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Inside this issue:

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Liquidator of Insolvent Insurer Not Bound by Engagement Letter Terms

By Amanda Sirk

WHEN A LIQUIDATOR OF AN INSURANCE COMPANY ACTS IN A STATUTORY capacity, the liquidator may not be considered a "successor of interest" to the insolvent insurer for purposes of an engagement letter entered into by and between a professional and the insurance company. The Ohio Supreme Court, in *Taylor v. Ernst & Young*, 2011 WL 5009416 (2011), recently considered whether an arbitration provision in an engagement letter is enforceable to a third-party nonsignatory. The Court held that, in the circumstances of that case, the provision does not control and the accounting firm could not compel arbitration.

The matter arose from an audit performed by Ernst & Young ("E&Y"), an independent accounting firm, for American Chambers Life Insurance Company ("ACLIC"). In November 1998, E&Y and ACLIC entered into an agreement to provide auditing services. The agreement included a mandatory arbitration provision. On February 25, 1999, E&Y submitted a report to the Ohio Department of Insurance ("ODI"), certifying that it performed an audit under generally accepted auditing standards and that ACLIC's financial statements fairly represented ACLIC's financial position.

In March 2000, the Ohio superintendent of insurance filed an action to place ACLIC in rehabilitation. During the liquidation proceedings, E&Y entered into a tolling agreement with the liquidator to toll the time for filing causes of action and claims against each until one year from May 2, 2002. In May 2000, the court found ACLIC to be insolvent and issued a final order of liquidation and appointment of a liquidator.

On April 30, 2003, the superintendant of insurance, as the liquidator of ACLIC, filed suit against E&Y alleging the following:

1. E&Y negligently performed its audit of ACLIC in accordance with generally accepted accounting principles and failed to discover or disclose material misstatements in ACLIC's financial statements. Specifically, the liquidator alleged that E&Y failed to discover or disclose material misstatements such as understatement of loss reserves, overstatement of receivables, unrecorded liabilities, and investments that exceeded the allowable amounts, which allowed ACLIC's financial position to go undetected and ACLIC to continue to transact business to the detriment of ACLIC, its policyholders and the public.

2. E&Y received preferential or fraudulent payments of more than $25,000 after ACLIC was insolvent, and refused to return the money, notwithstanding the liquidators demand to return the money. As a result, the liquidator alleged that E&Y received a greater amount of the insurer's debt than like creditors would receive in the distribution of ACLIC's estate.

E&Y moved to dismiss the liquidator's Complaint or to stay the proceedings and compel arbitration pursuant to the arbitration provision in its engagement letter with ACLIC. The trial court denied E&Y's Motion and E&Y appealed. The Appeals Court affirmed the trial court's decision because the liquidator had not signed the arbitration agreement. Finally, E&Y sought and was granted a discretionary appeal. E&Y asserted the following two propositions of law:

1. An insurance liquidator that does not disavow a contract entered into by an insurer is bound by an arbitration

provision in that contract, which must be enforced pursuant to Ohio's statutory code and strong policy favoring arbitration; and

2. A tolling agreement that preserves all defenses as of its effective date preserves an arbitration defense that existed on the effective date.

E&Y argued that the liquidator should be bound by the arbitration clause for the following three reasons: (1) the liquidator stands in the shoes of the insolvent insurer; (2) the liquidator is asserting claims arising out of E&Y's engagement letter that contains the arbitration clause; and (3) the Liquidation Act does not permit the liquidator to disavow the arbitration clause while enforcing the balance of the contract.

The Ohio Supreme Court rejected all of E&Y's arguments and concluded that the liquidator does not stand in the shoes as a mere successor in interest to an insolvent insurer. Rather, the liquidator stands in a unique public-protection role pursuant to The Insurers Supervision, Rehabilitation, and Liquidation Act (the "Liquidation Act"). The Liquidation Act empowers the liquidator broad powers to protect the rights of insureds, policyholders, creditors, and the public. The Supreme Court further reasoned that in contrast to the liquidator's broad powers to maximize the assets available to her in discharging her duties to claimants, shareholders, and creditors of an insolvent insurance company, and the liquidator's power of forum selection, creditors have limited rights to file claims against the insurer's estate and can only file suits in the liquidation court. The Supreme Court held that the liquidator is not bound to arbitration agreements entered into by the insolvent insurer as if she were the signatory insurer.

Additionally, the Supreme Court rejected E&Y's argument that the liquidator's claims arise from E&Y's engagement letter. E&Y asserted that the arbitration agreement is enforceable against the liquidator because her claims "relate to" the subject matter of the engagement letter. The Supreme Court rejected E&Y's argument stating that the test is whether the liquidator, a nonsignatory, has asserted claims that arise from the contract containing the arbitration clause. The Supreme Court concluded that the liquidator's malpractice claim does not arise from the engagement letter since it does not seek a declaration of E&Y's obligations under the engagement letter and because the liquidator's claim arises from the statutory powers given to the liquidator.

The liquidator's second claim alleged that ACLIC transferred money to E&Y after it became insolvent. The Supreme Court ruled that the liquidator's preference and fraudulent-transfer claims arise by statute and arise only in favor of the liquidator; they cannot as a matter of law arise from a contract entered into by an insolvent insurer. Therefore, the liquidator's malpractice and preference claims are not subject to arbitration based on the engagement letter entered into by E&Y and ACLIC.

Professionals entering into engagement letters with insurance companies need to note that, if a liquidator steps in, the terms of the professional's engagement letter may not govern. The liquidator may not be bound by the engagement letter, and may not be considered a successor in interest to an insolvent insurer for purposes of the accounting firm enforcing provisions in the engagement letter.

Litigation Privilege Protections Provided to Accountants Testifying as Expert Witness: The California Model

By Matthew P. Tuller

IN THE CURRENT DIFFICULT ECONOMIC ENVIRONMENT, ACCOUNTANTS are being increasingly called upon to testify as expert witnesses. The areas of testimony range from valuation of businesses for shareholder disputes to standard of care opinions regarding the professional services provided by accountants to business entities.

The question remains what legal protections are there for accountants to utilize to ensure this non-traditional engagement does not lead to unnecessary litigation or loss. While most states provide a quasi-judicial litigation privilege to parties or agents testifying in Court, the breadth of that privilege and the protections it provides vary. It is important that the limits of the protection afforded be understood prior to undertaking an expert engagement to ensure that the engagement letter accounts for the potential risk.

California's codified privilege and the case law that has developed surrounding its application to accountants provides an excellent example of the risks and protections of the litigation privilege afforded to testifying experts. California Civil Code section 47(b) protects as privileged a publication or broadcast made in any judicial proceeding[1]. The Courts in California have repeatedly stressed that the three public policies that underlie the privilege are:

1. Free access to the courts to secure and defend a person's rights without fear of harassment from subsequent suits;
2. Protection of the court system from the proliferation of suits after the first matter is resolved; and
3. Facilitation of crucial functions of the trier of fact[2].

The California Courts have repeatedly upheld this privilege to protect accountants who have been retained as expert witnesses.

In *Mattco Forge, Inc. v. Arthur Young & Co.,* 5 Cal.App.4th 392 (1992), the California Court of Appeals adopted the sole exception to the absolute privilege for accountants testifying as experts. Mattco had hired Arthur Young & Co. as Mattco's damage consultant and expert witness in its lawsuit against General Electric in Federal Court. Arthur Young & Co.'s primary role in the underlying action was to testify to Mattco's lost profits from its dealings with General Electric. During the prosecution of the underlying action, Arthur Young & Co. was precluded from testifying due to its instructions made to Mattco employees to re-create estimate sheets for evaluation by Arthur Young & Co. The re-created sheets were utilized to inflate the lost profits of Mattco. Mattco's suit against General Electric was dismissed because the Court felt that Mattco was complicit in a scheme to mislead the court with the re-created estimate sheets.

Arthur Young & Co. moved for summary judgment against Mattco on the grounds that the suit was barred by the litigation privilege codified in Civil Code section 47(b). The trial court ruled in Arthur Young & Co.'s favor dismissing the Mattco suit on the basis that Civil Code section 47(b) is an absolute bar to the suit as a matter of law. Mattco appealed the trial court's ruling arguing that the trial court's ruling actually contradicted the public policies which the law was enacted to protect. Mattco argued that to shield a party's retained expert from subsequent suit for professional malpractice would undermine the statute's efforts to promote truthful testimony without fear of retribution. Mattco argued, and the Court of Appeals agreed, that allowing an expert to testify with no potential consequences from its untruthful or negligent testimony would

actually promote misconduct by expert witnesses. The Court further reasoned that the present suit was analogous to a client's suit for malpractice against its former attorney, and the privilege did not bar such suits in California.

After reviewing the arguments, the California Supreme court held that the trial court erred in granting the motion for summary judgment in Arthur Young & Co.'s favor, writing:

> *Applying the privilege to bar plaintiffs' suit against an expert witness hired to assist them in litigation, under the circumstances alleged, does not further the policies underlying section 47, subdivision (b). Id. at 406.*

The Court's holding was limited to a party's suit against its expert, and did not extend this ruling to experts testifying for adverse parties. As such, the ruling essentially allowed a professional malpractice claim against the testifying expert.

In *Ramalingam v. Thompson*, 151 Cal.App.4th 491 (2007), the plaintiff sought to enlarge the exception to the litigation privilege to allow suit against a neutral expert hired to evaluate the assets in her divorce proceeding. The defendant was retained by the plaintiff and her ex-husband pursuant to a court stipulation to assist in the resolution of the community property and support issues. The plaintiff did not agree with Thompson's evaluation of the community property assets which was adopted by the Court, and upheld on appeal.

The plaintiff filed suit against her attorney and Thompson for professional malpractice. Thompson filed a motion for summary judgment on the grounds that Civil Code section 47(b) barred the accounting malpractice claim. The trial court ruled in Thompson's favor entering an order that the suit was barred by the litigation privilege.

The plaintiff appealed contending that the absolute privilege did not bar the suit because Thompson was not engaged in dispute resolution. In essence, the plaintiff argued it was not Thompson's testimony that was the basis for the claim, but his analytical work underlying the testimony that was the substance of the plaintiff's action.

The Supreme Court reviewed the parties' arguments focusing on the cause of the plaintiff's damages, i.e. the testimonial opinions of Thompson. The Supreme Court held that it was those communications, primarily Thompson's in-court testimony, which actually caused the damages alleged by the plaintiff, not the analytical work. The Court refused to extend the *Mattco* holding to neutral experts, even though the plaintiff retained the expert, citing several prior Supreme Court decisions that had upheld the privilege when the parties retained a neutral expert. The Court reiterated the holding from *Gootee v. Lightner*[3], where a neutral psychiatric expert retained to evaluate child custody issues was protected from suit by the privilege, writing:

> *Encouragement of witnesses to testify truthfully will be harmed if neutral experts must fear retaliatory lawsuits from litigants whose disagreement with an expert's opinions perforce convinces them the expert must have been negligent in forming such opinions.*

Therefore, the court upheld the trial court ruling finding that the Mattco exception could not be extended to neutral witnesses hired by litigants.

The California case law provides insight for accountants presented with potential engagements as expert witnesses. First, the accounting professional should seek legal advice on the status of the litigation privilege in the state where the litigation is situated. Second, the main source of potential post-engagement litigation is typically from the party retaining the accountant. Therefore, the engagement letter should address those risks through a limitation of liability provision or other contractual bars to suit against the professional.

1 *See Moore v. Conliffe,* 7 Cal.4th 634 (1994).
2 *See Abraham v. Lancaster Community Hospital,* 217 Cal.App.3d 796 (1990).
3 224 Cal.App.3d. 587 (1990).

Washington State Court of Appeals Clarifies Start Point for Statute of Limitations in Accountant Malpractice Claims

By Daniel C. Poteet

THE WASHINGTON STATE COURT OF APPEALS, IN *Murphey v. Grass, CPA & Associates, PS,* 2011 WL 5127622, recently ruled that, under Washington law, the statute of limitations for a claim based on the negligent preparation of state income tax returns does not being to run until the Washington State Department of Revenue ("Department") has issued its final assessment of the amount due. This case demonstrates that a party can have knowledge of a potential claim against an accountant for a considerable length of time before the statute of limitations begins to run, as a tax assessment may not become 'final' for purposes of activating a statute of limitations for some time.

Accordingly, if accountants are aware of assessments or other tax penalties levied against their clients, they should not assume that the statute of limitations has begun. Even if the accountant has received notice of a potential claim, the claimant may not be subject to the statute of limitations for years after the notice, as the outcome in *Murphey v. Grass* demonstrates.

Murphey, a principal in two construction businesses, initially retained Grass to prepare payroll and tax returns for Murphey. Grass's services began in 1997 and by 2000, Grass was managing all bookkeeping and accounting services for Murphey. In 2004, the Department randomly audited Murphey, and Grass was unable to produce requested documentation relative to whether Murphey paid sales as opposed to use tax. Murphey then learned that the IRS had issued tax liens for unpaid employment taxes. Several additional issues arose regarding Murphey's tax returns, and Murphey fired Grass and notified Grass through Murphey's attorneys that Murphey would seek damages and fees from Grass after assessing Murphey's damages.

The Department issued its assessment to one Murphey entity on October 2, 2006, for approximately $65,000, and an assessment to the other entity in June 2006 for approximately $115,000. Murphey utilized the Washington state statutory procedure for petitioning for correction of these figures. The Department appeals division issued its denial of Murphey's petitions on February 13, 2009. Murphey appealed to the board of tax appeals and, while the appeal was pending, filed suit against Grass in November of 2009.

Grass initially obtained summary judgment dismissing Murphey's suit based on the argument that the applicable three year statute of limitations had run because Murphey first knew about Grass's mismanagement in 2005 and 2006. The Court focused on the issue of when the actual injury to Murphey occurred, because the statute of limitations does not begin to run until all elements necessary to the claim exist. The Washington phrase for defining the injury is 'actual and appreciable damage' as opposed to anticipated but indefinite losses.

The Court relied on the Washington statute governing when a tax assessment "becomes final" over Grass's argument that the verbiage on the tax assessment documentation itself should control. The applicable Washington statute grants persons who receive assessments 30 days to petition for correction of the assessment before the assessment becomes final. On this basis, the Court determined that although Murphey knew in 2005 and 2006 of Grass's probable negligence, Murphey's actual injury did not accrue until the Department issued its final decision with respect to Murphey's tax assessment. The Department's final decision occurred in 2009, so even though Murphey and Grass had known for years of the basic facts of the claim against Grass, the statute of limitations did not begin to run until 2009.

Engagement Letters: Ensuring that Statutes of Limitations Apply to Arbitrations

By Cheryl A. Waterhouse

ENGAGEMENT LETTERS ARE AN ESSENTIAL METHOD OF MANAGING risk for professionals such as attorneys and accountants. They provide a means of communication in which both the client and the professional can agree on what services will be provided, what the costs will be and what will happen, and how, if the engagement does not proceed as planned. They can be a great tool for avoiding or mitigating loss when carefully drafted.

Provisions in the engagement letter for dispute resolution, mediation, arbitration and litigation, come into play when the relationship does not go as planned, either during or after the engagement, and mechanisms to resolve a dispute are required. One issue that can arise in such circumstances is whether a claim can be dismissed based upon a statute of limitations requiring a party to sue within a certain period of time or be barred from bringing such a claim. If the time period lapses prior to the claim being asserted, the claim is barred, providing a good defense to any attempt to bring such a claim in the future and providing comfort to the professional.

Professionals who agree to arbitration as a dispute resolution mechanism in their engagement letters may not get the benefit of certain state statutes of limitations, however. A recent case concerning whether state statutes of limitations apply to arbitrations as well as civil court proceedings indicates that in some circumstances state limitations statutes may not apply to arbitrations. In such cases, parties could bring claims long after they might otherwise be barred by state statutes of limitations. In the case of *Raymond James Financial Services, Inc. v. Phillips* (Dt. Ct. of Appeal, FL 2d Dt. 2011), the court held that, where the agreement with the client did not expressly provide that the Florida statutes of limitations would apply to arbitration, the claims were not barred and could proceed.

The case involved Raymond James financial advisors and individual account holders. The account holders had entered into an agreement with Raymond James that included an arbitration provision. In 2005 the account holders filed arbitration claims against Raymond James alleging negligence, misconduct including breach of fiduciary duty and state and federal securities violations. Raymond James moved to dismiss the claims on the grounds that they were barred by Florida's statutes of limitations. The account holders filed an action in court to determine whether the Florida statutes of limitations applied.

The agreement between Raymond James and the account holders did not specifically provide that Florida's statutes of limitations would apply to the arbitration provision. Although the contract's language stated that the agreement would not "limit or waive the application of any relevant state or federal statute of limitations," the court agreed with the account holders that that did not affirmatively incorporate Florida's statutes of limitations as applying to any arbitration claim asserted. The court did review whether Florida' statutes of limitations are relevant to the arbitration claims.

The appellate court considered "whether Florida's statutes of limitations are applicable to arbitration claims when the parties have not expressly included a provision in their arbitration agreement stating they are applicable." The court discussed the language of the Florida statute, dictionary definitions of the terms, legislative history and case law to determine whether the limitations periods applied to

arbitrations. Focusing on whether the statutory terms "civil action or proceeding" could include arbitrations, the court ruled that arbitrations are not "civil actions" and are not "proceedings", which it found are usually held to be court or judicial matters.

The court held that Florida's statute of limitations do not apply to arbitrations where the arbitration agreement does not expressly provide for the application. In doing so, it relied on the language of the agreement between the parties and the language of the statute, which did not provide for the application of the limitations to arbitrations[1].

As a result of this decision, in Florida, professionals whose engagement letters provide for arbitration as a means of dispute resolution should make sure that the provision expressly states that the Florida statute of limitations apply. For professionals practicing in other states, professionals need to know what the state statutes and caselaw provide in order to be sure that they know what the limitations periods may be. In some states, for example in New York and Georgia, the statutes of limitations specifically apply to arbitrations as well as civil actions. In other states it is not clear, so adding language to the engagement letter may be advisable.

This issue is just one consideration professionals need to address when reviewing the provisions of their engagement letters. As stated above, by taking care in drafting these documents and reviewing them regularly, engagement letters can provide helpful risk management.

[1] In this case, the court also considered the fact that Raymond James drafted the agreement and the general rule that contracts can be construed against the drafter.

The Financial Accounting Foundation Issues Its Post-Implementation Report of Effectiveness of FIN 48

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

IN 2006, THE FINANCIAL ACCOUNTING STANDARDS BOARD ISSUED FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. The stated purpose of FIN 48 was to provide "guidance for recognizing and measuring tax positions taken or expected to be taken in a tax return that directly or indirectly affect amounts reported in financial statements." Under FIN 48, businesses must analyze all tax positions that are less than certain. Only those positions that are more likely than not to produce benefit can be recognized in accruing tax. The likely outcomes of recognized positions are then computed and assigned probabilities. The most favorable set of outcomes that achieves 50% probability is then recognized. The business must then record tax expense or benefit, liabilities, and assets, as so measured. Although useful to taxing authorities, the implementation of FIN 48 also has a direct effect on investor and lender decisions which, therefore, have a concurrent effect on potential related accountant liability issues.

Tax positions requiring analysis include all aspects of tax returns, including whether tax returns are filed in a jurisdiction. Further, businesses must accrue and disclose the effect of interest and penalties as part of the FIN 48 analysis.

In January, the Financial Accounting Foundation, which is responsible for the oversight, administration and finances of the FASB, issued its Post-Implementation Review Report (PIR) for FIN 48. The three primary objectives of a PIR are to determine if a standard is accomplishing its purpose, to evaluate its costs and benefits and to recommend improvements with the process. Through the use of interviews and survey responses, the FAF found that, in spite of the concern of preparers that required disclosures would provide too much information, "on balance, the benefits of FIN 48's improved consistency and reporting of income tax uncertainty information outweigh its costs."

According to the FAF report, FIN 48 has resulted in more useful information being made available for investor decision making, with preparers being provided with a consistent method to recognize, measure and disclose uncertain tax positions. However, the report also notes that this information may not be predicitve of future cash flows since FIN 48 requires a benefit recognition approach rather than a best estimate approach as to the potential settlement of uncertain liabilites.

The report also indicates that, in general, preparers and practitioners understand FIN 48 and are generally able to apply its provisions. At the same time, it is recognized that the recognition and measurement rules are difficult to apply and require the substantial application of judgment in assessing likely outcomes.

As for changes in practice, the report indicates that although preparers and practitioers expected that changes would be necessary in operating practices, the most common changes seem to have been employing additional tax specialists and tax advisors from law or accounting firms. In addition, it appears that few practitoners changed their tax strategies and those that did became more conservative. The report also states, however, that although preparers have not found unexpected changes in taxing authority behavior in selecting entities for audit or in settlement negotiations, preparers are concerned that IRS Schedule UTP (Form 1120), which was introduced in 2010 and is directly related to FIN 48, could lead to adverse audit and settlement consequences.

Finally, the report notes that there were no significant economic consequences not otherwise considered during the standard setting process. Even so, the report does state that preparers and practitioners do not believe that FIN 48 resolves the issues that prompted the standard and, as a result, they do not believe that the costs involved with implementing FIN 48 are resonable compared to its benefits.

Engagement Limited to Compilation Limits Liability and Requires Complaint to Allege Specific Failures Within That Limited Standard of Care

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

A RECENT CASE, ***BANCROFT LIFE & CASUALTY ICC, LTD.*** *v. Intercontinental Management, Ltd.,* 2011 WL 5977083 (W.D. PA Nov. 29, 2011), emphasizes the importance of a well drafted engagement letter when attempting to obtain an early dismissal of a case against a professional.

Bancroft Life & Casualty, an insurance company located in St. Lucia, offered customized insurance coverage generally not available in the traditional marketplace through the use of entities called single parent IC's, i.e., captive insurers. The client would actually own the captive, but in order to issue a policy under Bancroft's license, the captive was required to register to do international insurance business with the government of St. Lucia. The captive also was required to make an election to be taxed as a United States taxpayer. Intercontinental Management had an agreement to perform the day to day operations of Bancroft with two Intercontinental principals providing regulatory and tax services as well as acting as outside general counsel. According to Bancroft's complaint, Intercontinental failed to perform as required and billed Bancroft for substantial funds reflecting work never performed.

Dernar & Associates, LLC is a CPA firm that was, according to the Bancroft complaint, retained to prepare financial statements and semi-annual reports for Bancroft and the IC's for submission to the St. Lucia Ministry of Finance as well as tax returns for Bancroft and the IC's. The complaint alleged that Dernar breached its duty of care by failing to prepare the required semi-annual reports and by failing to prepare financial statements which accurately reflected Bancroft's income, expenses and assets and failing to prepare accurate tax returns. As a result, Bancroft was not in compliance with the laws and regulations governing insurance companies in St. Lucia.

Dernar filed a motion to dismiss the claims against it. In deciding the motion, the court initially reviewed the current legal standard for such motions and stated that pursuant to recent Supreme Court decisions, it was no longer sufficient for a complaint simply to allege the elements of a cause of action. Instead, the complaint must allege specific facts which support the alleged failure. The facts alleged must support a plausible claim for relief not just the possibility of misconduct.

As a result, the court then reviewed the engagement letter between Bancroft and Dernar which clearly was limited to Dernar's providing compilation services only. Reviewing the three levels of accounting services, compilations, reviews and audits, the court then noted that a compilation provides the lowest level of service without providing an opinion or verification of financial statement information provided by the client. Although limited, however, Dernar could still incur potential liability if it failed to disclose to Bancroft glaring irregularities or illegal activities, i.e., "red flags" it encountered during its work.

Taking into account the limited standard of care involved with a compilation as described in the engagement letter and in light of the current legal standard applicable to motions to dismiss, the court ruled that the motion should be allowed since no "red flags" were specified in the complaint and, instead, the allegations were nothing more than a "formulaic recitation" of the elements of a professional malpractice

claim. In other words, the complaint allegations did not permit an inference of more than a mere possibility of misconduct.

The decision highlights the importance of a detailed engagement letter and demonstrates clearly the connection between the contents of a well drafted engagement letter and the ability of a court to dismiss a claim based upon the interrelation between the engagement's limits, the resulting standard of care and the current requirements for specificity in a court complaint.

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