FORENSIC MATTERS

ROUTE TO:

A Friedman LLP Publication Featuring Forensic Accounting Issues — Summer 2004

Michael Soudry, M.B.A.

Introducing Eco-Stat LLC

Eco-Stat LLC, an affiliate of Friedman LLP, was formed to help plaintiff and defense attorneys calculate and demonstrate the true value of economic damage. The trained economists and statisticians of Eco-Stat LLC explain quantitative issues in a clear and decisive manner. They can help to achieve fair settlements and avoid the uncertainties of trial by presenting a case using thorough research, documented reports and analytical commentary. Alternatively, in the event of a trial, we act as experienced and objective expert witnesses and testify regarding relevant economic outcomes.

Eco-Stat LLC, headed by Michael Soudry, M.B.A., has a reputation for reliable and expert reports and testimony. Michael has extensive trial and consulting experience with many of the issues in the civil courts today and has testified in close to one hundred cases in federal, state and municipal courts. In addition, Michael works with Dr. Seymour Barcun, Ph.D. and Dr. Rudy A. Jacob, Ph.D., two senior colleagues who have had their research findings published and have been involved in prestigious honor societies and professional associations.

For more information, please call Michael Soudry at 1.800.ECOSTAT.

Assisting Victims of 9/11

The instantaneous and irreversible losses suffered by so many following 9/11 were of a magnitude not seen in this country since the Civil War. The resources of the nation were called on to provide meaningful remedies to deal with both the tragic deaths and injuries and the economic losses suffered by so many victims.

It was clear early on that some plaintiffs needed remedies more quickly than could reasonably be expected from our system of due process. The September 11th Victim's Compensation Fund of 2001 was established by the federal government to develop a means for aiding surviving victims and the dependents of the deceased to gain fast and equitable compensation for the economic loss suffered. The scope of loss included nearly 3,000 families deprived of their breadwinners and countless more wage earners unable to quickly replace their pre-9/11 incomes. In order to blend fairness with speed, a two-tiered system was quickly developed. Plaintiffs were given a choice of fast track justice or prolonged litigation. In the interest of moving swiftly, the fast-track system had to be made to appeal to most surviving family members.

The initial publication of the Victim Compensation Fund's guidelines for computation of economic and non-economic loss attracted criticism from victims' families, as well as economic experts in the loss analysis area. The major criticisms were regarding the Fund's consideration of life insurance proceeds as collateral offsets, as well as lack of specification for recoverable value of lost household services. In part because of these issues, applications for the Victim Compensation Fund started slowly. However, by December 22, 2003, the deadline for application, 98% of surviving families applied to the Fund as they realized the plan was the best and fastest route to compensation.

To assist many low-income immigrant families who lost their main breadwinners and who were left in desperate situations, a pro-bono effort was organized by the New York Lawyers for Public Interest. The goal of this effort was to help these victims, who did not have the resources to hire legal counsel on their own, gain fair and adequate compensation for their loss. The group included law firms such as Cadwalader, Wickersham & Taft LLP, Shearman & Sterling and Cleary, Gottlieb, Steen & Hamilton.

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About Friedman LLP

Friedman LLP, Accountants and Advisors offers tax, accounting and advisory services. For 80 years, our firm has been helping our clients succeed in managing their businesses. We rank among the top 25 New York area accounting firms in Crain's New York Business and in Public Accounting Report and Accounting Today's Top 100 Firms nationwide. From our offices in midtown Manhattan, Uniondale, Long Island and Livingston, New Jersey, almost 200 professionals and staff service our diverse clientele.

Friedman LLP's personnel are dedicated to offering expert and timely services that are sensitive and responsive to changes in regulations and economic climates. We continually monitor and interpret the trends that impact business, in order to deliver well-informed financial and tax planning strategies.

Friedman LLP is a member of DFK International/USA, Inc., an affiliation of CPA firms across the country and around the world. Our affiliation with DFK allows us to harness additional resources or tap specialized services when required, giving Friedman LLP virtually unlimited capabilities and geographic coverage.

For more information about our firm, please call Carol Schrager at 212.842.7535 or log on to our website at www.friedmanllp.com.

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Accountants' Privity Law Upheld

On May 6, 2004, the New Jersey State Supreme Court upheld the 1995 state statute that third-party lawsuits against CPAs can only be brought by parties establishing "privity" with the accountant. The Supreme Court ruling upheld an earlier Appellate Court decision rejecting the plaintiff's case in the matter of E. Dickerson & Son, Inc. v. Ernst & Young. In this case, the Court found that the plaintiffs had not met the "privity" requirements established in the Accountants Liability Act.

Privity refers to the implied contractual relationship or "duty of care" that exists between CPAs and their clients. In addition, there are times when a CPA may also owe privity to a third-party non-client. Previously, anyone who had legitimate access to a firm's prepared financial statements could potentially sue the accounting firm, even if their involvement was peripheral. Privity laws were created in response to earlier standards making accountants potentially liable to any non-client who, in hindsight, could have been foreseen by the CPA to use his or her work product, effectively opening the door to litigation from an unlimited number of parties.

Privity laws can differ from state to state. In New Jersey, there is a three-part test requiring that the accountant (1) must have known at the time of the engagement, or agreed with the client after the engagement, that the professional accounting services would be made available to the specifically identified non-client in connection with a specified client transaction; (2) knew that the non-client intended to rely on the professional accounting services in connection with the specified transaction; and (3) directly expressed to the non-client in words or conduct, the accountant's understanding of the non-client's intended reliance.

In order for a non-client to have a valid claim against an accountant in New York, he or she must prove that the purpose for which the financial statements were prepared and manner in which the financial statements were used must have been known by the CPA; the CPA must have known that the non-client was going to rely on the financial statements; and the CPA by some action demonstrated the understanding that the non-client was going to use the financial statements. Readers are advised to consult their legal advisors regarding detailed privity laws in their particular state.

It is important to note that privity laws only address issues involving negligence. Third parties are still protected against fraud and misconduct on the part of the CPA. And, as you may be aware, accountants are also liable for fraud and intentional misrepresentations related to registrations or sales of publicly traded company securities. As a matter of fact, the recently enacted Sarbanes-Oxley Act created a public oversight board and enacted stiffer penalties for fraud.

Exercising due care in accepting, retaining and servicing new and existing clients is critical to CPAs whose work product may extend to a potentially wider audience. ■

Bankruptcy Insiders: Another Look

Insiders. Preferences. Fraudulent Transfers. Words that bring a sparkle to the eye and a glimmer of hope to third party creditors and bankruptcy professionals hoping for a recovery in cases under Chapter 7 or Chapter 11. As we are all aware, third party creditors – particularly those serving on Creditors Committees – frown on the possibility of having to return payments that were earned and received in good faith. After all, it was the debtor's insiders who guided the company to its existing condition in the first place.

As defined in the U.S. Bankruptcy Code (the "Code"), insiders include the individual debtor and his or her relatives, owners, officers, directors of a corporation and partners in related partnerships, among others. Preference provisions under the Code allow for the avoidance (return) of property to the debtor if the transfer was made while the debtor was insolvent or within 90 days of the bankruptcy filing, if received by a third party, or within one year if received by an insider. Fraudulent Transfer provisions of the Code allow for the return of property to the debtor if made within one year prior to the filing (or up to 6 years under New York state statutes) if the debtor was insolvent on the date of the transfer or became insolvent as a result. In short, just because you received it, does not mean you can keep it.

Whether hired by the bankruptcy trustee or by the Creditors Committee, the trained accountant searches through the debtor's records looking for payments to, or for the benefit of, insiders. These payments may or may not have legitimate business purposes; the more difficult to identify generally do not. In many closely held corporate bankruptcies, it is common to find personal expenses and/or debts of the insiders that were paid for by the company. These items are often treated by the company as business expenses for financial reporting and tax purposes. Today, as evidenced by several major bankruptcy cases, this practice has grown beyond just closely held or family businesses to include large publicly traded companies.

Once the accountant has identified the non business-related items, his next step is to determine if the debtor was insolvent when the transfers were made, or if the debtor became insolvent as a result of the transfers. What becomes of the accountant's analysis, however, if the debtor did not become insolvent as a result of the transfer until much later on, or if the pattern of abuse exceeded the six-year look-back period? Does the trustee or the Creditors Committee just walk away from potential recoveries?

We know that the insider may have benefited in many ways by having his personal items paid by the debtor. The owner/insider may have also recognized less income on his Form K-1, or simply not received a W-2 or 1099 for the payments made on his behalf. We also know that these payments were improperly accounted for in the company's books. Because these payments served no business purpose, they should not have been recorded as expenses of the business, but rather as officers' loans which should be paid back – with interest.

Should we reward these insiders for burying payments as expenses rather than reflecting them as loans? Any company has the right to pursue collections of officer loans, regardless of whether or not the company is insolvent, or has filed bankruptcy. Instead of debating the insolvency issue, why not raise the issue that the debtor's books and records were deliberately misleading to existing and future creditors? Perhaps restating the company's books would allow for the recoveries of unpaid officer loans, which could then be used to repay third party creditors. If a tax audit had identified these same items, the returns would be amended, the taxes adjusted and penalties assessed on both the company and the individual who benefited. Perhaps unsecured creditors should be afforded the same latitude and the right to recover.

The concept of recharacterizing insider payments made by bankruptcy debtors as recoverable officer loans may be an idea whose time has come, in order to best maximize the return to unsecured creditors. ■

Assisting Victims of 9/11

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To better reflect the victims' potential earnings capability, and therefore enhance the eventual financial awards, Eco-Stat LLC was retained by these attorneys for this pro-bono effort. We assisted 40 families of restaurant employees of Windows on The World and maintenance workers of the World Trade Center by providing economic loss reports. In total, over 150 cases were analyzed by Eco-Stat LLC, according to the specific circumstances of each victim and the recoverable loss to his or her family.

By the deadline of June 2004, we had participated in over 50 hearings and experienced the sadness of the loss and suffering of so many victims' families. Although the experience was hard, I was privileged to have had the opportunity to assist these families and was satisfied to hear that our services made a difference and helped to increase the awards. ■

Forensic Matters is a quarterly publication that contains articles of interest to attorneys relating to forensic and insolvency matters.

Forensic Matters is written by members of the Forensic Accounting Services Group of Friedman LLP.

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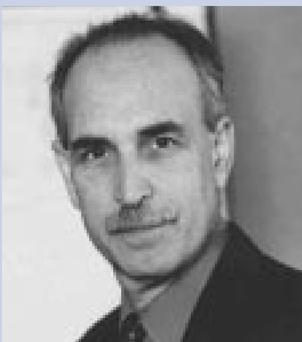

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The Forensic Accounting Services Group

The Forensic Accounting Services Group works with financially troubled companies, secured and unsecured creditors committees and court-appointed trustees. We also perform damage claims analyses, fraud investigations, due diligence services and collateral examinations on behalf of banks and institutional lenders. Members of the department have also been involved with pretrial and trial preparation and have testified at trials conducted by the United States Bankruptcy Court.

In addition, our forensic professionals can help you to comply with recent accounting requirements and provide credible, well-supported and independent financial valuation services to determine the fair value of goodwill or other intangibles.

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