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Employment

NY Court Expands Employer Liability for Economic Harm Due to Negligent Supervision

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Historically, negligent supervision claims under New York law have primarily involved personal injury or property damage rather than economic loss. For that reason, they are only rarely asserted in commercial cases. In *Moore Charitable Foundation v. PJT Partners, Inc.* (*Moore*), however, the New York Court of Appeals (Court) revived a negligent supervision claim in a decision with potentially far-reaching implications for New York employers, including hedge fund managers. This article explains negligent supervision claims under New York law, summarizes the fraud that led to the litigation in question, reviews the history of the *Moore* case and assesses the significance of the Court's opinion.

For more insights from Beaumont, see "What Hedge Fund Managers Need to Know About Arbitration of Disputes" (Feb. 10, 2022).

Negligent Supervision Claims Under New York Law

A negligent supervision claim typically is brought to recover damages from the employer of a so-called "rogue" employee. In addition to proof of damages, a negligent supervision claim requires proof that:

- the relevant employee had a propensity to do the act that harmed the plaintiff;
- the employer knew of that fact or of facts that would cause a reasonably prudent person to investigate the employee's propensity;
- the employer could reasonably have anticipated that the employee's propensity would likely cause injury to others; and
- the employer failed to use reasonable care to correct or remove the employee.

Because the claim is based on negligence, it is also necessary to prove the defendant owed the plaintiff a duty and breached that duty, and that the defendant's breach was the proximate cause of the plaintiff's damages.

A negligent supervision claim is distinct from the doctrine of *respondeat superior*, by which an employer can be held liable for its employee's acts that are within the scope of employment. That doctrine is based on agency principles and therefore applies only when an employee acts within the scope of his or her employment or in furtherance of the employer's interests. In contrast, a negligent supervision claim addresses an employee's conduct that is outside the scope of employment or not in furtherance of the employer's interests.

See "How Can Hedge Fund Managers Legally Penalize Employee Wrongdoing? (Part One of Two)" (Apr. 7, 2016).

The Caspersen Fraud

The lawsuit behind the *Moore* decision arose from a fraud perpetrated by Andrew Caspersen in 2015 and 2016. Caspersen was employed by PJT Partners, Inc. and Park Hill Group, LLC (together, PJT), where he worked in the secondaries business, which facilitates transactions in ownership interests in investment funds. Caspersen specialized in working with private equity fund managers that wanted to offer liquidity to their investors.

The first instance of wrongdoing arose from Caspersen's diversion of an $8.1-million fee owed to PJT by a firm called Irving Place in connection with a major transaction that Caspersen originated and closed in August 2015. A month after PJT should have received payment of the Irving Place fee, the firm's back office asked Caspersen why it had not been received. He told the back office there was a so-called "stub closing" on the transaction, whereby a portion of the interests to be sold had not yet been transferred and paid for; after the stub closing was complete, PJT would receive its full fee.

This explanation for PJT's non-receipt of the fee was false. According to the *Moore* complaint, Caspersen had given Irving Place a fake invoice for PJT's fee, which directed payment to an account controlled by Caspersen rather than a PJT account. Caspersen then used the stolen funds to buy securities, which subsequently lost all their value. Moreover, the Irving Place transaction did not actually involve a stub closing, which in any event should not have prevented PJT from receiving at least some of its fee. The *Moore* complaint alleges that Caspersen's explanation was "implausible and transparently false, and PJT should have recognized that and inquired further" but did not.

In addition to this specific embezzlement scheme, the *Moore* complaint also alleges that PJT knew or should have known that Caspersen engaged in excessive high-risk securities trading for his own account using the firm's facilities, through which he lost millions of dollars – including the diverted Irving Place fee. PJT also knew or should have known that he drank alcohol to excess during the workday.

In the months leading up to the end of 2015, Caspersen, using his PJT email address, contacted a friend who worked at the Moore Charitable Foundation, an entity related to Moore Capital

Management, which was not yet a PJT client. Caspersen offered the foundation an investment opportunity that involved lending money to what the foundation was told was an entity involved in the Irving Place transaction in exchange for a guaranteed 15% return. Caspersen took various steps to make the purported investment opportunity appear genuine, including:

- creating and sending fraudulent documents to the foundation;
- creating an entity called "Irving Place III SPV LLC";
- opening a bank account for that entity, which Caspersen controlled; and
- impersonating a fictitious person named "John Nelson," whose name and purported signature appeared on documents Caspersen gave the foundation in connection with the investment.

In November 2015, the foundation and Caspersen's friend agreed to participate in the purported investment opportunity and together wired a total of $25 million to the "Irving Place III" account that Caspersen created and controlled. Caspersen then wired a portion of those funds to PJT, making it appear that "Irving Place" was at last paying PJT's fee. The *Moore* complaint alleges that PJT either did not notice, or ignored, that the wire came from a source other than the specific Irving Place account from which the fee should have been paid.

Caspersen then made purported interest payments to the foundation for several months, thus maintaining the fiction of a bona fide investment. In March 2016, Caspersen asked the foundation to make further investments, and, as part of its due diligence, the foundation asked to speak with John Nelson. After various incongruities arose as a result of those inquiries, the foundation confronted Caspersen and the fraud was revealed. Caspersen was promptly arrested and pled guilty to federal securities and mail fraud charges.

The *Moore* Lawsuit

In June 2017, the foundation and an affiliate sued the two PJT entities and Caspersen in New York state court, asserting seven claims, including four against PJT, which consisted of two fraud claims on alternate theories of apparent authority and *respondeat superior*; a claim for negligent supervision/retention; and a claim for conversion.

PJT moved to dismiss all the claims against it, and, in August 2018, the court declined to dismiss the claim for fraud based on an apparent authority theory but did dismiss all other claims against PJT, including the claim for negligent supervision. Both the plaintiffs and PJT appealed. (The claims against Caspersen were not at issue on appeal.) In December 2019, the Appellate Division, First Department affirmed the lower court's decision and also dismissed the remaining fraud claim against PJT, thus ending the case as to PJT.

The plaintiffs then sought and obtained leave to appeal to the Court. On June 13, 2023, the Court issued its opinion, reversing the Appellate Division and reinstating the claim against PJT for negligent supervision, thus allowing the case to proceed to discovery.

The Court's Opinion

The Court's opinion has two major components. First, the Court found the *Moore* complaint adequately alleged PJT's actual or constructive notice of Caspersen's propensity to commit fraud. Second, the Court held that PJT owed the plaintiffs a duty to supervise Caspersen even though they were not yet PJT's clients or customers when Caspersen approached them about the bogus investment opportunity.

Notice of Propensity to Commit Fraud

At oral argument, the Court questioned the plaintiffs' counsel extensively about whether the complaint alleged sufficient facts to raise an inference that PJT had notice of Caspersen's propensity to commit fraud. The Court ultimately held that PJT's alleged knowledge of Caspersen's risky securities trading and alcohol abuse did not by themselves justify such an inference. It noted the "significant disconnect between excessive drinking and obsessive personal stock trading – neither of which are illegal or tortious – and the sophisticated fraud Caspersen ultimately perpetrated against plaintiffs."

Nonetheless, the Court concluded that the plaintiffs had adequately alleged PJT's notice of Caspersen's propensity, citing other allegations. First, the Court clarified that allegations that PJT had constructive notice – *i.e.*, that it should have known – of Caspersen's dangerous propensity were sufficient; allegations of PJT's actual knowledge were not required. The Court then noted that, in addition to the allegations of excessive drinking and stock trading, the complaint contained other allegations regarding the missing Irving Place fee and Caspersen's sloppy attempts to cover up his embezzlement of it. The Court also noted the plaintiffs' allegations that PJT's back-office personnel should have recognized something was amiss because of their familiarity with how a transaction with a stub closing works, which was contrary to Caspersen's explanation for the unpaid fee. In addition, the Court observed that the complaint alleged "that Caspersen engaged in at least one other similar diversion-and-cover-up scheme" and that further discovery could reveal more of the same.

Taking those allegations together, the Court concluded the plaintiffs' allegations of PJT's notice of Caspersen's propensity to commit fraud satisfied the liberal pleading standards applicable on a motion to dismiss.

Duty to Non-Clients

The Court then turned to PJT's argument that it owed no duty to non-clients such as the plaintiffs. The Court stated that "[w]e have never held that a cause of action for negligent supervision and retention is maintainable only by customers of the defendant" and "expressly reject[ed]" any requirement of a special relationship or privity between a plaintiff and an employer for a negligent supervision claim. It noted that other elements of the claim – particularly the requirements of actual or constructive notice and proximate cause – "already protect employers from limitless liability" to "an indeterminate class of plaintiffs."

Two judges dissented from this second component of the majority opinion, arguing that it "exposes law firms, banks, hedge funds, and countless other financial institutions to limitless liability for the criminal actions of rogue employees" and "will all but transform employers into insurers." The dissent characterized the majority opinion as permitting "all potential customers to sue employers for an employee's fraud unrelated to the employment but perpetrated via company email or phone." Indeed, the dissent argues that the majority opinion effectively overruled the Court's 1985 decision in *Credit Alliance Corp. v. Arthur Andersen & Co.*, which held that an accountant's negligence liability for economic harm extends only to those in privity or "a relationship sufficiently intimate to be equated with privity" with the accountant.

For more on *Credit Alliance*, see "Hedge Fund Service Providers Must Exercise Caution When Communicating With Investors or Face Liability" (May 26, 2016).

The Opinion's Significance

It will be interesting to see if the *Moore* decision breathes new life into negligence claims in the commercial context, as the dissent predicts. To be sure, the opinion provides new guidance on what would be necessary to state such a claim.

Notice Requirement

Specifically, there must be a substantial connection between the conduct that allegedly gives the employer notice of an employee's propensity for wrongdoing and the employee's specific wrongdoing against the plaintiff. In particular, it is not sufficient to allege simply that an employee misbehaved prior to harming the plaintiff, particularly when the misbehavior is not itself illegal or tortious, such as Caspersen's excessive securities trading and alcohol abuse.

However, the majority took an expansive view of the type of knowledge and conduct that give rise to the requisite notice. Specifically, the Court's determination that the plaintiffs had sufficiently alleged PJT's notice of Caspersen's dangerous propensity to commit fraud relied on the missing Irving Place fee and Caspersen's sloppy effort to cover up his embezzlement of that fee, coupled with an allegation that he had committed "at least one other" unspecified fraud.

Indeed, the Court seemed to overlook some evident weaknesses in the plaintiffs' allegations. For example, the plaintiffs alleged, among other things, that Caspersen's diversion of the Irving Place fee could have been detected by PJT's back office because it came from "the wrong account." This, however, ignores the fact that the account from which Caspersen wired the funds to PJT did bear an "Irving Place" name, although not that of the specific Irving Place entity that actually owed the fee. In light of that, it seems a stretch to allege that the specific account name of the payor ought to have attracted notice.

Moreover, although the Court expressly cited the plaintiffs' allegations of "at least one other" fraudulent scheme by Caspersen as tipping the balance against dismissal, those allegations are notably vague, referring only to "another earlier crime in which, as with the Irving Place fee, Caspersen had diverted funds."

Privity Requirement

Contrary to the dissent's view, it seems unlikely that the *Moore* decision amounts to a wholesale rejection of the existing privity requirement for certain negligence claims seeking recovery of economic losses under New York law, which the Court established in *Credit Alliance*, an accountant malpractice case. For one thing, the privity/near-privity requirement of *Credit Alliance* and its progeny arguably already has been limited to negligent misrepresentation claims.

Moreover, notwithstanding the rather catastrophizing rhetoric of the *Moore* dissent, the facts in the *Moore* case are easily reconciled with those in the *Credit Alliance* decision. *Credit Alliance* involved the consolidated appeals of two claims of alleged accountant negligence brought by two differently situated plaintiffs, Credit Alliance Corp. (CAC) and European American Bank and Trust Company (European American), which ultimately had very different outcomes.

CAC sued a company's accountant for negligence in preparing its financial statements, upon which CAC had relied in deciding to lend to the company. Critically, before the lawsuit was filed, the defendant accountant had no contact with or knowledge of the plaintiff, which had obtained the financial statements from the company without the accountant's knowledge or participation. In addition, there was no allegation the accountant had prepared the financial statements for the use of that particular lender or any particular transaction. Thus, the Court held that the accountant owed no duty to such a prospective lender absent privity – *i.e.*, a contract – or something approaching that type of "intimate" relationship. The fact that it was foreseeable that the company would enter into financing relationships with lenders in general was specifically found to be insufficient to expose the accountant to negligence liability to this particular lender.

European American, in contrast, was the principal lender to the company whose financial statements were at issue – and that was known to the accountant, who also was aware of the terms of the lending relationship and was "fully aware" that the lender was relying on the financial statements certified by the accountant in that case. Moreover, the lender and the accountant allegedly had direct communications during the entire course of the lending relationship. The Court thus concluded that the requisite "direct nexus between the parties" was alleged, supporting claims for both negligence and gross negligence.

If the framework established in *Credit Alliance* were to apply in the context of negligent supervision, PJT, which allegedly had direct contact with the plaintiffs through the rogue employee Caspersen, seems to be more like European American than CAC. Moreover, the Court's opinion in *Moore* indicates that the *Credit Alliance* framework might well be inapplicable outside the specific relationships at issue in those cases.

Conclusion

The *Moore* case is ongoing, and it will be interesting to watch what happens next, as well as how the Court's decision affects other future cases. For now, however, the lesson of that decision is that employers' risk of potential negligent supervision liability for economic harm to third parties may be greater than previously thought. On a practical level, this counsels that an employer should be less patient with or tolerant of even a single instance of dishonesty or other problematic conduct by an employee who is in a position to use the employer's facilities to defraud others.

In businesses in which large sums of money are routinely in play – particularly the "law firms, banks, hedge funds, and countless other financial institutions" the *Moore* dissent cited – this risk could be especially acute. Employers therefore should consider maintaining policies and procedures to limit (or, preferably, preclude) any single employee's ability to act autonomously with respect to the funds of third parties – whether or not they are current clients – that the firm might handle. Firms also may wish to factor this potential risk into decisions about appropriate liability insurance coverage and policy limits.

For a look at the duty to supervise, see our three-part series: "Recent SEC Enforcement Actions Claim Violations by Broker-Dealers and Investment Advisers" (Sep. 6, 2018); "Conduct Proper Trade and Electronic Communications Surveillance" (Sep. 13, 2018); and "Respond to Red Flags; Implement Reasonable Policies and Procedures; and Conduct Adequate Training" (Sep. 20, 2018).

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