

RECENT DEVELOPMENTS IN LAW
GOVERNING PROFESSIONALS',
OFFICERS', AND DIRECTORS' LIABILITY

*Allen N. David, Michael P. Duffy, Susan E. Cohen,
Sherry Y. Mulloy, Sharon S. Fry, Kathleen A. Papadeas,
Aisling A. Jumper, Jill Brannelly, John C. Rogers, and
Lindsey P. Hettinger*

I. Developments in Legal Malpractice	680
A. Expanding the Class of Plaintiffs Entitled to Sue for Legal Malpractice	680
B. Statute of Limitations—Principles Affecting Accrual of Cause of Action and Tolling of Limitations Period	684
II. Developments in Directors' and Officers' Liability and Insurance Coverage	688
A. Developments in the Law Regarding Liability of Corporate Directors and Officers	688
1. Pleading Scienter Under the Private Securities Litigation Reform Act of 1995 (PSLRA)	688
2. Pleading an Antitrust Conspiracy Through Allegations of Parallel Conduct	689
3. Fiduciary Duties in the Zone of Insolvency	690
4. Deepening Insolvency Claims	691

Allen N. David, Susan E. Cohen, and Michael P. Duffy are partners in the Boston office of Peabody & Arnold, LLP. Sharon Y. Mulloy is of counsel to Peabody & Arnold, LLP. Sharon S. Fry, Kathleen A. Papadeas, Aisling A. Jumper, and Jill Brannelly are associates in Peabody & Arnold, LLP. John C. Rogers is a partner in the Atlanta office of Carlock, Copeland & Stair, LLP and a member of the Professionals', Officers', and Directors' Liability Committee of the Tort, Trial, and Insurance Practice Section. Lindsey P. Hettinger is an associate with Carlock, Copeland, & Stair, LLP.

5. Scheme Liability Under § 10(b) of the Securities Act	692
6. Director Liability in Merger Transactions.....	693
B. Developments in the Law Regarding Directors' and Officers' Insurance Coverage	694
1. Disgorgement and the Definition of Loss	694
2. Consent to Settlement.....	695
3. Coverage for Breach of Contract Claims.....	696
4. Triggering the Excess Policy.....	698
III. Developments in Accounting Malpractice	699
A. Pleading Requirements.....	700
B. International Structure	700
C. Duties to Third Parties.....	701
D. Causation and Reliance	702
E. Proof of Damages	704
F. Liability for Interest Assessed by the IRS	705
G. Deepening Insolvency	705
H. <i>In Pari Delicto</i>	706
I. Statute of Limitations.....	707
J. Exculpatory Clauses.....	709
IV. Conclusion.....	710

I. DEVELOPMENTS IN LEGAL MALPRACTICE

A. *Expanding the Class of Plaintiffs Entitled to Sue for Legal Malpractice*

This past year saw a trend among the courts expanding the class of plaintiffs who are entitled to sue an attorney for legal malpractice to include an insurer that asserts a claim against counsel the insurer has assigned to represent its insured. Some courts held that the insured's attorney owes a duty of care not only to the insured, but also to the insurer, whereas other courts allowed the insurer to maintain the action under an equitable subrogation theory.

The U.S. District Court for the Southern District of California allowed an insurance company to sue its insured's attorney, holding that the attorney owed a duty of care to the insurance company as well as to the insured.¹ In *American Modern Home Insurance Co. v. Gallagher*,² the plaintiff insurer retained the defendant to represent its insured on a personal injury claim

1. *Am. Modern Home Ins. Co. v. Gallagher*, No. 06CV1157 JAH(RBB), 2008 WL 357120, at *4 (S.D. Cal. Feb. 7, 2008).

2. *Id.* at *1.

arising from an accident in which the claimant was rendered a quadriplegic.³ Before suit was filed, the claimant's attorney demanded the policy limits, and the insured's attorney responded that he needed to conduct a complete investigation of the claim but did not specifically respond to the demand.⁴ The claimant then withdrew the policy limits demand and filed suit against the insured, which was eventually settled for \$5.5 million.⁵

The insurer then sued the attorney it had assigned to represent the insured during the prelitigation period for legal malpractice and breach of fiduciary duty.⁶ The attorney moved for summary judgment on the grounds that he owed no duty to the insurance company with respect to settlement.⁷ The court rejected the attorney's argument that the receipt of the policy limits demand created a conflict of interest between the insurance company and the insured that nullified the attorney's duty to the insurance company in favor of the attorney's duty to the insured.⁸ The court also rejected the attorney's argument that he could not be held liable for failing to act with respect to the settlement demand because the duty regarding settlement falls squarely on the insurance company, which owes a nondelegable duty to its insured to settle the underlying claim within its policy limits.⁹ Because the attorney failed to present any authority or evidence supporting a finding that an attorney retained by an insurance company on behalf of an insured has a duty of care to the insurance company to act with respect to all legal issues except settlement, the court denied the attorney's motion for summary judgment.¹⁰

In *Querrey & Harrow, Ltd. v. Transcontinental Insurance Co.*, the Supreme Court of Indiana held that an excess insurer may bring an action for legal malpractice against the insured's attorneys under a theory of equitable subrogation.¹¹ The excess insurer, which had paid more than \$3.7 million as part of the settlement of a personal injury claim, sued the attorneys who represented its insured on a theory of equitable subrogation, contending that the attorneys were negligent by not timely raising a particular defense to the underlying claim.¹² The trial court denied the attorneys' motions for summary judgment, but the court of appeals reversed.¹³

3. *Id.*

4. *Id.*

5. *Id.* at *2.

6. *Id.* at *3.

7. *Id.*

8. *Id.* at *3 n.7.

9. *Id.* at *3.

10. *Id.* at *4.

11. 885 N.E.2d 1235, 1238 (Ind. 2008).

12. *Id.* at 1237.

13. *Id.*

Professing to follow the majority of states that have decided the issue, the Supreme Court of Indiana affirmed the decision of the court of appeals allowing the excess insurer to pursue its claim of legal malpractice against its insured's attorneys under a theory of equitable subrogation.¹⁴ The court observed that in order for the insurer to assert a right of subrogation, the insured must have a cause of action against the purported tortfeasor, and it must be equitable to allow the insurer to enforce a right of subrogation.¹⁵ The court found both elements were met.¹⁶ The court concluded that the proper allocation of the loss caused by attorney malpractice favored allowing the claim to proceed.¹⁷ Otherwise, attorneys who committed malpractice would enjoy a windfall merely because the insured contracted for excess insurance coverage.¹⁸ Moreover, immunity from suit by the insurer would place the loss for the attorney's malpractice on the insurer.¹⁹ The court noted, however, that any claim brought by an insurance company against its insured's attorney would have to be prosecuted without access to any confidential client information.²⁰

Similarly, in *Kumar v. American Transit Insurance Co.*, a New York court denied a motion to dismiss a legal malpractice claim brought by an insurer against its insured's attorney under a theory of equitable subrogation.²¹ In that case, assignees of the insured alleged that the insurer acted in bad faith by refusing to settle their claims against its insured for the policy limits, thereby rendering the insurer potentially liable for damages in excess of the policy limits.²² The insurer brought a third-party action against its insured's attorney, alleging that the attorney's failure to appear and defend the insured caused the damages sought by the plaintiffs.²³ The court rejected the attorney's argument that the principle of equitable subrogation did not apply because the insurer had not yet paid the loss of its insured.²⁴

A different result was reached in another New York case where the court held that an excess insurer could not maintain a suit for legal mal-

14. *Id. But see* State Farm Fire & Cas. Co. v. Weiss, No. 06CA2634, 2008 WL 4140593, at *3 (Colo. App. Sept. 4, 2008) (Roy, J.) (stating "the majority of jurisdictions that have addressed this issue, ten of sixteen . . . prohibit the equitable subrogation of professional negligence claims against attorneys").

15. *Querrey & Harrow*, 885 N.E.2d at 1237.

16. *Id.* at 1237-38.

17. *Id.*

18. *Id.* at 1238.

19. *Id.*

20. *Id.*

21. 854 N.Y.S.2d 274 (N.Y. App. Div. 2008).

22. *Id.* at 277.

23. *Id.* at 275.

24. *Id.* at 276.

practice against its insured's attorney.²⁵ In *Federal Insurance Co. v. North American Specialty Insurance*, an employee of the insured's subcontractor was injured while performing construction work.²⁶ The insured had a commercial general liability policy with a \$1 million limit, the owner of the premises had a policy purchased from the same insurer on the primary policy with a \$1 million limit, and the excess insurer had a policy with excess coverage up to \$10 million over its underlying coverage.²⁷ The underlying action was eventually settled for \$3 million, with \$1 million paid under the insured's primary policy and \$2 million paid by the excess insurer.²⁸ The excess insurer then brought a legal malpractice claim against the insured's attorney individually and as subrogee of the insured.²⁹ The excess insurer alleged that the insured's attorney negligently failed to raise the defense of antisubrogation in opposition to the owner's motion for summary judgment and that had the defense been raised, the owner's insurer would have had to contribute its policy limits of \$1 million to the settlement, thereby reducing the excess insurer's share of the settlement to \$1 million.³⁰

The court held the insured's attorney owed no duty of care to the excess insurer.³¹ "When counsel is assigned to defend an insured, the paramount interest independent counsel represents is that of the insured, not the insurer. Assigned counsel's duty is to the insured, and if there is a conflict of interest between the carrier and the insured, he cannot represent both."³² The court further held that the attorney did not owe a duty to the non-client excess insurer because there was no allegation that the insured's attorney made a negligent misrepresentation to the excess insurer knowing that the excess insurer would rely upon it, or that the excess insurer relied upon a misrepresentation made by the insured's attorney.³³

Further, the court held that the excess insurer's legal malpractice claim brought as subrogee of the insured failed because the insured did not personally suffer any loss due to the attorney's failure to raise the antisubrogation defense.³⁴ The only loss for which the excess insurer sought recovery was for its own loss.³⁵

25. Fed. Ins. Co. v. N. Am. Specialty Ins., 47 A.D.3d 52 (N.Y. App. Div. 2007).

26. *Id.* at 55.

27. *Id.*

28. *Id.* at 56.

29. *Id.* at 57.

30. *Id.*

31. *Id.* at 59.

32. *Id.* at 60 (internal quotations and further citations omitted).

33. *Id.*

34. *Id.* at 62.

35. *Id.*

B. *Statute of Limitations—Principles Affecting Accrual of Cause of Action and Tolling of Limitations Period*

Cases within the past year have focused on the discovery rule and continuous representation rule as doctrines that postpone the accrual of a legal malpractice claim or toll the statute of limitations period for such claims.

The majority of jurisdictions look to the date when the plaintiff is deemed to have suffered injury or damage stemming from the attorney's alleged malpractice for purposes of determining when a legal malpractice claim accrues, even if the plaintiff may not have suffered or does not yet know the full extent of the injury or damages, and even if the client's relationship with the attorney remains ongoing.³⁶ Under the discovery rule, the commencement of the statute of limitations period is treated as tolled, or the accrual of the cause of action is deferred, until the date when the plaintiff discovers or reasonably is expected to know the essential facts that give rise to the malpractice claim.³⁷ The discovery rule recognizes that clients frequently lack the skill and knowledge to enable them to recognize conduct amounting to malpractice when it occurs.³⁸ The continuous representation doctrine enlarges the time period for bringing a malpractice action until the termination of the attorney's representation in the same matter in which the alleged malpractice occurred.³⁹ This doctrine recognizes that a client may have no reason to believe that an attorney has committed malpractice while the attorney-client relationship continues, and that postponing commencement of the limitations period until the relationship has ceased benefits the client and the attorney by enabling the attorney to correct, avoid, or mitigate the consequences of an error.⁴⁰

Several recent cases examine the applicability of the discovery rule. In *Wachovia Bank, N.A. v. Ferritti*, the dismissal of breach of contract and negligence claims for legal malpractice on statute of limitations grounds was upheld on appeal.⁴¹ The court emphasized that, under Pennsylvania law, the occurrence rule still determines when the statute of limitations begins to run for legal malpractice claims, and that the discovery rule permits the tolling of the limitations period until the injured party should reasonably have learned of the breach.⁴² The court held that the bank's malpractice

36. See generally 3 RONALD MALLIN & JEFFREY SMITH, *LEGAL MALPRACTICE* § 23.11 at 344-52 (2008).

37. *Id.* § 23.15 at 462.

38. *Id.* at 465. The discovery rule is considered the predominant doctrine applicable to the determination when the statute of limitations for legal malpractice claims commences. *Id.* at 468.

39. *Id.* § 23.13 at 416-17.

40. *Id.*

41. 935 A.2d 565, 573-74 (Pa. Super. 2007).

42. *Id.* at 571-73.

claim accrued when the attorney failed to mark a judgment satisfied in order to discharge the judgment debtor, leading to litigation against the bank by the debtor, rejecting the argument that its cause of action did not accrue until it had suffered actual loss.⁴³ Applying the discovery rule, the court deemed the statute of limitations tolled until the bank reasonably could have been aware of the attorney's breach, which was deemed to have occurred when the debtor initiated proceedings against the bank.⁴⁴ As suit was not filed until nearly eleven years after the debtor's suit against the bank, the legal malpractice action was time-barred under the two-year limitations period for a professional negligence action as well as the four-year limitations period for a breach of contract suit.⁴⁵

In *Carmack v. Oliver*, the Tennessee Court of Appeals affirmed in part the entry of summary judgment in favor of the attorney on statute of limitations grounds in a malpractice action premised on the attorney's alleged negligent delay in seeking an injunction for a client against a neighboring developer.⁴⁶ The court applied the principle that a cause of action for legal malpractice accrues when a client has suffered a legally cognizable injury resulting from an attorney's negligence and the client knows, or in the exercise of reasonable diligence should know, facts sufficient to give notice of that injury.⁴⁷ The record below showed that the plaintiff had actual knowledge of a legally cognizable injury at least by the date he complained to the state Board of Professional Responsibility about the attorney's delay

43. *Id.* at 574. The court disagreed with the plaintiff's contention that because the bank had not suffered an actual loss until the appeal in the litigation against the bank concluded adversely, its cause of action for malpractice likewise did not accrue until the appeal terminated. *Id.* at 574-75. *Contra* *Nowak v. Pellis*, 248 S.W.3d 736, 739-40 (Tex. App. 2007) (statute of limitations tolled in legal malpractice action premised on negligence in the prosecution of a medical malpractice action until the entire suit concluded, even if one of the physicians had been dismissed earlier for lack of timely service of process; court applied the doctrine adopted in *Hughes v. Mahaney & Higgins*, 821 S.W.2d 154, 157 (Tex. 1991), that in the limited circumstances when an attorney engages in malpractice in the prosecution or defense of a claim that results in litigation, the statute of limitations on the malpractice claim is tolled until all appeals on the underlying claim are exhausted).

44. *Ferritti*, 935 A.2d at 574. The court refused to apply the continuous representation doctrine to extend the limitations period any further, ruling that Pennsylvania does not apply the continuous representation doctrine because the public policy against the prosecution of stale claims overrides the difficulty a malpractice plaintiff potentially may encounter if forced to take competing positions in the underlying claim and a malpractice action premised on the underlying claim. *Id.* at 575.

45. *Id.*

46. No. M2006-01873-COA-R3-CV, 2007 WL 4170824, at *1 (Tenn. Ct. App. Nov. 26, 2007).

47. *Id.* at *4. The court explained that knowledge of the injury may be established by actual or constructive knowledge, with the latter established where the plaintiff is reasonably aware of facts that reasonably should put him on notice that he has been injured as a result of the defendant's conduct, even if all of the consequences of the alleged malpractice are not known. *Id.*

in seeking an injunction. However, the court held that the portion of the malpractice suit premised on different conduct by the attorney that later took place within the statute of limitations period, and which caused harm unrelated to the earlier alleged malpractice, was not time-barred.⁴⁸

In *Immunocept, LLC v. Fulbright & Jaworski, LLP*, the U.S. Court of Appeals for the Federal Circuit affirmed the entry of summary judgment in favor of the defendant law firm based on the expiration of the two-year Texas statute of limitations, where the knowledge of the plaintiff corporation's agent of the defendant's deficient patent prosecution was imputed to the corporation.⁴⁹ The plaintiff alleged that the defendant negligently failed to secure adequate patent protection for certain technology because the terminology in the patent claim unduly restricted the scope of the patent. Applying the discovery rule, the court reasoned that even though the second attorney engaged by the plaintiff corporation to prosecute additional patents had not been asked to investigate the malpractice claim, the scope of his authority included reviewing and interpreting the limiting patent language at issue, which the corporation's own malpractice expert had opined was such a drastic and glaring restriction on the patent that any patent attorney would have discovered it.⁵⁰ The court held that because the corporation's reasonably discoverable knowledge of the facts on which the malpractice claim was based occurred more than two years before suit was filed, the malpractice claim was time-barred.⁵¹

The importance of proof that the attorney and the client had an ongoing relationship and that the ongoing relationship concerned the subject matter of the representation at issue for purposes of the continuous representation doctrine is demonstrated by several cases decided during the past year. In *Bleck v. Power*, the District of Columbia Court of Appeals affirmed the dismissal of a legal malpractice claim that arose from the attorney's failure to file a timely claim for long-term disability benefits.⁵² The court

48. *Id.* at *6.

49. 504 F.3d 1281, 1283 (Fed. Cir. 2007).

50. *Id.* at 1287-88. The court explained that under Texas law, the limitations period for legal malpractice claims begins to run when a "client discovers or should have discovered through the exercise of reasonable care and diligence the facts establishing the elements of a cause of action." *Id.* at 1286 (citation omitted).

51. *Id.* at 1288.

52. No. 07-CV-476, 2008 WL 4065794, at *1 (D.C. Ct. App. Sept. 4, 2008). The court explained that in the District of Columbia, a cause of action for legal malpractice accrues when the plaintiff has sustained some injury, even if the precise amount cannot be ascertained, and that the discovery rule and continuous representation rule, which applies even if the client knows before the attorney-client relationship terminates that the attorney has made an injurious error, have been adopted as bases to delay accrual of malpractice claims. *Id.* at *2.

held that under the continuous representation rule, the plaintiff's malpractice cause of action accrued by the time she knew her attorney had not filed her claim for benefits on time and once she hired new counsel, rather than a later date when her motion for relief from judgment was denied.⁵³

In *Hasty Hills Stables, Inc. v. Dorfman, Lynch, Knoebel & Conway, LLP*, a New York court ordered that the trial court enter summary judgment in favor of the defendant law firm, rejecting the plaintiff's argument that the continuous representation doctrine applied in circumstances where the plaintiff had hired new counsel during the limitations period and the defendant's subsequent representation of the plaintiff involved matters unrelated to the specific real estate transaction at issue in the malpractice action.⁵⁴

Inadequate proof of an ongoing relationship between the attorney and client also doomed the enlargement of the statute of limitations period in *Ickes v. Waters*.⁵⁵ In this case the beneficiary of an inter vivos trust filed a legal malpractice action nearly two years after her husband died against the attorney who had prepared an estate plan for her and her husband. The plaintiff filed suit after problems arose concerning the amount her stepdaughter-in-law, as successor trustee, would pay the plaintiff from the trust. The Indiana Court of Appeals held that the limitations period began to run when the inter vivos trust was executed since that was the point when the trust became operative and the plaintiff suffered damage in the form of her loss of control over her property.⁵⁶ The court rejected the plaintiff's argument that the continuous representation doctrine tolled the statute of limitations, as the evidence only indicated that the defendant had represented the plaintiff in the past and did not show that the plaintiff considered the attorney-client relationship to be ongoing.⁵⁷

53. *Id.* at *3.

54. 52 A.D.3d 566, 567-78 (N.Y. App. Div. 2008).

55. 879 N.E.2d 1105 (Ind. Ct. App. 2008). The court's analysis started from the premise that the two-year statute of limitations for legal malpractice begins to run when the plaintiff knows of, or in the exercise of ordinary diligence could have discovered, the tortious conduct. *Id.* at 1108.

56. The court distinguished the case at bar from cases involving wills, in which the malpractice claim accrues upon the death of the testator because that is when the will takes effect. *Id.* at 1109.

57. *Id.* at 1110. The court declined to apply the principle that in the absence of a clear-cut affirmative act by the attorney or client that terminates the attorney-client relationship, the court should consider the parties' subjective intent and reasonable expectations in deciding whether to apply the continuing representation rule, noting that the plaintiff had failed to present evidence showing that she subjectively intended or reasonably expected her relationship with the attorney to continue regarding the same subject matter as the alleged malpractice. *Id.*

II. DEVELOPMENTS IN DIRECTORS' AND OFFICERS' LIABILITY AND INSURANCE COVERAGE

A. *Developments in the Law Regarding Liability of Corporate Directors and Officers*

1. Pleading Scienter Under the Private Securities Litigation Reform Act of 1995 (PSLRA)

The PSLRA contains new and more exacting pleading requirements, under which plaintiffs are required, among other things, to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”⁵⁸ However, Congress did not further define in the statute what was meant by the key phrase “a strong inference.” In *Tellabs, Inc., et al. v. Makor Issues & Rights, Ltd., et al.*,⁵⁹ the Supreme Court resolved a split of authority among the courts of appeals on this issue.

Tellabs was a shareholder class action suit alleging that the Tellabs CEO had engaged in securities fraud by misleading the public in a number of ways, including overstating financial revenues, misrepresenting the performance of the company's flagship product, and misrepresenting the readiness of a new product. The U.S. District Court for the Northern District of Illinois dismissed the complaint for failure of the plaintiffs to sufficiently plead scienter on the part of the CEO. The U.S. Court of Appeals for the Seventh Circuit reversed, holding that the plaintiffs had sufficiently pleaded the CEO's scienter. In reversing the district court, the Seventh Circuit stated that a complaint could survive “if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent.”⁶⁰ The Seventh Circuit rejected a more exacting standard adopted by the Sixth Circuit, under which “plaintiffs are entitled only to the most plausible of competing inferences.”⁶¹

The Supreme Court reversed the decision of the Seventh Circuit. In *Tellabs*, the Supreme Court stated that the appropriate inquiry is whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, taken in isolation, would meet such a standard. In engaging in this inquiry, “the court must take into account plausible opposing inferences,” which the Seventh Circuit had expressly declined to do.⁶² The Court held that the inference of scienter “must be cogent and compelling, thus strong in light of other explana-

58. 15 U.S.C. § 78u-4(b)(2).

59. 127 S. Ct. 2499 (2007).

60. *Id.* at 2506.

61. *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004).

62. *Tellabs*, 127 S. Ct. at 2509–10.

tions,” and that a complaint will survive “only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”⁶³ In applying this standard, the court must consider plausible, nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff. The Supreme Court took note of the fact that one of Congress’s objectives in enacting the PSLRA was to set a uniform pleading standard, which would curb frivolous, lawyer-driven litigation, while preserving investors’ ability to recover on meritorious claims.⁶⁴ The Court did not decide if the complaint met the newly formulated pleading standard and it remanded the matter for further proceedings.⁶⁵

2. Pleading an Antitrust Conspiracy Through Allegations of Parallel Conduct

Liability under § 1 of the Sherman Act requires a “contract, combination . . . or conspiracy in restraint of trade or commerce.”⁶⁶ The question for the Supreme Court in *Bell Atlantic, et al. v. Twombly, et al.*⁶⁷ was whether a complaint under § 1 can survive a motion to dismiss merely by alleging that the defendants engaged in parallel conduct, absent additional factual allegations suggesting an agreement, as distinct from identical, independent action. The complaint alleged that a parallel course of conduct by the defendant telecommunications providers was strong evidence that they had entered into a contract, combination, or conspiracy to prevent competitive entry of other competitors into their respective telephone and/or high-speed Internet services markets. The Second Circuit had held that “plus factors are not *required* to be pleaded to permit an antitrust claim based on parallel conduct to survive dismissal.”⁶⁸

The Supreme Court reversed. The Court held that the factual allegations of the complaint must be enough to raise a right to relief above the speculative level and that there must be enough factual matter to suggest that an agreement was made.⁶⁹ The complaint must include allegations plausibly suggesting (not merely consistent with) the existence of an agreement.⁷⁰ Without further factual allegations, an allegation of parallel conduct and

63. *Id.* at 2510.

64. *Id.* at 2509.

65. *Id.* at 2513.

66. 15 U.S.C. § 1.

67. 127 S. Ct. 1955 (2007).

68. *Bell Atl., et al. v. Twombly, et al.*, 425 F.3d 99, 114 (2d Cir. 2005) (emphasis in original).

69. *Twombly*, 127 S. Ct. at 1965.

70. *Id.* at 1965–66.

a mere assertion that there must have been an agreement falls short of the line between possibility and plausibility.⁷¹

3. Fiduciary Duties in the Zone of Insolvency

In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*,⁷² the Delaware Supreme Court held that the creditors of a corporation that is either insolvent or in the zone of insolvency have no right to assert *direct* claims for breach of fiduciary duty against the corporation's directors. Other courts have split over whether or not to recognize a creditor's breach of fiduciary duty claim when the corporation is in the zone of insolvency.⁷³ In *Gheewalla*, the court reaffirmed that the directors' fiduciary duties are owed to the corporation, even in an insolvency situation.⁷⁴ However, the court also held that once a corporation becomes insolvent, creditors have standing to assert *derivative* claims against the directors for alleged breach of the duties they owe the corporation.⁷⁵

In *In re VarTec Telecom, Inc.*,⁷⁶ a bankruptcy trustee acting on behalf of the creditors asserted fiduciary duty claims against an individual who was both an officer of a Texas corporation and trustee of a Delaware business trust. The U.S. Bankruptcy Court of the Northern District of Texas therefore interpreted both Texas and Delaware law. The court found "highly persuasive" several recent decisions under Texas law concluding that a corporation's creditors can bring a fiduciary duty claim against the corporation's directors and officers once the corporation has entered the zone of insolvency.⁷⁷ The court then turned to *Gheewalla* for guidance in resolving the issue under Delaware law.⁷⁸ The court found that under Delaware law the trustee could bring fiduciary duty claims on a derivative basis.⁷⁹ Therefore, the motion to dismiss was denied as to both the Texas and the Delaware entities.

71. *Id.* at 1966. The Court acknowledged that the requirement of additional factual allegations at the pleading stage was not consistent with the frequently quoted standard first articulated in *Conley v. Gibson*, 355 U.S. 41 (1957), that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts that would entitle him to relief. The Court stated that "after puzzling the profession for 50 years, this famous observation has earned its retirement." *Twombly*, 127 S. Ct. at 1969.

72. 930 A.2d 92 (Del. 2007).

73. *See, e.g.*, *Carrieri v. Jobs.com, Inc.*, 393 F.3d 508 (5th Cir. 2004) (when a corporation reaches the "zone of insolvency," as with actual insolvency, the officers and directors have an expanded fiduciary duty to all creditors).

74. *Gheewalla*, 930 A.2d at 101.

75. *Id.*

76. No. 04-81694-HDH-7, 2007 WL 2872283 (Bankr. N.D. Tex. 2007).

77. *Id.* at *3.

78. *Id.* at *3-4.

79. *Id.*

In *Torch Liquidating Trust v. Stockstill*,⁸⁰ the U.S. District Court for the Eastern District of Louisiana followed *Gbeewalla* in deciding that once a corporation is in fact insolvent the creditors have standing to maintain a derivative claim against the directors for breach of fiduciary duty owed to the corporation. The court also held that even in insolvency the directors' fiduciary duties were owed to the corporation, rather than to the creditors.⁸¹ Therefore, the court held that the creditors could not assert a direct breach of fiduciary claim.⁸² The court concluded that the amended complaint filed by the plaintiffs did not allege a derivative action on behalf of the corporation but that the creditors instead were claiming a breach of fiduciary duties owed directly to them.⁸³ Since there was no such direct duty to the creditors, the court dismissed the action.

4. Deepening Insolvency Claims

An ongoing issue is whether directors have a duty to put an insolvent company into liquidation for the benefit of creditors, such that a failure to do so as the company's financial condition continues to worsen gives rise to a new cause of action for so-called deepening insolvency. In *Trenwick America Litigation Trust v. Billet*,⁸⁴ the Delaware Supreme Court affirmed a chancery court decision⁸⁵ that had held that Delaware law does not recognize an independent cause of action for deepening insolvency. The chancery court opinion noted that Delaware law imposes no absolute obligation on directors of a company that is unable to pay its bills to cease operations and liquidate.⁸⁶ Rather, even when a firm is insolvent, its directors can, in the appropriate exercise of their business judgment, take action that might result in worsening the insolvency of the corporation.⁸⁷ In the absence of evidence that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, the potentially greater loss suffered by unpaid creditors cannot be remedied merely by alleging that the corporation has become more insolvent as a result of the failed strategy.⁸⁸

In *Thabault v. Chait*, the U.S. Court of Appeals for the Third Circuit held under New Jersey law that deepening insolvency was a valid theory of damages recoverable under a negligence claim.⁸⁹ The court explained that

80. No. 07-133, 2008 WL 696233, at *5 (E.D. La. Mar. 13, 2008).

81. *Id.* at *5-6.

82. *Id.* at *6-7.

83. *Id.*

84. 931 A.2d 438, No. 495, 2007 WL 2317768 (Del. Aug. 14, 2007).

85. *Trenwick Am. Lit. Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006).

86. *Id.* at 205.

87. *Id.*

88. *Id.*

89. 541 F.3d 512 (3d Cir. 2008). In a previous case, *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001), the court had held that the Pennsylvania

prolonging an insolvent corporation's life through additional bad debt may cause the loss of corporate assets, and that this could be averted and these assets salvaged if the corporation is dissolved in a timely manner.⁹⁰ The court did not address deepening insolvency as an independent cause of action, but held that, under New Jersey law, traditional damages stemming from actual harm caused by the defendant's negligence do not become invalid merely because they have the effect of increasing a corporation's insolvency.⁹¹

5. Scheme Liability Under § 10(b) of the Securities Act

In *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc., et al.*,⁹² the Supreme Court helped to define the contours of the implied right of action under § 10(b) of the Securities Act in connection with allegations of scheme liability against customers and suppliers of a company, Charter Communications, that had allegedly issued fraudulent financial statements. The defendant customers/suppliers allegedly agreed to participate in transactions that would enable Charter Communications to inflate its revenue in order to meet project revenue and operating cash flow numbers. The customer/supplier defendants did not participate in the preparation or distribution of Charter Communications' financials, and their own financials accounted for the transactions as a wash.

The Supreme Court affirmed the dismissal of the complaint for failure to state a claim upon which relief can be granted. The Court held that the plaintiff investors failed to show reliance on any alleged deceptive statements and representations of the defendant customers/suppliers.⁹³ The Court noted that there is a rebuttable presumption of reliance when a party with a duty to disclose omits a material fact or when the alleged misstatements are publicly communicated.⁹⁴ However, the Court held that neither presumption applied to this case, since the defendants did not have a duty to disclose and their allegedly deceptive acts were not publicly communicated.⁹⁵ The Supreme Court also rejected the plaintiffs' scheme liability argument.⁹⁶ Under the scheme liability argument, plaintiffs asserted that liability was appropriate despite the lack of public statements by the

Supreme Court would recognize deepening insolvency as an independent cause of action where it causes damage to corporate property.

90. *Thabault*, 541 F.3d at 522–23.

91. *Id.*

92. 128 S. Ct. 761, 766 (2008).

93. *Id.* at 769.

94. *Id.*

95. *Id.*

96. *Id.* at 771–72.

defendants because investors in an efficient market rely not just on public statements relating to a security, but also on the underlying transactions reflected in the public statements.⁹⁷

The Supreme Court's decision in *Stoneridge* takes into consideration public policy concerns. The Supreme Court noted that if it adopted plaintiff's reliance argument based on a scheme liability theory, the implied cause of action under § 10(b) would expand to the entire marketplace in which the issuing company does business.⁹⁸ The Court predicted that an expanded potential class of defendants would lead to higher costs of doing business in the United States.⁹⁹ The Court also noted that it is Congress's role, not the Court's, to decide whether to expand liability under § 10(b).¹⁰⁰ Currently, there is no private cause of action for the aiding and abetting of securities fraud by secondary actors. Thus far, Congress has found it sufficient for the SEC to have enforcement power against secondary actors.¹⁰¹

6. Director Liability in Merger Transactions

In *Ryan v. Lyondell Chemical Co.*,¹⁰² the Delaware Chancery Court addressed the duties of outside directors under Delaware law with respect to mergers and acquisitions. Shareholders of Lyondell brought the action challenging the company's merger with Basell AF. The merger price involved a substantial premium per share. However, the merger was finalized and approved by the board in just seven days. At the time of the merger, Lyondell was not for sale and Basell was the only known potential buyer. The board did not play an active role in negotiating the merger and did not seek other bidders.

The court allowed the directors' motion for summary judgment on claims alleging breach of their duty of loyalty and nondisclosure. The undisputed evidence was that the directors were not motivated by self-interest and that shareholder disclosures were substantially complete. Despite the premium share price, however, the court denied the directors' motion for summary judgment on claims alleging violation of their "Revlon duties," to maximize shareholder value.¹⁰³ The court also denied the directors' motion for summary judgment on claims based on the deal protection terms of the proposed merger.

In denying summary judgment, the court relied on evidence that the board did not take any meaningful steps to confirm whether a better price

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.* at 772-73.

101. *Id.* at 773.

102. No. 3176-VCN, 2008 WL 2923427 (Del. Ch. July 29, 2008).

103. See *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

could be obtained or show that they were so knowledgeable about the company's value that such effort was not necessary.¹⁰⁴ The board did not perform a market check or shop the offer to see if a better proposal could be found.¹⁰⁵ The court noted that the merger agreement contained several deal protection provisions, such as a \$385 million break-up fee, and stated that at the summary judgment stage one could not exclude the inference that the provisions agreed to by the board served no purpose other than to squelch even the remotest possibility of a competing bid.¹⁰⁶ The court also precluded the defendants from relying on an exculpatory provision in the company's charter, on the grounds that the board's apparent lack of any effort to comply with the *Revlon* case could implicate the directors' good faith.¹⁰⁷ The case thus stands as a reminder that even an advantageous merger price may not immunize the directors against liability arising out of a merger.

B. *Developments in the Law Regarding Directors' and Officers' Insurance Coverage*

1. Disgorgement and the Definition of Loss

Several recent decisions held that D&O policies provide no coverage for disgorgement of unlawful gains by directors and officers.

In *CNL Hotels & Resorts v. Twin City Fire Insurance Co.*,¹⁰⁸ the Eleventh Circuit Court of Appeals affirmed in part a Florida district court's ruling that payments made to settle a purchaser class lawsuit were not covered loss under CNL's D&O policy. The underlying § 11 lawsuit alleged that the purchaser class bought shares at an excessive price of \$20 a share, and that when CNL subsequently went private, the shares were priced at just \$12 a share. CNL settled the purchaser class complaint for \$35 million and sought coverage from its D&O carriers. The court concluded that the settlement payment was restitutionary in nature, and therefore was not a loss covered by insurance.¹⁰⁹ The court rejected CNL's argument that § 11 does not require proof of fraud, stating that "[t]he return of money received through a violation of law, even if the actions of the recipient were innocent,

104. *Ryan*, 2008 WL 2923427, at *14.

105. *Id.*

106. *Id.* at *17.

107. *Id.* at *18-19.

108. No. 07-12706, 2008 WL 3823898 (11th Cir. Aug. 18, 2008), *aff'd in part* CNL Hotels & Resorts, Inc. v. Houston Cas. Co., 505 F. Supp. 2d 1317 (M.D. Fla. 2007).

109. The court cited the statement in *Level 3 Commc'ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908 (7th Cir. 2001), that the interpretive principle that a "loss" within the meaning of an insurance contract does not include the restoration of ill-gotten gains is clearly right. *CNL Hotels*, 2008 WL 3823898, at *2.

constitutes a restitutionary payment, not a 'loss.'"¹¹⁰ The court also found "too lacking in merit to warrant discussion" CNL's argument that the settlement payment was covered because of a provision in the settlement agreement that stated that the settlement was not restitution or disgorgement.¹¹¹ The court stated that the policy, not the settlement agreement, governs whether such payment is covered.¹¹² The case is significant because it finds disgorgement uninsurable even in the context of a settlement, where there has been no finding of wrongful conduct by the insured.

In *National Union v. U.S. Bank*,¹¹³ the carrier was successful in arguing that payment by a former CEO to a liquidation trustee of the defunct company was not a covered loss under the policy and also was excluded by the policy's profit and advantage exclusion. The liquidation trustee sought to recover from a former CEO over \$2 million in severance payments made to him in the context of his resignation from the company. The trustee asserted that such payments were avoidable preferences under federal law and were fraudulent transfers under both federal and Texas state law. A bankruptcy court entered judgment against the CEO for \$2.2 million, and National Union sought a declaration that the judgment was not covered under the policy.

The applicable definition of loss in the policy contained a carve-out for matters deemed uninsurable under the law. The court found that the payment was restitutionary in nature and therefore uninsurable as a matter of law.¹¹⁴ As an alternative basis for its decision, the court further found that coverage also was precluded by an exclusion for loss arising out of a profit or advantage to which the insured was not legally entitled.¹¹⁵ The court rejected the argument that the bankruptcy court's preference decision did not depend on a finding of fraud. The court stated that "not legally entitled" is not synonymous with "illegal," and that the exclusion does not require a finding that the insured committed fraud or another illegal act.¹¹⁶

2. Consent to Settlement

Most D&O policies also contain provisions that require insureds to seek carrier consent prior to entering into a settlement agreement. One recent

110. *CNL Hotels*, 2008 WL 3823898, at *3.

111. *Id.*

112. *Id.* The court remanded on the issue of whether an additional payment of legal fees incurred by a separate proxy class would be covered loss.

113. No. 4:07-CV-1958, 2008 WL 2405975 (S.D. Tex. June 11, 2008).

114. *Id.* at *5; see also *Level 3 Commc'ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908 (7th Cir. 2001); *TIG Specialty Ins. Co. v. Pinkmonkey.com, Inc.*, 375 F.3d 365 (5th Cir. 2004); *Pereira v. Nat'l Union Ins. Co.*, 2006 WL 1982789 (S.D.N.Y. July 12, 2006); *Unified W. Grocers Inc. v. Twin City Fire Ins. Co.*, No. 05-15986, 2006 WL 2337373 (9th Cir. Aug. 14, 2006).

115. *U.S. Bank*, 2008 WL 2405975, at *5-6.

116. *Id.* at *7.

decision enforced this provision, and found that coverage is barred in its entirety where an insured settles without carrier consent.

In *Vigilant Insurance Co. v. Bear Stearns*,¹¹⁷ the New York Court of Appeals reversed the appellate division in part and held that Bear Stearn's \$80 million SEC settlement was not covered under its D&O policy. In 2002, the Securities and Exchange Commission initiated an investigation into the potential conflicts of interest between the research and investment banking functions at Bear Stearns. The SEC brought suit against Bear Stearns for alleged violation of National Association of Securities Dealers and New York Stock Exchange rules arising out of such conflicts. In April 2003, Bear Stearns executed a consent agreement in which it acceded to the entry of a final judgment against it, agreed to be permanently enjoined from violating certain rules, and agreed to pay \$80 million to settle the SEC action, of which \$25 million was designated in the agreement as a penalty. Three days after signing the agreement, Bear Stearns wrote to its insurers requesting their consent to the settlement. The settlement agreement was approved by the court six months later, in October 2003.

Vigilant declined coverage on various grounds, including the uninsurability of disgorgement and the fact that Bear Stearns did not seek its consent before entering into the consent agreement. The trial court held that a triable issue of fact existed as to whether Bear Stearns breached the policy's consent provisions because the settlement was not final until approved by the court, and the intermediate appellate court affirmed. The court of appeals reversed the intermediate appellate court, granted summary judgment for Vigilant, and held that Bear Stearns had breached the policy's consent provisions by executing the consent agreement before notifying its insurers.¹¹⁸ The court found that the provision requiring that the insured would not enter any settlements without advance consent was clear and unambiguous and therefore would be enforced according to its terms to preclude all coverage for the settlement.¹¹⁹

3. Coverage for Breach of Contract Claims

Most D&O policies also contain an exclusion that provides that coverage is barred for damages arising out of a breach of contract. Several recent decisions have applied these exclusions to bar coverage for lawsuits arising out of contractual disputes.

In *Spartas Co. v. Federal Insurance Co.*,¹²⁰ the insured had entered into a written subcontract agreement to serve as a demolition subcontractor.

117. 884 N.E.2d 1044 (N.Y. App. 2008).

118. *Id.* at 1047-48.

119. *Id.* at 1048.

120. 521 F.3d 833 (7th Cir. 2008).

After a dispute, the insured was sued in a five-count complaint that alleged breach of contract, as well as several tort causes of action and a breach of fiduciary duty claim. The Eighth Circuit Court of Appeals held that the term “arising from” should be construed broadly when used in a policy exclusion and that an exclusion precluding coverage for claims arising from a contract not only applies to claims directly in contract, but also to related claims sounding in tort.¹²¹ Because the claims brought by MIG flowed from or had their origins in the breach of the contract, the Eighth Circuit affirmed the district court’s grant of summary judgment.¹²²

In *Newman v. XL Specialty Insurance Co.*,¹²³ the court reached the same result without relying on an exclusion for breach of contract claims. The underlying action was brought by a doctor who alleged that pursuant to his employment contract, he was entitled to shares of his employer’s common stock. After he was terminated, he filed a demand for arbitration. He ultimately was awarded damages at an arbitration for violation of his employment contract, and the employer sought coverage under its liability policy with XL. The court stated that the employer voluntarily entered into the employment contract and then voluntarily chose to honor the contract.¹²⁴ Although the XL policy did not contain a breach of contract exclusion, the court held that coverage was precluded because the arbitration award did not represent an amount the insured was legally obligated to pay on account of a wrongful act.¹²⁵ The court held that the insured was contractually, rather than legally, obligated to pay and that the obligation arose from the insured’s voluntary agreement to pay, rather than from a wrongful act by the insured.¹²⁶ Thus, the court followed other courts that have held that there is no coverage for contractual obligations, even where the policy does not contain a breach of contract exclusion.¹²⁷

In *America’s Collectibles Network, Inc. v. Chase Paymentech Solutions*,¹²⁸ the insured argued that the phrase “legally obligated to pay” was broad enough to include contractual obligations. However, the court did not reach the issue. Instead, the court held that the complaint could potentially be read to assert liability based on something other than or in addition to the

121. *Id.* at 836–37.

122. *Id.*

123. No. C-1-06-781, 2007 WL 2982751 (S.D. Ohio Sept. 24, 2007).

124. *Id.* at *6.

125. *Id.*

126. *Id.*

127. See also *Pac. Ins. Co. v. Eaton Vance Mgmt.*, 369 F.3d 584 (1st Cir. 2004); *Waste Corp. of Am. v. Genesis Ins. Co.*, 382 F. Supp. 2d 1349 (S.D. Fla. 2005), *aff’d per curiam*, 2006 WL 05383 (11th Cir. 2006).

128. No. 3:07-CV-279, 2008 WL 4546251 (E.D. Tenn. Sept. 24, 2008).

contract, such as negligence.¹²⁹ Therefore, the court denied the insurer's motion to dismiss. The court stated that it would be necessary to reach the policy interpretation issue only in the event it was determined the plaintiff's claims were solely for contractual obligations.¹³⁰

4. Triggering the Excess Policy

There are various circumstances where the insured and the primary insurer may wish to settle their coverage disputes on terms requiring the primary insurer to pay something less than the full amount of its policy limit. When the primary insurer and the insured make such a deal, this can result in an issue as to whether the excess carriers then have an obligation to pay. Excess policies typically provide that the insurer is not obligated to pay until the primary policy has been fully exhausted.

In *Qualcomm, Inc. v. Certain Underwriters at Lloyd's*,¹³¹ the California appeals court recently faced the issue of an excess carrier's obligation to pay after the insured settled with the primary carrier for less than its policy limit. The insured had settled with the primary carrier for \$16 million of its \$20 million policy limit, absorbed the \$4 million "gap" between the settlement amount and primary policy limit, and then sought coverage from its first excess carrier for an additional \$9 million in unreimbursed expenses. The excess carrier's policy contained two relevant provisions, a maintenance clause and an exhaustion clause. The excess policy's maintenance clause required as a condition precedent to coverage that the insured maintain the coverage provided by the underlying policy. The exhaustion clause provided that Underwriters shall only be liable if the underlying policy has "paid or . . . [has] been held liable to pay the full amount of the Underlying Limit of Liability."¹³²

The court affirmed the decision of the trial court that the coverage obligations of the excess policy had not been triggered. The court held that the literal language of the exhaustion clause applied and that this required the primary carrier to pay the full amount of its limit.¹³³ Since the primary carrier did not pay the full amount of its limit, the court held that the excess carrier's coverage obligation was not triggered.¹³⁴ The court declined to reach the issue of whether the maintenance clause would also serve to preclude coverage.¹³⁵

129. *Id.* at *13.

130. *Id.*

131. 161 Cal. App. 4th 184 (Cal. Ct. App. 2008).

132. *Id.* at 189.

133. *Id.* at 187.

134. *Id.* at 188.

135. *Id.* at 203.

Similarly, in *Comerica, Inc. v. Zurich American Insurance Co.*,¹³⁶ the U.S. District Court for the Eastern District of Michigan addressed the payment obligation of an excess carrier after the primary carrier settled with the insured. The court held that the excess carrier's payment obligation was not triggered because the excess carrier's policy required exhaustion of the primary carrier's limit.¹³⁷ The insured settled with the primary carrier for \$14 million of its \$20 million limit, absorbed the \$6 million "gap" between the settlement amount and the policy limit, then sought coverage from first excess carrier Zurich for an additional \$3.6 million in defense fees and loss. The excess policy provided that Zurich's coverage obligations do not attach unless the underlying insurance is exhausted "solely as a result of actual payment of loss."¹³⁸ Since the underlying insurance was not exhausted solely by the actual payment of loss, the district court held that Zurich did not have a payment obligation.¹³⁹

It is significant that the courts in both *Qualcomm* and *Comerica* rejected public policy arguments set forth in *Zeig v. Massachusetts Bonding & Insurance Co.*¹⁴⁰ and the cases that follow it. *Zeig* and its progeny allow "gap" filling by the insured, on the grounds that this encourages efficient settlements of coverage issues and does not prejudice excess carriers. Instead, the *Qualcomm* and *Comerica* courts honored the language of the insurance policies, refusing to rewrite contract language to further public policy.¹⁴¹ While not all excess policies contain as clear exhaustion language as the *Qualcomm* and *Comerica* excess policies, these two recent cases may lead to a change in approach by insureds. To avoid losing excess coverage, insureds now may more frequently seek to resolve future coverage issues through global settlement discussions including all layers of insurance.

III. DEVELOPMENTS IN ACCOUNTING MALPRACTICE

Although the pace remains slow and steady, courts continue to develop a body of case law in the area of accounting malpractice. In the last year, courts have produced opinions ranging from pleading requirements all the way through trial and directed verdicts.

136. 498 F. Supp. 2d 1019 (E.D. Mich. 2007).

137. *Id.* at 1028.

138. *Id.* at 1022.

139. *Id.* at 1021.

140. 23 F.2d 665 (2d Cir. 1928).

141. See *Comerica*, 498 F. Supp. 2d at 1037; *Qualcomm, Inc. v. Certain Underwriters at Lloyd's*, 161 Cal. App. 4th 184, 199 (Cal. Ct. App. 2008).

A. *Pleading Requirements*

A Connecticut trial court struck a complaint against an accountant because the plaintiff did not allege the claims with sufficient specificity. Conclusory allegations that the plaintiffs suffered damage in reliance on inaccurate financial statements were insufficient to plead claims for fraud, accounting malpractice, and negligent misrepresentation.¹⁴² The plaintiffs failed to allege damages or how they relied on the financial statements. The court also held that professional negligence generally does not constitute a violation of Connecticut's unfair trade practices statute and thus dismissed those claims as well.¹⁴³

B. *International Structure*

Another preliminary question is who can be a proper defendant. One narrow issue that continues to generate court opinions concerns which members of an extended family of accounting firms can be liable to suit. Plaintiffs often sue not only a local accounting firm, but also affiliated national and international firms. For example, in a recent New York case, the plaintiffs sued Deloitte & Touche LLP as well as a separate entity called Deloitte & Touche USA LLP.¹⁴⁴ A New York trial court dismissed Deloitte & Touche USA LLP because it had no contract with the plaintiffs.¹⁴⁵ At the same time, the court allowed claims to proceed against Deloitte & Touche LLP.

A Florida appellate court recently overturned a directed verdict in favor of an international firm.¹⁴⁶ Claiming a company fabricated records to conceal massive losses, investors sued both the local audit firm and an international affiliate incorporated in the Netherlands. The trial court found no agency relationship between the local member accounting firm and the Dutch firm. The appellate court reversed, noting that the member firm agreement obligated the local firm to (i) provide professional services at the request of the international firm, (ii) assist in developing accounting products for the international firm, and (iii) comply with audit manuals promulgated by the international firm.¹⁴⁷ Thus, there was an issue of fact as to whether an agency relationship existed.¹⁴⁸

142. *Stuart v. Freiberg*, No. FSTCV040200508S, 2008 WL 2930434, at *4-5 (Conn. Super. Ct. July 9, 2008).

143. *Id.* at *6.

144. *Seghers v. Deloitte & Touche USA LLP*, No. 602135/06, 2007 WL 3101242 (N.Y. Sup. Ct. Aug. 13, 2007).

145. *Id.* at *3.

146. *Banco Espirito Santo Int'l, Ltd. v. BDO Int'l, B.V.*, 979 So. 2d 1030, 1034 (Fla. Dist. Ct. App. 2008).

147. *Id.* at 1033-34.

148. *Id.*

C. Duties to Third Parties

The question of who is a proper plaintiff likewise generates litigation. Investors, creditors, and other nonclients often sue accountants. The question of whether accountants are liable to nonclients continues to generate a robust and somewhat varied body of case law. What often makes the difference is whether the accountant knows the nonclient will rely on the accountant's work product.

For example, a Georgia court upheld a verdict in favor of nonclients in *PriceWaterhouseCoopers LLP v. Bassett*.¹⁴⁹ A local nursing home merged with a larger publicly traded company. According to the plaintiffs, they later learned that the publicly traded company overstated its revenue and had serious cash flow problems. Without explanation, the Georgia Court of Appeals said that the "evidence authorized the jury to find that the [accounting firm's] partners knew that potential investors like the [plaintiffs] would rely on [the] audits" and therefore permitted recovery, even though there was no accountant-client relationship.¹⁵⁰

Applying Kansas law, a federal district court denied summary judgment on a bank's claims that it loaned money in reliance on a defective audit report.¹⁵¹ Because the accounting firm was not registered to practice in Kansas, it could not claim the benefit of a Kansas statute that protects accountants from claims by nonclients.¹⁵² Noting that Kansas had adopted *Restatement (Second) of Torts* § 552, the court rejected the accounting firm's common law argument that the bank lacked standing to sue.¹⁵³

But a nonclient lost where the accountant did not know he would use the financial statements.¹⁵⁴ A bank president allegedly took a job in reliance on the accountant's representations about the bank's financial health. Applying West Virginia law, the Fourth Circuit explained that a nonclient must be a member of a group who the accountant actually intends or knows will receive the information.¹⁵⁵ The audit report was delivered to the board of directors and explicitly said it was not intended for use by third parties.

149. 666 S.E.2d 721 (Ga. Ct. App. 2008).

150. *Id.* at 724.

151. *First State Bank v. Daniel & Assocs., P.C.*, 519 F. Supp. 2d 1157, 1160 (D. Kan. 2007) (finding KAN. STAT. ANN. § 1-402 inapplicable).

152. *Id.*

153. *Id.* at 1162. 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 professional knows that the recipient intends to supply the information. RESTATEMENT (SECOND) OF TORTS § 552(2)(a) (1977). The court did not make clear why the bank was entitled to rely on the audit report under the *Restatement* rule.

154. *Ellis v. Grant Thornton LLP*, 530 F.3d 280 (4th Cir. 2008).

155. *Id.* at 290 (citing RESTATEMENT (SECOND) OF TORTS § 552(2)(a) (1977)).

Potential employees were not intended users of the financial statements. In fact, the auditors were not even aware of the bank president's decision to take the job until after they decided to issue the audit report. On these facts, the bank president was outside the scope of potentially intended users.¹⁵⁶

In *Krier v. Vilione*,¹⁵⁷ the question was which one of several interrelated companies had standing to sue. One of the corporate principals allegedly misappropriated corporate funds for his own personal use. The accountants argued that only one of the corporate plaintiffs sustained damage. However, the plaintiffs' expert opined that all three companies lost goodwill and enterprise value as a result of the misconduct alleged. These damage claims gave all three corporations standing to sue.¹⁵⁸

D. Causation and Reliance

Just like duty and breach, the element of causation is hotly contested and has generated several reported opinions. To show causation in an audit malpractice case, plaintiffs typically must show the financial statements are false. It is not necessarily enough to show violations of generally accepted auditing standards (GAAS), as a New York trial court decision illustrates.¹⁵⁹ The plaintiffs claimed they were fraudulently induced to loan \$40 million to an auto parts company that later went into bankruptcy. Although they claimed the accounting firm was not independent as required by GAAS, the plaintiffs did not allege that the audit report contained any false information about the company's actual financial condition. Although the accountants issued no going concern opinion, the audit report actually did not issue until well over a year after the date of the financial statements. For this reason, the court found no proximate cause and dismissed the complaint.¹⁶⁰

It is not necessarily enough to allege transaction causation. In *Maxwell v. KPMG LLP*,¹⁶¹ auditors allegedly failed to detect "round-tripping" (where a company loans money to a firm under its control, understanding that the firm will use the loan to purchase services from the lender). The company then purchased an Internet business, which experienced heavy losses and led to the company's bankruptcy. The trustee claimed that if the auditors had disclosed an alleged overstatement of the company's income, the merger would have never occurred, and the business would have never im-

156. *Id.*

157. 742 N.W.2d 537 (Wis. Ct. App. 2007).

158. *Id.* at 545-56.

159. DDJ Mgmt., LLC v. Rhone Group L.L.C., No. 601832/07, 2008 WL1837442, at *13-14 (N.Y. Sup. Ct. Apr. 24, 2008).

160. *Id.* at *14.

161. 520 F.3d 713 (7th Cir. 2008).

ploded. The Seventh Circuit rejected this theory of causation. Neither the “dot com” troubles nor the merger resulted from the audit report.¹⁶² The auditors had no duty to give the company business advice. On the contrary, the risk of the merger was unrelated to what the company hired the auditors to do.¹⁶³ Even if the audit report was a “but for” cause of the merger, it was not in any way a proximate cause of the company’s collapse.¹⁶⁴

The Seventh Circuit even suggested that the trustee’s lawsuit may have been frivolous and said the accounting firm could file a motion for attorney fees.¹⁶⁵ Litigants have already quoted (and will probably continue to quote) the court’s observation that

[t]he filing of lawsuits by a going concern is properly inhibited by concern for future relations with suppliers, customers, creditors, and other persons with whom the firm deals (including government) and by the cost of litigation. The trustee of a defunct enterprise does not have the same inhibitions. . . . [T]he trustee of a defunct business has little to do besides filing claims that if resisted he may decide to sue to enforce. Judges must therefore be vigilant in policing the litigation judgment exercised by trustees in bankruptcy, and in an appropriate case must give consideration to imposing sanctions for the filing of a frivolous suit.¹⁶⁶

In *Thabault v. Chait*,¹⁶⁷ there was a causal connection sufficient to uphold a \$182.9 million jury verdict. Suing as a receiver, Vermont’s insurance commissioner claimed proper audits would have disclosed an insurance carrier’s insolvency and would have sooner enabled the commissioner to protect the insurer, its policyholders, claimants, and creditors. In annual statements submitted to the insurance commissioner, the carrier incorporated loss reserve figures from the audited financial statements. The insurance commissioner’s examiners relied on those loss reserve figures, and thus there was a jury question on reliance and causation.¹⁶⁸

The availability of financing was the causation issue in a Maine lawsuit over the dissolution of a shellfish company.¹⁶⁹ The shareholders deadlocked and wrangled over which one would buy out the other. As provided in the shareholder agreement, the company engaged an accounting firm to value the shares. The plaintiff complained that the valuation came in too low and that he received less than full market value for the shares. The buyer,

162. *Id.* at 716.

163. *Id.* at 717.

164. *Id.*

165. *Id.* at 718–19.

166. *Id.* at 718.

167. 541 F.3d 512 (3d Cir. 2008).

168. *Id.* at 524–25.

169. *Wetmore v. Macdonald, Page, Schatz, Fletcher & Co., LLC*, No. 06-26-P-S, 2007 WL 3332792 (D. Me. Nov. 7, 2007).

however, had to get a loan to finance the purchase and said the bank would not have loaned any more money than what he paid. The accounting firm thus argued that the buyers would not have been able to pay a higher price anyway and that there was therefore no causal connection between the valuation report and the price paid. However, the court concluded that “[n]one of this evidence establishes without dispute that the [buyer] could not or would not have paid more for the plaintiff’s shares if the [accounting firm’s] evaluation had been higher.”¹⁷⁰

E. Proof of Damages

Just like the other elements of malpractice claims, damages have generated several recent opinions. Courts have issued rulings on whether plaintiffs have proved their damages, as well as on what categories of damage the law allows. As in any tort case, proof of damages is critical; without proof of damage, courts will enter judgment against the plaintiff.¹⁷¹

A valuation report again resulted in litigation, this time in Louisiana.¹⁷² After they were removed for cause from three companies, the plaintiffs claimed they were underpaid for their ownership interests because the accountant negligently valued the companies. The accountant allegedly committed malpractice by combining the companies for valuation purposes and by failing to verify the information on which he relied. The appellate court found sufficient evidence of damage because the plaintiffs received an insufficient price for their shares.¹⁷³ However, the appellate court reduced the jury award because it clearly exceeded the loss sustained.¹⁷⁴

Proof of damages must be precise, as a recent Texas decision indicates. In *Blitz Holdings Corp. v. Grant Thornton, LLP*,¹⁷⁵ a creditor claimed it could have foreclosed on common stock held as collateral. However, its expert did not give an opinion on the value of the common stock at any particular point in time. Although the debtor had recoverable assets, an injunction prevented a foreclosure, and there was no evidence about what would have happened if the creditor had tried to lift the injunction. As there was no evidence of how the creditor could have collected on the debt, the trial court granted judgment in favor of the accountants, and the appellate court affirmed.¹⁷⁶

170. *Id.* at *10–11.

171. *Automatic Logistic Productivity Improvement Sys., L.L.C. v. UHY Advisors, Inc.*, No. 06-2387, 2007 WL 2292013, at *2 (6th Cir. Aug. 8, 2007) (affirming summary judgment where plaintiff’s counsel admitted there was no evidence of damage).

172. *Adams v. Kern*, 987 So. 2d 879 (La. Ct. App. 2008).

173. *Id.* at 884.

174. *Id.* at 885.

175. No. 01-04-00627-CV, 2008 WL 1971374 (Tex. App. May 8, 2008).

176. *Id.* at *7–8, *12.

F. *Liability for Interest Assessed by the IRS*

Courts have recently issued opinions on particular categories of damages in accounting malpractice cases. More and more jurisdictions are weighing in on the question of whether an accountant is liable for interest assessed when the IRS finds a client owes back taxes. Because the taxpayer enjoys the use of the money before the IRS assesses a delinquency, some jurisdictions hold that interest charged by the IRS is not damage.¹⁷⁷ Nebraska recently joined the ranks of jurisdictions refusing to adopt an absolute bar.¹⁷⁸ The Nebraska Supreme Court held that taxpayers can recover damage if the time value of the money was less than the rate of interest charged by the taxing authority.¹⁷⁹ This somewhat more flexible position appears to be at least gaining steam, if not becoming the dominant view around the country.

In New York, taxpayers generally cannot recover interest assessed by the IRS.¹⁸⁰ A New York appellate court recently rejected an attempt to make an end run around that rule, barring claims for fees incurred defending IRS audits.¹⁸¹ The court reasoned that the plaintiff was not entitled to recover costs incurred trying to convince the IRS that he should not have to pay taxes he legitimately owed.¹⁸² Nor could the plaintiff recover fees paid to the accounting firm for preparing returns that were later audited, as the accounting firm had merely charged for a valuable service.¹⁸³

G. *Deepening Insolvency*

“Deepening insolvency” is a theory of damage that continues to generate controversy and conflicting court decisions. Bankruptcy trustees frequently sue accounting firms, alleging that the debtor would have sooner filed for bankruptcy and avoided further operating losses or indebtedness.

In another decision arising from the Parmalat bankruptcy, a federal court dismissed claims brought by bankrupt subsidiaries of Parmalat, which collapsed in 2003.¹⁸⁴ The subsidiaries claimed they incurred debt in reliance on representations that the parent was financially healthy. The court found that the debt they took on was not damage; when they borrowed cash, they received an asset that directly offset the liability incurred on their

177. See *Frank v. Lockwood*, 749 N.W.2d 443, 451–52 (Neb. 2008) (citing cases).

178. *Id.* at 452.

179. *Id.*

180. *Id.* at 451 (citing *Alpert v. Shea Gould Climenko*, 160 A.D.2d 67, 559 N.Y.S.2d 312 (N.Y. App. Div. 1990)).

181. *Penner v. Hoffberg Oberfest Burger & Berger*, 44 A.D.3d 554, 554–55, 844 N.Y.S.2d 229, 230 (N.Y. App. Div. 2007).

182. *Id.*

183. *Id.* at 555, 844 N.Y.S.2d at 231.

184. *In re Parmalat Sec. Litig.*, 501 F. Supp. 2d 560 (S.D.N.Y. 2007).

balance sheets. In other words, there was no deepening insolvency.¹⁸⁵ The court held that delayed liquidation is not a viable theory of damage, as an insolvent company stands to lose nothing if it continues to operate and liquidates later.¹⁸⁶ The court acknowledged that a company could potentially claim damages if it missed out on the opportunity to “fight for survival under bankruptcy protection.”¹⁸⁷ However, the complaint did not allege any facts that would establish beyond speculation that a bankruptcy trustee would have sought reorganization or whether a plan for reorganization would have ultimately been approved. Nor did the complaint allege that a subsidiary operated at a loss or that its assets diminished in value simply as a result of continued operations. For these reasons, the court dismissed damage claims for debt that the plaintiffs incurred.¹⁸⁸

By contrast, claims for operating losses succeeded in the *Thabault v. Chait* case.¹⁸⁹ The Third Circuit upheld a \$182.9 million recovery for Vermont’s insurance commissioner, noting that his claims were not for an increase in the insurance carrier’s balance sheet insolvency. The jury awarded compensatory damages of \$119.9 million, which was the insurer’s net loss from operations that continued after an allegedly defective audit report. The court held operating loss was cognizable damage under New Jersey law because it was actual damage proximately caused by the defendant’s negligence.¹⁹⁰ These operating losses were not merely changes in the insurer’s balance sheet insolvency, and the court thus implied that the operating losses were not really damages for deepening insolvency at all.¹⁹¹

H. In Pari Delicto

Accountants frequently assert the *in pari delicto* defense against bankruptcy trustees. *In pari delicto* literally means “in equal fault.” The doctrine typically prevents a wrongdoer from suing a co-conspirator or accomplice. In malpractice cases, accountants often ask courts to impute an employee’s wrongdoing to a corporate plaintiff or bankruptcy trustee.¹⁹² The law does

185. *Id.* at 574.

186. *Id.* at 576.

187. *Id.* at 577.

188. *Id.* at 577–78.

189. 541 F.3d 512 (3d Cir. 2008). This is the Third Circuit’s third seminal deepening insolvency opinion. The two earlier and oft-cited opinions are *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001), and *Seitz v. Detweiler, Hershey & Assoc. (In re CitX Corp.)*, 448 F.3d 672 (3d Cir. 2006).

190. *Thabault*, 541 F.3d at 519.

191. *Id.* A loan that prolongs a company’s life is, according to the court, a “positive consequence,” as opposed to an operating loss, that is “an immediate negative consequence.” *Id.* at 521.

192. See generally *Bankr. Servs., Inc. v. Ernst & Young (In re CBI Holding Co., Inc.)*, 529 F.3d 432, 448 (2d Cir. 2008) (explaining the imputation doctrine).

not necessarily impute an employee's wrongdoing to a corporation if the employee acted entirely for his own benefit or adversely to the corporation's interests.¹⁹³

Applying these principles, the Second Circuit upheld a \$70 million judgment against an accounting firm.¹⁹⁴ The accountants audited the financial statements of a pharmaceutical products distributor called CBI. To deceive its lenders, CBI's president and management intentionally inflated earnings by delaying recording payables, placing fictitious inventory on the books, and transferring inventories between subsidiaries. Also, CBI's president defrauded the company by taking bonuses based on inflated earnings. When the disbursing agent under the reorganization plan sued over allegedly deficient audits, the accountants objected that management's fraud was imputed to the plaintiff and that the plaintiff therefore lacked standing. The bankruptcy judge had found as a fact that the sole purpose of the fraud was to obtain a larger bonus for the company president and that management had totally abandoned the corporation's interest. The district judge imputed management's fraud to the plaintiff and set aside the bankruptcy judge's \$70 million damage award. On appeal, however, the Second Circuit found the bankruptcy judge's factual finding was not clearly erroneous and therefore controlled the outcome.¹⁹⁵ Because management had totally abandoned the interests of the corporation, the court did not impute management's fraud to the plaintiff and thus rejected the accounting firm's lack of standing defense.¹⁹⁶ One noteworthy fact is that the accounting firm voluntarily subjected itself to bankruptcy court jurisdiction and waived its right to a jury trial by filing a \$210,850 proof of claim for unpaid fees.¹⁹⁷

I. *Statute of Limitations*

The statute of limitations is a popular and frequently litigated affirmative defense. In *Giarratano v. Silver*,¹⁹⁸ New York's three-year statute of limitations for accounting malpractice claims began running when an accounting firm helped the plaintiff invest life insurance proceeds in high-risk corporate bonds. Preparing annual tax returns were separate and discreet services. Thus, preparing tax returns in subsequent years did not constitute continuing representation that would have tolled the statute of limitations.¹⁹⁹ The court rejected various other arguments for tolling the statute

193. *Id.*

194. *Id.* at 437–38.

195. *Id.* at 449–53.

196. *Id.* at 453.

197. *Id.* at 466–68.

198. 46 A.D.3d 1053, 1055, 847 N.Y.S.2d 698, 701 (N.Y. App. Div. 2007).

199. *Id.*

of limitations. As the accountant never said or implied he was a securities broker, his failure to affirmatively state that he was not licensed did not toll the statute of limitations.²⁰⁰ That the accountant also took a free trip in the past and provided personal accounting services to the corporate president did not comprise concealed conflicts of interest and therefore did not toll the statute of limitations either.²⁰¹

The result can obviously depend on the law applied, as another New York case illustrates. In *Seghers v. Deloitte & Touche USA LLP*,²⁰² the accounting firm argued that a Texas statute of limitations barred claims because the plaintiff corporations admitted they were doing business in Texas. The court, however, distinguished between doing business in Texas and residing in Texas. As the pleadings did not establish beyond dispute that the corporations resided in Texas, the court denied a motion to dismiss.²⁰³ An individual plaintiff admitted he was a Texas resident, and the court dismissed his fraud claims as time-barred under a Texas statute of limitations.²⁰⁴ Characterizing the breach of contract claims as claims for professional negligence, the court found those claims time-barred under New York law, where audit malpractice claims accrue upon receipt of the audit report or other work product.²⁰⁵

A federal district court applied this same New York rule and dismissed claims over a tax shelter.²⁰⁶ The court found that the accounting malpractice claim began to run at the latest when the accounting firm issued its opinion letter and dismissed claims filed nearly four years later.²⁰⁷ Alleged repeated assurances about the validity of the tax shelter did not toll the statute of limitations, and the plaintiff had not pleaded fraudulent concealment with sufficient specificity.²⁰⁸

Over on the other side of the country, a California appellate court overruled a statute of limitations defense.²⁰⁹ Even though the IRS ultimately assessed no deficiency, the plaintiffs sued the accountants, claiming they negligently prepared income tax returns and inadequately documented their positions and thereby unnecessarily protracted the length and cost of the audit. Although the plaintiffs began incurring professional fees in connection with the audit much earlier, they sustained the “actual injury”

200. *Id.* at 1055–56, 847 N.Y.S. 2d at 701.

201. *Id.*

202. No. 602135/06, 2007 WL 3101242 (N.Y. Sup. Ct. Aug. 13, 2007).

203. *Id.* at *5.

204. *Id.* at *6.

205. *Id.* at *6–7.

206. *Arnold v. KPMG LLP*, 543 F. Supp. 2d 230, 236 (S.D.N.Y. 2008).

207. *Id.*

208. *Id.* at 236–37.

209. *Sahadi v. Scheaffer*, 66 Cal. Rptr. 3d 517, 530–32 (Cal. Dist. Ct. App. 2007).

necessary to trigger the statute of limitations at the *conclusion* of the audit process.²¹⁰ As the claim accrued within the period of limitation, the court reversed a directed verdict for the accountants.²¹¹

J. Exculpatory Clauses

Two recent decisions enforced exculpatory clauses in accountants' engagement letters. Applying Georgia law, the Eleventh Circuit enforced 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."²¹² At trial, the audit clients claimed they would have fired the company president and avoided the allegedly excessive expenses he caused the companies to incur if they had known the financial statements overstated net income. Finding that the exculpatory clause barred these damages, the Eleventh Circuit affirmed a judgment notwithstanding the verdict.²¹³ The court noted that the corporate plaintiffs were sophisticated clients with equal bargaining power.²¹⁴ The accounting services at issue were not practically necessary services (like medical or dental care, where exculpatory clauses may be unenforceable).²¹⁵ Also, Georgia has no statute specifically imposing a duty of care on accountants or that establishes any public policy that would override the exculpatory clause.²¹⁶ Note that damages limitation clauses are probably unenforceable in the publicly traded context.²¹⁷

A Massachusetts trial court reached a similar conclusion in the tax context.²¹⁸ The engagement letter provided that the firm's "maximum liability to Client arising for any reason relating to services rendered under this engagement shall be limited to the fees paid for those services."²¹⁹ On a summary judgment motion, a Massachusetts trial court judge enforced this provision and limited damages to the fees paid. The court noted that regulation of the accounting profession was under the control of the executive branch, not the judicial branch. The court said that any public policy to the contrary would have to come from the legislature or the Board of Public

210. *Id.*

211. *Id.*

212. TSG Water Resources, Inc. v. D'Alba & Donovan Certified Pub. Accountants, P.C., No. 06-11803, 2007 WL 445386, at *10 (11th Cir. Dec. 20, 2007).

213. *Id.* at *11.

214. *Id.*

215. *Id.*

216. *Id.*

217. Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 Fed. Reg. 6847-01 app. B (Feb. 9, 2006).

218. Rohstein Corp. v. KPMG, LLP, No. 04-3517, 2007 WL 4416840, at *1 (Mass. Super. Ct. Dec. 10, 2007).

219. *Id.*

Accountancy.²²⁰ As the plaintiff was a sophisticated commercial enterprise capable of negotiating agreements, the court rejected an argument that the exculpatory clause was unconscionable.²²¹

IV. CONCLUSION

In the past year, the area of legal malpractice faced a trend among courts expanding the class of plaintiffs entitled to sue and saw an increasing focus on the discovery rule and continuous representation doctrine. Director and officer liability was the subject of a wide range of cases this past year. Scierter under the PSLRA, insolvency issues, and scheme liability under § 10(b)(5) of the Securities Act were just a few of the notable topics regarding corporate directors and officers. Developments regarding insurance coverage pertained to disgorgement, consent to settle, and triggering of excess policies. Accounting malpractice opinions from the past year also addressed a variety of topics, including pleading requirements, international structure, causation, as well as recent trends in deepening insolvency and the *in pari delicto* defense. The body of case law in accounting malpractice continues to expand.

220. *Id.* at *2.

221. *Id.*