Financial Fraud Law Report

VOLUME 2 NUMBER 8 SEPTEMBER 2010

The FINANCIAL FRAUD LAW REPORT is published 10 times per year by A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207, For subscription information and customer service, call 1-800-572-2797. Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 10 Crinkle Court, Northport, NY 11768, smeyerow@optonline.net, 631-261-9476 (phone), 631-261-3847 (fax). Material for publication is welcomed — articles, decisions, or other items of interest.
POSTMASTER: Send address changes to the Financial Fraud Law Report, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207. *ISSN 1936-5586*

New York's Top Court Rejects Suit by Hedge Fund Partners Against Accounting Firm

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The authors analyze a recent court decision that illustrates the difficulties facing investors seeking to sue individually to recover losses as a result of a fraud against a fund.

In a recent decision, *Continental Cas. Co.* v. *PricewaterhouseCoopers, LLP*,[1] New York State's highest court, the New York Court of Appeals, held that investors who were limited partners in a hedge fund could not sue an outside accounting firm for the reduction in the value of their investment in the fund as a result of fraud because such claims were inherently derivative in nature and belonged to the fund itself and not to any individual investor. Thus, the Court ruled that the investor plaintiffs could not bring a claim because they had not shown that they suffered any unique damages apart from losses shared by all the investors in the fund as a whole.

BACKGROUND

Continental Casualty involved a lawsuit brought in New York Supreme Court, Commercial Division, in 2003 by a group of individual in-

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vestors who had invested over $120 million in a private investment fund (the "Fund"), organized as a Delaware limited partnership, between 1997 and 2001. During the period of the fund's existence, PricewaterhouseCoopers ("PwC") served as the Fund's outside auditor. In their lawsuit, the plaintiffs alleged that they made their investments in the Fund in reliance upon the Fund's financial statements that had been audited by PwC.

In 2002, it came to light that the Fund's financial statements, which had previously shown consistent growth in the value of the Fund's portfolio, had been overstated by millions of dollars. The General Partner of the Fund conducted an investigation and discovered that one of the Fund's managers (who subsequently pleaded guilty to securities fraud) had used an improper method of valuing the Fund's securities and, as a result, had materially overstated the value of the Fund's holdings. As a result of that fraud, the General Partner wrote down approximately 40 percent of the Fund's capital and proceeded to dissolve the fund in October 2002. Under the eventual liquidation plan, the investors recovered approximately $112 million. As part of its own investigation, the United States Securities and Exchange Commission found that the accounting firm's representation that its audits complied with GAAP were materially false and suspended the accountant in charge of auditing the Fund's financial statements.

A Trustee was appointed by a court in the spring of 2003 to investigate and bring any potential claims on behalf of the limited partner-investors who lost money as a result of the fraud and the collapse of the Fund. Significantly, in July 2004, the Trustee brought a lawsuit against PwC for accounting malpractice, fraud, breach of fiduciary duty and breach of contract. The Trustee settled that lawsuit in January 2010.

Also in 2003, a group of individual investors in the Fund commenced their own lawsuits against PwC, asserting claims for fraud, aiding and abetting fraud, aiding and abetting breach of fiduciary duty, negligent misrepresentation, and negligence. Plaintiffs' fraud claims alleged that PwC fraudulently induced them to invest in the Fund. This is the case that ultimately ended up at the New York Court of Appeals.

At the beginning of the case, PwC had moved to dismiss the investor plaintiffs' fraud claim, arguing that the investor plaintiffs had not pleaded an injury distinct from the injury attributed to the Fund as a whole and, thus, that the plaintiffs' action should be dismissed because it alleged only a derivative injury that was entirely duplicative of the claims that had been brought by the Trustee. The plaintiffs responded by arguing that their claims were distinct from the Trustee's claims because they were seeking damages for fraud in the inducement, *i.e.*, that they had been defrauded by the accounting firm into making their investments in the Fund and thus were injured at the time they made those investments. Justice Moskowitz of the Supreme Court, Commercial Division, in New York County, denied PwC's motion to dismiss, holding that "to the extent that plaintiffs assert direct claims, such as fraud in the inducement in their initial investment in the Partnership, they are not derivative."[2]

At the conclusion of discovery in the case, PwC moved for summary judgment, once again arguing that plaintiffs could not prove an injury distinct from that suffered by the Fund and being pursued by the Trustee. This time, however, the trial court granted PwC's motion for summary judgment and the Appellate Division, First Department, then affirmed. As the trial court explained, "plaintiffs fail to produce any evidence to support their claim that they suffered a direct injury at the time of their investments that is distinct from the injury to the Partnerships. Rather, … the only loss plaintiffs can demonstrate is the diminution in value of their investment."[3]

THE COURT OF APPEALS' DECISION

As a general matter, partners may not individually pursue claims of a partnership under New York law. Rather, any such claims must be brought in the name of the partnership itself. However, individual partners may assert direct claims which are distinct from those of the partnership. Indeed, the Court of Appeals in *Continental Casualty* noted that "an individual investor may have a direct claims for an investment made in reliance on a fraud."[4] So the question facing the Court of Appeals in *Continental Casualty* was where to draw the line — *i.e.*, whether the individual investor plaintiffs' claims against PwC were claims that belonged to the partnership or whether the plaintiffs could instead "come forward with direct, distinct, date of investment injuries."[5]

In an opinion written by Judge Pigott, the Court of Appeals affirmed the dismissal of the plaintiffs' claims, holding that the plaintiffs had failed to meet their burden of demonstrating direct damages distinct from those damages suffered by the partnership. The Court stated that the diminution in value of the plaintiffs' partnership interests "is attributable to their pro rata share of the partnership's losses after the date of their investment, and they experienced those losses in their capacities as limited partners in common with all other limited partners."[6] In her dissenting opinion, Judge Read disagreed, characterizing the issue in the case as "whether plaintiffs … suffered any injuries as a result of PwC's allegedly fraudulently inducing them to invest in the fund which were not derivative in nature — not whether plaintiffs have advance the proper measure for such direct injuries."[7]

DISCUSSION

The Court of Appeal's decision in *Continental Casualty* illustrates the difficulties facing investors seeking to sue individually to recover losses as a result of a fraud against a fund.[8] The Court made clear that it is not enough for individual investors to formulate their causes of action as distinct claims. Rather, individual investors must demonstrate that they were damaged in some unique and direct way. In other words, it is not sufficient to allege damages to the fund as a whole such as a diminution in value attributable to their partnership share.

One question that may have been left open in the Court's decision, however, is the effect of the pendency of the Trustee's action. As noted above, in 2004, the Trustee appointed by a court to represent the Fund as a whole brought suit against PwC for accounting malpractice, among other things, and that claim was settled in early 2010. While the logic of the Court's decision dictates that the result should have been the same regardless of whether the Trustee had pursued claims against PwC on the Fund's behalf, it appears that the Court considered the fact that the Trustee had already brought claims to recover the damages sought by the individual investor plaintiffs and that the Trustee's suit resulted in a significant recovery, as the Court noted that "the Trustee has prosecuted claims seeking the very same category of damages allegedly suffered by plaintiffs."[9]

In any event, the potential ramifications of the Court of Appeals' decision in *Continental Casualty* are intriguing. On the one hand, at least as presented in the majority opinion by Judge Piggot, the case presents a straightforward application of a longstanding common law principle — that the claims of a partnership are derivative in nature and cannot be pursued by individual partners — to a set of facts involving the dissolution of an investment fund, not an uncommon circumstance in today's financial world. On the other hand, however, it is at least conceivable that the logic of *Continental Casualty* could be extended to claims brought by investors not only in hedge funds or private equity funds, but in similar investment vehicles including collaterized debt obligations, that are that are structured as partnerships or similar to partnerships and that have been the subject of extensive litigation in the wake of the recent financial crisis. The Court of Appeals' decision thus could call into question the viability under New York law of individual investor suits against third parties for fraud as a result of a decline in the value of a fund's portfolio. To the extent that such lawsuits seek to recover the plaintiffs' pro rata investment losses, the court's decision in *Continental Casualty* may well prove to be a barrier to recovery, if the lower courts, following the logic of *Continental Casualty*, find that such claims are fundamentally derivative in nature and cannot be pursued by classes of individual investors.

NOTES

[1] 2010 N.Y. Slip Op. 05677, 2010 WL 2569187 (N.Y. Jun. 29, 2010).

[2] *Continental Cas. Co.*, 2010 WL 2569187, at *4.

[3] *Continental Cas. Co.* v. *PricewaterhouseCoopers, LLP*, No. 0120016/2003, 2007 WL 3992606 (N.Y. Sup. Nov. 7, 2007).

[4] *Continental Cas. Co.*, 2010 WL 2569187, at *5.

[5] *Id.*

[6] *Id.* at *6.

[7] *Id.* (Read, J. dissenting). In the context of a fraudulent inducement claim, the Court of Appeals noted while the investor plaintiffs in *Continental Casualty* could have demonstrated an actual pecuniary loss by presenting evidence of the difference between the actual value of the Fund's portfolio at the time the plaintiffs made their investments and the amount they paid, the plaintiffs presented no such evidence.

[8] *Continental Casualty* is the second Court of Appeals decision in just over a year that has circumscribed the ability of individual hedge fund investors to sue for torts allegedly committed against the fund. In a June 2009 decision in a suit filed by hedge fund investors against that fund's attorneys, the Court of Appeals held for the first time that "the fiduciary duties owed by a limited partnership's attorney to that entity do not extend to the limited partners." *Eurycleia Partners, LP* v. *Seward & Kissel, LLP*, 910 N.E.2d 976, 980 (N.Y. 2009).

[9] *Id.*