

Big Boy Letters

When Do Hedge Fund Managers Have a Duty to Disclose Material, Nonpublic Information?

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For hedge fund lawyers and compliance professionals who are charged with protecting their institutions from allegations of trading on material, nonpublic information, “Big Boy” provisions, or disclaimers of reliance, are potentially helpful tools. In the first of a two-part series of guest articles, Brian S. Fraser and Tamala E. Newbold, Partner and Staff Attorney, respectively, at Richards Kibbe & Orbe LLP, discuss the duty to disclose material, nonpublic information (or refrain from trading) and the differences between the Federal securities laws and New York common law on that issue, in particular, the “superior knowledge” trigger for the duty to disclose under New York law which has no Federal counterpart. The second article in this series will focus on the usefulness of Big Boy provisions in securities and non-securities transactions and steps that will increase the likelihood a court will enforce a Big Boy provision; the discussion of New York law in that second article will focus on its application in secondary market bank loan transactions.

The Duty to Disclose Material, Nonpublic Information Under the Federal Securities Laws and New York Common Law

New York state common law and the federal securities laws both recognize that a mere disparity in information among contracting parties does not, in itself, give rise to a duty to disclose. See *Walton v. Morgan Stanley & Co., Inc.*, 623 F.2d 796, 799 n.6 (2d Cir. 1980) (noting that New York and federal law both recognize that a duty to disclose does

not arise “from the fact that some investors have more information than others”); *Societe Nationale D’Exploitation Industrielle Des Tabacs Et Allumettes v. Salomon Bros. Int’l, Ltd.*, 268 A.D.2d 373, 702 N.Y.S.2d 258, 259 (1st Dep’t 2000). It is firmly established under both New York and federal law that nondisclosures are not actionable absent a duty to disclose. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n. 17 (1988) (“Silence, absent a duty to disclose, is not misleading under Rule 10b-5”); *Banque Arabe et Internationale D’Inuestissement v. Maryland Nat’l Bank*, 57 F.3d 146,153 (2d Cir. 1995) (claim for fraudulent concealment under New York law requires proof that the defendant had a duty to disclose material information).

A duty to disclose arises under Section 10 of the Securities Exchange Act of 1934 and Rule 10b-5 when 1) an insider trades securities on the basis of material, nonpublic information (see *Chiarella v. United States*, 445 U.S. 222, 228 (1980)); 2) a fiduciary or similar relationship of trust and confidence exists between the parties outside of the securities laws (see *United States v. O’Hagan*, 521 U.S. 642, 652 (1997)); or 3) the person or company at issue has previously made a statement of material fact that is false or misleading in light of undisclosed information (see 17 C.F.R. § 240.10b-5 (making it unlawful to “omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading”)); *In re Time Warner Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993)).

Under New York law, a party to a business transaction has a duty to speak in only three situations: first, where the party has made a partial or ambiguous statement, and it would be misleading to omit other information to correct the misimpression; second, when the parties stand in a fiduciary or confidential relationship with each other; or third, where one party's superior knowledge of material facts renders a transaction without disclosure "inherently unfair." See *Jana L. v. West 129th St. Realty*, 22 A.D.3d 274, 802 N.Y.S.2d 132,134 (1st Dep't 2005); *Brass*, 987 F.2d at 150-52.

The elements of fraudulent concealment under New York law are: (1) a duty to disclose material facts; (2) knowledge of material facts by a party bound to make such disclosures; (3) nondisclosure; (4) scienter; (5) reliance; and (6) damage. *P.T. Bank Central Asia v. ABN AMRO Bank N.V.*, 301 A.D.2d 373, 754 N.Y.S.2d 245, 250 (1st Dep't 2003). The duty to disclose also can arise in negligent misrepresentation claims. Under New York law, a claim of negligent misrepresentation requires proof that the defendant had a duty, as a result of a special relationship, to give correct information. *Solutia Inc. v. FMC Corp.*, 456 F. Supp. 2d 429, 448-49 (S.D.N.Y. 2006) (citing *Kimmell v. Schaefer*, 89 N.Y.2d 257, 652 N.Y.S.2d 715, 719 (1996)).

The significant difference between New York and federal law is the "superior knowledge" trigger for the duty to disclose under New York law which has no federal counterpart.

What is Superior Knowledge?

The origins of the superior knowledge doctrine, which applies equally to omissions and affirmative misrepresentations of material fact, date to 1892. See *Schumaker v. Mather*, 88 Sickels 590, 133 N.Y. 590, 595 (1892). In its current form,

the superior knowledge doctrine (also known as the "peculiar" knowledge doctrine) is premised on the notion that "[w]hen matters are ... peculiarly within the defendant's knowledge ... plaintiff may rely without prosecuting an investigation, as he has no independent means of ascertaining the truth." *DIMON, Inc. v. Folium, Inc.*, 48 F. Supp. 2d 359, 368 (S.D.N.Y. 1999) (citing *Lazard Freres & Co.*, 108 F.3d at 1542) (both applying New York law); see also *Strasser v. Prudential Securities, Inc.*, 218 A.D.2d 526, 527, 630 N.Y.S.2d 80, 82 (1st Dep't 1995).

In order to establish a duty to disclose material information based on superior knowledge, the plaintiff must prove: (1) that the defendant had superior knowledge; (2) that the information was not readily available the plaintiff; and (3) that the defendant knew that plaintiff was acting on the basis of mistaken knowledge. *Banque Arabe et Internationale D'Inuestissement v. Maryland Nat'l Bank*, 57 F.3d 146, 155 (2d Cir. 1995). Courts are very clear that a duty to disclose arises only when all three elements are present; the absence of even one element absolves the defendant of any duty to disclose based on superior knowledge. *Congress Financial Corp. v. John Morrell & Co.*, 790 F. Supp. 459, 473 (S.D.N.Y. 1992) ("failure of any single element bars application [of the superior knowledge] doctrine" to prove New York common law fraud).

Superior knowledge is, quite simply, material information about a transaction that a counterparty does not know and cannot find out through reasonable diligence. It is material information, known and knowable only to one party, that renders false the counterparty's basic assumptions about the transaction. See, e.g., *Laugh Factory, Inc. v. Basciano*, 608 F. Supp. 2d 549, 559 (S.D.N.Y. 2009) (defendant knew, but plaintiff did not, that at the time he was offering plaintiff

full rights to use the name Laugh Factory of NYC, he also contemplated offering the name to other investors); *Janel World Trade, Ltd. v. World Logistics Services, Inc.*, No. 08 Civ. 1327 (RJS), 2009 WL 735072, at *10 (S.D.N.Y. Mar. 20, 2009) (plaintiff could not rightfully obtain exclusive rights to all defendant's assets because defendant had entered side deal secretly granting a portion of those assets to a third party).

What Superior Knowledge Is Not

A party's knowledge is not "superior" where the relevant information was either a matter of public record, was not pursued by plaintiffs, or was disclosed at least in part which gives rise to a duty of further inquiry. See *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 739 (2d Cir. 1984). Nor is knowledge "superior" when a buyer has an opportunity equal to that of a seller to obtain information. *Brass*, 987 F.2d at 151; *Congress Financial Corp.*, 790 F. Supp. at 474 (finding no duty to disclose, and thus no fraudulent concealment, where plaintiff had "unrestricted" access to the books, records, facilities and personnel at issue and the means to utilize the access, but "failed to exercise diligence to discover allegedly omitted information"). In addition, courts apply a sliding scale when determining access to information, such that "the more sophisticated the buyer, the less accessible the information must be to be considered within the seller's [superior] knowledge." *Solutia Inc. v. FMC Corp.*, 456 F. Supp. 2d 429, 448 (S.D.N.Y. 2006) (citing cases).

Knowledge is not "superior" where it involves knowledge of extrinsic facts such as market conditions or changes in the law. Courts assume that that kind of information, though known to only one party, could have been obtained by either party.

Nor is disclosure required because one party has performed better research or due diligence than another. Again, the law presumes that a counterparty could have obtained the same information. See *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729,739 (2d Cir. 1984) (claim that defendant possessed superior knowledge was "without merit" where plaintiff had unrestricted access to defendant's facilities, books and records, and personnel but failed to use its access to discover the allegedly omitted information). In fact, a court recently held that "as a matter of law," one party's knowledge was not superior where the counterparty had access to the same sources of information and could have hired its own private investigators to search public records, "as defendant apparently did." See *Albion Alliance Mezzanine Fund, L.P. v. State Street Bank and Trust Co.*, 8 Misc. 3d 264, 797 N.Y.S.2d 699, 704-05 (N.Y. Sup. 2003). Another court held that a seller who hired professional drillers to test oil wells and discovered that the wells were "dry" did not have to disclose this information to purchasers, because the purchasers could have hired their own experts. See *Barcomb v. Alford*, 125 A.D.2d 907, 510 N.Y.S.2d 267, 269 (3d Dep't 1986).

When Will a Court Find Superior Knowledge Giving Rise to a Duty to Disclose?

Under what circumstances will a mere disparity in knowledge among sophisticated parties bargaining at arm's length evolve into something more, triggering disclosure obligations to a counterparty? Although the law does not require a party that expended considerable capital and effort to diligence a transaction to disclose the fruits of that diligence, unfortunately the courts have not provided a clear roadmap of what amounts to acceptable and unacceptable nondisclosures. Below, we attempt to harness

a few of the general concepts that have emerged under New York law.

Courts applying New York law generally hold that knowledge is “superior” to that of a sophisticated counterparty where (1) the subject of the transaction (whether tangible or intangible) contains a material defect or an encumbrance or other restriction on use or value that is intrinsic to the subject matter of the transaction and is known only to the seller, and the buyer could not have been expected to discover the defect; or (2) the defendant withholds facts about its own fraudulent transactions or conduct that affect the value of the subject matter.

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