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"Fraud: The Longest Arm of the Law"

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These days, when a securities offering goes sour or a business transaction runs amok, allegations of fraud are more and more likely to arise. Thomas Starnes and Scott Richie, of Andrews & Kurth L.L.P., reminds us that they can result in very costly litigation.

The latest statistics show a startling increase in the number of fraud claims filed in federal courts in the United States in 1997, up 17% from 1996 and 53% higher than four years ago. Many of these fraud claims involve international commercial contracts or cross-border tender offers in which foreign corporations find themselves in the unpleasant position of having to defend against a legal concept that is as alien to them as the US judicial system in which it is brought.

Unlike the civil law systems in most foreign jurisdictions, the body of common law in the United States has moved away from the doctrine of *caveat emptor*, or *buyer beware*, and gravitated toward a concept of fraud that punishes those who intentionally take advantage of or profit at the expense of others' ineptness. In fact, fraud can arise in some commercial dealings even when there is no intent to mislead or deceive. American-style fraud - like the amorphous concept of *fairness* on which it is based - is not easily defined, comes in myriad forms, and is subject to broad interpretation by judges.

One thing is certain, however. When fraud becomes an issue in a commercial dispute, the result can be extremely costly. Allegations of fraud can open the door in an otherwise straightforward contract dispute to claims for punitive damages, which are intended to punish the wrongdoer rather than merely compensate the victim for his actual losses. According to one US survey, punitive damages are awarded in 21% of all fraud cases, second only to defamation cases. Such damages can amount to many millions of dollars and often bear no relationship to the claimant's actual loss. Indeed, US lay juries, which tend to have little, if any, practical experience with (or appreciation for) the complexities of international commercial transactions, have wide latitude in awarding such damages, and have done so with increasing frequency. At the state court level alone, where the transactions in dispute tend to be smaller, more than 9% of all successful fraud claims result in damage awards of more than \$1 million.

In addition to increasing one's exposure to exorbitant damages, fraud claims also tend to complicate the already difficult process of litigating complex international commercial disputes in the United States. For example, US judges are far less likely to use their power to summarily dismiss fraud claims without a full trial, on the theory that issues of a party's intent and motive are inherently fact-intensive and, thus, are more properly decided by a jury based on a full airing of the evidence. Moreover, a party's ability to discover evidence from a defendant can be more expansive and intrusive where fraud has been alleged, due to a presumption that the accused defrauder is likely to have concealed any evidence of its misdeeds. *Haase v Chapman*, 308 F Supp 399 (WD Mo 1969) (broad discovery of corporate records permitted where company may have engaged in fraudulent transactions).

For any company contemplating a business or investment relationship with a US party, these developments in the area of commercial and securities fraud warrant careful consideration. It is no secret that the United States (its Congress and its courts) views American jurisdiction expansively, and regularly seeks to impose US legal concepts and regulations on transactions that many might view as essentially foreign.

In particular, the antifraud prohibitions of the Securities and Exchange Act are routinely applied extraterritorially, and US courts have gone so far as to assert jurisdiction over securities fraud claims raised by foreign purchasers of a foreign holding company's securities in which the sale was consummated outside the United States. See *Alfadda v Fenn*, 935 F2d 475 (2nd Cir), *cert denied*, 112 S Ct 638 (1991). Similarly, in the more general context of transnational commercial disputes, many US courts liberally interpret the traditional minimum contacts test in determining whether a foreign party should be

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subjected to fraud claims in a US court. Suffice it to say that virtually any transaction that involves solicitations, communications, negotiations or other similar conduct in the United States, or which results in a specific effect on an American party, runs the risk of falling under the jurisdiction of a US court. *Bersch v Drexel Firestone, Inc*, 519 F2d 974 (2nd Cir 1975). *Cert denied*, 96 Sct 453 (1975).

Among the types of commercial dealings that tend to be most susceptible to allegations of fraud are licensing and distribution agreements, joint venture arrangements, and securities offerings, all of which customarily involve some type of warranty or representation of quality, performance, anticipated profits or risk. In such instances, the representing party must be extremely cautious as to the type of representations being made, and - in some circumstances - the extent to which information material to the transaction may be inadvertently omitted. Companies interested in doing business with US entities in these types of transactions are best advised to seek competent American counsel to review the adequacy under US law of both the nature and scope of their representations.

Where, as in most transnational commercial arrangements, both parties are sophisticated companies dealing at arm's length, the burden of investigating the sufficiency of information being supplied falls equally on each party to the transaction. See *Thomas v NA Chase Manhattan Bank*, 1 F3d 320, 324 (5th Cir 1993). For such parties, the primary concern should be the extent to which the accuracy of the warranties and representations being made can be objectively demonstrated. Where possible, agreements should contain disclaimers, crafted with the assistance of counsel, to limit potential liability or to restrict the remedies that can be sought for any harm that might be attributed to a misleading representation. Particular care must be given to drafting provisions which touch upon: (1) representations as to ownership of intellectual property and the potential impact of other patents, copyrights or trademarks in license agreements, (2) representations with respect to best efforts to develop or use licensing technology, and (3) minimum quality obligations or representations that a product works or is functional. Such representations should be pegged to clearly identifiable objective standards, rather than subjective statements of quality or condition.

An additional concern arises where one party has a clear bargaining advantage over the other or possesses vastly superior knowledge or expertise regarding the particulars of the transaction. In such instances, American law can impose a higher duty of disclosure upon the dominant party to the extent that the superior party's failure to reveal all material or significant information regarding the transaction could give rise to actual or constructive fraud. In some cases, an action for constructive fraud can lie even where there is no intent to mislead or defraud if: (1) material facts are omitted or inaccurately disclosed, and (2) "the transaction involved facts and circumstances indicative of the imposition of trust and confidence, rather than . . . an arms length commercial contract." 37 *Corpus Juris Secundum* §6, at 181-82 (1997). It is important to note that, in these types of situations, disclaimers are likely to be given far less weight by US courts due to the unequal and unique relationship between the parties. In addition, the more extensive one's prior business dealings have been with a company, the greater the obligation is to disclose any changes in circumstances that could pertain to the transaction.

With respect to securities-related fraud, foreign companies seeking to raise capital from American sources or acquire ownership interests in a US company face the risk of potential legal action from two US fronts. The US Securities and Exchange Commission - oft-criticized as the self-appointed securities fraud policeman of the world - has extensive authority under American law (as well as bilateral agreements with many countries) to investigate and prosecute violations of US securities regulations by foreign entities. Sections 10(b) and 14(e) of the Securities Exchange Act of 1934, as amended in 1968, prohibit the use of all fraudulent, deceptive, and manipulative acts and practices in connection with the purchase or sale of securities and with the making of tender offers, including misstatements or omissions made in documents or the course of the solicitation between the parties. Additionally, foreign individuals or companies involved in securities-related activities also face the prospect of liability to private individuals for actual damages suffered. Many sections of the Securities Exchange Act expressly provide for a private right of action, on the theory that the threat of individual legal action creates an even greater deterrent against securities fraud.

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As with other types of representations made in the commercial context, US law requires that solicitations involving the purchase or sale of securities be based on accurate and complete disclosure of all material facts and corresponding risks. Silence can give rise to a claim of fraud as easily as the making of a misleading statement, where there is a duty to disclose knowledge that would be material to investors. *Strong v France*, 474 F2d 747, 752 (9th Cir 1973). Consultation with American attorneys experienced in securities transactions can provide a foreign party with invaluable guidance in determining the proper degree of disclosure, as well as innovative approaches to minimizing or avoiding the applicability of US law through negotiated transaction structures and exemption agreements.

Whatever type of transnational transaction one's company might be contemplating - whether it be a licensing agreement, joint venture, or securities-related deal - it is wise to keep in mind the potential extraterritorial application of US law and its unique concepts of fraud.