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Hedge Fund Law Report
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Fund Documents

U.S. District Court Dismisses All Federal Securities Fraud Claims Brought by Investors Against Hedge Fund Manager RAM Capital Resources, LLC, its Principals and the Funds it Sponsored, Holding that Disclaimers in Subscription Agreements Preclude Reliance on Certain Alleged Misrepresentations

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By Vincent Pitaro, *Hedge Fund Law Report*

Defendant RAM Capital Resources, LLC (RAM Capital), is a New York based asset manager and hedge fund sponsor. Defendants Stephen E. Saltzstein (Saltzstein) and Michael E. Fein (Fein) are RAM Capital's principals. Saltzstein was introduced to plaintiff Mario Frati through Saltzstein's sister, who was a childhood friend of Mario Frati's wife. The Fratis invested $2 million in RAM Capital's Shelter Island Opportunity Fund, LLC. Plaintiff Banco Popolare (Luxembourg), S.A., on behalf of Mr. Frati's mother, invested $1.5 million with RAM Capital's Truk International Fund, LP. When plaintiffs' redemption demands were not satisfied, plaintiffs brought suit. Their complaint, as amended, alleges federal securities fraud, common law fraud, breach of fiduciary duty, unjust enrichment and breach of contract. Plaintiffs claim the defendants misrepresented, among other things, that plaintiffs could redeem their investments after six months and that RAM Capital's principals were "heavily invested" in the sponsored funds. Defendants allegedly also wrongfully omitted to tell plaintiffs that RAM Capital, Saltzstein and Fein were under investigation by the Securities and Exchange Commission and that they were not registered broker-dealers. Defendants moved to dismiss the entire complaint for failure to state a claim.

The U.S. District Court dismissed all plaintiffs' federal securities fraud claims, holding that in light of disclaimers made in the funds' subscription agreements and other factors, the plaintiffs could not have reasonably relied on the defendants' alleged misrepresentations and omissions. The Court deferred ruling on plaintiffs' state law claims until the parties conducted discovery on whether diversity of citizenship jurisdiction exists. We summarize the Court's decision. *Mario Frati, Stacy Frati and Banco Popolare (Luxembourg), S.A., v. Stephen E. Saltzstein, Michael E. Fein, RAM Capital Resources, LLC, Shelter Island Opportunity Fund, LLC, Shelter Island GP, LLC, Midway Management Partners, LLC, Truk International Fund, LP, Truk Opportunity Fund, LLC and Atoll Asset Management, LLC*, U.S. District Court, Southern District New York, Case No. 10-CV-3255, decided March 14, 2011 (Judge Paul A. Crotty). For a detailed summary of plaintiffs' original complaint, see "Investors in Hedge Funds Managed by RAM Capital Resources, LLC Sue RAM, its

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Principals and its Funds Alleging Securities Fraud, RICO Violations and Other Claims Based on Alleged Misrepresentations and Self-Dealing by RAM Principals," Hedge Fund Law Report, Vol. 3, No. 20 (May 21, 2010).

Background and Parties

Defendant RAM Capital Resources, LLC (RAM Capital), is a New York based asset manager and hedge fund sponsor. Defendants Stephen E. Saltzstein (Saltzstein) and Michael E. Fein (Fein) are RAM Capital's principals. RAM Capital's funds included defendants Truk Opportunity Fund, LLC, Shelter Island Opportunity Fund, LLC (Shelter Fund), whose managing member was defendant Shelter Island GP, LLC, and whose investment manager was defendant Midway Management Partners, LLC (Midway), and Truk International Fund, LP (Truk Fund), whose manager was defendant Atoll Asset Management, LLC. Saltzstein and Fein were also principals of all of those entities.

Saltzstein was introduced to plaintiff Mario Frati through Saltzstein's sister, who was a childhood friend of Mario Frati's wife, Stacy Frati. In early 2008, the Fratis invested $2 million in the Shelter Fund. Acting on behalf of Mario Frati's mother, plaintiff Banco Popolare (Luxembourg), S.A. (Banco Popolare) invested $1.5 million with the Truk Fund. Neither the Fratis nor Banco Popolare was provided with the private placement memorandum (PPM) for either the Shelter Fund or the Truk Fund prior to signing the subscription agreements for their investments in those funds. In April 2009, plaintiffs requested redemption of their entire interests in those funds but, by the time this action was commenced, only $150,000 had been returned to Banco Popolare.

Plaintiffs' Claims

Plaintiffs amended complaint includes claims for fraudulent misrepresentation under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act), common law fraud, fraudulent inducement and breach of contract. The District Court's decision addresses plaintiffs' fraud claims under the Exchange Act and their bid to rescind their subscription agreements under Section 29(b) of the Exchange Act, which voids any contract made in violation of a provision of the Exchange Act or whose performance violates that Act.

In support of their fraud claims, plaintiffs cite three specific misrepresentations by the defendants: "(1) that Saltzstein's sister was an investor in the relevant fund, (2) that Saltzstein and Fein themselves were heavily invested in the funds, and (3) that Plaintiffs could redeem their investments after six months." They also cite three allegedly material omissions by the defendants: "(1) Saltzstein, Fein, and RAM [Capital] were under investigation by the SEC at the time that Plaintiffs invested in the Funds; (2) Saltzstein, Fein, and RAM [Capital] were acting as unlicensed broker dealers in violation of federal securities law; and (3) they did not intend to manage the funds in good faith, including 'fraudulently inflating fund valuations in order to generate higher commissions, entering into sham transactions, loaning monies to themselves and other funds managed by them and giving preferences for redemptions to themselves and their family and/or friends.'"

Analysis

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A properly pleaded fraud claim under Exchange Act Section 10(b) and Rule 10b-5 must allege in sufficient detail that "the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that the plaintiff's reliance on the defendant's action caused injury to the plaintiff." (Citations omitted.) A motion to dismiss a fraud claim under Federal Rule of Civil Procedure 12(b)(6) turns in large part on whether the complaint on its face shows that the alleged misrepresentations and omissions were "material" and that the plaintiffs reasonably relied on those misrepresentations and omissions. "Reasonableness" depends on "the entire context of the transaction, including factors such as its complexity and magnitude, the sophistication of the parties, and the content of any agreements between them." (Citations omitted.) Here, the Court ruled that plaintiffs' reliance on the alleged misrepresentations and omissions was misplaced, at best.

In moving to dismiss, the defendants relied heavily on the fact that plaintiffs had all signed subscription agreements that "contain express representations, warranties, and disclaimers that (i) negate each allegation on which Plaintiffs' alleged fraud claims are based and (ii) preclude Plaintiffs, as a matter of law, from demonstrating the element of reasonable reliance necessary to maintain each of their fraud-based claims." In addition, those agreements recited that the investors were "accredited investors" who had read the PPMs for the RAM Capital funds and relied only on information contained in those PPMs.

The Court made quick work of the misrepresentations regarding investments by Saltzstein's sister and by RAM Capital's principals: "These statements are immaterial and any alleged reliance [on] such information is patently unreasonable. Specifically, regardless of the complexity of the transaction (and the one at issue here is not complex) or the sophistication of the parties (and Plaintiffs are Accredited Investors), no reasonable investor would make an investment in any venture based on the representation that the promoter's sister, who was a close friend of the investor's wife, was also an investor." Such claimed reliance was "nonsense." The Court continued: "Not only could the information easily have been verified by the childhood friends speaking to one another, the alleged representations to the Accredited Investors fly in the faces of the disclaimers in the Subscription Agreements."

Similarly, given that the RAM Capital funds' PPMs specified a 12-month lockup period, the Court ruled that plaintiffs could not rely on an oral representation that the lockup would only be six months: "[E]ven Accredited Investors are required to read the transaction documents . . . [H]ad Plaintiffs simply requested copies of and reviewed their respective PPMs, such information would have been obvious. In light of the context of this transaction and the disclaimers in the Subscription Agreements, Plaintiffs' reliance on Saltzstein's oral representation was simply not reasonable."

With respect to the alleged fraudulent omissions, the Court pointed out that omissions do not give rise to liability for fraud unless there is a duty to disclose the omitted information. That duty only arises when "disclosure is necessary to make prior statements not misleading." (Citations omitted.) Here, the alleged omissions regarding the SEC investigation of Saltzstein, Fein, and RAM Capital and their failure to register as broker dealers were simply not things that those defendants were required to disclose because "[t]he law does not impose a duty to disclose uncharged, unadjudicated wrongdoing or mismanagement." (Citations omitted.)

The "omissions" regarding the funds' structure and fees were not omissions at all "because Plaintiffs could have easily informed themselves about these issues if they had insisted on reading the PPMs before signing the Subscription Agreements or had simply performed a cursory investigation regarding the fund in which they were planning to invest. Even though Plaintiffs prefer to walk away from their Accredited Investor status, Plaintiffs cannot claim that they were uninformed about the inner workings of a fund in which they planned to invest if they

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did not feel it necessary to review the fund documentation or perform any research prior to making such an investment. Thus, Plaintiffs' reliance on the silence of Saltzstein and Fein on these issues was clearly unreasonable."

In short, all alleged omissions involved "(1) information that was available to Plaintiffs if they had read the PPM or asked intelligent and obvious questions prior to investment, or (2) information that Defendants specifically did not have a duty to disclose."

Integration clauses and disclaimers in subscription documents often afford hedge funds substantial protection against federal securities fraud claims. For another example, see "Federal Court Dismisses Investor's Fraud Complaint against Apex Equity Funds, Effectively Holding that SEC Rule 10b-5 Applies to the Purchase of Private Hedge Fund Interests," Hedge Fund Law Report, Vol. 2, No. 36 (September 9, 2009). In contrast, state claims under the Uniform Securities Act receive more liberal treatment because reliance is not necessary to establish a fraud claim. For example, see "Massachusetts Trial Court Rules that Integration Clause in Subscription Agreement does not Protect Hedge Fund Manager from Fraudulent Misrepresentation Claims," Hedge Fund Law Report, Vol. 2, No. 17 (April 30, 2009).

Finally, the Court ruled that the plaintiffs had not pleaded adequate grounds to rescind their subscription agreements under Exchange Act Section 29(b), which voids "any contract made in violation of any provision of this chapter . . . and every contract . . . the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter . . ." In support of their claim for rescission, plaintiffs allege that (i) they were fraudulently induced to sign their subscription agreements, (ii) defendant Midway misrepresented that it is a registered investment adviser and (iii) Saltzstein, Fein, and RAM Capital failed to register as broker dealers. The Court rejected all three of plaintiffs' arguments: First, because their fraud claims failed, their claim of being fraudulently induced to sign the subscription agreements also failed. Second, Midway's misrepresentation was only a violation of the Investment Advisors Act of 1940, which does not give rise to rescission under Exchange Act 29(b). Finally, even if the failure of Saltzstein, Fein, and RAM Capital to register as broker dealers violated the Exchange Act, the subscription agreements could still be performed legally. Those subscription agreements were with the Shelter Fund and the Truk Fund, which were not required to register as broker dealers. Consequently, the subscription agreements did not involve violations of the Exchange Act.

The plaintiffs' sole surviving causes of action are state law claims that include fraud, unjust enrichment and breach of contract. Given that no federal claims survive, the Court has the power to dismiss the state law claims unless diversity of citizenship jurisdiction exists. The Court directed the parties to conduct expedited discovery to determine whether such jurisdiction exists.

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