proper uses.

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guided by the two goals of tort recovery: compensation to victims, and deterrence of future wrongdoing.

On the compensation prong of its tort recovery analysis, the *Cenco* court expressed the concern that only true *victims* of fraud should be entitled to compensation. Under the *Cenco* facts, as it turned out, recovery by Cenco from its auditors would benefit Cenco stockholders and, the *Cenco* court noted, the facts showed that there were only three potential groups of Cenco's stockholders who could possibly receive any benefits from a judgment against the accountants, *none* of whom were entitled to compensation: (1) stockholders who had actually participated in the fraud and thus clearly deserved no compensation, (2) stockholders who had already recovered from the class action settlement and thus had no need for compensation, and (3) stockholders who bought after the fraud was uncovered and who accordingly suffered no losses as a result of it. In short, there were no victims in *Cenco* for whom compensation would be appropriate. The *Cenco* court thus found that entering judgment against the auditors would be inappropriate because: "Once the real beneficiaries of any judgment are identified, it is apparent that such a judgment would be perverse from the standpoint of compensating the victims of wrongdoing." 686 F.2d at 455.

The second *Cenco* concern was deterrence of future wrongdoing. The court concluded that deterrence of management fraud could best be accomplished by placing the entire burden of detecting and preventing such fraud on shareholders, rather even than on admittedly negligent professional auditors:

> If Seidman had been a more diligent auditor, conceivably if it had been a more honest auditor, the fraud might have been nipped in the bud; and liability to Cenco would make Seidman, and firms like it, more diligent and honest in the future. But if the owners of the corrupt enterprise are allowed to shift the cost of its wrongdoing

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> entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced.

696 F.2d at 455. The *Cenco* court suggested that shareholders should hire their own independent auditors, be more diligent in hiring management and electing directors, and that large shareholders should do even more to monitor management. 686 F.2d at 455-456. Whatever the wisdom of attempting to place this burden on shareholders (and *Cenco* has been sharply criticized on this point from shortly after issuance of the decision),[24] such an analysis only makes sense in a factual setting like *Cenco* where the corporation is ongoing, and shareholders, large and small, actually exist and thus can still be motivated to "monitor".

When the *Schacht* case came up a year later involving an insurance company looted into insolvency (like Universal here), rather than an ongoing corporation whose value and assets had been increased by the fraud, the *Schacht* court considered — and discarded — the *Schacht* defendants' suggestion that a *Cenco* estoppel should apply. Firstly, and dispositively, the *Schacht* court, as previously discussed in full, flatly rejected the notion that being driven deeper into insolvency could be considered a "benefit" to the company, unlike the fraud in *Cenco* which actually did increase the company's assets.

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[24]Commentators appropriately question the wisdom of excusing malpracticing auditors for the avowed purpose of encouraging shareholder vigilance over corporate affairs. Shareholders of most corporations have neither the time nor the wherewithal to investigate and audit company affairs, whereas auditors are in the business of — and get paid for — doing just that. *See, e.g.*, Note, *Cenco, Inc. v. Seidman & Seidman: A Futile Attempt to Deter Management Fraud*, 1984 DUKE L.J. 141; J. Cay, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 757, 772, 774 (1984); Marion Probst Rosner & Jeffrey H. Squire, *The* Cenco *Defense*, *in* ACCOUNTANTS' LIABILITY 1988 (PLI Corp. Law & Practice Course Handbook Series No. 383).

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The court also went on to say that: "Even if a *Cenco*-type analysis were applied to the instant case, however, it would not yield the result that defendants urge." 711 F.2d at 1348. The *Schacht* court explained:

> In *Cenco*, we undertook a ***two-pronged analysis*** to determine whether such [denial of liability] should occur: ***whether a judgment in favor of the plaintiff corporation would properly compensate the victims of the wrongdoing, and whether such recovery would deter future wrongdoing.*** *Cenco*, 686 F.2d at 455. We find that, if warranted by the proof at trial, recovery by the Director on behalf of Reserve would do both.

711 F.2d at 1348. The facts presented in the *Schacht* case showed that — unlike in *Cenco* —both of the two prongs were met, as they are here: (1) the eventual recovery would compensate victims of the wrongdoing, and (2) the recovery would deter future wrongdoing. On the first prong, the *Schacht* court said:

> ***First, any recovery by the Director from the instant suit will inure to Reserve's estate.*** And under the distribution provisions of the governing liquidation statute, ***it is the policyholders and creditors who have first claim*** (after administrative costs and wages owed) ***to the assets of the estate.*** Ill.Rev.Stat., ch. 73, § 817 (1981). ***Thus, the claims of these entirely innocent parties must be satisfied in full before Reserve's shareholders***, last in line for recovery, ***receive anything.***

711 F.2d at 1348. Precisely the same situation obtains here, as the Cayman laws provide for exactly the same distribution order (which is also exactly the same as that provided under the Florida Insurance Code, see § 631.271, Fla. Stat.), with recovery going first to administrative costs, then to the innocent policyholders and creditors. No claims were made by Shah or any shareholders, nor would the Liquidator pay them if made (T. 734-345), so no wrongdoers stand to benefit here.

On the second prong — deterrence of future wrongdoing — the *Schacht* court said:

> Second, from the standpoint of deterrence, [in *Cenco*] . . . there existed large corporate shareholders in a position to police the

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> plaintiff's corrupt officers, an activity that would be discouraged by allowing the shifting of corruption-caused loss to outside defendants. *Cenco*, 686 F.2d at 456. By contrast, here, as noted earlier, there is no evidence that the wrongdoing officers of Reserve would benefit directly from the instant suit. There is also no evidence here of the existence of large corporate shareholders capable of conducting an independent audit, as in *Cenco*, and whose lack of investigatory zeal would be rewarded by a decision favorable to the Director.

711 F.2d at 1349. Here also, the wrongdoing director of Universal will *not* benefit from the Liquidator's recovery, nor was there ever any evidence of "large corporate shareholders capable of conducting an independent audit . . . whose lack of investigatory zeal would be rewarded" by the Liquidator's recovery in this case. Any such shareholders as may have existed[25] will certainly not be paid from the Liquidator's recovery here. (T. 734-735).

In short, the *Schacht* and *Cenco* decisions *both* dictate precisely the opposite result than that reached by the Third District. Since application of an estoppel here would *thwart* the *Cenco*-articulated goals of tort recovery, no estoppel should apply.

b. ***Security America***

The Third District also relied on an unpublished pre-*Schacht* decision from an Illinois district court, *Security America Corporation v. Schacht*, No. 82-C-2132 (N.D.Ill. 1983) (also not an insurance company case) for the proposition that in determining whether a corporation has "benefitted" from an insider's fraud (and thus whether the fraud should be imputed to the corporation), the only concern is whether the fraud benefitted the corporation in the ***short-term***.[26]

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[25]*See* note 8, *supra*.

[26]The panel stated: "The ultimate financial demise of Universal Casualty & Surety Co. was not the determining issue in the case before us." (R. 2086).

As set forth below, this proposition represents out-dated and bad law even in the Seventh Circuit where it originated. It should never have been adopted in Florida.

The Seventh Circuit in *Schacht* ***rejected*** the notion that short-term benefits — like continuing in business — are sufficient to trigger imputation of management fraud to a company:

> [A]s a consequence of the illegal activities of Reserve's directors and the outside defendants, Reserve was, *inter alia*, fraudulently ***continued in business past its point of insolvency and systematically looted . . . In no way can these results be described as beneficial to Reserve.***
>
> . . .
>
> [Reserve's artificial prolongation] pales in comparison with the real damage allegedly inflicted by the diminution of its assets and income. *Under such circumstances, the prolonged artificial insolvency benefitted only Reserve's management, and the other alleged conspirators, not the corporation . . ..* ***We do not believe that such a Pyrrhic "benefit" to Reserve is sufficient to even trigger the Cenco analysis which seeks to determine the propriety of imputing to the corporation the directors' knowledge of fraud.***

711 F.2d at 1347-1348. The *Schacht* court's comments recognized that continuing a company in business may well have short-term benefits for the company because the company is still taking in money. But if the money is being siphoned off by a fraudulent insider and the company is sliding further and further into insolvency, it is myopic in the extreme to characterize the short-term infusion of additional fraudulently obtained funds as "beneficial" to the corporation.

The only other case which has mentioned the *Security America* short-term benefit concept rejected the notion that it would apply in *Schacht*-type situations where the "misconduct is entirely oriented toward the ultimate bleeding of [the company] by its corrupt managers." *In re Wedtech Corp.*, 81 B.R. 240, 242 (Bankr. S.D.N.Y. 1987).

The *Security America* short-term benefit rule is also, the Petitioner submits, simply a bad idea that will make for bad law. Every fraud which is perpetrated through the use of a

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corporate entity benefits the corporation at least for a short term — if only for the time it takes for the money to be deposited in the corporate bank account and then withdrawn by its fraudulent "insider." Short-term benefits are so pyrrhic and ephemeral in looting cases that they should never be deemed benefits at all in the law. Adoption of a rule that short-term benefits are sufficient to trigger an imputation/estoppel defense in practice will always deny corporations the ability to sue their negligent auditors who should have discovered that the corporate entity was being abused for fraudulent purposes. The short-term benefit rule should be rejected on grounds that it can only lead to inequitable results.

c. The *FDIC* cases

The Third District also relied on one[27] of the many FDIC cases which have come to abound of late in connection with numerous savings and loan fiascos.[28] These FDIC cases, of course, do not arise in the insurance context, but rather as part of a vast federal regulatory scheme, and thus are not governing in state court insurance insolvency cases. The FDIC cases do, however, have some similar issues on imputation and estoppel when FDIC receivers seek recovery from professionals — like attorneys and auditors — for failing to uncover or participating in corrupt schemes of the banks' corporate insiders.

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[27]*FDIC v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992).

[28]*See, e.g.*, *FDIC v. O'Melveny & Meyers*, 969 F.2d 744 (9th Cir. 1992), *cert. granted*, ____ U.S. ____, 62 U.S.L.W. 3275, 1993 WL 384231 (Nov. 29, 1993); *FDIC v. Shrader & York*, 991 F. 2d 216 (5th Cir. 1993) *petition for cert. filed*, 62 U.S.L.W. 3336 (Oct. 26, 1993)(No. 93-651); *FDIC v. Clark*, 978 F.2d 1541 (10th Cir. 1992); *FDIC v. Ernst & Young*, 967 F. 2d 166 (5th Cir. 1992); *FDIC v. Thompson and Knight*, 816 F. Supp. 1123 (N.D. Tex. 1993); *FDIC v. Niblo*, 821 F. Supp. 441 (N.D. Tex. 1993); *FDIC v. Benjes*, 815 F. Supp. 1415 (D. Kan. 1993); *FDIC v. Nathan*, 804 F. Supp. 888 (S.D. Tex. 1992); *FDIC v. Gantenbein*, 811 F. Supp. 593 (D. Kan. 1992); *FDIC v. Regier, Carr & Monroe*, No. CIV-92-075-S (E.D. Okla. Aug. 17, 1992) (Order); *FDIC v. Deloitte & Touche*, 1992 WL 535588 (E.D. Ark. Oct. 1, 1992) (Order).

The Federal Circuits have basically ended up split on how to treat the imputation/estoppel issues. The Fifth Circuit has allowed an imputation defense to shield malpracticing auditors and lawyers from liability,[29] while the Ninth[30] and Tenth[31] Circuits have adopted the Seventh Circuit's approach from *Schacht* refusing to countenance any notion that being driven into insolvency or being used to perpetrate a fraud is a *benefit* to a corporation, holding, for example:

> [D]isaster, not benefit, accrued to [the savings bank] through the malfeasance of [its corrupt corporate officers]. *Schacht* and *Investors Funding* elaborate that conduct aggravating a corporation's insolvency and fraudulently prolonging its life does not benefit that corporation. Indeed, under *Schacht*, even if the corporation were somehow to benefit from the wrongdoing of insiders, the insiders' conduct is not attributable to the corporation if a recovery by the plaintiff would serve the objectives of tort liability by properly compensating the victims of the wrongdoing and deterring future wrongdoing.

FDIC c. O'Melveny & Meyers, supra, 969 F.2d at 750. The conflict has been accepted for resolution by the United States Supreme Court which recently granted a petition for certiorari review in *FDIC v. O'Melveny & Meyers, supra* — see 62 U.S.L.W. 3275, 1993 WL 384237 (Nov. 29, 1993) — and a petition for certiorari review is also pending in *FDIC v. Shrader & York,* 62 U.S.L.W. 3336 (Oct. 26, 1993)(No. 93-651). The future of the rulings in the *FDIC* cases are thus uncertain at this juncture.

As stated previously, the Petitioner/Liquidator believes that the *FDIC* cases are not governing in insurance insolvency cases. However, insofar as any analogies are to be drawn, the

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[29]*See FDIC v. Ernst & Young, supra; FDIC v. Shrader & York, supra.*

[30]FDIC *v.* O'Melveny & Meyers, 969 F.2d 744 (9th Cir. 1992), *cert. granted,* ____ U.S. ____, 62 U.S.L.W. 3275, 1993 WL 38423 (Nov. 29, 1993).

[31]*FDIC v. Clark,* 978 F.2d 1541 (10th Cir. 1992).

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Petitioner submits that the decisions which follow the *Schacht* rationale are much better reasoned and much more in harmony with equity. The *O'Melveny* court, for example, refused to allow malpracticing professionals to use imputation principles to advance an equitable defense of estoppel, both on the *Schacht* rationale and, quite simply, because a firm of professionals "cannot invoke an estoppel defense unless it is innocent itself." 969 F.2d at 744. Similarly, employing the age-old maxim that equity does equity, the *O'Melveny* court decided that even if certain equitable defenses might be appropriate against a bank because of the bank's officers misconduct, they would not be allowed against the receiver who had nothing to do with the wrongdoing and who represents the rights of the separate corporate entity whose obligations to third parties must be met. 969 F.2d 751-752.

The Third District ignored the *O'Melveny* line of cases and relied instead on *FDIC v. Ernst & Young*, although the court in that case specifically limited its holding narrowly to the facts of the case under Texas law. 967 F.2d at 172. The *Ernst & Young* case mechanically applied imputation principles to bar recovery from negligent auditors without any concern for — or reference to — equity's ends and admonitions with the predictably inequitable result that wrongdoers were absolved from liability and the wrong was left unremedied.

d. The Third District's decision perverts equity into an instrument for furthering injustice

Petitioner finally notes that the Third District's decision relieving these negligent auditors from the damages caused by their malpractice was based solely on *equity*, thus completely upending equity's intent to protect the innocent and to promote justice — but never to aid the wrongdoer.

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> The doctrine of estoppel is for the protection of innocent persons, and *only the innocent may invoke it.* A party may not invoke an estoppel for the purpose of shielding himself from the results of his own . . . dereliction of duty[.].

Meyers v. Moody, 693 F.2d 1196, 1208 (5th Cir. 1982), *cert. denied*, 464 U.S. 920 (1983). *See also*, *Reitano v. Fote*, 50 So. 2d 873 (Fla. 1951); *Standard Accident Insurance Company v. Bear*, 184 So. 97 (Fla. 1938).

Based specifically on these principles of equity jurisprudence, an imputation defense by malpracticing auditors against its insolvent insurance company client (like Seidman's here) was emphatically rejected in a case directly on point — *In re Liquidation of Integrity Insurance Co.*, 573 A.2d 928 (N.J. Super. Ct. App. Div. 1990). BDO Seidman's counterpart auditors in *Integrity* were Touche Ross, who argued — as Seidman did here and as the Third District reasoned — that since "Integrity's officers and directors were part of the fraudulent scheme to misrepresent the corporation's financial condition, Integrity must be regarded as having the knowledge of its agents [and therefore the Integrity Liquidator is estopped to recover from the Touche Ross auditors]." 573 A.2d at 928. The *Integrity* court succinctly pointed out that such an argument was quite wrong because the doctrine of constructive notice "is not available to one who contributed to the misconduct sought to be imputed." 573 A.2d at 941-942. The court emphasized that equitable principles are not to be invoked by wrongdoers, and thus negligent auditors are in no position to invoke an imputation defense based on management fraud:

> Therefore, even though an agent (the directors and officers) of a principal (Integrity) may be responsible for falsity, the third party's (Touche) culpability, if established, would estop it from raising the defense of imputation.
>
> ***The rule of implied notice is invocable to protect the innocent, never to promote an injustice.***

573 A.2d at 941-942.

BDO Seidman was in precisely the same situation here. No one was in a better position to know of Shah's fraud than BDO Seidman, whose *duty* it was as auditors to find out the true facts about Universal's financial condition. (T. 1528). BDO Seidman's negligently issued audits were the instruments of misrepresentation about Universal's financial condition which caused Universal to continue on in business racking up debts.

The bottom line of the Third District's "equity" decision is that the wrong committed by these auditors against their client Universal will go without a remedy. This conflicts directly with Florida equity jurisprudence which holds unequivocally: "It is a principle implicit in section 4 of the Declaration of Rights, Constitution of Florida, that equity will not permit a wrong to go without a remedy." *Farrington v. Flood,* 40 So. 2d 462, 465 (Fla. 1949).

The Third District's decision strips the Liquidator of a recovery of $16 million dollars in losses the malpracticing auditors caused the company. The Liquidator's recovery represents funds held for the benefit of all lawful claimants.[32] To dissipate that recovery via the Third District's estoppel holding is to use equity to ensure that a wrong goes unremedied, a particularly inappropriate result in the context of a receivership, where funds have been recovered for ultimate distribution to innocent claimants.

[32]Under the law of this Court, "The receiver is an arm of the Court and the funds in his possession are as though they were in the hands of the Court and are held for the benefit of all lawful claimants." *Columbia Bank for Cooperatives v. Pkeelanta Sugar Cooperative,* 52 So. 2d 670, 673 (Fla. 1951); *Knickerbocker Trust Company v. Green Bay Phosphate Company,* 56 So. 699 (Fla. 1911) (a receiver is the agent of the court). In their capacity as agents of 'arms' of the courts, receivers' recoveries are recognized as holdings for benefit of claimants: "The Court must zealously guard the funds in the hands of a receiver in the interest of all claimants thereto." *Columbia Bank, supra,* 52 So. 2d at 673.

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Equity had no interest in aiding these wrongdoing auditors, and the Third District's "equity" decision should be reversed.

POINT II

THE IMPACT OF THE THIRD DISTRICT'S DECISION: WHY THE CASE IS OF EXCEPTIONAL IMPORTANCE

This case is not only one of first impression in Florida, but it will have major impact in two areas of public interest and importance.[33] The holding of the Third District decision represents a significant departure from present universally accepted principles governing auditor liability. The decision also severely impairs insurance liquidators' rights of recovery from one of the two virtually inevitable groups of tortfeasors who are involved when an insurance company is tortiously driven into liquidation — negligent or fraudulent management and negligent auditors.

A. Departure from set principles of auditor liability

An established principle of auditor liability for failure to detect management fraud is that while the purpose of a general audit is not to detect fraud, auditors have a duty to investigate fully if indicia of fraud arise, as they most assuredly did here. This principle is so well established that it was confirmed in the record below from virtually every possible source: case

[33]This Court has carried the issue of jurisdiction with the case. In this section of the brief, the Liquidator respectfully submits that this Court may properly — and should — exercise its discretionary review jurisdiction because the case passes on a question of great public importance, as the Third District has certified. Petitioner also respectfully submits that this Court may base jurisdiction on the express and direct conflicts which the Third District's decision creates with other Florida appellate decisions, as set out in the jurisdictional brief previously filed by the Petitioner.

law;[34] the applicable generally accepted auditing standards set by the accounting profession itself and introduced by BDO Seidman at trial;[35] both parties' experts (T. 1419-20, 1500, 1517-18, 1667, 1631-33, 1683, 3119); Cayman and British authorities submitted by BDO Seidman at trial (R. 770, memorandum at 6-7); and BDO Seidman's own requested jury instructions. (R. 1004-1007).

As the *Cenco* opinion itself stated:

> Auditors are not detectives hired to ferret out fraud, but if they chance on signs of fraud they may not avert their eyes — they must investigate. The references to keeping an eye out for fraud that appear in the accounting standards . . . would have little point if not interpreted to impose a duty on auditors to follow up any signs of fraud that come to their attention.

686 F.2d at 454.

The Third District's decision abrogated this principle of auditor responsibility by holding that if a management fraud was for the "benefit" (however short-term or illusory)[36] of the company, the auditors will have *no liability* for breaching a duty to detect it.[37]

Unfortunately, management fraud is such a recurrent problem that it exists as a possibility in any given company on which an audit may be performed. Where signs of fraud are presented to alert auditors to its possible existence, auditors themselves have adopted in their

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[34]The *Cenco* opinion itself contained a succinct statement of the established principle, as set out in text, *infra*.

[35]American Institute of Certified Public Accountants Statement on Auditing Standards No. 16 (January 1977)(Defendants Trial Exhibit T).

[36]Petitioner vehemently disagrees that the facts in this record support a conclusion that the Petitioner/Liquidator's company was benefitted by the activities of Shah, as discussed at length above.

[37]Third party rights to sue are still very limited. *See First Florida Bank, N.A. v. Max Mitchell & Company*, 558 So. 2d 9 (Fla. 1990).

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standards a duty to detect it. And properly so, because if auditors' duties in preparing companies financial statements — which purport to be *accurate* depictions of the companies' financial condition — do not include the duty to respond to signs of management fraud, which is an ever-present possibility anyway, audit reports will not be worth the paper on which they are written.

This case is a perfect example. Shah said that Universal had $10 million in assets, held by CD at a bank in St. Vincent. Seidman's duty — under accountants' own auditing standards — was *not* to take *Shah*'s word for that, but *independently* to verify the company's assets. "CPA's are *required* to be independent from their clients when providing the attest services . . . [T]he State and the public rely on the CPAs to perform this vital function in the economy[.]. *State Department of Regulation Board of Accountants v. Rampell,* 589 So. 2d 1352, 1356 (Fla. 4th DCA 1991), *disapproved in part on other grounds,* 621 So. 2d 426 (Fla. 1993). This independent verification process is a necessity because of "the heavy reliance upon audited financial statements in the contemporary financial world." *First Florida Bank v. Max Mitchell & Co.,* 585 So. 2d 9, 15 (Fla. 1990).

The Petitioner/Liquidator respectfully submits that the Third District's modification of existing law on auditor liability for failure to detect management fraud is a step backwards in efforts to control and minimize the damages which can be caused when a corporate entity is abused by being utilized for fraudulent purposes. Those efforts are led in part by the accounting profession itself, which recognized that accountants can play a significant role in uncovering fraud and minimizing its ill effects on society. BDO Seidman's own expert at trial expounded at some length on the plethora of bankruptcies and companies with fraud problems in the 1980's which prompted Congress to consider imposing greater duties on accountants, which in turn prompted

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the accountants themselves to revise their audit rules — which they did as of 1988 — to require greater responsibility for detecting fraud within audited companies. (T. 3088-3094).

No harm is done by making parties respond for their own negligence, so no great blow is struck to the accounting profession by making it live up to its own standards of care. The fact is that the auditor's role in modern society is to present accurate, reliable financial information. If auditors negligently disseminate inaccurate and false information because of management fraud which they should have discovered by their own standards, no societal purpose of any kind is served by holding that such negligence carries no answerability.

B. Impairment of insurance liquidators' rights of recovery

The decision is also of exceptional importance because it affects insurance liquidators' rights of recovery on behalf of liquidating insurance companies and their unprotected policyholders. When the company's liquidation has been tortiously effected, virtually inevitably the tortfeasors involved are the negligent or fraudulent managers and the negligent auditors. *See, e.g.* D. Howard, *Making Accountants Account for Themselves When an Insurance Company Has No Tomorrows*, 40 FED'N OF INS. CORP. COUNS. Q. 342 (1990). As the author of that article noted:

> The past few years have been an extended winter of discontent for liquidators of insolvent insurance companies. The rate and severity of insurer insolvencies has dramatically increased. As a result, it is more important now than ever before for receivers of defunct insurers to marshall as many assets into the estate as possible for ultimate distribution to policyholders and general creditors, i.e., the real victims when an insurer goes bust. One way to infuse assets into the estate *is to sue those responsible for causing the carrier to fail.*

Id. at p. 342.

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Insurance companies are — and should be — highly regulated and protected entities under the law. Insurance companies sell a necessary component of modern society to members of the public — protection against loss. Those who *tortiously* deprive insurance companies of the ability to fulfill their loss coverage obligations should be required to make good on those obligations. When auditors are among the tortfeasors, there is no reason to afford them special exemptions from liability.

As a bottom line, the only auditors who will be required to pay are those who have breached their professional duty of care *and* whose breach has caused damage to the insurance company. Requiring auditors to pay under such circumstances merely comports with hundreds of years of basic tort law. On the other hand, absolving auditors from liability for their torts merely subverts common law principles of answerability without serving any alternative goal set by law or equity.

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CONCLUSION

Based on the foregoing facts and authorities, the Petitioner/Liquidator respectfully submits that this Court should exercise jurisdiction in this case and reverse the decision of the Third District with directions that the case be remanded for reinstatement of the judgment entered on the jury's verdict.[38]

Respectfully submitted,

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[38]If relief is granted as requested by the Petitioner/Liquidator, he also requests that the trial court be allowed to rule on his motion for pre-judgment interest as set forth in his original motion and in his motion filed in the Third District when this Court issued its decision in *McGurn v. Scott*, 569 So. 2d 1042 (Fla. 1992). (R. 1100-1101, SR. 125-131).

CERTIFICATE OF SERVICE

WE HEREBY CERTIFY that a true and correct copy of the Petitioner's Initial Brief on the Merits was mailed this 20th day of December, 1993, to: DANIEL S. PEARSON, ESQUIRE, Attorney for Defendant/Respondent Seidman & Seidman, 701 Brickell Avenue, Suite 3000, Miami, Florida 33131; MICHAEL R. YOUNG, ESQUIRE, Willkie, Farr & Gallagher, Attorneys for American Institute of Certified Public Accountants, One Citicorp Center, 153 East 53rd Street, New York, New York 10022-4669; DENNIS K. THREADGILL, Chief Attorney, Division of Rehabilitation and Liquidation, Florida Department of Insurance, P. O. Box 110, Tallahassee, Florida 33202; HELEN HAUSER, ESQUIRE, Dittmar & Hauser, P.A., Attorneys for Florida Department of Insurance, 3250 Mary Street, Suite 400, Miami, Florida 33133 and SUSAN E. MARTIN, ESQUIRE, General Counsel, National Association of Insurance Commissioners, 120 West 12th Street, Suite 110, Kansas City, MO 64105-1925.

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