

Federal Appellate Court Overrules OCC on Auditor Liability

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Last month the U.S. Court of Appeals for the D.C. Circuit issued a significant decision affecting professional service firms in *Grant Thornton, LLP v. Office of the Comptroller of the Currency (OCC)*. Under review in this case was the Comptroller's cease and desist and civil money penalty orders levied against Grant Thornton, LLP ("Grant Thornton") in connection with its external audit of First National Bank of Keystone, Keystone, WV. The OCC alleged several departures from accounting standards on the part of Grant Thornton, for example that it had relied upon oral confirmations of assets when prudential practices demanded obtaining written confirmations. Due to this and other alleged misfeasance, the OCC charged that Grant Thornton "recklessly engaged in an unsafe and unsound practice in conducting [Keystone's] affairs." The Court reversed the Comptroller's decision, deciding instead that the OCC had not met its statutory burden for jurisdiction through which to exercise enforcement authority over Grant Thornton under Section 8 of the Federal Deposit Insurance Act ("FDIA").

The rationale of the 2-1 majority in this case does not impart a feeling of certainty for service providers to financial institutions going-forward. The majority concentrated on the language in the FDIA, which in order to meet the standard for acquiring jurisdiction requires proving that the respondent recklessly participated in an unsafe or unsound practice in conducting the bank's business. According to the majority, Grant Thornton was not "participating" in the conduct of Keystone's business so as to invoke Section 8 jurisdiction and remedies because: (a) Grant Thornton was not engaged to perform a "banking practice," (b) Grant Thornton played no "directive role" in Keystone's affairs, and (c) nothing in the legislative history of the FDIA Section 8 suggests that poor auditing was the evil that Congress had intended to address in providing for third party liability. Moreover, the proper remedy for the OCC to address this type of issue lies, according to the Court, in the OCC's debarment authority, not a CMP or C&D.

The concurrence, which probably applied the better rationale if the ultimate judgment is believed to be correct, disagreed with the heart of the majority's theory that Grant Thornton is not liable because conducting an external audit to verify the bank's books fails as a "banking practice" and therefore is outside the scope of Section 8. The concurrence instead focused on whether the conduct of the two Grant Thornton auditors could be imputed to the entire firm. According to Judge Henderson, such could only be accomplished if sufficient numbers of other partners in the Grant Thornton organization had participated in, or at least were aware of, the alleged misfeasance.

If we read the Court's rationale narrowly, then we can view the Court's holding as merely carving out one area of service provider conduct for which Section 8 liability might not attach,

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and punting the more difficult exercise of identifying a workable test for a later dispute. Another reading of the decision, however, suggests that the Court intended a broader interpretation of the “bank practice” concept. The Court notes that Grant Thornton’s activity “is not a ‘practice’ of a depository institution or bank.” The Court then proceeds to discuss the definition of a “depository institution” or “bank” as described in the FDIA and Webster’s dictionary, suggesting that in order for a federal bank regulatory agency to properly exercise enforcement jurisdiction under Section 8, the third party must be performing a “banking practice” normally identified with banks. This leads to the question of whether the scope of “banking practice” would mean traditional banking activities, such as deposit taking, lending, and the like, versus any of the number of activities “incident to” the business of banking that the agencies have addressed.

In the end, assuming that this decision is left to stand, future courts may opt to avoid the possible ambiguities of the majority opinion. Instead, they may take the road more easily traveled by the concurrence, and decide that regardless of whether or not the third party was participating in banking activities, the alleged misfeasance at issue was not so pervasive throughout the respondent company to warrant exercise of jurisdiction under the Section 8 of the FDIA.

Enforcement actions against professional services firms are inherently troublesome, both from the agency’s viewpoint, and that of the respondent firm. Unlike enforcement actions against in-house professionals, where an agency has jurisdiction to bring an enforcement action against an insider as an “institutional-affiliated party” or “IAP” merely by virtue of the insider’s status as an employee, the statutory definition of an IAP as applied to an outside third party service provider requires the agency to prove that the third party was “reckless” before they can be labeled an IAP. Not only does this present a tougher burden of proof for enforcement counsel, it also stands as an obstacle to resolving an enforcement action through a consent order (settlement) because the opening paragraphs of most settlement documents, which recite the basis for jurisdiction, put the respondent in the position of possibly stipulating to reckless conduct (i.e., stipulating to IAP status as a third party). The OCC has in the past attempted to avoid this problem by omitting any reference to the specific statutory provision on reckless IAPs, opting instead to merely label the respondent as an IAP with no further explanation, or as Tony Soprano would say: “It is what it is.”

Make no mistake, this case is a victory for accounting firms, law firms, and most other large companies that perform services for depository institutions, as regardless of the rationale of the Court’s decision, enforcement counsel at the bank regulatory agencies will be less likely to bring enforcement actions against an entire firm for the missteps of a few.

But will this make banks safer and more sound? Often times, the line between what third party professional service providers are retained to do for a bank, and what they actually do, is gray at best. Especially in the case of smaller banks, or even large banks encountering novel issues, outside professionals, like accountants, attorneys, and consultants, are initially called upon to address one particular issue, but are relied upon by the institutions to provide informal advice on a broader range of matters. Because of this, federal agencies like the OCC should be able to look beyond the four corners of the engagement agreement, and examine what the professionals were actually doing. Did the accountant, attorney, or consultant’s conduct become, if not “directive,” at least “highly persuasive” to the institution’s policymakers such that they have become quasi-officers themselves? We will have to wait for the next major failure to find out.