# The Accountant/Attorney Liability Reporter

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# *In Pari Delicto* Defense Applies Against a Trustee Suing For Professional Negligence

By Amanda Mathieu

**THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT,** in *Peterson v. McGladrey & Pullen, LLP,* 676 F.3d 594 (2012), recently considered whether the *in pari delicto* defense (the idea that when a plaintiff is as culpable as the defendant, the law will let the losses rest where they fall), a doctrine typically available under Illinois state law in suits by clients against their auditors, should be inapplicable under federal bankruptcy law, so that the culpability of a corporate manager never would bar recovery against a negligent auditor. According to the 7th Circuit, the defense is available in bankruptcy proceedings.

The matter arose out of the bankruptcy of five mutual funds (the "Funds") established in 2002 which raised approximately $2.5 billion, The founder, Gregory Bell ("Bell"), reinvested the moneys into several businesses that claimed to be commercial factors. The Funds and Bell told investors that the commercial factors loaned money to operating businesses on the security of their inventories, and that these ventures were low risk because lockboxes had been established to which payments were made if and when the operating businesses sold any of their inventory. In actuality, there was no inventory, the commercial factors did not finance any business transactions, and Thomas Petters, the controller of most of the firms to which the Funds routed money, was running a Ponzi scheme. Petters had been executing the Ponzi scheme by using new investments to pay older debts and had been channeling some of the money for personal use.

In 2008, Petters was caught and later convicted of multiple federal counts. Gregory Bell was convicted of fraud in relation to Petter's Ponzi scheme. At this time, sixty percent of the Funds' money had disappeared, causing the Fund to collapse and enter bankruptcy. Ronald Petterson ("Trustee") was appointed as the bankruptcy trustee to manage and allocate any assets that remained.

The Trustee filed suit in federal district court under Illinois law against the Funds' auditing firm, McGladrey & Pullen, LLP, and some affiliated entities, based on their alleged negligence in failing to discover the Ponzi scheme. The Trustee argued that the auditing firm was negligent in not discovering that the money entering the lockboxes came from the commercial factors themselves, not from customers of the fraudulent businesses whose inventory the commercial factors supposedly financed. Additionally, the Trustee asserted that the auditors should have independently verified whether the Funds' controls were working and were sufficient to catch deceits practiced against it. Had the auditors been doing this, the Trustee argued, the Ponzi scheme would have been uncovered earlier and the Funds would not have invested in the illegal venture.

In the complaint, the Trustee asserted that, although Bell did know of and participated in the Ponzi scheme for the six months leading up to the scheme's disclosure, until this time, Bell honestly believed the Funds were real commercial factors and that the investments made in them had been fruitful.

The district court dismissed the complaint, invoking the doctrine of *in pari delicto*. Due to Bell's considerable connection to the Funds, the district court ascribed the Funds with having the same knowledge of the Ponzi scheme as Bell and implicated that Bell knew about the scheme considerably in advance of the time frame which the Trustee alleged. The district court articulated that if Bell were aware of the Ponzi scheme, the Funds would have no claim against the auditors for failure to warn the Funds of the fraud, because such knowledge would have been imputed to the Fund through its association with Bell. The district court determined that Bell had knowledge of the Ponzi scheme because he had been convicted of fraud. Consequently, the Funds also had this knowledge. The district court thus dismissed the case on the pleadings and not based on whether the auditing firm had acted negligently. Furthermore, in dismissing the case, the court also rejected the Trustee's argument that the defense of *in pari delicto* could not be asserted in a federal bankruptcy case.

**On Appeal**

The Trustee appealed the district court's ruling. The Court of Appeals held that the district court had improperly dismissed the case for failure to state a claim. At the complaint stage of litigation a court is supposed to assume that the allegations in the complaint are true. Thus, the district court should have taken the Trustee's assertion that Bell did not know about the Ponzi scheme as true for purposes of the motion.

The Trustee also asked that the *in pari delicto* defense not be applied, arguing that the culpability of a corporate manager should never bar recovery against a negligent auditor. While such a defense is available under Illinois state law, the Trustee, asserted that federal law prevents the use of *in pari delicto* once a company enters bankruptcy and a trustee is appointed. The circuit court disagreed and rejected the assertion that federal bankruptcy law pre-empts state law defenses.

The Court concluded that, in Illinois, the Trustee's claim against the auditing firm was subject to *in pari delicto* because under § 541(a), "property" is defined by state law. Thus, the Trustee was petitioning for the idea that a bankruptcy estate includes rights to recovery, divested of their state law defenses. They based such an argument on the notion that "public policy" favors greater recoveries for estates in bankruptcy, as well as greater deterrence of offenses by a corporation's leaders.

The circuit court found this argument unsustainable, based on the Supreme Court's ruling in *Butner v. United States,* 440 U.S. 48 (1979). In *Butner,* the Supreme Court held that state law defines "property" of the estate, unless a provision exists in the Bankruptcy Code that displaces state law. The Trustee did not provide the court with any such code in this case that would limit the application of *in pari delicto*. Accordingly, the Court followed the lead of three other circuit courts that had considered the matter, and concluded that "a person sued by a trustee in bankruptcy may assert the defense of *in pari delicto*, if the jurisdiction whose law creates the claim permits such a defense outside of bankruptcy." *Peterson*, 676 F.3d at 598-99.

The Trustee also argued that the *in pari delicto* defense was not applicable under Illinois state law because Bell was acting adversely to the interest of the Funds when he involved himself with the Ponzi scheme. The court rejected this argument, as Bell was not acting adversely to the funds, such as by stealing from them, and thus the *in pari delicto* defense would still apply.

Finally, the Court addressed the auditing firm's argument that a clause in their engagement contract with the Funds exculpates the auditing firm if the client, the Funds, makes material misrepresentations. The court noted that if the auditing firm is able to show that material misrepresentations were made by the Funds and those misrepresentations affected the performance of the auditing firm in its duties, then the firm will receive the benefits of the clause. The Court concluded however, because of factual issues, the fate of the clause in relation to the suit could not be determined in the present case.

Since accountants and attorneys often find themselves named as defendants in securities fraud cases resulting from a corporate collapse, the strong trend of Courts confirming the availability of the *in pari delicto* defense is welcome news.

# PCAOB Issues Report on the Progress of the Interim Auditor Inspection Program

By John B. Connarton, Jr.

**ON JULY 21, 2010, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT** amended the Sarbanes Oxley Act of 2002 by, among other things, giving the Public Company Accounting Oversight Board (PCAOB) explicit oversight authority with respect to audits of brokers and dealers that are registered with the Securities and Exchange Commission (SEC). In August, 2011, the PCAOB commenced an interim inspection program for auditors of such brokers and dealers. The program is expected to include inspections of approximately 100 registered public accounting firms of all sizes covering portions of over 170 audits by the end of 2013. A permanent inspection program is scheduled to begin after 2013.

Brokers and dealers are required to file with the SEC audited financial statements together with audited supporting schedules and an accountant's supplemental report on, among other things, material inadequacies in the accounting system, internal accounting controls and procedures for safeguarding securities of the broker dealer. Exchange Act Rule 17a-5 requires that the scope of audit procedures be sufficient to provide reasonable assurance that any material inadequacies in these systems will be disclosed in the accountant's supplemental report.

On August 20, 2012, the PCAOB released its first report on the progress of the interim inspection program. The report presents information from 23 audits at 10 accounting firms. In short, the report identified deficiencies in all audits inspected. As noted in the report, "The nature and extent of the findings are of concern to the Board."

In general, the deficiencies noted were in three areas: customer protection and net capital rules, financial statement audit and auditor independence. As to the first area, in 21 of 23 audits there was a failure to perform sufficient audit procedures to secure reasonable assurance as to disclosure of material inadequacies in the accounting system, internal accounting controls and safeguarding securities found to exist since the last examination. In addition, in two on nine audits the accounting firm failed to confirm compliance with special reserve bank account requirements and in seven of 23 audits the accounting firms failed sufficiently to test the broker dealer minimum net worth computation.

With respect to deficiencies related to financial statement audit, 13 of 23 firms failed to perform sufficient procedures to identify, assess and respond to financial statement fraud. Ten of 23 audits failed to perform sufficient procedures to identify related parties and material related party transactions. 15 of 23 audits did not perform sufficient procedures to test revenue recognition issues and 12 of 23 audits similarly failed adequately to test records and reports. Six of nine audits failed to perform adequate testing for valuation of securities, four of 23 audits failed adequately to test for internal control deficiencies and seven of 23 audits failed adequately to test the accuracy and completeness of financial statement disclosures.

As for auditor independence, auditors of brokers and dealers are required to comply with SEC independence rules, i.e., Rule 17a-5(f)(3) which differ from AICPA requirements. SEC rules provide, among other things, that an accountant is not independent if he/she provides bookkeeping or other services relating to accounting records or financial statements of the audit client unless the results of these services will not be subject to audit by the accountant. In two of the 23 audits, the accounting firm prepared or assisted in the preparation of the financial statements that were being audited.

The PCAOB will continue its Interim Inspection Program until the permanent inspection program is put in place. It expects to inspect 40 accounting firms and portions of approximately 60 audits in 2012. In addition, shortly before the release of this first report, on August 1, 2012 the PCAOB released a 22 page document providing information for audit committees about the PCAOB inspection process and providing various questions that an audit committee may wish to ask its audit firm about PCAOB inspections.

# Legal Considerations for Adding a Partner to your Accounting Firm – One Cautionary Tale

By Sa'adiyah K. Masoud

**ACCOUNTING FIRMS LOOKING TO HIRE NEW PARTNERS,** and consequently acquire corresponding books of business, should be aware of the potential legal risks. In *Barbagallo v. Marcum*, No. 11-CV-1358, 2012 WL1664238 (E.D.N.Y. May 11, 2012), such an acquiring accounting firm was left defending a lawsuit when it hired a partner who took firm clients from his former accounting firm.

Barbagallo, a partner at the accounting firm, Marcum LLP, joined another firm, Citrin Cooperman & Company, LLP, assuring Citrin during their negotiations that he would not be violating any obligations owed to his prior firm in taking certain clients with him to Citrin. Barbagallo also agreed to indemnify Citrin "forever" and hold it harmless:

> [F]rom and against all liability, costs or expenses (including attorney's fees and disbursement) *on account of the foregoing representations being untrue or any claims made against Citrin*.

In March of 2011, Barbagallo sued his former firm for failure to pay retirement benefits. Marcum, in turn, raised counterclaims against both Barbagallo and Citrin. Of note, Marcum asserted the following causes of action against Citrin: (1) tortuous interference with contract; (2) unfair competition; (3) aiding and abetting a breach of fiduciary duty; and, (4) unjust enrichment.

Initially, Barbagallo agreed it would reimburse Citrin for its defenses costs and indemnify it for any damages resulting from the lawsuit. In June of 2011, Citrin moved to dismiss all Marcum's claims, and was successful in dismissal of the unjust enrichment claim. Barbagallo soon after sent Citrin a check for $2,000.00 (to Citrin's lawyers) paying for a portion of these defense costs.

On January 3, 2012, Barbagallo reversed course and disclaimed any obligation to indemnify Citrin and resigned from the firm three days later. Citrin, in turn, brought the following causes of action against Barbagallo: (1) damages resulting from the breach of the contractual indemnification provision in Barbagallo's employment contract and a declaratory judgment that it was entitled to indemnification; (2) a declaratory judgment that Citrin acted without fault or with simple negligent; (3) damages resulting from Barbagallo's breach of his fiduciary duty to indemnify Citrin; (4) contribution; and, (5) common law indemnification.

Barbagallo moved to dismiss Citrin's claims and was successful except as to two claims. The Court held that regardless of the broadly-worded indemnification in the employment contract, Citrin could not be indemnified for "intentional torts." Regardless of this explicit language, it was against the public policy of the state for Citrin to receive indemnity for its own intentional torts. The reasoning being that no one should be able to contract away liability for their own intentional wrong doing. So, tortuous interference with contract; unfair competition, and aiding and abetting a breach of fiduciary duty were intentional torts for which Citrin could not be indemnified for with respect to any damages that might be awarded against it. The Court went further in holding that Barbagallo also did not have to reimburse Citrin for its defense of these claims. Although, here the Court commented that it may have decided differently if this case involved an insurance company ("Insurers may thus be required to defend against intentional torts that they cannot be required to indemnify."), here the contractual indemnitor (Barbagallo) as an individual had a substantially narrower duty to defend which was coextensive with his duty to indemnify.

The Court also determined the breach of fiduciary count was duplicative of the breach of contract, and accordingly dismissed that cause of action. The Court's reasoning in this regard is particularly important in explaining New York law as it applies to fiduciary duty:

> The duties of good faith and loyalty require a fiduciary to avoid self-dealing. They obligate a fiduciary to place the best interest of the beneficiary above his own self-interest. They do not protect beneficiaries from all forms of fiduciary misconduct.

Here, Citrin was claiming that Barbagallo breached his fiduciary duty when he breached his contract with Marcum. The Court held that Barbagallo had no duty of "good faith and loyalty" to Barbagallo in avoiding breaching his contract with another firm where only Barbagallo, not Citrin, was liable under that contract. The Court also held breaching the indemnity in the employment contract with Citrin was not a breach of fiduciary obligation, but a basic breach of contract claim.

In contrast, Citrin did succeed in its claim that it should be indemnified for its costs and attorneys' fees related to litigating the unjust enrichment claim that was previously dismissed by the court. Because this cause of action was not an intentional tort and was available even if Barbagallo *did not intend* to injure Citrin, it followed that it was acceptable for Barbagallo to agree to indemnify Citrin. So, Barbagallo pursuant to its contractual obligation would be responsible for paying Citrin's costs and attorneys' fees in defending against the unjust enrichment claim.

Citrin's claim for contribution also survived as to aiding and abetting a breach of fiduciary duty and unfair competition claims. Citrin was seeking to hold both Barbagallo and Marcum liable for fundamentally the same injury – i.e. – damage to Marcum's business relationships and good will resulting from poaching of its clients by Barbagallo. The Court reasoned that this was a tort action independent of any contract claim and Citrin could seek contribution from Barbagallo, if Marcum were successful.

In sum, this decision with its several moving parts is important for accounting and law firms when considering the addition of a lateral and when drafting any resulting employment contract.

# Lender's Lack of Reasonable Reliance on Audits of Borrower Precludes Finding Against Accountant

By John B. Connarton, Jr.

**THE POTENTIAL LIABILITY OF ALL PROFESSIONALS TO NON-CLIENTS** has increased substantially over the last fifteen to twenty years. Much of this expansion has resulted from the eventual acceptance by courts of the language contained in § 552 of the Restatement ( Second) of Torts providing that one who in the course of his/her business or profession negligently provides false information to another in the course of a business transaction may be liable for any pecuniary loss caused by that other person/entity's reasonable reliance on that information. These court decisions generally require that the claimant in such a circumstance prove that (1) the professional supplied the information for the guidance of others; (2) the professional failed to meet the standard of care applicable to his/her profession in obtaining or communicating the information; (3) he/she intended to supply the information to the claimant or knew that it would be supplied to the claimant; (4) he/she knew or reasonably should have known that the claimant intended to rely on the information and (5) that the claimant's reliance on the information was reasonable.

In a recent 43 page decision issued by a Massachusetts Superior Court judge following a 23 day non-jury trial with over 1600 exhibits, the court made a rare finding. Although an accounting firm's auditing procedures of a business failed to comply with Generally Accepted Auditing Standards (GAAS) where, unlike the auditor's opinion, the audited financial statements did not comply with Generally Accepted Accounting Principles (GAAP), a lender's reliance on the audit reports was not reasonable and, therefore, the auditor would not be liable for an alleged $20.5 million loss.

In *Bank of America, N.A. v. BDO Seidman, LLP,* 2012 WL 806007, the story involved a lengthy relationship between Bank of America and its predecessors (the Bank) and Cobblestone Corporation of Northern New England (CCNNE), a lending and equipment leasing business which was funded by a revolving line of credit loan provided by the Bank. CCNNE's customers were generally small businesses whose credit history fell below lending standards for banks. Some of CCNNE's business was loans made to its customers while some transactions were in the form of equipment leases. The leases were basically financing transactions with CCNNE holding title to the equipment financed and the customer making lease payments to CCNNE.

The original loan to CCNNE by Bank of Boston in 1992 was for $2 million. Through a series of seven amendments to the credit agreement, the loan amount increased to $20.5 million by 2003. As part of the loan agreement, the Bank was to receive annual audit reports prepared by an independent auditor and the Bank had the right to perform its own field audits at the expense of CCNNE. For each year, the Bank received an audit report from BDO Seidman (BDO) which included an opinion that the financial statements audited, showing increasing business and profits, were prepared in accordance with GAAP. At various times, the Bank, either itself or through an outside vendor, also performed field audit inspections and examinations.

Eventually, in 2004, the Bank began to notice unexplained large monetary transactions between CCNNE and its parent corporation. Further investigation revealed that the apparently increasing business from CCNNE's clients consisted largely of rewriting existing loans when clients were unable to pay. The risk, if CCNNE could not expand its loans to its customers was not that the customers would take their business elsewhere, but that they would default, causing CCNNE to default on its loan to the Bank. To be able to increase its loans to its customers so as to allow the customer to "pay off" its original loan with another loan covering the first loan's principal plus owed interest, CCNNE had to borrow more from the Bank. With worsening economic conditions in the early 2000's, 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. CCNNE's total reported assets , i.e., its accounts receivable, continued to grow but the security for those accounts did not. As long as CCNNE could keep borrowing increased amounts from the bank to fund the increasing loans to customer that could not make their payments, it appeared profitable and growing. If, however, the Bank cut off funding, the house of cards would collapse.

Further investigation led the bank in December, 2004 to issue a notice of non-renewal which, according to the loan agreement, would convert the existing revolving loan into a two year term loan requiring repayment during that term. The loan was not renewed in April, 2005 and by September, 2005, CCNNE was in complete default with the Bank's taking over all assets. Salvage efforts resulted in the Bank's recovering only approximately $1 million, all of which was applied to overdue interest and fees.

Following the trial of the Bank's claim against BDO that BDO's audit reports amounted to negligent misrepresentation which, in turn, caused the Bank's loss, the Court found that BDO did, in fact, fail to perform in accordance with the applicable standard of care. According to the Court, BDO held itself out to have a level of expertise with respect to GAAS and GAAP and that the Bank could fairly have interpreted BDO's audit reports as representing that BDO had complied with the standard of care in their preparation. The Court found that BDO's audit procedures failed to comply with GAAS including the use of due professional care, adequate planning, professional skepticism and obtaining competent evidential matter. As a result, according to the Court BDO provided false information in the audit reports for each of the audited financial statements.

Even so, however, the Court also found that the Bank did not reasonably rely upon the false information provided in the audit reports. The Court noted that the Bank was highly sophisticated and certainly so in the lending business and that the credit agreement between CCNNE and the Bank gave the Bank the right to conduct whatever investigation or inquiries it chose at any time and at the expense of CCNNE. According to the Court, however, the Bank's policy was not to rely on audited financial statements. Instead, its policy was to rely upon the safeguards it set up in its lending agreement including its insistence upon having physical possession of the customer loan documents, field examinations and the receipt of further monthly and quarterly reports which, if examined closely, would have alerted the bank to the problems which existed. Instead, the Bank failed to comply with its own policies, secured only cursory field examinations and failed to adequately review the various reports it did receive, all of which would have allowed the Bank to have information it did not have and allowed it to overlook information it did have. According to the Court, the Bank's own actions and omissions clearly indicated that 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."

Although a lack of reasonable reliance on the part of the claimant in this matter turned out to be the deciding factor in a successful result for the auditor, such a result is rare. Instead, the Court's finding of the auditor's clear failures to comply with the applicable standard of care by being willing to accept management responses to inquiries with little or no skepticism and, therefore, fail to act with the independence required are again a reminder of what a lack of independence can cause.

# When Does Malpractice Occur?

By Justin R. Giles, III, Esq.

**WHILE THERE IS NO LEGAL REQUIREMENT THAT A** professional perform flawlessly in performing services for a client, a professional is expected to meet the standard of care for similarly situated professionals. In situations where the professional's conduct falls below the accepted standard of care, a client may be able to recover from the professional for any damages suffered as a result of the professional's negligence. In situations where a client seeks recovery from a professional for negligence, the professional may be able to defeat the claim by evidencing that he or she met the applicable standard of care. However, this is not the only possible defense available to the professional. The professional may be able to assert procedural and statutory defenses, such as the statutes of limitation defense. Therefore, when facing a malpractice action, one of the first questions a professional should ask is when did the client's alleged injury occur? In *Shifren v. Spiro*, 206 Cal.App.4th 481 (2012), this issue was explored.

In 2001, Kenneth Shifren ("Shifren") and his wife Barbara hired the law firm of Altshuler & Spiro ("Attorneys") to draft amendments to the Shifren Family Trust ("Trust"). The Shifrens sought to amend the Trust to ensure that an expected gift of real property to Shifren ("Property") would remain his separate property. The Attorneys promptly prepared an amendment to the Trust; however, the Attorneys failed to alter or amend a previous transmutation agreement ("Agreement") that held that all future property acquired by either of the Shifrens would constitute community property.

As expected, the Property was conveyed to Shifren in 2002 as "a married man as his sole and separate property." As luck would have it, the Shifrens began divorce proceedings in 2006. In those proceedings, Ms. Shifren took the position that the Trust amendment failed to terminate the Agreement. As a result, Ms. Shifren claimed the Property was community property. The court agreed with Ms. Shifren and in 2009 ruled in her favor.

Shortly thereafter, Shifren filed a complaint against the Attorneys, claiming their failure to terminate the Agreement constituted a wrongful act or omission arising from the performance of professional services. The Attorneys moved for summary judgment claiming that Shifren's claim was barred by the applicable statute of limitations.[1] The Attorneys argued that Shifren's actual injury occurred either when the Shifrens executed the Trust amendment in 2001, when the Property was transferred to him in 2002 or when Shifren first incurred legal fees litigating the issue in the divorce proceedings in 2007. The lower court agreed and granted summary judgment to the Attorneys.

In reversing the lower court's decision, the appellate court held that Shifren's claim for professional negligence could not have matured until the court made a judicial determination that the 2001 Trust amendment failed to terminate the Agreement. The court stated that until the ruling issued, Shifren had no reason to believe that the Attorneys had negligently prepared the Trust amendment. The court stated that to hold otherwise would have required Shifren to litigate two lawsuits simultaneously – one to determine if the cause of action existed and one to recover from the professional for that cause of action in the event Shifren lost in the first proceeding. As stated by the Court, if Shifren had won in the marital dissolution proceeding, the Attorneys would have been ipso facto exonerated rendering the second action unnecessary.

[1] In California, the statute of limitations for professional negligence claims is one year. Code of Civil Procedure § 340.6.

Whether it is a doctor caring for a patient, a lawyer fighting for a client's rights or an accountant managing a client's money, if the result does not meet the client's expectations there is a chance the client will look to lay blame. A professional cannot prevent a client from filing a professional negligence claim. All the professional can do is perform the professional services according to the rules and standards in place for the professional. Therefore, anytime a client poses a question to the professional that is outside of the professional's normal practice, it is advisable to notify the client and seek assistance.

# Second Circuit Court of Appeals Affirms Importance of Pleading Requirements for Fraud and Strictly Applies Test for Accountant Liability to Investment Fund Investors Absent a Contractual Relationship

By Daniel C. Poteet

**IN *STEPHENSON V. PWC, LLP*, (2012 WL 1764191)** the Second Circuit Court of Appeals affirmed the District Court's dismissal of claims of professional malpractice, fraud and negligence asserted against PricewaterhouseCoopers ("PWC") by an investor in a so-called "feeder fund" ("Fund") of Bernard L. Madoff Investment Securities, LLC. PWC had audited the Fund both before the plaintiff's investment into the Fund and during the time when the plaintiff was invested in the Fund. The Court's decision emphasizes defenses available to accountants and the courts' relatively strict interpretation of pleading requirements with respect to claims by investors in funds that have been audited by the accountant defendant, but where there is no direct contractual relationship between the accountant and the particular investor in the applicable fund. In this case, the plaintiff alleged that PWC's professional malpractice, occurring in the form of an unqualified audit letter, led to his initial decision to invest in the Fund and then on PWC's subsequent audit letters in his decision to remain invested in the Fund. The plaintiff couched his claims in terms of both negligence and fraud by PWC[1].

The Court affirmed the dismissal of the professional malpractice claims for inducement and holding on differing bases. With respect to the holding claim, the Court interpreted the claim as a derivative claim that was barred because the plaintiff, as an individual investor within a partnership, did not plead an injury that was distinct from the injury to the partnership as whole, and therefore lacked standing to sue.

The Court recognized that the plaintiff had standing to sue with respect to the inducement claim, but dismissed that claim based on the plaintiff's inability to demonstrate that, based on the lack of a contractual relationship, PWC owed the plaintiff a duty as an investor in the Fund. The Court referenced New York's test for whether the accountant owed a duty, which requires (1) awareness of financial reports being used for a particular purpose; (2) in furtherance of which

[1] The plaintiff initially included claims of professional malpractice that the District Court found to be preempted by New York State's "Martin Act." This Court overruled the Martin Act dismissal, but addressed the substance of the malpractice claims in its inducement and holding discussion.

purpose a known party intended to rely; and (3) some conduct on the accountant's part that demonstrates awareness of the party's reliance. In this case, the Court found that the 'known party' element of the test is to be rigidly applied. Without an allegation that the defendant knew the identity of the specific party, the negligence claim fails.

Regarding the fraud claim, the test under New York law for establishing fraud requires that: 1) the defendant made a representation of material fact; 2) the representation was false; 3) the defendant intended to deceive the plaintiff; 4) the plaintiff justifiably relied upon and was induced by false statement; and 5) as a result of such reliance, the plaintiff sustained pecuniary loss. The Court also recognized that a plaintiff must plead fraud with particularity. The element at issue in this case was the 'intent to deceive' element that the Plaintiff was required to plead with particularity. The Court acknowledged that intent can result from recklessness by the defendant and recklessness, can be derived from the defendant's knowledge of "red flags" about the subject of the audit and disregard of such red flags. However, the Court noted the distinction between allegations of the existence of such red flags and the defendant's awareness and disregard of such red flags. Here, the red flags which the defendant was alleged to have knowledge of did not rise to the level to equate to fraud.

In sum, this case demonstrates that, at least insofar as interpreted by the Second Circuit, there are certain protections that are built into fraud and negligence claims asserted against accountants where the accountants had audited investment funds and the claims are asserted by fund investors who had no contractual relationship to the accountants. While not a complete defense, the Court's analysis in the case shows that the plaintiffs will be held to strict standards in pleading conduct and knowledge that would give rise to negligence or fraud on the part of the accountants. This interpretation places a substantial burden on would-be plaintiffs seeking to recover against auditors of funds in which the plaintiffs had invested, but where the plaintiffs had no direct relationship with the auditing accountants. ■

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