RECENT DEVELOPMENTS AFFECTING THE LIABILITY OF PROFESSIONALS, OFFICERS, AND DIRECTORS

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I. LEGAL MALPRACTICE

A. *Expert Witness Requirements*

For legal malpractice, a plaintiff must prove professional negligence, including the elements of duty, breach, causation, and harm. For causation, a plaintiff must generally show that "but for" the attorney's breach the plaintiff would have achieved a better result. Because attorneys perform a professional service typically outside a layperson's scope of common knowledge, expert testimony is often necessary for the plaintiff to establish the attorney's standard of care and whether the attorney breached it.[1] Also, a majority of states require expert testimony addressing causation unless the causal link is so obvious that it is in the realm of the common knowledge of the layperson.[2] Recent cases have elaborated on the type and sufficiency of expert testimony required to establish proximate cause between the attorney's breach of duty and compensable harm.

In *Frullo v. Landenberger*,[3] the Massachusetts Appeals Court held that expert testimony was required to establish a causal relationship between the attorney's negligence and the outcome of the underlying case. Frullo retained Landenberger to handle a business litigation matter. Landenberger failed to conduct discovery and failed to file a motion to amend the complaint to include a claim under the Massachusetts unfair trade practices act.[4] Frullo's business dispute went to trial on a breach of contract theory, which ultimately failed.[5] Frullo then filed suit against Landenberger for failure to assert the unfair trade practices claim.

Upon Landenberger's motion for summary judgment, Frullo filed an expert witness affidavit stating that Landenberger breached the standard of care, but avoiding any statement as to the effect of the negligence on

1. *See generally* R. Mallen & J. Smith, Legal Malpractice § 33.17, at 146 (2005) (describing expert testimony as mandatory to prove negligence).
2. *Id.* at 150–54.
3. 814 N.E.2d 1105, 1108 (Mass. App. Ct. 2004), *review denied*, 816 N.E.2d 1222 (Mass. 2004).
4. *Id.*
5. *Id.*

plaintiff's claims.[6] The court found the expert opinion insufficient to establish proximate cause because it did not deal substantively with whether there was a causal connection between the negligence and the outcome.[7]

On appeal, the court explained that the elements of negligence and proximate causation in an attorney malpractice matter are two different elements that must be fulfilled independently.[8] In deciding a legal malpractice case, the jury would need to understand the significance of Landenberger's failure to conduct discovery and failure to file a motion to amend the complaint in the context of the underlying business dispute.[9] Even though it may be clear that Landenberger, for example, failed to assert the unfair trade practices claim, the lay jury would not have the knowledge or expertise to understand whether that claim would have been successful in the underlying dispute and what difference it would have made for Frullo.[10]

In a case of first impression in its jurisdiction, the New Hampshire Supreme Court considered whether expert witness evidence is required to prove proximate causation in an attorney malpractice action. In *Carbone v. Tierney*,[11] attorney Tierney failed to serve process of Carbone's civil complaint, made untruthful status reports to Carbone, and demonstrated a distinct lack of knowledge of the Federal Rules of Civil Procedure.[12] As a result, Carbone sued Tierney for legal malpractice and moved for summary judgment.[13] Ruling that Tierney's actions were "obvious" and "blatant breaches" of the standard of care and that Carbone was not required to submit expert witness opinion, the district court granted summary judgment to Carbone without any expert witness affidavit.[14]

The New Hampshire Supreme Court overturned the district court's decision.[15] The court noted that expert testimony is generally required because legal malpractice issues are typically beyond the knowledge or experience of the average layperson.[16] Under New Hampshire law, however, where the legal malpractice subject at issue is within the ambit of "common knowledge" and daily experience, expert testimony would not be neces-

6. *Id.*
7. *Id.* at 1109.
8. *Id.*
9. *Id.*
10. *Id.*
11. 864 A.2d 308 (N.H. 2004).
12. *Id.* at 315 (agreeing with district court's characterization of defendant attorney's conduct as "egregious").
13. *Id.* at 313–14.
14. *Id.* at 315.
15. *Id.* at 314–15 (disagreeing that expert testimony was not required because the results of Tierney's conduct on the underlying case were not within the common knowledge of the layperson, thus establishing that "but for" causation required expert testimony).
16. *Id.* at 315.

sary.[17] In this case, the court held that the legal causation of Carbone's damages was not obvious to an average layperson because it was not within common knowledge what Tierney should have done and what result would have occurred if Tierney had not been negligent.[18]

Texas courts have also recently ruled that expert testimony is not necessarily required to prove proximate causation in a legal malpractice action. In *Alexander v. Turtur & Associates, Inc.*,[19] the Texas Supreme Court held that expert witness testimony is necessary unless the subject matter of causation is obvious to a layperson. Attorney Alexander's firm allegedly made poor decisions during a bankruptcy court trial, and the client, Turtur, sued Alexander for trial malpractice.[20]

Reviewing the alleged breaches of duty by Alexander, the Texas Supreme Court determined that the "decisions of which witnesses to call, what testimony to obtain or when to cross-examine almost invariably are matters of judgment . . . the wisdom and consequences of [which] are generally matters beyond the ken of most jurors."[21] Because the cause and effect of these trial decisions are based on professional judgments involving a lawyer's legal education, training, and experience, it is not within the "jury's common understanding, [and] expert testimony is necessary."[22]

Following the *Alexander* decision, in *F.W. Industries, Inc. v. McKeehan*,[23] the Texas Court of Appeals considered whether expert evidence on the causation issue is required where an attorney negligently pursued a collection matter for his client. On appeal, the plaintiff argued that the trial court improperly struck its expert witness affidavits and improperly granted summary judgment because expert testimony should not be required.[24] The court of appeals held that while expert testimony is not required where the

17. *Id.* at 314 (citing Silva v. Warden, N.H. State Prison, 839 A.2d 4 (N.H. 2003) and Wong v. Ekberg, 807 A.2d 1266 (N.H. 2002)).

18. *Id.* (finding that it is not obvious whether Carbone would have succeeded in the underlying case but for Tierney's negligence). This case has been followed by *In re R&R Assocs. of Hampton*, 402 F.3d 257 (1st Cir. 2005) (expert witness testimony is usually required in legal malpractice action), *Therrien v. Sullivan*, 2005 U.S. Dist. LEXIS 3935 (D.N.H. 2005) (expert testimony of causation is required), *Feddersen v. Garve*, 352 F. Supp. 2d 145 (D.N.H. 2005) (expert testimony of causation is required), and *Copp v. Atwood*, 2005 U.S. Dist. LEXIS 1142 (D.N.H. 2005) (plaintiff must prove causation by expert testimony and whether any judgment would have been collectable).

19. 146 S.W.3d 113, 120 (Tex. 2004), *reh'g denied*, 2004 Tex. LEXIS 1157 (Tex. Nov. 5, 2004).

20. *Id.* at 116–17.

21. *Id.* at 119 (indicating that litmus test for determining whether causation is within causal element is whether the allegedly negligent decision required the use of a professional judgment) (emphasis added) (internal quotations and citations omitted). *See also* CenTrust Mortgage Corp. v. Smith & Jenkins, 469 S.E.2d 466 (Ga. App. 1996).

22. *Alexander*, 146 S.W.3d at 119–20 (overturning appeals court's reversal of trial court's grant of judgment notwithstanding the verdict) (citations omitted).

23. 2005 Tex. App. LEXIS 5430, at *2 (July 15, 2005).

24. *Id.* at *8–9.

causation subject matter is in the "common understanding" of the jury, the effects of McKeehan's negligent conduct on the plaintiff's claims against the debtor would not be in the common understanding of a lay juror.[25] Moreover, even if the subject were in the common understanding of the juror, the plaintiff's affidavits presented expert witness opinion as to liability, not causation.[26] The court found that the plaintiff's failure to establish a triable fact as to causation constituted adequate grounds for dismissal of his complaint on summary judgment.

In *Luvene v. Waldrup*,[27] the Mississippi Supreme Court considered whether the plaintiff's expert witness's affidavit was sufficient to overcome the defendant attorney's motion for summary judgment. The court held that plaintiff is required to show both negligence as well as proximate causation through expert witness evidence.[28] The court examined the plaintiff's expert's affidavit, noting that the only reference to causation was the statement "due to the actions of both of the defendants in this matter . . . the plaintiff . . . suffered injury and damages, which directly resulted from, and were directly caused by, negligence committed by each defendant in handling" plaintiff's affairs.[29] The court noted that while the expert propounded a broad, conclusory statement of general causation, the expert failed to provide a factual basis for that conclusion.[30] Specifically, the expert was "silent on the issue of whether Luvene would have been successful in the [underlying case], had [the defendant attorneys] not been negligent."[31] The court reinstated and affirmed summary judgment in favor of the defendant attorneys.[32] Thus, at least in Mississippi, not only is expert witness opinion required to establish proximate causation of attorney malpractice to the plaintiff's damages, but the expert's opinion must be based on facts set forth in the testimony.

B. *Liability for the Exercise of Judgment*

Attorneys routinely exercise judgment in the performance of legal services. In response to legal malpractice claims, the defenses of judgmental immunity or of nonliability for the reasonable exercise of judgment are routinely asserted and litigated.

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25. *Id.* at *12 (finding "but for" causation of underlying collection action and bankruptcy matter to be outside "common understanding" of layperson) (citing *Alexander*, 146 S.W.3d at 113, 117 (not requiring expert testimony on causation if the causal link is obvious to the layperson) and Delp v. Douglas, 948 S.W.2d 483, 495 (Tex. 1997) (not requiring expert testimony on causation)).
26. *Id.*
27. 903 So. 2d 745 (Miss. 2005).
28. *Id.* at 748.
29. *Id.*
30. *Id.* at 748–49.
31. *Id.*
32. *Id.* at 749.

1. Unsettled Issues of Law

The judgmental immunity defense applied in most jurisdictions shields attorneys from liability for the exercise of judgment that concerns an unsettled issue of law, so long as the attorney takes reasonable steps to inform him- or herself about the state of the law and acts upon such information.[33] In *Jerry's Enterprises, Inc. v. Larkin, Hoffman, Daly & Lindgren, Ltd.*,[34] the Minnesota Court of Appeals held that defendant attorneys were not protected from liability under the judgmental immunity rule where there was no evidence that the defendants researched the legal issue on which they advised the plaintiff.[35]

2. Tactical or Strategic Decisions

In other instances the attorney's exercise of judgment is tactical or strategic, such as when the attorney decides whether and how to use evidence, chooses an expert, or makes comparable decisions where there are several available options. In a number of recent malpractice cases premised on the exercise of tactical judgment by attorneys in litigation, the success of defense motions for summary judgment or dismissal has depended on the strength and sufficiency of the parties' respective expert testimony and whether the plaintiff can establish proximate cause.

In *Rubens v. Mason*,[36] the Second Circuit reversed summary judgment in favor of defendant lawyers in a legal malpractice action alleging that defendants negligently represented plaintiff at the arbitration of her products liability claim. The plaintiff claimed that in the arbitration her lawyer negligently stipulated to the admission of certain evidence by the defendant, failed to understand and appreciate the significance of such evidence, failed to invoke an evidentiary presumption, and failed to timely disclose expert witnesses, resulting in the preclusion of necessary testimony on causation. On cross-motions for summary judgment, the district court was persuaded by the affidavit of the arbitrator stating that the alleged negligent conduct would not have affected his decision.

Preliminarily, the Second Circuit held that the lower court erred in admitting and relying on the arbitrator's affidavit, which impermissibly revealed the thought processes of the decision maker, usurped the fact-finding role of the jury, and could not be relied upon to support the conclusion that no reasonable jury could conclude that plaintiff could prove breach of the duty of care or proximate cause.[37] In evaluating the merits of

33. *See generally* Mallen & Smith, *supra* note 1, § 18.1 at 955–58 and cases cited at n.4.
34. 691 N.W.2d 484 (Minn. App. 2005), *review granted*, 2005 Minn LEXIS 214 (Apr. 19, 2005).
35. *Id.* at 493.
36. 387 F.3d 183 (2d Cir. 2004).
37. *Id.* at 191–92.

plaintiff's legal malpractice claim, the court emphasized that the determination of whether defendants' alleged failures were negligent or merely reasonable tactical decisions presented a question of fact that could not be resolved on summary judgment. Because the lower court improperly relied upon the inadmissible affidavit, defendants were not entitled to summary judgment.[38]

In *Achtman v. Kirby, McInerny & Squire LLP*,[39] the federal district court granted the attorney defendants' Rule 12(b)(6) motion to dismiss a legal malpractice claim brought by members of a class of securities purchasers against the co-lead class counsel. The plaintiffs alleged that the defendants were negligent in failing to name an accounting firm that had acted as a defense independent auditor in the securities class action, failed to alert the plaintiffs to the expiration date for the statute of limitations on claims against the accounting firm, and failed to include in the Notice of Pendency that the class members could also make a claim against the accounting firm. The court held that plaintiffs failed to allege negligence as a matter of law, applying the New York malpractice standard that a complaint alleging no more than an error of judgment by an attorney does not rise to the level of malpractice and that an attorney is not liable for an honest mistake of judgment where the proper course is open to reasonable doubt.[40]

In *Forest City Enterprises, Inc. v. Russo*,[41] the New York Court of Appeals granted the attorneys' summary judgment motion in a malpractice action premised on the attorneys' negligence in representing a mall owner in a negligent security lawsuit. The mall owner argued that it might have obtained a defense verdict if the defense had been properly presented, but the court found that because the trial judge found the tort plaintiff's evidence legally sufficient, the malpractice plaintiff could not prove that the tort plaintiff had no case or the mall owner would have prevailed. The court held that there was no causation to support the mall owner's claim that the case could have settled at a lower amount, because plaintiff had

38. *Id.* at 190.
39. 336 F. Supp. 2d 336 (S.D.N.Y. 2004).
40. *Id.* at 339. The court relied upon *Rosner v. Paley*, 65 N.Y.2d 736 (N.Y. 1985), and *Bernstein v. Oppenheim & Co.*, 554 N.Y.S.2d 487, 489 (N.Y. 1990). Based on the pleadings, the court ruled that the defendants made a reasonable decision not to pursue federal securities and other common law and statutory claims against the unnamed party, distinguishing the attorneys' reasonable exercise of judgment from malpractice cases where attorneys had failed to timely add or name the correct defendant. *Achtman*, 336 F. Supp. 2d at 341 n.1. Regarding the sufficiency of the Pendency of Class notice, because the court itself had approved the contents of the notice, there was precedent that the notice was adequate. The court concluded that the plaintiff had received adequate notice that the accounting firm was not being sued and the plaintiffs could have opted out of the class and pursued their own individual actions against the additional defendant. *Id.* at 342.
41. 797 N.Y.S.2d 253 (N.Y. 2005).

made its own decision to settle without relying upon the advice of the defendant attorneys.[42]

The defendant in *Gayhart v. Goody*,[43] a Wyoming legal malpractice case, prevailed on summary judgment where the plaintiff alleged that the attorney was negligent in dropping a common law marriage claim and in failing to list and use an audiotape as an exhibit instead of on rebuttal. The Wyoming Supreme Court held that the attorney satisfied his burden of proving that the common law marriage claim was not supported by applicable law and that the decision to use the tape recording for impeachment was a sound tactical decision.[44]

C. *Liability to Third Parties*

The preliminary determination of whether an attorney owes a duty of care to a nonclient commonly turns on the application of third-party beneficiary contract principles or a multipart balancing test that takes into account the degree to which the legal services were intended to affect the claimant, the foreseeability of harm to the claimant, the degree of certainty that the plaintiff suffered injury, the nexus between the attorney's conduct and the harm, and the public policy concerns of preventing future harm and avoiding undue burden on the legal profession.[45] Where the attorney's liability to a nonclient is predicated on fraudulent conduct or other intentional wrongdoing, the attorney's professional status is not a shield against liability.

The adverse relationship between the plaintiffs and the attorney's client served to bar a legal malpractice claim in *Jones v. Bass.*[46] In that case, the plaintiffs were bank customers who brought a malpractice claim against the bank's attorney stemming from the attorney's alleged negligent advice to the bank that it honor an IRS notice of levy served on the bank related to the customers' unpaid taxes. The court applied the multipart test re-

42. *Id.* at 257.

43. 98 P.3d 164 (Wyo. 2004).

44. *Id.* at 172. The court referred to *Moore v. Lubman*, 855 P.2d 1245, 1251 (Wyo. 1993), in which the court observed that when the attorney's acts are a matter of judgment, the expert must simply decide whether the attorney's conduct was reasonable under the circumstances. *Id. See also* Dimond v. Kazmierczuk & McGrath, 15 A.D.3d 526 (N.Y. App. Div. 2005) (affirming grant of summary judgment granted in favor of defendants in legal malpractice action where defendants demonstrated that their choice of an expert was a reasonable exercise of their judgment, and to the extent that the plaintiff claimed that defendants should have used a different expert, the selection of one among several was a reasonable course of action which does not constitute malpractice).

45. *See generally* Mallen & Smith, *supra* note 1, § 7.8 at 818–19 and cases cited at n.6. Principles of agency law are also invoked. *See* Crane Creek Ranch, Inc. v. Cresap, 103 P.3d 535, 537–38 (Mont. 2004) (seller's attorney not liable to buyer where attorney acting solely as agent for the seller and had no duty to third parties with whom attorney had no agency relationship).

46. 343 F. Supp. 2d 1066 (D. Wyo. 2004).

cently adopted by the Wyoming Supreme Court.[47] On those factors, the court held that the bank's attorney did not owe a duty of care to the plaintiffs, as the attorney's advice to the bank was directly adverse to the interests of the plaintiffs. The court reasoned that the attorney could not be liable under a negligence theory because an attorney cannot have a legal duty to an opposing party.[48]

Several recent cases exemplify the exception to the historical rule that there be privity of contract between the parties for an attorney to owe a duty of care to a nonclient where the attorney knows that the nonclient will rely upon the attorney's services and the attorney's services are intended to benefit the nonclient. In *Mercantile Capital Partners v. Agenzia Sports, Inc.*,[49] an Illinois district court denied the attorney defendants' motion to dismiss a negligent misrepresentation claim, applying the standard that the nonclient must allege that the primary purpose and intent of the attorney-client relationship from which the attorney supplied information to the third party was to benefit or influence the third party. In *Westlands Group, Inc. v. Lawlor*,[50] the Massachusetts Superior Court denied the summary judgment motion of an attorney for the seller of real estate on negligence, negligent misrepresentation, fraud, and unfair business practices claims by the purchaser where the attorney had certified title, knowing that both parties would rely on the certification and that it was essential to closing the transaction.

Where the interests of an insurer and its insured are not in conflict vis-à-vis defense counsel engaged by the insurer to defend the insured, courts have upheld the viability of legal malpractice claims by nonclient insurers. In *St. Paul Fire & Indemnity Ins. Co. v. Birch, Stewart, Kolasch & Birch, LLP*,[51] the federal magistrate judge held that under Massachusetts law, the liability insurer for a corporation had standing to pursue a legal malpractice action against defense counsel in an underlying business tort action that had been settled pursuant to the insurer's right of subrogation. Acknowledging that Massachusetts is among the minority of jurisdictions allowing the assignment of legal malpractice claims, the court reasoned that allowing subrogation of the claim served to allow the entity that had borne the brunt of the financial settlement to recover, whereas the insured client had little incentive to do so, and denying subrogation would tend to immunize the alleged attorney wrongdoers from the consequences of their malpractice.[52]

47. *Id.* at 1069, discussing *In re* Estate of Drwenski, 83 P.3d 457 (Wyo. 2004).
48. *Id.* at 1069–70.
49. 2005 WL 351926, at *8–9 (N.D. Ill. Feb. 10, 2005).
50. 2005 WL 1683887, at *3 (Mass. Super. May 25, 2005).
51. 379 F. Supp. 2d 183, 190 (D. Mass. 2005).
52. *Id.* at 193–96.

Applying similar reasoning, in *General Security Insurance Co. v. Jordan, Coyne & Savits, LLP*,[53] a district court held as a matter of first impression under Virginia law that the liability insurer could assert a legal malpractice claim as a nonclient beneficiary of the law firm's representation of the insured in the underlying personal injury action.

The principle that an attorney for a corporation owes a duty of care to the corporation and has no attorney-client relationship with its officers, directors, or shareholders remains a valid limitation on the viability of legal malpractice claims by persons or entities other than the corporation.[54] In *Manion v. Nagin*,[55] the Eighth Circuit upheld the trial court's dismissal of a legal malpractice claim brought by the former executive director of a corporation against the corporation's attorney. The court observed that the lower court had invoked the well-established rule that a corporate employee does not generally enjoy an attorney-client relationship with corporate counsel and that the rules of professional conduct of Florida and Minnesota both make clear that corporate counsel's duty of care attaches to the corporation and not to its officers or employees.[56]

In *Greenberg Traurig of New York, P.C. v. Moody*,[57] a Texas appellate court addressed the issue of whether an attorney for a company in connection with its initial public offering owed a fiduciary duty to the company's investors. Applying New York law to the Texas investors' fraud claims against the New York law firm, the court found that the law firm did not serve as counsel to the plaintiff investors and shared no attorney-client relationship with them. The court went on to hold that the evidence was sufficient to support the jury's finding against the law firm for civil con-

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53. 357 F. Supp. 2d 951, 958 (E.D. Va. 2005). The court predicted that Virginia courts would apply the principles of Restatement (Third) of the Law Governing Lawyers § 51(3) (2000), which delineates criteria for imposing liability on an attorney to a nonclient. *Id.* The court reasoned that the public interest would be served by allowing suit and observed that nearly all jurisdictions permit some form of legal malpractice action by an insurer against counsel retained to defend its insured under varying theories of liability. *Id.* at 956–58.

54. *See generally* Mallen & Smith, *supra* note 1, § 7.11 at 843 and cases cited at n.3.

55. 394 F.3d 1062 (8th Cir. 2005), *cert. denied*, 125 S. Ct. 2939 (2005).

56. *Id.* at 1068. Upon the particular facts alleged in *Manion*, the court found that the plaintiff had sufficiently pled that a separate attorney-client relationship was created between the defendant attorney and the plaintiff where he alleged that he sought and received legal advice from the defendant concerning his personal interest in and his employment agreement with the corporation, matters that were distinct from the legal services the attorney performed for the corporation itself. Dismissal of the claim was nevertheless warranted because of the plaintiff's own wrongdoing. The plaintiff was bound by the finding in an arbitrator's decision in a related action that the plaintiff had acted in bad faith against the corporation's interests, and his claim of legal malpractice could not succeed on the theory that the attorney had failed to warn him that he could lose control of the corporation for such bad faith misconduct and that the attorney failed to protect him from being terminated by the corporation because of such misfeasance. *Id.* at 1070.

57. 161 S.W.3d 56 (Tex. App. 2005).

spiracy.[58] Applying Texas law, under which an attorney can be held liable for conspiracy to defraud if he or she knowingly agrees to defraud a third person, the court held that the plaintiffs had met their burden of proof on the conspiracy claim through evidence that the defendant agreed to prepare an initial public offering by illegal means, including assisting the CEO's scheme to defraud investors by concealing information that caused harm to the investors.[59]

Aiding and abetting a client's breach of fiduciary duty may expose an attorney to liability to a nonclient. In *Reynolds v. Schrock*,[60] the Oregon Court of Appeals addressed whether an attorney can be jointly liable to a third party to whom the attorney's client, but not the attorney, owes a fiduciary duty if the attorney, knowing of the client's fiduciary duty, substantially aids, encourages, or acts in concert with the client in the client's breach of that fiduciary duty.[61] Relying on *Restatement (Second) of Torts* § 876, the court held that the attorney may be liable to his client's co-joint venturer where the attorney advises the client that he may do an act incompatible with the fiduciary relationship between his client and the plaintiff.[62]

Notably the court recognized the ramifications of its decision for discovery, as an attorney might be required to disclose confidential communications with the client in order to defend against the claim of complicity.[63] Accordingly, the court emphasized that under Subsection (a) of *Restatement* Section 876, there would need to be proof of an affirmative agreement between the attorney and client to aid each other in what the attorney knows is a breach of the client's fiduciary duty to the third party. Merely outlining for the client a range of options and the consequences flowing from such options would not be enough.

II. ACCOUNTING MALPRACTICE

Accountants are increasingly targets of lawsuits and, in the last twelve months, there were more reported decisions involving accountants than there were in the preceding year.

58. *Id.* at 89. The law firm asserted that there was no difference between Texas and New York law with respect to civil conspiracy, so the court applied Texas law, also noting comparable New York law on the subject.

59. *Id.* at 82. The court also addressed the admissibility of expert testimony by a law professor and a judge concerning the fiduciary duty owed by the law firm to the corporation's board of directors and responsibilities under Texas disciplinary rules. The court held that the admission of such irrelevant testimony was prejudicial, as the investors could not recover damages for breach of the law firm's fiduciary duties to the corporation, because the corporation is the only party that can bring such a claim against its attorneys. *Id.* at 94–100.

60. 107 P.3d 52 (Or. App. 2005).

61. *Id.* at 56–58.

62. *Id.* at 60. The court noted that courts in other jurisdictions have adopted the principles of Restatement § 876(b) to assign liability to attorneys who have aided clients in the client's breach of duty to a third party.

63. *Id.* at 57.

A. *Statutes of Limitation*

What triggers the commencement of a statute of limitations? A number of states apply a discovery rule, under which the statute of limitations does not start running until the plaintiff learns or should learn about the malpractice. For example, in a Tennessee case, *Miller v. Stone*,[64] the plaintiff's new accountant sent a letter in May 2000 referencing the defendant's allegedly unsound financial advice and started the clock ticking. The plaintiff became aware of the facts underlying the accounting malpractice claim when he received the letter in May 2000. Accordingly, Tennessee's one-year statute of limitations barred claims filed over two and one-half years after the letter.

The commencement of the statute of limitations is often a jury question. In *Ex parte Alabama Farmers Cooperative, Inc.*,[65] the Alabama Supreme Court recently found an issue of fact because an audit report may have allayed suspicion that the audit firm was suppressing its alleged earlier failures to properly account for unauthorized leases, and the court reversed a grant of summary judgment and remanded the case for trial.

Specific rules tend to govern the statute of limitations in tax preparation cases. In Massachusetts, the statute of limitations starts to run when the taxpayer first sustains appreciable harm. When appreciable harm occurs depends on the facts and is usually a jury question.[66] Appreciable harm such as having to pay fees to a new accountant to correct a prior accountant's negligent work can trigger Massachusetts's three-year statute of limitations.[67] But in *Kennedy v. Goffstein*, the Massachusetts Appeals Court ruled that a letter informing the plaintiffs of an audit did not necessarily fix the date of appreciable harm and reversed a directed verdict for the accountants.[68]

B. *Liability to Third Parties*

Accountants increasingly face lawsuits brought by nonclients. Frequently the claim arises when a nonclient allegedly relies on an audit report. Most jurisdictions follow the *Restatement (Second) of Torts* § 552, which says that if a professional negligently supplies false information to others in their business transactions, he or she is subject to liability for pecuniary loss caused by justifiable reliance on the false information. This is what is known as a negligent misrepresentation claim. A professional is liable under Section 552 only if he or she fails to exercise reasonable care or competence in obtaining or communicating the information.[69] According to the *Re-*

64. 2005 WL 711981 (Tenn. Ct. App. Mar. 29, 2005).
65. 911 So. 2d 696, 702–03 (Ala. 2005).
66. Kennedy v. Goffstein, 815 N.E.2d 646, 650–51 (Mass. App. Ct. 2004). In the opinion, the court discussed and rejected competing rules from other jurisdictions. *Id.* at 648–50.
67. *Id.* at 648–49.
68. *Id.* at 650–51.
69. Restatement (Second) of Torts § 552 (1) (1977).

statement, however, liability for negligent misrepresentation is limited to losses suffered by plaintiffs (1) for whose benefit and guidance the professional intends to supply the information, or (2) to whom the professional knows that the recipient intends to supply the information.[70] Also, liability is limited to losses suffered in a transaction that the professional intends the information to influence or that the professional knows that the recipient intends to influence.[71]

Often the plaintiff in a negligent misrepresentation case is an investor in, or a lender to, a company whose financial statements the accountant audited. Damages under this theory can be limited. The general rule is that an investor in a negligent misrepresentation case can recover only the difference between the price paid and the actual value of the item received.[72] A Delaware trial court recently held that neither rescission nor rescissory damages are available for negligent misrepresentation.[73]

In an Illinois case, *Premier Capital Management, LLC v. Cohen*,[74] the plaintiffs made two investments in a corporation, one a stock purchase, the other a loan. Before investing, the plaintiffs had received an information statement that they claimed was incorrect or misleading. The accountant defendants moved to dismiss the claims against them, arguing that the investors were not clients to whom the accountants owed any duties. The federal district court held that the ordinary pleading standards of Rule 8(a) of the Federal Rules of Civil Procedure governed the negligent misrepresentation claims.[75] Under this standard, the court decided not to dismiss negligent misrepresentation claims on the pleadings because the facts concerning the accountants' role in dissemination of the financial statements were not fully developed.[76] The court implied, however, that it would strike these claims on summary judgment if the plaintiffs failed to develop any facts showing that the accountants owed them a duty.[77]

Likewise, a New York appellate court refused to dismiss negligent misrepresentation and malpractice claims on the pleadings where the plaintiff

70. Restatement (Second) of Torts § 552(2)(a) (1977). *See, e.g.*, Badische Corp. v. Caylor, 356 S.E.2d 198, 200 (Ga. 1987) (holding that in the absence of privity, willfulness, physical harm, or property damage, accountants are not liable for negligent misrepresentation unless the accountants make the representation for the purpose of inducing third parties to rely).

71. Restatement (Second) of Torts § 552(2)(b) (1977).

72. *See* Restatement (Second) of Torts § 552B (1977) (limiting damages to the (1) difference between the purchase price and the value of what the plaintiff receives and (2) any other pecuniary loss suffered as a consequence of reliance upon the representation); *See, e.g.*, BDO Seidman, LLP v. Mindis Acquisition Corp., 578 S.E.2d 400, 401 (Ga. 2003) (adopting an out-of-pocket standard and rejecting benefit-of-the-bargain damages).

73. Coleman v. PricewaterhouseCoopers LLC, 2005 WL 405450, at *2 (Del. Super. Ct. Feb. 8, 2005).

74. 2004 WL 2203419 (N.D. Ill. Sept. 29, 2004).

75. *Id.* at *6.

76. *Id.*

77. *Id.* The court also noted that even if Virginia law did not recognize a cause of action for negligent misrepresentation, Virginia did recognize a similar tort of constructive fraud. *Id.*

alleged that the accountants were actually aware that a trustee and note holders would reasonably rely on the accountants' representations that the company had not defaulted on an indenture.[78] Specifically, the plaintiff alleged that officers, directors, and accountants of a debtor corporation conspired to cover up prohibited transactions that constituted defaults. In general, if an accountant is actually aware that a nonclient will rely on the accountant's audit report or other opinion, the accountant can be liable for negligent misrepresentation.[79] The allegation of actual awareness in the New York case was therefore sufficient to defeat a motion to dismiss.

Although negligent misrepresentation claims are not always easy to establish on a factual summary judgment record, careful pleading can overcome a motion to dismiss.

C. *Pleading Claims of Fraud*

While negligent misrepresentation claims must satisfy the pleading standards of Rule 8, federal securities fraud claims must satisfy the heightened pleadings standards of the Private Securities Litigation Reform Act of 1995 ("PSLRA").[80] Securities fraud plaintiffs must specify all misleading statements, explain why they are misleading, and state with particularity facts giving rise to a strong inference that the defendant made those statements with the requisite scienter.[81] Accountants often move to dismiss federal securities fraud claims on the ground that the complaint fails to assert facts giving rise to a strong inference of scienter.

In *Zurich Capital Markets, Inc. v. Coglianese*,[82] the Northern District of Illinois held that the complaint was sufficient to state federal securities fraud claims. The plaintiffs alleged a fraudulent investment scheme and asserted that a defendant falsely held himself out as a corporation's president and an independent accountant for several investment entities. The defendant allegedly signed various documents causing the plaintiffs to believe that he was an independent accountant. The plaintiffs also alleged that the defendant created some of the offering memoranda over which they were suing. The court found all of these allegations sufficient to satisfy the pleading requirements of the PSLRA and Federal Rule of Civil Procedure 9(b). While the defendant said that his representations about being

78. Semi-Tech Litig., L.L.C. v. Ting, 787 N.Y.S.2d 234, 237 (N.Y. App. Div. 2004). This case is also noteworthy because it was brought by an entity created by a bankruptcy court to pursue the debtor corporation's claims against officers, directors, and professionals. It is not unusual for bankruptcy trustees to sue accountants.

79. *E.g.*, Badische Corp. v. Caylor, 356 S.E.2d 198, 200 (Ga. 1987). Note that an accountant can avoid liability to nonclients with a disclaimer in the opinion. *Id.*

80. Pub. L. 104–67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

81. *See* 15 U.S.C. § 78u-4(b) (2005).

82. 332 F. Supp. 2d 1087 (N.D. Ill. 2004).

the corporate president were immaterial, the court refused to determine the materiality of these statements on the pleadings.[83]

Common law fraud claims and state law securities claims must also satisfy a stringent pleading standard.[84] In the *Premier Capital* case, the court explained that a fraud plaintiff must plead the "who, what, when, where, and how" of fraud claims under the Virginia Securities Act.[85] Because the complaint failed to make clear whether the plaintiffs were alleging that the accountant was liable for his own misrepresentations or indirect liability as a "control person" for the misrepresentations of his audit client, the court found the complaint insufficiently specific.[86] The court dismissed these state securities fraud claims without prejudice but allowed common law fraud claims to proceed because the complaint specifically identified the people making these representations; the time, place, and content of the misrepresentations; and the method by which the misrepresentations were communicated to the plaintiffs.[87]

In allowing the common law fraud claims to proceed, the court rejected the argument that cautionary language in the challenged information statement absolved the defendants of liability for fraud. Under the "bespeaks caution" doctrine, a defendant is not liable for predictions or opinions if they are accompanied by cautionary language sufficiently tailored to the risk involved. The court explained that the bespeaks caution doctrine does not necessarily insulate defendants from misrepresentations of "hard facts."[88]

To allege fraud with particularity it is not enough to say simply that an accountant made a mistake, nor is it sufficient to say that an accountant made a judgment call that an expert later called into question. Some courts hold that an "egregious refusal to see the obvious or to investigate the doubtful" satisfies the particularity requirement.[89] Is it enough to say that the accountant had access to all of the information in the client's books and records? The answer varies from case to case.

In *Marwil v. Ent & Smiler CPA Group, PC*,[90] the Southern District of Indiana found sufficient allegations that data was available to the auditors that was directly inconsistent with the representations they incorporated in their audit report. After the Securities and Exchange Commission ("SEC") brought a civil enforcement action against a church's financial arm, a receiver was appointed. The receiver sued the accountants who had

83. *Id.* at 1104–05.
84. *See* Fed. R. Civ. P. 9(b).
85. Premier Capital Mgmt., LLC v. Cohen, 2004 WL 2203419, at *3 (N.D. Ill. Sept. 29, 2004).
86. *Id.*
87. *Id.* at *4.
88. *Id.*
89. *E.g.*, Chill v. Gen. Elec. Co., 101 F.3d 263, 269 (2d Cir. 1996).
90. 2004 WL 2750255 (S.D. Ind. Nov. 24, 2004).

audited financial statements and helped prepare offering circulars prior to the insolvency. According to the receiver's complaint, the auditors had access to data that were directly inconsistent with the appraisals used to produce the financial statements and with the use of loan proceeds and the actual liquidity of the financial arm's funds, as represented in the offering circulars. Because the cited data would have given the auditors "direct evidence" that the financial statements and offering representations were amiss, the court held the complaint sufficient to state a claim for fraud.[91]

In contrast, it was not enough for the plaintiff in *VTech Holdings Ltd. v. PricewaterhouseCoopers LLP*[92] to allege fraud based merely on the auditor's access to the books of Lucent Technologies. The plaintiff brought suit after its unsuccessful acquisition of Lucent's consumer telephone business. Among other things, the plaintiff alleged fraud because a footnote in the audit report said that there had been no significant changes since the audit date. According to the complaint, Lucent had actually acquired thousands of telephone products that it could not sell, sales and production forecasts had declined, and independent testing found the new telephone product unmarketable. In charging the auditors with aiding and abetting Lucent's purported fraud, the complaint only alleged that the auditors acquired knowledge of the falsehood through their access to the books and records. According to the court, such conclusory allegations that the auditors had actual knowledge of the fraud or should have known of the fraud were insufficient.[93]

The differing results in *Marwil* and *VTech* may be explained by the "direct evidence" on which the receiver relied in *Marwil.* Where the *Marwil* receiver cited specific contrary evidence in his complaint, the purchaser in the *VTech* case cited no specific data and supplied no specific reason that the auditor should have been aware of the alleged fraud.

D. *AICPA Rules*

In *Kanani v. Frost, Ruttenberg & Rothblatt, P.C.*,[94] the Eastern District of Missouri held that there was no cause of action for violating the prohibition on conflicts of interest found in the Code of Professional Conduct of the American Institute of Certified Public Accountants ("AICPA"). The Missouri State Board of Accountancy requires certified public accountants to comply with the AICPA Code of Professional Conduct. The court reasoned that while statutes and professional rules may assist in determining the standard of care, they do not create a civil cause of action independent

91. *Id.* at *6–7.
92. 348 F. Supp. 2d 255 (S.D.N.Y. 2004).
93. *Id.* at n.104.
94. 2005 WL 1661521 (E.D. Mo. July 13, 2005).

from the one for common law negligence.[95] Neither Missouri accounting regulations nor the Missouri Accountancy Act specifically provided for a private cause of action, and the court refused to create one.[96]

E. *International Structure*

In two cases this year, courts addressed whether Big Four accounting firms could be liable for the work of their international affiliates. *In re Parmalat Securities Litigation*,[97] which arose from the Parmalat scandal, an Italian Extraordinary Commissioner (somewhat similar to a bankruptcy trustee) sued various accounting firms, including DTT, a Swiss entity and, according to the opinion, an "umbrella firm" for Deloitte and Touche. According to DTT, it did not hold itself out as one firm and specifically had disclaimed any liability for its member firms' acts or omissions. Noting that written disclaimers are not necessarily controlling, the federal district court refused to dismiss DTT on the pleadings.[98] The plaintiff alleged that DTT controlled member firms and intervened to direct the work of a Brazilian auditor. The complaint also alleged that the American Deloitte firms were under the control of an Italian member firm. Although the plaintiff claimed that there was a joint venture, the complaint contained only vague allegations of shared compensation and no indication of how they shared risk and showed that the member firms did not have the right to control their sister firms. Further, the complaint did not allege that the firms had overlapping personnel or failed to maintain separate corporate records. Under all of these facts, the complaint failed to allege a joint venture or an alter ego relationship between DTT and the American Deloitte firms.[99] Using a similar analysis, the court dismissed an American Grant Thornton firm but found the complaint sufficient to state a claim that Grant Thornton International was responsible for the work of GT-Italy.[100]

The same federal district court reached a different result in the *VTech* case. Pricewaterhouse contended that a separate entity called PWC Hong Kong generated the offering circular at issue. It also argued that the written contract between VTech and PWC Hong Kong foreclosed any possibility of an oral agreement for assistance from the American Pricewaterhouse firm. The court rejected these arguments because the plaintiffs had alleged the oral contract with Pricewaterhouse, and the court found this allegation

95. *Id.* at *3.
96. *Id.*
97. 377 F. Supp. 2d 390 (S.D.N.Y. 2005).
98. *Id.* at 404–05.
99. *Id.* at 405–09.
100. *Id.* at 408–09.

sufficient to defeat a motion to dismiss malpractice claims for lack of privity.[101]

F. *Breach of Fiduciary Duty*

In general, accountants serving as auditors are not fiduciaries of their audit clients. Nevertheless, no good audit malpractice complaint is complete without a claim for breach of fiduciary duty. Several cases reported in the last year have addressed this issue.

The court in *VTech* dismissed breach of fiduciary duty claims on the pleadings. The court noted that in New York, accountant-client relationships generally do not give rise to fiduciary duties.[102] The complaint incorporated the auditors' business advisory agreement, which did not suggest that they gained a superiority or influence over their clients. Noting the incorporated agreement, the court said that it was not sufficient for VTech simply to assert a relationship of confidence and trust. With no other facts alleged in the record, the court dismissed the breach of fiduciary duty claim.[103]

In contrast, the *Zurich Capital Markets* case alleged that the plaintiffs placed trust and confidence in the defendant based on assignment confirmations that he signed as an independent accountant. They claimed that they relied on the integrity of the accounting statements that he audited and that he essentially controlled their investment assets, given his role with an investment entity. With relatively little explanation, the federal district court found these allegations sufficient to allege a fiduciary duty.[104]

The U.S. District Court for the Eastern District of Missouri that refused to infer a cause of action for breaching AICPA conflict of interest rules in the same case[105] rejected as premature a motion to dismiss breach of fiduciary duty claims. The accountants handled income tax and other accounting matters for a motel venture. The decision does not make clear the facts alleged to claim a fiduciary relationship or the basis on which the accountants moved to dismiss the breach of fiduciary claim. The court, however, refused to dismiss the breach of fiduciary claim on the pleadings. It acknowledged that not every act of professional misconduct gives rise to a cause of action for breach of fiduciary duty, but that in some circumstances, Missouri law will permit a breach of fiduciary claim against an accountant. Explaining simply that the claims could stand as a cause of action

101. VTech Holdings Ltd. v. PricewaterhouseCoopers LLP, 348 F. Supp. 2d 255, 262–63 (S.D.N.Y. 2004).

102. *Id.* at 268.

103. *Id.*

104. Zurich Capital Markets, Inc. v. Coglianese, 332 F. Supp. 2d 1087, 1120 (N.D. Ill. 2004).

105. Kanani v. Frost, Ruttenberg & Rothblatt, P.C., 2005 WL 1661521 (E.D. Mo. July 13, 2005).

independent from the AICPA rule violations alleged, the court denied the accountants' request to dismiss the breach of fiduciary duty claims.[106]

These three cases appear consistent with the general proposition that an accountant-client relationship is not necessarily a fiduciary one. Special circumstances may give rise, however, to fiduciary relationships, and these claims can sometimes survive a motion to dismiss.

G. *Ownership of Workpapers*

Some state statutes declare that accountants own their workpapers.[107] In one bench trial in the Southern District of New York, the client sued an accounting firm for replevin, claiming that the accounting firm wrongfully refused to return client documents. The district judge found that the accountants possessed some client documents that the accountants did not create.[108] For this reason, the accountants were liable for replevin. The significance of this finding was that the district judge held the accountants liable for the time the client spent recreating the documents to the tune of $56,850.[109]

H. *Deepening Insolvency*

Bankruptcy trustees are not strangers to claims of accounting malpractice. Woe is the accountant who audits the financial statements of a company that ends up in Chapter 11. Claims by bankruptcy trustees recently produced three reported cases.[110] Bankruptcy courts and trustees can create entities to pursue claims against accountants for the estate.[111] They can also obtain an accountant's workpapers before even filing suit.[112] Liability may even travel overseas.[113] Trustees are not afraid to accuse accountants of conspiring with their audit clients.[114]

One of the theories that bankruptcy trustees often assert is the emerging "deepening insolvency" theory. It involves allegations that the defendants

106. *Id.* at *4.

107. *E.g.*, O.C.G.A. § 43–3-32(a) (2005).

108. Shared Communications Servs., Inc. v. Goldenberg Rosenthal, LLP, 2004 WL 2609546, at *10 (S.D.N.Y. Nov. 16, 2004).

109. *Id.* at *11.

110. *In re* Parmalat Sec. Litig., 2005 WL 1670246, at *1 (S.D.N.Y. July 18, 2005); *In re* Daisytek, Inc., 323 B.R. 180 (N.D. Tex. 2005); Semi-Tech Litig., L.L.C. v. Ting, 787 N.Y.S.2d 234, 236 (N.Y. App. Div. 2004).

111. *Semi-Tech*, 787 N.Y.S.2d at 236 (holding that an entity created by the bankruptcy court had standing to sue).

112. *Daisytek*, 323 B.R. at 185–86 (holding that a bankruptcy court had post-confirmation jurisdiction to compel production of accounting records).

113. *Parmalat*, 377 F. Supp. 2d at 390 (detailing an action brought in an Illinois state court by the Extraordinary Commissioner of a collapsed Italian company).

114. *Semi-Tech*, 787 N.Y.S.2d at 235–36 (holding pleadings sufficient to charge accountants on theories of conspiracy and aiding and abetting fraud).

(usually corporate officers and/or outside professionals) caused a company to slide deeper into insolvency and thereby decreased its value as a going concern. Currently, the courts are split as to whether deepening insolvency is a theory of damage or an independent tort.[115] In the *Parmalat* litigation, applying Illinois law, a federal judge in the Southern District of New York held that a claim of deepening insolvency was duplicative of other claims for professional malpractice.[116] Deepening insolvency was merely a type of damage alleged to have been suffered as a result of malpractice.

One of the defenses sometimes available is the in pari delicto defense, a Latin phrase meaning "of equal fault." The effect of the defense is that if both parties are equally at fault, the defendant wins. Because a bankruptcy trustee or other receiver stands in the shoes of the debtor, the trustee or receiver may be saddled with any wrongdoing committed by the debtor. This defense did not justify dismissal on the pleadings in the *Marwil* case. The receiver alleged that the company's officers embarked on a fraudulent scheme to cover up its financial difficulties. The accountants contended that the alleged fraud of the officers should be imputed to the receiver. Because the receiver alleged that the accountants were directly involved in the company's fraudulent misrepresentations, the court refused to dismiss the complaint.[117]

III. CORPORATE DIRECTORS' AND OFFICERS' LIABILITY AND INSURANCE COVERAGE

A. *Issues Relating to Liability of Directors, Officers, and Corporate Advisors*

1. Loss Causation

As plaintiffs' attorneys have become more adept at pleading scienter under the PSLRA,[118] defendants have increasingly shifted the focus of their motions to dismiss more and more to the pleading of loss and causation.[119] A recent U.S. Supreme Court case, *Dura Pharmaceuticals, Inc. v. Broudo*,[120] clarified the importance of pleading a causal connection between the alleged fraud and plaintiffs' economic loss, holding that allegations of artificial inflation of the price of a stock at the time of purchase are insufficient to show that the alleged misrepresentation proximately caused economic

115. *See Parmalat*, 377 F. Supp. 2d at 418–19 (collecting cases).
116. *Id.*
117. Marwil v. Ent & Smiler CPA Group, PC, 2004 WL 2750255, at *10 (S.D. Ind. Nov. 24, 2004).
118. 15 U.S.C. § 74 (2005).
119. Empirical data indicate that the number of securities fraud class actions has returned to or exceeded its pre-PSLRA level. "Today, complaints are better drafted, with stronger support for allegations of fraud." Adam C. Pritchard, *Should Congress Repeal Securities Class Action Reform?*, 471 Cato Inst. Pol'y Analysis 1 (2003).
120. 125 S. Ct. 1627 (2005).

loss. Prior to *Dura*, the federal circuit courts were in disagreement over whether allegations of a purchase-time value disparity, standing alone, could satisfy the loss causation pleading requirement.[121]

Plaintiffs alleged that Dura made statements that were false, misleading, or both regarding the profitability of drug sales and the future Food and Drug Administration ("FDA") approval of Dura's new asthmatic spray device. In November 1998, Dura announced that the FDA did not approve the spray device. The price of Dura's shares dropped following this announcement, but almost fully recovered within a week. Shareholders then filed suit against Dura and certain of its managers and officers.

The district court dismissed the complaint for failure to meet the pleading requirements of the PSLRA,[122] in part because the plaintiffs had not properly pled loss causation with respect to the alleged misrepresentations regarding the spray device. The Ninth Circuit reversed,[123] holding that loss causation is pled where plaintiffs allege that the price of the stock at the time of purchase was artificially inflated and there is "sufficient identification of the cause for this overvaluation."[124] The court found that plaintiffs had adequately pled loss causation by alleging that the artificial inflation of the purchase price was "in part" due to the alleged misrepresentations concerning the spray device.[125]

The U.S. Supreme Court reversed.[126] The Court held that the Ninth Circuit's holding that a plaintiff need only establish that the price on the day of purchase was artificially inflated to plead loss causation was wrong because, as a "matter of pure logic," a purchaser of inflated securities suffers

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121. *See, e.g.*, Emergent Capital Inv. Mgmt., LLC. v. Stonepath Group, Inc., 343 F.3d 189, 197 (2d Cir. 2003) (to plead loss causation, a plaintiff must allege a "causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff") (citation omitted); Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000) ("an investor must also establish that the alleged misrepresentations proximately caused the decline in the security's value to satisfy the element of loss causation"); Robbins v. Koger Properties, Inc., 116 F.3d 1441, 1447–48 (11th Cir. 1997) (while the court found that plaintiffs offered sufficient evidence to show artificial inflation of the stock at the time of purchase, "this showing of price inflation . . . does not satisfy the loss causation requirement"); Bastian v. Petren Res. Corp., 892 F.2d 680, 686 (7th Cir. 1990) (a plaintiff must show a causal relationship between the alleged wrongful conduct and the economic loss or "the trier of fact can have no confidence that the plaintiff would be better off if the defendant had refrained from the unlawful act"). *But see* Gebhardt v. ConAgra Foods, Inc., 332 F.3d 824, 832 (8th Cir. 2003) ("[P]laintiffs were harmed when they paid more for the stock that it was worth. This is a sufficient allegation."); Knapp v. Ernst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996) (in a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation) (citing Gray v. First Winthrop Corp., 82 F.3d 877, 886 (9th Cir. 1996)).

122. Dura Pharm., Inc. v. Broudo, 2000 WL 33176043 (S.D. Cal. July 12, 2000).

123. Dura Pharm., Inc. v. Broudo, 339 F.3d 933 (9th Cir. 2003).

124. *Id.* at 939.

125. *Id.*

126. Dura Pharm., Inc. v. Broudo, 125 S. Ct. 1627 (2005).

no loss at the moment the transaction takes place.[127] The Court went on to point out that the logical link between artificially inflated purchase prices and later economic loss is not necessarily a strong one, because if a purchaser sells the inflated shares before the relevant truth is revealed, the misrepresentation will not have caused that purchaser any loss. Additionally, the Court noted that even if a purchaser sells after the truth hits the marketplace, the loss might not necessarily be due to the misrepresentation. Rather, the loss could be due to "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price."[128] The Court noted that allegations of purchase price inflation were insufficient to give the defendant fair notice of either the nature of the economic loss or the causal connection between the alleged loss and the relevant misrepresentation.[129]

At first blush, *Dura* appears to pose a substantial obstacle to securities fraud plaintiffs, as it requires courts to scrutinize the complaints for all factors that may have caused plaintiffs' economic loss. *Dura* leaves open, however, whether the heightened pleading requirements of Rule 9(b) and the PSLRA apply to all elements of a securities fraud claim. The Court analyzed the causation allegations of the complaint in *Dura* under the "short and plain statement of the claim" standard of Rule 8(a)(2), assuming "for argument's sake" that the element of causation is not subject to any "special further requirements" with respect to pleading.[130] Lower courts have begun to focus on this language in their analysis of the sufficiency of loss causation pleading.[131] In *Rocker Management, L.L.C. v. Lernout & Hauspie Speech Products N.V.*, [132] the U.S. District Court for the District of New Jersey cited the Court's statement that the pleading rules "are not meant to impose a great burden on plaintiff" before stating that it was "satisfied" with the allegations of loss causation.[133] At least one commentator has

127. *Id.* at 1631.

128. *Id.* at 1632.

129. The Court noted that under the Ninth Circuit's rule, a plaintiff with a groundless claim could file a securities fraud action, "with the right to do so representing an *in terrorem* incremenet of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence." *Id.* at 1634 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741 (1975)). "Such a rule would tend to transform a private securities action into a partial downside insurance policy." *Id.*

130. *Id.*

131. *See, e.g.*, Rocker Mgmt., L.L.C. v. Lernout & Hauspie Speech Prods. N.V., No. Civ.A. 00–5965(JCL) (D.N.J. June 8, 2005); Pfeiffer v. Integrated Fund Servs., Inc., 371 F. Supp. 2d 502 (S.D.N.Y. 2005); *In re* Initial Pub. Offering Sec. Litig., No. MDL 1554(SAS) (May 6, 2005).

132. No. Civ.A. 00–5965(JCL) (D.N.J. June 8, 2005).

133. *Id.* at 7.

noted that this language may cause the plaintiffs' securities bar to adapt to the holding in *Dura*.[134]

Dura also leaves open whether a complaint for securities fraud must allege a corrective disclosure in order to sufficiently plead loss causation. Pre-*Dura*, in *Lentell v. Merill Lynch & Co., Inc.*,[135] the Second Circuit held that loss causation in a Section 10(b) securities fraud action requires both that the loss be foreseeable and caused by the materialization of concealed risk.[136] The court noted that this requirement meant that a plaintiff must allege that the subject of the fraudulent misrepresentation or omission was the cause of the actual loss suffered.[137] The *Lentell* action alleged that the defendant financial institutions engaged in a scheme to issue falsely optimistic investment recommendations that artificially inflated the market prices of certain securities in order to generate business for its investment banking business. Plaintiffs claimed that, as a result of the fraudulent recommendations, they lost millions of dollars when the price subsequently plummeted.

The district court granted defendants' motion to dismiss based on various pleading deficiencies, including the failure to plead loss causation.[138] As in *Dura*, the Second Circuit analogized the concept of loss causation to the tort law requirement of proximate cause (i.e., foreseeability), but noted that this analogy is "imperfect" in the context of securities fraud because "it cannot ordinarily be said that a drop in the value of a security is 'caused' by the misstatements or omissions made about it, as opposed to the underlying circumstance that is concealed or misstated."[139] Accordingly, the court held that a securities fraud plaintiff alleges a foreseeable loss by claiming "that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security."[140] In applying this rule to the facts of *Lentell*, the Second Circuit found it "fatal" that the complaint lacked any allegation that the market reacted negatively to a corrective disclosure, or that the defendant misstated or omitted the risks that did lead to a loss.[141]

134. *See* Wayne Borgeest & Melinda Margolies, *Analysis and Impact of Dura Pharmaceuticals, Inc., et al. v. Broudo, et al.*, Prof'l Liab. Underwriting Soc'y (July 2005).

135. 396 F.3d 161 (2d Cir. 2005).

136. In so holding, the Second Circuit clarified its earlier opinion in *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87 (2d Cir. 2001), which some courts and commentators have read as a rejection of the "materialization of risk" approach to loss causation.

137. *Lentell*, 396 F.3d at 173 (quoting *Suez Equity Investors*, 250 F.3d at 95) (emphasis added).

138. *In re* Merrill Lynch & Co., Inc., 273 F. Supp. 2d 351 (S.D.N.Y. 2003).

139. *Lentell*, 396 F.3d at 172–73.

140. *Id.* at 173.

141. *Id.* at 175.

In another pre-*Dura* case, *Fogarazzo v. Lehman Brothers, Inc.*,[142] the court held that in addition to alleging an external corrective disclosure followed by a drop in stock price, a plaintiff can allege loss causation where it alleges a market correction, i.e., "where ordinary market forces affect the rate of artificial inflation."[143] Similar to *Lentell*, *Fogarazzo* involved a securities fraud claim by investors against investment banks for issuing falsely optimistic research reports. The district court found that plaintiffs had adequately pled loss causation by pleading that a "number of events that operated, essentially, as disclosures or market corrections[,]" including the announcement of a restructuring charge and a write-down of earnings, ultimately led the defendant banks to drop coverage of the stock.[144] The district court called the defendant's decision to drop coverage the "ultimate disclosure."[145]

Post-*Dura*, it is unclear whether the Second Circuit will interpret *Lentell* as holding that a corrective disclosure is required to plead loss causation. It is also unclear whether allegations of market corrections qualify as corrective disclosures under Second Circuit law, especially in light of the U.S. Supreme Court's language in *Dura* indicating that market conditions may actually work against showing that a misrepresentation or omission caused the alleged economic loss.[146] In fact, Judge Scheindlin later qualified her opinion in *Fogarazzo* in *In re Initial Public Offering Securities Litigation*[147] by making a distinction between market manipulation cases and misrepresentation and omission cases, noting that the nature of artificial inflation in market manipulation cases is "different" and will inevitably dissipate over time.[148] Judge Scheindlin emphasized that in a misrepresentation and omission case, a failure to meet earnings forecasts has a negative effect on stock prices, but does not disclose the scheme, and therefore cannot have the corrective effect on artificial inflation that is necessary to allege loss causation.[149] Thus, it appears that the courts in the Second Circuit may be leaning toward a pleading rule that requires an external corrective disclo-

142. 341 F. Supp. 2d 274 (S.D.N.Y. 2004).

143. *Id.* at 292.

144. *Id.* (emphasis added).

145. *Id.*

146. *See* Dura Pharm., Inc. v. Broudo, 125 S. Ct. 1627, 1632 (2005) ("[A] lower [share] price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investors expectations, etc."). *But see In re* Parmalat Sec. Litig., 375 F. Supp. 2d 278, 306 (S.D.N.Y. 2005) (Judge Kaplan interpreted *Lentell* as holding that allegations of corrective disclosures may be "sufficient" to show loss causation, but they are not "necessary.").

147. 383 F. Supp. 2d 566 (S.D.N.Y. 2005).

148. *Id.* at 580 (quoting *In re* Initial Pub. Offering Sec. Litig., 297 F. Supp. 2d 668, 674 (S.D.N.Y. 2003)).

149. *Id.*

sure in order to show loss causation in misrepresentation and omissions cases.[150]

2. Holder Claims Under the Securities Litigation Uniform Standards Act of 1998 ("SLUSA")[151]

In 1998, Congress enacted SLUSA (1) to "prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than in Federal, court" and (2) to "implement a uniform law of securities fraud."[152] SLUSA's preemption and removal provisions apply where there is (1) a "covered class action"; (2) based on state or local law; (3) involving a "covered security"; and (4) which alleges either "misrepresentation or omission" of a material fact or use of a manipulative or deceptive device or contrivance "in connection with" the purchase or sale of that security.[153] Recent decisions have addressed the requirement that the claim arise "in connection with" the purchase or sale of a covered security, in relation to so-called Holder claims, where the plaintiff alleges that he or she was induced not to sell a security.

In *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[154] the Second Circuit held that (1) SLUSA preemption does not apply to claims alleging that a plaintiff held onto a security in reliance on alleged misrepresentations or omissions, but (2) SLUSA does preempt claims alleging that a plaintiff both purchased and held onto a security. The plaintiff was a former Merrill Lynch broker who alleged that he and other Merrill Lynch brokers relied on biased and misleading research and recommendations that were designed to tout the securities of companies whose investment banking business Merrill Lynch sought to obtain. He alleged that he lost clients and sought to bring a class action under state law. The case was removed and transferred to the U.S. District Court for the Southern District of New York. The court granted Merrill Lynch's motion to dismiss the complaint as preempted by SLUSA. The main dispute involved whether the alleged misrepresentations and omissions were "in connection with the purchase or sale" of securities within the definition of SLUSA.[155]

The Second Circuit first held that the phrase "in connection with" under SLUSA must be interpreted consistently with the usage of that term under

150. *See also* Collier v. Aksys, Ltd., No. 3:04CV1232(MRK), slip op. at 12 (D. Conn. Aug. 15, 2005) (rejecting plaintiff's argument that a "negative impact on the price of a stock after a corrective disclosure [as opposed to a market correction] is not the only way to demonstrate loss causation [in a misrepresentation or omission case]").

151. 15 U.S.C. §§ 77p, 78bb (2000).

152. *See* H.R. Conf. Rep. No. 105–803 (Oct. 9, 1998).

153. 15 U.S.C. § 78bb(f) (2000). *See* Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334, 1342 (11th Cir. 2002).

154. 395 F.3d 25 (2d Cir. 2005).

155. *Id.* at 34.

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The court reasoned that Congress intended to incorporate this meaning into the new statute to close a loophole in the PSLRA. The court next noted that the U.S. Supreme Court had previously held that standing to bring a Rule 10b-5 claim required that the plaintiff be an actual purchaser or seller of securities.[156] Merrill Lynch and the SEC both argued that the *Blue Chip* standing rule should not apply as a limitation on SLUSA preemption, because that rule was not part of the statute, but was developed by the courts. The court rejected this argument, stating that it was consistent with the purpose of SLUSA to adopt this purchaser-seller rule because it resulted in the preemption of those claims that could have been brought as federal securities fraud actions.[157] The court held that SLUSA preempted claims to recover damages incurred as a result of fraudulent inducement to both purchase and hold onto securities, but that it did not preempt a pure Holder case. The *Blue Chip* purchaser-seller rule was satisfied in *Dabit*, however, because the putative class was defined without distinguishing those who purchased securities after relying on misrepresentations and those who merely held onto their securities. As the putative class was not sufficiently defined into preempted and nonpreempted subclasses, the court dismissed the claims of the entire class, but remanded the case to the district court to allow the plaintiff an opportunity to replead.[158]

In *Kircher v. Putnam Funds Trust*,[159] the Seventh Circuit held that SLUSA did preempt claims that alleged investors held onto stock in reliance on misrepresentations or omissions. A putative class of mutual fund investors sued the defendant funds in state court alleging that the funds were liable for failing to prevent the arbitrageurs from exploiting the time differences in the various market's closings. The funds removed the lawsuit to federal court, and moved for dismissal under SLUSA. The district court denied the motion and remanded the lawsuit back to state court, but the Seventh Circuit reversed and remanded with instructions to dismiss the state law claims.

Like the Second Circuit in *Dabit*, the Seventh Circuit began with the proposition that the "in connection with" requirement should be construed consistently with Section 10(b) authorities. The Seventh Circuit held, however, that SLUSA preempted Holder claims because, although private plaintiffs could not recover under Rule 10b-5 on a Holder claim, the SEC could bring enforcement actions under Rule 10b-5 without showing a pur-

156. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).
157. *Dabit*, 395 F.3d at 43.
158. *Id.* at 44–47.
159. 403 F.3d 478 (7th Cir. 2005).

chase or sale. The court noted that the *Blue Chip* standard is limited to private plaintiffs[160] and concluded that it was consistent with Congress's intent in the enactment of SLUSA to require class action securities suits to be filed solely in federal court. The *Kircher* decision is in accord with an Eighth Circuit[161] decision and contrary to decisions by certain other courts.[162]

3. Primary Liability for Secondary Actors

In *In re Parmalat Securities Litigation*,[163] the U.S. District Court for the Southern District of New York addressed whether various banks were subject to private civil liability as primary violators of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 in connection with the collapse of an international dairy conglomerate. The plaintiffs were investors who alleged that the banks made representations and structured transactions that operated to defraud in violation of Section 10(b) and Rule 10b-5.[164] The banks argued that they merely structured or participated in transactions and that they did not make any misrepresentations, and that they therefore were, at worst, aiders and abettors not subject to private civil liability under Section 10(b).

The district court first found that, although *Central Bank* foreclosed the liability for aiding and abetting violations of Section 10(b) and Rule 10b-5, the decision did not change the scope of what conduct constituted a primary violation of Section 10(b) and Rule 10b-5. The district court found that the U.S. Supreme Court had specifically asserted that a bank that employed a manipulative device or made a misstatement could be held liable as a primary violator under Section 10(b) and Rule 10b-5. Thus, the district court found that the basic question was not whether the banks were aiders and abettors, but rather whether the conduct of the banks subjected them to private civil liability as primary violators of Section 10(b) and Rule 10b-5.[165]

The district court examined the language of Section 10(b) and found that it imposed primary liability on any person who directly or indirectly used or employed a manipulative or deceptive device or contrivance in-

160. *Id.* at 482–83.

161. Prof'l Mgmt. Assocs., Inc. Employees' Profit Sharing Plan v. KPMG LLP, 335 F.3d 800 (8th Cir. 2003) (rejecting argument that SLUSA does not apply to claims alleging damages incurred as a result of holding onto stock).

162. *See Dabit*, 395 F.3d at 25; Green v. Ameritrade, Inc., 279 F.3d 590 (8th Cir. Feb. 2002); Feitelberg v. Credit Suisse First Boston LLC, 2003 WL 22434098 (N.D. Cal. Oct. 24, 2003); Cape Ann Investors LLC v. Lepone, 2003 WL 22946491 (D. Mass. Oct. 24, 2003).

163. 376 F. Supp. 2d 472 (S.D.N.Y. 2005).

164. *Id.* at 480.

165. *Id.* at 498–99.

tended to mislead investors.[166] The court then looked at the conduct of the banks with respect to transactions involving regular factoring and securitization of worthless invoices. The court concluded that the banks had used deceptive devices or contrivances for the purposes of Section 10(b)[167] because they depended on a fiction, namely, that the invoices had value and it was impossible to separate the deceptive nature of the transaction from the deception actually practiced upon Parmalat's investors.[168] Taking the allegations of the complaint as true, the banks engaged in acts, practices, or courses of business with respect to the factoring and securitization transactions that would operate as a fraud or deceit upon others and thus fell within the conduct prohibited by Rule 10b-5 and Section 10(b).[169] The court found, however, that with respect to the allegations against the banks concerning transactions in which they made loans allegedly disguised as equity investments or assets, these transactions were not shams and did not depend on any fictions. In entering into these transactions, the banks did not use or employ a deceptive device or contrivance and, at worst, only assisted the fraud. Under *Central Bank* that conduct was not a basis for private liability and the complaint was dismissed as to those transactions.[170]

B. *Insurance Coverage Issues*

1. Rescission

In *Federal Insurance Co. v. Homestore, Inc.*,[171] the Ninth Circuit addressed an insurer's effort to rescind as to all insureds based on material misrepresentations in the applications for insurance. Homestore was appealing a summary judgment for the insurers declaring the D&O policies rescinded as to all insureds based on misrepresentations made in insurance applications. At issue was whether the misrepresentations in the company's recent quarterly report were material in the insurer's acceptance of the risk. The court began its analysis by noting that courts generally find that when an insurer demands answers in an application for insurance, that fact itself is usually sufficient to establish materiality.[172] The court noted that the pri-

166. *Id.* at 502 (citing *In re* Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161 (D. Mass. 2003)).

167. *Id.* at 503–04.

168. *Id.*

169. *Id.* at 505.

170. *Id.* The district court also looked at whether the banks could be liable for alleged misstatements or omissions in violation of Rule 10b-5(b). *Id.* at 512–15. The district court held that because the misstatements and omissions were not attributed to the banks, they ran afoul of the bright line test used by the Second Circuit. *Id.*

171. 144 Fed. Appx. 641 (9th Cir. 2005).

172. *Id.* at 646 (citing Thompson v. Occidental Ins. Co., 513 P.2d 353, 369 (Cal. 1973)); *see also* Jaunich II v. Nat'l Union Fire Ins. Co., 647 F. Supp. 209, 211 (N.D. Cal 1986) (holding that requested financial information was material because those very misrepresentations could ripen into claims covered by the policy).

mary carrier required that Homestore's most recent SEC filings be submitted as part of the application for insurance and specifically provided that the materials submitted with the policy constituted "representations." Thus, the court stated that the quarterly reports were indeed representations and noted that the policy specifically provided that representations "shall be deemed material to the acceptance of the risk or hazard" and that the policy was "issued in reliance upon the trust of such representations."[173] Accordingly, the court held that based upon the plain language of the contract, the then-CFO made material misrepresentations by submitting Homestore's most recent quarterly report.[174]

The court next addressed the district court's finding that the policy unambiguously provided that the insurers could rescind coverage "as to all Insureds" if one or more individuals signing the application had knowledge of material misrepresentations in the application. The Ninth Circuit concluded that the section regarding rescission anticipated rescinding coverage as to all insureds, including those without knowledge of misrepresentations, in the event of material misrepresentations by the signer. The clause provided that the policy would be void in its entirety if misrepresentations were known by one or more of the individuals who signed the policy. The court noted that the language "one or more" indicated that the number of insureds affected by a knowing misrepresentation of a single signer would consist of a greater number than just the signer. Further, the court noted that the phrase "in its entirety shall be void and of no effect whatsoever" described the subject "the Policy," further evidencing that there was no indication that the policy would be void as to only one individual.[175] Accordingly, the court ruled that because the policy language was clear and explicit, rescission of the policies "as to all Insureds" based upon the misrepresentations of the then-CFO was allowed.[176]

In *In re WorldCom, Inc., Securities Litigation*,[177] the U.S. District Court for the Southern District of New York held that an insurer's obligation to advance defense costs remains until there is a judicial determination that the insurer is entitled to rescind. WorldCom and its directors and officers were insured under a primary policy and also under seven excess policies. The excess carriers all argued that their policies were void ab initio and sought to rescind coverage as to the company and its directors and officers. The policies did not contain severability of the application or representations provisions. The first excess carrier informed WorldCom that, based on material misrepresentations and omissions in the financials submitted

173. *Federal Ins. Co.*, 144 Fed. Appx. at 646.
174. *Id.*
175. *Id.* at 647.
176. *Id.* at 648.
177. 354 F. Supp. 2d 455 (S.D.N.Y. 2005).

with the application, it considered the policy rescinded. The carrier asserted that New York law required that a director prove that he that could defeat the carrier's rescission claim before it could be required to pay defense costs. A former chairman of the board of directors filed a declaratory judgment against the excess carriers, seeking a determination that the purported rescission of the first excess policy was without good or sufficient cause and that the carriers were obligated to advance defense costs.

The matter was addressed on the director's motion for a preliminary injunction. The court held that to obtain a preliminary injunction the director was not required to show that he would succeed in defeating the carrier's rescission argument. Rather, the court stated that all the director had to demonstrate was a sufficiently serious question going to the merits to make it a fair ground for litigation and that the balance of hardships tipped decidedly in his favor.[178] The court stated that the director needed only to show that under the terms of the policy he was entitled to payment of defense costs and that the insurer's obligation continued until the rescission issue was resolved. The court found that the director had met his burden and that the carriers were not entitled to avoid their obligations to pay defense costs by unilaterally declaring the policies void ab initio. The court relied upon the policy language, which provided that "the Insurer shall . . . advance Defense Costs Payments prior to the final disposition of a claim."[179]

The court further held that the director satisfied his burden of showing that he would suffer irreparable harm unless the injunction was issued. The court noted that the class action securities lawsuit was near trial and that the director was in need of representation. Further, the court stated that the director was not required to show that he could not pay for defense counsel out of his own pocket and also noted that an adverse judgment could have ramifications beyond the money involved (i.e., damage to reputation). The court added, "D&O insurance is not only designed to provide financial security for the individual insureds, but also plays an important role in corporate governance in America. Unless directors can rely on the protections given by D&O policies, good and competent men and women will be reluctant to serve on corporate boards."[180]

2. "Related Wrongful Acts"

The typical D&O policy provides that related claims are all treated in the policy period in which the first such claim is made. In this context, courts

178. *Id.* at 463.
179. *Id.* at 466.
180. *Id.* at 469–70.

have construed the meaning of "related" with divergent results.[181] Key factors considered in assessing the relationship between claims or conduct are whether the acts are connected by "time, place, opportunity, pattern, and most importantly, method or modus operandi."[182]

In *Highwoods Properties, Inc. v. Executive Risk Indemnity, Inc.*,[183] the Eighth Circuit held that two lawsuits that challenged different aspects of the same merger transaction were "related" claims. The first suit, filed before the merger, sought to enjoin the transaction. The insurer denied coverage because the D&O policy in effect at that time had no entity coverage. After the merger, another shareholder filed suit for damages. By that point, a new D&O policy was in effect, with entity coverage for securities claims. The insurer denied coverage, however, on the grounds that the second suit was related to the first suit and the claims asserted were not first made within the second policy period.

At the outset, the court considered whether the first case constituted a "claim" under the definition used in the second policy. The court stated that the definition of a claim broadly encompassed both proceedings against directors and officers and proceedings against the entity itself. The court concluded that the first suit was a securities claim as defined in the second policy because it was brought against Highwoods as an entity and alleged breach of fiduciary duty in connection with the merger.[184] The fact that the first case did not constitute a claim under the first policy was of no consequence. Next, the court considered whether the second suit was sufficiently related to the first suit so as to make them a single claim for coverage purposes. The second policy defined "related claims" as "all claims for Wrongful Acts based on, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving the same or related facts, circumstances, situations, transactions or events or the same or related series of facts, circumstances, situations, transactions or events."[185] In determining the common meaning of the term "related," the court explored several definitions, including "connected by reason of an established or discoverable relation." The court stated that "relation" meant "an aspect or quality (as resemblance) that connects two of more things or parts as

181. *E.g.*, Gateway Group Advantage, Inc. v. McCarthy, 300 F. Supp. 2d 236 (D. Mass. 2003) ("logical or causal connection"); Bay Cities Paving & Grading Inc. v. Lawyers Mut. Ins. Co., 855 P.2d 1263, 1275 (Cal. App. 1993) (defining related wrongful acts to mean "logically or causally connected"); Gregory v. Home Ins. Co., 876 F.2d 602, 606 (7th Cir. 1989) (logically connected).

182. Nat'l Union Ins. Co. of Pittsburgh, P.A. v. Holmes & Graven, 23 F. Supp. 2d 1057 (D. Minn. 1998); Am. Commerce Ins. Brokers, Inc. v. Minn. Mut. Fire & Cas. Co., 551 N.W.2d 224, 231 (Minn. 1996).

183. 407 F.3d 917 (8th Cir. 2005).

184. *Id.* at 921–22.

185. *Id.* at 922.

being or belonging or working together or as being the same kind." "Series" was defined as "a number of things or events of the same class coming one after another in spatial or temporal succession."[186]

Applying these definitions, the court held that the suits were related claims because, although the two cases did not arise out of identical facts, they were grounded in actions taken by the defendants in relation to the merger. The plaintiffs were different and the legal theories were distinct, but both cases involved allegedly deceptive and incomplete communications to shareholders in connection with the same merger. The court concluded that there was only one claim and that it was first made prior to the start of the second policy period.[187]

3. "Insured v. Insured" Exclusion

Most D&O insurance policies contain an exclusionary provision known as the "Insured v. Insured" exclusion, which typically provides that the insurer is not liable for payment of loss in connection with any claim made against a director or officer brought by or on behalf of the company or another insured person. In the bankruptcy context, there has been a great deal of litigation as to whether this provision precludes coverage where claims are asserted against the directors and officers by a trustee or by some other entity than the company itself.

In *Stratton v. National Union Fire Insurance Company of Pittsburgh, PA*,[188] the court held that the "Insured v. Insured" exclusion applied to claims brought by a successor company following bankruptcy. The original insured under a 1997 D&O policy was Mariner Health Group, Inc. ("MHG"). In 1998, Paragon Post Acute Network, Inc. acquired MHG and changed its name to Mariner Post-Acute Network, Inc. ("MPAN"). In January 2000, MPAN and its subsidiaries commenced a reorganization proceeding under Chapter 11 of the Bankruptcy Code. The bankruptcy court approved a reorganization plan in which MPAN assumed MHG's remaining assets and liabilities and changed its name to Mariner Health Care, Inc. ("MHC"). MHC then sued a group of former MHG directors and officers.

The "Insured v. Insured" exclusion to the MHG D&O policy had been amended at the time of Paragon Post Acute Network's acquisition in 1998. As amended, Exclusion 4(i) of the policy provided, in relevant part, that the insurer would not be liable to make any payment for loss in connection with a claim made against an insured that was brought by any insured or by the company, Paragon Health Network, Inc., MPAN, or a successor

186. *Id.* at 924 (quoting The Merriam-Webster's Collegiate Dictionary (10th ed. 1998)).
187. *Id.* at 924–25.
188. 2004 WL 1950337 (D. Mass. Sept. 3, 2004).

company thereof.[189] The policy further defined "insured" as "any past, present or future duly elected or appointed directors or officers of the Company . . . or successor company thereof. . . ."[190] The insurer disclaimed coverage based on this exclusion. The directors and officers thereafter filed a declaratory judgment action seeking coverage. The primary issue was whether or not MHC was a successor to MHG or MPAN. The court granted summary judgment in favor of the insurer.

The court rejected plaintiffs' argument that the "Insured v. Insured" exclusion did not apply because MHC was not a successor to MHG or MPAN. The court found that it was clear that MHC was the successor of MPAN and MHG because (1) MHC restated and integrated MPAN's certificate of incorporation; (2) MHC retained MPAN's IRS number; (3) MHC established residence in MPAN's corporate headquarters; (4) MHC retained MPAN's key employees; (5) MHC assumed MPAN's remaining obligations; and (6) MHC took control over MPAN's assets and subsidiaries.[191]

In *Cirka v. National Union Fire Insurance Co. of Pittsburgh, PA*,[192] the Delaware Chancery Court held that the "Insured v. Insured" exclusion did not apply to a lawsuit brought by a creditors' committee against the corporation's directors. The insured, Integrated Health Services, Inc., filed a petition under Chapter 11 of the Bankruptcy Code. As debtor in possession, Integrated Health Services remained in control of the management and operation of the business. No bankruptcy trustee was appointed. In the bankruptcy proceedings, an Official Committee of Unsecured Creditors was formed. The creditors' committee demanded that Integrated Health Services allow the creditors' committee to sue Integrated Health Services' directors for breach of fiduciary duty based on the directors' approval of certain compensation agreements. When Integrated Health Services refused, the creditors' committee sought and obtained the bankruptcy court's permission to bring the suit on behalf of the bankruptcy estate.

The D&O policy insuring Integrated Health Services' directors contained an "Insured v. Insured" exclusion that barred coverage for claims brought by or on behalf of the company. "Company" was defined to include the debtor in possession. The exclusion also provided that it did not apply to claims brought by a bankruptcy trustee.[193] The exclusion did not expressly address its applicability to claims by a creditors' committee. The insurer denied coverage on the grounds that the creditors' committee was suing "on behalf of" Integrated Health Services in its capacity as debtor in possession.

189. *Id.* at *2.
190. *Id.*
191. *Id.* at *4.
192. 2004 WL 1813283 (Del. Ch. Aug. 6, 2004).
193. *Id.* at *2.

The court held that the exclusion did not apply to the suit brought by the creditors' committee, because the court order authorizing the suit provided that the suit was to be brought on behalf of the estate rather than on behalf of the debtor in possession. The court stated that the creditors' committee therefore did not act "on behalf of" the debtor in possession but rather on behalf of the estate. When the bankruptcy court permitted the creditors' committee to bring suit against the directors, the creditors' committee's standing was derivative in nature. Because it was derivative in nature, the creditors' committee did not sue on behalf of the debtor in possession, but instead sued on behalf of the estate. The suit was brought to enforce a right belonging to the estate, the court held. The creditors' committee obtained standing to bring a derivative claim from an order of the bankruptcy court in exercise of equitable powers, rather than from an assignment from the debtor in possession.[194]

194. *Id.* at *4–7.