West LegalWorks

17th Annual Litigation and Resolution of Complex Class Actions Workshop

November 1-2, 2007
San Francisco, CA

Litigation Against Accountants and Lawyers: The Year of Living Dangerously

Jonathan C. Dickey
Gibson, Dunn & Crutcher LLP
Palo Alto, California

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I. INTRODUCTION

This term, the U.S. Supreme Court will decide a watershed case involving the issue of whether primary liability under Section 10(b) of the Exchange Act extends to secondary actors who are alleged to have participated in a "scheme" to defraud. In *Stoneridge Partners LLC v. Scientific Atlanta,* the Court specifically will address the issue of whether certain "counter parties" to transactions with Charter Communications can be sued, even though those defendants did not make any false statements themselves, and are not alleged to have owed a duty to Charter Communications shareholders. But the potential import of the case reaches well beyond the fact pattern involved in *Stoneridge,* and could provide important guidance with respect to the liability of accountants and lawyers under Section 10(b). At least, that's what people think, given the enormous number of amicus briefs that have been submitted to the Court in the *Stoneridge* case. The scope of primary liability under Section 10(b) is not an idle issue for lawyers and accountants, judging from the results of a number of recent cases in which audit firms have been sued, and their motions to dismiss denied, in various federal securities class actions.[1]

Regardless of the outcome in *Stoneridge,* lawyers and accountants continue to be exposed to regulatory proceedings by the SEC and other federal and state agencies, where such secondary actors can be sued for "aiding and abetting" and other civil remedies that are not available to private litigants suing under the federal securities laws.

Another trend in the past few years is the frequency with which plaintiffs in high-profile cases have attempted to sue foreign affiliates of U.S. accounting firms—or vice versa-- under theories of vicarious liability. The theory under which some of these claims is brought is the so-called "one firm" theory, in which plaintiffs typically contend that all affiliates of the same global accounting firm act as a single, unified firm, and therefore all such firms should be responsible in damages for the transgressions of any of the affiliated firms. The "one firm" theory has been successfully exploited most notably in the *Parmalat* litigation,[2] and has been vigorously litigated in the *Royal Ahold* litigation and other cases.[3]

Finally, it has escaped no one's attention that in the last year, in-house lawyers are in the spotlight as never before, particularly due to the number of high-profile cases brought by the government against general counsels over their alleged role in backdating of stock options.[4] Although these cases have grabbed headlines, the numbers of such cases are still relatively small,

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[1] See Section II(A) *infra*.

[2] *In re Parmalat Sec. Litig.,* 375 F. Supp. 2d 278 (S.D.N.Y. 2005) ("*Parmalat I*"); *In re Parmalat Sec. Litig.,* 377 F. Supp. 2d 390 (S.D.N.Y. 2005) ("*Parmalat II*"); *In re Parmalat Sec. Litig.,* 2007 U.S. Dist. LEXIS (S.D.N.Y. Feb. 21, 2007).

[3] *In re Royal Ahold N.V. Sec. & ERISA Litig.,* 351 F. Supp. 2d 334 (D. Md. 2004); *In re Royal Dutch/Shell Transport Sec. Litig.,* 380 F. Supp. 2d 509 (D.N.J. 2005); *In re Lernout & Hauspie Sec. Litig.,* 230 F. Supp. 2d 152 (D. Mass 2002).

[4] See Section III(D)(2) *infra.*

and fact-specific. Indeed, one can conclude that all of the cases brought against lawyers in 2006-07 appear to involve conduct that included some element of knowing participation, and personal benefit. Thus, it remains the case that the SEC does not appear to be suing lawyers for mere "sins of omission," despite the concerns within general counsel circles.

II. LITIGATION AGAINST ACCOUNTANTS

A. Issues Affecting the Exposure of "Big Four" Accounting Firms

1. Private Civil Actions Against Auditors Continue to Pose Liability Risks

The exposure of audit firms to large claims continues, although in 2006 the number of civil class actions alleging accounting fraud seems to have dropped from the levels of prior years,[5] and certainly has declined in relation to the number of accounting restatements reported by public companies in the last 24 months.[6] The data on how much accounting firms have paid to resolve private litigation and/or regulatory claims is not well compiled. There have a few "mega" settlements in 2006 in which significant settlement payments were made by accounting firms, including several settlements by now-defunct Arthur Andersen.[7] Moreover, according to one study released earlier this year, over 90% of all new class action suits filed in 2006 included allegations of false financial statements. The same study reported a sharp increase in the number of cases alleging specific accounting irregularities, from 44% in 2005 to 68% in 2006.[8]

At the same time, however, accounting firms have successfully moved to dismiss a number of class action cases brought them in the last 24 months, an indication that the PSLRA heightened pleading standards, combined with recent decisions narrowly construing the scope of primary liability under Section 10(b) of the 1934 Act, continue to deter at least some meritless claims against accounting firms.[9]

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[5] According to the PricewaterhouseCoopers 2006 Securities Litigation Study, securities class action cases based on restatements declined from 82 in 2002 to only 37 in 2006. Similarly, the number of SEC Litigation Releases related to new accounting cases declined from 61 in 2002 to 30 in 2006.

[6] *Glass, Lewis Analyst Says Restatements On Track to Set Another Record in 2006,* Securities Regulation & Law (BNA) (Nov. 6, 2006).

[7] Examples include Arthur Andersen's settlement of Enron-related class action claims for the sum of $72,500,000.

[8] *Securities Class Action Case Filings: 2006, A Year in Review*, at 19 (Cornerstone Research), available online at www.cornerstone.com.

[9] *See, e.g., Ezra Charitable Trust v. Tyco International Ltd*, 466 F.3d 1 (1st Cir. 2006) (dismissing claims against PricewaterhouseCoopers notwithstanding Tyco's restatement of results, and holding, inter alia, that the mere fact of restatement does not give rise a strong inference of scienter). Other recent cases in which claims against accounting firms have been dismissed include *In re Royal Ahold Sec. & ERISA Litig.,* 2007 U.S. Dist. LEXIS 45935 (D. Md. June 18, 2007), in which the court ruled that plaintiffs' proposed amended complaint, adding new allegations against Deloitte & Touche Netherlands and Deloitte & Touche LLP, failed to state a claim. *See also In re SeraCare Life Sciences Inc. Sec. Litig.*, 2007 WL 935583 (S.D. Cal. March 19, 2007) (claims against KPMG dismissed); *In re Parmalat Sec. Litig.,* 2007 WL 2263893 (S.D.N.Y. August 8, 2007) (dismissing state law claims against Deloitte

[Footnote continued on next page]

A few recent examples of litigation brought against accounting firms highlight the concern of potentially crippling litigation. In May 2007, for example, a federal court rejected the summary judgment motion of one of the "Big Four" audit firms to dismiss claims against it by a bankruptcy trustee, arising out of the audit of SmarTalk Teleservices.[10] In that case, Plaintiffs alleged that the audit firm owed fiduciary duties to the company, and the district court held that there was a material fact dispute on that issue. Similarly, in August 2007, a major investor in Refco, T.H. Lee Equity Fund, sued Refco's former audit firm, Grant Thorton, over its role in the alleged fraud at Refco. Among other allegations, the suit charges that the lead audit partner had privately raised concerns about Refco prior to its public offering, and that Grant Thorton "failed to warn" investors.[11] Also in August 2007, a Miami jury awarded over $500 million indamages to a Cayman Islands banking group that sued BDO Seidman for accounting negligence in connection with a loan fraud scheme at Nassau-based E.S. Bankest L.C.[12]

This term, the United States Supreme Court will decide the critical issue of the scope of liability of "secondary actors" sued under Section 10(b) of the Securities Exchange Act, in a case that is closely watched by the accounting profession. In *Stoneridge Insurance v. Scientific Atlanta,* docket no. 06-43 (cert. granted March 26, 2007), the specific issue concerns the potential liability of "counterparties" in fraudulent transactions who did not themselves make any false statements, or otherwise have any legal duty to the shareholders of Charter Communications. In August 2007, the American Institute of Certified Public Accountants ("AICPA") filed an amicus brief in the action, arguing, *inter alia,* that extending primary liability to "secondary actors" in the manner advocated by plaintiffs would impair the quality of financial reporting by public companies because audit firms frequently perform services that do not involve audit work, and that such services could be swept into the litigation arena, including the quarterly review services that audit firms typically perform for public company clients. "As a result," the AICPA argues, " rational auditors may conclude that the safest course is to have nothing to do with any transaction or statement by a public company that has not been subjected to a formal audit." The views of the AICPA are echoed in an amicus brief filed by the Solicitor General of the United States. The government's brief noted, *inter alia,* that the scope of primary liability espoused by appellants "would expose not only *accountants and lawyers who advise issuers of securities*, but also vendors (such as respondents) and other firms that simply do business with issuers…" (emphasis added).

If the Court affirms the Court of Appeals decision in *Stoneridge*, the rate of securities class action cases against audit firms may diminish further. In the absence of more concrete reforms, however, audit firms no doubt will continue to face the prospect of catastrophic losses.

[Footnote continued from previous page]
and Grant Thorton entities); *Lundeen v. PricewaterhouseCoopers,* 919 A.2d 561 (Del. March 5, 2007) (granting summary judgment in favor of PwC).

[10] *In re SmarTalk Teleservices, Inc. Sec. Litig.,* 487 F. Supp. 2d 928 (S.D. Ohio May 22, 2007).

[11] *Refco Auditor New Target in TH Lee's Spate of Suits* (Securities Law 360, August 17, 2007).

[12] *Florida Jury Awards $521 Million to Bank In Suit Over BDO Seidman Audit Negligence,* Corporate Accountability (Vol. 5, No. 33, August 17, 2007).

2. Exposure of Accounting Firms and Audit Partners to SEC and PCAOB Enforcement Remedies

SEC Enforcement

In recent years, the SEC has used its enforcement authority frequently, and has brought administrative and court proceedings against audit firms and audit partners for violations of the federal securities laws. Recent statistics suggest that the SEC also is stepping up its enforcement efforts against individual audit partners. In 2006, the number of such actions was 27, up from the prior four year average of about 21 cases per year. Similarly, the number of 2-4 year suspensions of audit partners jumped in 2006, from an average of about 9 per year to 14 in 2006.[13] These statistics do not include any proceedings separately initiated by the PCAOB pursuant to its own independent enforcement powers over audit firms and audit partners.[14] For a representative summary of recent SEC proceedings against audit firms and audit partners, see Appendix A to this paper.

A few recent examples demonstrate the range of exposures audit firms face with the SEC. In December 2006, for example, an Ernst & Young partner settled an SEC enforcement action concerning audit issues at PNC Financial Services Group.[15] The audit partner accepted a settlement in which he agreed, without admitting or denying the charges, that he was a cause of PNC's antifraud, reporting and recordkeeping violations, and also violated auditor independence rules. Similarly, in another SEC settlement, an audit partner agreed to a three-year suspension as a result of charges of accounting negligence in connection with his audit work for two different investment funds.[16] Other examples of SEC actions in the period 2003 to 2006 against audit partners and audit firm can be found in connection with financial mishaps at such diverse companies as Warnaco, Gemstar, Xerox and California Micro Devices. The much-publicized battle between government prosecutors and of certain KMPG partners over their involvement in allegedly improper tax shelters is just one of several prominent cases currently on the docket.[17]

PCAOB

The PCAOB has been given broad powers under Section 105 of the Sarbanes-Oxley Act to investigate and discipline accounting firms and audit partners. In September 2003, the

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[13] *SEC v. Auditor—A Five Year Overview of SEC Enforcement Actions Against Accountants,* Accountants' Liability Alert (2007) [authored by Hughes Hubbard & Reed LLP].

[14] See Section II(A)(2) for a brief summary of recent PCAOB developments.

[15] *In re Joseph,* SEC Admin Proc. File No. 3-12502 (December 11, 2006).

[16] *In the Matter of James T. McCurdy,* SEC Admin. Proc. File No. 3-12322 (December 15, 2006).

[17] In *United States v. Stein,* 2007 WL 2050921 (S.D.N.Y. July 16, 2007), the court dismissed indictments against certain KPMG partners accused of misconduct in that matter. The dismissal followed heated motion practice concerning government actions that allegedly placed pressure on KPMG to not advance defense costs to the partners in question, in which the defendants argued that the denial of advancement amounted to a violation of due process. The district court agreed, finding that the conduct of the U.S. Attorney's office "shocked the conscience."

PCAOB adopted rules that govern its investigations and adjudications, and since then has—slowly—begun to exert its new powers to police the audit profession. As of September 10, 2007, the PCAOB website lists only nine disciplinary proceedings since it began this effort. By contrast, the website lists hundreds of inspections that the PCAOB has conducted, including a dozen against the "Big Four" accounting firms (six of them in 2007 alone).

In April 2006, new auditor independence and ethics rules were approved by the SEC, as proposed by the PCAOB. These new rules include, for example, new restrictions on an outside auditor from providing tax services to persons at an audit client who perform a financial reporting oversight role. These auditor independence rules have led to debate over where the appropriate line should be drawn on the giving of advice to smaller public company clients.

In January 2007, the PCAOB released its "Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud." This 14-page release is a clarion call to auditors that fraud detection is "an important focus of the Board." Towards that end, the release encourages auditors to have "brainstorming sessions" with the audit team, and to "set aside any prior beliefs" that the audit team has about the integrity or honesty of management.

In July 2007, the SEC approved a new PCAOB Auditing Standard No. 5, governing "an audit of internal control over financial reporting that is integrated with an audit of financial statements." This new rule controls audits ending on or after November 15, 2007. The new standard replaces old Standard No. 2, which had proven controversial as it related to auditing of internal controls under Sarbanes-Oxley Section 404. The new standard, inter alia, allows auditors to rely more on their own professional judgment, but with an increased emphasis on "fraud controls."

These examples of recent PCAOB initiatives serve as a reminder that the audit profession is being scrutinized as never before. Further, if and to the extent the PCAOB imposes disciplinary action against an audit firm or audit partner, the public nature of such discipline may serve to fuel parallel private civil litigation in the future.

3. Potential Exposures Under a "Principles-Based" System of Accounting

In 2002, as part of the enactment of the Sarbanes Oxley Act, Congress directed the SEC to report on efforts to move U.S. GAAP standards from the detailed "standards based" accounting rules now in place, to a more "principles-based" standard of accounting.[18] In July 2003, the SEC released its initial study on principles-based accounting. The SEC Study largely dismissed the concern over increased litigation risks that a "principals-based" accounting system might create. "We believe . . . that the concern over litigation uncertainty is sometimes

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[18] *See* Section 108(d) of the Sarbanes-Oxley Act of 2002 (requiring the Commission to prepare the study on principles-based accounting by July 31, 2003).

overstated and may arise our of a confusion between principles-based and principles-only standards."[19]

Since issuance of the SEC Study, SEC officials have joined with the Financial Accounting Standards Board (FASB) and other market participants to study how to make the nation's accounting standards less complex.[20] In general, "principles based" accounting standards encourages the exercise of accounting judgment, rather than reliance on bright line rules and technical standards. The current GAAP system is based on a myriad of principles, rules, interpretations, and standards. This "standards-based" regime recently was described by former SEC Commissioner Cynthia Glassman as follows:

> The financial reporting landscape is littered with pronouncements from the FASB, the AICPA, the EITF, the APB, the SEC and the PCAOB. We have pronouncements, rules, regulations, guides, bulletins, audit standards, interpretations and practice aids in the form of SOPs, FAQs, SABs, Q&As and FSPs. This has been going on for decades. The result today, U.S. GAAP is made up of over 2,000 pronouncements. That's a lot of ABC's, even for a CEO or CFO with a CPA.[21]

In contrast to a "standards-based" accounting system, FASB Chairman Robert Herz described "principles-based" accounting this way:

> Under a principles-based approach, one starts with laying out the key objectives of good reporting in the subject area and provide them as guidance explaining the objectives and relating it to some common examples. While rules are sometimes unavoidable, the intent is not to try to provide specific guidance or rules for every possible situation. Rather, if in doubt, the reader is directed back to the principles.[22]

Supporters of a principles-based system believe it will foster a more nuanced exercise of accounting judgment. However, certain constituencies have expressed the fear that a "principles based system" may expose them to greater risk of litigation. Without technical standards to point to, these constituents fear that regulators and private plaintiffs' lawyers will have too much latitude to second guess an accountant's exercise of judgment.

SEC officials continue to assure the business community that a "principles-based" system will not result in "gotcha" enforcement actions,[23] but a number of senior executives and accounting professionals are still skeptical. According to a recent survey by CFO.com magazine,

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[19] *See* Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (July 25, 2003).
[20] *See* Sec. Reg. & L. Rep. (BNA), (June 12, 2006); *see also* Sec. Reg. & L. Rep. (BNA) (June 19, 2006) quoting former SEC Commissioner Cynthia Glassman.
[21] Cynthia Glassman, former SEC commissioner, speaking at 25th Annual USC Leventhal School of Accounting SEC and Financial Reporting Institute Conference, Sec. Reg. & L. Rep. (BNA) (June 19, 2006).
[22] Remarks of Robert H. Herz, FEI Current Financial Reporting Issues Conference, (Nov. 4, 2002).
[23] Remarks of Linda Thomsen, SEC Director of Enforcement, 2006 Securities Regulation Institute (January 2006).

36 percent of CFO's who oppose principles-based accounting cited the risk of major shareholder lawsuits as a reason for concern. "If principles-based accounting is going to work, we need to be presumed to be right," said one financial executive.[24] "The big concern is that we make a legitimate judgment based on the facts as we understand them, in the spirit of tying to comply, and that plaintiffs' attorneys come along later with an expert accountant who says, 'I wouldn't have done it that way,' and aha! – lawsuit! – several billion dollars, please."[25] "CFO's are second-guessed by auditors, who are then third-guessed by the Public Company Accounting Oversight Board [PCAOB], and then fourth- and fifth-guessed by the SEC and the plaintiffs' bar."[26] It is not yet clear that "principles" can stop this pattern of "Monday morning quarterbacking."

The SEC, the FASB, and the PCAOB all appear to have made principles-based accounting a priority issue for the next year. In 2006, principles-based accounting has been promoted in speeches by SEC Chairman Christopher Cox, SEC Commissioner Paul Atkins, FASB chairman Robert Herz, and former SEC deputy chief accountant Scott Taub.[27] On March 23, 2006, for example, Scott Taub, the SEC's then-acting chief accountant, said that he is "a little disheartened" because the implementation of the new "objectives-oriented standards" "to my mind has not been principles-based."[28] In December 2006, the SEC's Chief Accountant, Conrad Hewitt, publicly declared that the issue of accounting complexity will be a leading topic of work by his office in 2007.[29] PCAOB Director of Registration and Inspection, George H Diacon, recently stated, "we shouldn't be second-guessing reasonable decisions made in the accounting field, however, PCAOB inspectors should challenge judgments that are not in the 'reasonable range.'"[30]

John White, director of the SEC Division of Corporation Finance, recently spoke to this topic. In response to the question, "what standard is used by Staff to determine when the company has complied with or failed to comply with principles-based regulation?" He said, "we understand that there is not a specific rule out there for every circumstance" and that the Staff will proceed "in good faith."[31] FASB Chairman Robert Herz seems to have acknowledged the

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[24] *Standing on Principles*, CFO Magazine (September 1, 2006) quoting David Rickard, CFO of CVS Corp. and Financial Accounting Standards Advisory Committee ("FASAC") member, available at *http://www.cfo.com/article.cfm/7852613/c_7850066*.
[25] *Id.*
[26] *Id.* (quoting Colleen Cunningham, president and CEO of Financial Executives International).
[27] *Standing on Principles*, CFO Magazine (September 1,2006), available at *http://www.cfo.com/article.cfm/7852613/c_7850066*.
[28] *Top SEC Accountant Requests 'Principles-Based' Use of Rules*, Securities Regulation & Law, (April 3, 2006).
[29] *SEC's Hewitt Says Accounting Complexity Is 'High Priority' Issue for Agency in 2007*, BNA Corporate Accountability, Vol. 4 No. 48 (December 15, 2006).
[30] Remarks of George H. Diacont, American Institute of Certified Public Accountants conference, Sec. Reg. & L. Rep. (BNA) (Nov. 20, 2006).
[31] Remarks of John White, director of the SEC's division of corporation finance, speaking at the Annual Securities Regulation Conference of the Practicing Law Institute, Corporate Accountability Report (BNA) (November 17, 2006).

issue when he remarked that "if it turns out some of the obstacles are hardwired into our structure, then maybe we need some legal changes as well."[32]

Will regulators be willing to consider some form of "safe harbor" for auditors exercising judgment under a new "principles-based" accounting system? At least one recent study urges such a solution. In November 2006, the Committee on Capital Markets Regulation made a number of recommendations for adjustments to our regulatory and litigation framework so that public markets are less burdensome. The Committee expressly recognized that regulators must reduce the risk of litigation to corporations, auditors, and outside directors, and specifically recommended that Congress consider enactment of safe harbors for certain auditing practices.[33]

Treasury Secretary Henry Paulson recently stated that auditors must be able to focus on ensuring the integrity and economic substance of management's financial statements. To get there, he said, accounting must be recognized as a profession, and not a science.[34] The goal Treasury Secretary Paulson suggests is an important one. More likely than not, the effort towards implementation of a "principles-based" accounting system will be "a long one."[35] As noted last year by Scott Taub, the SEC's former Interim Chief Accountant:

> Unfortunately, we have gotten to a place today where there is something of an aversion to applying judgment. Often, the answer people seek is whichever one is perceived to be the safest, but those answers are not always the most transparent for investors. And we constantly get calls for every potential interpretive matter to be documented and the answer officially blessed. This, of course, leads us further into complexity and rules-based accounting, places that most of us say we don't want to go.[36]

4. Contractual Limitations on Auditor Liability

In some cases accounting firms have taken steps to allocate litigation risk by including indemnity agreements in their engagement letters with clients in certain circumstances. Existing AICPA ethics rules permit such indemnification if, for example, there were knowing misrepresentations by management.[37]

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[32] *Standing on Principles*, CFO Magazine (September 1, 2006) quoting FASB chairman Robert Herz, available at *http://www.cfo.com/article.cfm/7852613/c_7850066.*

[33] Interim Report, supra note 34, at p. 80.

[34] *Treasury Secretary Urges Principles-Based Accounting and Internal Controls Reform,* SEC Today (Nov. 27, 2006).

[35] Remarks of SEC Chairman, Christopher Cox speaking at the SEC Historical Society Annual Meeting, Securities Regulation & Law Report (BNA) (June 12,2006).

[36] Remarks of former SEC Acting Chief Accountant, Scott Taub, speaking at the SEC Historical Society Annual Meeting, (June 6, 2006).

[37] *See, e.g.,* AICPA Ethics Ruling 94.

The SEC's position on this matter—at least as reflected in the Staff's answers to "Frequently Asked Questions" in 2004-- has been that an accountant's independence may be called into question if the accountant enters into an indemnity agreement with the registrant, if the indemnity purports to provide immunity to the accountant against liability for his or her own negligent acts. Likewise, the SEC has stated that indemnity agreements that protect auditors from liability caused by "knowing misrepresentations by management" may impair independence.[38]

During 2006, the AICPA began a process of reevaluating whether and to what extent audit firms may limit their liability through contractual indemnification agreements with their audit clients. The issue was brought forward most directly in an exposure draft issued by the AICPA's Professional Ethics Executive Committee in September 2005 that would allow auditors to limit liability under certain circumstances. Based on a limited number of comments received, the PEEC issued its proposed Interpretation 101-166 in September 2006. The proposed Interpretation would authorize audit firms to enter into indemnification agreements with their clients only if the audit firm has performed the audit services "in accordance with professional standards, in all material respects." The proposed Interpretation found that certain other actions, however, would not impair independence, including 1) indemnification for punitive damages claims by third parties, 2) "reasonable" time limitations on when an audit client may sue the auditor, and 3) ADR provisions mandating arbitration of auditor malpractice or other claims.

The proposed Interpretation has been met with mixed reactions from the accounting profession. Several comment letters on the proposed Interpretation were critical of the conditions placed on indemnification, particularly given the vagueness of the "in accordance with professional standards" condition.[39] Hearings on the proposed Interpretation that were supposed to have been held on November 30-December 1, 2006 were taken off calendar.[40]

Whether agency actions will affect the use of limitation of liability provisions in the future remains to be seen. In the meantime, the overarching issue remains, and audit firms continue to face liability risks without reliable protections against their own audit clients' misconduct.

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[38] Application of the Commission's Rules on Auditor Independence—Frequently Asked Questions (December 13, 2004).

[39] *See, e.g.,* December 8, 2006 comment letter from Deloitte & Touche. As well, the Technical Issues Committee of the AICPA objected to the proposed deletion of its Ethics Ruling 94.

[40] In the wake of the original PEEC exposure draft in September 2005, various federal agencies with regulatory authority over banking and financial institutions collaborated on an "Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters." This advisory declares it to be an "unsafe and unsound" practice for audit firms to use certain "limitation of liability" provisions in connection with audits of financial institutions.

B. Reform Proposals Directed to Protection of "Big Four" Accounting Firms

1. The "Paulson Committee" Report

The Paulson Committee Report includes several proposed reforms directed to the issue of auditor liability. The Report discussed the increasing liability risks posed to the remaining "Big Four" accounting firms, and the possible impairment of consumer choice if one of those firms were to fail. The Report noted in particular that there are more than three dozen cases involving tens of billions of dollars of potential exposure to accounting firms, and expressed the concern that even a relatively small share of proportional liability in these cases may lead to the financial failure of one of the remaining firms. "For the profession itself, there is consensus both inside and out that the demise of one of the remaining Big Four could have adverse consequences for audited companies and their shareholders."[41]

In light of these concerns, the Report suggested several possible reforms:

- Create a safe harbor for certain defined auditing practices;
- Set a cap on auditor liability in certain circumstances;
- Grant regulators specific powers to appoint "monitors" to oversee operations of audit firms found to have engaged in systemic failures in process, management or personnel;
- Clarify and limit an auditor's duties under Section 10A; and
- Restrict criminal indictments against firms, as opposed to individual audit partners.

In light of the Committee recommendations, on May 17, 2007 the U.S. Treasury Department announced that it was appointed a Committee, headed up by former SEC Chairman Arthur Levitt and former SEC Chief Accountant Donald Nicolaisen, to consider possible reforms relating to the accounting profession. The group will examine the accounting industry in an effort to "address auditing industry concentration, and to consider options available to strengthen the industry's financial soundness and its ability to attract and retain qualified personnel."

As of the date of this paper, the near-term prognosis for the Report's recommendations with respect to auditor liability is unclear. But recent public remarks by the SEC's Chief Accountant, Conrad Hewitt, suggest that support for some form of liability reform for audit firms is building.[42] In similar remarks last year on the subject of liability protection for audit firms, Mr. Hewitt is reported to have said that "I definitely think it needs to be looked at."[43]

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[41] Interim Report of the Committee on Capital Markets Regulation ("Report"), p. 87.

[42] Remarks of Chief Accountant Conrad Hewitt, SEC Speaks, February 9, 2007.

[43] *Concerned About Lawsuits Against Auditors, Top SEC Accountant Eyes Liability Safeguards*, BNA Corporate Accountability, Vol. 4 No. 48 (December 15, 2006).

2. The Bloomberg-Schumer Report

The 2007 Bloomberg-Schumer Report makes one recommendation directed at the protection of audit firms, echoing the Paulson Committee report. Specifically, the Bloomberg-Schumer report proposes imposition of a "cap" on auditor damages that would maintain the deterrent effect of large financial penalties, while also reducing the likelihood of the highly concentrated US auditing industry losing another major player.

3. Commission on Regulation of the U.S. Capital Markets in the 21st Century

This Commission recommends that domestic and international policy makers "seriously consider proposals… to address the significant risks faced by the public audit profession from catastrophic litigation." The Commission includes representatives from stakeholders from the mutual fund and pension fund industries, as well as financial services firms, the insurance industry, and other important industry representatives. Among other findings, the report states that "sustaining a strong, economically viable, public company audit profession is vital to domestic and global capital markets," and that this condition is threatened by the current climate of civil litigation and regulatory proceedings against accounting firms.[44] Specific recommendations of the Commission include:

- Focus any criminal indictments on culpable individuals within audit firms, not the firms themselves;

- Create a national charter, similar to the national bank charter, that would confer positive benefits for audit firms by replacing the multiplicity of conflicting state regulations now facing audit firms;

- Include international audit firm liability issues as a topic to be addressed by the Group of Eight (G-8) countries;

- Expand the overall capacity of the audit profession through expansion of the next tier of audit firms below the Big Four; and

- Strengthen the ability of audit firms to use arbitration or other ADR solutions instead of litigation in the court system.

4. European Commission Proposals

The concept of liability "caps" also is being considered by the European Commission as a means of avoiding the failure of any of the major audit firms practicing in the EU. Among the ideas being considered by the European Commission are:

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[44] Commission of the Regulation of U.S. Capital Markets in the 21st Century: Report and Recommendations (March 2007), available on the Commission website at www.CapitalMarketsCommission.com.

- Fixed monetary caps at the European level;
- Caps based on market capitalization of the audited company;
- Caps based upon a multiple of audit fees; and
- Proportionate liability based upon degree of responsibility.

Charles McGreevy, an EU Internal Market commissioner, voices support for these ideas: "there is a real danger of one of the Big 4 being faced with a claim that could threaten its existence," he said.[45] The European Commission has established an "Auditors Liability Forum" to consider the issues, comprised of representatives from the Big Four firms, as well as other constituencies. In January 2007, the European Commissions issued a Staff Working Paper on "Auditors Liability and Its Impact on the European Capital Markets," in which it noted an array of potentially adverse consequences if another Big Four audit firm were to fail, and also the challenges to attracting new audit firms to step forward. The Commission's Working Paper was largely based upon an independent study by London Economics.[46]

In sum, the idea of some form of liability "caps" or other reforms relating to litigation against auditors is gaining traction both in the United States and Europe. In the next year, we should expect to see greater clarity on whether meaningful reforms will be enacted.

III. LITIGATION AGAINST LAWYERS

"About half the practice of a decent lawyer is telling his clients that they are damned fools and should stop."

– Elihu Root, Lawyer, Statesman, Nobel Laureate

A. Lawyers Under Fire with Federal Regulators

Historically, the SEC has been extremely cautious about prosecuting civil claims against attorneys based on their legal advice to corporate clients. Perhaps out of concern that either its enforcement powers were not sufficiently strong,[47] or that the facts were not sufficiently strong, the SEC brought only a handful of enforcement actions against lawyers prior to 2002.

In the wake of the Enron and Worldcom debacles, the SEC began stepping up its enforcement actions against lawyers and accountants, and also began bringing more primary liability claims against lawyers under antifraud statutes. In September 2004, the then-sitting

[45] *EU Calls for Input on Auditor Liability Caps,* Compliance Week (Feb. 6, 2007).
[46] *EU Call for Opinions on Auditor Liability Caps*, Compliance Week (April 2007)
[47] Prior to 2002, the SEC typically disciplined lawyers under its Rules of Practice by instituting administrative proceedings to either suspend or disbar them from practicing before the Commission.

Director of the SEC's Division of Enforcement announced the SEC's intent to target attorneys in enforcement actions, stating that the pursuit of lawyers as "gatekeepers" was "the most targeted and effective way of using the agency's limited enforcement resources [and therefore] we have stepped up our scrutiny of the role of lawyers in the corporate frauds we investigate."[48] That clarion call has been renewed by the current Director of Enforcement, Linda Thomsen, in recent remarks concerning the stock option backdating scandal: "we will still look at lawyers," she declared.[49]

While lawyers have been placed "on notice" that their conduct was under the SEC microscope, the SEC nevertheless has taken the stance publicly that it would not prosecute attorneys based on acts of simple negligence.[50] In line with this philosophy, the SEC primarily has targeted lawyers who engaged in or were directly involved in the conduct that resulted in the violation, and therefore most cases against lawyers are based upon the attorney's aiding and abetting the company's securities violations (where the claim requires actually awareness of the improper conduct).

B. 2005 Enforcement Actions

In 2005, the number of SEC enforcement actions against lawyers increased.[51] The SEC's Chief Litigation Counsel explained that targeting gatekeepers provided the "best bang for the buck" given a gatekeeper's ability to prevent many cases of fraud before they occur.[52] As late as April 2005, however, SEC officials were not publicly deviating from past statements that the "Commission ordinarily will not sanction lawyers under the securities laws merely for giving bad advice, even if that advice is negligent and perhaps worse ."[53] The SEC Chief Counsel stated that the Staff was looking at cases in which the lawyer "knows something is wrong, but went in the wrong direction." [54]

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[48] Stephen M. Cutler, Director of the SEC Division of Enforcement, The Themes of Sarbanes-Oxley as Reflected in the Commission' Enforcement Program, Address at the UCLA School of Law, Los Angeles, Cal. (Sept. 20, 2004), available at http://www.sec.gov/news/speech/spch092004smc.htm.

[49] Remarks of Linda Chatman Thomsen, SEC Director of Enforcement, speaking at the Practicing Law Institute, Corporate Accountability Report (BNA) (Nov. 17, 2006).

[50] See *In the Matter of William R. Carter & Charles J. Johnson, Jr*., 22 SEC Docket 292, Rel. No. 17597 (1981) (Order Dismissing Proceedings).

[51] *See, e.g., In the Matter of Google, Inc. and David C. Drummond,* Admin. Proc. Rel. No. 33-8523 (January 13, 2005); *SEC v. Craig Scott,* Lit. Release No. 19077 (February 14, 2005); *In the Matter of Phlo Corp., James B. Hovis, and Anne P. Hovis,* Admin. Proc. File No. 3-11909 (April 21, 2005). For a full review of 2005 SEC cases against in-house counsel, see J. Villa, *SEC and Criminal Proceedings Against Inside Corporate Counsel* (Sept. 2005).

[52] Remarks of David Kornblau, Chief Litigation Counsel, SEC Division of Enforcement, at the 2005 SEC Speaks Conference, Practicing Law Institute (March 2005).

[53] Giovanni P. Prezioso, Remarks Before the Spring Meeting of the Association of General Counsel (Apr. 28, 2005), available at http://www.sec.gov/news/speech/spch042805gpp.htm.

[54] Remarks of Chief Counsel Joan McKowan, speaking at the American Bar Association Annual Federal Regulation of Securities Gathering, Sec. Reg. & L. Rep. (BNA) (Dec. 5, 2005).

Despite these public assurances, a few of the 2005 SEC enforcement actions looked as though they were based on conduct very close to professional negligence. The most notorious example was the SEC administrative action in *In re Ira Weiss*.[55] The SEC sued Ira Weiss for legal work he performed in connection with a municipal bond offering by a Pennsylvania school district. Weiss was acting solely in a legal advisor capacity when he issued an unqualified opinion that the bonds were issued in manner that would result in the interest gained on the bonds would qualify for a federal income tax exemption. Later, the IRS disagreed with the tax exempt status, which resulted in an SEC investigation.

In its administrative proceeding against Weiss, the SEC claimed that Weiss knew or should have known that the bond's tax exempt status was in serious doubt, and therefore his opinion used in the Official Statement used to sell the bond offering was misleading. In April 2004, the Administrative Law Judge (ALJ) dismissed the charges by concluding that Weiss had acted with the requisite standard of care, and therefore did not violate the securities laws. However, in December 2005, the SEC effectively reversed the ALJ, and found that Weiss had violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. In so concluding, the SEC remarked that Weiss' conduct was "at least negligent" and a departure from "reasonable prudence." Notably, Sections 17(a)(2) and (3) of the Exchange Act allow liability to be based on merely negligent conduct.

To the legal community, words like "reasonable prudence" and "at lease negligent" certainly sound like Weiss was found liable for professional negligence, and members of the bar called on the SEC to clarify its position.[56] While the SEC did not issue an official clarification, the Staff has continued to say that the SEC is not targeting lawyers who are "merely negligent in giving legal advice," but will only bring cases where there is egregious conduct on the part of the attorney.[57]

On November 28, 2006, the US Court of Appeals for the District of Columbia affirmed the SEC's decision against Ira Weiss. In upholding the SEC's ruling, the court found that "Weiss was responsible for misrepresentation and omissions in the Official Statement and in his legal opinions." The Court noted that "under the securities laws, a statement of opinion includes an implied representation that the speaker rendered the opinion in good faith and with a reasonable basis. [citation omitted]. Good faith alone is not enough. An opinion must have a reasonable basis, and there can be no reasonable basis for an opinion without a reasonable investigation into the facts underlying the opinion." The appellate court's emphasis on "reasonable basis" and "reasonable investigation" sound very much like a negligence standard, and the court decision noted that under Sections 17(a)(2) and (3), negligence was sufficient to establish liability. Nevertheless, the appeals court decision appears to focus more on the fact that

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[55] *In the Matter of Ira Weiss,* Securities Act Release No. 8641, Securities Exchange Act Release No. 52875 (December 2, 2005).

[56] Lawyer Liability: Why the SEC Should Clarify Its Recent Ira Weiss Decision, Corporate Accountability Report (BNA) (June 16, 2006).

[57] Remarks of Deputy Director of the SEC's Division of Enforcement Peter Bresnan, Sec. Reg. & L. Rep. (BNA) (Dec. 19, 2005).

Weiss knew that his opinions were to be published to and relied upon by bond purchasers, and that the misleading information in the Official Statement was material to investors. Thus, the appellate decision can be read to require something akin to "negligence plus."

C. 2006 Enforcement Actions

In 2006, the SEC continued to bring enforcement actions against lawyers. However, the fear that *Ira Weiss* would open the door for enforcement actions based on mere negligence appears unfounded, at least so far. Most of these actions involve direct involvement by the lawyer in the financial or accounting fraud, direct violations of insider trading laws by the lawyer, or other conduct that fall within the scope of "primary liability". Almost all of the 2006 reported decisions involved settled actions, and almost all of those were settled under both Section 17(a) of the 1933 Act (which may be based on mere negligent conduct) and Section 10(b) of the 1934 Act (requiring scienter). Thus, the 2006 cases can be read consistently with the *Ira Weiss* appellate decision to require something more than merely negligent conduct by the lawyer to trigger an SEC enforcement action. Following are several examples.

SEC v. Paul J. Silvester et al., United States District Court for the District of Connecticut

On February 26, 2006, the Connecticut federal district court entered a consent judgment against Jerome L. Wilson, a retired attorney formerly with the New York City firm of Rogers & Wells, LLP, in connection with an alleged kickback scheme. The complaint alleged that Wilson aided and abetted a portion of the scheme in which Paul J. Silvester, the former Connecticut State treasurer, awarded investments of hundreds of millions of dollars of state pension fund money in exchange for lucrative fees paid by the private equity firms to Silvester's friends and political associates. According to the complaint, Wilson, who was one of the equity firms' attorneys, allegedly knew that he was participating in a quid pro quo by arranging for a finder's fee to be paid to someone for a transaction that was already underway, and that Ben Andrews Jr., who was the recipient of the fee and a political associate of Silvester's, was paid for essentially no work. Wilson assisted Silvester and Landmark by arranging for the fees to be paid, and for arranging for his law firm to act as a conduit for the payments. Wilson consent to a permanent injunction under Section 17(a) of the 1933 Act, and Section 10(b) of the 1934 Act. As well, Wilson paid a penalty of $50,000.

The Commission has a related action against Charles V. Spadoni, former general counsel and vice-president of Triumph Capital Group, Inc., another equity firm involved in the alleged scheme, which is still pending.

Paul Simmons et al., Litigation Release No. 19541 (January 24, 2006)

On December 6, 2005, the U.S. District Court for the Middle District of Florida issued a Final Judgment in the SEC's civil suit against Eric P. Littman, a securities attorney. According to the complaint, Littman made unregistered sales of securities as part of a reverse-merger into a shell company that was 95% owned by Littman. As part of the merger, Littman secretly sold nearly all of the shares of the shell company to company insiders, including its executive officers, attorneys and promoters. Because these sales were not registered with the Commission,

Littman's sales violated Section 5 of the Securities Act. Littman was ordered to pay disgorgement of $120,000 and a penalty of $5,600. He was enjoined from further violations of Section 5 of the 1933 Act.

In a related case, the outside securities counsel for Nutraceutical, John Zankowski, was also charged with securities fraud and registration violations for participation in the alleged stock manipulation scheme. *See* Litigation Release No. 18968 (In the Matter of John B. Zankowski).

SEC v. Symbol, Inc., et., Litigation Release No. 19585

On February 7, 2006, a consent judgment was entered against Leonard Goldner, the former general counsel and senior vice-president of Symbol Technologies Inc., ("Symbol"). According to the complaint, Goldner and other executives engaged in a fraudulent scheme to inflate revenue and earnings in order to create the false appearance the Symbol had met or exceeded its financial projections. While the fraud was proceeding, Goldner allegedly manipulated stock option exercise dates to enable senior executives, including himself, to profit at the company's expense. Without board approval or public disclosure, Goldner allegedly deviated from the company's policy of using the actual exercise date, and attempted to cover up this fraud by having his staff alter documents to reflect phony exercise dates. He consented to a permanent injunction under Section 17(a) of the 1933 Act, and Sections 10(b), 13(a), 13(b), 14(a) and 16(a) of the 1934 Act. In a parallel criminal case, Goldner paid a fine of $2 million following a guilty plea.

SEC v Patrick A. Grotto, Mark B. Leffers and Jon M. Bloodworth, Litigation Release No. 19609

On February 27, 2006, a consent judgment was entered against Jon M. Bloodworth, former general counsel and a director of Busybox.com, Inc. ("Busybox"). In its complaint, the SEC alleged Bloodworth engaged in a fraud to close Busybox's initial public offering by purchasing the remaining shares that the underwriter had failed to sell to bona fide investors. The complaint alleged that Bloodworth and others funded the purchase with payments styled as bonuses and legal fees, thereby reducing the money raise in the IPO by almost 20%. Bloodworth consented to a permanent injunction under Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act. He also paid disgorgement of $105,000, and accepted a bar order for five years.

SEC v. Bruce Hill, et al., Litigation Release No. 19617

On March 2, 2006, a consent judgment was entered against Bruce G. Hill, former general counsel of Inso Corporation. According to the complaint, Hill and others arranged a sham transaction to increase Inso's revenues for the third quarter 1998. Then, Hill concealed the terms of the sale from Inso's finance department. As a result, the complaint alleged that the third quarter financial statements reflected an additional $3 million as a result of this allegedly sham sales transaction. On January 24, 2006, Hill was sentenced to a prison term of one year and one day followed by supervised release for two years as a result of criminal charges based on the same conduct. In the SEC action, Hill consented to a permanent injunction under Section 17(a) of the 1933 Act, And Sections 10(b), 13(a), and 13(b) of the 1934 Act. Hill also paid

disgorgement of $66,000, and a permanent bar from serving as an officer of any company registered under Section 15(d) of the 1934 Act.

SEC v. Ronald Ferguson et al., Litigation Release No. 19552

On February 2, 2006, the SEC filed an enforcement action against Robert Graham, a lawyer, and others, who were senior executives of General Re Corporation and American International Group, Inc. (AIG). According to the complaint, Graham and others created two sham reinsurance contracts, which included the creation of phony documents for the purpose of providing apparent support for the false accounting entries AID made on its books. Graham and the others were charged with aiding and abetting AIG's alleged violations of Sections 10(b) and 13(a) and (b) of the 1934 Act. The Commission's investigation is continuing.

SEC v. David T. Leboe and Dale G. Rasmussen, Litigation Release No. 19623

On March 27, 2006, the SEC filed charges against Dale G. Rasmussen, a former Enron attorney, for violating the antifraud provisions of the securities laws and with aiding and abetting Enron's securities violations. According to the complaint, Rasmussen and others carried out a scheme to recognize an immediate gain based on appreciation of an asset, in circumvention of GAAP accounting rules. Further, the SEC alleged that Rasmussen negotiated the terms of the transaction, drafted several key documents, and worked closely with Enron's accountant to ensure that the wording in legal documents did not jeopardize Enron's efforts to circumvent GAAP. Rasmussen consented to a permanent injunction under Sections 10(b) and 13(b) of the 1934 Act, and paid a civil penalty of $30,000.

SEC v. Lindsey P. Vinson and Clyde R. Parks, Litigation Release No. 19937

On December 6, 2006, The SEC settled an action against two attorneys, Lindsey P. Vinson and Clyde R. Parks, for their roles in a fraudulent scheme relating to the common stock of Moliris Corp. (Moliris). In the complaint, the SEC alleged that Vinson created a scheme to mislead investors into thinking that he had transferred ownership of Moliris to his personal lawyer, Parks, when he had not. Moreover, the complaint alleged that Vinson concealed his continuing control of Moliris, his SEC disciplinary record, and his prior bankruptcies. As a result, Vinson consented to judgment enjoining him from violating Sections 10(b) and 13(b)(5) of the 1934 Act, and from aiding and abetting violations of Section 13. Vinson also paid a penalty of $200,000, and agreed to pay disgorgement of $200,000. Parks, by contrast, had little or no involvement with Moliris other than signing and certifying Moliris' SEC filings. Nevertheless, he is charged with violating Section 10(b) and 15(b)(5), and aiding and abetting Section 13 violations.

SEC v. Herula et al., Litigation Release No 199900

On November 6, 2006, a consent judgment was entered against Charles Sullivan, general counsel and vice-president of Brite Business Corporation, for participating in a fraudulent offering scheme that raised at lease $52 million from investors. The SEC alleged that Sullivan assisted and supported a fraudulent trading program, disbursed certain investor funds, and took certain investor funds as "loans." Sullivan agreed to a permanent injunction under Section 17(a)

of the 1934 Act, and Section 10(b) of the 1934 Act. He also agreed to pay disgorgement of over $900,000, and a civil penalty of $120,000.

SEC v. Biopure Corporation, et al., Litigation Release No 19852

On September 12, 2006, the SEC announced consent judgments against Biopure Corporation and its general counsel, Jane Kober. The complaint alleged that Biopure falsely described and failed to disclose FDA comments about its synthetic blood for a period of over eight months. The complaint further alleged that Kober substantially participated, reviewed, and/or approved of many of these misleading statements. During this time, Biopure reported false good news and raised an additional $35 million from investors. According to the complaint, when the truth finally was revealed to the market, Biopure's stock dropped almost 66%. Kober consented to a permanent injunction from further aiding and abetting violations of Section 13(a) of the 1934 Act. The Commission dismissed allegations brought against her under Sections 17(a) of the 1933 Act, and Section 10(b) of the 1934 Act.

SEC v. Thomas J. Bucknum, United States District Court for the District of Massachusetts, Civil Action No. 06-10065 PBS

On January 12, 2006, the SEC filed a settled enforcement action charging Thomas J. Bucknum, general counsel of Biogen Idec Inc., with insider trading. According to the complaint, on February 18, 2005, Bucknum had told his broker to exercise his stock options and sell the shares when the price hit $68 a share. At a meeting later that day, Bucknum allegedly learned material, non-public information that was likely to have a negative impact on Biogen stock. After leaving the meeting, Bucknum allegedly had a second conversation with his broker wherein he instructed the broker to sell the shares immediately at the current market price of $67 a share. Ten days later, when Biogen publicly announced the adverse information, Biogen's stock declined more the 42% to $28.63. Bucknum consented to a permanent injunction under Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act, and agreed to pay disgorgement of over $1.9 million. He also agreed to a civil penalty of $969,232, and a five-year bar order.

SEC v. Robert J. Downs, Jr. and Stephen J. Messina, Litigation Release No. 19698

On May 15, 2006, the court entered a consent judgment against attorney Robert J. Downs, a partner in a Philadelphia law firm, for allegedly supplying a friend, Stephen Messina, with material inside information about a corporate client of his firm. While in possession and based upon this information, Messina allegedly purchased options and realized a profit of over $300,000. Messina consented to a permanent injunction under Section 10(b) of the 1934 Act, and paid a civil penalty of $308,335.

SEC v. Mitchell Drucker and Ronald Drucker et al., Litigation Release No. 19587

On March 2, 2006, the SEC filed insider trading charges against Mitchell Drucker, general counsel of NBTY, Inc. The complaint alleged that Drucker sold his stock after learning material non-public information that NBTY's fourth quarter earnings would be sharply lower than expected. The SEC also alleged that Drucker shared this information with his father, who sold his shares based upon this information. The action is still pending.

D. 2007 Enforcement Actions

2007 SEC enforcement actions through July have provided little additional proof that lawyers are becoming high profile targets, other than in the area of stock option backdating. Nevertheless, the SEC has publicly declared that lawyers are not immune from scrutiny by the Enforcement Division, as witnessed by the cases discussed below.

In an important speech in March 2007, SEC Chairman Christopher Cox described in-house counsel as "crucial gatekeepers" responsible for safeguarding shareholder interests, and that lawyers must take seriously their "reporting up" obligations under Sarbanes-Oxley. If lawyers fail to do so, "the Commission will bring enforcement actions," he said.[58] In connection with the SEC's cases against lawyers involved in stock option backdating, he asks, "where were the lawyers? Where were the gatekeepers?" He then outlined the "troubling" facts involved in the prosecutions discussed below against several former general counsels, as an object lesson, perhaps, in what not to do.

1. Non-Backdating Cases

In June, 2007, an older SEC action against a general counsel was in the news, when the State of Oregon suspended the lawyer from the practice of law based on his alleged role in false reports regarding the company's business. James Fitzhenry was the general counsel of FLIR Systems, Inc., a company that makes sophisticated camera systems. Specifically, Fitzhenry was alleged to have misled auditors into believing that a foreign government mad agreed to buy over $4 million of equipment, when that was not true. In 2002, Fitzhenry had agreed to a settlement with the SEC, which included a five year bar order. In 2005, a state disciplinary hearing found that Fitzhenry violated Oregon ethical rules for his role in the false reporting. In June 2007, the Oregon Supreme Court suspended Fitzhenry for 120 days, the culmination of a five year ordeal for this lawyer.

Also in June 2007, the former general counsel of Universal Express, Chris Gunderson, was the subject of headlines when the SEC decided to pursue contempt sanctions against him for allegedly violating an injunction entered against him in April 2007. Gunderson had served as counsel to Inc., in connection with the issuance of over 15 billion shares of company stock Gunderson had been ordered to pay $800,000 as part of the relief ordered earlier in 2007.[59]

Finally, although not an SEC action, state prosecutors recently resolved a case against the former general counsel of Take Two Interactive, Kenneth Selterman. In August 2007, Selterman pled guilty to related state criminal charges and agreed to pay a fine of $50,000. Selterman is specifically alleged to have been involved in concealing from Nasdaq regulators the fact that Take Two's chief executive officer and president both had received option grants that were not pursuant to an employee stock option plan, in violation of Nasdaq rules. Selterman also is

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[58] Remarks of Chairman Cox, Address to the 2007 Corporate Counsel Institute, March 8, 2007.
[59] SEC Lit. Release No. 20165 (June 25, 2007).

alleged to have altered the company's records to try to re-characterize the improper options as incentive options.[60]

2. Backdating Cases

The SEC Enforcement Division currently is investigating over 100 matters relating to potential stock option backdating. As of Fall 2006, the SEC had only brought two enforcement actions involving alleged backdating. Linda Chatman Thomsen warned at that time that, "We will still look at lawyers . . . [w]e look at all the roles" where there are investigations into conduct regarding backdating.[61] Since then, the SEC has moved against a number of lawyers involved in alleged backdating.

In *SEC v. Jacob Alexander, David Kreinberg, and William F. Sorin*, Litigation Release No. 19796, the SEC charged the former general counsel of Comverse, William F. Sorin, with participation is a scheme to routinely backdate stock option grants. According to the Complaint, management went so far as to create a secret slush fund by making backdated options grants to fictitious employees. Parallel criminal actions also were brought.[62] The SEC action sought relief against Sorin under Sections 10(b), 13(b), 14(a) and 16(a) of the 1934 Act, and aiding and abetting violations under Sections 13(a) and 13(b) of the 1934 Act. The SEC specifically alleged that Sorin, and the other named defendants, engaged in a decade long fraudulent scheme to grant undisclosed, in the money, options to themselves and others by backdating stock options. According to the complaint, Sorin created company records that falsely indicated that a committee of Comverse's board had actually approved the option grant date, when it had not, that Sorin made misrepresentations to Comverse's auditors in order to conceal the backdating scheme, and that Sorin initiated a similar backdating scheme at a majority-owned subsidiary of Comverse. In January 2007, Sorin settled the SEC enforcement action by agreeing to pay $3.1 million to settle civil fraud charges, including a $600,000 civil penalty and $1.67 million in disgorgement. In announcing the settlement, the SEC's enforcement director, Linda Chatman Thomsen, declared that the SEC would continue to "vigorously pursue those responsible for backdating schemes wherever the investigation may lead, even, as appropriate, into the offices of corporate counsel."[63]

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[60] *New York v. Selterman,* N.Y. Sup. Ct., No. 2645/2007 (sentencing 8/8/07).

[61] Remarks of Linda Chatman Thomsen, SEC Director of Enforcement, speaking at the Practicing Law Institute, Corporate Accountability Report (BNA) (Nov. 17, 2006).

[62] In entering a guilty plea on October 24, 2006 the former Comverse CFO told the court that "I was asked by the CEO to bring him a printout of the company's trading prices over a past year period to enable him to select the 'as of' date that would be used for the exercise price of the option grant." In entering his own guilty plea a few days later, Sorin admitted that "I knew what [the CEO] was doing was wrong and did not challenge his conduct or share my knowledge with the board of directors and auditors of the company." *Comverse's Former Finance Chief Pleads Guilty,* Wall Street Journal, Oct 25, 2006, p.C3. *A Second Comverse Ex-Executive Pleads Guilty*, Wall Street Journal, Nov. 3, 2006, p.A3.

[63] SEC Release No. 2007-4 (January 10, 2007).

Beginning in 2006, at least a half dozen companies announced the resignations or terminations of their general counsels in the midst of high-profile stock option backdating inquiries, including Apple Computer, McAfee, Mercury Interactive, CNET, Monster Worldwide, and Boston Communications. Since then, several of these general counsels have been sued.

Among the high-profile cases brought against in-house general counsel is the SEC's civil action against Nancy Heinen, former general counsel of Apple Computer. On April 23, 2007, the SEC sued Heinen and Apple's former Chief Financial Officer, Fred Anderson, under Section 10(b), 13(b), 14(a), 16(a) and 17(a) of the Exchange Act.[64] The SEC's complaint alleges that Heinen "twice engaged in a scheme to grant in-the-money options while falsifying records to make it appear that the options had been granted at-the-money." The SEC accuses of Heinen of having fabricated or falsified company records, including the creation of false minutes of a "non-existent" Board of Directors meeting. The time period of the allegedly backdated grants dates back to January 2001, when a large share grant was made to Apple's executive team, which included Apple's Chief Executive Officer Steve Jobs, Heinen, Anderson and others. On January 30, 2001, Heinen is alleged to have emailed Jobs and said that "I suggest we use January 10 [as the grant date]… That was one of the lowest closes of the month." Several alternative dates were discussed, and Heinen later informed Anderson that Jobs had agreed to use January 17, 2001 as the grant date. Heinen then prepared a false set of Board minutes effective as of January 17. Similar allegations are made with respect to a 7.5 million share grant to Jobs in October 2001. Heinen is alleged to have made false statements to Apple's auditors, to have caused Apple's books and records to be falsified, and to have participated in making false filings with the SEC. No enforcement action has been brought against Jobs.

The Apple case is not the only recent example of SEC actions against in-house counsel involved in backdating. In February 2007, for example, the SEC sued the former general counsel of Network Associates, Kent Roberts, for his alleged role in backdating of options over the period 2000-2006.[65] A parallel criminal indictment also was filed on February 27, 2007.[66] In Roberts' case, the alleged misconduct is much more personal—he is alleged to have been upset that his own options had become out-of-the-money, and he therefore director the controller of the company to backdate his own options, from a strike price of $29.72 per share to $19.75 per share. Although the options were never exercised, Roberts is alleged to have been aware of the backdating when Network Associates commenced an internal investigation, which he headed up, and then proceeded to conceal the facts concerning his own culpability.

Also in February 2007, the SEC brought civil charges against the former general counsel of Monster.com, Myron Olesnyckyj, alleging that he was directly involved in backdating options at his company from 1997 to 2003.[67] Related criminal charges also were brought, and in

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[64] *Securities and Exchange Commission v. Heinen,* C 07-2214 HRL (N.D. Cal. April 23, 2007)

[65] *Securities and Exchange Commission v. Roberts,* Case No. 1:07CV00407 (D.D.C. filed Feb. 28, 2007); SEC Lit. Release No. 20020 (Feb. 28, 2007).

[66] *United States v. Roberts,* CR 07-0100 MHP (N.D. Cal. February 27, 2007).

[67] SEC Litigation Release No. 20004 (February 15, 2007).

February Olesnyckyj pled guilty to criminal securities fraud and agreed to disgorge $381,000 in ill-gotten gains. In this case, internal emails are alleged to show that Olesnyckyj was aware of the accounting implications of backdating options, and he discussed how to "finesse" the issue with the company's outside auditors. The SEC's announcement of the settled action in March 2007 warns in-house counsel that "any lawyer who works for a public company should do everything possible to thwart fraud—not participate in it."

In May 2007, the SEC sued the former general counsel of Mercury Interactive, Susan Skaer.[68] The action alleges claims under Sections 10(b), 14(a), 17(a), 13(a) and (b), and 16(a) of the Exchange Act. The Mercury Interactive case involved allegations of backdating and accounting fraud over a five year period, 1997-2002, and dozens of option grants to senior executives, including Skaer herself. The SEC's complaint alleges that Skaer served as general counsel between 2000 and 2005, when she was forced to resign. Prior to 2000, she also had served as Mercury Interactive's outside counsel. As an officer of Mercury, Skaer is alleged to have "exerted substantial influence" over the pricing of the company's options, along with other senior executives. Skaer also is alleged to have prepared false unanimous written consents that were used to approve backdated options. Mercury's Chief Financial Officer, Sharlene Abrams, is alleged to have shared her knowledge of options accounting with Skaer, and therefore Skaer is alleged to have known that the financial statements falsely recorded the options expense. She also is alleged to have sent a number of emails reflecting her awareness that options were being deliberately backdated. In announcing the lawsuit, the SEC described the practices at Mercury Interactive as "widespread and pernicious."

Finally, in August 2007, the SEC filed a complaint against Lisa Berry, who formerly served as general counsel of two public companies in the technology sector, KLA-Tencor and Juniper Networks. In *Securities and Exchange Commission v. Berry,*[69] the SEC alleged that Berry was directly involved in backdating of options at those two companies in the period 1997 through 2003. At KLA, Berry is accused of participating in stock option backdating practices that included "deliberately delaying" grants to allow the selection of "historically low stock prices with the benefit of hindsight." One such example cited in the complaint was a grant allegedly made in August 1998, when in fact the grant was actually made in October 1998—and Berry personally benefited from this backdated option by receiving over 20,000 shares. A KLA employee is alleged to have specifically questioned the legality of the practice, and that it might not pass the audit test, but Berry did not stop the practice. Berry is alleged to have trained KLA employees in how to backdate at the time she was leaving the company. Similar conduct is alleged to have occurred at Juniper, including backdated board committee meeting minutes.

Overall, cases brought by the SEC against lawyers in 2007 illustrate that the Staff has taken a measured approach to the issue of lawyer liability, and generally is reserving

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[68] *Securities and Exchange Commission v. Mercury Interactive, LLC,* C 07-2822 (N.D. Cal., filed May 30, 2007). Simultaneously with the filing of this suit, Mercury Interactive agreed to settle with the SEC by paying a $28 million civil penalty and being permanently enjoined from future violations, which extending beyond backdated options to include certain alleged accounting manipulations and fraudulent loan practices.

[69] Case No. C-07-4431 RMW (filed August 28, 2007, N.D. Cal.).

enforcement actions for fact patterns where lawyers were directly involved in the securities violations, and some level of direct personal benefit was involved. Also, the cases brought in 2007 reflect that in virtually all cases, the lawyer's securities law violation was largely divorced from the provision of day-to-day legal advice to the corporation. Indeed, in a 2007 speech Chairman Cox expressly stated that none of the recent actions against lawyers "have been for giving bad advice."[70] As the SEC continues its stock option backdating investigations, we are likely to gain keener insight into the dividing line the Staff is drawing between lawyer conduct that is merely negligent or "bad lawyering," and conduct that invites an enforcement action.

IV. CONCLUSION

2007 cases demonstrate that lawyers and accountants continued to be exposed to material liability risks. It remains to be seen if any of the pending tort reform initiatives will serve to mitigate those risks. In the meantime, market participants await the Supreme Court's decision in *Stoneridge,* which will significantly affect the liability of lawyers, accountants and other secondary actors under Section 10(b) for years to come.

[70] Remarks of Chairman Cox, Address to the 2007 Corporate Counsel Institute (March 8, 2007).

ATTACHMENT A

Recent Enforcement Actions & Sanctions Against Major Accounting Firms

Date	Case Name	Conduct	Sanctions
11/19/99	*In re Hooper*	Hooper audited the financial statements of United Fire Technology in 1993 and 1994. In these financial statements, Hooper made numerous misrepresentations and omitted material facts regarding a license purchase. The Commission found that the statements were not prepared according to GAAP and that Hooper was not independent.	1. Hooper is denied the privilege of appearing or practicing before the Commission as an accountant. 2. He may request consideration of reinstatement after 5 years.
3/29/00	*In re Miller*	Miller, a partner at Chadbourne & Miller, was the outside auditor for Underwriters' Financial Group, Inc. UFG overstated its pre-tax net income in its 1994 10K and misappropriated several million dollars during that year. Miller signed the audit report which said that C&M conducted an audit and that the financials were accurate and followed GAAP. C&M did not verify management's representations, did not exercise "due professional care," or maintain "professional skepticism." Miller did not maintain an independent mental attitude: when she raised questions about the legality of transactions to UFG, UFG threatened litigation, and she signed the financial statement.	Miller is denied the privilege of appearing or practicing before the Commission.
8/31/00	*In re Ponce*	Ponce, the auditor for AAC, caused violations of antifraud provisions and aided and abetted recordkeeping violations. He also engaged in improper professional conduct within Rule 102(e)(1)(ii). These violations occurred in the context of AAC's acquisition of a license and Ponce's acceptance of AAC's valuation of the license.	1. Ponce is denied the privilege of appearing or practicing before the Commission as an accountant 2. May apply for reinstatement after 5 years.
1/19/01	*In re KPMG Peat Marwick LLP*	KPMG failed to adhere to standards for auditor independence in connection with its audit of Porta Systems Corp.'s financial statements. KPMG/Peat Marwick loaned money to the president of Porta while it was auditing its financial reports. Furthermore, Peat Marwick had entered into a partnership that gave it the right to a fee that was attributable, in part, to Porta's financial success.	KPMG is ordered to cease and desist from committing any violation or future violation of Rule 2-02(b) of Regulation S-X, or from being a cause of any violation of Section 13(a) of the Exchange Act or Rule 13a-1 thereunder.

Date	Case Name	Conduct	Sanctions
1/25/01	*In re Swart*	Swart prepared its client's (Am-Pac) financial statements and then audited them. Even after Am-Pac hired an independent accountant, Swart continued to do accounting tasks. Swart also engaged in improper accounting for a sale-leaseback transaction.	1. Respondents are ordered to cease and desist from committing or causing any violation and any future violation of Rule 2-02 of Regulation S-X, Section 13(a) of the Exchange Act, and Rules 13a-1 and 13a-13 thereunder. 2. Respondents are suspended from the privilege of appearing or practicing before the Commission. 3. Respondents can apply for reinstatement after 3 years. 4. Respondents liable for disgorging $32,750 in fees and for $9,231.03 in prejudgment interest.
6/19/01	*In re Arthur Andersen*	Arthur Andersen ("AA") was the auditor for Waste Management, Inc. From 1993 to 1996 AA issued audit reports stating that Waste Management's financial statements conformed to GAAP and that AA had conducted its audit in accordance with GAAS, and these statements were materially false and misleading. In 1994, AA issued an unqualified audit opinion even though it knew Waste Management misstated $128 million in the 2 previous years. Repeatedly, even though AA was aware of material misstatements, it issued unqualified audit opinions. AA engaged in improper professional conduct within the meaning of Rule 102(e).	1. Arthur Andersen is censured.
6/21/01	*In re Seymour*	Seymour was engaged, with a venture partner, to do Vista's audit in 1995. The venture partner owned 23,333 shares of Vista common stock, and Seymour knew or was reckless in not knowing this. Furthermore, Seymour never reviewed previous auditors' workpapers, and if he had done so, he would have realized that the company had, in the past, improperly tried to recognize revenue, and would have been able to prevent the company from doing it again (as it did). Finally, Seymour never conducted any meaningful audit review to see if Vista's sales were legitimate or fictitious. On	1. Seymour is ordered to cease and desist from causing any violation and any future violation of Section 13(a) and Rule 13a-1 thereunder. 2. Seymour is liable for disgorging $16,141.49 and post-judgment interest.

Date	Case Name	Conduct	Sanctions
		these bases, the Commission found that Seymour caused Vista to violate Section 13(a) of the Exchange Act and Rule 13a-1 thereunder.	
1/14/02	*In re KPMG, LLP*	KPMG invested in a fund (Short-Term Investments Trust) offered by one of its auditing clients, AIM. No one at KPMG noticed that it had invested in one of its audit clients, rather an AIM employee noticed the issue. After KPMG was alerted, it liquidated its investment and resigned from all AIM fund audit engagements. Regulation S-X (Sec. 2-01) provides that an accountant is not independent from its client if the account has any direct financial interest or material indirect financial interest in the client.	1. KPMG is censured pursuant to Rule 102(e)(1). 2. KPMG is ordered to designate at least one partner to ensure the firm's compliance with auditor independence rules. 3. KPMG treasury department personnel is required to undergo annual auditor independence training. 4. KPMG is required to adopt written procedures to provide assurance that it will not invest in audit clients. 5. KPMG is required to maintain a list identifying all financial relationships. 6. KPMG is required to ensure check to make sure it has maintained independence prior to confirming its independence. 7. KPMG is required to distribute SEC order to all audit professionals and treasury department personnel.
5/16/02	*In re Gaito*	Gaito, a former managing principal at Moore Stephens, PC, violated auditor independence standards. First, Gaito acted as a trustee that owned the securities of Moore Stephens' audit clients; second, as trustee, Gaito loaned money to a director and principal shareholder of one of his audit clients; third, Gaito had material investment relationships with directors and principal shareholders of several of his audit clients; and finally, Gaito knew or was reckless in knowing that his conduct would impair Moore Stephens' independence.	1. Gaito is ordered to cease and desist from committing or causing any violation of the Exchange Act Sec. 10(b) and Rule 10b-5, and Rule 2-02 of Regulation S-X, Sec. 13(a) and Rule 13a-1. 2. Gaito is denied the privilege of appearing or practicing as an accountant before the Commission.
6/27/02	*In re Moret Ernst*	Moret, a firm based in the Netherlands,	1. Moret is censured pursuant to Rule 102(e).

Date	Case Name	Conduct	Sanctions
	& Young Accountants	audited the financial statements of a client, Baan Company N.V. Moret entered into several joint business relationships with Baan, impairing its independence as an auditor. Moret implemented the software purchased by Baan's customers, and applied with Baan for a subsidy from the Dutch government for research in the software implementation field. Moret audited the accounting for the expenses of the project sent to the Dutch government. Moret and Baan also entered into a partnership agreement allowing both to benefit from their software implementation program. Moret and Baan also engaged in joint marketing activities.	2. Moret is ordered to pay a civil penalty of $400,000. 3. Moret is ordered to develop auditor independence policies. 4. Moret is ordered to require its employees to undergo auditor independence training. 5. Moret is ordered to require its audit teams to document procedures to confirm Moret's independence. 6. Moret is ordered to establish procedures to ensure it does not enter into business relationships with audit clients. 7. Moret is ordered to establish an "Independence Affirmation" which each of its partners and managers must sign annually.
7/2/02	*In re Horton & Co.*	Horton, the auditor of a company called Iron Holdings, was found to have aided and abetted a violation of Exchange Act Sec. 13(a) and Rules 13a-1 and 13a-13 for filing 10-KSB's when the forms were not audited by an independent public accountant. Horton made the bookkeeping entries for Iron Holding, prepared its cash journals, general ledger, balance sheet, and income statement. Horton was found to have engaged in improper conduct within the meaning of Rule 102(e)(1)(ii).	Horton and Horton & Co. are denied the privilege of appearing or practicing before the Commission for one year.
7/17/02	*In re Pricewaterhouse Coopers LLP*	This case involved three different kinds of improper conduct. First, PwC (and its predecessors) performed investment banking services, on a contingent fee basis, to its public audit clients. Second, PWC issued an unqualified audit for a company called Pinnacle, even though PwC caused Pinnacle to fail to account properly for certain costs, including non-audit fees to PwC. Third, PwC issued an unqualified audit to a company called Avon, even though it caused Avon to fail	1. PwC is censured pursuant to Rule 102(e)(1). 2. PwC is ordered to cease and desist from committing any violation and any future violation of Sections 13(a) and 13(b) of the Exchange Act, Rules 12b-20, 13a-1, and 13a-13 thereunder, Rule 2-02 of Regulation S-X, Section 13(a) of the Exchange Act and Rule 13a-1 thereunder.

Date	Case Name	Conduct	Sanctions
		to write off all of the capitalized costs of an uncompleted project that PwC consultants had been developing for Avon.	3. PwC is ordered to pay $2.5 million and PwC Securities ordered to pay $2.5 million to the United States Treasury. 4. PwC's independence office is ordered to review all new value added fee agreements. 5. PwC is ordered to require that an independent reviewing partner review the audits of SEC-registrants in which the client capitalizes PwC non-audit fees. 6. PwC is ordered to require that an independent reviewing partner review at least 5% of all other PwC audits of SEC-registrants. 7. PwC is ordered to develop written procedures for the independent reviewing partners. 8. PwC is ordered to provide annual training for all professionals on auditor independence issues 9. PwC is ordered to distribute a copy of SEC order to partners and principals.
11/21/02	*In re BDO International*	BDO International audited the financial statements of ACLN from 1995 to 2000. BDO was not independent because an entity affiliated with BDO maintained the books and records of ACLN. BDO's independence was compromised in violation of Rule 2.02 of Regulation S-X. Furthermore, BDO did not verify the source documents provided to it by management of ACLN, and the financial statements were not prepared in conformity with GAAP.	BDO and the other respondents are suspended from appearing or practicing before the Commission.
1/27/03	*In re Philip E. Harlow, CPA (Arthur Andersen)*	Harlow, a former partner at Arthur Andersen, audited Sunbeam's financial statements from 1994 to 1998. In 1996, Harlow knew that Sunbeam was improperly recognizing income. He	1. Harlow is denied the privilege of appearing or practicing before the Commission as an accountant.

Date	Case Name	Conduct	Sanctions
		proposed that the company reverse the entries, but when it refused, he issued an unqualified audit report. A similar incident occurred in 1997. Harlow failed to exercise due professional care and engaged in improper professional conduct for purposes of Rule 102(e).	2. Harlow may reapply to resume appearing before the Commission to appear as a preparer, reviewer, or independent accountant after three years.
5/22/03	*In re Pricewaterhouse-Coopers*	PwC provided audit services to SmarTalk TeleServices Inc., including performing the audit for SmarTalk's 1997 financial statements. SmarTalk's 10K contained materially false statements—reporting a one-time restructuring charge that did not conform with GAAP SmarTalk also charged 1997 operating expenses against this reserve. When the engagement partner left PwC, PwC reviewed the working papers for the audit and discovered that there were issues with the 1997 financial statement and that PwC had made undocumented changes to its audit working papers and discarded other documents relevant to its audit. PwC's conduct was improper professional conduct under Rule 102(e).	1. PwC undertakes to pay $1 million to the U.S. Treasury. 2. PwC undertakes to establish and maintain policies to preserve working papers. 3. PwC undertakes to retain independent consultant to help PwC establish the procedures mentioned above and conduct review of the procedure to preserve documents. 4. PwC is censured pursuant to Rule 102(e)(ii).
4/16/04	*In re Ernst & Young*	E&Y was not independent when it audited the financial statements of PeopleSoft, Inc. In addition to serving as PeopleSoft's auditor, E&Y Consulting had a partnership with PeopleSoft to develop and implement software to assist clients with determining tax consequence of keeping international employees.	1. E&Y is ordered to cease and desist from committing any future violations of Rule 2-02 of Regulation S-X and from causing any violations and any future violations of Sections 7(a) and 10(a) of the Securities Act of 1933, and Sections 13(a) and 14(a) of the Securities Exchange Act of 1934, and Rules 13a-1 and 14a-3 thereunder. 2. E&Y is ordered to disgorge $1,686,500 plus prejudgment interest of $478,050. 3. E&Y is ordered to retain an independent consultant acceptable to the Commission. 4. E&Y is suspended from accepting audit engagements for new Commission registrant audit clients for six months. (If E&Y takes any new audit engagements, the CEO and Vice Chair for Quality and Risk Management must certify that E&Y is

Date	Case Name	Conduct	Sanctions
			independent).
5/11/04	*In re Pricewaterhouse-Coopers*	PwC audited the financial statements of The Warnco Group, Inc. from 1995 to 1998. In particular, in 1998, PwC concluded that Warnco had overstated its inventory by $ 159 million, and could not write it off pursuant to its new accounting pronouncement. But PwC failed to object to the characterization of the write-off, and incorporated Warnco's characterization in its audit report. PwC aided and abetted Warnco's violation of Sec. 13(a) of the Exchange Act and Rules 12b-20 and 13a-1 thereunder.	1. PwC is censured pursuant to Rule 102(e)(iii).
8/5/04	*In re Grant Thorton LLP, Doeren Mayhew Co. P.C., Peter M. Behrens, CPA, Marvin J. Morris, CPA, and Benedict P. Rybicki, CPA*	Grant Thorton issued an unqualified audit opinion for the MCA Financial Corporation, when MCA's financial statements were materially misleading. The statements failed to divulge related party transactions, inflated MCA's income, and failed to write down overvalued assets. Grant Thorton did not maintain an attitude of professional skepticism, did not seek adequate documentation, and did not conduct appropriate tests. Grant Thorton aided and abetted MCA's violation of Section 10A of the Exchange Act and engaged in improper professional conduct under Rule 102(e).	1. Grant Thorton restructured the responsibilities of its senior leadership. 2. Grant Thorton must pay $1.5 million penalty. 3. Grant Thorton must require its audit professionals to undergo fraud protection training. 4. Grant Thorton is ordered to cease all joint audit arrangements with other auditors for a period of 5 years.
10/20/04	*In re KPMG, Bryan E. Palbaum, CPA, John M. Wong, CPA, Kenneth B. Janeski, CPR, David A. Hori, CPA*	KPMG engaged in improper professional conduct in the audits of Gemstar-TV Guide International, Inc. KPMG auditors should have known that Gemstar's recognition of revenue, was not in conformity with GAAP. KPMG's materiality determinations were unreasonable. KPMG failed to exercise due professional care and skepticism. Further, there was information that came to the attention of KPMG after the financial statement was issued, but KPMG was slow in withdrawing its audit opinion after it learned the new information.	1. KPMG is censured pursuant to Rule 102(e)(1)(ii). 2. KPMG undertakes to pay $10,000,000 to the Court. 3. KPMG undertakes to provide training to its partners and managers. 4. KPMG undertakes to adopt a new policy that requires the engagement team to discuss and document discussions of any restatements with the Department of Professional Practice.

Date	Case Name	Conduct	Sanctions
1/27/05	*In the Matter of Michael C. Mullen*	Mullen, who was a manager on the Ernst & Young audit team for NextCard, Inc during the years 2001 and 2002, was convicted in the District Court for the Northern District of California of concealing and covering up a material fact. Specifically, Mullen lied to the FBI about altering Ernst & Young working papers for an audit of NextCard, Inc. He was given one year probation and fined $100.	Mullen is suspended indefinitely from appearing or practicing before Commission.
3/3/05	*In the Matter of Thomas C. Trauger*	Trauger was the audit partner in charge of Ernst & Young's audit of NextCard, Inc. Trauger admitted to withholding information from the SEC about the alteration and deletion of Ernst & Young working papers for the audit of NextCard's financial statements for the year ended December 31, 2000 and quarterly reviews in 2001. On February 1, 2005, a judgment of conviction was entered against Trauger in the District Court for the Northern District of California, finding him guilty of falsification of records in a federal investigation. Trauger was sentenced to 12 months in prison and ordered to pay a $5,000 fine.	Trauger is suspended indefinitely from appearing or practicing before Commission.

Date	Case Name	Conduct	Sanctions
4/19/05	*SEC v. KPMG, LLP, et al.*	From 1997 to 2000, KPMG permitted Xerox to accelerate revenue from long-term leases of Xerox copiers and other sources to close a $3 billion gap between actual operating results and results reported to the investing public. Most of Xerox's accounting actions violated generally accepted accounting principles (GAAP), and all of them inflated Xerox's performance but were not disclosed to investors. The SEC found that KPMG had willfully aided and abetted Xerox's actions by issuing auditing reports that Xerox's accounting practices conformed with GAAP, thereby violating generally accepted auditing standards. KPMG issued such reports despite repeated warnings from member firms of KPMG that Xerox was using methods to close the gap between actual and desired results that did not have adequate evidentiary support. Though KPMG did suggest to Xerox management that it test the assumptions and results of its accounting adjustments to ensure they accurately portrayed Xerox's business, KPMG did nothing to test those assumptions itself when Xerox ignored its suggestions.	1. KPMG is ordered to cease and desist from committing or causing various violations of the Exchange Act of 1934 and Securities Act of 1933 and is censured pursuant to Rule 102(e)(1)(iii). 2. KPMG, as part of a settlement of civil litigation, agrees to pay a total of $22.475 million, $9.8 million of which represents disgorgement of its Xerox auditing fees from 1997-2000, $2.675 million of which represents prejudgment interest on those fees, and $10 million of which is a civil penalty. 3. KPMG also agreed to undertake reforms in the following areas: examination of an audit client's justification for using accounting practices that departed from GAAP; examination of an audit client's justification for departing from its existing accounting systems; documentation of consultations with individuals outside the audit engagement team; establishment of a procedure to review and document the circumstances surrounding any change in the engagement partner in charge of an audit; establishment of whistle-blower channels of communication within KPMG. The chairman of KPMG is required to certify to the SEC that these undertakings have been complied with and to provide evidence of compliance. Two years after such certification, KPMG is required to retain a consultant to certify continuing compliance.

Date	Case Name	Conduct	Sanctions
4/26/05	*SEC v. Deloitte & Touche*	Deloitte failed to implement audit procedures designed to detect illegal acts and material party or related party transactions during its audit of Adelphia's financial statements for the year ended December 31, 2000. Deloitte's failure to do so enabled Adelphia to understate subsidiary debt by $1.6 billion, overstate equity by more than $350 million and improperly conceal the extent of related party transactions. Deloitte's failure occurred despite the fact that it had identified Adelphia as presenting a "much greater than normal" audit risk as early as 1998, a finding which should have subjected Adelphia to a more intensive review under Deloitte's "Risk Management Program."	1. Deloitte must pay a total of $50 million into a fund to compensate the victims of the Adelphia fraud to settle both the administrative proceeding and the civil suit arising from its improper handling of the Adelphia audit. 2. The SEC censures Deloitte for improper professional conduct under Rule 102(e). 3. Deloitte must establish a detailed system for reviewing the audits of public companies placed in its "Risk Management Program," which is to include use of forensic specialists in the planning stages of such an audit and a review by both the Engagement Partner and Special Review Partner that identifies pervasive risks associated with the audit and details the procedures that were employed to deal with them. 4. Within 18 months, Deloitte must retain an independent consultant who will review Deloitte's compliance with the undertakings that detailed in the settlement and report his or her findings to the SEC.
4/26/05	*In the matter of Deloitte & Touche, Steven H. Barry, and Karen Baker*	Deloitte in general and Barry and Baker in particular were engaged to perform the audit of Just for Feet, Inc. for fiscal year 1998. Despite the fact that Just for Feet seriously overstated net income and assets by improperly recognizing unearned and fictitious receivables and revenue, failing to account for obsolete inventory, and improperly recording the value of display booths provided by vendors as income, Deloitte issued an unqualified audit report in support of Just for Feet's 1998 financial statements. Deloitte should have known that such statements were not prepared in accordance with generally accepted accounting principles	1. The SEC censures Deloitte pursuant to Rule 102(e). 2. Deloitte agrees to pay a $375,000 fine to the U.S. Treasury. 3. Barry is barred from practicing before the Commission for two years. 4. Baker is denied the privilege of appearing or practicing before the Commission for one year.

Date	Case Name	Conduct	Sanctions
6/30/05	*In the Matter of KPMG LLP, Gary Bentham, and John Gordon*	KPMG Canada, Bentham, and Gordon lacked independence when they audited the 1999-2002 financial statements of Southwestern Water Exploration Co. KPMG had provided Southwestern bookkeeping services for those years, then audited its own work. This lack of independence violated the auditor independence requirements prescribed by the SEC's rules and by generally accepted auditing standards in the U.S.	1. KPMG Canada is censured pursuant to Rule 102 (e). 2. KPMG Canada must pay $73,682, representing the amount KPMG Canada earned in fees from its accounting and bookkeeping services plus prejudgment interest. 3. KPMG agrees to adopt procedures to ensure auditor independence, including firm-wide training and the appointment of a partner responsible for complying with auditor independence requirements. 4. Bentham is denied the privilege of practicing before the SEC for two years. 5. Gordon is barred from practicing before the Commission for nine months.
08/15/05	*In the Matter of John Back*	Back, KPMG's audit engagement partner responsible for the 1999 audit of First American Health Concepts, Inc., falsely represented that KPMG had performed the audit of First American in accordance with GAAS and that First American's financials complied with GAAP. In fact, Back knew or should have known that First American's accounts receivable balances were not in reconciliation with its general ledger. This conduct constituted a violation of Rule 102(e)(1)(ii).	1. Back is permanently barred from practicing or appearing before the Commission as an accountant pursuant to Rule 102(e).
09/30/05	*In the Matter of William Caswell*	Caswell was the director of Deloitte & Touche's audit of the financial statements contained in Adelphia Communications Corporation's 2000 Form 10-K. Caswell failed to ensure that Adelphia's disclosure of its liabilities was sufficient, specifically failing to object to Adelphia's netting of related party payables and receivables.	1. Caswell is barred from appearing or practicing before the Commission as an accountant, with the ability to apply for reinstatement after two years, pursuant to Rule 102(e)(1)(ii).

Date	Case Name	Conduct	Sanctions
10/06/05	*SEC v. KPMG, LLP et al. (Joseph T. Boyle)*	In the course of serving as KPMG's relationship partner to Xerox Corporation during 1999 and 2000, Boyle was informed by the engagement partner that Xerox was engaging in improper accounting. Despite this warning, Boyle did not report these likely violations to Xerox's Audit Committee or take other steps as required by Section 10(A).	1. Boyle is ordered to pay a $100,000 civil penalty. 2. Boyle is suspended from appearing or practicing before the Commission as an accountant for one year. 3. Boyle is permanently enjoined from violating Section 10(A).
10/06/05	*SEC v. Fred Gold, John Parson & Brendon McDonald*	Gold, a former Arthur Andersen partner, and Parsons, a former Arthur Andersen audit manager, supervised, reviewed and approved American Tissue, Inc.'s Fiscal Year 2000 financial statement, despite the fact that American Tissue fraudulently inflated reported assets and earnings by improperly capitalizing $15.6 million of previously expensed supplies and overvaluing its finished goods inventory by at least $12.5 million. McDonald, a former Arthur Andersen experienced senior accountant, also supervised and participated in the audit. Gold, Parson & McDonald failed to request sufficient accounting documentation to verify American Tissue's audit statements. In doing so they each failed to exercise the due professional care and skepticism required by GAAS. Furthermore, when Gold, Parson & McDonald learned that this audit report had been selected for peer review by another accounting firm, they intentionally altered audit work papers and destroyed other documents in an attempt to conceal the failures of their audit work.	1. Parson & McDonald are each permanently enjoined from violating Section 10(b) and Rule 10b-5, as well as aiding and abetting violations of Section 15(d) and Rules 12b-20 and 15d-1. 2. Parson is ordered to pay a $50,000 civil penalty. 3. Parson is suspended from appearing or practicing before the Commission for an indeterminate period of time to be determined in a future administrative proceeding. 4. McDonald is ordered to pay a $30,000 civil penalty. 5. McDonald is suspended from appearing or practicing before the Commission as an accountant with the ability to apply for reinstatement after five years. 6. Gold has not reached a settlement with the Commission.
10/13/05	*In the Matter of Thomas Hauke, CPA*	Hauke, a former partner at Van Buren & Hauke, LLC, prepared a fraudulent audit report for inclusion in RAMO's 1999 10-K. Neither Hauke nor anyone else had audited RAMO's financial statements. Hauke attached another accountant's name to the report in order to mislead RAMO, its investors and the Commission into believing that the financial statements had been audited.	1. Hauke was suspended from appearing or practicing before the Commission as an accountant.

Date	Case Name	Conduct	Sanctions
12/5/05	*In the Matter of Gilbert Bergsman, CPA and Lee Levinson, CPA*	Bergsman, a former partner at Eichler Bergsman & Co, LLP, and Levinson, an audit manager with the same firm, performed quarterly reviews and issued quarterly review reports for eSafety's financial statements for the third and fourth quarters of 2000 and the first quarter of 2001. In doing so, they failed to make adequate inquiries into eSafety's recognition of its consulting revenues, failed to assess whether eSafety had implemented internal controls for a newly adopted accounting policy concerning a new and material revenue stream, and conducted no communications with eSafety's audit committee during the quarterly reviews. Nonetheless, Eichler Bergsman issued quarterly reports stating that it was not aware of any material modifications that needed to be made to the financial statements in order to conform with GAAP.	1. Bergsman and Levinson were suspended from appearing or practicing before the Commission as accountants with the ability to apply for reinstatement after one year.
2/9/06	*In the Matter of Lawrence A. Stoler, CPA*	Stoler, a partner at PwC, allegedly engaged in improper professional conduct in the 2000 audits of three hedge funds—Lipper Convertibles, Lipper Convertibles Series II, and Lipper Fixed Income Fund. Stoler allegedly failed to adequately assess evidence that the funds' portfolio manager was materially overstating the value of convertible bonds and stocks in which the funds were invested, and improperly relied on a purported confirmation process that was significantly flawed.	As of 4/10/06, the matter is pending before an SEC administrative law judge.

Date	Case Name	Conduct	Sanctions
2/16/06	*In the Matter of Kevin M. Hall, CPA, and Rosemary K. Meyer, CPA*	Hall and Meyer were engagement partner and senior manager, respectively, for the audit and review work that KPMG performed for U.S. Foodservice, Inc. ("USF") in 1999 and 2000. They allegedly discovered that USF had recognized substantial unearned "prepayments" of income, which Hall and Meyer documented as "audit exceptions" in their audit working papers. Such prepayments allegedly contradicted express representations by USF management that the company did not obtain vendor prepayments. In addition, the SEC alleges that Hall and Meyer were responsible for a flawed audit design, and did not take necessary steps to clarify inconsistencies or bring problems to the attention of USF's audit committee or others.	As of 4/10/06, the matter is pending before an SEC administrative law judge.

Date	Case Name	Conduct	Sanctions
2/22/06	*SEC v. KPMG, LLP, et al.*	In this Litigation Release, the SEC announced that all four remaining defendants in an action brought against them and KPMG in connection with a fraudulent earnings manipulation scheme by Xerox Corp. agreed to settle. The defendants whose settlements were announced are Ronald Safran, the KPMG engagement partner on the Xerox audit for 1998 and 1999; Michael Conway, the senior engagement partner on the Xerox audit for 2000; Anthony Dolanski, the engagement partner on the Xerox audit for 1997; and Thomas Yoho, the SEC concurring review partner for KPMG on the Xerox engagement from 1997-2000.	1. Safran, Conway and Dolanski each consented to the entry of final judgments against them by the U.S. District Court for the Southern District of New York. Safran and Conway each agreed to pay a civil penalty in the amount of $150,000; Dolanski agreed to pay a penalty in the amount of $100,000. 2. The final judgments also order that Safran, Conway and Dolanski be permanently enjoined from violating certain provisions of the federal securities laws (Sections 17(a)(2) and (3) of the Securities Act of 1933) and from aiding and abetting violations of other securities laws (Section 13(a) of the Securities Exchange Act of 1934 and Rules 12b-20, 13a-1 and 13a-13 thereunder). 3. Safran, Conway and Dolanski each also consented to the issuance of an SEC Order based on the entry of the injunctions which will suspend them from appearing or practicing before the SEC as accountants. Safran will be suspended with a right to reapply in three years, Conway in two, and Dolanski in one. 4. Yoho agreed to the entry of an SEC Order imposing a censure pursuant to Rule 102(e) of the SEC's Rules of Practice.
2/27/06	*In the Matter of Gregory G. Nelson, CPA*	Nelson was the engagement partner on PwC’s audits of Sun Communities, Inc. (“Sun”). During PwC’s 2000 and 2001 audits, Nelson concluded that Sun’s accounting for its interest in a joint venture (“SunChamp”) did not comply with GAAP. When Sun’s management refused to make recommended adjustments, Nelson incorrectly concluded that such adjustments were immaterial to Sun’s financial statements. Specifically, Nelson failed to review outside investor transactions to determine whether Sun transferred the risks and rewards of ownership to SunChamp.	1. Nelson is suspended from appearing before the Commission as an accountant, with the ability to reapply in two years.

Date	Case Name	Conduct	Sanctions
3/3/06	*In the Matter of Andrew J. McAdams, CPA*	McAdams was the engagement partner on PwC's audits of Aerosonic Corp. In supervising the audits, McAdams failed to perform his work in accordance with GAAS. Specifically, McAdams did not plan or adequately supervise audits, did not obtain sufficient evidentiary material, did not maintain an attitude of professional skepticism, and placed undue reliance on senior management's representations, all contributing to Aerosonic's filing of materially false financial statements.	1. McAdams is suspended from appearing before the Commission as an accountant, with the ability to reapply in two years.
3/30/06	*In the Matter of Clete D. Madden,CPA, and David L. Huffman, CPA*	Clete was a partner working on KPMG's 2002 audit of Tenet Healthcare Corp. Huffman was KPMG's senior manager on the audit. Madden and Huffman failed to assess the risk of material financial misstatements and design audit procedures accordingly, failed to use "analytical procedures" to ensure that the end result of the audit was sufficient, and failed to ensure that certain stop loss and outlier payments were reflected in Tenet's disclosures. In addition, Madden and Huffman improperly made changes to the audit working papers in order to "clean up," among other things, references to the outlier payments.	1. Madden is denied the privilege of appearing before the Commission as an accountant. 2. Huffman is suspended from appearing before the Commission as an accountant, with the ability to reapply in four years
3/30/06	*In the Matter of Aron R. Carr, CPA*	Carr was senior auditor on KPMG's 2002 audit of Tenet Healthcare Corp. Members of the audit team, including Carr, improperly made changes to the audit working papers in order to "clean up," among other things, references to certain outlier payments.	1. Carr is suspended from appearing before the Commission as an accountant, with the ability to reapply in three years.