Client Alert.

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MMF Independent Trustees in Crisis: MMF Executives Sue Independent Trustees for Fraud and Waste of Corporate Assets

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In a bizarre twist to the case of the money market fund that broke the buck, the investment adviser to the Reserve Primary Fund (Reserve Fund) and its principals sued the fund's independent trustees, laying the blame for the fund's spectacular 2008 collapse squarely at their feet.

In court papers filed on January 22, 2013 responding to a class action complaint against them, the principals, as third party plaintiffs, charged that the independent trustees had a "substantial, if not controlling, role in almost all the conduct with which [the plaintiff] takes issue." If they are found liable in the class action, the principals state, then the independent trustees should indemnify the principals to the extent the independent trustees themselves are responsible for the conduct.

It is abundantly clear from the complaint that the independent trustees in this case were under immense pressure from both the Securities and Exchange Commission (SEC) and the Reserve Fund's management. Moreover, it is well established that fund trustees owe a fiduciary duty of loyalty and care to a fund's shareholders. In short, the independent trustees were thrust into a maelstrom; the court is now asked to consider how well they navigated through it.

To be sure, independent fund trustees, their counsel, and their insurance carriers will follow this new development closely.

BACKGROUND

The class action arises out of the Reserve Fund's well-publicized troubles when it "broke the buck" in September 2008 due to its holdings of Lehman Brothers commercial paper. The failure of Lehman Brothers triggered substantial redemptions in the fund, and created challenges for both management and the independent trustees who struggled to fair value the Lehman paper in the tumultuous hours following Lehman's bankruptcy filing.

The plaintiffs in the class action originally named the independent trustees as defendants in the complaint, but later dropped them, allegedly because the plaintiffs hoped the independent trustees would provide helpful testimony. The third party complaint seeks to reassert claims against the independent trustees and makes several new claims.

CONTRIBUTION AND INDEMNIFICATION

The third party plaintiffs (consisting of the principals, the investment adviser and other service providers) deny any liability in the underlying class action. But, if and to the extent they are found liable, the principals say that the independent trustees should also bear responsibility. To support their claim, the principals allege, among other things, that:

- the seven independent trustees had "impressive credentials in the financial services industry";
- competent counsel with extensive experience in the Investment Company Act of 1940 advised the independent trustees;
- the independent trustees knew that the Reserve Fund held a significant position in Lehman Brothers paper and had, in fact, reviewed those holdings less than a week before the bankruptcy filing;

- the independent trustees convened by telephone multiple times in the two days after Lehman Brothers' bankruptcy announcement to fair value the fund's holding and to discuss how to manage the run on the fund;
- despite the officers' urging, the independent trustees did not move quickly enough to fair value the Reserve Fund's holdings of Lehman Brothers commercial paper, or to suspend purchases into and redemptions out of the fund to begin the process of liquidation; and
- the independent trustees took immediate action to protect their own interests by drafting executive session minutes that were not consistent with management's disclosure to the independent trustees during the course of those two days.

The principals also assert that while pursuing a "fraud" case against the principals, the SEC was inspired in part by "falsified" minutes of the executive session in question. A federal jury acquitted the principals of fraud charges in November 2012; the SEC has announced its plans to appeal that decision.

DERIVATIVE CLAIMS

The third party plaintiffs, in their capacity as fund shareholders, also bring a derivative claim for breach of fiduciary duty and seek to compel the independent trustees to return allegedly misappropriated fund assets so that the Reserve Fund can distribute those assets to creditors and shareholders. They allege that the independent trustees exploited their positions and used fund assets for their own gain. In particular, the independent trustees allegedly spent in excess of $1.8 million on their own compensation. The principals also claim that the independent trustees spent $5.2 million for legal services and $2.2 million for consultants related to lawsuits, notwithstanding the fact that the independent trustees were dropped as defendants in the underlying class action suit.

The third party plaintiffs question whether it is "best practice" for independent trustees to set their own compensation. They also note that, despite urging from the principals, the independent trustees did not closely supervise the money spent by outside counsel, nor did they seek fee discounts from counsel.

The principals also included an unusual twist in corporate governance. They allege that the independent trustees improperly removed the fund's chairman (one of the principals and the only trustee that was not "independent") without cause after the board amended the fund's by-laws. The vote to remove the chairman allegedly was to retaliate against the principals, who had rejected the independent trustees' "threats and intimidation." The principals said that the chairman was duly elected by fund shareholders, and claim that amending the bylaws to enable the independent trustees to remove him from that role is void.

In a statement certain to raise eyebrows in fund board rooms, the principals characterized themselves as "the only real watchdogs" against the independent trustees' "waste of corporate assets."

DIRECT CLAIMS RELATED TO CONTRACTS

The third party plaintiffs bring a number of new direct claims, including unjust enrichment, breach of contract, and tortious interference with a contract.

The third party plaintiffs claim that the investment adviser and other service providers continued to provide the services for which they had contracted with the Reserve Fund and, consistent with prior practice, to advance fund operating and other expenses (including the fees of the independent trustees). They also note that, as a result of the service providers' "care, custody and management" of the fund's assets, investors in the Reserve Fund received in excess of 99 percent of the money they invested in the fund.

Nonetheless, the service providers have not yet received payment for these services or reimbursement for the money advanced on behalf of the fund. The third party plaintiffs allege that the independent trustees continued this nonpayment "to curry favor" with the SEC and, as a result, benefited because the SEC did not sue the independent trustees and they were dropped from all of the civil litigation.

DIRECT CLAIM FOR MINUTES FRAUD

Finally, the principals allege that the independent trustees fraudulently "clarified" the minutes of their meetings held in September 2008, more than two years after the fact. They claim that this action was a direct result of requests of the SEC. The principals claim that the SEC conceded, immediately prior to trial in the enforcement action against the principals, that the minutes were correct as previously drafted. As a result, they seek to recover damages for the financial and reputational damage they have suffered as a result of the independent trustees' alleged actions.

CONCLUSION

The allegations that the independent trustees are substantially liable for the fund's troubles undoubtedly will make good theater. It is less clear, however, whether it will make good law or improve best practices in the board room. Regardless of the outcome of this lawsuit, it is clear that independent members of a board must proceed carefully in dealing with crises. Management and the independent members of a board must have an arm's-length relationship and clearly, each must act consistently with their fiduciary responsibilities. But the specter of lawsuits–and potential liability–will result in some qualified board candidates declining to take on that responsibility. Insurance carriers are also likely to consider the extent to which their policies cover allegations of this nature, and whether their premiums are appropriate.

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