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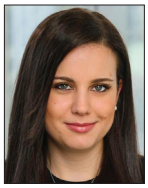
Fiduciary Duties in Arms-Length Business Transactions

By **Lara Flath** And **Thania Charmani**

In *Tiny 1, Ltd. v. Samfet Marble*, No. 14948, 2022 WL 24305, at *2 (1st Dep't. Jan. 4, 2022), the Appellate Division, First Department held that "unique circumstances" of an arms-length transaction gave rise to fiduciary duties. This holding diverges from the well-established principle that arms-length transactions generally do not create fiduciary obligations and arguably raises the bar for fiduciaries by expanding the scope of liability stemming from transactions that would ordinarily be shielded from scrutiny. *Tiny I* follows another similar decision in Pennsylvania, suggesting a potential trend towards expansion of fiduciary duty relationships in traditional arms-length transactions and an issue to keep an eye on.

In *Tiny 1*, one of the plaintiffs, the sole owner and president of a tile and marble company, suffered an illness and decided to sell his company to defendants. While still contemplating the sale, because of plaintiff's illness, the two prospective buyers, took over certain financial operations of the company to complete due diligence before finalizing the transaction. The complaint alleges that defendants then engaged in a fraudulent scheme to manipulate the company's financials ultimately forcing plaintiffto sell the company for far less than it was originally worth. Plaintiffs allege that defendants acted in their own self-interest for their own financial benefit and fraudulently concealed wire transfers from the company to one of their controlled entities, increased the company's debt, and denied plaintiffs timely access to the company's books and records, which had been falsified to artificially reduce the company's value.

The First Department affirmed the Supreme Court's denial of defendants' motion to dismiss holding that the complaint properly stated breach of fiduciary duty claims against defendants. The court reasoned that although "a fiduciary relationship does not exist in an arms-length business transaction," the pleadings in the action allege "unique circumstances" that do not constitute an ordinary arms-length transaction. Id. at *1. The court highlighted that while they were acting as buyers, defendants essentially took over the operations of the company thus also becoming "acting corporate officers of the selling company" and "creating a higher position of trust than ordinarily exists between buyers and sellers." Id.

The court rejected defendants' argument that under New York law the defendants, as deal adversaries of the plaintiffs, could not plausibly owe fiduciary duties to the plaintiffs because "[a] fiduciary relationship does not exist between parties engaged in an arm's length business transaction." See, e.g., *Dembeck v. 220 Cent. Park S.*, 33 A.D.3d 491, 492 (1st Dep't 2006); *Holzer v. Mondadori*, 2013 N.Y. Slip Op. 51410(U), 2013 WL 4523615 (Sup. Ct. N.Y. Cnty. 2013). The underlying principle for this well-established premise is that, as the Court of Appeals has held, the hallmark of a fiduciary relationship is "undivided and undiluted loyalty."

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Birnbaum v. Birnbaum, 73 N.Y.2d 461, 466 (1989). It almost inescapably follows that counterparties to a transaction are not fiduciaries because their economic interests are, by definition, not aligned. Indeed, the First Department has repeatedly held that even where a fiduciary relationship exists, "[it] ceases once the parties thereto become adversaries." *EBCI v. Goldman Sachs & Co.*, 91 A.D.3d 211, 215-16 (1st Dep't 2011); see also *Eastbrook Caribe, A.V.V. v. Fresh Del Monte Produce*, 11 A.D.3d 296, 297 (2004); *Baldasano v. Bank of New York*, 174 A.D.2d 457, 459 (1st Dep't 1991). "A fortiori, a fiduciary relationship cannot have been created between parties who have been adversaries throughout their transaction." *EBCI v. Goldman Sachs & Co.*, 91 A.D.3d 211, 215-16 (1st Dep't 2011).

Nonetheless, without discussing these decade-old precedents, both the Supreme Court and the First Department in *Tiny 1* focused on the relationship of trust defendants allegedly created based on this "unusual fact pattern" where "the defendant buyers and their representatives effectively ran the business during the extended period of due diligence while the representative of the seller, plaintiff, was ill." *Tiny 1, Ltd v. Samfet Marble*, No. 651860/2020, 2021 WL 1270197, at *1 (N.Y. Sup. Ct. April 1, 2021). Although this rationale seems to encompass, at least to some extent, an almost moral judgment of defendants' actions, it is consistent with what appears to be a recent trend in expanding fiduciary duty obligations outside their traditionally strictly defined and relatively narrow scope.

Just a few months ago, in *Slomowitz v. Kessler*, the Pennsylvania Superior Court held that even where the partners of an entity are given autonomy to act unilaterally on behalf of their partnerships, their actions might constitute a breach of fiduciary duty despite the fact that the actions in question not only complied with the governing partnership agreements but also benefited the other partners. *Slomowitz v. Kessler*, 2021 PA Super 230 (Nov. 29, 2021). The Pennsylvania Superior Court reversed the lower court's holding dismissing the action and held that "the conduct of [the defendant], as un-businesslike and offensive as it may be, is not relevant to the application and interpretation of the plain meaning of the [partnership] contract. To hold otherwise is to negate final expression of their intention at the drafting of the contract." Id. In doing so, the Superior Court relied on *Meinhard v. Salmon*, a 1928 New York State Court of Appeals decision written by then-Chief Judge Benjamin N. Cardozo discussing fiduciary relationships and stating:

> A co-owner of a business is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.
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> 249 N.Y. 458, 464 (1928).

'Tiny I' follows another similar decision in Pennsylvania, suggesting a potential trend towards expansion of fiduciary duty relationships in traditional arms-length transactions and an issue to keep an eye on.

It is thus perhaps not surprising that the Pennsylvania Superior Court found that the partner's "repugnant" actions in that case breached his fiduciary duties despite being consistent with the letter of the partnership agreements and having benefited all partners. *Slomowitz*, 2021 PA Super at *16.

The recent holdings in both *Tiny 1* and *Slomowitz* preserve the standard called for by Justice Cardozo in evaluating whether corporate officers breached their fiduciary duties, even when in an adversarial position of business counterparties, and seem to demand "not honesty alone, but the punctilio of an honor the most sensitive." *Meinhard*, 249 N.Y. at 464. Litigants and corporate officers alike should keep in mind that the traditional contours of fiduciary duty might be broader than previously contemplated.