Prime Plus Acquistition Corp. v Eisneramper LLP
2015 NY Slip Op 32336(U)
December 10, 2015
Supreme Court, New York County
Docket Number: 651139/2014
Judge: Shirley Werner Kornreich
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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 54

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PRIME PLUS ACQUISITION CORP. and
OASIS OAK ROCK INVESTORS, LLC,

Plaintiffs,

-against-

EISNERAMPER LLP,

Defendant.

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Index No.: 651139/2014

DECISION & ORDER

SHIRLEY WERNER KORNREICH, J.:

Motion sequence numbers 003 and 004 are consolidated for disposition

Defendant EisnerAmper LLP (EisnerAmper) moves, pursuant to CPLR 3211, to dismiss the Amended Complaint (the AC). Seq. 003. Plaintiffs Prime Plus Acquisition Corp. (Prime) and Oasis Oak Rock Investors, LLC (Oasis) oppose and move, by order to show cause, to disqualify Sidley Austin LLP (Sidley) from serving as EisnerAmper's co-counsel. Seq. 004. For the reasons that follow, defendant's motion to dismiss is granted and plaintiffs' motion to disqualify is denied as moot.[1]

I. Background

As this is a motion to dismiss, the facts recited are taken from the AC (*see* Dkt. 36) and

[1] The disqualification motion was filed on February 4, 2015, after EisnerAmper moved to dismiss. After oral argument [*see* Dkt. 107 (3/18/15 Tr.)], it was agreed that the motion to disqualify would be held in abeyance pending a decision on the motion to dismiss and that Sidley would not participate in any further briefing or argument on that motion. *See* Dkt. 106 & 108. EisnerAmper's co-counsel, Winston & Strawn LLP, solely represented EisnerAmper on the reply brief and at oral argument. Since the case is now dismissed, the court declines to decide the disqualification motion. However, in light of the parties' agreement to have Sidley refrain from participating in the motion to dismiss, Sidley should not participate in an appeal of this decision.

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the documentary evidence submitted by the parties.[2]

Here, the investors in non-party Oak Rock Financial, LLC (Oak Rock) seek to hold Oak Rock's auditor, EisnerAmper, liable for Oak Rock's fraud. That fraud was committed by Oak Rock's managing member, non-party John Murphy, who pleaded guilty to criminal bank fraud and conspiracy to commit bank fraud.

In an order dated November 14, 2014, this court dismissed similar claims asserted by Israel Discount Bank of New York (IDB). *See Israel Discount Bank of New York v EisnerAmper LLP*, 45 Misc3d 1218(A) (Sup Ct, NY County 2014) (the IDB Decision); *see* Dkt. 43. The court assumes familiarity with the IDB Decision, which sets forth the nature of Oak Rock's business and EisnerAmper's engagement as its auditor. That background was drawn from IDB's complaint, similar to the AC here. It will not be repeated in full.

That said, to recap, the court cites to the IDB Decision:

> Oak Rock, founded in 2001 by non-party John Murphy, is "a specialty asset-based lending company." Until the fraud at Oak Rock [] was discovered, Oak Rock was solely managed and controlled by Murphy. Oak Rock makes "revolving asset-based loans" to installment financing dealers. Simply put, Oak Rock funds the dealers' financing and collateralizes that funding with the receivables in which the dealers have a security interest. Oak Rock, in turn, finances its lending with credit facilities with a lower cost of debt than Oak Rock charges the dealers. Thus, Oak Rock leverages its ability to obtain relatively low-cost debt and creates credit lines for merchants via the dealers, with the dealers doing the actual merchant lending. The merchant lending is secured by the merchants' receivables, which is the collateral that flows upward to Oak Rock and its own financers, such as IDB, as the asset that backs this lending channel.
>
> EisnerAmper issued unqualified Independent Auditors' Reports on Oak Rock's balance sheet and other financial statements for the years 2002 through 2011. ... Each year, before EisnerAmper conducted its audit, Oak Rock signed substantially similar engagement letters. For instance, the engagement letter dated January 11, 2011 (for the 2010 audit) provided that "[t]he objective of [EisnerAmper's] audit is to express an opinion about whether [Oak Rock's]

[2] The documentary evidence is far more voluminous than on a typical motion to dismiss because of the production in the bankruptcy proceedings.

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> financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States [GAAP]." The engagement letter then explained that the audit would be conducted in accordance with generally accepted auditing standards (GAAS), which required that EisnerAmper "plan and perform the audit to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement whether caused by error or fraud. Accordingly, a material misstatement may remain undetected." The engagement letter further provided that "[t]he engagement is being undertaken solely for [Oak Rock's] benefit and the parties do not intend to provide contractual rights to any other person" [emphasis added]. The engagement letter also noted that "the financial statements are the responsibility of the management of [Oak Rock]" and that "[m]anagement is responsible for designing and implementing programs and controls to prevent and detect fraud."
>
> At the beginning of each audit report, EisnerAmper attached virtually identical short letters describing the report. These letters form the basis for IDB's fraud claim. The letter preceding the reports for 2009 and 2010, dated April 12, 2011, began by reiterating, as set forth in the engagement letter, that "[t]hese financial statements are the responsibility of [Oak Rock's] management. [EisnerAmper's] responsibility is to express an opinion on these financial statements based on our audits."

IDB Decision at 2-3 (citations omitted). Given the extensive detail in the IDB Decision, the court limits its discussion of the AC to facts and allegations unique to this case, such as plaintiffs' relationship to Oak Rock and EisnerAmper.

As indicated in the IDB Decision, IDB was heavily involved in Oak Rock's operations. In Oak Rock's bankruptcy proceeding, Prime submitted objections in which it set forth serious complaints about IDB's conduct. Prime and IDB, it turns out, were involved with Oak Rock from its inception. Prime explained:

> **[Oak Rock] was conceptually formed as a three-way venture between IDB, Murphy and [Prime] in 2001.** Murphy, a CPA with years of asset-based lending experience had worked for the previous 8 years as president of the asset based lending division of Sterling Bank in NY and IDB was a regular participant in numerous Murphy deals. IDB proposed that IDB, Murphy and [Prime] would all be better off if Murphy had his own new business. IDB stressed that Murphy needed only investment backing and a banking partner in order to build another business. IDB would provide low cost commercial lending, maintain oversight over Murphy's lending practices, and **continuously monitor the collateral**

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> **securing [Oak Rock's] loans to its customers.** [Prime] would contribute the equity and subdebt to support IDB's loans to [Oak Rock] at a 3.5:1 ratio. From the very beginning [Prime] was induced to invest in [Oak Rock] based upon IDB's assurances that [] IDB had 100% confidence in Murphy's integrity and expertise and that **IDB was an expert in asset-based lending and would provide the logistical support and oversight necessary to manage [Oak Rock's] collateral and ensure that loans to [Oak Rock's] customers remained in formula.** Over the years, IDB continually demanded that it be able to impose controls such as continuous internet access to [Oak Rock's] client data base, semi-annual on-site field exams, monthly detailed reports and meetings with Murphy. [Oak Rock's] junior creditors and investors were assured that **IDB would not merely rely upon Murphy's financial summaries, but that it would monitor the raw data to oversee the day to day operation of [Oak Rock]**. Oak Rock was also required to engage independent auditors to report to IDB. This is how IDB promotes itself in the marketplace and is precisely what was stated in IDB's bank draft term sheets.

See Dkt. 45 at 4-5 (emphasis added).

While Oak Rock's fraud and subsequent bankruptcy surely affected all of its clients, creditors, and business partners, IDB, Prime, and Oasis were not mere creditors. They were insiders. To explain, Oak Rock's original members were Murphy, Prime, and IDB. Oasis became a member in 2010. Murphy was Oak Rock's sole managing member, and could not be removed without an 80% vote of Oak Rock's common unit holders, an effective impossibility since Murphy owned almost half the equity. However, section 5(c) of Murphy's employment agreement permitted his termination, even without cause.[3]

Simply put, IDB, Prime, and Oasis were not in the dark. IDB, as noted above, had access to the very data the Murphy falsified, and IDB was supposed to closely monitor that data. Prime, while not tasked with such extensive involvement, was still entitled to access the data under section 11.1 of Oak Rock's operating agreement. *See* Dkt. 46 at 30 ("Each Member ... shall have the right to examine [Oak Rock's] books and records"). Prime does not allege it ever

[3] Section 5(a) also permits termination for cause. Murphy's fraud falls with the definition of cause.

availed itself of its right to examine the very data it accuses EisnerAmper of negligently failing to inspect. Moreover, the principals of Prime and Oasis, Jack Dell and Thomas Stevens, respectively, were members of Oak Rock's Board. Dell was the Board's Co-Chairman. Dell stored Oak Rock's backup computer at his home in Florida, where he had "realtime" access to Oak Rock's records.

For these reasons, plaintiffs' fraud and malpractice claims may be infirm for lack of reasonable reliance (a ground for dismissal not asserted by EisnerAmper). Plaintiffs had the means to access the very data that would have uncovered the fraud EisnerAmper did not detect. Critically, in EisnerAmper's retainer letter, EisnerAmper expressly stated that it would be relying on the data provided to it by management, and that management – not EisnerAmper – "is responsible for designing and implementing programs and controls to prevent and detect fraud."

That said, plaintiffs' claims fail for myriad other reasons (i.e., those set forth in EisnerAmper's briefs). As discussed below, some of the malpractice claims are time barred, all of the malpractice claims fail for lack of near-privity, and the fraud claim fails because plaintiffs do not plead the requisite scienter. Dismissal on these grounds negates the import of other arguments made by EisnerAmper. However, the court further explains why plaintiffs' claims are direct, not derivative, and why the question of whether certain of Prime's losses are recoverable is not amenable to resolution on this motion.

With respect to damages, as noted earlier, Prime was a member of Oak Rock since 2001. Over time, Prime loaned Oak Rock millions of dollars. As of September 30, 2009, Oak Rock owed $20 million in principal to Prime on outstanding loans, due to be paid in June 2010. In lieu of paying the $20 million, Oak Rock and Prime agreed that Prime would forego the right to receive the $20 million in June 2010. Instead, the loan balance would be reduced to $5 million in exchange for Prime receiving more equity in Oak Rock. Thus, Prime converted $15 million of debt into equity and extended the maturity date on the remaining $5 million of debt. Additionally, Oasis agreed to purchase equity in Oak Rock for approximately $7 million. In connection with these transactions, Oak Rock provided plaintiffs with an offering memorandum dated November 4, 2009, which attached EisnerAmper's 2007 and 2008 audits. The transactions closed on January 29, 2010 (the 2010 Transactions).

Subsequently, between January 2012 and January 2013, Prime made five additional loans to Oak Rock, totaling $3.32 million (the New Prime Loans). As noted in the IDB Decision, Murphy's fraud was discovered in April 2013 by Oasis' president, Thomas Stevens, when Stevens investigated unusual collection activity from one of Oak Rock's customers.[4] Murphy confessed his fraud to Stevens and resigned. Stevens immediately replaced Murphy as Oak Rock's manager and notified IDB of the fraud. After Oak Rock's lenders declared it in default, on April 29, 2013, Oak Rock's bankruptcy proceeding was commenced. It was initiated as an involuntary Chapter 7 proceeding, and was converted to a Chapter 11 proceeding shortly thereafter. Murphy pleaded guilty to a crime on December 20, 2013. The bankruptcy proceeding is ongoing.

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[4] Again, this demonstrates that Prime and Oasis, which always had the right and ability to look into Oak Rock's data, had the means to discover the fraud all along. *See UST Private Equity Invs. Fund v Salomon Smith Barney*, 288 AD2d 87, 88 (1st Dept 2001) ("a sophisticated plaintiff cannot establish that it entered into an arm's length transaction in justifiable reliance on alleged misrepresentations if that plaintiff failed to make use of the means of verification that were available to it"). This is not to say that EisnerAmper's audit was not negligent. For the reasons set forth in the IDB Decision and the AC, EisnerAmper's negligence is apparent. Nonetheless, even where malpractice is committed, reasonable reliance is a defense. Moreover, as already noted, the malpractice claim is time-barred and infirm due to the absence of near-privity.

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II. Procedural History

On April 11, 2014, the very same day IDB filed its lawsuit against EisnerAmper, plaintiffs commenced this action by filing their original complaint. *See* Dkt. 2. Plaintiffs asserted two causes of action: accounting malpractice and negligent misrepresentation. *See id.* at 11. EisnerAmper moved to dismiss on June 16, 2014. *See* Dkt. 5. In a so-ordered stipulation dated September 5, 2014, EisnerAmper withdrew its motion and agreed to permit plaintiffs to file an amended complaint. *See* Dkt. 30.[5] Plaintiffs filed the AC on November 3, 2014, which contains five causes of action, numbered here as in the AC: (1) negligent misrepresentation; (2) grossly negligent misrepresentation; (3) professional malpractice; (4) gross negligence; and (5) fraud. *See* Dkt. 36.

The court issued the IDB Decision on November 14, 2014. *See* Dkt. 43. EisnerAmper filed the instant motion to dismiss on December 8, 2014. *See* Dkt. 39. By letter dated January 9, 2015, plaintiffs notified the court of their intention to move to disqualify Sidley. *See* Dkt. 57. As previously noted, plaintiffs filed that motion on February 4, 2015, and pursuant to the parties' agreement, Sidley refrained from further participation in the instant motion. Briefing on the motion to dismiss was then completed, and the court reserved on the motion after oral argument. *See* Dkt. 147 (9/10/15 Tr.).

III. Legal Standard

On a motion to dismiss, the court must accept as true the facts alleged in the complaint as well as all reasonable inferences that may be gleaned from those facts. *Amaro v Gani Realty Corp.*, 60 AD3d 491 (1st Dept 2009); *Skillgames, LLC v Brody*, 1 AD3d 247, 250 (1st Dept

[5] As in the IDB case, the parties were permitted to redact or seal certain documents, but were ordered to make their briefs publicly available. As noted in the IDB Decision, "the court quotes from or discusses some of the sealed material where such evidence is essential to this decision and no good cause for sealing exists." *See id.* at 1 n.1.

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2003), citing *McGill v Parker*, 179 AD2d 98, 105 (1992); *see also Cron v Harago Fabrics*, 91 NY2d 362, 366 (1998). The court is not permitted to assess the merits of the complaint or any of its factual allegations, but may only determine if, assuming the truth of the facts alleged and the inferences that can be drawn from them, the complaint states the elements of a legally cognizable cause of action. *Skillgames*, *id.*, citing *Guggenheimer v Ginzburg*, 43 NY2d 268, 275 (1977). Deficiencies in the complaint may be remedied by affidavits submitted by the plaintiff. *Amaro*, 60 NY3d at 491. "However, factual allegations that do not state a viable cause of action, that consist of bare legal conclusions, or that are inherently incredible or clearly contradicted by documentary evidence are not entitled to such consideration." *Skillgames*, 1 AD3d at 250, citing *Caniglia v Chicago Tribune-New York News Syndicate*, 204 AD2d 233 (1st Dept 1994). Further, where the defendant seeks to dismiss the complaint based upon documentary evidence, the motion will succeed if "the documentary evidence utterly refutes plaintiff's factual allegations, conclusively establishing a defense as a matter of law." *Goshen v Mutual Life Ins. Co. of N.Y.*, 98 NY2d 314, 326 (2002) (citation omitted); *Leon v Martinez*, 84 NY2d 83, 88 (1994).

IV. Discussion

A. Standing & Damages

There is no merit to EisnerAmper's arguments that dismissal is warranted because plaintiffs' claims are supposedly derivative or that plaintiffs failed to allege proximately caused damages. Under New York law, the question of whether a claim is direct or derivative "must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" *Tooley v Donaldson, Lufkin & Jenrette, Inc.*, 845 A2d 1031, 1033 (Del 2004) (emphasis in original); *see Serino v Lipper*, 123

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AD3d 34, 40 (1st Dept 2014) (*Tooley* test adopted by First Department), citing *Yudell v Gilbert*, 99 AD3d 108 (1st Dept 2012). EisnerAmper argues that, under this standard, plaintiffs' claims are derivative because their losses merely resulted from the decrease in their interest in Oak Rock, a loss suffered similarly by all other investors. EisnerAmper is wrong. As plaintiffs correctly contend, where, as here, plaintiffs claim they were induced to invest based on an allegedly fraudulent audit, the claim is direct. *See Continental Cas. Co. v PricewaterhouseCoopers, LLP*, 15 NY3d 264, 270-71 (2010) ("an individual investor may have a direct claim for an investment made in reliance on a fraud"). Consequently, dismissal on *in pari delicto* grounds by virtue of imputation also is not warranted. *See Kirschner v KPMG LLP*, 15 NY3d 446 (2010).

On the other hand, EisnerAmper correctly avers that were this case to survive dismissal, there would be limitations on the damages recoverable on certain of plaintiffs' claims. For instance, Prime's recoverable loss on its claim for being fraudulently induced to convert $15 million of debt into equity is limited by the amount it could have recovered on the loan if Oak Rock's fraud were discovered in 2010, instead of in 2013.[6] That amount, however, is a question of fact that would require discovery. The record on this motion does not clearly establish Oak Rock's solvency (or lack thereof) in January 2010, precluding dismissal on the ground that the alleged inducement caused no damages because Oak Rock could never have repaid the original $20 million loan. Furthermore, even if Oak Rock's insolvency was undisputed, plaintiffs' other claims relating to Oasis' 2010 investment and the New Prime Loans would, if meritorious, entitle

[6] If Oak Rock could not pay back any portion of the $15 million in 2010, then the conversion did not cause a loss, and Prime would have no claim against EisnerAmper for negligence or fraud in connection with the conversion.

plaintiffs to damages. Hence, dismissal of the entire action for failure to plead damages is not warranted.

That said, this action is dismissed for other reasons.

B. Statute of Limitations

The malpractice claim relating to the 2010 Transactions is time barred. Pursuant to CPLR 214(6), "[a]n action for professional malpractice must be commenced within three years of the date of accrual." *Williamson v PricewaterhouseCoopers LLP*, 9 NY3d 1, 7 (1st Dept 2007). The "claim accrues when the malpractice is committed, not when the client discovers it." *Id.* at 7-8, citing *Glamm v Allen*, 57 NY2d 87, 93 (1982); *see Rodeo Family Enterprises, LLC v Matte*, 99 AD3d 781, 783 (2d Dept 2012) ("a cause of action alleging accountant malpractice 'accrues upon the client's receipt of the accountant's work product'"), quoting *Ackerman v Price Waterhouse*, 84 NY2d 535, 541 (1994). Plaintiffs commenced this action on April 11, 2014. The 2010 Transactions, and all of the audits plaintiffs allegedly relied on in connection with the 2010 Transactions, occurred more than three years before this action was commenced. On the other hand, the malpractice claim relating to the New Prime Loans is timely because that claim is based on the April 12, 2011 audit report. This action was commenced on the last day prior to the running of the statute of limitations.

Contrary to plaintiffs' contentions, they have not pleaded grounds to toll the statute of limitations. The continuous representation doctrine does not apply. *See Williamson*, 9 NY3d at 10-11 (no continuous representation where annual audits performed under separate, annual engagement letters). Nor have plaintiffs pleaded grounds for equitable estoppel, which, in this context, would only be warranted if EisnerAmper's fraud "induced plaintiff[s] to refrain from filing a timely action." *Mitschele v Schultz*, 36 AD3d 249, 253 (1st Dept 2006); *see Zumpano v*

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Quinn, 6 NY3d 666 (2006). The fraud alleged is *not* that EisnerAmper knowingly and intentionally sought to help Murphy conceal his fraud, but rather that EisnerAmper's audits were so woefully reckless that they should be deemed fraudulent as a matter of law. Below, this allegation is dismissed on the merits, and, hence, cannot be used as a predicate for equitable estoppel. Additionally, the equitable estoppel claim is not viable because the wrongdoing alleged as the basis for the tolling is the very wrongdoing at issue in this action. *See Stroud Prods. & Enterprises, Inc. v BMG Music*, 123 AD3d 598 (1st Dept 2014), citing *Zumpano*, 6 NY3d at 674 (it is "fundamental to the application of equitable estoppel for plaintiffs to establish that subsequent and specific actions by defendants somehow kept them from timely bringing suit").

While plaintiffs complain that EisnerAmper should have discovered Murphy's fraud and, had it done so, plaintiffs would not have invested, plaintiffs do not allege that at any subsequent time, EisnerAmper committed any act that further concealed the fraud. After the 2010 Transactions, EisnerAmper's continued failure to discover the fraud does not amount to an act of concealment that prevented plaintiffs from discovering the fraud and timely commencing suit. As noted earlier, plaintiffs always had access to the data and the means to uncover the fraud themselves. In fact, it was Oasis' own president that, when he decided to look into Oak Rock's business, discovered Murphy's fraud in short order. Hence, the notion that anything or anyone, let alone EisnerAmper, stood in the way of plaintiffs discovering the fraud is belied by the circumstances of how the fraud was actually discovered.

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C. *Privity & Linking Conduct*

Regardless of whether some of plaintiffs' malpractice claims are time barred, *all* of the malpractice claims fail on the merits. EisnerAmper's client was Oak Rock, not plaintiffs. As discussed in the IDB Decision:

> Before accountants may be held liable in negligence to noncontractual parties who rely to their detriment on inaccurate financial reports, certain prerequisites must be satisfied: (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance.

Credit Alliance Corp. v Arthur Andersen & Co., 65 NY2d 536, 551 (1986).

Plaintiffs cannot maintain a malpractice claim against EisnerAmper because they do not plead the requisite linking conduct. Oasis does not allege that it had *any* direct contact with EisnerAmper. The only alleged direct communication between Prime and EisnerAmper was a single conversation between Dell and Charles Weinstein, an EisnerAmper partner. That alleged conversation took place in 2001. The first audit at issue in this action did not occur until 2006. Five years beforehand, in 2001, Weinstein was seeking to convince Dell to make Prime's initial investment in Oak Rock, and he allegedly told Dell that he could rely on EisnerAmper's audit reports. This statement, allegedly made almost a decade prior to the 2010 Transactions, is insufficient to show that EisnerAmper knew the subject audits would be used for the "particular purpose" at issue here – the 2010 Transactions.

Absent a nexus between a communication and the subject transaction, the mere existence of some prior communication between an accountant and an investor will not give rise to a relationship "sufficiently approaching privity." *See Sec. Pac. Bus. Credit, Inc. v Peat Marwick*

Main & Co., 79 NY2d 695, 702-08 (1992). Near privity is not present here because no one at EisnerAmper is alleged to have told Prime it was entitled to rely on the 2007 and 2008 audit reports attached to the November 4, 2009 offering memorandum. As a result, there is no conduct linking Prime and EisnerAmper to the 2010 Transactions.

Moreover, Dell's reliance on his 2001 conversation with Weinstein flies in the face of the express terms of EisnerAmper's engagement letters, which clearly state that the audits are prepared only for the benefit of Oak Rock, i.e., not its members. Dell, a member of Oak Rock's board, cannot claim ignorance of the terms of the EisnerAmper engagement letters. This renders any reliance by Prime on Weinstein's alleged 2001 promise unreasonable as a matter of law. Again, absent a direct nexus between a specific communication and specific investment made in *reasonable* reliance on that communication, an investor does not have the right to sue an accountant for malpractice for all losses incurred due to the accountant's negligent work. The context of the 2001 conversations, the remoteness in time from the subject audits and 2010 Transactions, and the contrary terms of the engagement letters collectively preclude a finding of linking conduct based on communications between Weinstein and Dell.[7] Where, as here, there is no linking conduct with respect to the specific audits at issue, near privity between an auditor and a non-client investor cannot be predicated on alleged general assurances provided a decade before the subject transaction. Holding otherwise would contravene the Court of Appeals' long

[7] At oral argument, for the first time, plaintiffs sought leave to file a second amended complaint based on new allegations that there were further, similar communications between Weinstein and Dell. Putting aside the propriety of seeking leave to amend in this manner – after the malpractice allegations in the complaint were already amended once in response to a prior motion to dismiss – Dell being on the board, having knowledge of the engagement letters and access to Oak Rock's data still render the malpractice claim utterly devoid of merit. Of course, as noted earlier, even if there were linking conduct, the malpractice claim with respect to the 2010 Transactions is still time barred. Nor is any linking conduct specifically alleged with respect to the New Prime Loans.

standing policy of refusing to adopt broad linking conduct theories. *See Sec. Pac.*, 79 NY2d at 708 ("sweeping liability should [not] be newly and involuntarily imposed on the entire accounting industry by the simple act of lenders communicating their reliance in the manner promoted in this case.").

Finally, plaintiffs cannot establish linking conduct based on EisnerAmper providing Oak Rock's board and members, including Prime and Oasis, with copies of the audit reports. It is well settled that "[t]he fact that plaintiffs were entitled to and received a copy of the audited financial statements, or that [the auditor] knew that the investors would rely upon the information contained in the financial statements, does not establish the requisite linking conduct." *CRT Investments, Ltd. v BDO Seidman, LLP*, 85 AD3d 470, 472 (1st Dept 2011). Plaintiffs' malpractice claims, therefore, are dismissed.

The dismissal of the malpractice claim, the third cause of action, necessarily mandates dismissal of the first and second causes of action for negligent misrepresentation and grossly negligent misrepresentation. Absent near-privity, no special relationship exists that would permit recovery for wrongdoing based on a misrepresentation absent the requisite scienter. *See J.A.O. Acquisition Corp. v Stavitsky*, 8 NY3d 144, 148 (2007) ("A claim for negligent misrepresentation requires the plaintiff to demonstrate (1) **the existence of a special or privity-like relationship** imposing a duty on the defendant to impart correct information to the plaintiff; (2) that the information was incorrect; and (3) reasonable reliance on the information") (emphasis added). As discussed below, plaintiffs' fraud claim fails because such scienter is not pleaded.

D. Fraud

Plaintiffs, like IDB, also allege that EisnerAmper's audits were fraudulent.[8] "[E]ven where the law does not permit a claim of negligence to be brought against a professional by a person not in privity with the professional, this rule does not emancipate accountants from the consequences of fraud." *Houbigant, Inc. v Deloitte & Touche LLP*, 303 AD2d 92, 95 (1st Dept 2003), quoting *Ultramares Corp. v Touche*, 255 NY 170, 189 (1931). To state a claim for auditor fraud, plaintiffs must plead "a material misrepresentation of a fact, knowledge of its falsity, an intent to induce reliance, justifiable reliance by the plaintiff and damages" with the specificity required by CPLR 3016(b). *Eurycleia Partners, LP v Seward & Kissel, LLP*, 12 NY3d 553, 559 (2009); *see Pludeman v Northern Leasing Sys., Inc.*, 10 NY3d 486, 491 (2008).

EisnerAmper argues, as it successfully did in the IDB case, that plaintiffs' AC does not adequacy plead scienter. The court previously explained in the IDB case:

> "The standard for pleading auditor scienter is demanding." *Meridian Horizon Fund, LP v Tremont Group Holdings, Inc.*, 747 FSupp2d 406, 412 (SDNY 2010); *see CRT*, 85 AD2d at 472 ("Plaintiffs' allegations of GAAS violations 'without corresponding fraudulent intent' are insufficient to state a securities fraud claim against an independent accountant"), quoting *Rothman v Gregor*, 220 F3d 81, 98 (2d Cir 2000).
>
> "While a showing of recklessness will permit an inference that a fraud was in fact perpetrated, this recklessness must involve conduct that is highly unreasonable, and must 'in fact, approximate an actual **intent to aid in the fraud being perpetrated by the audited company**.'" *CRT*, 29 Misc3d 1218(A), at *13 (emphasis added), quoting *Rothman*, 220 F3d at 98. "The complaint must allege that the auditor's practices were so deficient as to amount to no audit at all, that there was a refusal to see the obvious, a failure to investigate the doubtful, or the auditor's judgments were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *CRT*, 29 Misc3d 1218(A), at *13 (citations and quotation marks omitted); *see Iowa Pub. Employee's Ret. Sys. v Deloitte & Touche LLP*, 919 FSupp2d 321, 337 (SDNY 2013) ("Where an auditor was not aware of facts indicating that a transaction was suspicious or part

[8] Plaintiffs' brief devotes a mere three pages to arguing that the fraud claim meets the applicable legal standard.

> of a fraud, the auditor's failure to investigate the transaction – even if negligent – does not provide a basis for a fraud claim"), *aff'd* 558 FedAppx 138 (2d Cir 2014), quoting *In re CBI Holding Co., Inc.*, 419 BR 553, 567 (SDNY 2009), accord *Rothman*, 220 F3d at 98.

IDB Decision at 9-10 (bold in original).

Contrary to plaintiffs' contentions, the AC's scienter allegations are not materially better pleaded than those set forth in IDB's complaint. IDB's complaint, *inter alia*, sought to establish scienter based on GAAS violations and failure to investigate supposed red flags of fraud. It is well settled that pleading GAAS violations, without more, is insufficient to plead scienter. *See CRT*, 85 AD2d at 472. Under New York law, to properly plead scienter, GAAS violations must be pleaded along with "corresponding fraudulent intent." *See id.* In other words, plaintiffs must plead some other, additional facts, separate and apart from the GAAS violations themselves, that, when viewed in the context of a GAAS violations, permit a reasonable inference of fraudulent intent.[9] No such inference can be drawn from the AC.

Plaintiffs make much of the fact that EisnerAmper's IT auditor indicated in a report that EisnerAmper "will not be able to rely" on certain data made available by Murphy and "should *consider*" verifying it. *See* Dkt. 128 at 8 (emphasis added). This observation, according to plaintiffs, caused EisnerAmper to have an obligation under GAAS to verify the accuracy of the underlying data. Plaintiffs allege EisnerAmper did not do so. However, in repeatedly focusing on the notion that the data was unreliable, plaintiffs seek to impart far more significance onto that notion than warranted. The reliability of the data, and, hence, the reasonableness (or lack

[9] There is no question that this is the required pleading standard. In *CRT*, where the First Department articulated the "corresponding fraudulent intent" requirement, it cited to and relied on *Rothman v Gregor*, 220 F3d 81 (2d Cir 2000). In *Rothman*, the Second Circuit described the requisite scienter as "approximat[ing] an actual intent to aid in the fraud being perpetrated." *See id.* at 98 (citations omitted). It also should be noted that, as discussed in the IDB Decision, the federal heightened pleading standard for fraud does not apply in this court.

thereof) of EisnerAmper's decision not to independently verify it is purely a matter of EisnerAmper's GAAS duties. Failure to do so allegedly is a GAAS violation. Indeed, EisnerAmper IT report did not suggest that the data was *actually* being falsified or even that there was any concern of impropriety. Rather, the report merely indicates that EisnerAmper "should consider" investigating further. This is not tantamount to a red flag of fraud.

To be sure, such an alleged GAAS violation is not to be taken lightly, as it could well make the auditor liable to its client for malpractice. Yet, as repeatedly noted, the standard for establishing auditor fraud is far more exacting than the standard for establishing malpractice. Thus, not all unreasonable conduct, such as GAAS violations, amount to fraud. There must be something more – some other egregious conduct that, along with the alleged malpractice, constitutes fraud. At a minimum, the conduct must be so egregious that it is considered legally reckless, i.e., highly unreasonable conduct. Merely pleading "a heightened form of negligence" is insufficient. *See Advanced Battery*, 781 F3d at 644 (collecting cases, and noting that even "accounting irregularities" and "a lack of due diligence" is insufficient). No reckless conduct is alleged.

Plaintiffs merely contend that EisnerAmper failed to investigate supposed red flags. To plead scienter on this basis, plaintiffs must allege the auditor "disregard[ed] signs of fraud so obvious that the defendant must have been aware of them." *Id.* Plaintiffs do not allege any obvious signs of fraud. Instead, they point to possibly suspicious data management and claim that an investigation into such management would have revealed Murphy's fraud. However, it is well settled that "[i]t is not "enough to 'merely alleg[e] that the auditor had access to the information by which it could have discovered the fraud.''" *In re DNTW Chartered Accountants Sec. Lit.*, 96 FSupp3d 155, 168 (SDNY 2015), quoting *Stephenson v PricewaterhouseCoopers,* *LLP*, 768 FSupp2d 562, 573 (SDNY 2011), quoting *In re Tremont Sec. Law, State Law & Ins. Lit.*, 703 FSupp2d 362, 370 (SDNY 2010); *see also Saltz*, 782 FSupp2d at 77 ("[M]erely alleging that the auditor had access to the information by which it could have discovered the fraud is not sufficient."), quoting *In re IMAX Secs. Lit.*, 587 FSupp2d 471, 484 (SDNY 2008). To demonstrate scienter, "the auditor must actually know about the red flags and unjustifiably ignore them." IDB Decision at 14, citing *Saltz v First Frontier, LP*, 782 FSupp2d 61, 76-77 (SDNY 2010). "[O]nly those red flags that [the auditor] is alleged to have known of, or that are so obvious that [the auditor] must have known of them, can support an inference of intent." *See Saltz*, 782 FSupp2d at 76, quoting *Stephenson v Citco Group Ltd.*, 700 FSupp2d 599, 623 (SDNY 2010), citing *In re Priceline.Com Inc. Secs. Lit.*, 342 FSupp2d 33, 57 (D Conn 2004) ("Even if the court could infer that [the auditor] was aware of the [nine] red flags set forth herein, which is no small leap, the red flags are not so egregious as to render [the auditor's] audit a farce").

Here, as in the IDB case, the flags identified by plaintiffs are were not actually red. "Redness" is a temporal variable, and reliance on hindsight is impermissible. As the court previously explained:

> EisnerAmper [allegedly] ignored red flags of fraud by failing to sufficiently investigate concerns such as the aging of the collateral, credit loss rate, and willingness to write off loans and continue lending to uncreditworthy dealers. These concerns, however, are not red flags of fraud. At most, they are an identification of the assets that mattered most to Oak Rock's financial health and areas of heightened risk, which, if fraud is occurring, would be where it most likely is occurring. A red flag, in contrast, is some indication that fraud is *actually* occurring. IDB has not identified any actual red flags that Murphy was *indeed* perpetrating a fraud in these identified high risk areas, which red flags were known to defendant and ignored.
>
> Regardless, even if the risks identified by EisnerAmper constitute the sort of "obvious" red flags needed to give rise to fraud claim, EisnerAmper did not simply ignore them. They did some diligence, which – again, in hindsight – was

> inadequate. Instead of conducting a robust fraud investigation, EisnerAmper employed allegedly deficient analytical methods to vet the accuracy of Oak Rock's records. At most, this was negligent. The court cannot deem EisnerAmper's audit to be so recklessly egregious as to warrant an inference of fraudulent intent. While there is no defined line between negligence and actionable recklessness, the "red flags" in this case are, regardless of what became clear in hindsight, more benign than in actionable red flag cases. *See, e.g., State St. Trust Co. v Ernst*, 278 NY 104, 117 (1938) (auditor knew account was being padded and had an insubstantial reserve); *DaPuzzo v Reznick Fedder & Silverman*, 14 AD3d 302, 303 (1st Dept 2005) (auditor "gave in to the CFO's demands to fix the financial reports to represent a more favorable financial position in order not to jeopardize its fee"); *Curiale v Peat, Marwick, Mitchell & Co.*, 214 AD2d 16, 19-20 (1st Dept 1995) (auditor knew that its client's SEC filings contained false information).

IDB Decision at 14-15 (emphasis in original).[10]

The fraud claim is dismissed. This is not a case where EisnerAmper's audits crossed the threshold from negligence to fraud. Particularly where, as here, plaintiffs had a right of access to the subject fraudulent data equal to (and possibly greater than) EisnerAmper, plaintiffs cannot

[10] At oral argument, plaintiffs submitted an unreported federal district court decision – not cited in their brief – that plaintiffs claim demonstrate the court's purported misconception of what it means for an auditor to perform "no audit at all." *See In re Refco Inc. Secs. Lit.*, 07 MDL 1092, Dkt. 1165 (SDNY May 31, 2011) (Rakoff, J.). That decision confirmed a March 28, 2011 Report and Recommendation of Special Master Daniel J. Capra. *See id.*, Dkt. 1105. Professor Capra's Report, as it relates to the element of scienter, observed that the "no audit at all" standard is but one of several options for establishing scienter. *See id.*, Dkt. 1105 at 16, citing *In re Scottish Re Group Secs. Lit.*, 524 FSupp2d 370, 385 (SDNY 2007) ("plaintiffs must allege sufficient facts to show that "[1] [t]he accounting practices were so deficient that the audit amounted to no audit at all, *or* [2] an egregious refusal to see the obvious, *or* [3] to investigate the doubtful, *or* [4] that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.") (brackets added; emphasis of "or" added by Professor Capra). In the IDB Decision, this court did *not* hold that a plaintiff must plead the auditor performed "no audit at all." To the contrary, the court, citing similar authority, noted that pleading "no audit at all" was but one way in which scienter could be established. For instance, the court cited the trial court opinion in *CRT* [29 Misc3d 1218(A) (Sup Ct, NY County 2010), *aff'd* 85 AD3d 470] where the court was clear that "no audit at all" is merely one way to establish scienter. *See* IDB Decision at 9. As in this case, as did the very case cited by Professor Capra, the court held that "[a]llegations of 'red flags,' when coupled with allegations of GAAP and GAAS violations, are sufficient to support a strong inference of scienter." *Scottish Re Group*, 524 FSupp2d at 385. IDB's complaint was deficient for the same reason plaintiffs' AC is – the alleged red flags were not actually red.

recover their investment losses in Oak Rock from EisnerAmper. Plaintiffs' recourse, like all of Oak Rock's other investors and creditors, is to seek relief in the bankruptcy action. Accordingly, it is

ORDERED that the motion by defendant EisnerAmper LLP to dismiss the Amended Complaint is granted, and the Clerk is directed to enter judgment dismissing the Amended Complaint with prejudice; and it is further

ORDERED that plaintiffs' motion to disqualify Sidley Austin LLP from serving as co-counsel for EisnerAmper is denied as moot.

Dated: December 10, 2015

ENTER:

J.S.C.

SHIRLEY WERNER KORNREICH
J.S.C