ACCOUNTANTS' LIABILITY UNDER RICO AFTER REVES v. ERNST & YOUNG

*Michael J. Garrison **James D. Hansen

I. INTRODUCTION

Much has been written recently about the ***liability crisis*** facing the accounting profession. A position paper by the Big Six accounting firms[1] and a study by the American Institute of Certified Public Accountants[2] outline the trends in accountants' liability—the dramatic increase in lawsuits and damage awards against accountants— and the consequences and potential effects of the civil liability system on the profession. The profession believes that the civil liability system, including the antifraud provisions of the federal securities laws, is out of control, resulting in unwarranted and frivolous lawsuits and massive jury awards. The additional costs imposed on the profession have caused accounting firms to reduce the types of accounting services offered to clients, increased the cost of audit engagements, and led some firms to cease doing business with firms in high-risk industries. The potential impact is not only to the reputation and solvency of the accounting profession, but also it is argued, the litigation crisis threatens the foundations of the national capital markets. In

* Associate Professor, North Dakota State University; J.D., 1979, University of North Dakota; B.S., 1976, North Dakota State University.

** Assistant Professor, North Dakota State University; Ph.D., 1993, University of Nebraska-Lincoln; M.B.A., 1982, North Dakota State University; B.S., 1970, University of North Dakota.

[1]Arthur Anderson & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, Price Waterhouse, The Liability Crisis in the United States. Impact on the Accounting Profession (August 6,1992) (on file with authors).

[2] American Institute of Certified Public Accountants, A Special Report By The Public Oversight Board of The SEC Practice Section, AICPA (1993).

response, the profession has mounted a public relations and lobbying campaign to secure necessary legislative and judicial reforms.

Recent cases suggest that the profession may be winning the battle in the courts. For example, in ***Bily v. Arthur Young & Co.,***[3] the Supreme Court of California abandoned the liberal ***foreseeable users*** rule for third party liability in professional negligence actions against accountants in favor of the more limited ***known-class-of-users*** rule of Section 552 of the Restatement (Second) of Torts.[4] At the federal level, accountants scored two major victories. Recently, in ***Central Bank of Denver v. First Interstate Bank,***[5] the Supreme Court held that there is no civil liability for aiding and abetting securities fraud under Section 10(b) of the Securities Exchange Act of 1934. In 1993, in ***Reves v. Ernst & Young***[6] the Court limited the scope of actions which could be brought against accountants under the Racketeer Influenced and Corrupt Organizations Act (RICO). By adopting a narrow interpretation of RICO in a suit involving a fraudulent sale of securities, the Court substantially limited the circumstances under which a plaintiff in a civil RICO case will be able to hold an auditor[7] liable for damages. The ***Reves*** decision is the subject of this article.[8]

II. RICO

The Racketeer Influenced and Corrupt Organizations Act, or RICO, was enacted in 1970 as part of the Organized Crime Control Act.[9] The primary purpose of the law was to provide criminal and civil

3 834 P.2d 745 (Cal. 1992).

4 The court adopted the Restatement rule for cases of negligent misrepresentation, the most common theory of liability in auditor liability actions, but adopted the most restrictive privity rule for other negligence actions against accountants.

6 62 U.S.L.W. 4230 (U.S. April 19,1994).

6 113 S.Ct. 1163 (1993). Justice Blackmun wrote the opinion for the Court for the seven-member majority. Justice Souter, joined by Justice White, wrote a dissenting opinion.

7 *Reves* was an action against a public accounting firm arising out of an independent audit, the area of practice where the profession has the most liability exposure. The decision, however, applies to other professional accounting services as well as auditing. The words accountant and auditor will be used interchangeably in this article in discussing the impact of the case.

'The case has reached the Supreme Court twice. In the first case, the Court held that the demand notes sold by the Farmer's Cooperative of Arkansas and Oklahoma were securities under federal law. Reves v. Ernst & Young, 494 U.S. 56 (1990). This article discusses the second case in which the Court addressed the RICO issue. Rather than refer to the second case as *Reves II,* it will simply be referred to as *Reves.*

9 Organized Crime Control Act of 1970, Pub. L. 91-452, tit. 9, 84 Stat. 941 (present version at 18 U.S.C. §§ 1961-1968 (1988 & Supp. V 1993)).

remedies to counteract the infiltration of business by organized crime. Thus, the law prohibits a person from engaging in three types of racketeering: (1) using or investing monies received from a pattern of racketeering activity to acquire an interest in an enterprise;[10] (2) acquiring or maintaining through a pattern of racketeering activity an interest in or control of an enterprise;[11] or (3) conducting or participating, as an employee or associate of an enterprise, in the conduct of the enterprise's affairs through a pattern of racketeering activity.[12] A conspiracy to commit any one of the three types of racketeering activity is also prohibited.[13] A ***pattern of racketeering activity*** is defined very broadly to encompass two acts of racketeering, or predicate acts, within a ten-year period.[14] The predicate acts consist of violations of specific state and federal criminal laws, including mail fraud, wire fraud, and securities fraud.[15] RICO violators are not only subject to severe criminal penalties,[16] but also they can be sued by any person who is injured in his or her business or property. RICO's civil remedy provision allows for the recovery of treble damages, costs, and a reasonable attorney's fee.[17]

Despite the original purpose of the law, the Supreme Court has not limited the scope of RICO to the activities of organized crime. Rather, the Supreme Court has liberally construed the remedial provisions of

"The Act provides that:

> It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt in which such person has participated as a principal within the meaning of section 2, title 18, United States Codé, to use or invest, directly or indirectly, any part of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

Id. at § 1962(a) (1988).

"The Act provides that:

> It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

Id. at § 1962(b) (1988).

12 *Id.* at § 1962(c) (1988). For a discussion of this provision, see *infra* notes 22-28, 133-152 and accompanying text.

13 18 U.S.C. § 1962(d) (1988).

14 *Id.* at § 1961(5) (1988).

16 *Id.* at § 1961(1) (1988).

16 *Id.* at § 1963 (1988).

"*Id.* at § 1965(c) (1988).

the Act. Thus, in ***Sedima, S.P.R.L. v. lmrex Company, Incorporated***,[18] the Court held that a plaintiff in a civil RICO case does not have to establish a prior criminal conviction of the defendant or a ***racketeering injury.*** In ***United States v. Turkette***[19] the Court rejected the contention that only criminal enterprises are subject to the RICO proscriptions. In ***H.J. Inc. v. Northwestern Bell Telephone Company,***[20] the Court adopted a liberal interpretation of the ***pattern*** element which requires only that the two predicate acts be ***related*** and ***continuous,*** that is, either a series of related violations over a substantial period of time, or present violations coupled with a threat of future racketeering activity. Most recently, the Court, in a unanimous opinion, held that RICO does not require proof that the enterprise or the predicate acts were motivated by an economic objective, and allowed a RICO suit to proceed against antiabortion activists allegedly engaged in an illegal conspiracy to shut down abortion clinics.[21]

Given the broad scope of RICO, and the inclusion of mail fraud, wire fraud, and securities fraud within the list of racketeering activities, it is understandable that plaintiffs have sued accountants under the Act in business-related litigation, particularly in tax and securities fraud cases. Plaintiffs have primarily relied on section 1962(c) which provides that:

> [I] t shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.[22]

Prior to ***Reves,*** some courts had taken an expansive view of section 1962(c) and allowed suits against auditors, attorneys, and other persons associated with an enterprise as long as there was some connection between the predicate acts committed by the person and the activities of the enterprise. For example, in ***Bank of America v. Touche Ross & Company,***[23] the Eleventh Circuit reversed a dismissal of a RICO claim under section 1962(c) against Touche Ross finding the necessary connection under section 1962(c). The case involved

'»473 U.S. 479 (1985).

[19] 452 U.S. 576(1981).

"492 U.S. 229(1989).

[21] National Organization for Women Inc. v. Scheidler, 62 U.S.L.W. 4073 (U.S. January 24, 1994).

"18 U.S.C. § 1962(c) (1988).

[23] 782 F.2d 966 (11th Cir. 1986).

five banks that lost 16.7 million dollars when their debtor, International Horizons, Incorporated, went bankrupt.[24] The essence of the RICO claim against Touche Ross was that the defendant engaged in acts of mail and wire fraud when they supplied unqualified opinions on the false financial statements of International Horizons, Incorporated, upon which the banks relied in extending credit to the company.[25] Touche Ross argued that a defendant must participate in the operation or management of an enterprise to be liable under section 1962(c).[26] The court, however, construed the ***conduct*** language more broadly in light of the qualifying language, the ***directly or indirectly*** phrase.[27] "The word conduct in section 1962(c) simply means the performance of activities necessary or helpful to the operation of the enterprise."[28] Thus, since the false financial statements were helpful to International Horizons, Incorporated in securing financing from the plaintiffs, the complaint satisfied the participation requirement of section 1962(c).

Other courts took a more restrictive view and dismissed suits against persons associated with an enterprise where the connection between the person's acts and an enterprise's activities was too tenuous.[29] These courts held that mere participation by a defendant in the predicate acts that was somehow related to a RICO enterprise was insufficient to establish liability under section 1962(c) without a showing that the defendant participated in the operation or management of the enterprise itself.[30] Under this ***operation or management*** test, auditors and other outsiders had to exercise some control over the RICO enterprise to be liable under section 1962(c). ***Reves*** provided the Court with an opportunity to resolve the conflict among the circuit courts and to clarify the reach of section 1962(c).

[24]*Id.* at 968.

[25]*Id.* at 968-69.

x*Id.* at 970.

11 Id.

™*Id.*

[29] See Arthur Young & Co. v. Reves, 937 F.2d 1310 (8th Cir. 1991) (finding fraudulent audit insufficient participation in management of enterprise to constitute a violation of § 1962(c)), *rev'd sub nom.,* Reves v. Ernst & Young, — U.S. —, 113 S. Ct. 1163 (1993) [hereinafter *Arthur Young],*

[30] *See* Yellow Bus Lines, Inc. v. Local Union 639, 913 F.2d 948 (D.C. Cir. 1990) (en banc) (requiring a RICO defendant to exercise significant control over an enterprise), *cert, denied,* ____ U.S. ____ , 111 S. Ct. 2839 (1991); Bennett v. Berg, 710 F.2d 1361 (8th Cir.) (en banc) (requiring a RICO defendant to participate in the operation or management of the enterprise), *cert, denied,* 464 U.S. 1008 (1983).

III. Reves v. Ernst & Young

A. THE FACTS

Reves involved the failure of the Farmer's Cooperative of Arkansas and Oklahoma (Co-op).[31] The Co-op sold unsecured and uninsured demand notes to members and nonmembers in order to raise operating monies.[32] The Co-op was operated by a general manager who was appointed by an elected Board.[33] In 1979, Jack White, the general manager of the Co-op, invested in a business constructing a gasohol plant which later became White Flame Fuels, Incorporated (White Flame).[34] In 1980, White, now the sole owner of White Flame, improperly borrowed four million dollars from the Co-op to finance the construction and operation of the plant.[36] White was later indicted, along with the accountant of the Co-op and White Flame, Gene Kuykendall, and convicted of tax fraud in connection with his self- dealing with the Co-op.[36] In November of 1980, White proposed to the Co-op that it purchase White Flame.[37] A friendly lawsuit was filed by the Co-op against White and White Flame in which the parties consented to a decree providing that the Co-op owned White Flame as of February 15, 1980, that the Co-op assumed White's debt to a bank, and that White was relieved of over four million dollars of indebtedness to the Co-op.[38]

In 1981, the Co-op hired Harry Erwin, the managing partner of Russel Brown and Company, to conduct the Co-op's 1981 audit.[39] Erwin had testified on behalf of White in the tax fraud trial.[40] Russel Brown eventually merged with Arthur Young which later became Erast & Young, the defendant.[41] Joe Drozal of Erwin's firm handled the audit.[42] In the performance of the audit, Drozal had difficulty computing the fixed asset value of White Flame.[43] Although he could not rely on the figures provided by Kuykendall, which were in part fabricated at White's direction, he nevertheless concluded that the

[31] *Reves,* 113 S. Ct. at 1166-68.
[32] *Id.* at 1166.
[33] *Id.*
[34] *Arthur Young,* 937 F.2d at 1315.
[35] *Reves,* 113 S. Ct. at 1166-67.
[36] *Id.* at 1167.

[38] *Arthur Young,* 937 F.2d at 1315-16.
[39] *Reves,* 113 S. Ct. at 1167.
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Arthur Young,* 937 F.2d at 1316.

plant's value at the end of 1980 was $4,393,242.66, the same value that Kuykendall had calculated.[44] Also, in determining what value should be used for accounting purposes, Drozal chose to use the 1981 fixed asset value of 4.5 million dollars rather than the fair market value at the time of purchase as required by generally accepted accounting principles.[46] This was accomplished by Drozal concluding, despite the true state of facts regarding the purchase of the plant in 1980, that the Co-op owned the plant from the beginning of construction in 1979.[46] Only in that way could he have used the 4.5 million dollar valuation. Had he used the fair market value of the plant, estimated to be somewhere between $444,000 and 1.5 million dollars, the net worth for 1981 would have been wiped out, and the Co-op would have been insolvent, precipitating a run on the demand notes.[47] The auditors never informed the Co-op Board that it concluded that the plant was owned by the Co-op in 1979, or that the phony valuation hid a net worth problem.[48]

In the 1981 audit report, the auditors rendered a qualified opinion noting that they had "some doubt as to the recoverability of the investment in the gasohol plant."[49] Also, Note 9 of the financial statements noted the continuing losses from the gasohol investment ($100,000 per month) and the possibility that the investment would not be recoverable.[50] A condensed financial statement without Note 9 was presented by Erwin to the members of the Co-op at the annual meeting.[51] Under questioning from the members, Erwin disclosed the losses incurred by White Flame as being 1.2 million dollars.[52] He did not, however, disclose the valuation problem, the information in Note 9, or the fact that the auditors had qualified their opinion.[53] Ernst & Young also conducted the 1982 audit, and issued a qualified opinion similar to the 1981 report.[54] Its auditor again presented a condensed version of the report to the Co-op members without the explanatory note and without making any other disclosures concerning the gasohol plant, which at this time was still valued at 3.5 million dollars.[55]

[44] *Id.* at 1316-17.
[45] *Id.* at 1317.
[46] *Id.*
[47] *Reves,* 113 S. Ct. at 1167.
[48] *Id.*
[49] *Arthur Young,* 937 F.2d at 1318.
[50] *Id.*
[51] *Reves,* 113 S. Ct. at 1167.
[52] *Id.* at 1167-68.
[53] *Id.* at 1168.
[54] *Id.*
[55] *Arthur Young,* 937 F.2d at 1320.

After the Co-op filed bankruptcy in 1984, the trustee filed a suit on behalf of the Co-op and some of the noteholders, and the district court certified a class of noteholders consisting of persons purchasing Co-op demand notes between 1980 and 1984.[56] The trustee and the class settled with all of the defendants in the suit except Ernst & Young and White, and the case proceeded to trial.[67] Ernst & Young was granted summary judgment on the plaintiffs RICO claim, but the plaintiffs were successful at trial, the jury finding that Ernst & Young committed state and federal securities fraud. The class was awarded approximately six million dollars in damages.[58] The case was appealed, and the Eighth Circuit reversed, holding that the notes were not securities.[69] The Supreme Court, however, held that the notes were securities.[60] On remand, the Eighth Circuit affirmed the summary judgment on the RICO claim, and the plaintiffs sought review by the Supreme Court.[61]

B. THE COURT'S OPINION

The critical issue in ***Reves*** was the proper interpretation of section 1962(c). The Eighth Circuit, following a rule it had adopted in ***Bennett v. Berg,***[62] held that section 1962(c) requires "some participation in the operation or management of the enterprise itself."[63] The circuit court concluded that although the Ernst & Young auditors had engaged in some reprehensible acts, their conduct of the audits and their presentations to the Board and the Co-op's membership did not constitute the necessary ***operation or management*** of the enterprise.[64]

The Supreme Court adopted the ***operation or management*** test in an opinion written by Justice Blackmun for a seven-member majority. In its interpretation of the phrase "to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs," the majority focused its attention on the use of the word ***conduct*** in section 1962(c).[66] As a verb, the Court reasoned, conduct means to "lead,

[66]*Reves,* 113 S. Ct. at 1168.

"*Id.*

"*Id.*

[59] Arthur Young & Co. v. Reves, 856 F.2d 52 (8th Cir. 1988).

"Reves v. Ernst & Young, 494 U.S. 56 (1990).

[61] Arthur Young & Co. v. Reves, 937 F.2d 1310 (8th Cir. 1991).

[62] 710 F.2d 1361 (8th Cir.) (en banc), *cert, denied,* 464 U.S. 1008 (1983).

[63]*Arthur Young,* 937 F.2d at 1324.

"***Id.***

[66]*Reves,* 113 S. Ct. at 1169-70.

run, manage, or direct."[66] Congress chose to prohibit participation in the conduct of the enterprise's affairs, rather than merely the enterprise's affairs. Thus, the phrase implied some degree of direction or control.[67] To read the language otherwise, the Court argued, would render the ***conduct of*** phrase superfluous.[68] The Court built upon this analysis when it interpreted the word ***participate.*** The majority conceded that the word is one of breadth, but it nevertheless rejected the position that ***participate*** was synonymous with "aid and abet."[69] It concluded that in ***context,*** the word means "to take part in."[70] Thus, combining the Court's interpretations of the two words within the statute, section 1962(c) requires an employee or associate of an enterprise to take "***some*** part in directing [an enterprise's] affairs."[71] This is, in effect, the operation or management test adopted by the Eighth Circuit.

Why Congress chose not to use words such as operation, management, or direction in section 1962(c) is not explained by the Court. Nor does the Court, in its context analysis of the language of the section, focus on the language of the entire section. As the dissent pointed out, it seems readily apparent that Congress intentionally made section 1962(c) extremely broad in its reach.[72] The section applies not only to those employed by an enterprise, but also to those who are merely associated with an enterprise. It prohibits those persons from conducting or participating in the enterprise's affairs, whether directly or indirectly. Finally, rather than prohibit such ***conduct in*** the management or control of an enterprise, Congress chose the words in the ***conduct of*** such enterprise's affairs. Given the liberal construction clause of RICO, the dissent made a strong case that a broader interpretation of section 1962(c) should be adopted.[7 ']

The Court attempted to support its interpretation of the section with the legislative history of the section, a part of the opinion that Justices Scalia and Thomas refused to join.[74] It seems clear from a review of the legislative history that legislators and Congressional reports referred to the section as prohibiting the operation or management of businesses by others.[76] The Court conceded, however,

[66]*Id.* at 1169.

[67]***Id.***

[68]*Id.*

[m]*Id.* at 1170.

'"*Id.*

[n]*Id.*

[12]*Id.* at 1174-75 (Souter, J., and White, J., dissenting).

[n]*Id.* at 1175 (Souter, J., and White, J., dissenting). [u]*Id.* at 1170-72. [n]*Id.*

that this was a slender reed upon which to base its interpretation of the law because the history did not necessarily indicate that the section was limited to that type of conduct.[76] It found some support, however, for its limited construction of the law in the fact that legislators' concerns about the over-inclusiveness of the pattern of racketeering concept were allayed by supporters who argued that the law required a showing that the violator must use that pattern to obtain or operate an interest in an enterprise.[77] The Court rejected the government's argument that a narrow construction of the section would defeat the primary purpose of the law to attack the infiltration of organized crime into legitimate organizations.[78] The operation or management test was not considered to be inconsistent with the overriding purpose of the law because infiltration was addressed by the two other substantive prohibitions of the law.[79] Also, unlike section 1962(a) and section 1962(b), the language of section 1962(c) was limited to persons employed by or associated with an enterprise, suggesting a more limited application of its provisions.[80]

Applying the test to the actions of the Co-op's auditors, the Court concluded that they did not participate in the operation or management of the Co-op in relation to their audit work.[81] The dissent argued that the auditors stepped out of their role as outside examiners of the financial statements and into the role of management.[82] This was based on the fact that the auditors determined the value of the gasohol plant and the way that asset would be reported, actions that are generally the responsibility of management.[83] The function of the outside auditors is to determine whether or not the financial statements, which are the responsibility of the audited firm, comply with generally accepted accounting standards. By adopting a phony valuation for the gasohol plant, the dissent argued, the auditors took on management responsibilities, "creat[ing] the very financial statements [they were] hired, and purported, to audit."[84] The Court rejected the dissent's contentions, noting that the auditors relied on existing records of the Co-op in preparing the audits, and that they revealed to the Board that the value of the plant was based on the Co-op's investment in it.[85] The auditor's failure to disclose that the

nId. at 1172.
77Id.
nId. at 1173.
79 *Id.*
80 *Id.*
81*Id.* at 1173-74.
82*Id.* at 1175-78.
"*Id.* at 1176. u*Id.* at 1175.
85*Id.* at 1173.

plant should have been valued at its market value was not considered sufficient participation in the operation or management of the Co-op to give rise to liability under section 1962(c).[86]

C. Analysis of *REVES*

Reves is a major victory for the accounting profession in its effort to limit the scope of its professional liability. The treble damage provision of RICO posed the risk of crippling damage awards in accountants' liability cases. ***Reves*** essentially eliminates the threat of disabling damage awards, and the leverage that threat provided plaintiffs in securities and tax fraud cases, at least in the vast majority of auditor liability cases. The essence of the opinion is that as long as an outside auditor does nothing more than review the financial statements of management and express an opinion of their validity, the auditor cannot be held liable under section 1962(c). This should be the case even when the auditor deviates from generally accepted auditing standards in the conduct of the audit, and even when the auditor commits fraud. The auditors in ***Reves*** intentionally falsified the valuation of the gasohol plant, and in effect, concealed the valuation from their client.[87] Despite the seriousness of their breach of auditing standards, the Court concluded that such actions did not constitute taking part in the operation or management of the Co-op.[88] Thus, even fraudulent nondisclosure by the auditor was not considered sufficient involvement with an enterprise to satisfy the operation or management test. As in ***Reves,*** unless the plaintiff alleges that an accountant participated in the operation of a RICO enterprise, the defendant should be able to secure summary judgment, or a dismissal, obviating the necessity of going to trial on RICO claims.

In its opinion, the Court gave some indication as to when an outsider's actions will fall within the operation or management test. In terms of the section's application to persons other than top management, the Court stated that:

> [W]e agree that liability under § 1962(c) is not limited to upper management ... An enterprise is "operated not just by upper management but also by lower-rung participants in the enterprise who are under the direction of upper management.
>
> An enterprise also might be "operated" or managed by oth-

m*Id.* at 1174.
87*Id.* at 1167-
88*Id.* at 1174.

> ers "associated with" the enterprise who exert control over it as, for example, by bribery.[89]

Auditors rarely have the type of control or effect on management envisioned by the Court in this quote. In fact, what happens most often in auditor liability suits is that management exercises undue control over the auditors. The auditor sacrifices his or her independence and modifies the audit report to satisfy the client. Such lapses of professional standards would not fall within the limited scope of the operation or management test.

One must be cautious, however, in concluding that an auditor can never be found liable under section 1962(c). The Court rejected any formulation of the operation or management test that requires ***significant control*** over an enterprise's activities.[90] Also, section 1962(d) prohibits a conspiracy to violate the three subsections of section 1962 and, therefore, provides a potential vehicle upon which a RICO claim may be based. Finally, unlike ***Reves,*** where the auditors deceived existing management of the business as well as its investors, an auditor may be in complicity with existing management in a fraudulent scheme. Under those circumstances, a plaintiff may be able to successfully argue that the auditor took some part, at least indirectly, in the operation or management of the enterprise or, alternatively, that the auditor is secondarily liable for aiding and abetting the RICO violation.

IV. Application OF The Reves Test

The above analysis of ***Reves*** is supported by the subsequent decisions of the federal courts applying the ***Reves*** operation or management test. Courts applying the operation or management test have consistently held that attorneys, accountants, and other outsiders are not liable under section 1962(c) when they merely performed customary professional services for a business enterprise. In ***University of Maryland v. Peat, Marwick, Main,***[91] for example, the Third Circuit applied the ***Reves*** test in a case involving a class action lawsuit brought by policyholders of Mutual Fire, Marine & Inland Insurance Company (Mutual Fire), an insolvent insurance company, against Peat, Marwick, Main & Company (Peat Marwick), the company's independent auditor. The plaintiffs alleged that Peat Marwick

[89]ta at 1173.
[x]*Id.* at 1170 n.4.
[91]996 F.2d 1534 (3d Cir. 1993).

issued unqualified opinions on the false financial statements of Mutual Fire from 1979-84, ignoring numerous signs of Mutual Fire's poor financial condition.[92] The policyholders purchased policies relying on Mutual Fire's ***B+*** rating from A.M. Best Company, and A.M. Best primarily relied on the audit reports in making its rating.[93] Once the true financial condition of Mutual Fire became known in 1985, Best gave it a ***no rating,*** and Mutual Fire was eventually placed in statutory rehabilitation in 1986.[94] It was further alleged that in addition to acting as Mutual Fire's auditor, Peat Marwick performed other management advisory services for Mutual Fire, including work related to the computerization of the company's accounting functions and in connection with the valuation and sale of a reinsurance subsidiary.[95] The plaintiffs contended that Peat Marwick's involvement with the business affairs of Mutual Fire was sufficient operation or management under the ***Reves*** test.[96] The court rejected this argument reasoning that:

> [T]hese services, like the audits, were merely financial services provided for Mutual Fire ... Simply because one provides goods or services that ultimately benefit the enterprise does not mean that one becomes liable under RICO as a result ... [T]he person must knowingly engage in ***"directing*** the enterprise's affairs" through a pattern of racketeering activity.[97]

Since the plaintiffs did not allege any other facts to establish that Peat Marwick took part in managing the affairs of Mutual Fire, the court upheld the dismissal of the complaint.[98]

Similarly, in ***Nolte v. Pearson***the Eighth Circuit dismissed RICO claims against attorneys who represented a music company in connection with investments in a master music recording leasing program. The investors had formed general partnerships that separately leased recording rights from Music Leasing Company. In return, they were to receive certain tax credits.[101] The attorneys for Music Leasing Company prepared documents so that the company could

[K]*Id.* at 1538.
[M]7d.
"*Id.*
[K]*Id.* at 1539.
[x]*Id.*
[37]*Id.* (citing *Reves,* 113 S. Ct. at 1170).
[98]*Id*.
"994 F.2d 1311 (8th Cir. 1993).
[m]*Id.* at 1314. [m]*Id.* at 1314-15.

provide prospective investors with information on the leasing investment, including an opinion letter on the income tax consequences of the investment.[102] The Internal Revenue Service disallowed the tax credits, and the investors sued the attorneys.[103] The district court granted a directed verdict for the attorneys finding no evidence of mail fraud.[104] The Eighth Circuit affirmed but on the theory that there was no evidence that the attorneys participated in the operation or management of the music enterprise under ***Reves***.[106]

The plaintiffs in ***Baumer v. Pachl***[106] alleged that an attorney did more than merely perform generic professional services. Investors in a fraudulent investment scheme sued James Pachl, the attorney who was involved with the sale of limited partnership interests in a California limited partnership known as Golden Hills Estates.[107] In 1982, the California Department of Corporations investigated the limited partnership, concluded that it was engaged in an illegal sale of unregistered securities, and demanded a halt to the sale of interests in Golden Hills Estates.[108] Thereafter, Pachl prepared letters that were designed to perpetuate and cover-up the scheme, including several to the Department of Corporations.[109] Moreover, the plaintiffs contended that Pachl knowingly filed a false partnership agreement which was mailed to limited partners to give a false impression as to the number of investors and as to legality of Golden Hills Estates.[110] Nevertheless, the Ninth Circuit found that Pachl's involvement was not sufficient under the operation or management test.

> Pachl at no time held any formal position in the limited partnership. Nor did he play any part in directing the affairs of the enterprise. Pachl's role was limited to providing legal services to the limited partnership ... Whether Pachl rendered his services well or poorly, properly or improperly, is irrelevant to the ***Reves*** test.[111]

Similar decisions have been reached by the federal district courts in cases involving RICO suits against attorneys and accountants pro

[m]*Id.* at 1314.
[103]*Id.* at
1314-15. [m]*Id.*
at 1315.
[105]7d. at 1317.
[106] 8 F.3d 1341 (9th Cir.
1993). [m]*Id.* at 1342.
[108]W.
[m]*Id.*
[m°]*Id.* at 1342-43.
[111] *Id.* at 1344.

viding professional services to clients. In ***Sassoon v. Altgelt, 77, Incorporated***,[112] investors brought securities and RICO claims against attorneys who had represented issuers involved in a public offering. The attorneys allegedly drafted the offering and other letters in connection with the sale of securities.[113] The court considered these actions insufficient under ***Reves*** noting that the conduct consisted of nothing more than the attorneys "providing legal services to the general partners and to the limited partners."[114] In ***Gilmore v. Berg,***[115] investors brought an action against an attorney, who had drafted a tax opinion letter, and an accountant, who had prepared a forecast letter in connection with a sale of limited partnership interests under a private placement memorandum. The letter prepared by the attorney and the financial projection prepared by the accountant were included in the private placement memorandum for Cooper River Office Building Associates, a New Jersey limited partnership.[116] The investors claimed fraud in the sale and sued the professionals under RICO.[117] The court dismissed the RICO claim finding that the conduct of the attorney and the accountant constituted the rendition of professional services, and did not constitute participation in the management or operation of the entities involved in the sale of the limited partnership interests.[118] Plaintiffs attempted to bolster their claim by contending that the attorney was intimately involved in every aspect of the securities sale.[119] The court still found no evidence that the attorney was directing the entities he was representing. "Preparing documents ... attending closings, preparing and filing Certificates of Limited Partnership ..., and serving as an agent for the receipt of process ... are all common professional services typically rendered by attorneys for their business clients."[120]

Even active participation in a client's scheme to defraud has been considered insufficient under the ***Reves*** test. In ***Biofeedtrac v. Koliner Optical Enterprises***,[121] the plaintiff claimed that Koliner Optical Enterprises and its attorney, Christopher Kuehn, attempted to market a competing product using plaintiff s technical secrets and to conceal the scheme through a number of deceptive communica-

[112] 822 F. Supp. 1303 (N.D. 111. 1993).
[113]*Id.* at 1307.
[lu]*Id.*
[115] 820 F. Supp. 179 (D.N.J. 1993).
[ne]*Id.* at 180-81.
[u,]*Id.* at 182.
[ne]*Id.* at 183.
[m]*Id.*
[m]*Id.*
[m] 832 F. Supp. 585 (E.D.N.Y. 1993).

tions to the plaintiff. In the light most favorable to the plaintiff, the facts indicated that Kuehn knew of the scheme, advised his clients how to minimize the legal risks involved, negotiated with the plaintiff to prevent plaintiff from uncovering the scheme, and suborned perjury by suggesting to one witness that he should mislead the court at a preliminary injunction hearing.[122] Also, Kuehn established the corporations that would market the competing product, prepared documents relating to the corporations and its business plans, and served as counsel, secretary, and a director for the corporations.[123] The district court concluded, however, that Kuehn's actions were "confined, at all times, to providing legal advice and legal services."[124] Because he did not participate in the decision to market the competing product, or otherwise become involved in the management of his client's business, his actions did not go beyond the "realm of legal advice."[126] Thus, his actions did not fall within the scope of the operation or management test "even though he may have intentionally assisted a scheme to defraud."[126]

In contrast to ***Biofeedtrac,*** the district court in ***Clark v. Milam***[127] held that auditors who knowingly participated in an enterprise's affairs by concealing RICO violations from state regulators were subject to liability under section 1962(c). The plaintiff, the West Virginia Commissioner of Insurance acting as a receiver for George Washington Life Insurance Company (GW Life), alleged that the accountants were aiders and abettors in a conspiracy to loot GW Life.[128] The court distinguished cases such as ***Peat Marwick***[129] because the GW Life accountants were alleged to have participated in the enterprise's affairs by conducting their work in a manner so as to conceal RICO violations from state insurance regulators, something more than the mere rendition of deficient services.[130] Although the complaint asserted that the accountants were secondarily liable under section 1962(c), the court did not resolve the issue of whether or not a person may be liable for aiding and abetting under the ***Reves*** decision. Rather, it interpreted the ***Reves*** test to mean that a defendant need not be the ***primary agent of control*** over the enterprise as long as the defendant controlled "some portion of the RICO enter

[122]*Id.* at 586-89.
™*Id.*
m*Id.* at 591.
m*Id.*
[126]W. at 592.
m 847 F. Supp. 409 (S.D.W.Va. 1994).
™*Id.* at 411.
[129]*Id.* at 416. For a discussion of this case see *supra* text accompanying notes 91-98.
"Clark v. Milam, 847 F. Supp. 409, 416 (S.D.W.Va. 1994).

prise."[131] Thus, the key issue under the operation or management test is "the quantity and quality of the defendant's participation in the RICO enterprise," an evaluation that must be conducted on an ***ad hoc*** basis.[132] As applied to the plaintiff's complaint, the Court found sufficient allegations of control.

> The Plaintiff has alleged that these defendants knowingly concealed the activity of other defendants who exercised day- to-day control over the enterprise. The concealment of the other defendants' conduct is alleged to have been integral to the continuing operation of the RICO enterprise. Although these Defendants' conduct may not have been as active as the conduct they were concealing, and although they may not have received the same benefits as other defendants, their control need not have been ***significant*** to impose liability under § 1962(c).[133]

Post-i?eues cases indicate that most RICO actions against accountants under section 1962(c) will not be viable because the plaintiff will not be able to establish the necessary operation or management of an enterprise's affairs. Customary professional services, even when performed in a negligent or fraudulent manner, will not be sufficient under the ***Reves*** test. However, an accountant who is in complicity with his or her client and knowingly participates in a fraudulent business scheme may be subject to liability under the operation or management test.

V. Alternative Theories OF Liability: Conspiracy And Aiding And Abetting

A plaintiff who is unable to establish involvement by an accountant in the operation or management of a RICO enterprise may attempt to sue an accountant under some alternative RICO theory, particularly conspiracy and aiding and abetting. Post-i?ei>es cases suggest that it will be difficult to hold an independent auditor liable under either theory.

Section 1962(d) makes it unlawful to conspire to violate any of the three substantive provisions of RICO.[134] The important element in a

m*Id.* at 417.
™*Id.*
[133] *Id.*
[134]18 U.S.C. § 1962(d) (1988).

conspiracy claim under RICO is the agreement among the conspirators to commit the predicate acts of racketeering. Some federal circuit courts require the conspirators to agree to personally commit the predicate acts.[135] A majority simply require that the RICO conspirators, with an awareness of the nature of the enterprise and an intent to participate in it, agree to the commission of the predicate acts by one of the co-conspirators.[136] However, under either rule, mere association with an enterprise, standing alone, is insufficient for a RICO conspiracy; an individual must agree to the commission of a RICO violation.[137]

Unless a complaint alleges an agreement to commit a RICO violation, the courts will dismiss conspiracy counts against outsiders. In ***Baumer v. Pachl,***[136] the court dismissed the section 1962(c) claim even though it was alleged that the attorney Pachl was actively involved in his client's fraudulent investment scheme.[139] The plaintiff investors also claimed a conspiracy in which Pachl "knowingly aided and abetted."[140] The court dismissed the conspiracy count because there was no allegation of an agreement by Pachl to violate RICO or evidence upon which such conspiracy could be inferred.[141] The allegations of aiding and abetting were considered insufficient because conspiracy is a separate and distinct offense from aiding and abetting that requires an agreement between the parties.[142]

[135] *See* United States v. Boylan, 898 F.2d 230 (1st Cir. 1990) (defendant must have agreed to commit, or have in fact committed, two or more specified predicate acts to be guilty of RICO conspiracy); United States v. Ruggiero, 726 F.2d 913 (2d Cir.) (government must prove that the defendant agreed to commit two or more predicate acts to establish RICO conspiracy), *cert, denied,* 469 U.S. 831 (1984).

[136] *See, e.g.,* United States v. Pryba, 900 F.2d 748 (4th Cir.) (RICO conspiracy does not require that each defendant personally agree to commit two or more acts of racketeering), *cert, denied,* 498 U.S. 924 (1990); United States v. Rosenthal, 793 F.2d 1214 (11th Cir. 1986) (RICO does not require that each defendant agree to commit two predicate acts); United States v. Neapolitan, 791 F.2d 489 (7th Cir. 1986) (Section 1962(d) is broad enough to encompass those persons who are intimately involved in a conspiracy but who neither agree to personally commit or participate in the commission of the predicate crimes); United States v. Joseph, 781 F.2d 549 (6th Cir. 1986) (it is necessary to prove only that the defendant agreed that another would commit two predicate offenses to prove a RICO conspiracy); United States v. Adams, 759 F.2d 1099 (3d Cir. 1985) (defendant must agree only to the commission of the predicate acts by a co-con- spirator to be convicted of a RICO conspiracy).

[137] United States v. Valera, 845 F.2d 923, 929 (11th Cir. 1988), *cert, denied,* 490 U.S. 1046 (1989).

[138] 8 F.3d 1341 (9th Cir. 1993).

[139] See *supra* notes 106-111 and accompanying text.

[140] Baumer v. Pachl, 8 F.3d 1341, 1345 (9th Cir. 1993).

[141] *Id.* at 1346.

[142] *Id.* at 1347.

Plaintiffs may be able to establish such an agreement even in the absence of evidence showing the defendant's participation in the operation or management of the enterprise.[143] In ***Morin v. Trupin,***[144] for example, investors brought a RICO action against Barry Trupin, a founder and promoter of tax shelters in which the plaintiffs invested, and Trupin's attorneys, Mintz, Fraade & Zeiger, P.C. The investors claimed that the attorneys participated in Trupin's enterprise by preparing private placement memoranda, correspondence, management agreements, and purchase agreements.[146] Plaintiffs also claimed that the attorneys indicated to their clients where they were to sign certain documents.[146] The court dismissed the claim under section 1962(c) against the attorneys, finding that the attorneys were merely providing legal advice and services for their business client.[147] The court refused to dismiss the conspiracy claim, however. The investors alleged that the attorneys agreed with Trupin to violate RICO and that the attorneys personally agreed to commit specific racketeering acts.[148] These allegations were sufficient to get past the dismissal stage.[149]

Similarly, in those cases where the plaintiffs are able to establish an accountant's participation in a RICO enterprise under section 1962(c), they may also be able to assert a conspiracy count. In ***Clark v. Milam,***[150] the court found sufficient control under the ***Reves*** test in that the defendant accountants knowingly concealed the RICO violations by the officers and directors of GW Life from state insurance regulators.[161] The court also permitted the conspiracy count to proceed to trial even though the plaintiff did not expressly allege an agreement among the parties to violate section 1962(c).[162] It found the allegations sufficient to permit an inference that the accountants participated in a conspiracy with the officers and directors of GW Life to violate section 1962(c).[153]

Aiding and abetting is another potential theory of recovery under RICO. Prior to ***Reves,*** many federal courts imposed secondary liabili-

[143] *See* United States v. Quintanilla, 2 F.3d 1469 (7th Cir. 1993) (it need not be established that the defendant participated in the management of the RICO enterprise to the extent required in *Reves* to establish a RICO conspiracy).

[144] 835 F. Supp. 126 (S.D.N.Y. 1993).

[145] *Id.* at 135.

[146] *Id.*

[147] *Id.* at 135-36.

[148] *Id.* at 136.

[149] *Id.*

[150] 847 F. Supp. 409 (S.D.W.Va. 1994).

[151] See *supra* notes 127-133 and accompanying text.

[152] Clark v. Milam, 847 F. Supp. 409,418 (S.D.W.Va. 1994).

[153] *Id.*

ty for aiding and abetting a RICO violation, that is, knowingly and substantially assisting another to commit a RICO violation.[154] Given the opinion in ***Reves,*** however, it is questionable whether aiding and abetting liability is consistent with the operation or management test. Although several post-iieues decisions have allowed aiding and abetting counts in a RICO complaint,[155] at least one court has severely limited the scope of aiding and abetting liability. In ***Rolo v. City Investing Company Liquidating Trust,***[156] the court considered the compatibility of aiding and abetting liability with the ***Reves*** test noting that "[I]t would be illogical to allow RICO plaintiffs to circumvent the limits on liability under section 1962(c) as defined in ***Reves*** simply by allowing them to use the label 'aider and abettor' to impose liability on a defendant whose level of involvement with an enterprise does not constitute operation or management." [157] The court concluded that the requirement of some operation or management of the enterprise must be an element of aiding and abetting.

> In sum, a defendant may be liable for aiding and abetting under § 1962(c) (i.e. be liable without actually having committed at least two predicate acts as required by the statute) only if that defendant has both (1) aided and abetted the commission of two predicate acts (as required by ***Petro-Tech***) and
> (2) participated in the operation or management of the enterprise (as required by ***Reves***).[168]

Obviously, under this formulation of secondary liability, plaintiffs face the same burden to establish operation or management as in a case alleging primary liability.

[154] *See* Petro-Tech, Inc. v. Western Co. of North America, 824 F.2d 1349 (3d Cir. 1987) (reasoning that applying common law doctrine of aiding and abetting advances RICO's goals); Armco Industrial Credit Corp. v. SLT Warehouse Co., 782 F.2d 475 (5th Cir. 1986) (recognizing civil liability for aiding and abetting); Downing v. Halliburton & Associates, Inc., 812 F. Supp. 1175 (M.D.Ala. 1993) (aider and abettor of two predicate acts can be civilly liable under RICO); In re Sahlen & Associates, Inc. Securities Litigation, 773 F. Supp. 342 (S.D.Fla. 1991) (to establish civil aiding and abetting liability, the plaintiff must establish that the defendant was associated with the wrongful conduct, participated in it with the intent to bring it about, and sought by his actions to make it succeed).

[1M] *See, e.g.,* Clark v. Milam, 847 F.Supp. 409 (S.D.W.Va. 1994) (allowing aiding and abetting claim to stand without resolving the issue of whether or not *Reves* precluded aiding and abetting liability under § 1962(c)); Fidelity Federal Savings & Loan Ass'n. v. Felicetti, 830 F. Supp. 257 (E.D.Pa. 1993) (reasoning that *Reves* did not implicitly reject aiding and abetting under § 1962(c)).

[166]845 F. Supp. 182 (D.N.J. 1993).

[157]*Id.* at 232.

[lm]*Id.*

The Supreme Court may have rung the death knell for aiding and abetting liability with its recent opinion in ***Central Bank of Denver v. First Interstate Bank.***[169] In ***Central Bank,*** the Court held that there is no aiding and abetting liability under section 10(b) of the Securities Exchange Act of 1934.[160] The Court relied primarily on the text of the statute and the absence of any express provision imposing secondary liability for securities fraud.[161] Moreover, it concluded that there is no general presumption that a person can sue aiders and abettors simply because a federal law allows suit against those who violate a statutory proscription.[162] Rather, civil aiding and abetting liability depends upon the particular statutory language.[163] Like section 10(b), neither section 1964, the civil liability section of RICO, nor section 1962(c) contains a provision imposing aiding and abetting liability. Thus, ***Central Bank*** may have eliminated aiding and abetting as a viable alternative theory under section 1962(c).

VI. CONCLUSION

It is clear that the Court's opinion in ***Reves*** places a significant limitation on RICO claims against ***outsiders,*** including attorneys and accountants. Accountants, in particular, should be free of RICO claims in connection with their work as long as they are engaged in customary professional services for a client. Even if their conduct is negligent or misleading, they will only be subject to liability under section 1962(c) if they control or at least participate in the control of their clients' business affairs. Accountants run the greatest risk of RICO liability if they become active participants in a fraudulent securities or business scheme with their clients. In such cases, injured plaintiffs may be able to successfully assert that the accountant was participating to some extent in the operation of the client's enterprise or was engaged in a RICO conspiracy.

"'62 U.S.L.W. 4230 (U.S. April 19, 1994). [m]*Id.* at 4237.

[161] *Id.* at 4232-34.

[162]*Id.* at 4235. [le3]*Id.*