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I've Been Sued for *What?* — Fiduciary Duty Claims Against Hedge Fund Managers and How to Avoid Them

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I've Been Sued for *What?* — Fiduciary Duty Claims Against Hedge Fund Managers and How to Avoid Them

By Zachary G. Newman and Jonathan M. Proman[i]

Not every investment or transaction performs as planned. Losses and depressed asset values have compelled certain investors to file breach of fiduciary duty claims against hedge, asset, and investment managers in an attempt to recoup losses. This article outlines "fiduciary duty" by providing and overview of what every manager should know about this area of law.

The Basic Principal: Selfless Obligation to the Fund or Investment

Fiduciary duty is largely judge-made law. The 1928 New York case *Meinhard v. Salmon*[ii] helped crystallize fiduciary duty's meaning. A fiduciary, such as a hedge fund manager, must place the fund's interests before the manager's own while exercising due care in the decision-making process.[iii] Courts with "[u]ncompromising rigidity" enforce fiduciary-duty law to ensure "the level of conduct for fiduciaries [is] kept at a level higher than that trodden by the crowd."[iv] Contemporary case law has distilled this principle into two components: (i) the duty of loyalty and (ii) the duty of care.[v] "Fiduciary duty" consists of these twin obligations.

The Duty of Loyalty

The fiduciary duty of loyalty may be summarized as four obligations: (i) candor;[vi] (ii) conflicts of interest avoidance;[vii] (iii) the "company opportunity" doctrine;[viii] and (iv) good faith.[ix]

A. Candor

Candor is straightforward: a fiduciary, such as a hedge fund manager, must always disclose material information fully to investors.[x] Withholding material information from investors or others may be as wrongful as affirmatively misrepresenting such information. Subsequently learning that earlier communications were false and failing to correct them also may be a duty of loyalty breach because of lack of candor.[xi]

B. Conflicts of Interest

Conflicts of interest should be avoided. Generally, a conflict exists where a manager is on "both sides" of a proposed transaction.[xii] Example: a fund enters into a transaction with its manager or another entity with which the manager also is affiliated.[xiii] Sometimes transactions with affiliated companies may be attractive because of the purported "conflict." But, managers should not decide unilaterally whether a conflicted transaction is proper and should exercise caution if they represent or have interests on both sides of the transaction. If you're a manager and affiliated in any way with both parties to the deal, it is wise to *always*

begin with an assumption that a conflict exists and ensure the conflict is properly addressed to help protect against potential claims.[xiv]

Some statutes provide certainty to managers presented with benign conflicts, by setting forth procedure which, when followed, shields the fiduciary from potential liability and permits a potentially conflict-tainted transaction to occur lawfully. For example, with respect to corporations, Delaware General Corporation Law § 144 provides that a conflicted transaction is *not* void or voidable where a transaction is:

- authorized by a majority of disinterested directors; or
- approved by shareholders in good faith; or
- fair to the company at the time entered into.[xv]

New York's Business Corporation Law § 713 is similar.[xvi] Partnerships present a somewhat different situation. In Delaware, Revised Uniform Partnership Act § 15-404 sets forth the fiduciary duties of loyalty and care general partners owe to one another and to limited partners. But, unlike with respect to corporations, a Delaware statutory process for ratifying an interested partner transaction is absent. Nonetheless, Delaware may apply corporate-law principles to a conflicted-partner transaction.[xvii]

Similarly, New York partners owe fiduciary duties to each other, but the Partnership Law does not state a ratification process. Courts have held, however, that "New York makes no distinction between the fiduciary duty owed by a general partner and that owed by a corporate director," and New York may apply the same tests used in corporate law for analyzing a conflicted-partner transaction.[xviii] What *is* certain is that ignoring a potential conflict invites a fiduciary duty lawsuit.

C. Company Opportunity Doctrine

Limited liability companies treat fiduciary duties differently in many states. For example, in Delaware, the prevailing law is that fiduciary duties can be waived. For a more detailed discussion on the enforceability of fiduciary duty waivers, see http://apps.americanbar.org/litigation/committees/commercial/articles/spring2013-0513-enforceability-of-fiduciary-duty-waivers.html.

The company opportunity doctrine does *not* involve a fund manager on both sides of a transaction but addresses a prospective business opportunity rightfully belonging to the fund, not to a manager in his or her individual capacity.[xix] For example, a fund manager may learn of a business opportunity in the course of acting as fund manager; the duty of loyalty in such circumstances often obligates the fund manager to offer the opportunity *to the fund* before the manager may consider it for personal benefit.[xx]

But where does one draw the line between a prospective transaction being a fund opportunity, versus something learned of by a fund manager in an individual or other capacity? Generally, it is a fact-intensive issue, considering how the fund manager learned

of the business opportunity and whether the opportunity is in the line of business in which the fund invests.[xxi] At a minimum, disclosing the opportunity is a prudent precaution.[xxii]

D. Good Faith

Good faith is an overriding element of the duty of loyalty. A fund manager, for example, cannot avoid a fiduciary duty breach by willfully ignoring red flags.[xxiii] The intentional dereliction of duty or conscious disregard for one's responsibilities also could result in liability for breach of the duty of good faith.[xxiv]

The Duty of Care

The duty of care obligates a managers to exercise the skill and diligence of a reasonably prudent person.[xxv] At first blush, the duty of care might appear straightforward. But, knowing precisely what the duty of care targets is essential for managers to understand the full scope of fiduciary duty imposed by law. The duty of care may be subdivided into two components: (1) substantive due care and (2) procedural due care.[xxvi]

A. Substantive Due Care

Substantive due care focuses on the merits of a fund manager's decision making.[xxvii] By itself, substantive due care seldom results in a manager's liability for investments gone sour. Only a manager who completely neglects his or her duties by entering into a "no win" transaction or course of conduct likely would be liable for a stand-alone substantive due care-based breach of fiduciary duty.[xxviii] Of course, concomitant loyalty breaches would make a court more inclined to find a money-losing decision was defective on the merits as well.

B. Procedural Due Care

As its name suggests, procedural due care focuses on whether a fund manager properly vetted a proposed transaction during the decision-making process. Courts may find a fund manager in breach of the fiduciary duty of care by failing to conduct adequate due diligence before selecting an investment, or by failing to subsequently monitor investment performance.[xxix]

Conclusion

Knowing what fiduciary duty consists of can help managers insulate themselves from liability. Volatile capital markets often mean an asset manager's returns will not outperform the benchmark. Even when underperforming, managers may help to mitigate the risk of breach of fiduciary duty lawsuits by apprising themselves of the necessary standards of conduct, and acting accordingly.

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[ii] *Meinhard v. Salmon*, 249 N.Y. 458 (1928).

[iii] *See Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, No. 5502-CS, 2011 Del. Ch. LEXIS 116, at *110 (Del. Ch. Aug. 8, 2011) (a general partner as manager of a hedge fund owes fiduciary duties to limited partners as investors, and must act with a good faith belief that it is advancing the best interests of the fund and its investors); *see also Ramius Private Select Ltd. v. Daugherty*, No. 11-CV-7421732011, 2011 Ohio Misc. LEXIS 355, at *14 (Ohio Ct. Common Pleas May 10, 2011) ("A fund manager owes a fiduciary duty to their clients.") (citations omitted).

[iv] *Meinhard*, 249 N.Y. at 464.

[v] *See Paron Capital Mgmt. LLC v. Crombie*, No. 6380-VCP, 2012 Del. Ch. LEXIS 114, at *21 (Del. Ch. May 22, 2012) (traditional fiduciary duty consists of the duties of care and loyalty).

[vi] *See Seidman v. Office of Thrift Supervision*, 37 F.3d 911, 936 n.34 (3d Cir. 1994) ("A fiduciary's duty of candor is encompassed within the duty of loyalty.").

[vii] *See Int'l Equity Invs., Inc. v. Opportunity Equity Partners, Ltd.*, 407 F. Supp. 2d 483, 501 (S.D.N.Y. 2005) (under both New York and Delaware law a general partner, like a director, must demonstrate that a conflicted transaction is fair and serves the best interests of the limited partners).

[viii] *See Pure Power Boot Camp, Inc. v. Warrior Fitness Boot Camp, LLC*, 813 F. Supp. 2d 489, 524 (S.D.N.Y. 2011) ("Under certain circumstances, a plaintiff may also demonstrate a usurpation of corporate opportunity in connection with a breach of the duty of loyalty."); *see also Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 972–73 (Del. Ch. 2003) (analyzing usurpation of corporate opportunity under the duty of loyalty).

[ix] *See Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006) ("The failure to act in good faith may result in liability because the requirement to act in good faith is a subsidiary element[,] *i.e.*, a condition, of the fundamental duty of loyalty.") (citation and internal quotations omitted) (alteration in original).

[x] *See Stroud v. Grace*, 606 A.2d 75, 85 (Del. 1992) (holding that the "duty of candor" means the duty to disclose all material information when seeking shareholder action).

[xi] *See Paron Capital Mgmt. LLC v. Crombie*, No. 6380-VCP, 2012 Del. Ch. LEXIS 114, at *22 (Del. Ch. May 22, 2012) ("Under Delaware law, a fiduciary who learns that her earlier communications to her beneficiaries were false and nonetheless knowingly and in bad faith remains silent even as the beneficiaries continue to rely on those earlier statements also breaches her duty of loyalty.") (citing *Metro Commc'n Corp. BVI v. Advances Mobilcomm Techs. Inc.*, 854 A.2d 121, 153 (Del. Ch. 2004)).

[xii] *See Oliver v. Boston Univ.*, Case No. 16570-NC , 2006 Del. Ch. LEXIS 75, at *77 (Del. Ch. Nov. 2, 2005) (describing as a classic conflict of interest the situation where a fiduciary is on both sides of a transaction or receives a benefit personally that is not received by those to whom the duty is owed) (citations omitted).

[xiii] *See Weinberger v. Uop*, 457 A.2d 701, 710–11 (Del. 1983) ("[I]ndividuals who act in a dual capacity as directors of two corporations … owe the same duty of good management to both corporations ….").

[xiv] *See Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, No. 5502-CS, 2011 Del. Ch. LEXIS 116, at *111 (Del. Ch. Aug. 8, 2011) (courts apply strict judicial scrutiny when a conflict exists).

[xv] Del. Code Ann. tit. 8, § 144(a)(1)–(3) (2012).

[xvi] N.Y. Bus. Corp. § 713 (2012) (providing that, like in Delaware, a conflicted transaction will stand if, after disclosure of all material information it is (1) approved by a board of directors; (2) approved by shareholders entitled to vote; or (3) entirely fair and reasonable at the time entered into).

[xvii] *See Active Asset Recovery Servs., Inc. v. Real Estate Asset Recovery Servs., Inc.*, No. 15478, 1999 Del. Ch. LEXIS 179, at *16 (Del. Ch. Sept. 10, 1999) ("[I]n the absence of a partnership agreement making plain the parties' intention to preempt the fundamental fiduciary duties of loyalty and care, a general partner remains obligated to act fairly toward the limited partners and to prove fairness when it makes self-interested decisions.").

[xviii] *Tucker Anthony Realty Corp. v. Schlesinger*, 888 F.2d 969, 973 (2d Cir. 1989).

[xix] *See Thorpe by Castleman v. CERBCO*, 676 A.2d 436, 443 (Del. 1996) (explaining that the corporate opportunity doctrine generally applies not when a fiduciary is on both sides of a transaction, but "in circumstances where the director and the corporation compete against each other to buy something").

[xx] *See Telxon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002) ("[T]he determination of whether or not the director has appropriated for himself something that in fairness should belong to his corporation is a factual question to be decided by reasonable inference from objective facts.").

[xxi] *See Guth v. Loft, Inc.*, 5 A.2d 503, 511 (Del. 1939) ("If there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.").

[xxii] *See Meyerson*, 802 A.2d at 263–64 (a safe harbor exists under Delaware law when a director fully discloses the corporate opportunity to the board of directors, and such opportunity is rejected by the company).

[xxiii] *See Zutty v. Rye Select Broad Mkt. Prime Fund, L.P.*, Case No.: 113209/09, 2011 N.Y. Misc. LEXIS 5596, at *20–24 (Sup. Ct. April 15, 2011) (discussing red flags and that willful disregard of them invites fiduciary liability).

[xxiv] *See McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008) (intentional dereliction of duty is a violation of the duty of good faith).

[xxv] *See Bullmore v. Ernst & Young Cayman Islands*, 45 A.D.3d 461, 463, 846 N.Y.S.2d 145, 148 (1st Dep't 2007) ("Professionals such as investment advisors, who owe fiduciary duties to their clients, may be subject to tort liability for failure to exercise reasonable care, irrespective of their contractual duties, since in these instances, it is policy, not the parties' contract, that gives rise to a duty of due care.") (citation and internal quotations omitted).

[xxvi] *See RCM Sec. Fund, Inc. v. Stanton*, 928 F.2d 1318, 1331 (2d Cir. 1991) (explaining that the duty of care requires both substantive and procedural due care).

[xxvii] *See id.*

[xxviii] *See Belmont v. MB Inv. Partners, Inc.*, Case No. 09-4951, 2012 U.S. Dist. LEXIS 1656, at *32 (E.D. Pa. Jan. 6, 2012) (finding no breach of fiduciary duty where plaintiff could not establish that bad faith caused investment advisor's failure to detect fraudulent investment).

[xxix] *See Schwarz v. Thinkstrategy Capital Mgmt. LLC,* 797 F. Supp. 2d 439, 448 (S.D.N.Y. 2011) (a fund manager's failure to conduct due diligence is a breach of fiduciary duty).