



Private Security Offers & Proper Disclosure Materials: an Analysis of New York Cases

Private Offerings provide businesses and entrepreneurs a way to raise capital funds privately, affording more flexibility than institutional lenders and allowing the parties to bypass SEC registration. However, those holding out Private Offerings (esp. to New York investors) should be careful to limit their legal liability, and comply with state laws regarding private investment. The best protection for any Offeror is by drafting liability-limiting language into the Private Placement Memorandum (“PPM”). The following summarizes another New York cases that illustrate this point.

CASE NUMBER 1

Jana Master Fund, Ltd. v. JPMorgan Chase & Co: A PPM Successfully Disclaims a Duty of Care on the Part of the Offeror

A recent ruling by the New York Supreme Court (the “Court”) upheld the liability-limiting language of a PPM, which warned of the high-risk nature of the investment. Private investors should make note whether their PPM’s contain such language, and whether they are willing to accept the risks of the investment. The Court held that, given the language of the PPM, the placement agent owed no duty of reasonable care to investors in providing financial projections or information. *Jana Master Fund, Ltd. v. JPMorgan Chase & Co.*, 19 Misc.3d 1106(A) at *5 (N.Y.Sup.Ct. 2008).

In *Jana Master Fund, Ltd.*, the plaintiffs (collectively “Jana Funds”), four hedge funds that buy up debt securities of distressed or insolvent issuers, purchased a series of notes issued by Sons of Gwalia (“Gwalia”). *Id.* at *1. Jana Funds alleged that JPMorgan Chase & Co. (“Chase”) directed its subsidiary Chase Securities, Inc. (“Chase Securities”) to conduct two private placements totaling \$170M. *Id.* Chase Securities allegedly performed the private placements with actual knowledge of undisclosed contingent liabilities in excess of \$443M against Gwalia. *Id.* at *2.

Jana Funds asserted *inter alia* negligent misrepresentation, and requested as damages the total amount due on the notes plus any compensatory damages. *Id.* The PPM contained language warning potential investors against relying on any financial forecasts, projections, etc. made by the placement agent or its representatives and disclaiming liability for third-party reliance on such information. *Id.* The Court noted this provision containing strong cautionary language:

The securities are being offered only to a limited number of institutional accredited investors that are willing and able to conduct an independent investigation of the risks associated with ownership of the securities. By accepting delivery of this memorandum, prospective investors will be deemed to have acknowledged the need to conduct their own thorough investigation of the company and to exercise their own due diligence before considering an investment in the securities.

The Court then laid out the standard a plaintiff must meet to sustain a claim for negligent misrepresentation. The claim requires a plaintiff to show that the defendant owed a duty of reasonable care in supplying information, that the information was false, and that the plaintiff reasonably relied on

such information. *Id.* at *5. The Court dismissed the claim because the PPM's language admonishing potential investors of the risks relieved the placement agent of that duty. *Id.* This decision demonstrates that placement agents should have PPM's with provisions outlining the risks and the potential investors' responsibility to independently investigate those risks.

Moreover, the Martin Act confers *exclusive* jurisdiction on the state's Attorney General to pursue claims of deceitful practices in the sale, exchange, distribution and purchase of securities that do not require proof of actual knowledge, i.e., negligence or recklessness. *Id.* Thus, the Martin Act covers any allegations that the placement agent negligently misrepresented or concealed information regarding Gwalia's true financial condition. The Martin Act does not provide for a private cause of action; in fact, it is left solely to the Attorney General to pursue these claims (or not). *Id.* Thus, potential investors should know that they have no private relief for tortious acts committed by placement agents without actual knowledge.

CASE NUMBER 2

II. *Barneli & Cie SA v. Dutch Book Funds: Risk Disclosure Language in PPM Fails to Insulate from Fraud Claim*

Though the New York Supreme Court may uphold risk disclosure language in the PPM by dismissing claims based on negligence or breach of duty, fraud claims against Offerors may be harder to dismiss. In *Barneli & Cie SA v. Dutch Book Funds, et al.*, despite the fact the Court dismissed some claims based on provisions of the PPM warning investors of the high risk nature of the investment, it allowed the fraud claim to go forward. Slip Op. 32137U (N.Y.Sup.Ct. 2010).

In the *Barneli* case, there were numerous players which are broken down below. Plaintiff Barnelli & Cie SA (B&C) was a Panamanian corporation with an office in Panama. *Id.* at **1. The Defendants were Dutch Book Funds SPC, Ltd. (the "Fund"), Dutch Book Partners, LLC ("Partners"), and Stanley Jonas (collectively, the Fund, Partners, and Jonas are "Defendants"). *Id.* The Fund was a Cayman Islands corporation, and Partners was a Delaware Limited Liability Company, both of which have offices in New York, New York. *Id.* Jonas was the director of the Fund and the CEO and CFO of Partners. *Id.*

The Fund offered shares in various investment portfolios and one of the portfolios was the Dutch Book Segregated Portfolio I (the "Portfolio"). *Id.* at **2. The offer was made pursuant to a Private Placement Memorandum issued in July of 2006, which provided that the Fund, through Partners, would try to create a 'Dutch Book' on the movement of market expectations. *Id.* A 'Dutch Book', according to the Memorandum, is "a set of positions 'betting' on a particular action that, in sum, earns a positive return for the owner of the 'Dutch Book' regardless of the outcome." *Id.* The prospect of a positive return was based on a set of algorithms allegedly developed by the Fund, which were, in turn, based on standard probability axioms successfully used by Defendants in the past, and structured to earn money regardless of Federal Reserve activity. *Id.* at **3.

B&C was the only investor, purchasing 50,000 shares in the Portfolio pursuant to a Subscription Agreement in the amount of \$50mil in July 2006. *Id.* In October 2006, the Portfolio lost \$4mil, and B&C withdrew \$30mil as a result. *Id.* at **4. The Portfolio continued to incur losses, and in less a year, lost



more than \$8mil while incurring fees of over \$2mil. *Id.* B&C brought suit, alleging breach of contract, breach of fiduciary duty, and fraud. *Id.* at **5.

II A. Barneli & Cie SA v. Dutch Book Funds: Breach of Contract and the Importance of Risk Disclosure

B&C alleged that the Fund and the Partners failed to make investments as set forth in the Memorandum. *Id.* at **7. Ultimately, the risk disclosing language in the Memorandum acted as a limitation on the Fund's liability. Hence, the Court 1) dismissed the claim as to Partners because its sole role pursuant to the Memorandum was to act as Investment Advisor; and 2) dismissed the claim against the Fund because the Memorandum provided "no assurance that the investment objective of the Dutch Book Segregated Portfolio I or any other portfolio of the Fund will be achieved." *Id.*

II B. Barneli & Cie SA v. Dutch Book Funds: Breach of Fiduciary Duty

B&C also asserted the Defendants breached their fiduciary duty by failing to invest in accordance with the Memorandum. *Id.* at **10. However, as to the Fund and Jonas, the Court found that B&C is a 'Sophisticated Investor', meaning it had sophisticated knowledge of investing management; furthermore, B&C acknowledged that status in executing the Fund's Subscription Agreement. *Id.* at **14. Hence, the Court dismissed the claim. *Id.* at **15. As to the claim against Partners, since B&C was not a client of Partners, the Court found Partners owed no duty. *Id.* at **15.

II C. Barneli & Cie SA v. Dutch Book Funds: Fraud

B&C finally asserted that Defendants induced B&C to invest in the Fund by representing it had successful algorithms that would be used to manage the Portfolio. *Id.* at **19. B&C further alleged that the representations were known to be false by Defendants when they made them and Defendants intended to deceive B&C and that B&C relied to its detriment on these representations. *Id.* Defendants countered the claim was meritless since: 1) the Memorandum contained aspirational statements regarding the investment strategy; 2) the Memorandum's risk disclosure negated any reliance claims; and 3) B&C acknowledged it had a chance to ask any questions or request to see the algorithms but it did not. *Id.*

Nonetheless, the Court did not dismiss the fraud claims. The Court found that the statements regarding the existence of algorithms and their successful use in the past were not "aspirational" and may have misled a reasonable investor to believe that success was assured. *Id.* at ** 21. Thus, the allegations served as a basis for fraud. *Id.* at **22. Moreover, the Court held that, although cautionary language can render misrepresentations about the future immaterial, it "[cannot] insulate a defendant who...[fails] to disclose current conditions adverse to the offering from liability." (J.S.C., Bransten, citing to *Ackerman v. Price Waterhouse*, 252 A.D.2d 179 (N.Y.1D 1998)). Indeed, B&C contended that Defendants' misrepresentations about the algorithms and past success actually constituted current conditions that Defendants failed to disclose, and these conditions were adverse to the offering. *Id.* at **23. The Court also found that the risk disclosures did not negate B&C's claim of reasonable reliance as to the existence and success of the algorithms. *Id.* at **25. Notably, Defendants' counter-argument that B&C's status as a sophisticated investor precluded it from bringing reliance claims because it had access to all relevant



information failed, *id.* at ** 25, as the Court noted that sophisticated investors can reasonably rely on fraudulent statements and whether or not they did so is an issue of fact. *Id.* **26.

Conclusion:

Though New York courts will apply the risk disclosure language of a PPM in dismissing a claim brought by an investor, Offerors should make sure to disclose all material risks. The language cannot be used as a shield where Offerors were not completely candid about the nature of the investment or the risks involved. Either way, a robust risk disclosure provision is a must-have.

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