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Kyle C. Bisceglie on

Pleading Fraud against Individual Corporate Officers under New York Law after *Pludeman v. Northern Leasing Systems*

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New York's Highest Court Suggests More Lenient Fraud Pleading Standard against Individual Officers. In *Pludeman v. Northern Leasing Systems*, 10 N.Y.3d 486 (N.Y. 2008), the Court of Appeals, in a 5 to 2 decision, affirmed the Appellate Division's decision permitting a fraud claim against corporate officers under New York's Civil Practice Law and Rules 3016(b). Commonly known as New York's "fraud pleading standard", CPLR 3016(b) requires that the "the circumstances constituting the wrong shall be stated in detail."

Plaintiffs were small, unrelated business owners from various states including Missouri, Texas, Washington and New York which claimed fraud against a micro-ticketing leasing and finance company and certain of its officers for allegedly deceptive sales practices and lease agreements for business equipment. Plaintiffs alleged they were each presented with a contract that appeared to consist of only one page in its entirety, however there were three more pages hidden underneath the top page on a clipboard. The "hidden pages" allegedly included harsh contract terms including hidden insurance charges, attorney's fees provisions and automatic deductions. Plaintiffs maintain, *inter alia,* that they were rushed into signing the leases, refused full copies of the leases by salespeople at the time of signing, and were over-charged and unlawfully disadvantaged in a variety of ways under the equipment leases.

Plaintiffs named certain corporate officers as individual defendants on the basis of their "corporate positions and titles," and did not assert direct allegations of fraud (specific or otherwise) against them. The Appellate Division suggested it could "deduce" from their position and titles that the officers operated the day-to-day operations and, therefore, would be involved in or know about the fraud. *Pludeman v. Northern Leasing Sys. Inc.*, 40 A.D.3d 366, 367, 837 N.Y.S2d 10 (1st Dept. 2007).

The Court of Appeals found the scheme of fraud pled sufficiently. "Personal participation in, or actual knowledge of" the fraud did not need to be detailed in the complaint to meet the CPLR 3016(b) requirement. The Court of Appeals explained:

> Although plaintiffs have not alleged specific details of each individual defendant's conduct, we have never required talismanic, unbending allegations. Simply put, sometimes such facts are unavailable prior to discovery.

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> Lest we willfully ignore the obvious – or the strong suspicion of fraud – we have always acknowledged that, in certain cases, less than plainly observable facts may be supplemented by the circumstances surrounding the alleged fraud.

Pludeman, 10 N.Y.3d at 493 (citations omitted). In addition, the court noted that "[t]he purpose of section 3016(b)'s pleading requirement is to inform a defendant with respect to the incidents complained of. We have cautioned that section 3016(b) should not be so strictly interpreted '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.'" *Pludeman* 10 N.Y. 3d at 491-92 (citing *Lanzi v. Brooks,* 43 N.Y.2d 778, 780 (3rd Dept. 1977)(further citations omitted).

This decision has struck many observers (and the jurists in the dissent at both the Appellate Division and Court of Appeals) as extraordinary, particularly because the record provided that the defendant corporation did not employ the salespersons! *Pludeman*, 10 N.Y.3d at 494, n. 4. The dissent, in fact, saw no basis to deduce that officers of a micro-ticket leaser and financer would supervise, instruct or, even, know about the conduct of salespeople who were employees of unaffiliated equipment distributors. *Id*. at 495-96.

For a number of reasons, we do not yet know how extraordinary this decision is. Clearly, the Court had before it a remarkable set of facts. The Court of Appeals found "significant" that this was "not an isolated case" but "took place over a number of years" from "unrelated plaintiffs" all "register[ing] parallel complaints" arising from the "language structure and format" of the allegedly deceptive lease agreements and "systematic" conduct of salespersons. *Id*. at 493. We certainly will see plaintiff's counsel attempting to wrest the *Pludeman* holding from its extraordinary circumstances or, at least, describe their case in such a way that supports "deduction" from the "circumstances" of fraudulent intent by individual defendants. Defense counsel will need to place *Pludeman* in context of New York's other leading fraud cases.

Pleading Fraud in New York State against Individual Defendants. New York law precludes the assertion of personal liability for fraud against a corporate officer except where the officer "participated in" or "had knowledge of" the fraud. *Marine Midland Bank v. Russo*, 50 N.Y.2d 31, 44 (1980). Such personal involvement must be pled in a fraud action against an individual officer.

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New York uses a two-part test in pleading fraud. First, all elements of the prima facie case for fraud must be established: "the plaintiff must allege representation of a material existing fact, falsity, scienter, deception and injury." *Lanzi v. Brooks*, 388 N.Y.S.2d 946, 947-48 (1976). Next, the plaintiff must show that each of these elements is "supported by factual allegations sufficient to satisfy the requirement of CPLR 3016(b) that 'the circumstances constituting the wrong shall be stated in detail' when a cause of action based upon fraud or breach of trust is alleged." *Id.* There is a difference between the prima facie elements for fraud and CPLR 3016(b) requirements. *Lanzi v. Brooks,* 43 N.Y.2d 778, 779 (1977). CPLR 3016(b) requires that "'the circumstances constituting the wrong shall be stated in detail'. This provision requires only that the misconduct complained of be set forth in sufficient detail to clearly inform a defendant with respect to the incidents complained of and is not to be interpreted so strictly as to prevent an otherwise valid cause of action…'" *Lanzi,* 43 N.Y.2d at 779 (citing *Jered Contr. Corp. v New York City Tr. Auth.,* 22 N.Y.2d 187, 194. (1968).

CPC International and Polonetsky. Prior to *Pludeman*, counsel looked to *Marine Midland, CPC International Inc. v. McKesson Corporation*, 70 N.Y.2d 268 (1987) and *Polonetsky, et al. v. Better Homes Depot, Inc.,* 97 N.Y.2d 46 (2001) to guide fraud allegations against individual defendants. In *CPC International*, plaintiffs alleged a scheme of fraud against the Company as well as named individual officers of that Company involving falsification of projections and related investment documents. The Court upheld an action against the individuals under common law fraud because the plaintiffs alleged these individuals had "knowingly engaged in a scheme to 'provide substantial assistance' to" the Company in carrying out the alleged fraud. *CPC International,* 70 N.Y.2d at 285-86. The complaint referred to the creation and distribution of the false projections and fictitious financial statements by the Company and individual defendants. The Court stated the rule to apply on a motion to dismiss is to look at the allegations "given their most favorable intendment." *Id.* at 286. The Court went on to say, "[g]iven its 'most favorable intendment', the complaint, read as a whole, describes a scheme – involving all the defendants – devised and executed for the specific purpose of defrauding" the plaintiff. *Id.* While certain factual questions of each individual's acts and involvements cannot be clear at the pleading stage of the case, "the individual defendants, as parties to the underlying fraudulent conspiracy, could, nonetheless, be liable for [defendant's] independent actions done in furtherance of it." *Id.* Here, the Court includes individual officers as viable defendants to a fraud claim when the circumstances and nature of such a claim indicate their involvement.

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In 2001, the Court of Appeals again took up the issue of pleading fraud against individuals. In *Polonetsky, et al. v. Better Homes Depot, Inc.,* 97 N.Y.2d 46 (2001), the Court allowed an action for fraud to proceed against the company and its president in a case involving real estate sales and services. Plaintiff, the Commission of the Department of Consumer Affairs, alleged defendants had employed deceptive practices in misrepresenting homes for sale as foreclosed properties, deterred customers from consulting their own attorneys, suggested company attorneys to buyers, misrepresented them as being endorsed by the federal government, promised repairs that were never done, made substandard repairs and threatened hesitant buyers with keeping their down payments. On the issue of individual liability of the company president, the Court first noted, "[i]n actions for fraud, corporate officers and directors may be held individually liable if they participated in or had knowledge of the fraud, even if they did not stand to gain personally." *Id.* at 55. The Court observed the Company president was involved in Company "operations on a day-to-day basis and [was] actively involved in its marketing and sales activities." *Id.* Plaintiff had also alleged that the individual defendant "participated personally in the sale of property and ... made fraudulent promises to at least one of the dissatisfied buyers that repairs would be made prior to closing." *Id.* This aspect of *Polonetsky* is distinguishable from *Pludeman* in that the *Pludeman* complaint did not identify specific acts of the individual defendants. It is this difference between the two cases that suggests *Pludeman* is a marked loosening of New York's pleading standard. Other aspects of the *Polonetsky* decision are notably consistent with *Pludeman.* Both cases agree that ultimately the question is whether a jury could draw reasonable inferences from the facts to support the allegations. *Id.* "Under these circumstances, we are unable to say that a jury could not infer his knowledge of or participation in the fraudulent scheme, given the degree of his personal activities and the nature and extent of the customers' dissatisfaction." *Id.* The *Polonetsky* Court's focus on the "nature and extent" of the fraud is consistent with the Court's focus and reasoning in *Pludeman.* Finally, the *Pludeman* court noted that the facts before it "differ only in degree from *Polonetsky*." *Pludeman*, 10 N.Y.3d at 493. Whether "degree" refers to the greater scope and extent of the alleged fraud in *Pludeman* or the more direct allegations against the officer in *Polonetsky* is unclear and perhaps not so important as whether a jury might be able to "infer" fraud.

Brief Comparison of New York State and Federal Pleading Standards. Comparison with federal precedent suggests New York state courts offer more lenient and flexible pleading standards for fraud than available in federal court. Federal Rules of Civil Procedure ("FRCP") 9(b) states: "In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and

other conditions of a person's mind may be alleged generally." As noted by the dissent in *Pludeman*, the Second circuit applies a "strong inference" rule in evaluating sufficiency of specificity of complaints under FRCP 9(b), whereas, the New York state courts apply a "reasonable inference" rule in evaluating claims under CPLR 3016(b). While the *Pludeman* dissent argued that these standards "do not differ greatly, if at all", the dissent believed the *Pludeman* majority produced a result under state law at odds with the federal standard. *Pludeman*, 10 N.Y.3d at 495.

In *Harsco Corp. v. Segui,* 91 F.3d 337 (2d Cir 1996), plaintiffs claimed against all defendants, including officers of the company, both federal securities fraud and common law fraud relating to a financial transaction between two steel companies. While the claims were dismissed primarily because the contract at issue precluded reliance on allegations of fraud outside of the agreement, the Court explained the purpose of FRCP 9(b): "[t]he policy behind *Rule 9(b)* is (1) to provide a defendant with fair notice of plaintiff's claim, (2) to safeguard a defendant's reputation from 'improvident charges of wrongdoing' and (3) to protect against the institution of a strike suit. *Id.* at 347 (citing *Acito v. IMCERA Group, Inc.,* 47 F.3d 47, 52 (2d Cir. 1995)). Plaintiff failed to adequately plead fraud under FRCP 9(b).

In *Eternity Global Master Fund Ltd. v Morgan Guar. Trust Co.,* 375 F3d 168 (2d Cir 2004), a claim for fraudulent misrepresentation against a corporation arose from a credit default swap transaction. Here, as in *Harsco Corp.*, the fraud claim failed the specificity requirements for an action of fraud under FRCP 9 (b). Plaintiff intended to infer prior knowledge by defendant that a particular market condition would not occur in eight months from the time of the contract execution. The Court held this insufficient. "Although 'malice, intent, knowledge and other condition of mind of a person may be averred generally,' *Fed R. Civ. P. 9(b)*, this leeway is not a 'license to base claims of fraud on speculation and conclusory allegations.'" *Id.* at 187, (citing *Acito v. IMCERA Group, Inc*., 47 F.3d 47, 52 (2d Cir. 1995)). The Court further explained the "strong inference" standard applicable under FRCP 9(b), "'[p]laintiffs must allege facts that give rise to a strong inference of fraudulent intent,' which may be established 'either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.'" *Id.*

This difference between state and federal pleading standards is even more pronounced in federal securities cases, which pleading requirements are a veritable buzz saw for the unwary plaintiff. The plaintiff not only must meet the standard for Rule 9(b) but also the

requirements of 15 USC § 78u-4[b][2]. *See ATSI Communications v. Shaar*, 493 F.3d 87, 98 (2d Cir. 2007).

In *ATSI Communications*, plaintiff sued companies and individual officers for allegedly making misrepresentations in connection with a securities transaction and manipulating the market in violation of §10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), Rule 10b-5, 17 C.F.R. § 240.10b-5 and § 20(a) of the Exchange Act, 15 U.S.C. § 78t(a). Here, the Court affirmed dismissal by the lower court for failure to meet pleading requirements in part because the usual FRCP 9(b) strong inference standard is heightened by additional pleading requirements of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). As noted by the Court:

> A securities fraud complaint based on misstatements must (1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent. *Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000). Allegations that are conclusory or unsupported by factual assertions are insufficient. *See Luce v. Edelstein*, 802 F.2d 49, 54 (2d Cir. 1986). Second, private securities fraud actions must also meet the PSLRA's pleading requirements or face dismissal. See *15 U.S.C. § 78u-4(b)(3)(A*). In pleading scienter in an action for money damages requiring proof of a particular state of mind, 'the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.' 3 Id. § 78u-4(b)(2). The plaintiff may satisfy this requirement by alleging facts (1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness. *Ganino*, 228 F.3d at 168-69. Moreover, 'in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences.' *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 168 L. Ed. 2d 179, 127 S. Ct. 2499, (June 21, 2007). For an inference of scienter to be strong, 'a reasonable person [must] deem [it] cogent and *at least as compelling* as any opposing inference one could draw from the facts alleged.' Id. (emphasis added). *Id.* at 99.

In this case, the Court found plaintiffs did not show any connection between the adverse changes in the market and defendants' actions and, because of heightened pleading

requirements of PSLRA, the inference made in the complaint was not sufficient. The Court explained that in a securities action for fraud, if there is another "plausible nonculpable explanation for the defendants' actions that is more likely than any inference that the defendants intended to manipulate the market" then the complaint fails to meet its pleading requirements. *Id.* at 104. For further cases on FRCP 9(b) pleading requirement standard. *See Manhattan Motorcars, Inc. v Automobili Lamborhini, S.p.A.,* 244 FRD 204 (S.D.N.Y. 2007).

The New York state fraud pleading standard under CPLR 3016(b) is more flexible and less strict. The "reasonable inference" state standard as compared to the "strong inference" federal test, especially when coupled with the heightened PSLRA standards in cases of securities fraud, suggests a lower hurdle for complaints to surmount in pleading fraud. Viewing *Pludeman* in this light, the bar appears to have been lowered "a bit." Additionally, federal law is much more demanding on how each and every element must be pled whereas state law is still relatively amorphous. The state law standard really being "we know it when we see it" standard, *viz.,* we know it when "we are unable to say the jury could not reasonably infer it." *See Pludeman*, 10 N.Y.3d at 493-94; *Polonetsky*, 97 N.Y.2d at 55. This provides greater opportunity for fraud claims to survive in state court, which practitioners should take into consideration in determining the types of claims to pursue and how and where to file fraud complaints.

Conclusion. Two cases to date have relied on *Pludeman*. *See Becher v. Feller,* 19 Misc. 3d 1138A (N.Y. 2008), and *Citibank (South Dakota), N.A. v. Ramirez*, 2008 NY Slip Op 51613U, 2008 N.Y. Misc. LEXIS 4501 (1st Dept. July 28, 2008). Both cases cite *Pludeman* to permit fraud claims to proceed, and both cases quote the exact same language: "The complaint must sufficiently detail the allegedly fraudulent conduct, that requirement should not be confused with unassailable proof of fraud.'" *Becher*, 19 Misc. 3d at 25; *Citibank*, 2008 NY Slip Op 51613U at *1-2 (quoting *Pludeman*). Only *Becher* appears to involve claims against individual defendants, and it appears that plaintiff made specific allegations against those individuals. As a result, we are left for now with our analysis of *Pludeman* and prior law to guide us.

It may be premature to say with certainty if *Pludeman* does in fact loosen the standards under CPLR 3016(b) for claims of fraud against individuals. Notwithstanding the dissent's view in *Pludeman*, state pleading requirements for fraud have not been viewed in practice as the equivalent of federal standards. *Pludeman* could potentially signal an enormous change in the pleading standards if read to allow actions for fraud to proceed against officers of companies based only on their corporate titles. However, it can be

argued that *Pludeman* is consistent with previous New York standards on pleading requirements and is merely a slight departure from an already relaxed standard because of the exceptional facts surrounding this particular allegedly fraudulent scheme. Namely, the scope, duration, magnitude, lease construction and the nationwide reach of the fraud permitted a reasonable inference that the officers and directors of the company knew of or participated in the fraudulent activities. Much like the Court reasoned in *Polonetsky*, this case focused on the "nature and extent" of the fraud as a whole. As in *CPC International,* the *Pludeman* decision gave the allegations their "most favorable intendment" and looked at the complaint as a whole to determine if a reasonable fact finder could infer involvement by the individual defendants, with the caveat that factual questions could reveal more specific information regarding the individuals' acts post discovery.

At a minimum, *Pludeman* suggests New York State courts will continue to apply a more lenient standard of reasonableness than federal courts in evaluating sufficiency of detail in fraud claims against individual officers and directors of companies. The precise implications of *Pludeman*, however, on pleading fraud remain to be seen.

Cross-References. For more information on the New York and federal pleading specificity requirements for fraud, *see Weinstein, Korn & Miller, New York Civil Practice: CPLR Ch. 3016* (practice guide on NY states pleadings)*, Particularity in Specific Actions*; *CPLR Manual § 19.08 Special rules governing pleading of specific issues* (Practice Guide on issue specific NY pleading rules); *Moore's Federal Practice (Matthew Bender 3d ed.), ch 9, Pleading Special Matters §§ 9.02 et seq.* (practice guide on FRCP 9 pleading requirements); and *Pleading Securities Fraud Claims with Particularity Under Rule 9(b)*, *97* HARV L REV *1432* (April 1984).

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