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New York Accounting Law Expands Oversight

By Cheryl A. Waterhouse, Esq.

AS THE COUNTRY ATTEMPTS TO DEAL WITH A FINANCIAL CRISIS, New York Governor David Paterson recently signed into law a bill designed to enhance public protection by ensuring greater accountability for CPAs. The law, which clarifies the current functions of accounting professionals, mandates more expansive regulation of the profession.

The changes are welcome and underscore the importance of performing high quality audits and other accounting services. New York's accountancy law was last updated in 1947 and reform bills have been considered by the legislature, as well as promoted by the New York State Society of CPAs, for almost a decade. Last year, the legislature passed this bill and, now that the governor signed the legislation, most of the bill's provisions will take effect in late July of this year, with peer review of CPA firms becoming mandatory in 2012. The mandatory quality review program for firms that provide attest services may be the biggest change for CPA firms. The change should provide the public with increased confidence in accountants and their services.

The new law clarifies and enlarges the scope of accounting services to be regulated, including management advisory, financial advisory and tax preparation and advisory services. In addition, accountants who work for businesses, government and educational institutions are also covered by the bill. All such CPAs must complete continuing professional education requirements. The bill requires CPA firms which provide attest or compilation services to register with the state's Education Department. CPA firms which provide attest services, except for sole proprietorships or firms with two or fewer accountants, must also undergo peer reviews every three years beginning in 2012 in order to renew their registrations. Firms that perform attest services for the state or municipal departments or agencies must undergo external peer review in accordance with government auditing standards of the comptroller general of the United States.

The law also provides for accountants licensed in other states which have significantly comparable CPA licensure requirements to obtain temporary permits, of up to 180 days in one year, to provide attest and compilation services in New York. Under the new law, out-of-state CPAs can perform non-attest services in New York if they are licensed in another state, practice public accounting in that state and agree to comply with New York's laws and regulations and be subject to the jurisdiction and disciplinary authority of the Board of Regents.

This new law will strengthen the quality of accounting services in New York. The provisions of the bill bring New York's oversight of accounting professionals up to date and provide assurances to businesses and individuals that the services accounting professionals provide are being overseen in order to protect the public.

First Circuit Recognizes Applicability of Work-Product Doctrine to Tax Accrual Work Papers

By John B. Connarton, Jr., P.C.

IN A DECISION ISSUED BY THE UNITED STATES COURT OF APPEALS for the First Circuit, the work-product doctrine, protecting documents from disclosure to an adversary, was held to apply to tax accrual work papers prepared by Textron, Inc. and sought by the IRS by way of an investigative subpoena. United States v. Textron, Inc., No. 07-2631 WL 136752 (1st Cir. January 21, 2009).

As with many companies, Textron prepares "tax accrual work papers" which list possibly questionable positions Textron was taking on its tax returns so as to estimate the likelihood that these positions might not withstand an IRS challenge and to establish reserves reflecting the additional tax liability that might result from a required revision of those positions. These work papers and estimates are also prepared for proper reporting of its assets and liabilities and to obtain an independent certification of its financial statements. As part of the auditing process, Textron showed these work papers to its independent auditor, Ernst & Young (E&Y). As a result of the IRS noticing potential tax shelter transactions, it issued an administrative summons pursuant to I.R.C. 7602 for these tax accrual work papers for Textron's 2001 tax returns. Textron refused to comply and the IRS sued to enforce the subpoena.

Textron took the position that it had created the documents in anticipation of a dispute with the IRS regarding the tax returns. The IRS countered that these types of documents were created in the ordinary and normal course of business to comply with securities regulations and, therefore, no privilege would apply. The United States District Court of Rhode Island ruled in favor of Textron on its work-product protection claim and further found that Textron's disclosure of the work papers to E&Y did not constitute a waiver. The court found that Textron's ultimate purpose in preparing the documents was to ensure that it was adequately reserved with respect to potential disputes or litigation with the IRS and that the documents would not have been prepared at all "but for" Textron's anticipated possibility of litigation with the IRS. The court also found that disclosing the documents to E&Y was not a waiver in that the confidentiality rules applicable to the Textron and E&Y relationship did not increase the chances that the IRS would be able to secure the documents.

On appeal, the First Circuit initially addressed the issue of whether tax disputes are "litigation," a necessary prerequisite to the application of the work-product doctrine. Although the IRS argued that the process is not meant to be adversarial, with little difficulty, the First Circuit ruled that while not all IRS procedures in an audit are "litigation,""the resolution of disputes through adversary administrative processes, including proceedings before the IRS Appeals Board, meets the definition of litigation."

As to whether the work papers were prepared in anticipation of litigation, the court rejected the IRS argument that the documents were prepared for other purposes and not subject to the work-product doctrine. The court ruled that where the function of the documents was to analyze litigation for the purpose of creating and auditing a reserve fund, the "driving force behind the preparation" of the documents was the need to reserve money in anticipation of disputes with the IRS. The court also rejected the IRS argument that a business or regulatory purpose for preparing such documents precluded the application of the work-product doctrine, in that " . . . dual purpose documents created because of the prospect of litigation are protected even though they were also prepared for a business purpose." The court also noted that the IRS position would result in documents prepared for this purpose being ultimately subject to production to opposing counsel in the litigation and could disclose counsel's ultimate mental impressions of the case. Summarizing the issue, the court noted that:

> " . . . [I]n the case of tax accrual work papers, the dual purposes—financial reporting and anticipating litigation—are necessarily intertwined; the function of preparing adequate financial reports inherently requires Textron to anticipate and analyze litigation."

Having solidly handed the IRS a major defeat with respect to the major issues in the case, the court did provide the IRS some solace by remanding the case back to the District Court for further findings on the E&Y waiver issue. The court clearly stated that the sharing of the work papers with E&Y by itself did not constitute a waiver. If, however, E&Y had incorporated the contents of the Textron work papers into E&Y's work papers and therefore a review of the E&Y work papers would reveal the information contained in Textron's own work papers, this might constitute a waiver and subject the E&Y work papers to disclosure as well. Although dealing with a fairly narrow fact pattern, the scope of the decision might well apply to situations other than tax accrual work papers. Similar issues exist in many circumstances where various types of litigation or contingent liability reserves are being established which require legal analysis of the underlying potential disputes. Similarly, however, the court's remand on the issue of the content of E&Y's own work papers should provide a cautionary note requiring care in avoiding incorporation of legal analysis into an independent auditor's own work papers.

Document Retention for Accountants

By Justin M. Jagher, Esq.

ACCOUNTANTS HAVE A DISTINCTLY DIFFERENT JOB THAN 25 YEARS AGO, when computers were still "new-fangled" and "e-filing" had not yet begun. It is important for accountants and their firms to remain up-to-date with technology and the legal ramifications of a constantly evolving world. Accountants must be aware of the rules pertaining to document retention and privacy; it is easier now more than ever to obtain information, and accountants must be able to navigate through the various rules and regulations to protect themselves and their clients.

Retention of Records for Accountants

Generally, an accounting firm must retain tax records for a period of three years after the due date of the return or the date the return is actually filed, whichever occurs later. Three years, however, should not be considered the rule, because material prepared for tax returns or produced in connection with an audit are subject to further review by either state or federal regulators. For example, in Massachusetts, records need to be retained so long as their contents are material. Thus, it is important to know your jurisdiction's law and what the applicable statute of limitations

are for a certain claim, and remember that not all jurisdictions are alike. In Massachusetts and New York, an accounting malpractice suit must be brought within three years, and a breach of contract action within six years. However, in California an accounting malpractice suit must be brought within two years, and a breach of contract claim within four years.

For publicly traded companies, the Sarbanes-Oxley Act of 2002 requires retention of records for seven years, and the period must account for potential causes of action that might accrue after accounting services have been provided.

Importance of Policy for Document Retention

As a general rule, erring on the side of caution and retaining documents for at least seven years is preferred. However, certain documents should be retained permanently or returned to the client rather than being destroyed. Furthermore, once you have reached the statutory limit or document retention termination date, what you do with those documents should also be documented. Documents that could be the subject of litigation need to be preserved. It is imperative that your firm have a policy and solid plan in place; disciplined and consistent treatment of records is necessary.

E-Filing

On April 14, when a client visits the accountant's office and the accountant simply has to hit send at the end of the day to file the client's tax return, it is important to note that the accountant, in transmitting that tax return via a software vendor, is sending confidential information to a third party. Although Rule 301 of the AICPA Professional Standards does not require client consent to an accountant using a third-party service provider, it is good practice to obtain client consent before utilizing such a third-party service. Furthermore, the accountant should be assured that the third-party provider has safeguards to protect against the unauthorized release of confidential information to others.

Rule 301 requires that an accountant not disclose any confidential client information without the specific consent of the client, although there are exceptions, such as complying with a subpoena, a summons, or the law and regulations.

The IRS has promulgated provisions that punish those who, both knowingly and unknowingly, release tax information improperly. Violators can be fined and/or imprisoned. The rule of thumb should be that your client always knows exactly how their information is being transmitted, and has always given consent.

If an accounting firm will use email to pass on confidential information, it should take the appropriate measures to make sure that the email is encrypted and password protected. Furthermore, if there is a breach, it must be reported to the client and the legal authorities immediately; it is not advisable to hope that others never catch on to your error!

E-Signatures

The Uniform Electronic Transactions Act, adopted by, at last count, 46 states in the U.S., applies to any electronic record or electronic signature created, generated, sent, communicated, received, or stored after 2003. To obtain legal effect, an accountant must obtain the client's consent to conduct a transaction by electronic means, and the recipient must be able to either print or store the electronic record sent to it.

Privacy Notice Rules

On October 13, 2006, President George W. Bush signed into effect Public Law 109-351, a provision that enabled accountants to escape the gambit of the Gramm-Leach-Bliley Act, which heavily regulates privacy and safety rules. Previously, CPAs were included in the Act and were heavily influenced by the Financial Privacy Rule, which required them to send out annual privacy notices detailing their privacy policies and providing clients with a non-disclosure or opt-out option. The new law, in essence, states that CPAs do not have to send annual privacy notices regarding confidential information when the CPAs are licensed in a state that has rules prohibiting disclosure of confidential information without consent. Considering CPAs were already required to maintain confidentiality under other laws and standards, this was a win for CPAs who now do not have to spend time sending out these notices every year.

However, CPAs still must comply with the Safeguards Rule. CPA firms must establish a written security plan that describes their program to protect client information. The program must be appropriate to the CPA firm's size and complexity, the nature and scope of its activities, and even the sensitivity of the client information at stake. More specifically, a CPA firm must also designate an employee or employees to establish the safeguards, perform risk management regarding the program, and continuously evaluate the program. Particularly important to the Federal Trade Commission is employee management and training, information systems, and detecting and managing system failures.

Destruction of Records

As referenced earlier, any documents concerning, referring to, or related to the subject of any potential, or ongoing legal or regulatory action must be preserved. In addition, every firm should have a policy, in writing, setting forth how long documents, both hard copy and electronic, will be retained by the firm. The policy should be developed with the assistance of management, IT, and counsel, and reviewed and updated yearly. Compliance with the policy should be mandatory. Detailed records should be kept of all documents which have been destroyed.

Accountants should also be sure to communicate their document retention policies to their clients. The policy should be provided to the client in the engagement letter so that the client is fully aware of the document retention policy. Clients should also be informed prior to document destruction.

Conclusion

There is no reason to fear these initiatives; rather they should embraced and explored so that your firm is not only in compliance with the rules, but also current and competitive in today's marketplace.

Accountant Liability When a Corporation Commits Fraud

By Cheryl A. Waterhouse, Esq. & Eliana Nader

IN A CASE IN WHICH ALL PARTIES AGREE that accounting fraud was orchestrated and concealed by senior management of a corporation, should the corporation's accountant be held liable to the unsecured creditors of the corporation in bankruptcy? A federal court in Pennsylvania found that senior management's wrongful acts were imputed to the corporation and, because the corporation was substantially liable for its own injury, the claims against the accountant were barred. The Court of Appeals for the Third Circuit has asked Pennsylvania's highest court for guidance on this issue before ruling on the appeal of that decision. The answers to the questions the federal court is asking could broaden the liability accountants have in cases in which their clients participate in fraud.

The doctrine of *in pari delicto*, which means "in equal fault," provides that a wrongdoer cannot benefit from its own wrongdoing. The premise is that, where the plaintiff and defendant bear equal fault, the position of the defending party is the better one. Courts should not have to expend judicial resources when both parties bear fault. In a case against accountants in Pennsylvania, the United States Court of Appeals for the Third Circuit petitioned for certification two questions of law to the Supreme Court of Pennsylvania. The questions are 1) what is the proper test for determining whether an agent's fraud should be imputed to the principal when an allegedly non-innocent third party seeks to shield itself from liability and 2) whether the doctrine of *in pari delicto* prevents a corporation from recovering against its accountant if the accountant conspired with the officers of the corporation to misstate the corporation's finances to the corporation's ultimate detriment.

The lower court, the United States District Court of Pennsylvania, held that the doctrine of *in pari delicto* barred the creditors' committee's claims against an accounting firm charged with breach of contract, professional negligence, and aiding and abetting breaches of fiduciary duty in the Allegheny Health, Education and Research Foundation ("AHERF") hospital bankruptcy. The Official Comm. of Unsecured Creditors of Allegheny Health, Educ. & Research Found. v. Pricewaterhouse Coopers, LLP, 2007 WL 141059 (W.D. Pa. Jan. 17, 2007). The lower court found that the misconduct of AHERF's corporate officers should be imputed to the corporation and that the creditors' committee stands in the shoes of the corporation.

The Third Circuit, before ruling on the appeal of the lower court's decision, seeks guidance from the state court. The Third Circuit stated that it is unclear whether the three causes of action at issue, negligence, breach of contract and aiding and abetting a breach of fiduciary duty, are subject to *in pari delicto* in the same way. The Third Circuit also wanted the state court's guidance on whether it is proper to apply the doctrine on the basis of imputed conduct.

The background of the case is as follows. In July of 1998, AHERF, a nonprofit Pennsylvania corporation, filed for bankruptcy under Chapter 11 of the Bankruptcy Code. Prior to the bankruptcy, Coopers & Lybrand, now Pricewaterhouse Coopers ("PwC"), audited the financial statements of AHERF and its affiliates. Plaintiff, the Official Committee of Unsecured Creditors of AHERF (the "Committee"), filed suit on behalf of the AHERF estates against PwC, alleging that PwC violated numerous auditing standards which caused AHERF's statements of operations and balance sheets for fiscal years 1996 and 1997 to significantly overstate net income and unrestricted net assets. According to the Committee, PwC's alleged violation led AHERF to follow a flawed business plan that involved the acquisition of hospitals, educational institutions, research facilities, and medical practices that it could not afford. These acquisitions resulted in AHERF's need to file for bankruptcy.

For its part, PwC asserted that the senior management at AHERF knowingly misstated AHERF's financial statements to its auditors in both 1996 and 1997 by directing improper accounting entries. PwC contended that it was entitled to summary judgment on the Committee's claims because the senior management of AHERF, acting in the course of their employment, materially misstated AHERF's financial statements to its auditors. Therefore, the Committee's claims are barred by the doctrine of *in pari delicto*. The court agreed, holding that the wrongdoing of the senior management at AHERF must be imputed to AHERF, and the doctrine of *in pari delicto* barred the Committee's claim.

The doctrine of *in pari delicto* prohibits a party from seeking affirmative relief for losses caused by its own wrongdoing. Essentially, if the conduct of AHERF's senior management could be imputed to the corporation, then *in pari delicto* would bar the suit because AHERF itself would bear fault for the claim.

The court utilized a two-part test to determine whether the fraud of an officer is imputed to the corporation. The officer must commit the fraud (1) in the course of his or her employment, and (2) for the benefit of the corporation. There was no disagreement among the parties that AHERF managers were acting within the scope of their employment in the preparation of the misleading financial statements. The issue, therefore, was whether the managers were acting solely for their own benefit or for the benefit of the corporation.

PwC argued that the conduct of AHERF management must be imputed to AHERF due to the lack of evidence that AHERF's interests were entirely abandoned. The Committee argued that summary judgment is improper because a trier of fact could reasonably conclude that the managers acted to preserve their own employment and reputations, rather than the company's best interest. The Committee's argument is known as the "adverse interest exception." This exception provides that when an agent has entirely abandoned the principal's interests and is acting solely for his or her own purposes, the agent's actions cannot be imputed to the principal.

In support of its holding, the court cited a First Circuit case from Massachusetts entitled Baena v. KPMG, LLP, 453 F.3d 1 (1st Cir. 2006). In Baena, a case with similar facts and arguments as Allegheny, the plaintiff argued that the imputation doctrine did not apply because the officers' interests were adverse to the corporation and not for the benefit of the corporation. The First Circuit, relying on Massachusetts law, found that it is irrelevant that the managers may have reaped benefits themselves; that alone does not make their interests adverse. Affirming the district court's decision to dismiss the action, the First Circuit held that nothing in the record suggested that the managers were acting solely to benefit anyone other than the corporation. The Baena court decided this issue on summary judgment, despite the plaintiff's argument that the adverse interest exception was an issue to be determined by a trier of fact.

The Allegheny court followed the same reasoning as the Baena court. Agreeing with PwC, the court held that there was no evidence in the record to suggest that AHERF's interests were abandoned and that the managers acted solely for their own personal benefit. On the contrary, AHERF received a short term benefit resulting from the managers' deception because the corporation acquired hospitals, educational institutions, and research facilities as a result of the falsified financial statements. The benefits to AHERF from these acquisitions included short-term increases in assets and additional income streams. The fact that the managers may have also seen personal benefits does not by itself trigger the adverse interest exception. Accordingly, the court found that AHERF bore at least substantially equal responsibility for the injury it sought to remedy; therefore, *in pari delicto* barred its claims against PwC.

The Allegheny court also cited a case from the District Court of New York in its analysis. In Wechsler v. Squadrom, Ellenoff, Plesent & Sheinfeld, LLP, 212 B.R. 34 (S.D.N.Y. 1997), the plaintiff, a bankruptcy trustee for the Towers Financial Corporation ("Towers"), brought claims against defendant, Towers' attorney, alleging that the firm breached its fiduciary duty to the company and committed legal malpractice for failing to stop the fraud committed by Towers' CEO. Plaintiff argued that defendant benefitted from this fraud by continuing to earn attorney's fees. As in Allegheny, the court granted the defendant's motion to dismiss on *in pari delicto* grounds, rejecting the plaintiff's argument that the adverse interest exception rule applied. According to the District Court of New York, the wrongdoing must be imputed to the corporation because the complaint failed to allege that an innocent member of Towers' management would have been able to prevent the fraud had he or she been aware of it. Relying on Wechsler, the court in Allegheny was unable to find support for the proposition that an innocent decision-maker would have stopped the wrongdoing.

In a more recent First Circuit case, Gray v. Evercore Restructing L.L.C., 544 F.3d 320 (1st Cir. 2008), the trustee in bankruptcy for High Voltage Engineering Corporation ("HVE") sued financial advisors and legal counsel who had assisted HVE in its original restructing efforts, asserting claims of gross negligence and breach of fiduciary duty, alleging that HVE relied on its professional advisors in providing outdated information that did not accurately reflect HVE's financial situation to the bankruptcy court and that HVE's corporate management were not serving the corporation, but were looking out only from their own self-interest. The Court, relying upon allegations in the complaint, found that the corporation both knew the stale financial data did not accurately reflect HVE's financial situation and knowingly presented it to the bankruptcy court. The doctrine of *in pari delicto* thus defeats the plaintiff's claims. Further, the fact that management received bonuses was not sufficient to invoke the "adverse interest" exemption; the fact that management also received benefits does not alone make their interests adverse.

Allegheny is now before the Supreme Court of Pennsylvania. The first issue before the Supreme Court involves deciding the proper test under Pennsylvania law for determining whether an agent's

fraud should be imputed to the corporation when it is an allegedly non-innocent third-party, here, the accounting firm, that seeks to invoke the law of imputation in order to shield itself from liability. The second issue before the Supreme Court is whether the doctrine of *in pari delicto* prevents a corporation from recovering against its accountants if those accountants conspired with officers of the corporation to misstate the corporation's finances. The answers to these questions could impact accountant liability in future corporate scandals.

Law Firm Can Impose Financial Disincentives on Withdrawing Partners

By Cheryl A. Waterhouse, Esq.

A LAW FIRM'S PARTNERSHIP AGREEMENT, which imposes financial impediments on all partners who leave the firm voluntarily, does not violate public policy considerations protecting clients' rights to choice of counsel, as set forth in the Massachusetts Rules of Professional Conduct. Pierce v. Morrison Mahoney LLP, 452 Mass. 718 (2008). Massachusetts' highest court, which had previously held that a prior provision of the same firm's partnership agreement did violate public policy because it imposed adverse consequences only on partners who left voluntarily and competed with the law firm, determined that, by treating alike all partners who leave the firm voluntarily, the partnership agreement did not limit client choice and thus did not violate public policy.

The rule at issue provides that a lawyer shall not participate in an "employment agreement that restricts the right of a lawyer to practice after termination of the relationship, except . . . concerning . . . benefits upon retirement. . . . " Mass. R. Prof. C. 5.6. The Court made clear that the purpose of the rule is to protect the interests of clients, not lawyers. The rule is designed to prevent restrictions on the ability of a client to make a free choice of counsel. The rule is not designed to protect lawyer mobility. Disincentives to leave a firm, including significant financial disincentives, are acceptable and do not violate public policy.

In the prior case, the partnership agreement at issue provided that monetary benefits, which were based on a partner's allocation of the net worth of the firm, could be distributed to a former partner after he or she left the firm, but only if he or she did not compete with the firm. Thus, partners who competed with their former firm had more adverse financial impacts than partners who left but did not compete. That forfeiture-for-competition provision was deleted and replaced with a provision that all partners would forfeit such benefits upon voluntarily withdrawing from the firm. In the prior case, the Court found the forfeiture-for-competition provision violated public policy. The basis of that ruling is that if a lawyer who leaves is reluctant to represent a former client of his or her former firm because the lawyer will lose certain financial benefits, the client's right to choice of counsel is impeded. In contrast, however, when all partners have the same disincentives when they leave a firm, whether or not they later compete with the firm, clients are not limited in their choice of counsel by the employment agreement's provisions.

Lawyers need to take care when attempting to set forth in their partnership agreements benefits for partners and what happens to those benefits when partners withdraw voluntarily. Public policy may not allow restrictions on partners that ultimately impinge upon client choice of counsel. However, restrictions that apply to all partners may be allowed.

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The Professional Practices Group at Donovan Hatem includes more than 40 attorneys who provide highly-specialized counsel to service professionals. Our experienced trial lawyers represent professionals in jury and non-jury cases, in the northeast and nationwide. In addition to professional liability claims defense, Donovan Hatem's scope of expertise encompasses risk management, contract review, and general business matters.

- The Donovan Hatem Professional Practices Group assists accountants with risk management advice, with the drafting and review of contracts and engagement letters, and with expanding their scope of professional services. The Group also represents accountants in Internal Revenue Service-related matters, including assisting them in producing documents and representing them at depositions.

- The Donovan Hatem Professional Practices Group represents attorneys in litigation involving professional liability claims in state and federal courts, at mediations, arbitrations, and other dispute resolution forums, and before the Board of Bar Overseers.

To learn more, please visit our website at www.donovanhatem.com.

The Accountant/Attorney Liability Reporter

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