Editor's Note: Due to the unusual length of the opinion in *Bank of America v. BDO Seidman, LLP* (115 typed pages), an abridged version was published in the *Massachusetts Law Reporter*, with this PDF of the full version being provided at *lawreporter.com*. In order to retain the pagination of the printed publication, this full opinion adds pages 518a through 518o between pages 518 and 519, and pages 526a and 526b to accommodate the additional footnotes omitted from the abridged version.

Bank of America, N.A. v. BDO Seidman, LLP et al.

Superior Court, Suffolk, SS
No. 20061705BLS1
Memorandum Dated February 10, 2012

Secured Transactions – Security Interests – Misc. Cases – Opinion Provides a Useful Case Study of the Risks Facing an Equipment Leasing Business Targeting Borrowers with Marginal Credit Ratings, the Public Accounting Firm Auditing the Business's Financial Statements, and the Institutional Lender Financing the Business. This opinion provides a case study of the risks facing an equipment finance leasing business that targets borrowers with credit ratings avoided by large, institutional lenders, the accounting firm which prepared the lessor's audited financial statements, and the institutional lender that provided the leasing business with the financing needed to provide the equipment leased to the business's targeted market. In this case the leasing business operated for nearly 15 years with strong backing by its institutional lender, secured solely by security interests in the lessor's accounts receivable and the equipment leased to the lessor's customers. The lessor avoided defaults by its borrowers by restructuring loans through transactions in which both the principal and interest due on an old loan would be booked as a new loan and the old loan marked as paid and therefore current, creating an illusion of continuing revenues, current accounts receivable, and a low default rate on the part of its customers. In reality, over time the amount of loans to poor credit risks accumulated, increasing the amount of outstanding loans without increasing the security of the assets securing the loans, resulting in a gradual erosion of the security upon which the lending bank was relying and a concentration of the lessor's customer base in a smaller pool of customers composed of customers with the least desirable credit ratings. The shortcomings of the accounting procedure, which in hindsight was clearly not in accordance with generally accepted accounting practices, was overlooked by the public accounting firm preparing the lessor's financial statements, and by the lending institution's loan officers, who relied on both the accounting firm's annual audit reports and their own occasional independent examinations of the lessor's financial records. The transactions were clearly entered in the lessor's books, so there is no clear indication of an intent to deceive the auditors or the institutional lender, and the business's true financial status could have been obtained through a careful analysis by either the auditor or the bank. In this case the lending bank has sued the auditor for negligent misrepresentation in the preparation of its annual audit reports, three of the company's executives (two of which were controlling owners) for negligent misrepresentation and Chapter 93A violations, and the corporate lessor and its parent companies. The opinion finds that the auditors made negligent misrepresentations to the bank but ruled in favor of the auditor on the basis that the bank's reliance was not reasonable in view of the bank's own negligence in monitoring the loan and failure to have reacted to warnings of problems from other sources. The opinion also rules for the defendants on the bank's negligent misrepresentation claims against the individual corporate officers, again based on the bank's unreasonable reliance on the claimed misrepresentations. However, the opinion awards partial damages against one officer on the bank's Chapter 93A claim. The damages awarded, however, are limited to loan advancements made only during the latter stages of the 15-year lending period, based on the court's finding that the bank would likely have made the loans during the earlier years even in the absence of the misrepresentations, and there is no multiplication of damages. The opinion also awards full damages against the three corporate defendants (the lessor, the lessor's parent and the parent's parent), but it appears doubtful that there are assets available to satisfy those damages. In view of the length of the opinion (115 typed pages), only selected sections have been reproduced in this issue. The full opinion will be available as a PDF on our web page at lawreporter.com for six months, and is permanently available from various online legal publishers.

**Torts – Fraud and Misrepresentation – Misc. Cases – Fraudulent Misrepresentation Claim by a Third Party Against a Public Accounting Firm for Negligence in Auditing a Client's Financial Statements Is Not Based on a Claim of a False Opinion, Because an Opinion Is Not a Statement of Fact, But

Rather on Implied Misrepresentations of Competence, Use of Due Diligence, and Reliance on Sufficient Information Upon Which the Opinion Was Based. This opinion recognizes the linguistic difficulty in holding an auditing firm liable for negligent misrepresentation to a third party who relied on an audit opinion, because an "opinion" is not a "fact" and therefore cannot constitute a negligent misrepresentation of a fact. The opinion explains, however, that an auditor's liability is based on the falsity of implied representations that the firm had a level of expertise in accounting matters at least equal to the industry standard, had exercised due care in the preparation of its opinion, and had gathered sufficient information concerning its client for the exercise of judgment in reaching the audit opinion.

Torts – Fraud and Misrepresentation – Reliance – Bank Suing a Public Auditor for Negligence in the Auditing of a Borrower in the Business of Equipment Finance Leasing Has a Heightened Burden of Proof on the Issue of Whether Reliance Was Reasonable, Because a Bank Is in the Same Line of Business as, and Therefore Particularly Knowledgeable Concerning, the Borrower's Business. In an action by a bank against a borrower and the public auditor that prepared the borrower's audited financial statements, allegedly relied on by the bank in extending a loan, the bank has a heightened burden of proof to establish that its reliance on the audit report was reasonable, because a bank is in the same line of business and therefore particularly experienced in the borrower's business.

FABRICANT, JUDITH, J.

INTRODUCTION

This action arises from a long-term lending relationship between Bank of America and its predecessors (the bank) and Cobblestone Corporation of Northern New England, Inc. (CCNNE). CCNNE defaulted on its debt to the bank in the amount of $20.5 million. The bank seeks to recover its loss from CCNNE's individual principals,[1] as well as from BDO Seidman (BDO), which audited financial statements for CCNNE's parent corporation, and for CCNNE for certain years.[2] The Court conducted a jury-waived trial over 23 days, beginning on September 8, 2011, and ending on October 13, 2011. Exhibits received in evidence during the trial numbered 1,672.[3] After completion of the evidence, the Court allowed the parties additional time to submit proposed findings and rulings. As of December 22, 2011, the Court has received proposed findings from all active parties, along with a stipulation of all those parties as to certain facts, and a separate stipulation as between the bank and BDO, in which the individual defendants do not join.[4] Based on the credible evidence presented at trial, and having considered the arguments of the parties, the Court finds and rules as follows.

I. FINDINGS OF SUBSIDIARY FACTS

1. The Seders and Their Business.

Prior to any of the events in issue in this case, brothers Larry and Jim Seder each had several decades of experience in the lending and equipment leasing business. Each also had substantial relevant education, Larry an MBA and Jim a law degree.[5] The brothers (particularly Larry) had developed strong relationships with senior executives at the bank's predecessors, who regarded the Seder brothers as trustworthy, competent, and experienced in the lending business.

The two brothers formed Redes Holding Corporation in 1990, each owning 50%. Redes purchased Cobblestone Corporation, a lending and leasing company, from what was then First Mutual Bank of Boston. Cobblestone formed CCNNE. Over the next twenty-some years, the Seder brothers conducted a lending and equipment leasing business through CCNNE,[6] funded by a revolving loan provided by the series of banks that has become the bank that is the plaintiff here.[7] CCNNE's customers were generally small businesses whose credit history fell below lending standards for banks.[8] Aside from the funds it borrowed from the Bank, CCNNE's income consisted of the loan payments it received from its customers. Its profits consisted of the difference between its own borrowing costs (and other operating costs, including the Seders' salaries) and the higher interest its customers paid. Its assets consisted almost entirely of its accounts receivable—that is, the anticipated stream of payments under its outstanding loans and leases.

Larry Seder held the primary decision-making and deal-making role at CCNNE. He solicited business, formed relationships with customers, evaluated their creditworthiness, and negotiated terms. He also played the primary role in CCNNE's relationship with the bank. Jim Seder was primarily responsible for documentation of transactions, but also participated in management and in interactions with the bank. Both Larry and Jim had full access to all CCNNE's files and information at all times. Both kept track of the status of significant customer accounts, including any delinquencies.

Robin Seder Isenberg, Larry's daughter, joined the business in 1992, after her graduation from college. She performed bookkeeping, accounting, data entry, and similar functions, and prepared and signed various reports submitted to the Bank. Although she had minimal business experience, and her only relevant training consisted of introductory accounting courses, she eventually came to hold the title of Chief Financial Officer. She took direction in her work from her father and uncle, and as to accounting matters, from BDO.[9] She served as CCNNE's primary contact with BDO, although Larry and Jim Seder also interacted with BDO and were fully informed of its activities. Isenberg did not overstate her credentials or experience, either to the bank or to BDO; both were generally aware of her level of sophistication.

CCNNE's approach to lending emphasized personal relationships. It had no formal or systematic underwriting standards or processes; Larry Seder made decisions based on his assessment of a customer's business plan, its assets, and its principals.[10] CCNNE generally obtained security interests in equipment, accounts receivable, or other collateral for loans, and filed UCC financing statements to reflect its interests, but it did not obtain appraisals of collateral. Nor did it obtain Dun & Bradstreet reports on its customers, or their financial statements or tax returns. It sometimes obtained personal guarantees from principals of its customers, but it did not do so consistently, and did not obtain financial statements from those individuals or credit reports on them. CCNNE's primary concern, in its relationships with its customers, was that they pay interest, if not when due then eventually, since interest payments were the source of its income and profits. CCNNE had less concern for repayment of principal, since its outstanding customer contracts were its primary (if not sole) assets.

Larry Seder was the one to decide how to handle any difficulties with customers. He made those decisions, like his initial lending decisions, based on his personal evaluation of the customer and its circumstances. He rarely declared a customer in default and proceeded to foreclose on pledged assets. Rather, his usual approach to a customer's inability to pay was to lend it additional money.[11] Sometimes that kind of loan was structured as a "payment in kind" or "PIK" note—that is, the customer made its interest payment to CCNNE in the form of a note. Sometimes such a transaction was structured as a rewriting (essentially a cash-out refinancing) of the original loan or loans—that is, one or more new loans would be issued to pay off the old loan or loans, along with accumulated interest. The result of either type of transaction was that the total principal of the loan would increase, while the value of the collateral would not.

Sometimes, if Larry came to believe that the original customer or its principals were no longer in a position to perform and would not become so, he would identify some other person or entity, often an entity formed by an employee of the original customer or a family member of its principals, to take over. In such instances, a loan would be issued to the new customer to pay off the loans to the previous customer, along with accumulated unpaid interest, and the new customer would take possession of either the equipment or the entire ongoing business of the previous customer. Such transactions would tend to result in loans with principal amounts that would far exceed the value of the collateral. To enable the customers to make the required on-going payments, often these loans were structured such that payments were drawn out over a long term or deferred for a substantial period of time, with a large balloon payment some years off.

Larry had (and still has) great faith in his ability to evaluate his customers and, if necessary, to make advantageous deals. His confidence sometimes proved well-founded. In some instances, the additional funding provided by CCNNE to a customer that was having temporary trouble enabled the customer to expand its business and eventually to pay off its entire debt. In some other instances, Larry succeeded in arranging a transaction in which a genuinely separate entity would purchase a customer's ongoing business and pay off its loans entirely. Over time, however, and with the worsening of economic conditions in the early 2000s, these kinds of successes became less frequent. CCNNE's business became increasingly concentrated in a small number of customers, whose loans far exceeded the value of the collateral, as a result of repeated refinancing transactions of various kinds. CCNNE's total reported assets—that is, the nominal value of its accounts receivable—continued to grow, but the security for those accounts did not. As long as CCNNE could keep borrowing ever increasing amounts from the bank, to fund its ever increasing loans to customers who otherwise could not make their payments, it appeared to be profitable and growing. But if the bank were to cut it off, and it could not refinance with another lender, its house of cards would collapse.

At least in its early years, CCNNE often obtained new customers through brokers, who were then entitled to commissions. As a method of managing the risk of default, CCNNE would withhold part of the brokers' commissions in what it referred to as a "special hold-back account." If a customer failed to pay, CCNNE would take funds from that account to pay itself the amounts due.[12] One consequence of this practice was to reduce CCNNE's need for writing off receivables as uncollectible, since it would collect missed payments from the special hold-back account. As a result, its charge-off rate, as reflected in financial statements, would understate the actual amount of its customers' delinquencies. In 1999 and 2000, the understatement was enough to make the difference between compliance and non-compliance with the limit on charge-offs under CCNNE's credit agreement with the bank. In later years, CCNNE obtained fewer new customers through brokers, and the special hold-back account became exhausted in 2000. Thereafter, CCNNE's methods of addressing customers' inability to pay were PIK notes and rewriting of loans, as described *supra*.

When CCNNE rewrote a loan or accepted payment in the form of a PIK note, it would document the transaction in a disbursement memorandum, which would set out how the proceeds of any new loan were to be disbursed on behalf of CCNNE's customer. For example, a disbursement memorandum might recite an amount to be paid to a seller for a new piece of equipment, an amount to be paid to CCNNE as repayment of the principal balance of one or more outstanding loans, an amount to be paid to CCNNE for outstanding interest on loans being repaid, and an amount to be paid to CCNNE for fees in connection with the transaction. CCNNE would retain the disbursement memorandum in its loan file for the customer.

With respect to amounts being disbursed from these transactions to CCNNE, CCNNE would issue a check to itself from its operating checking account, and then deposit the check into the same account, placing a copy of the check with the disbursement letter in the customer's credit file. One consequence of this practice was that, although the balance in CCNNE's bank account would not change, an accounting of amounts coming into and going out of the account would appear to show a larger volume of receipts and disbursements than was actually occurring. Similarly, financial statements that treated those checks as cash received would overstate the amount actually received.[13] Between 1996 and 2005, CCNNE wrote checks to itself totaling more than $13 million. The number and volume of such checks increased in each year between 1999 and 2004. In FY 1999, CCNNE wrote 11 checks to itself, for a total of $509,486. In FY 2000, it wrote 17 such checks, for a total of $931,643. In FY 2001, it wrote 33 such checks, for a total of $966,687. In FY 2002, it wrote 45 such checks, for a total of $2,084,410. In FY 2003, it wrote 60 such checks, for a total of $2,398,360. In FY 2004, it wrote 132 such checks, for a total of $3,289,063. In FY 2003 and 2004 the amounts CCNNE paid to itself on behalf of customers exceeded the other payments CCNNE received from customers.

In addition to rewriting and the use of PIK notes, CCNNE also, on occasion, held back certain amounts from new loans to existing customers, so as to have those funds available to offset future receivables from that customer that the customer could note otherwise pay. CCNNE would classify those amounts as "unapplied cash." In substance, such amounts functioned as reserves against anticipated defaults by those customers.

CCNNE did not point out these various practices either to the bank or to BDO, but it did not hide them. As indicated *supra*, its loan files included disbursement letters for each transaction, along with copies of the checks written to itself, and its checking account records also reflected the checks written to itself. As will be discussed further *infra*, both the bank and BDO had full access to all of CCNNE's files and records, and reports CCNNE submitted to the bank on a regular basis provided information that, on close examination, would have alerted the bank to these practices. In addition, CCNNE maintained its operating checking account at the bank, making all deposits into and drawing all checks from that account. The bank drew CCNNE's payments to it from that account, transferred loan proceeds into it, and had full access to all information about transactions in that account.

2. The Loan.

Unlike CCNNE, the bank, as might be expected, had very formal standards and processes. With respect to CCNNE, however, it did not always follow its own policies. Its departures resulted from at least four factors: the high regard in which its senior executives held the Seder brothers; evaluation and compensation systems for bank personnel that weighted incentives toward increased lending, rather than prudent evaluation of risks; internal distractions and failures of communication arising from the various bank merger transitions; and inadequacies in internal systems, resulting in failures to analyze and respond to information received.[14] The bank, much like CCNNE with respect to its borrowers, made its profits from CCNNE's payments of interest and various fees.[15] Like CCNNE, it focused its attention accordingly.

CCNNE's borrowing relationship with the bank began in 1992 with a secured revolving loan in the amount of $2 million, for a two-year term, issued by what was then Bank of Boston. Richard Remis, then a loan officer with Bank of Boston and now an Executive Vice President of the bank, approved the loan based on a report, prepared by a credit officer, that emphasized the Seders' background and experience. The terms of the loan were set forth in a credit agreement (trial exhibit 7), which Larry Seder signed for CCNNE. CCNNE's parent entities, Redes and Cobblestone, both provided guarantees, which Jim Seder signed for the guarantors. The credit agreement required CCNNE to execute a security agreement and an assignment of contracts, and CCNNE did so.

The loan functioned as a line of credit; CCNNE could borrow as it chose, up to the stated maximum amount, provided that its financial condition met certain requirements. It was required to pay only interest, not principal, during the period of the loan; it would be required to pay the principal in full at the end of the two-year term, unless the bank agreed to extend the term. During the loan term, the bank was entitled to full access to all books and records of CCNNE, and CCNNE was required to submit various reports and certifications, as specified in the credit agreement. Among the reports was an annual audited consolidated financial statement of CCNNE's ultimate parent, Redes. No audited financial statement of CCNNE itself, or its immediate parent, Cobblestone, was required under the 1992 credit agreement.

Between 1992 and 1995, the bank and CCNNE executed a series of amendments to the credit agreement, each raising the maximum amount of the loan and extending its term. On September 29, 1995, the bank and CCNNE executed a new credit agreement (trial exhibit 18) providing for a maximum loan amount of $12 million, again guaranteed by Redes and

Cobblestone. Again Larry Seder signed the credit agreement on behalf of CCNNE. Again the credit agreement required CCNNE to execute a security agreement and an assignment of contracts. Apparently—although the record is less than clear on this point—CCNNE did not execute those documents in connection with the 1995 security agreement.[16]

Under the 1995 agreement, unlike its predecessor, the loan would no longer terminate abruptly after a fixed period, with full payment due immediately. Rather, if the bank decided not to renew or extend the loan after its termination date, it would convert to a term loan amortized over 18 months, so that CCNNE would have to pay off the full principal balance, with interest, over that time. A 1999 amendment extended that period to 24 months.

The 1995 credit agreement, like its predecessor, gave the bank full access to all books and records of CCNNE, and also required CCNNE to submit regular reports. The reports required included: an annual audited consolidated financial statement of Redes (but not of CCNNE itself or Cobblestone) within 120 days after the September 30 end of its fiscal year; along with CCNNE's own "reviewed" but unaudited annual financial statement; CCNNE's own unaudited quarterly financial statements, certified by its "principal financial officer"; and a monthly "Borrowing Base Report" and "Contract Aging Report."[17] Along with each report submitted, CCNNE was required to provide a certification by its chief financial officer that the report was accurate, that it was prepared in accordance with GAAP, and that no event of default had occurred.

CCNNE did provide the specified reports. One or both of the Seder brothers hand-delivered the audited annual financial statements to bank personnel each year. Robin Seder Isenberg prepared the annual and quarterly unaudited financial statements for CCNNE, and the other reports, and either she or one of the brothers would deliver or transmit them. Larry and Jim both received, or had access to, all of the reports Isenberg provided to the bank. Isenberg used the annual audited financial statements as a template for her reports. Although she had only minimal familiarity with GAAP, she certified that each of the reports complied with it; her basis for that conclusion, as she testified, was that no one told her otherwise. The bank would regularly enter data from both audited and unaudited financial statements into what it referred to as its "spreading" system, which it would use to generate internal spreadsheets presenting financial information for a period of years. The bank would refer to those internal reports in connection with periodic evaluations of the account, including evaluations related to requests for increases in the loan amount or other changes in the loan.

In addition to reporting requirements, the credit agreement imposed financial requirements; CCNNE's failure to meet any such requirement would constitute an event of default. These requirements included that neither CCNNE nor either of its parent entities would incur a net loss in any quarter; that CCNNE would maintain specified ratios of debt to net worth and cash flow to interest expense; and that it would not incur charge-offs for any four-quarter period exceeding two percent of receivables.[18] The certifications regularly provided by Robin Isenberg represented that no default had occurred on these or the other requirements of the credit agreement, and set forth calculations indicating compliance. As will be discussed further *infra*, these representations were on some occasions inconsistent with some of the information that appeared on the face of the reports.[19] In certain other respects, although the representations were consistent with the numbers that appeared on the reports, they were inconsistent with the underlying reality, as a result of the techniques described *supra* that CCNNE used to address its customers' inability to pay.

Within the maximum loan amount as it stood at any particular time, the credit agreement limited the amount CCNNE could borrow to a specified percentage of the "Borrowing Base," defined as the "Net Present Value of Eligible Contract Receivables." Contracts were ineligible for inclusion in the borrowing base if they were in default, if payments were more than 60 days past due, if the customer was insolvent or in bankruptcy, or if the customer was located outside the United States. After August of 1999, as a result of an amendment executed at that time, contracts were also ineligible if they had been rewritten because of delinquency or other credit problems, although such contracts would become eligible again after two consecutive quarters with no default.[20]

The "Borrowing Base Reports" that Robin Isenberg submitted to the bank each month set forth calculations showing permissible borrowing based on contracts represented to be eligible. Isenberg determined eligibility, for purposes of the calculations set forth on the borrowing base reports, based on information in the "Aged Lease Receivable Report" that she attached to each borrowing base report. That document indicated for each contract the number of days payment had been due, in categories (that is, 1-30 days, 31-60 days, 61-90 days, 91-120 days, over 120 days). When CCNNE had brought a customer current by making a payment to itself on a customer's behalf, either in return for a PIK note or through rewriting of a contract, it would then classify the account as current, and Isenberg would treat it as eligible for inclusion in the borrowing base. She continued to do so, even after the 1999 amendment, with respect to accounts that had become current through rewriting. As a result, the borrowing base would regularly appear to be higher, and CCNNE would be permitted to borrow more than would have been the case if the reports had excluded those accounts.

The aged lease receivables report listed customers by name, in alphabetical order; set out by number all loans and leases for each customer; and indicated for each loan or lease the date of the next payment due and the term of the contract.[21] Thus, as will be discussed further *infra*, careful examination of a series of such reports would have permitted a reviewer to trace the sequence of events with respect to each customer and account, and to perceive patterns indicative of rewriting. As will be discussed further *infra*, the bank did not conduct that sort of analysis.

Between 1995 and August of 2003, the bank and CCNNE amended the 1995 credit agreement seven times, each time increasing the maximum amount of the loan and extending its term. Ultimately, the maximum loan amount reached $20.5 million. Some of the amendments made other changes as well, including changes in the various ratios and percentages specified for the financial covenants.

The 1995 agreement (like its predecessor), required that CCNNE deliver to the bank, for the bank to keep in its physical possession, all original leases and loan contracts between CCNNE and its customers, and further required that such contracts not be modified, transferred, or discharged without the bank's written consent. Any contract not in the bank's physical possession was to be excluded from the borrowing base. The purpose of these requirements was to enable the bank to monitor its collateral, and to protect the bank against potential conduct of CCNNE that could impair the collateral, such as pledging or selling contracts to another creditor, rewriting them, modifying them, or discharging them without payment or without obtaining adequate consideration that would provide substitute collateral for the bank.

CCNNE never complied with these requirements, and the bank never enforced them. As will be discussed further *infra*, in mid-1999 the bank and CCNNE reached agreement on a substitute technique that the bank determined would serve some of the purposes of the original requirements: CCNNE would place a stamped notation on each original contract or lease, indicating that it was pledged to the bank. CCNNE did not begin to do so, however, until 2005. CCNNE attributes the delay to the bank, in that CCNNE was waiting for the bank to specify the language for the notation, which it did not do until then. Between 1999 and 2005, the bank never checked to determine whether CCNNE was stamping the contracts.

The 1995 agreement also required that CCNNE submit to the bank a form "Notice of Borrowing" each time it sought to draw on the loan. The form included a renewal of all representations and warranties in the credit agreement, and a certification that no default had occurred or would result from the requested loan advance. The bank has no such documents, and no evidence to indicate that it ever received any from CCNNE. The Court infers that CCNNE did not submit those documents, but communicated its requests for advances by other means, to which the bank responded by transferring the requested amounts into CCNNE's account at the bank. As indicated *supra*, the bank did receive regular certifications of compliance with all covenants, and the absence of defaults, in various other forms. As will be discussed further *infra*, it appears that such transfers were essentially automatic, as long as the amount was within the limit of availability based on the calculations shown in the borrowing base reports. The evidence does not indicate that the bank engaged in any sort of evaluation and approval process in response to CCNNE's routine requests for advances within the loan availability.

Over the course of the relationship between the bank and CCNNE, the bank assigned a series of loan officers, relationship managers, and other personnel at various levels to the account. Those personnel would communicate with CCNNE regularly, sometimes in person, and would also, with assistance of various supporting staff members, review and examine the reports received from CCNNE with varying levels of intensity. The bank also, from time to time, conducted field examinations of CCNNE's records, of varying scope, either through its own personnel or through outside vendors.[22] Under the credit agreement, CCNNE bore all costs of field examinations. The scope of such examinations was entirely up to the bank.

Theoretically, if any information obtained through any of these reviews, or from any other source, at any time, identified an event of default, the bank could have declared the loan in default, stopped all advances, accelerated the loan, and demanded immediate full payment, failing which it could have seized all of CCNNE's assets, as well as enforced the guarantees against Cobblestone and Redes. In practice, the bank repeatedly overlooked information indicating that events of default had occurred. The bank also repeatedly overlooked information from which it could have drawn inferences that would have called into question both the specific information reflected in financial statements and the general assurances provided by the Seders (particularly Larry) in conversations with bank officials.

3. The Information the Bank Received, and Its Decisions.

The Bank conducted a field examination in June of 1997, and issued a report dated July 23, 1997. The report raised a number of issues, among which were that the borrowing base included a customer in bankruptcy, and that bad debt reserves were inadequate, in the examiner's view, by approximately $525,000. The report also noted a high level of delinquencies, some of which it attributed to accounts in bankruptcy. The report noted the rewriting of contracts with one customer, Mark Equipment, which "causes difficulty in analyzing the payment history" of the customer "and the actual payment terms of the notes." The examiner recommended "that all new notes receivable be forwarded directly to the relationship manager to ensure that rewrite activity is not excessive and to monitor that rewrites are not occurring to keep borrowers in the borrowing base." The examiner noted also that the bank had no information about the value of the equipment securing that account, beyond management's opinion that its value exceeded the amount of the loan. The examiner recommended "some supporting information be obtained to give us some assurance of this." The examiner also recommended increasing the frequency of field examinations to semi-annual. The bank did not, as far as the evidence discloses, implement any of the recommendations expressed in this report from 1997.

In 1999, CCNNE requested that the bank increase the loan from its then level of $14 million to $20 million, extend its term to 2003, and increase the so-called "advance rate"—that is, the percentage of the borrowing base that CCNNE was permitted to borrow. The loan officer on the account at the time was Pauline Mozzone.[23] Mozzone reviewed information in the credit file, including a "Credit Comment" dated March 26, 1999, authored by bank staff person Matthew Leighton (trial exhibit 1177). The credit comment reported that CCNNE's customers included "some larger accounts such as Exxon, H.P. Hood, Stop & Shop and Coors." That information was incorrect; none of those entities was a customer of CCNNE. The record does not establish the source of that erroneous information. The bank could have checked it by reference to the aged lease receivables reports, which listed all customers in alphabetical order; it did not. The credit comment also reported that "The financed equipment maintains a good collateral value." The document does not indicate how the author came to that conclusion, nor does it provide any information from which a reader could evaluate the basis of the statement. In fact, the statement was based solely on representations to that effect from Larry Seder in conversations with bank personnel.[24] As will be seen, these statements were repeated in various subsequent bank reports about CCNNE.

The credit comment reported that CCNNE sought to increase and extend the loan, "to support new growth in the Leasing/Loan portfolio." It set out financial information for fiscal years 1996 through the first quarter of 1999, drawn from Redes's audited consolidated year end statements for 1996-1998, and CCNNE's unaudited quarterly financial statements.[25] The document noted that the figures showed increasing revenue, assets, profitability, and net worth, that "CCNNE is in compliance with all [bank] covenants," and that a field examination in April of 1998 "reported no material problems or exceptions."[26] It did not identify the basis of the conclusion that CCNNE was in compliance with all covenants, beyond the financial information set forth. It recommended that CCNNE remain at its then risk rating of 5,[27] "due to the company's small size and limited access to capital markets,"and that [a] downgrade would be considered if operating performance deteriorates resulting in 2 consecutive quarters of net losses."[28]

Mozzone also reviewed a report of a field examination conducted in May 1999 (trial exhibit 1178). Such an examination, according to Mozzone's trial testimony, should "test the borrowing base submissions if they were submitted in accordance with the credit agreement, . . . look at trends from prior submissions month to month, . . . look at concentration of the customer base." Unlike an audited financial statement, according to Mozzone, a field examination "is tested against our credit agreement in terms of how we wanted the formulas calculated and submitted to us."

This particular examination, as indicated in the report, "was performed on a collateral-only basis, which is limited to a review of receivables, accounts payable, taxes, insurance, documentation, and internal controls as they relate to collateral." Its purpose, in substance, was to make sure that the bank's collateral—that is, CCNNE's accounts receivable—was as represented, and provided adequate security for the loan. The examination reported that CCNNE had receivables of $18,690,000, consisting of 193 contracts with 120 customers. Corresponding figures for the previous year were $16,848,000, consisting of 185 contracts with 128 customers. The examiner noted the increase of 11% in receivables, but did not comment on the decrease in the number of customers.[29]

The examiner noted two particular concerns: rewritten contracts, and the lack of stamps on original contracts. Regarding rewritten contracts, the examiner reported that CCNNE "has five re-written leases/loans," amounting to 4% of the total lease receivable balance, and that, according to management, "a re-write occurs basically when a customer faces financial difficulties and falls behind on agreed monthly payments." After reviewing the particular circumstances of each of the customers involved, the examiner recommended that rewritten contracts should be excluded from the borrowing base "because they are issued to companies with poor payment history," with an exception for one customer that had been current for nearly a year since the re-write, although that customer "should be monitored."[30]

Regarding a lack of stamps on leases, the examiner noted that, despite the requirement of the credit agreement, CCNNE had been keeping the originals of its contracts "for the last three to four years . . . because they are needed in the event of sold or cancelled leases." According to management, the examiner reported, "the company loses business when they have to wait the two weeks it normally takes [the bank] to retrieve them from archives and send them to the customer." The examiner did not recommend enforcement of the credit agreement requirement. Instead, he observed, "of more concern is the fact that these original leases are not stamped by the Bank to claim first priority security interest. We understand the need for the customer to have the original leases on the premises, but recommend that all those already at the customer site and all future leases be stamped by [the bank] to protect the Bank's interests."

Mozzone, in reviewing the field examination, noted the issue of re-written leases. That matter was of concern because, as she testified, "a lease could be rewritten because there were credit issues with the underlying borrower, and that would taint whether that was good collateral to be lending against." As to the issue of possession or stamping of original contracts, Mozzone found it acceptable to have them stamped, rather than in the bank's possession.

After reviewing these documents, and meeting with the Seders, Mozzone prepared a memorandum (trial exhibit 1179) recommending a temporary increase in the loan to $15 million, pending a larger increase after negotiation of an amendment to the credit agreement to address the issues raised in the field examination. Mozzone's memorandum, dated June 10, 1999, repeated the erroneous information about CCNNE's customers that had appeared in the credit comment, along with its unexplained assertion that "the financed equipment maintains a good collateral value." She recited financial figures drawn from the audited annual financial statements and unaudited quarterly statements. Mozzone noted the following under "Key Credit Issues": "Deterioration of Portfolio During Economic Downturn. While a downturn in the economy would have a [sic] impact on the quality of the portfolio, management's 20+ year history of successfully managing similar portfolios through various economic cycles somewhat mitigates the risk."

Mozzone provided to CCNNE a term sheet for the proposed temporary increase (trial exhibit 1203), in which eligible leases and loans were defined as those "less than 60 days past due and those that have not been 'rewritten.' 'Rewritten' leases/loans are defined as those that are a credit problem (i.e. rewritten for delinquency). These leases/loans can be included in the borrowing base as eligible after performing for two quarters." Mozzone discussed that provision with Larry Seder, who agreed to it, although CCNNE took no action thereafter to alter its practices to comply with that restriction. Mozzone also discussed the issue of stamping contracts with Larry Seder, and he agreed to do so; there again, however, CCNNE took no action to comply. The bank approved the temporary increase to $15 million. The parties executed amendment 2 to the 1995 credit agreement as of June 30, 1999, to reflect the change. The amendment, which Jim Seder signed for CCNNE, included a reiteration of the representations set forth in the credit agreement (including the absence of material adverse changes), and a representation of the absence of any default as of that date.

Soon thereafter, Mozzone prepared the necessary paperwork for a permanent increase to $15 million, along with the requested term extension and increase in the advance rate, subject to the same requirements regarding rewritten leases and stamping. Her "Credit Request Summary," seeking approval from her superiors, presented essentially the same information as her earlier memorandum (including the erroneous information noted *supra*), along with certain additional points. The memorandum commented that, "While delinquencies have been above the UW [underwriting] guidelines, it has not been an indicator of the charge-off history. Charge-offs have been below 1% for each of the last three years."[31] The memorandum also commented that "At the end of the three year term, should the revolver not be renewed, operating cash flow as well as the portfolio run-off ($500M per month) is sufficient to term out the balance in 24 months." Her sole basis for this statement was Larry Seder's oral representation to that effect.

Regarding collateral, the memorandum observed that "Given our primary reliance on the lease stream and the small dollar value of the majority of the individual pieces of equipment, we do not have UCC filings in each state in which the equipment is located." Mozzone reported, erroneously, that CCNNE's leases had an average maturity of 19 months; in fact, contemporaneous aged lease receivable reports showed average maturity between three and four years. The memorandum further noted that CCNNE's net worth did not meet the bank's underwriting standards, but that "This is mitigated by the company's Needham location and [the bank]'s longstanding relationship with the principals."

Mozzone also noted that CCNNE had loaned Cobblestone some $1 million, reportedly for purposes related to exploring potential new ventures.[32] The loan was reflected in CCNNE's financial statements as a "negative payable," which Mozzone considered an unusual way of describing what was in substance an account receivable. The receivable had the effect of increasing CCNNE's assets, and therefore its borrowing base. Collectibility of that receivable depended on Cobblestone, one of the guarantors of CCNNE's loan, which had reported net losses and negative net worth consistently since 1997. Mozzone nevertheless recommended approval of the increase. The only requirement she imposed regarding the inter-company loan was that no more than $1.5 million be expended on exploring new ventures. Larry Seder agreed to that restriction. The bank did not establish any enforcement mechanism. The bank approved the permanent increase, and the parties executed amendment number 3 to the 1995 credit agreement, dated August 20, 1999, to reflect the change. Larry Seder signed the amendment, which included a reiteration of the representations and warranties set forth in the credit agreement, including the absence of material adverse changes and of any default.

Mozzone prepared a "Credit Comment" dated August 30, 1999. She repeated much of the information and conclusions in the previous credit comment and in her earlier memoranda, including the erroneous and unsupported information referred to *supra*. Again drawing figures from audited annual financial statements and unaudited quarterly statements, she noted that "CCNNE continues to perform well characterized by stable revenue and profitability."

CCNNE soon requested another increase in the loan amount. Daniel Grondin, who had assumed primary responsibility for the account, evaluated the request in a credit offering memorandum dated December 14, 1999. His memorandum set out figures drawn from the same financial statements previously reviewed; the Bank had not yet received the audited financial statement for the fiscal year ending September 30, 1999. Grondin described the reason for the request as "an increase in the company's business over the past year." He repeated much of the same information provided in earlier memoranda, including the erroneous and unsupported information.[33] The bank granted the request, raising the loan amount to $16 million. The parties executed amendment 4, reflecting the change, as of January 12, 2000. Again Larry Seder signed the amendment for CCNNE, with the same representations as the previous amendments.

Between May of 1999 and July of 2001, the bank did not conduct a field examination of CCNNE. It did receive annual and quarterly financial statements, along with monthly borrowing base reports and the other reports described *supra*. As will be discussed further *infra*, some of the information in those reports, if examined closely, would have alerted the bank to increasing risk, or at least raised questions warranting inquiry.

CCNNE delivered the audited financial statement for fiscal year 1999 to the bank on January 19, 2000.[34] As of the time the bank received that report, the maximum amount of the loan was $16 million, and no request for increase or other change was pending. The earliest bank document that referred to the 1999 financial statement, or drew figures from it, was a "Financial Statement Analysis Checklist," dated May 20, 2000, prepared by portfolio manager Clark Hayes (trial exhibit 1216). That one-page form set out certain year-end figures from the audited annual statements for 1999 and 1998, and indicated the absence of any material trends or events, compliance with loan covenants, and current payment status of the loan.

Pertinent figures shown in the consolidated statement for 1999 were the following: income from direct finance leases and loans of $2,307,893 (up from $2,140,031 for 1998); net income of $66,927 (down from $109,327 for 1998); purchase of assets to be leased and origination of loans of $8,934,819 (up from $7,005,032 for 1998); principal payments received of $6,292,962 (up from $5,930,077 for 1998). Footnote 3 showed net minimum lease and loan payments of $16,965,743 (up from $14,518,725 for 1998), based on total receivables of $21,021,667 (up from $17,661,632 for 1998), plus estimated residual value of leased equipment, minus unearned income and an allowance for doubtful accounts of $150,117 (down from $204,949 for 1998). Footnote 3 also provided a schedule of payments to be received in each of the subsequent five years, and thereafter, with 34% due in the first year, and 2.4% after five years. Footnote 8 described CCNNE's revolving credit agreement with the bank, noting its maturity date of March 30, 2002, subject to renewal, converting to a 24-month term loan if not renewed. The attached consolidating statements showed net income of $459,128 and net worth of $3,058,096 for CCNNE, but a net loss of $292,245 and negative net worth of $742,131 for Cobblestone.

During calendar year 2000, CCNNE's monthly borrowing base reports, submitted to the bank, showed rapidly increasing delinquencies, with the percentage more than 60 days past due reaching a high of 19.07% in the month of August, and the percentage more than 120 days past due reaching a high of 14.61% for the month of October. During the same period, the borrowing base reports also showed that CCNNE's portfolio was becoming became increasingly concentrated. As of the end of 1999, CCNNE had 107 customers, with its ten largest customers representing 52.17% of its portfolio (nearly $11 million of a total just over $21 million). At the end of 2000, it had 81 customers, with the ten largest representing 68.71% of its portfolio (nearly $17 million of a total of $24.6 million). The evidence does not reflect any action by the bank in response to this information. The increasing concentration resulted in significant part from repeated rewriting of loans with existing customers, in increasing amounts to cover amounts due. Careful examination of the aged lease receivables reports would have revealed that pattern. Careful examination also would have revealed that, despite the agreement reached in 1999, CCNNE continued to include in the borrowing base accounts that had become current only as a result of rewriting of contracts or acceptance of PIK notes.

CCNNE delivered the audited financial statement for fiscal year 2000 to the Bank in late January 2001. As of that date, the loan amount remained $16 million, and no request for increase or other change was pending. Pertinent figures shown in the consolidated statement for 2000 were the following: income from direct finance leases and loans of $2,616,052 (up from $2,307,893 for 1999); net income of $18,712 (down from $66,927 for 1999); purchase of assets to be leased and origination of loans of $9,070,531 (up from $8,934,819 for 1999); principal payments received of $7,362,512 (up from $6,292,962 for 1999). Footnote 3 showed net minimum lease and loan payments of $18,199,967 (up from $16,965,743 for 1998), based on total receivables of $24,564,867 (up from

$21,021,667 for 1999), plus estimated residual value of leased equipment, minus unearned income and an allowance for doubtful accounts of $206,810 (up from $150,117 for 1999). Footnote 3 also provided a schedule of payments to be received in each of the subsequent five years, and thereafter, with 27% due in the first year, and 10.7% after five years. Footnote 7 described CCNNE's revolving credit agreement with the bank, again noting its maturity date of March 30, 2002, subject to renewal, converting to a 24-month term loan if not renewed. The consolidating statements showed net income of $357,092 and net worth of $3,415,188 for CCNNE, but a net loss of $541,993 and negative net worth of $1,111,124 for Cobblestone.

Clark Hayes filled out a financial statement analysis checklist, dated February 13, 2001, and also prepared a credit comment, dated February 20, 2001, both of which drew on information in the FY 2000 audited financial statement. The credit comment described its purpose as to "reaffirm" CCNNE's risk rating, according the bank's policy as then in effect. The document expressed the view that CCNNE continued to warrant a rating of 5, based on its reported financial condition, despite high leverage, but that a downgrade would be warranted "if the company experiences a substantial decline in financial performance such that OCF/TDS [operating cash flow to debt service ratio] falls below 1.25x and the Company experiences a quarterly net loss." Hayes did not comment, and apparently no one else at the bank commented, on the decrease in consolidated net income; the increase in the proportion of receivables due more than five years out; the large variation between CCNNE's reported collections of over $16 million, and Redes's income from "direct finance leases and loans" and "principal payments," totaling just under $10 million; the even larger variation between CCNNE's reported receivable additions of more than $19 million, and Redes's "purchase of assets to be leased and origination of loans" of $9.2 million; or the receipts more than double those for the previous year, and more than double the amount projected in the prior year's statement.

Comparison of the audited financial statements for the fiscal years 1997 through 2000 would have revealed increasing tenor (that is, duration) of receivables, as reflected in footnote 3 to each year's consolidated income statements. The percentage of receivables payable beyond five years was 0.24% for 1997, 1.8% for 1998, 2.42% for 1999, and 10.7% for 2000. Aged lease receivable reports submitted during 2000 showed a number of large accounts with tenors exceeding five years. Some, but not all of the monthly reports submitted during 2000 included custom cash flow projection schedules, which showed large balloon payments in later years. It does not appear that anyone at the bank took note of any of this information.

Also during FY 2000 and 2001, CCNNE's quarterly financial statements continued to show the inter-company loan as a "negative payable," in amounts ranging from $1,055,859 for the second quarter of FY 2000 to $1,588,361 for the third quarter of FY 2001. The quarterly and annual financial statements submitted to the bank for FY 1999, 2000, and 2001 showed that Cobblestone had suffered net losses, and had negative net worth, in each reporting period. That information provided ground for serious doubt as to whether CCNNE's receivable from Cobblestone would be collectable, as well as whether Cobblestone's guarantee of CCNNE's loan from the bank would be of any value. Although both Mozzone and Grondin had noted the issue, the bank took no action to address it.

Borrowing base reports, with attached aged lease receivable reports, submitted in 2001 showed accounts more than 60 days past due at more than 10% in eleven out of twelve months, reaching a high of 16.29% in March. Accounts more than 120 days past due were more than 12% for the first three months of the year, and more than 9% for the rest of the year. These included some of CCNNE's largest accounts. CCNNE customer LKM had an outstanding balance of $1.2 million, nearly all of which was more than one year delinquent. CCNNE customer Oklahoma Southern had an outstanding balance of $1.1 million, which was more than six months delinquent. These numbers far exceeded Redes's loan loss reserve of $206,810 as shown on its FY 2000 audited consolidated financial statement.

The 2001 borrowing base reports also showed increasing concentration, with the total number of customers decreasing from 81 in January 2001, to 71 in December 2001, and the ten largest customers representing 77% of the portfolio, with more than $19 million outstanding, as of the end of 2001. Meanwhile, the borrowing base reports for FY 2001 showed some $19 million in receivables collected, and $20 million in receivables added. These amounts far exceeded projections from the previous year's financial statements. The month of November 2000 particularly stood out, with over $5.2 million in receivables collected, and over $6.4 million in receivables added. These large amounts reflected rewriting of existing loans; CCNNE would lend to its existing customer, or to a new entity related to it, an amount sufficient to cover its outstanding loans, plus overdue interest. CCNNE would then pay the proceeds of the loan to itself, showing the amount of the new loan as an additional receivable, and the amount paid to itself as a receivable collected.[35] Thus, numbers that appeared to indicate business growth actually indicated increased risk. The bank, it appears, did not engage in sufficiently close analysis to perceive the significance of these numbers.

The aged lease receivables reports, as well as the annual audited financial statements, provided information about the tenor of CCNNE's contracts. Review of these documents would have revealed a trend to increasing tenor over time. At the end of FY 2000, 10.7 percent of the contracts had tenor over five years.[36] Monthly aged lease receivables reports submitted in 2001 showed 4 new customers with contracts extending between 72 and 101 months. Custom cash flow projection reports submitted during 2001 showed particularly large collections projected for certain months well into the future (May 2006, April 2007, and October 2009), indicating contracts with balloon payments. Here again, close review of the reports submitted would have revealed this information.

In June of 2001, the bank ordered a field examination to be conducted by an outside vendor, known as Tofias. Tofias submitted a report dated July 21, 2001 (trial exhibit 1208). Among the report's "key findings" was that CCNNE had included certain rewritten contracts in its borrowing base calculations; that CCNNE's top five customers accounted for 49% of its total accounts receivable, and more than $18 million outstanding; and that 11% of its accounts receivable were more than 60 days past due, with two of those customers in bankruptcy.[37] The rewritten leases that Tofias identified did not actually affect loan availability, because availability as calculated exceeded the $16 million maximum amount of the loan in effect at the time.

Upon receiving the Tofias report, Mozzone and Daniel Grondin prepared a credit comment (trial exhibit 1209). They noted the rewritten leases, but also noted that "the impact of excluding these leases is zero," and recommended "to continue monitoring rewritten leases."[38] Regarding accounts more than 60 days past due, they noted management's assurance to Tofias that the accounts were collectable. In conclusion, they reported that "[t]he overall exam is satisfactory with no material findings," and recommended no change in the loan.

CCNNE delivered the audited financial statement for fiscal year 2001 to the bank in late January 2002. As of that date, the loan amount still remained $16 million, and no request for increase or other change was pending. Pertinent figures shown in the consolidated statement for 2001 were the following: income from direct finance leases and loans of $2,572,706 (up from $2,616,052 for 2000)); net income of $68,518 (up from $18,712 for 2000); purchase of assets to be leased and origination of loans of $9,323,237 (up from $9,070,531 for 2000); principal payments received of $8,400,152 (up from $7,362,512 for 2000). Footnote 3 showed net minimum lease and loan payments of $18,835,105 (up from $18,199,967 for 2000), based on total receivables of $25,806,213 (up from $24,564,867 for 2000), plus estimated residual value of leased equipment, minus unearned income and an allowance for doubtful accounts of $284,551 (up from $206,810 for 2000). Footnote 3 also provided a schedule of payments to be received in each of the subsequent five years, and thereafter, with 25.8% due in the first year, and 13.7% after five years. Footnote 7 described CCNNE's revolving credit agreement with the bank, noting its maturity date of March 30, 2002, subject to renewal, converting to a 24-month term loan if not renewed. The consolidating statements showed net income of $357,092 and net worth of $3,415,188 for CCNNE, but a net loss of $173,000 and negative net worth of $1,111,124 for Cobblestone. The bank inputted data from the FY 2001 audited financial statement into its spreading system in April 2002.

As of early 2002, the economy was in recession, and commercial finance companies were negatively affected. The bank was aware of that circumstance, and expressed its expectations in an internal industry analysis (trial exhibit 1247). The bank anticipated that such companies would experience limited profit growth and increased charge-offs. Nothing in the evidence indicates that the bank's awareness of the industry trend in any way influenced its handling of the CCNNE account.

In April 2002, CCNNE requested an increase in the loan amount, and a three-year extension beyond the existing expiration date of June 30, 2002. Grondin prepared a credit offering memorandum dated April 22, 2002 (trial exhibit 1219). He set out financial information drawn from the annual audited financial statements for FY 1999, 2000, and 2001, and the unaudited quarterly statements for the first quarters of FY 2001 and 2002. He provided an overview of CCNNE and its principals, essentially the same as appeared in the various earlier memoranda, including the pronouncement that "the financed equipment maintains a good collateral value."[39] Grondin recommended approval "based on the Company's strong operating performance and confidence in management's ability to continue to manage the business effectively." As evidence of strong performance, he cited increased income and profit and strong cash flow.[40] He noted that revenue and net income had declined, but that receivables had increased, receivables over 60 days had decreased, and "credit quality remains strong as evidenced by the Company's low charge-off rate."[41] He concluded that "We are comfortable with management's verbal assurance of continued strong performance based on the Company's long operating history, which encompasses several economic cycles and management's industry expertise." Regarding the value of collateral, Grondin summarized the Tofias report, and concluded that the "NPV [net present value] appears reasonable and accurate." He recommended a continued risk rating of 5, to be downgraded, as before, "if the Company experiences a substantial decline in financial performance such that its debt service coverage falls below 1.25x and the Company experiences a quarterly net loss."

Grondin's superiors signed off on his memorandum, and the bank approved the increase to $18 million and three-year extension to March 31, 2005. Grondin issued a term sheet, which Larry Seder signed for CCNNE. The bank and CCNNE then executed amendment 5 to the credit agreement on June 26, 2002. Larry Seder signed for CCNNE, reaffirming representations and warranties as before.

In November of 2002, Grondin asked Tofias to conduct a field examination of CCNNE, focusing on receivables. Tofias issued a report dated November 14, 2002 (trial exhibit 1220). The report noted that CCNNE's five largest customers accounted for 64% of its receivables, with a total outstanding balance of nearly $18 million. One of these customers, Deerwood Express, alone accounted for 20% of CCNNE's accounts receivable.[42] But, the report noted, the percentage of accounts more than 60 days past due was down from 11% in the previous examination to 6%. The report recounted discussions with Larry Seder, who expressed his view that all of these accounts were fully collectable. Grondin, in a file memorandum dated December 17, 2002, noted that Tofias's findings were "remarkably benign, and reflect a very well refined business model and highly attentive management." Grondin recounted also that, in a conversation with Larry Seder, he [Grondin] had suggested that CCNNE "may want to pursue an increase to the facility. Larry agreed and planned to discuss this at our next meeting, where we plan to also review the financial results for the year ended in September."

CCNNE's monthly reports to the bank in 2002 showed fluctuating delinquency rates, but generally lower rates than the previous few years, despite an on-going recession. Accounts more than 60 days past due ranged from a high of 9.96% in June to a low of 5.95% in February; accounts more than 120 days past due ranged from a high of 6.6% in May and June to a low of 3.98% in March. At the same time, however its reports showed increasing concentration. The number of its customers, as reflected in its reports submitted to the bank, decreased from 66 in January 2002, to 46 in December of 2002, and as of December CCNNE's ten largest customers accounted for 87.51% of its outstanding accounts. Both trends reflected rewriting of accounts, but the bank did not perceive the connection.

The borrowing base reports submitted to the bank by CCNNE through 2002 also showed a pattern of receivables collected far exceeding amounts projected in the prior year's financial statements, with correspondingly large figures for receivables added. At the same time, the aged lease receivable reports showed new contracts with customers that had been in default, some with long tenors and deferred payments, bringing those customers current. The reports also showed cancellation of contracts that had been in default, replaced by new contracts under new customer names, again with long terms and deferred payments. This information, as before, would have led a careful observer to perceive rewriting of contracts.[43] The bank, it appears, did not examine the reports in sufficient detail to notice these trends, or their implications for the bank's security.

CCNNE delivered the audited, consolidated financial statement for Redes for FY 2002 in late January 2003. No request for increase was pending at that time. Pertinent figures shown in the consolidated statement for 2002 were the following: income from direct finance leases and loans of $2,170,323 (down from $2,572,706 for 2001); net loss of $7,722 (compared to net income of $68,518 for 2001); purchase of assets to be leased and origination of loans of $9,733,300 (up from $9,323,237 for 2001); principal payments received of $7,532,996 (down from $8,400,152 for 2001). Footnote 2 reported that 39% of the company's lease portfolio was attributed to three customers, and that eleven percent of the portfolio as of the end of 2001 had been attributed to one customer; the report commented that "[d]efault by any of these customers could potentially have a material adverse effect on the Company's financial condition." Footnote 3 showed net minimum lease and loan payments of $20,854,280 (up from $18,835,105 for 2001), based on total receivables of $28,526,152 (up from $25,806,213 for 2001), plus estimated residual value of leased equipment, minus unearned income and an allowance for doubtful accounts of $252,385 (down from $284,551 for 2001). Footnote 3 also provided a schedule of payments to be received in each of the subsequent five years, and thereafter, with 20.7% due in the first year, and 21.3% due after five years. As before, footnote 7 described CCNNE's revolving credit agreement with the bank, noting its then maturity date of March 30, 2005, subject to renewal, converting to a 24-month term loan if not renewed. The consolidating statements reported net income of $311,095 and net worth of $4,028,527 for CCNNE, but net loss of $347,275 and negative net worth of $1,722,120 for Cobblestone.

In early 2003, CCNNE requested an increase in the loan amount to $21 million. In considering that request, Grondin reviewed the audited financial statement for FY 2002, which he had received in late January 2003, along with the quarterly financial statement through the end of calendar year 2002. He apparently did not notice the reference to concentration of accounts. But he did notice an entry in the annual consolidating balance sheet that had not appeared as a separate entry in previous years' statements, indicating an "inter-company payable" for Cobblestone in the amount of some $2,654,986 million.

As discussed *supra*, the inter-company loan from CCNNE to Cobblestone, which CCNNE was including in its accounts receivable, was not news to the bank; Mozzone had learned that information in 1999, from the "negative payable" appearing on quarterly financial statements. Larry Seder had explained to her at the time that the money was being used to explore new business opportunities, and she had elicited from him a promise that no more than $1.5 million would be used for that purpose. Apparently the bank had done nothing to enforce that promise, or to monitor ongoing increases in CCNNE's loans to Cobblestone. Quarterly financial statements submitted to the bank during 2001 had shown the increasing amount of the inter-company loan, from $1,084,468 shown in the report for the first quarter of FY 2001, submitted in January 2001, to $1,357,110, for the second quarter of FY 2001, submitted in April 2001, to $1,588,361, for the third quarter of FY 2001, submitted in July of 2001. Quarterly financial statements for 2002 had shown continued increases: $1,801,241 in the report for the first quarter of 2002, submitted in January of 2002; $1,877,404 for the second quarter of 2002, submitted in April 2002; $2,112,051 for the third quarter of 2002, submitted in July of 2002; $2,654,986 for the fourth quarter of 2002, as shown in the 2002 annual financial statement; and $2,779,153 for the first quarter of 2003, submitted in January 2003.

Grondin's concern, in observing the entry, was that inclusion of the receivable due from Cobblestone in CCNNE's assets overstated CCNNE's net worth, since the receivable might be uncollectable from Cobblestone, which itself showed negative net worth and repeated quarterly losses. Overstatement of CCNNE's net worth meant understatement of its leverage. Leverage was limited by the financial covenants under the credit agreement. The use of the inter-company loan to fund operating expenses also resulted in overstatement of CCNNE's profits.[44] Grondin prepared a memorandum to his superiors, dated February 3, 2003. He indicated that "the impact of excluding this asset from tangible net worth calculations is significant; TL/TNW increases from approximately 3.5 without the exclusion to approximately 10.0x after exclusion." Although the difference did not indicate a covenant violation or default, because "the definition of tangible net worth in the legal documentation does not exclude inter-company accounts," "the issue is leverage for underwriting purposes is greater than leverage as calculated according to the legal documents."

Grondin proposed that the bank approve an increase of $1 million (not the $3 million requested), with certain conditions, including "[c]ap the total of the inter-company receivable at current levels, and work to reduce it over time." He reported also that he had proposed to Larry and Jim Seder that they provide personal guarantees, but "Larry Seder was not thrilled about this option." On February 19, 2003, the Bank downgraded CCNNE's risk rating to 6.[45] A memorandum of that date, authored by Grondin and signed by his superiors, attributed the downgrade to discovery of the inter-company accounts, and resulting higher leverage than previously recognized.

In March 2003, Grondin undertook to conduct further investigation. He ordered Dun & Bradstreet reports on CCNNE's ten largest customers, as shown in the January 2003 aged lease receivable report, with mixed results. No report was available for three of them: Deerwood Express, which was then the largest customer, with nearly $6 million outstanding; the second largest, Graphics Plus, with over $4 million outstanding; and the fourth largest, C&W Express, with more than $3 million outstanding.[46] Reports on four others (LKM, NetPub, Johnson Brothers Coal, and High Tech Type) showed adverse information, such as bankruptcies, multiple creditors, slow payments, and the like. Grondin had little confidence in the accuracy of Dun & Bradstreet reports, but he did find the absence of such reports concerning. Grondin made a telephone call to one customer, Graphics Plus, but did not document the conversation; he remembers only that the customer confirmed that it had a borrowing relationship with CCNNE. He did not undertake to obtain copies of CCNNE's contracts with these customers, or to review their terms.

On March 17, 2003, Grondin and another bank loan officer, Michael Houllahan, met with the Seder brothers, along with the two BDO accountants responsible for the account, Joe Cronin and Brian Doherty, at BDO's office in Boston. They discussed, among other topics, CCNNE's largest accounts, and the adequacy of CCNNE's loss reserves for certain of those accounts. The Seders assured the bank personnel that the reserves were adequate. The BDO personnel, citing BDO policy, refused to discuss their audits, although they apparently made some response to a question from bank personnel that the latter interpreted as providing comfort regarding adequacy of reserves.[47]

After that meeting, Grondin prepared a credit offering memorandum, dated March 20, 2003, in which he recommended approval of an increase in the loan amount to $19.5 million (trial exhibit 1227). The memorandum recited that "The request is made by the borrower to support continued growth in demand for financing from its customer base . . . The facility is secured by all business assets consisting primarily of lease and loan receivables. In keeping with the bank's longstanding handling of this account, the bank does not maintain custody over lease documents. Neither does the bank have specific UCC filings in each jurisdiction in which the equipment is located. Rather relying on our rights under an all asset security agreement with the borrower." The memorandum noted also the guarantees provided by Redes and Cobblestone, although, as Grondin noted later in the memorandum, Cobblestone's guarantee "does not provide any material support given the nature of the corporate structure (i.e. deficit stockholders' equity of Cobblestone Corp.)." The memorandum recommended additional changes, to adjust the leverage covenant "to exclude inter-company accounts (net basis) from tangible net worth and reset leverage limits to decline quarterly over time," reduce the advance rate, and "[l]imit the level of inter-company accounts to $2,150,000."

In explaining these recommendations, Grondin commented that "[a]nalysis of the company's year-end financial statements (9/30/02) revealed the existence of certain inter-company accounts which impact on tangible net worth and leverage. In prior years, these inter-company accounts were not as large and were not specifically disclosed in the company's audited statements and therefore escaped scrutiny." He also noted the company's high concentration as a risk factor, observing that CCNNE's top five accounts represented 64% of its total accounts receivable, and its top ten accounts represented 85%. He noted, however, that "none of the top 5 accounts had balances which were more than 60 days past due," and that "[t]he first and foremost mitigant of this risk is the borrower's long history of strong collections, minimal bad debt experience . . . supporting our view that management is highly experienced and skilled in underwriting and structuring. The borrower maintains a policy of conservative lease structures, providing full payout of credit exposure over periods generally limited to 5 years." This description of CCNNE's policy derived entirely from representations of Larry Seder. Neither Grondin nor anyone else at the bank had done anything to test these statements, even to the extent of examining the payout schedules that appeared on the face of the aged lease receivable reports. Grondin's reference to accounts that were not more than 60 days past due was based on the information that appeared on the face of the borrowing base report, without any consideration of how or whether rewriting might have distorted that information.

Grondin noted the results of the most recent field examination by Tofias, and indicated his plan to have another field examination conducted no later than the third quarter of FY 2003, to include "positive confirmations of lease receivables." He noted also that, although BDO "declined to discuss the specific scope or results of their audit," "Generally accepted auditing standards require that assets of this type for an operation of this nature require the use of positive confirmations. By the fact that the auditors issued an unqualified opinion of the financial statements, we can take some comfort that such confirmations and/or specific cash tests were included in the scope of the audit, though not specifically confirmed by the audit firm." Grondin's source of information about requirements of GAAS was a telephone conversation with an accountant friend, who then sent him excerpts from a GAAS manual; Grondin had no independent expertise on the subject, and did not obtain any formal consultation from anyone who did. Grondin noted that "The D&B search confirmed conversations with the principals, with a majority of the top 10 clients reporting a clear credit history," although, as he acknowledged, two were in bankruptcy. He did not report that, as discussed *supra*, the largest accounts had no D&B reports.

Grondin recommended "that the current cash flow test be replaced with a traditional interest coverage test, in part because the debt is non-amortizing, making the principal repayment portion of a cash flow test moot. In the event that the bank chooses not to extend the maturity date of this credit when it comes up for renewal in the future, thereby triggering a conversion to a fully amortizing 24 month term note, repayment will only be possible through liquidation of the borrower's loan/lease portfolio (unless refinanced elsewhere), not through internally generated cash flow, again making a traditional cash flow test inappropriate."

Shortly after he prepared that memorandum, Grondin left the bank, and Michael Houllahan assumed responsibility for the CCNNE account. The bank approved the increase to $19.5 million, and the change was memorialized in amendment 6 to the credit agreement, which Larry Seder signed for CCNNE on March 30, 2003, again reiterating the same representations and warranties as before.

Reports filed by CCNNE during this period continued to provide information from which one observing closely would have perceived rewriting of contracts, and worsening financial circumstances. The March 2003 aged lease receivable report showed that CCNNE's largest customer was Deerwood Express, with a total of $5.9 million outstanding, making it CCNNE's largest customer. The May 2003 report had no entry for Deerwood Express, but showed a new customer, Cornerstone Cartage, with the same telephone number and contact person, and three contracts for a total of $5.3 million. The May 2003 report also showed collections of just under $5 million, and new receivables over $6 million. A "New Business Report" for the same month detailed the new receivables as consisting largely of three loans to Cornerstone Cartage, while a "Cash Receipts Report" for the same month showed that the Deerwood loans had been paid off in amounts equal to the principal amounts of the Cornerstone Cartage loans (trial exhibit 134). The report also included a Custom Cash Flow Projection, which showed large balloon payments in the Cornerstone Cartage loans. Close review of these reports would have given rise to the strong inference, as was in fact the case, that Cornerstone Cartage had taken over Deerwood's loans, substituting loans with longer payout periods. Houllahan did not undertake such review.

Houllahan met with the Seder brothers on May 13, 2003, to review the quarterly financial statement for the quarter ending March 31, 2003 (the second quarter of FY 2003). He summarized the meeting in a file memorandum, noting that the company "continues to perform well," that "[s]olid operations reflect increasing opportunities from existing clients," and that although management "is not actively looking to grow its business," it "continues to experience growth from existing portfolio clients." Noting management's expressed intention of complying with the newly tightened loan covenants, Houllahan commented that "it is clear that this may require them to turn business away from existing clients. This becomes a risk to CCNNE's business, as the long-time clients may start taking their business elsewhere. To the extent that operations continue to be strong . . . the Officer [that is, the loan officer—Houllahan] will consider amending the step-down in leverage to be more flexible for the Borrower."

What Houllahan, like his predecessors, apparently failed to recognize, although the bank had the information from which he and his predecessors could have so determined, was that the apparently increasing business from CCNNE's existing clients consisted largely of rewriting of existing loans when clients were unable to pay. The risk, if CCNNE could not expand its loans to its customers, was not that they would take their business elsewhere; it was that they would default, causing CCNNE in turn to default on its loan to the bank. To be able to increase its loans to its customers, CCNNE, in turn, had to borrow more from the bank.

In June 2003, CCNNE requested an increase in the loan amount to $20.5 million, along with a slower schedule than it had recently accepted for reducing its leverage. Houllahan prepared a credit offering memorandum, dated July 28, 2003, recommending approval (trial exhibit 1251). He reported that the company "continues to perform well," that its year to date earnings were higher than the previous year, that it had begun to reduce its leverage, and that "although management is not actively looking to grow its business, solid operations reflect increasing opportunities from existing portfolio clients." He referred also to the "remarkably benign" findings of the November 2002 Tofias examination, and to decreased delinquencies. The bank approved the increase, which was memorialized in amendment 7, signed by Larry Seder on behalf of CCNNE on August 5, 2003, with reiteration of representations and warranties as before. The amendment required, for the first time, that CCNNE provide annual audited financial statements for itself, as well as for Redes.

At about the same time, in the fall of 2003, the federal Office of the Comptroller of the Currency (OCC) examined the CCNNE loan and expressed concerns to the bank, relating to the structure of the loan, the discount rate, and particularly the adequacy of the bank's collateral.[48] The response of bank personnel to the OCC's concerns was to, in the bank's word, "defend" the loan, and particularly to attempt to persuade the OCC that a single-step downgrade in CCNNE's risk rating, rather than a two-step downgrade, would suffice. The bank's efforts in that regard succeeded, and it downgraded the risk rating to 7 as of November 2003.

The bank obtained a "limited scope" field examination report from Tofias in October of 2003 (trial exhibit 1253). The report identified "no additional recommended ineligibles," and the examiner's recalculation of net present value of eligible accounts receivable resulted in an increase in borrowing availability. The examiner noted that CCNNE's top five accounts represented 63% of its accounts receivable, with Cornerstone Cartage alone representing 18%, and that average term was approximately 64 months. The report observed that "in a worst case scenario, if one of these customers defaulted on their balance, it may represent a potential risk to the bank. However, this risk is mitigated due to the Company's stringent credit policies, whereby, the Company acquires and holds all titles to equipment leased. Therefore, if the customer was to default on payment, the equipment could be repossessed and re-leased or sold. It should also be noted that all A/R balances for the top 5 accounts are current." Tofias described what it understood to be CCNNE's credit policies in detail, but did not identify the source of its information on those policies. Tofias reported that it had examined 25 customer files, and found satisfactory documentation. Tofias also reported that it sent verifications to fifteen of CCNNE's customers, with results to follow. Tofias reported that it reviewed payments on ten accounts "through daily deposit slips"; it apparently did not discover, or did not note, checks from CCNNE to itself. Tofias reported on discussions with Larry Seder and Robin Isenberg regarding delinquent accounts, which included customers in bankruptcy and some whose equipment CCNNE had repossessed.

Houllahan reviewed the Tofias report and considered it satisfactory. Nevertheless, Houllahan and other bank personnel were beginning to perceive the CCNNE loan, and the bank's lack of information about the collateral, as a source of risk to the bank. Risk manager Richard Sullivan directed Houllahan to obtain a list of additional information regarding CCNNE's practices, its customers, and its collateral. Also, in November 2003, the bank sought and obtained advice from outside counsel regarding its security interest in CCNNE's assets, based on the 1995 credit agreement.[49]

Houllahan reviewed CCNNE's ten largest accounts, looking at amounts outstanding for each customer, the tenor of each contract, and the date when payments would begin to be due. He noted that one of the contracts with LKM had no payment due until February 2007. Houllahan and Sullivan also focused on Cornerstone Cartage, then CCNNE's largest customer, with nearly $6 million outstanding. Houllahan ordered a Dun & Bradstreet report, which indicated that the company had started in 2003, and that "the limited information currently in the D&B file does not allow us to classify it within our rating system." Houllahan telephoned Larry Seder requesting information, and then followed up with a letter, dated November 24, 2003, setting forth a list of information the bank wanted regarding Cornerstone and other accounts (trial exhibit 1255). In December 2003, Houllahan directed the bank's "Special Inquiries Unit" to research public sources for information about Cornerstone. The resulting report informed him that Cornerstone had been formed in 2003; that its previous name was Deerwood Transport, LLC; that its principals, Mark and Darci Simond, had filed for bankruptcy in 2001; that Mark Simonds had tax liens in his name; and that Cornerstone had a second secured creditor, in addition to CCNNE.

In a file memorandum dated December 15, 2003, Houllahan reported on communications with CCNNE. Seder had explained the formation of Cornerstone as a new entity, and the large loan to it, as related to a "an opportunity to expand business." Robin Isenberg had explained Cornerstone's delinquent payment, as reflected in the November 2003, aged lease receivables report, as related to the Thanksgiving holiday. Houllahan noted, however, that Cornerstone "represents only a new name, as Cornerstone took over the former obligation of Deerwood express of app. $5.0MM." Houllahan expressed his intention to follow up with the Seders in January, after receiving the first audited financial statement for CCNNE. The record does not indicate that any follow up occurred specifically regarding Cornerstone.[50] As of December 10, 2003, the outstanding principal of CCNNE's debt to the bank was at the maximum allowed amount of $20.5 million. Internal bank communications soon after that time reflect increasing concern about the bank's risk, and questions about the adequacy of the collateral. In late January 2004, CCNNE delivered the audited consolidated financial statement for Redes for fiscal year 2003 (ending September 30, 2003), along with, for the first time, an audited statement for CCNNE itself for that period. Pertinent figures shown in the consolidated statement for 2003 were the following: income from direct finance leases and loans of $2,315,910 (up from $2,170,323 for 2002); net income of $161,832 (up from net loss of $7,722 for 2002); purchase of assets to be leased and origination of loans of $10,609,143 (up from $9,733,300 for 2002); principal payments received of $7,088,125 (down from $7,532,996 for 2002). Footnote 2 reported that 49% of the company's lease portfolio balance was attributed to four customers, and 39% was attributed to three customers; it commented that, "[d]efault by any of these customers could potentially have a material adverse effect on the Company's financial condition." Footnote 3 showed net minimum lease and loan payments of $23,485,587 (up from $20,854,280 for 2002), based on total receivables of $32,898,994 (up from $28,526,152 for 2002) plus estimated residual value of leased equipment, minus unearned income and an allowance for doubtful accounts of $370,147 (up from $252,385 for 2002). Footnote 3 also provided a schedule of payments to be received in each of the subsequent five years, and thereafter, with 20.2% due in the first year, and 25.3% due after five years. As before, footnote 7 described CCNNE's revolving credit agreement with the bank, noting its maturity date of March 30, 2005, subject to renewal, converting to a 24-month term loan if not renewed. The consolidating reports showed net income of $359,593 and net worth of $4,388,120 for CCNNE, but net loss of $192,295 and negative net worth of $1,914,415 for Cobblestone. The audited financial statement for CCNNE—the first provided to the bank—showed income of $2,288,798 from direct finance leases and loans. That figure included amounts paid by CCNNE to itself on behalf of its customers.

In a file memorandum dated February 10, 2004 (trial exhibit 1279), Houllahan reported on his review of the audited reports for FY 2003, noting that "the audited results of CCNNE were consistent with the reporting noted in the Consolidating Statements," with the exception of accounting for the intra-company receivable. As positive developments, he noted "a record year in FY '03, a satisfactory field exam & audit confirming the adequacy of the Bad Debt Reserve." He commented that the "The revolving portion of the facility expires 3/31/05, and the impending conversion date will create an opportunity to restructure the facility (or allow it to convert as documented to a 2-year fully amortizing term loan)." He did not comment on concentration of accounts, despite the specific reference to it in the audited financial statement.

In a "Credit Policy Compliance Form" dated February 24, 2004 (trial exhibit 1260), Houllahan noted the issues of concentration and inadequate information about collateral, but emphasized that "the auditors confirmed the adequacy of the reserve without requiring an increase." His recommendation was to "commence discussions with management regarding the 3/31/05 expiry/conversion date. Discuss potential modifications to the facility that would provide some level of personal guarantees, reduction in concentrations and reduction in Bank exposure," and "Improve reporting of specific equipment supporting the exposure to the top 5 customers." A "Relationship Summary Form," as of February 2004 (trial exhibit 1257), reflects similar information and a similar plan, noting also that, despite the audit report, the bank "feels that the reserve may not be sufficient."

In early 2004, CCNNE requested an increase in the loan limit by $1 million. For the first time, the bank refused. Sometime shortly thereafter, the bank downgraded the risk rating on the CCNNE loan to 8. On May 4, 2004, Houllahan met with the Seder brothers and informed them that any extension of the loan would involve restructuring, including personal guarantees and limits on concentration. He followed the meeting with a letter, dated May 12, 2004 (trial exhibit 1202), reiterating some of those points.

CCNNE's quarterly report for the third quarter of FY 2004, submitted to the bank in July 2004, showed an increase in delinquencies over 60 days to 12%, as a result of the bankruptcy of one customer, Mideas Baking Company.[51] Soon after receiving that report, the bank decided to transfer CCNNE's account to its Special Assets Group, which manages troubled and high-risk relationships. The process of transfer within the bank was completed in September 2004, through a transfer memorandum authored by Houllahan (trial exhibit 1254). The memorandum recited much of the same background information in the various earlier memoranda, including the Seders' long history and good repute with the bank, strong operating performance in recent quarters, apparent compliance with financial covenants, and that "[t]he Company has a full underwriting process with quarterly visits from Larry Sedar [sic]." It noted, "significant concentrations to existing clients," "insufficient detailed reporting on collateral," and aging of certain receivables in amounts exceeding reserves, but emphasized that "the Company's auditors (BDO) confirmed the adequacy of the reserve without requiring an increase." The bank's plan, according to the memorandum, was that after review of results for the then current quarter, "the Line and SAG [Special Assets Group] will finalize our strategy to move forward with a proposed renewal of the facility." Thus, it appears, the bank's intention as of September 2004 was to renew the loan in some form, despite its awareness as of that time of what it referred to as "structural weakness," and of issues including adequacy of reserves and collateral, and rewriting of contracts.

In November 2004, CCNNE was unable to make its monthly interest payment to the bank of $60,000, and requested a one-week extension, which the bank granted. Shortly thereafter, the bank downgraded its risk rating to 9, at the recommendation of Sandra Bennett in the Special Assets Group, who was then responsible for the account. Bennett's memorandum, dated November 19, 2004 (trial exhibit 1287), referred to many of the issues that had previously been raised regarding security for the loan, and noted that "Contracts are apparently neither held by the bank as required under the documents, nor stamped."

Soon thereafter, the bank ordered a field examination to be conducted by an outside vendor, Hollis Meddings, which provided a report dated December 1, 2004 (trial exhibits 68, 1289). The report noted a total of 28 customers, with concentration of 91% in the nine largest customers, four of those accounting for 59% of receivables. It noted also that eight contracts, accounting for 36% of receivables, had tenors between 74 and 136 months, with one of those—a restructure of pre-existing debt for LKM after it had emerged from bankruptcy—having no payments due until 2007.[52]

The report recommended a concentration cap, along with exclusion of certain long-tenor contracts from the borrowing base. It also recommended that CCNNE "should consider evaluating the adequacy of its bad debt reserve." The examiner reported that it had conducted test reviews of 11 leases, and found the documentation generally adequate, but "[n]o evidence was noted that notes are pledged to a lender." The examination included a review of cancelled checks, the results of which were set forth in a chart included in the report, showing three checks written from CCNNE to itself, for payments on behalf of three customers. The text of the report did not discuss these checks.

By letter dated December 3, 2004, Sandra Bennett gave CCNNE "notice of non-renewal" of the loan. She expressed the bank's expectation that "you are considering possible restructuring proposals which may or may not involve continuing your facility with us," and indicated that the bank would not renew on the current terms, but would require a new underwriting process and amendment of loan documentation. She also requested that, from December 17, 2004, on "the first page of each existing and future lease entered into by the Company as lessor, be stamped with the legend set forth on [an attached schedule], stating that such lease is subject to a security interest in favor of the Bank." She indicated that contracts not in the bank's possession could still be included in the borrowing base if stamped, but that "we reserve the right to request possession of all contracts at any time."

Through 2004, CCNNE had filed reports with the bank that, like the reports for earlier years, showed increasing concentration of accounts, and on close analysis would have revealed a continuing pattern of rewriting of contracts with existing customers or entities formed to replace them, with such rewritten contracts included in the borrowing base. The pattern continued, and continued to be reflected in reports filed with the bank, through early 2005.

In late January 2005, CCNNE delivered to the bank the audited consolidated financial statement for Redes, along with its own audited financial statement, for fiscal year 2004, ending September 30, 2004. Pertinent figures shown in the consolidated statement for 2004 were the following: income from direct finance leases and loans of $2,705,169 (up from $2,315,910 for 2003); net income of $315,285 (up from $161,832 for 2003); purchase of assets to be leased and origination of loans of $11,450,326 (up from $10,609,143 for 2003); principal payments received of $10,199,859 (up from $7,088,125 for 2003). Footnote 2 reported that 59% of the company's lease portfolio was attributed to four customers, compared to 49% percent attributed to four customers the previous year; it commented that, "[d]efault by any of these customers could potentially have a material adverse effect on the Company's financial condition." Footnote 3 showed net minimum lease and loan payments of $23,157,883 (down from $23,485,587 for 2003), based on total receivables of $31,709,362 (down from $32,898,994 for 2003), plus estimated residual value of leased equipment, minus unearned income and an allowance for doubtful accounts of $235,294 (down from $356,660 for 2003). Footnote 3 also provided a schedule of payments to be received in each of the subsequent five years, and thereafter, with 20.4% due in the first year, and 20.6% after five years. As before, footnote 7 described CCNNE's revolving credit agreement with the bank, noting its maturity date of March 30, 2005, subject to renewal, converting to a 24-month term loan if not renewed.

The bank did not renew the loan. Under the terms of the credit agreement, as of March 31, 2005, the loan converted to a 24-month term loan, with the full principal amortized over that time, and monthly payments due of $854,167. To no one's surprise, CCNNE was unable to make the first payment due on April 1, 2005.

At about the same time, the bank, through its outside attorney, engaged a consultant, Atwell, Curtis & Brooks (Atwell), to evaluate the bank's collateral—that is, CCNNE's loan and lease portfolio.[53] The bank received a report from Atwell in May (trial exhibit 1294). Atwell analyzed CCNNE's business, and business practices, more closely than the bank ever had before, and also analyzed individual customer files in depth. Its report noted the following: CCNNE's credit decisions placed "little or no reliance on collateral or collateral valuation." Its credit files showed a "lack of typical credit evaluation tools used in the operation." The portfolio of borrowers was small, with high concentration. Purportedly new loans to existing customers, made without any formal credit procedure and without documentation, had made up most of the new business over the last several years. In many instances CCNNE was " 'forced' into financing a client because the customer was 'buying' them out of a bad loan already on the books to another borrower." Atwell found numerous instances of CCNNE extending new money to existing borrowers for past due payments, thus keeping those accounts out of delinquency.[54] Without additional loans, which CCNNE was unable to make due to the bank's refusal to increase its loan, CCNNE's borrowers were moving into delinquency.

Atwell pointed out that the bank's loan to CCNNE "was not structured as a typical collateral based loan," in that "[t]he covenants were geared to monitoring a profitable company irrespective of the underlying collateral that supported each individual loan . . . Over time the underlying leverage increased as the individual loans were increased often without either collateral support or adequate real cash flow from the borrowers." The value of the underlying collateral, Atwell found, "is unknown or not specified in the files," and as a result of re-writing "and effectively capitalizing the interest," "it is likely that the collateral will prove to be of little value in the overall solution." In addition, moveable equipment, such as trucks and the like, "could be anywhere, and without cooperation, it would be very difficult to track down and sell." Atwell's analysis of individual customer files reflected repeated rewriting, and minimal information about collateral.

By letter from Sandra Bennett dated June 14, 2005, the bank declared the loan in default, reserved all rights, and demanded that CCNNE provide to the bank all original notes and contracts. At that point, CCNNE stopped writing new contracts. In late June or early July 2005, the bank began soliciting bids from potential buyers for the CCNNE loan. The bank sought to sell the loan on an "as is, where is" basis, without any representations or warranties. That approach arose from uncertainty about both the value of and the bank's rights to the underlying collateral, and concern for potential legal exposure. Although the bank had obtained a legal opinion assuring it that the credit agreement gave it a lien on all of CCNNE's contracts, the bank was aware that it had no executed security agreement or assignment of contracts. On August 3, 2005, a potential bidder, Republic Financial, requested a copy of the security agreement. At that point, the bank discontinued its efforts to sell the loan, and shifted its plan to selling CCNNE's portfolio.[55]

By letter dated September 22, 2005, the bank declared CCNNE in default, accelerated the loan, and demanded full payment. Unable to pay, CCNNE relinquished its assets to the bank. The bank engaged a company known as Argus to take possession of CCNNE's business and manage it until the sale of the portfolio. The total nominal amount of the receivables at that time was approximately $31 million. Review of the loan files revealed a lack of documentation in many of them. In consultation with Argus, the bank obtained so-called "desk" appraisals (that is, estimates based on publicly available sources) of collateral for the larger loans. The result was a valuation of approximately $1 million for receivables with a nominal total value of approximately $26 million. That information influenced the bank's approach to sale of the portfolio.

In early 2006, the bank engaged The Debt Exchange, Inc., to manage the sale process through its on-line system.[56] The Debt Exchange solicited bids on an "as is, where is" basis, with no representations or warranties. Seventy-one potential bidders reviewed the CCNNE portfolio through the Debt Exchange's system; 39 of those conducted some degree of due diligence; and three submitted bids on May 23, 2006. The highest bid, at $924,978, from an affiliate of Republic Financial, was contingent on production of a security agreement and other documentation, which the bank lacked. The bank accepted the second highest bid, of $749,998, and closed the sale in June 2006. The bank credited the sale proceeds, along with smaller amounts received during its management of the business, to overdue interest and fees.[57] On that basis, the bank takes the position that its loss is equal to the total principal amount of the loan, $20.5 million.

While the sale process proceeded, the bank considered possible sources of recovery for the loss it anticipated, with BDO identified as a potential target. In that connection, bank personnel made a point of noting the role of audited financial statements in the bank's handling of the account. In an internal email dated August 18, 2005 (trial exhibit 1318), referring to a draft memorandum regarding CCNNE, a bank staff person reported to Sandra Bennett, "I've added a few 'per the audits.' " The bank also identified Tofias and Hollis Meddings as potential targets, but decided not to pursue claims against them, at least in part because of ongoing relationships with them.

4. The BDO Audits.

As required by the credit agreement, CCNNE provided to the bank, in late January each year, a consolidated financial statement for Redes, audited by BDO, for the fiscal year ending the previous September 30.[58] Each statement set forth, in consolidated form for Redes and its subsidiary (Cobblestone, including its subsidiary, CCNNE), a balance sheet, statement of income and retained earnings, and statement of cash flows, each with explanatory notes. Each statement bore a cover sheet entitled "Independent Auditor's Report," signed by BDO. The report represented that BDO had audited the accompanying statements, which "are the responsibility of the Company's management," that BDO had conducted its audit "in accordance with generally accepted auditing standards" (GAAS),[59] and that, in BDO's opinion, the statements "present fairly, in all material respects, the consolidated financial position of Redes Holding Corporation and subsidiary . . . and the consolidated results of their operations and their cash flows for the years then ended, in conformity with generally accepted accounting principles" (GAAP). This standard form report sets forth what is commonly referred to as an unqualified audit opinion.[60]

Each annual statement also included material designated as "supplementary," consisting of a consolidating balance sheet, and a consolidating statement of income, each showing separate figures for each of the three entities.[61] A page captioned "Independent Auditors' Report on Supplemental Material," signed by BDO, appeared as a preface to the supplementary material. That report recited that the supplemental material "has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole." In accord with the last amendment to the credit agreement, executed in 2003, in late January of 2004 and 2005 CCNNE also provided to the bank financial statements for CCNNE audited by BDO, setting forth information specifically for CCNNE, with certification from BDO in the same terms.

In connection with each annual audit, BDO and Redes, and later CCNNE, entered into a standard form engagement agreement, signed by Larry Seder. The form agreement recited that "[t]he financial records and financial statements are the responsibility of your Company's management," that BDO's "responsibility is to express an opinion on the financial statements based on our audit," and that the audit includes "examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall financial statement presentation." The agreement went on to recite that BDO would "design our audit to provide reasonable rather than absolute assurance of detecting errors or fraud that would have a material effect on the financial statements," and that an audit performed in accordance with GAAS "is not a guarantee of the accuracy of the financial statements." Each year, Larry Seder and Robin Isenberg also signed, on behalf of Redes and later CCNNE, a letter reciting, among other representations, that "[w]e confirm that we are responsible for the fair presentation in the consolidated financial statements of financial position, results of operation and cash flows in conformity with [GAAP]," and that the financial statements are fairly presented in conformity with GAAP.

The BDO team that worked on the Redes account was led by partner Joseph Cronin and manager Brian Doherty. Both of them had substantial training and experience in accounting and auditing, but neither had previous experience with, or specialized training regarding, finance or leasing companies, nor were they familiar with financial accounting standards particularly applicable to leasing companies. A series of less experienced BDO staff members worked under their supervision; those individuals also lacked experience in and training regarding the particular industry and standards relating to it. Some of these individuals had come to BDO right from college, and had little training or experience at BDO before working on the Redes account.[62]

In the course of the relationship between BDO and Redes and its subsidiaries, members of BDO's audit team formed a general understanding of Redes's and CCNNE's business and practices. Based on discussions with Larry Seder, along with materials found in CCNNE's files, BDO believed that CCNNE based its lending and leasing decisions on in-depth knowledge and documentation of its customers' businesses, their creditworthiness, and the value of the leased equipment or collateral that secured their loans.[63] BDO did not undertake to determine in greater depth exactly how CCNNE made lending and leasing decisions, or what information or documentation it gathered regarding its customers' creditworthiness or the value of the equipment that served as collateral.

At the outset of each audit, the BDO team prepared and documented a formal plan for the testing procedures to be conducted, based on the team members' understanding of the nature of the business, the risks involved, and the level of change or discrepancy that would be material.[64] Thereafter, beginning shortly after the September 30 conclusion of each fiscal year, members of BDO's audit team would spend some two to three weeks at CCNNE's offices, executing their plan. CCNNE made all its records available to BDO for each audit, and answered all questions put by the BDO personnel. BDO documented its work in its file for each year.

The members of the BDO audit team were aware of CCNNE's loan from the bank, as well as of the existence and terms of the credit agreement and its various amendments, including the financial covenants, reporting requirements, and borrowing limitations. BDO knew that the audited financial statements were being provided to the bank. BDO also knew that CCNNE had no source of financing other than the bank loan. BDO was not specifically informed of the various requests for increases in the loan amount at the time such requests were made or were under consideration by the bank, but it was informed of, and provided advice regarding, amendments to the credit agreement that altered financial covenants. With the exception of the meeting in 2003 described *supra*, and the sending of form confirmation letters to confirm the existence and amount of the bank loan, BDO never had any direct contact or communication with the bank. Each audited financial statement made reference, in a footnote, to the bank's loan and its expiration date, noting that, if not renewed, the loan "converts into a term loan payable in twenty-four monthly installments with interest at the bank's base rate." None of the financial statements expressed any opinion as to whether CCNNE would be able to pay the loan if not renewed, or whether CCNNE would continue as a going concern in that event, although, as recited *supra*, footnotes in the statements for later years acknowledged that default by one or more of CCNNE's largest customers could have a material effect on CCNNE's financial condition.

Over the course of its annual audits, BDO personnel learned specific information about CCNNE's transactions with particular customers, especially larger accounts, including repeated rewriting of contracts; lending to cover interest payments due; and financing of sales of equipment or businesses to nominally new entities formed by principals of the previous customers. BDO personnel evaluated the accounting for such transactions, making sure that old contracts were removed from receivables and new ones added, and that interest payments to be due under the new contracts were properly categorized. It did not evaluate the implications of such transactions for the value of the collateral or for the likelihood that the resulting receivables would be collected, and it did not undertake to determine whether the rewritten contracts were, or should have been, treated as eligible for inclusion in the borrowing base. In these respects, BDO's audits did not conform to GAAS.

In the course of its testing, on a number of occasions between 1999 and 2004, BDO personnel saw or learned of checks that CCNNE had written to itself on behalf of customers.[65] Based on discussions with the Seders, BDO understood those checks as a means of accounting for refinancing of contracts. BDO regarded refinancing transactions as "not unusual" for a financing company.[66] BDO ascertained that CCNNE made accounting entries to remove each refinanced loan from accounts receivable and add each new loan, so that its entries accurately reflected accounts outstanding. It also evaluated potential tax implications of the refinancing transactions. It also satisfied itself that such entries did not affect reported cash flow, because they were reflected as both receipts and expenses. BDO did not inquire as to the overall volume of checks CCNNE wrote to itself, the total amount of funds transacted in this manner, or the pattern of the use of this technique over time. BDO also did not question the inclusion of the amounts represented by such checks in CCNNE's total reported receipts and expenditures, and the resulting appearance of CCNNE's total volume of business. BDO also did not question the implications of the practice of rewriting contracts, and taking PIK notes, for management's judgments about the likelihood that the accounts involved would be collectable, or about the value of collateral. In these respects, BDO's audit did not conform to GAAS.

Among the figures presented in each consolidated balance sheet was an amount for "direct finance leases and loan receivables." This figure provided the basis for the accounts receivable figure in each monthly borrowing base report, which in turn determined the amount CCNNE was permitted to borrow each month. As explained in footnote 3 of each annual audited statement, the amount shown in the balance sheet reflected a deduction for "allowance for doubtful accounts"—that is, a reserve for accounts deemed likely to be uncollectable. The same figure would be reflected as an expense, which would reduce reported net income.

GAAP requires a reserve when available information indicates that an account is not fully collectible: that is, according to Financial Accounting Standards Board (FASB) No. 5, when "it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." Application of that standard inherently involves an exercise of judgment, which Larry Seder exercised on behalf of CCNNE, based not on any set policy, but on his general familiarity with the circumstances of each customer. BDO's role with respect to reserves, as the auditor, was to conduct testing on a selected sample of accounts, to form its own independent judgments, and to recommend changes if it deemed warranted.

BDO undertook testing procedures to evaluate Larry's judgments, but it confined its testing to accounts appearing on CCNNE's "aged invoice by lease" reports as having payments more than 60 days past due. As a consequence of that approach, BDO excluded from its test procedures the contracts that were most likely to be impaired, in that they had become current as a result of rewriting, payments from CCNNE to itself on behalf of customers, application of funds from the special hold-back account, or application of unapplied cash. In making judgments about the accounts it did review, BDO relied heavily on Larry Seder's assurances of collectability, even with respect to customers in bankruptcy, and on his judgment as to the value of collateral.[67] The result was that BDO's recommendations regarding appropriate reserves seldom if ever differed significantly from CCNNE's judgment. BDO's approach, in these respects, did not conform to GAAS, and the resulting reserves did not conform to GAAP. Understatement of the reserves, in turn, resulted in overstatement of net receivables and of net income, similarly in violation of GAAP.

BDO learned of CCNNE's use of the special hold-back account in FY 1999 and 2000, and described it in memoranda for each of those years (trial exhibits 1359 and 1360). A handwritten note on the memorandum for FY 2000 (trial exhibit 1360), made by a BDO staff person, commented that the account "is used similar to a reserve for bad debt." The financial statements made no explicit reference to the account or its use as a reserve, but reflected the amount in the account as a liability. When CCNNE used funds from the account to offset a deficiency in a customer's payment, it would make a reduction in the liability, as well as a deduction from its receivables. The use of the account in this manner thus had no effect on the bottom line figures shown on its balance sheet, but it did have the effect of overstating receivables, since the figure shown for receivables did not reflect a full deduction for reserves. In addition, to the extent that the account substituted for reserves, it also resulted in an understatement of expenses shown on the income statement, which in turn resulted in overstatement of net income. In these respects, the statements were not in compliance with GAAP. In addition, the use of the account as a substitute for reserves had the effect of keeping the percentage of charge-offs shown in reports to the bank artificially low, since the reports would not show offsets from the account as charge-offs, although such offsets were substantively indistinguishable from the use of reserves to cover charged-off receivables.

BDO also learned of the amounts held as "unapplied cash," as reflected in a handwritten note made by a BDO staff person on a work paper in November of 2000. BDO did not raise any concern as to the propriety of the use of either the special hold-back account technique, or unapplied cash, or as to the effect of these techniques on the accuracy of the financial statements. BDO's failure to address these issues did not conform to GAAS.

BDO's test procedures included review of cost allocation between CCNNE and Cobblestone. In that context, in the course of the FY 2001 audit, BDO reviewed a file memorandum authored by Larry Seder, in which Larry explained the basis for allocating portions of his and Jim Seder's salary and benefits to Cobblestone. The BDO auditor noted on the memorandum, "seems reasonable." The focus of BDO's attention with respect to the allocation of costs between the related companies was on the legitimacy of the allocation for tax purposes, not on any implications of the allocation, and resulting inter-company liability, for CCNNE's compliance with the credit agreement. Although the inter-company liability was eliminated from the consolidated balance sheet, as the consolidated report expressly stated, BDO was aware that the inter-company liability was reflected in CCNNE's receivables as shown on the consolidating balance sheet, as well as in quarterly and other reports for CCNNE alone. In these respects, the reports were not in accord with GAAP.

BDO was also aware that Cobblestone had repeatedly shown net losses and negative net worth. BDO did not raise or address any question of whether Cobblestone's debt to CCNNE would be collectable, whether CCNNE should take a reserve with respect to that receivable, or whether CCNNE's inclusion of that receivable distorted its calculation of compliance with the leverage ratio limitation under the credit agreement. In these respects, BDO's audit failed to comply with GAAS.

BDO's test procedures included reviewing compliance with the financial covenants under the credit agreement. BDO performed that review by checking Isenberg's calculations, based on the figures presented in CCNNE's annual financial statement. At a relatively late stage in the relationship, BDO apparently came to recognize the possibility that CCNNE's rewriting of contracts and related practices could have implications for the financial covenants. A BDO form entitled "Consideration of Fraud in a Financial Statement Audit," for the period ended September 30, 2004 (trial exhibit 1456), listed the following as a risk factor: "Client has a line of credit with a bank, which requires the company to maintain certain financial ratios. Client could potentially generate false receivables or manipulate accounts in order to achieve positive ratios." The same form listed, as common frauds that occur in the industry, "cash receipts not posted to customers account properly, manipulation of financial ratios, fraudulent receivables & revenue." The form identified BDO's plan for addressing such risks "confirmation of lease receivables, substantive procedures over subsequent cash receipts, review of bank covenants." That approach, which BDO appears to have followed, addressed the risk of falsification, but it did not address the identified risk of manipulation of accounts to achieve positive ratios. In this respect, BDO's audits failed to comply with GAAS.

The bank's evidence at trial included expert opinions of Harris Devor regarding defects in the financial statements and in BDO's audit processes. BDO has challenged both the credibility and weight of his testimony on numerous grounds, including his bias, which was plainly apparent; his reliance on work performed by others, which he was unable to explain in any detail; and his reliance as to certain reserves on information available only in hindsight. The Court has carefully considered these points, and finds them largely well taken. Nevertheless, although the Court does not adopt Devor's opinions in full, it does credit his overall conclusions.[68] In particular, the Court credits Devor's conclusions that: BDO's audit processes failed in significant respects to comply with GAAS, particularly its standards requiring the exercise of due professional care, adequate planning, professional skepticism, and obtaining of competent evidential matter. The Court further credits Devor's conclusions that the annual audited financial statements, as well as the unaudited annual and quarterly financial statements submitted to the bank by CCNNE, for FY 1999 through 2005, failed to comply with GAAP with regard to the amounts identified as reserves for bad debt, the resulting amounts shown for net receivables and net income, and the amounts reported for payments received and for origination of loans. The Court also credits Devor's conclusion that, at least from FY 2000 forward, the deviations were such as a reasonable user of the financial statements would consider material. The issue of materiality is closer with respect to FY 1999, because the deviations in amounts are relatively small.[69]

Despite these findings, the Court does not find (and the bank does not contend) that BDO ever intentionally departed from the requirements of GAAS, or that the opinions it expressed with respect to the financial statements, and their compliance with GAAP, were other than the opinions it actually and honestly held. The Court similarly does not find, and the bank does not contend, that BDO was affected by any conflict of interest or corruption. The bank's contention, and the Court's finding, is that BDO was negligent.

5. The litigation.

The bank brought this action on April 21, 2006, naming as defendants BDO, CCNNE, Cobblestone, Redes, and the Seders individually. The claims that remain after dispositive motions are negligent misrepresentation against BDO and the Seders (counts I and II), violation of G.L.c. 93A against the Seders (count IV), and breach of contract against CCNNE, Redes, and Cobblestone (counts v. and VI).[70] BDO has asserted certain affirmative defenses, four of which it now presses: comparative negligence, contributory negligence, assumption of risk, and the statute of limitations.[71] As noted *supra*, default has entered against the three corporate defendants, establishing their liability for breach of contract. The Court will address each claim in turn, and will address the affirmative defenses as needed.

II. CONCLUSIONS OF LAW, FINDINGS OF ULTIMATE FACTS, AND DISCUSSION

1. Count I: Negligent Misrepresentation Against BDO.

The elements of the bank's claim of negligence misrepresentation against BDO are those set forth in the Restatement (Second) of Torts, §552. See *Nycal Corp. v. KPMG Peat Marwick LLP*, 426 Mass. 491, 496 (1998). The Restatement provides, in pertinent part:

> (1) One who, in the course of his business, profession or employment . . . supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> (2) . . . the liability stated in Subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Thus, to prove its claim against BDO, the bank must prove (1) that BDO supplied false information for the guidance of others; (2) that BDO failed to exercise reasonable care or competence in obtaining or communicating that information; (3) that BDO intended to supply the information for the benefit and guidance of the bank or knew that CCNNE (and/or Redes or Cobblestone) intended to do so; (4) that the bank reasonably relied on the false information in a transaction; (5) that the transaction was one, or was substantially similar to one, that BDO intended the information to influence or knew that CCNNE (and/or Redes or Cobblestone) intended it to influence[72] and (6) that the bank's justifiable reliance caused its loss.

The first element is the supplying of false information. For information to be false (or true) it must be "fact, not . . . expectation, estimate, opinion, or judgment . . . A fact is something susceptible of knowledge. *Zimmerman v. Kent*, 31 Mass.App.Ct. 72, 79 (1991) (internal quotations and citations omitted). Nevertheless, a statement about a future event can be a misrepresentation in a situation "where the parties to the transaction are not on equal footing but where one has or is in a position where he should have superior knowledge concerning the matters to which the misrepresentations relate." *Id.* (internal quotations and citations omitted).

The statements BDO made, on which its claimed liability is based, were that it had audited Redes's consolidated statements for FY 1999-2005, and CCNNE's annual statements for FY 2003 and 2004, in accordance with GAAS; that in its opinion each statement presented the financial position of the identified entity fairly in conformity with GAAP; and, as to the consolidating statements, that the information supplied in them had been "subjected to the auditing procedures" applied in the audit of the consolidated statements, and in BDO's opinion, "is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole." The claimed falsehood is not that BDO did not audit the information presented in the statements; there is no question that it did. The claim is that, contrary to its representation, it did not do so in compliance with GAAS, and that, contrary to its expressed opinion, the statements did not present the information fairly in compliance with GAAP.

BDO contends that these statements are, by their nature, opinion rather than fact, and therefore cannot constitute the supplying of false information. Both GAAS and GAAP, the argument goes, are sets of aspirational norms, application of which depends on the exercise of judgment. See *Bily v. Arthur Young & Co.*, 3 Cal.4th at 382, 400. That is particularly so, BDO points out, with respect to the determination of reserves, which depends on assessment of the probability of future events.[73] See *id.* at 400.

The bank responds, in substance, that BDO's position on this point would effectively immunize auditors from all liability to non-clients for negligent audit opinions, despite the many authorities that recognize the possibility of such liability under the rubric of negligent misrepresentation. See *Nycal*, *supra*, and cases cited; *Reisman*, 57 Mass.App.Ct. at 123-24; *Bily*, *supra*, at 407; Restatement §522, comments b, e, j; see also Restatement (Second) of Torts §539 (1977), comment b. As the California Supreme Court expressed the point in *Bily*:

> Under certain circumstances, expressions of professional opinion are treated as expressions of fact. When a statement, although in the form of an opinion, is not a casual expression of belief, but a

> deliberate affirmation of the matters stated, it may be regarded as a positive assertion of fact. Moreover, when a party possesses or holds itself out as possessing superior knowledge or special information or expertise regarding the subject matter and a plaintiff is so situated that it may reasonably rely on such supposed knowledge, information, or expertise, the defendant's representation may be treated as one of material fact.

3 Cal.4th at 408 (internal quotations and citations omitted).

This Court recognizes the conceptual (and linguistic) difficulty in characterizing BDO's audit opinions as statements of fact. In light of the authorities cited, however, the Court concludes that they were, for purposes of the bank's claim of negligent representation. As BDO stresses, and as will be discussed further *infra* with respect to the element of justifiable reliance, the bank was certainly a sophisticated reader of financial statements. Still, BDO held itself out as, and the bank could fairly have viewed it as, having a level of expertise with respect to both GAAS and GAAP that the bank could not be expected to have. In this context, the bank could fairly interpret BDO's audit reports as representing that BDO had exercised due care in the performance of its audits, in accord with applicable professional norms; that it had gathered and evaluated sufficient information to provide a basis for the exercise of reasonable professional judgment; that it had exercised such judgment; and that, to the extent that its opinions necessarily involved elements of estimation and prediction, the estimations and predictions it had made fell within the range of reasonable professional judgment. As indicated *supra*, the Court has found that that was not the case. The Court therefore finds and concludes that BDO provided false information in its audit reports for each of the audited financial statements.[74] On the same basis, the Court finds and concludes that BDO failed to exercise reasonable care or competence in obtaining and communicating that information, in that it failed to conduct its audits in compliance with GAAS. The bank has thus met its burden of proof as to the first two elements set forth *supra*.

The third element, that BDO intended to supply the information for the benefit and guidance of the bank or knew that CCNNE (and/or Redes or Cobblestone) intended to do so, is established in the evidence beyond room for serious dispute. BDO was fully aware of the existence and terms of the loan, including the requirement that CCNNE supply audited financial statements to the bank; indeed, BDO knew that the primary if not sole purpose of its audits was to satisfy that requirement. It also knew that CCNNE did in fact supply the audited financial statements to the bank each year. Whether and to what extent BDO knew exactly how the bank would use the audited financial statements, and in reference to what particular decisions, is a more difficult question that relates to the fifth element, which, for the reasons that will appear, the Court will not reach. As to the third element, the Court finds and concludes the bank has met its burden.

The fourth element, that the bank reasonably relied on the false information in a transaction, incorporates two closely related factual issues: whether the bank did in fact rely, and whether such reliance was reasonable. See *Scottish Heritable Trust, PLC v. Peat Marwick Main & Co.*, 81 F.3d 606, 615 (5th Cir. 1996) (applying Restatement §552). Reasonableness of reliance depends on the totality of the circumstances. *Kuwaiti Danish Computer Co. v. Digital Equip. Corp.*, 438 Mass. 459, 467-68 (2003) (reliance unreasonable when defendant's oral statement contradicted written agreement); *O'Connor v. Merrimack Mut. Fire Ins. Co.*, 73 Mass.App.Ct. 205, 214-16 (2008); *Collins v. Huculak*, 57 Mass.App.Ct. 387, 391-94 (2003). Relevant circumstances include the plaintiff's level of sophistication. See *O'Connor*, 73 Mass.App.Ct. at 215-16 (reliance was not justified where the plaintiff "was far from a neophyte in real estate matters"). A plaintiff's failure to perform reasonable investigation, when it has the opportunity to do so, undermines its claim of reasonableness. See *Collins*, 57 Mass.App.Ct. at 392 ("[t]he person claiming justifiable reliance is required to use his senses, and cannot recover if he blindly relies upon a misrepresentation the falsity of which would be patent to him if he utilized his opportunity to make a cursory examination or investigation") (citations omitted); see also *Trifiro v. New York Life Ins. Co.*, 845 F.2d 30, 34 (1st Cir. 1988) (applying Massachusetts law). A plaintiff cannot show justifiable reliance when it "had the ability and the right to investigate and thus could have performed its own investigation." *Banco Urquijo, S.A. v. Signet Bank/Maryland*, 861 F.Sup. 1220, 1248-49 (M.D.Pa. 1994) (citation omitted).

Here, the bank was highly sophisticated, particularly with respect to a customer that was in the same business it was in. Its credit agreement gave it the right to conduct whatever investigation it chose, at any time, at CCNNE's expense. The Court considers those facts in evaluating the reasonableness of its conduct.

The findings set forth *supra* show that the bank relied on the audited financial statements at least in a general sense. That is, each year it entered certain figures drawn from audited consolidated statements, particularly figures for Redes's total sales, operating profit, net income, and tangible net worth, into its spreading system, and included those figures in various memoranda and reports that its loan officers and others generated over the course of the relationship. It is also apparent that the various bank officials involved generally took comfort from receiving financial statements that included unqualified audit opinions. It does not necessarily follow that the bank relied on the audited statements in connection with any particular transaction, or, if it did, that such reliance was reasonable in the circumstances. That determination requires examination of the particular transactions that occurred during the period in issue, in relation to the bank's receipt of each financial statement.

The first financial statement that the bank contends was erroneous was the one for FY 1999, which the bank received on January 19, 2000. As of that date, the bank had approved, and the parties had signed, amendment 4 to the 1995 credit agreement, which raised the maximum amount of the loan to $16 million. Clearly, the bank did not rely on any false information received from BDO in deciding to approve a line of credit for CCNNE of $16 million. No further increase or other amendment occurred for the next two and half years, until June of 2002. When the bank received the audited statements for FY 2000 and FY 2001, in late January of 2001 and 2002, respectively, no request for increase or other action was pending or imminent. The next increase, to $18 million, occurred in late 2002, after completion of FY 2002, but before the bank had received the audited statement for that year. Thus, none of the audited financial statements through FY 2002 became a particular focus of the bank's attention in making a decision to increase the loan amount or otherwise amend the credit agreement.

The bank nevertheless contends that it relied on the FY 1999 statement, and each one thereafter, on a continuous basis, in deciding to continue making advances under the credit agreement, and not to exercise the various rights available to it for default by CCNNE. Put differently, the bank suggests that, had the FY 1999 statement, and each subsequent one, provided full and accurate information, the bank would have immediately stopped lending to CCNNE, accelerated the loan, and done everything available to it to collect the outstanding amount and otherwise protect its interests. The Court is not persuaded.

The bank knew, from the very beginning of the relationship, that CCNNE's business consisted of making loans to borrowers who would not qualify for loans directly from the bank. Thus, in effect, the bank was relying on CCNNE's principals—the Seder brothers—to do the underwriting, monitoring, and collection activity that the bank was unwilling to do with respect to such customers. The bank knew, or reasonably should have known, from the very beginning, that its position with respect to its loan was only as good as the work being done by the Seder brothers to manage CCNNE's loans.

The bank also knew, throughout the relationship, that it had no personal guarantees from any individuals; that the guarantees from Redes and Cobblestone had value only to the extent that those entities had value; and that Cobblestone showed consistent net losses and negative net worth beginning in 1997. Those losses were an event of default that gave the bank grounds to cease lending and accelerate the loan, but it did not do so. The bank also knew that its security consisted of CCNNE's receivables, the security for which in turn depended on the value of the underlying collateral. As to that collateral, the bank knew that it had no appraisals, no UCC filings, and no documentation or direct information. Again, its position depended on the diligence and judgment of the Seder brothers.

Thorough and competent audits of Redes's financial statements, beginning with FY 1999, would have provided information that should have led the bank to question its reliance on the Seder brothers. But the bank's policy was not to rely solely, or even primarily, on audited financial statements. Rather, its policy was to employ a list of additional safeguards, including possession of original contract documents; field examinations conducted at least annually; and receipt of monthly and quarterly reports that, if examined closely, would have alerted the bank to the practices that undermined the value of the bank's security. As the facts set forth *supra* indicate, the bank repeatedly and consistently departed from its own policies with respect to CCNNE; it did not obtain original contract documents; it waited long periods between field examinations, which it (or its vendors) conducted cursorily at best; it downplayed the negative findings that did emerge from those examinations; and it failed to conduct the careful examination of borrowing base reports and accompanying aged lease receivables reports that would have enabled it to perceive the significance of the information those reports provided. Those departures deprived the bank of information that it reasonably should have had, and led it to overlook information it did have.

Despite its departures from its own policies, the bank actually did receive, and did consider, information about the practices that it now contends BDO should have noticed and reported. As early as 1997, the bank's field examination pointed out customers in bankruptcy; inadequate reserves by some $525,000; a high rate of delinquencies; rewriting of a customer's contracts for credit reasons; and the absence of documentation regarding collateral. The bank, as far as the record discloses, took no action to address those issues at that time, and the loan officer (Mozzone) did not even review the report of that examination when she considered an increase in the loan amount in 1999. The loan officer did consider the 1999 field examination report, which raised some of the same concerns, and which also pointed out the large inter-company loan that the bank focused on some four years later. But the action the bank took to address those concerns was utterly ineffectual. Meanwhile, the bank relied on information that was repeated in a series of bank memoranda, but was either erroneous (the list of purported high-profile customers) or drawn solely from assurances given by Larry Seder (strong collateral value).

Through the next several years, information the bank did receive continued to show grounds for concern, which the bank did not address in any effective way. Borrowing base reports in 2000 and 2001 showed high delinquencies, and increasing concentration. The pattern of increasing concentration continued through 2002, while delinquencies decreased, without explanation or inquiry by the bank. The Tofias field examination report in June of 2001 alerted the bank to rewritten contracts that had been included in the borrowing base, increasing concentration, and customers in bankruptcy. That information in itself should have led the bank to question the amounts shown in the financial statements as reserves. Tofias's November 2002 report showed yet further concentration, with delinquencies down; Tofias, like the bank, apparently did not make sufficient inquiry to discover the relationship between reduced delinquencies through rewritten contracts, and increasing concentration. Meanwhile, the audited financial statements for 2000, 2001, and 2002, despite their flaws, showed increasing percentages of receivables that would not be collected until after five years, and increasing net losses for Cobblestone. The audited statement for FY 2002 explicitly pointed out high concentration and the resulting risk to CCNNE's financial condition. The bank, it appears, gave no attention to that information.

Overall, what this pattern reveals is that through the end of 2002 and into early 2003, the bank was paying little attention to the information it received, even when that information cried out for attention. The bank's conduct with respect to the CCNNE loan during this period was not reasonable. Nor is it credible to believe, in the face of this pattern, that more accurate reports from BDO would have gotten the bank's attention and triggered action.

In early 2003, the bank's loan officer (Grondin) did begin to take notice. But the information that caught his attention—the inter-company loan—had been known to the bank since 1999. Why the bank had not previously appreciated the significance of the loan for CCNNE's receivables, reserves, and leverage, and for the value of the Cobblestone guarantee, is unclear. What is apparent is that, even when it did perceive these issues, it did not take the actions it now suggests it would have if fully informed. Instead, the bank approved an increase to $19.5 million, along with a loosening of the leverage covenant to avoid violation, and then a second increase later in 2003 to $20.5 million. The loan officers (Grondin, Houllahan) recommended those steps despite the almost entirely adverse results of their efforts to investigate CCNNE's largest customers.

By the fall of 2003—before the bank had received the audited consolidated report for Redes for FY 2003, and before it had ever received any audited report for CCNNE alone, the loan had reached its maximum level of $20.5 million. At that point, all decisions to increase the loan amount were in the past, and no longer subject to influence from audited financial statements or any other source. That does not mean the bank had no decisions to make; had it concluded at any time that CCNNE was in default, it could have exercised its rights. But the events that followed hardly demonstrate that it would have done so with any vigor or expedition, no matter what information it received.

What ultimately led the bank to focus on the CCNNE loan in the fall of 2003 was not any of the information it received through reports or field examinations; it was the OCC investigation, which pointed out grounds at least for serious concern, if not immediate action. The bank's response was not to heed the warning, but to "defend" its loan to the OCC. At about the same time, a field examination report from Tofias indicated still higher concentration, and increased tenor, along with the erroneous information that CCNNE "holds all titles." The bank still took no action, either in reliance on that error by Tofias, or simply in continuation of its previous pattern.

By early 2004, when the bank received the audited reports for FY 2003, it had every reason to believe that the CCNNE loan posed severe risk, and to take whatever action it could to mitigate the risk. The audited reports (this time for both Redes and CCNNE), despite their flaws, provided additional information: they pointed out extreme concentration, and more than 25% of accounts receivable not due until after five years. The bank also knew that it had grounds for action; at least one event of default—Cobblestone's net losses—had occurred continuously since 1997. But it did not act. Instead, its loan officer (Houllahan), in his memorandum of February 10, 2004, described a plan to restructure the loan when it expired more than a year later. That memorandum belies the bank's present contention that it relied on understated reserves in adopting that plan; the memorandum acknowledged that the bank itself viewed CCNNE's reserves as insufficient, despite what Houllahan understood to be the auditor's confirmation.

Later that year, after unaudited quarterly reports showed increasing delinquencies, the bank transferred the loan to the special assets group. But in November, when CCNNE could not make its monthly interest payment, the bank did not take the opportunity to declare it in default; rather, it provided an extension. It obtained another field examination report in December, this time from Hollis Meddings, but the resulting findings of extreme concentration (nine largest accounts were 91%), long tenors, and checks from CCNNE to itself, still triggered no immediate action. By January of 2005, when the bank received the last audited reports, the bank had come to recognize its need to extricate itself from the CCNNE loan, and to preserve whatever value it could. It acted on that understanding at a glacial pace, but nothing in the evidence would support a finding that any different or more accurate information in the audited reports would have led it to act differently.

Overall, the Court finds and concludes, the bank did not reasonably rely in any transaction on false information provided by BDO. The bank has therefore failed to prove the fourth element of its claim against BDO, along with the remaining elements, and BDO is entitled to judgment.

This conclusion obviates the necessity for consideration of BDO's affirmative defenses. The Court nevertheless notes, for the sake of completeness, that were it to consider those defenses, it would rule that the claim of negligent misrepresentation is not time-barred, since the bank's cause of action accrued no earlier than when it first suffered injury, which was when CCNNE defaulted on April 1, 2005. The bank sued within three years of that date. The Court would rule further that comparative negligence applies as a matter of common law, see *Clark v. Rowe*, 428 Mass. 339, 345 (1998), and supersedes both the doctrine of assumption of risk and the audit interference doctrine, which was developed to ease the harshness of common-law contributory negligence. See *Scioto Memorial Hospital Ass'n v. Price Waterhouse*, 74 Ohio St.3d 474 (1996); *Halla Nursery, Inc. v. Baumann-Furrie & Co.*, 454 N.W.2d 905 (Minn. 1990); *Board of Trustees of Cmty. Coll. Dist. No. 508, County of Cook v. Coopers & Lybrand*, 281 Ill.2d 259, 282-90 (2003) (Garman, J., dissenting). The Court would find, as a matter of fact, that the bank was negligent, that its own negligent was a proximate cause of its harm, and that its negligence exceeded that of BDO.

2. Count II: Negligent Misrepresentation Against the Seders.

The elements of the bank's negligent misrepresentation claim against the Seders are the same as those already outlined as to BDO. The primary difference in the claims is the alleged false information, and the facts relating to the bank's claimed reliance. These issues must be considered separately with respect to each of these three individual defendants.

Larry Seder, as discussed *supra*, was the primary decision-maker at CCNNE; he set its strategy, policies, and practices. He also took the primary role in CCNNE's dealings with the bank. In the course of those dealings, he made multiple and repeated representations to the bank, both oral and written. Among his written representations were certifications, signed in connection with each amendment to the credit agreement, that CCNNE was in compliance with all covenants, and no event of default had occurred. Based on the facts found *supra*, those representations were false, beginning at least with the certifications signed in 1999. In fact, multiple covenant violations and events of default had occurred, including charge-offs (if calculated to reflect charges to the special hold-back account) exceeding 2%; Cobblestone's net losses; excessive leverage when calculated based on treating on the inter-company receivable as uncollectable; and inclusion of rewritten contracts in the borrowing base. Larry Seder did not sign financial statements, but he did deliver many of them, thereby implicitly representing that they were accurately presented in accordance with GAAP, which they were not. Larry Seder also, perhaps most importantly, gave repeated oral assurances to bank personnel that CCNNE followed strict underwriting practices, that it carefully monitored its collateral, and that the value of the collateral was sufficient to cover its loans. These representations were false.

They were also, at the very least, negligent, if not intentional. Larry Seder had insufficient familiarity with GAAP to determine whether financial statements complied with it, and he knew that he lacked such familiarity. He knew, however, that he was rewriting loans for credit reasons, and representing the new loans as current and eligible for the borrowing base. He was thoroughly familiar with his own underwriting and lending practices, including the practices described *supra* that inevitably and necessarily resulted in loans far exceeding any reasonable value of the collateral. He knew that those practices, and the value of the collateral, did not fit the descriptions and assurances that he gave the bank, and that the deviation grew as time went on. The bank relied heavily on Larry Seder's representations, particularly those regarding CCNNE's underwriting practices and the value of its collateral. Indeed, Larry Seder's credibility with senior bank executives was a key factor in its decision-making throughout the relationship. And his execution of certifications in connection with each amendment was a prerequisite to each; the bank would not have executed the amendments without them.

Robin Isenberg had far less authority than her father, and less significance in the minds of the bank's decision-makers. However, her role as chief financial officer put her in the position of signing and transmitting multiple documents containing representations, including monthly borrowing base reports, certifications of covenant compliance, and quarterly and annual financial statements. The borrowing base reports, although they disclosed much accurate information, were false insofar as they represented rewritten accounts as new, current, and eligible, and insofar as they overstated collections and new receivables. The quarterly and annual financial statements were false insofar as they were not presented in accordance with GAAP, for all the reasons discussed *supra*. The certifications of compliance were also false for reasons already discussed. The evidence provides no reason to believe that Isenberg actually knew of any falsehood. But she did know that she lacked sufficient basis to make the judgments that she purported to make. In that sense, her misrepresentations were negligent. The bank relied on Isenberg's reports, particularly the borrowing base reports, which directly triggered the loan advances. As discussed *supra*, from all that appears in the evidence, loan advances were automatic, up to the ceiling set by the calculations appearing in those reports.

Jim Seder, as far as the evidence discloses, did not sign certifications or financial statements, and made no oral representations. He did deliver some of the financial statements, thereby implicitly adopting them as his own representations. But the evidence does not provide a basis to determine which ones he delivered. Without that information, the Court cannot find that the bank relied on any particular representation that he adopted, with respect to any particular transaction. The Court therefore finds and concludes that the bank has proved negligent misrepresentation by Larry Seder and Robin Isenberg, but not by Jim Seder.

The flaw in the bank's claim of negligent misrepresentation against Larry Seder and Robin Isenberg is the same as in its claim against BDO; it has failed to show that its reliance was reasonable in the circumstances. As discussed *supra*, the bank had an absolute right, at all times, to examine all of CCNNE's books and records as thoroughly as it might choose, at CCNNE's expense. Had it exercised that right with more diligence, at any time earlier than the Atwell report in 2005, it would easily have found the checks CCNNE wrote to itself, along with records of the special hold-back account and of unapplied cash, both used as substitutes for reserves and charge-offs. It would also have discovered the absence from CCNNE's files of any evidence of systematic underwriting procedures and documentation of collateral value. Perhaps more to the point, if it had enforced the requirement under the credit agreement that it hold the originals of all contracts, and consent to any modification or discharge, it would have prevented the rewriting practices, which were funded through ever increasing borrowing from the bank, and which led to CCNNE's ultimate downfall and the bank's loss. Even if the bank had done none of those things, but had performed closer analysis of the information it actually received in the borrowing base reports, attached aged lease receivable reports, and financial statements, and from its own field examiners over the years, it could have detected the pattern and stopped it. Rather than do any of those things, the bank relied on its general esteem for the Seder brothers, along with the favorable numbers that appeared on superficial reading of the reports. The Court finds and concludes that the bank's reliance on the misrepresentations was unreasonable in the circumstances. The Court concludes, therefore, that the bank cannot recover from any of the three individual defendants for negligent misrepresentation.

3. The G.L.c. 93A Claim against the Seders (Count IV).

The bank's c. 93A claim against the Seders rests on the same conduct alleged in the negligent misrepresentation claim; the bank alleges that the Seders engaged in unfair and deceptive conduct in making those misrepresentations, and that such conduct caused it harm. For the reasons already discussed, the Court finds and concludes that Larry Seder made misrepresentations that were at least negligent, if not intentional. That conduct, the Court finds and concludes, was unfair and deceptive. Robin Isenberg's conduct, in the Court's view, although negligent, did not rise to the level of unfair or deceptive, because she acted entirely under the direction of others she had reason to trust, without any intent to deceive, and without comprehension of the potential consequences of her actions.

To recover against Larry Seder under G.L.c. 93A, §11, the bank must prove a causal connection between the deception and the loss, and that the loss was foreseeable as a result of the deception. *International Fidelity Ins. Co. v. Wilson*, 387 Mass. 841, 850 (1983), citing *Kohl v. Silver Lake Motors, Inc.*, 369 Mass. 795, 800-01 (1976). There is no question here that the bank lost money, and it is apparent that Larry Seder's deceptive conduct contributed in some degree to the bank's loss. As already discussed, however, in the Court's view, the bank's own conduct was the principal cause of its loss. As Larry Seder correctly perceived, the bank wanted to lend, and was willing to go to great lengths to do so, even as evidence mounted of the likely outcome. On the evidence presented, there is every reason to believe that, had Larry Seder fully and forcefully informed the bank of all of the practices it now complains of—CCNNE's idiosyncratic underwriting methods and inadequate security, the special hold-back account and unapplied cash, the rewriting of contracts, the checks to itself—the bank would still have made the loan at the outset, and it would have continued lending, and providing increases, for at least a substantial portion of the time involved.[75]

In these circumstances, the Court cannot conclude that the bank's entire loss, of $20.5 million, was a foreseeable consequence of Larry Seder's deceptive conduct. The effort to apportion the loss, so as to determine damages, requires consideration of hypothetical questions about what the bank would have done with what information when. That exercise necessarily involves a high degree of uncertainty, nearly verging on speculation.[76] The Court keeps in mind that the bank has the burden to prove the damages that flowed from Seder's conduct, as distinguished from its own. The bank has not proved, as it contends, that full disclosure at any particular time would have caused it immediately to cease lending, accelerate the loan and seize the collateral. Nor has it proved that, had it done so, it would have had significantly greater success than it ultimately had in selling its collateral.[77] The most the bank has proved, on the credible evidence presented, is that had Larry Seder been fully candid with the bank when he met with bank personnel in March of 2003, it would not have approved increases in the loan amount from the level of $18 million then in effect. It would thus have been spared the losses that resulted from subsequent increases to $20.5 million.

As discussed *supra*, the bank recovered a total of $921,103.91 from the sale of collateral, customer payments, and amounts seized from CCNNE's bank account. It credited those amounts to outstanding interest and late fees, as it was entitled to do under the credit agreement. Its total contract damages thus amount to the full $20.5 principal amount of the unpaid loan. But Larry Seder was not a party to the contract, and is not responsible for the bank's contract damages. His responsibility is for the bank's out-of-pocket loss resulting from his conduct in violation of c. 93A. That amount, the Court finds and concludes, was the difference between $18 million and $20.5 million, minus the $921,103.91 collected—that is, $1,578,896.10.

The question of whether Larry Seder's conduct was knowing and willful is close. He was and is a sophisticated businessman, with long experience in commercial lending, and full understanding of its risks. But he appears to have believed, with considerable basis, that he was doing essentially what the bank wanted him to do, and that his gamble would eventually pay off, both for CCNNE and for the bank, as a result of his own personal skills. Under these circumstances, the Court does not find that his conduct was knowing and willful, and declines to multiply the damages. The bank is entitled to judgment against Larry Seder in the amount of $1,578,896.10, with interest at the statutory judgment rate from the date of its filing of the complaint.

4. Default Judgment Against CCNNE, Redes, and Cobblestone (Counts V, VI).

As indicated *supra*, these three corporate defendants have defaulted in this action. The default establishes the liability of each of them, CCNNE for breach of the loan agreement, and Redes and Cobblestone for breach of their guarantees. The bank offers evidence, which is unrefuted, and which the Court accepts and credits, that the outstanding amount due under the credit agreement, including principal, late fees, and interest at the contract rate (the bank's prime rate plus 4%), through December 9, 2011, was $36,685,990.89. The bank is entitled to judgment against these three defendants, jointly and severally, in that amount, plus interest at the contract rate until the date judgment enters. The Court expects that counsel will provide to the clerk the information necessary to calculate the remaining prejudgment interest.

CONCLUSION AND ORDER

Based on the findings and rulings set forth herein, the Court orders entry of judgment as follows:

Count I: Judgment of dismissal.

Count II: Judgment of dismissal.

Count III: Judgment of dismissal as previously ordered.

Count IV: Judgment of dismissal as to James Seder and Robin Seder Isenberg. Judgment for the bank against Lawrence Seder in the amount of $1,578,896.10, with interest at the statutory judgment rate from the date of its filing of the complaint.

Counts v. and VI: Judgment for the bank against Cobblestone Corporation of Northern New England, Redes Holding Corporation, and Cobblestone Corporation, jointly and severally, in the amount of $36,685,990.89, plus pre-judgment interest at the contract rate from December 9, 2011 until the date of entry of judgment, and statutory post-judgment interest thereafter. The bank is entitled to judgment against these three defendants, jointly and severally, in that amount, plus interest at the contract rate until the date judgment enters.

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[1]The individual principals are brothers Lawrence (known as Larry) and James (known as Jim) Seder, and Larry's daughter, Robin Seder Isenberg. The Court will at times refer to the three collectively as the Seders. Where distinction between the brothers is necessary, the Court will use their first names, not out of any disrespect, but for clarity.

[2]The bank also seeks judgment against CCNNE, its parent, Cobblestone Corporation, and its parent, Redes Holding Corporation, based on default entered against them on June 21, 2010, for their failure to appear by counsel in this action, after their previous counsel had been permitted to withdraw. As to these defendants, the default establishes CCNNE's liability for breach of its credit agreement, and the two parent corporations' liability for breach of their guarantees. The amount of damages to be awarded remains for determination, which the Court will address *infra*.

[3]Many of the exhibits were never referred to either at trial, or in closing arguments, or in proposed findings. Aside from the cost to the parties, excess volume increases the Court's burden, and tends to delay the outcome.

[4]The "Facts Stipulated by Plaintiff Bank of America, N.A., and Defendants BDO Seidman, LLP, Lawrence R. Seder, James K. Seder and Robin Seder Isenberg," filed with the Court on December 22, 2011, are incorporated herein. The Court will not repeat the facts set forth in that document, except as necessary for clarity. The "Facts Stipulated by Plaintiff Bank of America, N.A. and Defendant BDO Seidman, LLP," filed with the Court on the same date, in which the individual defendants do not join, binds the bank and BDO but not the individuals. The Court treats that document as incorporated herein for purposes of the bank's claims against BDO, but not the bank's claims against the individuals. Where the Court's findings reflect facts stated in that document in relation to the claims against the individual defendants, the parties should understand that the Court makes those findings independently based on the evidence.

[5]Jim Seder has never been a member of any bar.

[6]The Seder brothers had ambitions for Redes and/or Cobblestone to expand into other lines of business, and it appears that, at least in the early years, Redes had some holdings in certain other entities. For most of the life of the three entities, and during the period most pertinent to the issues before the Court, CCNNE's lending business was the only business activity any of the three entities conducted.

[7]The series of bank mergers that resulted in Bank of America being CCNNE's lender is detailed in the parties' stipulation.

[8]Some of CCNNE's transactions were in the form of equipment leases. These were functionally financing transactions, through which customers obtained possession and use of equipment (such as trucks, printing presses, and the like) that they could not otherwise purchase, while CCNNE held title to the equipment (as opposed to liens on it), receiving lease payments from the customers instead of loan payments. Many of the documents submitted in evidence use the words "lease" and "loan" interchangeably, treating the two types of contracts as functionally the same. The Court will generally use the term "contracts" to encompass both.

[9]A small number of other people, including Robin's sister, worked in the business from time to time, but did not have roles of significance to the issues in this case.

[10]In approximately 1994, CCNNE had some discussions with a brokerage firm regarding the possibility of securitizing its accounts. In that context, a representative of that firm

prepared memoranda purporting to document CCNNE's policies and procedures for credit evaluation and for managing accounts. Those memoranda did not accurately reflect CCNNE's practices, and CCNNE did not adopt practices to conform to the memoranda. The memoranda nevertheless remained in CCNNE's files, and became at least part of the basis for BDO's understanding of CCNNE's practices.

[11]As will be discussed further *infra*, other techniques for addressing a customer's inability to pay were to transfer funds on behalf of the customer from a so-called "special hold-back account," which had been funded by amounts withheld from brokers' commissions, or to use funds from proceeds of earlier loans that had been held as "unapplied cash."

[12]Apparently brokers agreed to, or at least accepted this arrangement. In substance, it appears, the commissions the brokers actually expected and received were less than stated, with the difference functioning as a reserve to secure the customers' payment.

[13]As will be discussed further *infra*, such overstatement in financial statements was in violation of GAAP.

[14]These inadequacies may have been related to the bank's decision to manage the account in its "middle market" group, rather than in other units that had more experience with finance companies, such as its asset-based lending group or its financial institutions group.

[15]The bank's annual profit from the CCNNE account was generally in the range of about $250,000.

[16]If such executed documents ever existed, no one has been able to find them. No witness testified to their execution. The absence of those documents became a problem for the bank later, as will be discussed *infra*.

[17]As will be discussed further *infra*, a 2003 amendment required annual audited financial statements of CCNNE. CCNNE provided such statements, audited by BDO, for the years ending September 30, 2003, and September 30, 2004, in late January of 2004 and 2005, respectively.

[18]The agreement did not define charge-offs, or specify any circumstances in which CCNNE was required to take a charge-off. Generally Accepted Accounting Principles (GAAP) do not establish a standard for when a charge-off is required. As indicated *supra*, if CCNNE had taken charge-offs for the amounts it covered through the special hold-back account, its charge-offs would have exceeded 2% throughout 1999 and 2000.

[19]The most obvious example is that Cobblestone regularly, and Redes occasionally, showed a net loss, which was an event of default under the credit agreement.

[20]The 1999 amendment did not define "credit problems" or establish a mechanism or standard to determine whether a rewrite was because of delinquency or credit problems.

[21]The length of the term of a loan or lease is referred to as its "tenor."

[22]The bank's policy was to conduct field examinations annually, but it did not always do so in practice. As indicated *infra*, a period of some 25 months passed between field examinations in May of 1999 and July of 2001, and then 17 months from July of 2001 until the next examination in December of 2002. Apparently, although the record is less than clear on the point, at least the earlier of these gaps related to the merger of BankBoston into Fleet Bank.

[23]Mozzone was new to the account, apparently as a result of the transition from BankBoston to Fleet Bank.

[24]The bank never performed or obtained appraisals of any of the equipment that provided CCNNE's collateral until 2006.

[25]The bank does not contend that BDO's audits through fiscal year 1998 (that is, the year ended 9/30/98) were in any way deficient.

[26]As indicated *supra*, the apparently increasing revenue included CCNNE's payments to itself on behalf of its customers, while the apparently increasing assets included increased outstanding loan and lease amounts resulting from PIK notes and rewritten contracts.

[27]A rating of 5 was in the middle of the Bank's scale, which ran from 1 to 9. Mozzone described it as "certainly a pass rating."

[28]As noted *supra*, a single quarter of net loss for CCNNE or either of its parents was an event of default, authorizing the bank to stop lending and exercise its rights. As this credit comment makes clear, the bank did not view such action as automatic in case of any particular event of default; it exercised discretion to decide how to respond. In fact, the financial statements as of that time showed net losses for Cobblestone Corporation consistently in fiscal years 1997 through 1999.

[29]The examiner also reported, as the parties have stipulated, that CCNNE's top five borrowers accounted for 35% of its portfolio, and that the top two each accounted for 10%.

[30]As indicated *supra*, this report was not the first notice to the bank of CCNNE's practice of rewriting contracts; the 1997 field examination report had flagged that issue with respect to Mark Equipment. Mozzone did not review that report in connection with her evaluation of the requested increase in 1999.

[31]CCNNE's reported delinquency rate at the time was 6.48%, compared to the bank's standard of 4%. As indicated *supra*, the charge-off figure in the financial statements did not reflect transfers from the special hold-back account, of which the Bank was unaware.

[32]In fact, as later examination revealed, Cobblestone was paying most or all of CCNNE's operating expenses, with funds loaned to it from CCNNE. Apparently, although the point is less than clear, the Seders perceived a tax advantage in this arrangement.

[33]Grondin prepared a second memorandum in connection with this increase, captioned "Credit Request Summary," dated January 18, 2000, setting forth essentially the same information. Apparently the duplication related to the transition from BankBoston to Fleet Bank.

[34]That statement is the earliest on which the bank bases its claim against BDO.

[35]Two examples will illustrate. The June 2001, aged lease receivables report showed four contracts with Suhler Trucking, all nearly 60 days overdue, for a total of $2,447,740 outstanding. The July 2001, report showed all four of those contracts terminated, with five new contracts with Suhler Trucking, for a total of $2,454,536, all current. The May 2001, report showed three contracts with Citranella, all between 30 and 60 days past due, for a total of $1,921,622. The report for the following month showed no contracts with Citranella, but a single contract with a new customer, C&W Express, at the same address, in the amount of $2,054,470, with a term in excess of eight years. The report for December 2001, showed ten contracts with C&W Express, totaling $2,413,029. What had happened, in each instance, was that CCNNE had loaned the customer (or the newly created entity that replaced it) the larger amount, paying the proceeds to itself on the customer's behalf, to pay off the previous loans and overdue interest on them. The account thus appeared current, and eligible for inclusion in the borrowing base, while the new loans appeared as additional receivables, and the proceeds that CCNNE paid to itself appeared as receivables collected. The aged lease receivables reports provided the information necessary to show these patterns, upon examination.

[36]As indicated *supra*, comparable figures for earlier years were 2.4% for FY 1999; 1.8% for FY 1998, and .23% for FY 1997.

[37]As indicated *supra*, the bank's underwriting standard for accounts 60 days or more past due was 4%.

[38]In fact, the only monitoring the bank actually did regarding rewritten leases was to require that CCNNE exclude them from the borrowing base, without taking any action to enforce that requirement or to ascertain compliance. As Mozzone testified at trial, the bank was "taking the company's word that they were reporting rewritten leases."

[39]His memorandum also included a factual error regarding the number of CCNNE's customers; he reported the number at 120, although a contemporaneous aged lease receivables report submitted to the bank showed 64 customers.

[40]As noted *supra*, the income and cash flow figures that appeared in the financial statements reflected CCNNE's payments to itself, on behalf of its customers. Similarly, its increasing assets, based on accounts receivable, reflected loans to its customers of increasing amounts, the proceeds of which CCNNE used to make payments to itself on the customers' behalf. Despite the issues regarding rewriting that had been raised previously, and the availability of detailed information in the aged lease receivable reports, Grondin took these numbers in the financial statements at face value.

[41]As discussed *supra*, each of these apparently encouraging developments reflected rewriting of loans in increasing amounts, without any increase in underlying collateral.

[42]As noted *supra*, Deerwood Express had taken over previously delinquent obligations of C&W Trucking.

[43]Examples will illustrate. Reports during 2001 showed seven contracts with LKM totaling $1,221,000, with payment over 20 months past due. LKM was one of the customers that Tofias had identified as in bankruptcy. The January 2002, aged lease receivables report showed that all seven contracts had been terminated, and CCNNE had entered into two new contracts with LKM, for a total of $2,533,345, both of which were reported as current. One of those contracts, in the amount of $1,646,845, had no payments due for five years, until February 1, 2007. The June 2002, report showed six contracts with C&W Express, for a total of $2,092,686, with payments delinquent on all of them. The July 2002, report showed two new contracts with C&W Express, one with no payments due until December; the total had risen to $2,900,329, and all were reported as current. The reports also showed—or would have showed on close examination—that delinquent contracts with RD Roy had been replaced by new, larger, and reportedly current contracts with Deerwood Express, while delinquent contracts with Pheonix Printing had been replaced by new, larger, and reportedly current contracts with Graphics Plus, at the same location. The contracts with Deerwood Express, shown in reports filed in 2002, had tenors up to 102 months.

[44]Grondin also learned that funds loaned from CCNNE to Cobblestone had been used to fund a loan to a customer in Canada; the Seders had chosen to run that contract through Cobblestone because the credit agreement excluded contracts with non-U.S. customers from the borrowing base.

[45]The bank's risk manager, Richard Kelly, had a more pessimistic view of the situation. In a handwritten "review form"(trial exhibit 1225), he commented: "Inter Company receivable is a questionable asset. What is BDO's position on this asset? Isn't the hiding of these assets a potential fraudulent transaction? . . . Looks like a 7 to me."

[46]As noted *supra*, Deerwood and Graphics Plus were both new entities, or at least new names, that had paid debts of previous CCNNE customers through new loans from CCNNE. Information provided in aged lease receivable reports would have allowed an observer to discern the relationship between these entities and the previously delinquent accounts.

[47]The bank contends that the BDO personnel gave assurance that CCNNE's reserves were adequate. The evidence to support that contention consists of: (1) Houllahan's testimony to his "general memory" that, in response to a question about a particular customer, after Larry Seder represented that "it was appropriately reserved for," "BDO confirmed that it was included"; (2) an entry in Houllahan's handwritten notes of the meeting (trial exhibit 1248) reading: "Total loss reserve—BDO—total exposure—adequate reserves"; and (3) Grondin's internally conflicting testimony on the point, in which at times he said that BDO confirmed the adequacy of the reserves, and at other times he said that BDO made no comment beyond refusing to discuss its audits. The BDO personnel deny having said anything about adequacy of reserves. The Court does not attribute to any of the witnesses a deliberate effort to deceive on this point, but does not find, based on this evidence, that BDO gave any assurance that was sufficiently affirmative or specific to rise to the level of a representation.

[48]For reasons stated on the record, the Court has impounded certain exhibits reflecting the OCC examination and its conclusions, along with an exhibit reflecting legal advice the bank obtained from outside counsel on a related subject. The impounded exhibits provide additional detail regarding the OCC's concerns and recommendations.

[49]As indicated *supra*, it appears that CCNNE had never executed an assignment of contracts and security agreement as required by the credit agreement.

[50]Any follow up that did occur did not prevent CCNNE from making further loans to Cornerstone; by July of 2005, Cornerstone's outstanding debt to CCNNE had expanded to more than $6.4 million.

[51]CCNNE reported to the bank that it planned to sell Mideas's equipment, which would generate cash that it could use to reduce its leverage.

[52]Monthly reports as early as January 2002 had disclosed that the first payment due on the LKM contract was in February 2007. As indicated *supra*, Houllahan had made note of that information in the fall of 2003.

[53]The record does not identify with any precision the assignment given to Atwell. The circumstances, and some of the comments in Atwell's report, as will be detailed *infra*, tend to support defendants' suggestion that at least a significant part of the bank's (or its counsel's) purpose in commissioning the Atwell report was to lay the groundwork for litigation. The Atwell report is in evidence only for the limited purpose of showing what information the bank received, and the Court has considered it only for that purpose. Nevertheless, its conclusions are consistent with the Court's findings from the evidence received substantively, particularly the testimony of Larry Seder.

[54]Atwell commented, "We don't understand how the company's outside auditors could possibly have overlooked this aspect as it relates to a) the allowance for doubtful accounts, and b) the recognition of income." Atwell also identified a third issue that, in its view, should have been of concern to the auditor: "c) how are repossessed assets carried at lower of cost or market, when they include significant imputed interest?"

[55]Republic Financial had made reference to a price in the range of $4 to $5 million, but it never made any formal offer.

[56]As far as the record discloses, neither the bank nor Argus attempted to collect payments due from CCNNE's customers, to foreclose on or sell their assets, or to enforce any guarantees.

[57]The bank collected a total of $171,105.91 through customer payments and from CCNNE's bank account.

[58]In addition to audits, BDO performed certain other accounting services for CCNNE and its parents, including tax

advice, tax return preparation, advice regarding the various amendments to the credit agreement, and consultation with Robin Isenberg regarding her preparation of quarterly financial statements and other reports.

[59]GAAS requires that an auditing firm exercise due care in the planning and performance of the audit; that it gain a sufficient understanding of its client's business to determine the nature, timing, and extent of audit procedures to be performed; that it plan and supervise its work; that it exercise professional skepticism toward management; and that it gather and objectively evaluate sufficient evidential matter to provide a reasonable basis for forming an opinion.

[60]See generally, for an overview of the role of an audit firm and the standards and norms applicable to audit opinions, *Bily v. Arthur Young & Co.*, 3 Ca.4th 370, 379-84 (1992). See also *Reisman v. KPMG Peat Marwick LLP*, 57 Mass.App.Ct. 100, 103, n.3 (2003).

[61]The statements did not include, and were not required to include, consolidating statements of cash flows showing separate figures for the three entities.

[62]The stipulation, at paragraphs 245-367, identifies the staff members involved each year and their backgrounds, and sets out in general terms the procedures followed in connection with the planning and performance of each audit, along with some of the results of the various testing procedures performed, as well as the requirements of applicable auditing standards.

[63]See note 9, *supra*.

[64]BDO set the materiality threshold at $50,000 for FY 2000. The bank does not contend that that level was inappropriate.

[65]BDO had other information about rewriting transactions as well. CCNNE provided it with lists of accounts terminated and opened in each year. Review of those lists would have revealed the pattern of rewriting activity, particularly with respect to CCNNE's largest customers, including Suhler Trucking, R.D. Roy, and Johnson Brothers Coal.

[66]A BDO memorandum (trial exhibit 1353), based on information attributed to Isenberg, states that CCNNE "actually writes a check from CCNNE to CCNNE in order to provide an audit trail of the transaction as if the cash was actually received." Another BDO document, recording subsequent events testing for FY 2000 (trial exhibit 1412), notes a payment from CCNNE to itself for a "lease pay-off" for customer High Tech Type, indicating that "cash receipt was recorded to relieve A/R, although no cash received. Receipt is subsequently reversed when recording a new lease . . . Auditor traced and agreed entry to lease file. Appears reasonable."

[67]An example is LKM, which was in bankruptcy in 2000, when it owed CCNNE $1.2 million. Accepting Larry Seder's belief that it would nevertheless pay in full, BDO recommended a reserve of 5%. In the same year, BDO's confirmations elicited information that customers Larry Gentry Trucking and Oklahoma Southern Transport were also in bankruptcy. Based on Larry Seder's assurances, BDO recommended no reserve for Larry Gentry Trucking, and a 10% reserve for Oklahoma Southern Transport.

[68]It is of some significance that BDO did not offer any expert testimony as to its compliance with GAAS and GAAP.

[69]To illustrate: In Devor's opinion, the audited consolidated financial statement for FY 1999 understated reserves by $123,634, with the result that it showed net income of $66,927, when it should have showed a net loss of $13,693. That difference is such as could fairly fall within a range of legitimate professional disagreement. In the next year, however, in Devor's opinion the audited consolidated financial statement for FY 2000 understated reserves by $1,422,345, with the result that it showed net income of $18,712, when it should have showed net loss of $754,034. It is not necessary to accept Devor's opinion as to the appropriate reserve for each and every account to conclude that the financial statement as issued for that year was materially inaccurate. The deviations are still greater for each subsequent year.

[70]The Court (Hinkle, J.) dismissed the bank's c. 93A claim against BDO (count III) on BDO's motion for summary judgment.

[71]The Court treats the other affirmative defenses set forth in BDO's answer as waived.

[72]With respect to the fifth element, the SJC has observed: "The better reasoned decisions interpret §552 as limiting the potential liability of an accountant to noncontractual third parties who can demonstrate actual knowledge on the part of accountants of the limited—though unnamed—group of potential [third parties] that will rely upon the [report], as well as actual knowledge of the particular financial transaction that such information is designed to influence. The accountant's knowledge is to be measured at the moment the audit report is published, not by the foreseeable path of harm envisioned by litigants years following an unfortunate business decision." *Nycal*, 426 Mass. at 498 (internal quotations and citations omitted). That rule, the Court reasoned, "will preclude accountants from having to ensure the commercial decisions of nonclients where, as here, the accountants did not know that their work product would be relied on by the plaintiff in making its investment decision." *Id.* at 500.

[73]As discussed *supra*, the departures from GAAP in the audited consolidated financial statements all arise from the determination of reserves. The other significant departure from GAAP—the inclusion of checks from CCNNE to itself in figures for revenue received—appear only in audited statements only in the supplemental materials for FY 1999-2004, and in reports for CCNNE alone for 2003 and 2004.

[74]BDO cites a number of cases holding that statements regarding reserves in financial statements in SEC filings could not give rise to liability for misrepresentation because they were opinion, rather than fact. E.g. *Fait v. Regions Financial Corp.*, 655 F.3d 105, 110-11. The Court does not read these cases as holding that statements regarding reserves can never be fact; rather, the cases address specific claims in specific circumstances that differ from those presented here, particularly with respect to the departures from GAAS found *supra*.

[75]As indicated *supra*, at the same time that Larry Seder engaged in a pattern of deception, CCNNE did provide information to the bank from which it could, and reasonably should, have discerned the truth.

[76]In evaluating this issue, the Court does not consider Larry Seder's contention that the bank failed to meet a standard of commercial reasonableness in selling its collateral. Seder lacks standing to raise that issue, because he is not a debtor under the credit agreement. See G.L.c. 106, §9-610. The Court does consider whether Seder proved that the bank failed to mitigate its damages by the manner in which it sold its collateral, but concludes that he did not. In the circumstances presented, including the lack of adequate documentation, the evidence does not show that the bank reasonably could have obtained a higher price for the collateral.

[77]The Court does not adopt Mr. Devor's theory that all amounts CCNNE collected after a particular point in time would have inured to the benefit of the bank. CCNNE's relationships with its customers, although an inadequate basis for its lending decisions, did elicit payments that the Court cannot assume would have occurred after a takeover by the bank.