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Fraud

New York State Appellate Court Reinstates Investors' Claims Against CSAM Capital, General Partner of High-Risk Exchange Fund

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By Vincent Pitaro, *Hedge Fund Law Report*

In New York, the statute of limitations for fraud is the longer of six years from the wrongful conduct or two years from when the party knew, or should have discovered, the fraud. This particular statute of limitations was at issue in a case filed by investors against CSAM Capital, Inc., the general partner of a high-risk exchange fund, and allegedly related entities (collectively referred to as CSAM), alleging, among other things, fraud in connection with the loss of their investments in the fund. In this action, billionaire Ronald Lauder and other investors in the exchange fund brought an arbitration claim against the fund's general partner, CSAM Capital Inc., alleging that CSAM had fraudulently misrepresented the qualifications of the fund employees who were responsible for the fund's hedging strategy. CSAM went to court, claiming that the arbitration was barred by the statute of limitations. The trial court ruled that the claim was time-barred because it was not brought within two years after the claimants "knew or should have discovered the fraud." The Appellate Division disagreed and allowed the arbitration to proceed. Specifically, it ruled that prior correspondence with CSAM alleging mismanagement and prior arbitration proceedings based on misrepresentation of the fund's hedging strategy did not put the claimants on notice of a possible fraud as to the qualifications and expertise of the fund's employees. *See CSAM Capital, Inc., v. Lauder*, 2009 N.Y. *Slip Op*. 06605 (*App. Div., First Dept.*), *Sept*. 22, 2009.

Background of the Action

Ronald Lauder and other investors (Claimants) had invested in hedge fund DLJ Emerging Growth Partners, L.P. (the Fund) in 1999 and 2000. Defendant CSAM Capital Inc. (CSAM) was the Fund's general partner. The Fund's private placement memorandum indicated that it was particularly risky because its portfolio contained many "new economy" dot-com stocks with little operating history. However, it also stated that risk would be mitigated with an "active hedging strategy" to be implemented by 13 officers and directors who had "extensive experience" and "significant expertise in the design and use of the sophisticated hedging techniques . . . ."

In fact, in 2006, one of the Fund's 13 alleged experts testified that the Fund's hedging was handled by only two individuals, neither of whom had any hedging experience, having derived their knowledge of hedging only from reading "books and articles".

The Fund's governing documents called for all claims to be resolved through arbitration.

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Prior Claims Against the Fund

During the "tech wreck" and through 2002, the Fund lost more than 90 percent of its value. A number of complaints and arbitrations ensued before the Claimants' made their claims and demanded arbitration.

In 2001, as the Fund's value plummeted, one of the Claimants had written a letter to a CSAM principal suggesting that the Fund's poor performance was due to mismanagement and breach of fiduciary duty. The principal responded that the Fund's downturn was comparable to the fate of the "new economy" companies in general and tried to explain the Fund's logic in managing its portfolio.

In 2004, CSAM issued a financial statement disclosing that a limited partner had filed an arbitration claim in 2003 alleging "breach of contract, breach of fiduciary duty, misrepresentation, and gross negligence." Apparently, the claimant in that arbitration received an award of over $1 million.

In addition, a different investor filed an arbitration claim against CSAM in 2004. Included in that complaint were charges of fraudulent misrepresentation in connection with the operation of the Fund. However, the court emphasized that the charges did not include any allegations about the qualifications of the Fund's directors.

Trial Court Decision

The New York State Supreme Court agreed with CSAM's argument that Claimants' claim was barred by the statute of limitations which, for fraud claims, "is the longer of six years from the wrongful conduct or two years from when the party knew, or should have discovered, the fraud." It found that the Fund's substantial losses in 2002 should have put Claimants on notice of a potential fraud. The trial court believed that substantial losses, without more, created an inference of fraud. In addition, the trial court found that the 2001 letter claiming "gross mismanagement" gave the Claimants "actual notice" of a fraud.

Claimants appealed. The First Department reversed the lower court's decision and allowed Claimants' arbitration to proceed on the question of fraudulent misrepresentation of the Fund managers' credentials.

Legal Analysis

The First Department's decision shows that whether or not a fraud claim will be barred by the statute of limitations requires a very fact-specific inquiry – and that different parties will interpret the facts in dramatically different ways.

As an initial matter, the First Department confirmed that, even though an agreement contains an arbitration clause, when, as here, the arbitration clause requires the application of New York law, then it is up to a New York court – rather than the arbitrator – to determine whether the claim is barred by the applicable statute of limitations. Therefore, the court found that it was proper for CSAM to attempt to block that arbitration in State court.

The First Department relied heavily on the fact that Claimants' allegations of fraud centered on the alleged misrepresentation of the qualifications of the Fund employees who were responsible

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for hedging the portfolio. All the prior claims and correspondence dealt only with general allegations of misconduct and misrepresentation about the Fund's strategies – as opposed to the abilities of the people responsible for implementing those strategies.

The court made several critical determinations that could apply to hedge funds generally:

1. The mere fact of significant losses by a fund is not sufficient to impute knowledge of fraud to the investors. Here, the various disclaimers and statements of risk in the prospectus actually worked against CSAM: Because CSAM had stressed how risky the Fund would be, even sophisticated investors such as the Claimants would not be required to assume that a fraud had occurred. In addition, given that the Fund's losses paralleled those of the market as a whole, it was reasonable for the Claimants to assume that their losses were merely the result of market forces rather than fraud.
2. The 2001 letter to Fund management was nothing more than a statement of "suspected mismanagement." "[M]ere suspicion will not suffice as a ground for imputing knowledge of the fraud." (Citations omitted.) In fact, the Court considered the letter to be a request for an explanation of the Fund's poor performance. The Court considered the response to be "a representation that qualified people were acting purposefully in managing the fund. This provided no further grounds from which a reasonable person would necessarily infer fraud."

CSAM had also argued that the two prior arbitrations provided notice of the fraud. The Court quickly dismissed that notion with respect to the 2004 arbitration because there was no proof that Claimants actually knew about that arbitration. It was clear, however, that Claimants knew of the 2003 arbitration, which had been disclosed in the Fund's financial statements. Here, the First Department distinguished between fraud with respect to the Fund's "active hedging strategy," which was covered in the 2003 arbitration, and misrepresentations as to the qualifications of the Fund's directors, which was not. In fact, it was only during the November 2006 deposition of one of the alleged Fund experts (conducted as part of discovery in the 2004 arbitration) that any evidence at all surfaced as to the latter misrepresentation. Given that it took so long to unearth information about the unqualified managers, even during arbitration proceedings, the Court reasoned that no amount of diligence on Claimants' part would have revealed the alleged fraud any sooner.

In permitting Claimants to proceed, the First Department distinguished its prior decision in *Ghandour v. Shearson Lehman Bros.*, 213 A.D.2d 304, 624 N.Y.S.2d 390 (First Dept. 1995). In that case, the claimant's brother had also invested in the fund, had discovered the fraud, and had commenced a timely action long before the claimant did. That was apparently enough to put that claimant on notice of a potential fraud. However, the mere decline in portfolio value did not put that investor on "inquiry notice" of a possible fraud.

Dissent

Notably, Judge Peter Tom, one of the authors of the *Ghandour* decision, dissented. He believed that the prior allegations of fraud with respect to the Fund's hedging strategy were sufficient to start the clock on the two year statute of limitations. He saw little difference in the claims made by Claimants and those made in the 2003 and 2004 arbitrations. Claimants were in the same class of investors. He also relied on the fact that the 2004 arbitration (of which Claimants apparently had no knowledge) also questioned the "integrity, experience and skill of the Fund's managers" and alleged "fraud in the marketing and management" of the Fund. Judge Tom also

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believed that, in the face of 90 percent losses, no reasonable person could assume that a hedging strategy had actually been in place. Finally, Judge Tom was convinced that the fact that some investors in 2004 were able to discover and act on a potential fraud showed that Claimants could have discovered the fraud at that time as well.

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