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Fiduciary Duties In NY May Not Be In The Eyes Of Beholder

Law360, New York (October 03, 2013, 4:51 PM ET) -- Clients in unhappy business relationships may proclaim that the "bad guys" are breaching their fiduciary duties. What, exactly, is a fiduciary relationship and what are the duties of fiduciaries?[1]

Just like U.S. Supreme Court Justice Potter Stewart's observation about pornography, most people cannot explain fiduciary duty but (think) they know a breach when they see it.[2]

This note puts some flesh on the fiduciary bones for New York practitioners. However, the law in this area is very fact-intensive and surprisingly complex and fluid, as demonstrated by the New York Court of Appeals and federal court reversals of lower court rulings on the topic.

The Elements of Fiduciary Duty

The elements of a breach of fiduciary duty claim are threefold: a fiduciary duty existed between the parties, defendant breached that duty, and plaintiff was damaged as a result of the breach.[3]

The trickiest part, of course, is the existence of a fiduciary duty. This "is often a 'fact-intensive' inquiry appropriate for a jury."[4] The burden of proof is on the party claiming the relationship.[5]

Fiduciary Relationships in New York

A fiduciary relationship exists when one is under a duty to act for or to give advice for the benefit of another person upon matters within the scope of the relation.

Four elements are required to assert a fiduciary relationship: "(1) the vulnerability of one party to the other which (2) results in the empowerment of the stronger party by the weaker which (3) empowerment has been solicited or accepted by the stronger party and (4) prevents the weaker party from effectively protecting itself."[6]

To determine whether a fiduciary duty exists, courts look to four factors: the nature of the relationship between the parties, whether the alleged fiduciary appeared to have unique or special expertise, whether the alleged fiduciary was aware of the use to which information would be put, and the purpose for which the information was supplied.[7]

A fiduciary relationship is the exception to a typical commercial relationship and does not generally arise from the fact that unrelated entities engage in commercial transactions with each other even if one party has disparate economic power. These relationships are viewed as arms-length relationships.[8] Even a contractual provision that imposes confidential or nondisclosure obligations on the parties does

not necessarily create a fiduciary relationship.[9]

Partners are fiduciaries of each other, as Chief Judge Benjamin Cardozo held in the seminal case of Meinhard v. Salmon, 249 N.Y. 458 (1928).[10] The relationships between corporate officers and directors with shareholders are fiduciary in nature.[11]

There is no distinction drawn between a general partnership and a limited partnership with respect to a general partner's fiduciary obligations. However, a potential shareholder is not in a fiduciary relationship with the corporation's officers and directors.[12] Shareholders in closely held corporations share a fiduciary duty among themselves.[13]

In Brass v. American Film Technologies Inc., 987 F.2d 142, 150-51 (2d Cir. 1993), the Second Circuit observed that New York embraces "informal fiduciary relationships" that include priest and parishioner,[14] bank and depositor, majority and minority stockholder, and close friends or family members.

However, the court refused to expand the class of informal fiduciary relationships to include a sophisticated prospective investor who invested in a business based on a sales presentation by an officer of that business.[15]

Although Meinhard, and Cardozo's famous quote (see n.10, supra), are frequently cited, Meinhard and other early precedent do not help all that much in specific situations. More recent pronouncements of New York's highest court and the New York federal courts are similarly case specific.

For instance, Birnbaum v. Birnbaum, 73 N.Y.2d 461 (1989), involved partners/family members operating and managing a New Jersey shopping center. The issue before the court, answered in the negative, was whether brother Saul could hire his girlfriend Victoria to develop the property "and properly charge her compensation amounting to hundreds of thousands of dollars to the property, without the consent" of his niece and nephew, who succeeded to his deceased brother's 50 percent interest.

Based on Meinhard, the court concluded that Saul violated his fiduciary duties in two separate respects.

First, as a partner, since there was no agreement to the contrary, Saul could not be compensated for the services he provided to the shopping center. Therefore, Saul acted inconsistently with his obligation to protect the interests of his niece and nephew when he charged the property for services that he personally was obligated to perform without direct compensation.

Second, the fact that a fiduciary owes a duty of undivided and undiluted loyalty to those whose interests he must protect "is a sensitive and 'inflexible' rule of fidelity, barring not only blatant self-dealing, but also requiring avoidance of situations in which a fiduciary's personal interest possibly conflicts with the interest of those owed a fiduciary duty."
Because Saul's relationship with Victoria conflicted with his duty to his niece and nephew, it "violated the precept of undiluted trust at the core of his responsibilities as a fiduciary."

Frequently, shareholders in closely-held corporations are related to each other.[16] In Braddock v. Braddock, 60 A.D.3d 84, 88, 871 N.Y.S.2d 68 (1st Dept. 2009), plaintiff was treated quite shabbily by his cousin in a new business venture and sued. The trial court dismissed all the claims.

The First Department reinstated the fraud, breach of fiduciary duty, constructive trust[17] and promissory estoppel claims because, as the court noted, since the parties were cousins, plaintiff's "reliance on [his cousin's] good faith may be found to be reasonable even where it might not be reasonable in the context of an arm's-length transaction with a stranger."

Not All Fiduciary Relationships Are Created Equal

Muller-Paisner v. TIAA, supra, which involves fiduciary duties in the annuity context, is particularly interesting and demonstrates the highly specific and fact-intensive nature of a fiduciary duty analysis. This case has been in both the district court and the Second Circuit twice and is back in the district court for a third round.

Muller-Paisner I

The annuitant, Mary Engel, a 70-year-old college professor, retired while suffering from advanced emphysema. She chose to convert the bulk of her retirement funds held by TIAA-CREF, approximately $1.2 million, into an annuity that was to pay $8,000 per month for life, with all payments to cease at her death. She would have needed to live for another 12 years to recover the purchase price.

In the process of making her election, she had at least six telephone conversations with TIAA counselors at the company's call center (all of which were documented in detail in contemporaneous notes), and wrote numerous letters.

One counselor told Engel that at her age, given the large amount involved, her choice was "against normal logic." In subsequent conversations with other call center counselors, Engel confirmed that she intended to annuitize 100 percent of her funds with no survivor benefits, stating that she was a Holocaust survivor and had no family to which she should leave funds.

However, in fact, she had executed a will that provided for distribution of her assets, including substantial monthly payments for life to plaintiff, her executrix. Although TIAA suggested other alternatives to Engel, she specifically requested "a single life annuity without a guaranteed payment."

In subsequent correspondence, Engel confirmed that the annuity she had chosen did not provide for payments after her death and did not include any beneficiaries. She died six months after her annuity purchase, having collected only $48,000 in payments, at which point all payments ceased.

District Court I. Engel's beneficiary/executrix sued TIAA and related entities. The district court dismissed the common law fraud and securities law claims ("different counselors gave decedent information about the annuity and verbally counseled her against it") and the negligence claim (TIAA "owed no duty to decedent to ensure that she was making the best decision she could").[18]

The court did not believe that TIAA was a fiduciary to Engel, whether by virtue of the relationship or the circumstances of this particular case:

Plaintiff here does not allege that the benefits information disseminated to decedent was inaccurate or that defendants took a special interest in decedent or promised her preferential treatment, or purposefully lulled her into making the decision to purchase the annuity she did .... Decedent repeatedly sent letters informing defendants as to what she wanted to do with her retirement funds — including converting her original retirement annuities from Harvard and University of Michigan to a transfer payout annuity — and she asked numerous questions, implying a reasonable if not sophisticated level of understanding and belying the argument that she surrendered to the investment acumen of defendants ... [T]here is nothing to indicate that decedent … was incapable of understanding the repercussions of her actions, or too incapacitated to engage in arm's-length contractual negotiations.[19]

The court also dismissed the negligent misrepresentation claim.

Court of Appeals I. The Second Circuit affirmed dismissal of the fraud and securities law counts but reversed dismissal of the fiduciary duty and negligent misrepresentation claims based on TIAA's

advertising to the effect that trust is a "crucial dimension" of its relationship with its customers.

Muller-Paisner II

Plaintiff repleaded breach of fiduciary duty, negligence, unjust enrichment and rescission claims. The parties consented to having the matter decided by a magistrate judge, completed discovery and then both sides moved for summary judgment. The court again dismissed the complaint in its entirety.

District Court II. The court stated that it would be a jury question whether TIAA owed Engel a fiduciary duty. However, even if a fiduciary duty existed, defendants were entitled to summary judgment; "even assuming the existence of a fiduciary duty, a reasonable jury could not find that this duty was breached." The court held that there was no misconduct/breach of fiduciary duty, either through self-dealing or in some other manner.[20]

As a matter of "logic," the district court rejected the black-and-white test of Meinhard as not setting the governing standard because the relationship was of an entirely different character. It held that the circumstances that gave rise to the fiduciary relationship — TIAA's annuitization of Engel's large retirement fund — set the standard.

Therefore, the court rejected plaintiff's central argument that the mere fact that TIAA sold its own products to Engel constituted self-dealing because TIAA did not control her assets.[21]

The court then looked for any "misconduct" on TIAA's part, noting that the burden of proof was on plaintiff. It rejected plaintiff's argument that TIAA committed misconduct when it did not make additional inquiries of Engel at the time of her purchase about her health and financial situation, sources of funds, tax status and risk tolerance.

"The potential effect of poor health on the payouts from an annuity contract is self-evident to the purchaser as long as there is an understanding that all payment from the annuity end with death and that no money is available for an heir or beneficiary."[22]

Because a jury could not reasonably find that TIAA failed to fulfill any duty to make Engel aware of these two facts, and because there was no evidence that would allow a jury to conclude that TIAA used its position of trust to foist the annuity on her, defendants were entitled to summary judgment.[23]

Court of Appeals II. The Court of Appeals reversed for a second time and remanded because it could not resolve the fiduciary question as a matter of law for either party. It divided its analysis into breach of duty of loyalty and duty of care. The duty of care/fiduciary negligence aspect of the decision may have broad potential application to other types of advisors.

The Second Circuit affirmed the lower court ruling that TIAA did not breach any duty of loyalty relating to Engel's selection of the annuity on two grounds. First, plaintiff did not allege that TIAA withheld any details of the compensation TIAA would receive from her choice of retirement vehicle.

Second, the claim of self-dealing was not actionable because by definition, self-dealing only occurs where the same party is on both sides of the bargaining table. TIAA did not sell the annuity to itself or control Engel's retirement account such that it was positioned to engage in self-dealing. Therefore, as a matter of law, TIAA did not breach the duty of loyalty.

The Second Circuit articulated the question whether TIAA breached the duty of care by negligently recommending or facilitating Engel's election of the annuity as "whether TIAA, given the facts known or available to it, exercised the level of care in its dealing with Engel consistent with whatever fiduciary duty it might have assumed."[24] It held that the lower court's reliance on the fact that there was no

evidence that TIAA had recommended the annuity was insufficient.

According to the Second Circuit, the evidence, viewed in the light most favorable to the estate, would permit a jury to infer that TIAA (1) voluntarily assumed a duty to provide clients with advice about the investment products appropriate to their situations, or (2) exercised some input into Engel's choice of the option. It reinstated the negligence claim to the extent it overlapped with the fiduciary duty claim and the unjust enrichment claim for rescission.[25]

Why We Care Whether Or Not a Fiduciary Relationship Exists

Under New York common law, there are situations that give rise to a cause of action only under "special circumstances." The existence of a fiduciary relationship is one such special circumstance. Whether a remedy exists may depend upon whether plaintiff can establish a fiduciary relationship.

1. Fraud. Ordinarily, when a party to a contract claims that another party is in breach of the agreement, a separate claim based on fraud fails to state a claim and is subject to dismissal.[26] That is because there is no fraud cause of action where the fraud is predicated upon an alleged breach of contractual duties, and the supporting allegations do not concern representations extraneous to the terms of the relevant agreement.[27]

The Bridgestone exception to this rule is where a plaintiff can demonstrate a legal duty separate from the duty to perform under the contract.[28] By alleging that the parties are co-shareholders in a closely-held corporation and accordingly share a fiduciary duty among themselves, a shareholder can meet the Bridgestone exception, thereby successfully alleging fraud as well as breach of contract.[29]

2. Fraudulent Concealment. A cause of action for fraudulent concealment adds the element of a duty to disclose to the common law fraud elements. A duty to disclose may arise from a fiduciary or confidential relationship. Shareholders in closely held family businesses share fiduciary duties among themselves. Therefore, that relationship can satisfy the duty to disclose element for a fraudulent concealment claim.[30]

3. Fraudulent Misrepresentation. New York recognizes a duty by a party to a business transaction to speak in only three situations: where the party has made a partial or ambiguous statement, where the parties stand in a fiduciary relationship with each other; and where one party possesses superior knowledge, not readily available to the other, and that party knows that the other is acting on the basis of mistaken knowledge.[31]

Absent one of the three exceptions, under New York law, the ancient rule of caveat emptor still rules; a duty to speak does not arise merely because the parties contract with each other.[32] Thus, the existence of a fiduciary relationship may be key to bringing such a claim.

4. Accounting. The equitable remedy of an accounting, which is available in partnership disputes, is not a remedy to which parties generally are entitled.[33] However, as in Stadt, supra, courts make exceptions for a party who can establish that it is in a fiduciary relationship.

The Takeaway: What This All Means

Deciding whether the parties are in a fiduciary relationship is the first step in any action based on breach of fiduciary duty, but finding a fiduciary relationship is not the end of the inquiry.

Actions by an acknowledged fiduciary that would not pass muster under Meinhard may now be allowed. Particularly if the party claiming breach is sophisticated, it is under a duty to protect itself, at least where the situation is no longer one of unquestioning trust.

The New York Court of Appeals made this view abundantly clear in 2012 in Tzolis, supra, in which it reaffirmed its 2011 decision in Centro Empresarial Cemprese S.A. v.America Movil, S.A.B. de C.V., 17 N.Y.3d 269 (2011): "Where a principal and fiduciary are sophisticated entities and their relationship is not one of trust, the principal cannot reasonably rely on the fiduciary without making additional inquiry."[34]

Even in the noncommercial context, with a lay person such as Engel in the TIAA case, just because there is a fiduciary relationship does not mean that there is a breach of duty when plaintiff is disappointed in the fiduciary's performance. As the two appeals in TIAA demonstrate, even the courts may have difficulty with the parameters of the relationship.

As is true in many situations, careful drafting of the operative documents, be it a shareholder agreement, partnership agreement, operating agreement, license or virtually any other agreement, is the first step in clarifying whether the parties are in a fiduciary relationship and, if so, the scope of the fiduciary duties under various scenarios.

While it may be impossible to preclude litigation when former BFFs decide to hate each other, it is far better that they sue each other than counsel who drafted the operative documents.

--By Joan M. Secofsky and Richard I. Janvey, Diamond McCarthy LLP

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[1] On a related topic, our January 2013 Note, New York Limits Fiduciary Obligations in Limited Liability Companies, discussed Pappas v. Tzolis, 20 N.Y.3d 228 (2012), reargument denied, 20 N.Y.3d 1075 (2013), which limited the fiduciary duties of majority members of limited liability companies to minority members in the context of a buyout.

[2] "I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description [hard-core pornography]; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and [the movie The Lovers] is not that." Jacobellis v. Ohio, 378 U.S. 184 (1964) (Stewart, J. concurring).

[3] Gate Technologies v. Delphix Capital Markets, 12 Civ. 7075 (S.D.N.Y. July 9, 2013)(citing cases); Meisel v. Grunberg, 651 F. Supp.2d 98, 114 (S.D.N.Y. 2009); see N.Y. Pattern Jury Instructions 3:59. Ultimately, the jury in Meisel returned a verdict of $3 million in compensatory damages and $1 million in punitive damages (plus $1.5 million in prejudgment interest) for breach of fiduciary duty, which judgment was affirmed. 2013 WL 1197498 (2d Cir. March 26, 2013).

[4] Muller-Paisner v. TIAA, 881 F. Supp.2d 579, 595 (S.D.N.Y. 2012), vacated and remanded, 2013 WL 3064858 (2d Cir. June 20, 2013) ("We agree that the existence and extent of any fiduciary duty ... must be resolved at trial based on a careful review of the parties' relationship"); Anwar v. Fairfield Greenwich Ltd., 728 F.Supp.2d 372, 415 (S.D.N.Y. 2010) (citing cases).

[5] Muller-Paisner, 2013 WL 3064858 at *1-2.

[6] Atlantis Info. Tech., GmbH v. CA, Inc., 485 F. Supp.2d 224, 231 (E.D.N.Y. 2007) (cited in Gate Technologies); Osan Ltd. v. Accenture LLP, 454 F.Supp. 46, 56-57 (E.D.N.Y. 2006).

[7] Muller-Paisner, 881 F. Supp.2d at 593-94.

[8] "[T]he mere payment of monies [cannot] transform an ordinary business relationship into one between fiduciaries." Gate Technologies, supra.

[9] Stadt v. Fox News Network LLC, 719 F. Supp.2d 312, 323 (S.D.N.Y. 2010). Using key phrases from several New York cases, Judge Scheindlin described New York law in Stadt:

A fiduciary relationship exists … when one person is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation. While it is not entirely clear when fiduciary duties arise out of a contractual relationship, it is well-settled law that a conventional business relationship does not create a fiduciary relationship in the absence of additional factors. With respect to a fiduciary duty arising from a contractual agreement, being a party to a contract does not itself impose a fiduciary duty. Rather, this duty must arise from a position of trust or special confidence that imposes obligations beyond the express agreements between the parties. Id. at 318-19 (citations and internal quotations omitted).

[10] "Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." 249 N.Y. at 464.

[11] "New York makes no distinction between the fiduciary duty owed by a general partner and that owed by a corporate director. One is not greater, and the other lesser. Both are bound by the same rule of fair dealing with limited partners or shareholders who rely on [their] integrity ... to manage the business into which those passive investors have placed their funds." Tucker Anthony Realty Corp. v. Schlesinger, 888 F.2d 969, 973 (2d Cir. 1989).

[12] Gate Technologies, supra.

[13] Benson v. RJM Securities Corp., 683 F. Supp. 359, 374-75 (S.D.N.Y. 1988) (citing New York cases).

[14] Subsequently, in Lightman v. Flaum, 97 N.Y.2d 128 (2001), cert. denied, 535 U.S. 1069 (2002), New York's highest court categorically rejected plaintiff's claim that her rabbi had a fiduciary duty to her that he breached by disclosing her confidences. It held that CPLR 4505, which protects confidential communications to clergy as privileged, is a rule of evidence only and not the basis of a private cause of action for beach of a fiduciary duty involving the disclosure of oral communications between congregant and cleric.

[15] According to the Comments to New York Pattern Jury Instruction 3:59, the following relationships are fiduciary in nature: employees, corporate officers and directors, cooperative and condominium boards of directors, real estate brokers as agent for an owner, partners/co-venturers, attorneys, trustees, escrow agents, co-tenants, spouses and attorneys-in-fact. Also according to Section 3:59, school board members may be held liable for breach of fiduciary duty, insurance broker and customer is not a true fiduciary relationship, an investment broker ordinarily does not owe a fiduciary duty to a purchaser of securities but has a fiduciary obligation with respect to carrying out requested transactions, it is an "open question" whether clergy have a fiduciary relationship with parishioners, and a patient may have a breach of fiduciary duty claim against a physician for unauthorized disclosure of medical records.

[16] As noted, family members stand in a fiduciary relationship toward one another in a co-owned business (McCaffery v. McCaffery, 2012 WL 3260299 (E.D.N.Y. 2012)), although the scope of the

fiduciary duty may be limited by Tzolis, as described in our January 2013 Note.

[17] In Fairfield Greenwich, supra, although the court agreed that plaintiffs (Madoff feeder fund investors) adequately plead breach of fiduciary duty, it dismissed the constructive trust cause of action without prejudice because "a constructive trust is a remedy, not a cause of action, and is to be imposed only in the absence of an adequate remedy at law." 728 F.Supp.2d. at 419 (citations omitted).

[18] 446 F. Supp.2d 221, 229, 232 (S.D.N.Y.2006), aff'd in part and rev'd in part, 2008 WL 3842899 (2d Cir. 2008).

[19] Id. at 231-32.

[20] Muller-Paisner, supra, 881 F. Supp.2d at 595, 596.

[21] "Were the rule otherwise, a stockbroker who had a fiduciary duty with respect to executing trades could be sued for failing to inform a customer that a competitor charged lower transaction fees. In the end, the bar against self-dealing cannot possibly have the application that plaintiff argues: that is, to bar TIAA from engaging in its business with customers." Id. at 598.

[22] Id. at 599, 600-01.

[23] Similarly, because there was no misconduct constituting a breach of a fiduciary duty, plaintiff was not entitled to restitution for unjust enrichment or rescission, because those claims were predicated on the fiduciary duty claim.

[24] Id. at *2.

[25] The court noted that on remand the estate must further show that any breach of fiduciary duty proximately caused damages. Id. at *4.

[26] In New York, fraud requires a showing that (1) defendant made a material false representation or omission of fact, (2) made by defendant with knowledge of its falsity, (3) defendant intended to defraud the plaintiff thereby, (4) plaintiff reasonably relied upon the representation, and (5) plaintiff was damaged by reason of such reliance. Barbara v. Marinemax, 2012 WL 6025604 at *19; Banque Arabe et Int'l D'Investissement v. Maryland Nat'l Bank, 57 F.3d 146, 153 (2d Cir. 1995); Gaidon v. Guardian Life Ins. Co., 94 N.Y.2d 330, 348 (1999).

[27] See generally Atlantis Info. Tech., GmbH, supra, 488 F.Supp.2d at 232; Papa's-June Music, Inc. v. McLean, 921 F.Supp. 1154 (S.D.N.Y. 1996); Metropolitan Transp. Auth. v. Triumph Advertising Productions, 116 A.D.2d 526, 497 N.Y.S.2d 673 (1st Dep't 1986).

[28] Bridgestone/Firestone, Inc. v. Recovery Credit Services, Inc., 98 F.3d 13, 20 (2d Cir. 1996). See also Barbara v. Marinemax, Inc., 2012 WL 6025604 at *9 (E.D.N.Y. 2012).

[29] "It is well settled that the same conduct which may constitute the breach of a contractual obligation may also constitute the breach of a duty arising out of the relationship created by contract but which is independent of the contract itself." Mandelblatt v. Devon Stores, Inc., 132 A.D.2d 162, 521 N.Y.S.2d 672, 676 (1st Dep't 1987).

[30] See Palmer v. A & L Seamon, Inc., 1996 WL 153946 (S.D.N.Y. 1996).

[31] The third exception has been broadened in recent years. "We observe a tendency in New York to apply the rule of 'superior knowledge' in an array of contexts in which silence would at one time have

escaped criticism." Brass, 987 F.2d at 151-52 (citations omitted).

[32] Id. at 150.

[33] To state a claim for an accounting under New York law plaintiff must establish, at minimum (1) relations of a mutual and confidential nature; (2) money or property entrusted to the defendant imposing upon him a burden of accounting; and (3) no adequate legal remedy. IMG Fragrance Brands, LLC v. Houbigant, Inc., 679 F. Supp.2d 395, 411 (S.D.N.Y. 2009).

[34] See also Arfa v. Zamir, 17 N.Y.3d (2011), aff'g 76 A.D.2d 56, 58-59 (1st Dep't 2010) ("notwithstanding the fiduciary obligation owed by each side to the other with respect to the management of the underlying real estate business, [plaintiffs] as sophisticated businesspeople, had 'an affirmative duty to protect themselves from misrepresentations by investigating the details of the transactions and the business'").
