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Court Reaffirms Investment Banks Have No Fiduciary Duties to Shareholders Beyond Engagement Letters

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On August 19, 2008, the United States Court of Appeals for the Seventh Circuit affirmed the dismissal of a claim asserted by the shareholders of 21st Century Telecom Group, Inc. ("**21st Century**") against Morgan Stanley & Co., Inc. ("**Morgan Stanley**") for an alleged breach of extra-contractual fiduciary duties to the shareholders of 21st Century¹. In rejecting the claim, the Court of Appeals has reaffirmed its position that an investment bank's responsibilities to its clients are set by contract². Absent an express agreement to the contrary, those fiduciary duties do not run to a client's shareholders.

Joyce v. Morgan Stanley & Co.

This case arose out of a merger between 21st Century and RCN Corporation ("**RCN**") that was entered into on December 12, 1999. In connection with the stock-for-stock merger, 21st Century hired Morgan Stanley to advise its board of directors and to render an opinion letter regarding the fairness of the consideration to be received by 21st Century's shareholders. In the four-month period following the signing of the merger agreement, the market value of RCN's stock declined dramatically. By the effective date of the merger, April 28, 2000, the plaintiff shareholders acquired RCN stock that was essentially worthless.

In a one count complaint filed on August 2, 2006, more than six years after the effective date of the merger, the plaintiffs alleged that Morgan Stanley had committed constructive fraud by failing to provide shareholders with advice on proper hedging strategies to help minimize their exposure to a potential loss in the value of RCN stock. Constructive fraud is a type of fraud that "requires neither actual dishonesty nor intent to deceive."³ A tort claim for constructive fraud arises when a defendant knowingly breaches a fiduciary duty to the plaintiff. Therefore, in order to assert a successful constructive fraud claim, the plaintiffs had to establish the existence of a confidential or fiduciary relationship between Morgan Stanley and the shareholders of 21st Century.

The plaintiffs argued that a confidential relationship existed between Morgan Stanley and the shareholders of 21st Century because at the time it was engaged by 21st Century, Morgan Stanley understood that its client's shareholders would rely on the fairness opinion. According to the plaintiffs, this knowledge meant that Morgan Stanley owed a duty of full and fair disclosure to both 21st Century and its shareholders. In order to fulfill this duty, the plaintiffs believed that Morgan Stanley owed them an extra-contractual duty to advise them about potential hedging

strategies. The plaintiffs further alleged that efforts by Morgan Stanley to negotiate a price protection mechanism into the merger agreement were proof that Morgan Stanley had voluntarily entered into a fiduciary relationship with the shareholders.

In its dismissal of the plaintiffs' claim, the Court of Appeals held that in order for an extra-contractual duty to exist, "the allegedly superior party must have accepted a duty to guard the interests of the dependent party."⁴ In the present case, Morgan Stanley never accepted any such responsibility toward the 21st Century shareholders and thus owed them no extra-contractual fiduciary duties. In fact, both the engagement letter, which defined the advising relationship, and the fairness opinion explicitly stated that Morgan Stanley was working only for the corporation

and disclaimed any duty to the shareholders. In regards to the unsuccessful attempt by Morgan Stanley to negotiate a price protection mechanism into the merger agreement, the Court of Appeals held there was no authority to support the proposition that a mere "attempt to facilitate an outcome that would benefit a party" would be enough to create a fiduciary relationship between those parties.⁵

Joyce is the most recent in a string of Seventh Circuit cases refusing to hold investment banks and accounting firms liable for duties not specified in their engagement agreements.⁶ By dismissing this claim, the Court of Appeals for the Seventh Circuit has reaffirmed that "the duties of investment bankers are set by contract; the fact that someone wishes that a different contract had been written is not a basis for liability."⁷



If you have any questions concerning these developing issues, please contact either of the following Paul Hastings mergers and acquisitions partners:

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¹ *Joyce v. Morgan Stanley & Co.*, NO. 07-1992 (7th Cir. Aug. 19, 2008).

² *Joyce* at 11 (citing *HA2003 Liquidating Trust v. Credit Suisse Securities (USA) LLC*, 517F.3d 454 (7th Cir. 2008)).

³ *Pottinger v. Pottinger*, 605 N.E.2d 1130 (111. App. Ct. 1992).

⁴ *Joyce*, at 9 (citing *Pommier v. Peoples Bank Maycrest*, 967 F.2d 1115 (7th Cir. 1992) (holding that the dominant party must accept the trust of the other party in order for a fiduciary relationship to be created)).

⁵ *Joyce* at 11-12

⁶ See *HA2003; Fehribach v. Ernst Young LLP*, 493 F. #d 905 (7th Cir 2007).

⁷ *HA2003*; at 458-59

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