FOR ACCOUNTING FIRM ALLIANCES AND NETWORKS,
THE MOST RECENT CHAPTER IN
BANCO ESPIRITO SANTO INT’L, LTD. V. BDO INTERNATIONAL, B.V.
PROVIDES NEW REASONS FOR CONCERN
ABOUT VICARIOUS LIABILITY

To keep pace with the ever expanding global economy, accounting firms have joined together in alliances and networks to better take advantage of the new opportunities presented in our ever flattening world. There has been a significant growth in the number and types of accounting firm alliances, networks, associations and alternative practice structures in the United States and abroad. However, like the international accounting “firms,” which are structured as associations to address vicarious liability issues, the accounting firm alliances and networks also have kept a watchful eye on cases like Nuevo Holdings v. PriceWaterhouseCoopers LLP, In re Parmalat Sec. Litig. and Banco Espirito Santo Int’l, Ltd. v. BDO International, B.V. to assess the extent to which association with other firms can mean vicarious liability for their actions. The most recent appellate court decision in the Banco Espirito case presents new reason for concern.

On March 12, 2008, Florida’s Third District Court of Appeal reversed a trial court’s prior directed verdict in favor of BDO International, B.V., holding that there is a question of fact whether the international association is vicariously liable as principal for the conduct of BDO Seidman, LLP as agent in failing to detect a massive fraud in the course of conducting audits for the years 1998-2002.

CASE HISTORY

E.S. Bankest L.C. (“Bankest”) was a Miami-based lender engaged in the factoring business. Factoring is the practice of lending against a percentage of the future value of the borrower’s liquid assets, usually the borrower’s accounts receivable, in return for an assignment of those assets, which in the case of accounts receivable would result in the account becoming payable directly to the factor. Bankest engaged in a massive fraud involving the fabrication of financial records by its principals that concealed hundreds of millions of dollars in losses. After the company failed, several of those principals, including the CEO, were indicted and sentenced to prison.

Banco Espirito Santo Int’l, Ltd. (“Banco Espirito”) invested in Bankest prior to its failure. Bankest engaged BDO Seidman, LLP to audit its financial statements for the years 1998-2002. BDO Seidman did not detect the fraud and issued clean audit opinions for the years in question.

In 2004, Banco Espirito discovered the fraud and commenced a lawsuit against BDO Seidman and BDO International, B.V. in Florida state court. Banco Espirito alleged that BDO Seidman committed professional malpractice and was grossly negligent in its audits of Bankest’s financial statements. Banco Espirito also alleged that BDO International was vicariously liable as the principal for BDO Seidman’s malpractice and gross negligence as an agent.
BDO International first sought to dismiss the claims against it based on the argument that the Florida courts did not have personal jurisdiction over it because it was a Netherlands corporation with its principal business offices located in Belgium. The trial court denied that motion based on the finding that BDO International should expect to be called into court for the acts of its “underlings” and that BDO International actually transacted business in Florida through BDO Seidman. That holding was affirmed on appeal.

BDO International then sought to have the complaint dismissed as a matter of law based on the absence of any relationship upon which vicarious liability could be based. That motion also was denied based on the trial court finding there was a question whether BDO Seidman was an actual agent of BDO Seidman for which it could be held vicariously liable. Accordingly, the matter was slotted to go to trial against both defendants—BDO Seidman and BDO International.

The liability phase of the trial against BDO Seidman and BDO International started in early 2007. In June, the jury found BDO Seidman liable, but the trial court granted BDO International’s motion for a directed verdict and dismissed the case as against BDO International based on a finding that Banco Espirito had not presented sufficient evidence to prove an actual agency relationship.

At the conclusion of the damages phase of the trial in August, the jury awarded $170 million in compensatory and $351 million in punitive damages.

BDO Seidman is appealing the jury verdicts, and Banco Espirito appealed the trial court’s dismissal of BDO International. On March 12, 2008, Florida’s Third District Court of Appeal reversed the trial court’s directed verdict in favor of BDO International, B.V., holding that there is a question of fact whether the international association is vicariously liable as principal for the conduct of BDO Seidman, LLP as agent in failing to detect the fraud in the course of its audits.

**APPELLATE DECISION**

The Third District Court of Appeal (the “Court”) first noted that the only theory of liability presented against BDO International at trial and in the appeal was actual agency, and that apparent agency was not argued. The Court further noted that “[v]icarious liability may arise in various ways under Florida law.”

The Court then reasoned that actual agency required “(1) acknowledgement by the principal that the agent will act for him, (2) the agent’s acceptance of the undertaking, and (3) control by the principal over the actions of the agent.” The Court also noted that, unless these elements are proven by a contract between the parties, the existence of the relationship presents a question of fact to be assessed by looking at the totality of the circumstances.

The Court found that there was evidence presented during trial indicating that BDO International had acknowledged that BDO Seidman would act for it as an agent. The Court pointed to the Articles of Association, which indicate that one of BDO International’s objectives was to “manage and control” the members, which was further confirmed by the testimony of BDO International’s secretary, who testified that BDO Seidman’s activities were “coordinated” and “monitored” by BDO International. Further, BDO International was granted ownership and
control of the “BDO Technical Manuals,” which provided the guidelines and instructions for how all member firms were to provide accounting, auditing, investigative and other services. Additionally, other documentary evidence indicated BDO International was charged with implementing quality controls and training programs for member firms.

The Court also found that there was evidence presented during trial that indicated BDO Seidman accepted its role as an agent of BDO International. BDO Seidman signed the Member Firm Agreement, which obligated the firm, its partners and subsidiaries to agree to be bound by the agreement. BDO International’s secretary also testified that BDO Seidman agreed to make its partners and employees available to BDO International committees to prepare reports and develop products.

Finally, the Court found that evidence had been presented at trial indicating that BDO International had the right to control BDO Seidman. The Court made it very clear that the legal test was whether the principal had the right to control the agent, not whether the principal had actually ever done so in the past. The Court concluded that BDO International possessed the right to control BDO Seidman because the Member Firm Agreement required BDO Seidman to provide professional services at the request of BDO International, to assist in the development of accounting products for BDO International, and to comply with the audit and technical manuals promulgated by BDO International. BDO International also retained the right to review BDO Seidman’s management to ensure compliance with the Member Firm Agreement.

Accordingly, the directed verdict in favor of BDO International was reversed and the matter remanded for further proceedings.

LESSONS LEARNED

As the Florida Court of Appeals noted, actual agency is not the only legal theory that could result in a finding that an association is vicariously liable for the conduct of a member. The Florida Court of Appeals seemingly suggests apparent agency could be enough, which would only require conduct on the part of both the putative principal and agent that could reasonably result in a third-party believing an actual agency relationship exists. However, other courts have suggested that alter-ego theories and partnership or joint venture type relationships might also give rise to vicarious liability in the context of an accounting firm association.

The more important lesson to be learned from the Banco Espirito case is that vicarious liability under an actual agency theory is very fact specific, and the courts may disagree on what level of proof is necessary before the issue gets to a jury. While the language in the BDO International Member Firm Agreement and Articles of Association may give BDO International greater rights to control its members than is seen in the organizational documents of other associations, the language the Florida Court of Appeals held constituted sufficient evidence to submit the question of agency to the jury was far from overwhelming. In fact, the reasoning in the Banco Espirito case suggested that any level of control or supervisory rights beyond those found in a licensing agreement may be enough to submit the issue to a jury.

For those associations where the members have decided they want an organization that is a strategic alliance, rather than a network, the association documents should be scrutinized to
ensure that member agreements and the articles of the association do not suggest that the association has designated the member firms as its agents or that the association maintains some level of control over the members. The Banco Espirito court placed great significance on the fact that BDO International owned and promulgated the audit and other technical manuals that the member firms were expected to follow. If an association wants to avoid this type of liability, care must be exercised to avoid even the appearance of control.

For those associations where the members have decided that they want the organization to be a network, as that term has been defined by the International Federation of Accountants, the balancing act now seems much more precarious. The Banco Espirito case clearly suggests that an association could be considered to be its members’ keeper, possibly to the extent of $500 million. Since these organizations frequently seek to adopt and impose uniform practices and quality control standards, a finding of vicarious liability is a distinct possibility under the rationale expressed in the Banco Espirito case. However, there still may be risk management opportunities that can reduce this risk, while permitting the overall goal of the association to carry forward. The ways to manage this risk is unique to each organization and requires review of the association’s specific goals, operations and existing membership.

Finally, everyone interested in this area should keep an eye on what happens next in the Banco Espirito case. The parties continue to disagree on just about everything, including whether another trial is necessary to resolve BDO International’s actual liability. However, far more important will be the ability of Banco Espirito to use a finding of vicarious liability against BDO International, if there is or will be one, to reach the assets of the other member firms. While BDO International likely has some assets of its own, it is not likely that those assets will make any meaningful contribution to satisfying Banco Espirito’s judgment unless the member firms are obligated to contribute. That chapter in this story remains to be written.

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