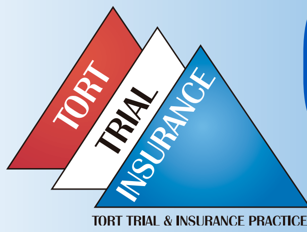

Committee News

Fall 2009

Professionals', Officers' and Directors' Liability Committee

THE JUDGMENTAL IMMUNITY DOCTRINE: HOW FAR DOES IT EXTEND AS A DEFENSE TO A LEGAL MALPRACTICE CLAIM?

By Glen R. Olson and John Hong[1]

Overview

A commonly litigated legal malpractice issue is whether the attorney's conduct in handling an underlying case or transaction is subject to the "judgmental immunity doctrine." Judgmental immunity typically applies in circumstances in which the attorney's work addresses an ambiguous or uncertain area of the law. California decisions describe the doctrine as providing an immunity[2] to an attorney that exercises his or her judgment within the realm of reasonable competence in addressing the legal issue at hand. Interacting with the question of whether the attorney breached the standard of care, judgmental immunity is frequently litigated on motions for summary judgment.[3]

As discussed below, an important theme emanating from the judgmental immunity decisions is the necessity for establishing that the attorney exercised due diligence in researching and applying his or her expertise to ambiguous or uncertain legal issues. The process by which the attorney evaluates such issues, as well as the nature of the issues themselves, can become very important in establishing the validity of a judgmental immunity defense. This is illustrated by a recent decision of the California Courts of Appeal, *Blanks v.*

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[1] Glen R. Olson and John Hong are attorneys at *Long & Levit, LLP* in San Francisco, California.

[2] As discussed below, whether the defense is an "immunity," as that term is commonly understood, is subject to some question. In actuality, judgmental immunity relates to the standard of care in circumstances where the attorney's work addresses a difficult or uncertain area of the law. As one treatise has noted, attorneys are not "immunized" from errors resulting from violations of the standard of care. *See 2 Mallen & Smith, Legal Malpractice*, §19:6, at 1238 (2009 ed.).

[3] A number of states recognize judgmental immunity, with the doctrine having developed concurrently with the law of legal malpractice. *2 Mallen & Smith, Legal Malpractice*, §19:1, 1226 n.4 (2009 ed.).

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LETTER FROM THE CHAIR AND CHAIR-ELECT

By Glen R. Olson and M. Machua Millett

We appreciate the fine efforts of our editor, Cecelia Lockner of Edwards Angell Palmer & Dodge LLP in publishing this Fall 2009 edition of the Professionals, Officers & Directors Liability (PODL) Committee Newsletter. The past few months have been very busy on the publication and program planning front for PODL. The committee sponsored a successful program at the ABA Annual Meeting in Chicago this summer. Immediate past PODL Chair, Joe Kingma, moderated and Chair-Elect, Mach Millett, and committee members, Christopher Ward and David Dwares, participated in a panel discussion concerning the increasing number of business failures and likely ramifications in the areas of defense and coverage.

Committee Chair-Elect Designee Rick Bale and committee members Selena Linde, Lisa Hall Johnson, Perry Granoff, Dick Neumaier, Allend David, Barbara Costello, and Broderick Harrell have been hard at work putting together PODL's contributions to the 2010 Spring Edition of TortSource and the Annual Survey of the Law.

Rick has also been heavily involved in planning and obtaining co-sponsorship and approval for PODL's 2010 ABA Annual Meeting program entitled "Financial Fraud Litigation: The Issues Confronting Professionals, Directors & Officers And Their Insurers."

We continue to hold monthly conference calls to discuss the committee's work. If you would like to be included in those calls, please contact Glen Olson at golson@longlevit.com. Our next call is scheduled for December 17, 2009 at 11 am (EST) and our next sit down meeting will take place at the ABA Midyear Meeting on a date to be announced shortly.

We could still use your involvement in the next newsletter! Please send your ideas for articles to Cecelia Lockner at clockner@eapdlaw.com.

We thank you for your interest in PODL and hope to see you at one of our events soon.

Very truly yours,
Glen R. Olson
M. Machua Millett

We're proud to tell you about a special legal podcast series called Legal TIPS

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THE JUDGMENTAL IMMUNITY DOCTRINE...

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Seyfarth Shaw LLP, 171 Cal.App.4th 336 (2009), a decision we discuss in some detail below.

Origins of the Doctrine

A decision frequently cited on the judgmental immunity defense is *Barner v. Leeds*, 24 Cal.4th 676 (2000). In *Barner*, following his conviction in an underlying criminal matter, the client obtained a judicial determination of factual innocence. He then pursued a legal malpractice action against the public defender who had represented him, and the client argued that the immunity afforded by California Government Code Section 820.2 (discretionary acts of a public official) did not apply.[4]

The *Barner* Court noted that, while a public employee's initial decision to provide professional services to an individual might involve the exercise of discretion subject to Section 820.2, once the employee undertakes to render such services, he or she is not immune for the negligent performance of professional duties that do not amount to "policy or planning decisions." While the court rejected the application of Section 820.2 immunity, it nonetheless noted that *an attorney engaged in litigation is granted latitude in choosing among legitimate but competing considerations*. Thus, attorneys are not liable for an informed tactical choice within the range of reasonable competence.[5]

The judgmental immunity doctrine was then explained in greater detail in *Village Nurseries, L.P. v. Greenbaum*, 101 Cal.App.4th 26 (2002), a case involving whether the defendant attorneys had perfected a mechanics liens on a construction project in which the developer had declared bankruptcy. The liens were ultimately found to be defective and the Bankruptcy Court denied a motion to replace them. The client, Village Nurseries, then filed a complaint for legal malpractice.

The *Village Nurseries* court discussed the applicability of the judgmental immunity doctrine to the underlying defendants' actions. The court described the doctrine as immunizing attorneys from liability "resulting from an honest error in judgment concerning a doubtful or debatable point of law."[6] The court noted, however, that the judgmental immunity doctrine involves a two-pronged inquiry: (1) whether the state of the law was unsettled at the time the professional advice was rendered; and (2) whether the advice was based upon the exercise of an informed judgment.[7] Thus, judgmental immunity does not apply unless the attorney establishes, as to the second prong, "reasonable research in an effort to ascertain relevant legal principles and to make an informed decision as to a course of conduct based upon an intelligent assessment of the problem."[8] If the two elements are established, the attorney may be entitled to summary judgment in the legal malpractice suit as a matter of law.[9]

Strict Interpretation of the Doctrine

California appellate courts have not been reluctant to reverse summary judgments where the two judgmental immunity elements are not established as a matter of law. *In Aloy v. Mash,* 38 Cal.3d 413 (1985), the Supreme Court held that the defendant had offered no evidence that it based its judgment on all available data and made a rationale professional judgment. Instead, the court characterized the attorney's actions as based upon an incomplete reading of a single case, which failed to appreciate all of the nuances of the legal issue in question.[10]

Similarly, in *Village Nurseries*, *supra*, the court held that the attorneys' moving papers did not address whether they performed any legal research or considered any particular authorities before advising Village Nurseries on the issue of lien validity. The record was also silent regarding the attorneys' experience in the relevant area of law. As a result, the defendants' motion failed to establish the second prong of the judgmental immunity doctrine.[11]

The Blanks v. Seyfarth Shaw Decision

1. The Greenfield Litigation

The plaintiff in the *Blanks* case, Billy Blanks, is the well-known inventor of the fitness program known as

[4] *See Caldwell v. Montoya*, 10 Cal.4th 972, 979-980 (1995).

[5] *Id*. at 690. *See Kirsch v. Duryea*, 21 Cal.3d 303, 309 (1978).

[6] *Id*. at 35. *See also Davis v. Damrell*, 119 Cal.App.3d 883, 887 (1981).

[7] *Village Nurseries*, 101 Cal. App. 4th at 36-37.

[8] *Id*. *See also Smith v. Lewis,* 13 Cal.3d 349, 359 (1975).

[9] *Stanley v. Richmond*, 35 Cal.App.4th 1070, 1094 (1995).

[10] *Aloy*, 38 Cal.3d at 418-419.

[11] The defendants in *Village Nurseries* argued that their actions were consistent with applicable treatises and therefore constituted the exercise of an informed judgment. The Court of Appeal, however, held that the defendants must establish that the law was unsettled *and* that they conducted sufficient research and analysis to exercise an informed judgment. *Id*. at 38.

"Tae Bo." In the early 1990s, Blanks engaged an accountant, Greenfield, to assist him with financial issues. Thereafter, Blanks hired a licensed talent agent, Unger, from the William Morris Agency.[12]

Although Greenfield did not have a talent agency license, he nonetheless arranged movie and television appearances for Blanks in 1998 and 1999. Blanks later contended that, due to Greenfield's "inept" actions, many business opportunities were lost. Greenfield nevertheless succeeded in convincing Blanks to fire the William Morris Agency, to have Greenfield handle all of Blanks' business affairs and, ultimately, to enter into a partnership with Greenfield to run the Tae Bo-related businesses.[13]

During the period of time that Blanks and Greenfield were in business together, Blanks wrote Greenfield a series of very large checks.[14] In September 1999, Blanks became aware both that Greenfield did not have a talent agency license and that the law required that he have such a license.[15] Blanks was then referred to an attorney at Seyfarth Shaw, Lancaster, for an evaluation of potential claims against Greenfield.[16] The firm was formally retained as Blanks' counsel on October 27, 1999.

On November 4, 1999, Seyfarth sued Greenfield for violations of the TAA. During the litigation, on December 29, 1999, the one-year TAA statute of limitations lapsed as to the first check written to Greenfield. The statute lapsed as to the sixteenth check written to him on August 2, 2000.

In February 2000, Blanks became aware that Seyfarth had not filed a petition with the labor commissioner within the one-year statute of limitations and that a recent decision had prominently held that the labor commissioner had exclusive jurisdiction over such claims. Blanks forwarded the letter to Seyfarth which held conferences about the issues that it raised. Lancaster then sent Blanks a letter advising him of the status of the case including an update on ongoing discovery disputes. The letter stated that a motion to stay the TAA claim and a TAA petition were being prepared and would be filed in the next week.

In late August 2000, Lancaster called Blanks' home inquiring when he had first learned that Greenfield was not a licensed talent agent.[17] Blanks' wife replied that he had first learned of Greenfield's lack of licensure in August or September 1999. Less than 24 hours later, Seyfarth sent a petition to determine the controversy to the labor commissioner by Federal Express. After the petition was received by the commissioner on August 28, 2000, Seyfarth moved to stay the *Blanks v. Greenfield* action.

Blanks thereafter substituted a new firm in place of Seyfarth Shaw. On March 11, 2002, the labor commissioner issued a formal determination of controversy finding that Greenfield was operating as an unlicensed talent agent and that he had violated the TAA at least twice. The commissioner ruled, however, that Blanks' petition was barred by the one-year TAA statute of limitations. Thus, the commissioner could not order Greenfield to disgorge money he had received from Blanks. Blanks' civil claims against Greenfield for TAA violations were then dismissed due to the bar of the statute of limitations.

2. The Legal Malpractice Case

Blanks sued Seyfarth Shaw and Lancaster alleging causes of action for legal malpractice, breach of fiduciary duty and fraudulent concealment. He alleged the attorneys had failed to timely file a petition before the labor commissioner, resulting in Blanks' inability to recover all of the approximate $10.6 million Blanks had paid to Greenfield.

The legal malpractice case went to trial. Seyfarth defended the case by arguing that it filed a civil complaint rather than a claim with the labor commissioner to allow for civil discovery, including Greenfield's deposition, to be conducted. Seyfarth claimed that a TAA position would have stayed the civil action and precluded necessary discovery.[18] Seyfarth claimed that Blanks agreed with this strategy as to a TAA petition although Lancaster admitted he knew that the crucial date was the date each payment was made to Greenfield.

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12 *Blanks v. Seyfarth Shaw, LLP*, 171 Cal.App.4th 336, 346 (2009).

13 *Id*. at 347-348.

14 *Id*. at 348.

15 The California Talent Agencies Act, Labor Code section 1700 *et seq*. (the TAA) requires all agents to be licensed and provides for the Labor Commissioner's exclusive jurisdiction over certain claims. If an agent procures work for an artist and is unlicensed, the TAA permits the Labor Commissioner to void *ab initio* all contracts between the parties and order the unlicensed agent to disgorge funds earned for those services. TAA claims are subject to a one-year statute of limitations running from the date that payment is first made to the unlicensed agent. *Id*. at 349.

16 *Id*. at 349.

17 *Id*. at 351.

18 *Id*. at 354.

B.B. Wolf vs. Curly Pig

Don't Miss the Mock Trial of the Century!

The ABA Tort Trial and Insurance Practice Section invites you to join us during the 2010 ABA Midyear Meeting in exciting Orlando, FL for a must-see special performance. Hear first-hand the high profile case in which Curly Pig is charged with attempting to cook B.B. Wolf.

Presented by real actors in costume, this mock trial will introduce the principles of the rule of law to the audience, and will allow children to serve as the jury, giving them the opportunity to test their internal values of fairness and morality in a fun and challenging setting.

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THE JUDGMENTAL IMMUNITY DOCTRINE...

Continued from page 1

The trial court granted a motion *in limine* that Seyfarth Shaw and Lancaster were negligent as a matter of law, effectively excluding most of Lancaster's testimony with regard to his litigation strategy. He was permitted to testify, however, that: (1) he was confident that the TAA statute of limitations would be tolled based upon the delayed discovery doctrine; (2) bringing suit in the superior court could satisfy the TAA's requirements of filing an "action or proceeding"; and (3) there was an open question whether the TAA applied if the arrangement between Blanks and Greenfield was a partnership, as Greenfield claimed. Lancaster also testified that Blanks' TAA claims were worth far less than $10.6 million because virtually all of that amount came from a particular deal.[19]

The jury thereafter returned a series of special verdicts finding that Greenfield had acted as a talent agent and that, had Seyfarth timely filed a TAA petition, Blanks would have been entitled to an award of $10.6 million. The jury found that Seyfarth was negligent in allowing Blanks' TAA claim to lapse and awarded Blanks $9.3 million in damages.[20]

3. The Appellate Decision

On appeal, Seyfarth first argued that pursuant to a "trial-within-a-trial" analysis for legal malpractice causation,[21] Blanks could not prove that, absent the claimed negligence, he would have received a better result. The Court of Appeal observed that if the underlying issue was originally a factual question that would have gone to a tribunal rather than a judge, the jury must decide what a reasonable tribunal would have done.[22] The court then held that Seyfarth could not circumvent the mandatory TAA procedural requirements by asserting that Blanks would have been fully compensated in a civil action alleging violations of California's Unfair Competition Law, Business & Professions Code section 17200, *et seq*.[23]

Seyfarth claimed that even if it was negligent in allowing a TAA statute to expire prior to filing a TAA petition, its conduct did not harm Blanks because the statute of limitations for an unfair competition (UCL) cause of action had not expired and allowed for the same recovery. Therefore, Seyfarth claimed that, as a matter of law, Blanks could not prove causation and damages under the trial-within-the-trial methodology. The Court of Appeal rejected this argument, however, holding that the TAA contains an unambiguous requirement that actions colorably arising under it are subject to the exclusive jurisdiction of the labor commissioner. That constituted an absolute bar to Blanks' civil UCL cause of action.[24]

Seyfarth then argued that, even if a timely petition under the TAA had been filed, Greenfield had nonetheless rendered services that were "non-agent" in nature. Thus, even a timely TAA petition would not have been able to obtain disgorgement of all of the amounts paid to Greenfield. While this contention was rejected by the trial court[25] the Court of Appeal noted that the lower court had erred as to its jury instructions on this severability argument. The Court of Appeal noted that the instructional error contravened the law and it was the jury's responsibility to determine causation and damages in light of the severability defense.[26] The court concluded that this instructional error constituted reversible error.[27]

The Court of Appeal then proceeded to reject Seyfarth's contention that the trial court had erred in ruling that the TAA statute of limitations could not be extended by the discovery rule.[28] The court agreed, however, that the trial court also erred in its motions *in limine* ruling that Seyfarth was negligent as a matter of law. In essence, the trial court's ruling did not give the parties an opportunity to address the facts required to assess negligence. The court effectively denied Seyfarth the ability to explain its action and present its position that it had met the standard of care and had made an informed decision.[29] Thus, the court concluded that the trial court's ruling that Seyfarth was

19 *Id*. at 354.
20 The jury also awarded Blanks damages for breach of fiduciary duty and fraudulent concealment, as well as punitive damages.
21 *Mattco Forge, Inc. v. Arthur Young & Co*., 52 Cal.App.4th 820, 834 (1997).
22 *Blanks*, 171 Cal.App.4th at 357-358.
23 *Id*. at 363-364.
24 *Id*. at 367.
25 *Id*. at 369.
26 *Id*. at 371.
27 *Id*. at 373.
28 *Id*. at 374-375.
29 *Id*. at 376.

negligent as a matter of law was another reason mandating reversal of the judgment.[30]

4. The Judgmental Immunity Ruling

The Court of Appeal then addressed the judgmental immunity doctrine as it applied to *Blanks'* TAA claim. The court noted that, when the law grants an immunity, it does not mean that the defendant's conduct is not tortious but rather that the defendant is absolved from liability. For instance, an immunity exempts public employees from liability who, in the exercise of their discretion, injure another.[31] Another immunity protects real property owners from liability from injury or death that occurs upon that property during the course of or after the commission of specified felonies by the injured or deceased person.[32]

In contrast, when courts discuss what has come to be called the attorney "judgmental immunity doctrine," they are actually addressing the factual issue of whether the attorney breached the standard of care. The court noted that the judgmental immunity doctrine relieves an attorney from a finding of liability even when there was an unfavorable result if there was an "honest error in judgment concerning a doubtful or debatable point of law… ."[33] The doctrine recognizes that an attorney does not "ordinarily guarantee the soundness of his [or her] opinions and, accordingly, is not liable for every mistake he [or she] may make in his [or her] practice."[34]

Applying the attorney judgment standard to the *Blanks* case, the Court of Appeal noted that when the issues of Seyfarth's negligence are raised upon remand the defendants would need to demonstrate that they made a reasoned choice to delay filing Blanks' TAA petition and that it was a prudent trial strategy to risk losing the TAA claims when the basis for Seyfarth's strategy was a number of uncertain and untested legal hypothesis that equal or greater results could be achieved for Blanks outside an action before the labor commissioner.[35]

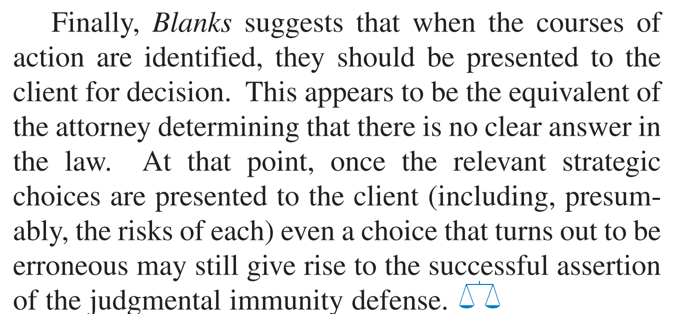
The *Blanks* court also noted that an attorney's obligation is not satisfied by simply determining that the law on a particular subject was doubtful or debatable.[36] Even where the law is unsettled, an attorney's decision must be informed, and based upon an intelligent evaluation of the case. At a minimum, the attorney has the duty to avoid involving his client in murky areas of the law if research reveals an alternative course of action. In addition, the attorney should at a minimum inform his or her client of uncertainties and let the client make the decision.[37]

Conclusion

The *Blanks* court's commentary on the judgmental immunity issue suggests several important concerns regarding the defense. First, the issue in question must in fact be "uncertain" or "ambiguous." While attorney's are certainly not responsible for errors in judgment, erroneous decisions in well-established areas of the law can be problematic in the context of a judgmental immunity defense. Against that backdrop, the Court of Appeal in *Blanks* expressed some skepticism as to whether Seyfarth's strategy ran afoul of established law on the TAA jurisdiction issue. Still, the court did not decide the judgmental immunity issue as a matter of law and left open the possibility that the firm could prove the exercise of a reasonable judgment.

Second, while the *Blanks* decision does not discuss the issue in detail, the process by which the attorney arrives at the chosen legal strategy is an important part of establishing the defense. In other words, the nature of the investigation followed by the attorney's "intelligent evaluation" of the issue becomes important. In particular, identifying the relevant strategic courses of action for the client may be a necessary element of the defense.

Finally, *Blanks* suggests that when the courses of action are identified, they should be presented to the client for decision. This appears to be the equivalent of the attorney determining that there is no clear answer in the law. At that point, once the relevant strategic choices are presented to the client (including, presumably, the risks of each) even a choice that turns out to be erroneous may still give rise to the successful assertion of the judgmental immunity defense.



30 *Id*. at 377.

31 Cal. Gov. Code §820.2.

32 Cal. Civ. Code §847.

33 *Davis v. Damrell*, 119 Cal.App.3d 883, 887 (1981).

34 *Smith*, 13 Cal.3d at 358.

35 *Blanks*, 171 Cal.App.4th at 379.

36 *See Horne v. Pechham*, 97 Cal.App.3d 404, 416 (1979).

37 *Blanks*, 171 Cal.App.4th at 379.

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A SURVEY OF LIABILITY "HOT SPOTS" FOR CPAS

By Kevin M. Murphy[38]

The current economic recession creates potential liability concerns for accountants. The "subprime mortgage crisis" morphed into the "credit crunch," leading to what has now been widely acknowledged as the most significant recession in decades. While some economic indicators have improved during mid-2009, there are further storm clouds gathering on the horizon according to many economists. For example, a second wave of mortgage and related credit problems due to significant stresses in the commercial real estate market is predicted by some analysts. Others have predicted another wave of problems in the residential mortgage market in 2010-2012, when a multitude of hybrid and "option ARM" mortgages refinanced earlier this decade, reset after five to seven years, resulting in much higher interest rates or balloon note payments. Businesses have struggled throughout the economy, failing in numbers not seen for decades. Corporate bankruptcy filings were up 63 percent in the 12 month period ending June 30, 2009 compared with the period ending June 30, 2008.[39] All of this has been punctuated by the well publicized collapse of "Ponzi schemes" which were exposed as the economic tide ran out.

Given the current economic conditions described above, and the integral role played by certified public accountants in businesses throughout the economy, it is not difficult to conclude that accountants are likely to face some substantial liability exposures that are driven by the economy. This author has conducted an informal survey of certain insurers of accountants, to gather their observations regarding claims against accountants during this recession. This article develops the comments from that survey regarding likely liability "hot spots" for CPAs as the economic conditions further shake out.

What Have the Insurers and Brokers Observed?

Those surveyed for this article include several insurers of small, medium and regional accounting firms, as well as a broker of small to regional sized firms, and a broker of larger, regional and national firms. While there were some minor variations in the comments, certain general observations appeared relatively uniform. First, there seems to have been a noticeable increase in claims by companies against their accountants for alleged failure to detect embezzlement by employees. Second, business failures have spawned a small uptick in the frequency of claims related to business failures, and a more noticeable uptick in the severity of such claims. Business failures generate claims by lenders, investors, shareholders and bankruptcy trustees, among others. While recent case law has slowed the growth of the "deepening insolvency" theory, it continues to arise regularly as a claim in business bankruptcy and receivership settings. The surveyed insurers also are keeping an eye on claims arising out of "Ponzi schemes" to gauge the extent of those claims, and they are observing with some concern the potential for claims arising out of CPA services to retirement plans. Also of some note is what appears to be an increased scrutiny of accountants by financial regulators, such as the SEC and PCAOB. The following is an overview of some of these liability "hot spots."

Fraud Detection Claims

With increasing frequency, controllers, bookkeepers and other persons with access to a company's assets may be tempted to siphon off some of those assets, especially as the economy puts pressure on the finances of such individuals. Claims against accountants occur most frequently where the CPA has audited such businesses, but some insurers have noticed more frequent claims where the accountants have only reviewed or compiled the financial statements. Effective October 2002, the AICPA issued Statement on Auditing Standards 99, which called for auditors to plan, inquire and then assess fraud risks. Even though standard audit engagement letters state that an audit cannot be relied upon to uncover fraud, nevertheless the more particularized auditing standards in recent years, combined with the increased frequency of embezzlement, make this a definite liability "hot spot." As noted above, insurers have seen a growing frequency and severity of claims against CPAs for alleged failure to detect fraud.

"Going Concern" Opinions and "Deepening Insolvency"

Auditing standards require an auditor to make and document an assessment of whether the auditor has substantial doubt regarding the company's ability to continue as a "going concern" for a reasonable period of time, not exceeding one year.[40] To the surprise of some,

[38] Kevin M. Murphy is an attorney at *Carr Maloney P.C.*

[39] *See* www.usgovinfo.about.com (8/19/09 report).

[40] *See* Auditing Standard § 341.

standards for accounting and review services (SSARS) may also require an accountant performing a review or a compilation to assess the client's ability to continue as a going concern under certain limited circumstances.[41]

In early 2009, the CEO of Grant Thornton predicted that the number of going concern opinions could hit an "all time high" this year, and that "we will see an unprecedented number of going concern footnote disclosures and clarifications from the auditors."[42] But, as often noted, the difficulty with going concern opinions is that they can become something of a "self fulfilling prophecy." In other words, if an accounting firm determines to add a going concern footnote to a company's financial statement, this can result in the company encountering problems with lenders, creditors, etc. Auditors are caught in the middle when doing this kind of an analysis. If they fail to include a going concern footnote, and then the company deteriorates and fails within the year, claims can follow.

In recent years, bankruptcy trustees, receivers and others have increasingly asserted "deepening insolvency" claims against auditors, asserting that an auditor's failure to issue a going concern warning, or an auditor's alleged approval of financial statements with overstated income or assets, has caused delay in the liquidation of a doomed entity, thereby causing the entity to accumulate additional losses, debt, etc., which adversely affects creditors, investors and others. Courts have grappled with this relatively new theory in recent years. Some courts have recognized it as a viable cause of action, while others have rejected it or described it as a potential theory of damages. Several of the more recent cases have questioned, rejected or limited the theory.[43] For a thorough treatment of going concern opinion liability issues, see "*Malpractice in this Era of Economic Uncertainty*," by Matthew J. Iverson, *For the Defense*, May 2009, pages 26-31. Clearly, as businesses fail, bankruptcy trustees, receivers, and investors will look back to question how the failure occurred. If they deem the financial statements of the company to have been overly optimistic, litigation is likely, with particular focus on the issue of a going concern analysis by the auditor in many of these cases.

Bankruptcy Trustee Claims

The Federal Judicial Center has reported a rise in "mega Chapter 11" filings and Chapter 7 corporate bankruptcies. In recent decades, numerous battles have been waged by trustees asserting claims against not only directors and officers, but also accountants, lawyers and other professionals for their services to the bankrupt entity, both pre-petition and post-petition. In one interesting case, the Seventh Circuit (Judge Posner) noted *sua sponte* that the trustee's malpractice claim against the auditor of the bankrupt "dot.com" entity appeared potentially frivolous, and suggested the filing of a sanctions motion.[44] The court said that judges must be "vigilant in policing the litigation judgment exercised by trustees in bankruptcy."[45] Many cases have established that a trustee "stands in the shoes of" the debtor company, although certain exceptions may apply.[46] Therefore, accountants have often deflected claims by bankruptcy trustees using the *in pari delicto* defense. Nevertheless, with the tremendous jump in corporate bankruptcies, insurers polled for this article identified concerns about an anticipated rise in both the frequency and severity of claims by bankruptcy trustees.

Deals Gone Bad

Venture capital and private equity firm acquisitions of companies reached new heights in the middle of this decade. In these transactions, it is common for contract provisions to establish the purchase price or investment levels based upon past or projected financial performance of the company. Given the sharp drop in the economy, deals that closed in the months or year before the economic downturn will now look much less favorable to the investors. If the investors can demonstrate that the acquired entity's auditor had knowledge that the audited financial statement would be used by the investors to determine acquisition terms, a substantial hurdle in many of these cases, then a claim may well follow. The privity issue is often paramount in these types of cases. Additionally, accountants who have provided due diligence services to investors may face claims from their client for allegedly not anticipating the negative performance that many companies are now experiencing, but such claims for "failure to read the tea leaves" can be hard to prove.

Lender Claims

Lenders often request the financial statements of their borrowers. In recent years, many lenders were

41 *See* Accounting Standard § 100.69.

42 *See* D&O Diary at www.dandodiary.com/2009/03/articles (March 6, 2009).

43 *See Trenwick America Litigation Trust v. Ernst & Young*, 906 A.2d 168, 204 (Del. Ch. 2006); *Fehribach v. Ernst & Young LLP*, 493 F.3d 905, 908-09 (7th Cir. 2007).

44 *Maxwell v. KPMG, LLP*, 520 F.3d 713 (9th Cir. 2008).

45 *Id*.

46 *See*, *e.g*., *CBI Holdings Co. v. Ernst & Young,* 2008 WL 2405702 (2d Cir. 2008).

satisfied with reviewed financial statements and did not demand audited financial statements as frequently as in the past. Lenders will sometimes assert claims against the borrower's accountant, but when those financial statements have been reviewed and not audited, the lender claim will be less likely to prevail. Lenders also encounter difficulties proving the privity, "near-privity" or foreseeability that is required under applicable state law for a suit against the borrower's accountant.[47] But despite these legal hurdles, there arguably exists a kind of "perfect storm" for the proliferation of lender claims against accountants. With the combination of the "credit crunch" impacting lenders' financial stability, and the distressed financial condition of many borrowers who will default on commercial loans, it can be anticipated that lenders will more frequently explore potential claims against the borrowers' accountants.

Surety Claims

As a natural consequence of the credit crunch, the construction industry has dramatically slowed. Many contractors, large and small, have either collapsed or experienced substantial difficulties performing existing contracts or paying subcontractors. Sureties issue payment or performance bonds on construction projects, and when a contractor fails to perform or to pay its vendors and subcontractors, the surety may receive a demand to perform or pay. Sureties have, in this situation, brought claims against accountants for the contractors who have issued audited or reviewed financial statements.[48] Again, the privity issue becomes a significant hurdle for the plaintiff. But, as described by Richard Bale in the Fall 2008 edition of this newsletter, in "New Developments in Accountant Liability to Third Parties," recent decisions suggest that the privity limitation may be a less significant obstacle to claims against accountants. Rick Bale's article addresses two recent cases from New York which arguably somewhat dilute (at least in some specific circumstances) the degree of "linking conduct" or "foreseeability" required between an accountant and the third party who alleges reliance on the financial statements.[49]

Ponzi Schemes

The investment scam perpetrated by New York financier Bernard Madoff is the poster child for Ponzi schemes that have been exposed by the rapid downturn in financial markets. But it is not the only one. There have been literally dozens of substantial Ponzi schemes uncovered over the last two years. Some of the largest include an "electronics" scheme allegedly run by Thomas Petters and a phony investment scheme allegedly operated by Allan Stanford in Texas. The question is whether there are likely to be widespread claims against accountants arising from these schemes. Certainly, the few accounting firms that prepared financial statements for the scheme entities will likely face claims. Interestingly, Madoff used a three-person accounting firm with only one active member to audit his broker-dealer business. Claims have been filed against that firm. But the more substantial question is whether accountants for so-called "feeder funds", and those who invested in the Ponzi schemes, will face liability. Insurance representatives surveyed for this article commented that accountant liability appears more likely for those who provided investment advisory services to their clients as opposed to those who audited feeder funds or investors in the Ponzi schemes. Those who audited the feeder funds or investors arguably did not have to conduct any significant testing of the viability of the ultimate investment. Nevertheless, according to several media reports, dozens of lawsuits have been filed against accounting firms for investors and feeder funds in the highly publicized Ponzi schemes. Those cases have yet to work their way through to any resolution.

Retirement Plan Liability

When the investment value of retirement funds decreases dramatically, there arises the potential for an increase in claims against plan sponsors and plan administrators. However, accountants usually only perform the role of either an auditor of the plan, or a third party service provider to the plan administrator. These roles are typically not considered "fiduciary services" under ERISA or Department of Labor regulations. However, fiduciary status is a question of fact, determined by what the party actually did and not by formal titles or document descriptions.[50] Therefore, if an accountant strays into a role that includes discretion over plan funds, claims may well follows. This becomes a larger concern in the wake of *LaRue v. DeWolff, Boborg & Associates*, 200 U.S. 321 (2008), in which the Supreme Court held that a plan administrator could be sued by an individual plan participant for mismanagement. Prior to that, most federal circuits

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47 *See*, *e.g*., *Bank of America v. Musselman*, 240 F. Supp.2d 547 (E.D.Va. 2003).

48 *See*, *e.g*., *Travelers v. Reznick Group P.C*., 2008 WL T12581 (11th Cir. 2008).

49 *See Dinerstein v. Auchin, Block & Auchin LLP*, 41 A.D.3d 167 (N.Y. App. 2007); *Chaikovska v. Ernst & Young, LLP*, 21 A.D.3d 1324 (N.Y. App. 2005).

50 *See Lockheed Corporation v. Spink*, 517 U.S. 882 (1996).

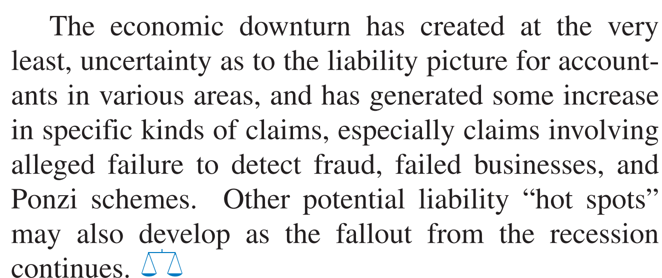
had barred individual participant claims and allowed only claims by the plan itself.

Securities Fraud Liability

Since the Supreme Court held that Section 10(b) does not give rise to a private cause of action for aiding and abetting a securities fraud in *Central Bank of Denver, N.A. v. Interstate Bank of Denver*, N.A., 511 U.S. 164 (1994), there have been several key decisions, which have generally reduced the potential for securities liability claims against accountants. In *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148 (2008), the court found that there was no private right of action under Section 10(b) for so-called "scheme liability" against third parties who allegedly assisted those who committed securities fraud. Perhaps more significantly, the Supreme Court found in 2007 that a plaintiff who brings a Section 10(b) securities fraud claim must allege facts that establish a "strong inference" that the defendant acted with the required *scienter* (intent to deceive, manipulate or defraud), and if the pleading does not establish this, it should be dismissed.[51] Most recently, the pleading requirement from *Tellabs* was applied to dismiss a securities fraud claim against an auditor where the court held that the "stronger, more plausible inference is that the accountants were, like the plaintiffs, victims of the fraud rather than its enablers."[52] There, the auditors issued opinions on financial statements for several years that had admitted overstatements of earnings, yet the court found the pleading insufficient. Therefore, the case law developments in recent years have made securities fraud claims against accountants substantially more difficult to allege and prove, which may serve to hold down the frequency and success rates of such claims despite increased corporate failures.

Conclusion

The economic downturn has created at the very least, uncertainty as to the liability picture for accountants in various areas, and has generated some increase in specific kinds of claims, especially claims involving alleged failure to detect fraud, failed businesses, and Ponzi schemes. Other potential liability "hot spots" may also develop as the fallout from the recession continues.



51 *Tellabs v. Makor Issues and Rights Ltd.*, 551 U.S. 308 (2007).

52 *Public Employees Retirement Association of Colorado v. Deloitte & Touche*, LLP, 551 F.3d 305 (4th Cir. 2009).

DIVERSITY SPOTLIGHT: STACEY J. MOBLEY

Breakthroughs in workplace diversity require a sincere commitment from corporate directors and officers to allocate the resources in furtherance of that goal. Persistence and dedication within the corporate hierarchy is also necessary to establish and maintain an environment receptive to racial, ethnic and cultural differences. Some are slow to change, others simply resist it. Long-term success in diversity initiatives will not be measured by the number of minority candidates hired, but by the retention rate and productivity of those individuals. Demonstrated ability and leadership among minority personnel are two of the best ways to advance the cause of diversity.

The PODL Diversity subcommittee is honored to feature Stacey J. Mobley for this SPOTLIGHT ON DIVERSITY. His more than thirty-five years as a corporate executive have served as a model for the talent that exists irrespective of race. However, his personal commitment to creating more corporate level opportunities for minorities highlights the ongoing need for proactive measures to make workplace diversity a reality.

Mr. Mobley earned his undergraduate degree from the Howard University School of Pharmacy in 1968, and his J.D. from the Howard University School of Law in 1971. He was the first African-American attorney hired by E. I. du Pont de Nemours and Company ("DuPont"); a $30.5 billion research and product development company operating in more than 70 countries around the world. While at DuPont, Mr. Mobley was named a senior vice-president in 1992 and he served as general counsel and chief administrative officer from 1999 to 2008. He further served as a member of the company's six-member office of the chief executive. Mr. Mobley retired from DuPont in June, 2008 and he is now in private practice.

Recently, Mr. Mobley took time to share with the PODL Diversity subcommittee some of his personal experiences and thoughts related to workplace

diversity. The following are the key points from that discussion:

Q: Mr. Mobley, as the first African American attorney hired by DuPont, describe what, if any, mentoring program was available for you when you arrived.

Mr. Mobley:

Well, there wasn't a formal program; the person who hired me ended up being my mentor. My interview with DuPont was a full day, during which time I met a number of people in the legal department. The process ended in the office of the assistant general Counsel, who was Chuck Welch at the time. Chuck asked me how the day went and I told him that I had met several sharp lawyers, was exposed to some interesting work, but I was hesitant because the place was a little too conservative. **I expressed my concern that there were no other African American lawyers and he said that I would be the first. My response was, that's fine, but what about others?** Chuck assured me that DuPont was going to change that and he asked for my help in making it happen. From that day on, we had a great working relationship. In fact, I still consider him to be my mentor.

Q: How long after you joined DuPont did they actually hire other minorities?

Mr. Mobley:

The DuPont legal department had already started down the path toward a more diverse workforce even before they hired me. Within 30 days after I started, the first female attorney came on staff, followed by another woman. Then an African American woman was hired. So, within 60 days, we had gone from a legal department with no people of color and no women; to two people of color and a total of three women. Chuck was a man of his word and these new hires were a product of his vision for the future of diversity at DuPont. There was a gradual diversity movement from there.

Q: Was there an assumption at DuPont that because you were an African American, you would automatically want to participate in diversity initiatives?

Mr. Mobley:

I don't think there was - it wasn't a presumption. **I let it be known that I certainly was available and wanted to participate in efforts to diversify the legal department.** In addition, one of the female attorneys (MaryJo Anderson) who joined shortly after I started - and is still with DuPont - also volunteered to help. It wasn't a passive participation; we were very active in that regard.

Q: Were there efforts in other departments of the company to diversify the workforce?

Mr. Mobley:

Shortly after we were hired, the human resources department - which way back then was called the employee relations department- developed some initiatives. As I think back to those days, it was really a function of the insight of the individual leaders like Chuck Welch, for example, and the incoming CEO Irv Shapiro. There were other leaders in other divisions of the organization who helped to foster a proactive diversity plan. At that time, they were points of light as opposed to there being an organized initiative company wide.

Q: Once you were named Senior Vice President for DuPont in 1992, how many other minorities were there at your level?

Mr. Mobley:

At that time, I was the only minority senior vice president at DuPont. Eventually, we had a total of four African Americans at the vice president level. We later had a female senior vice president in charge of IT. There were also two female group vice presidents. Ellen Kullman was one of those group vice presidents and she was recently promoted to CEO.

Q: Was diversity an important topic of discussion at the executive level?

Mr. Mobley:

At the Office of the Chief Executive ("OCE"), which is the management committee, and within the office of CEO, diversity was certainly on the agenda. We were very much aware of it and were certainly concerned about our population. We were even more concerned about the pipeline of diverse candidates coming into the company.

Q: What initiatives were you instrumental in helping to increase diversity among the entry level attorneys coming into DuPont?

Mr. Mobley:

Well, I did it on two levels. On the corporate level back in 1991, I, in concert with the other four African American VPs, presented the idea of creating an

African American corporate development conference and we went to the OCE for funding.

The funds were allocated and we selected 100 African American employees from various groups and departments across the company for a three day conference outside of Washington, D.C. During that meeting, we identified and addressed concerns among the African American employee population. That was the first time at DuPont that anything like that ever occurred. Ultimately, the outgrowth of that meeting later became the foundation for an African American employees organization. It was an infinity group that remains today.

Next, in the legal department, we had a separate group of African American staff members that got together and focused on what we thought was needed in the law department beyond recruitment. We focused on development and promotion and we met often with legal department management.

Q: Were there affinity groups similar to the African American employees group for other minorities at DuPont?

Mr. Mobley:

Absolute, there were. A women's network was created. There was also a Hispanic network, an Asian network, and the B-Glad network - which addresses gay/lesbian/bisexual concerns.

Q: Was there any resistance to these diversity initiatives?

Mr. Mobley:

Well, the affinity groups in their infancy stages were looked upon by certain individuals in the company as sort of divisive organizations. It was a challenge to show that these groups were constructive in their purpose and really were about allowing like-minded individuals to find a way to maximize their contribution to the company. In addition, on some level there was a lack of understanding of the purpose of these groups. I think they gained acceptance once people in management at plant sites and elsewhere understood the ultimate purpose, saw how positively they could impact employees, and experienced how helpful they were in allowing people to contribute and be better employees. Ultimately, the groups became a very constructive force in the company. People finally said, OK, this is a good thing. These groups are not about being divisive; they are about creating an environment which allows all employees to be more productive.

Q: I understand that you signed the Call to Action on behalf of DuPont. Why did you find that important?

Mr. Mobley:

You may recall that, prior to the call to action, there was a statement of principles for diversity in the workplace signed by several corporate representatives. It was great in terms of the affirmation, but it did not lead to any action. Well, Rick Palmore was leading the effort to do more and he came up with the notion of a call to action. As a law department, DuPont already had an affirmative commitment to diversity, but we felt it important to lend our name to the list as a demonstration of solidarity with the objectives of the call to action.

Q: What was your participation in that effort once you signed the Call to Action on behalf of DuPont?

Mr. Mobley:

We had already embraced this initiative and in fact we considered ourselves leaders in the field. So we went back to our network of law firms to say, in addition to expressing to you directly what our diversity principles are, we see this call to action as an indication to the world that we are serious about diversity. For the firms that work with us, we expect them to be in alignment with us. Part of my role was to make certain that firms working with us had the same commitment.

Q: So the Call to Action was just a continuation of the commitment that DuPont had already made?

Mr. Mobley:

Absolutely, and the other thing we wanted to do in support of Rick Palmore's effort was to add another corporate name publicly supporting workplace diversity. I think he ultimately got the participation by about 90 general counsel representatives, but we wanted to add to that momentum by saying, here is another company that's on the list in an effort to get others to sign on as well.

Q: What diversity related awards did DuPont receive while you were Chief Administrative Officer?

Mr. Mobley:

There were many, among them was recognition from the National Association of Women Lawyers. An award that I considered to be probably one of the most

significant honors of the legal department came from the Minority Corporate Counsel Association ("MCCA"). That organization awarded DuPont its Diversity Award in, I think 2000. In addition, they named the award going forward after Thomas L. Sager, for his tireless efforts in support of diversity over the years. Tom was at DuPont and in fact is my successor. That award symbolizes DuPont's longstanding commitment to diversity. I must also say that all credit for the awards we received goes to the entire organization because it took individual commitment as well as the dedication of resources by DuPont.

Q: On a personal level, what individual diversity related honors have you received?

Mr. Mobley:

I received the Trail Blazer award from MCCA in recognition of my individual efforts to promote diversity. In Delaware I was awarded the ACLU award for protecting civil liberties. I also received the Appleseed Award in 2008 for diversity and pro bono activities. The DuPont legal organization also received an Appleseed Award.

Q: In your opinion, what are some of the greatest obstacles that currently exist to enhancing diversity beyond where it stands today?

Mr. Mobley:

I think the current economy has created at least some temporary speed bumps on the road to greater diversity. Budgetary cutbacks can limit the allocation of monetary and workforce resources necessary to advance diversity initiatives. The economy should not be a constraint around retention and development but perhaps around recruitment. Nevertheless, true workplace diversity requires an ongoing commitment. In the face of economic challenges, it may require a reorientation of priorities.

In addition, my personal thought is that we need to be careful not to equate the election of an African American president as a sign that we have reached our diversity objectives. Some people may take the attitude that, we have an African American president, so there is really no need for us to continue to push for greater workplace diversity. This thought process is completely misguided.

Finally, one obstacle that continues to exist is the pipeline of talented minority candidates. Even the best corporate diversity programs are subject to underachievement if there are not enough qualified minority candidates available.

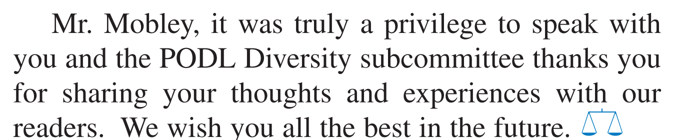
Q: What efforts have you made to mentor other minorities that have shown the talent to be the next executive leaders of tomorrow? How have you been able to share some of your experiences with others so that they can benefit from your trailblazing efforts?

Mr. Mobley:

Now that I'm retired, I've had a number of speaking events. In fact, I just came back from a diversity summit. One of my objectives is to express to future executive level minority candidates that they are brighter than I ever was or am, and here is the path that I've taken. Learn and benefit from my experiences and use them to go farther than I did.

I also continue to work with my alma mater, Howard University. We are actually celebrating the 140th anniversary of the law school later this month. I have a scholarship at Howard named in my honor. It is really important to me that bright individuals who have promise, who have the drive, but lack the financial resources can attend law school and succeed. **We cannot allow the lack of financial resources to prevent people from filling the diversity pipeline.**

Mr. Mobley, it was truly a privilege to speak with you and the PODL Diversity subcommittee thanks you for sharing your thoughts and experiences with our readers. We wish you all the best in the future.



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