



Outside Counsel Hedge Fund Liability: Causes Of Action Against Managers, Advisers

Expert Analysis

In the wake of Bernard Madoff's alleged \$50 billion Ponzi scheme, investors and their attorneys will likely examine potential legal claims against hedge fund managers and their financial advisers who recommended a particular hedge fund investment, in an attempt to recover lost funds.

While this article relies primarily on federal securities law and New York state law, it may make reference to the laws of other jurisdictions to illustrate points of comparison.

Fraud

Investors may maintain a cause of action under both the federal securities laws and under various state law provisions for fraud and fraudulent misrepresentation. As a threshold issue and a notable cautionary point, the Federal Rules of Civil Procedure, Rule 9(b) applies a heightened pleading standard for claims involving fraud: these claims must be pleaded with particularity.¹ A federal claim for fraud or fraudulent misrepresentation generally proceeds under §10(b) of the Exchange Act and Securities and Exchange Commission Rule 10b-5 promulgated thereunder. Several cases illustrate such a claim.

First, Bank of America recently filed suit against former hedge fund managers at Bear Stearns. "The suit claims the Bear unit and its managers concealed from Bank of America that the funds were suffering substantial withdrawal requests from investors and were in imminent danger of collapse in the spring of 2007."² Next, myriad litigations involving the collapse of Beacon Hill Asset Management illustrate another common factual scenario: intentional inflation of the net asset value (NAV) of a fund. In the *Beacon Hill* cases, various plaintiffs alleged that the defendant hedge fund managers inflated the NAVs and the fund's investment portfolio to prevent existing investors from seeking to redeem their investments and to induce new investors.³ In addition, the *Beacon Hill* plaintiffs alleged that the defendants "made fraudulent statements concerning the goals and objectives for the management of the funds and

By
**Howard S.
Meyers**



the method of valuing the funds as well as the month-end reports of rates of return and net asset values for each of the funds."⁴ Finally, other common factual allegations under which investors have brought fraud and fraudulent misrepresentation claims include: misstatements and omissions regarding asset value recognition policies,⁵ knowing misrepresentation of a fund's investment strategy,⁶ and misrepresentations about "minimizing downsides."⁷

Variations to these standard federal §10(b)/Rule 10b-5 causes of action exist. In *In re Bayou Hedge Fund Litigation*, 534 F.Supp.2d 405 (S.D.N.Y. 2007), a plaintiff investor group, South Cherry Street LLC (South Cherry), brought suit against their investment adviser, Hennessee Group LLC (Hennessee Group), for fraud, breach of contract, and breach of fiduciary duty.⁸ South Cherry alleged that Hennessee Group claimed that it conducted a "rigorous five-step due diligence" review before recommending a particular hedge fund to a client as an investment option.⁹ Hennessee Group further represented to plaintiff that it conducted ongoing due diligence of a client's hedge fund investment after it recommended that its clients invest in a particular hedge fund.¹⁰ This litigation arose after plaintiff's investment in a hedge fund, Bayou Group, based on Hennessee Group's recommendation and promised due diligence, turned out to be a massive Ponzi scheme.¹¹

The district court dismissed all of plaintiff's claims. With respect to South Cherry's §10(b) claim, the court focused on defendant's state of mind and whether there was "intent to deceive, manipulate, or defraud, or reckless conduct."¹² Where the requisite state of mind is based on reckless conduct, plaintiff must put forth strong circumstantial evidence to evidence scienter.¹³ Here, the court stated that

[t]he failure to conduct due diligence is not the same thing as knowing of or closing one's

eyes to a known 'danger,' or participating in the fraud. 'Where third-party advisers are concerned, to meet such a standard the allegations must approximate an actual intent to aid in the fraud being perpetrated by the...company.'¹⁴

In particular, the court considered the fact that the manager of Bayou had deceived the investing community and the SEC by covering up a Ponzi scheme for over nine years.¹⁵ The court reasoned, therefore, that even had Hennessee Group performed its diligence perfectly, it most likely would not have uncovered the fraud.¹⁶

In another fraud claim against an investment adviser, *Gabriel Capital LP v. Natwest Finance Inc.*, 137 F.Supp.2d 251 (S.D.N.Y. 2000), the underwriters of a security, Natwest Finance, brought a third-party complaint against employees of their investment adviser, Gabriel Capital LP (Gabriel Capital), for indemnification and contribution after Gabriel Capital sued Natwest for securities fraud.¹⁷ Gabriel Capital initially sued Natwest for alleged misrepresentations in both their offering memorandum and road show presentations for certain Senior Steel Mortgage notes in question.¹⁸ In response, Natwest Finance claimed that language in the offering memorandum gave rise to a duty on the part of Gabriel Capital to discover any misrepresentations in the offering memorandum before recommending the securities to an investor.¹⁹

The district court first held that the investment adviser had no independent duty to verify the accuracy of the facts contained in a document such as the offering memorandum in question.²⁰ The court then proceeded to examine plaintiff's §10(b) contribution claim by looking at the recklessness standard.²¹ It stated that "[w]here third-party advisers are concerned, to meet such a standard the allegations must approximate an actual intent to aid in the fraud being perpetrated by the [] company."²²

Breach of Fiduciary Duty

As a precursor to liability for breach of fiduciary duty, investors must prove that their hedge fund manager owed them a duty of care, loyalty, and/or good faith.²³

[I]nvestment advisers owe fiduciary duties to their clients, much as general partners owe fiduciary duties to limited partners. This is especially so where, as here, the investment

HOWARD S. MEYERS is a partner at Meyers & Heim and a visiting professor of law at New York Law School. ALICIA SURDYK, a third-year student, assisted in the preparation of this article.

adviser has broad discretion to manage the client's investments.²⁴

Hedge fund investors' claims against their managers for breach of fiduciary duty are often asserted in conjunction with allegations of fraud. Indeed, as one court has observed, hedge fund managers "[act] in bad faith and outside the scope of their duties" when they "willfully or recklessly [engage] in fraudulent acts."²⁵

Finally, a prospective plaintiff should be aware of certain standing requirements in key jurisdictions. Under both Delaware law and the law of the Cayman Islands, "claims based on breach of fiduciary duty...that result in the diminution of share value belong to the corporation and can only be brought by it or a shareholder suing derivatively."²⁶

Negligence

An investor plaintiff may bring a negligence cause of action against his or her hedge fund manager under an applicable state law standard. Under New York law, for example, a plaintiff must prove duty of care, breach of the respective duty, and proximate damages resulting from the breach.²⁷

The key threshold issue, as in any negligence cause of action, is whether or not there is a duty owed. Under New York law, "[a] duty of care may arise where the parties are in contractual privity or have a relationship 'so close as to approach that of privity.'"²⁸ The latter is established where a party can establish,

- (1) an awareness by the maker of the statement that it is to be used for a particular purpose;
- (2) reliance by a known party on the statement in furtherance of that purpose; and
- (3) some conduct by the maker of the statement linking it to the relying party and evincing its understanding of that reliance.²⁹

Thus in *Pension Committee*, plaintiffs brought suit against the hedge fund directors, alleging that their dissemination of reports with falsely inflated NAVs was negligent. There, the court found that the relationship between the investors and the hedge fund directors was enough to establish a duty of care.³⁰ In addition, under Connecticut state law, another key jurisdiction for hedge fund litigation, there is notably no cause of action for gross negligence.³¹ That is, in Connecticut, gross negligence does not establish a separate basis of liability.³²

In addition, it should be noted that professional malpractice exists as a subset of the negligence cause of action. "Under New York law, professional malpractice is a species of negligence."³³ Thus, to prevail on such a claim against a professional, such as a hedge fund manager or an investment adviser who recommended a particular failed hedge fund investment, a plaintiff must demonstrate the elements of negligence, and the breach of duty must be by a professional in a departure from accepted standards of practice.³⁴

Negligent Misrepresentation

A cause of action for negligent misrepresentation is a state law claim based on various state standards. Despite differences between the states, the key element of this cause of action, which is

shared between the states, is justifiable reliance. Negligent misrepresentation may be pleaded as an independent cause of action or may be pleaded in the alternative to fraudulent misrepresentation, since a negligent misrepresentation action does not require intent to defraud.³⁵

Using New York law as an example, the elements for a negligent misrepresentation cause of action are:

- (1) carelessness in imparting words
- (2) upon which others were expected to rely
- (3) upon which they did act or failed to act
- (4) to their damage; further,
- (5) the author must express the words directly, with knowledge that they will be acted upon, to one whom the author is bound to by some relation [of] duty or care.³⁶

New York law further requires that a prior relationship have existed between the defendant and the plaintiff.³⁷ In *ABF Capital*, the alleged negligent misrepresentations were made *pre-investment* by the hedge fund's future investor adviser and therefore, with respect to these particular statements, the court found that no "special relationship" existed between the hedge fund investors and the defendant at the time the statements were made.³⁸

California, another important jurisdiction for

Investors may maintain a cause of action under both the federal securities laws and under various state law provisions for fraud and fraudulent misrepresentation.

investor plaintiffs, has a different state law standard. In *Esterkyn v. Van Hedge Fund Advisers Inc.*, plaintiff pension fund's trustee brought suit against defendant hedge fund and its president for allegedly intentional and negligent misrepresentations.³⁹ Applying choice-of-law principles, the court applied California law of deceit which requires the common law element of *actual* reliance.⁴⁰

In other words, California law rejects the fraud-on-the-market theory of reliance. Applying this standard, the court found that since the pension fund's own advisers did independent research on the financial state of the hedge fund, the plaintiffs did not prove fraud or intentional and/or negligent misrepresentation claims.⁴¹

Breach of Contract

Like most of the previously discussed causes of action, breach of contract is necessarily governed by state law. In addition, under New York law, it may not be a duplicate claim: "claims of fraud and breach of fiduciary duty that merely duplicate contract claims must be dismissed."⁴² The contract upon which investors generally bring a breach of contract cause of action is based on the fund's offering documents: the private placement memorandum (PPM), the limited partnership agreement, and the subscription documents. A common claim here is that the defendant hedge

fund managers breached the implied covenant of good faith and fair dealing with respect to the parties' contract.⁴³ For example, in *Veras Capital Partners*, plaintiff investors claimed that their hedge fund managers breached the implied covenant of good faith and fair dealing in their contract where the managers disallowed plaintiffs to redeem their shares as was permissible under the respective investment contract.⁴⁴

Another frequently asserted variation on a breach of contract claim arises from the concept of style drift. For example, in the suit brought by the San Diego Retirement Association against the former managers of Amaranth, the plaintiffs alleged that Amaranth and its managers actually used a high-risk, single-strategy plan based around natural gas while misrepresenting to its investors that it was a "multi-strategy hedge fund."⁴⁵ Other such examples of a breach of contract claim based on style drift include: allegations of unauthorized trading in OTC derivatives that significantly departed from a fund's trading plan⁴⁶ and allegations that a fund entered into currency derivative contracts that were so "far larger" than necessary as to violate company policy.⁴⁷

Finally, it is important for a plaintiff to recognize the distinction between a breach of contract and fraud. Under New York law, "[i]t is well-established that '[t]he failure to carry out a promise made in connection with a securities transaction is normally a breach of contract...[and] does not constitute fraud unless, when the promise was made, the defendant secretly intended not to perform.'"⁴⁸ Under this principle, in *Alteram SA v. Beacon Hill Asset Management LLC*, plaintiffs' allegations, that defendant hedge fund managers abandoned a management strategy of investing principally in mortgage backed securities on a low-leveraged, fully-hedged basis in favor of a short position in U.S. Treasuries on a highly-leveraged basis, did not survive defendant's motion to dismiss.⁴⁹

Civil Conspiracy

This cause of action can be brought under state law in certain jurisdictions. In *GVA Market Neutral Master Limited v. Veras Capital Partners Offshore*, investors claimed that hedge fund manager defendants "accomplished by plan" alleged fraud, negligent misrepresentation and other illegal acts.⁵⁰ Using Texas law, they pleaded that there was clear "existence of agreement and combination" and that with "actual knowledge of such a plan" the defendant managers "maliciously and intentionally conspired" to accomplish their illegal acts.⁵¹ After the New York court dismissed plaintiffs' federal securities fraud claims as time-barred, it declined to exercise supplemental jurisdiction over this and various other state law claims.⁵²

Unjust Enrichment

To state an unjust enrichment claim under New York Law, "a plaintiff must allege that the defendant was enriched at the plaintiff's expense and that the circumstances are such that equity and good conscience require that defendant make restitution."⁵³ This claim will ordinarily be available only when there is no valid, governing contract.⁵⁴ Additionally, unjust enrichment claims, like breach of fiduciary duty claims, belong to a

fund, not to the individual investors.⁵⁵ Applying this standard, shareholder-investor plaintiffs in *ABF Capital Management* were unable to assert an unjust enrichment claim against their manager, who had an investment advisory contract with the named funds, because the plaintiffs had no authority for the claim that shareholders may bring such an unjust enrichment action against a third party.⁵⁶

Promissory Estoppel

Like a claim of unjust enrichment, promissory estoppel is based on the concept of quasi-contractual relief; thus, ordinarily, there is no valid claim for promissory estoppel where there is an enforceable contract governing the action at issue.⁵⁷ Thus in *Independent Asset Management*, the plaintiffs pleaded a claim of promissory estoppel in their original complaint in the alternative to any of their contractually-based causes of action.⁵⁸ The court dismissed both of plaintiff's unjust enrichment and promissory estoppel claims after the parties stipulated to the existence of a contract.⁵⁹

Since investors to a hedge fund generally have a contract originating from the various offering documents, claims of quasi-contractual relief are much less common than those involving fraud, breach of contract, or breach of fiduciary duty. However, there are cases where a plaintiff may otherwise plead such a claim. For example, in *Veras Capital Partners*, plaintiffs admitted the existence of an investment contract with their hedge fund.⁶⁰ However, they claimed that their hedge fund managers made oral promises both to the investors personally and through counsel that settlement funds would be allocated according to plan "A" where they were actually allocated to plan "B," thereby causing financial damage to plaintiff investors.⁶¹

Aiding and Abetting Fraud

In addition to claims against one's hedge fund managers, it may be possible to bring an aiding and abetting claim against an asset management company. Under New York law, to establish a cause of action for aiding and abetting fraud, a plaintiff must prove:

- (1) existence of a primary fraud;
- (2) the defendant knew of the fraud; and
- (3) the defendant lent substantial assistance in committing the primary fraud.⁶²

Likewise, to establish a cause of action for aiding and abetting breach of fiduciary duty, a plaintiff must prove: (1) primary breach of fiduciary duty; (2) the defendant knowingly induced or participated in the breach; and (3) plaintiffs suffered damage as a result of the breach.⁶³ In *Bullmore*, liquidators of two hedge funds brought such an action, alleging that BAS, the asset management company, assisted in the hedge fund manager's fraudulent scheme by "providing false values for individual securities in the funds' portfolios to auditors...."⁶⁴ Under the facts alleged, the court found the plaintiff's complaint sufficient to survive defendant's motion to dismiss.⁶⁵

Conclusion

In these uncertain times, hedge fund investors, and their attorneys, must be cognizant of potential claims and liability against hedge fund managers and the financial advisers who recommended a

particular hedge fund investment. Practitioners should examine multiple theories of federal and state liability, as well as potential defenses in order to advise their clients effectively.



1. FED. R. CIV. P. 9(b).
2. Chad Bray, "BofA Sues Bear Unit, Ex-Staffers," WALL ST. J., Oct. 30, 2008, http://online.wsj.com/article/SB122532516858982249.html?mod=googlenews_wsj. This case was recently filed in the U.S. District Court for the Southern District of New York and has been assigned docket number 08-CV-9265.
3. Marybeth Sorady, "Recent SEC Enforcement Actions and Litigation Involving Hedge Fund Managers," 1687 PLI/CORP 461, 478 (2008).
4. Id.
5. Complaint, *Rotman v. Bendall*, No. 03-23044, 2003 WL 23810779 (S.D.Fla. Nov. 17, 2003). *Brühl v. PricewaterhouseCoopers, Int'l*, No. 03-23044, 2008 WL 4500328 (S.D.Fla. Sept. 30, 2008) (order certifying plaintiff class to proceed as a class action).
6. "Pension Fund Files Fraud Lawsuit Over \$175 Million Investment in Amaranth Advisers," HEDGE FUND LITIG. REP., Aug. 2007, at 2, 2-5. (discussing *San Diego County Employees Ret. Ass'n v. Maounis*, No. 07-2618 (S.D.N.Y. March 29, 2007)). This is also one way in which investors have asserted a claim based on "style drift."
7. Id.
8. *Bayou*, 534 F.Supp.2d at 407.
9. Id.
10. Id. at 409.
11. Id. at 414.
12. Id. Pleading with particularity is required under the PSLRA.
13. Id. at 415.
14. Id. at 417 (citing *Gabriel Capital, L.P. v. Natwest Finance Inc.*, 137 F.Supp.2d 251, 263-4 (2000) (internal quotations and citations omitted)).
15. Id. at 418.
16. Thus under *Tellabs*, plaintiff put forth no inference that could be strong enough to state a cause of action for fraud.
17. *Gabriel Capital*, 137 F.Supp.2d at 256.
18. Id. at 258.
19. Id. at 259.
20. Id. at 262-63 ("An investment adviser is retained to suggest appropriate investments for its clients, but is not required to assume the role of accountant or private investigator and conduct a thorough investigation of the accuracy of the facts contained in the documents that it analyzes for the purpose of recommending an investment. The investment adviser is not the author of those documents and does not purport to certify the accuracy of those documents. This Court will not impose such an obligation on the class of investment advisers.").
21. Id. at 263-64.
22. Id. (citing *In re WRT Energy Sec. Litig.*, No. 96 Civ. 3610, 96 Civ. 3611, 1999 WL 178749, at *9 (S.D.N.Y. March 31, 1999) (internal citations omitted)).
23. See Douglas Cumming and Sofia Johan, "Hedge Fund Forum Shopping," 10 U. PA. BUS. & EMP. L. 783, 793 (2008). Cumming and Johan explain:

While there are very significant differences among the three funds [mutual funds, hedge funds, and private equity funds], what is significantly similar among them are that all three types of fund managers owe their funds and fund investors a fiduciary duty to act in the best interest of the fund and fund investors. The duties of good faith, fair dealing, loyalty, and care have to be upheld by all hedge fund managers as well as their counterparts.

24. *Bullmore v. Banc of America Securities LLC*, 485 F.Supp.2d 464, 469 (2007).
25. Complaint, *Rotman v. Bendall*, No. 03-23044, 2003 WL 23810779 (S.D.Fla. Nov. 17, 2003). This case has recently been certified to proceed as a class action.
26. *ABF Capital Mgmt. v. Askani Capital Mgmt.*, 957 F.Supp. 1308, 1332 (1997).
27. *Pension Comm. of Univ. of Montreal Pension Plan v. Banc of America Securities, LLC*, 446 F.Supp.2d 163, 199 (2006).
28. Id.
29. Id.
30. Id.
31. "Pension Fund Files Fraud Lawsuit Over \$175 Million Investment in Amaranth Advisers," HEDGE FUND LITIG. REP., Aug. 2007, at 2, 2-5. (discussing *San Diego County Employees Ret. Ass'n v. Maounis*, No. 07-2618 (S.D.N.Y. March 29, 2007)).
32. *Birdsall v. City of Hartford*, 249 F.Supp.2d 163, 176 (D. Conn. 2003).
33. *Pension Committee*, 446 F.Supp.2d at 198-99 (citing

VTech Holdings Ltd. v. PricewaterhouseCoopers, LLP, 348 F.Supp.2d 255, 262 (S.D.N.Y. 2004)).

34. *Pension Committee*, 446 F.Supp.2d at 198-99 (citing *VTech Holdings Ltd. v. Pricewaterhouse Coopers, LLP*, 348 F.Supp.2d 255, 262 (S.D.N.Y. 2004)).

35. See e.g., Complaint at 22, *Alteram S.A. v. Beacon Hill Asset Management LLC*, No. 03-CV-2387, 2003 WL 15461352 (S.D.N.Y. June 25, 2003).

36. *ABF Capital Mgmt. v. Askani Capital Mgmt. L.P.*, 957 F.Supp. 1308, 1333 (1997) (citing *Pits Ltd. v. American Express Bank Int'l*, 911 F.Supp. 710, 720 (S.D.N.Y. 1996)).

37. *ABF Capital*, 957 F.Supp. at 1333 (citing *Village on Canon v. Bankers Trust Co.*, 920 F.Supp 520, 531 (S.D.N.Y. 1996)).

38. Id.

39. 108 F.Supp.2d 876, 895-96 (1999).

40. Id.

41. Id.

42. *Bullmore v. Banc of America Securities LLC*, 485 F.Supp.2d 464, 469 (2007).

43. Amended Complaint, *GVA Market Neutral Master Limited v. Veras Capital Partners Offshore*, No. 07-CV-0519, 2007 WL 2272670 (S.D.N.Y. June 18, 2007).

44. Id.

45. "Pension Fund Files Fraud Lawsuit Over \$175 Million Investment in Amaranth Advisers," HEDGE FUND LITIG. REP., Aug. 2007, at 2, 2-5. (discussing *San Diego County Employees Ret. Ass'n v. Maounis*, No. 07-2618 (S.D.N.Y. March 29, 2007)).

46. Willa E. Gibson, "Is Hedge Fund Regulation Necessary?," 73 TEMP. L. REV. 681, 714 (citing *Crescent Porter Hale Foundation v. Pryt*, No. S-07-8809 (Cal. filed May 7, 1999), reprinted in *Derivatives Litig. Rep.*, June 3, 1999, at C1).

47. David Glovin and Carlos Caminada, "Sadia Accused of Misleading Investors on Hedging Bets," BLOOMBERG, Nov. 6, 2008, http://www.bloomberg.com/apps/news?pid=20601086&sid=a4e1_OVLV18&refer=latin-america. Note that it is unclear from this brief article whether or not the complaint named only the fund as a defendant or also included as defendants the fund's managers. The docket in the Southern District of New York is, *Westchester Putnam Counties v. Sadia*, No. 08-CV-9528 (S.D.N.Y. Nov. 5, 2008).

48. *Alteram*, No. 03-CV-2387, 2004 WL 367709 at *1 (S.D.N.Y. Feb. 27, 2004) (citing *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993)).

49. Id.

50. Amended Complaint, *GVA Market Neutral Master Limited v. Veras Capital Partners Offshore*, No. 07-CV-0519, 2007 WL 2272670 (S.D.N.Y. June 18, 2007).

51. Id.

52. *GVA Market Neutral Master Ltd. v. Veras Capital Partners Offshore*, No. 07-CV-0519, 2008 WL 4449366 (S.D.N.Y. Sept. 30, 2008).

53. See e.g., *ABF Capital Mgmt. v. Askani Capital Mgmt.*, 957 F.Supp 1308, 1334 (1997) (citing *Violette v. Armonk Assocs.*, 872 F.Supp. 1279, 1282 (S.D.N.Y. 1995)).

54. *ABF Capital Mgmt.*, 957 F.Supp. at 1334.

55. Id.

56. Id.

57. See e.g., *Indep. Asset Mgmt. v. Zanger*, 538 F.Supp.2d 704, 706 (2008).

58. Id.

59. Id.

60. Amended Complaint, *GVA Market Neutral Master Limited v. Veras Capital Partners Offshore*, No. 07-CV-0519, 2007 WL 2272670 (S.D.N.Y. June 18, 2007).

61. Id. The court dismissed this state law claim after plaintiffs' federal securities law causes of action were dismissed as time barred. *GVA Market Neutral Master Ltd. v. Veras Capital Partners Offshore*, No. 07-CV-0519, 2008 WL 4449366 (S.D.N.Y. Sept. 30, 2008).

62. See e.g., *Bullmore v. Banc of America Securities LLC*, 485 F.Supp.2d 464, 467 (2007).

63. Id.

64. *Bullmore*, 485 F.Supp.2d at 466.

65. Id. at 469.