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A legal update from Dechert's Corporate Finance Group

The Uncertain Fiduciary Duty of Investment Banks

Courts have reached opposite conclusions on whether investment banks owe a fiduciary duty to their clients in addition to any duties set forth in a contract between an investment bank and its client. In an opinion issued in August of this year, the U.S. Court of Appeals for the Seventh Circuit determined that investment banks' duties toward their clients under Illinois law derive solely from the parties' contracts.[1] This article summarizes the differing court decisions and provides some practical advice regarding how investment banks can establish evidence that they do not owe a fiduciary duty to their clients.

Seventh Circuit Decision

In *Joyce v. Morgan Stanley & Co.*, the Seventh Circuit held that an investment bank, in the course of advising an acquired company in a stock-for-stock merger, did not have a fiduciary duty to the acquired company's shareholders to recommend that they enter into hedging transactions for their newly acquired shares.[2] Under Illinois law, in order for the investment bank to have owed such a fiduciary duty to the shareholders, (1) the shareholders would have trusted the investment bank, as the more experienced party in merger transactions, to protect their interests and (2) the investment bank would have affirmatively demonstrated that it had accepted such trust of the shareholders.[3] The fiduciary duty, if it existed, also would have gone beyond the terms of the investment bank's contract with the acquired company.[4] The Seventh Circuit determined that the relevant documents made clear that the investment bank never owed any duties at all to the acquired company's shareholders but only to the acquired company.[5] Furthermore, the Seventh Circuit concluded that the investment bank could not have owed such a fiduciary duty to the shareholders because "investment banks' responsibilities are set by contract."[6]

Differing Decisions

In determining whether investment banks might have a fiduciary duty toward their clients outside of the parties' contracts, the courts have focused, as the Seventh Circuit did in *Joyce*, on the issue of whether the superior knowledge of the investment banks caused their clients to trust or rely on the investment banks to such an extent to create a fiduciary duty even though such a duty was not established expressly in the governing contract. Some

[1] *Joyce v. Morgan Stanley & Co.*, 2008 U.S. App. LEXIS 17588, at *11 (7th Cir. 2008)

[2] *Id.* at *11-12.

[3] *Id.* at *9.

[4] *Id.* at *8.

[5] *Id.* at *11.

[6] *Id.*

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courts have agreed with *Joyce* that, under normal circumstances, investment banks' duties to their clients are determined solely by their agreements. For example, in *Cafe La France, Inc. v. Schneider Secs., Inc.*, the U.S. District Court for the District of Rhode Island held that under Rhode Island law, the commercial relationship between an investment bank and its client did not give rise to the level of trust and confidence that would establish a fiduciary duty.[7] The parties' letter of intent, therefore, defined the parties' relationship.[8]

Other courts have taken a differing view and concluded that a jury could find that an investment bank owes an extra-contractual fiduciary duty to its clients.[9] In *Bear Stearns & Co. v. Daisy Sys. Corp.*, an investment bank advised a corporate client on the acquisition of another entity and promised to assist that client in raising financing for the acquisition.[10] The U.S. Court of Appeals for the Ninth Circuit held that under California law, a jury could conclude that the investment bank owed a fiduciary duty to the client beyond the terms of their contract if the jury determined that the client placed an inordinate amount of trust in the investment bank's advice due to the investment bank's superior knowledge of mergers.[11]

In 2005, the highest court in New York surprised the investment banking community by holding in *EBC I, Inc. v. Goldman, Sachs & Co.* (the case is commonly referred to as "*eToys*," which was the former name of EBC I, Inc.) that, under New York law, investment banks, in their roles as underwriters, may have fiduciary duties to issuers of securities.[12] The case was of particular importance because most contracts, including underwriting agreements, entered into by U.S. investment banks are governed by New York law. In *EBC I*, the Court of Appeals of New York decided that issuers may rely on underwriters' superior knowledge of security offerings to such an extent that juries may determine that underwriters owe a fiduciary duty to the issuers.[13] The court limited the potential underwriters' fiduciary duty to their role as advisor.[14] As a practical result of this decision, many underwriters now include provisions in underwriting agreements providing expressly that they do not owe the applicable issuers of securities any fiduciary duty, that the parties entered their agreement through arms-length transactions, that the issuers understand and accept the risks of the transactions, and that the issuers waive any claims against the underwriters based on owing them a fiduciary duty.

Practical Advice: Make It Clear

As the above cases demonstrate, courts have reached conflicting conclusions on whether juries could find that investment banks owe an extra-contractual fiduciary duty to their clients. Any court's decision that such a fiduciary duty could exist will rely on facts that demonstrate that the investment bank's client placed its trust in the investment bank's advice to an extent beyond the terms of their contract. Investment banks should, therefore, make clear in their agreements with their clients that their relationship is solely contractual in nature and that the relationship does not give rise to any fiduciary duties. For example, investment banks could use the following language, which is now standard in many underwriting agreements (edited as necessary for the relevant agreement):

The company acknowledges and agrees that:

> (a) the investment bank's responsibility to the company is solely contractual in nature, the investment bank has been retained solely to act as underwriter in connection with the offering of the securities contemplated herein, and no

[7] *Cafe La France, Inc. v. Schneider Secs., Inc.*, 281 F. Supp. 2d 261, 272-74 (D.R.I. 2003).

[8] *Id.* at 273.

[9] In a case tried without a jury, the judge will determine the facts of the case. In such a situation, the judge then would decide whether an investment bank owed a fiduciary duty to its client arising from the client's trust in the investment bank.

[10] *Bear Stearns & Co. v. Daisy Sys. Corp.*, 97 F.3d 1171, 1172-75 (9th Cir. 1996).

[11] *Id.* at 1177-79.

[12] *EBC I, Inc. v. Goldman, Sachs & Co.*, 832 N.E.2d 26, 31-33 (N.Y. 2005).

[13] *Id.* at 32.

[14] Id.

fiduciary, advisory, or agency relationship between the company and the investment bank has been created in respect of any of the transactions contemplated by this agreement, regardless of whether the investment bank or its representatives have advised or are advising the company on other matters;

(b) the price of the securities set forth in this agreement was established following arms-length negotiations and the company is capable of evaluating and understanding, and understands and accepts, the terms, risks, and conditions of the transactions contemplated by this agreement;

(c) it has been advised that the investment bank, its representatives, and their respective affiliates are engaged in a broad range of transactions that may involve interests that differ from those of the company and that the investment bank has no obligation to disclose such interests and transactions to the company by virtue of any fiduciary, advisory, or agency relationship; and

(d) it waives, to the fullest extent permitted by law, any claims it may have against the investment bank for breach of fiduciary duty and agrees that the investment bank shall have no liability (whether direct or indirect) to the company in respect of such a fiduciary duty claim or to any person asserting a fiduciary duty claim on behalf of or in right of the company, including stockholders, employees, or creditors of the company.

If a lawsuit develops with a client and the court hearing the case does not adhere to the reasoning of *Joyce* and *Cafe La France*, such language should serve to supply evidence that the parties desired that their contracts alone should define the scope of their duties to each other.

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