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REGULATORY FOCUS

Eternity v. Morgan Guaranty: When Does Reliance Give Rise To A Claim?

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A recent decision by a U.S. district court over credit derivatives transactions raises the possibility that the duty of a broker-dealer or other market professional to its customer or counterpart may be expanded based on the market professional's "unique or special expertise" – without regard to the other party's level of sophistication. This article examines how the decision may affect the obligations of a broker-dealer or other market professional to its customer or counterpart beyond, and notwithstanding, the documentation intended to govern their relationship.

THE DECISION

In *Eternity Global Master Fund Limited v. Morgan Guaranty Trust Company of New York*, 2002 U.S. Dist. LEXIS 20706 (S.D.N.Y. Oct. 29, 2002), **Eternity Global Master Fund Limited** sued **Morgan Guaranty Trust Company of New York** and **JPMorgan Chase Bank** (collectively, Morgan) for breach of contract, fraud and negligent misrepresentation. Eternity's claims for fraud and negligent misrepresentation were based upon alleged assurances and omissions regarding the liquidity of a secondary market for credit-default swaps Eternity had entered into with Morgan. Eternity had entered into these swap transactions to hedge its long position in emerging market bonds it had purchased from Morgan.

The district court found that:

> "Morgan's unique or special expertise in swap transactions and emerging market debt . . . as well as allegations that Morgan was aware of the use to which . . . information [provided] would be put,"

was sufficient to withstand a motion to dismiss the negligent misrepresentation cause of action.

To make a claim for negligent misrepresentation, Eternity had to allege, among other things, facts supporting the conclusion that, "as a result of a special relationship" with Eternity, Morgan had a duty to provide Eternity with accurate information. Further, "the alleged misrepresentation," according to the dis-

trict court, must "be factual in nature and not promissory or relating to future events that might never come to fruition." Relying on the New York Court of Appeals opinion in *Kimmell v. Schaefer*, 89 N.Y.2d 257 (1996), the district court listed the following factors to consider in determining the presence of a special relationship:

- whether the person making the representation held or appeared to hold unique or special expertise;
- whether a special relationship of trust or confidence existed between the parties; and
- whether the speaker was aware of the use to which the information would be put and supplied it for that purpose.

Although Eternity did not specifically allege a special relationship of trust with Morgan, the district court sustained the negligent misrepresentation claim based on Eternity's allegations regarding Morgan's "unique or special expertise in swap transactions and emerging market debt" and the fact that "Morgan was aware of the use to which the information [regarding the secondary market] would be put."

THE IMPACT ON A MARKET PROFESSIONAL'S DUTY TO PROVIDE ACCURATE INFORMATION TO ITS COUNTERPART

The court's decision could be viewed as creating a duty on the part of a sophisticated market professional to a less sophisticated market professional – even in the case of swap counterparties with no more than an arm's-length business relationship. That duty, to use reasonable care to ensure that the information it provides is accurate, would entitle the recipient of such information to rely on its accuracy and would form the basis for a claim should the information turn out to be incorrect. By holding that Eternity had alleged sufficient facts to support the existence of a special relationship between Eternity and Morgan, even in the absence of any allegation of a special relationship of trust, the district court may have created such a duty. If so, the *Eternity* decision would expand the scope of liability of institutional market professionals when they provide information to their clients and potential clients in the course of marketing and negotiating principal-to-principal transactions, such as derivatives transactions.

On the other hand, there is long-standing case law that special circumstances impose a higher duty on a broker only when they render the client dependent – for example, a client "who is so lacking in sophistication that *de facto* control of the account is deemed to rest in the broker."

CONTRACTUAL DISCLAIMERS IN LIGHT OF THE CASE

Morgan argued that the "no reliance" contractual disclaimer language included in its ISDA Master Agreement with Eternity precluded Eternity from claiming it relied upon the alleged misstatements. Citing the Second Circuit court's earlier decision in *Caiola v. Citibank*, the district court disagreed, holding that the contractual disclaimer language, commonly used in derivatives documentation, was insufficient to bar Eternity from relying on the alleged statements. However, in *Caiola*, the Second Circuit court reached its conclusion on the basis of intentional, material misstatements, on which the plaintiff reasonably relied to its detriment, in other words, allegations that the statements were not merely inaccurate, but fraudulent, and thus did not fall within the scope of the disclaimer.

Unlike the allegations of fraud in *Caiola*, the allegation in this case was essentially that Morgan was mistaken when it made predictions about future events. Eternity's allegation that Morgan intentionally misled it by providing certain assurances was belied by Eternity's admission that, initially, Morgan acted in accordance with those

assurances. The court held that this admission "preclude[d] any argument that Morgan had a preconceived intent not to honor its promise."

Given the Second Circuit's holding in *Caiola*, and the district court's decision in the *Eternity* case applying the *Caiola* holding to a negligent misrepresentation claim, it is questionable whether market professionals can rely on the enforceability of any standard contractual disclaimer provision. Under the *Eternity* holding, such provisions may not be sufficiently specific. In theory, a market professional could attempt to insulate itself from liability for reliance by listing in a schedule all information, including market views, provided to its customers and then requiring them to disclaim reliance on all information included in the schedule. Such a practice, however, does not seem feasible given the informal way derivatives transactions typically are marketed and negotiated.

Another approach would be to craft a disclaimer of reliance on a special relationship, such as the following:

> Neither party is relying on any unique or special expertise of the other party, or is in any special relationship of trust or confidence with respect to the other party. Neither party owes a duty to the other party to provide it with accurate information, no "special relationship" exists between the parties that would create such a duty, and any reliance upon information provided by one party to the other is hereby disclaimed.

Of course, until the Second Circuit speaks again, no standardized disclaimer or "no reliance" clause can be viewed as ironclad protection, enforceable in all circumstances.

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A more detailed discussion of the Eternity decision is available at Stroock's web site (www.stroock.com/publications.cfm)

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