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# THE AFTERMATH OF THE MUTUAL FUND CRISIS

*Following on Government Investigations, Mutual Fund Shareholders Have Generated Waves of Litigation Challenging a Variety of Industry Practices. The Courts Are Responding with New Precedents on Implied Private Rights, Excessive Fees, Standing, Fraud-on-the-Market Theory, and Federal Preemption of Shareholders' State-Law Claims.*

By James N. Benedict, Sean M. Murphy & Andrew W. Robertson*

For decades, the mutual fund industry remained largely scandal-free, and mutual fund advisers experienced minimal litigation relative to other types of securities firms such as investment banks and broker-dealers. Despite managing close to $8 trillion in assets, mutual fund advisers historically faced only a handful of lawsuits each year. Beginning in 2003, however, the plaintiffs' bar set its sights on mutual funds, filing over five hundred private class actions and derivative suits against mutual fund advisers.

Two events combined to ignite the recent explosion in mutual fund litigation. First, the stock market bubble burst in March 2000, and many mutual funds began to suffer losses after generating double-digit returns for much of the 1990s. Second, beginning in September 2003, federal and state law enforcement authorities assailed the mutual fund industry, alleging that numerous funds had engaged in improper or illegal trading practices, known as "market timing" and "late trading." Those allegations led to widespread investigations and scrutiny by regulators, legislators, and the media into nearly every aspect of the mutual fund industry, including widely accepted practices such as revenue sharing, directed brokerage, and Rule 12b-1 fees. The plaintiffs' bar then entered the fray, filing a wide array of lawsuits that frequently parrotted the regulators' allegations of misconduct.

Although many of the recently filed lawsuits remain at the early stages of litigation, they already are generating important precedent for mutual fund litigation under the Investment Company Act of 1940 (the "ICA") and the securities laws generally. Some of the precedent clarifies or reaffirms long-standing issues in mutual fund litigation, such as the much-debated existence of implied private rights of action under the ICA and the factors courts must consider when evaluating claims for excessive advisory

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fees under Section 36(b). Other precedent relates to emerging issues in mutual fund litigation, such as the preemption of state-law claims under the Securities Litigation Uniform Standards Act ("SLUSA") and the availability of a presumption of reliance pursuant to the "efficient market" theory. After briefly describing the conduct challenged by the recently filed lawsuits, this article discusses the recent precedent the lawsuits have already generated for mutual fund litigation.

## I. RECENT SCRUTINY OF THE MUTUAL FUND INDUSTRY

The recent spate of mutual fund litigation challenges the following industry practices, some of which were once both widespread and widely accepted.

### A. Market Timing and Late Trading

On September 3, 2003, following an investigation, the New York Attorney General ("NYAG") Eliot Spitzer announced the settlement of a civil action involving Canary Capital Partners LLC ("Canary"), a New Jersey-based hedge fund. Spitzer alleged that four mutual fund managers permitted Canary to engage in late trading, an allegedly unlawful practice whereby Canary placed trades after the close of the U.S. stock markets at the closing price. Spitzer also alleged that Canary engaged in market timing, which allows investors to realize short-swing profits by exploiting inefficiencies in mutual fund pricing. While not illegal, market timing allegedly dilutes the value of the fund's shares to the detriment of long-term shareholders.

The NYAG's allegations of market timing and late trading implicated some of the best known fund families, including Bank of America, Bank One, Janus, and Strong. Following the announcement of the Canary settlement, several federal and state regulators initiated industry-wide investigations, and within eighteen months, over a dozen fund families and broker-dealers reached market-timing and late-trading settlements with regulators.

On the private litigation side, within a period of several months, plaintiffs filed over four hundred lawsuits in state and federal courts around the country alleging improper market timing and late trading in mutual funds. The lawsuits — which include both derivative actions on behalf of the funds at issue and class actions on behalf of individual fund shareholders — assert claims under the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act"), the Investment Advisers Act of 1940 (the "IAA"), the ICA, and common law. In February 2004, the Judicial Panel on Multi-District Litigation centralized all of the federal actions before four judges in the U.S. District Court for the District of Mary-


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land, with separate subtracks for each of the nineteen fund families involved. Subsequent to consolidation, plaintiffs amended their complaints to add as defendants several broker-dealers who allegedly market-timed the mutual funds on behalf of their clients.

On August 25, 2005, the court issued the first opinions on defendants' motions to dismiss.[1] Writing specifically with regard to the claims against defendants in the Janus subtrack, Judge Motz dismissed all of the derivative plaintiffs' claims because plaintiffs failed both to make pre-suit demand on the funds' boards of directors and to demonstrate that demand was excused as futile. Judge Motz also dismissed the majority of the class plaintiffs' claims, allowing only the claims under Section 10(b) and Rule 10b-5 of the Exchange Act and Sections 36(b) and 48(a) of the ICA to proceed to discovery.

### B. Excessive Management Fees

In November 2003, NYAG Spitzer, appearing before the U.S. Senate Banking, Housing, and Urban Affairs Committee, testified that his office's market-timing and late-trading investigations revealed "a systemic breakdown in mutual fund governance" and proposed measures designed to increase the board's independence from the adviser.[2] He suggested that the next logical step was to examine the "exorbitant fees" charged by fund advisers.[3]

Spitzer based his contention that mutual fund fees are "exorbitant" on a comparison between the advisory fees charged to institutional investors, such as pension plans, and the advisory fees charged to retail mutual fund investors. He testified that his office had determined that Putnam's retail mutual fund investors were being charged 40% more than institutional investors for essentially the same advisory services. In Spitzer's view, there is no reason retail mutual fund investors should pay more than institutional investors for services such as "core money management." Accordingly, he testified that mutual fund directors should be required to consider what institutional investors are charged for investment advisory services when evaluating the reasonableness of mutual fund advisory fees.

Following Spitzer's testimony, the plaintiffs' bar filed lawsuits against a dozen major fund families — including Franklin, Janus, MFS, and Putnam — alleging that their advisory fees were excessive in violation of Section 36(b) of the ICA because the advisory fees were higher than those paid by institutional investors and did not reflect economies of scale. Such lawsuits are a direct challenge to the well-established holding in *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*[4] and its progeny, discussed *infra*, which twenty years earlier rejected comparisons between fees paid by retail fund investors and institutional clients, at least in the money market fund context.

### C. Revenue Sharing and Directed Brokerage

State and federal regulators recently began challenging the long-standing practice of revenue sharing. Revenue sharing is an arrangement pursuant to which a mutual fund family agrees to pay a broker-dealer fees in addition to ordinary sales commissions in return for certain marketing benefits from the broker-dealer. These payments can either be made from the adviser's own assets or by using the fund's assets. For example, until the practice was prohibited by the SEC,[5] many fund families made revenue-sharing payments to broker-dealers using directed brokerage — that is, by directing their funds to execute portfolio transactions through specified broker-dealers who sold fund shares.

Since November 2003, state and federal regulators — including the SEC, the NASD, the NYSE, California Attorney General Bill Lockyer, and the New Hampshire

1. *See In re Mutual Funds Inv. Litig.* (*In re Janus Subtrack Investor Class Opinion*), No. 04-MD-15863, 2005 WL 2045800 (D. Md. Aug. 25, 2005) ("*Market Timing Class Opinion*"); *In re Mutual Funds Inv. Litig.* (*In re Janus Subtrack Fund Derivative Opinion*), No. 04-MD-15863, 2005 WL 2045801 (D. Md. Aug. 25, 2005) ("*Market Timing Derivative Opinion*").
2. *See* Testimony of Attorney General Eliot Spitzer Before the United States Senate Banking, Housing, and Urban Affairs Committee (Nov. 20, 2003).
3. Spitzer's theory that mutual fund fees are "exorbitant" is reflected in the NYAG's December 2003 settlement of market-timing and late-trading charges against Alliance Capital, which required a 20% reduction in Alliance Capital's fees each year for five years. *See* Press Release, NYAG, Alliance Agreement Includes New Form of Relief for Shareholders (Dec. 18, 2003).
4. 694 F.2d 923 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983). *Accord Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321 (4th Cir. 2001); *Krantz v. Prudential Invs. Fund Mgmt. LLC*, 305 F.3d 140 (3d Cir. 2002).
5. *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, 69 Fed. Reg. 54728 (Sept. 9, 2004).

Bureau of Securities Regulation — have brought enforcement actions against six mutual fund families[6] and over a dozen broker-dealers based on the firms' revenue-sharing and directed-brokerage practices. The vast majority of the enforcement actions have been settled.

As with the other regulatory investigations into mutual fund practices, the investigations into revenue sharing and directed brokerage prompted numerous private lawsuits. In 2004, plaintiffs filed class actions against over two dozen fund families, including AIM/Invesco, Bank of America, Federated, MFS, Morgan Stanley, and Scudder Investments, challenging their distribution practices. The complaints typically assert causes of action under Sections 34(b) and 36(b) of the ICA, Sections 206 and 215 of the IAA, and state law based on the alleged receipt of excessive fees and the failure to adequately disclose revenue-sharing and directed-brokerage practices. The first round of court decisions on defendants' motions to dismiss have just recently been decided.

### D. Class A vs. Class B Shares

Regulators recently have also begun to scrutinize broker-dealers' and mutual funds' practices with regard to sales of Class A and Class B shares. Whereas Class A shares typically require an up-front sales charge and have lower on-going expenses, Class B shares do not require an up-front sales charge and have higher annual expenses. Regulators have investigated (1) whether fund disclosures adequately explain the differences between Class A and Class B shares and (2) whether broker-dealers and funds have directed investors to Class B shares — on which the distributor typically receives a higher commission — even though large purchases of Class A shares may result in lower overall fees to the investor because of breakpoint discounts on sales charges. Regulators have settled enforcement actions against several firms — including Morgan Stanley, Prudential Securities, and Citigroup Global Markets — based on allegedly improper sales and disclosure practices regarding Class A and Class B shares.[7]

Following the regulators' investigations, plaintiffs filed a number of shareholder class actions alleging improper sales practices with regard to Class A and Class B shares. For example, in *Benzon v. Morgan Stanley*,[8] plaintiffs asserted claims under the Securities Act, the Exchange Act, and common law based on the funds' alleged failure to adequately disclose the relative benefits of purchasing Class A and Class B shares. The court, however, granted the defendants' motion to dismiss the action based on its determination that the funds' prospectuses adequately disclosed the underlying factual information so as to enable investors to determine the best investment option for themselves.

### E. Rule 12b-1 Fees Charged on Funds Closed to New Investors

Since its adoption by the SEC in 1980, ICA Rule 12b-1 has allowed mutual funds, under certain conditions, to use their assets to pay distribution charges to facilitate overall sales of fund shares. In August 2003, an article was published discussing the debate over funds paying Rule 12b-1 marketing fees even though the funds were closed to new investors.[9] Critics contend that, if a fund is closed to new investors, there is no reason to charge a distribution or sales fee.

Following publication of the article, plaintiffs filed a number of lawsuits against AIM/Invesco, Dreyfus, Eaton Vance, and others. The suits complain that there is no reasonable basis for the payment of distribution fees for closed funds because the actual distribution costs are *de minimis* and there is no likelihood that the continued payment of distribution fees will benefit the funds or their shareholders. Thus, plaintiffs allege, the Rule 12b-1 fees are excessive in violation of Section 36(b).

In one such suit, plaintiffs withdrew their claims after defendants' in-court presentation explaining that Rule 12b-1 fees reimburse the distributor for sales commissions that the distributor advances to brokers and other inter-

6. To date, the Alliance Capital, American Funds, Franklin, MFS, PIMCO, and Putnam fund families have been named in one or more enforcement actions based on their revenue-sharing and directed-brokerage practices.
7. *See*, *e.g.*, *In re Citigroup Global Mkts., Inc.*, Rel. No. 33-8557 (Mar. 23, 2005); *In re Morgan Stanley DW Inc.*, Rel. No. 33-8339 (Nov. 17, 2003); *In re Prudential Sec., Inc.*, Rel. No. 34-48149 (July 10, 2003).
8. No. 3:03-0159, 2004 WL 62747 (M.D. Tenn. Jan. 8, 2004), *aff'd*, No. 04-5230, 2005 WL 2000927 (6th Cir. Aug. 22, 2005).
9. *See* Joe Morris, *Shuttered Funds Continue to Levy 12b-1s* (Aug. 5, 2003), *available at www.ignites.com*; *see also* Alison Sahoo, *12b-1 Fees Fall on Industry Reform Agenda* (Dec. 2, 2003), *available at www.ignites.com*.

mediaries who sell fund shares.[10] Since it generally takes six years for the distributor to recoup through the receipt of Rule 12b-1 fees the amounts it has advanced for commissions, the distributor arguably is entitled to continue to receive those payments even after the fund closes to new investors. In addition, Rule 12b-1 fees support shareholder servicing activities critical for a fund to maintain its size, even after it has been closed to new investors.

### F. Failure to Participate in Class Action Settlements

In January 2005, the same plaintiffs' counsel filed over forty class actions against more than forty different mutual fund advisers in various federal courts across the nation claiming that the advisers breached their fiduciary duties by allegedly failing to ensure that the mutual funds they managed participated in securities class action settlements. The virtually identical complaints asserted claims under Sections 36(a) and 36(b) of the ICA and common law based on the advisers' alleged failure to submit proof of claim forms on behalf of the funds in over 150 different settlements. According to plaintiffs, participating in the settlements would have increased the total assets held by the funds, and the increase would have been allocated to the then-current investors.[11]

Plaintiffs' counsel voluntarily dismissed more than two dozen of the actions after being presented with evidence that there was no factual basis to support the claims.[12] Additionally, defendants in many of the actions submitted motions to dismiss, and decisions on the motions are beginning to appear.

### G. Portfolio Selection

A number of private lawsuits have been filed against investment advisers challenging their selection of securities for investment in the fund's portfolio. For example, in *Benak v. Alliance Capital Mgmt. L.P.*,[13] shareholders in the Alliance Premier Growth Fund alleged that the fund's adviser failed to conduct fundamental research and failed to follow its stated investment process when it invested the fund's assets in Enron securities, thus allegedly breaching its fiduciary duties under Sections 36(a) and 36(b) of the ICA. Likewise, in *In re Merrill Lynch Focus Twenty Fund Inv. Co. Act Litig.*,[14] shareholders in the Merrill Lynch Focus Twenty Fund brought similar claims under Section 36(a) of the ICA and common law, alleging that the fund's adviser breached its fiduciary duties and was negligent because it caused the fund to invest in Enron securities.

## II. NEW LEGAL PRECEDENT FOR MUTUAL FUND LITIGATION

Although they remain largely at the early stages of litigation, the recently filed lawsuits have already generated some important precedent involving, among others, the following issues in mutual fund litigation.

### A. Implied Private Rights of Action

When originally enacted in 1940, the ICA did not expressly provide investors with any private rights of action. In 1970, responding to a perceived problem of excessive investment advisory fees, Congress amended the ICA to add Section 36(b), which expressly creates a private right of action for investors against investment advisers for breach of fiduciary duty with respect to the receipt of compensation. Congress did not create in 1970 an express private right of action under any section of the ICA other than Section 36(b). Nevertheless, for three decades, district and circuit courts alike routinely implied private rights of action under various sections of the ICA, typically relying on selected excerpts of legislative history that indicate that Congress intended for the ICA to benefit fund investors.[15]

Recently, however, district and circuit courts have rejected the practice of implying private rights of action under the ICA. The winds began to change with the U.S.

10. *See Pfeiffer v. Dreyfus Corp.*, No. 03 Civ. 9740 (DLC) (S.D.N.Y. Dec. 9, 2003); Press Release, Mellon Financial Corp., Class Action Lawsuit Against Dreyfus Voluntarily Dismissed (June 16, 2004); *see also 1NG Principal Prot. Funds Derivative Litig.*, 369 F. Supp. 2d 163 (D. Mass. 2005) .
11. *See*, *e.g.*, Complaint, *Arturo v. Ackerman*, No. 05 10038 (D. Mass. Jan. 10, 2005).
12. *See*, *e.g.*, *Hoppe v. Brown*, No. 05-0048-CV-W-ODS (W.D. Mo. Jan. 28, 2005) (ordered by the court Jan. 31, 2005).
13. No. Civ.A. 01-5734, 2004 WL 1459249 (D.N.J. Feb. 9, 2004); *see also Benak v. Alliance Capital Mgmt. L.P.*, No. 01-CV-573 (JLL), 2005 WL 1285652 (D.N.J. May 23, 2005) (companion case).
14. 218 F.R.D. 377 (E.D.N.Y. 2003), *aff'd sub nom. Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133 (2d Cir. 2004).
15. For a comprehensive discussion of implied rights of action under the ICA, see Benedict, Kornfeld, & Swift, *Implied Rights of Action Under the Investment Company Act of 1940*, Rev. of Sec. & Commodities Reg., Vol. 30, No. 19 (1997).

Supreme Court's decision in *Alexander v. Sandoval*.[16] Although *Sandoval* did not deal with the ICA, it provided lower courts with important guidance as to how to determine whether a private right of action to enforce a federal statute should be implied. The Court began by stating that "[l]ike substantive federal law itself, private rights of action to enforce federal law must be created by Congress," and that "[t]he judicial task is to interpret the statute Congress has passed to determine whether it displays an intent to create not just a private right but also a private remedy."[17] The Court explained, "Statutory intent on this latter point is determinative," because "[w]ithout it, a cause of action does not exist and courts may not create one, no matter how desirable that might be as a policy matter, or how compatible with the statute."[18] The Court acknowledged prior precedent that suggested that it could imply private rights of action "as . . . necessary to make effective the congressional purpose expressed by [the] statute," but it rejected such precedent as belonging to an "*ancien regime*."[19] Instead, the Court began and ended its inquiry with the structure and the text of the relevant statute. Finding no evidence in the statute that Congress intended to create a private right of action, the Court refused to imply one.

Following the Court's lead in *Sandoval*, the Second Circuit, in *Olmsted v. Pruco Life Ins. Co.*,[20] determined that no implied private rights of action exist under Sections 26(f) and 27(i) of the ICA because the structure and text of the statute reveal no congressional intent to create private rights of action to enforce those sections. *Olmsted* is the first case in which a U.S. Court of Appeals has refused to find an implied private right of action under the ICA.

In *Olmsted*, plaintiffs invested in variable annuity contracts that combined both insurance and investment features, enabling contract holders to allocate a portion of their purchase payments to separate accounts that invested in shares of specified mutual funds. Plaintiffs alleged that virtually all of the fees collected in connection with the contracts represented profit to defendants, and thus those fees were excessive and unreasonable in light of the benefits provided. Accordingly, plaintiffs claimed that defendants violated Sections 26(f) and 27(i) of the ICA, which prohibit the sale of variable insurance contracts unless the fees and charges deducted under the contracts are, in the aggregate, "reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company."[21]

The Second Circuit began its analysis with the rule distilled in *Sandoval* that legislative intent is "determinative" of whether a private right of action exists for violation of a federal statute. It found that no such rights exist under Sections 26(f) and 27(i) and affirmed the district court's dismissal of the action. In so doing, the court first observed that the ICA does not create an explicit private right of action to enforce Sections 26(f) and 27(i), which leads to a presumption that Congress did not intend to create one. It then noted three facts that bolstered this presumption: (1) the sections do not contain "rights-creating language;" (2) Section 42 of the ICA provides for enforcement of all ICA provisions by the SEC, but not by private litigants; and (3) Congress's provision of an express right of action under Section 36(b) of the ICA suggests the intentional omission of a private right to enforce the other sections. The court rejected plaintiffs' arguments that private rights of action are supported by the ICA's legislative history and that private rights of action are necessary because Congress did not adequately fund the SEC to enforce the ICA.

The Second Circuit acknowledged that its decision represented a significant break from the long-standing practice of an "overwhelming majority of courts" to find implied private rights of action under the ICA. It found this break to be compelled by recent Supreme Court decisions, such as *Sandoval*, which eliminated courts' discretion to imply private rights of action for policy reasons. It characterized those older decisions as part of an "*ancien regime*" and made clear that legislative intent is now "determinative" of the existence of private rights of action.

In its most recent term, the U.S. Supreme Court further strengthened the argument that no private rights of action exist under the ICA with its decision in *Exxon Mobil*

16. 532 U.S. 275 (2001) (holding that no private right of action exists under disparate-impact regulations promulgated under Section 602 of Title VI of the Civil Rights Act of 1964).
17. *Id.* at 286 (citation omitted).
18. *Id.* at 286-87 (citations omitted).
19. *Id.* at 287 (internal quotes omitted).
20. 283 F.3d 429 (2d Cir. 2002), *aff'g* 134 F. Supp. 2d 508 (E.D.N.Y. 2000).

21. 15 U.S.C. §§ 80a-26(f), 80a-27(i).

*Corp. v. Allapattah Servs., Inc.*[22] Although *Exxon Mobil*, like *Sandoval*, does not involve the ICA, it provides important guidance as to when a court should consider expressions of congressional intent in a statute's legislative history, holding that courts should not consider such material when the language of the statute is unambiguous. The issue before the Court was whether a federal court can exercise supplemental jurisdiction pursuant to 28 U.S.C. § 1367 over a plaintiff whose claims do not satisfy the amount-in-controversy requirement of 28 U.S.C. § 1332. The parties presented arguments based on statements in the legislative history that suggested that Congress did not intend for supplemental jurisdiction to extend to plaintiffs whose claims do not satisfy the amount-in-controversy requirement. The Court held that it would be inappropriate to consider this legislative history because the language of Section 1367 unambiguously encompasses such plaintiffs, noting: "[T]he authoritative statement is the statutory text, not the legislative history or any other extrinsic material. Extrinsic materials have a role in statutory interpretation only to the extent they shed a reliable light on the enacting Legislature's understanding of otherwise ambiguous terms."[23]

Two recent decisions in the settlement participation class actions, *Dull v. Arch*[24] and *Jacobs v. Bremner*,[25] apply *Exxon Mobil*'s holding to Section 36(a) of the ICA, and conclude that "[a]fter *Exxon Mobil*, there is simply no room to imply a private right of action under Section 36(a)."[26] In both cases, plaintiffs argued that, although Section 36(a) specifically provides for enforcement by the SEC but not by private plaintiffs, the court should nonetheless imply a private right of action based on selected excerpts of the ICA's legislative history. Following *Exxon Mobil*, these two courts refused to consider the legislative history because the unambiguous statutory text of Section 36(a) does not create a private right of action: "*Exxon Mobil* forecloses any possibility of using Section 36(a)'s . . . legislative history to create a private right of action where the unambiguous statutory language creates none."[27]

22. 125 S. Ct. 2611, 2625-27 (2005).
23. *Id.* at 2626.
24. No. 05 C 140, 2005 WL 1799270, at *2-*3 (N.D. Ill. July 27, 2005).
25. No. 05 C 143, 2005 WL 1719307, at *2-*5 (N.D. Ill. July 20, 2005).
26. *Id.* at *5.
27. *Id. See also Dull*, 2005 WL 1799270, at *3 ("Because the statute is unambiguous, the Court need not look to the legislative history.").

Accordingly, the courts determined that there is no private right of action under Section 36(a) and dismissed plaintiffs' claims.

Even before the Court's decision in *Exxon Mobil*, however, courts had begun to refuse to imply private rights of action under various sections of the ICA based on *Sandoval* and *Olmsted*. Indeed, since *Olmsted*, there have been more than a dozen different decisions to consider the issue of whether an implied private right of action exists under the ICA. In each and every one of those decisions, the courts have found that no implied right of action exists.

For example, in *Market Timing Class Opinion*,[28] plaintiffs brought claims under Sections 34(b) and 36(a) based on their allegations that defendants (1) breached their fiduciary duties by allowing certain investors to engage in late trading and market timing and (2) misled investors by failing to disclose the allegedly impermissible trading activity. The court refused to rely on pre-*Sandoval* cases that implied private rights of action under the ICA based on selected excerpts of the statute's legislative history because those cases relied on the "*ancien regime*" and "under the *regime actuel*":

> [t]he text of a statute is the focus of the inquiry . . . and such extraneous factors as isolated bits of legislative history, the expectations that the enacting Congress had formed in light of the contemporary legal context, and interpretations given by one Congress to the enactments of another, no longer carry the day.[29]

Instead, the court "join[ed] in the opinions of other courts that have considered the issue after *Sandoval* and h[eld] that the unambiguous language of Sections 34(b) and 36(a) makes clear that no private right of action exists under either statute."[30]

Similarly, in *In re Eaton Vance Mutual Funds Fee Litig.*,[31] plaintiffs alleged that the advisers, trustees, and affiliates of the Eaton Vance mutual fund family breached

28. No. 04-MD-15863, 2005 WL 2045800, at *12-*14 (D. Md. Aug. 25, 2005).
29. *Id.* at *14 (internal quotes omitted).
30. *Id.*
31. No. 04 CV 1144 (JGK), 2005 WL 1813001, at *7-*9 (S.D.N.Y. July 29, 2005).

their fiduciary duties by charging improper marketing fees and by using fund assets to make soft-dollar and revenue-sharing payments to broker-dealers. Plaintiffs further alleged that the defendants misled investors by failing to disclose these allegedly impermissible practices. In determining that no private rights of action exist to enforce Sections 34(b), 36(a), and 48(a), the court considered the following four factors from *Olmsted*: (1) none of the sections explicitly provides for a private right of action; (2) the sections do not include "rights creating language;" (3) Section 42 provides for SEC enforcement of the sections; and (4) Section 36(b) explicitly creates a private right of action to enforce that section. Accordingly, the court dismissed plaintiffs' claims because "[t]he reasoning of *Olmsted* dictates that there is no private right of action under Sections 34(b), 36(a), and 48(a)."[32]

In two other recent decisions, *Mutchka v. Harris*[33] and *Chamberlain v. Aberdeen Asset Mgmt. Ltd.*,[34] both courts determined that Congress did not intend to create a private right of action in Section 36(a). The court in *Mutchka* found "particularly instructive" the fact that Congress created an express right of action in Section 36(b), but not in Section 36(a): "'Congress's explicit provision of a private right of action to enforce one section of a statute suggests that omission of an explicit private right to enforce other sections was intentional.'"[35]

In *DH2, Inc. v. Athanassiades*,[36] plaintiff, a corporation that invested in mutual funds, variable annuities, and other investment instruments, alleged that defendants intentionally undercut plaintiff's trading strategy by (1) altering the methodology by which their funds calculated their net asset value and (2) failing to disclose the details of the new methodology. This, plaintiff claimed, amounted to price manipulation under Section 17(j) of the ICA. Finding that the Second Circuit's reasoning in *Olmsted* "applie[d] with equal force to Section 17(j)," the court held that there is no implied private right of action under that section and dismissed plaintiff's claims.

Several other courts have also held that there are no implied private rights of action under the ICA.[37] Indeed, since *Olmsted*, every court to have considered the issue of implied private rights under the ICA has declined to find that such rights exist.

### *B. Pure Excessive Fee Cases Under Section 36(b)*

In the 1970s and early 1980s, mutual fund shareholders filed dozens of different cases under Section 36(b) of the ICA alleging that investment advisers had received excessive management fees.[38] In the 1990s, however, plaintiffs increasingly availed themselves of the courts' willingness to imply private rights of action under other sections of the ICA and began to bring other types of claims.[39] For example, plaintiffs frequently attacked various types of transactions and relationships as breaches of general fiduciary duties in violation of Section 36(a) — an attempt to federalize common law breach of fiduciary duty claims. As courts have grown more skeptical of implied rights under the ICA in the post-*Sandoval* era, and prompted by recent criticism by NYAG Spitzer and others that mutual fund fees are unreasonably high, plaintiffs have now refocused their efforts on excessive fee claims under Section 36(b). Recent decisions in the latest round of excessive fee cases reaffirm that such claims are governed by the "disproportionality" standard articulated in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*,[40] but they are split on exactly what plaintiffs must allege in order to survive a motion to dismiss.

32. *Id.* at *9. *See also In re Lord Abbett Mutual Funds Fee Litig.*, No. 04-CV-0559 (WJM), 2005 WL 2090517, at *13-*16 (D.N.J. Aug. 30, 2005) (applying a nearly identical analysis and finding no implied rights of action under Sections 34(b) and 36(a)); *In re Franklin Mutual Funds Excessive Fee Litig.*, No. 04-CV-982 (WJM), 2005 WL 2175950, at *10-*13 (D.N.J. Sept. 9, 2005) (same).
33. 373 F. Supp. 2d 1021 (C.D. Cal. 2005).
34. No. 02-CV-5870 (SJ), 2005 WL 195520 (E.D.N.Y. Jan. 21, 2005), *vacated solely for purposes of settlement*, No. 02-CV-5870 (SJ), 2005 WL 1378757, at *1 (E.D.N.Y. Apr. 12, 2005).
35. 373 F. Supp. 2d at 1026-27 (quoting *Olmsted*, 283 F.3d at 433).
36. 359 F. Supp. 2d 708, 714-15 (N.D. Ill. 2005).
37. *See In re Van Wagoner Funds, Inc.*, No. C 02-3383 JSW, 2004 WL 2623972 (N.D. Cal. July 27, 2004) (Section 34(b)); *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243 (S.D.N.Y. 2003) (same); *meVC Draper Fisher Jurveston Fund I, Inc. v. Millennium Partners, L.P.*, 260 F. Supp. 2d 616 (S.D.N.Y. 2003) (Section 12(d)(1)); *White v. Heartland High-Yield Mun. Bond Fund*, 237 F. Supp. 2d 982 (E.D. Wis. 2002) (Sections 22 and 34(b)).
38. *See* Rogers & Benedict, *Money Market Fund Management Fees: How Much Is Too Much?*, 57 N.Y.U. L. Rev. 1059, 1061 n.3 (1982) (collecting cases).
39. *See generally* Benedict, Moyle, & Murphy, *Recent Trends in Litigation Under the Investment Company Act of 1940*, Rev. of Sec. & Commodities Reg., Vol. 32, No. 15 (1999).
40. 694 F.2d 923 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983).

In *Gartenberg*, the seminal case on Section 36(b), two shareholders of the Merrill Lynch Ready Assets Trust money market fund brought a derivative action attacking the fees paid to the adviser as excessive. Because advisory fees are calculated as a percentage of a fund's asset size, plaintiffs claimed that the adviser's fee unfairly increased with the fund's dramatic growth in assets and that the fee arrangement improperly failed to pass on to investors perceived economies of scale.

Affirming the district court's dismissal of the action, the Second Circuit held that plaintiffs had failed to meet their burden of proving that the fees charged by the adviser were so excessive or unfair as to amount to a breach of fiduciary duty within the meaning of Section 36(b). The court found that to give rise to a violation under Section 36(b), the fee must be "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[41] The court identified six factors to be considered in evaluating a claim for excessive fees: (1) the nature and quality of the services provided to fund shareholders; (2) the profitability of the fund to the adviser-manager; (3) economies of scale of operating the fund as it grows larger; (4) comparative fee structures; (5) fallout benefits — *i.e.*, indirect profits to the adviser and its affiliates attributable in some way to the existence of the fund — and (6) the independence and conscientiousness of the fund's directors.

Recent decisions have consistently reaffirmed that *Gartenberg* applies when the plaintiff's Section 36(b) claim is based purely on allegations that the advisory fees were "excessive" (i.e., that the adviser earned too much). These courts have uniformly held that a plaintiff challenging the fees as excessive must allege facts indicating that the fees were "so disproportionately large that [they] bear no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." For example, in *Eaton Vance*[42] the court held that plaintiffs failed to state a claim under Section 36(b) because they alleged "no specific facts that would provide a factual basis for an allegation that the fees were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining," as required by *Gartenberg*.[43]

Similarly, in *Yampolsky v. Morgan Stanley Inv. Advisers Inc.*,[44] the court concluded that plaintiffs' complaint "rel[ied] heavily on generalities about deficiencies in the securities industry, and statements made by industry critics and insiders," but contained no factual allegations "as to the actual fee negotiations or management and distribution services rendered by these defendants."[45] Because the complaint did not, "in sum or substance, indicate how or why the fees are 'so disproportionately large that [they] bear[] no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining,'" the court granted defendants' motion to dismiss.[46]

While these recent cases confirm that *Gartenberg* is still the governing law when it comes to claims of pure excessive fees, courts have struggled with what *Gartenberg* requires at the pleading stage. Certain courts have required that plaintiffs specifically plead facts supporting each of the six *Gartenberg* factors in order to survive a motion to dismiss. For example, in *Benak*,[47] the court granted defendant's motion to dismiss because plaintiff failed to allege facts supporting the six *Gartenberg* factors. The court held that plaintiff's excessive fee claims, which were based on the fund's unprofitable investments in Enron securities, satisfied at best only one of the *Gartenberg* factors — namely, "the nature and quality of services provided to fund shareholders." Because plaintiff failed to adequately plead facts in support of the remaining five *Gartenberg* factors, the court granted Alliance Capital's motion to dismiss.

Other courts, while still embracing *Gartenberg*'s disproportionality standard, have rejected the argument that

41. *Id.* at 928.
42. No. 04 CV 1144 (JGK), 2005 WL 1813001 (S.D.N.Y. July 29, 2005).
43. *Id.* at *13 (internal quotes omitted).
44. No. 03 Civ. 5710 (RO), 03 Civ. 5896 (RO), 2004 WL 1065533 (S.D.N.Y. May 12, 2004).
45. *Id.* at *2 (emphasis removed).
46. *Id.* (quoting *Gartenberg*, 694 F.2d at 928). Other courts have similarly reaffirmed that excessive fee claims must be evaluated pursuant to the *Gartenberg* standard but have denied defendants' motions to dismiss because plaintiffs adequately alleged facts supporting *Gartenberg*'s disproportionality standard. *See, e.g.*, *Strigliabotti v. Franklin Resources, Inc.*, No. C 04-00883 SI, 2005 WL 645529 (N.D. Cal. Mar. 7, 2005); *Gallus v. Am. Express Fin. Corp.*, 370 F. Supp. 2d 862 (D. Minn. 2005).
47. No. Civ.A. 01-5734, 2004 WL 1459249 (D.N.J. Feb. 9, 2004).

plaintiffs must specifically address each of the *Gartenberg* factors in order to survive a motion to dismiss. For example, in *ING Principal Prot. Funds Derivative Litig.*,[48] the court held that "plaintiff's failure to plead [the six *Gartenberg*] factors is not itself grounds for dismissal."[49] The court nonetheless dismissed one of plaintiffs' claims because it did not contain "a short and plain statement showing that the fee charged is so large that it bears no reasonable relationship to the relevant services actually provided."[50] Plaintiffs there alleged that the distribution fees charged during periods when the relevant funds were closed to new investors exceeded the distributor's expenses during such periods and that the service fees charged to investors were excessive.[51] With regard to the distribution fees, the court dismissed the claim because plaintiffs did not allege any facts supporting the allegation that "the distribution fees [were] disproportionate and unrelated to the sales-related services actually provided when shares of the funds were marketed and sold to the general public."[52] Likewise, with regard to the service fees, the court dismissed the claim because plaintiffs "alleged no facts that, if true, would indicate that the service fees are unrelated to the shareholder services provided by the broker-dealers."[53]

In addition, in *Pfeiffer*,[54] the court denied defendants' motion to dismiss a Section 36(b) claim where plaintiff alleged that the fees charged after the fund closed to new investors were not reasonably related to the services rendered because the fund increased significantly in value over a short period, resulting in dramatically higher Rule 12b-1 fees. The court held that it was "unnecessary for the plaintiff to set forth evidentiary details to support [its] allegation, or to support those elements of the *Gartenberg* test that may apply to promotion, distribution and service fees."[55] According to the court, whether plaintiff can satisfy its burden of demonstrating that the fees were excessive under the test outlined in *Gartenberg* would be decided at a later stage of the action, and plaintiff's failure to do so in the pleadings was not a ground for dismissal.[56]

### C. The Scope of Section 36(b) Beyond Excessive Fee Claims

The legislative history of Section 36(b) makes clear that the statute was enacted in order to create a cause of action for excessive or disproportionate advisory fees.[57] The statutory language of Section 36(b), however, does not specifically refer to excessive or disproportionate advisory fees; rather, it refers broadly to breaches of fiduciary duty "with respect to the receipt of compensation for services."[58] Faced with courts' recent unwillingness to imply private rights of action under other sections of the ICA in the post-*Sandoval* era, plaintiffs have increasingly sought to use Section 36(b) as a means to challenge allegedly impermissible conduct in the mutual fund industry, even if such conduct is not directly related to advisory fees.

This movement began with *Green v. Fund Asset Mgmt., L.P.,*[59] where the court denied defendants' motion to dismiss plaintiffs' Section 36(b) claim even though plaintiffs did not allege excessiveness or disproportionality. Plaintiffs alleged that the advisers for seven "leveraged" closed-end funds violated Section 36(b) by receiving compensation based upon the total assets of the funds, including assets acquired by leveraging through the issuance of preferred stock. Plaintiffs argued that the compensation arrangements created an improper and undisclosed conflict of interest because the adviser had an incentive to keep the funds fully leveraged at all times to maximize advisory fees, even when economic conditions dictated that leverage should be reduced. Although plaintiffs conceded that they had not alleged that the advisory fees were

48. 369 F. Supp. 2d 163 (D. Mass. 2005).
49. *Id.* at 168.
50. *Id.*
51. Plaintiffs also alleged that the funds' advisory fees were excessive, and the court held, with no analysis, that the complaint alleged sufficient facts to support this claim.
52. *Id.* at 169.
53. *Id.*
54. No. 03 Civ. 9741 DLC, 2004 WL 1903075 (S.D.N.Y. Aug. 26, 2004).
55. *Id.* at *4.
56. *See also Wicks v. Putnam Inv. Mgmt., LLC*, No. Civ.A.04-10988-GAO, 2005 WL 705360, at *4 (D. Mass. Mar. 28, 2005) (denying defendants' motion to dismiss plaintiffs' Section 36(b) claim because *Gartenberg* "does not establish a heightened pleading requirement for § 36(b) excessive fee claims" and "plaintiff's failure to plead certain *Gartenberg* factors is not itself grounds for dismissal"); *Millenco L.P. v. meVC Advisors, Inc.*, No. CIV. 02-142-JJF, 2002 WL 31051604, at *3 n.3 (D. Del. Aug. 21, 2002) (refusing to "engage in an analysis of the [six *Gartenberg*] factors" because "the *Gartenberg* decision does not set a pleading standard, but rather is helpful only after the complete evidentiary record has been established").
57. *See* S. Rep. No. 91-184 (1969), *reprinted in* Federal Securities Laws: Legislative History, 1933-1982, at 4041.
58. 15 U.S.C. § 80a-35(b).
59. 19 F. Supp. 2d 227 (D.N.J. 1998).

excessive or disproportionate, the court declined to dismiss the Section 36(b) claim, finding that Section 36(b) "is not expressly limited to situations in which the advisory fees received by an investment advisor were excessive, disproportionate or otherwise unreasonable."[60]

Recently, courts have continued to struggle with exactly what type of conduct, if any, is actionable under Section 36(b) where there are no allegations of disproportionality. For example, in *Eaton Vance,*[61] the court held that allegedly improper soft-dollar and revenue-sharing payments did not support a claim under Section 36(b) because that section addresses only the "negotiation and enforcement" of compensation agreements between mutual funds and their advisers, distributors, and other affiliates:

> The allegations that the defendants authorized improper 12b-1 fees, soft dollar payments, and commissions to brokers are insufficient to allege a claim under 36(b), which addresses only the negotiation and enforcement of payment arrangements between investment advisers and funds, not whether investment advisers acted improperly in the use of funds.[62]

The court's holding that the scope of Section 36(b) extends to "the negotiation and enforcement of payment arrangements" might leave room for plaintiffs to argue that the statute applies beyond excessive fees.

In *Market Timing Class Opinion*,[63] the court allowed plaintiffs' Section 36(b) claim to proceed, but only because the complaint adequately alleged that late trading and market timing resulted in excessive management and distribution fees. Indeed, the court specifically noted the limited scope of Section 36(b):

> Section 36(b) only concerns compensation. It was not enacted to provide a cause of action separate from Section 36(a) to govern the directors' independence or the investment adviser's general performance. For this reason, most of the cases decided under Section 36(b) are narrowly focused on disproportionate, excessive, or unearned fees. Thus, plaintiffs may not use Section 36(b) as a means generally to challenge late trading and market timing practices. Nor may they recover under Section 36(b) the profits paid to traders in connection with late trades or market timed transactions. They may, however, assert a claim under Section 36(b) for excessive fees and expenses resulting from the defendants' scheme. Such a claim is supported by allegations in the complaint that (1) management fees, which were based upon the amount of funds under management, were increased excessively by late trades and market timed transactions that increased the funds under management, (2) the influx of funds from late trades and market timed transactions excessively increased fees paid by funds for distribution of shares, and (3) the management fees paid as the result of the deposit of sticky assets that would sit quietly in low-risk money-market or government bond funds were entirely unearned.[64]

Moreover, in *Mutchka*,[65] the court confirmed that Section 36(b) creates a cause of action for only those breaches of fiduciary duty that relate directly to defendant's receipt of compensation for services. The complaint alleged that defendants breached their fiduciary duties by failing to ensure that the funds participated in class action settlements for which they were eligible. Plaintiffs attempted to fit their claims into Section 36(b) by arguing that because of defendants' fiduciary breaches, "'*any and all* compensation [they] received for their services to fund shareholders [was] excessive.'"[66] The court rejected

60. *Id.* at 234. In a nearly identical action brought by the same plaintiff against the adviser for a different mutual fund family, the Northern District of Illinois likewise held that plaintiff stated a claim under Section 36(b) even though the complaint did not allege that the advisory fees were excessive. *See Green v. Nuveen Advisory Group*, 186 F.R.D. 486, 490-91 (N.D. Ill. 1999).
61. No. 04 CV 1144 (JGK), 2005 WL 1813001 (S.D.N.Y. July 29, 2005).
62. *Id.* at *13. The court, however, rejected defendants' argument that Section 36(b) applies only to advisory fees and not to other fees, such as Rule 12b-1 fees, holding that Section 36(b) applies to all forms of compensation paid by funds to their advisers, distributors, and other affiliates.
63. No. 04-MD-15863, 2005 WL 2045800, at *12 (D. Md. Aug. 25, 2005).
64. *Id.* (internal quotes and citations omitted).
65. 373 F. Supp. 2d 1021 (C.D. Cal. 2005).

> assert a claim under Section 36(b) for excessive fees and expenses resulting from the defendants' scheme. Such a claim is supported by allegations in the complaint that (1) management fees, which were based upon the amount of funds under management, were increased excessively by late trades and market timed transactions that increased the funds under management, (2) the influx of funds from late trades and market timed transactions excessively increased fees paid by funds for distribution of shares, and (3) the management fees paid as the result of the deposit of sticky assets that would sit quietly in low-risk money-market or government bond funds were entirely unearned.[64]

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Finally, in *Benak*,[68] plaintiff alleged that its claim was cognizable under Section 36(b) because the adviser was paid $140 million in advisory fees despite failing to abide by its promised investment process in making the Enron investments. The court disagreed, holding that "the fee arrangement [was] at best incidentally related to the crux of Plaintiff's claims," which were in reality an *ex post* attack on the adviser's business judgment in selecting portfolio securities.[69]

Collectively, these cases do not offer definitive guidance on the exact scope of Section 36(b) when plaintiffs base their claims on something other than pure excessive fee allegations. It appears that no court is willing to expand the scope of Section 36(b) to cover claims that do not relate directly to the structure, negotiation, or enforcement of the advisory fee contract. For example, courts have uniformly rejected attempts to use Section 36(b) as a catchall provision to challenge general conduct of the adviser simply because the adviser's services may have been worth less as a result of the objectionable conduct. Beyond that, the scope of Section 36(b) remains somewhat unclear. What is clear is that plaintiffs will continue to test the outer boundaries of Section 36(b) as courts continue to refuse to imply private rights of action under every other section of the ICA.

66. *Id.* at 1025 (quoting plaintiffs' opposition to defendants' motion to dismiss).
67. *See also Hogan v. Baker*, No. Civ.A. 305CV0073P, 2005 WL 1949476, at *6 (N.D. Tex. Aug. 12, 2005) (holding that Section 36(b) is "limited to breaches of fiduciary duty involving investment advisory fees and does not extend to general breaches of fiduciary duty"); *Dull*, No. 05 C 140, 2005 WL 1799270, at *3 (N.D. Ill. July 27, 2005) (dismissing plaintiffs' Section 36(b) claim in a class action participation case because the allegations did not relate to "a fiduciary duty with respect to the receipt of compensation"); *Jacobs*, No. 05 C 143, 2005 WL 1719307, at *7 (N.D. Ill. July 20, 2005) (dismissing plaintiff's Section 36(b) claim because plaintiff's "'real complaint' is that defendants made a poor management decision by failing to participate in dozens of settlement agreements for which some fund was eligible, and he has not alleged any inherent improprieties in the compensation agreement itself").
68. No. Civ.A. 01-5734, 2004 WL 1459249 (D.N.J. Feb. 9, 2004).
69. *Id.* at *8.
70. *See Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108-09 (1991); *Marquit v. Dobson*, No. 98 Civ. 9089 (JSM), 2000 WL 4155, at *1 (S.D.N.Y. Jan. 3, 2000), *aff'd sub nom. Marquit v. Williams*, 229 F.3d 1135 (2d Cir. 2000) (unpublished table opinion).
71. *See, e.g., Tooley v. Donaldson, Lufkin & Jenrettte, Inc.*, 845 A.2d 1031 (Del. 2004); *Waller v. Waller*, 49 A.2d 449 (Md. 1946); *Pagounis v. Pendleton*, 753 N.E.2d 808 (Mass. App. Ct. 2001).
72. *See, e.g., Tooley*, 845 A.2d at 1031; *Delmarva Sash & Door Co. of Md., Inc. v. Andersen Windows, Inc.*, 218 F. Supp. 2d 729 (D. Md. 2002); *Jackson v. Stuhlfire*, 547 N.E.2d 1146 (Mass. App. Ct. 1990).
73. *See, e.g., In re Dreyfus Aggressive Growth Mutual Fund Litig.*, No. 98 Civ. 4318 (HB), 2000 WL 10211 (S.D.N.Y. Jan. 6, 2000) (holding that plaintiffs' claims under Sections 13(a)(3), 17(e), 17(j), 34(b), and 36(a) must be brought derivatively); *Strougo v. Scudder, Stevens & Clark, Inc.*, 964 F. Supp. 783 (S.D.N.Y. 1997) (holding that plaintiff's Section 36(a) claim must be brought derivatively).
74. 282 F.3d 162 (2d Cir. 2002).

### *D. Direct vs. Derivative Actions*

Many courts have held that claims under the ICA and state-law claims involving mutual funds must be brought derivatively on behalf of the fund rather than directly by fund shareholders. Whether a claim must be brought derivatively is determined by the law of the state where the fund is organized, frequently Delaware, Maryland, or Massachusetts.[70] Delaware, Maryland, and Massachusetts law — and the laws of most other jurisdictions — require plaintiffs to bring actions derivatively where the harm alleged affects plaintiffs only indirectly as a result of their status as fund shareholders.[71] In other words, to bring a direct action, plaintiffs must seek to recover for injuries that are distinct from any injury to the fund.[72] Applying this standard, courts have repeatedly held that claims under the ICA and state-law claims involving mutual funds must be brought derivatively where the harm alleged is a decrease in the fund's net asset value.[73]

One notable exception is *Strougo v. Bassini*,[74] where the Second Circuit allowed plaintiff to bring a direct action alleging violations of Section 36(a). Plaintiff, a shareholder in a closed-end mutual fund, alleged that the fund, the fund's board of directors, and the fund's investment adviser breached their fiduciary duties by conducting a rights offering that allowed existing shareholders to purchase newly issued shares at a substantial discount, thereby harming the fund and its shareholders by diluting the value of existing shares. The district court held that the Section 36(a) claims were required to be brought derivatively because the alleged injury affected all of the fund's shareholders equally and did not impact the plaintiff in any unique way.[75]

The Second Circuit vacated the district court's decision. It held that plaintiff could pursue the Section 36(a) claims directly because the alleged injury resulting from the coercive nature of the rights offering "does *not* derive from a reduction in the value of the Fund's assets or any other injury to the Fund's business," but rather from a "reallocation of equity value" from shareholders who did not participate in the rights offering to those who did.[76]

Another exception is *Lord Abbett*,[77] where Judge Martini held that plaintiffs properly brought their claims under Sections 34(b), 36(a), and 48(a) of the ICA and pursuant to state law directly rather than derivatively. Plaintiffs alleged four distinct types of injury from Lord Abbett's revenue-sharing practices:

> (1) loss of 'excessive' fees deducted from Fund assets by Defendants and used to pay excessive broker compensation; (2) payment of advisory fees to Lord Abbett out of Fund assets for services that were of no benefit to shareholders; (3) 'diminished marginal returns' on shareholder investment due to poorer Fund performance; and (4) decline in net asset value per share for shareholders (despite the Funds' net asset growth) as a result of new investors joining the funds.[78]

Judge Martini held that the first three types of injury were derivative in nature because they were indistinguishable from injuries to the funds themselves. On the other hand, Judge Martini held that the fourth type of harm was direct in nature because plaintiffs alleged that they were harmed due to the decrease in the funds' NAV per share but that the funds themselves benefited from the overall growth in assets.[79]

75. *See Strougo v. Bassini*, 1 F. Supp. 2d 268 (S.D.N.Y. 1998).
76. *Bassini*, 282 F.3d at 175.
77. No. 04-CV-0559 (WJM), 2005 WL 2090517, at *8-*10 (D.N.J. Aug. 30, 2005).
78. *Id.* at *8 (internal citations omitted).
79. Judge Martini's reasoning is difficult to reconcile with other recent decisions, including *Eaton Vance*, which held that claims based on nearly identical allegations were derivative in nature because any injury to fund shareholders due to a reduction in the fund's NAV is indirect. No.04 CV 1144 (JGK), 2005 WL 1813001, at *10 (S.D.N.Y. July 29, 2005). *See also* cases cited *supra* note 73. Indeed, in a case involving nearly identical allegations against the Franklin Templeton mutual fund family, Judge Martini held that plaintiffs' alleged injuries were derivative, not direct: "Because the excessive fees and charges reduced the net asset value of the funds and, in turn, reduced the net asset per share value, the plaintiffs did not sustain a direct injury distinct from that suffered by the funds." *Franklin*, No. 04-CV-982 (WJM), 2005 WL 2175950, at *9 (D.N.J. Sept. 9, 2005).
80. No. C 04-00883 SI, 2005 WL 645529, at *7-*8 (N.D. Cal. Mar. 7, 2005).
81. *Id.* at *8.
82. No. Civ.A. 305CV0073P, 2005 WL 1949476, at *2-*5 (N.D. Tex. Aug. 12, 2005).

A final exception is *Strigliabotti*,[80] where the court allowed plaintiffs to assert various state-law claims directly against the funds' advisers, distributors, and affiliates. Plaintiffs alleged that defendants breached their state-law fiduciary duties by charging the funds excessive fees that did not reflect economies of scale resulting from the funds' growth. The court allowed plaintiffs to bring the claims directly because given the "unique nature and structure of mutual funds," the alleged harm was an injury to the individual investors, not to the funds: "[T]he financial harm from overcharges is harm to the individual investors, who own the Funds' assets and bear its expenses directly on a pro rata basis."[81]

Other better-reasoned decisions, however, have reaffirmed that mutual fund plaintiffs may not bring a direct action to recover for alleged injuries that they suffered only indirectly as a result of their status as fund shareholders. For example, in *Hogan v. Baker*,[82] a settlement participation case, plaintiffs argued that due to the "unique structure of mutual funds," any decrease in the funds' NAV due to the failure to participate in class action settlements was "immediately passed on directly to the fund investors." The court rejected this argument and held that to the extent plaintiffs suffered any injury, they did so only indirectly as a result of their status as fund shareholders. The court specifically refused to follow *Strigliabotti*, noting that "its reasoning is at odds with the overwhelming majority of courts who have addressed this issue" and that it "does not cite any applicable case law in reaching its holding."[83]

In *Eaton Vance*,[84] applying Massachusetts law, the court held that plaintiffs' claims must be brought derivatively because "the injury asserted — the misuse of Eaton Vance Funds' assets to provide excessive compensation to brokers, improper 12b-1 plans, and soft dollar compensation to brokers — is an injury to the Eaton Vance Funds that adversely affects the plaintiffs only indirectly through their status as investors in the Eaton Vance Funds."[85]

In *In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig.*,[86] plaintiffs, investors in Merrill Lynch mutual funds, claimed that Merrill Lynch violated Section 34(b) by failing to disclose certain conflicts of interest between its mutual funds and its investment banking and research divisions. Plaintiffs alleged that Merrill Lynch's research department published misleading research reports that artificially inflated the share prices of certain issuers with which Merrill Lynch had or sought to have investment banking relationships, and that fund shareholders were injured when the funds purchased shares of the issuers at the inflated prices. Defendants moved to dismiss, arguing that to the extent Section 34(b) creates an implied private right of action, such claims must be brought derivatively. The court agreed, holding that plaintiffs' Section 34(b) claims must be brought derivatively because the only harm alleged was a decline in the funds' net asset value and such harm is not distinct from harm to the fund.

Recent decisions have also applied the derivative requirement to claims under Section 36(b) of the ICA. For example, in *Lord Abbett*,[87] although the parties had not briefed the issue, the court held that claims under Section 36(b) must be brought derivatively. The court based its holding on the plain language of Section 36(b), which provides that an action may be brought "by a security holder of such registered investment company *on behalf of such company*." (emphasis supplied). The court noted, however, that under the Supreme Court's decisions in *Daily Income Fund, Inc. v. Fox*[88] and *Kamen*,[89] a plaintiff need not make a pre-suit demand prior to instituting a derivative action under Section 36(b).[90]

Likewise, in *Mutchka*,[91] the court concluded that Section 36(b) claims must be brought derivatively for two

83. *Id.* at *4.
84. No. 04 CV 1144 (JGK), 2005 WL 1813001 (S.D.N.Y. July 29, 2005).
85. *Id.* at *10. By contrast, the court noted that plaintiffs' claims under Section 34(b) for misrepresentations and omissions regarding the management of the *Eaton Vance* Funds could be brought directly because the claims alleged "an injury directly to the investors who, based on the alleged misrepresentations and omissions, continued to invest in the *Eaton Vance* Funds and were thereby injured." *Id.* at *11 n.5. As discussed above, however, the court dismissed plaintiffs' claims for the independent reason that there is no private right of action to enforce Section 34(b).
86. 272 F. Supp. 2d 243 (S.D.N.Y. 2003).
87. No. 04-CV-0559 (WJM), 2005 WL 2090517, at *16 (D.N.J. Aug. 30, 2005).
88. 464 U.S. 523 (1984).
89. 500 U.S. 90 (1991).
90. *See also In re Franklin Mutual Funds Excessive Fee Litig.*, No. 04-CV-982 (WJM), 2005 WL 2175950, at *13 (D.N.J. Sept. 9, 2005) (applying an identical analysis and holding that claims under Section 36(b) must be brought derivatively).
91. 373 F. Supp. 2d 1021 (C.D. Cal. 2005).
92. 964 F. Supp. 783, 794 (S.D.N.Y. 1997).

reasons. First, as noted above, Section 36(b) provides that a claim may be brought "on behalf of" the fund. Second, to the extent the issue is governed by the law of the state in which the fund is organized, Massachusetts law requires claims for breach of fiduciary duty to be brought derivatively.

### *E. Demand Futility*

Once it is established that claims under the ICA must be brought derivatively, plaintiffs must comply with the requirements for bringing derivative actions under state law and Rule 23.1 of the Federal Rules of Civil Procedure, including the requirement that plaintiffs make a pre-suit demand on the fund's board of directors or demonstrate why such demand should be excused. Mutual fund plaintiffs have repeatedly argued that demand should be excused as futile where the funds' independent directors serve on multiple boards within the same fund family and receive "substantial compensation" from their board service.

Several courts have accepted this argument and excused plaintiffs from making pre-suit demand prior to pursuing their derivative actions. For example, in *Strougo v. Scudder, Stevens & Clark, Inc.*,[92] the court held that independent directors who serve on multiple boards of funds in the same complex and "receive substantial remuneration from their service on the boards" may be characterized as "house directors," as interested in benefiting the adviser at the expense of fund shareholders, as the adviser's employees. The court reasoned that, although the fact that a director serves on multiple boards does not in and of itself undermine his independence, when it is alleged that a director acted in the interests of the adviser and not the fund, "the receipt of substantial remuneration from a fund complex does call into question the directors' independence from the manager of that complex."[93] Because a majority of the independent directors of the fund served as directors of other funds affiliated with Scudder and were compensated for their service, the court excused the demand requirement. The court explained that the shareholders would essentially be asking the defendants to sue themselves or would have to replace the present board with one that could prosecute the suit.

*Strougo*'s holding conflicts with prior precedent on this issue,[94] and recent decisions reaffirm that demand will not be excused as futile merely because the fund's independent directors serve as directors for other funds in the same fund family and are compensated for such service. In *Merrill Lynch Focus Twenty*,[95] plaintiff brought a derivative action alleging that the fund's adviser breached its fiduciary duty and was negligent because the fund invested in Enron securities. Plaintiff alleged that demand should be excused as futile because eight of the nine independent directors of the fund's board received $160,000 to $260,000 in annual compensation for their service on boards of other funds managed by the same adviser. The court rejected plaintiff's argument, holding that well compensated service on multiple fund boards in the same fund family is not sufficient to demonstrate that those directors are so clearly conflicted or controlled by the adviser that demand would be futile.

Moreover, as pointed out by Judge Motz in *Market Timing Derivative Opinion*,[96] subsequent to *Strougo*, Delaware, Maryland, and Massachusetts all enacted statutes expressly providing that any investment company director who is not considered an "interested" director under the ICA is deemed "to be independent and disinterested for all purposes."[97] In light of these statutes, Judge Motz rejected plaintiffs' argument that the Janus directors should be considered interested and demand excused as futile because the directors served on the boards of multiple funds and were highly compensated for their service.

In a separate and somewhat unique attempt to avoid dismissal of their derivative claims for failure to make a pre-suit demand on the fund's board of directors, plain-

93. *Id.* at 795.
94. *See*, *e.g.*, *Langner v. Brown*, 913 F. Supp. 260, 266 (S.D.N.Y. 1996) ("Just as the mere receipt of director fees does not constitute a disqualifying interest as a matter of law, so too are cross-directorships insufficient to create interest.").
95. 218 F.R.D. 377 (E.D.N.Y. 2003), *aff'd sub nom. Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133 (2d Cir. 2004).
96. No. 04-MD-15863, 2005 WL 2045801, at *3 (D. Md. Aug. 25, 2005).
97. *Id.* (citing Del. Code Ann. tit. 12, § 3801(h) (1998); Md. Code Ann., Corp. & Ass'ns § 2-405.3(b); Mass. Gen. Laws Ann. ch. 182, § 2B (1998)).
98. No. 01-CY-573 (JLL), 2005 WL 1285652 (D.N.J. May 23, 2005).
99. *See also Franklin*, No. 04-CV-982 (WJM), 2005 WL 2175950, at *15 (D.N.J. Sept. 9, 2005) ("[P]laintiffs' allegations that the directors were chosen by the investment advisers, sat on multiple boards and received substantial compensation are, by themselves, insufficient to demonstrate that the directors are interested.").
100. 434 F.2d 727 (3d Cir. 1970), *cert. denied*, 401 U.S. 974 (1971).

tiffs in *Benak*[98] argued that the fund's stipulation to file an answer to the complaint within ten days of the court's decision on the pending motion to dismiss indicated that the directors were "neutral" and did not oppose the action. Plaintiffs also argued that the fund's directors were conflicted because they served as directors for several Alliance funds and were compensated for their service. The court found both of plaintiffs' arguments to be without merit and granted defendants' motion to dismiss for failure to make demand on the fund's board of directors as required by Rule 23.1.[99]

### *F. No Standing to Sue on Behalf of Funds Not Held by Plaintiff*

Frequently, a plaintiff who is a shareholder in one mutual fund attempts to assert claims involving other funds in the same family even though the plaintiff does not own shares in the other funds. Recent decisions have been split on whether a plaintiff lacks standing to assert claims on behalf of the other funds or on behalf of shareholders in the other funds. If the plaintiff brings the action derivatively, the primary obstacle is Rule 23.1 of the Federal Rules of Civil Procedure, whereas if the plaintiff brings the action directly, the primary obstacle is Article III, Section 2 of the Constitution.

Standing in the mutual fund context was addressed in 1970 in *Kauffman v. Dreyfus Fund, Inc.*[100] There, a shareholder in four mutual funds brought claims pursuant to the ICA, the Exchange Act, the IAA, and the Sherman Act against sixty-five mutual funds, among other defendants. Defendants moved to dismiss plaintiff's claims against the sixty-one mutual funds of which plaintiff was not a shareholder, arguing that plaintiff did not have standing to bring a derivative action against those funds. After the district court denied defendants' motion to dismiss, defendants appealed, and the Third Circuit reversed, holding that plaintiff did not have standing to bring a derivative action against the sixty-one funds of which he was not a shareholder. The court found that the plain language of Rule 23.1 compelled this result because it requires the plaintiff in a derivative action to allege in the complaint that he "was a shareholder . . . at the time of the transaction of which [he] complains." Moreover, the court reasoned, standing to bring a derivative suit "is justified only by [the] proprietary interest created by the stockholder relationship and the possible indirect benefits the nominal plaintiff may acquire qua stockholder of the corporation which is the real party in interest."[101]

Recent decisions have reaffirmed the principle established in *Kauffman*. Most recently, in *Zucker v. AIM Advisors, Inc.*,[102] plaintiff, a shareholder in the AIM Small Cap Growth Fund, alleged violations of Section 36(b) against the fund's adviser and state-law claims against the fund's adviser and directors. Plaintiff brought the claims derivatively on behalf of both the Small Cap Growth Fund, in which he owned shares, and the AIM Limited Maturity Treasury Fund, in which he did not own shares. Defendants moved to dismiss all claims brought on behalf of the Limited Maturity Treasury Fund, arguing that plaintiff did not have standing to bring a derivative action because he did not own shares in the fund. Citing *Kauffman*, the court granted defendants' motion to dismiss, holding that plaintiff lacked standing to pursue those claims because he failed to satisfy the requirements of Rule 23.1.[103]

In *In re Eaton Vance Corp. Sec. Litig.*,[104] plaintiffs alleged that the funds' registration statements were false and misleading in violation of Sections 11, 12(a)(2), and 15 of the Securities Act. Plaintiffs owned shares in only two of the four funds against which they asserted claims. Before considering plaintiffs' motion for class certification, the court first addressed whether plaintiffs had standing

101. *Id.* at 735-36.
102. 371 F. Supp. 2d 845 (S.D. Tex. 2005). *See also Lieber v. INVESCO Funds Group, Inc.*, 371 F. Supp. 2d 852 (S.D. Tex. 2005) (dismissing state-law claims brought on behalf of twenty-one funds in which plaintiff did not own shares) (companion case to *Zucker*).
103. In addition, in *Lord Abbett*, No. 04-CV-0559 (WJM), 2005 WL 2090517, at *16 (D.N.J. Aug. 30, 2005), the court — after holding that plaintiffs must amend their complaint to assert their Section 36(b) claim derivatively — noted that to the extent plaintiffs did so, they would not be able to assert claims on behalf of funds that they themselves did not own.
104. 219 F.R.D. 38, 40-41 (D. Mass. 2003).
105. Defendants in *Market Timing Class Opinion,* No. 04-MD-15863, 2005 WL 2045800 (D. Md. Aug. 25, 2005), likewise argued that plaintiffs who owned shares in a particular fund lacked Article III standing to assert claims in connection with other funds in the same family. While noting that this "contention may have merit," Judge Motz deferred ruling on the standing issue. *Id.* at *1 n.4.
106. 373 F. Supp. 2d 1021 (C.D. Cal. 2005).
107. The court noted that "[i]f a defendant played no role in the management of [the] fund [in which plaintiffs invested], there is a substantial question whether there is standing even if the defendant played an analogous role in some other funds." *Id.* at 1024.

under Article III, Section 2 of the Constitution to assert claims against the two funds of which they were not shareholders. The court held that plaintiffs did not have standing to sue the funds, reasoning that because plaintiffs did not own shares in the funds, they could not have been injured as a result of false or misleading statements in the funds' registration statements. Accordingly, no case or controversy existed as required by Article III, Section 2.[105]

By contrast, two recent courts refused to dismiss direct actions for lack of Article III standing even though plaintiffs sought to represent shareholders of funds in which they themselves did not own shares. In *Mutchka*,[106] plaintiffs alleged violations of Sections 36(a), 36(b), and 47(b) of the ICA, along with state-law claims for negligence and breach of fiduciary duty against the advisers, trustees, and affiliates of the Allianz mutual fund family based on defendants' alleged failure to ensure that the PIMCO funds participated in securities class action settlements. Plaintiffs were investors in only one of the many PIMCO funds. Defendants moved to dismiss plaintiffs' claims, arguing that plaintiffs did not have standing to assert claims on behalf of shareholders in funds in which plaintiffs themselves did not own shares. The court rejected defendants' argument because the complaint could be read to claim that each of the named defendants played some role in managing the fund in which plaintiffs invested.[107] Importantly, the PIMCO funds were organized as a series of funds issued by a single investment company, which courts have held presents different standing issues than cases where each fund is a separate registered investment company.[108] Moreover, plaintiffs did not name any of the actual funds as defendants; they named only the advisers, trustees, and affiliates of the funds. The court held, "At least on standing grounds, there is no basis for precluding [plaintiffs] from asserting claims against the defendants on the basis that they managed funds other than the one in which [plaintiffs] invested."[109] The court noted, however, that "[w]hether the [plaintiffs] can represent the holders of other funds on a class basis is a question to be addressed if and when they attempt to certify such a class."[110]

In *Lord Abbett*,[111] plaintiffs sought to represent a class of investors in all of the more than fifty Lord Abbett funds. Plaintiffs only invested in seven of the funds, and defendants argued that plaintiffs lacked standing to pursue claims on behalf of investors in the other funds. Judge Martini rejected defendants' argument, citing *Haas v. Pittsburgh Nat'l Bank*,[112] and holding that in the class action context, Article III requires only that the named plaintiffs have standing to assert at least one claim against the named defendants. If that requirement is satisfied, the plaintiffs may assert any other "closely related" claims against the defendants, even if the plaintiffs lack individual standing to pursue the additional claims. Judge Martini specifically noted, however, that he expressed no opinion as to whether the named plaintiffs could serve as class representatives for the claims against other funds.

Subsequently, in *Franklin*,[113] a case involving almost identical allegations against the Franklin Templeton mutual fund family, Judge Martini clarified that the standing analysis in *Lord Abbett* applies only to direct claims brought as class actions and not to derivative claims brought on behalf of the funds. In *Franklin*, plaintiffs were investors in three mutual funds, but they sought to assert direct claims on behalf of shareholders in all of the over one hundred funds in the Franklin Templeton family. After first noting that plaintiffs "traditionally . . . would lack standing to assert claims on behalf of investors involving the defendants associated with the one hundred other fund defendants," Judge Martini went on to explain that "[i]n the class action context, . . . traditional notions of standing are not completely informative of what claims may be asserted."[114] In particular, under *Haas*, to the extent plaintiffs properly asserted at least one claim against a given defendant, they could assert any other "closely related" claims against that defendant on behalf of the class, even if they lacked individual standing to pursue the additional claims. After dismissing plaintiffs' claims because they were required to be brought derivatively rather than directly, however, Judge Martini advised plaintiffs that if they amended their complaint to

108. *See generally Batra v. Investors Research Corp.*, No. 89-0528-CV-W-6, 1992 WL 278688 (W.D. Mo. Oct. 4, 1991).
109. *Mutchka*, 373 F. Supp. 2d at 1024.
110. *Id.*
111. No. 04-CV-0559 (WJM), 2005 WL 2090517, at *6-*7 (D.N.J. Aug. 30, 2005).
112. 526 F.2d 1083, 1088-89 (3d Cir. 1975).
113. No. 04-CV-982 (WJM), 2005 WL 2175950, at *6-*7, *13 n.13 (D.N.J. Sept. 9, 2005).
114. *Id.* at *7.
115. *Id.* at *13 n.13 (citing *Kauffman v. Dreyfus Fund, Inc.*, 434 F.2d 727 (3d Cir. 1970)).
116. *Basic, Inc. v. Levinson*, 485 U.S. 224, 242 (1987) (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

assert derivative claims, they would only have standing to bring those claims on behalf of the three funds in which they invested.[115]

### *G. Efficient Markets and the Presumption of Reliance*

In addition to claims under the ICA, mutual fund plaintiffs have asserted claims for fraud under the Securities Act and the Exchange Act, alleging that the funds made misrepresentations or omissions of material fact in their prospectuses, Statements of Additional Information, and other public documents. Plaintiffs asserting fraud claims pursuant to Section 10(b) and Rule 10b-5 of the Exchange Act typically claim that they should be presumed to have relied on the alleged misrepresentations pursuant to the "fraud on the market" theory of reliance. Recent precedent, however, establishes that the fraud on the market theory is inapplicable to mutual fund shares and that mutual fund plaintiffs must individually plead and prove reliance on alleged misrepresentations about mutual fund shares.

According to the Supreme Court, "'[t]he fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business.'"[116] Misleading or incorrect information about the company and its business distorts the stock price, and courts regard investors who purchased stock at distorted prices as having been defrauded without requiring the investors to demonstrate that they individually relied on the alleged misrepresentations. Courts have held, however, that the fraud on the market theory applies only to securities traded in efficient markets — *i.e.*, markets that "rapidly incorporate[] all publicly available information about a company's business and financial situation into the company's stock price."[117]

Recently, in *Clark v. Nevis Capital Mgmt., LLC*,[118] the court held that mutual fund shares are not traded in efficient markets and, therefore, mutual fund plaintiffs do not benefit from a presumption of reliance under the fraud on the market theory. The court reached this conclusion because of the manner in which mutual fund shares are priced. The price of a mutual fund share is the fund's NAV, which is the fund's total assets minus its total liabilities divided by the number of shares outstanding. Because of NAV pricing, the court reasoned, the share price of a mutual fund is determined primarily by the value of the fund's portfolio securities and "is unaffected by alleged misrepresentations and omissions concerning the fund itself."[119] Accordingly, the court held that the fraud on the market theory of reliance does not apply to mutual fund shares and required plaintiffs to individually plead and prove reliance on the alleged misrepresentations.

Moreover, in *Market Timing Class Opinion*,[120] Judge Motz noted two "difficulties" with plaintiffs' invocation of the fraud on the market presumption of reliance. First, whereas the fraud on the market theory is based upon the proposition that material misrepresentations or omissions result in inflated prices, plaintiffs alleged that late trading and market timing reduced the value of their mutual fund shares. Second, whereas the fraud on the market theory focuses on the point of sale, plaintiffs alleged that the value of their shares was diluted over time.

### *H. SLUSA Preemption*

In addition to claims under the ICA and other federal securities laws, mutual fund plaintiffs often assert claims for breach of state statutory or common law. Recently plaintiffs have filed numerous class actions which allege that mutual fund defendants breached their fiduciary duties and misled investors by engaging in practices such as revenue sharing and directed brokerage, even though such practices were not specifically prohibited by the federal securities laws. Courts have properly dismissed these claims, however, because SLUSA preempts state-law class actions involving allegations of securities fraud.

Congress passed SLUSA to curb abuses of federal securities fraud litigation whereby plaintiffs sought to avoid the

117. *In re Livent, Inc. Noteholders Sec. Litig.*, 211 F.R.D. 219, 221 (S.D.N.Y. 2002).
118. No. 04 Civ. 2702 (RWS), 2005 WL 488641, at *18 (S.D.N.Y. Mar. 2, 2005). *See also In re Van Wagoner Funds, Inc.*, No. C 02-03383 JSW, 2004 WL 2623972, at *9-*10 (N.D. Cal. July 27, 2004).
119. *Clark*, 2004 WL 488641, at *18.
120. No. 04-MD-15863, 2005 WL 2045800, at *8 n.17 (D. Md. Aug. 25, 2005).
121. *See Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 31-32 (2d Cir. 2005).
122. 421 U.S. 723 (1975).

Private Securities Litigation Reform Act's heightened pleading requirements and other procedural protections by bringing suit in state court under state statutory or common law rather than in federal court.[121] Congress sought to close this loophole by requiring that class actions alleging securities fraud be brought in federal court and governed by federal law. SLUSA preempts any state-law claim that meets five criteria: (1) the lawsuit is a "covered class action"; (2) the claim is based on state law; (3) the claim concerns a "covered security," which is defined to include mutual fund shares; (4) the plaintiff alleges a misrepresentation or omission of material fact; and (5) the misrepresentation or omission is made "in connection with the purchase or sale of a covered security."

Typically, mutual fund plaintiffs do not contest that their actions satisfy the first four criteria. Instead, they seek to avoid the "in connection with" requirement by asserting claims on behalf of investors who "held" mutual fund shares, arguing that the "holders claims" do not involve misrepresentations or omissions made in connection with the "purchase" or "sale" of mutual fund shares. In support of this argument, plaintiffs typically cite *Blue Chip Stamps v. Manor Drug Stores*,[122] which held that individuals who were allegedly induced to hold securities by defendant's misrepresentations or omissions cannot pursue claims under Section 10(b) and Rule 10b-5 of the Exchange Act. Plaintiffs contend that Congress did not intend for SLUSA to preempt state-law claims that could not be pursued under the federal securities laws. Several courts have accepted plaintiffs' arguments and agreed that plaintiffs can avoid SLUSA preemption by bringing holders' claims.[123]

In *Kircher v. Putnam Funds Trust*,[124] however, the Seventh Circuit held that plaintiffs cannot avoid SLUSA preemption by bringing such claims. *Kircher* involved several purported class actions brought on behalf of holders of Putnam mutual fund shares. Plaintiffs claimed that Putnam violated Illinois state law by failing to take appropriate action to prevent market timers from realizing short-swing profits, allegedly at the expense of long-term investors. In considering Putnam's motion to dismiss the actions as preempted by SLUSA, the court turned plaintiffs' *Blue Chip Stamps* argument on its head, reasoning that:

> [i]t would be more than a little strange if the Supreme Court's decision to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all.[125]

The court continued, "[P]laintiffs' effort to define non-purchaser-non-seller classes is designed to evade PSLRA in order to litigate a securities class action in state court . . . . It is the very sort of maneuver that SLUSA is designed to prevent."[126] Accordingly, the court ordered that plaintiffs' claims be dismissed as preempted by SLUSA.

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123. *See*, *e.g., Dabit*, 395 F.3d at 43 ("[I]n enacting SLUSA[,] Congress sought only to ensure that class actions brought by plaintiffs who satisfy the *Blue Chip* purchaser-seller rule are subject to the federal securities laws."); *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1345 (11th Cir. 2002) ("[U]nder *Blue Chip*, SLUSA does not apply to claims dealing *solely* with the retention of securities, rather than with purchase or sale.").
124. 403 F.3d 478 (7th Cir. 2005).
125. *Id.* at 484.
126. *Id. See also Disher v. Citigroup Global Mkts. Inc.*, No. 04-3073, 2005 WL 1962942, at *4-*5 (7th Cir. Aug. 17, 2005) (holding that plaintiff's claims satisfied SLUSA's "in connection with" requirement even though plaintiff sought to represent only holders and specifically excluded any claims based on class members' purchases and sales of securities).
127. *Kircher*, 403 F .3d at 482. One of the actions defined the class as "all investors who held the fund's securities during a defined period and neither purchased nor sold shares during that period." *Id.* at 483. The court determined that this class definition adequately pled a holders claim, but it dismissed the action because, as discussed above, allowing the action to proceed would be inconsistent with Congress's intent to require all securities fraud class actions to be litigated in federal court under federal law.
128. No. 04 CV 1144 (JGK), 2005 WL 1813001, at *16-*17 (S.D.N.Y. July 29, 2005).
129. *Id.* at *17. *See also, e.g., Franklin*, No. 04-CV-982 (WJM), 2005 WL 2175950, at *18 (D.N.J. Sept. 9, 2005) (holding that SLUSA preempted plaintiffs' claims because "[a]lthough plaintiffs' class definition scrupulously refers only to 'holders,' it is drawn broadly enough . . . to include any investor who purchased shares of the defendant funds . . . and thereby became holders"); *Lord Abbett*, No. 04-CV-0559 (WJM), 2005 WL 2090517, at *12 (D.N.J. Aug. 30, 2005) (holding that SLUSA applied to plaintiffs' proposed class, which was defined to include "all persons or entities who held one or more shares . . . in any of the Lord Abbett Funds," because it "necessarily encompasse[d] claims by investors who purchased or sold Lord Abbett shares"); *Dabit*, 395 F.3d at 46-47 (holding that SLUSA applied where plaintiff did not "expressly . . . exclude from the class claimants who purchased in connection with the fraud").

Even if the court concedes that, in certain circumstances, a plaintiff may avoid SLUSA preemption by bringing state-law holders' claims, it may reject a particular plaintiff's efforts to do so for two reasons. First, the court may determine that SLUSA applies because the plaintiff has not properly defined the class to exclude individuals who purchased or sold shares during the class period. Most of the class actions at issue in *Kircher* defined the class as "investors who held shares of a given mutual fund between two specified dates."[127] The court held that this class definition failed to avoid SLUSA preemption because it inevitably included holders who also purchased or sold shares during the class period. Likewise, in *Eaton Vance*,[128] the court dismissed plaintiffs' claims under state statutory and common law because the class definition — which was defined to include all investors who "held" shares of the Eaton Vance funds — made "no attempt to exclude class members who . . . purchased or sold shares" during the class period and the complaint did "not include sufficient information to permit the court to identify and separate preempted and non-preempted subclasses."[129]

Second, the court may find that SLUSA applies to holders claims where the allegedly impermissible conduct depends on purchases and sales of mutual fund shares. For example, in *Atencio v. Smith Barney, Citigroup Inc.*,[130] plaintiff alleged that Smith Barney breached its fiduciary duties and violated state statutory law because it allegedly received "kickbacks" from certain mutual fund families in exchange for "steering" investors to those families' funds. Although plaintiff specifically disavowed any claims based on purchases or sales, the court determined that the action nonetheless alleged misrepresentations in connection with the purchase or sale of securities for purposes of SLUSA preemption because "[i]f, as alleged, defendants' receipt of kickbacks caused defendants to steer class members to certain funds," then the claims "are inextricably related to [plaintiffs'] purchases of shares of those funds."[131]

## III. CONCLUSION

As the hundreds of lawsuits filed in the wake of NYAG Spitzer's market timing and late trading investigation work their way through the courts, they are generating important precedent for mutual fund litigation. Some of this precedent seemingly settles issues that have long arisen in mutual fund litigation, whereas other precedent is only the first attempt to deal with emerging issues. Much work remains to be done, however, as most of the recently filed lawsuits remain at the early stages of litigation. At this point, perhaps only one thing is certain: the days when regulators and the plaintiffs' bar largely ignored the mutual fund industry are gone. ■

130. No. 04 Civ. 5653 (MBM), 2005 WL 267556 (S.D.N.Y. Feb. 2, 2005).
131. *Id.* at *6. *See also Franklin*, 2005 WL 2175950, at *18 (holding SLUSA applied because "the only way for [the alleged] scheme to succeed was for investors to purchase . . . shares of the defendant mutual funds"); *Lord Abbett*, 2005 WL 2090517, at *12 (holding SLUSA applied because "[f]or [the alleged] scheme to work and cause harm to Plaintiffs, . . . new investors must purchase shares of the Fund"); *Eaton Vance*, 2005 WL 1813001, at *17 ("Because [plaintiffs] allege[] that the actions of the defendants that are the subject of plaintiffs' claims steered purchasers into buying shares of the Fund, the claims of class members who purchased shares during the class period are inextricably related to their purchases of shares of these funds and are preempted by SLUSA.").