KEVIN SCHLOSSER IN NYLJ: GRAPPLING WITH FIDUCIARY DUTIES IN ENFORCING CONTRACTS

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Warning to lawyers tasked with drafting contracts in which fiduciary duties are lurking: Fasten your seatbelts, you're in for a wild ride!

New York case law has been moving fast and furiously as to the enforceability of contracts involving fiduciaries where it is claimed that the contract was induced by a breach of the fiduciary's duties. From 2002, when the earth-shattering decision in Blue Chip Emerald LLC v. Allied Partners Inc., 299 A.D.2d 278, 279, 750 N.Y.S.2d 291, 294 (1st Dept. 2002), was handed down by the First Department, the cases have been on a whirlwind of twists and turns. The Court of Appeals recently jumped into the fray,1 only to see the First Department quickly get back onto center stage.2

Oftentimes, in this age of increasingly specialized legal representation, lawyers who write contracts do not also handle the disputes that arise over the meaning or enforceability of those contracts. Thus, those who write the contracts do not typically benefit from how the courts interpret those contracts.

Given the fast-moving case law interpreting contracts involving fiduciaries, those preparing the contracts should understand the evolving law and address the important issues. As discussed below, the Court of Appeals has now indicated that a fiduciary can in fact be relieved of its stringent and unbending duties by virtue of contractual disclaimers and/or releases, but the language used will be carefully scrutinized. Ignoring the latest law could have disastrous results.

'Blue Chip' and Its Progeny

While the concepts applicable to fiduciary duties have been recognized for centuries, the First Department's decision in Blue Chip applied them with eye-opening impact. 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 in control of day-to-day operations. The sole asset of the LLC was a valuable piece of real property in Manhattan.

After plaintiff sold its interest in the LLC to defendant based upon an $80 million valuation of the real property, defendant contracted to sell the property for $200 million just two weeks later. Plaintiff acknowledged in the transactional contracts that (i) it was entering into the buyout agreement without receiving 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; (ii) defendant had discussed the possible "operation, leasing, sale and/or valuation" of the property with 16 third parties, among whom the ultimate purchaser was identified; (iii) it had been "afforded an opportunity to conduct its own due diligence;" and (iv) it was satisfied with the information made available to it by defendant and otherwise.

Plaintiff also disclaimed any interest in the profit realized by the defendant on a future sale of the property to any of the disclosed third parties and "any claim for fraud, breach of loyalty or breach of fiduciary duty" arising out of the LLC except as to any claim in the event the defendant had sold or leased the property to an unidentified third party if the transaction arose from discussions on or before the buyout date.

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, seeking the additional $60 million of profit it would have realized when the property was sold. Plaintiff alleged that it was induced to sell its interest in the LLC for an unfairly low price based upon defendants' misrepresentations and omissions concerning the discussions they were conducting with third parties to sell the property, including failing to disclose both the true price range in which they were negotiating and the existence of an oral agreement to purchase the property for $200 million.

The trial court dismissed the complaint in its entirety based upon the contractual representations and disclaimers. The First Department reversed and reinstated the complaint.

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 continued: "Consistent with this stringent standard of conduct, which the courts have enforced with '[u]ncompromising rigidity'...it is well-established that, 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.... Stated otherwise, the fiduciary is obligated in negotiating such a transaction '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...."

Based upon these broad fiduciary duties, the First Department found that if plaintiffs could prove that defendants did not reveal material facts, or misrepresented them, all of the contractual disclaimers that the court below relied upon to dismiss the action would be voidable "as the fruit of the fiduciary's breach of its obligation to make full disclosure." The First Department concluded: "In sum, a fiduciary cannot by contract relieve itself of the fiduciary obligation of full disclosure by withholding the very information the beneficiary needs in order to make a reasoned judgment whether to agree to the proposed contract."

A number of informative Appellate Division decisions involving similar factual scenarios followed. In Global Minerals & Metals Corp. v. Holme, 35 A.D.3d 93, 824 N.Y.S.2d 210 (1st Dept. 2006), for example, the First Department acknowledged that defendant owed a fiduciary duty to the plaintiffs, but it came to a different result than in Blue Chip. The court affirmed the dismissal of the complaint, concluding that the corporate plaintiff did not reasonably rely on any alleged misrepresentation and that it failed to fulfill its duty to investigate because plaintiff either knew of the allegedly fraudulent conduct outright or had sufficient notice of it to investigate further. The First Department counseled that plaintiff "should have sought to condition the settlement on the truth of the representations by or on behalf of [defendant] that induced [it] to enter the settlement."

In Littman v. Magee, 54 A.D.3d 14, 860 N.Y.S.2d 24 (1st Dept. 2008), the First Department reversed the dismissal of a complaint by a minority member of an LLC alleging breach of fiduciary duty and seeking to invalidate the buyout of its interest by and release of the majority

member. Relying on Blue Chip, the court found that plaintiff sufficiently alleged "that defendants intentionally kept from plaintiff financial information vital to plaintiff's decision, information that he had demanded and that they had a duty to provide, while they falsely asserted that no other information was available." The court therefore concluded: "The assertions are sufficient to support the claim that the release should be set aside, so as to allow plaintiff to proceed with his claims for breach of fiduciary duty and fraudulent concealment."

The principles pronounced by Blue Chip and its progeny have also been followed in other departments. See, e.g., Dube-Forman v. D'Agostino, 61 A.D.3d 1255, 877 N.Y.S.2d 740 (3d Dept. 2009) ("a specific disclaimer clause cannot serve to defeat a claim of fraud if the seller owes the buyer a fiduciary duty but nonetheless breaches that duty by failing to 'disclose any information that could reasonably bear on [the buyer's] consideration of [the transaction]'"); Salm v. Feldstein, 20 A.D.3d 469, 799 N.Y.S.2d 104 (2d Dept. 2005) ("because the defendant had a fiduciary relationship with the plaintiff, the disclaimers contained in the contract, upon which the defendant relies, did not relieve him of the obligation of full disclosure").

Court of Appeals Decisions

Two other First Department cases recently made their way up to the Court of Appeals, giving the state's highest court the opportunity to weigh in on the extent to which a fiduciary can be relieved of its legal duties by contract and/or release. In Centro Empresarial Cempresa Sp.A. v. America Movil, S.A.B. De C.V., 901 N.Y.S.2d 618 (1st Dept. 2010), aff'd, 17 N.Y.3d 269 (2011), 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 underlying enterprise. In the purchase agreement, the parties executed and exchanged a broadly worded mutual release, including of any interest in the underlying enterprise. Plaintiffs claimed they were fraudulently induced to sell their interest for less than $130 million, while information they later discovered indicated that their interest allegedly would have been worth more than $1 billion several years later.

The trial court denied defendants' motion to dismiss, but 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 any agreement can be set aside, such as duress, illegality, fraud or mutual mistake. The Court, however, rejected plaintiffs' claim of fraud in an attempt to invalidate the release, because the alleged fraud involved the very subject that the release was intended to cover—the value of the membership interest.

Focusing on the impact of defendant's fiduciary duty to plaintiffs, the Court did acknowledge that "as a majority shareholder in a closely held corporation, [it] 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."

The Court emphasized that the complaint itself alleged that "plaintiffs knew that defendants had not supplied them with the financial information necessary to properly value" their interests, yet "chose to cash out their interests and release defendants from fraud claims without demanding either access to the information or assurances as to its accuracy in the form of representations and warranties." The Court concluded that "plaintiffs 'have been so lax in protecting themselves that they cannot fairly ask for the law's protection.'"3

'Blue Chip' Reaffirmed

Soon after the Court of Appeals rendered Centro, the First Department reaffirmed the essence of Blue Chip in Pappas v. Tzolis, 2011 NY Slip Op 06455 (1st Dept. Sept. 15, 2011). Pappas involved familiar facts—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 interests to him.

The motion court dismissed the complaint, but the First Department reversed.
In a compelling reaffirmation of Blue Chip, the court held that there was "no discernible difference in the facts" from Blue Chip, and therefore the court felt "compelled to act with the same uncompromising rigidity here as in Blue Chip." The court was unpersuaded that plaintiffs acknowledged in the contract that they performed their own due diligence and that defendant had no fiduciary duty to them, concluding that defendant nevertheless had an overriding duty to disclose his dealings with the assignee.

The First Department distinguished the Court of Appeals decision in Centro because plaintiffs there knew they were not provided with relevant information, had given "an exceedingly broad release," and were no longer in a position of unquestioning trust with the fiduciary, while plaintiffs in Pappas had no such knowledge, gave no broad release and there was no evidence that the relationship was not one of unquestioning trust. The First Department distinguished Afra on similar grounds.

Two justices dissented in Pappas, so there may be further word from the Court of Appeals. In the meantime, these cases cannot be ignored when drafting contracts involving fiduciaries.

Lessons for Contract Drafting

1. Consider whether the contemplated transaction involves a fiduciary relationship, and if so, the ramifications of the duties imposed by law, especially the heightened obligation of the fiduciary to disclose, affirmatively and without request, information that may be deemed material to the transaction. Address these duties directly in the contract.

2. The Court of Appeals has indicated that a fiduciary may be able to contract away fiduciary duties, but this requires effective drafting, given the qualifications both the Court of Appeals and the First Department have articulated. A simple contract provision disavowing the existence of a fiduciary duty will not be effective; nor will a mere statement that the contract was "negotiated at arm's length." If the fiduciary duty is indeed intended to be eliminated, the parties should not only expressly disavow any such duty, but acknowledge in writing that the relationship is not one of "unquestioning trust" and that each party understands it is protecting its own interests.

3. The cases show that the nature of due diligence, if any, by the beneficiary of the duty is important. If the beneficiary fails to undertake due diligence, especially in the face of missing or suspicious information, claiming that the fiduciary failed to disclose information is unlikely to prevail.

4. From the beneficiary's perspective, if bargaining power and leverage allow, the party to whom a fiduciary duty is owed should attempt to

preserve any and all rights derived from such fiduciary duties. The fiduciary should be asked to acknowledge the existence of the fiduciary duties, including the duty to disclose any and all material information having any bearing upon the transaction. While the fiduciary is likely to object to such a broad acknowledgment, the request could serve to flesh out relevant information or assist in obtaining specific representations and warranties.

5. The cases repeatedly refer to "prophylactic language" that the beneficiary should have included in transactional documents, in the absence of which courts may deem the beneficiary to have "assumed the business risk that the facts may not be as represented." Thus, notwithstanding the duty of a fiduciary to disclose material information, the party to whom such a duty is owed would be well advised to identify and itemize any and all information relied upon, whether by way of disclosure or omission, and include those items in an appropriate representation and warranty. Similarly, where disclaimers or releases of claims are included, specific items of information, representations and/or claims that are intended to be excluded and preserved should be identified explicitly.
Above all, before drafting the contract and formulating the language, the case law discussed above (and all of its permutations) should be carefully analyzed.

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Endnotes:
1. See Centro Empresarial Cempresa S.A. v. Amerca Movil, S.A.B. de C.V., 17 N.Y.3d 269 (June 7, 2011) and Afra v. Zamir, 17 N.Y.3d 737 (June 7, 2011), discussed further below.

2. Pappas v. Tzolis, 2011 NY Slip Op 06455 (1st Dept. Sept. 15, 2011).

3. In a similar case decided the same day as Centro, the Court of Appeals used the same reasoning to affirm the dismissal of fraud claims seeking to invalidate a release. See Afra v. Zamir, 905 N.Y.S.2d 77 (1st Dept. 2010), aff'd, 17 N.Y.3d 737 (June 7, 2011).