Sterling Natl. Bank v Ernst & Young LLP

2008 NY Slip Op 33242(U)

December 1, 2008

Supreme Court, New York County

Docket Number: 121916/03

Judge: Herman Cahn

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SCANNED ON 12/5/2008

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SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: Cahn
Justice

PART 49

Index Number : 121916/2003
STERLING NATIONAL BANK
vs
ERNST & YOUNG LLP
Sequence Number : 013
SUMMARY JUDGMENT

INDEX NO. ______
MOTION DATE ______
MOTION SEQ. NO. ______
MOTION CAL. NO. ______

The following papers, numbered 1 to ______ were read on this motion to/for ______

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	
Answering Affidavits — Exhibits	
Replying Affidavits	

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is ordered that this motion

MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION IN MOTION SEQUENCE

FILED
DEC - 5 2008
COUNTY CLERK'S OFFICE
NEW YORK

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: 12/1/08

J.S.C.

Check one: ☐ FINAL DISPOSITION ☐ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 49

---X

STERLING NATIONAL BANK,

Plaintiff,

-against-

Index No. 121916/03

ERNST & YOUNG LLP and KAPIL JAIN,

Defendants.

---X

HERMAN CAHN, J.:

Motions bearing sequence numbers 013, 014 and 015 are consolidated for disposition.

In motion sequence 013, defendants Ernst & Young LLP (E & Y) and Kapil Jain move for summary judgment dismissing the complaint, CPLR 3212, on the following grounds: (1) that plaintiff cannot show causation; (2) that its damages are speculative; (3) that plaintiff had no justifiable basis for relying on E &Y's unqualified opinion and audit of the July 2000 consolidated financial statement of Allied Deals, Inc. (Allied); and (4) that in any event, plaintiff cannot establish intentional egregious conduct to warrant a claim for punitive damages.

In motion sequence 014, defendants seek an order vacating in part the decision and order, dated April 1, 2008, issued by J.H.O. John A. K. Bradley, which directed defendants to respond to certain discovery requests of plaintiff, because it does not follow applicable law regarding discovery on punitive damages.

In motion sequence 015, defendants seek an order striking in whole or in part plaintiff's brief on the motion for summary judgment for exceeding the page limit, and rejecting the Perches affidavit as improper expert testimony, on the pending summary judgment motion.

The Procedural Motions–Sequence Numbers 014 and 015:

With respect to motion sequence 014, the defendants' motion to review and partially vacate the determination and order of J.H.O. Bradley, as to Items 3 through 9 of plaintiff's Fourth Request for Production of Documents and Requests 9 through 11, and 13 through 15 of plaintiff's Second Request for Production of Documents, the motion is granted. On a motion pursuant to CPLR 3104 (d) to review a Special Referee's decision, the decision will be upheld if it is supported by evidence in the record and has applied the applicable laws and standards. *Stark v Reliance Nat. Indem. Co.*, 273 AD2d 148 (1st Dept 2000). Here, the documents sought by plaintiff pertain to plaintiff's claim for punitive damages and are not subject to discovery at the pre-trial stage of these proceedings. *Dufresne v Duemler*, 108 AD2d 1102 (3d Dept 1985). The discovery sought is premature until there is a determination that punitive damages are warranted. Consequently, the document requests are stricken until such time as they become relevant.

With respect to motion sequence 015, there was no impropriety in the submission of the affidavit of Paul Persches, certified public accountant and member of the accounting firm of Rosenfarb Winters, LLC. There was no requirement to name an expert at the time that the Persches affidavit was submitted; the parties had agreed to provide such information at a later date, specifically within 30 days of trial. Furthermore, there was no prejudice or surprise to defendants, who were aware of Persches and his firm's participation in the lawsuit as consultant experts for plaintiff. They had previously been advised that Persches' firm would be examining the E & Y report and had been given expert information, including the accountant experts' curriculum vitae. In addition, Persches or other members of his firm were present and consulting at depositions of several of the witnesses. Their involvement could hardly be called a secret

sprung on the defense.

As for defendants' request that the court strike all or part of the plaintiff's brief for failure to observe the page limitation, that request is also denied. Defendants raised several complex issues, and the motion papers are voluminous. On the prior motion to dismiss under CPLR 3211, it was defendants who exceeded the page limits on their brief and no objection was raised. They should not be heard to stand on ceremony as to plaintiff's brief on the summary judgment motion, where they, too, have not followed court rules. In addition, a full and fair hearing of the issues requires that the entire brief be considered.

The Motion for Summary Judgment–Sequence Number 013:

Background:

In this action, plaintiff Sterling National Bank seeks to recover from defendant E & Y and one of its partners, Kapil Jain, for fraud based on defendants' role as auditor of Allied Deals, Inc., whose business involved a Ponzi scheme designed to defraud banks.

In July 1999, Sterling purchased a portfolio of loans from Park Avenue Bank (PAB), which included loans made to Allied. Allied held itself out to be a metals trading company that brokered deals between buyers and sellers of metals throughout the world. Unbeknowst to Sterling, in reality, Allied's legitimate business had declined over the years as it became more and more a criminally fraudulent enterprise.

After the initial purchase from PAB, Sterling approved, extended and renewed a $6,000,000 credit facility, and continued to make advances to Allied in 1999, 2000 and 2001. Sterling claimed to have relied on unqualified audit reports issued by E & Y that certified Allied's financial statements for the fiscal years ending July 31, 1998, 1999 and 2000. These

audits were the responsibility of defendant Jain, who had a close personal and professional relationship with the principals of Allied.

Sterling's reliance on E & Y's certification of the financial statements is reflected in Sterling's Terms of Approval (TOA) and other related contemporaneous memoranda. The Allied loans were designated as C ledger loans, which means that the bank relied upon the financial condition of the borrower to support its decision to lend, rather than base its decision to lend on any specific collateral, such as receivables or inventory. Sterling asserts that it did this because E & Y, a major accounting firm, certified that Allied's financial statements presented fairly in all material respects the financial position of Allied and its subsidiary. The audit reports showed Allied to be a healthy and growing company. Specifically, the 2000 audit report represented that Allied had $640,000,000 in sales, up from $376,000,000 in sales in 1999, with a concomitant significant increase in assets and receivables. However, the figures proved to be false, because Allied had become a more and more fraudulent operation. Allied's customers were sham entities it created in order to falsely inflate its sales and receivables so that it could keep getting more loans from its lender banks.[1]

From the date of the purchase from PAB, Sterling made a total of 41 loans to Allied under the $6,000,000 facility. On July 12, 2001, Sterling, relying on E & Y's "clean" opinion of Allied's audited financial statement, extended the credit facility for another six months. The last nine advances made to Allied have not been repaid and are the subject of this lawsuit. The records of the Jack Henry financial reporting system maintained by Sterling showed that from

[1] The Chapter 7 Trustee, John Pereira, was unable to recover any receivables and wrote off more than $180 million in receivables. See Landau Aff, Ex. X.

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January 2001 through June 2001 Allied loans totaled $5,987,466.06, and that from July 2001 to October 2001, the loan balance totaled $5,037,466.06.

Defendants contend that the loss was unrelated to the July 31, 2000 audit statement, because Allied had almost exhausted the whole credit facility prior to Sterling's decision to extend the credit facility on July 12, 2001 and that, as a result, plaintiff cannot show either transaction causation or loss causation.

Plaintiff contends that the figures in the Jack Henry system present an incomplete picture of what transpired in 2001, because the Jack Henry system does not show which specific loans comprised the balance, or whether during that time loans had been repaid and new advances made. Plaintiff argues that the loans were monitored through a demand and deposit checking account (DDA) at Sterling, and that the statements for the DDA give a truer picture of events, since they reflect the day-to-day transactions in the Allied loan account. The statements of the DDA show Allied's payment of prior loans as deposits of funds into the DDA. Then Sterling approved advances and funds were released from the DDA to Allied. These newly advanced funds were provided from the repaid funds in the DDA and, according to the TOAs and other loan documentation, the monies were released in reliance on E & Y's certified audit of Allied and upon presentation of appropriate documents for the new transactions to be financed. Sterling alleges that these new borrowings under the credit facility would not have been made in the absence of E & Y's certification of the financial statements that falsely represented Allied's financial condition, and that each advance constitutes a new transaction and loss. Thus, for example, the advances made on June 5, 2001 were taken from payments received from Allied earlier on the same date. Likewise, the $538,000 advance on August 13, 2001 came out of the

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$540,000 payment on August 13, 2001.

By 2001, Allied's business was 90% fictitious. Allied's customers were sham entities created by Allied, so that most, if not all, of Allied's receivables claimed on the financial statements audited by E & Y were really worthless. Plaintiff alleges that E & Y conducted a flawed audit that did not accord with generally accepted accounting principles in that it: permitted Allied to verify its own receivables; did not conduct other appropriate verification procedures; relied in part on an audit of the subsidiary by another firm, which audit it cannot produce; and ignored "red flags" and suspicious facts that Allied's business was not legitimate because of Jain's relationship with Allied's principals, and that Allied's principals statement that a $2,000,000 fund for so called "expenses" may have been used to bribe Jain to look the other way on the audit.

Mr. Rastogi, Allied's CEO, admitted that Allied knowingly used the "clean" opinion to obtain loans from various banks that would not have lent money to Allied without a respected accounting firm's imprimatur on its financial statements. Allied kept its criminal enterprise going by getting loans from one bank to pay off loans from another bank. When the banks became aware of Allied's real financial condition, they all called in their loans, Allied was placed in bankruptcy, and the federal authorities successfully prosecuted Allied's principals and key employees for fraud.

Defendants argue that plaintiff's damages are speculative. They contend that because of the fraudulent nature of Allied's business, plaintiff would have been no better off if it had called the loans in July 2001. The same scenario that played out would have occurred, only months earlier.

Plaintiff argues that in the absence of a qualified opinion by Allied's auditor of its financial statements, it would not have authorized further advances on the credit facility after the payments had been made, so it would never have lost the monies advanced on the last nine loans. The John Henry statements that defendants rely on do not show that Allied's debt level remained constant during the period in question. They indicate that Allied's debt to Sterling had been reduced by almost $900,000 from June 2001 to July 2001, which would appear to indicate that Allied had funds and was making payments, and that the payments exceeded the inflow from the new loans. Further, plaintiff asserts that during the period after the renewal of the facility, Allied had paid another creditor $9,000,000 and that, later, Allied had paid $100,000 to Sterling. Plaintiff claims that all of this is evidence that if plaintiff had refused to grant the nine advances to Allied it would have been in a better position financially then it was as consequence of allowing additional draw downs on the facility. Therefore, Sterling's loss is real, and presents a factual issue for a jury trial.

Defendants also maintain that the fraud claim fails since plaintiff had no basis to justifiably rely on the "clean" opinion and consolidated financial statement. Defendants urge that since the debt was Allied's alone, Sterling should have been looking at a stand-alone audit for Allied, not a consolidated financial statement containing confusing information as to its subsidiary, Suhaina General Trading (Suhaina).

Plaintiff counters that this position is raised improperly in the brief by defendants' attorneys and is not supported by evidence. Plaintiff responds that, in any event, its reliance on the audited consolidated financial statement was valid and justified. In support thereof, Sterling provides the Persches affidavit. This affidavit indicates that, under generally accepted

accounting principles. the appropriate means of financial reporting of a parent company, where there are wholly owned subsidiaries, should be in the form of a consolidated financial statement. Plaintiff argues that since the loan was based on the financial condition of the borrower, it only made sense to look to a consolidated financial statement that reflects the complete picture of Allied's finances, including those of its wholly owned subsidiary, since the loan would be premised on all of the borrowers' assets, which would, of necessity, include any wholly owned subsidiaries.

Defendants also contend that the 2000 audited financial statement with the unqualified opinion was outdated because it was 11 months old and, given the nature of Allied's commodities business did not present a true picture of Allied's finances at the time that Sterling chose to rely on it. Plaintiff argues that the financial statements were the most recent ones issued and that new ones would not have been available for at least six months, so that it was reasonable to rely on them.

Causation:

In *Laub v Faessel* (297 AD2d 28, 31 [1st Dept 2002]), the Court noted that in cases of fraud, "[t]o establish causation, plaintiff must show both that defendant's misrepresentation induced plaintiff to engage in the transaction in question (transaction causation) and that the misrepresentations directly caused the loss about which plaintiff complains (loss causation)."

Plaintiff has submitted documentation to support its claim that the transactions would not have been engaged in without a "clean" opinion regarding Allied's 2000 Financial Statement. The TOAs and related memoranda clearly indicate that "audited financial statements" were a condition of the extension of credit to Allied, and were considered on each of the nine

outstanding loans. McPartland Aff, ¶ 13; Ex. D. It was noted in the loan documentation provided on the motion that the Financial Statement audited by E & Y contained "unqualified opinion," and that "[a]dditional comfort is provided by the quality of the financial reports by Ernst & Young which issues audited statement with unqualified opinions." Id. This contradicts defendants' allegation that transaction causation is not present and, at the least, creates an issue of fact which can not be decided on a motion.

As for loss causation, the parties also present conflicting theories and data. Defendants posit that Sterling's loss predates the representations in the unqualified opinion since Allied owed Sterling $5,900,000 prior to the renewal of the credit facility. Thus, Sterling could not have been damaged by the renewal of the facility and the extension of the last nine loans based on defendants' issuance of the unqualified opinion. The defendants argue that because Allied was a sham criminal enterprise, it would make no difference when the truth became known; there would not have been sufficient funds for Allied to make payments on its obligations.

On the other hand, plaintiff asserts that, to the extent that defendants seek to place the loss in an earlier period, prior to the facility renewal in July 2001, Sterling alleges such loans were granted on reliance upon earlier E & Y audited financials that suffer from the same misrepresentations and flawed processes, so that the loss would still be attributable to E & Y's misconduct. Sterling has demonstrated that the nine loans in issue were funded from payments made by Allied on prior loans, and that if the new fundings were denied, Sterling might still have the payments it received on the old loans and would not be out of pocket. In addition, Sterling also points out that during this period, Allied apparently had the money to pay other creditors. Here, too, Sterling has provided sufficient evidence to raise an issue of fact as to loss causation.

Justifiable Reliance:

Defendants raise two reasons why plaintiff could not justifiably rely on the 2000 audited financial statement with the unqualified opinion. The first is that plaintiff should have used a stand-alone financial statement to evaluate the creditworthiness of Allied, instead of a consolidated statement. The second is that the financial reports were stale, because too much time had elapsed since they were rendered. In both cases, defendants are putting forth theories in conclusory terms without supporting evidence. There is no factual support for their allegation that a stand-alone financial statement would be the preferred method of evaluating Allied. The same is true for defendants' claim that the 2000 financial statement is outdated. This is not a sufficient basis upon which to grant summary judgment.

Moreover, plaintiff has put into contention both these theories, thereby creating further issues of fact. Plaintiff has presented evidence that a consolidated statement is the appropriate and recognized way of evaluating a business with wholly owned subsidiaries. See Persches Aff, ¶ 23. Plaintiff also has pointed out that the 2000 financial statement was the most recent and only available financial reporting on Allied upon which one could rely.

Punitive Damages:

Defendants raise once again the issue of whether plaintiff can claim punitive damages. They argue that plaintiffs have not demonstrated sufficient proof that the defendants acted with the requisite intent and malice to warrant the imposition of punitive damages. Plaintiff argues that it need not show intentional conduct, and it only must demonstrate wilful or wanton negligence or recklessness. Plaintiff asserts that the allegations regarding how E & Y conducted the audit support a finding that defendants acted recklessly and with wanton disregard of the

rights of those, like Allied's lenders, who were going to utilize the "clean" opinion. Plaintiff claims that the audit and opinion were not really a true inquiry into the financial condition of Allied, because there was a total failure to verify information and defendants let Allied confirm its own receivables figures, that defendants turned a blind eye to all of the red flags and ignored suspicious facts that caused plaintiff's expert to conclude that this was not even an audit at all. See Persches Aff. Indeed, the letter from Edward B. Quinlan indicates that the New York office was reluctant to inform the authorities after E & Y Dubai had pointed out that substantial fraud was going on. The document that demonstrates that defendants tried to cover-up the facts, was withheld from plaintiff through several years of discovery.

In addition, plaintiff points to the statement by Rastogi that he gave a $2,000,000 fund to Anand for so-called "expenses" for auditors that plaintiff takes to euphemistically mean a bribe. Defendants reply that the testimony of Rastogi and Anand denies that any such monies were used to pay Jain to influence the outcome of the audit. Where critical questions come down to the credibility of convicted felons, a jury issue is present.

As was noted on the earlier motion to dismiss, pursuant to CPLR 3211, the issue of whether defendants' conduct is so egregious as to warrant the imposition of punitive damages is a factual issue. *Sterling National Bank v Ernst & Young, LLP*, 9 Misc 3d 1129(A), 2005 NY Slip Op 51850(U) (Sup Ct, NY County Jan. 7, 2005). It is no less so on this motion for summary judgment. Generally, punitive damages are a jury question. *Nardelli v Stamberg*, 44 NY2d 500 (1978). Even in the case of *Prozeralik v Capital Cities Communications, Inc.*, (82 NY2d 466 [1993]), cited by defendant, the Court of Appeals, though dubious as to the proof on the issue, still remanded the case for trial on that issue. Here, plaintiff has a long road to prove its claim for

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punitive damages, but enough has been presented to permit plaintiff to present it to the jury.

There being triable issues of fact as to transaction causation, loss causation, speculative damages, justifiable reliance and punitive damages, there is no basis upon which to dismiss the complaint.

Accordingly, it is

ORDERED that motion sequence 013 for summary judgment is denied; and it is further

ORDERED that motion sequence 014 is granted and the order of Judicial Hearing Officer Bradley is vacated and the discovery requested by plaintiff is denied, and it is further

ORDERED that motion sequence 015 is in all respects denied.

Dated: December 1, 2008

ENTER:

J.S.C.

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