ALERTS AND UPDATES

Words Matter: Financial Advisors Need to Be Careful Using Form Engagement Letters

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Financial advisors may be held liable to third-party beneficiaries for breach of contract and fiduciary duty claims based in part on the specific language in a form public-company engagement letter that was used for a private company transaction. The decision by the U.S. District Court for the District of Massachusetts in *Baker v. Goldman Sachs*[1] demonstrates that some of the provisions in a form engagement letter designed to protect financial advisors in a public company deal may present distinct risks to the same financial advisors in a private company transaction.

Background

Goldman Sachs & Co. ("Goldman") represented Dragon Systems, Inc. ("Dragon"), a closely held company founded and controlled by Janet and James Baker (the "Bakers"), in the merger of Dragon into a subsidiary of Lernout & Hauspie Speech Products N.V. (collectively "L&H") on June 7, 2000. The Bakers alleged that Dragon entered into an all-stock merger with L&H in reliance on Goldman's advice and that the collapse of L&H following an accounting fraud scandal uncovered by *The Wall Street Journal* within months after the Dragon-L&H deal closed resulted in a loss to Dragon's controlling shareholders of approximately $300 million.

In an attempt to recover the consideration they were to receive, the Bakers filed suit against Goldman, asserting the following claims: (1) breach of fiduciary duty, (2) violation of Massachusetts unfair-practices statute, (3) breach of contract, (4) breach of contract / third-party beneficiary, (5) breach of the implied covenant of good faith and fair dealing, (6) negligence and (7) negligent misrepresentation. Goldman moved to dismiss all claims, contending that the Bakers were not parties to the engagement letter between Dragon and the financial advisor, and that its contractual and fiduciary duties ran exclusively to Dragon.

U.S. District Court Decision

Applying New York contract law, the court denied the motion to dismiss in principal part with respect to all counts, except for breach of contract. The court ruled that although the Bakers were not parties to the engagement letter, Janet Baker was an intended third-party beneficiary because she was a member of Dragon's board of directors and a majority shareholder at the time of Goldman's engagement by Dragon.

When interpreting the engagement letter, the court ruled that, while Goldman was hired by Dragon, the engagement letter showed an express intent of Goldman to benefit members of Dragon's board of directors. The engagement letter included language customarily used by financial advisors in public company transactions; specifically, it stated that "any written or oral advice provided by Goldman Sachs in connection with our engagement is exclusively for the information of the Board of Directors and senior management of the Company." Goldman argued that it referred to the board of directors in a representative capacity. However, the court emphasized that the letter not only was addressed to Janet Baker in her individual capacity, but also that the letter used the word "you" rather than "company" when discussing Goldman's duty to provide

"financial advice and assistance." The court determined that "you" should be given its plain meaning, and therefore interpreted "you" to refer to the addressee of the letter, giving her enforceable rights under the engagement letter.

With respect to the fiduciary duty claims, the court found that the relationship among the parties was "muddy" and that special circumstances existed to create a fiduciary relationship apart from the terms of the letter of which Janet Baker is allegedly the third-party beneficiary. The court distinguished this case from *Joyce v. Morgan Stanley & Co.*,[2] where the Seventh Circuit held that the engagement letter explicitly noted that Morgan Stanley was working only for the corporation. Unlike *Joyce*, the court in *Baker* emphasized that there was no explicit waiver in the engagement letter precluding an extra-contractual fiduciary duty. In addition, the court in *Baker* concluded that the Bakers were central players in the transaction and were in close and direct contact with the financial advisor—not mere bystanders as in the typical shareholder suit.

Lessons Learned Thus Far with Regard to Negotiating and Drafting Engagement Letters in Private Company Transactions

Baker involved a motion to dismiss; litigation regarding the merits of the claims is ongoing. Nevertheless, this decision may serve as a reminder to financial advisors to carefully draft engagement letters in private company transactions. This case demonstrates that careful thinking and drafting can be key in avoiding post-transaction litigation, particularly at these preliminary litigation steps. For instance, the *Baker* case instructs, when negotiating and drafting any engagement letter, that consideration should be given to being precise in the choice of language, including the addressees of the letter and the use of the word "you." If the engagement is intended to be between the financial advisor and the company, use of the word "you" may be replaced with the word "company" and the addressee of the letter should be the company, with attention to the members of the board of directors. In addition, if the company is the only party entitled to rely on the advice given pursuant to an engagement letter, consideration should be given to the utility of including express statements that any advice provided by the financial advisor is exclusively for the benefit and information of the company. With respect to fiduciary duties, financial advisors may want to consider the inclusion of an explicit waiver precluding extra-contractual fiduciary duties. Advisors may also wish to carefully note the type and quality of contact among parties associated with a transaction and the capacity in which each party serves.

While the *Baker* decision addresses financial advisors specifically, many of these lessons can be applied to the recipients of these letters and services. In many instances, bankers and their recipients refer to these letters as "forms," and this case demonstrates that courts are likely to read the letters carefully, even if the parties do not.

For Further Information

If you would like more information about this *Alert* or have questions regarding the review of documents, including engagement letters, please contact any member of the Corporate Practice Group or the attorney in the firm with whom you are regularly in contact.

Notes

1. *Baker v. Goldman Sachs*, No. 09-10053-PBS (D. Mass. Sept. 15, 2009).

2. *Joyce v. Morgan Stanley & Co.*, No. 07-1992 (7th Cir. Aug. 19, 2008).