Big Boy Update: Recent New York Case Demonstrates Limits of Big Boy Provisions Where Affirmative Acts of Concealment Are Alleged

By Brian S. Fraser and Tamala E. Newbold

Courts in New York routinely dismiss complaints alleging fraud in connection with transactions between sophisticated parties where the parties have agreed, pre dispute, to a specific disclaimer of reliance on any misrepresentations or omissions by either party in the course of negotiating or entering into the transaction. Such disclaimers are commonly known as “Big Boy” provisions. See generally Brian S. Fraser and Tamala E. Newbold, Who’s a Big Boy? Non-Reliance Provisions And Claims Of Insider Trading In Securities And Non-Securities Markets. New York courts, however, will not enforce such disclaimers of reliance where the complaining party can demonstrate that its claims are based on facts peculiarly within the knowledge of the non-disclosing party, so that reasonable diligence could not have uncovered the undisclosed information. Who’s a Big Boy? at 12. Courts applying New York law generally hold that knowledge is “peculiar” where (among other circumstances) the defendant withholds facts about its own fraudulent transactions or conduct that affect the value of the subject matter. Brian S. Fraser and Tamala E. Newbold, Who’s a Big Boy II: Superior Knowledge and the Duty to Disclose at 6.

The recent decision in Harbinger Capital Partners v. Wachovia Capital Markets LLC, 27 Misc.3d 1236(A), 2010 WL 2431613 (N.Y. Sup. May 10, 2010) reaffirms the reluctance of New York courts to enforce disclaimers of reliance, even between sophisticated parties and even where the disclaimer is specific, where it is alleged that the non disclosing party itself engaged in fraudulent conduct or actively concealed the information alleged to have been withheld. The Plaintiffs in Harbinger sued Wachovia Capital Markets LLC (“WCM” or “Wachovia”) in connection with a $285 million syndicated loan for beverage manufacturer Le Nature’s, Inc. (“Le Nature’s”) in September 2006. Wachovia arranged the loan just two months before Le Nature’s’ creditors placed the company in involuntary bankruptcy. Le Nature’s’ 2005 financial statements reported net sales of more than $275 million. However, a bankruptcy trustee subsequently determined that actual revenues were almost 90% lower than what had been reported.

The Plaintiffs were sophisticated lenders who purchased an interest in the loans either directly from Wachovia or in the secondary market. Plaintiffs alleged that Wachovia knew that Le Nature’s was engaged in fraud; specifically that Wachovia...
knew (i) that Le Nature’s was unable to make timely interest payments; (ii) that Le Nature’s’ reported sales data was inaccurate; (iii) that a special committee’s investigation into the abrupt resignation of Le Nature’s CFO and several other senior officers identified serious issues with the company’s financial reporting; and (iv) that Le Nature’s’ products were being pulled from stores.

Most importantly, however, Plaintiffs alleged that, in an effort to conceal Le Nature’s’ inability to pay interest on its existing credit facilities, Wachovia, through its affiliate Wachovia Bank, “fronted” interest payments to syndicate lenders by paying out interest without having received payment from Le Nature’s. Plaintiffs claimed that this “fronting” constituted a misrepresentation of Le Nature’s financial condition, that it was peculiarly within Wachovia’s knowledge, and that they would not have made or acquired the loans had Wachovia disclosed the information.

Wachovia moved to dismiss on grounds that plaintiffs’ purported reliance on the alleged misrepresentations or omissions was unreasonable as a matter of law, based on the express disclaimers in the parties’ credit agreement. Wachovia also argued that it had no duty to disclose information about Le Nature’s financial condition to lenders because, in addition to the disclaimers of reliance, the credit agreement also disclaimed any duty or responsibility on Wachovia’s part “to provide any Lender with any credit or other information concerning the business, operations, condition (financial or otherwise), prospects or creditworthiness” of Le Nature’s which may come into the possession of Wachovia or its affiliates.

In support of its motion to dismiss the complaint, Wachovia relied heavily on UniCredito Italiano SPA v. JPMorgan Chase Bank, 288 F. Supp. 2d 485, 498 (S.D.N.Y. 2003), in which plaintiffs, sophisticated Italian and Polish financial institutions, alleged that JPMorgan Chase (“Chase”) and Citigroup had defrauded them in connection with the formation of and payment under certain Enron-related syndicated credit facilities for which Citigroup and Chase served as co-administrative agents. The loan agreement precluded plaintiffs from claiming that they relied on any alleged representations by Chase or Citigroup, and absolved defendants of any responsibility to make disclosures regarding the financial risks of the transaction. The court dismissed plaintiffs’ fraud and negligent misrepresentation claims on grounds that “the contracts pursuant to which they made their Enron loan investments preclude them from establishing essential elements of those claims, namely, that the Defendant banks had a duty to disclose information regarding or gained from their business dealings with Enron, and that any reliance by Plaintiffs on misrepresentations by the Defendants was reasonable.” Id. The UniCredito court likewise refused to apply the peculiar knowledge exception, holding that “[e]xtension of the peculiar knowledge exception to defeat contractual allocation of risks away from Defendant banks in this case because the principal (Enron) was so adept at concealment of its fraud would require at a minimum some factual basis for finding reasonable Plaintiffs’ reliance on parties on whom it agreed it would not rely in any respect in making the operative decisions.” Id. at 501.

The Harbinger court, however, rejected the comparison with the UniCredito case and, on May 10, 2010, denied Wachovia’s motion to dismiss plaintiffs’ fraud claim. The court held that, although the disclaimers in the credit agreement were sufficiently specific, dismissal was inappropriate because plaintiffs’ complaint adequately invoked the “peculiar knowledge” and “superior knowledge” doctrines. The court declined to apply UniCredito and other New York cases like it because Plaintiffs alleged that Wachovia, through its affiliate Wachovia Bank, “actively prevented any possibility that lenders could have discovered Le Nature’s’ true financial condition” by covertly fronting Le Nature’s’ interest payments to syndicate lenders in order to conceal the fact that Le Nature’s was not able to make timely interest payments. Harbinger Capital Partners LLC, 2010 WL 2431613, at *7. Accepting the allegations as true, as it
must on a motion to dismiss, the court found that even though plaintiffs were sophisticated investors to whom the Credit Agreement granted broad access to Le Nature’s’ financial information and employees, it was not apparent at the motion to dismiss stage whether “the true nature of the situation” would have been revealed even upon inspection, and there was no way of knowing the degree of effort necessary to discern the truth. *Id.*

New York state and federal courts have held many times that the peculiar knowledge exception does not apply in situations where a sophisticated party agrees to perform its own due diligence and knows that it is not receiving full information. Courts in New York also hold, however, that information about a defendants’ own fraudulent transactions or conduct that affects the value of the subject matter of the transaction must be disclosed because “[b]y its nature, this information is of the type that was in defendants’ possession, not at plaintiff’s fingertips, and which, one can envision, defendants would have desired to keep close to the chest.” See *Nomura Sec. Int’l, Inc. v. E*Trade Sec., Inc.*, 280 F. Supp. 2d 184, 206 (S.D.N.Y. 2003). The *Harbinger* plaintiffs’ allegations, at least at the pleading stage, arguably meet this standard.

Wachovia has filed a Notice of Appeal and seeks to have the trial court’s decision reversed. Whatever the outcome after an appeal, the *Harbinger* case should not affect current practices regarding Big Boy letters between sophisticated parties. Specific, detailed disclaimers that closely track the terms of a transaction remain useful in most non-securities transactions. *Harbinger* simply reinforces the long held view in New York that contractual disclaimers of reliance cannot serve to shield intentionally fraudulent conduct.

QUESTIONS
If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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