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

Allen N. David, Susan E. Cohen, Michael P. Duffy, Jennifer Markowski, Sherry Y. Mulloy, Christopher A. Parady, Kathleen Santoro, Johannes S. Kingma, and John Rogers

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Allen N. David, Susan E. Cohen, Michael P. Duffy, Jennifer Markowski, Sherry Y. Mulloy, Christopher A. Parady, and Kathleen Santoro are attorneys at Peabody & Arnold, LLP, in Boston. Johannes S. Kingma and John Rogers are attorneys at Carlock, Copeland, Semler & Stair, LLP, in Atlanta.

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The following summary of recent developments affecting the liability of professionals, officers, and directors reviews significant decisions from 2005 and 2006. Specific areas of focus include the liability of attorneys, accountants, and directors and officers.

I. Legal Malpractice

Two issues figure prominently in the development of the law surrounding legal malpractice: judicial estoppel and the ability to assign a legal malpractice claim.

A. *Judicial Estoppel*

The equitable doctrine of judicial estoppel "prevents a party from asserting a position in a legal proceeding that is contrary to a position previously taken in the same or some earlier proceeding."[1] Judicial estoppel is intended "to maintain the integrity of the judicial system and to protect parties from opponents' unfair strategies."[2] Recent decisions demonstrate that in legal malpractice cases judicial estoppel may be applied defensively both to establish that a former client previously took a position contrary to the client's malpractice allegations and to prevent other parties from taking contrary positions before or after legal malpractice claims are raised.

In *Larson v. O'Donnell*,[3] a defendant successfully invoked the doctrine on a motion for summary judgment, resulting in the dismissal of the plaintiff's malpractice and breach of fiduciary duty claims against his former divorce attorney. The plaintiff instituted the malpractice action after his ex-wife successfully sued him for failure to pay the amount of child support and spousal maintenance owed pursuant to a divorce judgment that incorporated a marital settlement agreement. In his malpractice action, the plaintiff claimed that his misunderstanding concerning the amount he was required to pay his ex-wife was caused by his reliance on misinformation supplied by his divorce attorney. The Appellate Court of Illinois enumerated five

1. *See* 3 Ronald Mallen & Jeffrey Smith, Legal Malpractice § 21.15, at 211–12 (2006).
2. *E.g.*, Levin v. Ligon, 45 Cal. Rptr. 3d 560, 569 (Ct. App. 2006). *See* 3 Mallen & Smith, *supra* note 1, at 212, and cases cited at n.10.
3. 836 N.E.2d 863 (Ill. App. Ct. 2005), *appeal denied*, 844 N.E.2d 966 (Ill. 2006).

elements necessary for the application of the judicial estoppel doctrine: "(1) the party to be estopped must have taken two positions; (2) that are factually inconsistent; (3) in a separate judicial or quasi-judicial administrative proceeding; (4) intending the trier of fact to accept the truth of the facts alleged; and (5) have succeeded in the first proceeding and received some benefit from it."[4]

The court held that the plaintiff was judicially estopped from pursuing his claims against the attorney. The court observed that the record from the hearing for approval of the marital settlement agreement persuasively demonstrated that the plaintiff had affirmed that he understood his support obligations.[5] Accordingly, the court held that the plaintiff could not create a question of fact regarding his understanding of the settlement agreement by contradicting his previous position.

In *Meeks v. Dashiell*,[6] the Maryland Court of Special Appeals held that the denial of summary judgment was not an abuse of discretion where the attorney argued that his former client was judicially estopped from pursuing a malpractice action premised on the attorney's negligence in the preparation of a prenuptial agreement signed by the plaintiff thirteen years earlier. The court observed that the factors typically considered in Maryland and other jurisdictions in deciding whether to apply judicial estoppel in a particular case are those enumerated in *New Hampshire v. Maine*,[7] a 2001 U.S. Supreme Court decision. Those factors include (1) whether the party's later position was "'clearly inconsistent' with its earlier position"; (2) the party's success "in persuading a court to accept [the] party's earlier position, [such] that judicial acceptance of an inconsistent position in a later proceeding would create" the impression that "the first or second court was misled"; and (3) "whether the party seeking to assert an inconsistent position would derive an unfair advantage or impose an unfair detriment on the opposing party if not estopped."[8] In the malpractice action, the plaintiff claimed that

4. *Id.* (citing Barack Ferrazzano Kirschbaum Perlman & Bagelberg v. Loffredi, 795 N.E.2d 779, 784 (Ill. App. Ct. 2003)). Some courts have limited the doctrine to inconsistent factual positions, but others have also applied the doctrine to inconsistent legal positions or inconsistent positions involving mixed factual and legal issues. *See Levin*, 45 Cal. Rptr. 3d at 570, 581 (applying five-prong test enunciated in *Jackson v. County of Los Angeles*, 70 Cal. Rptr. 2d 96, 103 (Ct. App. 1997), similar to that in *Larson* but including the requirement that the party's prior position was not taken as a result of ignorance, fraud, or mistake).

5. *Larson*, 836 N.E.2d at 868.

6. 890 A.2d 779, 791–92 (Md. Ct. Spec. App. 2006).

7. 532 U.S. 742, 750–51 (2001).

8. *Meeks*, 890 A.2d at 793 (quoting *New Hampshire v. Maine*, 532 U.S. at 751, where the Supreme Court emphasized, "In enumerating these factors, we do not establish inflexible prerequisites or an exhaustive formula for determining the applicability of judicial estoppel. Additional factors may inform the doctrine's application in specific factual contexts.") (internal citations omitted). Some courts may be flexible regarding the necessity to prove that the party to be estopped was successful in maintaining the prior inconsistent position. *See* Cohoon v. IDM Software, Inc., 891 A.2d 552, 557 (N.H. 2005) (court applied judicial estoppel without deciding whether the doctrine always requires that there be success in the earlier case).

he did not know until he initiated divorce proceedings that his attorney had deleted a waiver of alimony clause in the agreement without the plaintiff's knowledge and had negligently advised him to sign the agreement without rereading it. In support of his judicial estoppel defense, the attorney presented evidence that the plaintiff had filed a motion for the court to declare the prenuptial agreement enforceable and had paid alimony to his ex-wife pursuant to the agreement. Although the appellate court concluded that the incomplete record of the divorce proceedings[9] did not persuasively demonstrate that the plaintiff's position in the malpractice action was altogether inconsistent with the client's position in the divorce action, its decision was without prejudice to the defendant's right to rely upon judicial estoppel as a defense pending a more fully developed record.[10] A lengthy dissenting opinion asserted that the court should consider the entire record in the divorce case even though it was not formally part of the summary judgment record. The dissent concluded that based on a review of the entire record, the plaintiff should be judicially estopped.[11]

Given the factors to be considered to invoke judicial estoppel successfully as a defense, a party relying upon the doctrine is not likely to succeed without proof beyond the pleadings. For example, in *In re Greater Southeast Community Hospital Corp.*,[12] judicial estoppel was raised defensively in an adversary proceeding brought against two law firms by the trustee of a liquidating trust established under the debtors' Chapter 11 bankruptcy plan of reorganization. The trustee claimed that the law firms negligently issued opinion letters regarding funding agreements that allowed the lenders to employ a Ponzi scheme overfunding the debtors and deepening their insolvency. The law firms' motion to dismiss was premised in part on the grounds that judicial estoppel barred the claims because the trust or its predecessor-in-interest knew of the claims, failed to disclose them before

9. The record included pleadings filed in the divorce action, the verified motion to enforce the prenuptial agreement, and the divorce case docket, together with the plaintiff's affidavit in opposition to the summary judgment motion explaining why he previously sought enforcement of the prenuptial agreement. *Meeks*, 890 A.2d at 783.

10. *Id.* at 792. Regarding the issue of whether the plaintiff's previous position was inconsistent, the court explained that although the plaintiff had previously accepted the benefits of the prenuptial agreement, the agreement limited his options concerning the payment of alimony; and the court suggested that his situation was analogous to a party who benefits from the settlement of litigation but is not foreclosed from suing the attorney for malpractice in connection with the settlement or conduct of the litigation. *Id.* at 794. The court also held that based on the record below concerning the time when the plaintiff claimed he first discovered the change in the prenuptial agreement, summary judgment was not warranted on the grounds that the statute of limitations had expired. *Id.* at 791.

11. *Id.* at 805–07. The dissent explained that a review of the entire record was necessary even though it was not presented to the lower court, to avoid a decision based on an incomplete and misleading record, "especially given that judicial estoppel is an issue the Court can raise and decide on its own, as it concerns the integrity of the legal system." *Id.* at 806–07.

12. 333 B.R. 506 (Bankr. D.D.C. 2005).

the liquidating plan was confirmed, and concealed the nature and scope of the claims in order to secure support for confirmation from creditors that would not benefit from the trust's distributions. The court ruled that the case was not ripe for application of judicial estoppel on a Rule 12(b)(6) motion to dismiss because the allegations in the complaint did not provide adequate support for the defendants' allegations.[13]

The judicial estoppel doctrine has also been invoked offensively based on an inconsistent position previously taken by the party to be estopped when that party was a legal malpractice plaintiff. In *Cohoon v. IDM Software, Inc.*,[14] the New Hampshire Supreme Court held that judicial estoppel precluded the defendant corporation from asserting a position in an investors' lawsuit seeking rescission of sales of unregistered securities that was inconsistent with the position taken by the corporation as a plaintiff in an earlier legal malpractice action. The corporation's malpractice action alleged that the attorneys' errors in registering shares of the corporation subjected the corporation to substantial exposure to shareholder claims for rescission. In connection with the defendant attorneys' motion in limine to exclude evidence of rescission damages in the malpractice action, the corporation persuaded the court that such evidence was admissible, after which the case settled. Without deciding whether judicial estoppel always requires that the party to be estopped succeed in the first action and without deciding how success should be defined for such purposes, the court determined that judicial estoppel should apply because there was sufficient proof that in the prior action an inconsistent position had been asserted and that the corporation had succeeded in persuading the court to accept its position.[15]

In *Levin v. Ligon*,[16] the California Court of Appeal held that judicial estoppel was properly invoked to bar the plaintiff from prevailing on a claim against his ex-wife and her employer that he was entitled to a share of his ex-wife's pension and other financial assets. The court based its decision on the fact that the plaintiff had previously brought and settled a malpractice action in England against his divorce lawyer in which he had alleged that the attorney neglected to advise him that his remarriage would divest him of rights in the same assets in which he now claimed an interest. The court rejected the plaintiff's contention that the settlement of the malpractice

13. *Id.* at 534.

14. 891 A.2d 552, 556–58 (N.H. 2005).

15. *Id.* at 557 (discussing different approaches taken by the courts concerning this factor and noting that the factors considered for application of judicial estoppel "are not fixed elements to be applied blindly in every case"). The court expressly rejected the corporation's contention that the doctrine requires a showing that the prior success of the party to be estopped induced the other party to take detrimental action. *Id.* at 556.

16. 45 Cal. Rptr. 3d 560, 581 (Ct. App. 2006).

action approved by the English court did not satisfy the requirement that he was successful in asserting a prior inconsistent position. In so ruling, the court held that the pivotal issue is whether the party succeeded in the first position or whether the position was a basis for, or important to, the settlement.[17] The court also rejected the contention that the plaintiff's positions in the two actions were not inconsistent. Specifically, the court observed that after receiving compensation in the legal malpractice proceeding on the basis of his declaration that he had lost the right to any interest in his ex-wife's financial assets, the plaintiff was seeking additional compensation in the instant lawsuit by claiming that he never lost his right to the very same assets and still owned them.[18] The court emphasized that application of the judicial estoppel doctrine to defeat the plaintiff's lawsuit served the important purpose of preventing the plaintiff from misleading the court and from seeking an unfair advantage by deliberately attempting to take advantage of inconsistent positions.[19]

B. *Assignment of Legal Malpractice Claims*

The majority of jurisdictions hold that legal malpractice claims are never assignable.[20] A minority has rejected this per se approach and addresses the issue on a case-by-case basis.[21] Several recent cases demonstrate the reluctance of courts to recognize the assignment of a legal malpractice claim.

In *Gurski v. Rosenblum & Filan, LLC*,[22] the Supreme Court of Connecticut held that the assignment of a legal malpractice claim to an adversary in the underlying action that gave rise to the legal malpractice claim is void as against public policy, but declined to adopt a bright-line rule that legal malpractice claims can never be assigned.[23] The case arose out of a medical malpractice action that a patient had brought against his podiatrist.[24] The patient successfully obtained a $152,000 default judgment against the podiatrist after both the podiatrist and his attorney failed to appear for multiple hearings.[25] A nondischargeable judgment was entered against the podiatrist during the pendency of his own previously filed bankruptcy.

17. *Id.* at 577.

18. *Id.* at 581 (observing that irreconcilable inconsistency between the plaintiff's present and prior positions was demonstrated by the allegations against his divorce attorney, as well as proof that in the malpractice action he had voluntarily dismissed his ancillary claim to the assets he sought in the current lawsuit).

19. *Id.* at 583.

20. *See generally* 1 Mallen & Smith, supra note 1, § 7.12.

21. *Id.*

22. 885 A.2d 163 (Conn. 2005).

23. *Id.* at 164.

24. *Id.* The attorney moved to withdraw from the case and notified the podiatrist of the date and time of the hearings and told him he would have to attend. The trial court entered a default judgment before ruling on the motion to withdraw. *Id.*

25. *Id.*

The podiatrist's assets were insufficient to pay the judgment. Eventually, the podiatrist and the patient agreed to a complete compromise of her claim in exchange for an assignment of the bankruptcy estate's legal malpractice claim against the law firm.[26] In accordance with the agreement, the podiatrist filed an action against the law firm alleging that its negligence and breach of contract led to the entry of judgment. The law firm asserted that the malpractice claim was invalid because it violated public policy.[27]

After a trial on the legal malpractice action in which the jury found for the podiatrist, the law firm moved to set aside the verdict and, thereafter, for judgment notwithstanding the verdict, arguing that as a matter of public policy it was improper for the podiatrist to assign his legal malpractice claim to his adversary in the underlying action.[28] The podiatrist argued that he did not assign his legal malpractice claim, only its proceeds, and therefore the assignment was valid.[29] The trial court agreed with the podiatrist and held that even where public policy prohibits the assignment of a legal malpractice claim, it does not prohibit the assignment of the proceeds from the legal malpractice action.[30] The law firm appealed.

On appeal, the court observed that numerous public policy issues are implicated when a legal malpractice claim is assigned to an adversary in the underlying action.[31] Specifically, allowing such an assignment would

> convert a legal malpractice action into a commodity; undermine the sanctity of the attorney-client relationship; result in decreasing availability of legal services to insolvent clients; impact negatively on the duty of confidentiality and further the commercialization of malpractice claims that in turn would spawn an increase in unwarranted malpractice actions.[32]

Based upon these public policy concerns, the court held that the assignment was improper, finding that "the assignment of a legal malpractice action to an adverse party in the underlying action creates a distortion that the profession cannot endure and thus should not tolerate."[33] The court rejected the podiatrist's contention that the assignment of the legal

26. *Id.* at 165. The bankruptcy court granted the podiatrist's motion to compromise subject to the following conditions: the podiatrist would (1) assign to the patient the bankruptcy estate's interest in the podiatrist's legal malpractice claim, (2) grant the patient a security interest up to the maximum amount of $152,000, (3) limit the patient's claim solely and exclusively to any recovery from the legal malpractice action, (4) authorize the estate to retain special counsel to prosecute the malpractice claim, and (5) subordinate the patient's right to recovery to special counsel's claim for attorney fees and expenses.

27. *Id.* at 166.

28. *Id.*

29. *Id.*

30. *Id.* at 166–67.

31. *Id.* at 169–70.

32. *Id.* at 175.

33. *Id.*

malpractice claim proceeds, rather than the claim itself, was permissible.[34] It held that the distinction between the assignment of a legal malpractice claim and the assignment of its proceeds was meaningless and had been made "merely to circumvent the public policy barring assignments."[35]

In *Kim v. O'Sullivan*,[36] the Court of Appeals of Washington similarly rejected a litigant's clever attempt to circumvent the general prohibition on the assignment of legal malpractice claims to an adversary in the underlying action by preparing an agreement providing that only the proceeds would be assigned to the adversary.[37] The case arose out of a bar fight after which the injured party sued the bar owners for his personal injuries. At one point during the litigation, the injured party demanded $200,000, which the bar owners rejected, relying on counsel's advice that the case was not worth that much. Sometime after the $200,000 demand expired, the bar owners came to believe that their attorney had drastically underestimated their exposure.[38]

The bar owners ultimately negotiated a $3 million settlement with the injured party in which they and the injured party agreed to entry of a $3 million judgment against the owners.[39] In exchange for the injured party's agreement that he would not enforce the $3 million judgment, the bar owners assigned the proceeds of their legal malpractice claims to the injured party.[40] The owners further agreed not to settle the claim without first consulting the injured party and agreed to use the injured party's attorney to pursue the legal malpractice action.[41]

The bar owners filed the legal malpractice action in their own name, and the defendant-attorney moved for summary judgment, arguing that the assignment of a legal malpractice claim to an adversary in the underlying matter violated public policy. The bar owners argued that the assignment was not barred because the legal malpractice was brought in their name, not in the assignee's name. Noting that the prohibition against the assignment

34. *Id* at 178.
35. *Id.* at 285 (citing Town & Country Bank v. Country Mut. Ins. Co., 459 N.E.2d 639 (Ill. App. Ct. 1984)).
36. 137 P.3d 61 (Wash. Ct. App. 2006).
37. *Id.* at 62.
38. *Id.* at 63.
39. *Id.*
40. *Id.* After the settlement was negotiated but before the bar owners filed the legal malpractice action, the Washington Supreme Court decided *Kommavongsa v. Haskell*, 67 P.3d 1068 (Wash. 2002), in which it held that an assignment of a legal malpractice claim to the adverse party in the underlying action was impermissible. *Id. Kommavongsa* directly impacted the parties' agreement because the bar owners had initially agreed to assign the claim rather than the proceeds of the claim. In order to avoid running afoul of the holding in *Kommavongsa*, the parties modified their initial agreement to reflect that the proceeds rather than the claim would be assigned. *Id.* at 64.
41. *Id.* at 64

of legal malpractice claims was not intended to "protect lawyers from the consequences of their own malpractice," the court explained that under some circumstances the proceeds from a legal malpractice action can be assigned to an adversary in the underlying action.[42] For an assignment of proceeds to be valid, however, the client must be the "real party in interest when the malpractice suit is litigated."[43] The court concluded that because the injured party and his attorney were in complete control of the malpractice action and because only the injured party would benefit from a settlement or judgment in the malpractice action, the bar owners were not the real parties in interest.[44] Thus, the assignment implicated the same public policy concerns as would an assignment of the claim itself.[45] Relying on the *Gurski* decision, the court concluded that the malpractice suit was barred as the assignment of proceeds was in reality an assignment of the legal malpractice claim.[46] The court left open the possibility that assignments of legal malpractice claim proceeds could be valid as long as the client remains the real party in interest while the litigation is pending.

The District Court of Appeal of Florida, faced with very different factual circumstances that did not trigger the typical public policy concerns, held that there was a factual basis for a valid assignment of a legal malpractice claim. *Security National Servicing Corp. v. Stern*[47] arose out of a mortgage foreclosure action that an attorney had handled for a mortgage lender.[48] The first lender in a long line of lenders who held the note and mortgage at issue filed a timely mortgage foreclosure action and then assigned the loan to a second lender.[49] The second lender retained an attorney who then filed a second untimely foreclosure action on the same note and mortgage.[50] The attorney negligently dismissed the first timely foreclosure action to pursue the second.[51] The loan was assigned to three subsequent lenders.[52] During the time the last lender held the loan, the untimely mortgage foreclosure action was dismissed because it had been filed beyond the statute of limitations.[53] The last lender brought a legal malpractice action against the

42. *Id.*
43. *Id.*
44. *Id.*
45. *Id.*
46. *Id.* at 64–65.
47. 916 So. 2d 934 (Fla. Dist. Ct. App. 2005). The Supreme Court of Florida has accepted jurisdiction and has docketed the matter as SC06–361. The court was scheduled to hear oral argument on November 3, 2006.
48. *Id.* at 936.
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.*

attorney for the second lender.[54] The attorney argued that there was a per se bar to the assignment of legal malpractice claims.[55]

Citing *Gurski*, the court noted that the "policy concerns are more readily apparent when the legal representations and assignment occur in a non-commercial setting, particularly when the assignment is made to a former adversary."[56] The court noted, "This latter situation, where a largely judgment-proof defendant assigns the right to sue his attorney to the successful plaintiff in exchange for a release, is generally recognized as the worst excess to be avoided."[57] The main policy concern that is raised by most legal malpractice assignment claims, namely, the creation of a market for legal malpractice claims, was not present in this case.[58] Given the absence of any significant policy concerns, the court held that the circumstances of this case presented one of the rare situations where an assignment of a legal malpractice claim was permissible.[59]

II. ACCOUNTING MALPRACTICE

Accounting malpractice in the news has been dominated by lurid charges of fraud in the creation and promotion of tax shelters. Meanwhile, the courts continue to develop a robust body of law governing accounting malpractice claims.

A. *Jurisdiction and International Firm Structure*

In *Deloitte & Touche Netherlands Antilles & Aruba v. Ulrich*,[60] a Texas court held that Deloitte Touche's overarching membership organization and a Caribbean member firm were both subject to jurisdiction in Texas.[61] Deloitte Touche Netherlands Antilles & Aruba ("DTNA") audited a foreign bank. Noting that (1) a major part of the bank's accounting work took

54. *Id.*

55. Before it reached the issue of whether the assignment was valid, the court first examined whether there was an attorney-client relationship between the attorney and the plaintiff lender, the existence of which would foreclose the need for an assignment. The lender argued that the validity of an assignment was irrelevant because it had an attorney-client relationship with the attorney when the cause of action accrued, i.e., when the appeal was completed. *Id.* at 936–37. The attorney, on the other hand, argued that it was not sufficient that the lender had an attorney-client relationship with the attorney at the time the cause of action accrued; the lender also had to "allege that a relationship existed between the parties with respect to the acts or omissions upon which the malpractice claim is based." *Id.* at 937. The court agreed with the attorney and went on to address whether the legal malpractice claim was one that could be assigned. *Id.*

56. *Id.* at 938.

57. *Id.*

58. *Id.* at 938–39.

59. *Id.*

60. 172 S.W.3d 255 (Tex. App. 2005).

61. *Id.* at 259.

place in Texas, (2) an auditor met with key bank personnel in Texas, and (3) internal controls testing took place in Houston, the court held that DTNA could reasonably anticipate suit in a Texas court.[62] A Swiss entity, Deloitte & Touche Tohmatsu ("DTT") is a membership association composed of individual accounting firms. DTT owns the name "Deloitte & Touche" and licenses it to individual firms. Because it borrows personnel from the American D&T firm and pays for the office space it uses in Houston to manage and advise member firms, DTT was also subject to the general jurisdiction of the Texas courts.[63]

B. *Liability for Interest Assessed by the Internal Revenue Service*

Another recurring issue is whether accountants are liable for interest assessed against their clients when the Internal Revenue Service finds they owe back taxes. Because the taxpayer has the use of the money before the IRS assesses a delinquency, some jurisdictions hold that the interest charged by the IRS does not constitute damages.[64] Others have refused to adopt an absolute bar.[65] Three recent decisions refused to bar the recovery of interest as a matter of law.

Where an accountant negligently prepared tax returns understating the taxpayer's liability, the South Dakota Supreme Court upheld a jury verdict awarding damages for the interest assessed by the IRS on the delinquent taxes.[66] The accountant argued that in order to pay the taxes, the client would have had to borrow money at a rate higher than the IRS charged. The taxpayer, however, came forward with evidence that he would have been able to borrow money from his family. Under these circumstances, there was a jury question as to whether the interest was an element of the taxpayer's damages.[67] On the other side of the country, a federal district court cited New Jersey's collateral source rule and held that a taxpayer can potentially recover interest charged by the IRS.[68] The court, however, noted that the accountant may be able to offset the damages by showing that the use of the money was a benefit to the taxpayer. Completing the triple play, another federal district court cited the recent South Dakota

62. *Id.* at 263–64.
63. *Id.* at 266–68.
64. O'Bryan v. Ashland, 717 N.W.2d 632, 636–37 (S.D. 2006) (collecting representative cases).
65. *Id.* at 637–38 & n.8 (collecting cases). A federal district judge characterized this split in authority as a "raging" debate. Amato v. KPMG LLP, No. 06cv39, 2006 WL 2376245, at *2 (M.D. Pa. Aug. 14, 2006).
66. *O'Bryan*, 717 N.W.2d at 639.
67. *Id.*
68. Carroll v. LeBoeuf, Lamb, Greene & MacRae, L.L.P., 392 F. Supp. 2d 621, 629–30 (S.D.N.Y. 2005).

decision as authority weighing persuasively in favor of a rule that recovery of interest depends on the facts and circumstances of the case.[69]

Under settled New York law, however, interest payments to the IRS "generally are not damages suffered by plaintiff but rather [are] payment to the IRS for his use of the money during the period of time that he was not entitled to it."[70] A New York trial court therefore dismissed claims against KPMG, noting that reimbursement of interest payments would place the taxpayers in a better position than they would have been but for the negligence alleged.[71]

C. *Tax Shelters*

Following the disallowance of tax shelters, both criminal and civil litigation has raged. The government has indicted some accountants in connection with tax shelters.[72] On the civil side, although many cases have settled and others have yielded procedural rulings,[73] relatively few cases have resulted in substantive reported decisions. One reported case involved an "Asian non-performing-loan strategy" rejected by the IRS and by the State of New Jersey.[74] In that case, an individual accountant had recommended the tax shelter before joining a firm. The plaintiffs sued, inter alia, the accountant and the firm that the accountant ultimately joined. Because the firm arrived on the scene after the taxpayers had already decided to invest in the tax shelter, the firm was not liable for damages arising from the initial investment decision; the loss of alternative tax-saving opportunities; or the resulting taxes, interest, and penalties.[75] The court did not, however, dismiss claims of negligence that arose after the firm began work for the taxpayer.[76]

In another tax shelter case, a New York court refused to allow the plaintiffs to circumvent the malpractice statute of limitations by converting

69. *Amato*, 2006 WL 2376245, at *6 (denying motion to dismiss claims for recovery of interest assessed by the IRS).

70. Rosenbach v. Diversified Group, Inc., No. 602463/2005, 2006 WL 1310656, at *6 (N.Y. Sup. Ct. May 10, 2006) (internal quotation marks omitted).

71. *Id.*

72. *See, e.g.*, United States v. Stein, 435 F. Supp. 2d 330, 374 (S.D.N.Y. 2006) (denying motion to dismiss indictment but finding that government improperly pressured accounting firm not to pay legal fees of indicted personnel).

73. *E.g.*, Becnel v. KPMG LLP, 229 F.R.D. 592, 598 (W.D. Ark. 2005) (denying class certification); Becnel v. KPMG LLP, 387 F. Supp. 2d 984, 986–87 (W.D. Ark. 2005) (denying motion to remand because legality of tax shelters presented a substantial question of federal law); Ng v. BDO Seidman, No. 04–434497, 2006 WL 864448, at *15 (Cal. Ct. App. Apr. 5, 2006) (enforcing most provisions of arbitration clause).

74. *See* Carroll v. LeBoeuf, Lamb, Greene & MacRae, L.L.P., 392 F. Supp. 2d 621, 624 (S.D.N.Y. 2005).

75. *Id.* at 627–28. The court noted that there was no allegation of a de facto merger between the individual accountant and the firm that would make the firm liable for what the accountant did before he joined.

76. *Id.* at 627.

their claim to an alleged breach of contract.[77] Finding that the taxpayers' claims against KPMG relating to an "option partnership strategy" were in essence malpractice claims, a trial court in New York dismissed the claims based on the applicable statute of limitations.[78]

D. *Liability for Fraud*

Courts draw a distinction between claims of negligence and intentional wrongdoing that is neither theoretical nor esoteric. This distinction often has substantive consequences. For example, in the case discussed above, at the same time the New York trial court dismissed tax shelter claims of professional negligence, it did not dismiss claims of fraud.[79] Because fraud requires proof of scienter, the fraud claims did not duplicate the untimely malpractice claims.

Despite a jury finding of negligence, the absence of fraudulent intent justified a directed verdict on fraud claims in an unpublished Ohio decision. Investors in an automobile leasing service argued that its financial statements were materially misstated, but the appellate court found no evidence that the accountants knew the financial statements were inaccurate or intended to mislead investors. "In fact, the plaintiffs' own expert . . . testified that the audits . . . were inadequate [but not necessarily] fraudulent." The expert chastised the accountants for their alleged lack of knowledge about the true financial condition of the leasing organization. Finding no evidence that the accountants intentionally overlooked material misstatements in the audit or intended to mislead investors, the appellate court affirmed the directed verdict on the plaintiffs' fraud claims.[80]

Where possible, courts may also seek to distinguish between intentional torts and negligence before trial at either the summary judgment or pleading stages. Although a Connecticut court found an issue of fact on professional malpractice claims, the court granted summary judgment on fraud claims because the plaintiff came forward with no evidence that the accountants intentionally misled the plaintiff or knew any representations were false.[81] These decisions show that accountants can get judgment as a matter of law on claims of intentional wrongdoing even though claims of negligence or malpractice may succeed.

77. Rosenbach v. Diversified Group, Inc., No. 602463/2005, 2006 WL 1310656, at *4 (N.Y. Sup. Ct. May 10, 2006).

78. *Id.* The court also dismissed claims for promissory estoppel and claims under consumer protection statutes that do not govern investment advice services. *Id.* at *5–6.

79. *Id.* at *5.

80. BFG Fed. Credit Union v. CU Lease, Inc., No. 22590, 2006 WL 544493, at *4–5 (Ohio Ct. App. Mar. 8, 2006).

81. Alliance Group Servs., Inc. v. Grassi & Co. CPAs, P.C., 406 F. Supp. 2d 157, 167 (D. Conn. 2005). The court also ruled that because there was a written contract over which the plaintiff could sue, the plaintiff had no claims for unjust enrichment, promissory estoppel, or conversion. *Id.* at 166, 169, 171.

At the pleading stage, courts will generally first look to Rule 9(b) of the Federal Rules of Civil Procedure, which requires plaintiffs to plead claims of fraud with specificity. Where applicable, courts will also invoke the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which requires plaintiffs to "specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading."[82] In addition, the PSLRA requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[83] These heightened pleading standards continue to generate reported case law.

For instance, applying PSLRA to a motion to dismiss, an Illinois federal judge found that the better part of a complaint stated claims against the accountants in *Waldock v. M.J. Select Global Ltd.*[84] The plaintiffs alleged that the accountants drafted, revised, and updated a mutual fund's performance records and included them in its offering documents. According to the complaint, the offerings failed to disclose that the fund's investments were illiquid. The court found these allegations sufficient to plead misstatements with the specificity required by the PSLRA.[85] The court also found the scienter requirement satisfied where the plaintiffs alleged that the accountants received documents showing that the fund was investing in illiquid securities and that commissions and referral fees gave them a motivation to commit fraud.[86]

E. *Duties to Third Parties*

Accountants often face claims from third parties, typically investors or creditors. Most jurisdictions follow § 552 of the *Restatement (Second) of Torts*, which provides that if a professional negligently supplies false information to others in his business transactions, he is subject to liability for pecuniary loss caused by the justifiable reliance on the false information. Such claims are known as negligent misrepresentation claims. A professional is liable under § 552 only if he or she "fails to exercise reasonable care or competence in obtaining or communicating the information" in question.[87] There are, however, important limitations on liability to nonclients. According to the *Restatement*, 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

82. 15 U.S.C. § 78u-4(b)(1) (2006).
83. 15 U.S.C. § 78u-4(b)(2).
84. No. 03 C 5293, 2005 WL 2978895 (N.D. Ill. Nov. 7, 2005). This is the latest in a series of reported decisions arising from claims against a Bahamian mutual fund.
85. *Id.* at *4–5.
86. *Id.* at *6–7.
87. Restatement (Second) of Torts § 552(1) (1977).

professional knows that the recipient intends to supply the information.[88] Liability is also limited to losses suffered "in a transaction that [the professional] intends the information to influence" or that the professional knows the recipient intends to influence.[89]

In *Stuart v. Freiberg, CPA*,[90] heirs brought negligent misrepresentation and malpractice claims against the accountants hired by the executor of their father's estate. A Connecticut trial judge ruled that an accountant who had contracted to provide services only to an executor had no duty—contractual or otherwise—to the beneficiaries. Accordingly, the court dismissed the complaint.[91]

F. *Imputation and the In Pari Delicto Doctrine*

Malpractice lawsuits frequently allege that auditors failed to detect wrongdoing by their clients' employees or officers. In response, accountants typically argue that the actions and knowledge of dishonest employees should be imputed to the audit client. Where corporate officers act on their own behalf and for their own benefit, courts usually will not impute knowledge of their dealings to the corporation.[92] There is an exception, however, to this rule.[93] If the officer is also acting for the corporation's benefit in the transaction, the law imputes knowledge of the transaction to the corporation even though the officer may have had some personal interest or benefit in it.[94] In general, these rules do not shield accountants who negligently fail to detect employee dishonesty.[95] Accordingly, where PricewaterhouseCoopers allegedly contracted to oversee the integrity of a scratch-off game operation, an employee's dishonesty was not necessarily imputed to the corporation. On this basis, the California Court of Appeal reversed a ruling dismissing negligence claims on a demurrer.[96]

Similarly, the New Jersey Supreme Court held that the imputation doctrine does not bar shareholders from suing auditors who negligently fail to uncover the fraud of corporate officers.[97] At the same time, the court acknowledged that auditors can raise imputation as a defense to claims by

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88. *Id.* § 552(2)(a). *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).

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

90. No. FSTCV040200508S, 2006 WL 1319816 (Conn. Super. Ct. Apr. 27, 2006).

91. *Id.* at *1–2.

92. Simon Mktg., Inc. v. PricewaterhouseCoopers, No. B175221, 2005 WL 2293031, at *4 (Cal. Ct. App. Sept. 21, 2005).

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at *5.

97. NCP Litig. Trust v. KPMG LLP, 901 A.2d 871, 873 (N.J. 2006).

shareholders who engaged in or knew about the wrongdoing.[98] The court reversed a trial court ruling granting a motion to dismiss negligence claims against KPMG, reasoning that KPMG had an independent contractual duty to detect the alleged employee fraud, and thus the imputation doctrine would not prevent the case from proceeding to discovery.[99]

Similar to the imputation doctrine, the in pari delicto doctrine may also bar claims arising from employee dishonesty. *In pari delicto* literally means "in equal fault."[100] The doctrine typically prevents a wrongdoer from suing a co-conspirator or accomplice.[101] Thus, where a bankruptcy trustee asserted that the board chairman, CEO, and managing directors all knowingly issued financial statements that overstated earnings, the in pari delicto doctrine barred his audit malpractice claims.[102] Because they were allegedly overstating the company's earnings for the company's benefit and not necessarily for their own, the adverse interest exception did not prevent application of the in pari delicto doctrine.[103]

G. *Proving Proximate Cause*

Accounting malpractice plaintiffs often claim negligence caused a series of business setbacks. In these cases, courts have to decide the sufficiency of the causal connection between the damages claimed and the negligence alleged. The Mississippi Supreme Court found the link too attenuated in *Webb v. Braswell.*[104] In *Webb*, an accountant had helped farmers obtain crop loans. When banks refused to extend them additional loans, the farmers sued the accountant, claiming the farm failed because the accountant did not advise them to seek financing from other sources. The farmers claimed their business failed for want of financing. The court, however, found no evidence that the farmers could have obtained funding from any alternate source. Thus, their negligence claims failed for lack of causation.[105]

Lack of proximate cause also proved fatal for claims of actuarial malpractice. A board of trustees sued an actuarial firm engaged to determine the rate of contribution necessary to fund a policemen's and firemen's retirement fund. The board claimed that the firm inaccurately estimated health

98. *Id.*
99. *Id.* at 882.
100. Baena v. KPMG LLP, 453 F.3d 1, 6 (1st Cir. 2006) (citing Black's Law Dictionary 791 (6th ed. 1990)).
101. *Id.*
102. *Id.* at 7–8.
103. *Id.* Applying Massachusetts law, the First Circuit declined to import the "innocent decision-maker" exception adopted by some trial courts in the Second Circuit. *Id.* at 8. Under the innocent decision-maker exception, the in pari delicto doctrine may not bar claims where innocent management personnel could have prevented the harm if the auditors had called it to their attention.
104. 930 So. 2d 387 (Miss. 2006).
105. *Id.* at 396.

care costs. However, the board did not have complete control over the funding rate, which had to be negotiated with the city. Thus, even if the firm had negligently estimated the health care costs, there was no evidence that the board would have been able to increase the funding rate. Summary judgment against the board resulted.[106]

H. *Statutes of Limitation*

Several recent cases addressed the often difficult issue of what triggers the commencement of a statutory period of limitation.

A number of states use a discovery rule, where the statute does not start running until the plaintiff learns or should have known about the malpractice. In a case involving claims that a banker stole funds, the statute started running when the plaintiffs and other creditors received a liquidator's report that mentioned the possible existence of claims against the auditors. [107] Even though the report did not certify that claims were viable, the possibility of claims put the plaintiffs on inquiry notice.

A bright line does not always mark the date on which the statute starts to run. As a recent Illinois accounting malpractice case shows, the commencement of the statute may be an issue of fact. In the case, the accountants argued that when they withdrew from the engagement, the clients could have sued to recover the fees they paid; and thus the statute started running on any claim the plaintiffs had in connection with the audit services. The Appellate Court of Illinois cast doubt on this argument, although it did not conclusively resolve when the statute began to run.[108] Instead, the court found that the accountants' affidavits did not show that the clients had a cause of action when the accountants terminated the engagement. In fact, the accountants claimed they had performed their contractual obligations, suggesting that no breach of contract claims arose at all.[109] Accordingly, the court found an issue of material fact as to when the statute began to run.

106. Bd. of Trs. of the Fire & Police Retiree Health Fund v. Towers, Perrin, Forster & Crosby, Inc., 191 S.W.3d 185, 191–92 (Tex. App. 2005). The court distinguished *Greenstein, Logan & Co. v. Burgess Marketing, Inc.*, 744 S.W.2d 170 (Tex. App. 1987), on which the plaintiffs relied. In *Greenstein*, there was a jury question on causation because the plaintiff came forward with evidence that it would have been able to make different management decisions had it known of the underpayment overlooked in an audit. By contrast, there was no evidence that the board in *Towers* could have made the necessary changes.

107. Donnybrook Invs., Ltd. v. Arthur Andersen LLP, No. 05 C 4883, 2006 WL 1049588, at *3 (N.D. Ill. Apr. 20, 2006). The court granted summary judgment, finding the claims time-barred. *Id.*

108. MC Baldwin Fin. Co. v. DiMaggio, Rosario & Veraja, LLC, 845 N.E.2d 22, 33 (Ill. Ct. App. 2006) (suggesting that when the plaintiffs lost their contractual relationship with another entity, allegedly as a result of accounting malpractice, there accrued a cause of action for malpractice separate from any claims that arose when the accountants terminated the engagement).

109. *Id.* at 34, 37.

What if accountants audit the same company's financial statements year after year? Does each audit start a new statute of limitations? Not automatically, according to a New York court. In a three-to-two appellate decision, the court reversed an order dismissing some of a liquidating trustee's accounting malpractice claims.[110] The trustee alleged that the auditors failed to recognize that a hedge fund manager "used an improper method for valuing the portfolio's securities." Each year, the auditors allegedly used as their starting point the inflated valuations from the prior year. Because the facts could conceivably justify application of the continuous representation doctrine, the majority concluded that it was premature to dismiss the trustee's claims. The majority explained,

> [T]he yearly signing of a new audit agreement and the yearly delivery of a final audit report does not alone establish as a matter of law that each year's audit was a separate and discrete event. To rely upon those documents in this manner would place too much weight on formalities and too little on the complexities of modern-day auditing and accounting work.[111]

Auditors should heed this warning before relying blindly on work from prior years.

I. *Expert Witness and Expert Affidavit Requirements*

Many states require a pretrial expert affidavit to support a malpractice claim,[112] and expert testimony is almost always necessary to prove malpractice at trial. Failure to satisfy these requirements can be fatal to an accounting malpractice lawsuit. The Minnesota Court of Appeals affirmed dismissal of accounting malpractice claims where the plaintiffs failed to provide a testifying expert's affidavit upon the defendants' request.[113] The court did not, however, affirm dismissal of claims for breach of contract, breach of fiduciary duty, and restitution because they could conceivably survive without expert testimony.[114] Where the plaintiff did not serve its expert's report until well after the close of discovery and past the deadline of Federal Rule of Civil Procedure 26(a)(2)(C), a federal judge in Michigan excluded the plaintiff's expert and granted summary judgment on the accounting malpractice claim.[115]

110. Williamson v. PricewaterhouseCoopers LLP, 817 N.Y.S.2d 61, 65 (App. Div. 2006).
111. *Id.* at 64.
112. *E.g.*, O.C.G.A. § 9–11–9.1 (2006).
113. Brown-Wilbert, Inc. v. Copeland Buhl & Co., P.L.L.P., No. A05–340, 2005 WL 3111959, at *3 (Minn. Ct. App. Nov. 22, 2005), *review granted* (Minn. Feb. 14, 2006).
114. *Id.*
115. Automatic Logistics Productivity Improvement Sys., LLC v. UHY Advisors, Inc., No. 05–73851, 2006 WL 2039992, at *5 (E.D. Mich. July 19, 2006).

J. *Destruction of Work Papers*

Although it now goes almost without saying that accountants should take care to preserve their files when they learn of a claim, under certain circumstances the destruction of files may not lead to evidentiary sanctions.[116] When defendant accountants allegedly destroyed workpapers spanning the years 1972–1993, a New York trial judge barred the defendants from introducing evidence of discussions with the plaintiff to show that he had been aware of the very fraud allegedly giving rise to his claims. The appellate division reversed the trial court's ruling, finding that there was no showing that the accountants' alleged spoliation of evidence was willful, deliberate, or contumacious.[117] In so holding, the appeals court emphasized that the plaintiff had failed to show that the destroyed documents were "essential physical evidence."[118]

K. *Exculpatory Clauses*

A federal judge in Savannah enforced an exculpatory clause and granted a posttrial judgment as a matter of law in favor of accountants who audited a closely held corporation. Specifically, the court addressed an exculpatory clause that absolved the auditors from "consequential, indirect, lost profit or similar damages . . . except to the extent finally determined to have resulted from . . . willful misconduct or fraudulent behavior."[119] At trial, the jury found there was no gross negligence. As a result, the court enforced an exculpatory clause despite the plaintiffs' objections that it violated public policy.[120]

Exculpatory clauses, like the one above, could protect accountants from speculative and sizable claims for business losses in connection with an audit. The American Institute of Certified Public Accountants ("AICPA"), however, has issued a proposed interpretation of its Ethical Rule 101 that could limit accountants' freedom to include exculpatory clauses in their audit engagement letters. Under Proposed Interpretation 101-16, the AICPA would consider that a provision limiting or eliminating liability for actual damages unacceptably impairs an auditor's independence.[121]

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116. Kerman v. Martin Friedman, C.P.A., P.C., 801 N.Y.S.2d 387 (App. Div. 2005).

117. *Id.* at 389.

118. *Id.*

119. TSG Water Res., Inc. v. D'Alba & Donovan CPAs, P.C., 366 F. Supp. 2d 1212, 1232–33 (S.D. Ga. 2004), *appeal docketed*, No. 06-11803-II (11th Cir. Mar. 28, 2006).

120. TSG Water Res., Inc. v. D'Alba & Donovan CPAs, P.C., No. 402-CV-258, slip op. at 9–13 (S.D. Ga. Aug. 4, 2006).

121. Am. Inst. of Certified Public Accountants, Proposed Interpretation 101–16, Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters, Under Rule 101, Independence, in Professional Ethics Executive Committee Open Meeting Agenda, app. 2C at 7 (Aug. 10–11, 2006), *available at* www.aicpa.org/download/ethics/august_open_meeting_agenda.pdf.

Arbitration clauses, clauses requiring a losing party to pay attorney fees, or clauses prohibiting punitive damages, however, would not impair independence.[122] This proposal augurs ill for the future of damages limitation clauses.

Similarly, several federal agencies, including the Office of Thrift Supervision and the Federal Deposit Insurance Corporation, have issued an interagency advisory informing financial institutions that they should not enter into audit engagement letters that "incorporate unsafe and unsound external auditor limitation of liability provisions."[123] Among those labeled "unsafe and unsound" are provisions indemnifying auditors from claims by third parties, limiting liability, or limiting remedies other than punitive damages.[124] The Securities and Exchange Commission has long maintained that damages limitation clauses impair the independence of accountants auditing public companies.[125]

III. Corporate Directors and Officers

As litigation derived from various corporate scandals moves through the legal system, courts continue to face issues of director and officer liability as well as questions relating to insurance coverage for such liability.

A. *Liability of Directors and Officers*

1. Primary Violation Liability After *Central Bank*

In *Central Bank of Denver v. First Interstate Bank of Denver*,[126] the Supreme Court held that aiding and abetting liability for secondary actors is not available under § 10(b) of the Securities Exchange Act of 1934[127] and Rule 10b-5 promulgated thereunder. The Court, however, noted that secondary actors may still be held liable under some circumstances as primary violators of the statute. In *In re Parmalat Securities Litigation*,[128] the Southern District of New York further defined this standard in the context of banks. Specifically, the court held that primary liability may be imposed on a bank when the bank participates in a deceptive scheme by directly or indirectly employing a manipulative or deceptive device intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market. Since that time, there has

122. *Id.* app. 2C at 7–8.
123. Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 Fed. Reg. 6,847–901 (Feb. 9, 2006).
124. *Id.* at 6853.
125. Am. Inst. of Certified Pub. Accountants, *supra* note 121, app. B (citing Indemnification by Client, 3 Fed. Sec. L. Rep. (CCH) ¶ 38,335, at 38603–17 (2003)).
126. 511 U.S. 164 (1994).
127. 15 U.S.C. § 78j(b).
128. 376 F. Supp. 2d 472 (S.D.N.Y. 2005).

continued to be considerable litigation as to the extent of such potential primary liability.

In *Simpson v. AOL Time Warner*,[129] the U.S. Court of Appeals for the Ninth Circuit further elaborated the standard under which a secondary actor may be held liable as a primary violator of § 10(b) under the Supreme Court's ruling in *Central Bank*. In *Simpson*, the plaintiffs alleged that AOL and certain of its individual directors and officers committed securities fraud by engaging in triangular transactions whereby Internet company Homestore.com would record revenues from its receipt of monies that came from its own cash reserves. The Ninth Circuit stated,

> [W]e see no justification to limit liability under 10(b) to only those who draft or edit the statements released to the public. To the contrary, 10(b) prohibits any person or entity from using or employing any deceptive device, directly or indirectly, in connection with the purchase and sale of securities.[130]

The court further stated that when determining whether a defendant can be held liable as a primary violator, the conduct of each defendant must be viewed alone for whether it had the "purpose and effect of creating a false appearance of fact in furtherance of [an overall] scheme" to defraud.[131] The court, however, affirmed the dismissal of the action because the complaint did not allege that the defendants created sham business entities or engaged in deceptive conduct as part of illegitimate transactions.[132]

In *In re Enron Corp. Securities Derivative & "ERISA" Litigation*,[133] the court followed a similar analysis in holding that the plaintiffs failed to state a claim of primary securities law violations against Barclays Bank. The plaintiffs alleged that Barclays had provided financing to various straw entities created by Enron. The court echoed the *Simpson* court's statement that liability is not limited to those parties who make an allegedly fraudulent statement. The court, however, concluded that the fraud was in Enron's accounting for the loan transactions in question, not in the loans themselves. Finding that Barclays was at most an aider and abettor, the district court concluded, "Under *Central Bank*, of course, that is not a basis for private civil liability."[134]

2. Loss Causation After *Dura Pharmaceuticals*

In *Dura Pharmaceuticals, Inc. v. Broudo*,[135] the Supreme Court held that in order to adequately plead loss causation under a § 10(b) securities fraud claim, a plaintiff cannot merely allege that he purchased securities at a price that

129. 452 F.3d 1040 (9th Cir. 2006).
130. *Id.* at 1049.
131. *Id.* at 1050.
132. *Id.* at 1052.
133. 439 F. Supp. 2d 692 (S.D. Tex. 2006).
134. *Id.* at 719.
135. 544 U.S. 336 (2005).

was inflated because of misrepresentations by defendants. From a purely logical point of view, buying at an inflated market price does not necessarily lead to damages when the buyer can still sell at the inflated price. Under *Dura*, the plaintiff must show an actual causal connection between a defendant's misconduct and the plaintiff's damages. *Dura* thus heightened the pleading requirements for loss causation and makes it more difficult for plaintiffs to prove damages.

Since *Dura*, courts have disagreed as to the extent to which plaintiffs must show that an immediate drop in stock price followed a corrective disclosure in order to establish the necessary causal connection.[136] In *In re Bradley Pharmaceuticals, Inc., Securities Litigation*,[137] a federal district court rejected the argument that a specific corrective disclosure was required and held that loss causation was adequately pleaded where revelation of the truth did not take the form of a single, unitary disclosure but occurred through a series of disclosing events.[138] In the *Enron* case, the district court adopted a similar approach in holding that disclosure of the fraudulent conduct can be gradual and partial and need not be by corrective disclosure.[139]

3. Holder Claims Under the Securities Litigation Uniform Standards Act of 1998

In 1998, Congress enacted the Securities Litigation Uniform Standards Act ("SLUSA")[140] (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."[141] SLUSA's preemption and removal provisions apply where there is a "covered class action" (1) based on state or local law, (2) involving a "covered security," and (3) that 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.[142]

136. *See e.g.*, *In re* TECO Energy, Inc., 2006 WL 845161 (M.D. Fla. Mar. 30, 2006) (to sufficiently plead loss causation, a plaintiff must allege a disclosure or revelation of truth about a defendant's prior misstatement or omission that is in some way connected with a stock price drop); Catton v. Def. Tech. Sys., Inc., No. 05 CIV. 6954, 2006 WL 1716862 (S.D.N.Y. June 20, 2006); *In re* Bradley Pharms., Inc., Sec. Litig., 421 F. Supp. 2d 822 (D.N.J. 2006); Freeland v. Iridium World Commc'ns, Ltd., 233 F.R.D. 40 (D.D.C. 2006).

137. 421 F. Supp. 2d 822 (D.N.J. 2006).

138. *Id.* at 828.

139. *See In re* Enron Corp. Sec. Derivative & ERISA Litig., 439 F. Supp. 2d 692, 723 (S.D. Tex. 2006).

140. 15 U.S.C. §§ 77p, 78bb (2000).

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

142. 15 U.S.C. § 78bb(f) (2000). *See* Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334, 1342 (11th Cir. 2002).

Two recent conflicting circuit court decisions 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. The Second Circuit held that (1) SLUSA preemption did 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.[143] Taking a contrary position, the Seventh Circuit held that SLUSA did preempt claims that alleged investors held onto stock in reliance on misrepresentations or omissions.[144] Given the conflict between the circuits, the Supreme Court agreed to review the decision of the Second Circuit.

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*,[145] the Supreme Court held that the background, text, and purpose of SLUSA's preemption provision all support the broader interpretation adopted by the Seventh Circuit; namely, the statute preempts state law security class action claims even if federal law provides no private remedy.[146]

In *Dabit*, 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. Alleging that he lost clients, he sought to bring a class action under state law. In support of its decision, the Second Circuit stated that, as used in SLUSA, fraud is only "in connection with the purchase or sale" of securities if it is alleged by a purchaser or seller of securities. Given that the brokers were "fraudulently induced, not to sell or purchase, but to retain or delay selling [the] securities," the Second Circuit found that the plaintiff's claim "fell outside SLUSA's preemptive scope."[147]

In a unanimous decision authored by Justice Stevens, the Supreme Court addressed the Second Circuit's interpretation of the purchaser-seller requirement in the *Blue Chip Stamps v. Manor Drug Stores* case.[148] The Court rejected the Second Circuit's analysis by reasoning that the purchaser-seller standing limitation adopted in *Blue Chip Stamps* was not based on the meaning of the "in connection with the purchase or sale" language of Rule 10b-5, but rather on "policy considerations" that "purported to define the scope of a private right of action under Rule 10b-5."[149] The Court

143. Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25 (2d Cir. 2005).
144. Kircher v. Putnam Funds Trust, 403 F.3d 478 (7th Cir. 2005).
145. 126 S. Ct. 1503 (2006).
146. *Id.* at 1507.
147. *Id.* at 1508.
148. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).
149. *Dabit*, 126 S. Ct. at 1512.

noted, however, that it has consistently interpreted the phrase *in connection with the purchase or sale of securities* broadly, requiring only deception "in connection with the purchase or sale of any security" and not deception of an identifiable purchaser or seller.[150] The Court further reasoned that there is a presumption that Congress envisioned a broad construction of the language in SLUSA because such a construction had been given to the same words under Rule 10b-5. It further noted that a more narrow reading would undercut the effectiveness of the 1995 Reform Act and run contrary to SLUSA's stated purpose of preventing "certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the 1995 Act."[151] The Court went on to state that adopting a narrow interpretation in the holder class actions context would be "odd, to say the least," given the "special risk of vexatious litigation" imposed by these types of class actions. Therefore, exempting them from SLUSA preemption would be "particularly troublesome."[152]

For these reasons, the Court held that the fraudulent manipulation of stock prices alleged by *Dabit* qualified as fraud "in connection with the purchase or sale" of securities and that the state law class action lawsuit was therefore preempted by SLUSA. The main effect of this decision is that, with very limited exceptions set forth in SLUSA, holder claims can no longer be maintained via class action litigation.

B. *Directors and Officers Insurance Coverage*

1. Prior Litigation and Related Wrongful Acts

Most directors and officers ("D&O") insurance policies contain an exclusion for claims related to prior litigation or to facts alleged in prior litigation. Recently, these provisions have been at issue in cases where directors were named in one class action lawsuit alleging securities law violations and in another alleging breach of fiduciary duty under Employee Retirement Income Security Act ("ERISA").

In *Federal Insurance Co. v. Raytheon Co.*,[153] the First Circuit held that coverage was not available for a 2004 ERISA class action that was related to a 1999 securities action. In *Raytheon*, a securities class action was filed in 1999 alleging that Raytheon failed to disclose to investors that it had "experienced cost overruns and was behind schedule on defense-related contracts." In May 2003, a second class action was filed against Raytheon and several of its officers and directors, this time asserting claims under ERISA. At the time of the ERISA case, "Raytheon was insured under a liability insurance

150. *Id.* at 1513.
151. *Id.* (internal quotation marks omitted).
152. *Id.* at 1514.
153. 426 F.3d 491 (1st Cir. 2005).

policy issued by Federal." The policy excluded coverage for any claim based upon prior litigation "or the same or any substantially similar fact, circumstance or situation underlying or alleged therein."[154] "[T]he factual allegations of the ERISA complaint were in many respects nearly identical to [those of] the Securities complaint, but in other respects were different."

The court of appeals stated that it could not reasonably give the wording of the Federal exclusion its broadest possible reading, under which any factual overlap at all would preclude coverage. Instead, the court adopted a "substantial overlap" test, under which coverage is precluded where there is a substantial, but not a complete, overlap with the prior complaint.[155] Applying this test, the First Circuit found that there was a substantial overlap between the allegations of the two cases and held that coverage for the ERISA action under the Federal policy was precluded notwithstanding factual differences between the cases (such as the presence of different parties).

The Second Circuit addressed a similar issue in *Zahler v. Twin City Fire Insurance Co.*[156] In *Zahler*, Loral Space & Communications Ltd. and certain of its officers were named as defendants in a securities class action filed in 2001. In 2003, Loral and several of its officers were named in an ERISA class action. At the time of the securities complaint, Loral was insured under a D&O policy issued by Twin City Fire Insurance Co. At the time of the ERISA complaint, Loral was insured under a D&O policy issued by Greenwich Insurance Co. Both insurers denied coverage for the ERISA case.

The Second Circuit first held that no coverage was afforded under the Greenwich policy due to an exclusion for claims reported under a prior policy. The policy first provided that all claims arising from "Interrelated Wrongful Acts" would be considered a single claim and then defined *Interrelated Wrongful Acts* broadly to include acts "in any way involving any of the same or related facts, series of related facts, circumstances, situations, transactions or events." Based on this definition, the court found an overlap in the allegations of the two cases sufficient to preclude coverage under the Greenwich policy. On the basis of similar, although slightly different Interrelated Wrongful Acts language in the Twin Cities policy, the court then held that the ERISA case related back to the prior securities case and therefore was covered under the Twin Cities policy.[157]

In *Pereira v. National Union Fire Insurance Co. of Pittsburgh, Pennsylvania*,[158] an insurer again sought to avoid coverage based on the Prior and Pending

154. *Id.* at 495.
155. *Id.* at 499.
156. 2006 WL 846352 (S.D.N.Y. Mar. 30, 2006).
157. *Id.* at *6–7.
158. No. 04 CIV. 1134 (LTS), 2006 WL 1982789 (S.D.N.Y. July 12, 2006).

Litigation exclusion. The court noted that its review of the complaints revealed a substantial, but not perfect, overlap in the factual allegations made. Despite finding this substantial overlap, the court did not grant the insurer's motion to dismiss the entire coverage action. Rather, the court stated that although it was clear that certain claims would be excluded from coverage, it could not be said that there were no circumstances under which the plaintiff could possibly recover on theories unrelated to the prior case.[159]

2. Insured Versus Insured Exclusion

Almost all D&O polices contain an exclusion providing that the policy does not afford coverage for lawsuits between insureds. This exclusion continues to be the source of much litigation.

One recurring issue involves application of the "insured vs. insured" exclusion where some, but not all, of the plaintiffs are insureds. In *Sphinx International, Inc. v. National Union Fire Insurance Co. of Pittsburgh, Pennsylvania*,[160] a former director initiated a securities class action lawsuit against the company. He then published a newspaper announcement soliciting additional plaintiffs and amended the complaint to add the group of shareholders who responded to his ad. The company's D&O policy provided, in pertinent part, that there was no coverage for claims brought "by or at the behest of . . . any DIRECTOR or OFFICER," which was defined to include former directors and officers. The court held that despite the presence of uninsured parties as plaintiffs, the insured vs. insured exclusion precluded coverage for the entire action. The court relied on the fact that the insured plaintiff had brought the suit by himself and then recruited the other plaintiffs. Additionally, the court relied on policy language providing that the exclusion applied to claims brought "by or at the behest of" an insured, as well as the lack of an allocation clause.[161]

In *Federal Insurance Co. v. Infoglide Corp.*,[162] the Western District of Texas addressed a similar issue but reached the opposite conclusion. There, two former officers of Infoglide, together with several additional parties, filed suit against the current directors and officers. Federal relied on the holding in *Sphinx International* to argue that coverage for the entire action should be precluded by the insured vs. insured exclusion. However, the district court distinguished *Sphinx International* and held that the exclusion barred coverage only for that portion of the case asserting claims on behalf of the insureds. The court relied on the fact that the noninsured plaintiffs were

159. *Id.* at *4.
160. 412 F.3d 1224 (11th Cir. 2005).
161. *Id.* at 1231.
162. 2006 WL 2050694 (W.D. Tex. July 18, 2006).

in the case from the outset and that the policy contained a provision for allocation of loss between covered and uncovered portions of the claim.[163]

Another recurring issue is the application of the insured vs. insured exclusion to claims brought by a bankruptcy trustee. In *Rigby v. Underwriters at Lloyd's, London*,[164] the insured corporation's bankruptcy trustee sued a former director of the corporation for negligence and breach of fiduciary duty. The former director sought coverage under the corporation's D&O policy. The policy had been renewed while the company was in bankruptcy, at which point the trustee had requested and received an endorsement listing him as an insured under the policy. Relying on this endorsement, the insurer denied coverage based on the insured vs. insured exclusion. The court, however, held that the exclusion did not preclude coverage because the lawsuit was not brought by the trustee in his capacity as an insured, but rather in his capacity as a Chapter 7 trustee.[165]

The Ninth Circuit also recently addressed whether coverage may be available for a suit brought by a bankruptcy trustee. In *Unified Western Grocers v. Twin City Fire Insurance Co.*,[166] the bankruptcy trustee of a former subsidiary of the named insured brought suit for breach of fiduciary duty, aiding and abetting, and civil conspiracy against individual directors and officers of the former subsidiary. The former subsidiary's directors were insured under the named insured's policy because their positions constituted "outside positions," as defined in the policy. However, the policy further provided that there was no coverage for claims brought by any director, officer, trustee, regent, governor, or employee of the former subsidiary. The insurer denied coverage on the grounds that this included claims brought by a bankruptcy trustee. Although acknowledging that this was a plausible reading of the policy, the court held that the word *trustee* was ambiguous in this context and construed the exclusion as not applicable to claims by a bankruptcy trustee.[167]

3. Public Policy Limitations on Insurability

Several recent cases continue the trend of finding it against public policy to insure against the disgorgement of ill-gotten profits. In *Vigilant Insurance Co. v. Bear Stearns Cos., Inc.*,[168] a New York court, relying on the proposition that one "may not insure . . . against the risk of having to return money"

163. *Id.* at *5–6. The court stated that it considered the decision of the Seventh Circuit in *Level III Communications, Inc. v. Federal Insurance Co.*, 168 F.3d 956 (7th Cir. 1999), to be more closely on point.

164. 907 So. 2d 1187 (Fla. Dist. Ct. App. 2005).

165. *Id.* at 1189.

166. 457 F. 3d 1106 (9th Cir. 2006).

167. *Id.* at 1117.

168. 814 N.Y.S.2d 566 (Sup. Ct. 2006).

improperly obtained, held that allowing such insurance would enable a "party to retain the proceeds of its wrongful acts" and "eliminate the party's incentive" to obey the law. The case involved a global settlement of regulators' claims regarding potential conflicts between Bear Stearns' research and investment banking divisions. Bear Stearns consented to the entry of a judgment that required Bear Stearns to pay $25 million as disgorgement of commissions. The court held that the insurers were not required to reimburse Bear Stearns for the $25 million disgorgement payment, stating that the fact "that these acts were not adjudicated at trial does not change the nature of the disgorgement payment."[169]

In *Pereira*,[170] a court relied on a similar public policy limitation on the insurability of disgorgement payments. Specifically, the *Pereira* court stated that insurance coverage was precluded as to judgments involving the restitution of ill-gotten gains or the return of property wrongfully in the possession of the defendant. The court noted, however, that only one of the insureds actually possessed the disputed funds. As such, the court allowed the insurer's motion to dismiss on public policy grounds only to the extent that the insureds sought coverage for the return of monies wrongfully obtained.[171]

In *Unified Western Grocers*,[172] the Ninth Circuit reiterated the rule that public policy precludes indemnification and reimbursement of claims that seek the restitution of an ill-gotten gain. The case involved an alleged conspiracy "'to loot [a corporate subsidiary] and strip it of its assets.'" The court noted, however, that the allegations and legal theories of the complaint did not necessarily restrict all recovery to restitution. The court held that the insurer was obligated to allocate between covered and uncovered losses and that a genuine issue of material fact precluded summary judgment.[173]

In *Waste Corp. of America, Inc. v. Genesis Insurance Co.*,[174] the court noted that similar public policy concerns would be implicated by insurance coverage for breach of contract claims. The case involved an alleged breach of a stock purchase agreement. The court observed that there was a strong public policy against insuring such claims because coverage would allow the insured to choose not to perform its contractual obligations with no economic consequences. Such a concept would eliminate all risk to the insured and would be "inimical to the [entire] concept of insurance." Despite these concerns, however, the court decided the case as a matter

169. *Id.* at 568.
170. *See* Pereira v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa., No. 04 CIV. 1134 (LTS), 2006 WL 1982789 (S.D.N.Y. July 12, 2006).
171. *Id.* at *3.
172. *See* Unified W. Grocers v. Twin City Fire Ins. Co., 457 F.3d 1106 (9th Cir. 2006).
173. *Id.* at 1115–16 (internal citations omitted).
174. 382 F. Supp. 2d 1349 (S.D. Fla. 2005).

of policy interpretation rather than as a matter of public policy. The court held that amounts due as a result of contractual obligations did not constitute a "loss" the insured was "legally obligated to pay as damages" and that the obligation to pay arose pursuant to the contract and not on account of a "wrongful act" as required under the policy.[175]

4. Rescission

In situations where an insured makes a misrepresentation in an application for D&O insurance, the insurer may seek to rescind the policy. There has been substantial litigation over the question of whether the company may rescind the policy even as to innocent directors and officers. In *TIG Insurance Co. of Michigan v. Homestore, Inc.*,[176] the chief financial officer of Homestore signed the application for insurance with knowledge that the materials he submitted to the carrier contained material misrepresentations. The insureds contended that the policy was ambiguous as to whether the insurer could rescind the policy as to the innocent insureds, who did not sign the application and were unaware of the misrepresentation. The California Court of Appeal held that TIG was entitled to rescind the D&O policy as to the company and all of the individual insureds. The court noted that severability provisions, under which rescission is limited to defined classes of actors, have become commonplace in the industry. The court relied on the fact that Homestore could have purchased such a provision by endorsement but apparently chose not to pay the additional premium.[177] The court further held that the false financial statements were material as a matter of law, rejecting the insureds' argument that there was a disputed issue of fact on this issue.[178]

In *Pereira*,[179] the court held open the possibility that an alleged misrepresentation not involving the company's financial statements might not be material. When the CEO of the insured signed the application for insurance, he stated that he was not aware of any acts, errors, or omissions that could give rise to a claim as to the relevant layer of the company's D&O coverage program. The court held first that there was a dispute as to the extent of the CEO's knowledge. In addition, however, the court stated that it was unable to rule on materiality in the context of a Rule 12(b)(6) motion to dismiss because, on the current record, it was unable to conclude as

175. *Id.* at 1357–58. The court stated that it found the First Circuit's holding in *Pacific Insurance Co. v. Eaton Vance Management*, 369 F.3d 584 (1st Cir. 2004), to be persuasive on this point.

176. 40 Cal. Rptr. 3d 528 (Ct. App. 2006).

177. *Id.* at 535–36.

178. *Id.* at 537–38.

179. *See* Pereira v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa., No. 04 CIV. 1134 (LTS), 2006 WL 1982789 (S.D.N.Y. July 12, 2006).

a matter of law that the insurers would not have provided coverage in the absence of such alleged misrepresentations.[180]

5. Attorney Fees as Damages

Some D&O policies define a covered claim as requiring a demand for damages. By doing so, they generally are deemed to exclude coverage for suits demanding purely injunctive or other nonmonetary relief. However, in a recent unpublished opinion, the Ninth Circuit held that coverage was available under a D&O policy where the plaintiffs sought nonmonetary equitable relief plus their attorney fees. In *National Casualty Co. v. Coastal Development Services Foundation*,[181] the D&O insurer sought a declaratory judgment that it need not indemnify its insureds. The policy defined *damages* to include a monetary judgment "and all costs taxed against the Insured." Holding that this language left the policy ambiguous as to whether a suit seeking attorney fees was a suit for damages, the court rejected the insurer's argument that attorney fees were only covered when ancillary to a claim for monetary damages. The court held that California law requires the ambiguity be resolved in favor of the insured when the insured's reading is objectively reasonable. Thus, the court held that coverage was triggered.[182]

180. *Id.* at *6.
181. 171 Fed. Appx. 680 (9th Cir. 2006).
182. *Id.* at 685–86.