

May 23, 2019

FUND DOCUMENTS

How Fund Managers Can Use Non-Reliance Clauses to Protect Themselves From Investor Claims of Misrepresentation

By [Jonathan Shepard](#), [Eric Dowell](#) and [Lauren Cooperman](#), [Pryor Cashman LLP](#)

When an investment manager sends a prospective investor the subscription package for one of its funds, the investor almost always will find that the documents contain a so-called “non-reliance” clause. The clause requires the investor to expressly disclaim reliance on any representation or statement not contained in the fund’s governing documents and private placement memorandum.

From the perspective of the investment manager, this clause is intended to ward off potential liability arising from, among other things, any statements that the manager’s marketing team made in meetings, teasers or pitch books concerning the merits of an investment in the fund. Whether those clauses are enforceable, however, is nuanced – particularly under New York law. Nevertheless, it is important for investment managers to understand how New York law – or Delaware law, which, as discussed below, is similar in relevant respects to New York law – treats non-reliance clauses in light of the fact that a significant portion of U.S. investment managers provide that New York or Delaware law will govern their funds’ documents. New York law is also frequently applied when resolving disputes concerning alleged misrepresentations of the type discussed herein.

This article discusses how non-reliance clauses are treated by New York courts, including in a recent instructive decision issued in the Southern District of New York; provides practical guidance for asset managers and their legal advisors on crafting appropriate non-reliance clauses; examines how managers can include additional protections in their fund documents to protect against investor misrepresentation claims; and reviews how the laws of New York and Delaware are both well-developed and more favorable to managers than those found in other states, most notably California.

See [“Contractual Provisions That Matter in Litigation Between a Fund Manager and an Investor”](#) (Oct. 2, 2014).

New York Courts’ Treatment of Non-Reliance Clauses

In fraud cases, an investor must show that it reasonably relied on the claimed misrepresentation – that is, that the extra-contractual statement reasonably induced “the investor’s decision to engage in the transaction.”¹ The question of reasonableness is fact-intensive and can be answered

only by a holistic assessment of the entire transaction, taking into account factors such as the complexity and magnitude of the subject investment, the sophistication of the parties and the terms of the governing documents.^[2] Because it is a highly fact-based analysis, courts generally are reluctant to determine at an early stage in a litigation whether an investor's reliance on extrinsic statements was unreasonable.^[3]

Nonetheless, a non-reliance clause can provide critical protection if it specifically tracks the language of the particular representation that forms the basis of the investor's claim.^[4] In such circumstances, New York courts do not hesitate to dismiss fraud claims – and fiduciary duty claims, to the extent that they rely on alleged representations to claim that plaintiff reposed trust and confidence in a fund manager – even on a motion to dismiss.^[5]

On the other hand, courts give little weight – particularly at an early stage in a litigation – to the sort of imprecise, generalized non-reliance clauses that commonly appear in fund documents, viewing such disclaimers as “boilerplate” attempts to cover a sweeping array of circumstances. For example, consider a clause often included in investment funds' subscription agreements stating that in making its investment in the fund, the investor did not rely on any advice, statements or recommendations made outside of the fund documents and conducted its own independent due diligence. Courts analyzing those clauses consistently have found them to be insufficiently particular to protect against fraud claims predicated on extra-contractual statements, at least at a motion to dismiss phase.^[6]

To preclude an investor's reliance-based claim early in a litigation, a non-reliance clause

must identify a specific matter to which the disclaimer of responsibility relates.^[7] Additionally, even when a disclaimer is specific in nature, New York courts still will reject those clauses if the facts allegedly misrepresented are “peculiarly” within the fund's knowledge (i.e., the relevant facts are solely available to the fund and could not have been discovered by investors through reasonable diligence).^[8]

For discussion of non-reliance clauses in another context, see [“Big Boys Don't Cry: How 'Big Boy' Provisions Can Help Hedge Fund Managers Avoid Liability for Insider Trading Violations”](#) (Dec. 3, 2009).

The Relevance of Investor Sophistication

At this point, an investment manager could be forgiven for lapsing into despair in presuming that non-reliance clauses will not be upheld under judicial scrutiny. The specificity requirement and New York's “peculiar knowledge” exception might appear to present formidable obstacles for a manager potentially facing investor claims under New York law. Understanding the key nuances, however, offers hope, as in practice, New York courts often deemphasize, or even disregard, these requirements when the investor is sophisticated and the subject investment terms were negotiated at arm's length.^[9] Underlying this treatment is an affirmative duty imposed by New York law on sophisticated parties to protect themselves from misrepresentations through adequate contractual negotiations and ordinary due diligence.^[10]

A recent decision issued by Judge Buchwald out of the Southern District of New York is instructive on this point.^[11] The case, entitled

Walsh v. Rigas et al., concerned a highly sophisticated plaintiff – himself a former investment manager – who was a shareholder in an offshore vehicle investing in shipping assets. The investment was governed by a standard set of documentation: a private offering memorandum, a subscription agreement and articles of association. Set forth in the fund documents were a number of general non-reliance provisions, such as the investor’s acknowledgement that he was “aware of the risks inherent in investing in the assets,” and that he relied solely on the statements set forth in the fund documents in making his investment decision. The investor also acknowledged in the subscription agreement that he was a “sophisticated investor” with “knowledge, expertise and experience in financial matters” who could “bear the risk of loss of [his] entire investment.”

Several years after making his investment, the investor brought fraud and fiduciary duty claims against Sciens Capital and eight of its principals and affiliates, claiming he was fraudulently induced into making his investment based, in part, on statements made by the asset manager’s marketing team and contained in the fund’s marketing materials. The investor also brought a direct (i.e., non-derivative) fiduciary duty claim, based in part on those same pre-investment interactions. Specifically, he alleged that the marketing team misrepresented the acquisition price of shipping assets and charter rates, and that both the marketer and the fund’s marketing materials made misleading projections concerning anticipated investment performance. The Court dismissed all of the plaintiff’s claims – set forth in a lengthy 138-page amended complaint – with prejudice on the pleadings, holding in relevant part that, given the non-reliance clauses contained in

the fund documents, paired with the plaintiff’s sophistication, any reliance on extrinsic statements was unreasonable as a matter of law.^[12]

Practical Guidance on Non-Reliance Clauses in Light of the Law

When drafted appropriately, New York courts will enforce non-reliance clauses; thus, they can serve as a powerful tool to defeat claims of misrepresentation based on extra-contractual statements. While there are no “magic words” to insert into fund documents that can preclude all investor fraud claims based on extrinsic statements, investment managers should be mindful of making unambiguous and precise disclaimers in fund documents to the greatest extent possible. Even where the investor base is anticipated to be sophisticated, the subject documents should not contain only boilerplate language.^[13]

It pays to articulate particular circumstances upon which it is common for investors to base fraud claims, such as statements made in marketing materials or by marketing personnel – like those in *Walsh v. Rigas* – concerning, among other subjects:

- past and future investment performance;
- costs and fees charged by managers;
- investment theses;
- preexisting assets and liabilities; and
- due diligence findings concerning underlying investments.

It also is beneficial to draft bilateral disclaimers whereby the investment manager disclaims making any representation concerning the due diligence on the investment and whereby

the investor acknowledges that it had the opportunity to conduct its own due diligence and relied only on that diligence in making its investment.

Furthermore, when dealing with a sophisticated investor base, it is important to ensure that all investors specifically acknowledge their sophistication in writing. As noted above, New York courts also place significant weight on the arm's-length nature of a transaction, which indicates that the terms of the governing documents were negotiated in good faith by two sophisticated parties. On this point, the Second Circuit has stated:

Where . . . a party has been put on notice of the existence of material facts which have not been documented and he nevertheless proceeds with a transaction without securing the available documentation or inserting appropriate language in the agreement for his protection, he may truly be said to have willingly assumed the business risk that the facts may not be as represented. Succinctly put, a party will not be heard to complain that he has been defrauded when it is his own evident lack of due care which is responsible for his predicament. We believe that the failure to insert such language into the contract – by itself – renders reliance on the misrepresentation unreasonable as a matter of law.^[14]

Thus, it also is critically important for investment managers to memorialize and document any specific requests made by investors to amend or supplement particular representation language in the fund documents, as this will demonstrate both investor sophistication and arm's-length negotiations.

Other Drafting Advice

Merger or Integration Clauses

Non-reliance clauses often appear alongside merger clauses – sometimes referred to as integration clauses – which provide that the contract sets forth all relevant representations and supersedes all previous agreements and representations. Although not dispositive or sufficient on their own to limit an investment manager's representations only to those set forth in the fund documents, merger clauses can provide another argument supporting an investment manager's defense against lawsuits premised upon extra-contractual statements.^[15] Investment managers are well advised to ensure that their funds' governing documents include appropriate merger clauses.

For more on merger clauses, see "[Manhattan District Court Writes Final Chapter in Litigation Between Internet Law Library and Hedge Fund Adviser Southridge Capital Management](#)" (Aug. 27, 2010).

Choice of Law and Venue Clauses

The law on non-reliance clauses differs from jurisdiction to jurisdiction. California courts, for example, are particularly inhospitable to enforcing non-reliance clauses because they view them as a mechanism for parties to contractually release future liability for fraud, which is against California's public policy.^[16] It therefore is critical to include appropriate forum selection and choice of law provisions in fund documents, expressly binding investors to the law of jurisdictions such as New York and Delaware, where managers can harness interpretive nuances to their benefit in the event of a dispute.^[17]

The reality is that being the target of investor claims based on alleged misstatements made outside of the governing fund documents is not a matter of if, but rather when, as there is an ever-expanding class of litigious investors supported by an aggressive plaintiffs' bar. That said, carefully drafted non-reliance language that provides maximum protection in the face of those lawsuits can be achieved with planning and thought. Wielded by an informed litigator, that language can result in the dismissal of investor actions at an early stage of litigation, as happened in the *Walsh* matter, saving managers significant time and expense.

Jonathan Shepard is a partner at Pryor Cashman and co-chairs the firm's investment management group. He is also member of the firm's executive committee. Shepard counsels investment managers of leading global hedge funds and private equity firms, as well as innovative businesses and emerging entities on a wide range of securities and complex commercial litigation matters.

Eric Dowell is a counsel at Pryor Cashman and is a member of the firm's litigation; intellectual property; media and entertainment; and investment management groups. Dowell handles a wide range of civil and criminal matters before federal and state courts. His clients include individuals; media and entertainment companies; large multinational corporations; real estate developers; and nonprofits, among others.

Lauren Cooperman is an associate in the litigation group at Pryor Cashman. Cooperman handles a broad range of complex commercial, white collar and securities matters before federal and state courts.

^[1] *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804, 812 (2011); *Emergent Capital Inv. Mgmt., LLC v. Stonepath Grp., Inc.*, 343 F.3d 189, 197 (2d Cir. 2003) (reliance may be established by showing that, but for the claimed statements, the investor would not have entered into the transaction).

^[2] *Emergent Capital Inv. Mgmt., LLC*, 343 F.3d at 195.

^[3] *Schlaifer Nance & Co. v. Estate of Warhol*, 119 F.3d 91, 98 (2d Cir. 1997).

^[4] See *Caiola v. Citibank, N.A., New York*, 295 F.3d 312, 330 (2d Cir. 2002) (“[A] valid disclaimer provision must contain explicit disclaimers of the particular representations that form the basis of the fraud claim.”).

^[5] See e.g., *Harsco Corp. v. Segui*, 91 F.3d 337, 345–46 (2d Cir. 1996) (enforcing a contractual disclaimer containing specific representations); *HSH Nordbank AG v. UBS AG*, 95 A.D.3d 185, 199 (1st Dep’t 2012) (“[T]he disclaimers and disclosures in these documents relate to “the very matter as to which [HSH] now claims it was defrauded” and therefore “destroy[] the allegations . . . that the agreement was executed in reliance upon . . . contrary oral representations.”).

^[6] See *Caiola*, 295 F.3d at 330; *Loreley Fin. (Jersey) No. 3 Ltd. v. Citigroup Glob. Markets Inc.*, 119 A.D.3d 136, 143–44 (1st Dep’t 2014).

^[7] For instance, in *Danann Realty Corp. v. Harris*, the Court of Appeals held that the purchaser of a building could not rely on oral representations made by the seller outside of a contract where the contract specifically provided that the seller had not and did not make any representations as to the “expenses, operation or any other

matter or thing affecting or related to the aforesaid premises, except as herein specifically set forth, and the Purchaser hereby expressly acknowledges that no such representations have been made.” 5 N.Y.2d 317, 320 (1959).

^[8] *Basis Yield Alpha Fund (Master) v. Goldman Sachs Group, Inc.*, 115 A.D.3d 128, 137 (1st Dep’t 2014) (“The law is abundantly clear in this state that a buyer’s disclaimer of reliance cannot preclude a claim of justifiable reliance on the seller’s misrepresentations or omissions unless (1) the disclaimer is made sufficiently specific to the particular type of fact misrepresented or undisclosed; and (2) the alleged misrepresentations or omissions did not concern facts peculiarly within the seller’s knowledge.”); see also *DIMON Inc. v. Folium, Inc.*, 48 F. Supp. 2d 359, 368 (S.D.N.Y. 1999).

^[9] See *Lazard Freres & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531 (2d Cir. 1997); *Harsco Corp.*, 91 F.3d at 345-46.

^[10] See *HSH Nordbank AG*, 95 A.D.3d at 195.

^[11] *Walsh v. Rigas*, 17-cv-04089-NRB, 2019 WL 294798 (Jan. 23, 2019 S.D.N.Y.).

^[12] *Id.* at *21. Furthermore, with respect to the direct fiduciary duty claim, the court held that any pre-investment interaction with the investor did not create (or breach) a fiduciary duty because there was no basis for inferring that the trust and confidence that the investor reposed in any defendant was anything more than the type parties normally seek before entering an arm’s-length transaction. *Id.* at *37. Where the non-reliance clauses helped was in supporting this finding: “Far from ‘trust and repose,’” explained the court, the investor “explicitly disclaimed reliance on extrinsic pre-investment representations and agreed to rely

entirely on the stated terms of the integrated agreement.” (*Id.* at *36) The 42-page decision also is noteworthy for several reasons outside the scope of this article, and to the extent it features full dismissal of a kitchen-sink pleading, is recommended general reading for fund managers and their legal advisors.

^[13] See, e.g., *Loreley Fin. (Jersey) No. 3 Ltd. v. Citigroup Glob. Markets Inc.*, 119 A.D.3d 136 (1st Dep’t 2014).

^[14] *Lazard Freres & Co.*, 108 F.3d at 1543 (quoting *Rodas v. Manitaras*, 159 A.D.2d 341, 343 (1st Dep’t 1990)).

^[15] See, e.g., *FIH, LLC v. Found. Capital Partners LLC*, 920 F.3d 134, 143 (2d Cir. 2019) (standalone merger clause cannot preclude reasonable reliance as matter of law but can rebut reasonableness when considered alongside other contractual representations and warranties).

^[16] Cal. Civ. Code § 1668; see also *Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Dev. Corp.*, 32 Cal. App. 4th 985, 992-94 (1995).

^[17] Delaware law on this issue generally tracks New York’s in that it recognizes a public policy favoring the enforcement of non-reliance clauses. That said, like New York, Delaware courts repeatedly have held that boilerplate integration clauses alone do not contain anti-reliance language sufficient to bar extra-contractual tort claims and that, in order to adequately disclaim reliance on extra-contractual representations, clauses must clearly identify “specific information on which a party has relied,” and “foreclose reliance on other information.” *Prairie Capital III, L.P. v. Double E Holding Corp.*, 132 A.3d 35, 50 (Del. Ch. 2015).