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An Exception to the Derivative Rule

ALLOWING MUTUAL FUND INVESTORS TO BRING SUITS DIRECTLY

INTRODUCTION

In April of 2015, the Ninth Circuit Court of Appeals decided the controversial case *Northstar Financial Advisors Inc. v. Schwab Investments*.[1] The court found that shareholders of a mutual fund could bring a direct instead of derivative action against the fund's external investment advisor for breach of fiduciary duty.[2] This holding allowed the plaintiffs to avoid the almost insurmountable demand requirement for derivative actions, which requires the plaintiffs to convince the board of directors of the fund to bring the action on behalf of the fund itself. In evaluating the breach of fiduciary duty claim, the court, using sweeping language, stated that the direct versus derivative suit distinction is not as relevant in the mutual fund context as with a traditional corporation.[3] Generally, a board of directors acts as representatives of the shareholders; the independent directors—usually defined as having no other relationship to the company aside from the directorship—are used in situations involving conflict of interest, including considering a demand request in derivative suits against management.[4] In *Northstar,* the court questioned the true independence of mutual fund board members who were labeled as independent.[5]

Since this decision, many private law firms that work with mutual funds have stated that this decision deviates from long-standing precedent and creates confusion and uncertainty in the mutual fund marketplace.[6] The Investment Company

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[1] Northstar Fin. Advisors Inc. v. Schwab Invs., 779 F.3d 1036 (9th Cir. 2015).

[2] *Id.* at 1056–62 ("[T]he distinction between direct and derivative actions has little meaning in the context of mutual funds . . . .").

[3] *Id.* at 1058–60.

[4] Burks v. Lasker, 441 U.S. 471, 484–85 (1979).

[5] *Northstar*, 779 F.3d at 1060–63.

[6] *See* Seth M. Schwartz & Jason C. Vigna, *The New Mutual Fund Exception: Ninth Circuit Allows Direct Claims to Redress Derivative Injury*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES (June 23, 2015), http://www.skadden.com/sites/default/files/publications/The_New_Mutual_Fund_Exception_Ninth_Circuit_Allows_Direct_Claims_to_Redress_Derivative_Injury.pdf ("This finding is likely to sow additional

Institute (ICI)—the national association of investment companies—filed an *amici curiae* brief in support of petition for rehearing of the case en banc. The ICI argued that the Ninth Circuit's decision "creates new legal relationships and duties between shareholders and boards" and "will discourage qualified individuals from serving on fund boards."[7] Prior to this case, the Supreme Court had categorized independent directors as "watchdogs," tasked with "looking after the interests of the funds' shareholders."[8] The *Northstar* decision questions whether independent directors of mutual funds are able to perform this "watchdog" role when the shareholders have been wronged and seek to bring an action against the managers of the funds. While *Northstar* introduced a new way to think about the relationship between shareholders and directors in the mutual fund setting, the precedential impact of the decision is fairly limited on its own. One reason the impact is limited is because of the jurisdictional scope of the decision. In the earlier case of *Burks v. Lasker*, the Supreme Court held that state corporations law governed in a claim alleging violation of the Investment Company Act of 1940, a federal statute governing mutual funds.[9] The Court noted that federal regulation of investment companies is not meant to be all encompassing and that because mutual funds are created pursuant to state law, state corporations law should govern.[10] *Northstar* was decided in the Ninth Circuit, which applied

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confusion and inconsistent application of the proper analysis in future investment company litigation."); Jeffrey B. Maletta et al., *Ninth Circuit Opinion May Open Litigation Doors Most Thought Closed*, K&L GATES (Mar. 2015), http://www.klgates.com/files/Publication/776485e6-edc4-4948-8556-b8e5ed8f4f79/Presentation/PublicationAttachment/dd3fed69-9a3d-4ae4-95f5-e453ada94370/IM_Alert_03192015.pdf [https://perma.cc/D4K7-6T22] ("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."); William F. Sullivan et al., *Regulatory Update: Recent Judicial Decisions Bring Changes to Financial Services Industry*, PAUL HASTINGS (June 2015), http://www.paulhastings.com/docs/default-source/PDFs/client-alert—-perez-northstar.pdf [https://perma.cc/V8T5-MB2P] ("[I]n many ways, the decision raises more questions than it answers."); *see also Burks*, 441 U.S. at 485 (holding that the Investment Company Act does not forbid termination of suits by independent directors); Scalisi v. Fund Asset Mgmt., L.P., 380 F.3d 133 (2d Cir. 2004); *In re* Evergreen Mut. Funds Fee Litig., 423 F. Supp. 2d 249 (S.D.N.Y. 2006).

[7] Brief of Amici Curiae Investment Co. Institute & Independent Directors Council in Support of Appellees' Petition for Rehearing en banc at 3–4, Northstar Fin. Advisors v. Schwab Invs., 779 F.3d 1036 (9th Cir. Apr. 2, 2015) (No. 11-17187) [hereinafter Brief of Amici Curiae Investment Co. Institute & Independent Directors Council].

[8] *Burks*, 441 U.S. at 485.

[9] *Id.* at 477–80; *see also* Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90 (1991) ("The presumption that state law should be incorporated into federal common law is particularly strong in areas in which private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state-law standards. Corporation law is one such area." (internal citations omitted)).

[10] *Burks*, 441 U.S. at 478.

Massachusetts state law;[11] therefore, its holding is nonbinding on Massachusetts or any other state.[12] Because a majority of mutual funds are set up under Massachusetts, Delaware, or Maryland law,[13] this federal case's precedential value is likely to be limited. If these states wish to curtail the requirement for derivative action in the mutual fund investor context, they will need to adopt new laws outlining the situations in which a normally derivative suit can be brought directly, taking into account the policy reason behind the derivative action requirement.

The application of the mutual fund exception in derivative actions addressed by *Northstar* also has limited precedential value because the portions of the decision addressing the direct versus derivative distinction as applied to mutual funds is merely dicta. The case turned on the court's holding that there was a binding contract created between the shareholders and the trustees of the fund when the shareholders voted to adopt the fund's fundamental investment policies.[14] These policies are set forth in the fund's prospectus, a document that the fund's sponsor must give to investors after they purchase shares but is often given prior.[15] Because the defendant breached this contract, the court was able to fit the plaintiff's claim into an existing Massachusetts law that allowed shareholder plaintiffs to bring direct action when the wrong against them involves their contractual rights.[16] This way of allowing direct action to mutual fund shareholders is a dangerous proposition, however, because the contents of a fund's prospectus are largely not at the discretion of the fund's sponsor and are instead mandated by federal law.[17] Further, because a mutual fund is perpetually offering shares, it must update its prospectus continually, and, if

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[11] *Northstar*, 779 F.3d at 1048.

[12] Although there will certainly be an influx of mutual fund shareholder plaintiffs who bring claims directly in the Ninth Circuit.

[13] 2014 INVESTMENT COMPANY FACT BOOK 225 & fig.A.1 (54th ed. 2014), http://www.ici.org/pdf/2014_factbook.pdf [https://perma.cc/Z7SV-BG7T].

[14] *Northstar*, 779 F.3d at 1054.

[15] *Mutual Fund Prospectus*, SEC (July 28, 2010), http://www.sec.gov/answers/mfprospectustips.htm [https://perma.cc/C6JR-LS3V].

[16] *Northstar*, 779 F.3d at 1057 (citing Lapidus v. Hecht, 232 F.3d 679 (2000)) ("To bring a direct action under Massachusetts law, a plaintiff must allege an injury distinct from that suffered by shareholders generally *or* a wrong involving one of his or her contractual rights, *such as* the right to vote.").

[17] Brief of Amici Curiae Investment Co. Institute & Independent Directors, *supra* note 7, at 12. Specifically, Form N-1A is a fifty-page form that "sets forth strict, detailed, and lengthy requirements for the organization and content of a mutual fund prospectus and all other parts of the fund's registration statement." *Id.* at 9–10; *see* Form N-1A, http://www.sec.gov/about/forms/formn-1a.pdf [https://perma.cc/G95A-VXEG].

courts follow the *Northstar* holding, could be liable for a stale prospectus from previous offerings.[18]

By forcing this breach of prospectus into contract law to avoid the derivative lawsuit requirement, the Ninth Circuit's decision raises the issue of whether mutual funds should be treated as typical public corporations when shareholders bring suit against the fund's advisor or board members. States—specifically Massachusetts, Delaware, and Maryland[19]—will have to decide whether they want to address this issue by expressly denouncing this type of application of their state laws and continuing to force shareholders of mutual funds to bring most claims derivatively. Instead of maintaining this status quo, states should reevaluate the need for derivative suits in the mutual fund space by explicitly allowing direct shareholder suits in more situations.

This note explores whether state courts should adopt rules that allow shareholders of mutual funds to assert claims against the fund's investment advisor directly and circumvent the procedural hurdles of derivative lawsuits. Part I of this note provides an overview of some of the unique characteristics mutual funds have when compared to more traditional public corporations—in particular a mutual fund's highly interested "disinterested" board members, the investor makeup of mutual funds, the fund's unique business model, and the fund's distinctive pricing structure. Part II explores when a claim must be brought derivatively rather than directly, the procedural consequences of that determination, and the close corporation exemption to this requirement. Part III examines the facts of the *Northstar* decision and argues that while the decision properly recognized the difference between mutual funds and corporations, it did not provide a clear framework to handle mutual fund shareholder suits moving forward. Part IV concludes that given the major differences between traditional public corporations and mutual funds, the normal policy reasons in favor of derivative suits do not apply as strongly to mutual funds. Because of this, the investors of these funds should be able to circumvent the derivative action requirement under certain circumstances. This note proposes using the derivative suit exception for close corporations that is advocated by the American Law Institute as a guide for applying this mutual fund exemption. This approach

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[18] Brief of Amici Curiae Investment Co. Institute & Independent Directors, *supra* note 7, at 14–15 (citing 15 U.S.C § 77j(a)(3) (2012)).

[19] The majority of all funds are incorporated in these three states. 2014 INVESTMENT COMPANY FACT BOOK, *supra* note 13, at 225.

will allow judges to use their discretion and look at each fund's characteristics to see if a particular action should be brought derivatively or directly.

I. MUTUAL FUNDS AND THEIR UNIQUE CHARACTERISTICS

Mutual funds are a huge investment vehicle in the United States. In 2014, around 90 million individuals invested in mutual funds in the United States, which comprised 43% of all households in the country.[20] For those households that invested in mutual funds, "the median amount invested . . . was $103,000."[21] In total, an estimated $15.8 trillion dollars was invested in mutual funds at the end of 2014.[22]

Mutual funds are initially organized by a sponsor, who, when the fund is first launched, is the sole shareholder and "elects the initial slate of directors."[23] The fund will then contract with an external investment advisor, who will be in charge of day-to-day fund management and making the investments for the fund.[24] The sponsor will then file a prospectus[25] and raise money from investors (shareholders), which will then be invested by the investment advisor of the fund.[26] The interrelation between the sponsor, the investment advisor, and the directors along with the unique business model of a mutual fund creates a conflict of interest that does not exist in traditional public corporations. As is discussed in Part II, it is especially important that independent board members be able to vigorously represent the shareholder's interests in derivative lawsuits against the fund's investment advisor or sponsor because they have the ability to outright refuse to bring the lawsuit and kill the suit in its infancy.[27]

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[20] 2015 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE U.S. INVESTMENT COMPANY INDUSTRY 114 & fig.6.1 (55th ed. 2015), https://www.ici.org/pdf/2015_factbook.pdf [https://perma.cc/3LD3-U6NX] [hereinafter 2015 INVESTMENT COMPANY FACT BOOK].

[21] *Id.*

[22] *Id.* at 30 fig.2.2.

[23] *Frequently Asked Questions About Mutual Fund Directors*, INV. CO. INST., https://www.ici.org/pubs/faqs/ci.faq_fund_gov_idc.idc [https://perma.cc/5DVR-L37G].

[24] A. Joseph Warburton, *Should Mutual Funds Be Corporations? A Legal & Econometric Analysis*, 33 J. CORP. L. 745, 748 (2008).

[25] A prospectus is a document that informs investors of important information about the fund such as the "fund's investment objectives or goals, its strategies for achieving those goals, the principal risks of investing in the fund, the fund's fees and expenses, and its past performance." *Mutual Fund Prospectus*, *supra* note 15.

[26] Warburton, *supra* note 24, at 748.

[27] *See infra* Part II.

A. The Business of a Mutual Fund

Generally, a mutual fund "manages money on behalf of individuals—or, less commonly, other entities—who buy shares in the [fund] . . . , which in turn invests the money in other companies."[28] Investors in a fund can then withdraw their shares at any time at the fund's current share price.[29] A mutual fund is different from a typical corporation because its only business is buying and selling investment instruments, and any increase or decrease in the price of those instruments "flows directly and immediately to the shareholders."[30] This is very unique when compared with a traditional publically held corporation where the share price is not just the value of its net assets divided by the number of shares outstanding, but also the product of many other elements.[31] These elements include market sentiment, growth expectations, valuation, momentum, and central bank activity.[32] By contrast, a mutual fund investor's shares can be redeemed at their daily Net Asset Value (NAV), which equals the "current mark-to-market value of all the fund's assets, minus liabilities (e.g., fund expenses), divided by the total number of outstanding shares."[33] This less dynamic pricing system helps underpin the structural differences between mutual funds and traditional publically held corporations.

Another important difference between mutual funds and typical corporations is that mutual funds normally have no employees and are externally managed by an investment advisor.[34] In practice, that external investment advisor is often also the sponsor of the fund.[35] These external investment advisors are charged with both managing the funds in a way to get the most

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[28] MELVIN ARON EISENBERG & JAMES D. COX, BUSINESS ORGANIZATIONS: CASES AND MATERIALS 304 (Robert C. Clark et al. eds., 11th ed. 2014).

[29] *Id.*

[30] Northstar Fin. Advisors Inc. v. Schwab Invs., 779 F.3d 1036, 1058 (9th Cir. 2015).

[31] *See What Is a Share?*, GUARDIAN (July 17, 2001), http://www.theguardian.com/money/2001/jul/18/shares.investinginshares1 [https://perma.cc/B58H-9P7G].

[32] Ben Baden, *5 Factors That Drive Stock Prices*, U.S. NEWS & WORLD REP.: MONEY (July 14, 2011), http://money.usnews.com/money/personal-finance/mutual-funds/articles/2011/07/14/5-factors-that-drive-stock-prices [https://perma.cc/689G-WUDN].

[33] 2015 INVESTMENT COMPANY FACT BOOK, *supra* note 20, at 257.

[34] *See* Warburton, *supra* note 24, at 748.

[35] Victoria E. Schonfeld & Thomas M.J. Kerwin, *Organization of a Mutual Fund*, 49 BUS. L. 107, 107–08 (1993); *see Northstar*, 779 F.3d at 1040–41 ("'[I]n theory, the [fund] is able to choose any adviser it deems appropriate to invest the fund's portfolio, based on the adviser's investing style, track record and fees,' in practice, the investment adviser picked to manage the portfolio is most often self-selected and unlikely to be removed." (quoting John Shipman, *Can You Answer This Question: Who Owns Your Mutual Fund?*, WALL ST. J. (May 5, 2003), https://www.wsj.com/articles/SB105207969873142900 [https://perma.cc/6YXS-QRVZ])).

profit for the fund's investors and, at the same time, trying to get the highest profit for their own shareholders, two objectives which can conflict at times.[36] While typically selecting themselves as the fund's manager, the sponsors also get to choose which affiliated individuals they want on the fund's board of directors and recruit the "disinterested" directors for the board.[37]

The Supreme Court has said that because the external investment advisor usually exclusively manages the fund, "a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy."[38] The investment advisor is paid a fee by the company, which is typically a "percentage of [the fund's] assets under management."[39] The issue with this fee structure is that increasing the assets under management does not always equate to a better return for the fund's shareholders and could be detrimental by actually decreasing their return.[40]

All of this amounts to a large number of conflicts of interest for the advisor and board.[41] Assuming the sponsor and the investment advisor are the same entity, that entity will have a strong relationship with the board whom they intentionally recruited. The company's board of directors is supposed to act as the representative for the shareholders, but given the strong ties to the investment advisor, they may not be willing to advocate for shareholders if it is against the interests of the investment advisor. As discussed in the next section, even the disinterested directors may not be as independent as they seem. A shareholder suit is an effective tool in policing the board and advisor to ensure that they are effectively managing this conflict; by forcing shareholder suits to be brought derivatively, a court could make this method of oversight nearly impossible.

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[36] Warburton, *supra* note 24, at 750.

[37] Schonfeld & Kerwin, *supra* note 35, at 107–08.

[38] Burks v. Lasker, 441 U.S. 471, 481 (1979) (quoting S. REP. NO. 91-184, at 5 (1969)).

[39] Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1020 (2005).

[40] Joseph Chen et al., *Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization*, 94 AM. ECON. REV. 1276, 1279 (2004).

[41] Galfand v. Chestnutt Corp., 545 F.2d 807, 808 (2d Cir. 1976) ("The relationship between investment advisers and mutual funds is fraught with potential conflicts of interest.").

B. "Disinterested" Directors

The inherent conflict of interest in the mutual fund space gave rise to the Investment Company Act of 1940 (ICA), a federal statutory scheme that serves as the primary regulatory framework applicable to mutual funds.[42] One important aspect of the ICA is the requirement that no more than 60% of the board of directors of a fund can be "interested persons."[43] As the Supreme Court has noted, this section of the ICA is "[t]he cornerstone of [its] effort to control conflicts of interest within mutual funds."[44]

An "interested person" as the ICA defines the term, is generally any person affiliated with the fund, a family member of an affiliate of the fund, or an affiliate of the investment advisor of the fund.[45] Some argue that this definition is not strong enough.[46] For instance, former employees of the fund's sponsor, investment advisor, or its affiliates are still considered independent once they leave the company under the ICA definition.[47] Despite the ICA only requiring 40% of a board be independent, in practice, most mutual fund boards have higher than 40% independence.[48] As of 2012, 85% of fund complexes had more than 75% independence on their boards.[49] The makeup of the independent portion of a board of directors is very important because the ICA has given independent board members special duties in an effort to enable them to represent the interests of the shareholders and help police conflicts of interests for the investment advisor.[50] For example, they must vote separately on certain issues such as contracts with the investment advisor.[51]

Despite the "watchdog" role[52] that independent directors are supposed to play for the investors in mutual funds, many scholars have questioned their true independence from the sponsor

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[42] *See* 15 U.S.C. §§ 80a-1 to 80b-21 (2012); Langevoort, *supra* note 39, at 1020 (citing JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 222–29 (rev. ed. 2003)).

[43] 15 U.S.C. § 80a-10(a).

[44] Burks v. Lasker, 441 U.S. 471, 482 (1979).

[45] 15 U.S.C. § 80(a)-2(19).

[46] *See, e.g.*, Eric D. Roiter, *Disentangling Mutual Fund Governance from Corporate Governance*, 6 HARV. BUS. L. REV. 1, 23–24 (2016); Shipman, *supra* note 35 ("The definition of 'independent' is fairly loose when it comes to fund board members . . . .").

[47] Shipman, *supra* note 35 ("So, for example, Joseph S. DiMartino, who was president of Dreyfus Corp. for a dozen years before becoming chairman of the fund boards for the Dreyfus fund group, is considered an independent director.").

[48] 2015 INVESTMENT COMPANY FACT BOOK, *supra* note 20, at 259.

[49] *Id.*

[50] Shipman, *supra* note 35.

[51] 5 U.S.C. § 80a-15(c) (2012).

[52] Burks v. Lasker, 441 U.S. 471, 484 (1979).

and investment advisor.[53] As Warren Buffet has put it, "[a] monkey will type out a Shakespeare play before an 'independent' mutual-fund director will suggest his fund look at other managers, even if the incumbent manager has persistently delivered substandard performance."[54] In fact, in any given year between 1993 and 2002, only about 10% of all mutual funds renegotiated their management fees—the fees paid by the fund to the investment advisor for advisory services.[55]

There are other issues regarding the true independence of the board of directors in mutual funds. Generally, a mutual fund's directors lack proficiency in managing a portfolio of stocks, which is something the investment advisor has in abundance.[56] Compounding that issue is the fact that boards must rely on the investment advisor to furnish them with information about the fund's operations and performance because the directors themselves do not have their own full-time staff.[57] With this lack of expertise and knowledge, the board may not be able to effectively negotiate with the external investment advisor on behalf of the mutual fund and its investors.

Further, independent directors of funds that are within large fund complexes—meaning that the investment advisor manages a large number of additional funds—often serve on the board of many, if not all, of the complex's managed funds.[58] Compared to directors of traditional publicly traded corporations "who might sit on two or three boards (and at most six or seven boards), it is not unusual for fund directors to sit on the boards of twenty, fifty, or even more than one hundred funds."[59] While sitting on such a large number of boards with the same investment advisor means a large amount of compensation, those board members are technically not employees of the investment advisors and can maintain their disinterested title under the ICA.[60] Despite this uncertainty of how truly independent these disinterested directors are, they play a crucial role in the context of derivative shareholder litigation.[61]

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[53] *See, e.g.*, PETER J. WALLISON & ROBERT E. LITAN, COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS 21–22 (2007); Warburton, *supra* note 24, at 751–55; *see also* Northstar Fin. Advisors Inc. v. Schwab Invs., 779 F.3d 1036, 1061 (9th Cir. 2015) ("They are essentially puppets of the investment adviser.").

[54] Shipman, *supra* note 35.

[55] Camelia M. Kuhnen, *Business Networks, Corporate Governance, and Contracting in the Mutual Fund Industry*, 64 J. FIN. 2185, 2186 (2009).

[56] Warburton, *supra* note 24, at 751.

[57] *Id.*

[58] *Id.* at 751–52.

[59] Roiter, *supra* note 46, at 23–24 (footnote omitted).

[60] *See, e.g.*, Scalisi v. Fund Asset Mgmt., L.P., 380 F.3d 133, 136 (2d Cir. 2004).

[61] *See infra* Section II.B.

C. Leverage

Another important aspect of the ICA is the limitation on the amount of debt mutual funds can have, often referred to as "leverage." A corporation traded on a public exchange is free to take out as much debt as it is able to raise and as management feels is financially prudent. As of February 2016, the average debt-to-equity ratio—the measurement of the amount of debt a company uses to finance their assets—of the S&P 500 was 1.1.[62] By contrast, the ICA says that a mutual fund can only borrow funds from a bank, "[p]rovided, [t]hat immediately after any such borrowing there is an asset coverage of at least 300 per centum for all borrowings of such registered company."[63] Asset coverage is defined in the statute as "the ratio which the value of the total assets of [the fund], less all liabilities and indebtedness not represented by senior securities [including loans], bears to the aggregate amount of [loans] . . . representing indebtedness of such [fund]."[64] This means that for every $1 of loans that the mutual fund takes out, it should have at least $3 of assets less nondebt obligations. Despite this limitation, many funds go further in limiting the amount they can borrow.[65] Often, funds will "adopt a policy stating that they will borrow only as a temporary measure for extraordinary or emergency purposes and not to finance investment in securities."[66] These restrictions, either by the ICA or by the policies of the mutual funds themselves, mean that there are often few, if any, creditors of funds, creating a very simple capital structure within the fund. This is crucial when evaluating whether a suit should be brought derivatively or directly because a judge will not have to worry about protecting creditors in recovery of a direct action.

D. Investor Makeup and Lack of Institutional Voice

Another important distinction between mutual funds and typical publicly held corporations is their investor makeup. A majority of shareholders in mutual funds are individual investors.[67] In 2014, institutions made up only 11% of the

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[62] Nir Kaissar, *The Great Corporate Debt Scare*, BLOOMBERG (Feb. 8, 2016), https://www.bloomberg.com/gadfly/articles/2016-02-08/about-that-29-trillion-in-corporate-debt [https://perma.cc/9UBP-A2UQ].

[63] 15 U.S.C. § 80a-18(f)(1) (2012).

[64] *Id.* § 80a-18(h).

[65] 2015 INVESTMENT COMPANY FACT BOOK, *supra* note 20, at 262.

[66] *Id.*

[67] *Id.* at 29.

shareholders of mutual funds.[68] By contrast, institutional investors owned approximately 51% of the common stock of public companies, and "73 percent of the stock of the largest 1,000 U.S. corporations as of 2009."[69] The rise of the institutional investor in the past thirty years has been credited with an increase in shareholder activism in publicly held corporations.[70] This increase in activism is a result of institutional shareholders being more sophisticated than a typical individual shareholder and incurring a lower cost of activism.[71] Additionally, institutional shareholders are better able to justify activism than retail investors because "[a]s a shareholding gets larger, the ratio between (i) the cost of investing time and effort in activism and (ii) the potential benefit—that is, increasing the value of portfolio corporations—becomes smaller."[72]

In its most basic form, activism is being diligent in voting on all management and shareholder proposals, meaning "considering such proposals on their merits, rather than automatically voting with management."[73] While activist shareholders generally do not nominate their own directors for fear of insider trading, they may choose to vote to reject incumbent directors or withhold votes in their elections.[74] Withholding votes can be a powerful tool because it sends a clear message of dissatisfaction to management and helps "induc[e] governance changes.[75]

With a lack of institutional shareholders, mutual funds do not benefit from the de facto corporate governance from increased shareholder activism that comes with their presence. Individual retail shareholders are less likely to detect misbehavior because they may not possess the requisite level of sophistication to detect it.[76] The lack of policing by retail shareholders is evident in the lack of engagement in retail shareholder votes.[77] When investors in a company are majority retail investors, shares are more

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[68] *Id.*

[69] EISENBERG & COX, *supra* note 28, at 306.

[70] *Id.* at 301 ("This shift from relatively complete shareholder passivity to varying degrees of shareholder activism was precipitated by a dramatic increase in the percentage of stock held by institutional, as opposed to individual shareholders . . . .").

[71] *Id.* ("[A]s the level of a shareholder's sophistication increases, the cost of activism decreases.").

[72] *Id.*

[73] *Id.*

[74] *Id.* at 301–02 (quoting Marcel Kahan & Edward B. Rock, *The Insignificance of Proxy Access* 12–13, 26 (New York University Law & Econ., Working Paper No. 240, 2010)).

[75] *Id.*

[76] David J. Carter, *Mutual Fund Boards and Shareholder Action*, 3 VILL. J.L. & INV. MGMT. 6, 11 (2001–2002).

[77] *Id.* at 26 ("[M]utual fund shareholders, in general, participate in the voting process less often than shareholders of traditional corporations.").

dispersed and it is hard to get enough votes to accept or reject a proposal.[78] In regard to board members, while the ICA requires all directors be elected by shareholders in the funds,[79] in practice, mutual fund shareholders almost never reject candidates for the board of directors brought to them by the fund's investment advisor.[80] Additionally, if there is a vacancy on the board, the independent directors—who were selected by the investment advisor—nominate a candidate to fill the void, and shareholders almost always affirm that nomination. As discussed above in Section I.B, the independent directors who choose the new board member are often heavily affiliated with the investment advisor, perpetuating the lack of true independence on the board.[81]

II. DERIVATIVE VERSUS DIRECT ACTION

A shareholder derivative suit is a common law concept that allows a shareholder of a corporation to compel that organization to bring suit for harm done to the corporation.[82] In its most basic form, the principle difference between a derivative and direct action is that a derivative action "is brought on the corporation's behalf" while a direct action "is brought on a shareholder's own behalf."[83]

A. Tooley *Test and Rationale*

In *Tooley v. Donaldson,* the Delaware Supreme Court established the basic framework for deciding whether a

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[78] *Id.* at 26–27.

[79] 15 U.S.C. § 80a-16(a) (2012) ("No person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose; except that vacancies occurring between such meetings may be filled in any otherwise legal manner if immediately after filling any such vacancy at least two-thirds of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities of the company at such an annual or special meeting.").

[80] Carter, *supra* note 76, at 25.

[81] Richard M. Phillips, *Deregulation Under the Investment Company Act—A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors*, 37 BUS. LAW. 903, 909–10 (1982) ("The shareholder vote is nothing more than a ritualistic ratification of nominees selected either by the external manager or the incumbent independent directors."); Warburton, *supra* note 24, at 757 ("In the history of the Investment Company Act, critics observe that there have been virtually no shareholder attempts to elect nominees to the board in opposition to management nominees, or to ouster an incumbent director through a proxy fight.").

[82] Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 351 (Del. 1988) ("The common law countries have devised one of the most interesting and ingenious of accountability mechanisms for large formal organizations: the shareholder's derivative suit." (quoting ROBERT CHARLES CLARK, CORPORATE LAW 639 (1986))).

[83] EISENBERG & COX, *supra* note 28, at 1029.

shareholder should bring a suit directly or derivatively.[84] The *Tooley* court held that the two questions to ask when deciding how a suit may be brought are: "(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"[85] However, in its decision, the Delaware court recognized that in practice there exists considerable difficulty in giving a definitive answer to either of those questions.[86] Still, the court urged for them to be used as a general guideline in helping decide if a case should be brought derivatively or directly.[87]

Many policy reasons urge for the distinction between direct and derivative actions. The general idea behind the need for a derivative suit is that "a corporation is a legal person separate from its shareholders."[88] If a director or officer mismanages the corporation in a way that decreases its share price, that wrong is against the corporation and the corporation is entitled to bring forth the suit.[89] However, the proposition that any wrong to the corporation is not a wrong to the shareholder is questionable because any harm to the corporation must harm that corporation's shareholders as well.[90] This is especially true in the context of how a mutual fund's shares are valued, where any harm will *automatically* flow to the shareholders.[91]

Derivative suits are also important in that they protect creditors in the case of a recovery.[92] The idea is that not only shareholders but also creditors can be injured by wrongful acts to the corporation.[93] If a suit is brought derivatively, then the proceeds from that suit go directly to the corporation and the creditors benefit as well as the shareholders.[94] If the suit is brought directly, then the proceeds go to the shareholder who

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[84] Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035–36 (Del. 2004).

[85] *Id.* at 1033.

[86] *Id.* at 1036; *see also* Grimes v. Donald, 673 A.2d 1207, 1212 (Del. 1996) ("Courts have long recognized that the same set of facts can give rise both to a direct claim and a derivative claim.").

[87] *Tooley*, 845 A.2d at 1036.

[88] EISENBERG & COX, *supra* note 28, at 1029.

[89] Smith v. Bramwell, 31 P.2d 647, 648 (Or. 1934).

[90] EISENBERG & COX, *supra* note 28, at 1030.

[91] *See* 2015 INVESTMENT COMPANY FACT BOOK, *supra* note 20, at 257.

[92] George Wasserman & Janice Wasserman Goldsten Family LLC v. Kay, 14 A.3d 1193, 1207 (Md. Ct. Spec. App. 2011); Peterson v. Kennedy, 791 S.W.2d 459, 464 (Mo. Ct. App. 1990); Rosenfeld v. Rosenfeld, 648 S.E.2d 399, 403–04 (Ga. Ct. App. 2007); EISENBERG & COX, *supra* note 28, at 1030 (citing Watson v. Button, 235 F.2d 235, 237 (9th Cir. 1956)).

[93] *Peterson*, 791 S.W.2d at 464 (citing Schick v. Riemer, 263 S.W.2d 51, 54 (Mo. Ct. App. 1953)).

[94] *Id.*

brought suit, excluding the corporate creditor from any benefit.[95] In addition to the protection of corporate creditors, much of the support for derivative suits derives from their ability to prevent a multiplicity of lawsuits from individual shareholders; because the corporation must bring the suit, there will only be one.[96] Further derivative suits protect the interests of all shareholders, even those not party to a suit because the damages awarded go to the corporation, which in turn benefits all of its shareholders.[97]

B. The Demand Requirement and Other Procedural Hurdles

Another common reason cited for the need to bring suits derivatively is that such suits enable the board of directors to dictate the corporation's actions through the demand requirement. The demand requirement means that a shareholder must first make a formal demand upon the board of directors before bringing a derivative suit against a corporation.[98] All jurisdictions have such a requirement.[99] This demand is essentially the shareholder telling the board that they should compel the corporation to bring the suit itself.[100] In the context of a mutual fund, these suits are often in regard to fee disputes—where shareholders feel that the investment advisor got more than they should have—or for deviation from the prospectus—where the investment advisor invests in stock that is contrary to what the shareholders were promised they would invest in.[101]

The "'demand requirement' affords the directors an opportunity to exercise their reasonable business judgment and 'waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right.'"[102] In evaluating the demand, the board must decide if it wants to invest the corporation's time and resources in pursuing

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[95] *Id.*

[96] *Wasserman*, 14 A.3d at 1207.

[97] *See id.*

[98] Dennis J. Block et al., *Derivative Litigation: Current Law Versus the American Law Institute*, 48 BUS. LAW. 1443, 1451 (1993).

[99] *Id.*

[100] *See id.*

[101] *See, e.g.*, Northstar Fin. Advisors Inc. v. Schwab Invs., 779 F.3d 1036, 1036 (9th Cir. 2015); *In re* Salomon Smith Barney Mut. Fund Fees Litig., 528 F. Supp. 2d 332, 337 (S.D.N.Y. 2007).

[102] Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 532–33 (1984) (quoting Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903)); *see* RCM Sec. Fund, Inc. v. Stanton, 928 F.2d 1318, 1326 (2d Cir. 1991) ("Whether a corporation should bring a lawsuit is a business decision, and the directors are, under the laws of every state, responsible for the conduct of the corporation's business, including the decision to litigate." (internal citations omitted)).

a claim.[103] This additional investigation "enables corporate management to pursue alternative remedies,"[104] which in turn "serves the interests of judicial economy."[105] Further reasons for the demand requirement are to allow the courts to avoid making decisions of internal corporate governance and to allow boards to prevent suits that harass the company or suits that are considered "strike suits," meaning they are brought for the benefit of the individual shareholder instead of the corporation.[106]

When demand is given to the board of directors, it is normally reviewed by independent directors who have no interest in the underlying conduct of the claim.[107] In the case of a suit against an investment advisor of a mutual fund, this would likely be the "disinterested" board members as defined in the ICA.[108] If the independent directors accept the demand, that will end the shareholder's control of the litigation.[109] If the independent directors reject a demand brought by a shareholder of the corporation, the court will scrutinize any challenge to that decision under the "'business judgment rule' standard of review."[110] This approach is the law in every jurisdiction that has addressed this issue.[111] The business judgment rule is an extremely deferential standard; the court will only overturn the decisions of the board of directors if the shareholder proves more than mere negligence by the board in its decision.[112] In other words, the shareholder must show "gross negligence, bad-faith, or recklessness."[113] Given this difficult standard to overcome, "[m]any shareholders opt not to make a demand on the board of directors because the board often decides that the litigation is not in the best interests of the corporation and . . . a court is unlikely to alter the board's decision and disturb its business judgment."[114]

Delaware, Massachusetts, and Maryland each have differing standards for when demand is required. Under Delaware law, if a shareholder does not make a demand on the

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[103] Starrels v. First Nat'l Bank of Chi., 870 F.2d 1168, 1173 (7th Cir. 1989) (Easterbrook, J., concurring).

[104] Cramer v. Gen. Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978).

[105] Barr v. Wackman, 329 N.E.2d 180, 186 (N.Y. 1975).

[106] Marx v. Akers, 666 N.E.2d 1034, 1037 (N.Y. 1996).

[107] PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.04 (AM. LAW INST. 1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE].

[108] *See* Burks v. Lasker, 441 U.S. 471, 484–85 (1979).

[109] Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 101 (1991).

[110] *Id.*

[111] Block et al., *supra* note 98, at 1457–58.

[112] Kurt A. Goehre, *Is the Demand Requirement Obsolete? How the United Kingdom Modernized Its Shareholder Derivative Procedure and What the United States Can Learn from It*, 28 WIS. INT'L L.J. 140, 145–46 (2010–2011).

[113] *Id.*

[114] *Id.* at 146.

board and still wants to bring a derivative suit, he will have to allege with particularity why demand would have been futile.[115] To succeed on a claim of futility of demand in Delaware, the plaintiff must plead that particularized facts create a reasonable doubt that "the directors are disinterested and independent" or "the challenged transaction was otherwise the product of a valid exercise of business judgment."[116] By contrast, Massachusetts,[117] along with nineteen other states,[118] has statutorily adopted the universal demand requirement for derivative actions as advocated by the American Law Institute.[119] This rule states that demand must be made in all derivative suits and a plaintiff cannot file suit until ninety days elapses from the date of demand.[120] The only exception to this rule is if the plaintiff is able to show that the corporation will suffer irreparable injury if it is forced to wait the ninety days.[121]

Finally, Maryland falls somewhere in between Massachusetts and Delaware, allowing excuse for demand in the event of futility in only a narrow number of circumstances.[122] Courts in Maryland will find a futility exception to demand only if the complaint particularly demonstrates that either:

> (1) a demand, or a delay in awaiting a response to a demand, would cause irreparable harm to the corporation, or (2) a majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule.[123]

Given the lack of judicial scrutiny applied to board decisions to reject demand and the difficulty of proving demand futility (if it is allowed at all), the demand requirement proves to be an almost insurmountable procedural hurdle to bringing a derivative action in the context of mutual funds. Due to a mutual fund's board's strong ties to the investment advisor,[124]

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[115] DEL. SUPER. CT. R. CIV. P. 23.1(a).

[116] Brehm v. Eisner, 746 A.2d 244, 253 (Del. 2000) (citing Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)).

[117] MASS. GEN. LAWS ANN. ch. 156D, § 7.42 (West 2004).

[118] Goehre, *supra* note 112, at 147 n.52 (citing Seth Aronson et al., *Shareholder Derivative Actions: From Cradle to Grave*, *in* CORP. L. & PRAC. COURSE HANDBOOK SER.: SEC. LITIG. & ENFORCEMENT INST. 261, 289–92 (Practicing L. Inst. Sept.–Oct. 2008)); *see* MASS. GEN. LAWS ANN. ch. 156D, § 7.42.

[119] Marx v. Akers, 666 N.E.2d 1034, 1038 (N.Y. 1996); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 107, § 7.03.

[120] *Marx*, 666 N.E.2d at 1038.

[121] *Id.*

[122] *See* Werbowsky v. Collomb, 766 A.2d 123, 144 (Md. 2001).

[123] *Id.*

[124] *See supra* Section I.A.

they would likely reject the shareholder's demand and refuse to initiate a suit on behalf of the company. A shareholder could try to plead futility if the shareholder were in Delaware or Maryland, but it is highly unlikely that she can prove futility because the test in those states for challenging independence of boards is stronger than the criteria for independence required by the ICA.[125] Based on all these hurdles, a shareholder would likely prefer to bring the claim directly rather than derivatively.

C. *Exception for Closely Held Corporations*

The American Law Institute has proposed a separate rule for deciding when a shareholder suit must be brought directly or derivatively in the context of closely held corporations.[126] Section 7.01(d) of the Principles of Corporate Governance says:

> In the case of a closely held corporation . . . , the court in its discretion may treat an action raising derivative claims as a direct action, exempt it from those restrictions and defenses applicable only to derivative actions, and order an individual recovery, if it finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons.[127]

In this section, the ALI recognizes the reality that for certain suits the typical policy reasons outlined above are not present or are less substantial.[128] In the case of closely held corporations, the ALI suggests doing a case-by-case analysis to see if the normal policy considerations—mainly the three enumerated in Section 7.01(d)—that urge a suit to be brought derivatively apply to a particular case.[129] In addition, the comments to Section 7.01 say that the court should consider whether the corporation has a disinterested board that could evaluate the suit in making this determination.[130] The reasoning behind this rule is that in a closely held corporation, these

[125] *See* 15 U.S.C. § 80a-2(19) (2012).

[126] PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note, 107, § 7.01(d). The ALI defines a closely held corporation as "a corporation the equity securities . . . of which are owned by a small number of persons, and for which securities no active trading market exists." *Id.* § 1.06.

[127] *Id.* § 7.01(d).

[128] *Id.* § 7.01 cmt. e ("In some circumstances, the normal policy reasons for requiring a plaintiff to employ the form of the derivative action may not be present or will be less weighty, even though the action alleges in substance a corporate injury.").

[129] *Id.*

[130] *Id.*; *see also* Barth v. Barth, 659 N.E.2d 559, 562 (Ind. 1995) ("[T]he court in making its decision should consider whether the corporation has a disinterested board that should be permitted to consider the lawsuit's impact on the corporation.").

enumerated policy reasons for requiring suits to be brought derivatively usually do not exist.[131] As explained in Part IV, this same rationale can be applied to mutual funds in allowing exceptions to the derivative requirement. While Delaware has not adopted this exception,[132] more states are looking at closely held corporations differently and applying a case-by-case analysis to determine whether or not to allow shareholders to bring a direct suit instead of a derivative suit.[133]

III. *NORTHSTAR FINANCIAL ADVISORS V. SCHWAB INVESTMENTS*: FINDING AN EXCEPTION TO THE DERIVATIVE RULE

In *Northstar Financial Advisors v. Schwab Investments,* the Ninth Circuit found that a breach of fiduciary duty claim against a mutual fund's investment advisor that would normally need to be brought derivatively could be brought directly instead.[134] Organized under Massachusetts law, Schwab Investments was an investment trust that sponsored a series of mutual funds, including Schwab Total Bond Market Fund.[135] The trust selected Charles Schwab Investment Management, Inc. as its outside investment advisor for all funds.[136] Charles Schwab Investment Management, Inc. and Schwab Investments were essentially the same entity and held themselves out as such to investors.[137]

Schwab Total Market Fund issued prospectuses to potential investors stating that the fund's fundamental investment strategy was to track "'the performance of the Lehman Brothers [U.S.] Aggregate Bond Index' . . . and was 'intended for investors seeking to fill the fixed income component of their asset allocation plan.'"[138] Because this was a fundamental investment strategy, it could only be changed with approval by the majority of shareholders.[139] Further, "[t]he [f]und was also precluded from investing twenty-five percent or more of the [f]und's total assets in any one industry."[140] The fund subsequently deviated from these two stipulations in the fund prospectus without shareholder vote

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131 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 107, § 7.01 cmt. e.

132 Bagdon v. Bridgestone/Firestone, Inc., 916 F.2d 379, 384 (7th Cir. 1990) (noting that Delaware has not accepted this close corporation exception).

133 *See Barth*, 659 N.E.2d at 562.

134 Northstar Fin. Advisors Inc. v. Schwab Invs., 779 F.3d 1036, 1056–62 (9th Cir. 2015).

135 *Id.* at 1039.

136 *Id.* at 1041.

137 *Id.*

138 *Id.*

139 *Id.*

140 *Id.* at 1042.

and the investors brought a direct class action against the investment advisor.[141]

The investors brought a breach of fiduciary duty claim against Schwab directly and the court went through a lengthy analysis in finding that the claim could proceed and did not need to be brought derivatively.[142] The court first looked at the declaration of trust of the fund and found that it did not preclude direct suit.[143] Next, the court found that because the mutual fund was set up as a trust, that the trustee (the investment advisor) had a fiduciary responsibility to the beneficiaries of the trust (the shareholders).[144] The court then applied a test from a prior Ninth Circuit case, applying Massachusetts law that found that plaintiffs can bring a direct suit if the wrong involved the shareholders' "contractual rights, such as the right to vote."[145] The Ninth Circuit held that the registration statements and prospectuses which contained both the investment objective and the industry maximum percentage were both offers by the investment advisor to sell shares in the fund.[146] By purchasing the shares, investors were accepting that offer, creating a binding contract.[147] The court found that deviating from these agreed upon investment strategies constituted a breach of contract by Schwab.[148] Because the court found that Schwab breached its contract, the court was able to fit the suit into the exception and allowed the shareholders to bring it directly.[149]

The court could have ended its inquiry there and found that the claim could be brought directly because there was a breach of contract; the court then went on, however, to make sweeping statements that highlighted the features of mutual funds that may be reason to allow direct suits. The Ninth Circuit noted that while traditional corporations engage in a business, a mutual fund has "no business other than acquiring investment instruments . . . . [a]ny decrease in a mutual fund's share price flows directly and immediately to the shareholders."[150] This means that a mutual fund is merely a conduit for their shareholders to invest in a variety of investment instruments and the shares in mutual funds are simply a product of the value of those investment

141 *Id.* at 1039.
142 *Id.* at 1056–62.
143 *Id.* at 1057.
144 *Id.*
145 *Id.* (citing Lapidus v. Hecht, 232 F.3d 679, 683 (9th Cir. 2000)).
146 *Id.* at 1054.
147 *Id.*
148 *Id.* 1054–55.
149 *Id.* at 1057–58.
150 *Id.* at 1058.

instruments. Moreover, the court called into question the true independence of disinterested board members in evaluating a potential demand in a derivative suit, calling them "puppets of the investment adviser."[151] The court pointed to the very loose definition of independence within the ICA, noting that it allows even former employees of the investment advisor to be independent board members.[152] Because independent board members are tasked with evaluating derivative demands for suits against the investment advisor, the court was concerned the independent directors would remain loyal to the investment advisor instead of shareholders.[153]

While the court admonished derivative suits in the context of mutual funds, the court's finding of a contractual breach was central to its holding that the claim could proceed directly. One issue with the decision is that it did not clearly indicate whether its reasoning applies only to mutual funds set up as Massachusetts Trusts,[154] or whether it also applies to funds set up as Delaware trusts or Maryland corporations.[155]

The court likely looked at the structure of mutual funds and their boards and thought a plaintiff should not have to go through the procedural hurdles of bringing a derivative suit because the independent board members lacked true independence. But, because there is no case law that finds a mutual fund exception to the derivative suit requirement, the court was forced to squeeze the case into the existing Massachusetts common law concept of a contractual exception to the derivate action requirement.[156] While this is perhaps one way of dealing with derivative suits in the mutual fund context, it arguably cannot be applied to future cases that do not involve a mutual fund in violation of its fundamental investment objectives

[151] *Id.* at 1061 (The court also noted that definition of independent directors in the ICA is "fairly loose.").

[152] *Id.*

[153] *Id.* at 1061–62.

[154] A Massachusetts Trust "is an unincorporated business organization created by an instrument of trust by which property is to be held and managed by trustees for the benefit of persons who are or become the holders of the beneficial interests in the trust estate." *Id.* at 1039. It is primarily used as a means to escape certain liability that a normal corporation may be subject to. *Id.* at 1039 n.1 (quoting JESSE DUKEMINIER ET AL., WILLS, TRUSTS, AND ESTATES 555–56 (8th ed. 2009)).

[155] A majority of mutual funds are set up under Massachusetts, Delaware, or Maryland law. 2014 INVESTMENT COMPANY FACT BOOK, *supra* note 13, at 225. Under Massachusetts and Delaware law, mutual funds are typically set up as trusts, while under Maryland law the funds are set up as corporations. *Id.* at 225 fig.A.1.

[156] In the opinion, there are no citations to any case law in the discussion of mutual fund structures, but there was a previous Ninth Circuit opinion applying Massachusetts law that found a breach of contract exception to the derivative suit requirement. *See Northstar*, 779 F.3d at 1056–62.

as laid out in the fund prospectus of a fund complex set up as a Massachusetts Trust. For example, if shareholders felt that the investment advisor breached a fiduciary duty owed to the fund, those shareholders would not be able to rely on *Northstar*'s holding to avoid demand on the board, because there was no breach of the terms of the prospectus.

IV. A MUTUAL FUND EXCEPTION TO THE DERIVATIVE SUIT REQUIREMENT

A. How Other Courts Handle Mutual Fund Suits

The Ninth Circuit acknowledged the important differences between a mutual fund and normal corporations in *Northstar*.[157] This decision, however, is an outlier. More often courts will treat a mutual fund shareholder suit no differently than a shareholder suit against a traditional corporation. An example of this refusal to recognize the inherent differences in the two corporate forms can be found in *Scalisi v. Fund Asset Management*, where the plaintiff brought a derivative suit without making a demand on the board and claimed futility because the fund directors served on forty-nine additional mutual fund boards under the same sponsor, collecting between $160,000 and $260,000 in fees.[158] The court would not consider the uniqueness of mutual fund complexes and held that it must apply the very limited demand futility exception that Maryland courts apply to every corporation.[159] By refusing to consider the realities of the mutual fund industry, the court killed the plaintiffs' suit by forcing them to make a demand on the mutual fund's very interested independent board members.

This application of traditional corporate law to mutual funds also applies when a court is grappling with the derivative versus direct distinction.[160] In *In re Evergreen Mutual Funds Fee Litigation*, investors in a mutual fund brought a direct suit for breach of fiduciary duty against an investment advisor for engaging in a kickback scheme where the investment advisor

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[157] *Id.* at 1058–61.

[158] *See* Scalisi v. Fund Asset Mgmt., 380 F.3d 133, 136 (2d Cir. 2004).

[159] *Id.* at 138–42 (The court defined the futility exception as "a very limited exception, to be applied only when the allegations or evidence clearly demonstrate, in a very particular manner, either that (1) a demand, or a delay in awaiting a response to a demand, would cause irreparable harm to the corporation, or (2) a majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule." (footnote omitted) (quoting Werbowski v. Collomb, 766 A.2d 123, 144 (Md. 2001))).

[160] *In re* Evergreen Mut. Funds Fee Litig., 423 F. Supp. 2d 249, 260 (S.D.N.Y. 2006).

paid brokerage houses to push their funds to clients.[161] The plaintiff-shareholders attempted to argue the harm was borne directly to them independent of the harm to the fund.[162] The district court, applying Delaware law, rejected this argument and found that the traditional *Tooley* rule that is applied to all corporations needed to be applied to the mutual fund to determine if the claim could be brought directly or had to be brought derivatively.[163] In applying the *Tooley* test, the court concluded the harm was to the corporation,[164] and must be brought derivatively.[165] While this case is only binding in the Southern District of New York, this holding dictates that shareholders now have to make a demand to the mutual fund's "disinterested" board members and hope they ignore their strong ties to the investment advisor. This is an unfortunate result because the plaintiff was unable to get a remedy for the wrongful acts of the fund's investment advisor due to the court's unwillingness to recognize the unique characteristics of mutual funds.

The courts in Delaware, Massachusetts, and Maryland need to reevaluate treating mutual funds the same as traditional corporations. Under the current model, courts wishing to recognize the differences between the two types of entities are forced to do what the *Northstar* court did and squeeze mutual fund shareholder suits into various pre-established exceptions to the derivative suit requirement to allow them to be brought directly. Instead, states should allow courts to analyze case-by-case whether the standard policy reasons for needing to bring a suit derivatively apply as a test to decide if the suit can be brought directly.

B. A New Way to Consider Direct Suits

Similar to closely held corporations, the inherent characteristics of mutual funds require a separate test to determine if a suit can be brought directly. Unlike shareholders of traditional corporations with large powerful institutional investor bases,[166] shareholders of mutual funds must have a way to exert their own corporate governance control over the funds. As is the norm now, investment advisors do not have to worry about investor activism due to the lack of institutional shareholders.[167] Further,

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[161] *Id.* at 254.
[162] *Id.* at 261.
[163] *Id.* at 260–61.
[164] Even though the fund was set up as a trust. *Id.* at 253.
[165] *Id.* at 260–61.
[166] EISENBERG & COX, *supra* note 28, at 306.
[167] *Compare id.* at 301.

because a mutual fund's investment advisor typically collects fees as a percentage of total assets,[168] and increasing total assets does not lead to enhanced performance of a fund,[169] the investment adviser's interests are not always fully aligned with investors' interests. The investment advisor has more leeway to do what it pleases in the management of funds. It can issue proposals requiring shareholder approval, even if those proposals are not in the best interest of the shareholders, and know that the shareholders are likely to vote with management regardless.[170]

Even if a shareholder realizes the wrongdoing of an investment advisor, the shareholder will likely be forced to make a demand on the board if she wants to bring a suit for breach of fiduciary duty,[171] unless she can plead futility,[172] which is already a very steep hill to climb[173] and is unavailable in Massachusetts.[174] By forcing demand, "disinterested" members of the board will have an opportunity to evaluate the claim and choose whether to accept or reject it, with the court only reviewing that decision on a business judgment standard of review.[175] Of course, the people evaluating the claim are "independent" board members, who for the most part are deeply affiliated with the investment advisor.[176] Thus, the board is likely to reject any demand made upon it to bring suit derivatively, effectively killing the rightful claim of breach of fiduciary duty. This hypothetical situation highlights the types of problems that arise when courts force mutual fund investors to make their claims derivatively.

Similar to closely held corporations, shareholder litigation in the context of mutual funds "will often not implicate the principles which gave rise to the rule requiring derivative litigation."[177] The idea that a mutual fund "is a legal person separate from its shareholders"[178] is more dubious in the context of mutual funds then in the context of a normal corporation. Mutual funds have no employees[179] and primarily are just vehicles for shareholders to invest in a diversified portfolio of investments with all increases and decreases of those investments

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[168] Langevoort, *supra* note 39, at 1020.
[169] Chen et al., *supra* note 40, at 1279.
[170] *See* EISENBERG & COX, *supra* note 28, at 301–02.
[171] Block et al., *supra* note 98, at 1451.
[172] DEL. SUPER. CT. R. CIV. P. 23.1(a).
[173] *See supra* Section II.B.
[174] MASS. GEN. LAWS ANN. ch. 156D, § 7.42 (West 2004).
[175] PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 107, § 7.04.
[176] *See supra* Section II.B.
[177] Barth v. Barth, 659 N.E. 2d 559, 562 (Ind. 1995).
[178] EISENBERG & COX, *supra* note 28, at 1029.
[179] Warburton, *supra* note 24, at 748.

going directly to the shareholder, not the corporation.[180] Everything the fund's investment advisor does in relation to the fund will automatically flow directly to the shareholders, because no complicated variables affect share price.[181] Further, funds often have no creditors who would get left out of recovery because the ICA limits leverage in funds, and mutual funds normally self-regulate this in their own policies by explicitly prohibiting any debt.[182] Additionally, class actions can help avoid the likelihood of multiplicity of suits and protect the interests of all shareholders.[183] As stated in the comments of the ALI's Principles of Corporate Governance, "[i]n general, when a direct action is brought on behalf of the entire class of injured shareholders and the corporation's solvency is not in question, there is less reason to insist that the action be brought derivatively."[184]

Recognizing that it would be unfair to assume that every mutual fund shareholder suit follows the pattern laid out in the above hypothetical, judges should use a case-by-case analysis to determine whether to require a normally derivative suit to be brought directly. This test is substantially the same test that the ALI advocates for closely held corporations in the same context.[185] The court in its discretion should allow a direct suit in the context of mutual funds so long as the suit does not "(i) unfairly expose the [mutual fund] or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the [mutual fund], or (iii) interfere with a fair distribution of the recovery among all interested persons."[186] Further, as the comments in the Principles of Corporate Governance advocate, in evaluating the fair distribution prong of this test, a plaintiff should be required to give reasonable notice to interested persons of the impending class action suit.[187]

There should not be a per se exception to the derivative litigation requirement for mutual funds. The primary policy reasons—namely the three prongs above—for requiring a derivative suit may be present in specific mutual fund shareholder litigation, and thus, the claim should not be exempt. In addition to

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[180] *See* EISENBERG & COX, *supra* note 28, at 304.

[181] 2014 INVESTMENT COMPANY FACT BOOK, *supra* note 13, at 225.

[182] *Id.* at 262.

[183] Northstar Fin. Advisors v. Schwab Invs., 779 F.3d 1036, 1062 (9th Cir. 2015) (These concerns are "ameliorated by the very nature of class action, which is designed to avoid a multiplicity of suits by shareholders and which contain procedural mechanisms to ensure that all members of the class are treated equally.").

[184] PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 107, § 7.01 cmt. e, at 22.

[185] *Id.* § 7.01(d).

[186] *Id.*

[187] *Id.* § 7.01 cmt. e.

considering the three prongs, the judge should still have the discretion to decide whether to allow a suit directly. Judges should evaluate factors such as the true independence of the fund's board, the fund's investor makeup (retail versus institutional) and the degree of the fund's leverage in determining whether to allow a claim to be brought directly in any specific shareholder suit. The judge should ensure that the recovery of a direct suit will be equitable for all shareholders of the fund and that the fund will not be open to a multiplicity of suits if it invokes the exception. The judge must use his or her discretion, after evaluating everything, in allowing a direct suit.

Opponents of this proposal may argue—as the ICI argued in their *amici curiae* brief in *Northstar*—that by allowing direct suits, courts will undermine the important role that independent board members are supposed to play in corporate governance.[188] While this argument perhaps makes sense in the context of public corporations where the independence of a board can be more trusted, independent mutual fund directors should not be afforded the right to terminate shareholder suits. Their independence simply cannot always be trusted given that it is permissive for them to have strong ties to investment advisors and still qualify as independent under the ICA.[189]

CONCLUSION

Courts must be afforded flexibility to prevent "disinterested" directors from rejecting meritorious lawsuits. Mutual fund shareholders must have a way of exerting their own corporate governance on mutual fund investment advisors. The way the direct and derivative suit dichotomy is governed cannot be applied the same way to mutual funds as it is to traditional corporations. Allowing a case-by-case analysis will force investment advisors of mutual funds to be more careful in their affairs, as they will know they cannot hide behind the procedural hurdles of derivative suits. States adopting this new rule will be protecting the large number of citizens who invest their hard-earned money into mutual funds.

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[188] Brief of Amici Curiae Investment Co. Institute & Independent Directors Council, *supra* note 7, at 3–4.

[189] *See supra* Section I.B.

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