

ClientAlert

July 13, 2010

New York's Top Court Affirms That Hedge Fund Investors Cannot Pursue Fraud Claims Against Accounting Firm For Purely Derivative Damages

In a victory for accounting firms, the New York Court of Appeals affirmed the dismissal of a fraud claim brought against an accounting firm by investors in a hedge fund who claimed that they were induced to rely on the firm's allegedly fraudulent audits of the fund's financial statements when making their investment. *Continental Casualty Co. v. PricewaterhouseCoopers, LLP*, 2010 WL 2569187 (N.Y. June 29, 2010). The Court of Appeals held that the fraud claim should be dismissed because the investors could not show any "direct" damages resulting from the auditor's alleged fraudulent inducement that occurred at the time the investment was made. Rather, the investors' only injuries were "derivative" damages resulting from their *pro rata* share of the hedge fund's losses, which occurred after the date of investment and were sought by a trustee on behalf of the fund in a separate case.

Continental will obviously be helpful to accounting firms and other defendants in obtaining dismissal of claims brought by individual investors in hedge funds or other investment vehicles where the fund itself also has asserted or could assert claims. In addition, the decision may be helpful to fraud defendants generally, since the Court took an arguably narrow view of the damages recoverable for fraud in the inducement. The Court made clear that such damages were limited to the plaintiff's "actual pecuniary loss" calculated at the time the investment was made, rather than a potentially broader scope of damages that could have included damages sustained after the date of investment.

Background

Plaintiffs in the case were limited partners in Lipper Convertibles, a hedge fund. In making their investments in the fund, Plaintiffs allegedly relied on statements about the fund's performance contained in the financial statements that were audited by the defendant accounting firm. Although these statements showed consistent growth in the value of the fund's portfolio, the fund disclosed in 2002 that its assets were overstated by hundreds of millions of dollars as a result of fraud by the fund's portfolio manager.

After the fraud was revealed, Plaintiffs sued the fund's auditor, alleging that the auditor failed to follow the proper auditing procedures to ensure that the fund's financial statements were accurate, charging the auditor with fraud, negligence, and other claims. A Trustee appointed in the fund's liquidation brought a separate action against the fund's auditor, raising similar claims on behalf of all limited partners who suffered losses. The auditor settled the Trustee's claims in January 2010.

After discovery, the auditor moved for summary judgment on the hedge fund investors' fraud claim. The auditor argued that the investors' sole injuries were their *pro rata* losses resulting from the diminution in value of the fund at the time of liquidation, and thus they could prove no injury to

themselves that was distinct from the injury to the fund as a whole, which was the subject of the Trustee's action. The trial court granted summary judgment in favor of the auditor and the Appellate Division affirmed. The Court of Appeals granted leave to appeal and also affirmed.

The Court of Appeals Decision

The Court of Appeals first noted that the issue on appeal was not whether the investors, as limited partners in the Lipper fund, could assert a legally cognizable claim against the auditor for fraud in the inducement. The issue, rather, was whether the investors could show any "direct" fraud damages that were distinct from "derivative" damages resulting from the investors' share of the fund's losses.

Damages recoverable for fraud in the inducement are the "actual pecuniary loss" resulting from the fraud on the date the investment was made. Put another way, fraud damages "are to compensate plaintiffs for what they lost because of the fraud, not for what they might have gained." Under this damages standard, the Court of Appeals held that the investors' fraud claim should be dismissed. The investors were not seeking "direct" damages for fraud as of the date they made their investment, but rather "derivative" damages based on losses to the fund that occurred *after* the investments were made that overlapped with damages sought by the Trustee. The Court held:

"The only injury [plaintiffs] seek to establish is the diminution in value of their limited partnership interests at liquidation. However, that diminution is attributable to their pro rata share of the partnership's losses after the date of their investments, and they experienced those losses in their capacities as limited partners in common with all other limited partners. Plaintiffs cannot recover their pro rata share of the partnership injury and also recover that same injury under the direct fraud action. Thus, [the auditor] was entitled to summary judgment dismissing the fraud cause of action."

In reaching this holding, the Court rejected the investors' attempt to rely on an exception to the fraud damages rule recognized in *Hotaling v. Leach & Co.*, 247 N.Y. 84 (1928), that would calculate damages based in part on the value of the investment after the fraud was discovered, rather than at the time the plaintiff made the investment. The Court held that the *Hotaling* exception did not apply for two reasons. First, the actual date-of-investment loss in *Hotaling* could not be calculated because the market value of the investment at issue as of the date the plaintiff purchased it could not be determined, whereas here the investors' own expert acknowledged that it was possible to determine the market value of Plaintiffs' shares in the fund on the day of purchase. Second, "there was no overlapping derivative claim in *Hotaling* that would inure to the plaintiff's benefit," as there was in *Continental* by virtue of the Trustee's separate lawsuit against the auditor.

Conclusion

On its face, *Continental* is important for accounting firms and other defendants facing fraud claims by individual investors in hedge funds or other investment vehicles in addition to a case brought by the fund itself. In such cases, the defendant should be able to obtain dismissal, on summary judgment or possibly even on an early motion to dismiss, of the investors' fraud claims if the defendant can show that the damages sought by the investors are "derivative" in nature.

Continental may also be significant to fraud defendants generally, since the Court of Appeals took an arguably narrow view of the damages recoverable for fraud in the inducement, by narrowing the *Hotaling* exception (at least in certain circumstances) and limiting the damages to "direct" damages resulting from the fraud at the time of the purchase.

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