

## OUTSIDE COUNSEL

BY THOMAS E. CHASE

### *Fiduciary Duties in Adversarial Contexts Under New York Law*

**A**ll is fair in love and war unless you are a fiduciary litigating against your beneficiary in New York state court.

New York state courts require fiduciaries to honor their duties to adversary-beneficiaries even during protracted disputes. Savvy counsel representing a beneficiary should seek leverage by insisting that an adversary-fiduciary continue to comply with these extrajudicial duties.

#### **Queensberry Rules**

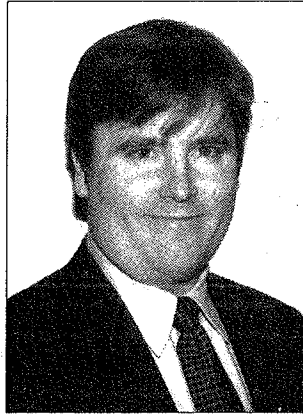
Counsel for a fiduciary should take care to follow Queensberry rules in a dispute with a beneficiary. Both sides should consider differences in state and federal case law in this area if given a choice of forum.

Questions concerning the persistence of fiduciary duties arise during settlement of disputes among business partners or shareholders. Does a controlling shareholder have to fully disclose to an outside shareholder the prospective fortunes of their enterprise even during a protracted dispute in which both have armed themselves with counsel and trust and confidence have entirely eroded? Does the fiduciary have to make disclosures sua sponte, rather than through the cribbed disclosure devices that may have come to dominate the litigants' exchange of information? State court case law holds that fiduciaries continue to have these duties.

In *Blue Chip Emerald, LLC v. Allied Partners, Inc.*, 299 AD2d 278, 279, 750 NYS2d 291, 294 (1st Dept. 2002), the First Department strongly affirmed a fiduciary's continued duty of disclosure. The court held that one coventurer breached its fiduciary duty when it bought out another coventurer without fully disclosing the likely value of the venture's sole asset, a building on 57th Street in Manhattan.

The defendant's duty to disclose was undiminished by the fact that the beneficiary was a highly sophisticated party and had retained counsel to negotiate the buyout with the fiduciary on an arm's-length basis. The duty to disclose was not even limited by the copious disclaimers in the buyout agreement entered by the beneficiary disclaiming any reliance on the fiduciary and releasing any claim of breach of fiduciary duty.

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 [release] contract." *Id.* at 280, 750 NYS2d 295.



There was no apparent history of acrimony between the parties in *Blue Chip*, but there is no reason to believe the fiduciary's disclosure obligations would have been diminished if there were. *Blue Chip* relied on *Birnbaum v. Birnbaum*, 73 NY2d 461, 541 NYS2d 746 (1989), where the Court of Appeals held that a fiduciary breached his duty to his beneficiaries by failing to disclose certain payments made by the enterprise.

The fiduciary had a continuing duty to disclose despite that his relationship with his beneficiaries had been contentious and litigious for several years. The First Department had described the action as "one battlefield in a litigation war," 139 AD2d 462, 463, 528 NYS2d 32, 33, but the fiduciary's "inflexible" duty to disclose persisted. *Birnbaum* at 466, 541 NYS2d at 748.

In *Ajettix Inc. v. Raub*, 9 Misc3d 908, 912, 804 NYS2d 580, 587 (Monroe Co. 2005), the court rescinded a shareholder purchase agreement holding that the fiduciary's duty to disclose recent developments in the enterprise was "not extinguished by [the fiduciary's] acrimonious relationship with plaintiff." See *T.D. Fender v. Prescott*, 101 AD2d 418, 423 (1st Dept. 1984) ("the fiduciary duty was not automatically extinguished by the agreement of the two principals to go their own way"). New York state courts have never limited a fiduciary's duties during disputes, litigation or settlement and the litigator representing a fiduciary should take care to fulfill these

likely nonintuitive obligations when hammering out a settlement. Failure to do so may render the settlement infirm.

#### **Federal Case Law**

New York federal case law takes a harder line with beneficiaries. Litigation and acrimony are deemed to place a beneficiary on notice not to rely unreasonably on a fiduciary's representations or failures to disclose. In *Alleghany Corp. v. Kirby*, 333 F2d 327 (2d Cir. 1964), a divided panel refused to rescind a settlement agreement procured by fiduciaries' alleged failure to disclose information that the settlement was highly unfavorable to beneficiaries. The court held that the embattled fiduciaries had disclosure obligations similar to ordinary litigants:

[I]f the defendant/directors were fiduciaries, they certainly were not considered as such by the stockholder plaintiffs. They were under attack and entitled to defend themselves by all legal means...there is no prerequisite to the settlement of a fraud case that the defendant must come forward and confess

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to all his wrongful actions in connection with the subject matter of the suit. *Id.* at 332-333.

Judge Henry J. Friendly dissented reasoning that Chief Judge Benjamin Cardozo's uncompromising opinion in *Meinhard v. Salmon*, 249 NY 458, 164 NE 545 (1928), required courts to "enforce the most exacting standards of good faith on fiduciaries desiring to settle such claims of self-dealing as were here alleged." *Id.* at 347.

In *Tyson v. Cayton*, 784 FSupp 69, 75 (SDNY 1992), a federal court refused to rescind a settlement allegedly procured by the fiduciary's failure to disclose material information. The court cited *Alleghany* and reasoned that the "purpose of a settlement is to end litigation, not

to provide a breather before the next round." In *Nycal Corp. v. Inoco PLC*, 988 FSupp 296, 306 (SDNY 1997), the court approvingly cited the "*Alleghany* rule" and *Tyson's* application of it. In *Red Ball Interior Demolition Corp. v. Palmdessa*, 874 FSupp 576, 589 (SDNY 1995), the federal court held that a fiduciary's alleged failure to disclose material financial information was not actionable because of the history of acrimony between fiduciary and beneficiary:

[Plaintiff's] own submissions indicate that he regarded [defendant] with skepticism and mistrust and dealt with him at arms' length, in an adversarial manner. It taxes credibility for [plaintiff] to assert that he relied to his detriment on [defendant's] depiction of Red Ball's affairs.

Federal courts, therefore, apply a more flexible approach to fiduciary duties than do state courts and are more forgiving of alleged breaches in adversarial contexts. It is difficult to reconcile the federal court decisions in *Alleghany*, *Tyson* and *Red Ball* with the uncompromising stand taken by state courts in *Blue Chip*, *Birnbaum* and *Meinhard*.

#### Conclusion

Counsel should consider New York state and federal courts' divergent views on the sanctity and persistence of fiduciary duties when jousting over the forum to litigate these issues. Prudent counsel should also consider the continuing scope of a fiduciary's duties during litigation, and especially at settlement, of any dispute between a fiduciary and beneficiary.