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A legal update from Dechert's Financial Services Group

NY Court: Officers of Investment Adviser May Be Personally Liable for Fund Losses

Corporate officers of an investment adviser may be personally liable for losses of a fund they advised, based on extra-contractual fiduciary duties arising out of their course of dealing with their clients, according to a decision by the First Department of the New York Appellate Division ("Appellate Division") on June 2, 2005.

The decision by the Appellate Division has made it possible for courts applying New York law to hold officers of an investment adviser personally liable for losses of a fund they advised. In *Sergeants Benevolent Association Annuity Fund v. Renck et al.*, the court found that a fiduciary duty on the part of an investment adviser may arise out of the course of dealing with its client, even though the advisory contract clearly set forth limited duties and the adviser complied with those duties.

The court then took another step and found that the individual employees of the adviser could be personally liable for breach of the fiduciary duty. S*ergeants* may mark a shift in New York with regard to the ease with which plaintiffs can bring such actions based on implied fiduciary duties against investment adviser employees in their individual capacities.[1]

Background

At the heart of the case is the concept of fiduciary duty. That concept under U.S. law generally is based not on specific statutory provisions but on the common law. One common formulation is that the duty of a fiduciary is to "discharge his duties ... solely in the interest of the beneficiaries" and "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man ... would use in the conduct of an enterprise of a like character and with like aims."[2] Under this standard, a fiduciary generally is liable for negligence.[3]

In a case involving the Investment Advisers Act of 1940 ("Advisers Act"), the U.S. Supreme Court stated that the Advisers Act reflects "the delicate fiduciary nature of an investment advisory relationship," and that the standard for fiduciaries under the Act includes "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' ... clients."[4]

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1 *Sergeants Benevolent Assn. Annuity Fund v. Renck*, 2005 NY Slip op. 04460.

2 *Bixler v. Central Pennsylvania Teamsters Health & Welfare Fund*, 12 F.3d 1292, n.14 (3d Cir. 1993).

3 Ordinary negligence is the omission of that care which a man of common prudence usually takes of his own concerns. *Briggs v. Spaulding*, 141 U.S. 132 (1891).

4 *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S.180, 195 (1963).

The *Sergeants* Case

Neither the court nor the plaintiffs in the *Sergeants* case relied on federal law.[5] Nonetheless, the Appellate Division's holding in the case is not inconsistent with that law, except possibly to the extent that it found corporate officers personally liable. A broadly-defined fiduciary duty is a two-fold boon to plaintiffs. First, a fiduciary duty is not discharged simply by fulfilling a contract, because a fiduciary relationship can be found in the parties' ongoing conduct and could require performance of more than just contractual duties.

Second, breach of a fiduciary duty is a tort rather than a mere breach of contract,[6] and officers can be held personally liable for tortious behavior on the job.[7] Thus, a plaintiff can sue outside of a contractual relationship and hold officers of an adviser personally liable for a duty never contained in any contract. Traditionally, however, New York courts have required specific allegations demonstrating how a "conventional business relationship" could give rise to an alleged extra-contractual fiduciary duty.[8] Even when these courts have found that a fiduciary relationship may exist, the relationship has bound the corporate defendant—not its employees.[9] *Sergeants*, however, steps away from that traditional reluctance by extending that liability to corporate employees.

In *Sergeants*, the plaintiff, a trust (the "Plaintiff") that managed annuity payments on behalf of New York City police sergeants and their beneficiaries, entered into an agreement with John T. Renck's investment advisory and management firm, Monitoring and Evaluation Services ("MES"), for investment consultancy services and supervision of the portfolio managers that managed the Plaintiff's assets. MES's duties under this agreement were largely limited to providing reports used to evaluate the return and asset allocation of portfolio managers.

Leading up to the bear market of 2000–2002, one of the portfolio managers, Trainer Wortham & Co. ("Trainer Wortham"), is alleged to have deviated significantly from the model asset allocation, holding over 80% of its portfolio in equities instead of the 60% equity benchmark set forth in the model. As the stock market declined, the Plaintiff's value declined from a peak of $144 million to $107 million. The Plaintiff contended that the failure to follow the asset allocation model caused the Plaintiff to lose approximately $12 million more than it would have if its portfolios had been properly rebalanced on a quarterly or monthly basis.[10]

However, MES's contract with the Plaintiff did not require it to rebalance the asset allocation; instead, it was limited to providing performance reports. How did the Plaintiff then contend that MES had breached its duty to balance the portfolio? They alleged that a fiduciary duty had arisen: John Renck and his son held themselves out as experienced investment consultants, and provided investment advice upon which the trustees relied. Over time, a fiduciary duty developed, which obligated the Rencks to balance the portfolio to comply with the asset allocation benchmark and terminate Trainer Wortham.

The trial court dismissed all counts against the Rencks, noting that nothing in the agreement between the Plaintiff and MES indicated a fiduciary relationship, and that there were no allegations regarding conduct by the Rencks outside the scope of the agreement that might support a finding that a fiduciary relationship developed over time. While the Plaintiff settled the related suit against Trainer Wortham for $4.5 million, it appealed the dismissal of the case against the Rencks.

The Appellate Division overturned the trial court. Although conceding that the advisory contract did not explicitly impose a fiduciary relationship, the court found that "ongoing conduct may give rise to a fiduciary relationship." This conduct involves one party placing confidence in the other and "reasonably rel[ying] on the other's superior expertise or knowledge." The Appellate Division determined that allegations covering those

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5 *See* note 10, *infra.*

6 Restatement 2d of Torts, § 874 (1979).

7 *McPhillips, Inc. v. Ellis*, 278 AD2d 682, 684 (2000).

8 *Oursler v Women's Interart Ctr.*, 170 AD2d 407, 408 (1991).

9 *Westminster Constr. Co. v. Sherman*, 160 AD2d 867, 868 (1990).

10 Trainer Wortham is registered as an investment adviser under the Advisers Act and potentially could be found to violate that Act for its failure to rebalance the trust's portfolio under the standard of the *Capital Gains* case. The plaintiff's failure to sue Trainer Wortham in federal court is probably due to the fact that the Supreme Court has held that there is no private action for damages under the Advisers Act, although there is one for rescission of an advisory contact and return of fees. *Transamerica v. Lewis*, 444 U.S. 180, 194 (1979).

elements were sufficient to raise a factual issue regarding the existence of a fiduciary duty.

Once the Appellate Division found that a fiduciary duty may have arisen, it allowed the claim to proceed not just against MES, but against the Rencks personally. The plaintiff did not allege that the Rencks acted other than in their corporate capacities, and neither of the Rencks signed the agreement in an individual capacity. The dissent concluded that "even if plaintiff could establish that fiduciary relationship existed, any fiduciary duty toward the [Plaintiff] devolved upon the corporate defendant, not its employees."

However, the majority noted simply that a breach of fiduciary duty is a tort rather than a breach of contract, and critically, company officers can be held personally liable for tortious conduct. Yet typically, a corporate officer is safe from personal liability absent negligence, fraud, or other serious wrongdoing. Thus, the dissent called it a "remarkable proposal" that the court allowed the action to proceed by implying a tort and then holding corporate officers personally accountable for such implied tort.

Analysis

This portion of the decision breaks new ground by easing the way for actions against investment advisers. Fiduciary duties arise out of the "scope of the relation" between parties.[11] As mentioned above, such a relation would involve a party with "superior expertise or knowledge."[12] But the scope of the contractual relation between the Rencks and the Plaintiff was almost purely administrative: preparing performance reports.

In view of those limitations, it is unclear whether the Rencks and MES had power to rebalance the portfolio or replace the investment manager. Thus, the Plaintiff's claim relies on an alleged fiduciary relationship arising out of a course of dealing, but, according to the dissent in the case, the claim "fails to specify a single instance in which the MES defendants acted in a fiduciary capacity."

Sergeants thus stands for the proposition that if a plaintiff cannot get past the first hurdle at trial, they need merely add an allegation—without specifics—that a fiduciary relationship was created out of a course of dealing.

Conclusion

At this stage, *Sergeants* will move to the trial court, where the Plaintiff will have to prove that a fiduciary relationship existed between the Plaintiff and MES or the Rencks. Whether or not the Plaintiff is successful, *Sergeants* sets the bar extremely low for plaintiffs who allege a fiduciary relationship, and will cost MES and the Rencks either settlement money or considerable legal expenses. A simple allegation in New York courts not only gets plaintiffs into court, but also opens up personal liability for the defendant's officers.

Because few relevant facts were alleged in *Sergeants*, practical steps to avoid fiduciary liability based on *Sergeants* are limited. Directors' and officers' insurance can limit the actual cost of personal liability for directors and officers, but this remains an expensive option. More than ever, officers of service providers need to consider the role they are playing for their clients and take steps not to exceed contractual boundaries. Even then, the *Sergeants* decision may leave officers exposed to personal liability for claims arising under New York law.

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[11] Restatement 2d of Torts, § 874 (1979).

[12] *Wiener v. Lazard Freres & Co.*, 241 AD2d 144, 122 (1998).

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