

The Accountant/Attorney Liability Reporter

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A L E R T

If Someone Had Only Listened: Financial Accounting Standards Board Chair Refers to FASB Mortgage Loan "Reminder" Issued in December 2005.

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Deductibility of Investment Advisory Costs for Estates and Trusts After *Knight*

By Cheryl A. Waterhouse, Esq.

IN JANUARY OF THIS YEAR, the United States Supreme Court ruled on the deductibility of investment advisory fees for estates and trusts under Section 67(e)(1) of the Internal Revenue Code. In *Knight v. Commissioner*, 128 S. Ct. 782 (2008), the Court held that investment advisory fees are generally not fully deductible, but are only deductible to the extent the deductions exceed 2% of adjusted gross income (the “2% floor”).

That decision, which resolves a split between Circuit Courts around the country, necessitates changes to the Proposed Regulation §1.67-4, issued by the IRS last July, which governs deductibility of fiduciary expenses, including costs for a trust’s outside investment advice. The decision also prompted the IRS to issue interim guidance in February on treatment of investment advisory costs subject to the 2% floor under Section 67 that are bundled as part of a commission or fee paid to the trustee or executor and incurred by a nongrantor trust or estate. The IRS has requested comments on §1.67-4 of the Proposed Regulations, and the IRS and Treasury Department have stated they expect to issue final regulations under §1.67-4 consistent with the Court’s holding in *Knight* and which address the issue of bundled-fee costs incurred by a fiduciary, some of which are subject to the 2% floor and some of which are fully deductible.

In *Knight*, the Court considered the exception, in Section 67 of the Internal Revenue Code, to the rule that trusts, like individuals, can subtract from their taxable income certain itemized deductions, but only to the extent the deductions exceed the 2% floor. The exception provides that costs incurred in the administration of the trust and that would not have been incurred if the trust property were not held by a trust are fully deductible.

When the Sixth Circuit had earlier considered the question of whether a trust’s investment advisory fees, which are subject to the 2% floor for individuals, are subject to the 2% floor or are fully deductible, it held that the fees are fully deductible. *O’Neill v. Commissioner*, 994 F.2d 302, 304 (6th Cir. 1993). The Fourth and Federal Circuit Courts, in contrast, held that the fees are subject to the 2% floor, because they are “commonly” incurred outside of trusts. See *Scott v. United States*, 328 F.3d 132, 140 (4th Cir. 2003); *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1281 (Fed. Cir. 2001). The Second Circuit held similarly, but based on a more “exacting test” only allowing full deductions for those costs which could not have been incurred by an individual. *Rudkin Testamentary Trust v. United States*, 467 F.3d

149, 156 (2nd Cir. 2006) (identified as *Knight* in the Supreme Court decision). The 2007 Proposed Regulations followed the Second Circuit by only allowing full deductions for costs that are “unique” and defining those costs to be costs that could not be incurred by an individual. The Proposed Regulations also provide examples of services unique to estates and trusts.

The Supreme Court found that the Second Circuit’s interpretation of the exception to the 2% floor rule was incorrect. The Section 67(e) exception requires that the cost “would not have been incurred” outside of a trust, not that the costs “could not have been incurred by an individual.” The Court then stated that in determining whether costs “would not have been incurred” by an individual, which would make such costs fully deductible, one looks at costs that “would be uncommon (or unusual or unlikely) for a hypothetical individual to incur.” Applying that to the case before it regarding investment advisory costs, the Court held that because such costs are not uncommon or unusual for an individual to incur, they are subject to the 2% floor and not fully deductible.

The Court did state, however, that there may be some trust-related investment advisory fees that are fully deductible. The Court provided the examples of special, additional charges only applicable to fiduciary accounts or any incremental costs of expert advice, based on an investment objective or a specialized balancing of competing interests which are beyond what would be required for an individual that would not be subject to the 2% floor.

Because the Supreme Court rejected the Second Circuit’s position, the Proposed Regulations, which were based on that Court’s decision, will have to be revised. Further guidance would be welcome to provide more certainty as to what expenses of fiduciary taxpayers are not subject to the 2% floor. Until the final regulations are issued, practitioners should be cautious when taking the position that administrative expenses are fully deductible.

The Interim Guidance, Notice 2008-32, provides assistance on the treatment of bundled fees for the 2007 tax year. The guidance provides that for years prior to 2008, taxpayers do not have to determine the portion of the bundled fiduciary fee that is subject to the 2% floor under Section 67, but may deduct the full amount of the bundled fee. The guidance states, however, that payments by the fiduciary to third parties for expenses subject to the 2% floor are readily identifiable and must be treated separately from the bundled fees.

The comment period for the Proposed Regulations closes at the end of May. The IRS and Treasury anticipate final regulations will be published soon thereafter. Those regulations should reflect the holding and findings in *Knight* as well as address the issue of determining allocation of bundled fiduciary fees between costs subject to the 2% floor and costs that are fully deductible.

Accountants Prevail in Enforcing Limitation of Liability Clause in Engagement Letter

By Nicholas A. Ogden, Esq.

A MASSACHUSETTS COURT has once again emphasized the importance of engagement letters. In *Rohtstein Corporation v. KPMG, LLP*, the Suffolk Superior Court issued a Memorandum and Order granting partial summary judgment to KPMG, and enforcing a limitation of liability clause contained in KPMG's engagement letters with the Rohtstein Corporation ("Rohtstein").

Rohtstein is an S-Corporation, whose president and sole shareholder is Steven Rohtstein ("Steven"). KPMG provided tax, audit and consulting services to Rohtstein from 1999 to 2002. Each year, KPMG and Rohtstein set forth the terms of their relationship in an engagement letter, which was signed by Rohtstein's controller. For the years 2001 and 2002, the engagement letters incorporated KPMG's Standard Terms and Conditions, which stated in part that "KPMG's maximum liability to Client arising for any reason relating to services rendered under this engagement shall be limited to the fees paid for those services." The 1999 engagement letter contained the same language in the body of the letter.

In 2002, Rohtstein transferred its accounting business to a different accountant, who allegedly found errors and omissions in KPMG's work. Rohtstein and its sole shareholder, Steven, filed suit against KPMG, claiming damages arising out of the alleged errors and omissions. Pursuant to the engagement letters, KPMG moved for partial summary judgment to limit any potential damages to the amount of its fees. The Superior Court ruled that limitations of liability are enforceable in Massachusetts, and declined to rule that the limitation of liability clause was unconscionable despite the fact

that it could significantly diminish any potential recovery. Rohtstein was capable of protecting its interests, the limitation language was prominently displayed in the engagement letters and there was no fraud or misrepresentation.

Rohtstein also argued that, because attorneys are subject to a disciplinary rule forbidding them from entering into agreements with their clients limiting their liability for malpractice, accountants, who also practice a profession of public importance, should be subject to the same restriction. As the executive branch, not the judiciary, regulates the accounting profession, and because no case had applied such a prohibition against accountants nor could the plaintiffs identify any statute, regulation or other authority that did so, the Court held that only the Legislature or Board of Public Accounting could determine the limitation violated public policy, not this Court.

In addition, the Superior Court ruled that the sole shareholder, Steven, could not avoid the impact of the limitation of liability clauses by arguing that he (individually) was not a party to the engagement letters. The Court held that Steven could not use the corporate form as both a sword and a shield by aligning himself with the corporation in

seeking to gain the benefit of Rohstein's engagement of KPMG but distancing himself from the corporation to avoid the implications of the engagement letters. The Court ruled that Steven's cause of action, if any, was subject to the terms of the engagement letters, including the limitation of liability clauses. Based on the above, the Superior Court ordered that any damages awarded at trial shall be limited in accordance with the limitation of liability clauses in the engagement letters.

This is another reminder that engagement letters, when carefully drafted, can be extremely important. Here, the accountant had engagement letters for each year of its services for which the plaintiff claimed liability. The Court ruled that the limitation of liability provisions in each letter would control at trial to contain the amount of damages, should liability be found against the accounting firm.

The Importance of Defining the Scope of the Engagement

By Cheryl A. Waterhouse, Esq.

IN TWO RECENT NEW YORK CASES, the Court focused on language in the accountants' engagement letters in determining whether to dismiss professional malpractice claims against the accountants. In each case, the issue was whether the statute of limitations, the time within which a plaintiff may bring a claim after the claim arises, barred the claim or whether the claim survived because the accountant may have continued to provide services related to the alleged malpractice and the "continuous representation" doctrine applied. Where the engagement letter language was more precise, the claims were dismissed. When the language indicated possible future services that related to the original services could be performed, the Court allowed the plaintiff to continue to assert its claims against the accountant.

These cases further emphasize the importance of carefully defining the scope of the services to be provided in the engagement letter. The Court's discussion of engagement letter language is helpful for all accountants. New York practitioners should particularly take note. Because New York's three-year statute of limitations begins to run not when the client discovers the malpractice, but when the client receives the work product, being precise in defining the scope of the engagement can lead to the dismissal of claims not commenced within three years after the accountant provides the work product.

In *Apple Bank for Savings v. Pricewaterhouse Coopers, LLP*, 18 Misc. 3d1137(A), Pricewaterhouse Coopers, LLP ("PWC") sought dismissal of malpractice claims for the years 2000, 2001 and 2002 on the grounds that they were time-barred, as Apple Bank for Savings (the "Bank") had not filed suit against PWC until 2006. PWC had long been the Bank's auditor and had provided consulting services to the Bank in 1999 regarding the tax impact of a stock redemption agreement the Bank was considering entering into with the estate of its deceased sole shareholder. PWC advised that the stock redemption agreement would cause the Bank no negative income tax consequences and provided services based on that advice for the next few years.

From 2000 to 2004, PWC prepared the Bank's financial statements and income tax returns. In 2005, PWC informed the Bank that it had been wrong about the tax consequences of the stock redemption. The Bank ultimately owed about \$12 million in back taxes and interest. Soon thereafter, the Bank informed PWC that it no longer would retain its services and filed suit against PWC in 2006.

PWC argued that the 2000, 2001 and 2002 services were separate and discrete engagements, each governed by an engagement letter, and the claims regarding those services should be dismissed as time-barred. The Bank countered by stating that the "continuous representation" doctrine applied and, from 2000 to 2004, PWC continued to affirmatively assert its position that the tax advice regarding the stock redemption was correct, and even provided further services in 2005 related to the malpractice by attempting to remediate the problem for the Bank.

The Court looked at the engagement letters for the audit services and for the tax services in deciding whether or not to dismiss any of the claims. The audit engagement letters were found to sufficiently define the scope of the services to the particular year of each audit. Thus, the Court found that there was no continuous representation relating to those services and dismissed the claims concerning

audit years 2000, 2001 and 2002. The letters for the tax services were not as helpful to PWC. The Court found those letters, which PWC referred to as engagement letters and the Court called simply "estimate letters," did not limit the tax services to certain years and were not helpful in limiting PWC's liability.

The helpful language in the audit engagement letter is as follows. First, simply stating that it was an "engagement letter" for a particular year and having it signed by the client was noted by the Court. Further, stating precisely the services to be provided, such as PWC will "audit the consolidated financial statements . . . for the year then ending" and upon completion "will provide you with an audit report" defined the scope. In addition, the language in the engagement letters that stated that any "additional services that you may request and we agree to provide will be the subject of separate written agreements" also limited the services to the defined scope and to that particular year. Based upon the language in the engagement letters for the audit services, the Court found the continuous representation doctrine did not apply and dismissed the claims relating to those audit services.

In contrast, the letters concerning the tax return services did not result in the dismissal of the claims relating to tax services. The "estimate letters" for the preparation of tax returns did not contain a signature line for the Bank to indicate it had accepted the terms stated in the letter. In addition, the "estimate letters" did not state that additional services would be subject to a "separate written agreement." The letters did provide, however, that the fee did not include other services such as responding to inquiries or tax examinations by the IRS and further stated that a separate fee estimate would be provided for such services. The Court found that that language indicated further services were contemplated, although for an additional fee. The Court concluded that the letters did not establish that the tax services were subject to discrete, separate agreements for each year. The claims relating to the income tax services thus were not barred by the statute of limitations.

Similarly, in *Tayebi v. KPMG, LLP*, 18 Misc. 3d 1139(A), the accountant, KPMG, LLP ("KPMG"), moved for dismissal of the professional malpractice claims against it based on the statute of limitations, arguing that its engagement letter limited its services, which terminated in 2000. The Court found that the engagement letter did not include language which ended the services in 2000, but, rather, the engagement letter indicated the parties contemplated further services pertaining to the alleged malpractice.

The case involved a fraudulent tax shelter scheme known as Bond Limited Issue Premium Structure or BLIPS. In 2000, KPMG convinced its client, Tayebi, to participate in the BLIPS scheme. Tayebi, who had retained KPMG as financial advisors for his medical practice, sold stock in one of his business entities in 2000, yielding proceeds of about \$35 million. KPMG told Tayebi that it was "more likely than not" that the IRS would allow a deduction for losses generated by BLIPS. In 2005, the IRS determined Tayebi's tax return for 2000 was invalid and Tayebi owed more than \$11 million in federal and state taxes.

KPMG had delivered an opinion letter to Tayebi on BLIPS in October 2000. In defense of the claims Tayebi brought against it, KPMG argued that any claim brought after October 2003 would be barred by the statute of limitations. It further stated that its engagement letter with Tayebi explicitly stated that its representation of Tayebi regarding BLIPS ended upon delivery of the opinion letter.

The Court found that the engagement letter contained no such definitive language. Rather, the Court noted that the engagement letter stated KPMG would not only provide Tayebi with the opinion letter, but would also meet with Tayebi "to discuss the U.S. federal income tax implications associated with participation" in BLIPS. The engagement letter also had some limiting language in it; it specifically stated that KPMG would not provide advice on changes in the law or regulations unless engaged to do so in writing. The Court found that the engagement letter did not sufficiently limit KPMG's engagement regarding BLIPS to the opinion letter. The Court looked to the intent of the parties as set forth in the engagement letter and stated that "the nature and scope of the Engagement Letter plays a big role in determining whether the parties contemplated continuous representation." *Williamson v. PriceWaterhouse, LLP*, 9 NY 3d 1 (2007).

In summary, engagement letter language must be carefully crafted to define the services an accountant intends to provide. This is especially true when the accountant provides a variety of services to the client. The accountant needs to evaluate whether, for each service, and for each year of service, there should be a separate engagement letter. By taking care to define the scope of the engagement, the accountant improves its services to the client by better communicating what responsibilities the accountant has, what responsibilities the client has and what limitations there may be on the services to be provided. In addition, as indicated above, a well-drafted agreement letter can help in the defense of a claim, should a dispute arise.

Work Product Doctrine Protection for Tax Accrual Papers on Appeal

By Mark D. Szal, Esq. and Cheryl A. Waterhouse, Esq.

THE CASE OF *UNITED STATES V. TEXTRON, INC.*, 507 F. Supp. 2d 138 (D.R.I. 2007), in which the United States District Court for the District of Rhode Island denied enforcement of an IRS administrative summons seeking “tax accrual workpapers” from a financial services subsidiary of Textron, Inc. is now on appeal to the First Circuit. The District Court held that the workpapers were protected by the work product doctrine. Although the court found the “tax practitioner privilege” and attorney-client privileged were applicable, the court also found that that privileges were waived when the workpapers were provided to an independent auditor. Only the argument that the documents were prepared in anticipation of litigation protected the workpapers from being disclosed to the IRS.

On appeal, the IRS argues that its enforcement responsibilities should carry greater weight than Textron’s interest in preserving work product protection. The IRS asserts that the “primary purpose” of the documents was to support Textron’s reserves and to support the audit, relying in part on the Fifth Circuit’s decision in *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), which denied protection on the basis of the work product doctrine to tax accrual workpapers created “primarily” to support financial statements. The IRS also argues that sharing work product with outside auditors constitutes a waiver of the work product doctrine’s protection. However, the First Circuit has not adopted the “primary purpose” test, but rather applies the “because of” test, which provides protection if the document is created in part in anticipation of litigation. In addition, both AICPA Rules and Congress support the position that sharing work product with an independent auditor does not negate confidentiality.

In the District Court case, the IRS sought copies of tax accrual workpapers underlying Textron’s 2001 tax returns. The documents consisted of spreadsheets containing, among other things, hazards of litigation percentages, reserve amounts should Textron not prevail in litigation, and other drafts, notes, and memoranda containing opinions from in-house tax attorneys and accountants.

Textron refused the IRS request and administrative summons for these documents, and the IRS instituted an action in the district court to compel production. After concluding that the IRS had established that the workpapers were sought for a legitimate purpose and were relevant, the court moved on to consider Textron’s claims that the workpapers were exempt from disclosure.

The court agreed that while preparing a tax return is generally considered accounting work, legal advice provided in connection

with such preparation may be privileged. The court held that the documents sought were protected by the attorney-client privilege, as they provided advice regarding uncertainty in the law, potential liability, and chances of success in litigation.

The court also found that the “tax practitioner privilege” embodied in 26 U.S.C. § 7525 was applicable. That privilege protects tax advice given in confidential communications between a taxpayer and a federally authorized tax practitioner to the same extent that communications between a taxpayer and an attorney would be protected. Further, where Textron’s tax accountants performed “lawyers’ work” in advising Textron regarding tax liability, legal uncertainty, and hazards of litigation of transactions that had already occurred, the opinions contained in the tax accrual workpapers were privileged.

However, by voluntarily disclosing the tax accrual workpapers to an independent auditor, the court found that Textron had waived the attorney-client and tax practitioner privileges. The attorney-client privilege is waived by disclosure to a third party, regardless of whether that third party agrees to maintain confidentiality, and the tax practitioner privilege mirrors that of the attorney-client.

Nevertheless, because Textron had prepared the tax accrual workpapers “in anticipation of litigation,” the court held that the documents were protected from disclosure by the “work product” doctrine. In applying the more inclusive “because of” test rather than the “primary purpose” test, the court found that Textron prepared the tax accrual workpapers because of the possibility of litigation and the need to establish adequate reserves. The court also concluded that the fact this was done in the ordinary course of Textron’s business was of no consequence.

The work product doctrine serves the purpose of preventing an adversary from obtaining documents which would provide an unfair advantage in prospective litigation. As such, because of the independent auditor's professional obligation and express agreement to Textron not to disclose the information contained in the tax accrual workpapers, the court held that the privileged was not waived. It reached this conclusion because the disclosure at issue did not substantially increase the opportunity for potential adversaries to obtain the information contained therein. The court relied upon the AICPA's Code of Professional Conduct section 301, which provides that the auditor has a professional obligation not to disclose confidential client information, and the express agreement of the auditor not to disclose the information. Finally, the court

concluded that the IRS could not show the requisite substantial need for the protected documents. Thus, the court denied the IRS's effort to enforce the summons. The IRS then appealed to the First Circuit.

The First Circuit's decision on this case could significantly impact how taxpayers create and handle workpapers. The issues of whether documents supporting financial statements can be protected by the work product doctrine and whether disclosure to an independent auditor waives the work product doctrine protection are important for taxpayers and their counsel and accountants.

Auditor May Be Primarily Liable for Securities Fraud for Failure to Correct False or Misleading Financial Opinions

By Douglas M. Marrano, Esq.

THE SECOND CIRCUIT COURT OF APPEALS recently ruled that an auditor has a "duty to correct" false or materially misleading statements contained in its reports on a company's financial statements in certain circumstances. The court ruled that a certified public accountant acting as an auditor may be primarily liable for securities fraud under §10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 even if the auditor is unaware that his opinion is false or misleading at the time it is made, if the auditor later learns of the false or misleading opinion and takes no action.

In *Overton v. Todman & Co.*, CPAs, PC, 478 F. 3d 478 (2d cir 2007) Todman & Co., CPAs, and its successor in interest Trien, Rosenberg, Rosenberg, Winber, Ciullo & Fazzari, LLP, (collectively "Todman") audited the financial statements for Direct Brokerage, Inc. ("DBI"), a broker-dealer registered with the Securities and Exchange Commission ("SEC") and the New York Stock Exchange ("NYSE"). Todman issued an "unqualified" opinion that DBI's financial statements accurately portrayed its fiscal health each year between 1999 and 2002. DBI filed its financial statements and Todman's certified opinions with the SEC and NYSE each year.

Todman made a significant error in its 1999 certification resulting in a failure to report DBI's single largest liability. Todman failed to accurately record the liability in 2000, 2001, or 2002.

David Overton and Jerome I. Kransdorf (collectively, "the Plaintiffs") allege that Todman recklessly audited DBI's financial affairs and recklessly opined whether DBI could survive as an ongoing concern. The Plaintiffs allege Todman ignored several serious red flags regarding the accuracy of DBI's financial statements and Todman failed to follow its own recommendation to determine if certain liabilities were understated.

The errors in DBI's financial statements came to light in 2003. After the State of New York opened an investigation, DBI performed an internal review and discovered the discrepancies. DBI hired an outside forensic accounting firm to review Todman's audits. The forensic accounting firm found Todman's audits were deficient and lacking, such that if Todman had properly reviewed DBI's liabilities,

it would have determined a need to further evaluate the materials available and to make additional inquiries of DBI employees.

DBI's unrecorded liabilities resulted in more than \$3 million in back taxes, interest, and penalties. In addition, DBI needed approximately \$1 million in capital to meet SEC and NYSE capitalization requirements. Despite knowing of these problems, Todman failed to take any steps to change or withdraw the 1999 through 2002 certifications.

When DBI sought outside financing to meet financial requirements, DBI provided investors like the Plaintiffs with copies of Todman's 2002 certification of DBI's audited financial statements. The Plaintiffs invested and loaned \$2 million to DBI, which collapsed three months later under the weight of its own debts.

In their complaint, the Plaintiffs alleged Todman made a materially misleading misrepresentation to the Plaintiffs by failing to correct or withdraw the certification of DBI's audited financial statements. The trial court dismissed the single federal claim with prejudice for failure to plead a viable theory of primary liability. The trial court dismissed the remaining state-law claims for lack of subject matter jurisdiction.

In dismissing the federal-law count, the trial court reasoned that 1) federal securities laws do not provide a cause of action for aiding and abetting securities fraud, and 2) DBI was a closely-held company, not publicly traded, and thus concluded that securities laws apply with "less-than-normal rigor, or not at all."

In reversing the trial court, the Second Circuit ruled that an auditor has an affirmative duty, in certain circumstances, to correct its certified opinion. The court stated that previous case law did not provide an opportunity for the court to determine whether an auditor could have primary liability for securities fraud for the failure to correct an audit. Other cases, including the U.S. Supreme Court decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S.Ct. 1439 (1994), held that §10(b) of the Securities Exchange Act of 1934 does not authorize liability for aiding or abetting securities law and that an actor must affirmatively make a material misrepresentation or commit a manipulative act in order for liability to attach. The Second Circuit also cited to its own previous opinion in which the court stated that when an accountant later discovers an opinion or certification that is submitted to the public for its reliance is wrong, the accountant has a duty to disclose the

error to the public. *Shapiro v. Cantor*, 123 F.3d 717 (2d Cir. 1997). Having alluded to an accountant's duty to correct misstatements over the years, the Second Circuit affirmatively stated that:

an accountant violates the "duty to correct" and becomes primarily liable under §10(b) and Rule 10b-5 when it (1) makes a statement in its certified opinion that is false or misleading when made; (2) subsequently learns or was reckless in not learning that the earlier statement was false or misleading; (3) knows or should know that potential investors are relying on the opinion and financial statements; yet (4) fails to take reasonable steps to correct or withdraw its opinion and/or the financial statements; and (5) all the other requirements for liability are satisfied.

The court noted that there are limits to an accountants' potential liability. An accountant only has a duty to correct its prior certified statements, as opposed to updating those statements. In addition, the accountant only has a duty to correct statements that were false when made, as opposed to correcting a statement made misleading by intervening events.

In light of its ruling, the court determined that the trial court erred in dismissing the federal-law claim against Todman. The Plaintiffs pled that Todman's certifications were false or misleading when made regarding DBI's existing liability, that Todman became aware of the false or misleading statements subsequent to the review by the independent forensic accountant, that Todman knew DBI used Todman's certifications to attract outside investors, and that despite its knowledge, Todman took no action to correct or withdraw its certifications. As a result, the Second Court vacated the trial court's dismissal, and remanded the case to the trial court for review of the claim on the merits.

This decision could have broad consequences for accountants and the businesses they audit. As a result of this decision, an accountant must make affirmative efforts to correct or withdraw certifications of financial statements when the accountant learns the certification contained false or misleading statements at the time it was made and knows or should know potential investors may rely on the opinion. To not do so would be to risk being held primarily liable under the securities laws for damage to persons or entities who may rely on those certifications.

May 2008

If Someone Had Only Listened: Financial Accounting Standards Board Chair Refers to FASB Mortgage Loan "Reminder" Issued in December 2005.

Speaking at a conference on May 1, 2008, Financial Accounting Standards Board Chair Robert Herz reminded attendees that the FASB had issued an "unusual" six-page "reminder" in December 2005 that specifically warned about risks involved in investments related to subprime mortgages. The paper, entitled "Terms of Loan Products That May Give Rise to a Concentration of Risk," also known as FASB Staff Position SOP 94-6-1, warned investors and, more specifically, financial preparers (i.e., accountants), that the FASB was aware of "...loan products whose contractual features may increase the exposure of the originator, holder, investor, guarantor or servicer to the risk of nonpayment or realization." Features such as negative amortization, adjustable rates, and interest-only loans were specifically included in the warning as were references to the danger associated with low introductory interest rates, potentially delaying inevitable defaults and losses.

When the paper was issued, the FASB specifically emphasized that financial statement preparers should consider whether the financial statements included sufficient information concerning the risk of such loan products and whether market condition changes required additional disclosures pursuant to various accounting standards including FAS 107.

Mr. Herz also stated that the FASB may change some accounting rules to make it more difficult for banks to get subprime loans off their books, including rules changes that might require banks to keep loans on their books that they previously have been able to package and sell.

Although Mr. Herz' comments were directed to investors and accounting professionals, the potential legal liability arising out of the subprime market problem has now reached attorneys involved at all levels, including those whose only involvement has been representing lenders in foreclosure actions such as the lawsuit filed against CitiMortgage, Inc. in Federal Court in Albany, New York on December 31, 2007 which included claims against the New York law firm of Sweeney, Gallo, Reich & Bolz.

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