04-5972-bk(L), 04-6300-bk(XAP)

United States Court of Appeals

for the

Second Circuit

In re: CBI HOLDING COMPANY, INC.,

Debtor,

BANKRUPTCY SERVICES, INC.,

Plaintiff-Appellant-Cross-Appellee,

– v. –

ERNST & YOUNG, ERNST & YOUNG LLP,

Defendants-Appellees-Cross-Appellants.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* IN SUPPORT OF THE POSITION OF ERNST & YOUNG AND REHEARING AND REHEARING EN BANC

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The American Institute of Certified Public Accountants is a nonprofit corporation. It has no parent corporation, and no publicly held corporation owns 10% or more of its stock.

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PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants respectfully submits this brief as *amicus curiae* in support of Ernst & Young's Motion for Rehearing and Rehearing en Banc.

INTERESTS OF THE AICPA

The AICPA is the national organization of the certified public accounting profession, all of whose more than 340,000 members are certified public accountants. Among the AICPA's purposes are the promotion and maintenance of high professional standards of practice. Because of its historical role in formulating standards relating to audits, reviews, compilations, and attest engagements, and the reports issued thereon, the AICPA maintains a strong interest in the scope and bases of civil liability sought to be imposed on accountants pursuant to those standards. The AICPA regularly submits *amicus* briefs in actions concerning these issues, including those in state and federal courts as well as the U.S. Supreme Court.

The AICPA is deeply concerned about the Panel's unduly expansive view of the adverse interest exception to imputation. The New York courts have carefully balanced an injured party's interest in recovering damages with fair limits on accountants' liability. The Panel's decision threatens to upset that balance and expose accountants to broadly expanded liability for negligence.

Professional malpractice claims are frequently asserted against auditors and other professionals following undetected corporate frauds; the Panel's decision accordingly has serious consequences for the profession. In addition to the obvious financial and reputational exposure lawsuits cause, increased litigation risk affects the profession's ability to recruit and retain highly qualified personnel. This, in turn, may further reduce the availability, and therefore increase the cost, of accounting services.

The AICPA therefore respectfully requests that the Second Circuit grant rehearing or rehearing en banc, or certify to New York's Court of Appeals the question whether a company may invoke the adverse interest exception to imputation in a negligence action simply upon evidence of the self-interested motivation of the client's management, even though the management's wrongdoing was not adverse to the company's interests.

ARGUMENT

I. THE PANEL HAS MISCONSTRUED THE SCOPE OF THE ADVERSE INTEREST EXCEPTION UNDER NEW YORK LAW.

The Panel's reliance on a finding that CBI management was motivated by self-interest in reaching the conclusion that the adverse interest exception applied here was erroneous. Self-interested motivation may be relevant, but, under New York law, it is not sufficient. Rather, the exception applies only where, as its name suggests, the actions of management consciously and adversely harmed the interests of the corporation. *See Center v. Hampton Affiliates, Inc.*, 66 N.Y.2d 782, 784 (1985). The Panel's analysis entirely omits this critical requirement.

Two very recent New York cases (discussed in detail in E&Y's Petition, so the facts are not repeated here) emphasize its import. In *Symbol Techs., Inc. v. Deloitte & Touche, LLP*, No. 33150-06 (Sup. Ct. N.Y. Co., June 16, 2008) (E&Y Petition Ex. 3), the court explained that oversight of financial statements is an ordinary function of management done on the company's behalf. The court accordingly held that, regardless of the fact that management acted to benefit themselves in the form of over $100 million in bonuses, managements' inflation of revenues and earnings was not adverse to the company's interests. In fact, the court recognized that "[a] fraud by top management to overstate earnings, and so facilitate stock sales or acquisitions, is not in the long term interests of the company." *Id.* at 6-7. Analogizing it to price-fixing, however, which is also not in the long-term interests of a company, the court nevertheless held that the adverse interest exception was inapplicable because the conduct benefits the company in the first instance. *Id.*; *see also Bullmore v. Ernst & Young Cayman Islands*, 2008 N.Y. Misc. LEXIS 3789, at *4 (Sup. Ct. N.Y. Co., June 19, 2008) (adverse interest exception inapplicable when fraudulently inflated value of hedge fund's portfolio resulted in higher management fees, since the fraud permitted fund to attract and retain capital from investors).

The Panel's reliance to support its decision on a single sentence in *Capital Wireless Corp. v. Deloitte & Touche*, 216 A.D.2d 663 (3rd Dep't 1995), is misplaced. There, plaintiff alleged that its president and CEO, Gregg Oswald, inflated the number of customers and misreported revenue and accounts receivable to lure investments in *other* companies in which Oswald had a majority or partnership interest, thereby using the plaintiff company as a Ponzi scheme. *Id*. at 664. On those facts, the court found that Oswald may have abandoned plaintiff's interest because he may have "*contemplated the obliteration of plaintiff*" by destroying it to raise money for his *other* companies. *Id.* at 666 (emphasis added). This therefore properly raised the question of whether Oswald intended to cause harm to plaintiff's interests, not whether he merely intended to benefit himself. The Third Department's use of the word "intended" thus did not alter the analysis *Center* requires.

Also contrary to established law was the Panel's attempt to characterize as "illusory" the benefits CBI received as a result of management's actions. The Seventh Circuit, in *Cenco Inc. v. Siedman & Siedman*, 686 F.2d 449 (7th Cir. 1982), correctly perceived the difference between conduct that benefits a corporation and conduct that harms it. In *Cenco*, defendants fraudulently inflated inventories, in turn inflating the price of Cenco's stock. Among other things, Cenco used the inflated stock to buy other companies and to borrow money at lower rates. *Id*. at 451. The Seventh Circuit imputed the company's management's knowledge of this conduct to the corporation, explaining that "turning the company into an engine of theft" against outsiders aggrandized the company at the expense of outsiders, not the company itself. *Id*. at 454. Applying the "underlying objectives of tort liability," which are to compensate the victim of wrongdoing and deter future wrongdoing, the court found:

> 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 the only victims; their equities vis-à-vis a careless or reckless auditor are therefore strong. But the stockholders of a corporation whose officers commit fraud for the benefit of the corporation are beneficiaries of the fraud.

Id. at 455-56.

The conduct in this action was no different from that in *Symbol*, No. 33150-06, slip op. at 6-7, discussed above, and *Cenco*. For example, according to the Panel, the creation of fictitious inventory "helped CBI to continue borrowing money from the lending banks and to avoid having its loans called." *CBI Holding Co. v. Ernst & Young*, 529 F.3d 432, 452 (2d Cir. 2008). Similarly, "paper" transfers of inventory between CBI subsidiaries allowed the subsidiaries to borrow past their loan limits, increasing CBI's cash flow. *Id.* The Panel's description of this conduct as nothing more than Castello's attempt to maintain "control" of CBI disregards its actual substance and effect. In fact, under the Panel's reasoning, *any* action taken to extend the life of a company could be interpreted as management's attempts to retain control of the company. Because of the ability to make these allegations in nearly every accounting irregularity case, the Panel's reasoning ensures the evisceration of the imputation doctrine.

The Panel's holding that prolonging the life of a corporation in the face of increasing insolvency does not benefit the corporation is also at odds with New York jurisprudence. For instance, the "engine of theft" analysis was applied in the insolvency of Drexel Burnham Lambert Group to deny recovery from its insurers:

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

Drexel Burnham Lambert Group, Inc. v. Vigilant Ins. Co., 595 N.Y.S.2d 999, 1009 (N.Y. App. Div. 1993); *see also Symbol*, slip op. at 6-7 (like price-fixing, inflation of financial statements benefits the company in the short run); *Bullmore*, 2008 N.Y. Misc. LEXIS 3789, at *4 (inflation of hedge fund portfolio value allowing hedge fund to survive was not abandonment of the company's interests).[1]

The Panel's conclusion in this regard also increases the specter of yet a different category of potential liability for auditors arising from "deepening solvency." Though this theory has been criticized as without adequate economic

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[1] The cases the Panel cites for the proposition that "deepening insolvency" is not a benefit to the company are inapposite. In *Allard v. Arthur Andersen & Co. (USA),* 924 F. Supp. 488 (S.D.N.Y. 1996), the court rejected an argument that the company could not claim damages for additional indebtedness. *Id*. at 494. That issue of damages is different from the liability question here. The court in *In re Maxwell Newspapers, Inc.,* 164 B.R. 858 (Bankr. S.D.N.Y. 1994), found that the adverse interest exception applied because the Maxwells' interest in purchasing and operating the Daily News was to use the newspaper as a money-laundering device for other Maxwell-controlled entities. *Id*. at 869.

foundation, it has nevertheless become yet another source of liability for accountants. In *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 174 (Del. Ch. 2006), the Delaware Chancery Court found that "deepening insolvency" "does not express a coherent concept," and held that deepening insolvency "is no more of a cause of action when a firm is insolvent than a cause of action for 'shallowing profitability' would be when a firm is solvent." *Id.* The court observed: "In so ruling, I reach a result consistent with a growing body of federal jurisprudence, which has recognized that those federal courts that became infatuated with the concept did not look closely enough at the object of their ardor." *Id.* at 206; *see also In re Global Serv. Group, LLC*, 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004) (under New York law, deepening insolvency is not an independent tort because "a business is worth more to everyone alive than dead"). Accordingly, the Panel's conclusion that management's efforts to keep CBI afloat were not beneficial to CBI is inconsistent with current law rejecting the theory that "deepening insolvency" causes harm to a company.

In short, under the Panel's interpretation of the adverse interest exception, practically every claim against an auditor brought by an insolvent corporation alleging management wrongdoing is likely to survive motions to dismiss or for summary judgment. This is because many, if not all, actions of corporate officers and employees that may serve their company also are motivated by their own financial self-interest. In fact, almost all companies compensate senior management based on the company's financial performance. Thus, plaintiffs will readily be able to muster evidence that management acted to benefit themselves, through better compensation or even just retention of employment. The courts in *Symbol* and *Bullmore*, however, as discussed above, are clear that New York law renders this evidence insufficient. Rather, there must be allegations, and, ultimately, evidence that the wrongdoers' conduct was directed at harming the company. If the courts do not require such a showing, the imputation doctrine will quickly be swallowed by the exception.

II. THE PANEL'S DECISION HAS SERIOUS POLICY IMPLICATIONS FOR THE PROFESSION AND IS WHOLLY UNPRECEDENTED.

Accountants have been and should continue to be permitted to rely fully on fault-based defenses, such as the imputation defense, in cases such as this. The policy behind such a defense is recognition that an auditor's role in the accurate presentation of a client's financial statement is limited, and most importantly, secondary to that of the client. Corporate financial statements are prepared by and the responsibility of management, not the company's auditors. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 762 (Cal. 1992) (citations omitted); *Responsibilities and Functions of the Independent Auditor*, 1 AICPA Professional Standards AU § 110.02 (AICPA 1993).[2] Because the client typically prepares its own financial statements, "it has direct control over and assumes primary responsibility for their contents."

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[2] The version of AICPA Professional Standards referenced is that applicable during audit years at issue in this action, 1992-1994.

Bily, 834 P.2d at 762; *Symbol*, slip op. at 6-7 (oversight of financial statements is a function of management). The client, not its auditor, is responsible for, among other things, "adopting sound accounting policies and for establishing and maintaining internal controls that will . . . process, summarize, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements." *Bily*, 834 P.2d at 762.

Furthermore, within the auditor's relatively limited role, an auditor's tasks require discretion and judgment. *See, e.g., id.* at 749 ("For practical reasons of time and cost, an audit rarely, if ever, examines every accounting transaction in the records of a business."). Thus, auditors plan and perform their audit to "obtain reasonable assurance" of detecting material "errors and irregularities." AU § 316.05. And professional standards are unequivocal that a properly planned and executed audit cannot guarantee discovery of management fraud. *See* AU § 316.07-08 (because of characteristics of irregularities, "particularly those involving forgery and collusion," even a "properly designed and executed audit may not detect a material irregularity"). A "financial statement audit performed in accordance with [GAAS] is not a 'fraud audit' or a detailed forensic-style examination of evidence." Public Oversight Board Panel On Audit Effectiveness, *Report And Recommendations* 76 (2000).

The imputation doctrine recognizes the primary role of management in preventing and detecting fraud, and the auditor's well-accepted more limited role.

Expansion of the adverse interest exception, on the other hand, would essentially permit the company to shift its own responsibility to the outside auditor. If an auditor cannot assert the imputation defense when management's own fraud has caused the company's damages, management may have less incentive to avoid such fraud, let alone uncover that fraud itself. *See, e.g., Cenco*, 686 F.2d at 455 ("[I]f the owners of the corrupt enterprise are allowed to shift the costs of its wrongdoing entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced.").

Auditors thus will be effectively transformed into guarantors of their clients' financial statements. Courts have routinely rejected this proposition, because, as discussed, it is inconsistent with the relevant standards applicable to the performance of audits and therefore results in a misallocation of responsibility. *See, e.g., Devco Premium Fin. Co. v. N. River Ins. Co.*, 450 So. 2d 1216, 1219 (Fla. Dist. Ct. App. 1984) (auditor's obligations in relation to client's internal control do not "convert the auditor into something of management's agent who must police the system created by management."); *Monroe v. Hughes*, 860 F. Supp. 733, 738-39 (D. Or. 1991) ("[A]uditors are not 'police' as plaintiffs suggest, and under professional standards, were not required to ensure that [the client] corrected internal control problems prior to its re-issuance of the audit report."), *aff'd*, 31 F.3d 772 (9th Cir. 1994).

Recognizing the inherent limitations of an auditor's undertaking, New York courts have repeatedly focused on the need to balance an injured party's interest in recovering damages from an auditor with fair limits on liability. For example, New York adopted one of the strictest privity standards in the nation to sustain a non-party claim against an accountant. The New York Court of Appeals in *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931), rejected a broader class of plaintiffs than those essentially in "privity" with an auditor, holding that auditors would otherwise be exposed to virtually unlimited liability. As Judge Cardozo explained:

> If liability exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

Id. at 444.[3]

New York jurisprudence thus reflects a recognition of well-considered and clear standards relating to and limiting auditor liability that properly balance the risks associated with overly broad liability with appropriate redress for legitimate damages.

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[3] A further example of the New York courts' careful balancing of the equities affecting auditors' liability involves the applicable statute of limitations. In *Ackerman v. Price Waterhouse*, 84 N.Y.2d 535 (N.Y. 1994), the Court of Appeals observed that "We are regularly confronted with claims by plaintiffs seeking to expand the breadth and scope of statutes of limitation against professionals in cases involving negligence in the discharge of their services." *Id*. at 542. The court rejected an argument that the statute of limitations for accountants' malpractice should accrue at the time when there is an assessment of the accountant's work, finding rather that it accrues when the client receives the accountant's work product.

The Panel's decision misconstruing the adverse interest exception vastly expands accountants' liability contrary to the Court of Appeals' expressed intent that such liability be carefully and thoughtfully confined to reflect the limited scope of the auditor's role. The undesirable consequences of the Panel's decision will reach innocent corporations, their shareholders and ultimately consumers, who may be forced to subsidize, through higher auditing costs and reduced auditing services, the conduct of cynical and fraudulent corporations.

CONCLUSION

Because the Second Circuit's decision has important and far-reaching implications for the profession and the public, the Second Circuit should grant a rehearing or rehearing en banc, or certify the question (*see supra* page 2) to New York's Court of Appeals.

Dated: New York, New York
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STATE OF NEW YORK)
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I, , being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at the address shown above or at

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the attorney(s) in this action by delivering **2** true copy(ies) thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the Attorney(s) herein.

Sworn to before me on August 20, 2008

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CASE NAME: In re: CMI HOLDING COMPANY, INC.

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