Legal Brief

The Duty to Act Fairly

We have written several times in this column about the obligations that the law imposes on those who manage or control a business enterprise. Those obligations, collectively referred to simply as "fiduciary duty," require that people engaged in business act with loyalty and fairness relative to co-owners or partners.

In imposing these obligations, the law is not acting out of some vague notion of morality. Rather, the law understands the larger issues involved. Our standard of living (for both owners and workers) is based in large part on the success of business enterprises. To succeed, those enterprises frequently need to pool the capital of a variety of individuals. The minority shareholder, the passive investor, and the silent partner, are vitally important to the process of business formation and success. To be encouraged to part with their money and take this backseat role, the investor must be confident that he or she will be treated fairly, and that those in control will act with loyalty. When there is a lack of fairness or a breach of loyalty, the courts should, and in most cases will, intervene.

These fiduciary duties are considered so important that they are often seen as extending beyond the mere operation of the business, but also to the transactions in which partners or investors enter or exit the enterprise. Consider the case of *Herring et al. v. Offutt, 266 Md. 593 (1972),* which deals with claims brought by a Mr. Offutt after he invested in an existing partnership.

In the 1960s, four men had formed a partnership for purposes of developing real estate in Prince George's County, Maryland. One of the partners, Mr. Duley, died owning 25 percent of the venture. Two of the surviving partners, Mr. Dewees and Mr. Herring, sought a purchaser for Duley's interest and found Offutt. Dewees and Herring told Offutt that 24.5 percent of the venture could be purchased from Duley's estate for $25,000. (What was to happen to the other 0.5-percent interest that Duley owned is not clear.) Offutt was not willing to come up with such a large sum but did offer to invest $10,000.

Dewees and Herring then arranged to purchase the 25-percent partnership interest of the late Duley for themselves. However, instead of paying $25,000 for such interest, they quietly paid Duley's estate $14,000. They then turned to Offutt and transferred a 10-percent interest to him for $10,000. In this fashion, Dewees and Herring were able to increase their own interest in the venture at very little cost. In addition, they failed to tell Offutt, their new "partner," that he could have purchased his 10-percent interest directly from Duley's estate at a much lower price. It was five years later, during the course of unrelated litigation, that Offutt learned the true facts. He promptly filed suit, claiming Dewees and Herring had breached their fiduciary duty; that is, their duty to act fairly.

Dewees and Herring put forth two significant arguments in their defense. First, they claimed that their pre-purchase discussions with Offutt occurred before any fiduciary duty ever arose. These negotiations, they asserted, should be judged by the principle of "buyer beware." An emphatic "No!" said Maryland's highest court, adding:

"[T]he principle of utmost good faith covers not only dealings and transactions occurring during the partnership, but also those taking place during the negotiations leading to the formation of the partnership." *Herring et al. v. Offutt, 266 Md. at 597.*

Second, Dewees and Herring argued that Offutt's claim was barred by Maryland's three-year statute of limitations. After all, five years had passed since the transaction had occurred. The Court disagreed, noting that the statute of limitations is extended when the plaintiff (Offutt) has been kept in ignorance by the defendants (Dewees and Herring). But, Dewees and Herring argued, the truth could have been discovered long ago if Offutt had simply looked at the public records in the county courthouse concerning the Duley estate. The Court refused to accept the argument. Instead, the Court declared that because partners owe a fiduciary duty to one another, a partner has a right to relax his or her vigilance and rely on the good faith of the other partners. Quite simply, a partner has no duty to be suspicious of a fellow partner.

Thus, even the formative stage of a business enterprise is cloaked with this fiduciary duty — this obligation to act with loyalty and fairness. By enforcing this duty, the courts serve society's larger interests. ☆

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