MEMO# 19279

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NY COURT FOUND OFFICERS OF INVESTMENT ADVISER MAY BE PERSONALLY LIABLE FOR FUND LOSSES

 [19279] October 26, 2005 TO: BOARD OF GOVERNORS No. 53-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 64-05 COMPLIANCE MEMBERS No. 22-05 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 15-05 INVESTMENT ADVISER MEMBERS No. 20-05 SEC RULES MEMBERS No. 116-05 SMALL FUNDS MEMBERS No. 90-05 RE: NY COURT FOUND OFFICERS OF INVESTMENT ADVISER MAY BE PERSONALLY LIABLE FOR FUND LOSSES A New York appellate court recently held that officers of an investment adviser may be personally liable for losses of a fund they advised, based on extra-contractual fiduciary duties arising out of their course of dealing with their client. In Sergeants Benevolent Association Annuity Fund v. Renck,* the court, applying New York law, found that a fiduciary duty on the part of an investment adviser may arise out of the course of dealing with its client, even though the advisory contract set forth specific limited duties and the adviser complied with those duties. The court also found that the individual officers of the adviser could be personally liable for breach of the fiduciary duty. In Sergeants, the plaintiff, a trust that manages annuity payments entered into an agreement with the defendant, an investment advisory firm, for investment consultancy services and supervision of the third-party portfolio managers that managed the plaintiff's assets. The other named defendants in the suit included the adviser's president and vice president. The adviser's duties under the agreement were largely limited to providing reports used to evaluate the return and asset allocation of the portfolio managers. According to the court's opinion, one of the plaintiff's portfolio managers allegedly deviated significantly from the model asset allocation, holding over 80 percent of the plaintiff's portfolio in equities instead of the 60 percent equity benchmark set forth in the model. The plaintiff alleged that when the stock market declined, the trust's value declined from a peak of $144 million to $107 million. The plaintiff contended that the defendants' failure to rebalance the trust in accordance with the asset allocation model caused the plaintiff to lose approximately $12 million more than it would * 2005 NY Slip op. 04460 (NY App. Div. June 2, 2005). The court's opinion is available at http://www.courts.state.ny.us/reporter/3dseries/2005/2005_04460.htm. Shortly after the decision, the parties reached a settlement agreement. 2 have if its portfolios had been properly rebalanced on a quarterly or monthly basis. The defendants argued that the contract with the plaintiff did not require it to rebalance the portfolio; instead, it was limited to providing performance reports. The plaintiff alleged, however, that a fiduciary duty had arisen because the individual defendants had held themselves out as experienced

investment consultants, and provided investment advice upon which the plaintiff’s trustees relied. The plaintiff further alleged that over time, a fiduciary duty developed, which obligated the individual defendants to balance the portfolio to comply with the asset allocation benchmark and to terminate the portfolio manager. The trial court allowed claims against the adviser to go forward but dismissed all counts against the individual defendants, noting that nothing in the agreement between the plaintiff and the adviser indicated a fiduciary relationship between the plaintiff and the individual defendants. The trial court further noted that there were no allegations regarding conduct by the individual defendants outside the scope of the agreement that might support a finding that a fiduciary relationship developed over time. While the plaintiff settled the related suit against the portfolio manager, it appealed the dismissal of the case against the individual defendants. In a 3-1 decision, the New York Appellate Division overturned the decision of the trial court. Although conceding that the advisory contract did not explicitly impose a fiduciary relationship, the court found that “ongoing conduct may give rise to a fiduciary relationship.” According to the majority, this conduct involves one party placing confidence in the other and “reasonably rel[ying] on the other’s superior expertise or knowledge.” In addition, despite the fact that neither officer signed the agreement with the plaintiff in an individual capacity, the majority noted that a breach of fiduciary duty is a tort rather than a breach of contract, and company officers can be held personally liable for tortuous conduct. The dissent concluded that the plaintiff “fail[ed] to specify a single instance in which the [ ] defendants acted in a fiduciary capacity.” The dissent also called it a “remarkable proposal” that the court allowed the action to proceed by implying a tort and then holding the adviser’s officers personally accountable for such implied tort. Jane G. Heinrichs Associate Counsel