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NY Employers Face Expanded Liability for Negligent Supervision

Can a New York employer be held liable for economic losses suffered by a party that has no business relationship with the employer based on an employee's unauthorized fraudulent scheming? This issue was recently presented to the New York Court of Appeals. The Court recognized such liability on a claim of negligent supervision and retention notwithstanding a vigorous dissent.

In *Moore Charitable Foundation v. PJT Partners, Inc*., the plaintiff alleged that it had been swindled out of $25 million through a fraud perpetrated by an employee of the defendant, an investment bank. The employee used his position as a manager of large-scale investment transactions and his access to confidential data from the deals that he handled to dupe the plaintiff, through a personal relationship, into investing $25 million in a fictitious financial security. The employee then stole the investment, using $8 million to cover a prior embezzlement scheme and losing most of the balance through high-stakes securities speculation.

The plaintiff sued the employer alleging negligent supervision and retention of the employee who committed the fraud. This claim had been dismissed by the lower courts because the plaintiff was not a customer and had no other special relationship to establish privity with the defendant that would give rise to a duty of care.

A claim for negligent supervision or retention is a tort that generally requires a showing of a duty owed to the plaintiff by the defendant, a breach of that duty and injury proximately resulting from that breach. Specifically, in the context of a negligent retention or supervision claim, the plaintiff must prove that: (i) the employer had actual or constructive knowledge of the employee's propensity for the sort of behavior which caused the plaintiff harm; (ii) the employer knew or should have known that it had the ability to control the employee and knew of the necessity and opportunity for exercising such control; and (iii) the employee engaged in tortious conduct on the employer's premises or using property or resources available to the employee only through their status as an employee. Liability only arises, however, if the defendant owed a duty of care to the plaintiff. "[A]bsent a duty running directly to the injured person there can be no liability in damages, however careless the conduct or foreseeable the harm."

The question of whether a defendant employer owes a duty of care to a plaintiff is a legal issue, not a question of fact, and a matter to be resolved by the court, not by a jury.

In *Moore*, the defendant argued it owed no duty of care to the plaintiff, and therefore could not be sued on a negligence theory, because it had no relationship with the plaintiff that was not a customer or a prospective customer. The Court, however rejected this defense.

The majority reasoned that in establishing the appropriate legal standard, it needed to balance interests and apportion risks. "We fix the point of a duty in a particular case 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." Assessing these factors, the Court concluded that a customer relationship or other privity was not a prerequisite to a negligent supervision or retention claim. The Court relied on precedent involving an employer's liability for physical injuries to an unrelated third party in support of its decision to allow liability for financial losses and further reasoned that an employer's duty to supervise its employee together with the other limitations on liability in the tort doctrine (including adequate knowledge of the employee's negligent proclivity and causation) were sufficient to justify imposing the risk of loss and, thus, this new liability, on employers.

Having found the potential for liability, the Court turned to whether the plaintiff had adequately alleged that the employer knew or should have known of the employee's propensity to commit fraud. In *Moore*, there were allegations that the employee drank to excess, including while at work, and also obsessively engaged in personal high-risk securities trading. The Court found these allegations to be too remote to put the employer on notice of the potential for large scale fraud. However, the plaintiff also alleged that the employee had misappropriated an $8 million fee due to the employer from a deal the employee had handled and covered up his theft by lying to his employer. The plaintiff alleged that the bogus explanations that the employee gave to his employer were so implausible and transparently false that a reasonable employer would have investigated and uncovered the employee's embezzlement in time to prevent his defrauding of the plaintiff. The Court concluded that these allegations were sufficient to defeat the defendant's motion to dismiss and allow the negligent supervision and retention claim to proceed. Significantly, the plaintiff was not required to show that the employer had actual knowledge that the employee was likely to commit fraud; constructive knowledge – meaning a reasonable employer should have known – was sufficient. The Court also noted, as further justification for its holding, that evidence as to what the defendant knew, and when, was primarily in the defendant's control to be established in pre-trial discovery.

The dissent was alarmed by the potential ramifications of the majority's ruling. While, in prior cases, employers had been found liable for the negligent retention or supervision of their employees who injured unrelated third parties, those cases involved claims of physical injuries (*e.g.*, the employee with a bad driving record who injures a pedestrian in a preventable traffic accident). The dissent argued that financial injuries were, and should be, subject to a different result – requiring a showing of a customer or similar special relationship – otherwise the potential for liability from a rogue employee would be limitless.

> "Permitting all potential customers to sue employers for an employee's fraud unrelated to the employment but perpetrated via company email or phone would result in unmitigated proliferation of claims and virtually unlimited liability, well beyond the traditional concepts of respondeat superior and apparent authority. . . . [Now] any time an employee makes use of 'the employer's premises' or of 'property or resources available to the employee only through their status as an employee,' the employer may be held liable in negligent supervision. . . . [By the majority's] logic, any employee, regardless of their title, who goes into the office or uses a telephone to defraud any third party may expose the employer to liability. Arguably, employers now could owe a duty to virtually anyone."

The *Moore* decision presents a cautionary tale for financial institutions, law firms and other financial services firms, as well as those managers responsible for the accounting and financial operations at any New York employer. As the dissent cautioned: "Today's majority opinion . . . exposes law firms, banks, hedge funds, and countless other financial institutions to limitless liability for the criminal actions of rogue employees." This expansion of potential liability warrants a re-calibration of how diligently employers investigate and respond to allegations of employees' mismanagement, misappropriation or other wrongdoing in financial affairs because such incidents could now be the predicate for the employer's "constructive knowledge" of the employee's propensity in the future to defraud some third party. Human resources managers and counsel will need to carefully evaluate this new risk of liability in their decision making as these situations arise.

If you have any questions about the information presented in this blog post, please contact Thomas Eron, any attorney in Bond's labor and employment practice or the Bond attorney with whom you are regularly in contact.

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