FIFTH CIRCUIT AFFIRMS DISMISSAL OF DERIVATIVE SUIT AGAINST MUTUAL FUND ADVISER AND TRUSTEES

NEW AUTHORITY FOR TRUSTEE INDEPENDENCE AND SHAREHOLDER DEMAND INVESTIGATIONS

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The Fifth Circuit Court of Appeals recently affirmed the dismissal of a shareholder derivative suit filed against the manager and trustees of a Massachusetts business trust and SEC-registered investment company. In doing so, the Court provided a new and favorable appellate authority regarding the standard for trustee independence in Massachusetts, which underscores the deference and weight that should be accorded to good faith business judgments reached by independent board members concerning litigation involving registered funds.[1]

PROCEDURAL BACKGROUND

Plaintiff, a fund shareholder, sent a demand letter to the fund's Board asserting allegations against the adviser and the trustees and requesting that the Board take legal action. In response, the Board formed a committee to review the demand and to make a recommendation as to whether the fund should pursue litigation. After conducting a months-long investigation with the assistance of independent outside counsel, the committee issued a report recommending that the demand be rejected. This recommendation was adopted by a unanimous vote of the Board's independent trustees. Her demand having been refused, Plaintiff then filed a lawsuit in the Northern District of Texas against the adviser and the trustees. In addition to her substantive claims on behalf of the fund, Plaintiff argued that the Board's rejection of her demand was improper and based on a defective investigation process.

Defendants filed a motion to dismiss pursuant to chapter 156D § 7.44 of the Massachusetts General Laws, which provides that a derivative lawsuit “shall be dismissed by the court on motion by the corporation” if a majority of independent board members present at a board meeting (if they constitute a quorum) “determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of a derivative proceeding is not in the best interests of the corporation.” The district court granted the motion and dismissed Plaintiffs' lawsuit, concluding that: (1) Defendants' formulation of the standard for independence under the Massachusetts General Laws was correct; (2) this standard had been satisfied by the independent trustees; and (3) the independent trustees' decision to reject the demand was made in good faith based on a reasonable investigation.

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Following a *de novo* review, the Fifth Circuit rejected Plaintiffs' arguments on appeal and embraced each of the district court's conclusions.

KEY HOLDINGS

The District Court Applied the Correct Standard for Evaluating Independence for Funds Organized as Massachusetts Business Trusts

Determination of trustee independence in this case turned, as an initial matter, on a dispute regarding the interpretation of the Massachusetts General Laws. Although § 7.44 codifies the business judgment doctrine with respect to independent trustees' decisions regarding shareholder demands, the statute does not define "independent." To fill this gap, Plaintiff asserted that the district court should have applied a "totality of the circumstances test" referenced in a Massachusetts lower court decision evaluating independence outside of the investment company context. Like the lower court, however, the Fifth Circuit rejected this view and agreed with Defendants that the relevant independence standard for a trust that is a registered investment company is supplied by another explicit provision of Massachusetts law. Specifically, Chapter 182 § 2B of the Massachusetts General Laws expressly applies to trusts that are SEC-registered investment companies and incorporates the "interested person" standard from the Investment Company Act of 1940 (ICA) in evaluating the independence of a trustee's actions.

The Majority of the Trustees Were Independent Under § 2B

Section 2B provides that a trustee is independent if she is not an "interested person" as defined in the ICA. In relevant part, the Fifth Circuit explained, the ICA defines "interested person" as "'any affiliated person' of an investment company or investment advisor, 'any member of the immediate family' of an 'affiliated person,' or an 'interested person of any investment advisor' for the investment company."[2] The Fifth Circuit further noted that whether someone is "affiliated" depends on, among other things, the extent to which the person has a "controlling influence over the management or policies of the company."[3] The Court held that Defendants demonstrated adequate evidence to show the trustees' independence and that Plaintiff failed to rebut this showing as required to defeat a motion to dismiss under § 7.44. Specifically, agreeing with the district court's analysis, the Court stated that Plaintiff's allegations of "structural conflicts" and personal conflicts from past business and personal relationships did not "show a controlling influence" regarding any of the trustees.

Rejection of Demand Was Made in Good Faith After a Reasonable Investigation

Massachusetts law presumes that a rejection of a shareholder demand is a valid business judgment absent a showing by the plaintiff of bad faith or lack of investigation. Like the district court, the Fifth Circuit determined that Plaintiff failed to make this requisite showing. The Court observed that, in investigating Plaintiff's demand, the trustees formed a committee which "held sixteen meetings; hired independent counsel, who billed for one-thousand hours of attorney time; reviewed thousands of pages of documents; interviewed ten witnesses; met with [Plaintiff]; and asked [her] for any relevant documents," culminating in a 96-page report recommending the rejection of Plaintiff's demand. According to the Court, Plaintiff's challenges to the good faith and reasonableness of the investigation were unconvincing and contradicted by this record, such that she could not rebut the Board's business judgment.

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CONCLUSION

This decision represents a positive result for fund boards, as it validates the role of disinterested members in making determinations concerning litigation and the deference granted under the business judgment doctrine. The Court's ruling also serves as a clarifying authority for board member independence standards with respect to funds organized under Massachusetts law that are also registered under the ICA.

K&L Gates represented the adviser and its affiliates in this matter at the district court level and on appeal.

FOOTNOTES

[1] *Lanotte v. Highland Cap. Mgmt. Fund Advisors, L.P., et al.*, No. 20-10649, 2023 WL 2663276 (5th Cir. March 28, 2023).

[2] *Id.* at *3 (quoting 15 U.S.C. §§ 80a-2(a)(19)(A)(i)-(iii), (B)(i)-(ii)).

[3] *Id.* (quoting 15 U.S.C. § 80a-2(a)(9)).

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