Not Reported in N.W.2d, 1994 WL 481345 (Minn.App.)
(Cite as: 1994 WL 481345 (Minn.App.))

Court of Appeals of Minnesota.
NORTHWEST RACQUET SWIM AND HEALTH CLUBS, INC., Respondent,
v.
DELOITTE & TOUCHE, f/k/a Touche Ross and Company, Appellant.
No. C9-94-301.

Sept. 6, 1994.
Review Granted Nov. 16, 1994.

Appeal from District Court, Hennepin County; Gary Larson, Judge.
Kay Nord Hunt, Phillip A. Cole, and James M. Lockhart, Lommen, Nelson, Cole & Stageberg, P.A., Minneapolis, for respondent.

Charles Quaintance, Jr., Lawrence M. Shapiro, Wayne S. Moskowitz, and Brenda J. Arndt, Maslon, Edelman, Borman & Brand, Minneapolis, for appellant.

Considered and decided by AMUNDSON, P.J., and HUSPENI and KALITOWSKI, JJ.

OPINION

AMUNDSON, Judge.

***1** In a discretionary review of an order denying summary judgment, appellant argues that (1) respondent's claims should be dismissed as derivative, (2) there is no genuine issue of material fact regarding respondent's actual and justifiable reliance on the auditing firm, (3) Midwest Federal's criminal conduct was an intervening superseding cause of respondent's losses, and (4) it owed no duty to respondent under Restatement (Second) of Torts § 552 (1976). We reverse and remand.

FACTS

Appellant Deloitte & Touche (Touche) is an accounting firm that was engaged by Midwest Federal Savings & Loan Association (Midwest) as an independent certified public accountant from the late 1970s to 1988. Respondent Northwest Racquet Swim and Health Clubs, Inc. (Northwest) is a closely held Subchapter S corporation owned by members of the Wolfenson and Ratner families. All financial decisions for Northwest are made by Harvey Ratner and Marvin Wolfenson, its founders, co-owners, officers, and sole directors. Northwest had a long history of dealing with Midwest.

In December 1987, as part of a single transaction, Midwest loaned Northwest $100 million and Northwest bought a $15 million subordinated debenture from Midwest. Under the terms of the debenture agreement, Midwest was to make quarterly interest payments at the rate of 11.5% beginning December 31, 1987 and the principal was to be repaid on December 29, 1995.

In February 1989, the Federal Home Loan Bank Board declared Midwest insolvent. Midwest defaulted on the debenture.

In May 1989, Northwest sued Midwest seeking rescission of the subordinated debt security agreement and a declaration of its right to set off the entire unpaid balance against amounts due from Midwest's loan to Northwest. These claims were dismissed. *See Northwest Racquet Swim & Health Clubs, Inc. v. FSLIC*, 721 F.Supp. 211 (D.Minn.1989), *aff'd sub nom. Northwest Racquet Swim & Health Clubs, Inc. v. RTC*, 927 F.2d 355 (8th Cir.1991), *cert. denied*, --- U.S. ---- (1991). In December 1990, Northwest sued Green Tree Acceptance, Inc. and fifteen of Midwest's former directors and officers. *See Northwest Racquet Swim & Health Clubs, Inc. v. Green Tree Acceptance, Inc.*, No. 4-90-CV-930 (D.Minn.).

After the claims against Green Tree were dismissed, Northwest brought this action in February 1992, asserting claims against Touche for common law fraud, consumer fraud, and negligence. Northwest alleged

that:

> Touche knew that the FIR [FN1] was worth substantially less than the $153 million at which Green Tree had it recorded. Midwest Federal, on Touche's recommendation and advice, recorded the FIR at $188 million although Touche knew the value of the FIR asset was materially less than that amount. As a result, Midwest Federal's financial statements, prepared by Touche, materially misstated its true financial condition. This misstatement remained on Midwest Federal's financial statements until after 1987.
>
> > FN1. "Finance Income Receivable"-a bank asset that was an income stream from the pooling of 80,000 mobile home loans.
>
> ***2** During the months following the May 1985 FIR transaction, Midwest Federal continued its long standing practice, well known to Touche, of selling its debentures to certain investors. As a result, Midwest Federal sold millions of dollars in debentures using the same inaccurate financial information, and making the same material misrepresentations.
>
> Northwest purchased $15 million of these debentures on December 29, 1987. Northwest purchased these debentures in reliance on Midwest Federal's inaccurate and misleading financial statements. Midwest Federal is now insolvent and in receivership prepared by Touche. A major and significant cause of the failure of Midwest Federal and its default on the debentures was the purchase of the FIR asset for an amount which greatly exceeded its true value. As a result, Northwest has lost its entire investment in the Midwest Federal debentures. Northwest seeks to recover that loss in this action.

Touche moved for summary judgment. The district court denied Touche's motion for summary judgment and this court granted Touche's petition for discretionary review.

DECISION

On appeal from the denial of a motion for summary judgment, this court must examine the record to determine whether any genuine issues of material fact exist and whether the district court erred in applying the law. *Rasivong v. Lakewood Community College*, 504 N.W.2d 778, 781 (Minn.App.1993), *pet. for rev. denied* (Minn. Oct. 19, 1993).

Touche argues that Northwest's claims should be dismissed because they are derivative.

Minnesota adheres to the general principle that an individual shareholder may not assert a cause of action that belongs to the corporation. *Arent v. Distribution Sciences, Inc.*, 975 F.2d 1370, 1372 (8th Cir.1992). This principle applies to the claims of subordinated debenture holders as well. *National City Bank v. Coopers & Lybrand*, 409 N.W.2d 862, 868 (Minn.App.1987), *pet. for rev. denied* (Minn. Oct. 21, 1987).

A well-recognized method for determining whether a claim belongs to the corporation, rather than its shareholders, is to ask whether the injury to each stockholder is of the same character. *Arent*, 975 F.2d at 1372. The crucial inquiry is not whether Touche owed a duty to Northwest, but whether the injury Northwest suffered was direct. *See National City Bank*, 409 N.W.2d at 868. To bring a direct action, creditors must allege a direct injury to them that is separate, distinct, and not dependent upon the injury caused to the corporation. *Id.*

Northwest alleges no such injury in this case. Northwest was injured when Midwest became insolvent and defaulted on the debenture. Had Midwest not defaulted, Northwest would have had a right to receive its bargained-for interest payments and return of its principal.

This case is similar to *Arent* and *National City Bank*. In *Arent*, as in this case, plaintiffs alleged that non-disclosures deprived shareholders of negative information about the company, which affected their investment decisions. 975 F.2d at 1372-73. The *Arent* court's analysis is instructive:

> ***3** We agree with plaintiffs that fraud may give rise to claims for direct shareholder recovery, but only when the fraud causes separate and distinct injury to the plaintiff shareholder(s). For example, in *Grogan v. Garner*, 806 F.2d 829 (8th Cir.1986), a corporate officer structured a takeover so that a group of favored shareholders would receive additional assets

> and then withheld this information in order to induce plaintiffs to sell their stock at the offered price. We upheld an individual recovery by the shareholder plaintiffs, noting that only some of the shareholders were injured and that this was a direct fraud on the plaintiffs. Here, on the other hand, DSI's failure to disclose that the merger would fail affected all LAN shareholders equally. Therefore, this is not an individual shareholder claim. As the Seventh Circuit said in *Kagan v. Edison Bros. Stores, Inc.*, 907 F.2d 690, 692 (1990), "the nub of the problem is that the investors' injury flows not from what happened to them ... but from what happened to [the company]."

Id. at 1373 (footnote omitted). In this case, the alleged fraud was not direct. There was no direct contact between Touche and Northwest. Northwest only got hurt if Midwest failed. Contrary to Northwest's assertion that it bought a worthless security, it was guaranteed a rate of return and a date of return of its capital, and the nub of Northwest's problem flows from what happened to Midwest-its insolvency and inability to pay Northwest 11.5% interest quarterly and return the $15 million on December 29, 1995.

In *National City Bank*, the court noted that "[t]he noteholders' alleged injury exists only because [the corporation] was injured, and the amount of their injury is wholly dependent on the diminution of the value of [the corporation's] assets." 409 N.W.2d at 869. In this case, Northwest was to receive a set rate of return and a return of the principal on a certain date-the only way Northwest would not get the benefit of the bargain was if Midwest became insolvent. Thus, Northwest's injury was dependent on injury to Midwest, making the injury indirect, not direct.

Northwest claims that Touche is focusing on only one part of the complaint and that its claim against Touche is not for what Touche did to Midwest Federal but for its misrepresentation/fraud in the inducement of Northwest to invest $15 million with Midwest Federal. Northwest argues that its claim focuses on what was done to it when it invested $15 million to purchase "a wholly worthless security." The debenture, however, only became worthless when Midwest defaulted. Up until that time, Northwest had a right to receive a certain level of interest and a right to the repayment of the principal on December 29, 1995.

Our conclusion is in accord with other federal courts that have considered similar issues. In *In re Sunrise Sec. Litigation*, 916 F.2d 874 (3d Cir.1990), depositors at the original savings and loan association and its successor brought suit against the officers and directors of the original association, alleging RICO violations and other claims. Plaintiffs in that case contended that the gravamen of their complaint was that defendants' fraud induced them to deposit their money and maintain their accounts in the original association, Old Sunrise. *Id.* at 882. Their claim of fraudulent inducement was based on allegations that defendants misrepresented Old Sunrise as a "well run and secure" institution in "publicly disseminated materials," and that defendants failed to disclose that Old Sunrise was not financially secure, that they had mismanaged Old Sunrise, that they had omitted information from financial statements, and that they had engaged in self-dealing. *Id.*

***4** The court concluded that, although the allegations were cast in terms of defendants' misrepresentations of and failure to disclose information, those allegations did not state a claim of direct injury founded on fraud since "the asserted injury emanated from mismanagement, not fraud" and their injury could not be separated from the injury suffered by the institution and all other depositors. *Id.* at 883. The court noted that "[p]laintiffs do not assert and the record does not disclose that they received personal assurances from defendants that Old Sunrise was financially stable" but instead relied on publicly disseminated materials that were available to all depositors alike. *Id.* at 887.

In two later cases, the Third Circuit Court of Appeals distinguished *Sunrise* and concluded that the claims were not derivative. In *University of Md. v. Peat Marwick Main & Co.*, 923 F.2d 265 (3d Cir.1991), the policyholders of an insolvent insurer brought an action against an independent auditor of the insurer's books, seeking damages allegedly resulting from the auditor's false and misleading certification of the insurer's financial statements.

The court distinguished *Sunrise* by noting that the policyholders did not allege that the auditor's actions caused the insurer's insolvency, but rather that the auditor wrongfully certified the insurer's financial statements, upon which the policyholders relied to their detriment. *Id.* at 274.

In *Hayes v. Gross,* 982 F.2d 104 (3d Cir.1992), a purchaser of stock in a state-chartered savings association that was in receivership of the Resolution Trust Company brought a securities fraud suit against officers and directors of the association. Plaintiff alleged that defendants knowingly or recklessly misrepresented the financial and operating condition of the association, that this resulted in the artificial inflation of the market price for the stock, and that plaintiff and others were injured when they purchased stock at an inflated price. *Id.* at 105.

The court noted that in *Sunrise,* plaintiffs did not allege that the Old Sunrise certificates of deposit they were induced to buy were worth less when received than they paid for them. *Id.* at 108. The court concluded that plaintiff had alleged a direct injury from fraud:

> Plaintiff's claim is based on specific misrepresentations that affected prospective purchasers similarly situated to plaintiff differently from existing stockholders. Plaintiff here seeks to recover the difference between the allegedly inflated price he paid for his stock and the price he would have paid had defendants made accurate statements regarding such subjects as the adequacy of Bell's loan reserves and the strength of Bell's assets.

Id.

Touche argues that this case is like *Sunrise.* Northwest argues that this case is more like *University of Md.* and *Hayes.* We agree with Touche. [FN2]

> FN2. In analyzing whether Northwest's claims are derivative, we look to the body of the complaint, not the labels Northwest uses. *See Sunrise,* 916 F.2d at 882 (whether a claim is derivative is determined from the body of the complaint rather than from the label employed by the parties); 12B Fletcher Cyclopedia of the Law of Private Corporations §§ 5908, 5912 (1993) (same). Thus, we reject Northwest's contention that its consumer fraud claim cannot be derivative since it could not have been brought by the bank since Northwest was the "consumer," i.e., it was the one that purchased the debenture.

First, Northwest, like the plaintiffs in *Sunrise,* was injured at the time of Midwest's insolvency, not the time of purchase. *See Hayes,* 982 F.2d at 108 (noting that plaintiffs in *Sunrise* acknowledged that they suffered no loss at the point of purchase, but that the plaintiffs in *Hayes* alleged injury at the time of purchase of stock due to inflated price of stock); *cf. Riley v. Simmons,* 839 F.Supp. 1113, 1126 (D.N.J.1993) (plaintiffs did not allege they were injured as of the date of their purchase of annuities, but instead alleged that their injury did not occur until after the insurer became insolvent). Until about April 1989, Midwest had been making interest payments to Northwest on the debenture. Up until April 1989, Northwest got the same benefits from the debenture agreement as it would have received had Midwest not defaulted. Thus, Northwest's injury did not occur at the time of purchase.

***5** Second, Northwest does not allege it received personal assurances, but instead relied on publicly-disseminated materials. *See Sunrise,* 916 F.2d at 887; *Riley,* 839 F.Supp. at 1126 ("Plaintiffs do not suggest that they relied on any unique information which was privately disseminated by a director. Plaintiffs instead refer to their reliance on publicly disseminated information); *Tafflin v. Levitt,* 608 A.2d 817, 820 (Md.App.1992) (depositors alleged that they were fraudulently induced to deposit their money but they "allegedly relied upon misleading information available to all depositors" and thus their allegations of fraudulent representations were not distinct from the injury sustained by the savings and loan association and all its depositors), *cert. denied* (Md. Nov. 10, 1992).

Third, Northwest alleged that Touche's actions were a cause of Midwest's insolvency. *See University of Maryland,* 923 F.2d at 274 (the policyholders did not allege that the auditor's actions caused the insurer's insolvency); *see also Tafflin,* 608 A.2d at 820 (distinguishing *University of Maryland* on the ground that "the policyholder's claims were not premised on conduct that had injured the institution"). Northwest alleged in its complaint that the "major and significant contributing factor to Midwest Federal's failure and its default on the Debenture was the losses resulting from its purchase of the FIR from Green Tree at a cost which was substantially in excess of its value."

Northwest argues that holding its claim to be derivative would be at odds with Restatement (Second) of

Torts § 552 (1976) [FN3] as adopted by the Minnesota Supreme Court in *Bonhiver v. Graff*, 311 Minn. 111, 121-122, 248 N.W.2d 291, 298-99 (1976). Northwest contends that holding that such claims are derivative would prohibit all third parties from bringing a § 552 claim whenever the third party professional's conduct also eventually harmed the client. As Touche correctly notes however, just because Northwest's claim is derivative does not mean that a third party cannot plead a non-derivative claim that satisfies *Bonhiver* and § 552. *See National City Bank*, 409 N.W.2d at 869 (holding that noteholders' claim was derivative was in accord with *Bonhiver*).

> FN3. Section 552 establishes liability for those who supply "false information for the guidance of others in their business transactions" under certain circumstances.

Thus, we conclude that Northwest's claims are derivative. Since we conclude that Northwest's claims are derivative, we need not address the other issues raised by Touche. Accordingly, we reverse the decision of the district court and remand for entry of summary judgment for Touche.

Reversed and remanded.

Minn.App.,1994.
Northwest Racquet Swim and Health Clubs, Inc. v. Deloitte & Touche
Not Reported in N.W.2d, 1994 WL 481345 (Minn.App.)

END OF DOCUMENT