PAUL, WEISS, RIFKIND, WHARTON & GARRISON

SECOND CIRCUIT REVIEW

RECENT DECISIONS: ACCOUNTANT LIABILITY, FOSTER-FAMILY DUE PROCESS RIGHTS

MARTIN FLUMENBAUM - BRAD S. KARP

PUBLISHED IN THE *NEW YORK LAW JOURNAL*
JUNE 2000

In this month's column, we discuss two recent decisions in which the United States Court of Appeals for the Second Circuit confronted very different questions of state law. In the first case, involving an issue of accountant liability, the Second Circuit determined that it could not answer the specific questions of state law and instead certified the issues the New York Court of Appeals. In the second case, the Second Circuit found the state law clear enough to decide issues involving the Due Process rights of a foster family.

'SIPC V. BDO SEIDMAN, LLP'

As we discussed in prior columns, there is an increasing tendency in the Second Circuit to certify uncertain but determinative questions of state law to the state's highest court. Indeed, three months ago, in *Tunick v. Safir*,[1] a panel of the Second Circuit declared that the Supreme Court's recent teaching "is that we should consider certifying in more instances than had previously been thought appropriate, and do so even when the federal courts might think that the meaning of a state law is 'plain.'"[2] In *Securities Investor Protection Corp. v. BDO Seidman, LLP*,[3] the Second Circuit heeded this directive again and certified complicated issues involving accountant liability under state law to the New York Court of Appeals.

Seidman arises out of the 1996 dissolution of the brokerage firm A.R. Baron & Co. Inc. (Baron) and the criminal conviction of Baron and 13 of Baron's employees for defrauding investors. After Baron filed for bankruptcy, the district judge entered an order finding the Baron's customers required the protections of the Securities Investor Protection Act (SIPA) and directed the appointment of a trustee to oversee the liquidation. SIPA was enacted in 1970 to protect and insure customers in the event of a broker-dealer liquidation. SIPA created the Securities Investor Protection Corp. (the SIPC), a private, nonprofit membership corporation which monitors the activities of broker-dealers and which insures customers in the event of a liquidation.

In *Seidman*, plaintiff-appellants the SIPC and James W. Giddens (the Trustee), as trustee for Baron's liquidation (collectively, "the plaintiffs"), brought an action against the accounting firm BDO Seidman, LLP (Seidman), claiming that Seidman engaged in fraud, negligent misrepresentation, and breach of contract by filing false audit reports on Baron's behalf with the Securities and Exchange Commission (SEC). The plaintiffs claimed that Seidman's conduct caused financial damage both to Baron's customers, who the Trustee represents in liquidation and to whose claims the SIPC is subrogated, and to the SIPC in its own right insofar as it has advanced funds to cover the costs of Baron's liquidation. The district court dismissed the plaintiffs' claims, finding that the SIPC lacked standing to sue on its own behalf and that neither the SIPC nor the trustee could state a claim upon which relief could be granted on behalf of Baron's customers because the customers did not themselves directly rely on Seidman's audit reports.

In an opinion written by Judge Sonia Sotomayor and joined by Judge Thomas J. Meskill and Southern District Judge John F. Keenan (sitting by designation), the Court ruled that the lower court had erred in concluding that the SIPC lacked standing to sue on its own behalf but it affirmed the district court's dismissal of both the SIPC's and the trustee's claims on behalf of Baron's customers. The Second Circuit then certified to the New York Court of Appeals the question of whether "the SIPC may recover damages where Seidman was aware that the SIPC would receive from the SEC any negative information about Baron's financial condition contained in the audit reports, but never provided those reports directly to the SIPC or engaged in more than minimal direct contact with it."[4]

The Court first passed on the issue of the SIPC's standing as the subrogee to the claims of Baron's customers, holding that the time was not ripe to revisit the precedent that had led the district court to find that the SIPC had standing to pursue customer claims. Because other Court held that the SIPC's claims on behalf of the customers failed under 12(b)(6) grounds, it simply assumed without deciding that the SIPC had standing as subrogee. The Court did, however, reverse the district court in ruling that the SIPC has standing under the SIPA to sue in its own right for any losses suffered as a result of Seidman's misconduct. The Court noted that the plain language both of the SIPA and of the D.C. Nonprofit Corporation Act grant to the SIPC the power to sue and be sued on its own behalf. It also noted that case law involving similar government-created corporations supports this view of the SIPA.

With regard to the trustee's standing to sue on behalf of Baron's customers, the Court also assumed without deciding that the trustee did have standing, noting, as it had for the SPIC, that it need not decide this issue because the claims on behalf of the customers failed under 12(b)(6) grounds. Turning to the plaintiffs' claims on behalf of the Baron investors, the Second Circuit noted that, in their capacity as subrogee, their claims could survive dismissal only if the customers would have had claim against Seidman for either fraudulent or negligent misrepresentation. The Court affirmed the lower court's conclusions that (i) the plaintiffs could not make this showing because they could not prove that Baron's customers ever had relied on Seidman's alleged misrepresentations; and (ii) the plaintiffs' negligence claim failed because they had not established any privity between the defendants and the customers.

First, the Court held that no claim could lie for fraudulent misrepresentation because, as the investors never received any Seidman representations in any form, the plaintiffs could not show that the customers had relied to their detriment on the misinformation. In so holding, the Court rejected the plaintiffs' "fraud on the regulatory process" argument — an extension of the "fraud on the market" theory — because the theory had not been recognized in this Circuit and, to the extent the theory had been recognized in any federal courts, it has been applied only in the context of the federal securities laws rather than in state common law cases. With regard to negligent misrepresentation in a case such as this involving claims against an accountant with whom there is no contractual relationship, the Court noted that three elements must be established under New York law: (i) the accountant must have been aware that the reports would be used for a particular purpose; (ii) in furtherance of which a known party was intended to rely; and (iii) some conduct by the accountant "linking" him to that known party.[5] In the circumstances of this case, the Court held that this second "known party" element was not satisfied, as the plaintiffs had not alleged that Seidman knew

of any particular customers who would rely on their representations; likewise, the third "linking conduct" element was not met because there was no allegation of any direct contact at all between the customers and Seidman.

Turning to the SIPC's claims for losses sustained in its own right, the Court noted that the "success of failure of the SIPC's fraud claim depends on the precise extent of New York's reliance requirement, specifically whether the SIPC can establish reliance on Seidman's audit reports despite never having received or read those reports."[6]

The regulatory scheme that created the SIPC requires regular reports from an independent accounting firm on a brokerage firm's capitalization and financial condition to be forwarded to the SEC. If the SEC and the National Association of Securities Dealers (NASD) believe the firm to be in distress, they are required to notify the SIPC, which can then choose to begin liquidation proceedings. Thus, the SIPC argued that, insofar as it relies on notifications from the SEC and NASD, the accounting firms' silence created the impression that Baron was in good shape. This theory of liability — known as the "no news is good news" theory[7] — finds some support in New York law, but would require the federal court to expand somewhat New York fraud law because while "New York law is fairly clear that a plaintiff may establish reliance on misrepresentations it receives from a third party in a repackaged form, such as a credit report or a financial report, New York courts have not extended this rule to cover a third party's failure to convey information at all."[8] The Court thus ruled that this question should be entrusted to the state court.

Similarly, the Second Circuit held that New York law also is unclear with regard to the SIPC's negligence claim for losses sustained in its own right. As noted by the Court, in order to state such a claim, New York courts require some direct relationship between the plaintiff and the defendant. The issues for negligence liability are thus whether the SIPC can be considered a known party and whether it can show the requisite linking conduct despite the lack of meaningful contact with the accounting firm. The Court stated that "the case represents a close question as to whether the SIPC has established the necessary 'privity-like' relationship between itself and Seidman."[9] While the Court held that the SIPC has satisfied the "particular purpose" requirement, it also stated that the questions of whether the SIPC has met its burden of proving that it was a "known party" to Seidman and whether the SIPC has alleged a sufficient connection to satisfy the "linking conduct" requirement are close questions under New York law. Consequently, the Second Circuit also certified these questions to the New York court.

The Second Circuit concluded that "[b]ecause New York case law indicates some uncertainty as to the contours of these limitations on liability and because resolution of these issues requires a delicate balancing of state policy concerns," certification to the New York Court of Appeals was appropriate.[10] In a decision handed down just a few days after *Seidman*, the Court clarified that it would not certify questions to the state court unless the issue as determinative of the action. In *Mehlenbacher v. Akzo Nobel Salt Inc*.[11] the Court said that while it "might be inclined to certify the issue to the New York Court of Appeals," in that case "certification would not be warranted" because there were alternative bases for the Court's holding and therefore the "issue is not determinative of the action."[12]

'Rodriguez v. McLoughlin'

In *Rodriguez v. McLoughlin*,[13] the Second Circuit confronted yet another vexing state law issue raised by society's fluid definition of "family." Reversing the lower court, the Second Circuit held that New York law does not create a protected liberty interest for a foster parent and child in continuing to live together or in postremoval visitation.

In this case, plaintiff Sylvia Rodriguez sued defendant Cardinal McCloskey Children's and Family Services (the agency) and defendants City of New York, the City Child Welfare Administration (CWA) and the City Department of Social Services (together, the City or City defendants), individually and on behalf of her now-adopted minor child Les Andrew Kelly (Andrew), for due process violations in connection with the temporary removal of Andrew from Rodriguez's home when he was her foster child. Andrew had lived with Rodriguez virtually from birth. When he was about three years old, a court order terminated his birth mother's parental rights (his father never having been identified) and transferred legal guardianship to McCloskey and the City. Rodriguez had long expressed an interest in adopting her foster son, and she and McCloskey entered into a standard one-page Adoptive Placement Agreement in contemplation of that adoption. Most of the adoption paperwork had been completed by March 1994, the time of the events underlying this lawsuit. At that time, a caseworker went to Rodriguez's home for a scheduled visit and found the four-year-old Andrew and another three-year-old foster child supervised only by Rodriguez's 12-year-old emotionally handicapped, special education grandson. After approximately two hours had passed and Rodriguez still had not returned, the caseworker was instructed to remove the children. McCloskey subsequently filed a Report of Suspected Child Abuse or Maltreatment with the state agency, which in turned triggered an investigation by CWA's Office of Confidential Information (OCI). While the investigation was pending, Rodriguez requested a hearing before the state agency, an independent CWA review, and visitation with Andrew. She was permitted only very limited visitation rights.

During this time, OCI determined that McCloskey's Report of maltreatment should be rejected. It found that there was "no credible evidence to substantiate" that view, although it recommended a training program for Rodriguez. McCloskey disagree with this determination, however, and refused to return Andrew to Rodriguez pending the outcome of the independent city review by CWA. CWA, in turn, ordered Andrew's return to Rodriguez, stating that his removal "may be considered arguably valid," but concluding that the ensuing denial of visitation was "very questionable since neither Mrs. Rodriguez nor Andrew could obviously have been prepared for their separation from each other and visiting could have helped the child's understanding of the situation." While endorsing OCI's recommendation, that Rodriguez receive training, CWA also recommended that the adoption process be reinitiated following a 90-day period of close agency supervision. Andrew was returned to Rodriguez in July 1994; the adoption process resumed in January 1995; and Rodriguez's adoption of Andrew was finalized in August 1995.

In March 1996, Rodriguez commenced the underlying lawsuit under 42 U.S.C. § 1983 on behalf of herself and Andrew as her minor child, asserting due process violations. Among other things, the complaint alleged that Andrew's health and safety did not warrant his summary removal from Rodriguez's home and that McCloskey had unconstitutionally deprived Rodriguez of notice and an opportunity to be heard prior to interfering with her

right as a foster and preadoptive parent and with the liability interests of herself and Andrew in family integrity. The complaint also alleged that McCloskey had wrongfully, arbitrarily, and capriciously denied Rodriguez a meaningful opportunity to be heard in connection with its refusal to return Andrew to her home and its denial of visitation.

Upon defendants' motion, the district court dismissed plaintiffs' claim that Andrew's removal was unjustified, holding that there was an objective basis for the caseworker to have believed that Rodriguez's unsupervised foster children were at risk and should be removed. The court denied defendants' motion to dismiss plaintiffs' claim with regard to the denial of postremoval hearing and visitation rights, holding as a matter of law that, with respect to "a New York foster mother who was in final stages of adopting her foster child, whom she had cared for continuously since his first weeks of infancy [,] there is a constitutionally protected liberty interest in the stability and integrity of the relationship between such a foster mother and foster child."[14] The district court thus ruled that while the decision to remove Andrews in March 1994 was reasonable and lawful, the subsequent delay in providing Rodriguez with notice and an opportunity to be heard to contest the removal and the denial of Rodriguez's request to visit Andrew for some three months were unconstitutional. A jury was impaneled to decide whether and to what extent Rodriguez and/or Andrew had suffered injury from the delay and the denial of visitation. The jury returned a verdict finding that Rodriguez (but not Andrew) had suffered compensable injury, and awarded damages.

On appeal, the City conceded that if a liberty interest in fact existed, plaintiffs had not received procedural process; the defendants argued, however, that plaintiffs had no such liberty interest in living together and in postremoval visitation. The Second Circuit, in an opinion written by Judge Amalya L. Kearse and joined by Chief Judge Ralph Winter and Northern District Judge Norman A. Mordue (sitting by decision), agreed.

The Court began its opinion by noting that "[a]liberty interest may arise from either of two sources—the Due Process Clause itself [or] the laws of the States."[15] The Court then stated that a foster family, whose relationships ordinarily are not based on blood or marriage, "has its source in state law and contractual arrangements," and that "where, as here, the claimed interest derives from a knowingly assumed contractual relationship with the State, it is appropriate to ascertain from state law the expectations and entitlements of the parties."[16] The Court concluded that "any liberty interest arising in the preservation of a biologically unrelated foster family would arise, if at all, only under state law and not under the Due Process Clause itself."[17]

The Court then turned to the statutory and regulatory provisions of New York law that the district court had relied on to find a constitutionally protected liberty interest in the plaintiffs' foster-family relationship. Rejecting the lower court's view that these provisions created a liberty interest, the Second Circuit concluded: "In sum, none of the statutory or regulatory sections called to our attention contains any substantive predicates or explicitly mandatory language giving directives to decisionmakers as to the cohabitation or visitation rights of a foster mother and child in the wake of an emergency removal of the child from the foster home. We cannot conclude that these provisions are sufficient to give plaintiffs the liberty interests they assert."[18]

Finally, the Court held that the Adoptive Placement Agreement also did not confer a protectable liberty interest, as "the terms of the Agreement made clear that adoption was not a foregone conclusion and that the agency retained both custody of Andrew and discretion to determine whether his best interest would be served by effectuating the adoption or by removal from the foster home."[19]

In conclusion, the Court made a point of noting that "[e]nsuring appropriate treatment by the private agencies that the City chooses to authorize to administer foster care remains a matter for supervision by state and local legislative and administrative bodies."[20] The Court sternly concluded that "[i]t is to be hoped that those authorities will take appropriate steps to prevent the recurrence of judgmental errors such as this."[21]

ENDNOTES

1. 209 F.3d 67 (2d Cir. March 24, 2000).
2. Id.
3. 2000 WL 713909 (2d Cir., June 5, 2000).
4. Id. at *1.
5. Id. at *9.
6. Id. at *12.
7. Id.
8. Id. at *13.
9. Id. at *14.
10. Id.
11. 2000 WL 791774 (2d Cir. June 20, 2000).
12. Id.
13. 2000 WL 719447 (2d Cir., June 5, 2000).
14. Id. at *4 (citation omitted).
15. Id. at *8 (citation omitted).
16. Id. at *8-9 (citation omitted).
17. Id. at *9.
18. Id. at *13.
19. Id.
20. Id. at *14.
21. Id.

* * *

Martin Flumenbaum and Brad S. Karp are partners in the New York office of Paul, Weiss, Rifkind, Wharton & Garrison.