

Sterling Natl. Bank v J.H. Cohn LLP
2012 NY Slip Op 33459(U)
August 28, 2012
Supreme Court, New York County
Docket Number: 650879/2012
Judge: Melvin L. Schweitzer
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**SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY**

PRESENT: MELVIN L. SCHWEITZER
Justice

PART 45

STERLING NATIONAL BANK

INDEX NO. 650879/2012

-v-

MOTION DATE _____

J. H. COHN LLP

MOTION SEQ. NO. 001

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

Notice of Motion/Order to Show Cause — Affidavits — Exhibits _____ ☐ No(s). _____

Answering Affidavits — Exhibits _____ ☐ No(s). _____

Replying Affidavits _____ ☐ No(s). _____

Upon the foregoing papers, it is ordered that this motion *is by defendant to dismiss the complaint in its entirety*
is GRANTED per the attached
Decision and Order.

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

Dated: Aug 28, 2012
[Signature]

[Signature] J.S.C.
MELVIN L. SCHWEITZER
J.S.C.

1. CHECK ONE: ☒ CASE DISPOSED ☐ NON-FINAL DISPOSITION
2. CHECK AS APPROPRIATE: MOTION IS: ☐ GRANTED ☐ DENIED ☐ GRANTED IN PART ☐ OTHER
3. CHECK IF APPROPRIATE: ☐ SETTLE ORDER ☐ SUBMIT ORDER
- ☐ DO NOT POST ☐ FIDUCIARY APPOINTMENT ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK : PART 45

-----X	
STERLING NATIONAL BANK,	:
	:
Plaintiff,	:
	:
-against-	:
	:
J.H. COHN LLP,	:
	:
Defendants.	:
-----X	

Index No. 650879/12

DECISION AND ORDER

Sequence No. 001

MELVIN L. SCHWEITZER, J.:

This matter arises out of the audited consolidated balance sheets and statements of income (collectively, the Financial Statements) of non-party USA Financial Services LLC (USA Financial) and the related unqualified audit reports dated March 27, 2009 and March 30, 2010 (collectively, the Audit Reports) prepared by defendant J.H. Cohn LLP (J.H. Cohn), which Plaintiff Sterling National Bank (Sterling) relied upon in making, extending, and renewing loans to USA Financial. Sterling brings this action for fraud and gross negligence tantamount to fraud, alleging that J.H. Cohn stated in the Audit Reports that the Financial Statements fairly represented the financial health of USA Financial when, in fact, J.H. Cohn knew, or should have know, that they were a ruse masquerading a company in dire straits.

J.H. Cohn now moves to (a) dismiss the complaint in its entirety pursuant to New York Civil Practice Law and Rules (CPLR) Section 3211 (a) (7), contending that (i) Sterling fails to state a claim for fraud and (ii) New York law does not recognize a cause of action for gross negligence tantamount to fraud, and, in the alternative, it merely duplicates the claim sounding in fraud, and (b) strike the demand for punitive damages because the complaint is bereft of any allegations justifying such an award. Sterling opposes the motion.

Background

The Parties

Accepting the allegations in the complaint as true, the following facts emerge: USA Financial was a limited liability company organized under New York law engaged in the business of leasing equipment and vehicles to consumers nationwide until its dissolution in October 2010. Complaint, ¶¶ 7, 14. USA Financial borrowed funds from various banks in order to finance these leases. *Id.*, ¶ 7.

One of these banks was Sterling, which is organized under the laws of the United States with its principal place of business in New York. *Id.*, ¶ 5. Pursuant to a Revolving Warehouse Credit Agreement, Sterling extended a \$1 million line of credit and made \$3 million in loan advances during 2009 and 2010 to USA Financial in order for it to finance the leases. *Id.*, ¶ 8. These loans were evidenced by a promissory note in a principal amount equal to the loan advance and secured by USA Financial's lease contracts, the leased equipment, and personal guarantees. *Id.*

J.H. Cohn is a New Jersey limited liability partnership with its principal place of business in New York that provides accounting and auditing services. *Id.*, ¶ 6. At some unspecified point, USA Financial retained J.H. Cohn to prepare the Audit Reports, which reflected the Financial Statements for years ending December 31, 2007, 2008, and 2009. *Id.*, ¶ 9.

USA Financial's Deception

At least as early as 2008, USA Financial began to see a slow down in its business and orchestrated a scheme to conceal this from not only Sterling, but also the other lenders with whom USA Financial transacted business. *Id.*, ¶ 10. USA Financial perpetuated this through a

series of sleight of hand maneuvers that gave the guise of a vibrant company dutifully performing its obligations to the various banks. *Id.* For example, if a lease went into default, rather than accelerate the debt and report it to the bank, USA Financial would continue to make payments on the lease as if no default had occurred. *Id.*, ¶ 10. In other instances, USA Financial either fabricated the existence of a lease or financed the same lease with more than one bank, and then misappropriated the corresponding loan proceeds and payments. *Id.*, ¶¶ 9,10. In addition, when USA Financial received lease termination payments, it did not remit the proceeds to the bank, but rather continued to make periodic payments as if the lease were still in effect. *Id.*, ¶ 12. All of these practices violated unspecified covenants with numerous banks, and were not disclosed in the Financial Statements. *Id.*

The Audit Reports, Sterling's Reliance, and USA Financial's Collapse

J.H. Cohn, as the author of the Audit Reports, knew, or should have known, that the Financial Statements did not accurately portray the financial condition of USA Financial. *Id.*, ¶¶ 11,13. It ostensibly gained the knowledge of USA Financial's struggles and the corresponding coverup through the ordinary course of its audit activities. *Id.*, ¶ 11. However, and in despite of this knowledge, J.H. Cohn stated in the Audit Reports that the Financial Statements accurately represented, in all material respects, the result of US Financial's operations and cash flows for the years then ended. *Id.*, ¶ 2.

Sterling, in reliance on the statements in the Audit Reports confirming the veracity of the data in the Financial Statement, made, extended, and renewed loans to USA Financial during years 2009 and 2010. *Id.*, ¶ 9. Sterling would not have done so but for the Audit Reports confirmation of the Financial Statements' accuracy. *Id.*

In or about October 2010, unable to maintain its charade any longer, USA Financial defaulted on its loans to Sterling and other banks, closed its doors, and ceased doing business. *Id.*, ¶ 14. Numerous, yet unspecified, civil proceedings have been commenced against USA Financial and its former CEO, James Moscatello. *Id.*, ¶ 15. At some point prior to the commencement of this action, Sterling obtained a judgment in the amount of \$3,443,422.81, plus interest, against USA Financial.¹ *Id.*

Sterling Commences this Action

On or about March 21, 2012, Sterling commenced this action against J.H. Cohn. In Count I, Sterling alleges that J.H. Cohen committed fraud because it knew that the Financial Statements were false and that USA Financial was (a) making lease payments on defaulted leases as if no default occurred; (b) fabricating leases or financing the same lease with different banks; and (c) not remitting lease termination payments to the bank. *Id.*, ¶ 20. Sterling further alleges that it relied on the Audit Reports to its detriment, thereby entitling it to (a) damages in the amount of \$3,443,422.81 plus interest, costs, and attorneys' fees and (b) punitive damages in an amount to be determined at trial. *Id.*, ¶¶ 21, 22.

In Count II, Sterling avers that J.H. Cohen was grossly negligent tantamount to fraud because it had "red flag warnings", which it ignored or failed to pursue, that the Financial Statements were false and did not accurately portray USA Financial's situation. *Id.*, ¶ 28. As in Count I, Sterling further alleges that it relied on the Audit Reports to its detriment, thereby

¹ While not specified in the complaint with detail, Sterling commenced an action for summary judgment in lieu of complaint pursuant to CPLR 3213 against USA Financial, James Moscatello, Anthony Moscatello, and Matthew Moscatello on or about January 5, 2011. The court (Kapnick, J.) granted the motion on or about April 28, 2011 with judgment entered shortly thereafter in favor of Sterling. *Sterling National Bank v USA Financial LLC et al.*, Index No. 650020/2011.

entitling it to (a) damages in the amount of \$3,443,422.81 plus interest, costs, and attorneys' fees and (b) punitive damages in an amount to be determined at trial. *Id.*, ¶¶ 31, 32.

This Motion

On or about May 15, 2012, J.H. Cohen moved to dismiss the complaint in its entirety. In particular, J.H. Cohen argues that Sterling fails to plead a claim for fraud because there are no facts alleged that would permit an inference that J.H. Cohen made any material misrepresentations, intended to defraud Sterling, and that Sterling reasonably relied on the Audit Reports. Furthermore, J.H. Cohen contends that New York law does not recognize a separate cause of action for gross negligence tantamount to fraud and that such a claim simply duplicates the one sounding in fraud. Finally, J.H. Cohen moves to strike the demand for punitive damages, averring that the complaint does not allege conduct so nefarious as to justify such an award.

In opposition, Sterling avers that (a) it adequately pleads a claim for fraud as well as one for gross negligence² and (b) the complaint contains sufficient detail demonstrating its entitlement to punitive damages.

Discussion

The Standard for Dismissal under CPLR 3211 (a) (7)

J.H. Cohen moves to dismiss the complaint pursuant to CPLR 3211 (a) (7) for the failure to state a claim upon which relief can be granted. In considering a motion to dismiss, the court must accept plaintiff's allegations as true and the complaint must be accorded "the benefit of

² As more fully set forth *infra*, Sterling attempts to argue in opposition to this motion that it pled a claim for gross negligence, despite the fact that it styled Count II as one for gross negligence tantamount to fraud.

every possible favorable inference.” *CMMF, LLC v J.P. Morgan Inv. Mgt. Inc.*, 78 AD3d 562, 565 (1st Dept 2010) *quoting Leon v Martinez*, 84 NY2d 83, 87 (1994).

A. Count I: Fraud

J.H. Cohen argues that the fraud claim is fatally flawed because the complaint fails to allege, with any specificity, that it knew of USA Financial’s alleged fraud, was aware that Sterling would receive the Audit Reports, and that it intended for Sterling to rely on the Audit Reports. Memorandum in Support of the Motion to Dismiss (Memo. in Support) at pp. 1-3. CPLR 3016 (b) provides a rigorous standard for a plaintiff seeking to assert a fraud claim, mandating that the surrounding circumstances be pled in detail. CPLR 3016 (b). As such, to state a viable claim for fraud, the plaintiff must demonstrate (1) a misrepresentation or omission of a material fact that the defendant knew to be false at the time it was made (scienter); (2) that the misrepresentation was made for the purpose of inducing the other party to rely upon it; (3) justifiable reliance of the other party on the misrepresentation or material omission; and (4) injury. *Lama Holding Co. v Smith Barney Assoc.*, 88 NY2d 413, 421 (1996). Thus, it is incumbent upon Sterling to establish that due to J.H. Cohn’s intentional misrepresentations, it was induced to make loans to USA Financial, and suffered damages as a direct result thereof. *Peach Parking Corp. v 346 W. 46th St. LLC*, 42 AD3d 82 (1st Dept 2007).

Here, Sterling pleads as follows:

The Audit Reports were false and misleading in that the Financial Statements did not fairly represent the financial position of USA Financial and the results of its operations and cash flows

Complaint, ¶ 19

* * *

J.H. Cohen knew that the Financial Statements were false and did not accurately set forth the financial condition of USA Financial because it knew that (a) USA Financial was making lease payments on defaulted leases as if no leases occurred; (b) when USA Financial received lease termination payments, it failed to remit proceeds to the banks and instead continued to make period payments on behalf of the lessees; (c) that the payments and failure to report the defaults to the banks were a violation of various bank covenants; and (d) the undisclosed defaults under the bank covenants made the Financial Statements and Audit Reports materially false and misleading.

Id., ¶ 20.

* * *

Sterling justifiably relied upon the unqualified J.H. Cohen Audit Reports in making, renewing, and extending loan advances to USA Financial.

Id., ¶ 21.

* * *

As a result of the foregoing, Sterling was damaged in the amount of \$3,443,422.81

Id., ¶ 22.

Scienter

Contrary to J.H. Cohn's argument, Sterling has sufficiently asserted that J.H. Cohn knew that the Financial Statements were false but nevertheless attested to their veracity in the Audit Reports. While Sterling indeed did not particularize the manner in which J.H. Cohn knew, for example, that USA Financial failed to tender lease payments to Sterling and other banks, such an intricate level of detail is not necessarily needed for a plaintiff to adequately plead scienter. *See Lanzi v Brooks*, 43 NY2d 778 (1977) (holding that CPLR 3016(b) "not be interpreted so strictly

as to prevent an otherwise valid cause of action in situations where it may be impossible to state in detail the circumstances constituting a fraud”).

The Appellate Division, First Department has recognized the difficulty in ascertaining, prior to discovery, the actual proof of an accountant’s alleged knowledge regarding its client’s malfeasance. To be sure, probing an accountant’s mind to ascertain its level of knowledge without the benefit of evidence can be a near-impossible task. As such, a plaintiff satisfies its pleading burden by demonstrating a “rational basis” for inferring that the accountant knowingly made the alleged misrepresentation. *Houbigant, Inc. v Deloitte & Touche LLP*, 303 AD2d 92 (1st Dept 2003). A court may thus infer scienter when, based upon the attending circumstances as alleged in the complaint, it can rationally deduce that the accountant, given its position and access to certain financial information, knew of the client’s fraudulent conduct. *DDJ Mgt. v Rhone Group LLC*, 78 AD3d 442 (1st Dept 2010).

Here, Sterling alleges that J.H. Cohn, as USA Financial’s auditor, had access to certain information concerning USA Financial’s fraudulent practices, and, as a consequence, knew that the Financial Statements were inaccurate, yet nevertheless verified the Financial Statements in the Audit Reports. These allegations, coupled with the inferences rationally drawn from them, sufficiently state, for pleading purposes, that J.H. Cohn knew of the fraud. *J.P. Morgan Chase Bank v Winnick*, 350 F Supp 2d 393 (SDNY 2004), *applying New York law*. Given the early stage of this litigation, Sterling is entitled to favorable inferences from its pleading, including inferences arising from J.H. Cohn’s position and responsibilities. *Pludeman v Northern Leasing Servs., Inc.*, 40 AD3d 366 (1st Dept 2007). Sterling has, therefore, sufficiently stated scienter.

Reliance and Detriment

In similar vein, Sterling sufficiently states that it relied on J.H. Cohn's misrepresentations, to wit the Audit Reports, to its detriment. J.H. Cohn's argument that the reliance allegation is insufficient because it fails to expound on the circumstances – such as the exact time and date when Sterling received the Audit Reports – is unavailing. Memorandum in Support at p. 14. Sterling indeed specifies that as a result of, and in reliance upon, J.H. Cohn's issuance of the Audit Reports, it engaged in the transaction with USA Financial, which ultimately resulted in Sterling suffering a loss north of \$3 million. Such an allegation is wholly plausible and properly stated, and thus acceptable as true for pleading purposes. *Skillgames LLC v Brody*, 1 AD3d 247 (1st Dept 2003).³

Intent

Notably absent from the complaint is the bridge between scienter and reliance, namely, an allegation that J.H. Cohn knowingly *intended* to dupe Sterling into relying on the Audit Reports. To be sure, Sterling does not dispute that the complaint is void of any such allegation. Memorandum in Opposition at p. 16. Rather, Sterling contends that a claim for fraud need not allege that defendant intended to defraud the plaintiff, but only that defendant was aware of the misrepresentation. *Id.*

To be sure, there is a line of cases which hold that the *intent* to deceive may be drawn from the allegations concerning scienter, thereby creating an inference that defendant knew the

³ J.H. Cohn's reliance on *Waggoner v Caruso*, 20 Misc 3d 1149(A) (NY Sup. Ct. 2008) is misplaced. There, the court found plaintiff's allegation insufficient because it simply stated that it relied on defendant's alleged misrepresentations without further detail on the attending circumstances. Here, in contrast, Sterling specifically alleges that as a consequence of its in reliance on the Audit Reports, it made loans to USA Financial.

misrepresentation may be reasonably relied upon. However, courts that have accepted such an inference have done so because the plaintiff pled that the defendant-accountant knew of the plaintiff's connection to the documents prepared by the defendant-accountant, thereby raising a sufficient specter of the intent to deceive. *See e.g. Sterling Nat. Bank v Ernst & Young LLP*, 9 Misc 3d 1129(A) (NY Sup. Ct. 2005) (plaintiff pled that the defendant-accountant knew that the purpose of the report was to induce plaintiff and other similarly-situated banks into making loans); *Houbigant*, 303 AD2d 92 (1st Dept 2003) (the complaint contained the allegation that the defendant-accountant knew that the plaintiff received the allegedly misleading financial statements); *Fidelity and Deposit Co. of Maryland v Arthur Andersen & Co.*, 131 AD2d 308 (1st Dept 1987) (affirming the lower court, which held that plaintiff pled sufficient facts to infer that the defendant-accountant knew that plaintiff was a leading performance bond underwriter who would rely on the certifications to determine whether to bond the work performed).

Here, Sterling does not allege any facts averring that J.H. Cohn knew of Sterling, its relationship with USA Financial, or that Sterling would utilize the Audit Reports in deciding whether to extend loans to USA Financial. To this end, Sterling has not only failed to specifically allege J.H. Cohn's intent to defraud it, but it also provides no basis for the court to rationally infer such an intention. Indeed, if facts are not alleged that J.H. Cohn even knew of Sterling and its relationship to USA Financial, there hardly can be any inference of an intent to defraud. Absent a finding of intent, the fraud claim cannot proceed. *Pontos v Renovation, Inc. v*

Kitano Arms Corp., 226 AD2d 191 (1st Dept 1996). Accordingly, the motion to dismiss Count I is granted.⁴

B. Count II: Gross Negligence Tantamount to Fraud

J.H. Cohen contends that New York law does not recognize an independent claim for gross negligence tantamount to fraud and, alternatively, that it merely repackages the one sounding in fraud. Memorandum in Support, p. 15. Case law, however, is scant as to whether a plaintiff may assert such a cause of action. Courts tasked with analyzing such claims have done so by examining the four corners of the complaint within the requisite liberal standard in order to determine the exact nature of the claim pled. For example, in *Ambassador Factors v Kendel & Co.*, 215 AD2d 305 (1st Dept 1995), the Appellate Division, First Department found that the claim pled was actually one for fraud, where a showing of gross negligence could permit the trier of fact to draw an inference of defendant's fraudulent conduct. *Id.* Similarly, in *Sterling Nat. Bank v Ernst & Young*, *supra*, the court ascertained that the plaintiff had, in fact, pled gross negligence, despite labeling it as a claim lying on the cusp of fraud.

⁴ In further defense of the viability of its fraud claim, Sterling submits copies of J.H. Cohn's work papers from its audits of USA Financial, which Sterling obtained pursuant to a subpoena issued in the matter styled as *Sterling National Bank v USA Financial LLC et al.*, Index No. 650020/2011 (the Work Papers). The first page of the Work Papers references instances where USA Financial advanced payments for customers, to which Eric Gulotta, USA Financial's CFO, explained were "special situations" where USA Financial considered those loans to be "active and current", with an expectation that the clients would repay them. Affirmation of Paul C. Evans in Opposition to the Motion to Dismiss, Ex. 2. Sterling contends that these statements, and corresponding entries in the Work Papers, support its allegation that J.H. Cohn knew of the fraud, while J.H. Cohn counters that it actually disproves the claim. The court finds neither contention availing. Facially, these statements simply reflect that J.H. Cohn understood that USA Financial made certain arrangements with some of its clients, and does not conclusively establish one way or the other whether J.H. Cohn knew of the fraud. Moreover, an examination of this statement necessitates an inquiry beyond the pleadings, which is not appropriate on a CPLR 3211 (a) (7) motion. *Lefkowitz v Esposito*, 99 Misc 2d 590 (NY Sup. Ct. 1979). Additionally, there is nothing in the Work Papers that remotely suggests J.H. Cohn knew of Sterling.

Here, when the complaint is afforded a liberal reading, it is evident that Sterling attempts to state a claim for gross negligence against J.H. Cohn – an accounting firm – in which it is undisputedly not in privity. As such, in order for Sterling to sustain this claim, J.H. Cohn must have been aware that the Audit Reports would be used by Sterling for a particular purpose and that Sterling intended to rely on them. Thus, there must be some conduct “linking” J.H. Cohn to Sterling. *See Credit Alliance Corp. v Arthur Andersen & Co.*, 65 NY2d 536 (1985).

In addition to the averments that the Audit Reports were false, Sterling alleges as follows:

J.H. Cohn has red flag warnings, which it ignored or failed to pursue, that the Financial Statements were false and did not accurately set forth the financial condition of USA Financial

Complaint, ¶ 28.

* * *

J.H. Cohen was heedless and reckless when it disregarded and turned a blind eye to the red flag fraud warnings which were obvious indications of fraud.

Id., ¶ 29.

Sterling’s pleading misses the mark. At the outset, it is plainly clear, as discussed *supra*, that the complaint does not contain any allegations whatsoever that J.H. Cohen *knew* that Sterling would use, and consequentially rely upon, the Audit Reports in making the decision to extend loans to USA Financial. Additionally, Sterling fails to allege the requisite “linking” conduct between J.H. Cohn and itself as a non-client/third party. To demonstrate linking conduct, a plaintiff must plead some form of direct contact between itself and the accountant-defendant such as “a face-to-face conversation, the sharing of documents or some other substantive communication between the parties.” *Securities Investor Protection Corp. v BDO Seidman, LLP*, 222 F3d 63 (2d Cir. 2000) *applying New York law*. Here, the complaint is devoid of any

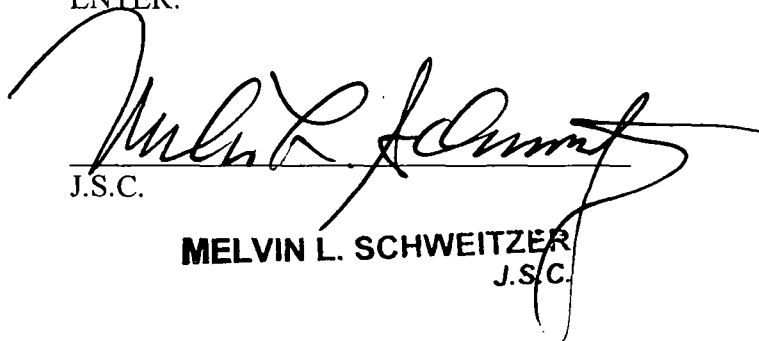
allegations that establishes a link between Sterling and J.H. Cohn. *Cf. Seaview Mezzanine LLP v Ramson*, 77 AD3d 567 (1st Dept 2010). At most, what can be gleaned from the complaint is that J.H. Cohen prepared the Audit Reports pursuant to an agreement with USA Financial, which was not undertaken pursuant to any specific duty owed to Sterling. Therefore, Sterling cannot establish the direct nexus necessary to give it a claim against J.H. Cohen sounding in negligence. Accordingly, the motion to dismiss Count II is granted.^{5 6}

Accordingly, it is

ORDERED that the complaint is dismissed in its entirety.

28
Dated: August 28, 2012

ENTER:


J.S.C.
MELVIN L. SCHWEITZER
J.S.C.

⁵ As the complaint is dismissed in its entirety, the motion to strike the demand for punitive damages is denied as moot.

⁶ The court takes judicial notice that Sterling already has obtained a judgment against USA Financial in the exact amount of damages that it seeks here. *Thimmaiah v Air-India Ltd.*, 19 Misc 3d 138(A) (NY Sup. App. Term 2008).