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When ‘Expert Advice’ Can Lead to Legal Trouble

By Michael W. Peregrine – October 1, 2012

Michael W. Peregrine, a partner at the law firm McDermott Will & Emery, advises corporations, officers and directors on issues related to corporate governance, fiduciary duties and internal investigations.

Hiroko Masuike for The New York Times Bruce Bent, founder and chairman of the Reserve Primary Fund, is among the defendants in an S.E.C. civil suit.

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Much attention is focused on the civil trial involving the Securities and Exchange Commission’s fraud complaints against the Reserve Primary Fund, the bankrupt money management fund.

Yet from a corporate governance perspective, much of the important action has already occurred during a pretrial ruling on Sept. 12 by Judge Paul G. Gardephe of the United States District Court for the Southern District of New York.

The judge is allowing the defendants to argue at trial that they relied on the advice of outside counsel when the Reserve Primary Fund and its managers made public comments related to fund’s status. The S.E.C. complaint says that these statements were false and misleading to investors to the extent that they addressed the safety and security of the fund.

That ruling may have the indirect result of focusing more attention — boardrooms and among regulators — on the strength and scope of the time-honored “reliance on experts” defense.

The ability to rely on the advice of expert advisers has long been a bedrock defense to allegations of breach of the duty of care. Directors have an obvious and practical need to rely on management, committees and outside experts in connection with their oversight and decision-making obligations.They must be authorized to rely on management — and experts — in order to act with prudence and good faith.

In the case in question, the Reserve Primary Fund, “broke the buck” in 2008 when its net asset value fell below $1 a share. Since then, the fund has withheld a significant amount of money from investors pending the outcome of numerous lawsuits filed against the fund, its trustees and other officers and directors.

When sued by the S.E.C. on fraud charges, the officers and directors responded that they were just following the advice of counsel. The S.E.C. had argued that relying on that advice was unreasonable because legal counsel had a conflict of interest — an argument with which the court did not agree.

From a broader governance perspective, however, the court’s ruling serves as a cautionary note on the limitations of the reliance defense, particularly in a regulatory environment in which individual accountability is often the order of the day.

Still, it has been well established that the defense must pass muster – that the directors must feel that the advice was “reasonable.” Therefore, directors can’t use the defense when they are aware of circumstances

that would make that reliance unjustifiable. For instance, their advisers may be considered a bad fit if they are not experts in the particular subject matter, they have a conflict of interest or their "advice" was actually a series of observations and suggestions, not analysis.

"The lawyers have signed off on the deal" or "the accountants are supporting our tax position" may seem reasonable, but it must accurately reflect professional advice that directors can rely on in good faith.

Still, as the S.E.C.'s action suggests, regulators will be much more willing to challenge a director's "reliance on expert advice" defense. Thus, the availability of the defense should not be taken for granted by directors.

From a governance perspective, board members must be sure that they have asked crucial questions to be able to use this defense. Who are the advisers? Are they truly "experts"? What was the scope of their engagement? Were conflicts of interest checked? Did they have access to all the facts? Was their advice in writing? Did it have the input of the senior people? What were their caveats, if any? Did they review their advice with a board committee?

Being assertive might ruffle feathers, and it might upset the planned agenda. It may cause frayed relationships between management and members of the board, increase the cost of certain advice or could hamper the timely pursuit of certain initiatives. It may make the entire process more tedious. Indeed, the board may find out something that it didn't want to know that might make the reliance unreasonable.

At the same time, assertiveness might cast needed sunshine on the details of a transaction and the supporting analysis. It could increase checks and balances, make outside advice more responsive to governance, and expose the weakness of suspect transactions while confirming the benefit of others. In this instance at least, it may pay for directors to be pushy.

Mr. Peregrine's views do not necessarily reflect the views of McDermott Will & Emery LLP or its clients.