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Declining to Follow *Northstar*, New York Federal Court Dismisses Breach of Contract Claim Against Mutual Fund for Purported Violation of Concentration Policy

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In a victory for the mutual fund industry, a federal district court in New York rejected the attempt of fund shareholders to assert a breach of contract claim against the fund for a purported violation of an investment policy contained in part of the fund's prospectus. In doing so, Judge George B. Daniels of the U.S. District Court for the Southern District of New York in *Edwards v. Sequoia Fund, Inc.*[1] declined to follow the Ninth Circuit's 2015 decision in *Northstar Financial Advisors, Inc. v. Schwab Investments*,[2] holding that the terms of the concentration policy contained in Sequoia Fund, Inc.'s Statement of Additional Information ("SAI") cannot form the basis of a contractual obligation to the Fund's shareholders. Judge Daniels further ruled that even if shareholders could assert a breach of contract claim, the plaintiffs failed to allege a violation of the Fund's concentration policy. The court held that a fund does not act contrary to SEC guidance by concentrating in a particular industry where the investments exceed the 25% concentration threshold merely as the result of a passive increase in the share value of fund holdings, as opposed to the acquisition of additional shares.

Judge Daniels' decision may be a sign of relief for the mutual fund industry, as it is the first to reject *Northstar's* holding that terms in a fund prospectus or SAI can form the basis of a contractual obligation to shareholders. In *Edwards*, a pair of shareholders brought a putative class action, asserted directly against the Fund, alleging a sole claim for breach of contract. The shareholders claimed that the Fund violated the concentration policy contained in its SAI, which stated that the Fund would not concentrate in any particular industry, as concentration is defined by SEC rules and guidance. The plaintiffs alleged that the Fund breached this policy because its investments in the healthcare industry – Valeant Pharmaceutical in particular – at times exceeded 25% of Fund assets, the industry concentration threshold articulated by SEC guidance. Although the plaintiffs conceded that the Fund never made any purchases of healthcare shares that caused the Fund to exceed the 25% limit, they alleged that the policy was violated nonetheless due to the passive increase in value of the Fund's shares in Valeant. Relying heavily on *Northstar*, the shareholders argued that the Fund's alleged violation of the concentration policy was a breach of a contractual agreement to manage each shareholder's investment in a manner consistent with the policy.

Following oral argument, the District Court rejected the shareholders' reliance on *Northstar*, concluding that a statement contained in a fund disclosure does not form the basis of a contractual obligation. The Court noted that *Northstar* involved a Massachusetts business trust, under which the shareholders are parties to an underlying contract with the trust. The Court also noted that in *Northstar* the policies at issue were expressly adopted pursuant to a vote by the shareholders, whereas in *Edwards* the concentration policy was adopted directly by the Fund without shareholder involvement. Thus, the Court ruled that, unlike in *Northstar*, there was no meeting of the minds sufficient to support a finding that a valid contract was formed.

In limiting the *Northstar* holding to its very particular facts, the Court cited with approval a number of cases that have rejected the contention that terms set forth in mandatory disclosures can form the basis of a breach of contract claim. For example, the Court relied upon a California district court decision pre-dating *Northstar* – *In re Charles Schwab Corporate Securities Litigation*,[3] in which the court held that shareholders could not assert a breach of contract claim against a fund for failure to adhere to certain investment policies – including a concentration policy – because

[1] Case No. 1:18-cv-04501-GBD (S.D.N.Y. Oct. 18, 2018).
[2] 779 F.3d 1036 (9th Cir. 2015).
[3] No. 08 Civ. 1510 (WHA), 2009 WL 1371409, at *5 (N.D. Cal. May 15, 2009).

prospectuses and SAIs are not contracts but rather mandatory regulatory disclosures. In addition, the Court relied on a New York state court decision to the same general effect.[4]

In addition to rejecting the plaintiffs' contract claim, the Court also ruled that they failed to allege that the Fund's concentration policy was violated. The Court held that a fund does not run afoul of SEC guidance by concentrating in a particular industry where investments in an industry come to exceed 25% of the fund's assets merely as the result of a passive increase in their value. The Court rejected the plaintiffs' argument that the SEC had rescinded its 1983 guidance that specifically states that a fund is not required to sell assets that exceeded the 25% threshold if the excess were due merely to a passive increase in asset value. Instead, Judge Daniels adopted the Fund's understanding that subsequent 1998 SEC guidance continued to apply that interpretation of the concentration limit.

The *Edwards* decision is potentially significant to the mutual fund industry, as it is the first to reject *Northstar's* holding that terms in a fund prospectus or SAI can form the basis of a contractual obligation, albeit on somewhat different facts than presented by *Northstar*. This decision may help quell future suits brought on behalf of shareholders from relying on *Northstar* to assert direct breach of contract claims against mutual funds for purported violations of policies contained in fund disclosures.

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[4] *See Stichting Pensionenfonds ABP v. Credit Suisse Grp. AG*, No. 653665/2011, 2012 WL 6929336, at *5 (N.Y. Sup. Ct. N.Y. Cnty. Nov. 30, 2012) (stating that "a prospectus is not an offer to enter into a contract" and that inconsistencies between how investments were managed and the information contained in fund disclosures is "not enough to create a cause of action for breach of contract").