RECENT DEVELOPMENTS AFFECTING PROFESSIONALS', OFFICERS', AND DIRECTORS' LIABILITY

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I. Developments in Legal Malpractice 440
A. E-Discovery, Contract Attorneys, and the Liabilities Imposed 440
B. Mediation Confidentiality Statutes and Their Application in Legal Malpractice Cases 443
C. The Extension of Attorney-Client Liabilities to Third Parties 445
D. Preemptive Strikes to Legal Malpractice Claims 448
II. Developments in Accounting Malpractice 449
A. *Daubert* Exclusion of Accounting Expert Witness 449
B. In Pari Delicto Defense 449
C. Respondeat Superior 451
D. Liability to Third Parties 452
E. Defenses 452
F. Statutes of Limitation 453
G. Audit Interference Rule 456
H. Securities Fraud Claims 456
III. Developments in Directors' and Officers' Liability 457
A. Liability for Causing a Company to Act Illegally 457

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B. Duties Owed to Creditors ... 458
C. Delaware State Law Claims for Insider Trading ... 458
D. Advancement and Indemnification of Legal Fees and Expenses ... 459
IV. Developments in Agent/Broker Malpractice 460
A. Scope of a Producer's Duty ... 460
B. Liability for Misrepresentation on the Insurance Application ... 463
C. Update on New York Law Regarding Payment by an Insurance Agent to an Unlicensed Person ... 466

I. DEVELOPMENTS IN LEGAL MALPRACTICE

Over the last year, courts around the country have grappled with a number of new variants of old issues in the area of legal malpractice. This article highlights some of the emerging issues raised in recent notable cases involving allegations of legal malpractice.

A. *E-Discovery, Contract Attorneys, and the Liabilities Imposed*

Litigators have always faced potential legal malpractice claims arising from court-imposed sanctions.[1] Frequently, these court sanctions arise from the discovery process, including the lawyer's failure to conduct adequate investigation through the discovery process or a failure to timely respond to an opponent's discovery requests. When these errors result in the client being penalized through restrictions in the evidence the client can present at trial, adverse jury instructions, or losing the case altogether through a default judgment or dismissal, a suit against the litigation lawyer typically will follow.

The 2006 amendment to Rule 34 of the Federal Rules of Civil Procedure adding electronically stored information to the rule imposed a new dimension to the lawyer's oversight and management of the client's discovery obligations and increased the potential for discovery sanctions imposed upon the client. As one federal court recently held, the litigation attorney clearly has the responsibility "to take affirmative steps to monitor compliance so that all sources of discoverable information are identified and searched."[2] The additional duty imposed upon a lawyer to preserve, collect, and subsequently produce relevant electronically stored information is triggered as soon as a

1. *See*, *e.g*., Century Media Corp. v. Carlile Patchen Murphy & Allison, 773 F. Supp. 1047 (S.D. Ohio 1991); Nappe v. Correri & Sapienza, 580 N.Y.S.2d 465, 466 (N.Y. App. Div. 1992) (discussing how an attorney's alleged failure to respond to discovery requests led to adverse summary judgment); Robinson v. Bodoff, 382 F. Supp. 2d 229, 231 (D. Mass. 2005) (discussing a suit against lawyers for failing to oppose summary judgment).
2. Zubulake v. UBS Warburg, LLC, 229 F.R.D. 422, 432 (S.D.N.Y. 2004).

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credible threat of litigation is made against the lawyer's client. The sanctions imposed for failing to comply with the e-discovery requirements range in severity. Sanctions can involve the imposition of legal fees, the issuance of severe adverse inference jury instructions, default judgment, and dismissal.

The current economic conditions create challenges for law firms as they attempt to comply with e-discovery requirements for cost-conscious clients. In an attempt to reduce costs, contract attorneys are often hired to conduct critical pre-trial document reviews, which often require that they read and review huge volumes of electronic documents in complex cases.[3] This practice has become increasingly attractive, given the large numbers of underemployed law graduates, and is facilitated by technological advances that permit the easy attorney review of voluminous electronic documents remotely. With the volume of data involved in many cases, the number of documents available through the e-discovery process, and the lack of formal training in reviewing e-discovery available to contract attorneys, often due to their short-term contracts, privileged documents are susceptible to inadvertent release and relevant documents may inadvertently not be preserved. Such potential consequences raise new legal malpractice concerns, which became apparent in the recent complaint filed in California in *J-M Manufacturing Co. v. McDermott Will & Emery*.[4]

The case arose from the defendant's representation of the plaintiff regarding subpoenas received in 2006 and 2007 from the federal government and the States of California and Texas.[5] The subpoenas "sought information regarding the False Claims Act allegations made in *United States ex rel. Hendrix v. J-M Manufacturing Co*., which was then a non-public complaint filed under seal. Each of the subpoenas required JM to produce paper and electronic documents."[6] During its representation of JM, McDermott Will & Emery worked with JM to identify about 160 custodians who were likely to possess responsive electronic information. McDermott engaged Stratify, a third-party electronic discovery vendor, which used a list of keywords to search the data for responsive information. McDermott then produced the documents containing the keywords to the federal government. While reviewing these documents, the government found a significant number of privileged documents and asked McDermott "to conduct a privilege review and submit a new production set."[7] In response to the

3. *See generally* Vanessa O'Connell, *New Work Rules for Temp Lawyers*, Wall St. J., June 15, 2011, *available at* http://online.wsj.com/article/SB100014240527023037147045763836502 02372000.html.

4. Complaint, J-M Mfg. Co. v. McDermott Will & Emery, No. BC462832 (Cal. Super. Ct. June 2, 2011).

5. *Id*. at 3.

6. *Id*.

7. *Id*.

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government's request, McDermott hired contract attorneys to review documents that had undergone a second keyword list filter to determine whether documents were privileged. The contract attorneys reviewed the documents and allegedly divided them into three categories: "responsive but privileged; responsive and not privileged; and non-responsive."[8] McDermott's permanent attorneys allegedly performed a limited spot-check of the contract attorneys' work and allegedly did not conduct any further privilege review. As a result of the document review conducted by the contract attorneys, "[a]bout 250,000 electronic documents were produced to the governmental entities, including many based on the contract attorneys' assessments of responsiveness and privilege."[9]

In March 2010, JM allegedly discharged McDermott and retained new counsel in the matter, Sheppard Mullin Richter & Hampton, LLP.[10] Around June 2010, counsel for the party in interest in the False Claims Act suit informed JM's new counsel that it had received JM's document production from the federal government. In reviewing the documents produced, the recipient's attorneys found some documents that reportedly appeared to be privileged and segregated those documents. Following requests by JM's attorneys to destroy the privileged documents, the recipient refused to do so, alleging a subject matter waiver of the attorney-client privilege. The recipient alleged two attempts on the part of JM's previous counsel, McDermott, to review the documents to ascertain whether any of them were privileged prior to producing them.[11] JM subsequently sued McDermott for legal malpractice, breach of fiduciary duty, and unlawful accounting practices.[12] In its malpractice suit, JM alleged on information and belief that "approximately 3,900 privileged documents were produced by [McDermott] and that such 3,900 documents should not have been produced by [McDermott]."[13]

The issues raised in the *J-M Manufacturing* case present new potential questions of liability in the legal practice. For example, with the increasing use of less-supervised temporary contract attorneys, to what extent are law firms liable for their actions? A recent trend has been for law firms to require that contract attorneys agree to indemnification provisions for any potential malpractice claims arising from their work.[14] This trend reverses the traditional approach in which employers obtain liability insurance to cover errors and omissions by their employees. This raises the question: to

8. *Id.*
9. *Id.* at 3–4.
10. *Id.* at 4.
11. *Id.*
12. *See generally id.*
13. *Id.*
14. *See generally* O'Connell, *supra* note 3.

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what extent should a law firm hold an employee as an insurer of the employer and/or client? The requirement of indemnification agreements may also affect the productivity levels of contract attorneys in the long term as they become increasingly aware of their personal risk of malpractice. The growing use of contract attorneys coupled with the increasingly extensive use of e-discovery raises some interesting issues concerning what precautionary measures law firms should expect and be required to take in the years following the *J-M Manufacturing* case.

B. *Mediation Confidentiality Statutes and Their Application in Legal Malpractice Cases*

A common claim of legal malpractice against litigation attorneys involves their representation of the client in the settlement of the underlying litigated matter.[15] The lawyer is required to investigate, evaluate, and communicate a settlement offer to a client.[16] An attorney's failure to adhere to these duties could subject the attorney to liability for failure to inform a client of a settlement offer, accept an existing settlement offer, or adequately investigate and evaluate the client's case prior to making a settlement recommendation. Increasingly, the settlement of litigation is reached through various forms of mediation, as parties resort to mediation either by their own volition or due to court mandate.[17]

To encourage the use of mediation, states have legislated mediation confidentiality statutes that aim to insulate statements made during mediation from their use in subsequent proceedings.[18] However, the increase in settlement of cases through mediation raises additional legal malpractice concerns as states enforce mediation confidentiality statutes not only in the case being mediated, but also in the use of such communications in

15. *See*, *e.g.*, Fishman v. Brooks, 487 N.E.2d 1377, 1379–80 (Mass. 1986) (coerced settlement due to lawyer's failure to prepare for trial); Scognamillio v. Olsen, 795 P.2d 1357 (Colo. Ct. App. 1990) (attorneys liable for failure to recommend a settlement offer).

16. 4 Ronald E. Mallen & Jeffrey M. Smith, Legal Malpractice § 32:41, at 776 (4th ed. 2011).

17. The U.S. Department of Justice's Office of Dispute Resolution reports that from 2007 until 2009, the number of settlements arrived at by voluntary ADR proceedings rose from sixty-nine percent to eighty percent. U.S. Department of Justice, Statistical Summary: Use and Benefits of Alternative Dispute Resolution by the Dep't of Justice (2010), http://www.justice.gov/odr/doj-statistics.htm. The Eastern District of New York reported that of the settled or unsettled cases reported between July 1, 2009, and June 30, 2010, seventy percent were settled as a result of mediation. U.S. Dist. Court, E. Dist. of New York, Mediation Report: Alternative Dispute Resolution, July 1, 2009–June 30, 2010 (2010), http://www.nyed.uscourts.gov/adr/ADR_Information/ADR_Statistics/adrstats2010.pdf. For the period between July 1, 2002, and June 30, 2003, the Eastern District reports that 53.6% were settled after mediation, an almost twenty percent increase in just seven years. *Id*.

18. *See*, *e.g.*, Cassel v. Superior Court, 244 P.3d 1080, 1083 (Cal. 2011) (discussing California's mediation confidentiality statute).

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a subsequent legal malpractice suit. This issue recently arose in the California case of *Cassel v. Superior Court*. In *Cassel*, the Supreme Court of California squarely addressed "the effect of the mediation confidentiality statutes on private discussions between a mediating client and attorneys who represented him in the mediation."[19] In the case, Michael Cassel agreed to a mediated settlement of business litigation in which he was a party and subsequently sued his attorney for malpractice, breach of fiduciary duty, fraud, and breach of contract. Prior to trial, the defendant attorneys moved to exclude all evidence of private attorney-client discussions "immediately preceding, and during, the mediation concerning mediation settlement strategies and defendants' efforts to persuade petitioner to reach a settlement in the mediation."[20] The trial court granted the motion, but the California Court of Appeal vacated the lower court's order. The California Supreme Court reversed the appellate court's decision due to a strict construction of the language of California's mediation confidentiality statutes.[21]

Citing the statutory language, the California Supreme Court held that all things said or written by participants in a mediation are inadmissible in any civil action.[22] In its analysis, the court noted the purpose of the mediation confidentiality statutes, which is "to encourage the mediation of disputes by eliminating a concern that things said or written in connection with such a proceeding will later be used against a participant."[23] In adhering to this statutory purpose, the court found that the statutory language extended to attorneys participating in a mediation unless "such a result would violate due process, or would lead to absurd results that clearly undermine the statutory purpose," even if such an application may "compromise [a] petitioner's ability to prove his claim of legal malpractice."[24] Thus, attorneys are participants whose statements at mediation cannot and will not be used against them in a court of law. The Ninth Circuit reached a similar result under Oregon law.[25]

Although its decision was an admirable attempt to strictly apply statutory language and purpose to the case at hand, the court's holding in *Cassel* raises multiple concerns. The primary concern raised is to what extent do

19. *Id.*
20. *Id.* at 1084.
21. *Id.*
22. *Id.*
23. *Id.* at 1088.
24. *Id.* at 1084.
25. Fehr v. Kennedy, 387 F. App'x 789, 791 (9th Cir. 2010) (holding that the term "subsequent adjudicatory proceedings" within the meaning of an Oregon mediation confidentiality statute extended to subsequent legal malpractice claims arising from the underlying mediation).

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mediation confidentiality statutes shield attorneys from malpractice and associated malpractice claims? Moreover, applying confidential mediation statutes to bar evidence in a subsequent legal malpractice action may also undermine the strength of a prospective plaintiff's legal malpractice claim for the attorney's failure to properly investigate and advise as to the settlement. Variations of the issues raised in *Cassel* will likely unfold in other jurisdictions with similar mediation confidentiality statutes in the years to come.

C. *Extension of Attorney-Client Liabilities to Third Parties*

Another recurring issue raised in courts in recent months concerns the extent to which an attorney owes a duty of care to a nonclient. In most jurisdictions, courts have established the general rule that "an attorney's liability for malpractice is limited to some duty owed to a client. . . . Where there is no attorney-client relationship there is no breach or dereliction of duty and therefore no liability."[26] Therefore, the "[e]xistence of an attorney-client relationship is an element of a malpractice plaintiff's proof."[27] In various circumstances and under rules that vary from state to state, attorneys can incur liability to third parties.

One scenario where the question of an attorney's duty to a third party consistently arises is in cases brought by beneficiaries of failed wills. A case dealing with this same issue arose recently in California. In *Hall v. Kalfayan*, a prospective beneficiary of a will, which was not validly executed, sued the attorney who drafted the will for legal malpractice.[28] The court in *Hall* dismissed the claim for legal malpractice, stating that the attorney involved owed no duty to the prospective beneficiary. In arriving at its holding, the appellate court surveyed a number of cases addressing similar factual circumstances and concluded that where the courts had found a duty, the beneficiaries were ascertained through some definitive prior act showing an intent to designate the claimants as beneficiaries.[29] In such cases, the beneficiaries were named and a will already executed, but the will simply failed due to the lawyer's negligence. In these instances, the California courts have found that the question is "whether the will or trust had been negligently prepared so as to frustrate the testator's intent."[30] The *Hall* court emphasized that in cases where a duty existed, there was more evidence of commitment "in [the form of] a signature on testamentary documents than

26. DeVaux v. Am. Home Assurance Co., 444 N.E.2d 355, 357 (Mass. 1983) (citing McGlone v. Lacey, 288 F. Supp. 662, 665–66 (D.S.D. 1968)).
27. Miller v. Mooney, 725 N.E.2d 545, 549 (Mass. 2000).
28. 118 Cal. Rptr. 3d 629 (Ct. App. 2010).
29. *Id*. at 633–36.
30. *Id*. at 634.

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in a preliminary direction to prepare such documents for signature."[31] The court noted that finding a duty to a prospective beneficiary in the absence of clear intent from the testator '"could improperly compromise an attorney's primary duty of undivided loyalty to his or her client, the decedent.'"[32]

Another area of increased exposure for attorneys to nonclients arises from the deluge of foreclosures and the decline of the real estate market. Particularly at risk are those attorneys involved in certain unusual real estate transactions. In New Jersey, a jurisdiction that potentially permits legal malpractice plaintiffs to recover their legal fees and costs when prosecuting a malpractice claim[33] and where lawyers can be liable to third parties who foreseeably rely on information that lawyers provide,[34] lawyers have been targets in claims asserted by homeowners in foreclosure rescue transactions.[35] Lawyers have been held liable in homeowner suits contesting these foreclosure transactions, despite having a signed nonrepresentation acknowledgment provided by the homeowner sellers.[36]

For instance, in *Jackson v. Lurski*,[37] Cindy Jackson, facing foreclosure, elected to sell her Newark home to Anne Lurski for $190,000 while continuing to live there as a tenant with an option to purchase.[38] At the closing, Jackson's mortgage was paid off and over $41,000 was disbursed by the settlement agent lawyer for various "other liabilities."[39] After noting a variety of errors in the HUD-1 settlement statement and other problems with the transaction itself, the court entered summary judgment

31. *Id.* at 635.

32. *Id.* (citing Radovich v. Locke-Paddon, 41 Cal. Rptr. 2d 573, 583 (Ct. App. 1995)). The California court's approach in *Hall v. Kalfayan* reflects that of other jurisdictions where the courts find there is a more reasonable claim for a duty owed by an attorney to a beneficiary where the beneficiary is ascertained, as opposed to those involving a mere prospective beneficiary. In the former cases, there is no conflict between the duty owed to the attorney's client, the testator, and the intended beneficiaries, as both would want the will allowed. *See* Logotheti v. Gordon, 607 N.E.2d 1015, 1017 (Mass. 1993).

33. Saffer v. Willoughby, 670 A.2d 527, 534–35 (N.J. 1996).

34. Petrillo v. Bachenberg, 655 A.2d 1354, 1359–60 (N.J. 1995).

35. Hoping to save their homes, homeowners facing foreclosure, or its looming specter, sometimes enter into sale/leaseback real estate transactions whereby the homeowners convey title to third-party investors. The homeowner/seller enters into a lease with an option to buy back the property at a fixed amount, presumably when the homeowner's financial circumstance improves after time. The selling homeowner pays a fee, frequently equivalent to whatever equity the homeowner had left in the property, to the investor or a third party that facilitated the foreclosure rescue. *See* Philip Shishkin, *When "Rescue" Means Eviction*, WALL ST. J., Feb. 26, 2009, *available at* http://online.wsj.com/article/SB123561189654377741.html.

36. *E.g.*, O'Brien v. Cleveland (*In re* O'Brien), 423 B.R. 477, 499–500 (Bankr. D.N.J. 2010), *aff'd sub nom.* Cleveland v. O'Brien, No. 10-3169(GEB), 2010 WL 4703781 (D.N.J. Nov. 12, 2010).

37. No. ESX-C-235-08 (N.J. Super. Ct. Ch. Div. Feb. 22, 2011).

38. *Id.*, slip op. at 2.

39. *Id.*

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against the lawyer defendant, holding that he "had a duty of care with regard to the [p]laintiff. [The lawyer] prepared the documents signed by [p]laintiff, which effectuated the closing of the property. He was fully aware of the unconscionable transaction, whereby all of [p]laintiff's equity in her home was disbursed by him to himself and the other defendants in this matter."[40]

Similarly, in *O'Brien v. Cleveland*, the U.S. Bankruptcy Court for the District of New Jersey found that an attorney, acting as the settlement agent and who arguably had an attorney-client relationship with the buyer of the real estate in a sale/leaseback transaction, was nonetheless liable to the homeowner/seller for legal malpractice.[41] The lawyer prepared the closing documents and, according to the court, the buyer could not have carried out the scheme if the lawyer had fulfilled his ethical responsibilities.[42] The court further held that the lawyer knew or should have known that the buyer's scheme was improper and that the lawyer was therefore complicit in a conspiracy with the buyer.[43] In fact, the court commented that

> [the defendant,] as an attorney licensed in New Jersey, should have refused to participate in a fraudulent, unconscionable transaction. He should not have prepared a HUD closing statement that grossly overstated the purchase price, falsely showed Cleveland investing significant cash in the deal, and falsely stated that the O'Briens were to receive substantial cash proceeds.[44]

Notably, in *O'Brien*, the lawyer was not merely the scrivener of the closing documents; he also knew or should have known that the HUD-1 was erroneous, at best, and misrepresented the essence of the transaction. Moreover, the lawyer was also aware that the buyer had the seller execute three different and conflicting agreements concerning the repurchase transaction.[45] Although the court acknowledged there was no attorney-client relationship, the court nevertheless found the lawyer liable not only as a co-conspirator but also under a theory that lawyers have a duty to refrain from participating in fraudulent or illegal transactions.[46] Thus, in the current economic climate, real estate attorneys should be particularly vigilant in sale/leaseback transactions to avoid liability and damage exposure.

40. *Id.*, slip op. at 7.
41. 423 B.R. at 499–500.
42. *Id.* at 500.
43. *Id.*
44. *Id.* at 501.
45. *Id.* at 485.
46. *Id.* at 499–500.

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D. *Preemptive Strikes to Legal Malpractice Claims*

Another issue recently raised in courts involves the use of declaratory judgments to preempt legal malpractice claims. In the Massachusetts case of *Bingham McCutchen, LLP v. Frank H. McCourt, Jr.*,[47] a law firm filed a declaratory judgment complaint against a former client, who was the owner of the Los Angeles Dodgers. The law firm sought a judicial finding that it had met the standard of care for professionals providing legal representation.[48]

An attorney at Bingham McCutchen named Lawrence Silverstein assisted McCourt in acquiring the Dodgers. He also drafted a Marital Property Agreement (MPA) that set forth which assets belonged to each spouse and that specified each spouse would keep his or her respective property in the event of divorce.[49] Each spouse signed identical copies of the MPA, but a document referred to as Exhibit A, attached to the copies, was not identical. One version said the Dodgers would be the property of Frank McCourt and the other version said the Dodgers would belong to his spouse. When Jamie McCourt filed for divorce, a California court invalidated the MPA for lack of a contractual meeting of the minds.[50]

Following the California court's decision in December 2010, the law firm sought a preemptive declaratory judgment in a Massachusetts Superior Court that its services met the standard of care for professionals in the legal practice and that "the law firm's conduct did not cause McCourt to suffer any loss with respect to his ownership of the Dodgers."[51] The Massachusetts Superior Court granted McCourt's motion to dismiss the law firm's complaint.[52]

The court held that to allow the complaint for declaratory judgment would "permit the reversal of roles in a negligence action and to allow the tortfeasor to sue first would upset the traditional right that our judicial system gives to the injured plaintiff to choose when and where to litigate."[53] The court also found that a contrary holding would pervert the purpose of declaratory judgment, since the outcome of the malpractice claim would depend on several other pending cases between the parties, and the action appeared to be "motivated more by desire to gain some strategic advantage, not to avoid or minimize any possible future harm to anyone."[54]

47. No. 11-1405-BLS2 (Mass. Super. Ct. Aug. 17, 2011).
48. Order Denying Declaratory Judgment, Bingham McCutchen, LLP v. McCourt, No. 11-1405-BLS2 (Mass. Super. Ct. Aug. 17, 2011).
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* at 8.
53. *Id.* at 4.
54. *Id.* at 6–7.

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II. DEVELOPMENTS IN ACCOUNTING MALPRACTICE

A. *Daubert Exclusion of Accounting Expert Witness*

The U.S. District Court for the Middle District of Florida excluded testimony from an accountant who proposed to testify that the defendant accounting firm failed to have proper quality control systems and breached ethical rules.[55] After noting that the defendant was engaged to provide consulting and accounting advice regarding a business plan, and concluding that the professional standards for quality control are "plainly inapplicable" to that work, the court excluded the expert's testimony because he did not examine the quality control systems in question but instead "[appeared] to work backward from the fact that the illegal activity was not detected [by the defendants] to reach a conclusion that [defendants'] systems for detecting such activity were not in place."[56] The court also excluded opinions that the accountants breached ethical rules by failing to resign after they allegedly learned of financial fraud, reasoning that "it should be obvious to the average person that the accountant who learns of financial fraud of the client . . . and simply goes along with that has committed an ethical violation."[57]

B. *In Pari Delicto Defense*

In a New York case, the in pari delicto defense barred a plaintiff from recovering where top-level managers knew of or participated in the financial wrongdoing at the heart of the misstated financial statements.[58] After noting that management had inflated the value of accounts receivable and inventory by approximately $5 million, the court reasoned that " 'knowledge acquired by an agent acting within the scope of his [or her] agency is imputed to his [or her] principal and the latter is bound by such knowledge although the information is never actually communicated to [the principal].' "[59] The court also said the assignee of the audit client's rights acquired no greater rights than those of the assignor and was subject to all defenses to the assignor's claims, including in pari delicto.[60] Finally, the court concluded that the adverse interest exception to the in pari delicto defense did not apply because that exception requires that the wayward agent " 'must

55. Mirabilis Ventures, Inc. v. Rachlin Cohen & Holtz, LLP (*In re* Mirabilis Ventures, Inc.), 2011 WL 2784105, at *4–6 (M.D. Fla. 2011).
56. *Id.* at *5.
57. *Id.* at *6.
58. Chaikovska v. Ernst & Young LLP, 913 N.Y.S.2d 449, 451 (N.Y. App. Div. 2010).
59. *Id.* at 452 (citing Center v. Hampton Affiliates, Inc., 488 N.E.2d 828, 829 (N.Y. 1985)).
60. *Id.* at 451.

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have *totally abandoned* [the] principal's interests and be acting *entirely* for his [or her] own or another's purposes,' not the [principal's]."[61] Here, the court found that the purpose of the fraudulent conduct was to permit the audit client to continue to borrow money from its lender.

On different facts, however, the District Court for the Southern District of New York sustained the adverse interest exception on a motion to dismiss.[62] The complaint contained summary allegations that allege "precisely what the adverse interest exception requires"—that the agent-wrongdoer whose knowledge is sought to be imputed to his principal acted for his own exclusive interests.[63] The court rejected the defendants' arguments that the principal benefited from the wrongdoing, noting that while the principal received interest payments, the principal earned less than it would have without the misconduct.[64] The complaint therefore alleged "the functional equivalent of the 'theft or looting or embezzlement' that . . . is the classic example of the adverse interest exception."[65]

Applying West Virginia law, the Fourth Circuit declined to invoke the in pari delicto defense in an action brought by the FDIC.[66] The court predicted that the West Virginia Supreme Court of Appeals would find the doctrine inapplicable where the FDIC sought to vindicate the rights of the public and not just the rights of the business to whom knowledge of wrongdoers would be imputed.[67] The court thus affirmed the district court's decision disallowing the accounting firm's affirmative defenses of in pari delicto, comparative negligence, and other defenses imputing bank management's knowledge to the FDIC.

A Pennsylvania court denied a motion to dismiss on the in pari delicto defense in *Bechtle v. Master, Sidlow & Associates, P.A.*[68] The receiver of a defunct investment firm filed a malpractice claim against the firm's auditors for failing to detect the investment firm's Ponzi scheme. The accounting firm argued that the receiver's claims were barred because the investment firm, by providing false data to the accountants, was at least equally responsible for the wrongs alleged. The court denied the auditors' motion because it oversimplified the legal contours of the doctrine and because further development of the factual record was necessary.[69]

61. *Id.* at 452 (citations omitted).
62. *In re* Refco Sec. Litig., 779 F. Supp. 2d 372 (S.D.N.Y. 2011).
63. *Id.* at 375.
64. *Id.* at 376 n.3.
65. *Id.* at 376.
66. Grant Thornton LLP v. FDIC, 435 F. App'x 188, 201 (4th Cir. 2011).
67. *Id.* at 200.
68. 766 F. Supp. 2d 547, 554–55 (E.D. Pa. 2011).
69. *Id.* at 554. In Pennsylvania, accountants accused of negligence may successfully argue for imputation of wrongdoing to their client if three conditions are met: (1) the actions of

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A Nevada federal judge granted summary judgment to Deloitte & Touch, LLP based on the doctrine of in pari delicto in a lawsuit brought by the bankruptcy trustee of Deloitte's former client, USACM.[70] The trust alleged Deloitte issued unqualified audit opinions in 2000 and 2001 that allowed USACM's corporate insiders to fraudulently misappropriate service fees, steal from the trust account, and operate a Ponzi scheme with investor funds.[71] The trust claimed imputation was improper because the insiders were not acting within the scope of their authority and were acting adversely to USACM's interests. Agreeing with Deloitte, the court found that the insiders who perpetrated the fraud acted within the scope of their corporate authority and were the sole relevant actors, such that even if they were acting adversely to USACM's interests, their knowledge and actions could nevertheless be imputed to the company and its trust.[72] Accordingly, USACM was the party guilty of greatest fault, and its liquidating trust could not recover from Deloitte.[73]

C. *Respondeat Superior*

In *Oetting v. Heffler, Radetich & Saitta, LLP*, an accounting firm was retained to administer a class action settlement fund.[74] One of its employees, hired to assist in valuing submitted claims, himself submitted false claims seeking payment from the settlement fund. After noting that Missouri law applies, the court described the doctrine of respondeat superior, under which the employer is liable to third parties for torts committed while the employee was engaged in activities within the course and scope of employment.[75] Because there were no allegations that the employee was serving his employer's interests, the court concluded that the plaintiff failed to allege sufficient facts to support a claim under respondeat superior.[76]

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the agent must be for the company's benefit, not adverse to the company's interests; (2) the accountants must have dealt in good faith with the company; and (3) there must be no other public policy considerations that counsel against imputation. *Id.* at 553 (citing Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PriceWaterhouseCoopers, LLP, 989 A.2d 328, 339 (Pa. 2010)). However, the court acknowledged that in pari delicto remains a viable defense to claims of auditor malpractice under Pennsylvania law. *Id.* at 554.

70. USACM Liquidating Trust v. Deloitte & Touche LLP, 764 F. Supp. 2d 1210, 1228–29 (D. Nev. 2011).

71. *Id.* at 1213–15.

72. *Id.* at 1222.

73. *Id.* at 1230.

74. No. 4:11-CV-253 (CEJ), 2011 WL 3055235 (E.D. Mo. July 25, 2011).

75. *Id.* at *3. "If the act is fairly and naturally incident to the employer's business, although mistakenly or ill-advisedly done and did not arise wholly from some external, independent or personal motive, it is done while engaged in the employer's business." *Id.*

76. *Id.* at *4.

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D. *Liability to Third Parties*

Applying New York law, the Third Circuit affirmed summary judgment in favor of accountants in an action brought by an equipment leasing company.[77] The leasing company purchased the leased assets from a predecessor leasing company after examining one accounting firm's prior year audit report and an interim compilation report and a second firm's current year audit report. Shortly after the purchase, the lessee ceased making lease payments and declared bankruptcy. After finding that New York law governs, the Third Circuit affirmed summary judgment because there was no evidence that the accounting firms knew the plaintiff leasing company would rely on their work product.[78]

In *Stuart v. Freiberg*, nonclient beneficiaries of an estate brought an action against an accountant, alleging that the defendant improperly assisted the executor in using estate funds for the executor's personal benefit.[79] Significantly, the undisputed facts indicate that the plaintiffs had already brought a legal action seeking the removal of the executor before the defendant accountant was hired to do any accounting work for the estate. The court granted summary judgment, finding that the plaintiffs could not show they relied upon the accountants' allegedly wrongful representations because they were well aware of the alleged executor misconduct before the accountant was retained.[80] Thus, the court granted summary judgment on claims of fraud, negligent misrepresentation, accounting malpractice, and unfair trade practices.

E. *Defenses*

The Fourth Circuit considered causation defenses on appeal from a bench trial in *Grant Thornton LLP v. FDIC*.[81] The accounting firm argued that the

77. Overland Leasing Grp., LLC v. First Fin. Corporate Servs. Inc., 436 F. App'x 119, 124 (3d Cir. 2011).

78. *Id.* Under New York law, a nonclient must show (1) the accountants must have been aware that their reports would be used for a particular purpose, (2) in the furtherance of which the nonclient was intended to rely, and (3) there was some conduct linking the accounting firms to the nonclient that evinced the accounting firms' awareness that the nonclient would rely on their work. *Id.* at 123. The district court had initially applied New Jersey law and granted summary judgment under a New Jersey statute governing accountants' liability to third parties. *Id.* at 121.

79. No. FSTCV040200508S, 2011 WL 3671904 (Conn. Super. Ct. July 15, 2011).

80. *Id.* at *7. At the same time, the court explained the potential liability of an accountant to a nonclient. Connecticut judges have adopted the New York rule for liability and negligence to third parties. *Id.* at *8. Also, the court explained that a nonclient may bring an action against an accountant for professional malpractice, without reference to privity, so long as the plaintiff is the intended or foreseeable beneficiary of the professional's undertaking. *Id.* at *9. Finally, the court referred to Connecticut's Unfair Trade Practices Act and indicated that accountants, like other professionals, though generally exempt from the application of the act, are potentially liable for conduct that implicates "the entrepreneurial aspects of the defendant's accounting practice," including, for example, advertising and bill collection activities. *Id.* at *11.

81. 435 F. App'x 188, 194–197 (4th Cir. 2011).

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bank's post-audit losses resulted from the bank's long-standing, unprofitable activities and were not the proximate result of the audit. The court rejected the argument, noting that the accounting firm was not hired in the ordinary course, but at the insistence of federal regulators.[82] Pointing to facts indicating the auditors' awareness of past financial statement irregularities and suspected problems and weaknesses in the bank's financial reporting, the Fourth Circuit found no clear error in the trial court's factual finding that audit failures proximately caused net operating losses in the four months following the audit report.[83]

Similarly, the Fourth Circuit rejected the auditor's intervening cause defense. The auditor pointed to evidence that the bank's executives recklessly continued operations to hide the bank's true financial condition. After reviewing West Virginia precedent, the court concluded that an intervening cause must be one that is new and independent of any prior act, making it the only proximate cause of the injury. Applying this principle, the court found continued fraudulent conduct by bank management was not unforeseeable and did not operate independently of the failed audit.[84]

In *Dallman Acquisition, LLC v. Dallman*, the district court was presented with a claim of accounting malpractice asserted on behalf of an audit client and a claim of fraudulent inducement brought by the purchaser of the client's assets.[85] In defense of the fraudulent inducement claim, the accounting firm asserted that an expression of opinion could not constitute fraud. Quoting an 1862 seminal Indiana Supreme Court decision, the district court concluded that a representation as to past financial matters is a potentially actionable fact, while a representation as to a future financial matter would be a nonactionable expression of opinion.[86]

F. *Statutes of Limitation*

Which statute applies? The U.S. District Court for the District of Massachusetts was presented with competing claims that an action against an accountant and his firm was governed by a three-year statute pertaining to malpractice of public accountants, a six-year statute pertaining to contract claims, or a four-year statute for unfair and deceptive acts and practices. Looking at the essential nature of the claims in *RTR Technologies, Inc. v.*

82. *Id.* at 194. The trial court had explained that the "unique position that [the accounting firm] was in at the time period in question—with federal regulators carefully watching the [b]ank's actions and waiting for assurances from the outside auditor that the [b]ank's financial statements were accurate—distinguish [sic] this case from any of the other cases relied upon by the parties." *Id.* (citations omitted).

83. *Id.* at 196.

84. *Id.* at 198.

85. No. 2:10-cv-007, 2011 WL 798093 (S.D. Ohio Mar. 1, 2011).

86. *Id.* at *6 (citing Jenkins v. Long, 19 Ind. 28, 29 (1862)).

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Helming, the court found the case was essentially a professional malpractice action against a certified public accountant.[87]

In *Black v. Sussman*, the Tennessee Court of Appeals applied different statutes of limitation to different claims brought by an entertainer.[88] After the trial court ruled that the gravamen of the lawsuit was a claim for accounting malpractice, the court of appeals first ruled that a claim can have more than one gravamen.[89] The court found that some of the allegations concerned a claim of accounting malpractice, subject to a one-year statute of limitations; others, however, involved claims that the accountant breached his fiduciary duties in his capacity as the entertainer's business manager and were therefore subject to a three-year statute of limitations.[90]

In *Morgan v. Fennimore*, the Seventh Circuit considered whether the continuing representation doctrine tolled the Indiana statute of limitations.[91] In *Morgan*, the plaintiff claimed the accountant continued to provide tax preparation services and later agreed to look into a tax problem some four years after the negligent act in question. The Seventh Circuit ruled that the ongoing tax preparation engagement was nothing more than a general, ongoing professional relationship that would not trigger the continuous representation doctrine. Concerning the telephone call and the accountant's agreement to look into the tax problem, the court found they were tied to the specific act of malpractice, but that they occurred too late, well after the statute of limitations had already expired.[92]

87. C.A. No. 09-cv-30189-MAP, 2011 WL 4381921, at *6 (D. Mass. Sept. 19, 2011). To do otherwise, the court reasoned, would allow a plaintiff to double the length of the limitations period by simply recasting a malpractice claim as an action for breach of contract and would render meaningless the three-year statutory deadline for filing malpractice actions against accountants. *Id.* The accounting firm also argued that the nonclient plaintiff had no right to rely upon the audit report because it had a reasonable opportunity to examine the property and judge its value. The court rejected the opportunity-to-examine defense, stating, "[I]t seems unlikely that [p]laintiff, even if a sophisticated buyer, could determine the value of the [c]orporation's assets, liabilities, cash flows, or profits and losses upon its own inspection. If it could, the need for a professional accounting firm would be unnecessary." *Id.* at *7.

88. No. M2010-01810-COA-R3-CV, 2011 WL 2410237 (Tenn. Ct. App. June 9, 2011).

89. *Id.* at *7.

90. *Id.* at *8.

91. 429 F. App'x 606 (7th Cir. 2011). In Indiana, the continuing representation doctrine applies only if there was an ongoing, professional relationship. The continuing representation doctrine has no application when there is an alleged act of malpractice and, afterwards, there remains some general, ongoing professional relationship between the client and the accountant. *Id.* at 609.

92. *Id.* at 610. Also, the court found that "a single act of representation on a related issue four years after [the negligent act] is insufficient to find that the continuous representation doctrine applies." *Id.*

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When does a cause of action accrue in a tax preparation engagement? In one case, involving an accountant who failed to file a § 754 election,[93] the Minnesota Court of Appeals found that the statute of limitations began to run when the tax return was filed without the election.[94] The court found the plaintiff was damaged when the returns were filed without the § 754 elections, which resulted in the immediate overpayment of taxes and the loss of use of those funds.[95]

Where an accountant's alleged malpractice caused the client to sustain an increased tax liability, the Illinois Appellate Court determined that a cause of action accrued upon the earlier of two events: (1) the assessment by the Internal Revenue Service of additional taxes on the client taxpayer; or (2) the taxpayer's agreement with the IRS to pay additional taxes, penalties; or interest that the taxpayer would not have had to pay but for the accountant's substandard performance.[96] Relying on the discovery rule, the plaintiffs argued the statute of limitations began to run when they first received refund checks and thus gained actual knowledge of the damages.[97] Rejecting the plaintiffs' argument, the court explained that in overpayment cases, a plaintiff incurs damages immediately. At issue then is when the plaintiff discovers the overpayment such that there is a reasonable belief that wrongful conduct caused the injury, thereby creating an obligation to inquire into the issue further. In this case, the plaintiffs knew about inconsistencies in their tax returns by 2003, triggering the two-year statute of limitation and obligating them to inquire further.[98] Accordingly, their 2006 lawsuit was untimely.[99]

Fiduciary status made the difference in a case from Maine. In *Erlich v. Ouellette, Labonte, Roberge & Allen, P.A.*, a pension fund argued that its claims did not accrue until the fund did discover, or should have discovered, the injury.[100] In limited circumstances, Maine courts will consider an action to accrue when the injury is discovered rather than incurred, as in an attorney malpractice action based on a negligent title search or in a suit

93. This is an election to increase the tax basis of partnership assets, thereby reducing future taxable income when the assets are sold after appreciating. 26 U.S.C. § 754 (2011).

94. Ames & Fisher Co., II, LLP v. McDonald, 798 N.W.2d 557, 564 (Minn. Ct. App. 2011). Minnesota adheres to the damage-accrual rule, under which a cause of action accrues once a party suffers any legally cognizable damage, regardless of whether it is claimed or sought in the pleadings. *Id.* at 562.

95. *Id.* at 564.

96. SK Partners I, LP v. Metro Consultants, Inc., 944 N.E.2d 414, 415 (Ill. App. Ct. 2011).

97. *Id.* at 417. Under Illinois law, the discovery rule delays commencement of the statute of limitations until the plaintiff knows or reasonably should have known of the injury and that it may have been wrongfully caused by the defendant.

98. *Id.* at 419.

99. *Id.*

100. 637 F.3d 32 (1st Cir. 2011). Civil actions in Maine are ordinarily governed by a six-year statute of limitations that begins to run when the cause of action accrues. *Id.* at 35.

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against a fiduciary.[101] Affirming judgment on the pleadings, the First Circuit declined to extend the scope of the discovery rule in this case because the auditor was not a fiduciary and dismissed the claims as time barred.[102]

G. *Audit Interference Rule*

In *Comerica Bank v. FGMK, LLC*, the district court considered an Illinois audit malpractice dispute that potentially called for the application of the audit interference rule.[103] Under that doctrine, the negligence of an employer who hires an auditor is a defense only when it contributes to the auditor's failure to perform.[104] Comerica sued an accounting firm in connection with its audits of one of the bank's borrowers, claiming that the audits failed to detect fraud perpetrated by the borrower's principal. Comerica moved to strike the auditor's affirmative defenses of comparative fault, contributory negligence, and several liability, arguing they were barred under the audit interference doctrine. Dodging the undecided question of whether the audit interference rule governs claims by nonclients, the court denied the motion to strike. The pleadings were not clear whether the auditor owed the bank a duty, so the court let the case proceed through discovery.[105]

H. *Securities Fraud Claims*

A New York district court dismissed securities fraud claims against the outside auditor for a Madoff feeder fund.[106] The court found that "[m]erely alleging that [the auditor] 'would' or 'could' or even 'should' have known of Madoff's fraud if only it had paid attention to the red flags is insufficient to make out a 10(b)(5) claim."[107] The auditor's failure to identify problems with Madoff's investments or lack of investments did not constitute reckless conduct sufficient to impose 10(b)(5) liability, and allegations of GAAS or GAAP violations, standing alone, were insufficient to state a claim for relief against an accountant under the federal securities laws.[108] Here, there were no allegations of fraudulent intent or that the auditors deliberately ignored warning signs. Referring to the claims as fraud by hindsight, the court dismissed the claims for lack of scienter, thereby becoming the fourth Madoff-related case to reject securities fraud claims against a feeder fund's outside auditor.[109]

101. *Id.* at 36.
102. *Id.* at 37.
103. No. 10 C 1930, 2011 WL 91044 (N.D. Ill. Jan. 11, 2011).
104. *Id.* at *3.
105. *Id.* at *5–6.
106. *In re* J.P. Jeanneret Assocs., Inc., 769 F. Supp. 2d 340, 377 (S.D.N.Y. 2011).
107. *Id.*
108. *Id.*
109. *Id.* at 378.

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III. Developments in Directors' and Officers' Liability

A. *Liability for Causing a Company to Act Illegally*

To the extent there existed any doubt in the minds of officers and directors—as well as those that advise them—that corporate fiduciaries should strive to avoid causing the companies they serve to act in an illegal manner, a May 2011 decision from Delaware's Court of Chancery makes clear that officers and directors who cause their corporation to act illegally are acting disloyally to the stockholders whose trust they hold. In the case of *In re Massey Energy Co.*, the court was presented with stockholder litigation relating to a merger involving Massey Energy Company.[110] As the court saw it, Massey Energy's management, with the board's knowledge, "fostered an adversarial relationship with the company's regulators and accepted as ordinary the idea that the company would regularly be accused of violating important safety regulations."[111] While the court ultimately refused to enjoin a proposed merger between Massey Energy and a third party, the court's discussion of the duty of oversight by officers and directors—especially regarding the corporation's compliance with the law—is significant.

As the court noted, Delaware "does not charter law breakers."[112] This statement was the court's recognition that the Delaware General Corporation Law allows corporations to pursue many means towards making a profit for its owners, subject however to the caveat that those means must be lawful.[113] Thus, "a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit from violating the law."[114] While these pronouncements do not seem controversial, officers and directors should sit up and take note of the context, given the court's finding that the plaintiffs had pled nonfrivolous claims that even the independent directors on Massey Energy's board engaged in "non-exculpated breaches of fiduciary duty."[115] The take-away from this opinion for officers and directors is that they should be sure that there exist compliance procedures reasonably designed to raise warning flags indicating

110. C.A. No. 5430-VCS, 2011 WL 2176479 (Del. Ch. May 31, 2011). Massey Energy operated a West Virginia coal mine that suffered a catastrophic explosion in 2010, killing twenty-nine miners.

111. *Id.* at *1.

112. *Id.* at *20.

113. *Id.* (citing Del. Code Ann. tit. 8, §§ 101(b), 102 (2011)).

114. *Id.*

115. *Id.* at *18. The import of this statement is that the court found nonfrivolous claims had been pled that the independent directors had acted disloyally and possibly in bad faith, which is conduct that would not be exculpated by Del. Code Ann. tit. 8, § 102(b)(7).

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corporate misconduct, and if those flags are flying, the fiduciaries should act promptly and decisively to correct the conduct.[116]

B. *Duties Owed to Creditors*

In a challenging economic environment, officers and directors often face the question of where their loyalties lie when the entity is insolvent or nearly insolvent.[117] The solution to this question is often analyzed by the Delaware courts as a question of who might have standing to bring a derivative suit alleging that the officers and directors have breached their fiduciary duties.[118] Critically, when may creditors of an entity bring such a suit? For creditors of a Delaware LLC, the answer is almost never.[119]

The Delaware Supreme Court recently issued its decision in *CML V, LLC v. Bax*.[120] The court found the unambiguous language of Delaware's LLC act evinced the legislature's intent to limit derivative standing to bring fiduciary duty claims to members and assignees only.[121] While this decision would appear to be a significant departure from the way creditors of Delaware corporations are treated in a similar context, the foundation of the court's decision is the long-standing recognition by both Delaware's General Assembly and its courts that corporations and LLCs are different species of entities, with LLCs allowing interested parties to largely define their relationships via contract.[122] Given that freedom to self-order, the court recognized that creditors of Delaware LLCs are uniquely positioned to protect their interests via contract—rather than resorting to common law notions of fiduciary duty.[123]

C. *Delaware State Law Claims for Insider Trading*

In last year's survey of recent developments of law affecting professionals', officers', and directors' liability, this article highlighted the Court of

116. *See generally* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (contemplating liability for failing to implement systems of reporting, information, or controls); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969–70 (Del. Ch. 1996) (discussing directors' obligation to keep themselves reasonably informed).

117. *See, e.g.*, N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (holding that creditors of an insolvent Delaware corporation have standing to maintain derivative claims against officers and directors on behalf of the corporation for breaches of duty).

118. *See id.*

119. As discussed below, creditors of LLCs may protect themselves by contract.

120. 28 A.3d 1037 (Del. 2011) (en banc), *aff'g* 6 A.3d 238 (Del. Ch. 2010).

121. *Id.* at 1041. The court applied the terms of Del. Code Ann. tit 6, § 18-1002 (2011), which says in pertinent part: "In a derivative action, the plaintiff must be a member or an assignee of a limited liability company interest at the time of bringing the action . . . ."

122. *See id.* at 1043.

123. *See id.* In footnote 20, the court highlighted several options open to creditors of Delaware LLCs, one of which is the creditors' ability to negotiate an automatic assignment of membership interests upon an LLC's insolvency.

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Chancery's decision in *Pfeiffer v. Toll*, in which that court limited a Delaware *Brophy* claim to derivative claims seeking to redress actual harm to the corporation itself rather than providing an additional remedy to contemporaneous traders otherwise protected by the federal securities laws.[124] In a June 2011 opinion in the matter of *Kahn v. Kolberg Kravis Roberts & Co.*, the Supreme Court of Delaware declined to adopt "*Pfeiffer*'s thoughtful, but unduly narrow, interpretation of *Brophy* and its progeny."[125] In so ruling, the court upheld *Brophy*'s original teachings that the corporation need not suffer an actual loss and that the focus would remain on preventing fiduciaries from unjustly enriching themselves by trading in corporate stock on the basis of material, nonpublic information.[126] While the *Kahn* decision does not really expand the potential liability that officers and directors face for insider trading claims, it does make clear that Delaware state law claims for that behavior remain viable.

D. *Advancement and Indemnification of Legal Fees and Expenses*

In the unfortunate circumstance that officers and directors find themselves the target of litigation, the topics of advancement and indemnification assume greater significance. While there have been no significant substantive changes in this relatively established and stable area of Delaware law, two decisions in the last twelve months are worth mentioning.

It is not uncommon for a corporation, despite adopting rather broad advancement obligations in its governing documents, to regret that obligation when faced with the prospects of advancing what can be significant legal fees to officers and directors protected by those provisions. In the matter of *Fuhlendorf v. Isilon Systems, Inc.*, the Court of Chancery has once again applied the so-called *Duthie* procedure for addressing the tension between enforcing advancement obligations and protecting the corporation from unreasonable fees and expenses.[127] The *Duthie* procedure sets forth a system where (1) counsel for the officer or director seeking advancement certifies that the amounts sought were reasonably incurred; (2) the company must then identify any specific charges that it believes fall outside the

124. 989 A.2d 683, 699 (Del. Ch. 2010). The lineage of the Delaware state law claims for insider trading goes back to the Court of Chancery's decision in *Brophy v. Cities Service Co.*, 70 A.2d 5 (Del. Ch. 1949).

125. 23 A.3d 831, 840 (Del. 2011).

126. *See id.*

127. Fuhlendorf v. Isilon Sys., Inc., C.A. No. 5772-VCN, 2010 WL 4570225 (Del. Ch. Nov. 9, 2010); Fuhlendorf v. Isilon Sys., Inc., C.A. No. 5772-VCN, 2011 WL 3300338 (Del. Ch. July 22, 2011). In this litigation, Vice Chancellor Noble is applying a procedure for addressing the reasonableness of fees and expenses first established in *Duthie v. CorSolutions Med., Inc.*, C.A. No. 3048-VCN, 2008 WL 4173850 (Del. Ch. Sept. 10, 2008).

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advancement obligation, and its counsel must certify their good faith belief of the same; (3) the fees to which there are no dispute must be promptly paid; and (4) any fees that remain in dispute shall be referred to a special master.[128] The court's continued use of this procedure should be welcome news to directors and officers, as it limits a corporation's ability to delay the advancement of fees because of disputes over reasonableness.

On the indemnification front, in the matter of *IAC/InterActiveCorp v. O'Brien*, the Supreme Court of Delaware recently provided additional guidance that certain contingency fees are not exempt from indemnification obligations solely based on their contingent nature.[129] So long as the fee is reasonable and otherwise meets the standard for indemnification, the director or officer is entitled to indemnification for those fees and expenses.[130]

IV. DEVELOPMENTS IN AGENT/ BROKER MALPRACTICE

Agents and brokers are often parties to litigation when an insured's claim is denied by an insurance company, when an insurer seeks to rescind a policy, or if a policy secured by an insurance broker/agent is insufficient to cover a sustained loss. Insurers are often able to rescind an insurance policy if the insurance application contains material misrepresentations. This can lead to questions as to what the producer's duty is to the insured and who is responsible for the misrepresentation.

A. *Scope of a Producer's Duty*

In *Langwith v. American National General Insurance Co.*, Dennis and Ben Langwith sued their insurance broker over coverage provided by their umbrella liability policy and for failure to provide risk-management advice to clients.[131] The insurance producer was a self-employed captive agent for American National doing business under the name of American National Janet Fitzgerald Insurance Services. For years, Dennis and Susan Langwith purchased substantially all of their insurance through Fitzgerald. They had consistently carried an automobile liability insurance policy with limits of $250,000 and an umbrella policy with limits of $3 million, both issued by American National. The policies covered the Langwiths' two children, including their son Ben.

In December 2003, Ben's driver's license was suspended, prompting American National to cancel Ben's benefits under the automobile liability

128. *See Fuhlendorf*, 2010 WL 4570225, at *1.
129. 26 A.3d 174, 179 (Del. 2011).
130. *Id.*
131. 793 N.W.2d 215 (Iowa 2010).

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policy. American National also sought to cancel the umbrella policy but did not do so after Dennis and Susan Langwith signed a form excluding Ben from coverage. When Ben's driver's license was reinstated, Susan Langwith spoke with Fitzgerald regarding insurance, and Fitzgerald procured a high-risk policy through American National for when Ben was driving the Langwiths' vehicles. The policy had coverage limits of $250,000. The Langwiths assumed Ben was once again covered by the umbrella policy because Ben's license had been reinstated and he had obtained the required underlying liability coverage. Contrary to this understanding, the driver exclusion for Ben remained in effect in the Langwiths' umbrella policy.

On July 16, 2006, Ben was in an accident when driving a vehicle titled in Dennis Langwith's name. A passenger in Ben's vehicle was severely injured. The passenger brought suit against Ben alleging he negligently operated the vehicle and against Dennis Langwith as the vehicle's owner. American National provided coverage for the claims under the automobile liability policy and tendered a defense. However, American National denied any liability under the umbrella policy based upon the driver exclusion for Ben. Plaintiffs filed a lawsuit alleging Fitzgerald breached a duty of care to them by failing to disclose the driver exclusion in the umbrella policy continued after Ben's license was reinstated and for failing to advise them that Dennis Langwith could avoid all exposure for Ben's driving by transferring title of the vehicle to Ben.[132]

Generally, the relationship between insured and an insurance agent is one of principal-agent.[133] Consistent with this relationship, an insurance agent owes the principal the use of such skill as is required to accomplish the object of their appointment, which is usually the procurement of the requested insurance.[134] The duties of an insurance agent can be expanded when the agent holds himself out as an insurance specialist, consultant, or counselor, or if the agent gives additional advice or receives additional compensation apart from premiums paid by the insured.[135]

The *Langwith* court said it is for the fact finder to determine, based on a consideration of all circumstances, the scope of the agreement between the parties with respect to the service to be rendered by the insurance agent and whether that service was performed with skill and knowledge normally possessed by insurance agents under like circumstances. Some circumstances to be considered include the nature and content of discussions between

132. *Id.* at 217.

133. *Id.* at 218 (citing Collegiate Mfg. Co. v. McDowell's Agency, Inc., 200 N.W.2d 854, 858 (Iowa 1972)).

134. *Id.* at 219.

135. *Id.* at 221 (citing Sandbulte v. Farm Bureau Mut. Ins. Co., 343 N.W.2d 457, 464 (Iowa 1984)).

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agent and client; prior dealings of the parties, if any; knowledge and sophistication of the client; whether the agent holds himself out as an insurance specialist, consultant, or counselor; and whether the agent receives compensation for additional or specialized services.[136] The client bears the burden of proving an agreement to render services beyond the general duty to obtain the coverage requested. In the absence of circumstances indicating the insurance agent assumed a duty beyond the procurement of the coverage requested by the client, the insurance agent has no obligation to advise a client regarding additional coverage or risk management.[137]

In ruling on the parties' summary judgment motions, the court found Susan Langwith had the most contact with Fitzgerald regarding the family's insurance and that the relationship was based solely upon the Langwiths' "insurance liability and needs."[138] The Langwiths would follow the advice given by Fitzgerald. When Ben lost his driver's license, Susan Langwith called Fitzgerald to have Ben removed from their automobile liability policy. At that time, Fitzgerald asked the Langwiths to sign an exclusion on their umbrella policy for liability arising from Ben's operation of any vehicle in order to avoid cancellation of that policy. The Langwiths signed the requested form and were aware the exclusion precluded coverage under the umbrella policy for claims arising from Ben's driving. After Ben's license was reinstated, Susan met with Fitzgerald asking "what we could do about Ben."[139] Susan testified she "was asking for [Fitzgerald's] professional advice."[140] Fitzgerald told her they could get a high-risk policy for Ben with limits of $250,000, which Fitzgerald did. There was no discussion regarding the umbrella coverage, and Susan and Dennis Langwith assumed the umbrella policy again covered Ben's driving once his license was reinstated. Fitzgerald did not inform the Langwiths that the driver's exclusion had been removed from the umbrella policy, nor did she tell them it had not been removed. The court found a genuine issue of material fact with respect to whether "Fitzgerald should have told the Langwiths that the driver exclusion remained on the umbrella policy."[141] As a result, the court reversed the summary judgment on that issue.[142]

At the same time, the court took a narrower view of the agent's duty to provide risk management advice. With respect to the claim that Fitzgerald should have advised the Langwiths to transfer title on the vehicle to Ben,

136. *Id*. at 222.
137. *Id*.
138. *Id*.
139. *Id*. at 225.
140. *Id*.
141. *Id*.
142. *Id*. at 226.

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the court upheld summary judgment for Fitzgerald, finding there was no express agreement that Fitzgerald would assess the Langwiths' liability risk with respect to Ben and advise them on how to avoid that risk.[143] The court noted Fitzgerald did not hold herself out as a specialist, consultant, or counselor; nor did the Langwiths compensate her for consultation and advice apart from the premiums they paid. Moreover, there were no prior dealings between these parties in which Fitzgerald was ever requested to give advice outside of the proper insurance policy to ensure a particular risk.[144]

The Iowa General Assembly partially overruled *Langwith* in 2011. The Iowa General Assembly passed a statute limiting an agent's duties unless the agent holds himself or herself out as a specialist, consultant, or counselor and receives compensation apart from the policy premium.[145] The statute reinstated the law under a 1984 Iowa Supreme Court opinion.[146]

B. *Liability for Misrepresentation on the Insurance Application*

In *Moslem v. Parietti & McGuire Insurance Agency*, a homeowner claimed Parietti made misrepresentations on an insurance application and should therefore be liable for noncompensated fire damage to the property.[147] The plaintiff purchased a single-family house and insured the property through Foremost Insurance Company. About six months later, the plaintiff listed the property for sale but continued to live there. With the Foremost policy about to expire, the plaintiff contacted Parietti requesting a quote for a homeowner's policy. Parrietti asked several questions to ensure the plaintiff was eligible for homeowner's insurance and to determine the appropriate policy rates, as he was a captured agent of the Vermont Mutual Insurance Company. Based on their conversation, Parietti believed the plaintiff had just purchased the property and was planning to use it as his primary residence and that he was therefore qualified to buy homeowner's insurance.

Parietti used information he learned during their discussion to complete portions of the plaintiff's insurance application. On June 14, 2006, Parietti met with the plaintiff to review the completed homeowner's insurance application. The finalized application showed the plaintiff was the owner of the house, he occupied the premises daily, the house was to be used as a primary residence, and the house was not for sale. It also noted the house

143. *Id*. at 226–27.
144. *Id*.
145. Iowa Code § 522B.11.7.a (2011).
146. Iowa Code § 522B.11.7.b. (reinstating Sandbulte v. Farm Bureau Mut. Ins. Co., 343 N.W.2d 457 (Iowa 1984)).
147. No. 07 Civ. 7962(SAS), 2011 WL 721653 (S.D.N.Y. Feb. 24, 2011).

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was a new purchase, and any questions about a prior policy were inapplicable. The application contained a warning that its benefits and coverage could be canceled based upon the submission of false information. Without asking Parietti to make any changes, the plaintiff signed the application, thereby specifically attesting that he had read the application in its entirety and that the information was correct.

Vermont Mutual approved the application. In a letter dated August 7, 2006, Parietti informed the plaintiff that the Vermont Mutual policy had been issued in accordance with his request and attached a copy of the policy. Parietti's cover letter asked plaintiff to "[p]lease look at this policy over and make sure that all of the information is correct. If anything needs to be changed it is your responsibility to contact us immediately."[148] The letter instructed the plaintiff to read the policy and to be aware of the coverage afforded.[149] The plaintiff acknowledged receipt of the policy and never contacted Parietti with any objections or questions.

Without informing Parietti or Vermont Mutual, the plaintiff vacated the property and began leasing it out in July 2006. The property was subsequently destroyed by fire. The claim for property damage under the Vermont Mutual policy was denied due to material misrepresentations in the application. Vermont Mutual discovered four inaccuracies on the insurance application: (1) the plaintiff recently purchased the property, (2) no prior insurance information was provided, (3) the plaintiff had other residences, and (4) the premises were listed for sale.[150]

The plaintiff sued Parietti and claimed Parietti was liable for any misrepresentations on the homeowner's application because he provided full and complete information to Parietti in response to Parietti's questions. The plaintiff asserted he did not read the application in its entirety, and any misrepresentations in the document were generated solely by Parietti. The court found that by signing the application, the plaintiff effectively endorsed the misrepresentations and made them his own.[151]

In *Mountain City Ford, LLC v. Owners Insurance Co.*, the Kentucky Court of Appeals reached a similar conclusion.[152] The Elite Agency, Inc. prepared on behalf of Mountain City Ford an automobile insurance application, which was submitted to Auto-Owners Insurance Company. Mountain City Ford employee Rick Gussler was not listed anywhere on the application. Gussler's driver's license was suspended, and had he been listed on the insurance application, Auto-Owners would not have issued the policy. Mark

148. *Id.* at *2.
149. *Id.*
150. *Id.*
151. *Id.* at *5.
152. No. 2009-CA-002233-MR, 2011 WL 3862745 (Ky. Ct. App. Sept. 2, 2011).

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Grimm of Elite completed the insurance application for Mountain City Ford. Although Elite was provided an updated drivers list, Grimm never updated the preliminary drivers list before submitting the application to Auto-Owners.

Gussler was involved in a car accident while driving one of Mountain City Ford's cars, resulting in the death of the other driver. After defending and settling the underlying claims under a reservation of rights, Auto-Owners filed an action against Mountain City Ford for rescission and reimbursement on a material misrepresentation theory, as Gussler was not on the list of drivers on the insurance application prepared by Elite. Mountain City Ford averred Elite was an agent for Auto-Owners and that all information it provided to Elite was imputed to Auto-Owners.

At issue was whether an insurance agency is an agent for the insured or the insurer when an inaccurate insurance application is submitted. Elite had authority to bind coverage when Auto-Owners's underwriting guidelines were met.[153] It was undisputed that Gussler disqualified Mountain City Ford from eligibility for any liability coverage under the Auto-Owners' guidelines. Elite never read the guidelines and made no effort to verify compliance before binding coverage. The court found Elite was not acting within its authority to bind coverage for a driver who was not eligible to drive company vehicles and who should have been disclosed to Auto-Owners so it could make a fully informed decision on whether to supply insurance coverage.[154] Auto-Owners was therefore allowed to rescind the policy and seek reimbursement of the monies paid in the underlying action.

To determine whether an insurance agency was acting on behalf of the insured, the court considered whether the insured signed or verified the application and whether there were special preexisting factual conditions or circumstances, such as a long-standing relationship between the insurance agent and the insured.[155] The CFO of Mountain City Ford signed and verified the application as required by Auto-Owners after having an opportunity to review the application, although he did not read it. Additionally, Mountain City Ford and Elite had a long-standing relationship.[156] Because Mountain City Ford verified and signed the application, Elite was not held responsible for the misrepresentation on the insurance application.

153. *Id*. at *6.
154. *Id*.
155. *Id*. at *7.
156. *Id*. at *8. Generally under Kentucky law, applicants are responsible for any inaccuracies in an insurance application. However, the Kentucky courts softened this rule to finding an applicant liable only when he or she signs the insurance application. *Id*. at *7.

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C. *Update on New York Law Regarding Payment by an Insurance Agent to an Unlicensed Person*

The Office of the General Counsel of the New York Insurance Department issued an advisory opinion finding an insurance producer cannot pay a fee to an association for the association to provide access to the association's employer members so the agent/producer can sell group policies of life and accident and health insurance to the employer members.[157]

The inquirer was a licensed life, accident, and health and property/casualty insurance agent/producer. The producer proposed to enter into an arrangement with a multi-employer association, which is a multiple employer welfare arrangement under ERISA and which provides health, dental, and life insurance benefits to employees. The association provides health and life insurance benefits through group insurance policies under which the association is the group policyholder. The association sought to unwind its health benefits program, and the producer was attempting to solicit the association's contributing employers to purchase group insurance policies directly as a policyholder. The association would continue to maintain its group health insurance policies until all contributing employers obtained coverage through the producer independently of the association's group insurance policy.[158]

The producer and the association sought to enter into an agreement under which the producer would pay the association a finders fee. Under the agreement, the producer would pay the association a quarterly administration fee of $75.00 for each employee who is insured under the association's group health insurance.[159]

The General Counsel's Office found the finder's fee payment to be a compensation, rebate, or inducement violating New York law. New York law allows an agent or broker to compensate an unlicensed person who makes a referral to the producer only if the referral does not include a discussion of specific insurance policy terms and only if the compensation for the referral is not based on the purchase of insurance by the persons so referred. A group policyholder may not receive compensation for referrals from the producer of record on the group policy because the group policy holder is the insured under the group policy.[160]

The Office of the General Counsel did not find any violations of New York Insurance Law regarding the quarterly fee of $75 for administrative

157. Proposed Payment by an Insurance Agent to an Unlicensed Person, Op. No. 11-01-02 (Office of Gen. Counsel, N.Y. Ins. Dep't, Jan. 5, 2011), http://www.dfs.ny.gov/insurance/ogco2011/rg110102.htm.

158. *Id.*

159. *Id.*

160. *Id.*

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costs for each employee who is then insured under the association's group health insurance. A producer may provide a service not specified in the insurance policy or contract to an insured without violating the anti-rebating and inducement provisions if (1) the service directly relates to the sale or servicing of the policy or provides general information about insurance or risk reduction and (2) the insurance producer provides the service in a fair and nondiscriminatory manner to like insureds or potential insureds.[161]

161. *Id.*

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