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Court Allows Fiduciary Duty Claims Against Financial Adviser

The Ruling

In September 2009, the US District Court for the District of Massachusetts¹ refused to grant a motion by Goldman Sachs to dismiss all of the breach of fiduciary duty and breach of contract claims brought by certain shareholders of Dragon Systems, Inc. in the wake of the collapse of Lernout & Hauspie Speech Products N.V. (L&H) after its acquisition of Dragon Systems. L&H had acquired Dragon in an all-stock deal, and upon L&H's filing for bankruptcy, Dragon's founders and controlling shareholders lost approximately US\$300 million plus the intellectual property developed by their company over decades.

Dragon's founding shareholders sued Goldman Sachs for failing to properly investigate L&H and to advise Dragon and its shareholders about the risks of a stock transaction. The shareholders argued that Goldman Sachs' actions constituted a breach of its engagement letter with Dragon and a breach of its fiduciary duty to the shareholders. Goldman Sachs, in its motion to dismiss, argued that its engagement letter was between it and Dragon, and that it owed no contractual or fiduciary duties to the shareholders themselves. The court, in refusing to dismiss all of the shareholders' causes of action, relied on a detailed analysis of the language of the Goldman Sachs engagement letter, including the identity of the addressees of the letter (the letter was addressed to three individuals, who were not identified in their representative capacities) and the

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use of the personal pronoun "you" in the letter when describing to whom the services would be rendered (which, in the court's view, meant the individual shareholders, rather than Dragon, given how the letter was addressed).

Although the court dismissed the shareholders' direct contractual claim against Goldman Sachs, it held that, under the circumstances of this transaction, one addressee, who was also a founding shareholder, could bring a claim that she was an intended third party beneficiary of the engagement letter and could state a claim for recovery for an indirect breach of contract. On this point, the court focused on how the engagement letter was addressed, its use of the term "you" and that Goldman Sachs had dealt directly with that shareholder throughout the engagement in concluding that the allegations were sufficient to evidence an intent by Goldman Sachs and Dragon to benefit that shareholder.

On the fiduciary duty claims, the court noted that a fiduciary duty is an "extra-contractual duty" that depends on "the defendant's knowledge of the plaintiff's reliance upon him." In reviewing the facts, the court held that the shareholders made "sufficient allegations that special circumstances existed to create a fiduciary relationship apart from the terms of the contract" and specifically noted that there was "no explicit waiver in the Engagement Letter precluding any extra-contractual fiduciary duty."

Engagement Letters Remain Critical in Defining Scope of Potential Liability

Although *Baker* is not a final decision on the merits of any of the shareholders' claims against Goldman Sachs, it is a significant cautionary reminder for investment bankers. Although courts, as a general proposition, are reluctant to extend the scope of investment bankers' legal duties beyond the express contract language, the *Baker* ruling is a reminder that, when a deal goes significantly wrong, the parties on the losing end will leave no stone unturned in their search for recovery. As the court's focus on the specific language of Goldman Sachs' engagement letter – even such details as the addressees and the choice of pronouns – shows, the engagement letter remains a critical risk management tool for investment bankers. This analysis, as the court noted, is not "a mere semantic quibble": it is the basis on which the court held that Goldman Sachs potentially owes duties, and has potential exposure to liabilities, that were significantly broader than it contemplated when it entered into its engagement letter for the Dragon transaction.

If you have any questions regarding this court decision or would like further information regarding any of the matters discussed above, please contact [Daniel G. Berick](#) or your principal Squire Sanders lawyer.

¹ *Baker v. Goldman Sachs*, Civ. No. 09-10053-PBS (D. Mass. Sept. 15, 2009).

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