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Re: FKB Accountant Malpractice Advisory: New York Courts utilize the "Tooley" derivative/direct standing test to preclude claims brought by non-clients against accountants

Dear Clients and Colleagues:

In the context of accounting malpractice, the general rule is that non-clients do not have standing to assert a claim. Claims for accounting malpractice by non-clients frequently arise in the context of a shareholder or corporation principal alleging that an accountant or auditor failed to detect some corporate impropriety, such as an employee's embezzlement, resulting in a loss of income or diminution in value of corporate shares. Similarly, a corporate investor or shareholder may allege that an auditor issued misleading audit reports or overstated valuations resulting in shareholder loss. Indeed, in this past year, the New York Courts were asked to consider both of these scenarios, and in both instances, the Court ruled that the individual/shareholder lacked standing to pursue a direct claim against the accountants. In so doing, the Courts applied Delaware's "*Tooley*" standing test, as recently formally adopted by the New York Courts.

When evaluating the nature of a claim (derivative vs. direct), the seminal case relied on by most courts, including the New York Courts, is a Delaware case, Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. Supr. 2004). Tooley provides for a two pronged inquiry: 1) "who suffered the alleged harm – the corporation or the suing stockholder individually"; and 2) "who would receive the benefit of any recovery or other remedy?" Tooley, *supra* at 1035. For the claim to be direct, the shareholder must be the one purportedly harmed and the injury must be "independent of any alleged injury to the corporation." Id, at 1039.

More recently the New York's Appellate Division, First Department in Yudell v. Gilbert, 99 A.D.3d 108, 949 N.Y.S.2d 380 (1st Dept. 2012), agreed to adopt the test set forth in Tooley, finding that the "Tooley test" is consistent with New York law, and provides a clear and simple framework to determine whether a claim is direct or derivative. This past year, the New York Courts were asked to apply the test set forth in Tooley and its progeny, Yudell, in the context of claims for accounting malpractice.

In Ghiz v. Schreck & Co., 2013 N.Y. Misc. LEXIS 3559, 2013 NY Slip Op 31869(U) (N.Y. Cty. Sup. Ct. Aug. 9, 2013) the New York County Supreme Court dismissed a claim brought by a principal shareholder of a closely held professional corporation, a dental facility, against the professional corporation's accountants and auditors. Ronald Ghiz, D.D.S. ("Ghiz") is a dentist and the principal shareholder in R.S.G. Dental Healthcare, P.C. ("P.C."). In this accounting malpractice action, Ghiz and the P.C. alleged that its C.P.A. and auditor failed to detect the embezzlement of an office manager, who misappropriated $400,000 over the course of two years. In dismissing Ghiz's malpractice claim and finding his claim to be derivative, the Court utilized the two-pronged test set forth in Yudell, concluding that regardless of Ghiz's close affiliation with the corporation, his individual claim against the accountants and auditors was incidental to the injury sustained by the P.C. Thus, while the P.C. could maintain its accounting malpractice claim, Ghiz lacked standing to pursue a claim.

Similarly, in Serano v. Lipper, 2013 N.Y. Misc. LEXIS 1738, 2013 NY Slip Op 30871(U) (N.Y. Cty. Sup. Ct. Apr. 24, 2013) the trial court was asked to consider whether a hedge fund Chief Operating Officer, Kenneth Lipper, could pursue a cross-claim against PriceWaterhouseCoopers LLP ("PwC"), who performed audits of certain Lipper investment/hedge funds (the "Funds"). Kenneth Lipper was a co-defendant, along with PwC and others, in two class action lawsuits brought by fund investors following the Funds' collapse. In sum, it was alleged that a portfolio manager, Edward Strafaci, over-valuated securities held by the Funds. Strafaci ultimately plead guilty to one count of securities fraud and was sentenced to six years in prison. PwC was engaged to conduct annual audits of behalf of the Funds.

As respects PwC, investors brought claims for *inter alia*, accounting malpractice and fraud. Kenneth Lipper also asserted cross-claims against PwC for fraud, negligence/malpractice, negligent misrepresentation, breach of contract and breach of fiduciary of duty. PwC moved for summary judgment seeking dismissal of Kenneth Lipper's cross-claims. In granting summary judgment, the New York County Supreme Court applied the Tooley/Yudell test, finding that the vast majority of damages sought by Mr. Lipper "is the money he lost when the Funds collapsed." Id., at *6. The Court found Mr. Lipper's cross-claims to be derivative, as "[t]he damages suffered by Mr. Lipper are identical to those suffered by other investors." Id., at *7.

From the standpoint of those who defend and insure accountants, determining whether a plaintiff has standing to pursue a claim is often a determination that can be made from the outset of litigation. Again, the key inquiries under the Tooley/Yudell test concern who is alleged to have suffered the harm (the individual or the corporation), and who would ultimately receive the benefit of a recovery. This determination may often be made without the need for discovery. If an individual/shareholder's claim is derivative in nature, defense counsel may have a basis to file a pre-answer, pre-discovery motion to dismiss pursuant to CPLR 3211. Obtaining dismissal of derivative claims on a pre-discovery basis is advantageous for a number of reasons; discovery may be streamlined and thereby prove to be less costly, and the scope of damages sought may be limited.

Should you have any questions concerning the above or accounting malpractice generally, please feel free to contact Andrew S. Kowlowitz (akowlowitz@fkblaw.com).

Yours faithfully,

Andrew S. Kowlowitz

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