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Big Boys Take Big Risks: Big Boy Letter Bars Investor State Law Fraud Claims

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A recent federal appellate ruling in favor of Credit Suisse in a fraud action brought by Pharos Capital has strengthened the case for using so-called "Big Boy" letters. Pharos held that a well-drafted Big Boy letter made it impossible for an investor to show justifiable reliance and thereby doomed state law fraud and misrepresentation claims. While these letters may not entirely block federal securities claims, they are a potent tool for limiting any claim that requires a showing of reliance.

A US appellate court ruling recently upheld a decision in favor of Credit Suisse, dismissing a fraud action by Pharos Capital ("Pharos"). The court held that because of the parties' "Big Boy" agreement, Pharos could not have justifiably relied on Credit Suisse's representations regarding a potential investment.[1] This decision confirms that "Big Boy" letters may shield parties from state law fraud and misrepresentation claims, although these agreements may not fully protect against federal securities law claims or SEC claims.

Big Boy Letters

So-called "Big Boy" letters are used in private investment transactions. The buyer acknowledges that it is a sophisticated party; has experience and knowledge with these kinds of investments; is relying on its own due diligence and investigation; and is not relying on the counter-party's representations or omissions. An investor signing a Big Boy letter accepts that there is material information that it is not seeing, and commits to relying on its own due diligence and expertise in making an investment decision. Big Boy letters have become important to financial industry participants, where parties often play multiple roles that may include financing, advising, managing and/or trading in a company. In addition, in certain circumstances, companies or their affiliated shareholders may be unable or unwilling to disclose certain material information to potential purchasers of securities. Nonetheless, there have been questions about how courts would treat Big Boy letters. The Fifth, Seventh and Ninth Circuits previously have enforced Big Boy letters as against state law claims.[2]

The *Pharos* Decision

In 2002 Pharos, a private equity firm, approached Credit Suisse about potential investments. At the time, Credit Suisse was acting as a co-placement agent for National Century ("NCFE"), working to arrange a private placement of the company's equity securities. Over several months, Credit Suisse provided Pharos with a private placement memo, as well as access to NCFE due diligence materials and management, and expressed enthusiasm over NCFE's prospects. Before the closing, Credit Suisse emailed Pharos a Big Boy letter. The agreement stated that Pharos was relying "exclusively" on its own due diligence and would bear the risk of loss on its

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investment.[3] The letter also stated that Credit Suisse had made no representations as to NCFE or the credit quality of the securities, that any such information or advice was neither "necessary [nor] desired," and that Credit Suisse had no duty to disclose non-public information to Pharos.[4] Pharos signed the letter and the transaction closed. Within four months NCFE filed for bankruptcy and Pharos lost its investment. Pharos sued alleging fraud, negligent misrepresentation and violation of the Ohio Securities Act.[5]

The district court granted summary judgment to Credit Suisse, meaning that the court held that based on undisputed facts the case could be decided as a matter of law. The court found that all of Pharos' claims required a showing of justifiable reliance, and that Pharos could not establish justifiable reliance after signing a Big Boy letter.[6]

The court stressed that the parties were sophisticated actors with access to counsel and information, even noting the educational background of the Pharos managing partners as well as their business expertise.[7] Pharos also performed its own due diligence of NCFE. Moreover, Pharos was put on notice of potential problems at NCFE when Goldman Sachs, which was considering whether to serve as lead investor, pulled out of the deal, and also saw the letter in which Goldman Sachs explained why it decided not to invest.[8]

Turning to the Big Boy letter, the court found it clear on its face. The agreement stated that Pharos was a sophisticated party which was relying exclusively on its own due diligence investigation, its own sources of information and its own credit analysis in deciding to invest. It also stated that Credit Suisse had made no representations about NCFE, that Credit Suisse's information was neither necessary nor desired and that any non-public information Credit Suisse possessed about NCFE need not be provided to Pharos.[9] The agreement underscored that Pharos would bear the risk of loss on its investment and stated that Credit Suisse was not a financial advisor or fiduciary to Pharos. Finally, the court held that specificity of the Big Boy letter allowed that letter to protect Credit Suisse beyond any "boilerplate" disclaimer in the private placement memo.[10]

In affirming, the Sixth Circuit also noted that Pharos had failed to specify any material information that Credit Suisse had which outside investors could not have discovered, and noted that even had Pharos done this, it was unclear whether its reliance then would have been justifiable.

Implications

Pharos highlights the importance of a well-crafted Big Boy letter as a shield against fraud liability under state law (both common law fraud and fraud under state securities law) – four US appellate courts now have held that Big Boy letters may block fraud claims.[11] Moreover, under this holding, there is no reason why Big Boy letters would not apply to other parties to a transaction (i.e., not only sellers and purchasers).[12] It should be noted, however, that Pharos leaves unresolved the issue of resale, where a party buys securities under a Big Boy letter and immediately resells them without disclosing to a downstream purchaser the circumstances surrounding the original sale.[13]

Big Boy Letters and Federal Securities Law

Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") and SEC Rule 10b-5 require disclosure of material information in connection with the purchase or sale of any security.[14] If a seller fails to disclose material information, or makes a misleading statement or omission, with intent to defraud and that failure causes a loss, the seller may be liable. Significantly, Section 29(a) of the 1934 Act then prohibits parties from contracting around securities regulations.[15] Thus, Big Boy letters will not shield parties from an SEC insider trading action,[16] nor will they necessarily shield parties from a private securities action under Section 10(b). At least one federal appellate court has held that Big Boy letters do not preclude a Section 10(b) action because that would be tantamount to privately contracting out of compliance with the 1934 Act, which is prohibited by Section 29(a).[17] But, it should be noted that a Big Boy letter may nonetheless be helpful given that a Section 10(b) claim requires a showing of justifiable reliance.[18] Thus, Pharos further strengthens the value of a well-drafted Big Boy letter.

Endnotes

1. Pharos Capital Partners L.P. v. Deloitte & Touche, No. 12-4381 (6th Cir. Oct 23, 2013).
2. In re Capro Energy. Inc., 669 F.3d 274, 284 (5th Cir. 2012); Extra Equipamentos e Exportacão Ltda. v. Case Corp., 541 F.3d 719, 724 (7th Cir. 2008); Bank of West v. Valley Nat'l Bank of Ariz. 41 F.3d 471, 477-78 (9th Circ. 1994).
3. In the Credit Suisse Big Boy letter Pharos agreed as follows: "(a) that we are a sophisticated institutional investor and have such knowledge and experience in financial and business matters and expertise in assessing credit risk, that we are capable of evaluating the merits, risks and suitability of investing in the Securities, that we have conducted our own due diligence investigation of the Company, that we are relying exclusively on our due diligence investigation and our own sources of information and credit analysis with respect to the Securities and that we are able to bear the economic risks of and an entire loss of our investment in the Securities." Pharos Capital Partners, L.P. v. Deloitte & Touche, 905 F. Supp.2d 814, 820-821 (S.D. Ohio 2012).
4. Also in the Credit Suisse Big Boy letter Pharos agreed: "(b) that (i) neither the Agent nor any Affiliate (as defined herein) has been requested to or has provided us with any information or advice with respect to the Securities nor is such information or advice necessary or desired, (ii) neither the Agent nor any Affiliate has made or makes any representation as to Company or the credit quality of the Securities, and (iii) the Agent and any Affiliate may have acquired, or during the term of the Securities may acquire, non-public information with respect to the Company, which we agree need not be provided to us." Id. at 814, 820-821.
5. Id. at 814, 818-20. The Ohio Securities Act (Ohio Rev. Code Ann. § 1707.41), imposes liability on a party who offers a security for sale for loss or damage sustained by a relying person by reason of the falsity of any material statement contained therein or for the omission of material facts. Pharos presumably did not bring a claim under Section 10(b) of the Securities Exchange Act of 1934 because they held their securities through NCFE's collapse, and Section10(b) does not apply to holders, but only those sustaining losses in buying or selling securities.
6. Id. at 817.
7. Id. at 817-818, 820.
8. Id. at 819-820.
9. Id. at 825.
10. Id. at 826.
11. Including *Pharos*, there are now four circuit court decisions enforcing "Big Boy" letters against sophisticated parties. *See* Capro Energy, Extra Equipamentos, and Bank of West, supra note 2.
12. Pharos, at 817.
13. See R^2 Invest. LDC v. Salomon Brothers Smith Barney Inc., Case No. 01-03598 (S.D.N.Y. 2001). Purchasers brought suit against intermediaries, alleging that the intermediary had a duty to disclose that it had executed a "Big Boy" letter with the seller. This case was ultimately settled.
14. Securities Exchange Act, 15 U.S.C. § 78a, 1934; Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5.
15. 15 U.S.C. § 78cc provides "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."
16. Rachel McTague, 'Big Boy' Letter Not a Defense to SEC Insider Trading Charge, Official Says, BNA Sec. L. Daily, Nov. 19, 2007, (comments of Fredric Firestone, Associate Director, SEC); Josh Stoffregen, Big Boy Letters No Shield, Says SEC, Compliance Reporter, Nov. 16, 2007, LexisNexis Academic; Rachel McTague, In Insider Case, Big Boy Letter Signatory Need Not Have Been Deceived, Official Says, BNA Sec. L. Daily, 2007.
17. AES Corp. v. Dow Chemical Co., 325 F.3d 174, 183 (3rd Cir. 2003).
18. See Harsco v. Segui, 91 F.3d 337, 343-44 (2nd Cir. 1996) (2nd Circuit affirmed the dismissal of a buyer's 10b-5 claims alleging reliance on extra-contractual representations when agreement contained specific language as to which representations Harsco was entitled to rely on); One-O-One Enterprises, Inc. v. Caruso, 848 F.2d 1283, 1286-87 (D.C. Cir. 1988) (integration clause in a written agreement signed after eight months of negotiations superseded all previous understandings and agreements, and rendered reliance on prior representations unreasonable); Rissman v. Rissman 213 F. 3d 381 (7th Cir. 2000) (dismissed a buyer's Rule 10b-5 claims alleging oral misrepresentations notwithstanding a non-reliance provision);); Jensen v. Kimble, 1 F.3d 1073, 1078 (10th Cir. 1993) (defendant revealed to the plaintiff that there were material omissions and as such these omissions were not manipulative or deceptive within the meaning of 10b-5).