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FDIC Professional Liability Group Set to Pursue Audit Firms

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Special to the Legal

The past three years have seen a plague of bank failures tied to the collapse of the real estate market and related securities markets: 25 banks went under in 2008, 140 in 2009 and 157 in 2010. Compare these numbers with 2007, during which just three banks failed. These are dangerous and uncertain times for banks, and for the professionals – attorneys, accountants, appraisers, brokers — who provide services to them.

The Federal Deposit Insurance Corporation (FDIC), in its role as regulator and receiver, acquires the rights to assert claims for losses caused by the wrongful conduct of the directors and officers who were at the helm, as well as by their outside professional service providers, for their errors and omissions. To investigate and pursue such claims, the FDIC has formed a Professional Liability Operation, which in every instance of bank failure opens an investigation into the possibility of asserting D&O as well as E&O claims.

According to its website, the stated position of the FDIC regarding professional liability lawsuits is that they "are only pursued if they are both meritorious and cost-effective. Before seeking recoveries from professionals, the FDIC conducts a thorough investigation into the causes of the failure. Most investigations are completed within 18 months from the time the institution is closed. Prior to filing the claim, staff will attempt to settle with the responsible parties."

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When outside accountants are the target, the claims typically involve one or more of the following allegations: the valuation of loans and/or mortgage backed securities; the adequacy of loan loss reserves and the timing of write-downs for impaired assets; and the strength of management's internal controls as well as the bank's compliance with those crucial controls.

Though decidedly technical in nature, these are nevertheless fundamentally accounting, or more specifically, audit malpractice claims, wherein the issue is whether the auditor's conduct met the applicable professional standard of care. That is not to say that claims of conspiracy, or aiding and abetting, are unknown in this context; they certainly are not. But in the main, the FDIC's pursuit of civil actions against outside audit firms has historically involved professional negligence.

LEARNING FROM THE PAST

With the banking crisis now in full cry, what is the status of the FDIC's hunt for negligent bank auditors? What lies ahead? If past is predicate, what does the response of the FDIC to auditor negligence during the last banking crisis, some 20 years ago, tell us about its likely response following the real estate market collapse of 2008? Here's what we can expect.

First, consider that the FDIC, in its capacity as bank receiver, stands in the shoes of the bank. It can use bank funds to fuel the litigation. It can hire outside counsel to investigate and pursue claims. And, it enjoys the full range of civil liability claims and remedies.

Next, consider the array of liability theories in its arsenal. Based on the last wave of auditor liability claims following the savings and loan crisis of the late 1980s, theories of auditor liability in the event of a bank failure will center around the well-established principles of the profession, namely Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS), along with other sanctioned statements of standards applicable to audits generally and bank audits in particular.

In addition, deviations from technical standards can be addressed by way of contract law (tied to the letter of engagement), as well as under principles of mis-

representation or fraud, as the case may be. In fact, it is this latter rubric — the requirement that audited financial statements fairly disclose the bank's financial position and not be misleading, that is often seen at the core of an audit liability claim.

Working with the benefit of hindsight, the FDIC knows that the financials were materially misstated and were therefore misleading. With a clean audit opinion in hand, the FDIC must show that the auditor in the exercise of reasonable care should have discovered whatever it is that was amiss.

Well-understood (if misplaced) public perceptions about the role of auditors as all-seeing "watch dogs" can tend to tip the playing field in the FDIC's favor on this issue. But, as will be seen below, when defending bank-failure-related malpractice cases, auditors will seek to change the game through the use of affirmative defenses and by placing a sharp focus on causation. These tactics can help the auditor avoid the unflattering lens of hindsight and place the focus back on bank management.

By way of damages, the FDIC will typically relate its claim to the making or continued funding of loans from which the bank ultimately suffered significant losses. While this is not the only source of damages to be seen in the wake of a bank failure, it provides a clear and concrete context for presenting and valuing claimed damages, as opposed to the loss in shareholder value, or the lost opportunity for future profits, for example.

A solid liability claim and provable damages are crucial, but they nevertheless depend on the linchpin to a successful professional negligence claim: proximate causation. Here, the FDIC's pursuit of outside auditors — as compared with former bank management — is especially interesting. After all, auditors themselves do not make loans, and they are rarely even consulted in connection with their client's loan underwriting decisions. So tying a technical breach of audit standards together with proximate causation of loan portfolio damages can and should be a challenge.

MANY TOOLS IN DEFENSE OF AUDITORS

In defense of audit malpractice claims brought by the FDIC, auditors can be expected to assert a slew of non-accounting defenses. As noted above, hindsight is unkind in this context, so the auditor may be well-served to move the conversation away from its work product, and towards issues that do not involve the audit process and the standard of care.

When defending bank-failure-related malpractice cases, auditors will seek to change the game using affirmative defenses and focusing on causation.

There are several traditional common law affirmative defenses that can help the auditor do exactly that, most of them focusing on the comparative or contributory misconduct of bank management. But first, in order to get these affirmative defenses in play, the auditor must come to terms with the FDIC's unique status as a litigant.

THE FDIC AS A PLAINTIFF

The FDIC in its role as receiver enjoys, in many federal judicial districts, protection from the consequences of its own post-closing negligence and/or its failure to mitigate damages. As a matter of public policy, courts during the last banking crisis have held that it would be "paradoxical" and contrary to the public interest to impose a duty of care on the FDIC such that the public "bear[s] the risk of errors of judgment made by its officials in attempting to save a failing institution." Hence, the acts of the FDIC, separate from those of the bank officers whom it succeeds, have been deemed immune or otherwise subject to "no duty" in many courts. One can reasonably expect that this important issue will be tested anew in auditor claims yet to come, as the facts of each case will be unique.

Likewise, the government's alleged failure to mitigate damages in its capacity as bank receiver can be an effective means of putting this high-powered claimant on the defensive. Courts are by no means uniform in their tolerance of mitigation as an affirmative defense, however, so this too will be an interesting issue to follow as it is further tested in failed bank litigation.

Sovereign immunity afforded through the Federal Tort Claims Act (FTCA)is yet another argument available to the FDIC as a shield against affirmative defenses which would target the agency's own actions in its capacity as receiver. Under 28 U.S.C. 2680(a), the FTCA provides that immunity is not waived with respect to "[a]ny claim based upon an act or omission of an employee of the Government ... based upon the exercise of performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused."

The so-called discretionary function exception has in the past been applied to the FDIC's post-closing actions, although

as with the "no duty" rule discussed above, case law is hardly uniform, so the results are likely to be non-uniform in future claims against auditors, attorneys and others arising out of bank failures.

THE AUDITORS' AFFIRMATIVE DEFENSES

Of course, when the FDIC steps in as receiver, it must be prepared to deal with affirmative defenses based on the acts of bank executives that are imputed to it as a successor-in-interest. The pre-receivership wrongful conduct of management can be a significant source of comparative or contributory fault in jurisdictions in which the common law supports this defense. One such defense that may prove to be at the forefront of auditor liability claims is known by the Latin phrase "in pari delicto potior est conditio defendentis," meaning "in a case of equal or mutual fault the position of the defending party is the stronger one."

The so-called in pari delicto defense is based on the general rule, deriving from agency-law principles, that fraudulent conduct of a corporate officer is imputed to the corporation if committed in the course of the officer's employment and for the benefit of the corporation. In fact patterns involving fraud by bank management, the in pari delicto defense can be a potent weapon, as it can bar recovery completely. The doctrine is not without its challenges for defendants, though. Since it is based on the imputation of an agent's wrongful acts, the defense bears the burden of proving that the bank's executives were in fact acting both on the bank's behalf and for its benefit.

Rampant self-dealing or looting will likely be found to fall outside of the scope of employment, and will likewise be found to have been a detriment to the bank, rather than a benefit. In such cases, the doctrine of in pari delicto would not apply. And yet, bank executives who engaged in fraud in a misguided attempt to sustain the bank as a going concern may find that their activities, albeit wrongful, were within the scope of their employment and did, at least for a time, confer a benefit on the bank. In such cases, the in pari delicto defense may avail. For a recent discussion of this important and highly nuanced defense, see *Official Committee of Unsecured Creditors of Allegheny Health, Education and Research Foundation vs. PriceWaterhouseCoopers*.

Finally, auditors sued by the FDIC might see strategic value in a third-party claim against former officers or directors, or perhaps others, as a means of forcing an allocation of causal fault. After all, in litigation as elsewhere, misery typically loves company.

THE CURRENT STATE OF PLAY

As of Dec. 14, 2010, the FDIC has authorized suits against 109 individuals for D&O liability with damage claims of approximately $2.5 billion. This includes two filed D&O lawsuits naming 15 individuals. The FDIC also has authorized four fidelity bond and attorney malpractice lawsuits. The FDIC has not, as of mid-December, authorized suit against any audit firms based on violations of the standard of care. But that is neither to suggest nor to predict that such cases are not coming.

According to sources in the professional liability insurance and professional liability defense communities, in a good number of bank failures the FDIC has established a fulsome dialogue with the former auditors. This is typically centered around the auditors' work papers, whether produced informally or in response to a subpoena. There is, therefore, reason to conclude that this particular litigation pot is first coming to a boil. Look for claims in districts most rife with failed banks, such as Florida (42 failed banks since 2008) and Georgia (51), as opposed to, say, Pennsylvania (three).

As receiver, the FDIC has three years for tort claims and six years for breach-of-contract claims to file suit from the time a bank is closed. If state law permits a longer time, the state statute of limitations is followed. Given this limitations period, this story is long from over. •

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