NEW YORK COURT OF APPEALS ROUNDUP:

UNDERWRITER LIABILITY, DUTY OF CARE, AND DESTRUCTIVE SEARCHES ADDRESSED BY THE COURT

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Three civil Court of Appeals cases that we discuss this month revolve around the defendants' alleged duties. In *AG Capital Funding Partners, L.P. v. State Street Bank and Trust Co.*, the Court allowed to survive a motion to dismiss a claim that, based upon the parties' course of conduct and alleged industry custom (including as to responsibilities assigned by practice to whoever hosts a closing), duties allegedly assigned by contract to another party were assumed by the underwriters and the issuer's counsel. *Matter of New York City Asbestos Litigation* and *Gilson v. Metropolitan Opera,* both negligence cases, addressed whether, based upon the facts alleged, the defendant owed a duty of care to the plaintiff.

In a criminal case, *People v. Felix Gomez*, the Court set standards for obtaining consent to a destructive vehicle search.

Underwriter Duty

AG Capital Funding Partners perhaps does not warrant shivers down the spine of those involved in corporate transactions, as it merely permitted claims to proceed beyond the pleading stage, but such parties should take careful note of the decision. The Court found that another party's contractual obligation in an offering may be assumed by the issuer, underwriter, or counsel based upon alleged industry custom and the conduct of those parties. The result stands in sharp contrast to the decision of the Appellate Division, which would not allow the party allegedly obligated under a contract to rely upon industry custom and usage "to subvert the agreement's plain meaning."[1]

Lowen Group had issued debt securities to be collateralized by a pool of assets. The security interest was to be obtained by having the debt holders or their "secured party representative," indenture trustee State Street Bank & Trust, deliver to the collateral trustee, Bankers Trust, a registration form signed both by the issuer and by the holders or State Street on

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their behalf. Registration forms for this debt, however, did not make their way to Bankers Trust.

Later, Lowen filed for bankruptcy. The debt holders settled their claims with Lowen at a discount because their secured-creditor status was in doubt. They sued State Street, claiming breach of a contractual obligation to deliver the registration forms to Bankers Trust. State Street brought a third-party action against UBS Warburg and Salomon Smith Barney as lead underwriters of separate debt issuances whose lawyers had run the closing of the respective transactions, and Thelen Reid & Priest LLP ("TRP") as Lowen's counsel in those transactions, alleging that *if* it had an obligation to deliver the registration forms (which State Street denied), such duty had been assumed by the third-party defendants.

Before the Court of Appeals were the lower court rulings on the third-party defendants' motions to dismiss the complaint. The Court considered material beyond the pleading, namely the contracts submitted by UBS, Salomon and TRP in support of their CPLR 3211(a)(1) motion for a defense found on documentary evidence, and various forms of evidence submitted by State Street to "amplif[y]" its allegations in opposition to the CPLR 3211(a)(7) motion to dismiss for failure to state a claim. Emphasizing that it was expressing no view on whether State Street ultimately would be able to prove its case, the Court (5-2), in an opinion by Judge Carmen Beauchamp Ciparick, held that State Street had stated causes of action for negligence and contribution against each defendant.

Key to the outcome were the allegations, supported by an expert affidavit, that it is custom and practice "within the corporate trust industry" for the issuer, issuer's counsel, underwriter and/or underwriter's counsel to file the documents necessary to record a security interest, as indenture trustees never make filings themselves, and that an indenture trustee's contractual duty to "deliver" documents means "to leave executed documents at the closing table." A TRP attorney's deposition testimony supported that it is industry custom to "deliver" documents to the closing table, and for "the lawyer who is hosting the closing [to] distribute[] the documents appropriately."

These claims were supplemented with course-of-conduct allegations and documentary evidence indicating that: UBS's counsel had at one time asserted that an associate of the firm delivered the registration forms to Bankers Trust (although the law firm later retracted its assertion); when TRP realized that Salomon's counsel had failed to include the registration forms in the closing checklist, TRP obtained the necessary signatures and sent the forms to the underwriter's lawyers with the expectation they would deliver the forms to Bankers Trust; and Lowen's counsel on prior note issuances (TRP in one instance and a different firm in another) themselves recorded the registration forms with Bankers Trust.

The Court found that the allegations of industry custom, "coupled with" the parties' conduct, supported State Street's claim that the third-party defendants had assumed

any duty State Street may have had to register the plaintiffs' security interest with Bankers Trust. It observed that a course of conduct inducing reliance "may implicate a duty of care." Thus, even absent any contractual obligation to file the registration forms themselves, the issuer's counsel or the underwriters may be held liable for the debt holders' losses under an assumption-of-duty theory.

State Street had failed, however, to plead adequately its other claims against TRP. Absent privity or a relationship that "otherwise closely resembles privity," no cause of action for negligent misrepresentation will lie, and, absent privity, no cause of action for attorney malpractice will lie without "fraud, collusion, malicious acts or other special circumstances."[2]

The dissenters would have dismissed TRP from the case altogether. Judge Robert S. Smith authored the partial dissent, in which Judge George Bundy Smith joined, expressing the view that the evidence was insufficient to support a claim that issuer's counsel, as opposed to the underwriters, may have undertaken any contractual duties of State Street.

Duty of Care

Recently the Court twice was confronted with the recurring issue of whether a duty was owed to a plaintiff seeking recovery for personal injury sustained through the alleged negligence of the defendant. In both cases, the Court found no duty as a matter of law, and the plaintiffs' claims were dismissed.

However, the issue of duty is by no means a simple one, nor put to rest by these decisions. This is shown by the fact that in *New York City Asbestos Litigation*, the Court (Chief Judge Judith S. Kaye taking no part) reversed the unanimous decision of the Appellate Division, First Department, that had reinstated plaintiff's negligence claim, and in *Gilson v. Metropolitan Opera*, the Court was unpersuaded by the dissenting opinion of Judge George Bundy Smith (or the dissenting opinion of two Justices of the Appellate Division, First Department), that the defendant "had a duty to protect its patrons from harm caused by conditions on its premises."[3]

While the two decisions surely provide guidance to the lower courts in conducting a careful review as to whether a duty exists, they also make clear that the determination of that issue of law will continue to require an equally careful review of the facts in each case.

New York City Asbestos Litigation involved the wife of a Port Authority employee, who claimed that she had contracted mesothelioma as a result of exposure to asbestos dust in the course of laundering the work clothing of her husband, who handled asbestos-containing materials at his job. At the heart of a comprehensive opinion for the Court by Judge Susan Phillips Read, holding no duty was owed by the employer to its employee's spouse, was the

Court's earlier opinion in *Hamilton v. Beretta U.S.A. Corp.*, 96 N.Y.2d 222 (2001). That opinion is particularly applicable when dealing with efforts by the plaintiffs' Bar to expand the scope of liable defendants in asbestos cases. The *Hamilton* Court stated:

> [t]he threshold question in any negligence action is: does defendant owe a legally recognized duty of care to plaintiff? Courts traditionally fix the duty point by balancing factors, including the reasonable expectations of parties and society generally, the proliferation of claims, the likelihood of unlimited or insurer-like liability, disproportionate risk and reparation allocation, and public policies affecting the expansion or limitation of new channels of liability. Thus, in determining whether a duty exists, courts must be mindful of the precedential, and consequential, future effects of their rulings, and limit the legal consequences of wrongs to a controllable degree.

Under this standard, the wife in *Asbestos Ligitation* was just too far removed from the defendant to be protected.

Metropolitan Opera presented a much more compelling case for a finding of duty. There, the plaintiff was seriously injured while attending the opera when another patron, afflicted with Parkinson's disease, fell on her while returning to his seat amid dim aisle lighting following an intermission and 10 minutes into the second act. In affirming the grant of summary judgment to the Met, the Court brushed aside as beyond the necessary standard of care the fact that a house rule required patrons to be escorted to their seats with the aid of flashlights when the lights had been lowered and a performance was in progress, as well as the argument that the physical condition of the offending patron was known to the Met's ushers and thus obligated the ushers to escort him to his seat.

The two cases teach us that the imposition of a duty will continue to be an issue in New York, and that in order to avoid dismissal, plaintiffs will be required to make a persuasive showing of facts to justify a finding of duty.

Destructive Search

People v. Gomez arose out of a destructive vehicle search. The Court held that, absent circumstances indicating a defendant authorized the actions taken by the police, "a general consent to search alone cannot justify a search that impairs the structural integrity of a vehicle or that results in the vehicle being returned in a materially different manner than it was found."

In *Gomez,* the police pulled over a car for excessively tinted windows, a violation. An officer looked under the car because, in his experience, the undercarriage often reveals telltale signs when a vehicle has been modified to transport drugs. He noticed a fresh undercoating under the gas tank. The officer asked if there were weapons or drugs in the car, to which the defendant answered "no," and then asked for defendant's consent to search the car, which was given.

With the defendant standing nearby, the officer unlocked and pulled back the rear seat of the car, pulled up the glued carpeting underneath, used a pocket knife to pull up the floorboard where it had been cut and, after returning to the police vehicle for a crowbar, pried open the gas tank, where he found cocaine in a secret compartment.

The Appellate Division, First Department affirmed the denial of defendant's motion to suppress, finding consent to the search, but did not review the alternative basis on which the motion had been denied – that the police had probable cause. The Court of Appeals reversed the consent ruling, and returned the matter to the Appellate Division for consideration of the probable cause issue.

The scope of consent is determined by what a reasonable person would have understood based upon his exchange with the police, the Court explained in its opinion, also authored by Judge Ciparick. Before a search may go beyond its objectively reasonable scope, more specific permission is needed. Thus, the burden is not upon the suspect to place explicit limitations on police conduct or object when the search exceeds the scope of his consent, but rather on the police to obtain the permission necessary. Here, the Court held, taking a crow bar to the gas tank exceeded the scope of defendant's consent.

Judge Read was the lone dissenter, in particular objecting that the majority's ruling was as a matter of law. The dissent alluded to the threat of terrorism and asserted that courts should be "most reluctant to create hard-to-apply rules that hamstring police officers who reasonably suspect that a vehicle contains a hidden compartment," although the reasonableness of the search under probable cause standards was not before the Court. (The majority retorted that the police are well-served by rules that provide guidance in advance as to whether their actions will be lawful.)

Judge Read would have found that a reasonable person, aware the police were looking for drugs, would be expected to know both that drugs could be concealed in a hidden compartment and that a searcher might have to "exert some degree of force" to find such a compartment. Moreover, even if use of the crowbar did exceed the scope of his "initial expectations," the defendant never asked the police to stop their search. The dissent would also have found that such "silence in the face of [the officer's] evolving actions constituted consent to the search as conducted."

[1] *AG Capital Funding Partners, L.P. v. State Street Bank and Trust Co.,* 10 A.D.3d 293, 295 (First Dep't 2004).

[2] *Quoting Estate of Spivey v. Pulley,* 138 A.D.2d 563, 564 (Second Dep't 1988).

[3] It should not go unremembered that the celebrated case of *Palsgraf v. The Long Island Railroad Co.,* 248 N.Y. 339 (1928), held that without a duty there can be no negligence. *Palsgraf* was itself a 4-3 decision of the Court that reversed the decision of the Appellate Division.