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First Department Holds that No Fiduciary Duty Exists Between Issuer and Underwriter

On June 27, 2006, the New York Appellate Division, First Department, decided *HF Mgt. Servs. LLC* v. *Pistone*,[1] addressing the relationship between underwriter and issuer and finding that in the ordinary situation no fiduciary duty exists between them. Based thereon, the First Department reversed the trial court's disqualification of plaintiff's counsel, who earlier had served as counsel for defendants' underwriter and in that capacity had access to defendant's confidential information.

I. FACTS AND PROCEDURAL HISTORY

In 2003, the law firm of Epstein, Becker & Green ("EBG") represented Morgan Stanley, performing due diligence in connection with Morgan Stanley's underwriting of WellCare's initial public offering ("IPO"). In that role, EBG reviewed files, interviewed WellCare personnel, and reviewed business plans, strategic market analyses, employee policies, and recruitment and retention documents. EBG also discussed WellCare's litigation strategies with WellCare's head of litigation and its general counsel.

A year later, represented by EBG, HF Management Services brought suit against WellCare, alleging that two of HF's former employees had breached their non-solicitation agreements and that WellCare had raided HF's sales force.

WellCare moved to disqualify EBG, arguing that in the course of IPO due diligence for Morgan Stanley, EBG had acquired confidential information that would prejudice WellCare's defense. The trial court held that, as its underwriter, Morgan Stanley owed a fiduciary duty to WellCare and that EBG, as Morgan Stanley's agent in the IPO, shared that fiduciary duty to WellCare. Finding that EBG had obtained confidential information in the course of a fiduciary relationship, the trial court disqualified EBG from serving as HF's counsel against Wellcare.

In a split decision, the First Department reversed the trial court, holding that Morgan Stanley owed no duty to WellCare, and thus EBG should not have been disqualified.

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1 2006 WL 1737871 (1st Dep't June 27, 2006).

II. RATIONALE OF THE COURT

A. The Opinion of the Court (per Catterson, J.)

The Opinion for the Court first recognized that a party seeking disqualification need not be a current or former client of the attorney it is seeking to disqualify. Instead, "the crux of disqualification is not the attorney-client relationship itself, but the fiduciary relationship that results from it."[2] Accordingly, disqualification would be appropriate if the moving party was owed a fiduciary duty by the counsel they sought to disqualify, whether or not that duty stemmed from an attorney-client relationship.[3]

Because EBG had access to WellCare's confidential information through its due diligence performed on behalf of Morgan Stanley, the question before the court was whether or not the underwriter-issuer relationship between Morgan Stanley and WellCare triggered a fiduciary duty that could be imputed to EBG as Morgan Stanley's counsel. "A fiduciary relationship may exist where one party reposes confidence in another and reasonably relies on the other's superior expertise or knowledge, but an arms-length business relationship does not give rise to a fiduciary obligation."[4]

The Opinion for the Court hinges on its determination that an underwriter and an issuer are typically engaged in an arms length transaction and, if anything, the relationship is adversarial. The court focused on the fact that an underwriter has a statutory duty to investors, not to the issuer. The underwriter therefore cannot have a simultaneous fiduciary duty to the issuer, as that would create a conflict of interest with its primary duty to investors because, among other things, the underwriter's counsel may determine that the deal should not go forward, even though such result would be against the best interest of the would-be issuer.[5]

In addition, the court observed that a fiduciary relationship between the underwriter's counsel and the issuer of securities "makes no sense under the federal securities laws."[6] The court noted that underwriters perform due diligence specifically so that they may later avail themselves of the due diligence defense. The securities laws do not provide a due diligence defense to the issuer, however, demonstrating that EBG's due diligence investigation was performed for the sole benefit of Morgan Stanley.

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2 *Id.* at *2 (citation omitted).

3 *Id.*, citing *Greene* v. *Greene*, 391 N.E.2d 1355 (N.Y. 1979).

4 *Id*.

5 *Id*. at *4.

6 *Id.*

The court addressed the Court of Appeals' recent holding in *EBC I Inc.* v. *Goldman, Sachs,*[7] which held that an underwriter (Goldman Sachs) did owe a fiduciary duty to the issuer (eToys) in the circumstances of that case, observing that the Court of Appeals' holding was not based on the underwriter-issuer relationship *per se*, but rather on a preexisting advisory relationship independent of the underwriting agreement.[8] eToys had "repose[d] confidence in Goldman Sachs' knowledge and expertise,"[9] apart from the underwriting relationship which was found sufficient to trigger a fiduciary duty.

The court read *EBC I* as standing only for the proposition that a fiduciary duty exists "between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation"[10] and that the holding in *EBC I* was "not at odds with the general rule that fiduciary obligations do not exist between commercial parties operating at arm's length."[11] The court found that *EBC I* did not effect any change in the law; it simply restated the "long recognized [] non-fiduciary nature of the underwriter-issuer relationship.[12]

In the case at hand, the record did not indicate that Morgan Stanley acted as an advisor to WellCare, and there was no evidence of a relationship beyond the standard underwriting agreement.[13] In the absence of any facts establishing a basis for a fiduciary relationship, EBG had no duty to WellCare and its disqualification was therefore inappropriate.[14]

B. The Dissenting Opinion (per Andrias, J.P.)

The dissent argued that disqualification was appropriate because EBG obtained confidential information in the diligence process within the context of a fiduciary relationship and that information was substantially related to the issues presented in the instant litigation. The dissent argued that the trial court correctly found that a fiduciary relationship existed between Morgan Stanley and WellCare "at least to the extent that Morgan Stanley was bound to preserve from adverse use against WellCare in other con-

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7 5 N.Y.3d 11 (2005).

8 *Id.* at 20.

9 *Id.*

10 *Id.* at 19, citing *Restatement [Second] of Torts* § 874, Comment a.

11 *EBC I*, 5 N.Y.3d at 22.

12 *HF Mgt. Servs. LLC*, 2006 WL 1737871, at *4, citing *Blue Grass Partners* v. *Bruns, Nordeman, Rea & Co.*, 75 A.D.2d 791 (1st Dep't 1980) and *Breakaway Solutions* v. *Morgan Stanley & Co. Inc.*, 2004 WL 1949399 (Del. Ch. 2004).

13 *HF Mgt. Servs.LLC*, 2006 WL 1737871, at *3.

14 *Id.*

texts confidential information elicited from it to facilitate the underwriter's due diligence. This duty was properly imputed to EBG in its capacity as Morgan Stanley's counsel."[15] The dissent focused on the fact that EBG obtained "secret" information from WellCare within the meaning of Code of Professional Responsibility DR 4-101, to which it would not otherwise have been privy outside the underwriting relationship, finding that at the very least EBG owed WellCare a "fiduciary or special" obligation not to disclose to anyone other than Morgan Stanley the information it obtained.

III. SIGNIFICANCE OF DECISION

HF Mgt. Servs. LLC v. *Pistone* supports the proposition that New York law does not recognize the existence of a fiduciary obligation based *solely* on the issuer-underwriter relationship. The description of the underwriter-issuer relationship as arms'-length and adversarial, however, should serve as a reminder that confidential information shared for purposes of due diligence may not be entitled to any protection from further disclosure absent agreement relating thereto.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at (212) 701-3323 or jschuster@cahill.com.

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15 *Id.* at *6.