

**Delta Fin. Corp. v Morrison**

2007 NY Slip Op 32756(U)

August 30, 2007

Supreme Court, Nassau County

Docket Number: 1188-03/

Judge: Ira B. Warshawsky

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**SHORT FORM ORDER**

**SUPREME COURT OF THE STATE OF NEW YORK  
COUNTY OF NASSAU – COMMERCIAL DIVISION**

**P R E S E N T :**

**HON. IRA B. WARSHAWSKY,  
Justice.**

**TRIAL/IAS PART 12**

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DELTA FINANCIAL CORPORATION, in its individual capacity and as Initial Member of DELTA FUNDING RESIDUAL EXCHANGE COMPANY, LLC.,

Index No. 011118/2003  
Index No. 003084/2004  
Index No. 018599/2005

Plaintiff,

-against-

**CONSOLIDATED  
ACTIONS**

JAMES E. MORRISON, DELTA FUNDING RESIDUAL MANAGEMENT, INC. and DELTA FUNDING RESIDUAL EXCHANGE COMPANY, LLC,

**DECISION REGARDING  
LLC'S DEMAND FOR  
KPMG TAX  
WORKPAPERS**

Defendants.

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DELTA FUNDING RESIDUAL EXCHANGE COMPANY, LLC, and DELTA FUNDING RESIDUAL MANAGEMENT INC.,

Plaintiffs,

-against-

DELTA FINANCIAL CORPORATION, SIDNEY A. MILLER, HUGH MILLER, MARC E. MILLER, RICHARD BLASS, and ARNOLD B. POLLARD,

Defendants.

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DELTA FUNDING RESIDUAL EXCHANGE COMPANY, LLC,

Plaintiff,

-against-

KPMG LLP,

Defendant.

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## BACKGROUND

In or about July 2003, Delta Financial Corporation ("DFC") filed a lawsuit against defendants James Morrison ("Mr. Morrison"), Delta Funding Residual Exchange Company, LLC ("DFREC"), and its management company, Delta Funding Residual Management, Inc. ("DFRM") (collectively known hereinafter as the "LLC") after the LLC withheld certain monies allegedly due to DFC under the terms and conditions of an agreement between the LLC and DFC. The LLC thereafter on or about September 11, 2003 commenced an action for approximately \$110 million plus interest for, inter alia, fraud and breach of contract regarding an exchange of assets between the LLC and DFC in and about August 23, 2001 (the "2001 Exchange").

In and about July, 2004, the LLC commenced an action against the accounting firm of KPMG ("KPMG"), the auditor of DFC, for approximately \$110 million plus interest for, inter alia, negligent misrepresentation and professional negligence with regard to KPMG's audit of DFC and certification of various SEC documents related to the 2001 Exchange. All matters have been consolidated before this court. Familiarity with the facts is assumed and only relevant facts will be restated when necessary.

## FACTS

On or about October 5, 2005, the LLC served KPMG with its First Request for Documents (the "First Request") which ostensibly included a demand for KPMG's REMIC<sup>1</sup> tax workpapers (the "Tax Workpapers"). Although it is unclear to the Court at this time what agreement, if any, may have been reached between counsel for the LLC and KPMG regarding the demand for Tax Workpapers as counsel do not agree on the facts, what this Court does know

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<sup>1</sup> A "REMIC" (Real Estate Mortgage Investment Conduits) is a special purpose entity formed to hold a pool of individual mortgage loans for investment purposes.

is that in response to the First Request, KPMG timely objected to the demand for the Tax Workpapers as overbroad and unduly burdensome and did not produce them. What occurred after the objection is also unclear as KPMG claims that the LLC waived and/or abandoned any right it may have had to Tax Workpapers because counsel for the LLC had engaged in extensive negotiations regarding other outstanding discovery disputes with counsel for KPMG and never raised an issue regarding the Tax Workpapers after the initial discussions. On the other hand, the LLC states that during the outstanding discovery negotiations, KPMG offered to defer discussions of the request for Tax Workpapers to a later date and counsel for the LLC agreed.

What is not in dispute is that on April 6, 2007, counsel for the LLC sent correspondence, via e-mail, that requested KPMG make the Tax Workpapers available as requested in the First Request and to let counsel know when those documents would be made available. According to the Discovery Referee assigned to these consolidated matters, Michael Cardello III, Esq., numerous discussions were held, via telephone and e-mail, to discuss the issue in an effort to reach an amicable resolution. On April 9, 2007, Mr. Cardello heard oral argument on the issue, and on April 15, 2007, issued a ruling deciding, inter alia, that "the likelihood of the discovery of admissible evidence within the KPMG's Tax Workpapers would be extremely remote and far too attenuated under the facts of this case and the production of them would only lead to a fishing expedition. Therefore, LLC's demand for the production of KPMG's Tax Workpapers is hereby denied." (the "Prior Ruling").

On or about April 15, 2007, Counsel for the LLC sent correspondence to the Discovery Referee indicating that the LLC did not have an opportunity to submit documentary evidence to support its position that the production of the Tax Workpapers may lead to the discovery of admissible evidence. After further discussion with the Discovery Referee regarding

specifically what counsel for the LLC intended to submit as documentary evidence for further consideration, Mr. Cardello, upon consultation with the Court, inform counsel in correspondence dated April 20, 2007 that the Court has directed that the issue of the production of the Tax Workpapers be briefed.

Subsequent to the submission of the LLC and KPMG's briefs and exhibits, the deposition of Mr. Douglas Williams, a Tax Partner at KPMG, was held. In a communication dated May 8, 2007, counsel for the LLC requested time to review the transcript of the Williams deposition to determine whether supplementation to the submitted briefs was warranted given the testimony by Mr. Williams regarding the Tax Workpapers. On May 9, 2007, the Discovery Referee informed counsel that the Court would permit the supplementation of the briefs in order to set forth new arguments and facts to the Court, and not to rehash prior arguments. However, prior to serving any supplementation to the briefs, counsel for the LLC indicated in correspondence sent via e-mail dated May 10, 2007, that "LLC has determined it will withdraw its demand for those work papers if other documents [tax models] whose existence Mr. Williams confirmed in his deposition (and for which LLC has previously made a document demand) can be produced by KPMG." Thereafter, KPMG and LLC could not agree on the production of those additional documents and LLC renew its demand for the Tax Workpapers and the supplementation to the original briefs were filed and served by the parties.

As a result of the LLC's objection to the Discovery Referee's Prior Ruling, the court determined that a formal decision by the Court was warranted. Having considered all the submissions of the parties, the Court decides the issue as set forth below.

**LLC's Argument That KPMG  
Must Produce Tax Workpapers**

LLC argues that its First Demand requests, inter alia, the production of the Tax Workpapers for tax services performed by KPMG for DFC. Specifically, LLC is interested in the Tax Workpapers that pertain to valuations associated with DFC's pools of mortgages that make up the securitized trusts for the REMICs that underlie or are otherwise relevant to the DFC excess cash flow residual certificates. Counsel for LLC argues that KPMG's tax work is an independent and different source of KPMG's extensive base of knowledge about the financial performance of the mortgage pools that underlie the various securitized trust certificates, including residuals, and that the LLC has a right to examine this body of tax valuation work and knowledge which is related to, but different from the audit work. According to counsel for the LLC, in order for KPMG to calculate the allocable income or loss from each REMIC, it was necessary, on at least a quarterly basis, for KPMG to know the sum of the present value of the future cash flows of all the payments to be made from the securitized mortgage pools and for each certified class issued by the securitization. Therefore, according to the LLC, the information is relevant to this lawsuit.

Significantly, in its supplemental submission to the Court, counsel for the LLC refined its argument based upon the review of certain documentation now claimed to be in context based upon deposition testimony. LLC argues that certain documents, which are annexed to its supplemental submission, indicate that on August 10, 2001, DFC personnel forwarded via e-mail the KPMG tax professionals data showing losses that DFC had incurred by the end of the second quarter. According to counsel for the LLC, these losses were much greater than anticipated and are believe to be inconsistent with and substantially greater than the loss information that DFC had provided to the auditors at KPMG only several months earlier. LLC also contends that the KPMG tax professionals received monthly information regarding cash

flows which was different from what DFC has previously told the KPMG auditors. According to counsel for the LLC, either of these factors would have led KPMG and DFC to believe the residuals were worth less than what was represented in the 2001 Exchange documents.

In summary, LLC argues that the Tax Workpapers (as they relate to the residuals) should be produced because they explain what, if anything, DFC and the KPMG tax professionals knew and communicated regarding the new income and loss information obtained in early August 2001, particularly given KPMG's previous valuation and its certification on August 21, 2001 in its permission letter that no material change had occurred so as to not make its previous valuation misleading. Therefore, the Court should overrule the Prior Ruling and direct the production of the Tax Workpapers.

**KPMG's Argument That the Production  
Of the Tax Workpapers Will Not Lead to  
The Discovery of Admissible Evidence**

Counsel for KPMG contends that the LLC has waived its right to any documentation related to this particular demand as the LLC did not raise an issue regarding the production of these documents during the extensive negotiations held by counsel regarding the LLC's First Demand. Specifically, KPMG claims that after it objected to the overbroad request, counsel for both LLC and KPMG met and conferred regarding other discovery issues in the First Demand to determine if a resolution was possible. KPMG claims that the LLC did not pursue the production of the Tax Workpapers and did not even mention them until an April 6, 2007 e-mail from counsel for the LLC. Thus, according to KPMG, the LLC, by its failure to pursue the documents over a course of many discussions has, in fact, waived any right it may have had to the documents.

KPMG also argues that the Tax Workpapers are neither relevant to the issues in this action nor likely to lead to the discovery of admissible evidence. KPMG contends that there has been no testimony, nor will there be, that the Tax Workpapers, or the cash flow projections prepared for the tax returns, are relevant to any issue in this case or will lead to any relevant evidence because the tax return cash flow projections are prepared based on specialized rules in the tax code and regulations that are different from, and inconsistent with, the rules applicable to financial statement cash flow projections. Specifically, KPMG contends that cash flow projections used to determine the "fair value" of the residual certificate for financial statement purposes (the issue in this case) are to be based on reasonable prepayment and default assumptions, which are regularly updated based upon the past performance of the relevant mortgage pool and other factors. Under the tax code by contrast, according to KPMG, a taxpayer is required to use the assumptions that were present at the settlement of the securitization and would not use any such updated assumption. Instead, under specific requirements unique to the tax code, a taxpayer is required to use the prepayment speed that was initially used in the prospectus at the time of the offering of the securities and it may not update the prepayment speed assumption for the changes in payment patterns or other factors. Similarly, KPMG argues, the tax code makes no allowance for cash flow projections to assume future defaults, an assumption entirely at odds with economic reality. Thus, KPMG contends that the cash flows prepared for tax purposes are not comparable to and would have no bearing on, the cash flows that were, or should have been, projected for financial statement purposes.

In its supplemental brief, KPMG argues that LLC's argument that KPMG tax professionals received certain loss information as part of their work performing DFC's tax filings which was not provided to KPMG's audit team is without import. KPMG states that the tax team

performed entirely different work than the audit team; which required entirely different material and that by merely pointing out that both the audit team and tax team did not receive precisely the same material does not demonstrate that production of the Tax Workpapers is likely to lead to the discovery of admissible evidence. KPMG contends that the Tax Workpapers, and the information they contain, are entirely unrelated to KPMG's audit work, and LLC's attempt to confuse the two should be rejected.

### **LAW REGARDING DISCLOSURE**

Section 3101(a) of the Civil Practice Law and Rules ("CPLR") directs that there shall be "full disclosure of all evidence material and necessary in the prosecution or defense of an action." "The words, 'material and necessary', are, in our view, to be interpreted liberally to require disclosure, upon request, of any facts bearing on the controversy which will assist preparation for trial by sharpening the issue and reducing delay and prolixity." Allen v. Crowwell-Collier Publ. Co., 21 N.Y.2d 403, 406, 235 N.E.2d 430, 288 N.Y.S.2d 449 (1968). In determining when disclosure is appropriate, "[t]he test is one of usefulness and reason." Id. The court continued that "CPLR 3101(a) should be construed, as the leading text on practice puts it, to permit discovery of testimony 'which is sufficiently related to the issues in litigation to make the effort to obtain it in preparation of trial reasonable.'" Id., quoting 3 Weinstein-Korn-Miller, N.Y. Civ. Prac., par 3101.07, p.31-13.

However, "unlimited disclosure is not required." Beckles v. Kingsbrook Jewish Medical Center, 36 A.D.3d 733, 830 N.Y.S.2d 203, 204 (2d Dept 2007), quoting Smith v. Moore, 31 A.D.3d 628, 818 N.Y.S.603 (2d Dept 2006). While the "material and necessary" standard set forth in CPLR 3101(a) is to be liberally construed, "this does not mean that litigants have carte blanche to demand production of whatever documents they speculate might contain

something helpful." Vyas v. Campbell, 4 A.D.3d 417, 771 N.Y.S.2d 375 (2d Dept 2004). "It is incumbent on the party seeking disclosure to demonstrate that the method of discovery sought will result in the disclosure of relevant evidence or is reasonably calculated to lead to the discovery of information bearing on the claims." Id., Crazytown Furniture v. Brooklyn Union Gas Co., 150 A.D.2d 420, 421, 541 N.Y.S.2d 30 (2d Dept 1989); see Acosta v. Hadjigavriel, 6 A.D.3d 636, 775 N.Y.S.2d 179 (2d Dept 2004). Moreover, supervision of disclosure is generally left to the trial court's broad's discretion" Bragrove v. Cox, 294 A.D.2d 526, 742 N.Y.S.2d 865 (2d Dept 2002).

### DISCUSSION

After review of the supplemental submissions of LLC and KPMG as well as the original submissions, this Court hereby modifies the Prior Ruling of the Discovery Referee Michael Cardello, Esq. (who did not have the benefit of the parties' written submissions prior to rendering the Prior Ruling), dated April 15, 2007, which denied LLC's request for the production of KPMG's Tax Workpapers for tax work performed by KPMG on behalf of REMICs. The Court modifies the Prior Ruling to the extent that it is now requiring the production of Tax Workpapers for the work performed by KPMG on behalf of the REMICs for the First, Second and Third Quarters of 2001. The Court's decision to modify the Prior Ruling is based upon its belief that the production of the First, Second and Third Quarter Tax Workpapers for 2001 may reasonably lead to the discovery of relevant evidence.

As stated above, LLC argues that certain documents produced in discovery are now in context regarding what KPMG may have known or should have known regarding higher than expected losses and its effect on the value of the residuals. On August 10, 2001, DFC provided a KPMG tax professional, via e-mail, data showing losses DFC had incurred by the end

of the second quarter (see DF0172655 & DF0058498). Apparently, the losses were greater than expected by DFC. LLC contends that the loss information provided to KPMG's tax professional may be inconsistent with and substantially greater than the loss information that DFC had provided to the KPMG audit professional several months earlier and that KPMG tax professionals received monthly information regarding cash flow from DFC which was different from which DFC had previously provided to KPMG audit professionals.

While the Court recognizes that different departments within KPMG may require different information to perform their respective responsibilities, the Court believes that the discovery of certain Tax Workpapers may lead to the discovery of admissible evidence, e.g., what KPMG knew or should have known regarding the loss data and how those losses may have affected the value of the residuals because different loss information was submitted to the tax professionals at KPMG than to the audit professionals at KPMG during a similar timeframe. The forwarding of contradictory or at least different loss data to two different areas of KPMG is relevant because it goes to KPMG's knowledge regarding the effect on the value of the residuals during a time in which KPMG provided a permission letter which, according to the LLC, implicitly attested that there was no material changes in financial circumstances through August 21, 2001 from the Spring of 2001 as set forth in the S-4. Therefore, the Court believes that the production of certain specific Tax Workpapers may lead to the discovery of admissible evidence.

However, in the Court's view, the LLC's demand as it stands is overly broad in that it does not narrow the request for documents to the time period relative to either when KPMG received documents regarding the losses or the time frame for the losses themselves. Therefore, the Court is limiting the demand for the Tax Workpapers to the Quarters 1, 2, and 3

for 2001 for all of the REMICs. The Court sees no need for any other REMIC Tax Workpapers to be produced either before or after the time frame stated as they would be irrelevant to the losses experienced during the first three quarters of 2001 and therefore, what KPMG should have or may have known regarding those losses and their effect if any on the value of the residuals. In addition, the Court believes the production of Tax Workpapers for DFC is irrelevant and does not direct the production of those Tax Workpapers.

**CONCLUSION**

The Prior Ruling of the Discovery Referee is hereby modified to the extent that KPMG is ordered to produce the Tax Workpapers for the First, Second and Third Quarter of 2001 for the following REMICs: 1995-1; 1995-2; 1996-1; 1996-2; 1996-3; 1996-4; 1997-1, 1997-2; 1997-3; 1997-4; 1998-1; 1998-2; 1998-3; 1998-4; 1999-1; 1999-2; 1999-3; 2000-1; 2000-2; and 2000-3. All other relief sought is denied.

Dated: August 30, 2007

  
J.S.C.

**ENTERED**

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