

Courts Bolster Release of Fiduciary Duties and Fraud

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The Need to Adapt Contracts to Case Law

When contract disputes give rise to litigation, the resulting court decisions are often studied and used by the attorneys who argue the cases. Attorneys who could benefit the most from such decisions, however, are the ones who are responsible for drafting the contracts in the first place. As the case law evolves, contract provisions must adapt accordingly to account for the changing scope of the law so as to avoid litigation and to protect the parties from unintended consequences.

One area that has recently developed is the contractual release and waiver of claims of breach of fiduciary duty and fraud. There has never been a better time for transactional attorneys to incorporate principles pronounced by the New York Court of Appeals in preserving and releasing claims in transactions involving fiduciaries.

The typical factual scenario involves owners of a business, whether members in a limited liability company, shareholders in a corporation or partners in a general partnership, who are buying and selling their interests between and among themselves. Of course, owners of a business owe each other fiduciary duties during the course of their relationship.¹ When one owner seeks to buy out another, therefore, the issues become quite thorny because of the existence of the normal fiduciary duties. Ordinarily, for example, the fiduciary duty requires one owner to disclose to the other owner, without being asked, information that would be material to the contemplated transaction. Given that many owners are sophisticated business people, however, at least one party to the transaction often wishes to disclaim reliance upon any representations regarding the transaction. Moreover, a fiduciary may wish to obtain a release of any claim of breach of such duty or reliance upon disclosures otherwise required by such duty.

Thus, it is quite important for those drafting the transactional agreements to understand the legal duties between and among the parties and how to limit or preserve those duties effectively in an enforceable agreement.

Recent case law provides valuable insight to guide the contract draftsman.

The Powerful Breadth of Fiduciary Duties

A good starting point to review the context of the principles involving contractual waivers and releases of fiduciary duties is the once earth-shattering case of *Blue Chip Emerald LLC v. Allied Partners Inc.*² In *Blue Chip*, a limited liability company was owned 50 percent by plaintiff and 50 percent by defendant, which also was the managing member and controlled day-to-day operations.

Plaintiff sold its interest in the LLC to defendant based upon an \$80 million valuation of the LLC's real property. However, just two weeks later, defendant entered into a contract to sell the property for \$200 million.

Plaintiff made several significant acknowledgements in the transactional contracts in which it sold its interests, including that it had not received any "representations or warranties" from defendant as to the "actual or projected value" of the real property or "any other matter affecting or related to" the property and had been "afforded an opportunity to conduct its own due diligence." After learning of defendant's deal to sell the property for \$200 million, plaintiff sued defendant and its principals for fraud and breach of fiduciary duty. The trial court dismissed the complaint based upon the contractual representations and disclaimers, but the First Department reversed.

Notwithstanding the explicit contractual disclaimers, the First Department found that the trial court "overlooked" the unbending fiduciary "duty of undivided and undiluted loyalty" the defendant owed to plaintiff. The Court observed that fiduciary duties are enforced "with '[u]ncompromising rigidity.'" Thus, the Court continued, "when a fiduciary, in furtherance of its individual interests, deals with the beneficiary of the duty in a matter relating to the fiduciary relationship, the fiduciary is strictly obligated to make 'full disclosure' of all material facts [and] 'to disclose any information that could reasonably bear on [the beneficiary's] consideration of [the fiduciary's] offer'.... Absent such full disclosure, the transaction is voidable...."

The Court of Appeals Bolsters Contractual Waivers and Releases

Although several appellate decisions followed the basic concepts pronounced in *Blue Chip*, the Court of Appeals has significantly limited the breadth of *Blue Chip*. While *Blue Chip's* description of the scope of fiduciary duties is still sound, the Court of Appeals has bolstered the enforceability of releases of these duties, thereby laying out a firm framework for enforcing contractual waivers of fiduciary duties. For example, in *Centro Empresarial Cempresa S.A. v. America Movil, S.A.B. DE C.V.*,³ plaintiffs alleged that they were induced to sell their minority interest in a foreign mobile telephone company by misrepresentations made to them by the majority owner concerning the value of the enterprise. In the purchase agreement, the parties exchanged a broadly worded mutual release, including any interest in the underlying enterprise. Plaintiffs claimed they were fraudulently induced to sell their interest for less than \$130 million because information they later discovered indicated that their interest was worth more than \$1 billion.

The trial court denied defendants' motion to dismiss, but this time, the First Department reversed.

The Court of Appeals affirmed the First Department's dismissal of the complaint. The Court acknowledged that a release may be invalidated based on the same grounds upon which any agreement can be set aside, such as duress, illegality, fraud or mutual mistake. The Court, however, rejected plaintiffs' claim of fraud because the alleged fraud involved the very subject that the release was intended to cover—the value of the membership interest.

The Court acknowledged that "as a majority shareholder in a closely held corporation, [defendant] owed a fiduciary duty to plaintiffs, minority shareholders, [and] was therefore required to 'disclose any information that could reasonably bear on plaintiffs' consideration of [its purchase] offer.'" The Court announced, however, that a "sophisticated principal is able to release its fiduciary from claims—at least where, as here, the fiduciary relationship is no longer one of unquestioning trust—so long as the principal understands that the fiduciary is acting in its own interest and the release is knowingly entered into." The Court then cautioned that "[t]o the extent that" *Blue Chip* and similar decisions "suggest otherwise, they misapprehend our case law."

In *Pappas v. Tzolis*,⁴ – the most recent guidance from the Court of Appeals – the Court took yet another opportunity to bolster contractual waivers of fiduciary duties. In *Pappas*, a member of an LLC bought out the other members, and after the buyout, plaintiffs learned that defendant assigned the lease owned by the LLC for several million dollars allegedly arising from negotiations before the buyout. In the buyout contracts, plaintiffs agreed that defendant "has no fiduciary duty to [plaintiffs] in connection with" the sale of their interest to him.

The motion court dismissed the complaint, but the First Department reversed, despite the Court of Appeals decision in *Centro*.⁵ Citing its own decision in *Blue Chip*, the First Department held that there was "no discernible difference in the facts" from *Blue Chip*. With two justices dissenting, the case went up to the Court of Appeals.

On appeal, the Court of Appeals unanimously reversed, dismissing plaintiffs' complaint in its entirety. Relying heavily upon *Centro*, the Court of Appeals held the release was enforceable, noting that "plaintiffs were sophisticated businessmen represented by counsel. Moreover, plaintiffs' own allegations make it clear that at the time of the buyout, the relationship between the parties was not one of trust, and reliance upon [defendant's] representations as a fiduciary would not have been reasonable." In fact, the Court noted that the "relationship between plaintiffs and [defendant] had become antagonistic, to the extent that plaintiffs could no longer reasonably regard [defendant] as trustworthy." The Court observed that in *Centro* it had held that "'[a] sophisticated principal is able to release its fiduciary from claims—at least where . . . the fiduciary relationship is no longer one of unquestioning trust—so long as the principal understands that the fiduciary is acting in its own interest and the release is knowingly entered into' Where a principal and fiduciary are sophisticated entities and their relationship is not one of trust, the principal cannot reasonably rely on the fiduciary without making additional inquiry."

The Court also rejected the claims of fraud and misrepresentation, noting in the release document plaintiffs “in the plainest language announced and stipulated that [they were] not relying on any representations as to the very matter as to which [they] now claim [] [they were] defrauded.⁶”

The lower courts have also started to take note from these recent Court of Appeals decisions. For example, in *Kafa Investments, LLC v. 2170-2178 Broadway, LLC*⁷, the court relied heavily upon *Centro* in enforcing a release between fiduciaries and rejecting claims of fraud. The court refused to follow *Blue Chip*, ruling that in light of *Centro*, “the unambiguous language of the release cannot be abrogated by the fact that the parties were fiduciaries, especially here, where the [transactional agreement] was in effect an agreement to end the parties’ relationship with respect to their interests...”

The New York Pattern Jury Instructions have summarized the relevant case law as follows:

A fiduciary cannot by contract, through a waiver or disclaimer provision, relieve itself of the fiduciary obligation of full disclosure by withholding the very information the beneficiary of the duty needed in order to make a reasoned judgment whether to agree to the proposed contract, However, that principle does not preclude a sophisticated investor from releasing a fiduciary from claims where the relationship is no longer one of trust, the principal has “hints of falsity,” the principal understands that the fiduciary is acting in its own interest and the release is knowingly entered into,

Lessons For Contract Drafting

What does all this mean for the lawyer drafting such contracts? First, read and learn from the above case law. In any situation where one or more of the parties owes a fiduciary duty to the other party to a contract, careful thought must be given to the legal obligations that arise therefrom. If a party is in fact relying upon information or a duty to disclose information, that fact should be described explicitly in the contract. In each of the cases discussed above, plaintiffs claimed that they were relying upon either a representation or were misled by the concealment of material information. The problem, however, was that none of that was set forth in the contract. Thus, explicit representations must be provided in the contract if a party intends to preserve its actual reliance upon such information or the duty to disclose arising from the fiduciary duty.

On the other hand, for those seeking to avoid any claim based upon the fiduciary duty to disclose information, the disclaimers, waivers and releases should be express and explicit. The contract should explicitly state that the other side is not relying upon the fiduciary to disclose any information, that the relationship of the parties is not one of “unquestioning trust,” and that each party has fully and completely investigated the transaction on their own and without reliance upon the other in any respect, including upon any duties to disclose that would otherwise arise from the fiduciary relationship.

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