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ALERT

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After 10 Years of Litigation, Ninth Circuit Dismisses *Northstar v. Schwab* Class Action

Attorneys
John C. Ertman
Robert A. Skinner
Amy D. Roy

On September 14, 2018, the United States Court of Appeals for the Ninth Circuit put an end to the long-running *Northstar Financial Advisors v. Schwab Investments* class action. In a much anticipated ruling, a panel of three Ninth Circuit judges held that Northstar's ten-year-old lawsuit against Schwab was barred in its entirety by the federal Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), giving Schwab a complete victory.[1] The decision is of profound importance to the mutual fund industry, because if the panel had ruled the opposite way and allowed the *Northstar* case to go forward, it potentially could have sparked a new wave of class action litigation against mutual fund advisers and trustees. One caveat though – as of the time of this publication, it is still possible for Northstar to seek an *en banc* review of the decision from the full Ninth Circuit.

The *Northstar* case, first filed in 2008, arose from allegations that the Schwab Total Bond Market Fund was overinvested in mortgage securities, contrary to the stated investment policies in the fund's prospectus. Plaintiff Northstar asserted a class action on behalf of fund shareholders against the fund's adviser and trustees, not for violations of the federal securities laws due to inaccurate disclosure in the fund's prospectus, but instead for breach of contract (*i.e.*, breach of the prospectus' investment policies) and breach of fiduciary duty.

The novel aspect of the *Northstar* case was that those types of state law claims normally cannot be brought directly by mutual fund shareholders in a class action. Instead, any claims of mismanagement of a fund's investment program by a fund's adviser would fall under the domain of the fund's trustees, who have the right to assess all the circumstances and address such situations according to their business judgment as to what would be in the best interests of the fund. A shareholder seeking to assert such claims typically would have to sue derivatively, after first meeting the stringent requirements for bringing a derivative action, including that they made a demand on the fund's board to bring suit against the fund's adviser and the board unreasonably refused.

In accordance with these legal principles, the U.S. District Court for the Northern District of California initially dismissed the Northstar case in August 2011.[2] But on appeal, in March 2015, the Ninth Circuit, in an opinion that surprised the mutual fund industry (the "March 2015 *Northstar* Opinion"), held that mutual fund shareholders should not be limited to bringing derivative claims over alleged mismanagement in a mutual fund.[3] Instead, the court believed that mutual fund shareholders could bypass mutual fund boards entirely and bring class actions based on state law directly against advisers and trustees for breaching a fund's investment policies.[4]

Apparently due to certain legal technicalities in the case, the Ninth Circuit in its March 2015 *Northstar* Opinion chose not to address, and instead remanded for further proceedings, a key argument Schwab made for dismissal – that Northstar's case was precluded under SLUSA. Accordingly, on remand, the District Court assessed Schwab's SLUSA argument, and ruled that SLUSA barred Northstar's claims for breach of contract and breach of

[1] *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, -- F.3d --, 2018 WL 4372948 (9th Cir. Sept. 14, 2018) (referred to herein as the "September 14 Opinion").
[2] *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 807 F. Supp. 2d 871 (N.D. Cal. 2011).
[3] *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 779 F.3d 1036 (9th Cir. 2015).
[4] *Id.* at 1058.

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fiduciary duty.[5] Northstar appealed, and the Ninth Circuit affirmed the District Court's dismissal in its September 14 Opinion.

Specifically, the Ninth Circuit panel held in its September 14 Opinion that, by enacting SLUSA, Congress intended to strictly limit the type of claims under state law that shareholders could bring. State law class actions by shareholders are barred under SLUSA where: (1) the plaintiff alleges that the defendant made a misrepresentation or omission; and (2) the misrepresentation or omission is a fact on which the proof of plaintiff's state law cause of action depends.[6]

Applying this test to the *Northstar* case, the Ninth Circuit panel held that the plaintiff's claims were prohibited by SLUSA, because they depended on showing that there were misrepresentations and omissions in the fund's prospectus (that is, that the fund prospectus stated the fund would abide by certain limitations in the fund's investments but then the fund did the opposite). Notably, the panel's decision is the second time in the last year that the Ninth Circuit, following SLUSA, has rejected a putative mutual fund shareholder class action based on state law breach of contract and breach of fiduciary claims. In *Hampton v. Pacific Investment Management Co.*,[7] in an unpublished decision, the Ninth Circuit affirmed the dismissal of a shareholder class action under SLUSA where the PIMCO Total Return Fund allegedly deviated from an investment strategy stated in its prospectus. In *Hampton*, the Ninth Circuit held, like in *Northstar*, the plaintiffs' class action claims were barred because at core they were premised on misrepresentations and omissions in the fund's prospectus. The September 14 *Northstar* Opinion favorably cites to the *Hampton* decision.

The Ninth Circuit's September 14 Opinion did reverse the District Court's decision to dismiss Northstar's case with prejudice, instead granting Northstar leave to re-plead. This appears to mean that Northstar is free to re-plead its case not as a class action, but as an individual action; presumably, Northstar's individual damages are *de minimis*.

Observations

In sum, the new September 14 *Northstar* Opinion moots the earlier March 2015 *Northstar* Opinion. While the March 2015 *Northstar* Opinion suggested that mutual fund shareholders could bring a class action based on state law theories of breach of contract and breach of fiduciary duty for a prospectus violation, the September 14 *Northstar* Opinion obliterates that view, holding that SLUSA prohibits such class actions.[8] As a result, if the September 14 *Northstar* Opinion stands and is not reversed in an *en banc* hearing, mutual fund shareholder class actions in the Ninth Circuit based on state law theories of liability would in most, if not all, cases be barred by SLUSA.

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Ropes & Gray's litigators are actively involved in defending advisers, funds and their boards in litigation, and are closely monitoring developments in the case law. For further information, please contact John Ertman, Robert Skinner, Amy Roy or your usual Ropes & Gray contact.

[5] *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 135 F. Supp. 3d 1059, 1088-89 (N.D. Cal. 2015) and *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, No. 08-CV-04119-LHK, 2016 WL 706018, at *11 (N.D. Cal. Feb. 23, 2016).
[6] Although other courts have worded the test slightly differently, the Ninth Circuit's ruling is in substance consistent with every other Circuit and prior rulings in the Ninth Circuit itself.
[7] 705 F. App'x 558 (9th Cir. 2017).
[8] Under SLUSA, a class action is a lawsuit brought by 50 or more shareholders.

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