PAUL, WEISS, RIFKIND, WHARTON & GARRISON

THE SCOPE AND NATURE OF COMMON LAW DUTIES OF FINANCIAL INSTITUTIONS TO CUSTOMERS AND COUNTER-PARTIES: A BRIEF SURVEY OF THE LEADING CASES

RICHARD A. ROSEN - KRISTINE M. ZALESKAS

PUBLISHED IN THE *FUTURES AND DERIVATIVES LAW REPORT, vol. 21, no. 8*

NOVEMBER 2001

This article highlights some of the most important and illuminating cases that address the scope and nature of the duties that brokers, dealers and other financial institutions owe to customers and counterparties. For ease of reference, it is organized by legal theory, but the reality is that several of the relevant theories have routinely been invoked by plaintiffs in serious disputes of this nature.

Note that, although there has been a large volume of litigation concerning the scope of fiduciary duties, there is a paucity of judicial precedent concerning common law negligence claims in the brokerage context. If the Second Circuit affirms the *de Kwiatkowski* decision, that will change very dramatically.

I. Negligence

A. Expansive Applications of Negligence Liability in Financial Markets

1. *de Kwiatkowski* v. *Bear Stearns & Co., Inc.*, 126 F. Supp. 2d 672 (S.D.N.Y. 2000): (futures/OTC)

Plaintiff de Kwiatkowski opened a nondiscretionary currency trading account at Bear Stearns, through which he traded foreign currency futures and in the over-the-counter market. In managing his currency trading before, during, and after his dealings with Bear Stearns, de Kwiatkowski adopted a consistent "dollar-bullish" trading strategy. Between 1991 and December 1994, de Kwiatkowski made nearly $450 million in profits from funding, primarily because of the relative strength of the dollar during that time period. Between December 1994 and early March 1995, however, he lost those profits plus an additional $7 million, when the value of the dollar declined.

At trial, de Kwiatkowski asserted breach of fiduciary duty and negligence claims against Bear Stearns, arguing that Bear Stearns did not give de Kwiatkowski advice that would have permitted him to reduce or avoid his loss. The jury rejected plaintiff's fiduciary duty claim, but it found for plaintiff on the negligence claim, awarding him $111.5 million in damages plus an additional $53 million in prejudgment interest.

In a lengthy opinion rejecting Bear Stearns's post-judgment motion for judgment as a matter of law or a new trial, the district court held that:

(i) a broker has a duty to do whatever a "reasonable" broker would have done under the circumstances, and it was for the jury to determine what reasonableness required; and

(ii) special circumstances could have imposed additional duties in this case, although the jury had not been instructed on, or asked to find, any such circumstances.

**©2001 *Futures & Derivatives Law Report.* All rights reserved.
Used with permissionof Glasser LegalWorks,
150 Clove Road, Little Falls, NJ 07424.
(800) 308-1700. www.glasserlegalworks.com**

In particular, the court noted that:

> [T]he theory of liability and the corresponding legal duty in question here are not grounded on Bear Stearns's obligation to provide any particular item of investment advice or information, but on its failure to exercise the reasonable care and display the skill and standard of conduct expected of a prudent broker under the circumstances that prevailed here. The case thus does not turn necessarily on a brokerage firm's furnishing or omitting to furnish any given materials, but more generally on Bear Stearns's deficient performance as a broker in its dealings with Kwiatkowski and handling his account under the circumstances[.]

The court concluded that the jury could have found that Bear Stearns failed to exercise due care in the handling of de Kwiatkowski's account in the following ways: by failing to conduct an ongoing risk analysis and suitability review; failing to inform de Kwiatkowski of any higher risks associated with his investments as market conditions adversely changed; by conveying to de Kwiatkowski encouraging market assessments at a number of critical times; by failing to inform de Kwiatkowski about two Bear Stearns analysts' forecast for the dollar; by failing to inform de Kwiatkowski of the increased risk profile of meeting margin calls by liquidating positions; and failing to liquidate his accounts with reasonable prudence and skill in March 1995.

This decision has been appealed to the Second Circuit; *amicus* briefs in support of Bear Stearns have been filed by the Securities Industry Association and the National Futures Association. Oral argument was held on October 24.

2. *Lehman Brothers Commercial Corp.* v. *Minmetals International Non-Ferrous Metals Trading Company*, No. 94 Civ. 8301, 2000 WL 1702039 (S.D.N.Y. Nov. 13, 2000): (derivative swaps)

Minmetals engaged in derivative swap transactions with Lehman Bros. Commercial Corp. ("LBCC"), and incurred a sizable debit to LBCC. LBCC sued for payment, and Minmetals counterclaimed, asserting, *inter alia*, that LBCC was negligent in its handling of the transactions. LBCC moved for summary judgment on this claim, arguing that it owed no duty of care to Minmetals. The court denied LBCC's motion, finding that there were questions of fact whether LBCC owed a fiduciary duty to Minmetals (see discussion *inra*) and whether LBCC owed a duty of care: "Because a jury must decided whether the relationship between [the parties] gave rise to a duty of care, [Minmetals'] negligence claim cannot be dismissed as a matter of law."

3. *Salomon Brothers, Inc.* v. *Huitong International Trust & Investment Corp.*, No. 94 Civ. 8559 (LAP), 1996 WL 675795 (S.D.N.Y. Nov. 21, 1996): (treasury securities)

Salomon Brothers, Inc. ("Salomon") and Huitong International Trust & Investment Corp. ("Huitong") entered into a repurchase agreement by which Huitong would sell treasury securities to Salomon, and would be required to repurchase such securities at another specified price at a later date; if Huitong defaulted, Salomon could liquidate the

account and recover any losses resulting from the liquidation. When Huitong defaulted, Salomon liquidated its account and sued for breach of contract, contending that the resulting loss from the liquidation was chargeable to Huitong.

Huitong's defense was that no valid contract ever existed between the parties. It also counterclaimed on the theory that that, even if a valid contract existed, Salomon had breached it, as well as breached its fiduciary duties and its duty of care to Huitong. Salomon moved to dismiss the negligence counterclaim, arguing that New York does not recognize separate causes of action for negligent performance of contract and breach of contract.

The court agreed with Salomon that if the parties' relationship was purely contractual, then plaintiff could not assert separate claims for breach of contract and negligent performance of a contract. However, drawing all inferences in favor of Huitong, the court concluded that if Salomon had some relationship to Huitong giving rise to independent fiduciary duties, including a duty of care, then, Huitong could make out a negligence claim. Accordingly, the court denied Salomon's motion to dismiss.

4. *AJ Contracting Co.* v. *Trident Managers, Inc.*, 234 A.D.2d 195, 651 N.Y.S.2d 498 (1st Dep't 1996): (insurance)

Plaintiff AJ Contracting Co. purchased a comprehensive insurance policy from defendant insurance broker but was unaware of the fact that it was subject to a retrospective rating agreement. Plaintiff sued defendant for failure to provide ongoing services after purchase of the policy, specifically the monitoring of claims and the rendering of advice on risk management so as to minimize plaintiff's premium under the rating agreement. The trial court dismissed the case, and plaintiff appealed.

The court found that the plaintiff had made a sufficient showing to withstand defendant's motion for summary judgment, holding that an insurance broker could be held liable for negligence without violating a contractual duty because "[r]egardless of whether a specific promise has been made, a professional is required to exercise the skill and knowledge normally possessed by members of his or her trade or profession in good standing in similar communities."

B. Narrow Applications of the "Duty of Care"

1. *Puckett* v. *Rufenacht, Bromagen & Hertz, Inc.*, 587 So.2d 273 (Miss. 1991): (commodity futures trading)

Plaintiffs, individual investors, lost more than $2 million in commodity futures trades. They sued their broker in federal court, alleging breach of fiduciary duty and negligence, claiming that the broker had a duty to monitor the suitability of their transactions and warn them that their trading was excessive. The trial court granted summary judgment for defendant, and plaintiffs appealed. The Fifth Circuit certified for the Mississippi Supreme Court the question whether a commodities broker is bound by a duty of due care. The Court answered in the negative:

Under the general law from other jurisdictions, the answer to this question is that a commodities broker in a non-discretionary account only owes his customer the duty to properly execute trades as directed by him, and has no further duty to call upon his own professional skill and prudence as to the wisdom of any of his customer's trades.

2. *Murphy* v. *Kuhn*, 90 N.Y.2d 266, 682 N.E.2d 972, 660 N.Y.S.2d 371 (1997): (insurance)

Plaintiff Murphy and had purchased property, casualty and liability insurance from defendant Kuhn in connection with his golf business since 1973. Plaintiffs never specifically requested any increase in the liability limits on their policy from 1984 onward, and in 1991, Murphy's son was involved in a fatal car accident. Plaintiffs then sued defendant for breach of fiduciary duty and negligence, arguing that a special relationship developed from a long, continuing course of business between the parties, generating special reliance and an affirmative duty to advise with regard to appropriate or additional coverage. The trial court granted summary judgment for defendants and the appellate division affirmed. On plaintiffs' appeal, the New York Court of Appeals affirmed, holding that insurance agents have a common law duty to obtain requested coverage for their clients within a reasonable time, but they have no continuing duty to advise, guide or direct a client to obtain additional coverage. The court noted that insurance agents or broken are not personal financial counselors and risk managers.

II. Breach of Fiduciary Duty

A. New York cases dismissing fiduciary duty claims:

1. *Independent Order of Foresters* v. *Donaldson, Lufkin & Jenrette, Inc.*, 157 F.3d 933 (2d Cir. 1998): (collateralized mortgage obligations)

Plaintiff Independent Order of Foresters (IOF), a fraternal benefit society, purchased from defendant Donaldson, Lufkin & Jenrette, Inc. ("DLJ") collateralized mortgage obligation (CMO) derivatives over an eleven-month period. When IOF suffered losses of over $14 million on its investments, it sued DLJ for breach of fiduciary duty. IOF claimed that because DLJ possessed greatly superior sophistication and knowledge of about CMOs, DLJ had breached a fiduciary duty by failing to advise IOF of the risks associated with the CMO purchases. The district court dismissed this claim and the Second Circuit affirmed, holding that under New York law there is no general fiduciary duty inherent in an ordinary broker/customer relationship; "such a duty can arise only where the customer has delegated discretionary trading authority to the broker."

2. *Procter & Gamble* v. *Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996): (derivative swaps) (applying New York law)

Plaintiff Procter & Gamble ("P&G") engaged in a series of complex interest rate swap transactions with defendant Bankers Trust Co. ("Bankers Trust"). After Bankers

Trust demanded payment for these transactions, P&G sued, claiming that in it had agreed to the transactions because of that long relationship that it had with Bankers Trust, Bankers Trust had a fiduciary duty to P&G, which they had breached. The court granted summary judgment for Bankers Trust on this claim. Applying New York law (which the parties had agreed would apply), the court concluded that the parties were in a business relationship, not a fiduciary one, and even if Bankers Trust had superior knowledge about swap transactions, "that does not convert their business relationship into one in which fiduciary duties are imposed."

3. ***Fekety* v. *Gruntal & Co., Inc.*, 191 A.D.2d 370, 595 N.Y.S.2d 190 (1st Dep't 1993): (securities)**

Plaintiff investors sued their broker, alleging racketeering and fraud, and then sought leave to amend the complaint to add a claim of breach of fiduciary duty. The trial court granted defendant's motion to dismiss and denied plaintiff's request to amend the complaint. The Appellate Division held that plaintiff's leave to amend was properly denied became "a broker does not, in the ordinary course of business, owe a fiduciary duty to a purchaser of securities."

4. ***Castellano* v. *Young & Rubicam, Inc.*, 257 F.3d 171 (2d Cir. 2001)**

Castellano, an employee shareholder of Young & Rubicam, Inc. ("Y&R"), resigned from Y&R shortly before the company entered into a leveraged recapitalization that proved to be very valuable to its shareholders. Castellano sued the company, alleging, *inter alia* securities fraud, breach of fiduciary duly, negligent misrepresentation, unjust enrichment and rescission. On Y&R's motion to dismiss, the district court held that Castellano had failed to show any affirmative misrepresentations on which he relied, and dismissed all claims except for breach of fiduciary duty and unjust enrichment, which were later dismissed on summary judgment. On appeal, the Second Circuit held that Castellano's breach of fiduciary duty claim was barred by the Martin Act, New York's blue sky law. Noting that New York courts do not recognize a private cause of action under the Martin Act, the court concluded that sustaining a cause of action for breach of fiduciary duty in the context of securities fraud would effectively provide a private action under that statute and thus could not stand.

5. ***Press* v. *Chemical Inc. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999) (securities)**

Plaintiff alleged that his broker-dealer violated its fiduciary duties by failing to disclose a markup on the sale of a Treasury bill. The district court dismissed the claim because the plaintiff made only "naked allegations" that the defendants were his fiduciaries. The Court of Appeals affirmed the district court's dismissal but made it clear that the duties a broker owes to its client require attention to the specific circumstances of the relationship and the scope of the entrusted matters. However, the court found no fiduciary duty in this case, holding that a broker is obligated to provide to his client the

information relevant to the affairs entrusted to him, but that information about the markup on a security does not fall into that category.

6. *Village on Canon* v. *Bankers Trust Co.*, 920 F. Supp. 520 (S.D.N.Y. 1996)

Village on Canon (VOC), a general partnership, borrowed $29 million in November 1989 for a one-year term from Bankers Trust Co., secured by VOC's interest in certain commercial real estate. Shortly after the loan closed, Bankers Trust and VOC entered into an exchange agency arrangement that enabled Bankers Trust to solicit investors to provide long-term financing to VOC beyond the term of the one-year loan. VOC claimed that Bankers Trust orally assured it that the bridge loan would be extended if permanent financing was not arranged before the expiration of the loan. In August 2000, Bankers Trust sent VOC a letter proposing terms and conditions for a possible extension. VOC replied, disagreeing with two items on Bankers Trust's list of terms. The extension was never made, and VOC sued, alleging claims of breach of contact, breach of fiduciary duties, fraud, and negligent misrepresentation as a result of Bankers Trust's failure to extend the loan. The court dismissed VOC's; claim of breach of fiduciary duty, holding that no fiduciary duty arises from a debtor-creditor or creditor-guarantor relationship.

7. *Rozsa* v. *May Davis Group, Inc.*, 152 F. Supp. 2d 526 (S.D.N.Y. 2001)

Canadian investor sued his broker-dealer, an account executive of the broker-dealer, a clearing broker for the broker-dealer, and the principal of a foundation that handled the investor' funds, alleging, *inter alia*, violations of the Racketeering Influenced and Corrupt Organizations Act, breach of fiduciary duty, breach of contract, and conversion. The court dismissed the breach of fiduciary claim against the clearing broker, SG Cowen. Noting that in general, clearing brokers have no fiduciary duty to investors, and observing that "[c]learing brokers may have a fiduciary duty in certain *extenuating circumstances*," (emphasis added), the court concluded that the plaintiff had failed to allege facts from which the court could find that SG Cowen had acted as anything other than a general clearing agent.

B. New York cases allowing fiduciary duty claims to go forward

1. *Lehman Brothers Commercial Corp.* v. *Minmetals International Non-Ferrous Metals Trading Company*, No. 94 Civ. 8301, 2000 WL 1702039 (S.D.N.Y. Nov. 13, 2000)

See factual discussion *supra*. Minmetals brought a counterclaim against LBCC, claiming that LBCC had breached its fiduciary duty, and LBCC sought summary judgment. Relying on *de Kwiatkowski* and *Huitong*, the court noted that "[c]ourts in this District have found that a fiduciary duty could potentially arise in a 'principal-to-principal' arm's-length relationship based upon the degree of trust that exists in that relationship,"

but held that whether such a fiduciary duty arose between LBCC and Minmetals was a question of fact for a jury to determine. It accordingly denied LBCC's motion.

2. *de Kwiatkowski* v. *Bear Stearns & Co, Inc.*, 1999 WL 1277245 (S.D.N.Y. 1999)

See factual description *supra*. In the pretrial phase of the same case, defendant's motion for summary judgment on breach of fiduciary duty had been denied. Even if a customer's account is nondiscretionary, the court held, fiduciary duties may arise by virtue of (1) the particular relationship between the parties; or (2) the scope of matters entrusted to the broker.

3. *Salomon Brothers, Inc.* v. *Huitong International Trust & Investment Corp.*, No. 94 Civ. 8559 (LAP), 1996 WL 675795 (S.D.N.Y. Nov. 21, 1996)

See factual description *supra*. On Salomon's motion to dismiss Huitong's claim for breach of fiduciary duty, the court noted that Huitong claimed that Salomon Brothers had functioned as more than a traditional arm's length counterparty, and concluded that if these allegations were proven, Huitong could sustain the claim that its counterparty had assumed a fiduciary duty. The court hold that a fiduciary relationship may potentially arise in a "principal-to-principal" arm's-length relationship, depending on the degree of trust that exists in the relationship. The court accordingly denied Salomon's motion to dismiss on the breach of fiduciary claim.

C. Establishing the Existence of a Fiduciary Duty in Other Jurisdictions -- An Easier Task

1. California: *Duffy* v. *King Cavalier*, 215 Cal. App.3d 1517 (1989): (securities)

The trustees of a profit sharing plan sued King Cavalier, a securities brokerage firm, alleging breach of fiduciary duty in handling of the plan's brokerage account. The trial court ruled in favor of the trustees, and the defendants appealed. The Court of Appeal affirmed the trial court's decision, noting that "the relationship between a stockbroker and his or her customer is fiduciary and nature":

> [T]here is in all cases a fiduciary duty owed by a stockbroker to his or her customers; the scope of this duty depends on the specific facts and circumstances presented in a given case. These include the relative sophistication and experience of the customer; the customer's ability to evaluate the broker's recommendations and exercise an independent judgment thereon; the nature of the account, whether discretionary or non-discretionary; and the actual financial situation and needs of the customer.

The court held that the stockbroker's fiduciary duty requires "more than merely carrying out the stated objectives of the customer." Relying on the leading case *Twomey*

v. *Mitchum, Jones & Templeton, Inc.*, 262 Cal. App.2d 690 (1968), it noted if there is evidence that the stockbroker's recommendations are invariably, followed the stockbroker must determine the customer's actual financial situation and needs.

2. South Dakota: *Davis* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206 (8th Cir. 1990): (securities)

Plaintiff investor Davis sued Merrill Lynch, alleging, *inter alia*, violation of § 10(b), common law fraud, and breach of fiduciary duty. After plaintiff prevailed at trial, Merrill Lynch appealed, arguing that nondiscretionary securities accounts cannot give rise to a fiduciary relationship between securities brokers and customers as a matter of law. The Eighth Circuit disagreed:

> We refuse to elevate form over substance by holding that nondiscretionary accounts can never give rise to a fiduciary relationship. To do so in this case would result in manifest injustice. When analyzing fiduciary claims arising from unauthorized trading of securities, the crucial question is who exercised actual control over the account. Whether an account is discretionary or nondiscretionary is one factor that indicates control.

3. Louisiana: *Beckstrom* v. *Parnell*, 714 So.2d 188 (La. Ct. App. 1998) (securities)

Plaintiff sued a stockbroker and his employer, alleging violation of the state securities act, breach of contract and breach of fiduciary duty. The trial court ruled in favor of the investor. On appeal, the Louisiana Court of Appeal held that the nature of the fiduciary duty owed varies, depending on the relationship between the broker and the investor, and is a fact-based inquiry. Although the court concluded that the plaintiff did not establish a breach of fiduciary duty, it acknowledged: "although courts draw no bright-line distinction between the fiduciary duty owed customers regarding discretionary as opposed to nondiscretionary accounts, the nature of the account is a factor to be considered.

III. Unsuitability Claims

Unsuitability claims are sustainable only in cases involving securities; there are no suitability obligations in the context of commodity futures.

A. Unsuitability as Rule 10b-5 Violation: "Misstatement/Omission" or "Fraudulent Conduct"?

Courts have analyzed unsuitability claims asserted in the context of Rule 10b-5 claims using two distinct theories. The majority of courts have viewed such claims as equivalent to a "misstatement" or "omission" case. Under this theory, liability is imposed on the theory that a broker misstated to its customer that the investment was suitable; or alternately failed to disclose that the security was unsuitable in courts in which it had the duty to disclose this information. Under the "fraudulent conduct" theory, the broker's

recommendation of an unsuitable security is deemed inherently deceptive. The following two cases set forth the elements of an unsuitability claim under each theory:

1. Misstatement/Omission: *Brown* v. *E.F. Hutton*, 991 F.2d 1020, (2d Cir. 1993)

Brown is a leading case that applies the "misstatement/omission" theory of unsuitability in the class action context. Investors who had purchased interests in oil and gas limited partnerships brought claims under the federal securities laws. The court set forth the basic elements of an unsuitability claim under § 10(b) and Rule 10b-5:

a. the securities purchased were not suited to the buyer's needs;

b. defendant knew or reasonably believed the securities were not suited to the buyer's needs;

c. defendant recommended or purchased the unsuitable securities for the buyer anyway;

d. with *scienter*, defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities;

e. buyer justifiably relied to its detriment on the defendant's fraudulent conduct.

Willful blindness is evidence of recklessness that is sufficient to support an inference of fraud under Section 10(b). Scienter may be inferred by including that the defendant knew or reasonably believed that the securities were unsuited to the investor's needs, misrepresented or failed to disclose the unsuitability of the securities, and proceeded to recommend the securities anyway.

2. Fraudulent Conduct: *O'Connor* v. *R.F. Lafferty & Co., Inc.*, 965 F.2d 893 (10th Cir. 1992):

O'Connor is a leading "fraudulent conduct" suitability case in the Rule 10b-5 context. In *O'Connor*, the Tenth Circuit held that to establish liability in a suitability claim a plaintiff must prove that:

a. the broker recommended (or in the case of a discretionary account purchased) securities which are unsuitable in light of the investor's objectives;

b. the broker recommended or purchased the securities with an intent to defraud or with reckless disregard for the investor's interests; and

c. the broker exercised control over the investor's account.

B. NASD Rule 2310

Rule 2310 of the NASD Manual (formerly NASD Rules of Fair Practice, Art. III, Sec. 2) provides, in pertinent part:

> (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
>
> (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
>
> (1) the customer's financial status;
>
> (2) the customer's tax status;
>
> (3) the customer's investment objectives; and
>
> (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer....

In recent disciplinary proceedings, the NASD has set forth guidelines as to what conduct violates Rule 2310:

> Most often, a broker violates the suitability rule by recommending to a customer a security that might be suitable for some investors, but that is unsuitable for that particular customer. *F.T. Kaufman & Co.*, 50 S.E.C. 164, 167 (1989). A broker also must have a reasonable basis "to believe that the recommendation could be suitable for at least some customers." *Id.* at 168. ... This is called "reasonable basis" suitability, and it "relates only to the particular recommendation, rather than to any particular customer." *Id.* In addition, a broker has a "quantitative" suitability obligation, which prohibits the broker from engaging in an inappropriate frequency of trades, often referred to as excessive trading or churning. A broker could violate the suitability rule, for example, where he or she recommended to a customer an excessive (and based on the customer's financial situation and needs, an inappropriate) number of securities transactions and the customer routinely followed the broker's recommendations. *See, e.g.*, Harry Gliksman, Exchange Act Rel. No. 42255, at 4 (Dec. 20, 1999) ("Under [Rule 2310], recommendations may be unsuitable if the trading is excessive based on the customer's objectives and financial situation."); Rafael Pinchas, Exchange Act Rel. No. 41816, at 11-12 (Sept. 1, 1999) ("[E]xcessive tracking, by itself can violate NASD suitability standards by representing an unsuitable frequency of trading.")

In the Matter of Dep't of Enforcement v. *Chase*, NASD Complaint No. C8A990081 (August 15, 2001). *See also*, *In the Matter of Dep't of Enforcement* v. *Howard*, NASD Complaint No. Cl1970032 (Nov. 16, 2000).

C. Unsuitability and the Sophisticated Investor

1. *Banca Cremi, S.A., et al.* v. *Alex Brown & Sons, et al.*, 132 F.3d 1017 (4th Cir. 1997)

Defendant dealer recommended and sold to plaintiff bank certain derivative instruments (inverse floaters and "inverse IOs"). The bank alleged that it had communicated its desire for "'low risk'" investments to the dealer. The district court dismissed the plaintiff's breach of fiduciary duty claim on defendant's motion for summary judgment, holding that the bank and the dealer dealt at arm's length in a principal-to-principal relationship. This case suggests that institutional investors have great difficulty establishing the element of justifiable reliance in the context of a suitability claim.

2. *State of West Virginia* v. *Morgan Stanley & Co., Inc.*, 459 S.E.2d 906 (W.Va. 1995)

State sued Morgan Stanley & Co., Inc. ("Morgan Stanley"), alleging that the firm had engaged in constructive fraud in connection with $280 million in trading losses resulting from allegedly speculative investments. On Morgan Stanley's appeal from the jury's verdict for the Bank, the court held that "[n]otwithstandmg that Morgan Stanley sedulously cultivated good customer relations with the State of West Virginia, Morgan Stanley was nonetheless a principal in the transactions at stake, not a broker, and Morgan had the right to trade with the State without undertaking the obligation to insure the State against its elected officers' lack of wisdom. 'Sophistication', as that term is used in the investment law, should never be confused with intelligence, prudence or good luck." *Id.* at 913 (emphasis in the original).

3. *City of San Jose* v. *Paine, Webber, Jackson & Curtis Inc.*, No C 84-20601 RFP (N.D.Cal. June 6, 1991)

Defendant dealers moved to overturn a jury verdict in favor of the City of San Jose on an unsuitability claim. In an order memorandum advising counsel on what issues should be argued, the court noted that an unsuitability claim "would arise where a defendant, knowing of plaintiff's investment objectives, recommends a course of trading that is at odds with those objectives. In such a case, the defendant has omitted the fact that the recommendation is unsuitable." However; the court noted, "[i]n order for a failure to disclose certain facts to be actionable, however, the defendant must first have a duty to disclose the information", and that this duty to disclose arises from a fiduciary relationship. The court reasoned that "it would seem that the defendants' mere failure to disclose that the recommendation is unsuitable—by itself—is insufficient to impose liability. . . .The critical question, therefore, would seem to be the source of that duty."

The court noted that the city had presented no evidence that the dealer defendants were acting as brokers or agents for the city.

4. *Proctor & Gamble* v. *Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996)

See factual description *supra*. P&G claimed that Bankers Trust breached its fiduciary duty by recommending unsuitable investments, and violated federal securities laws by making a number of misrepresentations concerning those investments. The court held that the parties' business relationship had not been converted into one in which fiduciary duties were property imposed.

D. CFTC and NFA Rules: No Suitability Obligation in Futures Context

Under the rules of the CFTC and the National Futures Association (NFA), a futures commission merchant (FCM) must take two steps with respect to a commodities account, both before opening the account.

1. Under CFTC Rule 1.55, the firm must provide a commodities customer with a detailed risk disclosure statement (17 C.F.R. Section 1.55(a), (b), A-1483-88).

2. Under NFA Compliance Rule 2-30, the firm must obtain several specified items of information (customer's name, address, principal occupation or business, estimated annual income, net worth, age, and previous investment and futures trading experience.

The CFTC has confirmed that no suitability obligations arise under the antifraud provisions of the Commodity Exchange Act. In its amicus brief filed in *de Kwiatkowski*, the NFA makes its position clear as well:

> NFA Compliance Rule 2-30 should not be confused with the suitability rules commonly applied in the securities industry. Compliance Rule 2-30 requires that a determination regarding the appropriateness of futures trading in general be made up front, at the time an account is opened, not on a transaction by transaction basis. The final determination is ultimately made by the customer after receiving appropriate risk disclosure—which may be that futures trading is too risky—from the futures professional.

1. *Minor* v. *Alaron Trading Group*, [Current] Comm. Fut. L. Rep. (CCH) ¶ 28, 085 (CFTC Mar. 30, 2000):

A customer who made a knowing election to undertake the risks of futures or options trading cannot claim that her account executive should have specifically warned her that she was unsuitable for such a risk. Defendant had provided additional disclosure because plaintiff was a new futures trader. However, this novice status alone did not render her either unable to understand the risk disclosures or unprepared to undertake the

risks of futures and options trading. Thus, in the absence of a claim of misrepresentation by plaintiff during the account opening, her unsuitability claim failed.

IV. Negligent Misrepresentation

Under New York law, the elements of negligent misrepresentation are: (1) that defendant had a duty, as a result of a *special relationship*, to give correct information, (2) that defendant made false representation that the defendant should have known was incorrect; (3) that the information supplied in the representation was known by defendant to be desired by plaintiff for a serious purpose; (4) that plaintiff intended to rely and act upon the information; and (5) that plaintiff reasonably relied on the information to plaintiff's detriment. *See, e.g.*, *Hydra Investors, Inc.* v. *Trafalgar Power Inc.*, 227 F.3d 8 (2d Cir. 2000), and cases cited.

A. The "Special Relationship" Requirement

As explained by the Court of Appeals in *Kimmel* v. *Schaffer*, 89 N.Y.2d 257, 675 N.E.2d 450, 652 N.Y.S.2d 715 (1996), under New York law, "liability for negligent misrepresentation has been imposed only on those persons who possess unique or specialized expertise, or who are in a special position of confidence and trust with the injured party such that reliance on the negligent misrepresentation is justified." *Id.* at 263, 675 N.E.2d at 454, 652 N.Y.S.2d at 719. The court further noted that:

- "Professionals, such as lawyers and engineers, by virtue of their training and expertise, may have special relationships of confidence and trust with their clients. . . ." *Id.*;
- In the commercial context, because of "the absence of obligations arising from the speaker's professional status", there must be some other "identifiable source of a special duty of care."
- In particular, whether the nature and quality of a parties' relationship is such that an ordered party's reliance on a negligent representative generally raises an issue of fact; factors that should be considered in making this determination include:
    - whether the person making the representation held or appeared to hold unique or special attendance;
    - whether a special relationship of trust or confidence existed between the parties;
    - whether the speaker was aware of the use to which the information would be put and supplied it for that purpose.

Id. at 257, 675 N.E.2d at 454, 652 N.Y.S.2d at 719.

B. Recent Cases Discussing the "Special Relationship" Requirement

1. *Lewis* v. *Rosenfeld*, 138 F. Supp.2d 466 (S.D.N.Y. 2001)

Investors in a company that operated ice cream stores sued the attorneys representing the stores in connection with the investment alleging, *inter alia*, negligent misrepresentation. In dismissing the negligent misrepresentation claim, the court rejected investors' contentions that a special relationship had arisen between them and the company's attorneys; "it is well established that a simple commercial relationship, such as that between a buyer and seller; does not constitute a 'special relationship' supporting a negligent misrepresentation claim."

2. *Dimon Inc.* v. *Folium, Inc.*, 48 F. Supp.2d 359 (S.D.N.Y. 1999)

Purchasers of stock of a corporation sued the sellers and the individuals controlling the sellers, alleging that they were fraudulently induced to pay too much for the company by an accounting scheme that resulted in the overstatement of the company's earnings and net worth. Defendants moved to dismiss plaintiffs' negligent misrepresentation claim, arguing that there was no special relationship between the parties. The court disagreed. It noted that parties' transaction "was more than a simple sale" and that the parties had engaged in lengthy negotiations; "the Court cannot exclude at this stage the possibility that the relationship among the parties was sufficient to impose a duty of due care upon the defendants in making representations about the subjects of the transaction."

3. *Lehman Brothers Commercial Corp.* v. *Minmetals International Non-Ferrous Metals Trading Company*, No. 94 Civ. 8301 2000 WL 1702039 (S.D.N.Y. Nov. 13, 2000)

See factual description *supra*. The court refused to grant LBCC's motion for summary judgment on Minmetals' claim of negligent misrepresentation. It noted that "[t]his Court has already that there is a material issue of fact concerning the existence of a fiduciary between [the parties.] Therefore, there similarly exists a question of fact concerning the existence of a 'special relationship' between them, since the standard for establishing a special relationship is less rigorous than the standard for establishing a fiduciary relationship." (footnote omitted.)

4. *Procter & Gamble* v. *Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996)

See factual description *supra*. The court dismissed P&G's counterclaim for negligent representation, concluding that there was no "special relationship" between the parties: "BT and P&G are sophisticated corporations whose dealings were on a business level."

5. *Village on Canon* v. *Bankers Trust Co.*, 920 F. Supp. 520 (S.D.N.Y. 1996)

See factual description *supra*. The court dismissed plaintiff's claims of negligent misrepresentation, holding that neither the parties' financial advisory relationship, nor the parties' loan and guaranty arrangements, gave rise to a "special relationship" between the parties to support a claim of negligent misrepresentation.

V. Fraudulent Concealment

In general, in order to state a claim for fraudulent concealment, plaintiff must allege that: (1) the defendant had a duty to disclose; (2) the defendant suppressed material facts; (3) the suppression induced the plaintiff to act or to refrain from acting; and (4) the plaintiff suffered damages as a proximate result of the defendant's conduct. *See Restatement (Second) of Torts* §§ 550, 551.

A. The "Duty to Disclose"

As set forth in *Brass* v. *American Film Technologies, Inc.*, 987 F.2d, 142 (2d Cir. 1993), in the absence of a fiduciary duty, there are two ways to establish a "duty to disclose":

1. A *prima facie* showing of *superior knowledge* is sufficient in New York to establish a special relationship; or

2. Misleading or ambiguous disclosures create a duty to disclose. One party to a business transaction is under a duty to disclose to the other such additional matters known to him in order to prevent his partial statement of the facts from being misleading.

B. Cases Addressing the Duty to Disclose

1. *Brass* v. *American Film Technologies, Inc.*, 987 F.2d 142 (2d Cir. 1993)

Brass, a purchaser of stock warrants, asserted a fraud claim against the issuer, AFT, arguing that AFT had not disclosed certain restrictions on the resale of its warrants. Brass alleged that: during a period of active solicitation by AFT, no representative informed Brass that the warrants and the underlying common stock shares would not be freely transferable for two years. The court found that there was a duty to disclose based upon superior knowledge. A duty to disclose based on superior knowledge arises where one party to a contract possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge. The Court observed a trend "in New York to apply the rule of superior knowledge in an array of contexts in which silence would at one time have escaped criticism. Moreover, the Second Circuit held that the "requirement that information not be readily available to the plaintiff must not be read broadly."

VI. Breach of the Implied Covenant of Good Faith and Fair Dealing

In New York, every contract contains an implied covenant of good faith and fair dealing. New York has adopted Section 1-203 of the Uniform Commercial Code, which states, "Every contract or duty written in this Act imposes an obligation of good faith in its performance or enforcement." New York has also adopted the principles articulated in the Restatement (Second) Contracts, that every contract imposes on each party a duty of good faith and fair dealing in its performance and enforcement. *See, e.g.*, *Procter & Gamble Co.* v. *Bankers Trust Co.*, 925 F. Supp. 1270, 1290 (S.D. Ohio) (applying New York law).

The covenant requires that no party to a contract do anything that will destroy or injure the right of another party to receive the benefits of the contract. A party may breach this implied duty of good faith and fair dealing even if it is not in breach of the express contractual obligations. *See, e.g.*, *Chase Manhattan Bank N.A.* v. *Keystone Distributors, Inc.*, 873 F. Supp. 808 (S.D.N.Y. 1994). If a party violates this covenant, it cannot enforce the contract. *See, e.g.*, *Bank of China* v. *Chan*, 937 F.2d 780 (2d Cir. 1991).

A. Cases Addressing the Implied Covenant of Good Faith and Fair Dealing

1. *Shamis* v. *Ambassador Factors Corp.*, No. 95 Civ. 9818 (RWS) 1996 WL 457320 (S.D.N.Y. Aug. 14, 1996)

Defendant moved to dismiss a complaint alleging fraud and breach of the implied covenant of good faith. In its motion, it presented two arguments. First, it argued that the implied covenant of good faith could never impose an obligation on the parties inconsistent with the terms of the contractual relationship. Second, it argued that the covenant does not extend so far as to undermine a party's right to act on its own interests in a way that may incidentally lessen the other party's anticipated fruits of the contract. The court rejected both arguments as premature.

2. *Procter & Gamble* v. *Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996)

See factual description *supra*. The district court held that New York law imposes a duty to deal fairly and in good faith during the performance of swap transactions.

3. *Chase Manhattan Bank, N.A.* v. *Keystone Distributors, Inc.*, 873 Supp. 808 (S.D.N.Y. 1994)

Plaintiff Chase Manhattan Bank entered into a contract with Keystone Distributors, Inc. ("KDI"), a mutual fund distribution company. Under the terms of the agreement, KDI advanced its own funds to separate mutual funds for sales commissions to brokers and dealers on the sale of shares of the mutual funds. Chase bought from KDI its right, title and interest in, as well as a portion of, the reimbursement of these funds by the mutual funds back to KDI. Chase ultimately sued KDI for breach of contract, breach of good faith and fair dealing, breach of fiduciary duty, and fraud. The court granted a motion for

summary judgment for defendant on all counts except breach of good faith and fair dealing, noting that a party may breach this implied duty even if it is not in breach of its express contractual obligations.

VII. Limitation of Liability by Contract

A. General Principles Limiting Exposure

1. *Danann Realty Corp.* v. *Harris*, 5 N.Y.2d 317, 157 N.E.2d 597, 184 N.Y.S.2d 599 (1959)

Danann Realty is the seminal case in New York jurisprudence for the proposition that a plaintiff alleging fraud cannot use extrinsic evidence to establish a defendant's fraud in the inducement of a transaction, if the parties' subsequent agreement includes a merger clause disclaiming any representations not set forth in the agreement. The court held that a specific disclaimer—in this case providing that "neither party is relying upon any statement or representation not embodied in this contract"—"destroys the allegations in plaintiff's complaint that the agreement was executed in reliance upon these contrary oral representations." The *Danann* court emphasized that a general "omnibus statement that the written instrument embodies the whole agreement, or that no representations have been made" is not enough to prevent a party from claiming that he was fraudulently induced to enter the contract.

2. *Grumman Allied Indus., Inc.* v. *Rohr Indus., Inc.*, 748 F.2d 729 (2d Cir. 1984)

Plaintiff, who had purchased assets of defendant's subsidiary, sued for fraud and misrepresentation, alleging that defendant had failed to disclose material facts during the parties' negotiations. Defendant argued that the parties had contractually disclaimed reliance in their agreement. District court granted summary judgment in favor of defendant. Relying on *Danann* for the principle that "where the parties to an agreement have expressly allocated risks, the judiciary shall not intrude into their contractual relationship," the Second Circuit upheld the district court, noting that the disclaimer provisions in the parties' agreement were "sufficiently specific and unambiguous to invoke the *Danann* rule."

B. International Swaps and Derivatives Association (ISDA) Agreements

Principles and Practices for Wholesale Financial Market Transactions: To confirm the relationship between Participants and to articulate a set of best practices with respect to the over-the-counter financial market transactions between Participants, in March 1995, ISDA and other industry groups released a draft of "Principles and Practices for Wholesale Financial Market Transactions" (the "Principles"). The stated purpose of the Principles was to "confirm the relationship between Participants and to articulate a set of best practices with respect to over-the-counter financial markets transactions between Participants." Section 4.2.2 of the Principles states in relevant part:

> Absent a written agreement or an applicable statute, rule or regulation that states affirmative obligations to the contrary, a Participant should assume that each counterparty deals at arm's length for its own account. A Participant should not treat or construe communications (whether written or oral and including ideas or suggestions regarding potential transactions) from another Participant as recommendations or investment advice and should not rely on them as such.

After soliciting public comments on draft Section 4.2.2, the drafters learned that many commenters were concerned that this section, as written, would be interpreted broadly to disclaim responsibility for even the factual accuracy of statements made to counterparties. As a result, the section was redrafted, and the final version of Section 4.2.2 reads as follows (emphasis added):

> A Participant may communicate to its counterparty economic or market information relating to Transaction and trade or hedging ideas or suggestions. *All such communications (whether written or oral) should be accurate and not intentionally misleading. Non-reliance language was never intended to shield a party from liability for its own misstatements of fact.*"

* * *

Richard A. Rosen is a litigation partner at Paul, Weiss, Rifkind, Wharton & Garrison in New York, where he chairs the Securities, Futures, and Derivative Litigation Group. Kristine M. Zaleskas is an associate in the litigation department of Paul, Weiss, Rifkind, Wharton and Garrison.