SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 15

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ELI HOFFMAN, as Receiver to, and on Behalf of
COBALT ASSET MANAGEMENT, L.P.,
Plaintiff,

Index No.: 150620/2016

-against-

Mot. Seq. No. 002

RSM LLP (formerly McGladrey LLP),
RICHARD NICHOLS, JOHN DOES 1-10
(being fictitious names), ABC CORPORATIONS
(being a fictitious name),
Defendants.

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MELISSA A. CRANE, J.S.C.:

Plaintiff Eli Hoffman ("Hoffman") as receiver to, and on behalf of Cobalt Asset Management, L.P. ("CAM") (collectively the "plaintiff"), seek to recover under a theory of professional malpractice, gross negligence, and aiding and abetting fraud. Defendants RSM LLP ("RSM") and Richard Nichols ("Nichols") (collectively the "defendants") move, pursuant to CPLR 3211(a)(2) and (a)(7), to dismiss plaintiff's amended complaint.

Background

Six limited partners formed Cobalt Capital, L.P. (later renamed Cobalt Asset Management, L.P. ["CAM"] in 1992 (Am. Compl. ¶ 19). Charles Thompson ("Thompson") founded the "Cobalt" brand and facilitated the creation of several auxiliary and co-dependent entities, including Cobalt Holding Co., Inc. ("Cobalt Holding"). Thompson owned 100% of the shares of Cobalt Holding. Cobalt Holding served as a general partner of CAM. Following the formation of Cobalt Fund, L.P. ("Cobalt Fund"), in January 1993, the Cobalt Fund retroactively admitted CAM as a general partner and investment advisor.

CAM's investment management agreements with Cobalt entitled CAM to an annual administrative fee equal to 1% of Cobalt Fund's net assets, and to a performance fee equal to

20% of Cobalt Fund's net increase in assets. CAM derived its income from these investment management agreements. The limited partnership agreement for CAM (the "CAM LPA"), appointed Thompson as general partner, and six limited partners – Ingham, Casey, Graves, Kenny, Garner, and Phelps (collectively, the "limited partners") (Am. Compl. ¶ 26). The CAM LPA provided that the limited partners would receive profits from the investment management agreements in proportion to their initial capital contributions (Am. Compl. ¶ 27).

In 1995, Thompson assigned CAM's investment management agreements (the primary asset of CAM), to H.G. Wellington & Co., Inc. ("Wellington"), in return for cash, a salary for Thompson, and Wellington equity (referred to as the "Wellington Transaction") (Am. Compl. ¶¶ 37-38). The Wellington Transaction allegedly assigned away CAM's primary asset and rendered CAM insolvent. CAM's limited partners could not recoup their investments (Am. Compl. ¶ 1, 38, 42). CAM never attained profitability, and a lengthy disentanglement process ensued to recover any remaining residual value for the limited partners.

Ingham, a limited partner, first learned of the Wellington Transaction after she began to inquire into her holdings in CAM during routine estate planning (Sullivan Aff., Ex. 5 [Ingham Compl.] ¶ 15). In 2010, Ingham, derivatively, on behalf CAM, brought an action against Thompson and alleged, *inter alia*, breach of fiduciary duty, fraud, negligent mismanagement, and waste of assets (the "Ingham Litigation"). Ingham reported Thompson's fraudulent behavior that included self-dealing, misallocation of CAM's fee income, unsanctioned distributions from CAM, totaling approximately $2 million, and unauthorized payments of his personal expenses from CAM's accounts (Am. Compl. ¶ 38). Ingham asserted that Wellington transaction stripped CAM of its primary asset at the detriment of its limited partners (Am. Compl. ¶¶ 38, 42).

On February 21, 2013, the American Arbitration Association ("AAA") unanimously

awarded Ingham $4 million derivatively on behalf of CAM (the "Arbitration Award"). The AAA held that Thompson defrauded CAM's limited partners relating to Thompson's management of CAM. To date, Ingham and CAM are unable to collect funds from Thompson.

On March 17, 2015, the court appointed plaintiff, Eli Hoffman ("Hoffman"), as the receiver of CAM. On March 8, 2016, plaintiff commenced this action against defendants RSM LLP ("RSM") and Richard Nichols ("Nichols") (collectively the "defendants"). Plaintiff sought to recover more than five million dollars in damages that plaintiff sustained "as a direct and proximate consequence of RSM' and Nichols' negligent performance of accounting services, failure to comply with the terms of their engagement letters, failure to adhere to the professional standards required of certified public accountants, and aiding and abetting the looting of CAM assets by its former principal, [Thompson]" (First Compl, ¶ 1). Plaintiff alleged six causes of action: (1) professional malpractice; (2) negligence; (3) gross negligence; (4) breach of contract; and (5) breach of implied covenant of good faith and fair dealing (*id.*).

Defendant moved to dismiss the original complaint. On December 5, 2016, Justice Rakower granted defendant's motion and dismissed plaintiff's initial complaint, but gave plaintiff leave to file an amended pleading (Sullivan Aff, Ex. 24 [12/5/16 Tr.] at 57:9-13). On February 3, 2017, plaintiff filed an amended complaint, and alleged that RSM had a single, continuous conflict of interest for decades where "...RSM [ ] continuously represented CAM as its tax preparer. During that same time, however, RSM also represented Thompson and his wife, in their individual capacity, preparing Thompson's personal tax returns, as well as the CAM investment arm, the Cobalt Fund, as its auditor" (Am Compl, ¶ 3). According to plaintiff, RSM "stood at the epicenter of a two-decade long scheme whereby Thompson, with RSM's knowledge and assistance, both express and implied, diverted CAM's assets to himself on a

yearly basis" (*id.* ¶ 4). Plaintiff alleged three causes of action: (1) professional malpractice; (2) gross negligence; (3) aiding and abetting fraud (Am. Compl).

On April 6, 2017, defendants moved to dismiss plaintiff's amended complaint. That motion is now before the court.

Discussion

A court must deny a motion to dismiss under CPLR 3211 (a)(2) "if from the pleading's four corners, factual allegations are discerned which taken together manifest any cause of action cognizable at law" (*Richbell Info. Servs. v Jupiter Partners*, 309 AD2d 288, 289 [1st Dept 2003] [internal quotation marks omitted], quoting *511 W. 232nd Owners Corp. v Jennifer Realty Corp.*, 98 NY2d 144, 151-152 [2002]). The court must afford the pleading a "liberal construction," and "the benefit of every possible favorable inference" (*Leon v Martinez*, 84 NY2d 83, 87 [1994]). However, the court may disregard "bare legal conclusions" and "inherently incredible" facts. *Matter of Sud v Sud,* 211 AD2d 423, 424 [1st Dept 1995]). Moreover, "[w]hen the moving party offers evidentiary material, the court is required to determine whether the proponent of the pleading has a cause of action, not whether [he or] she has stated one" (*Asgahar v Tringali Realty, Inc.*, 18 AD3d 408, 409 [2d Dept 200]).

Statute of Limitations

Continuous Representation Doctrine

Under CPLR 3211(a)(5), a defendant bears the burden to establish that the time to bring a lawsuit has expired (*Savarese v Shatz,* 273 AD2d 219, 220 [2d Dept 2000]). For accounting malpractice actions, plaintiff must bring a claim three-years from the date that defendant committed the malpractice (see CPLR 201; CPLR 214[6]). A claim accrues when defendant commits the malpractice, and not when the client discovers it (*see Williamson v Lipper*

Convertibles, 9 NY3d 1, 8 [2007]). The continuous representation doctrine tolls the accrual of the statute of limitations for accounting malpractice causes of action where the continuous representation is "in connection with the specific matter directly in dispute, and not merely the continuation of a general professional relationship" (*see Ackerman v Price Waterhouse,* 252 AD2d 179, 205 [1st Dept 1998]; *see also,* CPLR 214-a).

The court must decide whether the continuous representation doctrine applies to the 22-year long conflict of interest arising from defendant's improper conduct when it represented Thompson, individually, and CAM and Cobalt.

Defendant argues that, despite plaintiff's new theory of an ongoing conflict of interest, defendant provided "discrete and severable transactions." This court agrees. Plaintiff alleges that CAM retained RSM on a yearly basis to prepare CAM's annual tax returns. RSM gave CAM a new engagement letter for each year that it provided tax services. After it filed the tax return, RSM did no further work for CAM. CAM did not ask RSM to provide corrective or remedial services.

In *Williamson,* defendant entered into annual engagements for "separate and discrete audit services" … "and once defendant performed the services for a particular year, no further work as to that year was undertaken" (9 NY3d 1, 10-11 [2007]). The Court of Appeals found that, where the parties did not require further representation, like, for example, to reexamine a prior year's financial statements, the parties did not have a "mutual understanding" required under the doctrine (*id.* at 11). The allegations in plaintiff's amended complaint show the continuation of a general professional relationship (*see, CLP Leasing Company v Nessen*, 12 AD3d 226, 227 [continuous representation did not toll applicable limitations period where documentation plaintiff submitted showed a general professional relationship rather than an

"ongoing representation concerning the specific matters from which their claims arose"]; *see also, Apple Bank for Savings v PricewaterhouseCoopers LLP,* 70 AD3d 438, 362 [1st Dept 2010] [no continuous representation where accountant prepared annual tax returns and audits, but never had an agreement to provide further tax advice]).

Plaintiff alleges an "unbreakable 22-year deviation from the acceptable standards of care required of accountants when faced with a conflict of interest between the clients" (Rice Aff, p.11). Despite this, defendant performed yearly services to prepare tax returns and yearly audits. None of the singular transactions are in dispute in this lawsuit. The 22-year long conflict of interest is indicative of a general professional relationship (*see, Booth v Kriegel,* 36 Ad3d 312 [1st Dept 2006] [continuous representation doctrine did not apply where, "[r]egardless of the common mistake affecting the tax returns, each return was a separate and discrete transaction"). Accordingly, the continuous representation doctrine does not toll the statute of limitations. Plaintiff's claims are therefore limited to the 2012 tax year and onward.

Engagement Letters' Terms and Limitations

Defendant also argues that the terms and conditions set forth under RSM's yearly engagement letters bar plaintiff from bringing any claim based on services for any tax year prior to 2013. Paragraph 5.3 of RSM's yearly engagement letters provide:

> **Time Limitation on Claims.** No claim or action by either party, regardless of whether the claim is in contract, in tort, at law or in equity, arising out of or relating to any matter under the Arrangement Letter may be brought by either party (i) *more than 24 months [two years] after the party first knows or has reason to know* that the claim or cause of action has accrued or (ii) more than 60 months [five years] following the completion of the services under the Arrangement Letter. This paragraph may shorten, but in no event will it extend, any period of limitation on actions otherwise provided by applicable law.

(Sullivan Aff, Ex. 2 [McGladrey & Pullen LLP Terms and Conditions, applicable to the 2011 tax

year] [emphasis added]). The engagement letter's time limitation requires actual knowledge of the cause of action. Ingham first learned of Thompson's efforts to defraud CAM, and of the Wellington Transaction, in 2010 when Ingham began to inquire into her holdings. Ingham then initiated the Ingham Litigation. She had access to CAM's yearly tax returns at that time.

According to defendant, plaintiff's claims accrued from 2010 when Ingram learned of Thompson's fraud. However, plaintiff alleges that "it was not until Hoffman's appointment as receiver in September 2015 that it had reason to know that the alleged acts of Thompson had been aided and abetted by RSM" (Am Compl ¶¶ 6-7, 135 & n.5). On a motion to dismiss, the court accepts facts alleged in the complaint as true and views them in a light most favorable to the plaintiff. The court, therefore, holds that the engagement letter does not bar plaintiff's claims because plaintiff did not have actual knowledge of the fraud until 2015.

Professional Malpractice and Gross Negligence

A defendant owes plaintiff a duty of appropriate professional care as his accountant (*Carper v Nussbaum,* 36 AD3d 176 [2d Dept 2006]). The accountant must have committed a negligent act that was the proximate cause of the damage claimed. The plaintiff must show that "but for" the accountant's alleged malpractice, plaintiff would not have sustained some actual ascertainable damages.

To plead gross negligence, plaintiff must allege conduct that (i) demonstrates reckless disregard for the rights of others, or (ii) "smacks" of intentional wrongdoing (*Colnaghi, USA, Ltd. v. Jewelers Prot. Servs., Ltd.,* 81 NY2d 821, 823-24 [1993]; *see also, Assured Guar. [UK] Ltd. v JP Morgan Inv. Mgmt., Inc.,* 80 AD3d 293, 305 [1st Dept 2010]). "A mistake or a series of mistakes alone, without a showing of recklessness, is insufficient for a finding of gross negligence" (*AT&T Co. v. City of New York,* 83 F3d 549, 556 [2d Cir. 1996]).

Defendant argues that plaintiff's three causes of action are duplicative and "premised on a professional's 'failure to exercise due care or to abide by general professional standards'" (*see* Sullivan Aff p.21, *citing to Sage Realty Corp v Proskauer Rose LLP,* 251 AD2d 35, 38-39 [1st Dept 1998]). Plaintiff argues that defendant "failed to act upon a known conflict of interest; and failed to conduct necessary diligence where red flags are raised by client's conduct (Rice Aff, p.16-17)." As a result, CAM's partners did not know of Thompson's deceit and self-dealing.

The conflict of interest plaintiff refers to stems from the Wellington Transaction that occurred in 1995: "[d]espite the fact that the Wellington Transaction posed a conflict of interest between two of its clients (Thompson and CAM), RSM took no action to address, much less resolve this conflict" (Am Compl at 22, ¶¶ 96-97). Without plaintiff's time-barred claims, defendant's conduct does not rise to gross negligence, as it did not "smack of intentional wrongdoing" (*see, Apple Bank for Savings v PricewaterhouseCoopers* 70 AD3d at 362; *see also, Lobel Chemical Corp v Petitto,* 2016 WL 628101 [NY Sup Ct 2016]). Similarly, plaintiff cannot allege a professional malpractice claim without the time-barred claims. Therefore, the court dismisses the first and second causes of action.

Aiding and abetting fraud

To state a claim for aiding and abetting fraud, the plaintiff must allege: (i) the existence of an underlying fraud; (ii) defendant's knowledge of the fraud; and (iii) substantial assistance of the defendant in the achievement of the fraud (*CRT Investments, Ltd. v BDO Seidman*, LLP, 85 AD3d 470 [1st Dept 2011], citing *National Westminster Bank USA v. Weksel*, 124 AD2d 144, 147 [1st Dept], appeal denied 70 N.Y.2d 604 [1987]). "'Substantial assistance,' a necessary element of aiding and abetting fraud, means more than just performing routine business services for the alleged fraudster" (*CRT Investments, Ltd.*, 85 AD3d at 472). The purported aider and

abettor must act with the intent of aiding the primary fraudulent scheme; however, one may satisfy the intent requirement by "the proposed aider's knowledge of the fraud" (*Nat'l Westminster Bank USA v Weksel*, 124 AD2d 144, 149 [1st Dept 1987]).

The parties do not dispute the existence of an underlying fraud. Defendant prepared tax returns for CAM and for Thompson from 1995 through 2015 (Am. Compl. ¶ 168). Through preparing both tax returns, defendant received and possessed information indicative of Thompson's self-dealing. Defendants, by preparing the returns, "substantially assisted" Thompson's fraud because the fraud could not have continued without the tax returns and defendant's "willful ignorance" (Am. Compl. ¶ 168) (*see, Houbigant, Inc. v Deloitte & Touche, LLP*, 303 AD2d 92 [1st Dept 2003]; *see also Abu Dhabi Comm. Bank v Morgan Stanley & Co Inc.*, 651 FSupp2d 155, 179 [SDNY US Dist Ct, 2009]). Accordingly, the court denies dismissal of the third cause of action of aiding and abetting fraud.

Accordingly, it is hereby

ORDERED that the court grants defendant's motion to dismiss the complaint (motion sequence number 002) only to the extent that it dismisses the first and second causes of action. The court directs defendant to serve an answer to the complaint within 20 days after service of a copy of this order and decision with notice of entry; and it is further

ORDERED that counsel for the defendant, as well as counsel for the plaintiffs in each of the actions, are directed to appear for a status conference in Room 303, 71 Thomas Street, on June 12, 2018, at 9:30 AM.

Dated: 4/2/2018

ENTER:

HON. MELISSA A. CRANE, J.S.C.

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HON. MELISSA A. CRANE