

The new mutual fund exception: 9th Circuit allows direct claims to redress derivative injury

(August 25, 2015) - Courts have sought to simplify their approach to determining whether an action is derivative or direct — a determination that the Delaware Supreme Court has acknowledged "is sometimes difficult." *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004). Proper determination is critical in shareholder litigation; however, the 9th Circuit's March 2015 decision in *Northstar Financial Advisors Inc. v. Schwab Investments*, 779 F.3d 1036 (9th Cir. 2015), allows direct lawsuits from shareholders in a case that seemed to be a straightforward example of a derivative claim. The 9th Circuit further complicated the issue by trying to carve mutual funds out of the analysis entirely, suggesting that courts abandon the distinction between direct and derivative claims in lawsuits arising from investments in mutual funds because, according to the court, the claims of investor plaintiffs should be deemed direct claims in virtually all instances. This finding is likely to sow additional confusion and inconsistent application of the proper analysis in future investment company litigation.

In *Northstar*, investors in the Schwab Total Bond Market Fund asserted claims of breach of contract and breach of fiduciary duty against the fund's trustees and investment adviser. Those claims were based on allegations that the defendants violated the fund's "fundamental investment objectives" by investing too heavily in mortgage-backed securities. The plaintiffs also alleged that the offending investments generated significant losses and therefore directly injured the fund by diminishing the value of its assets. Because the plaintiffs asserted all their claims as direct claims on behalf of themselves and a putative class of fund investors, the defendants filed a motion to dismiss those claims, arguing that they were really derivative in nature, and plaintiffs therefore lacked standing to assert them directly. The district court granted the motion, but the 9th Circuit reversed.

Because the fund is a mutual fund organized as a Massachusetts business trust, the 9th Circuit in *Northstar* applied the "internal affairs doctrine" to find that Massachusetts law governed the standing question before it. However, in its application of Massachusetts law, the court made a common mistake in this context: Namely, it erroneously held that a plaintiff may adequately plead a direct claim by alleging the breach of a contractual right held by a plaintiff *qua* shareholder, even if the plaintiff's injury is derivative of the harm suffered by the company.

The court based its decision in large part on *Lapidus v. Hecht*, 232 F.3d 679 (9th Cir. 2000), a prior 9th Circuit opinion that relied solely on Delaware law to determine when a direct action may be brought under Massachusetts law. The *Northstar* court also relied on the Delaware Supreme Court's subsequent decision in *Tooley*. In our view, the law of both jurisdictions warrants a different result.

In *Tooley*, the Delaware Supreme Court reiterated that in determining whether a claim is direct or derivative, "a court should look to the nature of the wrong *and* to whom the relief should go." 845 A.2d at 1039 (emphasis added). This test focuses principally on who has suffered the alleged injury and who, therefore, should be compensated for it. Applying this test, when a stockholder claims to be the injured party, his "claimed direct injury must be *independent of* any alleged injury to the corporation." *Id.* Thus, as explained by the court in *Tooley*, standing to assert a direct claim requires a plaintiff stockholder to show both "that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation." *Id.*

Massachusetts law is in accord with *Tooley*. Under that state's law, an alleged breach of a contractual or fiduciary duty owed directly to a shareholder is not, by itself, sufficient to state a direct claim. Even in that instance, the claim will be deemed derivative whenever the injury alleged by the plaintiff "is a claim of harm to the corporation." *Schaeffer v. Cohen, Rosenthal, Price, Mirkin, Jennings & Berg, P.C.*, 541 N.E.2d 997 (Mass. 1989).

Additionally, the *Northstar* court proposed to modify the law by suggesting the elimination of derivative claims "in the context of mutual funds." 779 F.3d at 1058. Mutual funds deserve different treatment, the court reasoned, because the business of "publicly held corporations" is, in the court's view, fundamentally different from the business of mutual funds. But the only real difference that emerges from the 9th Circuit's analysis is one pertaining to business valuation. The financial success of a

"traditional" corporation is measured generally by the income it earns for the indirect, pro rata benefit of its shareholders. In the same vein, the financial success of a mutual fund is measured generally by the gains realized on the fund's assets for the indirect, pro rata benefit of the fund's shareholders. In both cases — a decline in income and a decline in fund assets — the direct result generally is a decline in the value of the business, which shareholders bear indirectly pro rata to their ownership stake in the company. Such a decline, if caused by the wrongdoing of the company's fiduciaries, is direct injury to the company that may be redressed in litigation only by the company suing directly on its own behalf or by shareholders suing derivatively on behalf of the company.

In the final analysis, the laws of Massachusetts and Delaware do not support the 9th Circuit's effort to place mutual fund shareholder litigation in a special category of its own. Moreover, we believe it is unlikely that Massachusetts, Delaware or other courts outside the 9th Circuit will adopt *Northstar's* suggestion of placing mutual fund shareholder litigation in a special category of its own. In all events, *Northstar* is a sobering reminder that fund boards should adopt well-drafted forum selection clauses to protect against the risk attendant to litigation outside the states where their funds are organized.

By Seth M. Schwartz and Jason C. Vigna

Partner Seth M. Schwartz and counsel Jason C. Vigna are members of Skadden, Arps, Slate, Meagher & Flom's Litigation practice in New York.

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