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Standing of New York Limited Liability Company Members to Bring Derivative Claims

The limited liability company ("LLC") combines characteristics of both corporations and partnerships, with a corporation's limitation on its owners' personal liability and a partnership's operating and management flexibility. But, in New York, one thing LLCs may not have in common with corporations and partnerships is the ability of its owners to bring derivative claims on behalf of the entity.

The New York Limited Liability Company Law ("LLC Law"), adopted in 1994, does not expressly authorize members to bring derivative claims on behalf of their LLCs. This is unlike New York's corporation and partnership statutes, which expressly authorize derivative claims. *See* N.Y. Bus. Corp. § 626 (allowing derivative actions to be brought on behalf of the corporation); N.Y. P'ship § 121-1002 (allowing derivative actions to be brought on behalf of the limited partnership). This is a troublesome omission, particularly where a claim belongs exclusively to the LLC and the alleged wrongdoers are the majority members or third parties controlled by the majority members. While New York case law has historically not been receptive to the concept of derivative claims by LLC members, a recent decision of New York's Appellate Division, First Department, breathes new life into the argument that LLC members have standing to seek legal redress for wrongs committed to the LLC.

The Statutory Background

The difficulty with LLC members bringing derivative claims can be traced back to the legislative history of New York's LLC Law. The initial draft of that LLC Law con-

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LLC Claims

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tained a provision (Article IX) which would have expressly authorized derivative suits. However, after legislators raised questions concerning this provision, it was deleted to avoid jeopardizing passage of the statute. With no statutory authority to bring derivative claims, and because LLCs were a new form of business entity with no common law precedent existing to recognize this right, since the adoption of the LLC law New York courts have generally rejected the notion of a common law right to assert a derivative action on behalf of an LLC, finding "the more persuasive authority is that there is no such right [to institute a derivative claim] . . . ." *Lio v. Zhong*, 10 Misc. 3d 1068(A), 814 N.Y.S.2d 562 (Table), 2006 WL 37044, at *3 (N.Y. Co. Jan. 6, 2006); *see also Hoffman v. Unterberg*, 9 A.D.3d 386, 388-89, 780 N.Y.S.2d 617, 620 (2d Dep't 2004). Indeed, last year the Appellate Division, Second Department resounded this principle in *Caprer v. Nussbaum*, 2006 N.Y. Slip Op. 7443, at *7, 825 N.Y.S.2d 55, 67 (2d Dep't 2006): "Limited liability companies seem to be the one exception thus far to judicial recognition of the authority to bring a derivative action . . . a member of a limited liability company has no right to bring a derivative action on behalf of the company."

The First Department Case

Recently, however, the Appellate Division, First Department adopted the opposite view, relying on common law principles applicable to corporations and partnerships in allowing LLC members to assert derivative claims. In *Tzolis v. Wolff*, 829 N.Y.S.2d 488 (1st Dep't 2007), the appellate court reasoned that "the mere omission of . . . [express language in the LLC Law allowing for derivative actions], a factor other courts see as a sole or significant reason to reject standing, is not enough to deprive a limited partner of the right to assert a claim on behalf of the company."

Tzolis involved a New York limited liability company that owned a hotel. The plaintiff minority members alleged that the majority members had initially leased and later sold the hotel at below market prices to entities owned by the majority members. Plaintiffs brought suit derivatively on behalf of their LLC seeking, *inter alia*, a judgment declaring the lease and the sale of the hotel unauthorized and void. The lower court dismissed the derivative claims on the ground that the plaintiffs lacked standing.

In reversing and reinstating the derivative claims, the First Department held that an LLC member may maintain a derivative action, relying on the common law right applicable to corporations and partnerships, noting:

> "1) the historic judicial recognition of the common-law right to bring a derivative action on behalf of a corporation or a limited partnership, both of which share many of a limited liability company's characteristics; 2) the principles of statutory construction, which provide that only a clear statement of legislative intent may override the common law; 3) the fact that most states provide a statutory right to bring a derivative claim; and 4) the unpersuasive rationale of those decisions which have rejected derivative claims for limited liability company members."

The court found there was "nothing inherent in the limited liability company structure, operation, purpose, status or benefits that would call for treating its members any differently, on the issue of standing, from the shareholders of corporations or the members of limited partnerships." As for the LLC Law's legislative history, the court found that given the "gen-

Ultimately, only a ruling of New York's highest court or an amendment to New York's LLC Law will finally put this issue to rest.

eral rule of statutory construction that a clear and specific legislative intent is required to override the common law," the statute's silence on this issue could not be interpreted as a specific legislative intent to override common law.

Some federal courts, applying New York law, have likewise looked to the common law in recognizing the right of LLC members to bring derivative claims. In *Weber v. King*, 110 F. Supp. 2d 124, 126 (E.D.N.Y. 2000), the court found it "peculiar" that the New York legislature had not "include[d] a provision expressly permitting derivative lawsuits by members of an LLC," given that "[t]he LLC . . . borrows features from both the corporate and partnership forms," that LLC members "have been analogized to corporate shareholders and limited partners," and that "shareholders or limited partners are permitted by statute to bring a suit derivatively on behalf of the corporation or partnership." However, the court concluded: "We do not believe that the legislature's failure to include a derivative action provision in the [LLC Law] prevents us from recognizing such a right at common law."

Similarly, in *Bischoff v. Boar's Head Provisions Co., Inc.*, 436 F. Supp. 2d 626 (S.D.N.Y. 2006), plaintiff LLC member sued fellow members alleging defendants had diverted profits from the LLC to a related corporation in which they held a greater interest. Holding that plaintiff could maintain a derivative action, the court reasoned that because the LLC was designed as a hybrid of the corporate and partnership forms, LLC members should have the same right as shareholders and partners to bring a derivative action, and that the common law right to bring a derivative action could only be superseded by "a clear statement of legislative intent, and the legislature's omission of explicit authorization for derivative actions does not constitute such intent."

Conclusion

New York case law is currently split on the issue of an LLC member's right to bring derivative claims on behalf of the LLC. Though the legislative history of the LLC Law reflects a clear intention not to provide for a statutory right, several courts recently have found a derivative action right to exist as a matter of common law. Ultimately, only a ruling of New York's highest court or an amendment to New York's LLC Law will finally put this issue to rest. ◎

Bank Safe From Liability Absent Legal Duty To Warn

The Commercial Division of New York Supreme Court has once again refused to impose an obligation on lenders to police customers' accounts where no fiduciary duty exists. In *Rizer v. Breen*, No. 601676/05, 2007 N.Y. Misc. LEXIS 801 (N.Y. County Jan. 29, 2007), the plaintiff brought suit against HSBC for claims arising from a power of attorney over the account that the plaintiff had given to her stepfather, who allegedly abused it. The plaintiff sued HSBC — among other banks, investment firms, businesses, and individuals — for aiding and abetting fraud, aiding and abetting breach of fiduciary duty, aiding and abetting conversion, breach of contract, unjust enrichment and negligence. The court granted HSBC's motion for summary judgment on each of these claims.

Plaintiff Margaret-Mary McGowan Rizer, a professional model, traveled continuously and had neither the time nor the experience to manage her financial affairs. *Id*. at *1. In May 1999, at the age of twenty-one, Rizer granted powers of attorney ("POA") to her mother and stepfather, John R. Breen, Jr., over her standard deposit and credit card accounts at HSBC. *Id*. at *3. The POA specifically provided that the plaintiff's mother and Breen could act separately in the plaintiff's name "in any way which I myself could do" and provided that the appointed agents would have "broad power" to dispose of property "without advance notice to you or approval by you." *Id*. at *8. The plaintiff placed no limitations on the POA despite the fact that the form of POA, which was provided by the bank, contained a section that allowed for the addition of "special provisions or other limitations." *Id*. Eventually, plaintiff's mother relinquished sole responsibility for the accounts to Breen and stopped participating in the management of the plaintiff's financial affairs. *Id*. at *3.

At some point, Breen allegedly developed serious alcohol and gambling problems, allegedly stealing at least $3,000,000 from Rizer's accounts to pay personal debts and expenses. *Id*. at *4. Breen allegedly wrote hundreds of unauthorized checks to cash, to his own order and to his personal creditors, and also forged documents in order to loot Rizer's insurance and brokerage accounts. *Id*. Breen was criminally prosecuted in 2002 for having stolen all of Rizer's money over a three-year period. *Id*. On October 22, 2002, Breen pled guilty to three counts of grand larceny, scheme / continued page 4

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to defraud in the first degree, and criminal possession of a forged instrument. *Id*. Breen was sentenced to a sixteen month to four year prison term with restitution to be determined at a later date. *Id*. at *5.

Rizer maintained that HSBC, and other financial institutions, assisted Breen in his scheme to steal from his stepdaughter by failing to act upon obvious signs of wrongdoing. *Id*. She alleged that Breen's conduct could not have gone unnoticed in their small town, especially because Breen, although unemployed, was openly living well beyond his means. *Id*. Additionally, Rizer argued that the banks did not investigate Breen's conduct or notify her of irregular account activity such as improper check endorsements, overdrafts, and check-kiting. *Id*. at *6.

HSBC moved for summary judgment on the ground that the POA executed by Rizer in favor of Breen foreclosed her causes of action. *Id*. at *8. Indeed, under New York law, banks are obligated to accept a properly executed POA. *See* General Obligations Law § 5-1504(3). Because Rizer did not allege the POA was improperly executed, revoked, forged or limited, HSBC "could not have lawfully refused the properly executed POA." *Id*. at *13. Further, HSBC argued that it had no duty to monitor or police Rizer's accounts as their relationship was never anything more than "the normal relationship of a bank and its depositor." *Id*. at *15. Although Rizer could have opened a special trust, custodial, or fiduciary account, her accounts at HSBC were all standard deposit accounts. *Id*. at *9. Under such a debtor-creditor relationship, a bank owes no fiduciary duty to its customer. *Id*. Finally, HSBC presented evidence that, "despite ample opportunity to do so, it was Rizer herself who wholly failed to monitor the activity in her accounts." *Id*. at *18. Although Rizer regularly accessed the ATM where her account balances were readily available, she claims she never realized her stepfather was looting her accounts. *Id*.

On Rizer's claims of aiding and abetting, the court found Rizer's allegations insufficient to raise a triable issue of fact. *Id*. at *20. To prevail on a claim of aiding and abetting, plaintiff must prove (1) the existence of wrongful conduct by the primary wrongdoer, (2) knowledge of the wrongful conduct on the part of the defendant, and (3) substantial assistance of the defendant in achieving the wrongdoing. *Id*. at *19. First, Rizer failed to prove HSBC had actual knowledge of Breen's underlying torts. "Allegations of constructive knowledge, or that defendant was on notice as to the tortious behavior of the wrongdoer, are not legally sufficient to sustain a cause of action." *Id*. at *20. Rizer's conclusory allegation that Breen's actions could not have gone unnoticed in their small town did not establish HSBC had actual knowledge of Breen's wrongful conduct. *Id*. Second, Rizer failed to prove HSBC substantially assisted Breen's actions. *Id*. at *22. Rizer alleged that HSBC processed bank withdrawals, bank transfers and checks for Breen. *Id*. at 21. Rizer also alleged that HSBC's inaction constituted substantial assistance. *Id*. However, the court noted: "It is well settled that without an independent duty to disclose, such as a fiduciary duty, inaction by itself does not amount to substantial assistance for purposes of determining aider and abettor liability." *Id*. Because the bank had no duty to monitor Breen's actions and was required by law to honor Breen's banking transactions under the POA executed by Rizer, the court concluded HSBC did not substantially assist Breen in his wrongdoing. *Id*.

The court also dismissed Rizer's breach of contract claim. *Id*.

Requiring banks to monitor access to the accounts and supervise the use of assets would be intrusive, if not absurd.

at *23. Rizer claimed that she entered into a contract with HSBC pursuant to which HSBC "was obliged to exercise good faith in monitoring the activity of the account." *Id*. The court found that documentary evidence showed HSBC did not contract to monitor her accounts and, in fact, that Rizer was obligated to indemnify HSBC for any claim arising from its reliance on the POA. Additionally, the court rejected Rizer's claim for unjust enrichment because the claims arose from the deposit contract between the plaintiff and HSBC. *Id*. at 22. The court found that no claim for unjust enrichment can exist where the matter is controlled by a contract. *Id*.

Finally, the court dismissed Rizer's negligence claim. *Id*. at 27. Rizer alleged that she was owed a duty of care that required HSBC to monitor her account to ensure the appropriate use of her POA. *Id*. at *26. However, the court found, "it is settled that a depositor may not sue [her] bank in negligence based solely on the contractual relationship between bank and depositor." *Id*. Rizer failed to show any evidence that she and HSBC intended their relationship to be anything more than the ordinary bank-depositor relationship. *Id*. at *27. Therefore, HSBC had no duty Rizer beyond honoring the depositor-bank contract. *Id*. at 26.

As the court summarized: "Rizer's claims rest upon the theory that HSBC had a duty to do what she did not: (1) monitor Breen's access to the accounts at issue; (2) prevent his access where necessary; and (3) supervise the use of her assets." *Id*. at *11. Such a requirement would become unduly burdensome on banks, especially where a customer's own diligence could prevent such defalcations. Indeed, to impose these duties upon a bank would defeat the purpose of a properly executed POA to empower an attorney-in-fact "to take any and all acts 'as fully as the principal might or could do.'" *Id*. at *12. Because the "attorney-in-fact is essentially an alter ego of the principal," *id*., requiring banks to monitor access to the accounts and supervise the use of assets would be intrusive, if not absurd. ◎

Second Circuit Addresses Auditor Liability Under the Federal Securities Laws in Two Recent Decisions

The United States Court of Appeals for the Second Circuit issued two recent decisions that may have significant ramifications on the scope of auditor liability under the federal securities laws. The decisions concern: (1) an auditor's duty to correct statements in a certified opinion that the auditor subsequently learns are false and misleading; and (2) an auditor's liability (or lack thereof) for misstatements in financial statements that the auditor "reviewed" but did not "audit."

Overton v. Todman & Co., 478 F.3d 479 (2d Cir. 2007)

In *Overton*, the Second Circuit resolved a long-unsettled issue by confirming that an auditor may incur primary liability under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 if the auditor fails to correct or withdraw statements in a certified opinion that the auditor later learns were false or misleading at the time made, if the auditor knows or has reason to know that potential investors may be relying upon those statements.

The auditor defendant in *Overton* audited the financial statements of a broker-dealer from 1999 through 2002, and, in each year, issued an "unqualified" opinion that the broker-dealer's financial statements accurately portrayed its financial position. The auditor, however, made "significant errors" each year by inaccurately reporting the broker-dealer's payroll tax liability. The errors were revealed in 2003 when the New York State Department of Taxation determined that the company had failed to pay its payroll taxes in 1999 or 2000.

Following that determination, the broker-dealer conducted an internal investigation and hired a forensic accounting firm, which concluded that the auditor's "audits were deficient and lacking in many respects." The auditor was aware of the findings of both the Department of Taxation and the forensic accounting firm, yet it never took any steps to withdraw or correct its unqualified opinion. The broker-dealer then sought to raise additional capital to deal with its payroll tax liability, and as part of this process provided potential investors with its 2002 certified financial statements.

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According to the complaint, the auditor knew that the 2002 certified financial statements were being used to solicit potential investors.

The broker-dealer later collapsed. Plaintiff, an investor that had relied on the 2002 financial statements, brought suit in the Southern District of New York, alleging that the auditor violated § 10(b) and Rule 10b-5 by failing to correct its 2002 audit opinion after it became aware of the payroll tax liability error. The District Court reasoned that the auditor's failure to correct its audit opinion would amount, if anything, only to aiding and abetting the broker-dealer's primary violation of the securities laws, and that under *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), a defendant could not be held liable for merely aiding and abetting such primary violations. The District Court thus concluded that the auditor could not be held liable for failing to correct its audit opinion and dismissed the § 10(b) and Rule 10b-5 claims.

The Second Circuit reversed, holding that the auditor's failure to correct its audit opinion could result in liability for a primary violation of § 10(b) and Rule 10b-5. The Second Circuit noted that it had previously "alluded" to a duty by an auditor to correct a certified audit opinion, but never squarely held that such a duty exists or that its violation would give rise to a primary violation of § 10(b) and Rule 10b-5. For example, in the pre-*Central Bank* case of *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980), the court had held that an auditor could be found liable for aiding and abetting a violation of § 10(b) and Rule 10b-5 for failing to correct its certified statements, but *Central Bank* abrogated *Cornfeld*'s holding on that point and thus left unclear if there remained any basis to impose federal securities law liability on the auditor in those circumstances. The Second Circuit in *Overton* further noted that in other decisions since *Cornfeld* it had essentially assumed, without ever formally deciding, that an auditor could be held liable for a primary violation of § 10(b) and Rule 10b-5 based upon the violation of the supposed "duty to correct."

Overton gave the court the opportunity to cement its prior views on this auditor liability issue. The court "recognized that when an accountant issues a certified opinion, it creates . . . [a] special relationship with the investing public" which gives rise to a duty to disclose. Accordingly, it held that an auditor has a "duty to correct" an audit opinion, and thus may be held liable under § 10(b) and Rule 10b-5 for failing to do so, when it: "(1) makes a statement in its certified opinion that is false or misleading when made; (2) subsequently learns or was reckless in not learning that the earlier statement was false or misleading; (3) knows or should know that potential investors are relying on the opinion and financial statements; yet (4) fails to take reasonable steps to correct or withdraw its opinion and/or financial statements; and (5) all the other requirements for liability are satisfied."

> Auditors who fail to correct or withdraw their prior certifications of financials that were later found to have been incorrect when made may now have to confront claims of primary liability from injured investors under the federal securities laws.

The court took pains to clarify the limits of its holding. Specifically, the court held that "the duty to correct requires only that the accountant correct statements that were false *when made*," but did not require an auditor to update a statement which, although true when made, had become false or misleading in light of intervening events. The court specifically declined to reach the issue of whether an auditor has a "duty to update." Furthermore, the court held that the

duty to correct applies only to the statements in its audit opinion and/or the certified financial statements themselves, and does not require an auditor to "divulge information collateral to the statements of accuracy and financial fact set forth in its opinion and the certified financial statements, respectively."

Thus, in *Overton*, Second Circuit confirmed what it had previously hinted at — that an auditor has a "duty to correct" or withdraw statements in a certified opinion that the auditor subsequently learned were false or misleading when made, and the failure to do so may give rise to liability under the federal securities laws in appropriate circumstances. While the circumstances in *Overton* were rather extreme — a company not just attempting to raise capital through use of past financial statements that were previously determined to be erroneous, but seeking that capital for the very purpose of helping remedy the tax consequences of those very past errors — the case is likely to provide the plaintiffs' bar with some additional legal ammunition to aim at the accounting industry whenever there is trading in the stock of a company whose past financials were later found to be erroneous. Auditors who fail to correct or withdraw their prior certifications of financials that were later found to have been incorrect when made may now have to confront claims of primary liability from injured investors under the federal securities laws.

Lattanzio v. Deloitte & Touche LLP, 476 F.3d 147 (2d Cir. 2007)

Auditors for years have distinguished between the familiar traditional "audit," which is usually performed annually, and a quarterly "review." A "review" typically consists more of just discussion and observations rather than the performance of substantive audit procedures, and principally involves applying analytical procedures to the company's financial data, making inquiries of the company's officers responsible for financial and accounting matters, and bringing to management's attention if anything is observed that is in contravention of GAAP (generally accepted accounting principles). In *Lattanzio*, the Second Circuit held that an auditor cannot be held liable under the federal securities laws for alleged misstatements contained in a company's quarterly financial statements that the auditor had reviewed but not audited.

> In *Lattanzio*, the Second Circuit made clear that an auditor may not be held liable under the federal securities laws for alleged misstatements made in companies' unaudited quarterly financial statements that the auditors merely reviewed.

Plaintiffs in *Lattanzio* brought a putative class action against a company's auditor, alleging that there had been numerous misstatements in the company's yearly and quarterly financial statements, and asserting claims for breach of fiduciary duty and violations of § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. The plaintiffs claimed to have suffered losses when the company later went into bankruptcy. The district court dismissed plaintiffs' claims and plaintiffs appealed.

The Second Circuit affirmed on several grounds. First, the court held that the auditor could not be held liable for the alleged misstatements in the company's unaudited quarterly financial statements that the auditor had simply reviewed. The court noted that, under *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), a defendant can only be liable under the federal securities laws for its own material misstatements, not for aiding and abetting another's violation. The court further noted that while the quarterly financial statements at issue had been reviewed by the auditor, they "did not contain an audit opinion by [the auditor], and were not attributed to [the auditor] when they were disseminated." The court held that the auditor "is not / continued page 8

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liable for merely assisting in the drafting and filing of the quarterly statements."

The court rejected the plaintiffs' argument that since the company was required to have its quarterly statements reviewed by an auditor pursuant to 17 C.F.R. § 210.1001(d), the auditor's "mandated review of [the company's] quarterly financial statements associated [the auditor] with those statements to such a degree that they became [the auditor's] statements…." The court held that this argument conflicted with the court's prior opinion in *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), where the court held that a defendant could only incur § 10(b) liability if a misstatement is attributed to that defendant at the time the statement is disseminated. The mere "public understanding" created by § 210.1001(d) that the auditor had reviewed the quarterly statements does not "create an exception to the requirement that an actionable misstatement be made by the accountant."

The court also rejected the plaintiffs' argument that § 210.1001(d) "imposes on accountants an actionable duty under § 10(b) to correct the unaudited financial statements," the breach of which amounts to a "statement" for purposes of § 10(b). The court held that such an argument would expand the scope of liability under § 10(b) "beyond the scope of conduct prohibited by the statutory text." Moreover, the court pointed out that since § 210.1001(d) gives a company an option to either include a report from its auditor in its quarterly statements or not, to impose liability on the auditor where the company had chosen not to include a report would render that option meaningless. Further, pointing to the numerous regulations governing the duties and requirements associated with an auditor's annual audit and the absence of such regulations with respect to quarterly reviews, the court noted that "[c]learly Congress knows how to impose duties on accountants and expose them to liability, when it wants to do so."

The court also rejected the plaintiffs' attempt to recast their defective claim as one for breach of fiduciary duty, invoking the well-settled rule that an outside auditor does not owe a fiduciary duty to a company's shareholders. The court additionally held that even if there had been misstatements in the company's yearly audited financial statements made during the class period that could give rise to liability on behalf of the auditor, the plaintiffs still had failed to plead "loss causation" with regard to those alleged misstatements because, whatever the alleged misstatements' other failings, they had not concealed the company's risk of bankruptcy, which was the theory behind the plaintiffs' case.

Accordingly, in *Lattanzio*, the Second Circuit made clear that an auditor may not be held liable under the federal securities laws for alleged misstatements made in a company's unaudited quarterly financial statements, even if the auditor had participated in or performed a "review" of those unaudited statements. The *Lattanzio* decision should give comfort not only to the accounting industry performing quarterly reviews, but also to their clients, who are thus spared the increased time and expense that would undoubtedly be required for auditors' review services if auditors had to face liability under the federal securities laws for errors in companies' unaudited quarterly financial statements that the auditors merely reviewed. ◎

New York City Bar Task Force Report Recommends Best Practices Regarding the Lawyer-Auditor Relationship and Financial Disclosures

A 30-member Task Force of the New York City Bar issued a report in November 2006 entitled *The Lawyer's Role in Corporate Governance* (the "*Report*") (*see* http://www.nycbar.org/pdf/report/CORPORATE_GOVERNANCE06.pdf). The members of the Task Force included general counsel to public companies, litigation and transactional attorneys, government attorneys, a federal judge, two law professors, the general counsel of a major accounting firm, and one non-lawyer who has served on the audit committees of two public companies. The 190-page *Report* addresses a wide range of issues relating to the lawyer's role in corporate governance, including at the outset an examination of the role played by lawyers in nine of the highly publicized wave of financial scandals, including Enron, WorldCom, Adelphia and HealthSouth.

One of the most significant areas of the *Report*, which is the focus of this article, is the section regarding "The Lawyer-

Auditor Relationship and Financial Disclosures." As the *Report* points out, "[a]lmost all of the recent high-profile corporate scandals have involved financial frauds, typically focused on accounting manipulations" and accordingly, this "lends urgency to the need to examine the role of lawyers with respect to client financial disclosures, including the manner in which lawyers and auditors work together, or fail to do so, as they render their respective services to a common client." *Report* at p. 14. The Task Force made a number of noteworthy recommendations for "best practices" with respect to how lawyers should fulfill their role in connection with their clients' financial disclosures.

Recommended Best Practices for Lawyers

In discussing the relationship between lawyers and outside auditors in dealing with financial disclosures by public companies, the Task Force recommends what it terms "best practices," described as "suggestions concerning the preferred way for lawyers to act, within the framework of law and ethical rules but usually beyond the minimum obligations they impose, to enhance their role in corporate governance and better secure their clients' compliance with the law." *Report* at p. 8. Recognizing that lawyers have an important role to play in connection with their clients' financial disclosures, the Task Force proposes five "best practices" relating to the relationship between lawyers and outside auditors:

1. **Understanding Accounting Concepts**. First, the *Report* states that "a basic familiarity with the accounting concepts relevant to a client is essential for a lawyer advising a public company on financial disclosure and financial structuring." *Report* at p. 129. The Task Force recommends that law firms should provide training for their attorneys in these areas and that in-house lawyers should be similarly trained, although the *Report* does not provide specific recommendations as to the nature of the training.

2. **Lawyer Consultation on Financial Disclosure**. Second, the *Report* discusses how lawyers should be consulted on financial disclosure issues. In particular, the Task Force recommends that lawyers be consulted in connection with the internal control provisions of Section 404 of the Sarbanes-Oxley Act ("SOX") as a means to mitigate the risk of accounting "misdeeds" and improve the mechanisms of corporate governance. *Report* at p. 129. The *Report* gives several examples of areas in which counsel will typically have knowledge and experience bearing on accurate preparation of a public company's financial statements, such as (i) the status of litigation affecting the adequacy of litigation reserves; (ii) information relating to a patent that affects whether the patent is properly accounted for as an asset; (iii) whether accounts are collectible and therefore properly accounted for in the company's receivables and reserves; and (iv) the terms of distribution agreements that could impact revenue recognition. The *Report* recognizes that counsel is not responsible for determining the proper accounting treatment for such transactions, and may not even be aware of the accounting significance of such information, but explains that the lawyer may be in possession of factual information that is relevant to determining the ultimate accounting treatment. *See id*. at pp. 130-31.

Accordingly, the Task Force concludes that an "optimal system of internal controls" should "require the financial personnel responsible for public accounting to consult with a lawyer when it is reasonably foreseeable that the / continued page 10

The Task Force recommends that lawyers be consulted in connection with the internal control provisions of Section 404 of the Sarbanes-Oxley Act.

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lawyer is knowledgeable about these kinds of facts regarding material transactions." *Id*. at p. 131. The *Report* observes that by establishing consultation with lawyers as a best practice, "the lawyers would become an essential part of internal controls" and that "the lawyer would be held responsible for what he does know and for ensuring that the appropriate accounting personnel know the essential facts in his possession concerning each material transaction." *Id*. The Task Force did not recommend a particular form of consultation for all public companies, although it referred to the possibility of requiring some form of written certification or confirmation by the lawyers to the responsible financial personnel. The Task Force, however, stressed that the recommendation that there be best practices that actively involve lawyers in the system of internal controls and in the process supporting the certification of financial statements pursuant to Section 302 of SOX, should apply to every public company. *See id*. at 131-32.

3. **The 1975 ABA-AICPA "Treaty"**. Third, the *Report* addresses the 1975 ABA-AICPA "Treaty" (*see Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 31 Bus. Law. 1709 (1976)), which recommends how lawyers should respond to auditors' inquiries regarding asserted and unasserted claims (loss contingencies). The Task Force does not recommend any modification of the Treaty. The *Report*, however, points out that it is necessary for lawyers to be aware of how the SEC's lawyer conduct rules and the 2003 amendments to the ABA Model Rules are relevant to a lawyer's conduct consistent with the Treaty, such as requiring counsel to "report up" under the SEC rules if management resists the lawyer's advice that a material unasserted claim be disclosed to the company's auditors and in its financial statements. *Report* at pp. 132-33.

4. **Reporting Claims Directly to the Audit Committee**. Fourth, the Task Force addresses the procedure under the Treaty whereby outside counsel typically confirm in their response to auditors' letters that it is their practice to consult with clients when counsel learns of unasserted claims that may require financial statement disclosure. The *Report* notes that these consultations typically occur only with company management, and recommends that counsel should insure that the Audit Committee is also made aware of such unasserted claims and of any advice provided to management that a claim should be disclosed to the auditors or in the financial statements. *Report* at p. 133.

5. **No Recognition of Attorney-Auditor Privilege**. Fifth, the Task Force considered whether to recommend that a privilege be recognized with respect to communications between a company's lawyers and its auditors, and ultimately decided not to recommend recognition of such a privilege. In this regard, the Task Force observed that there has been increased tension in recent years in the relationship between auditors and lawyers for the audited company. Auditors are under heightened pressure to obtain information in the course of conducting their audits, while lawyers are reluctant to engage in non-privileged communications with auditors or to recommend disclosure of information that would waive attorney-client privilege in situations where there is a risk of third-party litigation. *See Report* at pp. 133-34. The *Report* points out that "[o]pen, less guarded and less adversarial communications would be helpful in achieving the common interest of the auditors and their clients of ensuring the accuracy and completeness of financial disclosures." *Id*. at 134.

The *Report* cites those decisions that have found no waiver of attorney work product protection based on disclosure of internal investigatory materials to outside auditors. *See Merrill Lynch & Co. v. Allegheny Energy, Inc*., 229 F.R.D. 441, 448 (S.D.N.Y. 2004) (finding no waiver of attorney work product protection

> The Report emphasized that information material to a company's financial condition must be disclosed to the auditor, including facts known to outside and in-house counsel, but that this does not mean that the auditor need be given access to privileged attorney-client communications.

by a company's providing internal investigation documents to its auditor since the interests of the company and its auditor are aligned "insofar as they both seek to prevent, detect and root out corporate fraud"); *International Design Concepts, Inc. v. Saks Inc.*, 05 Civ. 4754 (PKC), 2006 WL 1564684 (S.D.N.Y. June 5, 2006). The Report does not cite *Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (S.D.N.Y. 2002), in which the court came to a contrary result, holding that disclosure to the auditor constituted a waiver of work product protection.

Although observing that a limited privilege covering attorney-auditor communications could facilitate more open communications, the Task Force nevertheless decided not to recommend the recognition of such a privilege. The *Report* concludes that an attorney-auditor communications privilege would be inconsistent with the auditor's public role in certifying a company's financial statements and "the relevance, in the event of later litigation or regulatory scrutiny, of all facts and procedures on which the certification was based." *Id*. In defining the nature of the auditor's role, the *Report* relies on the Supreme Court's decision in *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984) (to insulate accountant's workpapers from disclosure would be "to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations").

The Task Force drew a basic distinction, which may be difficult to apply in practice, between disclosure of non-privileged "facts" and the privilege that otherwise applies to attorney-client communications. The *Report* emphasizes that information material to a company's financial condition must be disclosed to the auditor, including facts known to outside and in-house counsel, but that this does not mean that the auditor need be given access to privileged attorney-client communications. *See id*. at 134-35. ◎

Personal Jurisdiction in New York Upheld Based Solely on Electronic Contacts

Recently, a divided panel of the Appellate Division, First Department, held that a New York court may exercise long arm jurisdiction under Section 302(a)(1) of the C.P.L.R. over defendants whose contacts with the state were entirely through electronic means. In *Fischbarg v. Doucet*, N.Y.L.J., Mar. 15, 2007, at 24 (App. Div. 1st Dept. Mar. 15, 2007), a New York-based attorney sued a California corporation and its principal in the New York State Supreme Court, seeking approximately $60,000 in unpaid legal fees generated from the attorney's representation of the defendants in copyright litigation pending in Oregon. *Id*. Notably, neither defendants nor their agents physically entered New York in connection with the representation. Rather, the parties communicated solely by telephone, fax and e-mail. *Id*. Apparently, the attorney never left New York in connection with the representation. Defendants moved unsuccessfully in the Supreme Court to dismiss the action for lack of personal jurisdiction. *Id*.

On appeal, a divided First Department affirmed, reasoning that defendants had "projected themselves" into New York for purposes of establishing jurisdiction under C.P.L.R. 302(a)(1) through a series of "purposeful acts," including, *inter alia*, electronically transmitting contracts, correspondence and copyrighted commercial property to New York. *Id*. Thus, the court held that "by working with plaintiff on a consistent basis during the period in question, defendants transacted business in New York sufficient to subject themselves to this State's jurisdiction over them in a fee dispute." *Id*. (Internal quotations omitted). Moreover, the majority declared, New York Court of Appeals precedent dating from 1970 supported the proposition that, in the absence of physical presence, instantaneous long-range communication may be used to carry out "extensive purposeful activity" in the state for jurisdictional purposes. *Id*. (quoting *Parke-Bernet Galleries, Inc. v. Franklyn*, 26 N.Y.2d 13, 17 (N.Y. 1970)).

Two justices dissented, concluding that the Californian defendants did not "actively project themselves" into New York so as to justify exercising long arm jurisdiction over them because they did no more than communicate by telephone, facsimile and e-mail with a person in New York. *Id*. at 24-25. Since a number of New York cases have held that mere contract negotiation using the telephone or mail will not by itself establish long arm jurisdiction under C.P.L.R. 302(a)(1), under the circumstances presented, where neither defendants nor their agents entered New York and litigation took place in Oregon, Justice Sullivan did not find that they "actively projected themselves" into the state to support personal jurisdiction in New York for a fee dispute arising out of the Oregon litigation. *Id*. at 24-25. ◎

Et al.

Newsworthy

On April 9, 2007, Gerard S. Citera joined Chadbourne as counsel in the New York office. Gerard joined from UBS Securities LLC, where he had been Executive Director and Regulatory Risk Manager for the U.S. Equities Division. Gerard has extensive experience in the financial services industry and will be a part of Chadbourne's Securities Litigation and Regulatory Enforcement Practice, representing broker-dealers, investment banks and other financial institutions in a wide-range of legal, compliance, and regulatory matters.

On March 22, New York partner Thomas Bezanson co-chaired the Federal Bar Council reception honoring and introducing the new Chief Judges of the Second Circuit. The reception was held at the Union League Club in New York City.

On May 20, 2007, New York partner Tom Hall was interviewed on Bloomberg News Radio concerning litigation over claims to artwork looted by the Nazis.

Awards

New York partner Judge George Bundy Smith recently received several awards. On March 15, 2007, he was honored by the New York State Bar Association's Commercial and Federal Litigation Section, which presented him with its inaugural George Bundy Smith Award. On April 21, 2007, he was honored with an award at the annual dinner of the Touro Law School Black Law Students Association. On May 8, 2007, he was given an award by the Center for Law and Social Justice, Medgar Evers College. On May 10, 2007, he was honored at the dinner for retired judges of the New York State Court of Appeals at Banking Hall in New York City. Finally, on May 15, 2007, Judge Smith received a lifetime achievement award from the Fund for Modern Courts, in Bryant Park in New York City.

Publications

Partner Tom Hall published an article in the May 2007 addition of *The Banking Law Journal* entitled "The Rights of Individual Lenders in Multi-Lender Loans to Enforce Remedies."

Counsel Gretchen Werwaiss co-authored two chapters in the *ABA Fifty State Survey on Punitive Damages*. Associate Cassandre Charles co-authored the chapter on Minnesota law with Gretchen, and associate Dorollo Nixon co-authored the chapter on New York law.

Contributors to this edition of *The Gavel* include: Thomas J. Hall, Thomas E. Butler, Robert A. Schwinger, Robert Sidorsky, Matthew Kliegman, Cassandre Charles, Bernadette Galiano and Dorollo Nixon, Jr.

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