

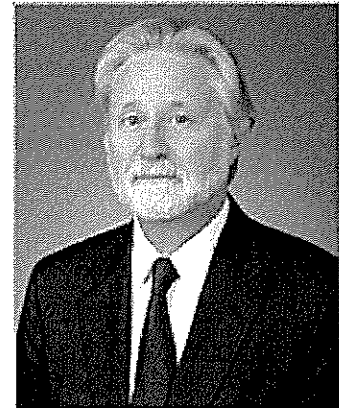
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Schwab Case Opens Litigation Doors Most Thought Closed

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Law360, New York (April 01, 2015, 10:25 AM ET) -- A recent Ninth Circuit Court of Appeals opinion charts potential new pathways for claims for damages resulting from portfolio losses by mutual fund shareholders against both a fund's trustees and its investment adviser. However, much of the sweeping language and analysis in the court's opinion is not merely novel but is inconsistent with established principles of investment company governance and litigation, which could limit the precedential impact of the opinion.

The case, Northstar Financial Advisors Inc. v. Schwab Investments et al., No. 11-17187 (9th Cir. Mar. 9, 2015), involved a mutual fund's alleged failure to comply with its fundamental investment objectives of tracking the investment results of the Lehman bond index and limiting its investments in any one "industry" to not more than 25 percent of the fund's assets. These fundamental investment policies had been approved by shareholder vote and were described in the fund's registration statement and prospectus.[1] The fund's Statement of Additional Information (SAI) described the fund's interpretation of "industry" in a manner that allowed greater than 25 percent concentration in mortgage-backed securities. The fund invested greater than 25 percent of its assets in MBS and experienced portfolio losses during the credit crisis.



Jeffrey B. Maletta

The plaintiff, a financial adviser that had invested client assets in the fund, argued to reinstate three claims that had been dismissed by the district court: a claim for breach of contract against the trust of which the fund was a series; a claim for breach of fiduciary duty against the fund trustees and adviser, and a third-party beneficiary contract claim based on the investment management agreement against the fund's investment adviser. A 2-1 majority of the court rejected a standing challenge and ruled that

the plaintiff could proceed on all three claims. It is not clear what law the court applied in finding a binding contract, as it cited to general principles and treatises.

Breach of Contract

The court first concluded that the fund's shareholders' adoption of fundamental investment policies, which could only be changed by further shareholder vote and which were reflected in the fund's registration statements and prospectuses, were part of a contract between the trustees and the shareholders. The court described the shareholders' adoption of the fundamental investment objectives as adding "a structural restriction on the power conferred on the trustees in the agreement and declaration of trust that can only be changed by a vote of the shareholders." This, the court concluded, created a contract between the trustees and every shareholder.

Further, the court found, anyone who invested in the fund after the fund's registration statement and prospectus began describing the fundamental policies was contractually entitled to have his investment managed in accordance with those policies, unless the shareholders voted to permit otherwise. When shareholders invested in the fund, according to the court, they accepted the offer made by the fund in the fund's prospectus. The court noted that this is the same mechanism by which the shareholders became parties to the fund's agreement and declaration of trust, which provided that "[e]very Shareholder by virtue of having become a Shareholder shall be held to have expressly assented and agreed to the terms hereof and to have become a party hereto."

The court also rejected the defendants' argument that the contract was modified by disclosure of the fund's interpretation of "industry" in the SAI, holding that the SAI did not provide adequate notice of the interpretation. The court concluded that "it is reasonable to assume that there are many ordinary shareholders who do not" read the SAI.

Fiduciary Duty Claim — Direct vs. Derivative

The court's analysis of the breach of fiduciary duty claim centered on whether the claim was a derivative claim held by the fund or one that could be brought directly by shareholders. The court rejected the defendants' argument that this claim could only be brought derivatively, saying that the argument "simply ignores the plain terms of the Agreement and Declaration of Trust." The trust instrument states expressly that:

The Trustees hereby declare that they will hold all cash, securities and other assets, which they may from time to time acquire in any manner as Trustees hereunder IN TRUST to manage and dispose of the same ... for the pro rata benefit of the holders from time to time of Shares in this Trust.

The fund is a series of a Massachusetts business trust, and the breach of fiduciary duty claims were premised on Massachusetts law. The court then noted that it is unaware of any Massachusetts case holding that agreements of this kind cannot be enforced directly by the beneficiaries of a trust.[2]

In more sweeping language that would apply beyond the context of the particular trust or Massachusetts law, the opinion then asserts that the distinction between direct and derivative actions has little meaning in the context of mutual funds, noting that in a mutual fund there is no business other than acquiring investments for the pro rata benefit of the shareholders; any decrease in a mutual fund's share price flows directly and immediately to the shareholders. The court also reasoned that a

direct action was appropriate where the recovery available in a derivative action — damages payable to the fund — does not provide a just measure of relief to the complaining shareholder.

The majority also expressed the view that the process for bringing derivative actions is inapt in the mutual fund setting. In most cases, a shareholder seeking to sue in the name of a corporation must first make a demand on the board. Demand allows disinterested directors to exercise their authority over litigation on behalf of the fund and exercise their business judgment in the best interest of the company. The court essentially dismissed the significant role of independent directors in the demand process and in fund governance generally by describing mutual funds as “essentially puppets of the investment adviser.”

Third-Party Beneficiary

Finally, the court allowed the shareholders to bring a third-party beneficiary claim against the fund’s investment adviser based on the advisory agreement between the fund and the adviser. That agreement specifies that it is governed by California law, and the court applied that state’s law in analyzing the claim. The court found that the plaintiff had plausibly alleged that the investment adviser understood that it was the intent of the fund to benefit the shareholders of the fund. The contract between the adviser and the fund was required to be approved by a majority of the fund’s shareholders. This, the court noted, establishes more than a “remote” relationship on the part of the shareholders to the contract between the adviser and the fund, and it indicates that the shareholders are the actual beneficiaries of the advisory agreement.

Implications

The Northstar opinion is in many respects at odds with other cases as well as the general principles, developed over and supported by years of consistent practice, providing the legal framework for the operation and governance of mutual funds. If followed by other courts, it could have adverse effects on all mutual funds, whether they are organized as Massachusetts business trusts, Delaware statutory trusts or corporations.

In its most sweeping statements, the court discarded the fundamental distinction between claims that may be brought directly by a shareholder, and derivative claims, which ordinarily may only be brought with the authorization of an investment company’s board of directors or trustees. The court essentially ruled that almost any alleged breach of duty by management or the board that allegedly adversely affects net asset value may be the subject of a direct action by shareholders against the directors and the adviser.

The rationales for this holding — the “direct” impact on shareholders through NAV and the view of funds as “puppets” of the adviser — have been rejected directly by numerous courts and are inconsistent with the rulings of others, including U.S. Supreme Court cases that recognize the direct/derivative distinction and the demand requirement in the mutual fund context.[3] Similarly, Northstar’s third-party beneficiary analysis offers another means of bypassing the established procedures for raising and redressing alleged injuries to the fund from wrongful misconduct of the adviser.

The direct contractual claims are similarly troubling, if less sweeping. The court found a contract established by a combination of the shareholders’ voting rights with respect to fundamental investment policies and the basic contractual offer-and-acceptance structure presented by a

prospectus's securities offering. The court's basis for this contract theory is not grounded in generally accepted principles of mutual fund organization and governance, but it may provide plaintiffs with a way to artfully plead as breach of contract claims, misrepresentation claims that would otherwise be precluded by the Securities Litigation Uniform Standards Act of 1998.

Limited Impact?

Despite some of its startling language, the impact of the decision may be limited. The defendants have petitioned for reconsideration through rehearing or rehearing en banc. The rulings might also be the subject of a petition for a writ of certiorari to the United States Supreme Court. In addition, Northstar's effect on other cases may be less dramatic.

The court's rulings are purportedly based primarily on state law. Perhaps the most troubling ruling, on the breach of fiduciary duty claim, is controlled by the law of Massachusetts. However, as a federal court, the Ninth Circuit's rulings on this issue are not binding on the Massachusetts courts, other state courts, or even federal courts outside the Ninth Circuit.

As noted above, other courts have reached different conclusions on key issues, and courts in the future may well not accept the Ninth Circuit's reasoning. Massachusetts courts may effectively overturn these rulings, either in cases brought in Massachusetts or under procedures (not used in Northstar) that permit federal courts to certify questions to the Massachusetts Supreme Judicial Court for resolution.

Finally, as they did in the "Strougo" cases 15 years ago, state legislatures may address the implications of court decisions that undermine generally accepted principles of corporate governance.
[4]

Steps to Consider

Mutual fund complexes operating through trusts nonetheless may consider prophylactic steps, such as a review of the provisions of their trust instruments, to determine the extent to which the express terms of the instrument limit contractual rights and fiduciary duties. The declaration of trust of a Massachusetts business trust can limit contractual rights and fiduciary duties. "Trust fiduciary law is default law that the parties can alter to their needs." [5]

The Northstar opinion itself quotes a commentator's description of fiduciary duties as being subject to modification by the parties to the trust: "The familiar standards of trust fiduciary law protect trust beneficiaries of all sorts, regardless of whether the trust implements a gift or a business deal (unless, of course, the terms of the transaction expressly contraindicate)." [6]

Similarly, the Delaware Statutory Trust Act specifically permits limitations of contractual rights and fiduciary duties so long as these limitations do not eliminate the implied contractual covenant of good faith and fair dealing. [7] In addition, a Delaware statutory trust can expressly limit liability for breach of contract and fiduciary duties to the extent that these limitations do not limit or eliminate liability for any act or omission that constitutes a bad-faith violation of the implied contractual covenant of good faith and fair dealing. [8]

Investment company advisers and boards may anticipate the possibility of more litigation, particularly in states covered by the Ninth Circuit, as the plaintiffs' bar seeks to take advantage of the Ninth Circuit's expansive opinion.

—By Jeffrey B. Maletta, Mark P. Goshko, Scott E. Waxman, Clair E. Pagnano, Nicholas G. Terris and Joel D. Almquist, [K&L Gates LLP](#)

Jeffrey Maletta and Nicholas Terris are partners in K&L Gates' Washington, D.C., office. Mark Goshko, Clair Pagnano and Joel Almquist are partners in the firm's Boston office. Scott Waxman is a founding partner in the firm's Wilmington, Delaware, office.

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[1] That the fund's fundamental investment policies had been approved by the fund's shareholders presents an unusual case, as most funds' fundamental policies are set upon the launch of a fund without shareholder approval.

[2] However, Massachusetts courts have consistently held that shareholders in a Massachusetts business trust can assert breach of fiduciary duty claims derivatively against the trustees. See, e.g., *Peterson v. Hopson*, 306 Mass. 597, 29 N.E.2d 140 (1940).

[3] See, e.g., *Burks v. Lasker*, 441 U.S. 471 (1979)

[4] See, e.g., *Strougo v. BEA Associates*, 188 F.Supp.2d 373 (S.D.N.Y. 2002) and Mass.G.L. c. 182 § 2B.

[5] John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L.J. 165, 183 (1997).

[6] *Id.* at 166.

[7] Delaware Statutory Trust Act, 12 Del. C. § 3806(c).

[8] Delaware Statutory Trust Act, 12 Del. C. § 3806(e).

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