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Inside Fraud, outside Negligence and the Savings & Loan Crisis: When Does Management Wrongdoing Excuse Professional Malpractice

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INSIDE FRAUD, OUTSIDE NEGLIGENCE AND THE SAVINGS & LOAN CRISIS: WHEN DOES MANAGEMENT WRONGDOING EXCUSE PROFESSIONAL MALPRACTICE?

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I. INTRODUCTION

The Federal Deposit Insurance Corporation (FDIC),[1] seeking to make attorneys and accountants liable for losses at corrupt savings and loan associations (S&Ls or thrifts), has filed an unprecedented number of malpractice suits against these professionals.[2] Many of these suits resemble the following hypothetical case of Charley K., a successful real-estate-developer-turned-savings-and-loan-kingpin.

In the early 1980s, Charley bought Jefferson Savings & Loan, a small thrift that until then had only made single-family home loans.[3] Charley believed he could make more money by directly investing depositors' funds in riskier ventures. Under Charley's management, Jefferson S&L bought 100 acres of undeveloped land on the outskirts of a large

1. The FDIC is a federal agency that insures bank accounts up to $100,000 per depositor, examines bank financial statements and acts as receiver for insolvent institutions. Iwana Rademaekers, *Historical Perspective*, *in* BANKS AND THRIFTS: GOVERNMENT ENFORCEMENT AND RECEIVERSHIP § 1.01, § 1.04[1] (Barry S. Zisman ed., 1992). In 1989, the FDIC absorbed most of the insurance, regulatory and receiver functions for thrifts formerly exercised by the Federal Savings and Loan Insurance Corporation (FSLIC), which had become insolvent. *See id.* § 1.04[2], at 1-16. Congress created the Resolution Trust Corporation (RTC) effective August 1989 to act as receiver for thrifts that failed after that month. *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (codified as amended in scattered sections of 12 U.S.C.).

2. The FDIC listed 49 pending suits as of May 1990 that included claims for attorney or accountant malpractice. *See* FDIC, Professional Liability Litigation (May 23, 1990) (unpublished report, on file with *Loyola of Los Angeles Law Review*); *see also* Linda Himelstein, *S&L Spotlight Focusing on Malpractice*, RECORDER, Nov. 20, 1990, at 1 (reporting that FDIC planned to pursue as many as 140 new claims against lawyers for failed S&Ls).

3. *See infra* note 16.

city for $50 million. Unfortunately for Charley, the real estate market crashed, and the land value declined to $40 million. Because Jefferson S&L's capital was only $10 million to start with, the $10 million loss wiped out all of Jefferson's capital. The institution was—on paper, at least—worth nothing.

Charley should have reported Jefferson's insolvency to the Federal Savings and Loan Insurance Corporation (FSLIC), which would have closed the thrift. Instead, Charley made a secret deal with speculator *X*, who owned land near Jefferson's holdings. Charley, as an individual, would buy Ms. *X*'s land for $50 million (which was $10 million more than market value) if Ms. *X* would buy Jefferson's land for $60 million (which was $20 million more than market value).[4] Charley agreed that his S&L would make a $10 million nonrecourse loan[5] to Ms. *X* to buy the land without putting any cash into the deal. Besides being an unsound business deal, the transaction violated federal law, and Charley knew it. First, Ms. *X* could not legally borrow $10 million from Jefferson S&L because that exceeded the maximum amount the thrift was allowed to lend to one person.[6] Second, Charley intended to borrow money from Jefferson to buy Ms. *X*'s land. This not only exceeded the maximum that the S&L could lend to one borrower, but also would raise regulatory concerns about preferential insider lending.[7] Charley covered up these problems by making the loans to Ms. *X* and himself through a handful of "dummy" corporations controlled by "straw" parties. The loan applications named neither Charley nor Ms. *X*.

Charley hired two prestigious law firms to handle the loan documentation. He paid more in fees to split the work, when one firm could have done the job more efficiently, so that neither firm would suspect the true nature of the overall transaction.[8] If lawyers at either firm had scratched below the surface, they would have discovered the connections between the dummy corporations, Charley and Ms. *X*, but neither firm did. The land deals closed, resulting in a $10 million "profit" to Jeffer-

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4. See *infra* notes 19, 118 and accompanying text for descriptions of similar land transactions.

5. With a nonrecourse loan, the real estate is the only collateral and the borrower is not personally liable in the event of default. *See* BLACK'S LAW DICTIONARY 1057 (6th ed. 1990).

6. Any bank borrower is limited to secured loans totalling 10% of capital, or in this hypothetical, $1 million. *See* 12 U.S.C. § 84(a)(2) (1988). This limit applies to federal S&Ls as well. *Id.* § 1464(u)(1) (Supp. III 1991).

7. Loans to bank insiders may not exceed loan limits to a single borrower and must be made on substantially the same terms as transactions with noninsiders. *Id.* § 375b(1), (3) (1988). This section applies equally to federal S&Ls. *Id.* § 1468(b)(1) (Supp. III 1991).

8. See *infra* note 346 and accompanying text for an example of an S&L that changed accounting and law firms to avoid detection of fraud.

son. Because the sale on paper appeared to be an arms-length transaction, Jefferson's Big Six accounting firm[9] approved the entire $10 million as profit—an overnight doubling of the thrift's capital.

Charley's scheme, however, could not last indefinitely. The slump in the real estate market worsened, forcing Charley and Ms. *X* to default on $60 million in loans from Jefferson S&L. By then, the two tracts of land were worth only $40 million together. The two bad loans wiped out Jefferson's capital and left a $10 million negative net worth.[10] The FSLIC paid off depositors and covered the deficit out of the S&L insurance fund.

Shortly after closing Jefferson S&L, FSLIC lawyers sued the two law firms and the accounting firm to recover $20 million in losses allegedly caused by the firms' negligence. According to the FSLIC, the land deals were so obviously fraudulent that the professionals must have "looked the other way" to protect a client and their large fees. Because Charley was bankrupt, the well-insured professionals were the "deep pockets" to which the FSLIC looked for recovery.[11] The accounting and law firms were shocked to discover their unwitting role in Charley's and Ms. *X*'s fraud and embarrassed that they had not uncovered it. The firms, however, adamantly denied liability, even if they were negligent. The firms moved for summary judgment on the grounds that Charley's insider fraud and concealment cut off any liability for mere negligence.[12]

The alleged negligent omission of Jefferson's attorneys and accountants was the failure to uncover the fraud and concealment by their client's top management. Professionals in this situation have raised what this Comment refers to as the "insider fraud defense." Part II of this Comment examines the role of attorneys and accountants in the S&L crisis and defines the "insider fraud defense." Part III compares the facts, procedural background and reasoning of the two leading cases on the insider fraud defense: *FDIC v. O'Melveny & Meyers* [sic],[13] which

9. The nation's six largest accounting firms are Arthur Andersen & Co., KPMG Peat Marwick, Coopers & Lybrand, Deloitte & Touche, Price Waterhouse and Ernst & Young.

10. In this hypothetical, the total loans on the two pieces of property were $60 million and the value of the property was $40 million, leaving a $20 million deficiency. Ten million dollars in capital or stockholders' equity less $20 million in loan losses leaves an overall negative net worth of $10 million.

11. *See infra* note 20 and accompanying text.

12. *See, e.g.*, Buttitta v. Newell, 531 N.E.2d 957, 959-60 (Ill. App. Ct. 1988) (stating that knowing, intentional violation of usury law precluded malpractice recovery from attorney who negligently advised that interest rate was lawful).

13. 969 F.2d 744 (9th Cir. 1992). The court of appeals misspelled the defendant's name, O'Melveny & Myers. This Comment uses the correct spelling when referring to the party's name.

rejected the defense, and *FDIC v. Ernst & Young*,[14] which allowed it. Part IV explores the bases in case law for the defense and applies the precedents to S&L fraud and professional malpractice. Finally, this Comment concludes that courts should allow the insider fraud defense when top management dominated the thrift and successfully concealed its wrongdoing from outside professionals.

II. THE FDIC VERSUS S&L ATTORNEYS AND ACCOUNTANTS

The S&L debacle will be an enduring blemish on the integrity of the legal and accounting professions.[15] Nonetheless, deregulation,[16] insider fraud[17] and unchecked massive real estate lending[18] contributed to many more S&L failures than did legal and accounting malpractice. In many cases the S&L owners defrauded investors, creditors and the government through accounting sleight of hand that transformed worthless real es-

14. 967 F.2d 166 (5th Cir. 1992).

15. "There is little doubt that the modern trend towards white collar crime is too often aided and abetted, if not promoted outright, by members of the legal profession." JOSEPH W. COTCHETT & STEPHEN P. PIZZO, THE ETHICS GAP 88 (1991); *see also* Nancy Rutter, *Dirty Hands*, CAL. LAW., Jan. 1992, at 30, 83 (quoting statement by legal ethics expert that " 'there is something wrong with the loyalty concept when it leads to disgust and disgrace, as it has in the S&L debacle' ").

16. S&Ls traditionally took in passbook deposits, on which they paid a regulated interest rate, and used the deposits to make home loans, a safe investment. MILES A. COBB, FEDERAL REGULATION OF DEPOSITORY INSTITUTIONS: ENFORCEMENT POWERS AND PROCEDURES ¶ 1.03[3] (1984). The thrift industry underwent massive change in the late 1970s and 1980s, as described by investigative reporter Stephen Pizzo:

> The interest rate cap, designed to help the housing sector, became a serious handicap for thrifts in the 1970s. The wildfire of inflation that then swept the economy put savings and loans in a bind because by 1979 inflation was running at 13.3 percent but thrifts were limited to paying only 5.5 percent on deposits, and depositors were not willing to invest their money at such low rates.

STEPHEN PIZZO ET AL., INSIDE JOB: THE LOOTING OF AMERICA'S SAVINGS AND LOANS 11 (1989).

In 1982, Congress passed the Garn-St. Germain Depository Institutions Act, Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.), which allowed S&Ls to offer high-interest money market accounts. *See* 12 U.S.C. § 3503(c) (1988). To earn higher returns in order to be able to pay out the higher rates, thrifts were allowed to invest up to 40% of their assets in nonresidential real estate. *See id.* § 1464(c)(1)(B) (1988), *amended by id.* § 1464(c)(2)(A) (Supp. II 1990) (limiting such loans to 10% of assets). The commercial investments were much riskier than home loans and made the thrifts vulnerable to enormous losses. PIZZO ET AL., *supra*, at 12.

17. "[M]any of the 'entrepreneurs' attracted [to S&L ownership] by these changes [in regulation] were actually con men intent upon draining as much money from the system as they could. . . ." PIZZO ET AL., *supra* note 16, at 13; *see also* MICHAEL WALDMAN, WHO ROBBED AMERICA? A CITIZEN'S GUIDE TO THE SAVINGS & LOAN SCANDAL 5 (1990) ("Prosecutors believe that these S&L high-flyers weren't just frivolous, they were fraudulent. At as many as six out of every ten failed S&Ls, insiders engaged in serious misconduct.").

18. *See infra* notes 19, 73, 118.

tate into paper profits.[19] Whatever the primary cause of S&L failures, often the best source of recovery—the only "deep pocket"—is the malpractice insurance policies of outside professionals.[20] Suits brought by the FDIC and other S&L bailout agencies[21] against attorneys and accountants have produced more than a dozen multi-million dollar settlements,[22] which lightens the estimated $200 billion-plus taxpayer burden of the S&L crisis.[23] The litigation is also politically popular because of the perception—true in some cases—that lawyers and accountants either turned a blind eye toward their clients' misdeeds, or worse, actively aided

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19. Authors Paul Pilzer and Robert Deitz described some of the common fraudulent land deals among S&L owners and developers:

> [T]hrift owners could trade bad loans among themselves, so that if the regulators happened to show up unexpectedly, the books would look clean. This practice was known as the "dead horse for a dead cow" trade in which a "rolling loan gathers no loss." Several thrift owners would get together and, with the help of friendly appraisers, form a "daisy chain" to "flip" a piece of property back and forth among themselves.

PAUL Z. PILZER & ROBERT DEITZ, OTHER PEOPLE'S MONEY: THE INSIDE STORY OF THE S&L MESS 93 (1989). For additional discussion of the S&L debacle, see MARTIN MAYER, THE GREATEST-EVER BANK ROBBERY (1990).

20. Charles F. Byrd & Isabella W. Sammons, *FDIC Legal Action Against Attorneys and Other Professionals*, 108 BANKING L.J. 420, 420 (1991).

21. In addition to the S&L suits it has filed since August 1989, the FDIC took over FSLIC litigation when it absorbed that agency. *See supra* note 1. As of September 1990, the RTC had filed 10 suits against lawyers and 15 suits against accountants. *See* Byrd & Sammons, *supra* note 20, at 421. See *supra* note 2 for a summary of FDIC activity. A third agency, the Office of Thrift Supervision (OTS), filed and settled one of the largest S&L professional negligence suits to date. *See infra* note 22. This Comment mainly discusses FDIC suits, which are more numerous than those of the other bailout agencies. *See supra* note 2. Most of the discussion, however, applies equally to other S&L and bank bailout litigation.

22. *See* Susan Beck & Michael Orey, *They Got What They Deserved*, AM. LAW., May 1992, at 68 (reporting OTS settlement of Lincoln S&L claim with New York law firm Kaye, Scholer, Fierman, Hays & Handler for $41 million); James S. Granelli, *Law Firm to Pay $51 Million in Keating Case*, L.A. TIMES, Apr. 20, 1993, at D1 (reporting RTC settlement of $51 million with Cleveland-based Jones, Day, Reavis & Pogue); Robert A. Rosenblatt, *Auditor Pays $400 Million for Not Signaling S&L Crisis*, L.A. TIMES, Nov. 24, 1992, at A1 (reporting joint OTS, RTC and FDIC settlement with Ernst & Young for audits of several failed thrifts, including Lincoln S&L); Steven Wilmsen & Robert Kowalski, *Token Sums OK'd in Silverado Accord*, DENV. POST, June 19, 1991, at 1A (reporting FDIC settlement of Silverado thrift suit with law firm for $16.5 million and accounting firm for $20 million); FDIC, Professional Liability Law Suits Against Individual Attorneys/Law Firms, Closed Cases and Settlement Information (Dec. 13, 1990) (unpublished report, on file with *Loyola of Los Angeles Law Review*) (listing, among others, following settlements: $35.9 million with Philadelphia law firm Blank, Rome, Comisky & McCauley in Florida S&L suit; $9.85 million and $9.6 million with Dallas law firm Jenkins & Gilchrest in claims involving two Texas S&Ls); *see also* David Newdorf, *FDIC Stumbles in Malpractice Trials*, RECORDER, Jan. 3, 1991, at 1, 6 (reporting that professional liability recoveries from lawyers and law firms totalled $60 million in 1989).

23. PILZER & DEITZ, *supra* note 19, at 16 (estimating bailout at more than $200 billion); WALDMAN, *supra* note 17, at ix (estimating bailout at $500 billion).

and abetted fraud.[24] The lawyers and accountants contend, however, that they are not legally responsible because insider fraud caused the losses.[25]

In addition to the usual tort defenses,[26] attorneys and accountants named in the FDIC suits have asserted the insider fraud defense. The defense is based on the intentional and fraudulent conduct of the owners or top managers of a thrift, which, under theories of estoppel,[27] *in pari delicto*,[28] contributory or comparative negligence,[29] or proximate

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24. A professional who actively assisted a client's fraud should not be able to avoid liability using the insider fraud defense because one of the principal justifications for the defense is balancing equities and policy considerations. *See infra* part IV.C. At Lincoln Savings & Loan Association, the thrift's lawyers allegedly knew about sham real estate deals, risky loans and backdated documents. *See* Beck & Orey, *supra* note 22, at 70-72. Nonetheless, from 1987 until Lincoln was finally shut down in April 1989, the lawyers attempted to persuade regulators that Lincoln was clean and healthy. *See id.* at 68, 70-72. The government and private lawsuits against the firm settled long before trial, *see id.* at 68, 73, so possible defenses were never tested.

In Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901 (D.D.C. 1990), Judge Stanley Sporkin observed: "The questions that must be asked are: Where were these professionals . . . when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated?" *Id.* at 920.

25. *See, e.g.*, *Litigation Against Professionals Will Damage U.S. Economy, Study Says*, 59 Banking Rep. (BNA) 224 (Aug. 10, 1992) (stating that outside professionals " 'are simply "deep pockets" to whom some very slight fault may be attributable' "); Timothy D. Naegele, *Rabid Regulators Want Your Hide*, AM. BANKER, May 27, 1992, at 4 (attributing professional liability suits to scapegoatism).

26. The common defenses to professional negligence include: disproving any of the required elements of negligence, *see infra* note 36; statute of limitations; contributory or comparative negligence; release or waiver; res judicata; collateral estoppel; indemnity or contribution; and unjust enrichment. 2 RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE §§ 17.1-.18 (3d ed. 1989).

27. *See* FDIC v. O'Melveny & Meyers [sic], 969 F.2d 744, 749 (9th Cir. 1992). The Ninth Circuit, which rejected the defense, explained: "Under this argument the FDIC would be estopped from making a claim against O'Melveny by the wrongdoing of the corporate insiders." *Id.*

28. *In pari delicto* means "in equal fault." BLACK'S LAW DICTIONARY, *supra* note 5, at 791; *see also* Evans v. Cameron, 360 N.W.2d 25 (Wis. 1985) (holding that client who lied under oath on advice of attorney could not recover damages from attorney because client was *in pari delicto*).

29. *See* Stratton v. Miller, 113 B.R. 205, 210 (D. Md. 1989) (holding that intentional fraud of corporation president barred recovery from corporation's attorneys for malpractice based on corporation's contributory negligence), *aff'd sub nom. In re* First Am. Mortgage Co., 900 F.2d 251 (4th Cir. 1990) (per curiam).

cause,[30] bars the S&L or the FDIC from recovering from outside attorneys and accountants who did not participate in the fraud.[31]

The U.S. courts of appeals in two recent decisions reached opposite conclusions on the validity of the insider fraud defense. Applying the defense, the U.S. Court of Appeals for the Fifth Circuit in *FDIC v. Ernst & Young*[32] allowed the accountants to show that their inaccurate audit did not cause the thrift's losses because the 100% owner was engaged in fraud.[33] Rejecting the defense, the U.S. Court of Appeals for the Ninth Circuit in *FDIC v. O'Melveny & Meyers* [sic][34] decided a negligent law firm would be liable even if the S&L's two owners " 'cook[ed] the books' " and concealed their fraud from the lawyers.[35]

The insider fraud defense takes several forms. In *O'Melveny*, the defense was an attack on the existence of a duty, which would have defeated the plaintiff's prima facie case of negligence.[36] In *Ernst & Young*, the accountants raised the insider fraud defense to defeat the element of causation.[37] Other defendants have used variations on the defense as a form of contributory or comparative negligence.[38]

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30. *See id.* (stating that proximate causation was not proved because "it is mere speculation to suggest that . . . the losses . . . would have been prevented if [the corporation's] attorneys had advised other directors of [the] misconduct").

31. These common-law and statutory defenses vary from state to state, and a detailed exposition of the defenses is beyond the scope of this Comment. The insider fraud defense, as described in this Comment, combines one or more of these state law defenses with federal common-law principles. This Comment focuses on the federal questions. *See infra* part III.A.2-3.

32. 967 F.2d 166 (5th Cir. 1992).

33. *Id.* at 170.

34. 969 F.2d 744 (9th Cir. 1992).

35. *Id.* at 746 (alteration in original) (quoting parties' stipulation). O'Melveny argued that "a lawyer owes no duty to uncover a client's fraud nor to advise the client and the world of that fraud." *Id.* at 748.

36. *Id.* at 748; *see also* 1 MALLEN & SMITH, *supra* note 26, § 8.10 ("The cause of action for legal malpractice involves the same basic elements as any ordinary negligence action: duty, negligent breach of duty, proximate cause and damage.").

37. 967 F.2d at 170 ("The issue . . . is whether either Woods or Western relied upon Arthur Young's audit to *cause* injury to Western." (emphasis added)). Another question of causation, which the cases have not yet addressed, is whether a professional who is bound by a duty of confidentiality could stop client fraud if he or she uncovered it. *See infra* part IV.C.4.

38. *See* FDIC v. Clark, 978 F.2d 1541, 1552 (10th Cir. 1992) (holding that attorneys' 19% fault for bank's losses resulted in pro rata reduction of attorneys' liability under Colorado law). In FDIC v. Ferguson, 982 F.2d 404 (10th Cir. 1991), a federal district court jury found that attorney Donald P. Ferguson, who represented Home Savings & Loan in Oklahoma in two transactions, was 15% at fault, another defendant 15%, and Home itself 70% at fault in causing loan losses. *Id.* at 406. Under Oklahoma's comparative negligence statute, a plaintiff adjudged more than 50% negligent may not recover from joint tortfeasors, and so the FDIC took nothing. *Id.*

The insider fraud defense may affect the outcome of FDIC suits nationwide in which millions of dollars in liability are at issue. The defense also affects extrinsic public policy concerns. The FDIC has asserted that it is "critically important" that courts reject the defense to protect the S&L bailout.[39] Attorneys have responded that disallowing the defense is "unworkable and utterly inconsistent with the nature of the attorney-client relationship."[40] The courts cannot satisfactorily resolve the issue without considering the objectives of professional negligence law.[41]

III. The Insider Fraud Defense

A. Background

1. The FDIC acts as receiver for failed thrifts

In most FDIC professional liability suits, the FDIC acts as receiver for the failed S&L.[42] The FDIC as receiver "stands in the shoes of the insolvent bank"[43] and brings claims that the entity itself could have brought before being placed in receivership.[44] The claims of the FDIC as receiver are in most cases subject to the same defenses as would have been available against the bank or S&L.[45] In some situations, however, the FDIC has greater rights than the insolvent institution would have had.[46]

FDIC professional liability suits, in bare terms, typically allege that the outside attorneys or accountants were negligent and professional malpractice was the proximate cause of the S&L's losses.[47] In many

39. Appellants' Opening Brief at 2, *O'Melveny* (No. 90-55769); *see infra* part IV.C.1.

40. Appellee's Petition for Rehearing and Suggestion of Rehearing En Banc at 14, *O'Melveny* (No. 90-55769). See *infra* part IV.C.2-3 for a discussion of the professional-client relationship and the professional's duty of client confidentiality.

41. *See infra* part IV.C.1.

42. 12 U.S.C. § 1821(c)(2)(A)(ii) (Supp. III 1991) (stating that FDIC shall be appointed receiver for any federally chartered bank or S&L); *id.* § 1821(c)(3) (Supp. III 1991) (stating that state regulator may appoint FDIC receiver for any FDIC-insured state-chartered bank or S&L).

43. FDIC v. Glickman, 450 F.2d 416, 418 (9th Cir. 1971); *accord* Jacobson v. FDIC, 407 F. Supp. 821, 827 (S.D. Iowa 1976).

44. *Jacobson*, 407 F. Supp. at 827.

45. Camerer v. California Sav. & Commercial Bank, 4 Cal. 2d 159, 170, 48 P.2d 39, 44 (1935) ("It is . . . fundamental that as a general rule, the receiver takes the insolvent's property subject to all . . . defenses . . . to which it is subject in the hands of the insolvent."); 10 Am. Jur. 2d *Banks* § 764 (1963).

46. See *infra* part IV.B.2 for a discussion of the *D'Oench, Duhme* doctrine, which in some cases gives the FDIC greater rights than a private receiver.

47. Besides professional negligence, the FDIC suits have alleged breach of fiduciary duty, negligent misrepresentation, breach of contract, breach of express or implied warranty, unjust enrichment, aiding and abetting management in violations of legal and fiduciary duties, fraud

FDIC suits the alleged negligence consists of failing to uncover and halt illegal and fraudulent transactions by the S&L's top management.[48] Because the FDIC generally has no greater rights as receiver than the S&L had, the FDIC may only prevail against the thrift's negligent attorneys and accountants if the S&L could have prevailed on the same claim.[49] Therefore, these suits are largely the equivalent of the thrift suing its attorney or accountant, although the FDIC brings the suit on behalf of the thrift after the S&L becomes insolvent.[50]

2. Federal common law governs FDIC suits

In the absence of federal constitutional provisions or federal statutes, federal common law governs most actions of the FDIC because of the need for uniform laws and policy concerning the federal banking and S&L systems.[51] The courts may look to the law of the state most closely connected to the transaction for guidance in fashioning federal common law, so long as state law does not conflict with the policy of maintaining uniform federal bank and S&L law.[52] The decision to create a new fed-

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and deceptive trade practices. Byrd & Sammons, *supra* note 20, at 423-24, 433-34; Michelle D. Monse, *Ethical Issues in Representing Thrifts*, 40 BUFF. L. REV. 1, 2 & n.1 (1992).

48. This was the case in FDIC v. O'Melveny & Meyers [sic], 969 F.2d 744 (9th Cir. 1992), and FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir. 1992). See *infra* part III.B.1-2 for a detailed discussion of *O'Melveny* and *Ernst & Young*. The prospect of an attorney or accountant "blowing the whistle" on a client raises controversial issues of client confidentiality. *See infra* part IV.C.3.

49. *See Ernst & Young*, 967 F.2d at 169 (stating that FDIC as receiver could recover only those damages potentially available to failed thrift). The court in *Ernst & Young* viewed the FDIC suit as essentially the same as a "case in which a [thrift] is suing its auditor." *Id. But see O'Melveny*, 969 F.2d at 752 (holding that FDIC as receiver is not subject to same defenses as S&L).

50. *See Ernst & Young*, 967 F.2d at 169.

51. FDIC v. Bank of San Francisco, 817 F.2d 1395, 1398 (9th Cir. 1987) (holding that suit by FDIC against issuer of letter of credit was governed by federal rather than state law); FDIC v. Bird, 516 F. Supp. 647, 649 (D.P.R. 1981) (holding that action by FDIC against former directors and officers of bank was governed by federal law).

Federal common law generally applies to cases affecting the government's legal relations and proprietary interests. *See* Clearfield Trust Co. v. United States, 318 U.S. 363, 366-67 (1943); JACK H. FRIEDENTHAL ET AL., CIVIL PROCEDURE § 4.7, at 229 (1985).

52. FDIC v. Palermo, 815 F.2d 1329, 1334 (10th Cir. 1987); *see also* FDIC v. New Hampshire Ins. Co., 953 F.2d 478, 482 (9th Cir. 1991) (adopting California rule as federal common law).

Some federal courts, in the name of judicial restraint or federalism, have applied state law out of reluctance to create new federal common law. *See, e.g.*, *Ernst & Young*, 967 F.2d at 170 (applying Texas law to defenses available for defendant in FDIC malpractice action because "[n]o statutory justification or public policy exists to treat the FDIC differently"); FDIC v. Jenkins, 888 F.2d 1537, 1544-46 (11th Cir. 1989) (applying federal law, but refusing to "fashion[ ] a federal common law absolute priority rule" for FDIC claims); FSLIC v. Capozzi, 855 F.2d 1319, 1325-26 (8th Cir. 1988) (applying state law to liability of S&L directors), *vacated on* eral common-law rule in place of state law is subject to a three-part balancing test: (1) Whether, in the absence of direction from Congress, the question requires a "nationally uniform body of law"; (2) whether use of state law would obstruct "specific objectives of . . . federal programs"; and (3) whether and to what extent a different federal law would "disrupt commercial relationships [based] on state law."[53]

In FDIC professional negligence suits, courts generally have applied state law to define the elements of negligence[54] and comparative or contributory negligence.[55] The courts generally have applied federal common law to determine the validity of the insider fraud defense.[56]

3. Bases for the insider fraud defense

In defending against a claim that a lawyer or accountant failed to discover and inform the S&L's management of its own fraud, the professional may assert several state-law defenses. The professional defendant may argue that the S&L was engaged in fraud and "a participant in a fraud cannot also be a victim entitled to recover damages."[57] Alternatively, the professional may argue the related doctrines of *in pari delicto*[58] or contributory or comparative negligence.[59] Lastly, the defendants may

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other grounds, 490 U.S. 1062 (1989); *cf.* Erie R.R. v. Tompkins, 304 U.S. 64 (1938) (requiring federal courts to apply state substantive law in diversity cases). Although FDIC suits may implicate the policy of federalism, *Erie* does not apply to these cases because federal courts do not rely on diversity of the parties to obtain subject matter jurisdiction over FDIC suits. The United States Code states that, with limited exception, suits by or against the FDIC "shall be deemed to arise under the laws of the United States," thus qualifying for federal question subject matter jurisdiction under 28 U.S.C. § 1331 (1988). *See* 12 U.S.C. § 1819(b)(2)(A) (Supp. III 1991).

53. United States v. Kimbell Foods, 440 U.S. 715, 728-29 (1979); *accord* Mardan Corp. v. C.G.C. Music, Ltd., 804 F.2d 1454, 1458 (9th Cir. 1986); FDIC v. Main Hurdman, 655 F. Supp. 259, 265-66 (E.D. Cal. 1987).

54. *See, e.g.*, FDIC v. O'Melveny & Meyers [sic], 969 F.2d 744, 748-49 (9th Cir. 1992) (applying California negligence law).

55. *See, e.g.*, FDIC v. Clark, 978 F.2d 1541, 1551-52 (10th Cir. 1992) (applying Colorado's proportionate liability law); FDIC v. Cherry, Bekaert & Holland, 742 F. Supp. 612, 614-15 (M.D. Fla. 1990) (applying Florida's contributory negligence defense).

56. *See, e.g.*, *O'Melveny*, 969 F.2d at 750-51.

57. Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 454 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982); *see also* Mettes v. Quinn, 411 N.E.2d 549, 551 (Ill. App. Ct. 1980) (holding that client engaged in fraud cannot recover from attorney for negligence). The court in *Mettes* said:

> Mettes would now have us allow a recovery from her attorney because his faulty advice caused her fraud to be uncovered in such a way that she could no longer benefit therefrom. Whether Mettes received negligent advice from Quinn is immaterial to our decision, for the essence of her prayer is that she be permitted to benefit from her fraud.

Id.

58. *See supra* note 28.

59. *See supra* note 29.

argue that they did not proximately cause the damages because even if they had discovered the fraud, they would have been powerless to stop it due to their duty of confidentiality.[60] The success of these defenses depends on the principle that the FDIC "stands in the shoes" of the failed S&L and is, therefore, subject to the same defenses as the S&L.[61]

Apart from the state law defenses noted above, the viability of the insider fraud defense depends on two federal law issues. The first question is whether fraud by the top managers, officers, directors and controlling shareholders is the same as fraud by the corporation itself. The courts frame this question as whether the corporate officers' knowledge of their own fraud is attributed or imputed to the corporation.[62] Imputing an officer's knowledge to the corporation is, in a sense, the reverse of "piercing the corporate veil." When a court pierces the corporate veil, it holds a shareholder liable for an obligation of the corporation.[63] When a court attributes the knowledge of an officer to the corporation, however, it bars a claim by the corporation based on the conduct and knowledge of its officers.[64]

The second question is whether the insider fraud defense is valid against the FDIC. In some situations, the FDIC has greater rights and powers than the S&L or a private receiver.[65] If a court finds that the FDIC is not subject to the insider fraud defense, then even if the court were to attribute the insiders' knowledge to the corporation, the professional would still be liable to the FDIC for negligence.[66]

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60. If the professional could not have "blown the whistle," then causation may not exist. *See infra* part IV.C.4. Lack of causation was a successful defense in *Ernst & Young*, which held that the accountant did not cause the loss because the S&L's chief executive officer, who defrauded outsiders and knew the thrift's true financial condition, could not have relied on Ernst & Young's audit to uncover fraud. FDIC v. Ernst & Young, 967 F.2d 166, 171-72 (5th Cir. 1992).

61. *See* FDIC v. Glickman, 450 F.2d 416, 418 (9th Cir. 1971).

62. *See, e.g.*, FDIC v. Clark, 978 F.2d 1541, 1550 (10th Cir. 1992); FDIC v. O'Melveny & Meyers [sic], 969 F.2d 744, 750 (9th Cir. 1992); *Ernst & Young*, 967 F.2d at 170.

63. Piercing the corporate veil, also known as disregarding the corporate form, is an exception to the general rule of limited liability for shareholders. It allows a plaintiff to recover on a corporate obligation or tort from shareholders in certain limited circumstances, including fraud. HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 146, at 346 (3d ed. 1983).

64. *See* 3 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 789-790 (perm. ed. rev. vol. 1986). Although the effect is opposite, the reason for piercing the corporate veil and imputing knowledge is the same: to achieve a just result. *See* 3 *id.* § 787; HENN & ALEXANDER, *supra* note 63, § 146, at 346.

65. D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447, 461 (1942).

66. *O'Melveny*, 969 F.2d at 752. However, two aspects of the insider fraud defense should apply even if the court does not impute the officer's knowledge to the corporation or the court finds that the FDIC has greater rights than the S&L: (1) comparative negligence, and (2)

B. *Split Among the Circuits*

The facts in *FDIC v. O'Melveny & Meyers* [sic],[67] which rejected the insider fraud defense, and *FDIC v. Ernst & Young*,[68] which accepted the defense, were similar. Both clients—American Diversified Savings Bank (American) and Western Savings Association (Western)—were emblematic of insider fraud at S&Ls. The courts disagreed, however, on the two principal legal issues: whether corporations should be responsible for fraud by their dominant, controlling officers;[69] and whether special federal common-law rights of the FDIC should be extended to defeat state-law defenses.[70]

1. *Federal Deposit Insurance Corp. v. O'Melveny & Meyers* [sic]

a. *American Diversified Savings Bank*

American, based in Irvine, California, was one of the new breed of S&Ls that flourished in the 1980s based on speculative investments, but soon failed in spectacular fashion.[71] When the FSLIC seized American in 1986, it had a negative net worth of $417 million and losses grew to $800 million by 1988.[72] American had invested heavily in commercial

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causation. First, in comparative and contributory negligence jurisdictions, if the top managers are partially at fault, even if their knowledge is not attributed to the corporation, the liability of the defendant will be proportionately reduced or eliminated. *Clark*, 978 F.2d at 1550, 1552 (stating that fraud of bank president was not attributed to bank, but liability of attorney defendants was reduced by proportionate fault of others under Colorado law). Second, causation is required in every tort. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 41, at 263 (5th ed. 1984). Therefore, proof that the acts of others were the *sole* cause of loss, even if the court does not impute the actor's knowledge to the plaintiff, would be a complete defense. *See id.*

67. 969 F.2d 744 (9th Cir. 1992).

68. 967 F.2d 166 (5th Cir. 1992).

69. *See supra* part III.A.3; *infra* part IV.A.

70. *See supra* part III.A.3; *infra* part IV.B.

71. Deregulation in the 1980s allowed S&L owners to leverage money on a large scale for real estate or other investments. *See* MAYER, *supra* note 19, at 5-6. Martin Mayer described the regulatory and business environment that faced American:

> After January 1, 1983, California law allowed an S&L to use federally insured S&L deposits to do just about any damned thing its owners felt like doing.
>
> . . . By 1983 [the] capital requirement had been dropped to only 3 percent [of total assets]. With $3 million in "equity" from the asserted value of [the S&L owner's] properties, [American] could own $100 million in assets, and [it] could get the money to buy those assets very easily, simply by promising people that [it] would pay them more for their deposits than other S&Ls would pay. The depositors ran no risks; the federal government insured both principal and interest on every dollar deposited in American Diversified.
>
> . . . Between June 1983 and December 1985 . . . American Diversified grew from $11.7 million to $1.1 *billion*. The FSLIC was on the hook for all of it.

Id.

72. *Id.* at 8.

real estate development, which held out the possibility of big gains or, if the investments failed, big losses.[73]

Real estate developer Ranbir Sahni, chairman of the board and chief executive officer of American, owned ninety-six percent of the thrift's stock; Lester Day, its president, owned the remaining four percent.[74] In separate litigation regarding American, a U.S. court of appeals panel affirmed a finding that Messrs. Sahni and Day were the alter egos of American.[75] The FDIC, in yet another American-related case, sued Sahni and Day as directors for alleged breach of fiduciary duty and Sahni for alleged Racketeer Influenced and Corrupt Organizations (RICO) Act violations.[76]

b. the facts

In September 1985, American retained the law firm of O'Melveny & Myers as outside counsel for an offering of real estate limited partnership shares known as Wells Park and Gateway Center.[77] O'Melveny was largely responsible for preparing the 300-page private placement memoranda used to solicit outside investors to buy shares in the two real estate syndications.[78] The two deals closed December 31, 1985, and collapsed shortly thereafter when, on February 14, 1986, the FSLIC took over American because of its insolvency.[79] The FDIC alleged that O'Melveny

73. American's risk-laden investment portfolio included financial futures, options, stocks and $300 million face value of junk bonds. *Id.* at 6-7. American's largest investment was in two subsidiaries that organized tax-shelter real estate partnerships, which in turn invested in shopping centers and condominium projects. *Id.*

74. Appellee's Brief at x, *O'Melveny* (No. 90-55769).

75. California Union Ins. Co. v. American Diversified Sav. Bank, 948 F.2d 556, 566 (9th Cir. 1991). Under the alter-ego doctrine, the court disregards the corporate entity and holds individual stockholders responsible for fraud committed using the corporation as an instrumentality. BLACK'S LAW DICTIONARY, *supra* note 5, at 77-78. Under the sole actor doctrine, if a shareholder is the alter ego of the corporation, the corporation may be responsible for the shareholder's fraud. 3 AM. JUR. 2D *Agency* § 292, at 797-98 (1986). See *infra* part IV.A.5 for a discussion of the sole actor doctrine.

76. FSLIC v. Sahni, No. 86-1075 (C.D. Cal. filed Feb. 19, 1986). The suit, which sought more than $60 million in damages, settled in 1990. Although the settlement amount was never officially disclosed, due to a confidentiality agreement among the parties, an investigative report stated that Sahni paid $1.15 million. *See* Stephen Pizzo, *FDIC Let Thrift Owner Settle with Loan Proceeds*, NAT'L MORTGAGE NEWS, Mar. 11, 1991, at 30.

77. *O'Melveny*, 969 F.2d at 746. A wholly-owned subsidiary of American served as general partner of Wells Park and Gateway Center. Appellants' Opening Brief at 9, *O'Melveny* (No. 90-55769). The subsidiary acquired property using loans from American and sold limited partnership shares in the property to outside investors. *Id.* American anticipated profit from the deals through interest on the loans and fees and commissions for management, brokerage and other services. *Id.*

78. *O'Melveny*, 969 F.2d at 746.

79. *Id.* at 747.

negligently failed to confirm the accuracy and completeness of the private placement memoranda.[80]

In the course of its work, O'Melveny failed to contact American's two former accounting firms,[81] its current accountants, other outside counsel for American, or state and federal thrift regulators.[82] The FDIC contended that O'Melveny should have gone to these sources, which had information that American was in financial and regulatory trouble and probably insolvent.[83] After taking over the institution, the FSLIC as conservator[84] decided to repay the investors because the agency determined that the private placement memoranda were misleading for failing to disclose American's weak financial condition.[85] On May 12, 1989, the FDIC filed suit against O'Melveny for professional negligence, negligent misrepresentation and breach of fiduciary duty.[86] The FDIC filed two types of claims. First, as receiver, it sued on behalf of American, O'Melveny's former client.[87] Second, it sued on behalf of the investors who had assigned their claims against O'Melveny to the FSLIC in exchange for a refund of their investment.[88]

O'Melveny and the FDIC agreed that Mr. Sahni, Mr. Day and Wyn Pope, executive vice president of the thrift, fraudulently overvalued American's assets, engaged in the sham sale of assets to reap illusory profits and generally " 'cook[ed] the books.' "[89] O'Melveny moved for summary judgment on the grounds, among others, that: (1) It owed no

80. *Id.* at 745-46.

81. *Id.* at 747. American had terminated Touche, Ross & Co. ostensibly for being too expensive and replaced Arthur Young & Co. after it "express[ed] concerns about [American's] financial condition." *Id.* at 746.

82. *Id.* at 747.

83. Appellants' Opening Brief at 13-17, *O'Melveny* (No. 90-55769).

84. Conservators have the same powers as receivers, but regulators use conservatorship when the bank or thrift has a prospect of reopening. *See* COBB, *supra* note 16, § 8.03. Receivers often replace conservators, as was the case at American. *See id.*

85. Appellants' Opening Brief at 11, *O'Melveny* (No. 90-55769).

86. *O'Melveny*, 969 F.2d at 747.

87. Appellants' Opening Brief at 1, *O'Melveny* (No. 90-55769).

88. *Id.* The court in *O'Melveny* applied the same analysis to both the third-party investor claims and the client's malpractice claims. "Given a broad duty to protect the client, this distinction [between duty to client and duty to investors] is a false one. Part and parcel of effectively protecting a client . . . is to protect the client from the liability . . . from . . . a false or misleading offering to investors." *O'Melveny*, 969 F.2d at 749. Whatever distinction there may be between the two types of claims, the Ninth Circuit focused on the claims of the FDIC as receiver. *See id.* O'Melveny's liability to the investors, who were not clients, is beyond the scope of this Comment. For a discussion of auditor liability to third parties, see Scott Vick, Note, Bily v. Arthur Young & Co.*: Is Limiting Auditor Liability to Third Parties Favoritism or Fair Play?*, 26 LOY. L.A. L. REV. — (1993).

89. *O'Melveny*, 969 F.2d at 746 (alteration in original) (quoting parties' stipulation). The FDIC and O'Melveny stipulated to the facts for O'Melveny's summary judgment motion. *Id.*

duty to American to "ferret out [American's] own fraud";[90] (2) the conduct of wrongdoing officers must be imputed to American;[91] and (3) as a receiver, the FDIC has no greater rights than American had.[92] The U.S. district court granted O'Melveny's summary judgment motion.[93]

The U.S. Court of Appeals for the Ninth Circuit reversed, holding that: (1) O'Melveny owed a duty of care to American;[94] (2) estoppel did not bar the FDIC's claims because the wrongdoing insiders at American acted adversely to the corporation;[95] and (3) even if the court imputed insider fraud to the corporation, O'Melveny could not assert the insider fraud defense against the FDIC based on the *D'Oench, Duhme* doctrine and public policy.[96]

c. *the Ninth Circuit on imputing corporate officers' wrongdoing to the corporation*

The court of appeals in *O'Melveny* did not impute Messrs. Sahni's and Day's knowledge of their wrongdoing to American because " 'knowledge acquired by the agent who is acting adversely to his principal will not be attributed to the principal.' "[97] The court determined whether the agents' actions were adverse to the corporation based on whether the insiders or the corporation benefitted from the fraud.[98] The court decided that "disaster, not benefit, accrued to [American] through

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90. *Id.* at 747.
91. *Id.*
92. *Id.*
93. *Id.* The district court did not issue a written opinion providing the basis for its decision. *See* Appellants' Opening Brief at 8, *O'Melveny* (No. 90-55769).
94. *O'Melveny*, 969 F.2d at 748-49. The court of appeals applied state law to the negligence issue, as have other courts in deciding FDIC professional liability claims. *See, e.g.*, FDIC v. Ernst & Young, 967 F.2d 166, 170 (5th Cir. 1992) (applying Texas law). Under California law, an attorney owes a duty to " 'protect his client in every possible way.' " *O'Melveny*, 969 F.2d at 748 (quoting Day v. Rosenthal, 170 Cal. App. 3d 1125, 1143, 217 Cal. Rptr. 89, 99 (1985), *cert. denied*, 475 U.S. 1048 (1986)). The standard of care is defined as using " 'such skill, prudence and diligence as lawyers of ordinary skill and capacity commonly possess.' " *Id.* (quoting Day v. Rosenthal, 170 Cal. App. 3d 1125, 1143, 217 Cal. Rptr. 89, 99 (1985), *cert. denied*, 475 U.S. 1048 (1986)). "No California cases advise us of an exception to the general rule that a lawyer has to act competently to avoid public harm when he learns that his is a dishonest client." *Id.*
95. *Id.* at 749-51.
96. *See id.* at 752.
97. *Id.* at 750 (quoting Meyer v. Glenmoor Homes, Inc., 246 Cal. App. 2d 242, 264, 54 Cal. Rptr. 786, 800-01 (1967)). The decision also cited *In re* Investors Funding Corp., 523 F. Supp. 533, 540-41 (S.D.N.Y. 1980); Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982) and Schacht v. Brown, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983), which are discussed *infra* in part IV.A.3.
98. *O'Melveny*, 969 F.2d at 750.

the malfeasance of Sahni, Day and Pope," and therefore concluded that the three officers were acting adversely to the corporation.[99] The court noted that "conduct aggravating a corporation's insolvency and fraudulently prolonging its life does not benefit that corporation."[100]

Finally, the court applied an alternative analysis modeled after one of the tests used in *Schacht v. Brown*,[101] *Bloor v. Dansker (In re Investors Funding Corp.)*[102] and *Cenco Inc. v. Seidman & Seidman*.[103] The Ninth Circuit, citing these cases, said it would not impute an officer's knowledge to the corporation if "a recovery by the plaintiff would serve the objectives of tort liability by properly compensating the victims of wrongdoing and deterring future wrongdoing."[104]

The Ninth Circuit noted that whether a corporation is closely held did not affect its analysis. " 'It is fundamental, of course, that a "corporation is a distinct legal entity separate from its stockholders and from its officers." ' This rule applies even when, as here, a single individual owns nearly all of the corporation's stock."[105]

d. the Ninth Circuit on special protection and powers for the FDIC as receiver

The U.S. court of appeals in *O'Melveny* held that even if it attributed Messrs. Sahni's and Day's misdeeds to American, the FDIC would not, like a normal receiver, be barred from prosecuting a malpractice action.[106] The court stated that under California law " '[a] receiver occupies no better position than that which was occupied by the . . . party for whom he acts . . . and any defense good against the original party is good

99. *Id.*

100. *Id.* (citing Schacht v. Brown, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983); *In re* Investors Funding Corp., 523 F. Supp. 533, 540-41 (S.D.N.Y. 1980)).

101. 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983).

102. 523 F. Supp. 533 (S.D.N.Y. 1980). This Comment cites *Bloor* as *In re* Investors Funding Corp. to be consistent with the other cases discussed in the Comment.

103. 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

104. *O'Melveny*, 969 F.2d at 750-51 (citing Diamond Mortgage Corp. v. Sugar, 913 F.2d 1233, 1247-48 (7th Cir. 1990) (applying *Investors Funding* to legal malpractice claims of corporations in bankruptcy), *cert. denied*, 111 S. Ct. 968 (1991); Schacht v. Brown, 711 F.2d 1343, 1348 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983); Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 455 (7th Cir. 1982)).

The *O'Melveny* court noted that the Ninth Circuit relied on the holding of *Schacht* to decide Kempe v. Monitor Intermediaries, Inc., 785 F.2d 1443 (9th Cir. 1986). *Kempe* concerned a liquidator's suit to recover losses caused by a conspiracy of company insiders and outsiders. *Id.* at 1444.

105. *O'Melveny*, 969 F.2d at 750 (citations omitted) (quoting Merco Constr. Eng'rs v. Municipal Court, 21 Cal. 2d 724, 729, 581 P.2d 636, 639, 147 Cal. Rptr. 631, 634 (1978)).

106. *Id.* at 752.

against the receiver.' "[107] However, based on the doctrine established in *D'Oench, Duhme & Co. v. FDIC*, the court held that federal, not state, law governed the application of defenses against the FDIC.[108]

The court said it was guided by the equitable maxim that a court may " 'look through the form of the transaction, and adjust the equities of the parties with a view to its substance.' "[109] Distinguishing the FDIC from a "normal successor in interest," the court noted that the FDIC has no choice in the matter—"it is thrust into [the failed thrift's] shoes."[110] The court balanced the FDIC's interest in the "regulatory scheme designed to protect the interests of third parties who . . . were not privy to the bank's inequitable conduct"[111] against O'Melveny's interest as "a party asserting an equitable defense."[112]

Allowing the defense, the court said, would "diminish[ ] the value of the asset pool held by the receiver and limit[ ] the receiver's discretion in disposing of the assets."[113] Since this would frustrate the FDIC's regulatory goals, the court concluded that "equitable defenses [valid] against the bank should not be available against the receiver."[114]

2. *Federal Deposit Insurance Corp. v. Ernst & Young*

a. Western Savings Association

Dallas-based Western was, like American, a closely held corporation. Jarret E. Woods, Jr. purchased 100% of Western's stock on August 30, 1982, and appointed himself chairman of the board and chief executive officer.[115] The U.S. Court of Appeals for the Fifth Circuit affirmed a finding that "Woods effectively dominated and controlled Western."[116]

Mr. Woods transformed a sleepy S&L into one that "engag[ed] in complex commercial ventures and risky loans."[117] Western became a link in a "daisy chain" of Texas thrifts that financed "land flips," in

107. *Id.* at 751 (alteration in original) (quoting Allen v. Ramsay, 179 Cal. App. 2d 843, 854, 4 Cal. Rptr. 575, 583 (1960)).
108. *Id.* (citing D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447, 456 (1942)).
109. *Id.* (quoting Drexel v. Berney, 122 U.S. 241, 254 (1887)).
110. *Id.*
111. *Id.* at 752.
112. *Id.*
113. *Id.*
114. *Id.*
115. FDIC v. Ernst & Young, 967 F.2d 166, 168 (5th Cir. 1992).
116. *Id.*
117. FDIC v. Ernst & Young, No. 3-90-0490-H, 1991 U.S. Dist. LEXIS 13955, at *2 (N.D. Tex. Sept. 29, 1991) (mem.), *aff'd*, 967 F.2d 166 (5th Cir. 1992).

which the same property would trade hands at rapidly rising prices until "the final outside borrower, dazzled by what appeared to be rapidly escalating value of the land, would be left holding the loan—and along with it, a property that was actually worth far less than its appraised value."[118] After the fall of Western, the U.S. Department of Justice indicted Mr. Woods, and the FDIC filed a civil action against him in his capacity as an officer and director of Western.[119]

b. the facts

Before the thrift collapsed, Mr. Woods's strategy appeared wildly successful. Western hired as auditors Arthur Young & Co., who certified a net worth for the thrift of more than $41 million in 1984 and $49 million in 1985.[120] Western's seeming financial strength, however, stemmed from "paper profits." According to the FDIC, "Woods made false entries in Western's books with intent to deceive Western's board and government regulators, and he conspired to misapply Western's funds. . . . [T]hese policies were part of a scheme by Woods to defraud Western's depositors and creditors."[121] Re-examination of Western's books after federal regulators shut it down showed the thrift had a negative net worth of more than $100 million in 1984 and $200 million in 1985.[122] Total losses at the thrift were $560 million by the time the FSLIC stepped in as receiver on September 12, 1986.[123]

The FDIC on March 1, 1990, sued Ernst & Young[124] for negligence and breach of contract for failing to uncover the losses during its annual audits.[125] The FDIC alleged that if the thrift's board of directors had accurate financial information showing losses rather than profits, it would have "stopped making the high risk loans that caused the $560 million in losses."[126] Ernst & Young argued that Mr. Woods, as sole

118. PILZER & DEITZ, *supra* note 19, at 93. For example, one daisy chain started with the purchase of 2175 acres of raw land 20 miles from Fort Worth, Texas, for $17.25 million on October 28, 1983. *Id.* at 93-94. The property remained unimproved, but changed hands over the following two years at successive sales prices of $24 million, $44.7 million, $37.4 million (after some of the original land was sold separately) and $64.4 million. *Id.* at 94-95. Western financed the final sale at $85.5 million. *Id.* at 95. When federal regulators closed Western in September 1986, the land was reappraised at $21 million. *Id.*

119. *Ernst & Young*, 967 F.2d at 169 n.1.

120. *Id.* at 168.

121. *Id.*

122. *Id.*

123. *Id.* at 168-69.

124. Ernst & Young is the successor partnership to Arthur Young & Co. *Id.* at 169.

125. *Id.*

126. FDIC v. Ernst & Young, No. 3-90-0490-H, 1991 U.S. Dist. LEXIS 13955, at *3 (N.D. Tex. Sept. 29, 1991) (mem.), *aff'd*, 967 F.2d 166 (5th Cir. 1992).

stockholder, chairman of the board and chief executive officer, knew the true state of Western's financial condition, and therefore Western could not have relied on the false audits.[127] The district court granted summary judgment to Ernst & Young on the negligence claim.[128] The court of appeals affirmed, stating that "[i]f nobody relied upon the audit, then the audit could not have been a 'substantial factor in bringing about the injury,' "[129] and therefore causation did not exist.

c. the Fifth Circuit on imputing corporate officers' wrongdoing to the corporation

The U.S. court of appeals in *Ernst & Young* concluded that Texas had adopted the majority rule that "a bank officer or director's knowledge [is imputed] to the bank unless the officer or director acts with an interest adverse to the bank."[130] Under Texas law, the test to determine whether an officer's fraud is adverse to the corporation is whether it is " ' "[f]raud on behalf of a corporation" ' " or " ' "fraud against it." ' "[131] The Fifth Circuit concluded that Mr. Woods served both his own interests and the corporation's through his fraud.[132] "Woods acted on the corporation's behalf because by serving Western, he served himself.... As the sole owner, Woods' fraudulent activities on Western's behalf benefitted himself and injured outsiders to Western—i.e. depositors and creditors."[133] Therefore, the court of appeals imputed Mr. Woods's knowledge to Western.[134]

In addition to agency law, the court applied a "common sense" analysis to the imputed-knowledge issue based on: (1) the policy of deterring and punishing corporate fraud, and (2) the identity of interests between a corporation and its sole owner.[135] Noting Mr. Woods's complete ownership and control of Western, the court of appeals stated:

127. *Ernst & Young*, 967 F.2d at 170.

128. *Id.* at 168. The district court dismissed the breach of contract count for failing to state a claim. *Id.*

129. *Id.* at 170 (quoting McClure v. Allied Stores, 608 S.W.2d 901, 903 (Tex. 1980)).

130. *Id.* (citing FDIC v. Lott, 460 F.2d 82, 88 (5th Cir. 1972)).

131. *Id.* at 171 (quoting Greenstein, Logan & Co. v. Burgess Mktg., Inc., 744 S.W.2d 170, 190-91 (Tex. Ct. App. 1987) (quoting Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 456 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982))). See *infra* part IV.A.3.c for a discussion of *Cenco*.

132. *Ernst & Young*, 967 F.2d at 171.

133. *Id.*

134. *Id.*

135. *Id.* This analysis is similar to the holding in J.J. McCaskill Co. v. United States, 216 U.S. 504, 515 (1910). *See infra* notes 239-40 and accompanying text.

> "Because a corporation operates through individuals, the privity and knowledge of individuals at a certain level of responsibility must be deemed the privity and knowledge of the organization, 'else it could always limit its liability.' . . . Where the level of responsibility begins must be discerned from the circumstances of each case." In the present case, the level of responsibility must extend at least to the sole owner who dominated the board of directors.[136]

Having disposed of the imputed-knowledge issue in favor of Ernst & Young, the court considered whether the insider fraud defense was valid against the FDIC.

d. the Fifth Circuit on special protection and powers for the FDIC as receiver

The Fifth Circuit Court of Appeals stated that the FDIC as receiver was an ordinary assignee and treated the case as the functional equivalent of a "case in which a client is suing its auditor."[137] The FDIC as receiver " 'obtains only the right, title, and interest of his assignor at the time of his assignment, and no more. Accordingly, an assignee may recover only those damages potentially available to his assignor.' "[138]

The court noted that the *D'Oench, Duhme* doctrine bars borrowers from asserting defenses against the FDIC based on secret side contracts[139] and that federal policy dictates that the FDIC in some cases has greater rights than the failed bank.[140] However, the court declined to extend federal common law to defenses available against the FDIC when it brings tort claims belonging to a failed institution.[141]

The Fifth Circuit relied on *FDIC v. Cherry, Bekaert & Holland*[142] and other cases[143] that declined to extend the *D'Oench, Duhme* doctrine beyond its " 'limited . . . scope' " to defenses available to bank auditors

136. *Ernst & Young*, 967 F.2d at 171 (footnote omitted) (citation omitted) (quoting Continental Oil Co. v. Bonanza Corp., 706 F.2d 1365, 1376 (5th Cir. 1983)).

137. *Id.* at 169.

138. *Id.* (quoting State Fidelity Mortgage Co. v. Varner, 740 S.W.2d 477, 480 (Tex. Ct. App. 1987)).

139. *Id.* (citing Campbell Leasing, Inc. v. FDIC, 901 F.2d 1244, 1248 (5th Cir. 1990)).

140. *Id.* (citing *In re* Jeter, 48 B.R. 404, 410 (Bankr. N.D. Tex. 1985)).

141. *Id.* at 170.

142. 742 F. Supp. 612 (M.D. Fla. 1990). See *infra* part IV.B.5 for a discussion of *Cherry, Bekaert*.

143. FDIC v. Jenkins, 888 F.2d 1537, 1545-46 (11th Cir. 1989); FDIC v. Harrison, 735 F.2d 408, 412 (11th Cir. 1984). See *infra* text accompanying notes 306-10 for a discussion of *Jenkins*.

sued by the FDIC for negligence.[144] The court echoed *Cherry, Bekaert's* judicial-restraint rationale in concluding that the FDIC is not entitled to special protection when it brings a tort claim against a third party on behalf of a failed bank.[145] "No statutory justification or public policy exists to treat the FDIC differently from other assignees . . . ."[146] On both principal issues, imputed knowledge and the rights of the FDIC, *Ernst & Young* was a victory for the insider fraud defense.

IV. ANALYSIS

A. Imputing the Wrongdoing of a Corporate Officer to the Corporation

Two independent legal theories support application of the insider fraud defense to the facts of *FDIC v. O'Melveny & Meyers* [sic]. First, based on the analysis used in *Cenco Inc. v. Seidman & Seidman*,[147] the interests of Messrs. Sahni and Day were *not* adverse to American, so the court should have attributed their acts and knowledge to the corporation. Second, even if their interests were adverse, Messrs. Sahni and Day dominated and controlled American, so the court should have attributed their acts and knowledge to the corporation based on the sole actor doctrine.[148]

1. Knowledge of the agent is presumed knowledge of the principal

Under general principles of corporations law, the corporate entity is distinct from its shareholders, directors, officers and employees.[149] A corporation is a legal "person" that makes contracts, buys, owns and sells property, and carries on its business through designated agents.[150] The law of agency, in this regard, is applicable to the law of corporations.[151] Under agency law, the principal is bound by the knowledge acquired by an agent in the course of his or her agency.[152] The rationale for the rule is that corporate officers have a duty to inform their employ-

144. *Ernst & Young*, 967 F.2d at 169-70 (quoting FDIC v. Cherry, Bekaert & Holland, 742 F. Supp. 612, 614-15 (M.D. Fla. 1990)).

145. *Id.* at 170.

146. *Id.* The court said: "The most significant factor in the present case's outcome is the FDIC's decision to sue only as Western's assignee. The FDIC did not sue on its own behalf or on Western's creditors' behalf." *Id.* at 169. The court suggested that "[e]ither Western's creditors or the FDIC on its own behalf may have a cause of action against [Ernst & Young]." *Id.* at 171-72.

147. 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

148. *See infra* part IV.A.5.

149. 1 FLETCHER, *supra* note 64, § 25 (perm. ed. rev. vol. 1990).

150. 1 *id.* § 30.

151. 1 *id.*

152. RESTATEMENT (SECOND) OF AGENCY § 272 (1957).

ers and to take appropriate actions based on knowledge relating to their official functions.[153]

The rule of imputed knowledge finds frequent application in bank and S&L cases.[154] Thus, knowledge acquired by a bank officer while acting in an official capacity is imputed to the corporation.[155]

2. The adverse interest exception

An exception to the rule is that an agent's knowledge is *not* imputed to the principal if the agent acted adversely to the principal.[156] The requirements of the adverse interest exception are: (1) The agent acts for his or her own benefit, *and* (2) the agent acts against the interest of the principal.[157] The rationale for the adverse interest exception is that the agent's self-interest makes it less likely that the agent would fully inform the principal.[158] For example, if a cashier's purpose is to defraud a bank, a court will not impute the cashier's knowledge to the bank.[159] Courts reach the same result if a cashier embezzles funds deposited at the bank.[160]

Fraud by the agent does not necessarily make the agent's interest adverse to the corporation. The cases distinguish between an agent's

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153. United States v. Bank of New England, 821 F.2d 844, 856 (1st Cir. 1987).

154. 3 FLETCHER, *supra* note 64, §§ 806, 806.1.

155. American Nat'l Bank v. Miller, 229 U.S. 517, 521-22 (1913); FDIC v. Clark, 978 F.2d 1541, 1550 (10th Cir. 1992); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 231 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); City of Phila. v. Westinghouse Elec. Corp., 205 F. Supp. 830, 830 (E.D. Pa. 1962); Austin v. Hallmark Oil Co., 21 Cal. 2d 718, 729, 134 P.2d 777, 784 (1943); 10 AM. JUR. 2D *Banks*, *supra* note 45, §§ 163, 167; 3 FLETCHER, *supra* note 64, §§ 789-790.

156. *American Nat'l Bank*, 229 U.S. at 521-22; RESTATEMENT (SECOND) OF AGENCY, *supra* note 152, § 282.

157. 3 FLETCHER, *supra* note 64, §§ 819-820. One test to determine if an agent's interest is adverse to the principal is whether, in the circumstances of the case, the agent's interest is so incompatible with the principal's interest as to render it reasonably unlikely that the agent would act on behalf of the principal or disclose relevant knowledge to the principal. International Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 580 (Tex. 1963); Goldstein v. Union Nat'l Bank, 213 S.W. 584, 590-91 (Tex. 1919); 3 FLETCHER, *supra* note 64, § 821.

158. SEC v. Seaboard Corp., 677 F.2d 1301, 1310 (9th Cir. 1982) (stating that agent's knowledge is not imputed to corporation if agent participated in fraud against corporation); Maryland Casualty Co. v. Tulsa Indus. Loan & Inv. Co., 83 F.2d 14, 16 (10th Cir. 1936) ("[I]t is . . . essential to the existence of . . . a fraud that the agent conceal the facts and consequently the ordinary presumption that he will communicate to his principal all facts concerning the business does not arise.").

159. Hadden v. Dooley, 92 F. 274, 278-79 (2d Cir. 1899).

160. Matz v. Ibach, 291 N.W. 377, 380 (Wis. 1940) (holding that presumption that cashier communicated knowledge to bank is rebutted if cashier's adverse role in transaction would induce cashier to withhold information).

fraud *against* the corporation (such as embezzlement)[161] and an agent's fraud *on behalf of* the corporation.[162] An agent's independent fraudulent acts solely for his or her own benefit are examples of the former, and knowledge of the fraud is not imputed to the corporation.[163] The agent's interest in the action is personal and does not benefit the corporation.[164]

Fraud *on behalf of* the corporation, such as theft from creditors, depositors or others outside the corporation, may benefit the corporation and does not create an adverse interest.[165] If a corporation benefits from an agent's conduct, it may not retain the benefit while disclaiming knowledge of the fraud.[166] For example, a cashier who stole from a depositor's account to increase the bank's capital was deemed to have acted on behalf of the bank.[167] The court imputed the bank's receiver with knowledge of the embezzlement.[168]

Based on similar concerns of corporate fraud, another court held that the adverse interest exception applies only if a third person seeks to enforce some demand against the corporation, but has no application if a corporation seeks to enforce the benefit of a fraud perpetrated by its officer on a third person.[169] Otherwise, the adverse interest exception to the rule of imputed knowledge would be "a vehicle for the consummation of fraud."[170]

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161. Fidelity & Deposit Co. v. People's Bank, 72 F.2d 932, 937 (4th Cir.) (stating that embezzler's knowledge is not imputed to bank), *cert. denied*, 293 U.S. 627 (1934); 3 FLETCHER, *supra* note 64, § 826.

162. Schneider v. Thompson, 58 F.2d 94, 97 (8th Cir. 1932).

163. American Sur. Co. v. Pauly, 170 U.S. 133, 158-59 (1898); 3 FLETCHER, *supra* note 64, § 826.

164. *American Sur. Co.*, 170 U.S. at 159; 3 FLETCHER, *supra* note 64, § 826.

165. 3 FLETCHER, *supra* note 64, § 826.

166. Curtis, Collins & Holbrook Co. v. United States, 262 U.S. 215, 224 (1923) ("[I]f the Company insists on retaining the fruits of that adventure, it must be charged with the knowledge of the agent through whom the fruits came."); 3 FLETCHER, *supra* note 64, § 830.

167. *Schneider*, 58 F.2d at 97.

168. *Id.* In addition to the benefit to the bank, the court imputed the cashier's knowledge to the bank because the cashier was in practice the sole manager of the bank. *Id.* Thus, both the sole actor doctrine, *see infra* part IV.A.5, and the rule for fraud on behalf of a corporation support the holding.

169. Gordon v. Continental Casualty Co., 181 A. 574, 576 (Pa. 1935). The case of a thrift or its receiver suing a professional for malpractice, when the negligence consists of failing to uncover the fraud of an officer, is analogous to seeking to benefit from the officer's fraud. *Cf. id.*

170. *Id.* In *Gordon*, the plaintiff argued that the bank's chief executive, who had embezzled $26,000, was acting adversely to the bank when he later obtained a bond to indemnify the bank against loss due to the dishonesty of its officers and employees. *Id.* The court held: "In procuring the bond, Matthews was not acting adversely to the bank, but in its behalf. The adverse act of embezzling the money had been consummated previously." *Id.* Absent an

Determining whether an agent's fraud makes him or her adverse to the corporation is central to a court's decision on whether to attribute the agent's knowledge to the corporation. However, recent cases on the adverse interest exception, including *FDIC v. O'Melveny & Meyers* [sic][171] and *FDIC v. Ernst & Young*,[172] have applied conflicting analyses.[173]

3. Two approaches to the adverse interest exception

The *O'Melveny* and *Ernst & Young* decisions relied largely on three cases in deciding when insider fraud makes the officers' interest adverse: *In re Investors Funding Corp.*,[174] *Schacht v. Brown*[175] and *Cenco Inc. v. Seidman & Seidman*.[176] All three cases involved receivers' suits against outside accountants,[177] but the decisions reveal two different approaches.

In *Investors Funding* and *Schacht*, the key factor in determining that the agents' interests were adverse was that the companies ended up in bankruptcy.[178] In *Cenco*, the key factor was not the end result but whether the fraud was directed at stockholders or outsiders.[179] Only in *Cenco* did the defendant prevail based on an insider fraud defense.[180]

a. In re Investors Funding Corp.

In re Investors Funding Corp.[181] concerned three corporate officers who allegedly bankrupted Investors Funding through insider misappropriation of funds and secret, sham transactions designed to conceal losses.[182] The bankruptcy trustee sued the outside auditor for breach of contract and malpractice for failing to uncover the fraud.[183] The auditor

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adverse interest, the bank was deemed to have notice of the chief executive's dishonesty and was not entitled to collect on the bond. *Id.* at 576, 579.

171. 969 F.2d 744 (9th Cir. 1992).

172. 967 F.2d 166 (5th Cir. 1992).

173. *Compare* Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 456 (7th Cir.) (concluding that fraudulent employees' interests were not adverse), *cert. denied*, 459 U.S. 880 (1982) *with* Schacht v. Brown, 711 F.2d 1343, 1347-48 (7th Cir.) (concluding that fraudulent employees' interests were adverse), *cert. denied*, 464 U.S. 1002 (1983).

174. 523 F. Supp. 533 (S.D.N.Y. 1980).

175. 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983).

176. 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

177. *See Schacht*, 711 F.2d at 1345; *Cenco*, 686 F.2d at 440; *Investors Funding*, 523 F. Supp. at 537.

178. *See Schacht*, 711 F.2d at 1347-48; *Investors Funding*, 523 F. Supp. at 541.

179. *See Cenco*, 686 F.2d at 456.

180. *See id.*

181. 523 F. Supp. 533 (S.D.N.Y. 1980).

182. *Id.* at 536. Jerome, Norman and Raphael Dansker were "the principal officers, controlling directors, controlling stockholders and the dominant force of [Investors Funding]." *Id.*

183. *Id.* at 537.

argued that the court should impute the insiders' knowledge to the corporation and its bankruptcy trustee.[184] The auditor defendants contended that the officers' interests were not adverse to the corporation because the fraud benefitted Investors Funding by obtaining capital that staved off bankruptcy.[185]

The *Investors Funding* court held that fraudulently extending the life of the corporation only benefitted the officers, not the corporation.[186] The court believed the end result—bankruptcy—retroactively showed that the agents served their personal interests to the detriment of the principal.[187]

According to the *Investors Funding* analysis, therefore, the key factor is the end result. If the corporation is bankrupted, then the agent's fraud is adverse to the principal. The Seventh Circuit Court of Appeals applied the same analysis in *Schacht v. Brown*.[188]

b. Schacht v. Brown

In *Schacht*, the Illinois State Director of Insurance sued, among others, the directors and three outside auditors of Reserve Insurance Co. (Reserve) for arranging and concealing fraudulent transactions designed to hide the insolvency of the company.[189] By issuing high-risk policies and maintaining inadequate capital, Reserve accrued a $100 million deficit as of the time the State placed it in receivership.[190] The State alleged that the outside accounting firms "knew of Reserve's insolvency" and the concealment from regulators, but nonetheless issued audits showing a positive net worth.[191]

The accountant defendants argued that because the officers and directors controlled the fraud, the insiders' knowledge estopped both Reserve and its liquidator from recovering damages from the accountants.[192] The *Schacht* court found that Reserve's officers and directors

184. *Id.* at 540.
185. *Id.* at 541.
186. *Id.*
187. *See id.*
188. 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983).
189. *Id.* at 1345.
190. *Id.*
191. *Id.* The State further alleged that "the accounting firm defendants joined with . . . Reserve's officers and directors in a multifaceted, fraudulent scheme which kept Reserve operating long past insolvency in a manner which resulted in enormous losses to the . . . company." *Id.* at 1345-46.
192. *Id.* at 1346. Some of the accountants argued, in the alternative, that even if estoppel did not apply, the plaintiff could not prove the causation element of fraud because the corporation knew of the insolvency through its officers and directors. *Id.* at 1346 n.2. The court

harmed the company by fraudulently extending its life, stripping away its assets and income and running up larger deficits.[193] The court of appeals stated: "[T]he prolonged artificial insolvency of Reserve benefitted only Reserve's managers and the other alleged conspirators, not the corporation."[194]

In *Schacht*, as in *In re Investors Funding Corp.*,[195] the key factor in determining whether the agents' interests were adverse was whether the fraud ultimately hurt the corporation. The court of appeals applied a very different analysis in *Cenco Inc. v. Seidman & Seidman*.[196]

c. Cenco Inc. v. Seidman & Seidman

In *Cenco*, rather than focusing on the final result, the court asked whether the agent's fraud was *against* the corporation or *on behalf of* the corporation.[197] Under the *Cenco* analysis, the fraud's ultimate effect on the corporation is unimportant.[198] The *Cenco* approach often yields a different result from the analysis applied in *Schacht* and *Investors Funding*.

At Cenco, the chairman, president, other top managers and two of the nine members of the board of directors—none of whom were majority shareholders—fraudulently inflated the company's inventory.[199] Shareholders filed a class action/derivative suit against the corrupt managers and the outside auditors who failed to uncover the fraud.[200] The auditors, Seidman & Seidman, settled with the shareholders for $3.5 million, but went to trial on the claims asserted by the corporation, which was under new management.[201]

Considering whether to impute the insiders' fraud to the corporation, the Seventh Circuit Court of Appeals stated that auditors must be vigilant against fraud, but

> this does not tell us what the result should be if the fraud permeates the top management of the company and if, moreover,

treated the causation and estoppel arguments as raising the same issue. *Id.* In FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir. 1992), the accountants prevailed using the same causation argument. *Id.* at 170.

193. *Schacht*, 711 F.2d at 1347-48.

194. *Id.*

195. 523 F. Supp. 533 (S.D.N.Y. 1980).

196. 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

197. *Id.* at 456.

198. *See id.*

199. *Id.* at 451.

200. *Id.*

201. *Id.*

> the managers are not stealing from the company—that is, from its current stockholders—but instead are turning the company into an engine of theft against outsiders—creditors, prospective stockholders, insurers, etc.[202]

Judge Richard Posner, writing for the court of appeals, concluded that the fraud by Cenco's employees and officers was fraud "for the benefit of the company, not against it," and therefore the court attributed it to the corporation.[203] Distinguishing between fraud on behalf of the corporation and fraud against it, Judge Posner explained that fraud against the corporation usually hurts just the corporation and its stockholders.[204] Conversely, he continued, "stockholders of a corporation whose officers commit fraud for the benefit of the corporation are beneficiaries of the fraud."[205]

The insider abuse did not bankrupt Cenco, as it did Investors Funding. Under Judge Posner's analysis, however, a resulting bankruptcy would not necessarily transform outward-directed fraud on behalf of the corporation into inward-directed fraud. Fraud on behalf of the corporation is not limited to cases in which the corporation is a "net beneficiar[y]."[206] In some cases, the corporation may be a net loser after the fraud is uncovered, "[b]ut the primary costs of a fraud on the corporation's behalf are borne not by the stockholders but by outsiders to the corporation, and the stockholders should not be allowed to escape all responsibility for such a fraud."[207]

Judge Posner's decision to impute knowledge of the fraud to Cenco allowed the accountants a defense because, under Illinois law, a participant in a fraud cannot also be a victim of the fraud entitled to recover damages.[208] The court of appeals placed great

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202. *Id.* at 454.
203. *Id.* at 456.
204. *Id.*
205. *Id.*
206. *Id.*
207. *Id.*
208. *Id.* at 454. This defense recognizes that a victim-participant does not rely on the fraudulent representations and therefore the fraud does not cause the injury. *See id.*

Judge Posner also performed an intricate balancing based on the "underlying objectives of tort liability," which are "to compensate victims of wrongdoing and to deter future wrongdoing." *Id.* at 455. He concluded that the accountants should not be held liable to the corporation because: (1) The accountants had already compensated the injured shareholders through the earlier class-action settlement; (2) the wrongdoing officers who were still shareholders of Cenco would benefit pro rata from Cenco's recovery against the auditors; and (3) deterrence would be best accomplished by giving shareholders an incentive to ensure the honesty of management. *Id.* at 455-56.

weight on the fact that "fraud permeat[ed] the top management of Cenco."[209]

4. The *Cenco* analysis requires corporate responsibility

The *Cenco* analysis makes corporations responsible for their officers' frauds. The *Cenco* court recognized that when an individual commits fraud using a corporation as the tool, both the individual and the corporation may "gain," at least in the short term.[210] On the other hand, when an individual steals corporate assets, only the individual benefits, and the personal gain is at the corporation's expense.[211] *Cenco* established a clear-cut test for distinguishing the two situations: whether stockholders or outsiders bear the brunt of the fraud.[212] The net gain or loss of the company is not a factor because even outward-directed fraud—when outsiders bear the brunt of the loss—may result in insolvency after the fraud is uncovered or runs its course.[213]

The alternative test, found in *In re Investors Funding Corp.*,[214] differs in that the analysis focuses on the end result. The court in *Investors Funding* concluded that fraudulently obtaining capital to prolong the life of a corporation does not benefit the corporation.[215] The fault with this holding, and the same conclusion in *Schacht v. Brown*,[216] is that it assumes fraud can benefit *either* the officers or the corporation, but not *both*.

In *FDIC v. O'Melveny & Meyers* [sic],[217] the Ninth Circuit stated it was following *Cenco*, *Schacht*, and *Investors Funding*, but it failed to distinguish the two different approaches.[218] The *O'Melveny* court seemed to adopt the *Schacht* and *Investors Funding* approach, stating: "Here, disaster, not benefit, accrued to [American] through the malfeasance of [the insiders]."[219] A court applying this superficial analysis could never im-

209. *Id.* at 456.
210. *See id.*
211. *See id.* at 454-55.
212. *See id.* at 456.
213. *See id.*
214. 523 F. Supp. 533 (S.D.N.Y. 1980).
215. *Id.* at 541 ("[I]t is manifest that the prolonged artificial solvency of [Investors Funding] benefitted only the Danskers and their confederates, not [Investors Funding].").
216. 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983). *Schacht* adopted the *Investors Funding* test. "[T]he prolonged artificial insolvency of Reserve benefitted only Reserve's managers and the other alleged conspirators, not the corporation." *Id.* at 1347-48.
217. 969 F.2d 744 (9th Cir. 1992).
218. *See id.* at 750.
219. *Id.*

pute the knowledge of fraudulent top officers to the corporation if the corporation ultimately suffered a loss.

If the Ninth Circuit had applied the *Cenco* test to the facts of *O'Melveny* in a manner consistent with Judge Posner's opinion, the court would have considered who gained and who lost due to Messrs. Sahni's and Day's fraud.[220] The two stockholders lost an investment of a few million dollars.[221] Creditors, depositors and ultimately the S&L insurance fund lost *$800 million*.[222] This was outward-directed fraud. In *Ernst & Young*, the Fifth Circuit correctly applied the *Cenco* test to facts similar to those in *O'Melveny* and concluded that the corporation and its sole owner gained from the fraud, while the thrift's depositors and creditors lost.[223]

American's two 100% owners, who held the positions of chairman, chief executive officer and president, used the thrift as a vehicle for fraud and concealed the fraud from outsiders.[224] Yet under the decision in *O'Melveny*, the corporation avoided any responsibility for the fraud.[225] In concluding that the owners' interests were adverse to the corporation, the Ninth Circuit ignored the fact that there can be no gain in stealing from a solvent corporation when one owns all the stock. Under the *O'Melveny* court's view of agency law, corrupt S&L owners such as Messrs. Sahni and Day could benefit from their fraud by suing—in the name of the thrift—the lawyers and accountants who failed to uncover and stop their fraud.[226]

O'Melveny is one of a handful of cases that has muddied the waters of agency law.[227] A major area of confusion seems to be how to deter-

220. *See* Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 454-56 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

221. Mr. Sahni purchased 100% of the stock of Tokay Savings Bank, which he renamed American, for $2.88 million in 1983. Memorandum of Contentions of Fact and Law of Lester G. Day et al. at 4, FSLIC v. Sahni, (C.D. Cal. filed Sept. 5, 1989) (No. 86-1075).

222. MAYER, *supra* note 19, at 8.

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

224. *See O'Melveny*, 969 F.2d at 746.

225. *Id.* at 750-51.

226. The *O'Melveny* court did not expressly limit its holding to FDIC receiverships. *See id.* It follows, then, that if regulators had not seized American, the rule announced in *O'Melveny* would apply to American in the same way it applied to the FDIC. Because Messrs. Sahni's and Day's fraudulent conduct caused loss to American, their interests were adverse to the corporation and therefore their knowledge is not attributed to American. *Id.* at 750. American, then, should be entitled to recover from O'Melveny for professional negligence, *see id.*, even though the true beneficiaries of any recovery by American would be the wrongdoers, Messrs. Sahni and Day, who own all the stock.

227. *Compare O'Melveny*, 969 F.2d at 750-51 (deciding not to impute officers' knowledge to corporation) *and* Schacht v. Brown, 711 F.2d 1343, 1347-48 (7th Cir.) (same), *cert. denied*, 464 U.S. 1002 (1983) *and In re* Investors Funding Corp., 523 F. Supp. at 533, 540-41

mine whether an agent's interest is adverse to that of the principal.[228] In *Cenco*, Judge Posner articulated the most logical and sensible approach by recognizing that a corporation can be used as a vehicle for fraud.[229]

5. Sole actor doctrine

The sole actor doctrine, a limitation on the adverse interest exception, provides a second, independent grounds for attributing S&L officers' wrongdoing to the corporation. If an agent is the "sole actor" or "sole representative" for a corporation in a transaction, the knowledge of the agent will be imputed to the corporation even if the agent's interest is adverse to the corporation.[230] The sole actor limitation on the adverse interest exception is based on fairness.[231] When a principal acts exclusively through one agent, the agent acts *as* the principal, thus the agent has no need to convey information to the principal.[232] The sole actor doctrine is the majority rule in the United States.[233]

(S.D.N.Y. 1980) (same) *with Ernst & Young*, 967 F.2d at 170-71 (imputing officers' knowledge to corporation) *and Cenco*, 686 F.2d at 454 (same). See *supra* part III.B for a discussion of *O'Melveny* and *Ernst & Young* and part IV.A.3.a-c for a discussion of *Investors Funding*, *Schacht* and *Cenco*.

228. *Compare Schacht*, 711 F.2d at 1347-48 *and Investors Funding*, 523 F. Supp. at 541 (stating that delaying corporation's ultimate insolvency does not benefit corporation) *with Cenco*, 686 F.2d at 454 (focusing on identity of beneficiaries and losers to determine whether agent's interest is adverse).

The court of appeals in FDIC v. Clark, 978 F.2d 1541 (10th Cir. 1992), applied a third approach to the adverse interest exception, although the *Clark* decision used different terminology. In that legal malpractice case, the court did not impute the bank president's and vice president's knowledge to the bank because the officers "were not acting within the scope of their employment or agency with the Aurora Bank." *Id.* at 1550. According to the Tenth Circuit, "acts done to accomplish an independent purpose of the employee [are] not acts within the scope of employment." *Id.* In the *Clark* case, the bank's president and vice president were involved in a scheme to buy $9 million of stolen currency for $2 million in "clean money." *Id.* at 1546. The bank officers obtained the purchase price by approving fraudulent loans and overdrafts to others involved in the scheme. *Id.* The bank president was ultimately convicted and sentenced to two years in prison for criminal fraud. *Id.* at 1549 n.5. Based on these facts, the *Cenco* analysis would produce the same result because the stockholders were directly defrauded. The bank was the victim, not the vehicle, for the fraud. The *Clark* case differs factually from *O'Melveny* and *Ernst & Young* because the fraudulent officers were not entirely in control of management. The bank's chairman of the board was not involved in the fraud, and the bank fired the president after the scheme was uncovered. *Id.* at 1548.

229. *Cenco*, 686 F.2d at 454.

230. Curtis, Collins & Holbrook Co. v. United States, 262 U.S. 215, 222 (1923) (stating that company "is charged with Holbrook's knowledge because he was the sole actor for the Company in procuring the fraudulent patents"); Maryland Casualty Co. v. Tulsa Indus. Loan & Inv. Co., 83 F.2d 14, 17 (10th Cir. 1936); 3 FLETCHER, *supra* note 64, §§ 809, 827.

231. *See* 3 FLETCHER, *supra* note 64, § 827.1.

232. 3 *id.*

233. Courts in 33 states have accepted the sole actor doctrine: Alabama, Tatum v. Commercial Bank & Trust Co., 69 So. 508, 512-13 (Ala. 1915); Alaska, Matanuska Valley Bank v.

The Second Circuit applied similar reasoning in *Munroe v. Harriman*,[234] in which bank president Joseph Harriman of Harriman National Bank & Trust Co. dominated the loan committee and caused it to rubber stamp a loan to a dummy corporation he owned.[235] The loan was secured by stocks fraudulently acquired by Harriman from a third party.[236] The court of appeals in *Munroe* found that the loan committee, on Harriman's instructions, approved the loan after it had already been made.[237] Deciding to impute Harriman's knowledge to the bank, the court said:

> With respect to loans to Harriman . . . the other officers and employees of the bank did without question whatever he requested, and the District Court found that they were completely dominated by him. . . . His will alone caused the making

Arnold, 223 F.2d 778, 781 (9th Cir. 1955); Arizona, Pearll v. Selective Life Ins. Co., 444 P.2d 443, 445-46 (Ariz. Ct. App. 1968); Arkansas, City Nat'l Bank v. Vanderboom, 422 F.2d 221, 231 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); California, First Nat'l Bank v. Reed, 198 Cal. 252, 259-60, 244 P. 368, 371 (1926); Colorado, Vail Nat'l Bank v. Finkelman, 800 P.2d 1342, 1345 (Colo. Ct. App. 1990); Connecticut, First Nat'l Bank v. Town of New Milford, 36 Conn. 93, 101 (1869); Florida, Amvest Capital Corp. v. Banco Exterior de Espana, 675 F. Supp. 640, 644 (S.D. Fla. 1987); Georgia, Brunswick Nursing & Convalescent Ctr. v. Great Am. Ins. Co., 308 F. Supp. 297, 300 (S.D. Ga. 1970); Illinois, First Nat'l Bank v. Lewco Sec. Corp., 860 F.2d 1407, 1417-18 (7th Cir. 1988); Iowa, FDIC v. National Sur. Corp., 281 N.W.2d 816, 820-21 (Iowa 1979); Kansas, Supreme Petroleum, Inc. v. Briggs, 433 P.2d 373, 378-79 (Kan. 1968); Kentucky, Anderson v. General Am. Life Ins. Co., 141 F.2d 898, 908 (6th Cir. 1944), *cert. denied*, 323 U.S. 798 (1945); Massachusetts, Atlantic Cotton-Mills v. Indian Orchard Mills, 17 N.E. 496, 501 (Mass. 1888); Michigan, National Turners Bldg. & Loan Ass'n v. Schreitmueller, 285 N.W. 497, 499 (Mich. 1939); Minnesota, Sussel Co. v. First Fed. Sav. & Loan Ass'n, 238 N.W.2d 625, 628 (Minn. 1976); Missouri, Newco Land Co. v. Martin, 213 S.W.2d 504, 511 (Mo. 1948); New Jersey, Mick v. Royal Exch. Assur., 91 A. 102, 105-06 (N.J. 1914); New York, Yager Pontiac v. Fred A. Danker & Sons, 343 N.Y.S.2d 209, 212 (App. Div. 1973); North Carolina, Le Duc v. Moore, 15 S.E. 888, 889 (N.C. 1892); North Dakota, Grebe v. Swords, 149 N.W. 126, 130 (N.D. 1914); Ohio, Politte v. Farris, No. 86 C.A. 39, 1987 WL 15353, at *4 (Ohio Ct. App. Aug. 6, 1987) (unpublished opinion with limited precedential value under Ohio Supreme Court Rule 2); Oklahoma, United States Fidelity & Guar. Co. v. Oklahoma *ex rel.* Sebring, 383 F.2d 417, 419-20 (10th Cir. 1967); Pennsylvania, Gordon v. Continental Casualty Co., 181 A. 574, 577-78 (Pa. 1935); Rhode Island, Cook v. American Tubing & Webbing Co., 65 A. 641, 655 (R.I. 1905); South Dakota, Black Hills Nat'l Bank v. Kellogg, 56 N.W. 1071, 1072-73 (S.D. 1893); Tennessee, Smith v. Mercantile Bank, 177 S.W. 72, 73 (Tenn. 1915); Texas, Wellington Oil Co. v. Maffi, 150 S.W.2d 60, 63 (Tex. 1941); Virginia, Coronado-Inglenook Land & Dev. Co. v. Black, 96 S.E.2d 737, 740 (Va. 1957); Washington, Puget Sound Nat'l Bank v. St. Paul Fire & Marine Ins. Co., 645 P.2d 1122, 1127 (Wash. Ct. App. 1982); Wisconsin, Milwaukee Acceptance Corp. v. Dore, 168 N.W.2d 594, 598 (Wis. 1969); West Virginia, Knobley Mountain Orchard Co. v. People's Bank, 129 S.E. 474, 475-76 (W. Va. 1925); Wyoming, American Nat'l Bank v. Foodbasket, 497 P.2d 546, 548 (Wyo. 1972).

234. 85 F.2d 493 (2d Cir.), *cert. denied*, 299 U.S. 601 (1936).

235. *Id.* at 494.

236. *Id.*

237. *Id.* at 496.

of the loan and the acceptance of the collateral. Therefore he should be treated as the sole actor on behalf of the bank. . . .[238]

The U.S. Supreme Court expanded the sole actor doctrine to cover situations involving more than a single agent. The Court recognized that the interests of a small number of controlling shareholders and officers are likely to be identical to the interests of their closely held corporation.[239] To hold otherwise, the Court said, would allow "the corporation to become a means of fraud or a means of evading its responsibilities."[240]

Neither the parties nor the court in *FDIC v. O'Melveny & Meyers* [sic][241] addressed the sole actor doctrine. The *O'Melveny* court correctly noted that the principles of corporateness apply even when one person owns all the stock,[242] but failed to consider other factors, such as the sole actor doctrine, which might make it appropriate to disregard the corporate form. Mr. Sahni's ninety-six percent stock ownership is not by itself a sufficient reason to impute his knowledge to American, because even close corporations are legally distinct from their shareholders.[243] Mr. Sahni's domination and control of American, however, make him a sole actor.[244]

Assuming the interests of Messrs. Sahni and Day were adverse to American, the sole actor doctrine nonetheless requires courts to impute to the corporation the knowledge of the 100% owners who were also the controlling officers.[245] The rationale for imputing the knowledge of a sole representative applies to the facts of *O'Melveny*. In this case, there was no one else to whom Messrs. Sahni and Day were responsible and no superior within the corporation from whom to conceal their fraud.[246] As in *Munroe v. Harriman*, Messrs. Sahni and Day so dominated the management of American that they "should be treated as the sole actor[s] on behalf of the bank."[247]

238. *Id.*

239. J.J. McCaskill Co. v. United States, 216 U.S. 504, 515 (1910). In *McCaskill*, the corporate president and secretary incorporated the business, owned "a large majority of the stock" and possessed "the entire management and control of the business and affairs." *Id.* In this situation, the personal interests of the top managers were identical, and not adverse, to the corporation. *Id.* In imputing the officers' knowledge to the corporation, the Court emphasized the agents' close relationship with the corporation, rather than the agents' competing interests. *See id.*

240. *Id.*

241. 969 F.2d 744 (9th Cir. 1992).

242. *Id.* at 750.

243. *See* HENN & ALEXANDER, *supra* note 63, § 147, at 353.

244. *See* Munroe v. Harriman, 85 F.2d 493, 496 (2d Cir.), *cert. denied*, 299 U.S. 601 (1936).

245. *See supra* note 230 and accompanying text.

246. *See* 3 FLETCHER, *supra* note 64, § 827.1.

247. *See Munroe*, 85 F.2d at 496.

The U.S. Court of Appeals for the Fifth Circuit in *FDIC v. Ernst & Young*[248] applied reasoning similar to *Munroe*, although it did not invoke the sole actor doctrine by name. The Fifth Circuit concluded that the corporation possessed the same knowledge as the "sole owner who dominated the board of directors."[249] The same rationale should apply to a case in which not one, but several members of the S&L's top management constitute the dominant, controlling force.[250] When the co-conspirators are at the very highest level of an organization, there is no meaningful "duty" to convey their knowledge to higher-ups and no need to conceal their fraud from other top managers.

The court in *O'Melveny* created a loophole in agency law by, in effect, considering any inside defrauder whose misdeeds lead to insolvency "adverse" to the corporation.[251] The courts will have to close this hole in the future when fraudulent corporate owners discover it and attempt to shift liability for their misdeeds to outside professionals. The federal courts should resolve this by adopting the sole actor doctrine and the *Cenco* analysis as the federal common-law rule.

If the courts impute the knowledge of corrupt S&L officers to the corporation, the thrift itself could not recover fraud-related losses from negligent outside professionals.[252] The question remains, however, whether the FDIC as receiver for the thrift should recover from the outside professionals.

B. The Rights and Powers of the FDIC as Receiver

1. The powers of receivers in general

Receivership is intended to protect the rights of all interested parties and preserve property.[253] A majority of jurisdictions holds that a receiver for an insolvent bank or thrift acquires the same, and no greater, rights in the institution's funds and assets as the institution possessed

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248. 967 F.2d 166 (5th Cir. 1992).

249. *Id.* at 171; *cf.* FDIC v. Lott, 460 F.2d 82 (5th Cir. 1972) (holding that sole actor doctrine does not apply to bank president who owns 52% of stock because he was not in "sole control").

250. *See* J.J. McCaskill Co. v. United States, 216 U.S. 504, 515 (1910); *cf.* Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 456 (7th Cir.) (holding corporation responsible for top management's collective fraud), *cert. denied*, 459 U.S. 880 (1982).

251. FDIC v. O'Melveny & Meyers [sic], 969 F.2d 744, 750 (9th Cir. 1992).

252. *See supra* notes 27-30 and accompanying text.

253. Marguerite Woung, *Origin and Nature of Bank and Thrift Receiverships*, *in* BANKS AND THRIFTS, *supra* note 1, § 15.01, § 15.01.

before receivership.[254] Therefore, a defense valid against a corporation's claim is just as valid against the receiver.[255]

2. *D'Oench, Duhme & Co. v. FDIC*

The U.S. Supreme Court in *D'Oench, Duhme & Co. v. FDIC*[256] opened the door to special rights and powers for the FDIC as receiver. D'Oench, Duhme & Co. (D'Oench, Duhme) had executed a promissory note in favor of a bank for the purpose of inflating the bank's assets so that it would appear solvent.[257] The receipt for the note stated: "This note is given with the understanding it will not be called for payment."[258] When the bank failed, the note was among the bank's assets, and the FDIC sued D'Oench, Duhme to collect on the note.[259]

D'Oench, Duhme defended on the basis of the receipt, which was, in effect, a side agreement not to enforce the obligation.[260] However, the court found that, because the note itself was a sham transaction that had misled the FDIC, D'Oench, Duhme could not use the secret side agreement to avoid payment on the note.[261] The Supreme Court found in the Federal Reserve Act[262] "a federal policy to protect [the FDIC], and the public funds which it administers, against misrepresentations as to the

254. Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 429 (1972); Morrison-Knudsen Co. v. CHG Int'l, Inc., 811 F.2d 1209, 1222 (9th Cir. 1987), *cert. dismissed*, 408 U.S. 935 (1988); Jacobson v. FDIC, 407 F. Supp. 821, 827 (S.D. Iowa 1976); Camerer v. California Sav. & Commercial Bank, 4 Cal. 2d 159, 170, 48 P.2d 39, 44 (1935); 10 AM. JUR. 2D *Banks*, *supra* note 45, § 764; 2 RALPH E. CLARK, LAW AND PRACTICE OF RECEIVERS § 362, at 619 (3d ed. 1959); Woung, *supra* note 253, § 15.07[2].

Although in England appointment of a receiver was originally solely within the power of courts of equity, Parliament extended the power to courts of law in 1873. 1 CLARK, *supra*, § 4, at 5. United States federal courts at their inception inherited equitable power from their predecessor courts of equity. 1 *id.* § 6, at 6. In 1934, the new Federal Rules of Civil Procedure combined equitable and legal powers in the U.S. trial courts for all civil actions. FED. R. CIV. P. 1, 2. There are several types of receivers: those appointed by courts, by the parties pursuant to an agreement or contract, or by a government official pursuant to statute. 1 CLARK, *supra*, § 11, at 13-15. The FDIC is a statutory receiver. *See* 12 U.S.C. § 1821(c) (1988 & Supp. II 1990).

255. *Morrison-Knudsen*, 811 F.2d at 1222; Tosco Corp. v. FDIC, 723 F.2d 1242, 1247 (6th Cir. 1983); *Jacobson*, 407 F. Supp. at 827; *Camerer*, 4 Cal. 2d at 170, 48 P.2d at 44; Allen v. Ramsay, 179 Cal. App. 2d 843, 854, 4 Cal. Rptr. 575, 582-83 (1960).

256. 315 U.S. 447 (1942).

257. *Id.* at 454.

258. *Id.*

259. *Id.*

260. *Id.* at 456.

261. *Id.* at 461.

262. Ch. 6, § 1, 38 Stat. 251 (1913) (codified as amended in scattered sections of 12 U.S.C.).

securities or other assets in the portfolios of the banks which [the FDIC] insures or to which it makes loans."[263]

3. Extension of the *D'Oench, Duhme* doctrine

Courts have extended the *D'Oench, Duhme* doctrine to cover situations other than secret side agreements with borrowers. For example, the FDIC as receiver can collect on a loan even if the bank itself could not collect because of its own unlawful conduct.[264] In *FDIC v. Gulf Life Insurance Co.*,[265] the court further expanded the doctrine by applying it to a suit against a nonborrower debtor.

In *Gulf Life*, the FDIC attempted to recover amounts overpaid on insurance policies held by two failed banks.[266] The insurance company defended on the basis that, under Alabama law, the bank would only have been entitled to a refund of what the insurer actually received, which was thirty-five percent of the stated premium.[267] Sixty-five percent of the premium went to others in the form of commissions.[268] The U.S. Court of Appeals for the Eleventh Circuit fashioned a new federal common-law rule[269] based on the FDIC's need to evaluate with certainty the worth of assets it obtains from insolvent institutions and to reduce loss of FDIC funds.[270] The court held: "[W]hen the FDIC in its corporate capacity obtains an asset in the course of a purchase and assumption transaction, for value, in good faith, and without knowledge of the defenses, its rights in the asset are not limited by the defenses of waiver, estoppel, or unjust enrichment."[271] The court in *Gulf Life* stated the rule broadly, but a narrow reading of the case based on the facts before the court suggests the rule should be limited to negotiable instruments and contract claims.[272] The court did not mention FDIC tort claims.

The court in *O'Melveny*, however, greatly expanded on *D'Oench, Duhme* and *Gulf Life* by creating a new federal common-law rule that

263. *D'Oench, Duhme*, 315 U.S. at 457.

264. For example, the FDIC may collect a loan that violated federal securities laws. Kilpatrick v. Riddle, 907 F.2d 1523 (5th Cir. 1990), *cert. denied*, 111 S. Ct. 954 (1991); FDIC v. Investors Assocs. X., 775 F.2d 152 (6th Cir. 1985).

265. 737 F.2d 1513 (11th Cir. 1984).

266. *Id.* at 1515.

267. *Id.* at 1515-16.

268. *Id.* at 1514-15.

269. The court of appeals held that federal common law governed the defenses allowed because "the rights and obligations of the FDIC are at stake." *Id.* at 1517.

270. *Id.* at 1518.

271. *Id.*

272. *See id.*

FDIC tort claims are not subject to equitable defenses.[273] The bases for the rule, according to the *O'Melveny* court, are: (1) The FDIC is involuntarily "thrust into" the insolvent thrift's shoes;[274] and (2) the "intricate regulatory scheme" for the protection of depositors would be frustrated if the FDIC were unable to recover for negligence.[275] Neither rationale is persuasive.[276]

Federal law generally requires the FDIC to act as receiver for failed thrifts.[277] Absent a federal statute, however, courts have the equitable power to appoint a receiver for an insolvent thrift.[278] Whether court-appointed or statutory, the receiver's role and function is to preserve assets for the benefit of depositors and creditors.[279] Therefore, the existence of a statute that makes the FDIC an involuntary receiver cannot justify the *O'Melveny* court's rule.

Second, the Ninth Circuit overstates the extent to which the insider fraud defense would block FDIC professional liability suits. For example, the court at one point describes the professionals as "those who may have aided and abetted [insiders] in bringing about the disaster."[280] Courts that have allowed an insider fraud defense have only applied the defense in cases of a professional's *non*intentional or *non*knowing conduct,[281] not aiding and abetting. O'Melveny was charged with negli-

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273. FDIC v. O'Melveny & Meyers [sic], 969 F.2d 744, 751-52 (9th Cir. 1992).

274. *Id.* at 751.

275. *Id.* at 752.

276. The U.S. district court in FSLIC v. McGinnis, Juban, Bevan, Mullins & Patterson, 808 F. Supp. 1263 (E.D. La. 1992), stated the argument for the FDIC more effectively:

> [W]hen litigating as receiver of a failed institution, the FDIC has a special role quite unlike that of the typical private plaintiff. The FDIC is duty-bound in making decisions regarding the disposition of a failed institution, its assets, and its claims to advance "the best interests of the institution, the depositors of such institution, and the [FDIC]." It acts at all times to "preserve and conserve the assets and property of [the] institution," for the benefit of the failed institution's creditors and the insurance fund.

Id. at 1278 (second alteration in original) (citations omitted) (quoting 12 U.S.C. § 1821(d) (Supp. III 1991)). The *McGinnis, Juban* court made a better argument, but the logic suffers from the same weakness as the *O'Melveny* decision. *See infra* notes 277-79 and accompanying text.

277. *See supra* note 42.

278. *See supra* note 254 and accompanying text.

279. *See supra* note 253 and accompanying text.

280. *O'Melveny*, 969 F.2d at 748.

281. *See, e.g.*, FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir. 1992) (allowing defense for negligent accountants); Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.) (same), *cert. denied*, 459 U.S. 880 (1982). The insider fraud defense should not apply to suits which allege the professional participated in or aided and abetted fraud because one of the principal justifications for the defense is balancing equities and policy considerations. *See infra* part IV.C.

gence, not intentional or knowing conduct.[282] The insider fraud defense is further limited to those cases in which the top managers turned the S&L into "an engine of theft"[283] or dominated and controlled the institution as the thrift's alter ego.[284]

The *O'Melveny* rule greatly expands the protection given to the FDIC in *D'Oench, Duhme & Co. v. FDIC*.[285] However, *D'Oench, Duhme* and *O'Melveny* differ factually. First, in *D'Oench, Duhme*, the court allowed the FDIC to recover on a promissory note that the bank itself would have been unable to collect because of a secret side agreement with the borrower.[286] Thus, *D'Oench, Duhme* concerned the type of negotiable, financial instrument that comprises the bulk of bank and S&L assets. *O'Melveny* involved a nonfinancial, noncontractual and uncommon S&L "asset"—the right to bring a malpractice suit. Yet the *O'Melveny* court does not discuss this difference.

Second, in *D'Oench, Duhme*, the borrower knew he was entering into a sham transaction[287] and therefore either was reckless or aided and abetted bank fraud. In contrast, the O'Melveny firm was not charged with aiding and abetting fraud because it was unaware of any fraud. At most, O'Melveny was negligent in failing to uncover the fraud.[288]

4. Applying the *Kimbell Foods* analysis

The majority state rule subjects receivers to the same defenses as the failed institution.[289] Therefore, the courts must create a contrary federal common-law rule to give the FDIC greater rights. When a federal court creates a rule that differs from state law, it should apply the three-part analysis used in *United States v. Kimbell Foods*.[290] Neither the

282. *O'Melveny*, 969 F.2d at 745-46.

283. *Cenco*, 686 F.2d at 454.

284. 3 AM. JUR. 2D *Agency*, *supra* note 75, § 292, at 797-98.

285. 315 U.S. 447 (1942). One commentator has argued the basic holding of *D'Oench, Duhme* is unfair because the bank borrower "has been forced to bear more than his fair share of responsibility for the recent economic downturn and resulting loan losses as well as those caused by the nonfeasance and/or malfeasance of the institutions and their regulators." Richard E. Flint, *Why* D'Oench, Duhme? *An Economic, Legal, and Philosophical Critique of a Failed Bank Policy*, 26 VAL. U. L. REV. 465, 478 (1992). Professor Flint, however, does not discuss the extension of the *D'Oench, Duhme* doctrine to nonborrower defendants such as negligent professionals.

286. *See* 315 U.S. at 461.

287. *Id.* at 454.

288. *See* FDIC v. O'Melveny & Meyers [sic], 969 F.2d 744, 746, 752 (9th Cir. 1992).

289. *Supra* notes 254-55.

290. 440 U.S. 715, 728-29 (1979); *see supra* note 53 and accompanying text.

O'Melveny nor the *Ernst & Young* courts formally applied the entire *Kimbell Foods* test.[291]

First, does the issue require a "nationally uniform body of law"?[292] The court in *O'Melveny* apparently concluded that the banking and S&L insurance system is a national program that requires uniformity to be effective.[293] However, uniformity was not at stake in this case because the majority state rule on the power of receivers *is* nearly uniform,[294] so the real issue was whether there should be a different federal rule.

Second, would the use of state law obstruct the "specific" aims of the FDIC?[295] The general aims of the FDIC are to insure bank and S&L deposits and to protect the insurance fund. Allowing the insider fraud defense eliminates some recoveries from outside professionals. In a general sense, then, allowing the defense against the FDIC frustrates to a small degree the FDIC's goal of preserving the bank and S&L insurance funds. The *O'Melveny* court adopted this broad view of FDIC objectives.[296] While the FDIC has authority to sue negligent professionals, Congress has not specifically empowered the FDIC to override state-law defenses. Thus, the insider fraud defense does not obstruct any specific FDIC goals.[297]

Third, to what extent would special rights and powers for the FDIC as receiver disrupt state law commercial relationships?[298] Holding attorneys and accountants liable for failing to stop insider fraud creates a new

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291. *Cf.* FSLIC v. McGinnis, Juban, Bevan, Mullins & Patterson, 808 F. Supp. 1263, 1276-79 (E.D. La. 1992) (applying *Kimbell Foods* analysis to decide whether state rule on credit for partial settlements applies to FSLIC attorney malpractice suit). The *McGinnis, Juban* court considered whether Louisiana's proportionate-reduction rule applied to a $60 million settlement with the thrift's officers and directors. *Id.* at 1276. In Louisiana, the damages award would be reduced by the proportion of fault attributed to the settling defendants. *Id.* The court concluded that federal common law applied, *id.*, and rejected the state rule because "[w]hen the FDIC is involved . . . '[a]scertainment of the relative culpability of joint tortfeasors is overshadowed by the goal of making the FDIC as whole as feasible.'" *Id.* at 1279 (second alteration in original) (quoting FDIC v. Geldermann, Inc., 763 F. Supp. 524, 529 (W.D. Okla. 1990), *rev'd*, 975 F.2d 695 (10th Cir. 1992)).

292. *Kimbell Foods*, 440 U.S. at 728.

293. *See O'Melveny*, 969 F.2d at 751-52.

294. The majority rule is long standing and entrenched. *See, e.g.*, Allen v. Todd, 12 Cal. App. 3d 654, 657, 90 Cal. Rptr. 807, 809 (1970); Martin v. General Am. Casualty Co., 76 So. 2d 537, 540 (La. 1954); Wellbro Bldg. Co. v. McConnico, 421 P.2d 837, 840 (Okla. 1966); Warner v. Conn, 32 A.2d 740, 741 (Pa. 1943); Morse Electro Prods. Corp. v. Beneficial Indus. Loan Co., 579 P.2d 1341, 1342 (Wash. 1978); Barber v. Reina Nash Motor Co., 260 P.2d 928, 934 (Wyo. 1953); 65 AM. JUR. 2D *Receivers* § 165 (1972); 2 CLARK, *supra* note 254, § 362.

295. *Kimbell Foods*, 440 U.S. at 728.

296. *O'Melveny*, 969 F.2d at 752.

297. *See* FDIC v. Cherry, Bekaert & Holland, 742 F. Supp. 612, 614 (M.D. Fla. 1990); *infra* note 304 and accompanying text.

298. *Kimbell Foods*, 440 U.S. at 728-29.

duty to blow the whistle on clients that is diametrically opposed to client confidentiality.[299] Such a duty would significantly interfere with state-law professional relationships.

The Ninth Circuit in *O'Melveny* slavishly applied *D'Oench, Duhme* without fully considering the second and third factors in the *Kimbell Foods* analysis. Based on the near uniformity of state law on receivers, the lack of specific legislative intent to override state-law tort defenses and the potential disruption of state-law relationships between professionals and clients, courts should not extend the *D'Oench, Duhme* doctrine to professional negligence claims.

5. The *D'Oench, Duhme* doctrine should be limited

Despite the *Gulf Life* and *O'Melveny* decisions, not all courts have agreed with the FDIC's expansive view of the *D'Oench, Duhme* doctrine. In *FDIC v. Cherry, Bekaert & Holland*, the FDIC sued the auditors of Park Bank for negligence.[300] The auditors asserted the comparative or contributory negligence of the Park Bank officers as a defense.[301] The FDIC argued that the *D'Oench, Duhme* doctrine created "special federal rules allowing the FDIC to carry out its function of attempting to stabilize the national banking system."[302] However, the U.S. district court found that the special protection afforded the FDIC under *D'Oench, Duhme* was limited mainly to secret side agreements and fraud by former bank officials vis-a-vis defaulted borrowers of the bank.[303] Discussing comparative negligence, the district court in *Cherry, Bekaert* stated:

> [T]he FDIC does not cite any statutory authority affording it special protection from this defense, and . . . this Court declines to speculate that Congress contemplated that negligence suits against third party defendants are a necessary part of the recovery of the insurance fund. Therefore, the Court finds that Cherry Bekaert may assert its affirmative defenses against the FDIC in this action.[304]

In *FDIC v. Jenkins*,[305] the FDIC argued that its negligence claims against a bank's attorneys and accountants should have priority over

299. *See infra* part IV.C.2-3.
300. 742 F. Supp. at 613.
301. *Id.*
302. *Id.* at 614.
303. *Id.* at 614-15 (citing FDIC v. Harrison, 735 F.2d 408, 412 n.6 (11th Cir. 1984)).
304. *Id.* at 614. In FDIC v. Carter, 701 F. Supp. 730 (C.D. Cal. 1987), the district court also declined to extend the *D'Oench, Duhme* doctrine. *Id.* at 736 (holding that failure to mitigate damages is valid defense to FDIC claims).
305. 888 F.2d 1537 (11th Cir. 1989).

similar suits filed by the bank's shareholders.[306] The FDIC contended that minimizing insurance fund losses by suing negligent professionals was an express goal of the FDIC's statutory framework.[307] Finding no authority for the FDIC's "expansive view" of its powers, the Court of Appeals for the Eleventh Circuit rejected this argument.[308] The court stated that federal law does not "compel" the FDIC to sue negligent professionals and that Congress did not envision such suits as "a necessary part of the recovery to the deposit insurance fund."[309] Exercising judicial restraint, the court said a federal rule giving the FDIC priority over shareholders' lawsuits "will have to come from Congress, not this Court."[310]

The principles of judicial restraint and federalism caution against creating a federal rule hostile to a majority state rule. The U.S. Court of Appeals for the Fifth Circuit adopted this rationale in *Ernst & Young*, finding that "[n]o statutory justification or public policy exists to treat the FDIC differently from other assignees."[311]

C. The Insider Fraud Defense and Public Policy

1. Purposes of professional negligence liability

The courts must address the policy questions raised by the insider fraud defense. The decision in *FDIC v. O'Melveny & Meyers* [sic][312] relied largely on the important public policy goal of assisting the S&L bailout.[313] The court concluded that even if the wrongdoing benefitted the corporation, "the insiders' conduct is still 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."[314] The court hastily discussed these broad policy issues without considering countervailing policies, such as the importance of the attorney-client relationship.[315]

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306. *Id.* at 1538-39.

307. *Id.* at 1540-41.

308. *Id.* at 1543.

309. *Id.* at 1546.

310. *Id.*

311. FDIC v. Ernst & Young, 967 F.2d 166, 170 (5th Cir. 1992).

312. 969 F.2d 744 (9th Cir. 1992).

313. *See id.* at 748, 752.

314. *Id.* at 750 (citing Schacht v. Brown, 711 F.2d 1343, 1348 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983); Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 455 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982)).

315. *See infra* part IV.C.2-3.

Compensating the FDIC for losses is certainly important because of the central role deposit insurance plays in the national savings and banking system. The FDIC, however, is not powerless and, perhaps, not entirely blameless. The FDIC/FSLIC has the right and responsibility to examine thrifts' books and halt unsound lending practices.[316] The agency should have protected the insurance fund and the national thrift and banking system from fraudulent S&L owners such as Mr. Sahni *before* insolvency occurred.

Tort liability also seeks to deter wrongdoing.[317] The wrongdoing in *O'Melveny* was primarily Messrs. Sahni's and Day's fraud and secondarily O'Melveny's possible negligence. The alleged negligent omission by O'Melveny was its failure to uncover the financial information that American's owners were concealing from regulators and others.[318] The court concluded that imposing liability would cause O'Melveny and other professionals to be more careful in the future.[319] Courts are understandably reluctant to create a rule that would encourage professionals to "look the other way," thereby acting with wilful ignorance, when there is a hint of client fraud.

The *O'Melveny* court, however, distorted agency law so as to allow the defrauders to conceal material facts from outside professionals and then sue the professionals for malpractice when they fail to discover the fraud.[320] Such a rule deters negligence by professionals at the expense of *encouraging* fraud by corporate clients. As a practical matter, the deterrence value of the *O'Melveny* rule is limited when professionals are dealing with closely held corporations. As both *O'Melveny* and *FDIC v. Ernst & Young*[321] show, when top management controls the board of directors, it can easily conceal its fraud from outside professionals.[322] In these situations, corporate power is concentrated in just a few hands.[323]

316. *See supra* note 1.

317. KEETON ET AL., *supra* note 66, § 4, at 25.

318. American changed auditors twice in order to forestall releasing financial statements that would show its insolvency. *O'Melveny*, 969 F.2d at 746. When another law firm performing work on other real estate syndications was informed by an auditor of American's likely insolvency, American stopped using that firm and hired O'Melveny instead. *Id.* at 747.

319. *See id.* at 750 (citing Schacht v. Brown, 711 F.2d 1343, 1348 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983)).

320. *See supra* part IV.A.4.

321. 967 F.2d 166 (5th Cir. 1992).

322. *See* Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 456 (7th Cir.) (stating that "the number and high rank of the managers involved . . . complicated the task of discovery" for the auditors), *cert. denied*, 459 U.S. 880 (1982).

323. HENN & ALEXANDER, *supra* note 63, § 147, at 353.

> [T]he rule that corporateness will be sustained only so long as it is used for legitimate purposes has special significance when applied to the one-person, family, or other

Imposing liability on the outside professional achieves some valid tort and policy objectives, but the balance of gain and loss is much closer than the court's one-sided analysis in *O'Melveny* suggested. A full weighing of the issues requires consideration of extrinsic policies, particularly the professional-client relationship.

2. The professional-client relationship

In general, shifting the cost of the S&L bailout onto the outside professional comes at the expense of the professional-client relationship. A federal common-law rule giving the FDIC the power to overcome the insider fraud defense will make attorneys and accountants reluctant to work for financially shaky S&Ls—whether they are fraudulent or honest—because once a thrift becomes insolvent, the potential liability for the professional increases.[324] The greater liability stems from the risk of being held accountable by the FDIC for the concealed fraud of top management. Professionals will not be as concerned about the risk of concealed fraud while the S&L is financially healthy because the thrift, if not under FDIC receivership, will generally be barred from recovering for losses caused by its own fraudulent controlling managers.[325]

The policy of protecting the professional-client relationship[326] applies with particular urgency to the financially troubled client. An S&L on the skids, even one with honest management, has more incentive than a healthy thrift to skirt the law if management views this as the only hope

> closely-held corporation. Such an enterprise concentrates control and superior knowledge in the principal shareholder or shareholders and thereby lends itself to illegitimate use.

Id.

324. *See* Kelley Holland et al., *Big Six Firms Are Firing Clients*, BUS. WK., Mar. 1, 1993, at 76 ("Huge lawsuits make them choosy about whom they'll audit."). For example, Ernst & Young withdrew from auditing Tehama County Bank in Red Bluff, California. *Id.* According to Lawrence A. Weinbach, chief executive officer of Arthur Andersen & Co., " 'Liability risk has gone so far, it's not worth the risk to audit some . . . small banks.' " *Id.*

325. *See supra* part IV.A. However, in addition to the *O'Melveny* court's expansion of the powers of the FDIC as receiver, the *O'Melveny* rule on imputing knowledge could allow a fraudulently managed thrift to recover from its accountants or attorneys before FDIC receivership. *See supra* note 226.

326. Courts and lawmakers have been highly deferential to the accountant-client and attorney-client relationship, as evidenced by the privileges against testifying about client confidences. *See* 8 JOHN H. WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW § 2286, at 532-33 & 533 n.22 (accountant-client privilege), §§ 2290-2291 (attorney-client privilege) (John T. McNaughton rev. ed. 1961 & Supp. 1991). The attorney-client privilege is based on the value of legal counsel to individual clients and the need for full disclosure by the client to maximize the benefit of the attorney's advice. CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 6.1.3 (1986). Presumably, clients would, in some cases, withhold relevant but incriminating information if they believed it could somehow be used against them. *Id.* The same policy underlies the professional's ethical duty of confidentiality. *Id.*; *see infra* part IV.C.3.

for survival. This type of client—desperate but not intent on fraud or legal violations—can benefit most from competent professional advice.

On the basis of an inadequate balancing of equities and policy concerns, the *O'Melveny* court decided that outside professionals are, in effect, the *insurers* of their clients' misdeeds if the client ends up in FDIC receivership. This rule will certainly make it more difficult for a financial institution to secure professional advice as it approaches insolvency.

Shifting S&L losses onto professionals will have an even more direct impact on the professional-client relationship by creating a strong incentive, if not a duty, to break confidences. Under the *O'Melveny* rule, a professional who uncovers fraud may be held liable if he or she fails to stop it. If a client cannot be persuaded to voluntarily abandon unlawful conduct, the professional faces a difficult choice: withdraw[327] and keep quiet, or breach the duty of client confidentiality by reporting the client to regulators.[328] The ethical rules could subject an attorney to discipline for breaching confidences, while the *O'Melveny* rule could make an attorney liable if he or she does not report the conduct. The *O'Melveny* rule is designed to reduce the harm caused by fraudulent S&Ls, but it fails to take into account the intricate balancing attempted by the ethical rules. Despite the protection confidentiality gives some unlawful clients, the ethical rules almost always require confidentiality because of the importance of the professional-client relationship.[329]

3. Duty of confidentiality when a professional uncovers fraud

Professional rules of confidentiality generally prohibit disclosing client confidences or secrets.[330] Usually, the only course allowed to an attorney or accountant who has discovered corporate fraud is to advise the corporation's top managers or board of directors to abandon the unlawful conduct, and if that fails, to withdraw from the professional-client relationship.[331]

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327. The attorney, in some cases, must withdraw. *See infra* part IV.C.3.

328. *See infra* part IV.C.3.

329. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 cmt. (1992); MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 4-1 (1981).

330. For attorneys' ethical duty of confidentiality, see MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6; MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101; Monse, *supra* note 47, 15-27. For accountants' ethical duty of confidentiality, see CAL. CODE REGS. tit. 16, § 54 (1992); AMERICAN INST. OF CERTIFIED PUB. ACCOUNTANTS, CODE OF PROFESSIONAL ETHICS § 301 (1977).

331. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.16(a)(1); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2-110(B)(2), DR 7-102(B)(1).

The American Bar Association's *Model Rules of Professional Conduct*[332] and *Model Code of Professional Responsibility*[333] allow limited exceptions to the duty of confidentiality.[334] The *Model Code* allows, but does not require, disclosure of a client's secrets without his or her consent to the extent "necessary to prevent [a] crime."[335] This provision gives attorneys discretion to report a client's intention to violate criminal banking or S&L laws in the future, but confidentiality must be maintained as to any past crimes or intent to violate civil statutes or regulations.[336] The *Model Rules*, which are more restrictive, permit discretionary disclosure without the client's consent "to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm."[337]

An attorney who has discovered noncriminal fraud by a client, however, must not participate in it.[338] The attorney must try to persuade the client to act lawfully.[339] If the attorney cannot persuade the client to

332. Thirty-five states and the District of Columbia have adopted a version of the *Model Rules*, making it the majority approach to legal ethics. *See* 2 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING: A HANDBOOK ON THE MODEL RULES OF PROFESSIONAL CONDUCT § AP4:107, at 1269-70 (2d ed. Supp. 1992). The states are: Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Texas, Utah, Washington, West Virginia, Wisconsin and Wyoming. *Id.*

333. Four states still follow a modified version of the *Model Code*: Massachusetts, Oregon, Virginia and New York. *See id.* § AP4:101, at 1255 n.1.

334. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6(b)(1); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101(C)(3). California, which has adopted neither the *Model Code* nor the *Model Rules*, does not include any stated exception to its rule on client confidentiality. *See* CAL. BUS. & PROF. CODE § 6068(e) (West 1990 & Supp. 1993) (stating it is attorney's duty "[t]o maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client").

335. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101(C)(3). Other *Model Code* exceptions to client confidentiality include disclosure: with the informed consent of the client, *id.* DR 4-101(C)(1); when required by law, court order, or the disciplinary rules, *id.* DR 4-101(C)(2); and to collect a fee or defend accusations of wrongful conduct against the attorney, *id.* DR 4-101(C)(4).

336. *See id.* DR 4-101(C)(3); WOLFRAM, *supra* note 326, § 12.6.4, at 668-69. Most banking and S&L statutes and regulations provide only civil penalties. For example, the FDIC brought only civil charges against Messrs. Sahni and Day of American, and the suit was settled without admission of liability. *See supra* note 76. However, the Justice Department prosecuted Mr. Woods, owner of Western. *See supra* note 119 and accompanying text.

337. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6(b)(1). The *Model Rules* also allow disclosure without the client's consent for the attorney's defense of criminal or civil charges or in an attorney's claim against the client. *Id.* Rule 1.6(b)(2).

338. MODEL RULES OF PROFESSIONAL CONDUCT Rules 1.2(d), 3.3(a)(2), 4.1; MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 7-102(A)(7).

339. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 7-102(B)(1).

follow the law, the attorney in some cases must withdraw.[340] The *California Rules of Professional Conduct*, for example, establish a clear protocol if the attorney believes an agent of a corporate client is breaking the law.[341] The California rule makes clear that a legal violation by a corporate agent is not grounds for breaching confidentiality.[342] The attorney "may take such actions as appear . . . to be in the best lawful interest of the organization," such as urging reconsideration or referring the matter to a higher corporate authority.[343] If these steps fail to stop the unlawful conduct, "the [attorney's] response is *limited* to the [attorney's] right, and, where appropriate, duty to resign."[344]

4. Causation and the duty of confidentiality

Finally, the duty of confidentiality is a factor in determining causation.[345] Allegations of professional negligence in failing to uncover insider S&L fraud raise the question of whether attorneys or accountants could have stopped the conduct or prevented the harm. Withdrawal, which is the most extreme measure consistent with confidentiality, will not necessarily prevent illegal activity or financial loss. The facts of *O'Melveny* are telling. American went through three accounting firms and two law firms in its final year of existence, apparently terminating any firm that became suspicious of its financial condition.[346]

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340. *See* CAL. RULES OF PROFESSIONAL CONDUCT Rule 3-700(B) (West Supp. 1992); MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.16(a)(1); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2-110(B)(2).

341. *See* CAL. RULES OF PROFESSIONAL CONDUCT Rule 3-600 (West Supp. 1992); *see also* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(b) (stating that when representing organization, attorney who uncovers unlawful conduct must act "to minimize . . . the risk of revealing information relating to the representation to persons outside the organization").

342. CAL. RULES OF PROFESSIONAL CONDUCT Rule 3-600(B) (citing California statute on client confidentiality, CAL. BUS. & PROF. CODE § 6068(e) (West 1990 & Supp. 1993)).

343. *Id.*

344. *Id.* Rule 3-600(C) (emphasis added). Despite the position of the *Model Rules*, the *Model Code*, and the California Rules of Professional Conduct, some bank and thrift regulators claim that lawyers have a duty to inform regulators of client violations. *See FDIC Seeks $300 Million in Suit Against Law Firm; Alleges Malpractice, Negligence*, 54 Banking Rep. (BNA) 547 (Mar. 26, 1990) (reporting FDIC suit asserting law firm's duty "to disclose material information . . . to the Bank's accountants and regulators"); *Speech by OTS Chief Counsel Weinstein on Duties of Depository Institution Fiduciaries*, 55 Banking Rep. (BNA) 510, 512 (Sept. 24, 1990) (asserting S&L directors and fiduciaries owe duty to regulators). No court has as yet endorsed a duty to report client wrongdoing.

345. Unlike the preceding discussion of the professional-client relationship as an extrinsic policy concern, causation is an intrinsic issue in every negligence case.

346. FDIC v. O'Melveny & Meyers [sic], 969 F.2d 744, 746-47 (9th Cir. 1992). American terminated Touche Ross & Co. in April 1985, allegedly because the firm was "too expensive." *Id.* at 746. In October of the same year, when Arthur Young & Co. expressed concern over American's financial condition, it was replaced with Coopers & Lybrand. *Id.* Before

The American case demonstrates that a professional's withdrawal will not stop corporate officers who are determined to commit fraud.[347] American may represent an extreme example, but some professionals do not think so. One banking lawyer wrote: "[L]awyers and accountants work for management on a day-to-day basis. If a lawyer or accountant ever said he or she was going directly to the board of directors, the next lawyer or accountant would be there in a wink, as a replacement."[348] In a closely held corporation such as American, "going directly to the board" would most likely be futile because the board would be dominated by the likes of Messrs. Sahni and Day and their proxies.

The limits placed on attorneys and accountants by their ethical duty of confidentiality make it speculative that a professional could actually stop insider S&L fraud if he or she uncovered it. Causation is a necessary element of the tort of professional negligence.[349] Unless a plaintiff can prove, based on more than speculation, that the fraud would not have succeeded but for the professional's negligence, the plaintiff must lose.[350]

V. CONCLUSION

Should the lawyers and accountants for the fictional Jefferson S&L[351] pay? Legal and policy considerations suggest they should not. While FDIC litigation against professionals is an appropriate response to the massive S&L crisis, the public policy in favor of recovering losses of insured deposits does not outweigh the public interest in orderly, logical and consistent development of the law of agency and the *D'Oench,*

O'Melveny, American had hired the law firm Rogers & Wells to prepare other real estate syndication documents, but Rogers & Wells required that a current balance sheet for the thrift be given to investors. *Id.* at 746-47. American replaced Rogers & Wells with O'Melveny. *Id.* at 747.

347. *See id.* at 746-47.

348. Naegele, *supra* note 25, at 5. Mr. Naegele, former counsel to the Senate Banking Committee, experienced an FDIC professional liability suit as a defendant. The suit settled with the FDIC for $4.6 million in 1989. FDIC, *supra* note 22 at 1.

349. *See supra* note 36.

350. KEETON ET AL., *supra* note 66, § 41, at 265 ("An act or an omission is not regarded as a cause of an event if the particular event would have occurred without it."); *see* FDIC v. Ernst & Young, 967 F.2d 166, 172 (5th Cir. 1992) (affirming summary judgment for accountants because "the audit was not a cause of the losses"); Stratton v. Miller, 113 B.R. 205, 210 (D. Md. 1989) (holding that causation was not proved because it was speculative that loss would have been prevented if attorneys had advised board of directors of misconduct), *aff'd sub nom. In re* First Am. Mortgage Co., 900 F.2d 251 (4th Cir. 1990) (per curiam).

351. *See supra* part I.

Duhme doctrine. "In our zeal to exact reparations [for the S&L crisis] . . . we must not be blinded to the requirements of the law . . . ."[352]

Fraud committed by the controlling officers of an S&L is generally fraud on behalf of the corporation, and the corporate entity should be held accountable for it. By attributing the knowledge and conduct of the fraudulent officers to the corporation, professionals may avail themselves of state law defenses such as estoppel, *in pari delicto* and contributory or comparative negligence.

Under the majority rule, receivers are subject to the same defenses as the insolvent institution. As a matter of federal common law, the FDIC should not be immune to these defenses. This is the appropriate federal rule because state receivership law provides uniformity, there is no specific legislative intent to override state tort law and granting the FDIC special rights would disrupt the professional-client relationship.

The argument for the insider fraud defense in cases similar to *O'Melveny*, *Ernst & Young*, and the fictional Jefferson S&L, where a fraudulent, dominant shareholder managed the thrift,[353] is compelling for practical reasons as well. Such fraud is easily concealable, and if it is discovered, outside professionals have little power to stop it because of their duty of confidentiality.

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352. FSLIC v. Molinaro, 889 F.2d 899, 906 (9th Cir. 1989).

353. *See* FDIC v. O'Melveny & Meyers [sic], 969 F.2d 744, 746 ("The parties agree that Sahni [chairman, chief executive officer and 96% stockholder], Day [president and 4% stockholder] and Wyn Pope, Executive Vice President of [American] had intentionally and fraudulently overvalued [American's] assets, engaged in the sham sale of assets in order to create inflated 'profits' and generally 'cook[ed] the books.'" (final alteration in original) (quoting parties' stipulation)); *Ernst & Young*, 967 F.2d at 168 ("Woods [the 100% owner] effectively dominated and controlled Western.").

* This Comment is dedicated to my wife, Cheryl Sindel, for her wise counsel on matters of the heart and the world. Her sacrifice and encouragement made this possible. I would also like to thank professors David Burcham, David Leonard and Therese Maynard for their comments.