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SERVICE PROVIDERS

Hedge Fund Service Providers Must Exercise Caution When Communicating With Investors or Face Liability

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In a unanimous decision on May 12, 2016, the Appellate Division, First Department reversed a lower court's dismissal of a hedge-fund investor's negligent misrepresentation claim against the fund manager's outside counsel.[1] Although some coverage suggests that the decision in *Chanin v. Machcinski* represents a departure from New York law's established "near-privity" requirement for negligent misrepresentation claims, the decision is consistent with prior case law. It also serves as a reminder of the care that hedge-fund service providers must exercise in dealing with a fund's investors and potential investors.

In a guest article, Anne E. Beaumont and Nora Bojar, partner and associate, respectively, at Friedman Kaplan Seiler & Adelman, discuss the *Chanin* case, negligent misrepresentation claims by hedge fund investors against service providers and lessons for hedge fund service providers.

For additional insight from Beaumont, see "*BDC Finance v. Barclays: Derivatives Collateral Calls in a Chaotic Market*" (Mar. 19, 2015); "*Eighteen Major Banks Agree to Adopt FSB/ISDA Resolution Stay Protocol That Postpones Exercise of Right to Terminate Derivatives on Bank Counterparty Failure*" (Nov. 20, 2014); "*The 1992 ISDA Master Agreement Says Notice Can Be Given Using an 'Electronic Messaging System'; If You Think That Means 'Email,' Think Again*" (May 23, 2014); and "*Five Steps for Proactively Managing OTC Derivatives Documentation Risk*" (Apr. 25, 2014).

The Chanin Case

Beginning in 2011, Alvin and Myra Chanin invested a total of $352,000 in the Meditron Fundamental Value/Growth Fund (Fund), which was controlled by Dr. Walter V. Gerasimowicz and two management entities. Gerasimowicz apparently abandoned the Fund's original strategy of investing in marketable securities and financial instruments and instead made unsecured loans to a struggling electrical contracting business he controlled.

In Fall 2011 – around the time the electrical contractor filed for bankruptcy – the SEC contacted the Chanins about their investment in the Fund. The Chanins asked Gerasimowicz for an explanation and two weeks later received a letter from Victor Machcinski, a lawyer representing Gerasimowicz and the Fund's management company.

Machcinski wrote that "the SEC has vigorously implemented its new oversight responsibilities under Dodd-Frank, and its communications with you regarding the Fund resulted from this new and very expansive authority." In addition, he told the Chanins to "[p]lease be assured that there has been no suggestion or insinuation by the SEC that there is or has been any impropriety regarding" the management of the Fund.

A few months later, the SEC sent Gerasimowicz and the Fund a Wells notice, and in Fall 2012, it brought an administrative proceeding against Gerasimowicz, the management company and the Fund alleging misappropriation and misuse of assets. The SEC ultimately concluded that the respondents had diverted approximately $2.65 million and violated the federal

securities laws, and ordered disgorgement of $3.1 million and civil penalties of over $1.9 million. Gerasimowicz also was barred from acting as a broker, dealer or investment adviser.

The Chanins did not recover any of their investment in the Fund and sued Machcinski and his firm in New York Supreme Court, asserting a single claim for negligent misrepresentation. Machcinski and his firm moved to dismiss the action, and the court granted the motion, finding the "pleadings fail[ed] to allege the existence of a privity, or a privity-like relationship between plaintiffs [and defendants] that would support a negligent misrepresentation claim."[2]

The court noted that "neither the complaint nor plaintiffs' opposition alleges that plaintiffs solicited the explanation from Machcinski (or the Firm), and or that Machcinski knew of plaintiffs' purpose of the letter, to wit: to determine whether to withdraw their invested funds." The court therefore found that "plaintiffs fail[ed] to assert facts giving rise to a special relationship of confidence and trust between them and defendants."[3]

The Chanins appealed the dismissal, and in a decision dated May 12, 2016, the Appellate Division, First Department reversed, finding that plaintiffs had alleged a "privity-like relationship" with Machcinski "under the circumstances."[4] The court noted:

> The evidence shows that plaintiffs requested a letter from defendants, who were outside counsel to a hedge fund in which plaintiffs had invested, regarding the implications of certain [SEC] inquiries into the fund. Defendants responded with a letter, addressed to plaintiffs, specifically answering plaintiffs' questions by characterizing the SEC inquiry as part of a new routine the SEC would be following under the newly passed Dodd-Frank legislation. Plaintiffs allege that, based upon defendants' assurances, they did not withdraw their investment in the fund. . . . Plaintiffs allege that they lost their entire investment as a result of their reliance on defendants' false and misleading statements.[5]

Negligent Misrepresentation Claims by Hedge-Fund Investors Against Service Providers

Chanin is not the first case in which an investor has sought to recover from a hedge-fund service provider, such as an auditor, administrator or outside counsel, alleging that a negligent misrepresentation caused the investor to remain in the fund and ultimately lose its investment.

Indeed, where a manager and the fund are judgment-proof as a result of fraud, a negligent misrepresentation claim against an auditor, administrator, outside counsel or other third-party service provider may be an investor's only viable avenue to recover its investment because of legal barriers to other potential claims. An investor does not ordinarily have a direct contractual or fiduciary relationship with such service providers, so breach of contract claim or fiduciary duty claims are unlikely to be viable except in circumstances where there is a more direct relationship or pattern of communication between the investor and the service provider.[6]

Fraud Claims

While fraud claims do not require allegations of such direct duties, such claims usually are not viable for an investor that did not make or redeem an investment based on the alleged misrepresentation. A federal securities fraud claim requires a purchase or sale of securities,[7] and New York law does not normally recognize a claim for common-law fraud where an investor has merely maintained (rather than made or redeemed) an investment in reliance on the alleged misrepresentations – sometimes known as a "holder" or "fraudulent maintenance" claim.[8]

Aiding and abetting claims can be equally problematic; federal law does not recognize a private civil claim for aiding and abetting securities fraud,[9] and New York law requires allegations of a third party's actual knowledge and substantial assistance of the primary wrongdoer's

fraud or breach of fiduciary duty – a challenging showing at the pleadings stage when no discovery has been taken.[10]

Negligent Misrepresentation Claims and "Near-Privity"

New York law also limits the ability of an investor to sue a third party for negligent misrepresentation. Generally speaking, "before a party may recover in tort for pecuniary loss sustained as a result of another's negligent misrepresentations there must be a showing that there was either actual privity of contract between the parties or a relationship so close as to approach that of privity."[11]

The New York Court of Appeals has articulated a three-part test for determining whether the relationship between a plaintiff and a third-party professional such as an auditor, administrator or attorney meets this "near-privity" requirement. The plaintiff must allege that:

1. the professional was aware that its representations were to be used for a particular purpose;
2. in the furtherance of which a known party was intended to rely; and
3. there must have been some conduct on the part of the professional linking them to the plaintiff that evinces an understanding of the plaintiff's reliance.[12]

Credit Alliance and its companion case, European American Bank & Trust Co. v. Strauhs & Kaye, together illustrate the contours of near-privity. In *Credit Alliance*, near-privity was held to be lacking, because the defendant accountant had not been retained by its client for the particular purpose of inducing the plaintiff to extend credit to the client and had no direct dealings with the plaintiff.[13]

In contrast, near-privity was held to be present in European American Bank, because the defendant auditor had multiple, direct and substantive communications and meetings with the plaintiff lender. The auditor thus was "well aware that a primary, if not the exclusive, end and aim of auditing its client . . . was to provide [the plaintiff] with the financial information it required."[14]

The *Credit Alliance* test thus limits the parties to whom a service provider owes a legally actionable duty to an identifiable group, such as the existing shareholders of a fund or company, although it does not expressly require that the service provider know a particular party by name. In general, prospective investors often are not sufficiently identifiable to satisfy the test, although in certain circumstances, a prospective investor may have a sufficiently direct communication with a service provider that it satisfies the test.[15]

Moreover, the day-to-day conduct of a fund's service provider normally does not give rise to a privity-like relationship even with an existing investor, who cannot ordinarily assert a claim for negligent misrepresentation absent special circumstances.[16]

Chanin Is Consistent With Case Law

The Appellate Division's decision in *Chanin* is consistent with *Credit Alliance* and the cases that follow it, given the directness of the communication at issue and the fact that the Chanins were existing investors in the Fund at issue. Machcinski made the alleged misrepresentations directly to the Chanins by name, and – although the defendants' motion denied it – there appeared to be a reasonable inference that Machcinski's statements in his letter to the Chanins would be used for the "particular purpose" of considering whether to maintain their investment in the Fund.

Thus, the *Chanin* court simply followed well-settled New York law in finding the requisite near-privity relationship. Whether the Chanins' allegations will withstand discovery and can be proven at trial remains, of course, to be seen, including for many of the reasons raised in the defendants' motion.

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Lessons for Hedge-Fund Service Providers

Although the outcome of *Chanin* was somewhat predictable, it should serve as a reminder for hedge-fund service providers to exercise care when communicating directly with both prospective and existing investors in the funds they serve even though they do not necessarily owe such parties ongoing, direct duties.

Most prospective investors' due diligence now routinely includes direct communications with a fund's service providers. Service providers' approaches to these inquiries vary greatly and appear to be informed by an awareness that direct communications can in some circumstances give rise to a near-privity relationship that could set the stage for a claim if there is a misrepresentation.

Some service providers respond much like many employers do in providing employee references – agreeing only to confirm that the fund in question is a client and for how long – while others make themselves available for interviews, complete written questionnaires and provide other substantive disclosures. Still others – some of the major auditing firms in particular – may require a prospective investor to execute a written waiver of claims prior to the auditor providing any information, including in some cases audited financial statements.

There are pros and cons – for both the prospective investor and the service provider – to all of the above approaches. In general, however, where a service provider is communicating directly with someone who identifies themselves as a prospective investor in a client fund, there is a heightened risk that even a negligent misrepresentation may give rise to a claim.

The risk, of course, is even greater where a service provider is communicating with a client fund's existing investors, for whom there is a strong inference that any representation is likely to be used by such investors for the "particular purpose" of making some kind of assessment or decision about their investments. While service providers might be tempted to load up such communications with caveats and disclaimers, it is unclear whether such precautions would insulate the service provider from liability for a misrepresentation. An even more aggressive approach would be to follow the lead of some of the major auditing firms and condition any direct communication on a written waiver of claims or disclaimer of reliance. In either case, though, such defensiveness is unlikely to endear a service provider to its clients (the fund or its manager) or the investor.

Regardless of the state of the law, hedge fund auditors, administrators, outside counsel and other service providers must at all times be scrupulously truthful and exercise the greatest possible care when they do communicate, whether directly or indirectly, with prospective and existing investors. In all events, service providers must never intentionally misrepresent facts. While that may not preclude a claim from being asserted, it should suffice to defeat one on the merits.

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[1] *Chanin v. Machcinski*, No. 651579/2014, 2016 WL 2746431 (1st Dep't 2016).
[2] *Chanin v. Machcinski*, No. 651579/2014, 2014 WL 7333878, at *5 (Sup. Ct. (N.Y. Cty.) Dec. 24, 2014).
[3] Id. at *4.
[4] *Chanin v. Machcinski*, No. 651579/2014, 2016 WL 2746431 (1st Dep't 2016).
[5] Id.
[6] See, e.g., *Jordan (Bermuda) Inv. Co. v. Hunter Green Inv. LLC*, 2007 WL 2948115, at *4, 23-24 (S.D.N.Y. 2007) (fund administrator owed no fiduciary duty to investor, where administrator was not involved in fund's investment decisions and services were nondiscretionary); *Eurycleia Partners, LP v. Seward & Kissel, LLP*, 46 A.D.3d 400, 402 (1st Dep't 2007), aff'd, 12 N.Y.3d 553 (2009) (outside counsel's fiduciary duty was owed to the fund, not investors); but see *Jordan (Bermuda) Inv. Co. v. Hunter Green Investments Ltd.*, No. 00 CIV. 9214 (RWS), 2003 WL 21263544, at *4 (S.D.N.Y. June 2, 2003) (investors stated breach of fiduciary duty claim against administrator); *Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Secs., LLC*, 592 F. Supp. 2d 608, 640-41 (S.D.N.Y. 2009) (triable issue of fact existed as to whether administrators owed fiduciary duty to investors where administrator had direct contact with investors and made representations to investors about quality of its services, such that it "not only accepted that it owed a fiduciary duty to investors, but . . . invited this duty").
[7] See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-32 (1975).
[8] See, e.g., *Starr Found. v. Am. Int'l Grp., Inc.*, 76 A.D.3d 25, 27-28 (1st Dep't 2010) (holder claim to recover hypothetical lost profits barred under out-of-pocket rule); but see *Matana v. Merkin*, 989 F. Supp. 2d 313, 323-24 (S.D.N.Y. 2013) (allowing investor to assert claim to recover out-of-pocket expenses due to fraudulently induced retention of investment).
[9] See *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).
[10] See, e.g., *Pension Comm. of Univ. of Montreal*, 592 F. Supp. 2d at 625.
[11] *Parrott v. Coopers & Lybrand, L.L.P.*, 95 N.Y.2d 479, 483 (2000).
[12] See *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 551, amended, 66 N.Y.2d 812 (1985).
[13] Id.at 553-54.
[14] Id. at 554.
[15] Compare *Anwar v. Fairfield Greenwich Ltd.*, 884 F. Supp. 2d 92, 97 (S.D.N.Y. 2012) ("known party" prong of *Credit Alliance* test not "satisfied when the claim pertains to inducement of an initial investment" because auditors "cannot owe a duty to prospective investors who were unknown to [them] at the time they made the alleged misrepresentations"); with *Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 2d 372, 456 (S.D.N.Y. 2010) (evidence supported plausibility of auditor's intention that known class of future investors would rely on its financial reports where firm knew its name would be used on marketing materials to draw new investors and audit letters would be made available to prospective and existing investors).
[16] See, e.g., *Eurycleia Partners*, 46 A.D.3d at 402-03 (dismissing negligent misrepresentation claim by hedge fund investors against law firm based on alleged misrepresentation in offering memorandum which listed firm as counsel).