NOTES

DO THE SHOES FIT? CREATING FEDERAL COMMON LAW IN LEGAL MALPRACTICE CASES WHEN A BANKING REGULATOR IS A PARTY

Federal Deposit Insurance Corp. v. O'Melveny & Meyers, 969 F.2d 744 (9th Cir. 1992), *cert. granted*, 114 S. Ct. 543 (1993).[1]

Legal malpractice cases are traditionally the subject of state law.[2] State law also defines defenses to legal malpractice, such as fraud, estoppel, and comparative negligence.[3] However, federal

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1. 969 F.2d 744 (9th Cir. 1992), *cert. granted*, 114 S. Ct. 543 (1993). The Ninth Circuit opinion misspelled the law firm's name. The correct spelling is O'Melveny & Myers. Oral argument was heard on March 21, 1994. The American Bar Association (A.B.A.), the Big Six accounting firms, and other defendants in various savings and loan actions filed amicus briefs with the Court. Steve France, *Lawyer's S&L Liability at Issue*, A.B.A. J., Mar. 1994, at 20.

The Federal Deposit Insurance Corporation (FDIC) became a party to the *O'Melveny* case by statute after placing the savings and loan association, also known as a thrift, into conservatorship. *O'Melveny*, 969 F.2d at 746. See *infra* notes 19–20 for a further discussion of the FDIC's responsibilities. See *infra* notes 8–25 and accompanying text for a discussion of the thrift's failure.

2. See *infra* notes 39–43 and accompanying text for a discussion of state legal malpractice actions. See *infra* notes 44–49 and accompanying text for a discussion of the emerging theories of legal malpractice actions.

3. See *infra* notes 78–127 and accompanying text for a discussion of defenses to legal malpractice.

Contributory negligence is defined as the conduct on the part of the plaintiff that contributed to the harm suffered. RESTATEMENT (SECOND) OF TORTS § 463 cmt. b (1965). Comparative negligence is defined as that proportionate amount attributable to each party for the injury or damage caused. BLACK'S LAW DICTIONARY 282 (6th ed. 1990). Many states have replaced contributory negligence with comparative negligence to more

courts are now hearing legal malpractice cases in which a banking regulator is a party. The regulators, armed primarily with public policy reasons for recouping the losses of the savings and loan debacle,[4] are trying to replace the traditional state law malpractice actions with a new federal common law.

The results of the lower court decisions have been mixed.[5] Without a clear statutory directive or consistent judicial interpretation, the federal courts must fashion a rule on a case-by-case basis. At best, this has led to confusing opinions. At worst, it has left attorneys wondering what their liability may be when representing a failed or weak financial institution.

The case of *Federal Deposit Insurance Corp. v. O'Melveny & Meyers*[6] presented the United States Court of Appeals for the Ninth Circuit with the opportunity to clarify when and how federal common law should be created in cases of legal malpractice in which the Federal Deposit Insurance Corporation (FDIC) is a party. However, the Ninth Circuit court issued a confusing opinion with sweeping dicta and little citation to authority. Subsequent courts are relying on *O'Melveny*'s holding and expansive dicta and are either ignoring or not adequately applying the test previously developed by the United States Supreme Court in *United States v. Kimbell Foods, Inc.*[7] The United States Supreme Court, by granting certiorari, has

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equitably apportion damages and reduce the plaintiff's burden. While there is a distinct legal difference between the two doctrines, this Note will use the term comparative negligence when generally discussing proportional liability. See *infra* notes 104–27 for a discussion of several cases in which the legal distinction between the doctrines is central to the holding of the case.

4. The General Accounting Office estimated the savings and loan bailout will cost American taxpayers $500 billion. *Area Votes in Congress*, PHILA. INQUIRER, May 16, 1993, at B7.

5. Courts that have followed the Ninth Circuit court's reasoning in *O'Melveny* include: *In re* Sunrise Sec. Litig., 818 F. Supp. 830 (E.D. Pa. 1993); FDIC v. Benjes, 815 F. Supp. 1415 (D. Kan. 1993); Comeau v. Rupp, 810 F. Supp. 1127 (D. Kan. 1992); FSLIC v. McGinnis, Juban, Bevan, Mullins & Patterson, P.C., 808 F. Supp. 1263 (E.D. La. 1992).

The reasoning and holding in FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir.), *reh'g denied*, 976 F.2d 732 (5th Cir. 1992) (en banc), is in direct conflict with *O'Melveny*. Courts which have followed the Fifth Circuit court's reasoning in *Ernst & Young* include: FDIC v. Thompson & Knight, 816 F. Supp. 1123 (N.D. Tex. 1993); FDIC v. Deloitte & Touche, 834 F. Supp. 1129 (E.D. Ark. 1992); FDIC v. Gantenbein, 811 F. Supp. 593 (D. Kan. 1992); FDIC v. Cherry, Bekaert & Holland, 742 F. Supp. 612 (M.D. Fla. 1990).

6. 969 F.2d 744 (9th Cir. 1992), *cert. granted*, 114 S. Ct. 543 (1993).

7. See *infra* notes 56–65 and accompanying text for a discussion of the test developed by the Supreme Court in United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979).

the opportunity to resolve the conflict in the federal circuits. Using the *Kimbell Foods* test, the Court should conclude not only that the plaintiff in a legal malpractice action must prove all elements of the action, but also that the defendants may assert all available defenses. The substance and procedure of legal malpractice actions should not change merely because a federal banking regulator steps into the litigation.

I. *THE FACTS OF* O'MELVENY

Ranbir Sahni and Lester Day acquired a 100% interest in American Diversified Savings Bank (ADSB) in 1983.[8] Sahni served as ADSB's chairman and chief executive officer, and Day served as president.[9] In addition to ADSB's primary function as a savings and loan institution, ADSB engaged in purchasing, developing, and selling real estate.[10] The corporation used its subsidiaries to create real estate limited partnerships and funded the partnership activities through the deposits of the thrift.[11]

ADSB hired the law firm of O'Melveny & Myers in September 1985,[12] to assist in the preparation of two private placement mem

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8. FDIC v. O'Melveny & Meyers, 969 F.2d 744, 746 (9th Cir. 1992), *cert. granted*, 114 S. Ct. 543 (1993). Sahni owned 94% and Day owned 6% of ADSB. California Union Ins. Co. v. American Diversified Sav. Bank, 948 F.2d 556, 558 (9th Cir. 1991). ADSB owned 100% of American Diversified Capital Corporation (ADCC), which owned 100% of ADC Financial Corporation (ADCFC). ADCFC was the general partner of both the Gateway Center and Wells Park real estate partnerships. Defendant's Reply Brief in Support of Motion for Summary Judgment at 4–5, No. CV-89-2877 (C.D. Cal. 1990). See *infra* notes 11, 13 for a discussion of the partnerships.

9. Sahni was chairman of the board and chief executive officer of ADSB, ADCC, and ADCFC. Day was president and a director of ADSB, ADCC, and ADCFC. Defendant's Reply Brief at 5, No. CV-89-2877.

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

11. *Id*. ADSB's insured deposits totaled $958 million by December 1985, the time the Gateway Center and Wells Park partnership offerings closed. *Id*. at 746–47. ADSB and its subsidiaries would derive income from the interest charged on loans to the partnerships and from fees charged to the partnerships for management brokerage and other services. Melvin R. Goldman et al., *The Responsibility of Lawyers in Light of* FDIC v. O'Melveny & Myers, *in* 2 CALIFORNIA MCLE MARATHON WEEKEND 431, 453 (PLI Corp. Law & Prac., No. B-802, 1992).

12. *O'Melveny*, 969 F.2d at 746. During 1985, ADSB hired two law firms and three accounting firms. ADSB hired O'Melveny & Myers after it terminated another law firm, Rogers & Wells. *Id*. Rogers & Wells prepared documents for another partnership, the Hickory Trace offering. Rogers & Wells never received the audited financial statements necessary for inclusion in the Hickory Trace offering, therefore, this offering never closed. *Id*. at 747.

oranda (PPMs).[13] The law firm disputes the extent to which the firm represented ADSB's financial condition in the PPMs and whether the success of the offerings, known as Gateway Center and Wells Park, depended on the financial condition of ADSB.[14] However, both the FDIC and O'Melveny & Myers stipulated that Sahni, Day, and Wyn Pope, ADSB's executive vice president, "intentionally and fraudulently overvalued ADSB's assets, engaged in the sham sale of assets in order to create inflated `profits,' and generally `cook[ed] the books.'"[15]

While preparing the Gateway Center and Wells Park PPMs, O'Melveny & Myers never contacted the previously terminated accounting or law firms.[16] Additionally, O'Melveny & Myers never

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In April 1985, ADSB terminated Touche, Ross & Co. as the company's auditor, publicly stating that the firm was "too expensive." *Id*. at 746. Within seven months, ADSB terminated a second accounting firm, Arthur Young. The opinion stated that by October 1985, Arthur Young questioned ADSB's financial condition. *Id*. However, the reasons for terminating the firm are not stated. ADSB then retained a third accounting firm, Coopers & Lybrand, who began work on the financial statements for the Gateway Center offering. *Id*.

13. *O'Melveny*, 969 F.2d at 746. The PPMs are designed to inform outside investors about the opportunity of becoming a limited partner in a real estate development project. The two placements involved in this case are the Gateway Center and the Wells Park PPMs. The PPMs described O'Melveny & Myers "as special counsel . . . to the General Partner and its Affiliates in connection with Federal Securities law, Federal income tax law, and certain other matters." *Id*.

There is some disagreement surrounding the firm's responsibility to ADSB. *Id*. at 746 n.3. An exhibit included in the PPMs stated that O'Melveny & Myers "expressed no opinion on any matters not specifically discussed in the *tax matter's* section." Appellee's Opening Brief on Appeal at 12 n.14, FDIC v. O'Melveny & Meyers, 969 F.2d 744 (9th Cir. 1992) (No. CA-90-55769).

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

15. Defendant's Reply Brief at 5, No. CV-89-2877. Prior to filing the original complaint, the parties engaged in a voluntary mediation. Goldman, *supra* note 11, at 452. The mediation resulted in a finding that this case could be tested as a matter of law. *Id*. While subsequent proceedings were based on a joint stipulation, both parties agreed later discovery may change the stipulated facts. *Id*. The facts were taken as true for the purposes of summary judgement in this part of the litigation. *Id*.

16. *See supra* note 12. On May 3, 1985, Touche Ross notified ADSB, Rogers & Wells, and federal regulators that it believed ADSB's net worth was less than zero. *O'Melveny*, 969 F.2d at 746. By October 1985, Arthur Young had audited the March 31, 1985, financial statements and expressed concern about the thrift's financial condition. The accounting firm did not know O'Melveny & Myers had included the audited financial statements of ADSB in the Gateway Center and Wells Park PPMs. *Id*. at 747.

The FDIC further alleged O'Melveny & Myers never sought the monthly operating statements that were readily available from the Federal Home Loan Bank Board, the thrift's regulator at the time. Appellant's Opening Brief on Appeal at 13–18, *O'Melveny* (9th Cir. 1992) (No. CA-90-55769).

discussed the information included in the PPMs with Day, Pope, or ADSB's chief financial officer.[17] The Gateway Center and Wells Park offerings closed on December 31, 1985.[18]

The FDIC[19] stepped in as conservator for ADSB on February 14, 1986.[20] Five days later, the FDIC filed a lawsuit against Sahni and Day alleging breach of fiduciary duty and RICO violations against Sahni.[21] On May 12, 1989, the FDIC filed suit against O'Melveny & Myers for negligence in providing professional legal advice to ADSB.[22]

The United States District Court for the Central District of California granted summary judgment for O'Melveny & Myers because the Gateway Center and Wells Park investors had been repaid.[23] The United States Court of Appeals for the Ninth Circuit

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17. *O'Melveny*, 969 F.2d at 747. However, Sahni, other ADSB personnel, and Coopers & Lybrand personnel attended various meetings regarding the PPMs. Appellee's Opening Brief on Appeal at 12, *O'Melveny* (No. CA-90-55769).

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

19. The Federal Savings and Loan Insurance Corporation (FSLIC) was the original party to this action. As a result of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101–73, 103 Stat. 183 (1989) (codified as amended in scattered sections of 12 U.S.C.), the FSLIC transferred its assets and liabilities to the FSLIC Resolution Fund. *O'Melveny*, 969 F.2d at 746 n.2. The FDIC is the manager of this fund. *Id*.

20. *O'Melveny*, 969 F.2d at 746. A conservator operates an institution as a going concern, while a receiver has the power to liquidate and wind up the affairs of an institution. 12 U.S.C. § 1821(c)(5) (1988 & Supp. IV 1992) (as amended by the Federal Deposit Insurance Corporation Improvement Act (FDICIA), Pub. L. No. 102-242, § 133, 105 Stat. 2236 (1991)). For a general discussion about the FDIC's duty to either liquidate a financial institution or facilitate a purchase and assumption transaction, see Gunter v. Hutcheson, 674 F.2d 862 (11th Cir. 1982).

On February 16, 1986, the FDIC declared ADSB insolvent. ADSB had a negative net worth in excess of $400 million at that time. Appellant's Opening Brief on Appeal at 7, *O'Melveny* (No. CA-90-55769).

21. *O'Melveny*, 969 F.2d at 747. RICO stands for the Racketeer Influenced and Corrupt Organizations Act, Pub. L. No. 91-452, 84 Stat. 922 (codified in 18 U.S.C. §§ 1961–1968 (1970)).

22. *O'Melveny*, 969 F.2d at 746. The FDIC independently determined that the PPMs were misleading and offered rescission to the investors. *Id*. at 747. In exchange for the rescission offer, the investors assigned their individual claims to the FDIC. *Id*.

23. *Id*. at 744. When granting O'Melveny & Myers' motion for summary judgment the district court stated:

> Well, I think it is fairly clear that the purpose of the Securities Act is to compel full and fair disclosure but [to] the investors, and knowing that the investors have been protected here since, indeed, there has been repayment, we no longer have a problem as far as O'Melveny is concerned.
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> They [O'Melveny & Myers] owe no duty to [ferret out fraud to] anyone

reviewed *de novo* the district court's grant of summary judgment, reversed, and remanded the case to the district court. HELD: A genuine issue of material fact existed as to whether O'Melveny & Myers discharged its duty not only to the investors but also to its client, ADSB.[24] Additionally, the court held that the FDIC, acting as ADSB's receiver, could litigate the claims assigned from the partnership investors.[25]

The *O'Melveny* decision is important because the Ninth Circuit court's opinion purported to establish federal common law without citing legal precedent or explaining its provisions. In so doing, the court displaced the requirements of proving traditional state law elements and allowing defenses in this type of action. Further, it appears from subsequent cases that the Ninth Circuit court's sweeping language continues to erode state-based legal malpractice defenses. This confusion has led to uncertainty when the FDIC steps in as a party to legal malpractice actions. Because of the general policy-based holding in *O'Melveny*, the larger question left unanswered is whether the FDIC's desire for an immediate recovery of funds from attorneys and other professionals should displace the traditional rules and defenses available to legal malpractice defendants in state actions.

This Note begins by briefly reviewing the sources of enforcement powers used by banking regulators to supervise financial institutions. These powers are reviewed in light of the traditional sources and defenses of legal malpractice actions available under state law and the new theories of liability that banking regulators are using against outside professionals. This Note then turns to a discussion of when courts should create federal common law and what the parameters of that law should be. An analysis of the *O'Melveny* court's opinion discusses that court's creation of federal common law and the apparent preclusion of asserting traditional defenses in legal malpractice actions.

> other [than investors], so I am going to grant their motion for summary judgment.

Appellee's Opening Brief on Appeal at 5–6 n.5, *O'Melveny* (No. CA-90-55769). See *infra* note 139 for a discussion of the rescission payments.

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

25. *Id*. O'Melveny & Myers contended that because of the insiders' fraud, the FDIC should be estopped from suing the law firm because the FDIC is the successor to ADSB. *Id*. at 749. The court disagreed with the firm's argument. *Id*. at 752.

Next, this Note critically analyzes the *O'Melveny* opinion. Using two defenses, imputation and comparative negligence, as examples, the discussion illustrates how the Ninth Circuit court's newly created federal common law has left confusion in its wake. Finally, this Note concludes that courts should use the United States Supreme Court's test developed in *United States v. Kimbell Foods, Inc.*[26] and incorporate state law regarding professional malpractice actions into the federal common law. Although the size of the savings and loan bailout is large,[27] without a clear directive from Congress, the federal courts should not circumvent state law in the area of legal malpractice merely for political expediency.

II. HISTORICAL OVERVIEW

A. Source of Enforcement Powers

Banking regulators derive their administrative enforcement powers statutorily.[28] Actions are taken to protect the financial institution and its depositors.[29] The regulators impose sanctions through the administrative process, thereby eliminating the necessity of going to court.[30] The Office of Thrift Supervision (OTS), the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Fed), and the FDIC can impose administrative actions.[31] The regulators can pursue several types of ac

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26. 440 U.S. 715 (1979). See *infra* notes 56–65 and accompanying text for a complete discussion of the *Kimbell Foods* test.

27. See *supra* note 4 for a discussion of the cost of the savings and loan bailout.

28. The enforcement statutes are located in scattered sections of Title 12 of the United States Code. The general enforcement statute is located in § 8 of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. § 1818 (1988 & Supp. IV 1992).

29. 12 U.S.C. § 1818(a) (1988). Such actions may be taken:

> Whenever the [regulator] shall find that an insured bank or its directors or trustees have engaged or are engaging in unsafe or unsound practices in conducting the business of such bank, or is in an unsafe or unsound condition to continue operations as an insured bank, or violated an applicable law, rule, regulation or order, or any condition implied in writing by the [regulator].

Id.

30. *See Laborers in Different Vineyards? The Banking Regulators and the Legal Profession*, REPORT BY THE A.B.A. WORKING GROUP ON LAWYERS' REPRESENTATION OF REGULATED CLIENTS 17 (Discussion Draft Jan. 1993) [hereinafter A.B.A. WORKING GROUP]. The increase in administrative actions against attorneys was the impetus for forming the A.B.A. Working Group.

31. The OTS supervises savings and loan institutions, the OCC supervises national banks, the Fed supervises state-chartered member banks and bank holding companies,

tions including: cease-and-desist orders,[32] restitution,[33] civil money penalties,[34] removal,[35] and suspension against persons including lawyers and other professionals whom the regulators consider "institution-affiliated parties."[36] The regulators usually enter into admin-

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the FDIC supervises federally insured, state-chartered, non-member banks, and the Resolution Trust Corporation (RTC) manages all cases involving savings and loans whose accounts were insured by the FSLIC. See 12 U.S.C. § 1813(q) (1988 & Supp. IV 1992) for the scope of the regulator's supervisory authority. For additional examples of the regulator's use of administrative enforcement actions, see Karol K. Denniston, *Regulatory Actions Against Institution Affiliated Parties Under FIRREA*, *in* 1 CALIFORNIA MCLE MARATHON WEEKEND 757 (PLI Corp. Law & Prac., No. B-802, 1992).

32. A temporary cease-and-desist order may include asset preservation orders under 12 U.S.C. § 1818(c) (1988 & Supp. IV 1992). One of the most publicized administrative actions was the action against the Kaye, Scholer, Fierman, Hays & Handler firm. Although this action was not the first against a law firm, it was the first time a regulator used an asset preservation order against a law firm. For a further discussion of the *Kaye, Scholer* asset order, see A.B.A. WORKING GROUP, *supra* note 30, at 24–30. For a general discussion about the effects of the *Kaye, Scholer* action, see the articles located in the symposium published in 66 S. CAL. L. REV. (1993).

The A.B.A. Working Group has also proposed an amendment to 12 U.S.C. § 1818(i)(4), which would require banking agencies to demonstrate more than a prima facie case to obtain an asset preservation order. A.B.A. WORKING GROUP, *supra* note 30, at 116–17.

33. The OTS recovered almost $40 billion in restitution during 1992, compared to just over $600,000 in 1991. *Civil Money Penalties Increase: Other Enforcement Actions Decline, OTS Says*, Banking Rep. (BNA), May 3, 1993. For other examples of settlements, see Henry J. Reske, *Firm Agrees to Record S&L Settlement*, A.B.A. J., July 1993, at 16; Richard B. Schmitt, *Paul Weiss to Pay U.S. $45 Million Over Representation of CenTrust*, WALL ST. J., Sept. 29, 1993, at B8.

Although the restitution recovery figures are large, congressional investigation appears imminent. House Banking Committee Chairman Henry Gonzalez (D-Tex.) stated he is investigating the tactics used by the regulators. Representative Gonzalez stated: "I want to identify any changes that need to be made in order to collect the maximum amount from professionals who contributed to the thrift crisis." *FDIC, RTC Legal Shops Under Fire from House Banking Chairman Gonzalez*, Banking Rep. (BNA), May 24, 1993.

34. *See generally* A.B.A. WORKING GROUP, *supra* note 30, at 17–41 (discussing the background of the use of administrative and civil actions, including civil money penalties, by banking regulators).

35. *Id*.

36. Suspension is defined in 12 U.S.C. § 1818(e)(3)(A) (1988 & Supp. IV 1992). The statute states in part: [T]he appropriate Federal banking agency may suspend such party from further participation in any manner in the conduct of the affairs of the depository institution . . . . *Id*.

Institution-affiliated parties (IAPs) are defined in 12 U.S.C. § 1813(u) (1988 & Supp. IV 1992). These parties include officers, directors, employees, stockholders, and in certain circumstances, agents, consultants, and independent contractors.

Attorneys are expressly mentioned in subsection (u)(4) as independent contractors. The statute states in part:

istrative actions with the consent of all the parties.[37] While regulators frequently use administrative actions, there has been an increase in civil litigation against attorneys who represent financial institutions.[38]

B. Traditional Sources of Attorney Liability

Historically, banking regulators sue attorneys through traditional malpractice claims based on negligence, breach of fiduciary duty, and breach of contract.[39] An action in negligence may include claims where attorneys fail to use ordinary care and skill in exercising these duties.[40] Defenses traditionally available to the attorney are the statute of limitations, lack of privity, comparative negligence, estoppel, fraud, and failure of the plaintiff to establish any

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> (u)(4) [A]ny independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in —
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> (A) any violation of any law or regulation;
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> (B) any breach of fiduciary duty; or
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> (C) any unsafe or unsound practice,
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> which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution.

Id. A violation is defined as "any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation." *Id*. § 1813(v).

37. However, if there is no consent, the regulators proceed with formal administrative enforcement under 12 U.S.C. § 1818 (1988 & Supp. IV 1992).

38. The RTC currently has 40 cases pending against attorneys. Rita Jensen, *For the Third Straight Year Malpractice Rates Rise Again*, NAT'L L.J., Apr. 12, 1993, at 3.

39. This Note only discusses negligence actions because this theory was the basis of the suit in *O'Melveny*. Legal malpractice elements are unique to each state. However, the basic elements of legal malpractice include: (1) the existence of a duty through an attorney-client relationship, (2) a breach of that duty, and (3) damages to the client that were proximately caused by the attorney's breach. Resolution Trust Corp. v. Garner, 798 F. Supp. 790, 797 (D.D.C. 1992). For a more complete listing of cases outlining the elements of a legal malpractice action, see RONALD E. MALLEN & JEFFREY M. SMITH, 1 LEGAL MALPRACTICE § 8.10 (1989 & Supp. 1992) and the cases from 43 states cited therein.

40. 7 AM. JUR. 2D *Attorney at Law* § 199 (1980); DAVID J. MEISELMAN, ATTORNEY MALPRACTICE: LAW AND PROCEDURE § 2 (1st ed. 1980).

An attorney acting in a dual capacity as general counsel and securities counsel may have a heightened level of fiduciary duty. In the seminal case of Escott v. BarChris Construction Corp., 283 F. Supp. 643, 687 (S.D.N.Y. 1968), the court found the lawyer, who was also acting as the corporation's assistant secretary, had breached his fiduciary duty. The court stated that the attorney, in his role as assistant secretary, should have investigated the truth of the statements contained in the registration statement in order to satisfy the "reasonable independent investigation" standard. *Id*.

essential element of the claim.[41]

Banking regulators bring the majority of litigation in their capacities as receivers for the failed institution.[42] The most common claims made against attorneys are ones in which the attorney serves as outside counsel as well as a director of an institution or in some other "insider" capacity.[43] However, attorneys acting only as outside counsel increasingly face new sources of liability.

C. New Sources of Liability

Recent administrative enforcement actions and civil litigation between banking regulators and attorneys have produced new and somewhat controversial theories of liability, extending beyond the traditional theories discussed above. However, because the majority of these actions settle before trial, their success in the courts is only speculative. The new theories[44] include: a lawyer's duty to investigate and monitor compliance with banking laws and regulations,[45] a lawyer's duty to advise a financial institution on the prudence, safety, and soundness of its business decisions,[46] and a lawyer's duty to disclose material information to government regulators and the public.[47]

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41. MEISELMAN, *supra* note 40, § 7.1.

42. As receivers, the regulators succeed to all "rights, titles, powers, and privileges of the insured depository institution, and of any stockholder, member, account holder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution." 12 U.S.C. §§ 1821(d)(2)(A)(1) (FDIC), 1441a(b)(4)(A) (OTS) (1988 & Supp. IV 1992).

43. The regulators generally hold attorneys to a higher standard when they act as both counsel and director. A.B.A. WORKING GROUP, *supra* note 30, at 123. *See also supra* note 40.

44. *See* A.B.A. WORKING GROUP, *supra* note 30, at 129–34.

45. *See* FDIC v. O'Melveny & Meyers, 969 F.2d 744, 749 (9th Cir. 1992) (noting that the firm had a "duty to guide the thrift as to its obligations and to protect it from liability"), *cert. granted*, 114 S. Ct. 543 (1993).

46. *See* FDIC v. Wise, 758 F. Supp. 1414 (D. Colo. 1991) (discussing the case against the Sherman & Howard law firm for failing to advise the directors of Silverado Savings and Loan that several transactions were imprudent or unwise).

47. Although under the Model Rules of Professional Conduct it may be appropriate for the attorney go to a higher authority within an organization to disclose information about a violation, there is no general requirement to notify outside interests, including regulators. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13 (1993). *But see* FDIC v. Clark, 978 F.2d 1541 (10th Cir. 1992) (holding attorneys liable for malpractice for negligently failing to discover and stop the fraud of the insiders); FDIC v. Eckert Seamans Cherin & Mellott, 754 F. Supp. 22 (E.D.N.Y. 1990) (holding an attorney liable for failing

One commentator viewed these new broad liabilities as requiring "lawyers to view their primary role as policemen of their clients, with overriding obligations to the attainment of federal regulatory policy as construed by the [regulator]."[48] Under the new theories of liability, attorneys appear to have conflicting responsibilities to the financial institution, regulators, and ultimately to taxpayers.

The FDIC has increasingly used the argument that courts should create federal common law in the legal malpractice area because the result would serve the congressional goal of maximum recovery for the insurance fund.[49] While the new theories are be

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to advise the board of directors and the OCC that an insider was trying to buy out a subsidiary).

48. A.B.A. WORKING GROUP, *supra* note 30, at 123 (citing Sidney S. Rosdeitcher, *The Thrift Crisis and Lawyers' Liability, Civil and Criminal Liability of Officers, Directors, and Professionals*, *in* BANK & THRIFT LITIGATION IN THE 1990's 243 (PLI Corp. Law & Prac., No. 595, 1991)).

See also Kline v. First W. Gov't Sec., 794 F. Supp. 542, 551 (E.D. Pa. 1992) (stating "even an ethical duty to withdraw from the representation or to disclose the information will not create a legal duty to disclose enforceable with civil liability"); Bettina L. Alexander et al., *Protecting Yourself and Your Firm in the Representation of Insured Depository Institutions: Lessons to be Learned from the* Kaye, Scholer *Case*, A.L.I.-A.B.A. INSIDER TRADING, FRAUD, AND FIDUCIARY DUTY UNDER THE FEDERAL SECURITIES LAWS (Apr. 1993) (discussing how the bank's lawyer reconciles the additional duty to the regulators and insurance fund to conduct due diligence on its client and disclose negative information to the regulators with attorney-client confidentiality).

Cf. Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992). In *Bily*, the California Supreme Court cited to the United States Supreme Court's decision in *United States v. Arthur Young & Co.* to distinguish between the independent auditor's responsibility to the public and the attorney's more narrow responsibility to the client. The court stated that accounting firms who certify public reports engage in a "public watchdog" function. *Id*. at 751–52 (citing United States v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984)). The *Bily* court noted "the confidential nature of attorney-client communications and concluded that the imposition of attorney professional liability to third parties in such a context would divert a lawyer's attentions from the service of the client and place an undue burden on the profession." *Id*. at 770 n.18.

49. FDIC v. Jenkins, 888 F.2d 1537, 1546 (11th Cir. 1989). However, in *Jenkins*, the court rejected the FDIC's argument. The court noted:

> Of course, it would be convenient to the FDIC to have an arsenal of priorities, presumptions and defenses to maximize recovery to the insurance funds but this does not require that courts must grant all of these tools to the FDIC in its effort to maximize . . . recovery. Any rule fashioned must have its base on the goal of effectuating congressional policy. We are not convinced that Congress considered collections against parties such as the bank-related defendant is this case as a necessary part of the recovery to the deposit insurance fund. Any such priority . . . will have to come from Congress, not this Court.

Id.

See also FDIC v. Bowles Livestock Comm'n Co., 937 F.2d 1350, 1351 (8th Cir.

ing tested, the courts should analyze the legal basis of malpractice actions before resorting to an equitable argument.

D. Federal Common Law v. State Law

While cases involving the FDIC are "deemed to arise under the laws of the United States,"[50] the federal banking statutes do not clearly enunciate any applicable federal law in the area of legal malpractice. However, there are at least two areas in which the federal banking statutes appear to create uniform guidelines in malpractice actions. The first statute, as discussed in *FDIC v. Canfield*,[51] established a national standard of gross negligence for officers and directors; however, state law will define gross negligence.[52] As a result, this federal statute and its interpretation by the courts precludes any creation of federal common law. The second statute, as discussed in *FDIC v. Cherry, Bekaert & Holland*,[53] defines the statute of limitations for actions brought by the banking regulators. Under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), the statute of limitations is six years in a contract action and three years in a tort action unless the state statute provides for

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1991) (concluding that the FDIC cannot recover "despite the never-lose position the FDIC ordinarily enjoys"); FDIC v. Niblo, 821 F. Supp. 441, 461–62 (N.D. Tex. 1993) (rejecting the FDIC's public policy argument that officers and directors of the bank should be held accountable and not shift the loss to the taxpayers).

50. 12 U.S.C. § 1819 (Fourth) (1988). Therefore, it is clear that federal law applies in most cases when the FDIC is a party. FDIC v. Bank of Boulder, 911 F.2d 1466, 1471 (10th Cir. 1990); Trigo v. FDIC, 847 F.2d 1499, 1502 (11th Cir. 1988).

However, state law will apply if the FDIC is party to a suit as a receiver of a *state* bank, the suit involves only the rights of the bank's creditors, and the rights are derived from state law. *In re* S. Indus. Banking Corp., 872 F.2d 1257, 1260 (6th Cir. 1989).

51. 967 F.2d 443 (10th Cir. 1992).

52. The statute states in pertinent part: "A director or officer of an insured depository institution may be held personally liable . . . for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care . . . as such terms are defined and determined under applicable *state* law." 12 U.S.C. § 1821(k) (1988) (emphasis added). *See* FDIC v. McSweeney, 976 F.2d 532, 539 (9th Cir. 1992) ("Nowhere does FIRREA indicate an aim to create national uniformity in liability standards. Notably, § 1821(k) incorporates state definitions of gross negligence and intentional tortious conduct, which vary from state to state."); FDIC v. Miller, 781 F. Supp. 1271, 1275 (N.D. Ill. 1991) (stating that by adopting § 1821(k) "Congress `spoke directly' to the issue" and thereby eliminated the need for courts to make new law).

53. 742 F. Supp. 612, 615 (M.D. Fla. 1990).

a longer period.[54] As these two examples indicate, courts must construe the applicable federal statutes in light of state law and, therefore, are not free to create federal common law.

However, if there is no applicable federal statute, then the courts may create federal common law in limited circumstances.[55] In *United States v. Kimbell Foods, Inc.*,[56] the United States Supreme Court developed a three-pronged test for determining whether courts should establish federal common law. First, the court should

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54. *Id*. at 615. 12 U.S.C. § 1821(d)(14) (1988 & Supp. IV 1992) states in pertinent part:

> [T]he applicable statute of limitations with regard to any action brought by the [FDIC] as conservator or receiver shall be —
>
> (i) in the case of any contract claim, the longer of —
>
> (I) the 6-year period on which the claim accrues; or
>
> (II) the period applicable under State law; and
>
> (ii) in the case of any tort claim, the longer of —
>
> (I) the 3-year period beginning on the date claim accrues; or
>
> (II) the period applicable under State law.

Id. As the statute reflects, there is a federal statute of limitations; however, the law also incorporates applicable state law.

55. Several factors should be considered by a court before creating federal common law. These factors include:

> [C]ongressional intent; the extent to which the right asserted is a creature of congressional enactment; whether the area of activity involves essential government functions; whether the effectiveness of federal law or of a federal program demands a uniform national rule; whether the asserted right, duty, or status is created by the state; and whether following state law would frustrate a federal policy.

Taylor v. Citizens Fed. Sav. and Loan Ass'n, 846 F.2d 1320, 1324 (11th Cir. 1988) (citing Local Div. 732, Amalgamated Transit Union v. Metropolitan Atlanta Rapid Transit Auth., 667 F.2d 1327, 1345 (11th Cir. 1982)).

A case often cited by the FDIC is D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942). The *D'Oench* doctrine is an exception to the general rule that when the FDIC acts as a receiver, it "stands in the shoes" of the failed bank. FDIC v. Deloitte & Touche, 834 F. Supp. 1129, 1142 (E.D. Ark. 1992).

In *D'Oench*, D'Oench, Duhme & Co. executed a promissory note for the purpose of inflating the bank's assets by not showing any past due bonds. 315 U.S. at 454. The receipts for the note stated: "This note is given with the understanding it will not be called for payment." *Id*. However, when the bank failed, the FDIC, as part of a purchase and assumption transaction, sued to collect the note. *Id*. D'Oench alleged the note was given with the understanding that it would not be collected. *Id*. at 456. The Supreme Court found that the side agreement could not be used as a defense, otherwise it would encourage fraudulent activity. *Id*. at 461. This federal common law rule has since been codified in 12 U.S.C. § 1823(e) (1988). The *D'Oench* doctrine is primarily invoked in cases where side agreements are not reduced to writing; therefore, the regulator has no notice of the agreement's existence.

56. 440 U.S. 715 (1979).

determine if there is a need for a uniform national law.[57] Second, the court should determine if the application of the state law would likely impair the defined objectives of the federal policy or program.[58] Finally, the court should decide if the federal rule would disrupt commercial relationships based on state law.[59]

In *Kimbell Foods*, the issue before the Court was whether absent a federal statute, contractual liens that arose from federal loan programs would take priority over private liens.[60] In applying the three-pronged test, the Court adopted state law regarding the priority of the liens.[61] The Court determined that under the first prong, state law would not affect the administration of the federal lending programs.[62] Therefore, there was no need to create a uniform national law. Next, the Court noted that state law would not frustrate the federal program because the government could screen loan applicants.[63] Finally, the Court stated that the application of a new federal common law would disrupt business practices because creditors rely on state law to secure their liens.[64] The Court concluded by stating that established state law should not be supplanted unless Congress changed the statute.[65]

When a court does create a federal common law rule, it may incorporate the state law into the federal rule. The United States Supreme Court in *Kamen v. Kemper Financial Services, Inc.*[66] stated, "[t]he presumption that state law should be incorporated into federal common law is particularly strong in areas in which private parties have entered legal relationships with the expectation that

57. *Id*. at 728–29.

58. *Id*.

59. *Id*.

60. *Id*. at 715.

61. 440 U.S. at 718.

62. *Id*. at 729–30. The Court further stated that administrative convenience does not rise to a level to require a uniform federal law. *Id*. at 733.

63. *Id*. at 735–36. The governmental agency screened the loan applicants individually and structured the transactions to incorporate state law into the repayment terms. *Id*. at 736.

64. *Id*. at 739. The creditors' expectations would be altered whenever the federal agency would be a party to an action. This would undermine the stability necessary for businesses to adequately evaluate the credit risk. *Id*.

65. *Id*. at 740.

66. 111 S. Ct. 1711, 1722–23 (1991) (holding that federal courts must incorporate state law regarding the demand futility exception because it is not inconsistent with federal policies).

their rights and obligations *would be governed by state-law standards*."[67] Any gap in the federal statutes should incorporate state law, not be filled by a newly created federal law.[68]

Incorporating well-defined state law into federal common law is important when the underlying cause of action may affect the conduct and rights of those not directly involved in the litigation. In *FDIC v. Jenkins*, the United States Court of Appeals for the Eleventh Circuit rejected the FDIC's argument that it had absolute priority to the assets of the officers, directors, and third parties who may have been responsible for the failure of the bank.[69] The court declined to use the *Kimbell Foods* test to establish a federal common law rule of priority.[70] The court determined that, while it would be helpful for the FDIC to defeat priorities and defenses, the court was not required to assist the FDIC in its recovery efforts.[71]

Commercial law and negligence actions are generally governed by state law. Using the *Kimbell Foods* analysis, the United States Court of Appeals for the Eighth Circuit, in *FDIC v. Bowles Livestock Commission Co.*,[72] noted that while a uniform rule would make litigation easier for the FDIC, that alone was insufficient to create federal common law.[73] Because Bowles complied with Nebraska commercial law, he sold the goods free of the underlying security

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67. *Id*. at 1717 (citing *Kimbell Foods*, 440 U.S. at 728–29) (emphasis added).

68. *Id*.

69. 888 F.2d 1537, 1538 (11th Cir. 1989).

70. *Id*. at 1545–46. In a footnote, the court noted that the *Jenkins* case did not parallel the *Kimbell Foods* case; because in *Jenkins*, the FDIC did not voluntarily assume the risks as in *Kimbell Foods*, and the FDIC's desire to replenish the insurance fund did not rise to the level of importance of tax liens. *Id*. at 1545–46 n.15.

71. *Id*. at 1546. The court further stated:

> We agree that preservation of the permanent insurance fund is vital to the continued health of the nation's banking system. The FDIC should take all feasible measures authorized in the FDIA to maximize recovery to the fund. We cannot, however, approve of judicial expansion of the express powers and rights granted to the FDIC in the Act by Congress. As the FDIA contains no indication of an intention to create an absolute priority rule in favor of the FDIC, we must reverse the district court's finding based on policy considerations in favor of such a rule for the FDIC.

Id. at 1541.

72. 937 F.2d 1350, 1354 (8th Cir. 1991). In this case, Bowles acted as a middleman and sold hogs on behalf of the hog farmer, Wehmer. *Id*. at 1352. Wehmer financed his operation through a loan secured by the hogs. *Id*. When the bank failed, the FDIC filed this action in conversion. *Id*.

73. *Id*. at 1354. The court opined that under a *Kimbell Foods* analysis, the application of the state law would not defeat the purposes and goals of the FDIC. *Id*.

interest; and therefore, the FDIC could not recover.[74] As the United States District Court for the District of Hawaii stated in *First Hawaiian Bank v. Alexander*,[75] negligence actions traditionally are left to the state courts.[76] The district court could not find any interest that would benefit by the creation of a federal common law.[77] Therefore, using a *Kimbell Foods* analysis, courts should incorporate state law into federal common law, especially in cases where the state law is well-established and when the rights of non-parties may be affected.

E. Defenses to Legal Malpractice

One example of developing a federal common law rule that would ignore state law is to strike defenses such as comparative negligence or imputation.[78] These defenses are generally factual issues which cannot be dismissed as a matter of law. Under some state laws, the wrongdoing of a sole or primary shareholder is attributable to the insolvent financial institution.[79] Once the factfinder credits the wrongdoing to the owner, the defendant attorney can assert traditional defenses such as comparative negligence or imputation.[80] As a result, the regulator which acquires the institution as a receiver also has the wrongdoing imputed to it.[81] Adopt

74. *Id*. at 1356. The court applied the Nebraska Uniform Commercial Code. *Id*.

75. 558 F. Supp. 1128 (D. Haw. 1983). In this case, First Hawaiian Bank loaned money to prospective shareholders of a thrift in order to purchase its stock. *Id*. at 1130. The thrift subsequently failed, which left the shareholders with a worthless asset and the bank with worthless collateral. *Id*. The bank subsequently filed this action against the thrift's officers and directors. *Id*.

76. *Id*. at 1131.

77. *Id*. However, the court did note that because federal agencies regulate the thrifts, it would recognize a federal common law cause of action for breach of fiduciary duty against the thrift's officers and directors. *Id*. at 1133. See also *supra* note 52, discussing the gross negligence standard for officers and directors.

78. Imputation, as used in a legal context, means to attribute the actions of others vicariously. An act will be imputed to an individual who is unaware of the act, because the wrongdoing party is under the control of the individual. BLACK'S LAW DICTIONARY 758 (6th ed. 1990).

79. The alter ego doctrine will be used when an individual acts knowingly or intentionally in the name of a corporation. In this situation, the individual and the corporation will be held responsible, because the individual is, in effect, the corporation. *Id*. at 77–78.

80. As explained *supra*, in note 3, this Note will use the term comparative negligence when discussing proportional liability.

81. *See* FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir.), *reh'g denied*, 976 F.2d

ing the banking regulator's argument for establishing federal common law would avoid the consequences of state law by striking these defenses.[82]

1. Imputation

The facts of each case determine whether courts will impute the actions of others. The parties to the action and their relationships must first be identified.[83] The United States Court of Appeals for the Seventh Circuit addressed the issue of imputation in the case of *Cenco, Inc. v. Seidman & Seidman*.[84] Cenco's management engaged in fraud by inflating the value of the company's inventories.[85] This increased the assets and net worth of the company.[86] Writing for the Seventh Circuit, Judge Richard A. Posner held that the jury instruction which permitted the auditors to use the wrongdoing of the corporate insiders as a defense against charges of malpractice was correct.[87] The *Cenco* court, in reaching this conclusion, emphasized the distinction between the case of fraud on behalf of a corporation and the case of fraud against a corporation.[88] The court found that the fraud perpetrated by Cenco's management was on behalf of the cor-

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732 (5th Cir. 1992) (en banc). The court held that the FDIC, as receiver, stood in the shoes of the failed bank and imputed the fraud committed by the sole shareholder to the FDIC. *Id*. at 169. However, the court left open the question of whether the FDIC, suing in its corporate capacity, could avoid imputation. *Id*.

82. The FDIC advanced this argument in *O'Melveny*.

83. FDIC v. Deloitte & Touche, 834 F. Supp. 1129, 1133–34 (E.D. Ark. 1992) ("The first question that the [c]ourt must address is always important but rarely so difficult: [W]ho, or what, exactly is the plaintiff?"); *In re* Jeter, 48 B.R. 404, 410 (Bankr. N.D. Tex. 1985) (determining in which capacity the FDIC is acting is the threshold question).

84. 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

85. *Id*. at 451.

86. *Id*.

87. *Id*. at 456. In fact, the court went so far as to say that auditors are not hired as detectives to "ferret out fraud." *Id*. at 454.

88. 686 F.2d at 456. Judge Posner stated:

> Fraud on behalf of a corporation is not the same thing as fraud against it. Fraud against the corporation usually hurts just the corporation; the stockholders are the principal if not only victims; their equities vis-a-vis a careless or reckless auditor are therefore strong. But the stockholders of a corporation whose officers commit fraud for the benefit of the corporation are beneficiaries of the fraud . . . . [T]he 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, as they are trying to do in this case.

Id.

poration, and their actions should not shift full liability to the auditors.[89]

Judge Posner fashioned a two-pronged analysis to determine when imputation should occur for or against a corporation. To determine imputation, the court, guided by objectives of tort liability, should examine whether the victims of wrongdoing received compensation and whether future wrongdoing could be deterred.[90] The court found that if the judgment were in favor of Cenco, the result "would be perverse from the standpoint of compensating the victims" because the wrongdoers were also Cenco shareholders.[91]

The United States District Court for the Southern District of New York also addressed the imputation issue in the case of *In re Investors Funding Corp.*[92] The accounting firm of Peat, Marwick & Mitchell asserted that the conduct and knowledge of the corporate insiders should be imputed to the corporation.[93] The court found that the principal officers and shareholders had covered up their fraudulent activities and transactions, which inflated the financial position of the corporation.[94] However, the court denied the accountant's motion for summary judgment because it could not, as a matter of law, impute the activities to the corporation.[95]

Within a year of *Cenco*, the Seventh Circuit court decided the case of *Schacht v. Brown*.[96] The Director of Insurance of the State of Illinois sued the officers and directors of an insurance company under RICO to recover damages sustained by the company.[97] The court held that the defendant's actions could not, as a matter of law, be

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89. *Id*. The court stated Cenco's management did not steal from the company, but rather they turned the company "into an engine of theft against outsiders — creditors, prospective stockholders, insurers." *Id*. at 454.

90. *Id*. at 455. Additionally, the court noted that future deterrence would best be accomplished by requiring the shareholders to more closely supervise management. *Id*.

91. *Id*.

92. 523 F. Supp. 533 (S.D.N.Y. 1980).

93. *Id*. at 540–41.

94. *Id*. at 536.

95. *Id*. at 540–41. In *Investors*, management's wrongdoing prolonged the corporation's existence. The court noted "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." *Id*. at 541.

96. 711 F.2d 1343 (7th Cir. 1982), *cert. denied*, 464 U.S. 1002 (1983).

97. *Id*. at 1345–46. The allegations stated that the Reserve Insurance Company's parent continued to operate Reserve even though the insurance company was insolvent. The result was over $100 million in losses to the policyholders and creditors. *Id*.

imputed to the corporation.[98] The *Schacht* court distinguished *Cenco* in two ways. First, the *Schacht* case arose under the federal RICO statute instead of state law. Second, and more importantly, the actions of the insurance company did not benefit the corporation.[99] The *Schacht* case is similar to the *Investors* case in that the officers fraudulently kept the corporation in business so that the officers could continue to steal from the corporation. However, these cases can be distinguished from *Cenco*. In *Cenco*, the management kept the corporation in business not to steal from the corporation but to defraud third parties: the outsiders, creditors, insurers, and prospective stockholders.

Imputation was again the central issue of a case decided shortly after *O'Melveny*. In *FDIC v. Ernst & Young*,[100] the United States Court of Appeals for the Fifth Circuit granted the accounting firm's motion for summary judgment. The court held that the sole shareholder's knowledge of his own wrongdoing was imputed to the thrift because by serving the thrift, the owner served himself.[101] The court treated the FDIC as an ordinary assignee.[102] The FDIC asked the Fifth Circuit court to vacate the decision, but the court declined to do so.[103] Therefore, at least in the Fifth Circuit, actions by a sole or primary shareholder will be imputed to the corporation when the

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98. *Id*.

99. *Id*. at 1347–48. The court noted Reserve's prolonged existence benefitted only the managers, not the corporation. *Id*. at 1348.

100. 967 F.2d 166 (5th Cir.), *reh'g denied*, 976 F.2d 732 (5th Cir. 1992) (en banc).

101. *Id*. at 169. The thrift's sole owner was also the chairman, chief operating officer, chief executive officer, and served on five policy committees. *Id*. at 168. The *Ernst & Young* court did not explicitly use the term "alter ego;" however, the court applied the doctrine in this case. The owner so dominated the thrift that the owner's actions were considered the thrift's actions. *See also supra* note 79; 2 AM. JUR. 2D *Agency* § 284 (1980).

102. *Ernst & Young*, 967 F.2d at 170. The court noted:

> Critically important to the ultimate resolution of the case is the FDIC's decision to bring this suit only as assignee of a claim by Western against the auditors. The FDIC had authority to sue Ernst & Young in its own behalf or on behalf of Western's creditors, but it chose not to do so.

Id. at 169.

103. Ernst & Young made a "global settlement" with the banking regulators covering actions by the accounting firm from 1985 to 1992 for $400 million in restitution. This was the largest settlement ever paid by a law or accounting firm to resolve government charges of liability in connection with a financial institution. *Ernst & Young Settles with Regulators, Agrees to $400 Million in Restitution*, Banking Rep. (BNA), Nov. 30, 1992. As part of the settlement, the Fifth Circuit court was asked to vacate its decision. The motion was denied. FDIC v. Ernst & Young, 976 F.2d 732 (5th Cir. 1992).

fraud perpetrated on behalf of the corporation ultimately benefits the owner.

2. *Proximate Cause and Negligence*

In some cases, even if the imputation defense is not allowed, other defenses such as comparative negligence are available to the defendant. In addition, a plaintiff should still be required to prove all the elements in a state law malpractice action, including proximate cause. Even if a banking regulator is a party to the action, a court should not strike state law malpractice elements or defenses as a matter of law unless there is a clear federal statutory mandate.

Several circuits have addressed the issue of comparative negligence as a defense in professional malpractice cases. In ***FDIC v. Gantenbein***,[104] the United States District Court for the District of Kansas held that because the FDIC brought the malpractice action as an assignee of the thrift, it would be treated as any other assignee.[105] The court reasoned that since Kansas law governed the underlying cause of action, without a clear federal statute to the contrary, there was no public policy reason to treat the FDIC differently.[106] Therefore, Gantenbein would be allowed to assert the comparative

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104. 811 F. Supp. 593 (D. Kan. 1992).

105. *Id*. at 595. The court stated that where the FDIC is suing on behalf of the failed institution, it is treated as any other assignee and is subject to state law defenses. *Id*.

See also FDIC v. Glickman, 450 F.2d 416, 418 (9th Cir. 1971) ("At this point, however, a distinction must be drawn between FDIC's dual capacity as federal insurer of deposits and as liquidating agent for the bank . . . . In the latter instance FDIC stands in the shoes of the insolvent bank.") (citations omitted); FDIC v. Harrison, 735 F.2d 408 (11th Cir. 1984) (same); Owen v. Resolution Trust Corp., 766 F. Supp. 1163, 1165 (S.D. Fla. 1991) ("It is well settled that when the FDIC or RTC acts as a receiver, it stands in the shoes of the insolvent bank."); FDIC v. Renda, 692 F. Supp. 128, 134 (D. Kan. 1988) ("The FDIC and FSLIC may also act as receivers for failed financial institutions. When acting in this capacity, state law governs, . . . and various defenses available to the entities in their corporate capacity are not available to the entities in their capacity as receivers.") (citation omitted).

But compare *FSLIC v. McGinnis, Juban, Bevan, Mullins & Patterson, P.C.*, where the court found that the FDIC had acquired greater rights than its predecessor. 808 F. Supp. 1263 (E.D. La. 1992). The attorneys argued that "because the FDIC, as receiver of Sun Belt merely stands in the shoes of Sun Belt in this suit, the shoes ought to hurt, and officer and director misconduct likewise bars the FDIC's malpractice claims." *Id*. at 1273. The court was not persuaded by the attorneys' argument. *Id*. at 1276.

106. *Gantenbein*, 811 F. Supp. at 595.

negligence defense at trial. In *FDIC v. Cherry, Bekaert & Holland*, the United States District Court for the Middle District of Florida denied the FDIC's motion for summary judgment.[107] The court held that the accountants could use the comparative negligence of the former bank officers as a defense against the FDIC.[108] As in *Ernst & Young*, the court treated the FDIC as an ordinary assignee, subject to applicable state law.[109]

The use of imputation, comparative negligence, and proximate cause are generally factual issues, which cannot be supported in a motion to dismiss. In *FDIC v. Deloitte & Touche*,[110] the FDIC sued the accounting firm of Deloitte & Touche for professional malpractice in connection with auditing a savings and loan.[111] Deloitte & Touche filed a motion to dismiss the action arguing it could not, as a matter of law, be liable for failing to disclose what Deloitte & Touche contended the insiders already knew.[112] The district court found that imputing knowledge is a factual determination based on corporation law and agency law.[113] Agreeing with the FDIC, the court stated that knowledge of some transactions does not equate to knowledge of the thrift's overall financial condition.[114]

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107. 742 F. Supp. 612, 617 (M.D. Fla. 1990).

108. *Id*. at 615. The FDIC brought this action in its corporate capacity as receiver for the failed bank. The court rejected the FDIC's argument to extend the *D'Oench* doctrine because the FDIC in *Cherry* sued as an assignee. *Id*. Although the opinion uses the term contributory negligence, Florida is a comparative negligence state. *See supra* note 3.

109. 742 F. Supp. at 615. The FDIC in this case conceded that under state (Florida) law, the assignee takes subject to any defenses that may be asserted against the assignor. *Id*. *But see* FDIC v. Martin, 770 F. Supp. 623, 627 (M.D. Fla. 1991) (holding that state law that denies assignability of malpractice claims is preempted by federal law in the course of liquidating a bank).

110. 834 F. Supp. 1129 (E.D. Ark. 1992).

111. *Id*. at 1133.

112. *Id*.

113. *Id*. at 1137, 1140.

114. 834 F. Supp. at 1137. The court noted the difference between the "principles of imputation" and the "principles of receivership." *Id*. at 1140. Principles of imputation determine what is "left in the thrift's shoes." *Id*. Principles of receivership determine "whether the FDIC has to stand in those shoes while it brings [the] lawsuit." *Id*. The court found it is a factual question whether the FDIC constructively acquired the knowledge of the thrift's insiders because the FDIC stands in the shoes of the thrift under receivership principles. *Id*.

The *Deloitte* court noted it was "not entirely comfortable with the notion of a bank having shoes. Fictional personality is a necessary legal concept. Fictional footwear, however, is a troubling self-inflicted metaphor to which the court will only resort when

While the court did not grant Deloitte & Touche's motion to impute the knowledge of the insiders to the FDIC as a matter of law, neither did it strike Deloitte & Touche's remaining defenses as the FDIC requested. Rather, the court emphasized that proximate cause is an element of the plaintiff's case which the FDIC must prove.[115] Otherwise, this would result in a "dramatic departure from the most fundamental principals of tort law."[116] Further, the affirmative defense of comparative negligence is a factual issue that is best left to the trier of fact.[117] The FDIC argued that the *D'Oench* doctrine should be expanded to strike any defenses. The court, however, agreed with the reasoning in *Cherry* that without a clear statutory directive, it would not create an exception in this case.[118]

The FDIC's equitable argument that allowing defenses would shift the savings and loan losses from accounting and law firms to the taxpayers is persuasive. In *Comeau v. Rupp*,[119] the court held that the conduct of the stockholders could not be imputed to the FDIC.[120] The court stated that if the accounting firm asserted a *contributory* negligence defense, the firm would shift its liability to the public.[121] Using the *Cenco* objectives of tort liability, the court

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precedent so requires." *Id*. at 1140 n.14.

115. *Id*. at 1140–41.

116. *Id*.

117. *Id*. at 1141.

118. *Id*. at 1141–43.

119. 810 F. Supp. 1127 (D. Kan. 1992).

120. In *Comeau*, the minority shareholders and the FDIC sued the thrift's accountants. *Id*. at 1137. The Rupp family owned 70% of the organization, and the Comeaus owned 30%. *Id*. at 1141 n.5. The court distinguished *Ernst & Young* because the Rupps' involvement in the thrift was not as a sole shareholder. *Id*.

The court did not impute the knowledge of the shareholders to the thrift for two reasons. First, using a *Cenco*-type analysis, the *Comeau* court noted that if the agent acted adversely to the corporation, the activities would not be imputed just because the shareholder's activities caused the thrift to fail. *Id*. at 1139. The court said it was at least a question of fact whether the Rupps acted for themselves or for the benefit of the corporation. *Id*. at 1141. Second, even if the shareholder's activities could be imputed to the corporation, the activities could not be imputed to the FDIC. *Id*.

121. *Id*. at 1142. It is at this point where the harsh result of contributory negligence is important. *See supra* note 3. Any negligence on the part of the plaintiff would preclude recovery from the defendant accounting firm and therefore shift the losses to the taxpayers.

See also FDIC v. Benjes, 815 F. Supp. 1415, 1419 (D. Kan. 1993) (holding that the defendant attorney may not impute the negligence or intentional acts of the former directors and officers to the FDIC); Resolution Trust Corp. v. Farmer, 823 F. Supp. 302, 311 (E.D. Pa. 1993) (striking the defendant attorney's affirmative defenses which would

found that the beneficiaries of any recovery would be the public, not the shareholders as in *Cenco*, and that if the public paid for the wrongdoing, there would be no effective deterrence.[122] However, the court noted that the accountants still could argue that the actions and knowledge of the shareholders were the legal and proximate cause of the thrift's losses and not the result of any negligence on the accountants' part.[123]

In a case factually similar to *Comeau*, the United States District Court for the Eastern District of Pennsylvania, in *In re Sunrise Securities Litigation*,[124] granted the FDIC's motion to strike Deloitte & Touche's defenses.[125] The *Sunrise* court reasoned that if the accounting firm could assert a negligence defense, the result would shift the cost from the accounting firm to the public.[126] However, the court noted that the FDIC still must prove that the accounting firm's negligence was the proximate cause of the loss.[127]

As these cases illustrate, the federal courts are in conflict as to when to impute knowledge to the FDIC or whether to strike affirmative defenses when the FDIC is a party. However, it is clear that these courts require the plaintiff, the FDIC, to prove all the elements of a state law malpractice action, including proximate cause.

F. Impact on Malpractice Insurance

The increasing number of malpractice claims have occurred in three primary areas: banking law, securities law, and claims by non-client third parties.[128] As a result, firms representing finan

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have imputed the contributory negligence to the RTC). However, the *Farmer* court noted that the attorneys would only be liable for the damages that they had proximately caused. 823 F. Supp. at 314. The court suggested that the defendants file third-party complaints against those whom the attorneys consider responsible for the wrongdoing. *Id*. The court stated that the proximate cause element was not an affirmative defense but only an assertion that the proximate cause element cannot be proven. *Id*.

122. 810 F. Supp. at 1141–42.

123. *Id*. at 1142.

124. 818 F. Supp. 830 (E.D. Pa. 1993).

125. *Id*. at 843. The *Sunrise* court agreed with the reasoning of *Comeau* that although contributory and comparative negligence are defenses available against an assignee, the FDIC in this case would not be treated as an ordinary assignee. *Id*.

126. *Id*. The court held: “I will not apply Florida law with respect to assignments and contributory negligence; pursuant to federal common law, I will strike [the affirmative defenses] alleging contributory or comparative negligence.” *Id*.

127. *Id*.

128. *See* Fortson v. Winstead, McGuire, Secherst & Minick, 961 F.2d 469 (4th Cir.

cial institutions are finding it difficult to obtain insurance coverage, if the firms can obtain coverage at all.[129] It is unclear if liability waivers would give attorneys a reliable defense.[130] This Note will not address the issue of unavailability of coverage. However, the impact of the *O'Melveny* case and the confusion about which law, federal or state, applies will likely exacerbate the uninsurability problem.[131]

1992). In *Fortson*, the issue presented to the court was whether the attorney owes a duty of disclosure to the party that is being defrauded. *Id*. at 471. The court affirmed the attorney's motion for summary judgment because there was no intended third-party beneficiary. *Id*. The court further stated that there is no duty grounded in public policy:

> The policy apparently is that of having law firms monitor, upon pain of liability, the representations that their clients make to any third party. The end result would have attorneys stand as the guarantors of integrity in all commercial transactions, whether the context be one of raising capital, marketing a product, or negotiating a contract. Lawyers, in short, would function in the business world as designed watchdogs.

Id. at 475. The court further opined that the new duty would not only be unfair to lawyers but also might destroy incentives for clients to be forthcoming with their attorneys. *Id*. The consequences would artificially inflate the cost of involving legal counsel in commercial ventures. *Id*.

See generally Joseph T. McLaughlin et al., *Overview: Ethical Problems, Disqualification, and Lawyers' Potential Liability for Malpractice and Fraud*, A.L.I.-A.B.A. CONFERENCE ON LAWYERS' PROFESSIONAL LIABILITY IN THE 90s (Oct. 1991) (discussing the increase and severity in the number of lawsuits against attorneys in these areas).

129. Some believe the search for "deep pockets" through law firms and their insurance carriers may be a good source of income to help pay for the bailout of the savings and loan debacle. Ronald R. Glancz et al., *Coverage? What Coverage?*, BUS. L. TODAY, Nov.–Dec. 1992, at 22. However, Bill Smith, president of the National Union Fire Insurance Company, explained the extortion tactics used in asset-freeze cases, such as the *Kaye, Scholer* case, has resulted in the regulators "accusing lawyers of actions that are essentially not insurable." *Id*. at 24. In 1991, some policies began excluding coverage for failing or failed financial institutions, including the "regulatory claim exclusion" that states that the policy "does not apply to any claim made by any governmental authority" (expressly including the FDIC, Fed, OCC, OTC, or the RTC), whether the regulator "is acting in its capacity as a receiver, conservator, liquidator or otherwise." *Id*. at 25. The result of the exclusions was a 15–50% increase in premiums during 1991 in those cases where the firm was able to negotiate a policy. *Id*. For examples of the exclusionary policy language, see A.B.A. WORKING GROUP, *supra* note 30, at 267–71.

130. David A. Schwartz & David Siegel, *Attorney Due Diligence Obligations to Clients and Investors After* FDIC v. O'Melveny & Myers, *in* 2 CALIFORNIA MCLE MARATHON WEEKEND 381, 417 (PLI Corp. Law & Prac., No. B-802, 1992). The authors state that disclaimers in the text of public offerings or in engagement letters may not provide any protection to attorneys from third-party or client liability. *Id*. It is also unclear if a formal waiver from the client would be a defense because, according to the *O'Melveny* court, "equitable defenses good against a bank do not carry over against the bank's receiver." *O'Melveny*, 969 F.2d at 751.

131. For more information about the effects on insurance coverage, see A.B.A. WORKING GROUP, *supra* note 30, at 48–53.

III. COURT'S ANALYSIS

In *FDIC v. O'Melveny & Meyers*,[132] the United States Court of Appeals for the Ninth Circuit reviewed *de novo* the district court's grant of summary judgment.[133] The *O'Melveny* court held that (1) O'Melveny & Myers owed a duty of care not only to the investors of the partnerships but also to ADSB,[134] and (2) the FDIC, as an involuntary successor, could litigate the assigned partnership claims against O'Melveny & Myers.[135] Finally, the court suggested that if the FDIC were successful on remand, the FDIC should recover the out of pocket costs attributable to the fraudulent transactions.[136]

The court began its analysis by stating that O'Melveny & Myers could only be found negligent if the firm violated a duty.[137] The firm conceded its duty to the investors.[138] However, the firm argued that because ADSB's affiliates fully compensated the investors,[139] the firm owed no additional duty to the investors or the FDIC.[140] The

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132. 969 F.2d 744 (9th Cir. 1992), *cert. granted*, 114 S. Ct. 543 (1993).

133. *Id*. at 747–48.

134. *Id*. at 752. The court remanded the case because there was a genuine dispute as to whether the law firm properly exercised its duty to ADSB. *Id*. See *supra* notes 11, 13 for a discussion of the partnerships.

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

136. *Id*. The damages would include any documented fees paid to O'Melveny including, "settlement costs, brokers' commissions, and any losses on property purchased as a result of the offering having closed." *Id*. The FDIC did not seek reimbursement for the rescission payments. *Id*. An ADSB subsidiary repaid the investors. *Id*.

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

138. *Id*. The duty to the investors consisted of an accurate disclosure in the PPMs. *Id*. See *supra* note 13 for a discussion of the PPMs.

139. The FDIC made rescission payments of $3,650,000 (Gateway Center) and $1,620,000 (Wells Park) through the ADSB structure after the thrift had been put into conservatorship. Appellee's Brief on Appeal at 35, *O'Melveny* (No. CA-90-55769). As part of the rescission agreement, each investor assigned all claims to the FDIC as the *conservator* for ADSB. *Id*. at 34.

The FDIC argued it repaid the investors as the *receiver* because the payment diminished the assets of ADSB. *Id*. at 35. The FDIC further alleged that the depositors, the regulator, and the creditors were the true victims; and these groups would benefit from any recovery. The recovery would, the FDIC argued, help deter future wrongdoing by attorneys who have contributed to the losses from the savings and loan failures. Appellants' Reply Brief on Appeal at 12, *O'Melveny* (No. CA-90-55769).

O'Melveny & Myers argued that a subsidiary of ADSB fully repaid the investors. The only future payments to be made would not be made to investors but to other future creditors of ADSB, to whom the law firm owed no duty. Appellee's Brief on Appeal at 35 n.44, *O'Melveny* (No. CA-90-55769).

140. *O'Melveny*, 969 F.2d at 748. Specifically, O'Melveny & Myers argued it had no

court rejected this argument on two grounds. First, the court examined several California cases and stated that California law requires an attorney to act competently if and when the attorney discovers that his client is dishonest.[141] The second problem concerned the question as to the difference between a duty to a client and a duty to an investor.[142] The court stated that there is no difference between the investor and client because a securities counsel must make a due diligence investigation to determine if any information is false or misleading.[143] On this basis, the court determined that there was a triable issue of fact because O'Melveny & Myers did not make a reasonable, independent investigation.[144]

The *O'Melveny* court next turned to the issue of whether the wrongdoing of the corporate officers could be imputed to the thrift. Rejecting O'Melveny & Myers' argument that the FDIC "stands in the shoes"[145] of the thrift, the court stated that the FDIC was not estopped from litigating the claims against O'Melveny & Myers.[146]

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further duty to the FDIC, as successor in interest to ADSB, to inquire, obtain, and disclose information that ADSB insiders already knew and were trying to conceal. *Id*.

141. *Id*. The A.B.A. Working Group called this general rule a "novel theory." A.B.A. WORKING GROUP, *supra* note 30, at 129–30. Although a threshold question in this case is whether the firm could have reasonably ascertained ADSB's true financial condition, there is no evidence on the record that the law firm knew of the insiders' fraudulent activities.

142. *O'Melveny*, 969 F.2d at 749. O'Melveny & Myers conceded its duty to perform to a due diligence standard on behalf of the investors. However, the court stated that the firm also had a duty to protect its client, ADSB, from liability. *Id*.

143. *Id*. (quoting Felts v. National Account Sys. Assoc., Inc., 469 F. Supp. 54, 67 (N.D. Miss. 1978)). *Felts* can be distinguished from *O'Melveny*. In *Felts*, the lawyer was not only responsible for the issuer's compliance with the law, but his name and office were used fraudulently as president of the corporation. 469 F. Supp. at 68. The court found the attorney was active in the fraudulent scheme and gave "active, affirmative assistance." *Id*. The attorney, therefore, participated and was jointly liable with the issuers for all damages. *Id*. In *O'Melveny*, the FDIC sued the law firm on the basis of negligence. *See O'Melveny*, 969 F.2d at 744. See also *supra* note 40 for a discussion of Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

144. *O'Melveny*, 969 F.2d at 749.

145. *Id*. O'Melveny & Myers argued that it had no duty to uncover its client's own fraud and that the FDIC is barred from asserting this fraud against O'Melveny & Myers. *Id*. The firm argued that the fraud should be imputed to the FDIC because the FDIC sued as assignee for the investors. *Id*. If the FDIC were not a party to this action, the investors would not be successful in suing the firm because the actions of the insiders, Sahni and Day, would be imputed to the thrift.

146. *O'Melveny*, 969 F.2d at 749. The court further opined: "We disagree with this flat statement of the law, particularly in view of the public expectation that the wrongdoing will be exposed, the wrongdoers pursued, and the innocent victims of fraud will

Reviewing three federal cases,[147] the court found that there could be no attribution or estoppel when the insiders, not the corporation, benefitted from the fraud.[148] Any activities of Sahni and Day were not attributable to ADSB, and consequently to the FDIC, because the insiders contributed to the thrift's demise.[149] Further, O'Melveny & Myers could not argue a defense of estoppel if the firm was not innocent itself.[150]

Next, the court addressed the issue of whether the FDIC could

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have a chance at recovering." *Id*. In this case, the court stated that the victims were the taxpayers, not the investors. *Id*.

147. The *O'Melveny* court analyzed Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1992), *cert. denied*, 464 U.S. 1002 (1983); Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982); and *In re* Investors Funding Corp., 523 F. Supp. 533 (S.D.N.Y. 1980). See *supra* notes 84–99 and accompanying text for a detailed discussion of these cases.

148. *O'Melveny*, 969 F.2d at 750–51.

149. The *O'Melveny* court, while citing *Cenco*, did not distinguish between the case of fraud on behalf of a corporation and the case of fraud against a corporation. *See supra* note 88. Insiders, including officers, directors, and shareholders, who steal from the corporation engage in fraud against a corporation; and the insiders' activities will not be imputed to the corporation and subsequently to any receiver. *See Cenco*, 686 F.2d at 456. If the insiders' activities contributed to the corporation's demise, the insiders, not the corporation, will bear the losses. Consequently, imputation will not be allowed.

Insiders who steal from outsiders, including creditors and insurers, engage in fraud on behalf of the corporation. *Id*. at 454. In this situation, the activities of the insiders will be imputed to the corporation and subsequently to any receiver. *Id*. at 456. If the activities of the insiders benefitted the corporation, the activities also benefitted the insiders. Consequently, the corporation cannot escape liability created by the insiders, and imputation will be allowed.

In the *O'Melveny* case, Sahni and Day were 100% shareholders and dominating officers of ADSB and its subsidiaries. *See supra* notes 8–9. In a related case, *California Union Ins. v. American Diversified Sav. Bank*, the Ninth Circuit court affirmed the district court's grant of summary judgment against the FSLIC. 948 F.2d 556 (9th Cir. 1991). The FSLIC, as receiver, tried to recover under fidelity bonds for losses incurred due to the wrongdoing of the bank's officers. *Id*. at 557. In deciding whether Sahni and Day were "employees," the Ninth Circuit court stated:

> It is not disputed that Sahni and Day controlled ADCC and ADSB. While they were not the sole officers of ADCC, they were the principal officers and directors. Furthermore, Sahni and Day owned 100% of the stock of ADSB, of which ADCC is a wholly-owned subsidiary. Because Sahni and Day *controlled* the Insured [ADSB], rather than the Insured's controlling them, they do not meet the policy definition of "employees."

Id. at 566 (emphasis added). The court further stated that it is against public policy to allow a corporation to collect because of the wrongdoing of its *alter ego*. *Id*. Given the Ninth Circuit court's analysis of Sahni and Day's ownership and activities in ADSB in the *California Union* case, it is impossible to reconcile the same court's analysis of the same organization in the *O'Melveny* case.

150. *O'Melveny*, 969 F.2d at 751.

bring this lawsuit as receiver for the thrift. The court rejected O'Melveny & Myers' argument that, under California law, the receiver stands in the same position as the original party.[151] The court stated: "[I]t is by now clear beyond doubt that federal, not state, law governs the application of defenses against [the] FDIC,"[152] and that the court "must instead establish federal law."[153] Therefore, the court found that equitable defenses that are good against a thrift do not apply against the thrift's receiver.[154] Further, citing public policy reasons, the court did not impute the behavior of the thrift and its officers to the FDIC.[155] The court concluded by stating that any damages would include repayment of any fees paid in connection with the Gateway Center and Wells Park offerings.[156]

IV. CRITICAL ANALYSIS

In *FDIC v. O'Melveny & Meyers*,[157] the court's conclusion that federal law applied in this case was correct.[158] Because there is no federal malpractice statute, the court was left to fashion a federal common law rule. However, the court ignored the *Kimbell Foods* test formulated by the United States Supreme Court which determines

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151. *Id*.

152. *Id*.

153. *Id*.

154. *O'Melveny*, 969 F.2d at 751. The court analogized the FDIC's role as that of a bankruptcy trustee. The FDIC involuntarily entered into the position as receiver and was not a party to the original wrongdoing. However, the analogy may not be accurate. In *Stratton v. Sacks*, the bankruptcy trustee sued an accounting firm for negligence and breach of contract. 99 B.R. 686, 688 (Bankr. D. Md. 1989). The accounting firm asserted the contributory negligence of the controlling shareholder who was also the chairman of the board, chief executive officer, and the dominant management figure. The court stated "it is well established that a trustee in bankruptcy stands in the shoes of the debtor and has no greater rights than the debtor itself had." *Id*. at 692. Therefore, "any defense, legal or equitable, which might have been raised against a debtor may be raised against the trustee." *Id*. *See also* 2 COLLIER ON BANKRUPTCY § 323.02 (15th ed. 1992) (stating that a trustee in reorganization has no statutory authority to sue third parties).

155. *O'Melveny*, 969 F.2d at 752. The court said the regulatory purpose would be undermined if the thrift's conduct was imputed to the FDIC. Interestingly, the court did note that "it does not necessarily follow that *equitable* defenses can never be asserted against FDIC acting as a receiver; we hold only that the bank's *inequitable* conduct is not imputed to FDIC." *Id*. (emphasis added). The court did not elaborate in which cases equitable defenses would apply.

156. *Id*. at 752. See *supra* note 136 for a discussion of damages.

157. 969 F.2d 744 (9th Cir. 1992), *cert. granted*, 114 S. Ct. 543 (1993).

158. *See supra* text accompanying note 50.

whether a court should create a new federal common law rule or incorporate state law into that common law rule.[159] As a result, the *O'Melveny* court's improper creation of a new federal common law has resulted in a denial of defenses that attorneys can assert in traditional legal malpractice actions. The Ninth Circuit court's reasoning in *O'Melveny* and the Fifth Circuit court's reasoning in *FDIC v. Ernst & Young* have left a direct conflict between the federal circuits.[160] As discussed below, courts presented with legal malpractice cases should adopt the *Kimbell Foods* analysis and incorporate the state law into federal common law when a banking regulator steps into the litigation.

Initially, the Ninth Circuit court should have discussed the role that the FDIC had taken in this case and whether the FDIC stood in the shoes of the failed thrift. The FDIC strongly argued that it did not stand in the shoes of the thrift but had greater rights.[161] However, this argument in the legal malpractice area relies primarily on public policy grounds instead of focusing on broader factors when determining whether a court can legally create federal common law.[162] The trend in the circuits, with the exception of the Fifth Circuit,[163] appears to concentrate on expanding the FDIC's rights as an assignee and foreclosing defenses that might have been available to attorneys under state law.

A. Federal Common Law v. State Law: The *Kimbell Foods* Test

Legal malpractice actions are traditionally subject to state law.[164] While there is a national standard of gross negligence for officers and directors of financial institutions, no such standard

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159. See *supra* notes 56–65 and accompanying text for a discussion of the Supreme Court's test developed in *United States v. Kimbell Foods, Inc.*

160. *See supra* note 5.

161. See *supra* note 105 for a discussion of whether the FDIC has greater rights than the failed institution.

162. See *supra* note 55 for a list of the factors that should be considered before a court creates federal common law.

163. *See* FDIC v. Shrader & York, 991 F.2d 216 (5th Cir. 1993), *petition for cert. filed*, (U.S. Oct. 26, 1993) (No. 93-651); FDIC v. Ernst & Young, 967 F.2d 166 (5th Cir.), *reh'g denied*, 976 F.2d 732 (5th Cir. 1992) (en banc); FDIC v. Thompson & Knight, 816 F. Supp. 1123 (N.D. Tex. 1993).

164. See *supra* notes 39–43 and accompanying text for a discussion of traditional state legal malpractice claims.

exists for attorneys and other professionals.[165] The *O'Melveny* court correctly stated that federal law should apply in this case because the FDIC was a party. However, the court's statement, "it is by now clear beyond doubt that federal, not state, law governs the application of defenses against [the] FDIC," was misleading.[166] The Ninth Circuit court did not cite any case precedent or statutory authority for this statement but instead relied only on equity principles.[167] Neither did the court explain the provisions of this new federal common law. The Ninth Circuit court should have used the test developed by the United States Supreme Court in *Kimbell Foods* to determine whether federal common law should be established when such a law would alter the traditional rules of malpractice liability for the purpose of "maximizing the asset pool."[168]

Using the analysis developed in *United States v. Kimbell Foods, Inc.*,[169] the Ninth Circuit court should have incorporated state law into its adoption of a federal common law rule. The first prong of the *Kimbell Foods* test requires a court to determine whether there is a need for a national uniform rule.[170] There are several limited situations where the courts have created a federal common law when the FDIC was a party to the litigation.[171] However, as the United States District Court for the District of Hawaii correctly noted in *First Hawaiian Bank v. Alexander*,[172] state law traditionally controls negligence actions.[173] Given the fairly uniform elements and defenses of state malpractice actions, there is no need to fashion an alternative uniform federal legal malpractice cause of action.[174]

The second prong of the *Kimbell Foods* test asks if the creation

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165. See *supra* note 52 for a discussion of the officer and director negligence standard.

166. *See supra* text accompanying notes 152–56.

167. *See supra* text accompanying notes 152–56.

168. See *supra* note 49 for a discussion of the FDIC's equitable argument.

169. 440 U.S. 715 (1978). See *supra* notes 56–65 and accompanying text for a further discussion of *Kimbell Foods*.

170. *See supra* text accompanying note 57.

171. *See supra* note 55.

172. 558 F. Supp. 1128 (D. Haw. 1983).

173. See *supra* notes 75–77 and accompanying text for a discussion of the *First Hawaiian* case.

174. *See* Burnes Int'l, Inc. v. Western Sav. and Loan Ass'n, 978 F.2d 553, 556 (9th Cir. 1992) (stating that negligence is an area traditionally left to the state courts); FDIC v. Canfield, 967 F.2d 443, 447 (10th Cir. 1992) (stating that there is no national standard of negligence liability). *See also supra* notes 39, 52.

of federal common law would frustrate the objectives of the federal program.[175] While the FDIC's argument that it needs to "maximiz[e] the asset pool"[176] may be valid, Congress has not spoken directly on this issue. The United States Court of Appeals for the Eleventh Circuit in ***FDIC v. Jenkins***[177] found that the purpose of maximizing recovery to the insurance fund was insufficient to establish federal law to give the FDIC greater rights than any other assignee.[178] This reasoning was echoed by the Eighth Circuit court in ***FDIC v. Bowles Livestock Commission Co.***[179] Therefore, while a national legal malpractice rule might make litigation easier for a banking regulator, applying state law will not frustrate the objectives of the regulator.

Finally, the *Kimbell Foods* test requires a court to determine if the federal common law rule would disrupt existing commercial relationships.[180] This question requires an analysis of the traditional state law malpractice rules, the proposed change in those rules, and the effect on existing commercial relationships. If courts establish federal common law, as the FDIC argues, it begs the question of how the fundamental duties of an attorney would change.[181] Although the Model Rules of Professional Conduct are not a basis of liability, one can look to the rules to see what effect a new rule would have on commercial relationships.[182] The attorney-client relationship would be significantly compromised in those cases where the client is a financial institution simply because a banking regulator may eventually step in as a party to the litigation.

Courts must also consider the economic costs of changing well-established state law in legal malpractice cases. The changes will result in an increase in litigation and corresponding administrative costs.[183] There may also be a corresponding increase in low- or no-

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175. *See supra* text accompanying note 58.

176. *See supra* note 49.

177. 888 F.2d 1537 (11th Cir. 1989).

178. *See supra* notes 49, 70–71.

179. 937 F.2d 1350 (8th Cir. 1991). *See supra* note 73 and accompanying text.

180. *See supra* text accompanying note 59.

181. See *supra* notes 47–48, 128 for a discussion of expanding an attorney's duty.

182. The Model Rules of Professional Conduct are promulgated by each state's highest court. Therefore, it is unclear if the FDIC is arguing for two separate bodies of professional conduct rules, one for state actions and one for actions when the FDIC is a party. See *supra* notes 47–48, 128 for a further discussion of expanding an attorney's duty under the new theories of liability.

183. The level of due diligence required between an attorney and client is a matter of contract; and absent a contract or a specific clause, a court may have to fill the gap.

merit claims that will increase costs and have a damaging effect on a firm's reputation.[184] As a result, law firms will be reluctant to accept new financial institutions as clients or may withdraw from representing weak or failing institutions.

Applying the *Kimbell Foods* test, the *O'Melveny* court should have analyzed the three prongs and incorporated state law regarding legal malpractice actions into federal common law. The FDIC presented no argument, other than one based solely on public policy, why federal common law should circumvent well-established state law. Therefore, absent a clear federal statute or other action by Congress, the courts should not create a new federal common law rule in the area of legal malpractice.

B. Striking Defenses to Legal Malpractice Actions

As a result of the Ninth Circuit court's improper creation of federal common law, defenses traditionally available in state legal malpractice actions are in jeopardy. Courts are split as to whether to strike affirmative defenses such as imputation or comparative negligence. As the following discussion suggests, the courts should not strike these affirmative defenses solely because the FDIC has stepped into the litigation.

Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 92 (1993). Langevoort notes that management is the most efficient supplier of information, and verification by outsiders is relatively costly. Therefore, he suggests the holding in *O'Melveny* will result in "specific risk-allocation language" in these contracts. *Id*. But see *supra* note 129, discussing whether waivers would be effective in light of *O'Melveny*.

See also Latigo Ventures v. Laventhol & Horwath, 876 F.2d 1322 (7th Cir. 1989). In *Latigo*, the court found that accountants who were merely aware of fraud by a client did not have a duty to broadcast the fraud to anyone who might buy the company's stock. *Id*. at 1326. The costs of auditing would skyrocket to compensate the accounting profession for the enormous expansion in potential liability, including an increase in the costs of publishing the information. *Id*. at 1327.

184. *See* Langevoort, *supra* note 183, at 116. *See also* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlement in Securities Class Actions*, 43 STAN. L. REV. 497 (1991) (suggesting that even low merit claims will be settled).

1. Imputation

The leading case in the area of imputation or attribution is

Cenco, Inc. v. Seidman & Seidman.[185] The Seventh Circuit court explained the difference between fraud on behalf of a corporation, when imputation should occur, and fraud against a corporation, when imputation should not occur.[186] In both cases, whether the fraud is on behalf of the corporation or against the corporation, the result likely will be the same: disaster. The *O'Melveny* court stated that because disaster had resulted, the activities of Sahni and Day would not be imputed to the thrift.[187] However, the court should not have focused on the net result of the insiders' activities but should have instead looked to whether the insiders' activities benefitted the corporation.

Applying the *Cenco* test to the *O'Melveny* case, the Ninth Circuit court should have reached the opposite result.[188] The sole shareholders, Sahni and Day, were in essence the alter ego of the corporation.[189] Their actions benefitted the corporation because, for example, the third-party investors of the Gateway Center and Wells Park partnerships were left with a worthless asset.[190] Thus, although the thrift failed, the fraud perpetrated was on behalf of the thrift and not against the thrift. Sahni and Day stole not from the thrift but from its outsiders, the third-party investors. Therefore, the court should have allowed the attorneys to assert the state law defense of imputation. This result is consistent with the *Cenco* test in that the wrongdoers, Sahni and Day, would not benefit from this outcome.

2. *Proximate Cause and Negligence*

There are instances when the alter ego doctrine should not be used to impute knowledge. However, in these cases, the plaintiff must still prove all the elements in a malpractice action, including proximate cause. Additionally, the defendant should be able to assert other available defenses. Although O'Melveny & Myers did not

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185. 686 F.2d 449 (7th Cir.), *cert denied*, 459 U.S. 880 (1982).

186. *See supra* notes 88, 149.

187. *O'Melveny*, 969 F.2d at 750.

188. An opposite result in *O'Melveny* would agree with the result in *FDIC v. Ernst & Young*. See *supra* notes 100–03 and accompanying text for a further discussion of the *Ernst & Young* case.

189. See *supra* note 149, noting the conflict with the FSLIC's position in *California Union Ins. v. American Diversified Sav. Bank* where the court stated that Sahni and Day were the alter ego of ADSB.

190. *See supra* note 139.

assert a comparative or contributory negligence defense, at least two federal courts have followed the reasoning in *O'Melveny* and refused to permit the defense of contributory negligence.[191] In these cases, however, the court still required the FDIC to prove proximate cause.[192]

Even if a court would not allow an imputation or contributory negligence defense to be asserted, comparative negligence should be available to a defendant, and the plaintiff must still prove proximate cause. This was properly done in *FDIC v. Gantenbein*.[193] The *Gantenbein* court determined that the underlying cause of action was a state claim and that state-based defenses, including comparative negligence, could be raised at trial.[194] In *FDIC v. Deloitte & Touche*,[195] the court did not impute knowledge to the FDIC but required the FDIC to prove proximate cause and allowed the accounting firm to assert other affirmative defenses.[196] The *Deloitte* court did not see any reason to depart from well-settled tort law and preclude the accounting firm from asserting defenses against the FDIC.[197] The *O'Melveny* court, if presented with this case at trial, must require the FDIC to prove proximate cause and allow the law firm to assert defenses, including comparative negligence.

V. CONCLUSION

State law traditionally governs legal malpractice actions. However, with the increase in litigation by federal banking regulators against professionals, federal courts are formulating federal common law applicable to legal malpractice cases with mixed results. The United States Supreme Court, by granting certiorari in the

191. See *supra* notes 119–27 and accompanying text for a discussion of Comeau v. Rupp, 810 F. Supp. 1127 (D. Kan. 1992) and *In re* Sunrise Sec. Litig., 818 F. Supp. 830 (E.D. Pa. 1993). It is at this point where the doctrines of contributory and comparative negligence makes a significant difference. Contributory negligence will completely preclude recovery if the plaintiff is at fault while comparative negligence only apportions the fault. In *Comeau* and *Sunrise*, the courts were reluctant to allow contributory negligence to be used because this would shift the entire cost of the thrift failure to the taxpayers.

192. See *supra* notes 119–27 and accompanying text for a discussion of these cases.

193. 811 F. Supp. 593 (D. Kan. 1992).

194. *See supra* text accompanying notes 104–06.

195. 834 F. Supp. 1129 (E.D. Ark. 1992).

196. *See supra* notes 110–18 and accompanying text.

197. *See supra* notes 110–18 and accompanying text.

O'Melveny case, has the opportunity to resolve the conflict in the federal circuits. Using the *Kimbell Foods* test, the Court should exercise judicial restraint and apply state-based malpractice law which requires the plaintiff to prove proximate cause and allows the defendants to assert available defenses. Without a clear directive from Congress, the rules in a legal malpractice action should not be changed merely because a federal banking regulator steps into the litigation.

Meredith E. Level