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**WHEN ACCOUNTANTS LITIGATE: DECISIONS
IN CONTESTED RULE 102(e) PROCEEDINGS, 2000-2006**

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SEC disciplinary proceedings under Rule of Practice 102(e) have a more grievous impact on accountants’ professional careers than do other administrative sanctions such as cease-and-desist orders. This outline summarizes the twelve contested SEC enforcement proceedings brought under Rule 102(e) in which the initial decision by the administrative law judge was rendered after January 1, 2000. In nine of the twelve (KPMG, Wallace, Scuttilo, Yesner, Marrie & Berry, Horton & Co., Edwards, Pascale, and Harris), the respondent ended the proceeding with either no Rule 102(e) sanction, or a lesser sanction than the Division of Enforcement had requested, although the pro-respondent results in three of cases (KPMG, Yesner, and Marrie & Berry) were substantially aided by the fact that the conduct at issue pre-dated the SEC’s 1998 loosening of the scienter standard required for a violation of Rule 102(e). In the remaining three proceedings (McCurdy, Ernst & Young, and Rubin) the final Rule 102(e) sanction in the case was identical to the sanction that the Division of Enforcement had requested.

While the sample is small in size, it supports the conclusion that litigation is a viable way for accountants to minimize the likelihood that they will be subjected to Rule 102(e) sanctions, or at least lessen the severity of any Rule 102(e) sanctions that are ordered.

- A. *In the Matter of KPMG Peat Marwick LLP*, Init. Dec. Rel. No. 157 (Jan. 21, 2000); *In the Matter of KPMG Peat Marwick LLP*, Rel. No. 34-43862, AAER No. 1360 (Jan. 19, 2001); *KPMG, LLP v. S.E.C.*, 289 F.3d 109 (D.C. Cir. 2002).
1. The Order Instituting Proceedings (“OIP”) sought a cease and desist order with certain additional reporting obligations, along with a censure under Rule 102(e), against KPMG for violating Rule 2-02 of Regulation S-X, and causing violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder, alleging that KPMG lacked independence in connection with its 1995 audit of Porta Systems Corp. *See* OIP, Rel. No. 34-39400, AAER No. 994 (Dec. 4, 1997).
 2. In his initial decision, ALJ Mahony determined that KPMG had not acted recklessly and therefore was not liable under Rule 102(e) as it existed in 1995. He also concluded that while KPMG did lack independence by virtue of a loan

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that it had extended to a Porta officer, KPMG should not be subjected to a cease and desist order.

3. The Division of Enforcement petitioned for review of the ALJ's decision. The Commission found a broader range of independence violations. Like the Law Judge, the Commission concluded that KPMG had not acted recklessly and therefore was not liable under the applicable version of Rule 102(e). However, in a watershed opinion regarding its exercise of its cease-and-desist authority, concluded that such an order should be issued.
 4. KPMG, now aggrieved by the Commission's cease-and-desist order, petitioned for review by the Court of Appeals for the D.C. Circuit, which denied the petition.
- B. *In the Matter of Carroll A. Wallace, CPA*, Init. Dec. Rel. No. 178 (Dec. 18, 2000); *In the Matter of Carroll A. Wallace, CPA*, Rel. No. 34-48372, AAER No. 1846 (Aug. 20, 2003).
1. In a proceeding filed on April 1, 1999, respondent Wallace, a partner in KPMG's Denver office, was charged with improper professional conduct under Rule 102(e) in connection with the audits of the annual financial reports for 1994 and 1995 filed by The Rockies Fund, Inc., a closed-end investment company. Wallace was the engagement partner for both audits. The issue in the case was the Fund's treatment of restricted securities in a company called "Premier," which the Fund carried as "unrestricted" and valued accordingly. *See* OIP, Rel. No. 34-41240, AAER No. 1121 (April 1, 1999).
 2. ALJ Kelly found that the Fund's valuation of the Premier shares departed from its previously-disclosed valuation methods and was incorrect. The ALJ further ruled that the audit team had not responded appropriately to "red flags" in the forms of deficiency letters issued by the SEC after its examinations of the Fund, and the Fund's inconsistent valuations of Premier in its quarterly reports. The ALJ also faulted the auditors for taking insufficient steps to test management's representation that the Premier shares were unrestricted, and failing to test the valuation accorded those shares in the Fund's description of its assets and securities portfolio, as well as for ignoring year-end transactions in both 1994 and 1995 that pointed to problems with the Fund's valuations.
 3. The ALJ determined that the Division of Enforcement was using amended Rule 102(e) against Wallace, but noted that the Division was limiting itself to allegations of reckless conduct and was not attempting to use one of the lesser scienter standards newly allowed by amended Rule 102(e). The ALJ approved this approach, but also ruled that "the type of recklessness that is actionable against an outside auditor must approximate an actual intent to aid in the fraud being perpetrated by the company," Init. Dec. Rel. No. 178 at 36, and that "the Division cannot bootstrap its way to victory in an auditing recklessness case by stringing together separate acts of auditing negligence," *id.* at 38. The law judge found that Wallace's conduct rose to the level of recklessness when he ignored

the fact that the Fund had different and inconsistent valuation policies, failed to investigate whether the Premier shares were restricted, and paid insufficient attention to the above-mentioned “red flags” confronted during the 1994 and 1995 audits.

4. The ALJ rejected the Division’s call for a Rule 102(e) bar with a right to reapply in three years, and decided instead that the appropriate sanction was a one-year suspension.
5. Respondent Wallace petitioned for Commission review of the ALJ’s decision. On review, the Commission imposed the same one-year suspension that ALJ Kelly had ordered.

C. *In the Matter of Barry C. Scuttillo, CPA, and Mark F. Jensen, CPA*, Init. Dec. Rel. No. 183 (May 3, 2001); *In the Matter of Barry C. Scuttillo*, Rel. No. 34-48238, AAER No. 1822 (July 28, 2003).

1. Scuttillo was the audit engagement partner for Sky Scientific. The OIP charged Scuttillo and the concurring partner, Jensen (who settled the proceeding) with failing to plan or perform appropriate audit procedures to audit Sky Scientific’s Russian CDs and its mineral properties, failing to maintain control over the confirmation process for the CDs, failing to obtain sufficient competent evidential matter for the valuation of the CDs, the mineral properties, or Sky’s Form S-8 stock, and failing to assure that Sky’s financial statements complied with GAAP on those items. *See* OIP, Rel. No. 34-41241, AAER No. 1122 (April 1, 1999).
2. The Division of Enforcement requested a permanent Rule 102(e) bar against Scuttillo. In his initial decision, ALJ Kelly barred Scuttillo from practicing before the Commission for three years based on his failure to expand his audit scope to meet the high risk that Sky presented, the economic irrationality of the purported Russian CD transactions, his failure to keep thorough work papers despite a prior peer review criticizing him on this score, his surrender of his professional judgment to the demands of his client in crediting a doubtful confirmation, and his failure to audit Sky for unrecorded expenses.
3. Both the Division and Scuttillo were dissatisfied with ALJ Kelly’s ruling, and both petitioned for review by the Commission. On review, the Commission imposed the same three-year Rule 102(e) bar on Scuttillo that ALJ Kelly had ordered.

D. *In the Matter of Albert Glenn Yesner, CPA*, Init. Dec. Rel. No. 184 (May 22, 2001), *Finality Order*, Rel. Nos. 33-7989, 34-44452, AAER No. 1415 (June 19, 2001).

1. Yesner was controller and director of business controls of Sensormatic Electronics Corporation. The OIP alleged that Sensormatic had improperly recognized revenue in its financial statements for six quarters in 1994 and 1995, and had issued a press release in July 1995 that contained inflated earnings estimates. Yesner was charged with knowing of and participating in these improper accounting practices, and thereby willfully violating Rules 13b2-1 and

13b2-2; aiding and abetting Sensormatic's violations of Sections 13(b)(2)(A) and (B); causing Sensormatic's violations of Section 17(a) of the Securities Act and Sections 10(b) and 13(a) of the Exchange Act along with certain of the rules thereunder; and violating Rules 102(e)(1)(ii) and (iii). *See* OIP, Rel. No. 33-7258, 34-39916, AAER NO. 1027 (April 27, 1998).

2. In his initial decision, Judge Mahony concluded that Yesner had not committed "intentional or knowing conduct, including reckless conduct, that result[ed] in a violation of applicable professional standards," Init. Dec. Rel. No. 184 at 40 (the lower-intent variations of the 1998 amendment to Rule 102(e) were not applicable because of the age of the conduct at issue), but that Yesner should be subjected to a cease and desist order based on his having been a cause of Sensormatic's violations of Sections 17(a)(2)-(3) of the Securities Act and Section 13(a) and 13(b)(2)(A) of the Exchange Act along with certain of the rules thereunder.
3. No party elected to petition for review of the initial decision, and the cease and desist order became final.

E. *In the Matter of Michael J. Marrie, CPA, and Brian L. Berry, CPA*, Init. Dec. Rel. No. 191 (Sept. 21, 2001); *In the Matter of Michael J. Marrie, CPA, and Brian L. Berry, CPA*, Rel. No. 34-48246, AAER No. 1823 (July 29, 2003), *rev'd, Marrie v. SEC*, 374 F.3d 1196 (D.C. Cir. 2004).

1. Marrie was the engagement partner, and Berry the engagement manager, for Coopers & Lybrand's 1994 audit of Cal Micro. The Division/OCA alleged that respondents recklessly failed to conduct a GAAS audit of Cal Micro's 1994 financial statements in the areas of accounts receivable, inventory, and property. Specifically, they were charged with having ignored "red flags" including Cal Micro's write-off of 33% of its accounts receivable, and also with having failed to follow applicable auditing standards in the areas of inventory obsolescence and property and equipment. *See* OIP, Rel. No. 34-41720, AAER No. 1151 (Aug. 10, 1999).
2. The Division of Enforcement requested that Marrie and Berry be denied the privilege of appearing and practicing before the Commission. In his initial decision, ALJ Kelly concluded that Marrie and Berry had not acted recklessly, therefore had not violated Rule 102(e) as it existed at the time of their conduct, and dismissed the proceeding.
3. The Division petitioned for review by the Commission, which concluded that Marrie and Berry had acted recklessly, and imposed the Rule 102(e) bar that the Division had sought.
4. Marrie and Berry, in turn, petitioned for review by the Court of Appeals for the District of Columbia Circuit. The court of appeals, citing its decisions in

*Checkosky I*² and *Checkosky II*,³ concluded that the Commission's standard for recklessness under Rule 102(e) was unclear in the summer of 1994, when the Cal Micro audit was conducted, and that while the 1998 amendment to Rule 102(e) had clarified that standard, the amended rule could not be applied retroactively to Marrie and Berry. Thus, the court of appeals reversed the SEC's opinion and order.

F. *In the Matter of Horton & Company and Edward C. Horton*, Init. Dec. Rel. No. 208 (July 2, 2002), *Finality Order*, Rel. No. 34-46295, AAER No. 1609 (Aug. 1, 2002).

1. The Division/OCA charged Horton & Co. and Edward Horton with aiding and abetting Monarch Investment Properties, Inc.'s violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13, as well as with engaging in improper professional conduct, by failing to record or cause Monarch to record an expense related to options issued to consultants in 1997, rendering Monarch's 1997 and 1998 financial statements materially misstated. Respondents were also charged with lacking independence because the audit firm's staff accountant made all of Monarch's bookkeeping entries, and the firm then audited the resulting financial statements. *See* OIP, Rel. No. 34-43498, AAER No. 1339 (Oct. 31, 2000).
2. The Division of Enforcement requested that both Horton and Horton & Co. be censured and denied the privilege of appearing or practicing before the Commission for two years. ALJ Foelak rejected all of the Division/OCA's charges except for lack of independence, but on that ground alone suspended Horton & Co. and Horton from appearing or practicing before the Commission for one year. She declined to censure the respondents on the ground that this lesser sanction was unnecessary in view of the suspensions.
3. On August 1, 2002, the Commission issued a notice stating that no party had filed a petition for review from the initial decision, and that ALJ Foelak's one-year suspension order would become final.

G. *In the Matter of James Thomas McCurdy, CPA*, Init. Dec. Rel. No. 213 (Aug. 13, 2002); *In the Matter of James Thomas McCurdy, CPA*, Rel. No. 34-49182, AAER No. 1952 (Feb. 4, 2004); *McCurdy v. SEC*, 396 F.3d 1258 (D.C. Cir. 2005).

1. McCurdy, through his firm McCurdy & Associates, audited the financial statements of JWB Aggressive Growth Fund for the year ended December 31, 1998. The Division/OCA alleged that McCurdy issued an unqualified audit report notwithstanding that those statements contained a receivable as to which collectibility was not probable, and that he had failed to obtain sufficient competent evidential matter, to maintain an attitude of professional skepticism, to

² *Checkosky v. SEC*, 23 F.3d 452 (D.C. Cir. 1994).

³ *Checkosky v. SEC*, 139 F.3d 221 (D.C. Cir. 1998).

render an accurate report, and to exercise due professional care. *See* OIP, Rel. No. 34-44425, AAER No. 1404 (June 14, 2001).

2. The Division of Enforcement argued that McCurdy should be denied the privilege of appearing or practicing before the Commission for one year. In her Initial Decision, ALJ Foelak concluded that McCurdy should have obtained more evidence from additional sources, but that he had not acted recklessly or highly unreasonably in failing to do so, and that accordingly no Rule 102(e) sanction was appropriate. Since the Division had sought no other sanction, Judge Foelak dismissed the proceeding.
3. The Division of Enforcement petitioned for review by the Commission. On the petition for review, the Commission agreed with the Division of Enforcement that McCurdy had acted recklessly or highly unreasonably, and imposed a one-year Rule 102(e) suspension on him.
4. McCurdy sought review by the Court of Appeals for the District of Columbia Circuit, which affirmed the Commission's decision.

H. *In the Matter of Scott E. Edwards, CPA*, Init. Dec. Rel. No. 219 (Dec. 12, 2002), *Finality Order*, Rel. No. 34-47268, AAER No. 1708 (Jan. 28, 2003)

1. Edwards was charged with having engaged in improper professional conduct by issuing an unqualified opinion on 1995 financial statements of Firstmark Corp., even though Edwards learned during the audit that Firstmark's investments in one of two start-up companies had become worthless, and that Firstmark had improperly recognized income on appreciation of its investment in the second such company by reclassifying the stock it owned from restricted to tradable. *See* OIP, Rel. No. 34-42910, AAER No. 1271 (June 8, 2000).
2. The Division of Enforcement argued that Edwards should be denied the privilege of appearing or practicing before the Commission as an accountant for three years. In her initial decision, ALJ McEwen suspended Edwards from appearing or practicing before the Commission for one year.
3. On January 28, 2003, the Commission issued a notice stating that no party had filed a petition for review from the initial decision, and that ALJ McEwen's one-year suspension order would become final.

I. *In the Matter of Ernst & Young LLP*, Init. Dec. Rel. No. 249 (April 16, 2004), *Finality Order*, Rel. Nos. 33-8413, 34-49615, AAER No. 1991 (April 26, 2004).

1. In this proceeding, the Commission alleged that E&Y had violated Rule 2-02 of Regulation S-X because it was not independent when it audited the financial statements of PeopleSoft Inc. for 1994-1999, caused PeopleSoft to violate Sections 7(a) and 10(a) of the Securities Act, Sections 13(a) and 14(a) of the Exchange Act and certain rules thereunder, and engaged in improper professional

conduct within the meaning of Section 4C of the Exchange Act and Rule 102(e). *See* OIP, Rel. Nos. 33-8146, 34-46821, AAER No. 1661 (Nov. 13, 2002).

2. The Division of Enforcement sought a cease-and-desist order against E&Y, \$1,686,500 representing E&Y's fees for auditing PeopleSoft during 1994-1999, prejudgment interest on that amount, the retention of an independent consultant, and a six-month suspension on E&Y accepting any new SEC registrant audit clients. Chief ALJ Murray ordered each of the elements of relief that the Division asked for.
3. Neither party petitioned for review, and Chief ALJ Murray's initial decision became the order of the Commission.

J. *In the Matter of Philip L. Pascale, CPA*, Init. Dec. Rel. No. 251 (May 17, 2004); *In the Matter of Philip L. Pascale*, Rel. Nos. 33-8555, 34-51393, AAER No. 2214 (March 18, 2005).

1. Pascale was the engagement partner on the audits of Composite Holdings, Inc. The OIP charged him with violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, with willfully aiding and abetting and causing violations of Section 15(d) of the Exchange Act and Rules 15d-1 and 15d-13, and with engaging in improper professional conduct within the meaning of Rule 102(e)(1)(ii) and (iii), in connection with Composite's accounting for a patent acquired pursuant to an acquisition, its subsequent failure to take an impairment charge on the patent, and its recording of a deferred tax asset. *See* OIP, Rel. Nos. 33-8259, 34-48247, AAER No. 1824 (July 29, 2003).
2. In her initial decision, ALJ McEwen ruled that Pascale had committed no violations, and dismissed the proceeding.
3. The Division of Enforcement petitioned for review by the Commission, which ruled that Pascale had caused Composite's violations of Section 15(d) and Rules 15d-1 and 15d-13, and also had failed to maintain an attitude of professional skepticism, obtain sufficient competent evidential matter, render an accurate audit report, or exercise due professional care. The Commission issued a cease-and-desist order against Pascale for causing those violations, but chose not to address the fraud, aiding and abetting, and Rule 102(e)(1)(iii) violations alleged in the OIP. Moreover, while it found that Pascale's audit had violated Rule 102(e)(1)(ii), the Commission stated, with no other explanation, that "[i]n light of our issuance of a cease and desist order, under the particular circumstances of this case, we have determined not to sanction Pascale for his improper professional conduct under Rule 102(e)(1)(ii)." Rel. No. 33-8555 at 22 n. 40.

K. *In the Matter of Kevin M. Harris, C.P.A.*, Init. Dec. Rel. No. 259 (Sept. 27, 2004), *Finality Order*, Rel. No. 34-51486, AAER No. 2228 (April 6, 2005).

1. Harris was the second respondent in an administrative proceeding that also charged Rita J. McConville, the CFO of Akorn, Inc. from 1997 through March 21,

2001, with violations of Section 10(b) and 13(b)(5) of the Exchange Act and various rules thereunder, and with causing Akorn's violations of Sections 13(a) and 13(b)(2) and certain rules thereunder, in connection with Akorn's understatement of its allowance for doubtful accounts and its accounting for chargebacks and rebates. Harris, who succeeded McConville as Akorn's CFO for six months at the end of the relevant period, was charged with violating Rule 13b2-2, and with causing and aiding and abetting Akorn's violations of Section 13(a) and the certain rules thereunder. See OIP, Rel. No. 34-48770, AAER No. 1910 (Nov. 12, 2003).

2. The Division of Enforcement sought a cease-and-desist order, disgorgement of \$38,000, and a "sanction" (not further specified in the initial decision) under Rule 102(e) against Harris who, unlike McConville, was a CPA. In her initial decision, Chief ALJ Murray found that Harris had willfully violated Rule 13b2-2 and willfully aided and abetted and caused Akorn's violations of Section 13(a) and the related rules. Nevertheless, based on Harris' short tenure with Akorn, his lack of profit from any violations, and his general credibility and demeanor, Chief ALJ Murray declined to issue the cease-and-desist order, concluded that disgorgement should not be ordered, and denied the Division's request for a Rule 102(e) sanction because "[t]his measure tarnishes an accountant's professional career for life, and [was] too severe in these circumstances." Init. Dec. Rel. No. 259 at 43.
3. No party chose to review the initial decision as to respondent Harris, and Chief ALJ Murray's order was allowed to become final as to him.

L. *In the Matter of Kenneth L. Rubin, CPA and Michael W. Lewis, CPA*, Init. Dec. Rel. No. 295 (Sept. 8, 2005), *Finality Order*, Rel. No. 34-52607, AAER No. 2336 (Oct. 14, 2005).

1. Rubin was the engagement partner, and Lewis the manager, on their firm's audit of Eisner Securities, Inc. for the year ended December 31, 2000. The OIP alleged that Eisner's financial statements failed to accrue a contingent liability that resulted from Eisner's offer to settle claims of certain customers whose funds had been misappropriated by a former registered representative, with the result that the financial statements hid Eisner's violation of the net capital rule. The OIP further alleged that respondents had failed to obtain sufficient competent evidential matter, exercise due professional care, or maintain professional skepticism with respect to the size of the misappropriation. See OIP, Rel. No. 34-50745, AAER No. 2144 (Nov. 29, 2004).
2. The Division of Enforcement requested a three-year Rule 102(e) bar against each respondent. In his initial decision, ALJ Mahony agreed and imposed the bar that the Division sought.
3. No party petitioned for review from the initial decision, and the three-year bars became final.