The New Liability Circle, Post Enron! ™©2003

With Excerpts from The New Accountants Liability - Beyond SOX ™

CPAs, Directors, Executives, Lawyers, Financial Advisors & Bankers,
Beware of the New Cost of Success Post Enron!

Learn New Tools & Skills of Success | *New Corporate Governance* | *New Laws, New Liability!* |
The New Circle of Liability Includes You! | *Liability for Mistakes!* | *New Co-Creator Liability!*
New Executive & Professional Liability! | *New Opportunities!*

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Emphasis in Entity Integration, Corporate Governance and Litigation

New Laws, New Circle of Liability, Post Enron! ™©2003

New Corporate Governance Rules |
New Executive & Professional Liability! |

New laws bring new liability and new opportunities!

Post Enron, the cost of success is now more expensive than it use to be, and it has to be. If freedom must have the personal cost of personal responsibility, so must the success of our financial markets have the cost of actual investor and consumer confidence!

The first step to recovery is not a tax cut, lower interest rates, more credit, or any other economic device. ***The very first step is to repair and rebuild confidence.*** Confidence is everything. There can be only one way to do so. Let the people see the law at work; let the people see that the law works, and when it doesn't, make new law that does! Quickly and publicly prosecute the boardroom fraud, dirty deeds, duplicitous dealings, conflicts of interest, and greed-Inspired misdeeds. We must immediately show the public (both the consumer and investor) that such deeds which caused them to lose 70% of their portfolio[i] were deeds that are wrong and not allowed, and that the wrongdoers will be punished for them (fined and jailed). But even this is not enough in our modern and sophisticated world. We have both a competent and sophisticated population, as well as an uninformed and impulsive one. They all need the same initial lesson if we are to obtain a *true* renewed confidence. *In today's instant information society, we need to point out where the law failed, and fix it! That's correct.* *Fix it and scream it from the housetops!* The fact that Mr. Spitzer moved to settle as quickly as possible and avoid a long uncertain lawsuit, is testament that he understands rule one, ***build confidence***.

Once we begin to overcome the lack of confidence of the deeply hurt and shell-shocked investor and consumer, we as the business person, boardroom member, director, officer, risk-taker, business creator, entrepreneur, CPA, lawyer, investment banker, advisor, and business investor, must be keen to learn and use the existing and new laws to stimulate our great capitalist instinct, or we will stumble or fail yet again. *Tax cuts – deficit-debt spending restrictions alone will not create the foundation of confidence necessary to rebuild America. We must first build confidence through legal public justification!*

The second step to recovery is to learn how to use our existing and *new laws* of business safely and to our advantage. However, to understand where we are, we must understand where we have been, and what conditions existed in the 90's that added to or became a cause of the financial disaster as of the turn of the century.

Duty of Care (The Circle of Liability Foundation)

By function, ***Directors*** are to oversee management (officers) for the benefit of the shareholders (corporation). When Directors fail to do so competently, or at law, in breach of the ***"Duty of Care",*** they may incur legal liability. By personal glory, Directors are in-the-know with often several companies, and able, if they choose, to cross-collateralize information and opportunities. Sometimes this benefits all of us, but sometimes it harms us greatly. One of law's functions is to draw the line. Capitalism will always push the line, but mostly it will benefit the line if fair and simple rules are understood. They need to be taught. Public education of not only the executives, directors and professions is critical, but of the general public from small businesspersons, to kids. **The cost of new success brings new laws with new liability.** The ***Duty of Care*** generally requires the director to *act in good faith, in the best interest of the corporations and shareholders, and to exercise such care, with inquiries, as an ordinary prudent person would in similar circumstances*. What directors have done in the past may not meet the bill in the future. *New law[ii] expressly allows, or in practice requires, Directors to hire and rely on experts, outside counsel, independent professionals, advisors and CPAs, or land in the circle of liability.* Is this a 'safe harbor' that limits liability? It certainly limits 'mens rea' (intent, bad-will, evil motive or reckless disregard). So use it! Many law firms will start to offer this service, eventually the pricing will be built into our national economic business model.

From 1990 to 1995 the legal and legislative community escaped certain responsibility for its own actions. Such laws, judicial decisions, and legal arguments created an environment that allowed shades of gray to materialize into stock and investor fraud. Accountants, lawyers, investment bankers and other so-called 'secondary actors' were greatly shielded from liability. Let's face it, the now infamous corporate scandals of **Enron, Adelphia, Tyco, Global Crossing, and WorldCom** would not have occurred without the de facto help or assistance of investment bankers, accountants, lawyers, financial advisors or secondary actors. **In 1995, Congress** passed the PSLRA (*Private*

Securities Litigation Reform Act) which set strict pleading standards for securities fraud, protected projections and forecasts and favored proportionate fault liability over and *eliminating joint and several liability*. Well, things are now 'a-changing'. Or are they?

The New Liability Circle! | New Laws! | New Liability!

New Law: Post Enron / Zandford: Now a lawyer, accountant, investment banker, financial advisor, or "secondary actor" is *likely to be held liable* for acts he/she would not be liable for just a few years ago, along with the executives, managers and directors.

The Enron and Zandford cases, have thus far reshaped the liability circle. The circle now includes executives, managers and directors, the lawyer, CPA, accountant, investment banker, financial advisor, or "secondary actors". Although I am very pro-business, and anti-regulation, however, it is high time to use the law to add value to the markets by way of example and a check and balance enforcer, but only to the extent that regulations do not impede responsible progress (success).

Securities fraud claims under 10(b) [Securities Exchange Act of 1934][iii] and 10b-5 [Securities and Exchange Commission Rule][iv] must allege that the defendant made a misstatement or omission of a material fact, made with scienter (or with the "intent to deceive, manipulate, or defraud"[v]), on which plaintiff relied, proximately causing plaintiff's injury[vi]. Except under 10b-5 liability it is not limited to untrue statements or omissions. 10b-5 includes use "in connection with the purchase or sale of any security," of "any device, scheme, or artifice to defraud" or any other "act, practice, or course of business" that "operates…as a fraud or deceit."[vii]

With or despite the 1990-1995 laws, Judge Harmon in the Federal Southern District ***Enron*** case, broadened the liability circle to include accountants (Arthur Andersen), investment bankers and brokerage houses (Citigroup, JP Morgan, Merrill Lynch), and lawyers (Vinson & Elkins) – as "primary actors" going around the *Central Bank* prohibition on *aiding-and-abetting* or *secondary actor* liability; defining a rule that the Supreme Court did not preempt the circumstance where a secondary actor might have engaged in conduct which constitutes *primary actor liability under 10b-5*.

Specifically, the Enron district court rejected the bright-line test limiting secondary actor liability to where the secondary actor must make the subject misstatement, but also the misstatement must be publicly attributable to the actor at the time it is made or broadcast. [viii] Instead, the court cast a wider net by holding "When a person, acting alone or with others, creates a misrepresentation [on which the investor-plaintiffs relied], the person can be held liable as a primary violator if he acts with the requisite scienter."[ix] Now accountants, lawyers, board members, directors, investment bankers and secondary actors can be held liable as a co-creator of a misstatement, even if he did not initiate the misrepresentation. The secondary liability test lives within 10b-5 liability when the secondary actor has "substantial participation or intricate involvement" in issuing false public statements, even if "that participation might not lead to the actor's actual making of the statements."[x] or the actor is not publicly identified or associated with the misrepresentation.[xi]

Judge Harmon relied on in part the Supreme Court's 'churning/retention' case *of Securities and Exchange Commission v. Zandford*[xii] to find that: 10b-5 secondary actor liability is *not limited to those who make false statements or omit important facts, but* *extends to those who employ a scheme, device, or artifice to defraud,[xiii] including but not limited to "continuous series of unauthorized sales of securities", improper retention of the proceeds as a fraudulent 10b-5 scheme.[xiv] The court noted that "neither the SEC not this court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the [Securities Exchange Act],[xv] and in fact the Central Bank court expressly warned that 10b-5 secondary liability may be found, even if 10(b) aiding-and-abetting liability is absent.[xvi]*

The *Enron* court went on to expressly expand 10b-5 liability or affirm it, or remind us that a *group acting together can be each primarily liable for respective allegations of a specific misstatement or omission, for a manipulative or deceptive act to defraud, made with scienter, and upon plaintiff's reliance, causing injury*.[xvii]

The court held that intricate involvement, or the devising of financing methods that allowed Enron to *conceal its debt, unlawfully maintain its credit rating, and falsify its publicly reported financial condition* by Enron's executives or professional team (accounting firm, outside lawyers, banks and financial advisors) will satisfy liability under Rule 10b-5.

Accountants seemingly have an even more direct route of liability. Call for our special report on **"*Accountants – Asset Protection & Liability Report, Post Enron!"***

***Off-Balance Sheet Contingencies* | "*RAhD" (randomly activated hidden debt or liability*)**.

Sometimes words speak loudly but confuse. One such concept that has to be addressed upfront is the concept of ***OFF-BALANCE SHEET ITEMS***. What does this mean? First of all, balance sheets are supposed to have and fairly report all assets, liabilities and net worth (stockholders equity) and contingencies. Even if a Board member is confused or unsure, just the item of "***liabilities"*** should concern the Director, because if such liabilities can potentially come back for payment by the company, the nature and extent is a ***critical concern***. I like to think of it as "***RAhD" (randomly activated hidden debt or liability***). Enron apparently, through a series of related entities garnered a massive off-balance sheet contingency that exposed the company to risks, not respected by its investors. **Literally, 'untold' exposure is etched in the fabric of "off-balance-sheet" contingencies. *June 15, 2003 and December 15, 2003*** are deadlines pending for reporting **off-balance sheet** items and the new **disclosure requirements for the table of contractual obligations** (in "tabular format")**.** Just a friendly reminder. Just another way of avoiding liability.

For the fiscal years ending on or after ***June 15, 2003***. Registrants will be required to comply with the disclosure requirements for off-balance sheet arrangements in Commission filings. For the fiscal years ending on or after ***Dec. 15, 2003*** registrants will be required to comply with the disclosure requirements for the table of contractual obligations in Commission filings. The Final Rule is reprinted below:

> ***"Final Rule:***
> ***Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations***
>
> Securities And Exchange Commission
> 17 CFR Parts 228, 229 and 249

[Release Nos. 33-8182; 34-47264; FR-67
International Series Release No. 1266
File No. S7-42-02]
RIN 3235-AI70
Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

Agency: Securities and Exchange Commission.Action: Final rule.Summary: As directed by new Section 13(j) of the Securities Exchange Act of 1934, added by Section 401(a) of the Sarbanes-Oxley Act of 2002, we are adopting amendments to our rules to require disclosure of off-balance sheet arrangements. The amendments require a registrant to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the "Management's Discussion and Analysis" ("MD&A") section of a registrant's disclosure documents. The amendments also require registrants (other than small business issuers) to provide an overview of certain known contractual obligations in a tabular format. Dates: *Effective Date*: April 7, 2003. *Compliance Date*: Registrants must comply with the off-balance sheet arrangement disclosure requirements in registration statements, annual reports and proxy or information statements that are required to include financial statements for their fiscal years ending on or after June 15, 2003. Registrants (other than small business issuers) must include the table of contractual obligations in registration statements, annual reports, and proxy or information statements that are required to include financial statements for the fiscal years ending on or after December 15, 2003. Registrants may voluntarily comply with the new disclosure requirements before the compliance dates." (printed in part)

The New Accountants Liability, Post Enron!

Direct or First Party Liability.

First party accountants' malpractice lawsuits are alive and well. A client under a defined scope of work retainer is in first party privity with the CPA and has a direct cause of action for Professional Negligence (i.e.: breach of a duty owed which causes damages[xviii]), fraud, intentional and negligent misrepresentation[xix], and in some states like ***California, Breach of Fiduciary Duty***[xx]. ***In California, the accountant-client relationship is <u>fiduciary</u> in nature and <u>confidential</u>.***[xxi] However, in a negligence suit, or to proffer a duty owed and breached, the client (plaintiff) has the burden of proof and reasonable care and diligence do not equal infallibility.[xxii] In a suit for negligent misrepresentation or deceit for failure to disclose, or for concealment, the CPA (defendant) *need <u>not</u> have intended to defraud and deceive; only have made the statement without reasonable grounds for believing it to be true; but only the intent to induce plaintiff's reliance*.[xxiii]
Historically, duties were placed on accountants by several vehicles from case law, statutory law, and accounting principles, such as **FASB**[xxiv] (Financial Accounting Standards Board), generally accepted accounting principles (**GAAP**), and generally accepted auditing standards (**GAAS**[xxv]). More recently, serious duties and grave exposure to liability *<u>regardless to first party privity</u>*, are found against the accountant **<u>in The Sarbanes-Oxley Act</u>** (***July 30, 2002***), and in the **Enron** (supra) and *Supreme Court* case of **Zandford** (supra).

Indirect or Third Party Liability.

As indicated, unlike first party claims, the accountant was historically shielded from third party claims. Third Party party claims usually take the form of *fraud, misrepresentation*[xxvi]*, and securities law violations (10b, 10b-5)*. In *California,* "the report" with misrepresentations forms the basis of the negligence liability, not the audit services itself. The *California Supreme Court* held that an accountant who performed the audit and issued the audit report may be held liable for *negligent misrepresentations in the report, and intentional misrepresentations for reasonably foreseeable third parties in the preparation and dissemination of the audit. Third parties may find intentional fraud* ***<u>without the need to pled and prove "actual knowledge"</u>*** *of the false or baseless character of the opinion. Third parties can sue for fraud by only showing scienter (that the statement (report) was made recklessly without knowing whether the statement was true or false)*[xxvii]*.*

New accountants liability laws (both for civil and criminal violations) are now found in **<u>The Sarbanes-Oxley Act</u> of *July 30, 2002***,[xxviii] and the primary and *secondary actors* liability for securities fraud found or affirmed in the **Enron** case (supra) and the *Supreme Court* case of **Zandford** (supra). *Third party shareholder suits* for securities fraud may also be brought against the accountant for written misrepresentations, individually or as a class-action. False and misleading statements may be found in the *company's prospectus and proxy solicitation, and in the 10-Q and 10-K.* The 1995 PSLRA requires that FRCP 9(b) pleading standards satisfy "all averments of fraud or mistake." This would include "the required state of mind."[xxix] In California, the Ninth Circuit in *In re Silicon Graphics, Inc., Securities Litigation*, held strong circumstantial evidence satisfied the alleged misconduct.[xxx] *State of mind in Section 11 of the Securities Act of 1933* ***does not require intentional culpable conduct*** *but just acts that are untrue or omitted material statements*.[xxxi] Section 14(a) claims of the Securities Exchange Act of 1934 requiring proxy solicitation probably do not require scienter. [xxxii] 10b and 10b-5 claims under the Securities Exchange Act of 1934 do require scienter. Liability is alive for 'mistakes' and 'fraud'.

<u>The Sarbanes-Oxley Act</u> also extends the statute of limitations and <u>precludes the discharge in bankruptcy</u>, debts resulting from civil judgments or even, settlements. <u>The Sarbanes-Oxley Act</u> otherwise (1) requires increased disclosures and certifications by auditors attesting to a company's internal controls and communication with the audit committee, (2) restricts the auditors from certain type of work such as nonaudit services for audit clients, including bookkeeping, appraisal, actuarial or valuation services, management functions, human resources, broker-dealer, investment-advisor, investment-banking services, legal or expert services unrelated to the audit, (3) creates the Public Company Accounting Oversight Board, which sets standards, inspects the auditors performances, and disciplines CPAs, (4) mandates rotation of audit partners and concurring partners every five years, (5) oversees studies on topics as the potential effects of mandatory rotation of accounting firms for public companies, the consolidation of public accounting firms, accounting rules that result in financial statements reflecting the economics of off-balance sheet transactions, the role and function of credit-rating agencies, investment banks and financial advisors helping public companies hide their true financial condition, and the number of accountants who have aided-and-abetted a violation of the federal securities laws but have not been sanctioned or penalized. [xxxiii] Moreover the SEC adopted the rule under ***Section 302(a)*** that requires the principal executive and financial officers of publicly traded companies to *certify financial and other information in the companies' quarterly and annual reports (10-Q, 10-K)*.[xxxiv] This will expose executives/officers/directors to *'quicker'* liability.

Accountants under the recent cases of *Enron and Zandford* are potentially liable under 10b-5 for false statements or omissions for services rendered in "unaudited" financial statements (or "reviews" of "interim" financial statements later found to be *materially false and misleading*); notwithstanding old law refusing to find liability of same absent an "audit" level engagement.[xxxv] The old law gave a quasi presumption as to what duty is owed, or who are foreseeable plaintiffs. Anything less than an "audit" was not a "statement" (or "report"). The lower the level of engagement ("review", or a "compilation"), the less likely liability would extend, however the higher the engagement commitment, such as an "audit", which generally requires a higher independent audit testing standard under GAAS, the more likely liability would extend.

Public companies are required to file Form 10-Q and 10-K reports with proper disclosures[xxxvi] with the SEC,[xxxvii] all in compliance with GAAP.[xxxviii] The SEC requires "professional standards and procedures for conducting such reviews."[xxxix] GAAS requires that that procedures tie and test financial statement amounts and other worksheet items, to the general ledger, trail balance, etc., and make sufficient inquiry into the adequacy of *internal controls*, with analysis of *fraud and risk factors*.[xl]

Protection from New Rules and New Liability!

Malpractice insurance is going through the roof! ***CPAs, Attorneys, Financial Advisors and Executives will be hit with the new liability***. ***The new liability circle includes you!*** You not only need to know the new rules and advise your clients of the new rules, but you need to know the rules of asset and liability protection and advise your client of same as well, or recommend an expert in that area of the law. Of course you should implement a plan for asset and liability protection as well.

Just like you need to protect yourself and your own practice, so must you have the skills set to protect your clients! Do you know how to use certain entities and contracts to *lock-away wealth* for you, or your clients, legally? Do you know what States have enacted protection that can lock away up to *30-50% of wealth in a safe harbor*? Do you know what domestic entity can act like a personal bank and lock away substantial wealth? Do you know how a client can build a dynasty protected from creditors? Do you know how to advise a client on a personal and business integration plan? Do you know the best way for a Director to operate? Can you protect a client's deferred compensation plan? [**Call for the 13 Secrets of the Rich or Informed!™**] **[You may call 877-WIN-4-YOU anytime and get your free Asset Protection Handout: "You're Begging to be Sued!™"]** Call **877-WIN-4-YOU** for our special new report on ***"Accountants – Asset Protection & Liability Report, Post Enron!"***

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[i] USA TODAY; May 1, 2003 By Kevin McCoy; Tyco; "70% plunge in share value."
[ii] California Corporations Code, Section 309; Delaware General Corporation Law Section 141 (e)
[iii] 15 U.S.C. Section 78(j)(b)
[iv] 17 C.F.R. Section 240.10b-5 (2002)
[v] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976)
[vi] Abrams v. Baker Hughes, Inc. 292 F.3d 424, 430 (5th Cir. 2002)
[vii] 17 C.F.R. Section 240.10b-5 (2002)
[viii] Wright v. Ernst & Young 152 F 3d 169, 175 (2d Cir. 1998), cert denied, 525 U.S. 1104 (1999)
[ix] In re Enron Corp., 235 F. Supp. 2d 549, 588, 692.
[x] In re Software Toolworks, 50 F.3d 615, 628 n.3 (9th Cir. 1994); Adam v. Silicon Valley Bancshares, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995); In re ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994); Cashman v. Coopers & Lybrand, 877 F. Supp. 425, 432 (N.D. Ill. 1995).
[xi] In re Enron Corp., 235 F. Supp. 2d 549, 586-88.
[xii] 122 S.Ct. 1899 (2002)
[xiii] 15 U.S.C. Section 78j(b); 17 C.F.R. Section 240.10b-5.
[xiv] 122 S.Ct. 1899 @ 1903.
[xv] 122 S.Ct. 1899 @ 1906.
[xvi] Central Bank, 511 U.S. 164, 191.
[xvii] In re Enron Corp., 235 F. Supp. 2d 549, 592.
[xviii] Hydroculture, Inc. v. Coopers & Lybrand, 848 P. 2d 856 (Ariz. Ct. App. 1992); Mattco Forge, Inc. v. Arthur Young & Co., 60 Cal. Rptr. 2d 780, 788-90 (Ct. App. 1997);
[xix] CAL. CIVIL CODE Section 1710.2 (West 2001-02).
[xx] Neel v Magana, Olney, Levy, Cathcart & Gelfand, 491 P.2d 421, 428-9 n. 24 (Cal. 1971); Int'l Engine Parts, Inc., v. Feddersen & Co., 888 P. 2d 1279, 1295 (Cal. 1995); Peat, Marwick, Mitchell & Co. v. Superior Ct., 245 Cal. Rptr. 873, 880 (Ct. App. 1988), cert dismissed, 490 U.S. 1086 (1989).
[xxi] CAL. CODE REGS. Tit. 16 Section 54.1 (2003); Weck v. District Court, 408 P.2d 987, 991-92 (Colo. 1966).
[xxii] Gagne v. Bertran, 275 P. 2d 15, 21 (Cal. 1954)
[xxiii] Id. 275 P.2d 15, 20 n.5.
[xxiv] Jan R. Williams, 2003 Miller GAAP Guide (2002)
[xxv] Larry . Bailey, 2003 Miller GAAS Guide (2002)
[xxvi] RESTATEMENT (SECOND) OF TORTS section 552(1977)
[xxvii] Bily v Arthur Young & Co. , 834 P.2d 745, 773, 767, 768-69 (Cal. 1992); Indus. Indemn. Co. v. Touche Ross & Co. , 17 Cal. Rptr. 2d 29, 32-33 (Ct. Ap. 1993).
[xxviii] Pub. L. No. 107-204, 116 Stat. 745 (2002)

[xxix] 15 U.S.C. section 78u-4(b)(2) (2002.
[xxx] 183 F.3d 970 (9th Cir), 195 F.3d 521 (9th Cir. 1999)
[xxxi] Herman & MacLean v Huddleston, 459 U.S. 375, 382 (1983)
[xxxii] Adams v. Standard Knitting Mills 623 F.2d 422, 428 (6th Cir)
[xxxiii] U.S. SEC. & EXCH. COMM'N REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES-OXLEY ACT OF 2002, 4 (2003)
[xxxiv] U.S. SEC. & EXCH. COMM'N, FINAL RULE: CERTIFICATION OF DISCLSOURE IN COMPANIES QUARTERLY AND ANNUAL REPORTS (2002)
[xxxv] In re Kendall Square Research Corp. Sec. Litig., 868 F. Supp. 26, 28 (D. Mass. 1994).
[xxxvi] 17 C.F.R. Section 210.10-01(a)
[xxxvii] 17 C.F.R. Section 210.10-01(d).
[xxxviii] American Institute of Certified Public Accountants, Interim Financial Information, Statement on Auditing Standards No. 71 (1992).
[xxxix] 17 C.F.R. Section 210.10-01(a)
[xl] AICPA, PRACTICE ALERT 2000-4, QUARTERLY REVIEW PROCEDURES FOR PUBLIC COMPANIES (2000).