

# PUBLICLY-TRADED OPEN END MUTUAL FUNDS IN COMMON LAW AND CIVIL LAW JURISDICTIONS: A COMPARISON OF LEGAL STRUCTURES

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## I.

### INTRODUCTION

A U.S. or U.K. publicly-traded open end mutual fund (a "PTOE mutual fund") is essentially a tangle of agency, contract, and trust relationships. This is the case even when packaged as a corporation. A PTOE mutual fund established in a European civil law jurisdiction such as Germany or Luxembourg also is a tangle of legal relationships. While the constellation of relationships of a PTOE mutual fund established in a civil law jurisdiction bears some resemblance to its common law counterpart, the correlation is by no means perfect. In this article we deconstruct the major common law and civil law PTOE mutual fund structural models and examine the basic legal building blocks.

Equitable *ownership* of corporate America is diffusing ever deeper into the population while *control* over corporate America is concentrating ever higher into the hands of major financial intermediaries. Direct ownership of stocks by U.S. households has declined from 91% in 1950 to 32% today.<sup>1</sup> On the other hand, the percentage of U.S. households investing

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1. John C. Bogle, *Individual Stockholder, R.I.P.*, WALL ST. J., Oct. 3, 2005, at A16.

in mutual funds jumped from 5.7% in 1980 to 47.5% in 2005.<sup>2</sup> This is part of the so-called “fiduciary capitalism” phenomenon.<sup>3</sup>

Though the aggregate value of mutual fund assets in the U.S. is currently in the range of \$8.9 trillion and in Europe in the range of \$6.3 trillion<sup>4</sup>, there is considerable confusion in the literature and elsewhere about what is happening legally under the hood of this popular investment vehicle. In the United States, the confusion is, in part, attributable to the fact that a mutual fund, whether operating in trust or corporate form, is in substance a common law trust established under the law of a state. Some unfortunate terminology in the Investment Company Act of 1940, an act that merely tweaks the common law at the margins, is fueling this confusion. The term “investment company” is particularly unhelpful. Also fueling the confusion is the disjunction between fact and law, between business reality and the actual legal structure of the typical U.S. mutual fund or U.K. unit trust. We specifically refer to the fact that the sponsor, generally the fund’s public face, is legally an agent of and in a contractual relationship with the titleholder of the fund’s underlying assets. It is the title-holder who is legally the principal in the agency relationship.

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2. See Investment Company Institute Fact Book 2006, available at [http://www.iciifactbook.org/06\\_fb\\_sec6.html](http://www.iciifactbook.org/06_fb_sec6.html).

3. Today, the trust has really come into its own in the employee benefit, charitable, and commercial areas, so much so, in fact, that a relatively small number of institutional fiduciaries collectively have the power to control many large U.S. corporations. Mutual funds, for example, hold 30% of U.S. equities and corporate pension and savings plans 20%. See John C. Bogle, Letter to the Editor, *Shareholder Democracy: Economic Rewards for Risking Capital*, WALL ST. J., Dec. 7, 2006, at A19 (“This phenomenon has been labeled ‘fiduciary capitalism.’”); JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 803 (2000) (citing James P. Hawley & Andrew T. Williams, *The Emergence of Fiduciary Capitalism*, 5 CORP. GOVERNANCE 206 (1997)). As far back as 1940, Congress anticipated the phenomenon. See the findings and declaration of policy of the Investment Company Act of 1940, specifically 15 U.S.C.A. § 80a-1(a)(3)-(4) (2005) (finding that investment companies, whether trustees or incorporated, have the power to “dominate and control” the management of corporations engaged in interstate commerce, “are media for the investment in the national economy of a substantial part of the national savings,” and “may have a vital effect upon the flow of such savings into the capital markets”).

4. DWS Global Fund Analysis 2005, <http://www.dws.de/about/PressNewsDetail.aspx?id=47&NavId=1> (last visited March 5, 2007).

On the European continent it is the fiendishly complex constellation of corporations, agencies, joint interests, and connecting contracts that is the legal anatomy of the typical civil law mutual fund which serves to obfuscate the rights, duties and obligations of the parties to those relationships.

Finally, from a global perspective, the prevailing cross-border taxonomy does not comfortably accommodate both common law and civil law traditions. We are referring to the current practice of classifying a mutual fund structural model as either corporate or contractual, with the trustee mutual fund being assigned to the contractual classification.<sup>5</sup> The two-part classification, as we shall see, may make some sense from the civil law perspective, but from the common law perspective, it is not helpful, particularly when it comes to sorting out the rights, duties, and obligations of the parties.

One reason why the two-part classification is confusing is that the purchaser of a participation in a trustee mutual fund operating in a common law jurisdiction has an equitable or beneficial property interest in the fund itself, and perhaps even some interest in the underlying property.<sup>6</sup> Thus, the investor is much more than just a party to a contract with the fund trustees; he or she is a trust beneficiary. "The beneficiary of a trust has something more than a mere chose in action, something more than the merely personal claim that a creditor has against his debtor."<sup>7</sup> In other words, the trust relationship is *sui generis*.

Another reason why classifying all PTOE mutual funds as either contractual or corporate can be an impediment to an orderly sorting out of the rights, duties and obligations of the parties relates to the incorporated mutual fund. In a common

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5. See, e.g., The Consultation Report, Examination of Governance for Collective Investment Schemes, Technical Committee of the International Organization of Securities Commissions, Feb. 2005, 1531 PLI/Corp, 1303, 1311 (identifying only two main PTOE mutual fund structural models, the corporate and the contractual, the trust model being deemed a variation of the contractual model).

6. See generally G. G. BOGERT & G. T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 183 (rev. 2d ed., repl. vol. 1995) [hereinafter BOGERT & BOGERT] (suggesting that it is now reasonably settled that a trust beneficiary possesses a proprietary interest in the trust property itself).

7. 1 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 12.1 (4th ed. 1987) [hereinafter SCOTT & FRATCHER].

law jurisdiction, a stock-holder is generally in a contractual relationship with the corporation.<sup>8</sup> That is generally not the case in civil law jurisdictions. In a civil law jurisdiction, a share of a corporation evidences more than mere contractual rights.<sup>9</sup> It is no wonder that when it comes to mutual fund structures, fashioning a unified classification system that is internally coherent is easier said than done.

Why are we in this taxonomic muddle? In part it is because the civil law has nothing really comparable to the common law trust, other than perhaps the *Treuhand*. (While the *Treuhand* has some attributes of the common law trust, it also has some attributes of a third-party beneficiary contract).<sup>10</sup> In part it is because of the marginalization of the common law trust in the curriculum of the U.S. law school.<sup>11</sup>

We define a mutual fund as a pool of items of property - whether tangible, intangible or real, and whether fractional or whole - that is, legally structured so that beneficial ownership of the pool itself, as contrasted with the property interests that comprise the pool, is divisible and transferable. A fractional ownership interest in the fund itself is known as a "share of beneficial interest" or "participation," and in pre-dematerialization days was sometimes represented by a paper that resembled a stock certificate.<sup>12</sup>

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8. See generally BOGERT & BOGERT, *supra* note 6 at § 16 (suggesting that the relation of shareholder to corporation is merely contractual, and in no way analogous to the relation of beneficiary to trustee).

9. Uwe Hüffer, BECK'SCHE KURZKOMMENTARE AKTIENGESETZ § 1(II)(1) (a) (7th. ed. 2006) (explaining the extra-contractual property interests that a corporate shareholder has under German law).

10. See 1 JEFFREY A. SCHOENBLUM, MULTISTATE AND MULTINATIONAL ESTATE PLANNING, 1260-62 (1999) (noting, for example, that unlike the underlying assets of a common law trust which are generally unreachable by the trustee's personal creditors, the underlying assets of a *Treuhand* are subject to the claims of the *Treuhänder's* personal creditors).

11. See generally Charles E. Rounds, Jr., *The Case for a Return to Mandatory Instruction in the Fiduciary Aspects of Agency and Trusts in the American Law School*, 18 REGENT L. REV. 251 (2006).

12. See Richard R. Stanley, *Global Custody Operations of Banks*, 114 BANKING L.J. 418, 423 (1997) (noting that the modern trend is to use the electronic medium instead of paper certificates. The process of replacing paper certificates with electronic data entry is known as "dematerialization"); see generally Group of 30, *Clearance and Settlement Systems in the World's Securities Markets* (1988) (recommending a worldwide move to "dematerialize" securities).

We limit our coverage to funds that are open-ended and publicly traded, namely regulated "investment companies" of the type sponsored by such entities as Fidelity, Vanguard, and Bank of America on the U.S. side, and "*Investmentvermögen*" of the type sponsored by Deutsche Bank, the Dresdner Bank, and the Sparkassen on the European side. An open end fund is a fund whose shares may be exchanged by their owners for fund cash. In other words, the shares are "redeemable."<sup>13</sup>

We devote equal attention to the common law and civil law mutual fund structural models. We do so, however, from the common law perspective. This means that we have broken down the common law structural models into their constituent legal and equitable relationships and then compared those relationships with their civil law counterparts and analogs.

Unfortunately, the common law and the civil law regimes do not share a common understanding of what an agency or a trust is or what it means to be a fiduciary. Thus, we have been forced by the methodology to venture into the poorly charted waters of civil law fiduciary analogs.<sup>14</sup> The methodology has a common law flavor to it in that we do not assume that things are what they appear to be. A corporation, for example, may actually be a trust in corporate clothing. That is one reason why care has been taken to avoid some of the unfortunate terminology of the Investment Company Act of 1940 (the "Act"). We have also steered away from the simplistic and artificial two-part approach to classifying mutual fund structures. As noted above, to force a particular mutual fund structural model into either the contract or the corporation pigeon hole can actually mask, rather than clarify, the rights, duties, and obligations of the parties.

The U.S. and U.K. mutual fund structural models are similar both in form and in function, although at first glance the legal structure of the U.K. corporate model, the so-called Open End Investment Company or OEIC, looks quite different from that of its U.S. counterpart. As we shall see, however, both corporate models are not that dissimilar in that they are,

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13. See 15 U.S.C.A. § 80a-5(a) (2005) (defining an open end mutual fund as a fund whose title-holder offers for sale or has outstanding redeemable securities in the fund itself).

14. See generally Pierre Lapaulle, *Civil Law Substitutes for Trusts*, 36 YALE L.J. 1126 (1927).

for all intents and purposes, trusts in disguise. Together, the U.S. and U.K. account for 55.2% of the world's aggregate mutual fund asset pool.<sup>15</sup>

On the other hand, the reader is warned that the so-called UK REIT or Real Estate Investment Trust, a creature of the Finance Act 2006, bears no structural resemblance whatsoever to a U.S. REIT or Real Estate Investment Trust. A U.S. REIT is a trustee mutual fund, and thus falls within the scope of this article. A UK REIT, on the other hand, is not really a REIT in that it is neither a trust nor a mutual fund. Rather, it is similar in form and function to a U.S. Subchapter S Corporation.<sup>16</sup> This is the case as well for the so-called G-REIT<sup>17</sup>, which the German parliament authorized in 2007.<sup>18</sup> Accordingly, the UK REIT falls outside the scope of this article which only deals with examples of corporations disguising themselves as trusts.

Our generic model of a trustee mutual fund is based on a composite of the Massachusetts Business Trust<sup>19</sup>, the Delaware statutory trust<sup>20</sup>, and the U.K. unit trust. Fidelity's funds, as well as Bank of America's Columbia Funds, utilize the Massachusetts Business Trust while Vanguard utilizes the Delaware statutory trust. Approximately 50% of U.K.'s mutual funds are trustee. Our generic model of the U.S. incorporated mutual fund is based on the Maryland corporate model, the vehicle of choice for the privately owned American Funds complex.<sup>21</sup>

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15. DWS Global Fund Analysis 2005, <http://www.dws.de/about/PressNewsDetail.aspx?id=47&NavId=1> (this study by Germany's largest mutual fund company DWS was published in 2006) (last visited March 5, 2007).

16. Finance Act 2006 Chapter 25, c. 9 part 4. (Real Estate Investment Trusts.)

17. Jan F. Bron, Das G-Reit-Gesetz — Eine Analyse auf Basis des Gesetzentwurfes der Bundesregierung, <http://wcms.uzi.uni-halle.de/download.php?down=819&elem=236076&func=b85c12bd023bc98341ad09e2ba9f701c>.

18. [http://reits-in-deutschland.de/fileadmin/templates/pdf/REITs-Gesetz\\_Beschlussempfehlung-Finanzausschuss.pdf](http://reits-in-deutschland.de/fileadmin/templates/pdf/REITs-Gesetz_Beschlussempfehlung-Finanzausschuss.pdf).

19. MASS. GEN. LAWS, ch. 182, § 1, *et seq.* (2006). See generally Sheldon A. Jones, Laura M. Moret, James M. Storey, *The Massachusetts Business Trust and Registered Investment Companies*, 13 DEL. J. CORP. L. 421, 448 (1988).

20. DEL. CODE ANN. tit. 12, §§ 3801-3862, (2001).

21. The 30 incorporated mutual funds comprising the American Funds complex are advised by Capital Research and Management, which is Los Angeles based. Filings with the SEC confirm that the \$160 billion Growth Fund of America, the complex's largest fund, is a Maryland corporation. SEC Filing for the Growth fund of America (2005), available at <http://www.sec.gov/>

The Fidelity fund complex is the largest in the U.S. with \$1.1 trillion under management.<sup>22</sup> The Vanguard fund complex is second with slightly less than \$1.1 trillion under management, and the American fund complex is third with \$972 billion under management.<sup>23</sup> While there has been some Federal regulatory preemption at the margins, a U.S. mutual fund is governed and regulated first and foremost by state law.

Our U.K. corporate model is the Open End Investment Company, or OEIC, which came on the scene in 1997. It is a so-called investment company with variable capital. Approximately 50% of U.K. mutual funds are now OEICs.

Our generic civil law mutual fund models are creatures of German and Luxembourgian legislation. Germany and Luxembourg together account for 38% of the European Continent's mutual fund asset pool and 12.64% of the global pool.

This article is a manual for dissecting the basic anatomy of typical PTOE mutual funds operating on both sides of the Atlantic. We leave for another day consideration of the big picture policy issues, e.g., the societal implications of the "fiduciary capitalism" phenomenon. We also defer discussion of the small picture policy issues, e.g., whether the common law approach or the civil law approach better protects the mutual fund investor. Having said that, as to the issue of investor protection, we have a preliminary sense that, while there are adequate safeguards in place on both sides of the Atlantic to protect mutual fund assets from the creditors of the intermediaries who have title to or control of those assets, the Anglo-American equitable concept of the fiduciary may bring with it more pro-activity and less respect for the corporate package than does its civil law statutory analogs when it comes to looking out for the investor. Also, more of the parties in a mutual fund's tangle of legal relationships are likely to be tagged with the fiduciary or "fiduciary-like" label in a common law jurisdiction than in a civil law one. Thus, the common law models may afford the investor more non-regulatory protec-

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Archives/edgar/data/44201/000004420106000003/0000044201-06-000003.txt (last modified April 1, 2006.)

22. See Lawrence C. Strauss, *Living Large, in a Fishbowl*, BARRON'S, Jan. 8, 2007, at L5 (discussing the phenomenal growth spurt of the American Funds complex since the end of 2001).

23. *Id.*

tion in the form of private rights of action than the civil law model. Moreover, in a multi-fiduciary environment, the common law principle of co-fiduciary liability causes to be put in place, at least in theory, a private system of checks and balances and cross-fiduciary oversight that can only inure to the benefit of the investor-beneficiary. But again, a vetting of such issues we leave for another day as there first needs to be a general sorting out of the applicable black letter common law and black letter civil law.

Part III contains diagrams of the following PTOE mutual fund models: (1) The U.S./U.K. trustee model, (2) the U.S. Corporate Model, (3) The U.K. corporate model, (4) the German/Luxembourgian *Miteigentum/FCP* model (joint ownership analog), (5) The German *Treuhand* model (trusteeship analog), and (6) the German/Luxembourgian corporate model.

In Part IV we discuss the concept of the “fund” in the common law and civil law traditions, with a particular focus on title issues.

In Part V we consider who has title to the underlying assets of the typical PTOE mutual fund operating in the U.S., the U.K., Germany & Luxembourg.

In Part VI, we discuss the duties that are owed to investors in a PTOE mutual fund by the person or entity that has title to the fund’s underlying assets and by the fund’s sponsor and investment manager, who may or may not be one and the same.

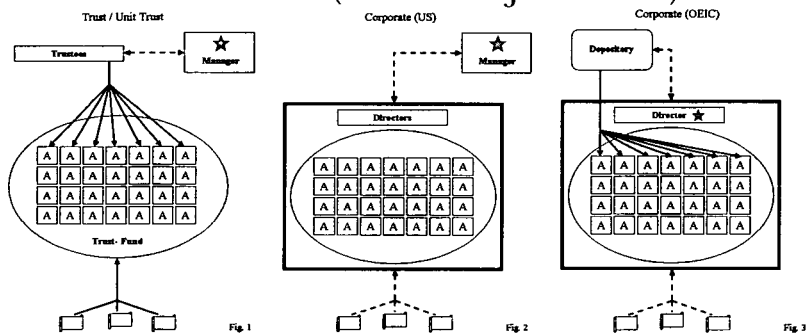
In Part VII, we articulate our conclusion that the core substantive difference between the common law and civil law mutual fund lies not in their dissimilar structures, but in whether there are fiduciary or fiduciary-like duties that sponsors owe the investors. While the sponsor of a common law mutual fund generally has fiduciary duties that run directly to the investors, the sponsor’s civil law counterpart generally does not. Thus, the investor in a common law mutual fund would have a private right of action directly or derivatively against the sponsor for breaches of the sponsor’s fiduciary duties to the investor. Because the sponsor of a PTOE mutual fund established in a civil law jurisdiction is neither in a contractual relationship with the investors nor owes fiduciary duties to them incident to some other kind of relationship, the investors’ only recourse against the sponsor for harm done to fund assets occasioned

by the sponsor's malfeasance or nonfeasance is to inform the regulatory authorities.

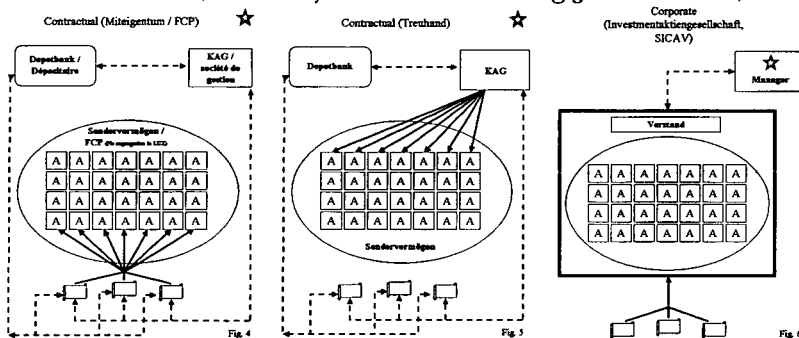
## II.

### DIAGRAMS OF THE DIFFERING LEGAL ANATOMIES OF SIX STANDARD OPEN END MUTUAL FUND STRUCTURAL MODELS

#### Common Law (U.S. & U.K. Jurisdictions)



#### Civil Law (Germany and Luxembourg Jurisdictions)



#### Legend:

- Unbroken arrowed lines run from title-holders/owners of properties to the properties
- Broken lines connect contracting parties
- A denotes an underlying mutual fund asset
- denotes a "fund"
- denotes a corporation
- denotes a mutual fund investor
- ★ denotes a mutual fund sponsor

Fig.1: *A standard U.S. trustee mutual fund or U.K. unit trust (open end).* Title to the underlying assets is in the fund trustees, who hold the underlying assets for the sole benefit of the investor-beneficiaries. The trustees are in a contractual and agency relationship with the investment manager, which typically is the fund's sponsor and public face. It is the sponsor who designed and launched the fund. The sponsor selects the fund trustees, subject to investor approval. The manager has fiduciary duties that run directly to the investor (these duties are un-depicted).

Fig.2: *A standard U.S. open end incorporated mutual fund.* Title to fund assets is in the corporation, which is governed by directors. The directors have trustee-like fiduciary duties that run directly to the investors (these duties are un-depicted). The manager, which is typically the sponsor and public face of the fund, is in a contractual and agency relationship with the corporation. The manager provides investment management and other services to the corporation. The investors are the stockholders of the corporation. They are in a contractual relationship with the corporation, the holder of the title to the underlying assets.

Fig.3: *A standard U.K. incorporated open end mutual fund or Open End Investment Company (OEIC).* An OEIC typically has only one director, the fund's sponsor and public face. The director, in most cases a corporation, manages the investing of the underlying assets. An independent depository bank, however, holds the legal title to the underlying fund assets. It also has certain oversight responsibilities. These roles make the depository the functional equivalent of the trustee of a U.S. mutual fund. As well as being in a contractual and agency relationship with the OEIC, the depository has fiduciary duties that run directly to the investor (these duties are un-depicted). The investors are shareholders of the OEIC, which is also known as an "investment company with variable capital".

Fig.4: *A standard German open end mutual fund - Miteigentumslösung type.* The fund's assets are collected in a segregated fund, or *Sondervermögen*, title to which is held collectively by the investors themselves. The *Sondervermögen* is managed by a *Kapitalanlagegesellschaft* (KAG), which is typically a daughter company of the sponsor and the fund's public face. The *Depotbank* is a custodian of the underlying assets of the *Sondervermögen* and oversees some of the activities of the KAG.

The KAG, the Depotbank, and the investors are in contractual and agency relationships with one another. A Luxembourgian *fonds communs de placement* or FCP has almost the same legal structure. In the case of a FCP, however, there is no segregated *Sondervermögen*.

Fig.5: A standard German open end mutual fund - *Treuhandlösung* type. The fund's underlying assets are collected in a segregated fund, or *Sondervermögen*, title to which is in the KAG, typically a daughter company of the sponsor and the fund's public face. The KAG is a *Treuhänder* with a duty to act solely in the interests of the investors. A *Treuhänder* has some, but not all, of the attributes of a common law trustee. Unlike the beneficiaries of a common law trust, for example, the investors have no beneficial interest in the underlying assets, the relationship between the KAG-Treuhänder and the investors being merely contractual. The *Depotbank* is custodian of the *Sondervermögen*. The KAG, the *Depotbank* and the investors are in contractual and agency relationships with one another.

Fig.6: A standard German/Luxembourgian incorporated mutual fund (*open end*). Title to the underlying fund assets is in the investment company (*Investmentaktiengesellschaft*) which is governed by a board of directors (*Vorstand*). The manager is not a KAG, though it is typically a daughter company of the sponsor and the fund's public face. The manager is in a contractual relationship with the investment company. The investors are the stockholders of the investment company. They do not have title to the fund's underlying assets. There is a requirement under Luxembourg law that a bank custodian (*dépositaire*) hold the underlying assets of a SICAV. German law has no such requirement.

### III.

#### THE CONCEPT OF THE "FUND"

As a general rule, a segregated collection of assets, a "fund," cannot be freestanding,<sup>24</sup> meaning that it cannot in and of itself be a legal person or entity. Thus, the legal title to

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24. It should be noted that in the definitional section of the Investment Company Act of 1940 a "fund" is deemed to be a "company." 15 U.S.C.A. § 80a-2(a) (8) (2005). The reader is cautioned, however, that the Act would defer to state law on the question of whether or not a segregated fund actually is a juristic person. See generally *Burks v. Lasker*, 441 U.S. 471 (1979)

a fund's underlying assets has to be somewhere extrinsic to the fund itself. It can be in a human being in his or her own right or as trustee. It can be in a corporation in its own right or as trustee. In any case, it has to be somewhere and cannot be in the fund itself. This has been the case since Roman times when the head of a family would segregate a *peculium*, defined as a portion of his estate, for the benefit of his slave or, perhaps, his son. Ownership of the *peculium* - *special patrimony* in English and *Sondervermögen* in German - remained, however, with the head.<sup>25</sup>

A. *A Segregated Fund in a Common Law Jurisdiction: Where is Title to the Underlying Assets?*

In a common law jurisdiction, the holder of the legal title to property generally cannot place the property in limbo merely by physically segregating the property from the owner's other assets or general patrimony. The property owner, for example, might transfer the shares in a portfolio of stocks from the desk drawer in his home office to a bank safe deposit box rented by the owner. Absent other facts, however, this is a legal non-event. The legal title to the stocks remains with the owner, notwithstanding the physical segregation from the owner's other assets or general patrimony. Moreover, the owner's creditors will have full access to the box's contents. However, if the owner were to declare himself or herself trustee of the contents of the safe deposit box for the benefit of another or transfer the contents to another human being or a corporation in trust for the benefit of a third party, that event would have legal significance. It would not, however, place the title in limbo. In the case of the trust declaration, title to the subject property, the fund, would remain with the settlor-trustee.<sup>26</sup> In

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(confirming that an investment company is a creature of state law, not the Investment Company Act of 1940).

25. See generally Henry Hansmann, Reiner Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335, 1358 (2006) (confirming that "[t]he *peculium*, plus any profits it generated, formally remained the property of the master.").

26. Cf. *Taliaferro v. Taliaferro*, 260 Kan. 573, 575 (1996) (noting that that in the case of a declaration of trust, that is a trust where the settlor and the trustee are one and the same, the settlor need not transfer legal title to the subject property to the settlor himself or to a third party for the trust to arise).

the case of the transfer in trust, legal title would pass to the trustee.<sup>27</sup> In either case, the chain of legal title would be unbroken.

That is not to say that the alienability of the equitable interest under a trust could not be restrained or lodged in persons yet to be conceived, but the legal title to the underlying property would be in someone and fully alienable.<sup>28</sup> Nor is it to say that the sticks in the bundle of rights that constitute property ownership could not be rearranged by entrustment. Depending upon the type of trust that the fund becomes subject to, the fund might become insulated from the reach of both the settlor's creditors and the trustee's creditors<sup>29</sup> while becoming vulnerable to the reach of the beneficiaries' creditors.<sup>30</sup> In addition, the joint and several liabilities of the trustee and the beneficiaries alike to extrinsic creditors in connection with the trust's administration could be limited by contract to what is in the fund.<sup>31</sup> And, last but not least, an equitable property interest would accrue to the trust beneficiaries, some of whom could even be persons yet to be conceived.<sup>32</sup> But however much the rights, duties and obligations of the parties are reshuffled, title to the underlying assets still

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27. See RESTATEMENT (THIRD) OF TRUSTS § 2 (2003) (confirming that title to the property of a trust is in the trustee).

28. Cf. *Broadway National Bank v. Adams*, 133 Mass. 170, 171-72 (1882) (upholding a trust spendthrift provision as not being void as against public policy because the right of the legal title-holder, i.e., the trustee, to alienate the underlying property remains unimpaired).

29. See generally Henry Hansmann, *supra* note 25 at 1384 (noting that "[d]uring the seventeenth century it likely became settled doctrine that a trustee's personal creditors could not levy on trust assets, even though the trustee held those assets in his own name.").

30. See generally IIA SCOTT & FRATCHER, *supra* note 7, § 147 (confirming that the creditors of a trust beneficiary may reach the beneficiary's equitable interest, except in certain cases when the terms of the trust or a statute may provide otherwise).

31. See generally IIIA *id.* § 263 (confirming that "[i]f the trustee is unwilling to make himself personally liable upon a contract made by him in the administration of the trust, he may contract in a way as to exclude personal liability.").

32. See generally II *id.* §112.1; RESTATEMENT (THIRD) OF TRUSTS §44, cmt. c (2003) (confirming that in the U.S. a trust may be created for persons who are unborn and unascertained). In Louisiana, however, a civil law jurisdiction, other than in the case of a so-called class trust, one must be in being and ascertained at the time of a trust's creation in order to qualify as a beneficiary. LA. REV. STAT. ANN. §9:1803 (1991).

remains in the hands of some natural or juristic person. It can neither be in the fund itself nor, with rare exceptions, e.g., abandoned property<sup>33</sup>, can it be in limbo:

“The theory that the fee may be in abeyance, or in nubibus, is not without common-law authority. 2 Blackstone, Com. 107; Illinois, etc., R. Co. v. Bosworth, 133 U.S. 92, 10 Sup. Ct. 231, 33 L. Ed. 550. But it was ever odious and never recognized unless in cases of extreme necessity. 4 Kent, Com. 257; Fearn on Remainders, 409, 410.”<sup>34</sup>

B. *A Segregated Fund in a Civil Law Jurisdiction: Where is Title to the Underlying Assets?*

The principle that title to property has to be somewhere, that it can be neither in limbo nor *in nubibus*, also is very much a part of the fabric of the civil law. The German *Sachenrecht*, - the body of German statutory law regulating property rights - has five core principles.<sup>35</sup> One of them, the so called *Bestimmtheitsgrundsatz*, provides that, with some minor exceptions of which the mutual fund is not one, every property right at any given time must have identifiable owners. Thus, as is the case with a U.S. mutual fund, title to the underlying assets of a German mutual fund has to be in at least one natural or juristic person. Luxembourg is no different from Germany in this regard.

We owe the legal structure of the modern American mutual fund to the trial and error of creative common law lawyers practicing in the first half of the 20th century, particularly in Massachusetts.<sup>36</sup> Their media were common law legal relationships, namely the agency, the contract, the trust, and to some extent the statutory corporation. While the American mutual fund structure has evolved over time with minimal legislative

33. See generally 1 C.J.S. *Abandonment* § 15 (2005) (noting that “[p]ersonal property, upon being abandoned, ceases to be the property of any person, unless and until it is reduced to possession with the intent to acquire title to, or ownership of, it.”).

34. *Alsman v. Walters*, 184 Ind. 565, 568 (1914).

35. Manfred Eberhard Rinne, *Einleitung Band 3. Sachenrecht*, in: MÜNCHENER KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH, 4th ed., München 2004. (Listing the five core principles: *Absolutheit*, *Typenzwang*, *Abstraktheit*, *Bestimmtheit*, *Offenkundigkeit* and *Akzessorietät*).

36. Massachusetts Investors Trust, America’s first open end mutual fund, was launched in 1924.

input, the modern German mutual fund structure came into the world fully formed one day in 1954 thanks to the efforts and actions of the German parliament.<sup>37</sup> A cursory reading of the legislation will reveal that the civil law lawyers who drafted it were influenced by the Anglo-American experience with commingled investment products.<sup>38</sup> The common law duty of loyalty, for example, was translated almost verbatim into German and incorporated into the legislation's text.<sup>39</sup> As we shall see, however, there may have been less of a nod to the Anglo-American experience than meets the eye.

The German *Investmentgesetz* is the body of Federal German statutory law that, among other things, prescribes how a German mutual fund may be structured and what the rights, duties and obligations of the parties shall be. In keeping with the civil law tradition, it is all-inclusive. The *Investmentgesetz* requires that a German mutual fund only be administered by a KAG or an *Investmentaktiengesellschaft*. A KAG is a special type of corporation whose sole purpose in the mutual fund context is to administer a mutual fund. All the assets that make up the fund are collected and form a special patrimony, the *Sondervermögen*<sup>40</sup>. An *Investmentaktiengesellschaft*, a statutory creation of relatively recent origin, on the other hand, is essentially an incorporated *Sondervermögen*. It bears some resemblance, at least in legal structure, to an incorporated U.S. mutual fund.

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37. Mutual funds were not unknown in Germany prior to 1954. A German mutual fund established before 1954, however, had a legal structure that in many respects did not meet the requirements of the 1954 legislation. See Ernst von Caemmerer, *Kapitalanlage- oder Investmentgesellschaften*, JURIS-TENZEITUNG [JZ], 41-50 (1958) (discussing Germany's experience with the mutual fund prior to 1958).

38. See Jürgen Thiel, *Der Schutz der Anleger von Wertpapierfonds im deutschen und amerikanischen Recht*, in *Europäische Hochschulschriften* 1982, at 53 (Reihe 2: Rechtswissenschaft Vol. 300, 1982). (noting that the German legislature has twice sent a delegation to the U.S. to gather information on the inner workings of the U.S. mutual fund industry).

39. See *Investmentgesetz* [Investment Act] Jan. 1, 2004, § 9 II no. 1 (F.R.G.) (*Die Kapitalanlagegesellschaft ist verpflichtet bei der Ausübung ihrer Tätigkeit im ausschließlichen Interesse ihrer Anleger und der Integrität des Marktes zu handeln*).

40. Note, that it is not just in the German mutual fund context that we encounter the *Sondervermögen*. The German federal railway system, for example, was at one time organized as a *Sondervermögen*, title to which was in the Federal Republic of Germany.

A *Sondervermögen* is a portion of a legal entity's<sup>41</sup> patrimony (estate) that has been segregated from the rest of the entity's patrimony in order to carry out a purpose specified in some statute. By statute, the segregated portion has a different legal status in relation to the entity itself and third parties, e.g., the entity's creditors, than does the rest of the entity's patrimony.<sup>42</sup> The corpus of a common law trust is essentially a non-statutory *Sondervermögen*. This segregation, however, is not so complete as to transmogrify the fund into a juristic person<sup>43</sup>. Thus, title to the *Sondervermögen* still must reside with someone extrinsic to the fund itself, be it the KAG or the investors. A word of caution: When commentators in the mutual fund context refer to the *Sondervermögen* as quasi-independent, they are not suggesting, or should not be suggesting, that it constitutes an exception to the *Bestimmtheitsgrundsatz*, the principle that at any given time property must have an identifiable owner. They are referring to the fact that, by statute, the creditors of the KAG will not have access to the *Sondervermögen*. Thus, even though there is a measure of "entity shielding" ("asset shielding" is probably more precise), title to the underlying assets of a German mutual fund must still reside in some natural or juristic person:

"Organizational law empowers firms to hold assets and enter contracts as entities that are legally distinct from their owners and managers. Legal scholars and economists have commented extensively on one form of this partitioning between firms and owners: namely, the rule of limited liability that insulates firm owners from business debts. But a less-noticed form of legal partitioning, which we call 'entity-shielding,' is both economically and historically more significant than limited liability. While limited liability shields owners'

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41. In the mutual fund context, this entity is likely to be either a KAG or a class of mutual fund investors, even though the composition of the class could vary on a daily basis and be comprised of persons who are strangers to one another.

42. See Wilhelm Graulich, *Die Rechtsverhältnisse der Sondervermögen nach dem Gesetz über Kapitalanlagegesellschaften im Vergleich zu den Rechtsverhältnissen anderer Sondervermögen des Privatrechts*, Mainz (1968) (Ph.D dissertation, Johannes-Gutenberg-Universität Mainz) (defining a German private law *Sondervermögen*).

43. See Ernst Zitelmann, *Sondergut nach dem deutschen Internationalprivatrecht*, in: *Festschrift für Otto Gierke zum 70. Geburtstag*, at 255 (EG. Art. 28, 1911) (confirming that a *Sondervermögen* has no legal personality).

personal assets from a firm's creditors, entity shielding protects firm assets from the owners' personal creditors (and from creditors of other business ventures), thus reserving those assets for the firm's creditors."<sup>44</sup>

Under Luxembourg law as well, title to property generally cannot be in limbo. Luxembourg, however, does not appear to have a *Sondervermögen* jurisprudence, at least not one as developed as Germany's. This probably accounts for why Luxembourg effects asset shielding for her mutual funds by having a special purpose corporation, a SICAV or a SICAF, or the investors themselves take the legal title; and why Luxembourg does not afford her mutual fund sponsors a *Treuhand* or trust structuring option.

#### IV.

##### WHO HAS THE LEGAL TITLE TO A MUTUAL FUND'S UNDERLYING ASSETS?

###### A. *Title to the Underlying Assets of a U.S./U.K. Mutual Fund*

Legal title to the underlying assets of a U.S. or U.K. mutual fund is either in its trustees or in a corporation. In the case of the board of trustees, title is held jointly by the individuals themselves who comprise the board, a trustee "board" generally not being a juristic person.<sup>45</sup> In the case of a U.S. mutual fund packaged as a corporation, legal title to the underlying assets is in the corporate entity itself. It is not in its directors, either individually or as a board<sup>46</sup>, nor is it in the manager-sponsor. In the case of a U.K. OEIC, however, title to the underlying assets is not in the OEIC. It is in a depository bank<sup>47</sup> which is in an agency and contractual relationship with the OEIC. On paper, then, the structure of a U.S. incorporated PTOE mutual fund is radically different from the structure of its U.K. counterpart, the OEIC. As we shall see, how-

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44. Hansman et al., *supra* note 25, at 1335.

45. See generally Charles E. Rounds, Jr., *Loring A Trustee's Handbook* §3.4.4.1 (2007 ed.) (discussing the rights duties and obligations that co-trustees have to one another and to the beneficiaries).

46. See generally *Id.* at §9.9.8 (noting that directors of a corporation are not trustees of the corporate assets).

47. See H.M. Treasury, *OEICs Made Easy!* (Jan. 1997) (confirming that title to the underlying assets of an U.K. OEIC is not in the OEIC itself but in the depository bank).

ever, the difference may be more in form than in substance, at least when it comes to safeguarding the interests of investors.

Though the trust has for some time been the preferred vehicle for structuring a mutual fund in both the U.K. and the U.S., for U.S. Federal regulatory purposes the Investment Company Act of 1940 deems a mutual fund operating in whatever form, including the trust form, to be an "investment company."<sup>48</sup> Notwithstanding the corporate terminology, a mutual fund operating as a Massachusetts business trust or a Delaware statutory trust, for example, is still a trust, title to the underlying assets is still held jointly by its trustees, and it is still state common law that in the first instance defines and regulates the core rights, duties, and obligations of the parties<sup>49</sup>, notwithstanding at least one unfortunate early Massachusetts case to the contrary.<sup>50</sup>

"The enactment . . . [in the U.S.] . . . of the Revenue Act of 1936 laid the basis for the modern investment company business by providing for conduit or pass-through . . . [tax] . . . treatment for investment companies under certain conditions."<sup>51</sup> Before then, some courts had held that Massachusetts business trusts or their equivalent, at least for tax purposes, were partnerships<sup>52</sup>, even corporations.<sup>53</sup> As a matter of state trust and property law, however, they are neither. Unfortunately, such muddling of the nomenclature was carried over into the design and packaging of the Investment Company Act of 1940. One need only consider the term "corporation" in the

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48. See 15 USCA § 80a-2(a)(8) (2005).

49. See generally Laurin Blumenthal Kleiman & Carla G. Teodoro, *Forming, Organizing and Operating a Mutual Fund: Legal and Practical Considerations*, in *The ABCs of Mutual Funds 2006*, at 22-23 (PLI Corp. Practice, Course Handbook Series No. 8455, 2006) (confirming that "[i]n addition to the duties and responsibilities to which a fund may be subject under U.S. federal law, funds organized in the United States are also subject to requirements under state statutes and common law").

50. *Frost v. Thompson*, 106 N.E. 1009, 1010 (Mass. 1914) (holding what purported to be a business trust to be a partnership because the owners of the transferable shares of beneficial interest could control the trustees).

51. *Jones et al.*, *supra* note 19, at 448.

52. See, e.g., *Ricker v. American Loan & Trust Co.*, 5 N.E. 284, 286 (Mass. 1885) (holding a business trust to be a constructive partnership).

53. See, e.g., *Morrissey v. Comm'r of Internal Revenue*, 296 U.S. 344, 360 (1935) (holding a business trust to be sufficient "analogous" to a corporation to warrant it being taxed as a corporation).

Act's short title<sup>54</sup>, a choice of words guaranteed to confuse lawyers on both sides of the Atlantic who are not well versed in the common law.<sup>55</sup>

Again, we assert without reservation that an entrusted mutual fund is neither a partnership nor a corporation; it is a trust.<sup>56</sup> We go much further, however. We suggest that in the mutual fund context, a U.S. mutual fund operating in corporate form does so in form only. In substance and in equity it is a common law trust with a few peripheral statutory corporate attributes. In some U.S. jurisdictions, for example, the corporate form may afford *the mutual fund investor* slightly more liability protection than does the trust.<sup>57</sup> Directors of an incorporated mutual fund are trustees in every respect except legal title possession. To reflect the equitable reality, we refer to them as director-trustees. This is appropriate as, under both U.S. state and federal law, a mutual fund director-trustee has a direct and personal duty to act solely in the interests of the investors.<sup>58</sup> As we shall see later, this translates first and foremost into a duty to prudently select investment managers, supervise their activities, and remove them when to do so is in the interests of the investors.<sup>59</sup>

If it walks like a duck and talks like a duck, then it is a duck. In equity, a trust in corporate clothing is still a trust. There is ample precedent in the U.S. charitable context for ignoring corporate packaging. As Professor Scott notes:

The question is in each case whether a rule that is applicable to trustees is applicable to charitable corporations, with respect to unrestricted or re-

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54. 15 U.S.C.A. § 80b-20 (2005).

55. See generally Rounds,, *supra* note 11.

56. See generally Jones *et al*, *supra* note 19.

57. *Id.*

58. See, 4 SCOTT & FRATCHER, *supra* note 7, at §326.3 (noting that directors and officers of trust companies owe fiduciary duties that run directly to the trust beneficiaries); Herzog v. Russell, 483 F. Supp. 1346, 1348, n.1 (E.D.N.Y. 1979) (recognizing that directors of an incorporated mutual fund owe fiduciary duties that run directly to the mutual fund investors under federal law, namely under the Investment Company Act of 1940, as well as under common law principles).

59. See Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir. 1977) (confirming that the directors of an incorporated mutual fund have a direct duty to the investors to prudently select and monitor the activities of the investment advisor).

stricted property. Ordinarily the rules that are applicable to charitable trusts are applicable to charitable corporations, as we have seen, although some are not. It is probably more misleading to say that a charitable corporation is not a trustee than to say that it is.<sup>60</sup>

In the analogous agent-fiduciary context, there is ample U.S. precedent as well. An attorney-at-law doing business as a corporation, for example, enjoys no limited liability in the rendering of legal services to the client, at least with respect to his or her own actions.<sup>61</sup>

What, then, in the U.S. mutual fund context is the equitable function of the corporate package? The corporation generally has little, if any, plant and equipment. Most, if not all, of its day-to-day administrative functions are outsourced to agents. The entity is likely to have few, if any, employees. As a practical matter, the entity is little more than a shell.<sup>62</sup> We suggest that when all is said and done, when it comes to the fundamental legal relationships that comprise an incorporated U.S. PTOE mutual fund, the corporation's only real function is to hold the legal title to the fund's underlying assets *on behalf of the director-trustees* for the benefit of the investors. In other words, in equity the corporate entity is merely a custodial trustee, a nominee as it were, with each director-trustee having a direct equitable duty to act solely in the interests of the mutual fund investors. One could even say that the director-trustees themselves have the equitable title to the underlying fund assets while the investors share the equitable interest, it being settled law that the equitable or beneficial interest in one trust may constitute the property of another.<sup>63</sup> In other words, there are actually two trusts: the corporate nominee trust and

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60. See 4A SCOTT & FRATCHER, *supra* note 7, at §348.1.

61. See generally Dirk G. Christensen & Scott F. Bertschi, *LLC Statutes: Use by Attorneys*, 29 GA. L. REV. 693, 700 (1995) ("LLC statutes generally shield a member's personal assets from claims against the limited liability company; however, with regard to professional services, these statutes hold an individual personally liable for the acts and omissions he personally committed or supervised but relieve the others from vicarious personal liability.").

62. See Tannenbaum, 552 F.2d at 405 (characterizing the typical incorporated mutual fund as a "mere shell").

63. See 1A SCOTT ON TRUSTS §83; 1 SCOTT & ASCHER §10.4 (confirming that a transferable equitable interest in one trust may be held in another trust).

the directors' trust, with the latter containing beneficial interests in the former.

Having said all that, courts will, however, give deference to principles of state corporate law, except in cases where to do so would violate the letter and/or spirit of the Investment Company Act of 1940 or fundamental common law fiduciary principles. One, however, does not have to look hard to find the trust counterparts and antecedents. Take the state law principle that before the shareholders of a corporation may bring a derivative action on behalf of the corporation to remedy harm done to it by the directors and/or third parties, the shareholders must first make a demand on the directors to correct the problem, unless it would be futile to do so. In the case of an investor derivative action involving an incorporated mutual fund, which usually entails some gripe against the third party sponsor, courts will generally "apply the demand futility exception as it is defined by the law of the State of incorporation".<sup>64</sup> In states where the futility exception has been abolished, disgruntled mutual fund shareholders in all cases must first make demand on the corporate director-trustees or the trustees, as the case may be.<sup>65</sup> The common law of trusts has a comparable demand requirement which predates its corporate counterpart: If a trust suffers harm at the hands of a third party, e.g., the trustee's investment agent, the trust beneficiaries first must make a demand on the trustees to correct the problem.<sup>66</sup>

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64. *Kamen v. Kemper Financial Servs, Inc.*, 500 U.S. 90, 108-09 (1991) (holding that "a court entertaining a derivative action under the . . . [Investment Company Act of 1940]. . . must apply the demand futility exception as it is defined by the law of the State of incorporation.").

65. Massachusetts, for example has adopted a universal demand requirement. See MASS. GEN. LAWS ch. 156D, § 7.42 (West 2005); See, e.g., *ING Principal Prot. Funds Derivative Litig.*, 369 F. Supp. 2d 163, 170 (D. Mass. 2005). The universal demand requirement generally applies to mutual funds. See *ING*, 369 F. Supp. 2d at 171 ("Plaintiffs. . . argue that the newly enacted universal demand requirement only applies to derivative suits brought on behalf of corporations. But a business trust 'in practical effect is in many respects similar to a corporation.' This court believes that Massachusetts courts will apply the requirement of universal, pre-suit demand to derivative actions brought on behalf of business trusts.") (footnote omitted).

66. See G. G. BOGERT & G. T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 869, n.35 and accompanying text (rev. 2d ed., repl. vol. 1995) (confirming that if the trustee refuses to sue or defend on behalf of the trust estate, the beneficiary may proceed against the trustee and third parties, but he trustee

The point of all of this is that when it comes to the rights, duties, and obligations of the parties, the director-trustees are at the center of the action in the U.S. The nominee-corporation, the entity that holds the bare legal title, is just a sideshow. In the land of the mutual fund where nothing is what it appears to be, the substantive law of trusts trumps the substantive law of corporations, not the other way around.<sup>67</sup>

In the U.K., as well, things are not necessarily what they seem. While a U.K. open end investment company, or OEIC, on paper looks like a civil law investment company with variable capital, perhaps a Luxembourgian SICAV, substantively it resembles a U.K. unit trust and is generally administered as if it were one.<sup>68</sup> Typically, the fund sponsor and public face, a corporate entity, acts as sole director of the OEIC. Safekeeping and oversight responsibilities, however, are delegated out to an independent fiduciary depository bank whose duties and obligations are similar in scope and intensity to those of a unit trust trustee. Title to the underlying assets, for examples, resides with the depository bank. Thus, in equity, the safekeeping and oversight fiduciary functions of a U.K. OEIC depository bank are equivalent to those of the trustee of a U.S. mutual fund or U.K. unit trust while the investment management functions of the OEIC are equivalent to those of the manager-sponsor of a U.S. mutual fund. The OEIC can then be all

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must be shown to be in default). *See generally* ROUNDS, *supra* note 45 at §5.4.1.8 (discussing the right and standing of beneficiaries to proceed in the stead of the trustee against those with whom the trustee has contracted, tortfeasors, agents of the trustee, and third parties generally).

67. Equity has a way of transmogrifying legal relationships. In *Williams v. Inhabitants of Milton*, 215 Mass. 1, 6, 102 N.E. 355 (Mass. 1913), the court held that though the holder of the legal title to certain property was "in a sense a trustee" of a business trust with transferable shares, a trustee of course being a principal, he was actually an agent holding the legal title for the convenience of the equitable interests who, "speaking with accuracy," were actually members of a partnership, not the beneficiaries of a trust. *Id.* at 356. If a trustee can be deemed an agent, certainly a corporation can be deemed a trustee. In fact there is ample precedent for this in the charitable context. A restricted gift to a charitable corporation will likely make the corporate entity a trustee of the gift with an obligation to segregate the gift from its general assets. *See, e.g., In re Estate of Lind*, 734 N.E.2d 47 (Ill. App. Ct. 2000).

68. Open-Ended Investment Companies Regulations, 2001, S.I. 2001/1228 (U.K.).

things to all people. To the civil law lawyer it can be a corporation; to the common law lawyer it can be a trust.

B. *Title to the Underlying Assets of a German or Luxembourgian Mutual Fund*

The German *Investmentgesetz* authorizes two ways to structure a mutual fund: the contractual and the corporate.<sup>69</sup> Where the legal title to the fund's underlying assets resides will depend upon which model, the contractual or the corporate model, has been utilized. The contractual model has two sub-categories, the *Treuhandlösung* and the *Miteigentumslösung*, the former involving an imperfect common law trust analog and the latter an imperfect common law tenancy in common analog.

Luxembourg mutual fund law also has a corporate option and a *Miteigentumslösung* option. It, however, does not have an option for structuring its mutual funds that is equivalent to the German *Treuhandlösung*, and certainly not an equivalent to the U.S. trustee mutual fund structure or the U.K. unit trust structure.

1. *The Contractual Model Generally*

Recall that, by statute, the *Kapitalanlagegesellschaft*, or KAG, administers the underlying assets of a German mutual fund.<sup>70</sup> (A KAG has a special banking license issued by the German Federal Banking Agency).<sup>71</sup> Recall also that there is a fundamental principle of German property law that every property right at any given time must have an identifiable owner. In keeping with this principle, § 30 I of the *Investmentgesetz*, provides that in the case of the *Treuhandlösung* (the trust-like approach), title to the underlying assets is in the KAG, which is only in a contractual relationship with the fund investors. In the case of the *Miteigentumslösung*, the investors

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69. See generally Peter Wendt, *Treuhandverhältnisse nach dem Gesetz über Kapitalanlagegesellschaften*, Münster 1968, p. 9 (discussing the differences between the two models and their historic development).

70. See § 2 II *Investmentgesetz* (providing that only a *Kapitalanlagegesellschaft* or KAG can administer a mutual fund *Sondervermögen* or special patrimony).

71. Bundesamt für Finanzdienstleistungsaufsicht [BaFin].

collectively have the legal title, with the KAG acting contractually as their investment agent.

The underlying assets of most German mutual funds that do not invest in real estate employ the *Miteigentumslösung* where the underlying assets are collectively owned by the investors themselves. At first glance, these funds resemble common law partnerships, with the KAG having a function analogous to that of a general partner. A partnership "is a contract of two or more competent persons to place their money, effects, labor, and skill, or some or all of them, in lawful commerce or business, and to divide the profit and bear the loss in certain proportions."<sup>72</sup> Like a general partner, the KAG has both unlimited liability with respect to its own assets<sup>73</sup> and the sole asset management function. Like a limited partner, the investor has both the collective legal title and limited liability. Unlike a common law partnership, however, it cannot be said that the KAG and the investors have co-ownership of the *Sondervermögen*. Thus, it is probably fair to say that the KAG is not a partnership. Rather, it is in some kind of simple agency relationship with the investors, the investors collectively being the principal with the KAG as their agent.

Luxembourg's *Miteigentum* option is the *fonds communs de placement*, or FCP.<sup>74</sup> Investors in a FCP collectively take title to the mutual fund's underlying assets. The parties to the investment management contract are the investors themselves and a KAG-equivalent known as a *société de gestion*.<sup>75</sup> In this case, the contractual classification is certainly justified, the FCP itself not having a legal personality.<sup>76</sup>

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72. Laura Hunter Dietz et al., *Partnership*, in 59A AM. JUR. 2D *Partnership* § 3 (2006).

73. The KAG, of course, can be a private limited company (GmbH) and in practice generally is. This means that there is a statutory cap on the portion of the KAG's own assets that can be reached by its creditors.

74. See Law Dated March 30, 1988 Relating to Undertakings for Collective Investments, art. 4 (Lux.) (providing that when title to the underlying assets of a mutual fund are held collectively by the investors as a *Miteigentum*, the "fund" shall not have a legal personality).

75. See Law Dated March 30, 1988 Relating to Undertakings for Collective Investments, art. 4 (Lux.) (providing that the underlying assets must be held by a custodian bank).

76. See Jürgen Bauer, *Investmentgesetze I*, (2d ed. 1997) (confirming that a FCP has no legal personality).

Because direct collective ownership by the investors of each and every underlying asset of a large open end retail real estate mutual fund is impractical, sponsors of German real estate mutual funds have generally favored the *Treuhandlösung*, or "trust" approach, over the *Miteigentumslösung*, or "joint ownership" approach because the *Miteigentumslösung* is considered impractical when it comes to collective investments in real estate. The German *Offenkundigkeitsprinzip*, or public notice doctrine, requires that the ownership of every parcel of real estate be registered in the *Grundbuch*, a national title registry. Whenever a parcel of real estate is sold, the new owner has to be recorded in the *Grundbuch* to effect the passage of title.<sup>77</sup> While it is mechanically possible for a parcel of real estate to be held collectively by a group of investors, known as a *Miteigentum*<sup>78</sup>, it is seldom practical as each investor and his/her pro rata share of the collective ownership (*Bruchteilsgemeinschaft*) has to be registered in the *Grundbuch*. It is obvious that the *Miteigentumslösung* is inappropriate for an open end mutual fund that invests in real estate as it would be impractical, if not impossible, to keep the *Grundbuch* current in the face of even a small daily volume of mutual fund share sales and redemptions. Thus, by statute, investors in a German real estate fund may not have collective ownership of the fund's underlying assets. Title must be in the KAG.<sup>79</sup> The *Treuhandlösung*, or "trust", approach addresses the practical problems inherent in direct collective ownership.<sup>80</sup>

The *Treuhandlösung*, as the term implies, involves the use of the *Treuhand*, a civil law construct grounded in contract that has some of the attributes of a common law trust.<sup>81</sup> In the

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77. See Bürgerliches Gesetzbuch [BGB] [Civil Code], § 873 I.

78. See generally Karsten Schmidt, §741 BGB, in 5 MÜNCHENER KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH Rn.50-53 (4th ed. 2004).

79. § 75 of the *Investmentgesetz* provides that assets in a so called *Immobilien-Sondervermögen* (a mutual fund that invests in real estate) must be held in a KAG. That leaves the *Treuhandlösung* as the only structural option for German PTOE.

80. See generally Peter Wendt, *Treuhandverhältnisse nach dem Gesetz über Kapitalanlagegesellschaften* (Feb. 17, 1968) (private dissertation, Universität Münster) (comparing the version of the *Treuhand* that is utilized in the mutual fund context with versions employed in other contexts).

81. See generally Helmut Coing, *Die Treuhand kraft privaten Rechtsgeschäfts*, in 31 SCHRIFTEN DES INSTITUTS FÜR ARBEITS- UND WIRTSCHAFTSRECHT AN DER UNIVERSITÄT KÖLN (1973) (noting that the *Treuhand*, though not a creature

*Treuhandlösung*, the mutual fund investors transfer monies to the KAG. The KAG functions as a *Treuhänder* (a type of fiduciary) for the benefit of the investors.<sup>82</sup> By statute, it must commingle the underlying mutual fund assets in a *Sondervermögen*, a segregated fund or special patrimony.<sup>83</sup> In exchange, the investors get contractual rights, namely that the KAG will administer the fund and redeem the mutual fund shares as specified in the investment contract. The contract itself must conform in form and substance to the requirements of the *Investmentgesetz*, the special body of statutory law that, among other things, regulates the administration and structuring of mutual funds. As is the case with a common law trustee, the *Treuhänder* takes legal title to the subject property. By statute, the assets of the *Sondervermögen* are insulated from claims of the *Treuhänder's* creditors. In this respect as well, the *Treuhänder* resembles a common law trustee.

By providing that all investments within the *Sondervermögen* accrue to the *Sondervermögen* - the fund's collection of underlying assets - and not to the *Treuhänder*, the German parliament has defanged the *Unmittelbarkeitsprinzip* as it might otherwise have been applicable in the mutual fund context. The *Unmittelbarkeitsprinzip*<sup>84</sup> - an invention of the German courts<sup>85</sup> - essentially provides that only inception assets (in the case of a mutual fund, the monies initially paid into the fund

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of statute, is still a relationship that is legally definable); see also Hein Kötz, *Trust und Treuhand* (1963) (discussing the characteristics that the trust and the *Treuhand* share).

82. Karl Ohl, *Die Rechtsbeziehungen innerhalb des Investment-Dreiecks*, in 57 *UNTERSUCHUNGEN ÜBER DAS SPAR-, GIRO- UND KREDITWESEN, ABTEILUNG B: RECHTSWISSENSCHAFT* 28f (1989) (confirming that the KAG is a *Treuhänder*).

83. See *Investmentgesetz* [Investment Act], at § 2 I,II, § 30 I,II (F.R.G.) (§2 allows only a KAG to administer a mutual fund *Sondervermögen*. Note that a *Sondervermögen* is employed only when a KAG acts as a *Treuhänder*, or when title to the underlying assets of a mutual fund are in the investors. An incorporated mutual fund does not have a *Sondervermögen*.).

84. See generally Gerhard Walter, *Das Unmittelbarkeitsprinzip bei der fiduziarischen Treuhand* (1974) (examining the rationale for the *Unmittelbarkeitsprinzip*).

85. See RGZ 84, 214 (217); RGZ 91, 12 (16); RGZ 133, 84 (87) (pre-World War II decisions of the *Reichsgericht* enunciating the *Unmittelbarkeitsgrundsatz*); Bundesgerichtshof [BGH] [Federal Court of Justice], *Entscheidungen des Bundesgerichtshofes in Zivilsachen* [BGHZ] page, 1223 (1959) (F.R.G.) (a decision of the post World War II *Bundesgerichtshof* ratifying the *Unmittelbarkeitsgrundsatz* principle).

by investors) are insulated from the claims of the *Treuhänder's* personal creditors. Absent the statutory exemption, any investment of funds by a KAG in its capacity as *Treuhänder* of a *Sondervermögen* would be subject to the *Treuhänder's* personal creditors. Obviously, the *Unmittelbarkeitsprinzip* was incompatible with the concept of a retail open end mutual fund and needed to be neutralized legislatively.

It should be noted that by insulating the *Sondervermögen* from the reach of the creditors of the KAG, the German parliament essentially bestowed on the mutual fund investor a quasi property interest in the *Sondervermögen*, title to which is in the KAG. This quasi-property interest resembles an equitable or beneficial interest in a common law trust where the trustee has the legal title but the beneficiaries have the economic interest. This civil law equitable analog is either an exception to or an expansion of the catalog of types of property interests that are allowable under German law, the so-called *Numerus Clausus*. With a few exceptions, e.g., the administration of the property of a decedent<sup>86</sup>, German law does not recognize the severance of legal title to an interest in property from its ownership.<sup>87</sup> Such a severance, of course, is the hallmark of the common law trust.

Luxembourg affords mutual fund sponsors two ways to structure their mutual fund products: collective investor ownership and incorporation. Employing an intermediary such as a *Treuhänder* (or its equivalent) or a trustee (or its equivalent) to take title to a fund's underlying assets is generally not an option.

## 2. *The Corporate Model Generally*

In the case of a German mutual fund that is structured as a corporation, the corporation has the legal title to the underlying assets<sup>88</sup>, the status of the investors being that of shareholders of the corporation and not direct or indirect owners of a *Sondervermögen*. The idea of structuring a mutual fund as a

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86. See Günter Roth, *Das Treuhandmodell des Investmentrechts*, in 30 WIRTSCHAFTSRECHT UND WIRTSCHAFTSPOLITIK 111 (1972) (confirming that in Germany the *Treuhand* is most commonly employed in the context of the administration of probate estates).

87. *Id.*

88. Wendt, *supra* note 80, at 9.

corporation is not new. In the U.S., there have been mutual funds operating in corporate form since 1920 when the Overseas Security Corporation opened its doors. Only recently, however, has this been practical in Germany. It was not until 1998 that Germany's parliament authorized the creation of *Investmentaktiengesellschaften* (Investment-AGs)<sup>89</sup>, that is to say mutual funds structured as corporations, and it was not until 2004 that these entities were allowed by law to issue new shares without the approval of the existing shareholders, making them "open ended." The investor becomes a shareholder of the Investment-AG with all the attendant rights (voting rights, dividends etc.)<sup>90</sup> by paying in an *Einlage* (capital contribution).

The German and Luxembourgian approaches to mutual fund structuring are quite similar. By statute, Luxembourg has two corporate models: the popular open-end *Société d'investissement à capital variable* [SICAV] and the older and less flexible closed-end *Société d'investissement à capitale fixe* [SICAF].<sup>91</sup> In each case, the investment company is required to deposit underlying fund assets with a custodial bank (*dépositaire*).<sup>92</sup> Title, however, remains with the investment com-

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89. See generally Georg Thoma & Uwe Steck, *Die Investmentaktiengesellschaft (closed-end fund), Investmentalternative oder gesetzgeberischer Fehlschlag?*, DIE AKTIENGESELLSCHAFT (F.R.G.) (2001) at 330 (discussing the Investmentaktiengesellschaft, which has recently been authorized by statute, and questioning if this legal vehicle will live up to its expectations). See also Johannes Köndgen, in SCHIMANSKY/BUNTE/LWOWSKI, BANKRECHTS-HANDBUCH, INVESTMENTGESCHÄFT, 2d. ed., 2001, § 113 Rn. 48.

90. Wendt, *supra* note 80, at 9 (confirming that the rights of the shareholder of an *Investmentaktiengesellschaft* are no different from those of any corporate shareholder).

91. Luxembourg's legislature until relatively recently did not provide any mechanism for issuing additional shares of a mutual fund on a regular basis, or even for redeeming outstanding shares. In 1959 Luxembourg's first open-end incorporated mutual funds were launched. To deal with the additional share issuance and share redemption problem, these investment corporations had to create special redemption corporations (*société de rachat*) whose only purpose was to buy the shares of their affiliated investment corporations for re-sale to new investors. Since 1983, investment corporations may have a "flexible capital" structure. This has rendered these special redemption corporations obsolete. For the history of Luxembourg's mutual fund industry see BAUR, *supra* note 76, at 98-103.

92. Law Dated March 30, 1988 Relating to Undertakings for Collective Investments, art. 16 (Lux.) (requiring that this *dépositaire* must be either a Luxembourg bank or a bank that is based in an EU-country that has an office in Luxembourg).

pany. The investors are shareholders of the investment company which retains title to the underlying fund assets. Unlike the role of the depository in the U.K. OEIC model, the role of the SICAV depository is more ministerial than fiduciary.

## V.

### FIDUCIARY DUTIES OWED BY THE MUTUAL FUND TITLE-HOLDER AND THE SPONSOR TO THE INVESTORS

#### A. *What are the Duties that the Title-Holder of a Mutual Fund Owes to the Investors?*

##### 1. *The U.S./U.K. Model*

Let there be no misunderstanding: those who hold the legal title to a mutual fund's underlying assets, for example, the fund trustees, are common law fiduciaries.<sup>93</sup> So are the director-trustees of an incorporated mutual fund.<sup>94</sup> In the U.S., the common law informs the Investment Company Act of 1940, not the other way around. It cannot be overemphasized that one who invests in a U.S. mutual fund becomes the beneficiary of a common law trust relationship that is first and foremost a creature of state law with the fund title-holder owing the investor a vast array of fiduciary duties rooted in state law that are incident to that relationship. Unlike the Investment Company Act of 1940, whose codifications are selective and narrowly-focused, the common law as it relates to mutual

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93. See 1 SCOTT & FRATCHER, *supra* note 7, at §2.5 (confirming that the relationship between trustee and beneficiary is a fiduciary relationship, involving "a duty on the part of the fiduciary to act for the benefit of the other party to the relation as to matters within the scope of the relation."). Professor Bogert notes that "[o]n most points of law arising in connection with the administration of business trusts the rules of law applicable are the same as, or similar to, those which would govern in the case of trusts generally," mutual fund investors, of course, being essentially common law trust beneficiaries. BOGERT & BOGERT, *supra* note 6 at § 247(U). The federal Investment Company Act of 1940 (ICA) assumes that mutual fund director-trustees and trustees are state common law fiduciaries. See *Burks v. Lasker*, 441 U.S. 471, 484-85 (1979) (confirming that "the structure and purpose of the ICA indicates that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds' shareholders").

94. *Brown v. Bullock*, 194 F. Supp. 207, 229 (S.D.N.Y. 1961) (confirming that not only the directors but also the investment advisor of an investment company are fiduciaries).

funds is all-encompassing and self-contained. The common law does not need the help of the Act when it comes to protecting investors, but the Act would be gibberish without the common law. The Act does not create the concept of the fiduciary, it invokes it<sup>95</sup> and does so with minimal Federal preemption.<sup>96</sup> Thus, in the mutual fund context, when it comes to parsing the rights, duties, and obligations of the parties, we start with the common law, not the Act. In the case of a Fidelity or Bank of America mutual fund, it is the Massachusetts' law of trusts; in the case of Vanguard, it is Delaware's trust law; and in the case of the incorporated American Funds, it is the common and statutory laws of Maryland.

Apart from the requirements of the Investment Company Act of 1940, a U.S. mutual fund director-trustee or trustee owes the investor-beneficiary the following core common law duties with respect to the trust property:

- ◆ the duty of undivided loyalty<sup>97</sup>,
- ◆ the duty to give personal attention<sup>98</sup>,

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95. See *Burks*, 441 U.S. at 484-85 (confirming that "the structure and purpose of the ICA indicates that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds' shareholders.").

96. See 15 U.S.C.A. § 80a-49 (West 2005) (confirming that the Investment Company Act of 1940 defers to applicable state law in matters pertaining to the administration of mutual funds to the extent state law does not conflict with the Act's provisions). See, e.g., *Rome v. Archer*, 197 A.2d 49, 55-56 (Del. 1964) (equity court applying Delaware's law respecting laches in adjudicating whether mutual fund investor was time barred from bringing a derivative action against fund directors).

97. See generally *ROUNDS*, *supra* note 45 at § 6.1.3 (discussing the trustee's duty of loyalty generally); *BOGERT & BOGERT*, *supra* note 6 at §247(U) (confirming that in the case of a business trust, which is what an incorporated or trustee mutual fund essentially is, "general trust rules apply with regard to the duty of loyalty").

98. See generally *ROUNDS*, *supra* note 45 at §6.1.4 (discussing generally a trustee's duty to prudently select and monitor on an ongoing basis the activities of the trustee's agents). In the context of the Massachusetts business trust, see, e.g., *Ashley v. Winkley*, 95 N.E. 932, 934 (Mass. 1911) (confirming that a trustee of a Massachusetts business trust under state law may not properly discharge the trustee's fiduciary duties by surrendering substantial or entire control of the trust estate or otherwise imprudently delegate the trustee's authority to others).

- ◆ the duty to account<sup>99</sup>,
- ◆ the duty to carry out the terms of the trust<sup>100</sup>, and
- ◆ the duty to be generally prudent.<sup>101</sup>

As noted, it is common practice in the U.S. for mutual fund trustees to delegate the performance of almost all fund administration functions to an agent - namely the fund sponsor - who likely had a hand in securing the trustee's appointment in the first place.<sup>102</sup> The U.K. is no different in this re-

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99. A trustee has an affirmative obligation to furnish the beneficiaries with all the information the beneficiaries need to protect their equitable interests. *See generally* ROUNDS, *supra* note 45 at § 6.1.5.1 (discussing the trustee's general duty to keep the beneficiary reasonably informed); *see also* RESTATEMENT (SECOND) OF TRUSTS § 173 (1959). A trustee of a business trust is not exempt from this common law duty to provide information. *See, e.g.,* Wallace v. Malooly, 122 N.E.2d 275, 280-81 (Ill. 1954) (citing RESTATEMENT (SECOND) OF TRUSTS § 173).

100. *See generally* ROUNDS, *supra* note 45 at § 6.1.2 (discussing the trustee's general duty to carry out the terms of the trust); Fogelin v. Nordblom, 521 N.E.2d 1007, 1011-12 (Mass. 1988) (holding that the trustees of a Massachusetts business trust may not favor one class of shareholders over another unless authorized to do so by the terms of the trust).

101. *See generally* ROUNDS, *supra* note 45 at § 6.1.1 (discussing a trustees duty to use reasonable care, skill and caution in the administration of the trust generally). When it comes to business trusts, however, the trustee's general duty of prudence is tempered somewhat to accommodate the purposes for which the fund was established. One court explains:

It is certainly true that trustees of the conventional type of non-business trust will not ordinarily be permitted to invest in anything so speculative as futures contracts. *See* 2 Scott on Trusts, p. 1206. It may well be that in such trusts the trust instrument should be construed strictly in order to afford maximum protection to the beneficiaries. But these rules, evolved to govern the traditional type of trust, cannot be carried over and applied without change in the field of business trusts of the type here presented. The defendant trust was created, not to conserve an estate or guarantee a steady income to certain beneficiaries, but to aggregate the capital contributions of the six associates for the purpose of conducting an extensive and complex business which ordinarily would be carried on by a partnership or a corporation. It can scarcely run with the hares and hunt with the hounds by disclaiming the corporate analogy when this becomes inconvenient. The defendant's powers are of course limited to those conferred by its deed of trust; but we think this instrument should be considered as analogous to a corporate charter and as broadly interpreted.

*Bomeisler v. M. Jacobson & Sons Trust*, 118 F.2d 261, 265 (1st Cir. 1941).

102. *See* *Chamber of Commerce of the United States v. SEC*, 412 F.3d 133, 136 (D.C. Cir. 2005) (confirming that although a mutual fund board of di-

gard. U.S. common law is well-equipped, however, to deal with the incestuous aspects of this industry practice. There is, for example, a well-developed body of U.S. common law regulating such acts of self-dealing by fiduciaries<sup>103</sup>, including transactions with affiliated parties. Professor Bogert's common law catalog of voidable self-dealing transactions between trustees and third parties, for example, is far more detailed, all-encompassing, subtle, and developed than are the fiduciary self-dealing proscriptions of the Investment Company Act of 1940.<sup>104</sup>

It has long been state default law applicable to trusts that says, in voting shares of stock or otherwise exercising powers of control over enterprises, a trustee shall act in the best interest of the beneficiaries.<sup>105</sup> Accordingly, those responsible for voting the underlying shares of a mutual fund must act in the best interests of the fund investors, not their own interests.<sup>106</sup> Federal law brings little new to the table in this regard:

However, as former Chairman Pitt noted, "[A]n investment adviser must exercise its responsibility to vote the shares of its clients in a manner that is consistent with the general antifraud provisions of the Investment Advisers Act of 1940, as

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rector-trustees or trustees is "authorized to operate the fund, it typically delegates the management role to an 'adviser,' which is a separate company that may have interests other than maximizing the returns to shareholders in the fund").

103. Cardozo's oft-quoted description of the trustee's duty of undivided loyalty comes to mind:

A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions.

Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

104. See BOGERT & BOGERT, *supra* note 6 at § 543.

105. See, e.g., UNIF. TRUST CODE § 802(g) (2003).

106. See Harvey L. Pitt, Chairman, Sec. & Exch. Comm'n, Remarks Before the Investment Company Institute at the General Membership Meeting (May 24, 2002), available at <http://www.sec.gov/news/speech/spch562.htm> (last visited Sept. 10, 2003) [hereinafter Pitt Remarks]; Letter from Harvey L. Pitt, Chairman, Sec. & Exch. Comm'n, to John P. M. Higgins, President, RAM Trust Services (Feb. 12, 2002) available at <http://www.thecorporatelibrary.com/special/pitt/pitt-higgins.pdf> (last visited Sept 10, 2003).

well as its fiduciary duties under federal and state law to act in the best interests of its clients.’”<sup>107</sup>

We could go on and on: There is a well-developed body of U.S. common law regulating what fiduciary functions are delegable by a trustee, including how a trustee is to manage the selection, supervision, and removal of agents.<sup>108</sup> A mutual fund trustee has a common law duty to proactively furnish the investor-beneficiary with all information relating to the entrusted funds which the investor-beneficiary would need to protect the investor-beneficiary’s equitable property interests.<sup>109</sup> This is implicit in the trustee’s common law duty to account. Common law liability for breaches of trust is generally personal.<sup>110</sup> Equitable sanctions can be both creative and draconian.<sup>111</sup>

The Investment Company Act of 1940 with its regulatory apparatus actually contributes little to the scheme of things. The Act confirms that a mutual fund trustee, or director-trustee in the case of an incorporated mutual fund, has a duty of undivided loyalty to the investor in authorizing the SEC to bring breach of fiduciary actions<sup>112</sup>; imposes a 40% independent director-trustee/trustee minimum requirement<sup>113</sup>; codi-

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107. Brian D. Stewart, *Disclosure of the Irrelevant? Impact of the SEC’s Final Proxy Disclosure Rules*, 9 FORDHAM J. CORP. & FIN. L. 233, 235-36 (2003); see also Pitt Remarks, *supra* note 106.

108. See generally RESTATEMENT (THIRD) OF TRUSTS § 80 (Tentative Draft No. 4, 2005); 2 SCOTT & FRATCHER, *supra* note 7, at § 171.

109. See 2 SCOTT & FRATCHER, *supra* note 7, at § 173; cf. UNIF. TRUST CODE § 813(a) (2003) (codifying by statute the trustee’s common law duty to furnish the beneficiary with all information that the beneficiary would need to see to it that the equitable interest is protected).

110. See, e.g., Nickel v. Bank of America Nat’l Trust and Sav. Assn., 290 F.3d 1134, 1139 (9th Cir. 2002) (holding that the appropriate remedy for a corporate trustee’s overcharging its trust accounts is to allot to those accounts a proportionate share of the bank’s profits during the years of misappropriation).

111. See *id.*

112. See 15 U.S.C.A. § 80a-35(a) (West 2005).

113. See 15 U.S.C.A. § 80a-10(a) (West 2005). Until relatively recently, there generally was no *per se* common law requirement that a fiduciary must be disinterested. The trustee of a discretionary trust, for example, could be one of the permissible beneficiaries. All things being equal, however, it was preferable that the trustee be disinterested, as the trustee remained bound by the duty of undivided loyalty in the actual administration of the trust to include the duty of impartiality, unless relieved of that duty by the terms of

fies when, where and how fund director-trustees and trustees may enter into transactions with affiliated persons<sup>114</sup>; creates procedures intended to mitigate the incestuous aspects of the trustees' investment management contract with the sponsor<sup>115</sup>; and regularizes how mutual fund trustees account to investor-beneficiaries.<sup>116</sup> On the margins, some behavior has been criminalized.<sup>117</sup> As to all else that pertains to the rights, duties, and obligations of the parties, such as what constitutes a valid trust and what it means to be a fiduciary, the Act generally defers to state common law. The Act was written by lawyers who were clearly well-versed in the common law and who presumed that their successors would be as well.<sup>118</sup>

Vis a vis the investors, the rights, duties and obligations of the trustee of a U.K. unit trust (or an OEIC fiduciary depository) and those of the trustee of a U.S. PTOE mutual fund (or director-trustee of an incorporated U.S. PTOE mutual fund) are pretty much the same. This should come as no surprise, England being the cradle of the common law tradition.

## 2. *The Civil Law Model*

As a general rule, Germany and the other civil law jurisdictions do not have a generalized body of non-statutory fiduciary law like common law jurisdictions do, e.g., Massachusetts and England. In a given situation, e.g., the administration of a mutual fund by a KAG, however, statutory fiduciary or fiduciary-like principles may be applicable.

### i. Duties Imposed by Statute

The German *Investmentgesetz*, a specialized body of investment-related statutory law, provides that a KAG in the course of administering a mutual fund must act solely in the interests

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the trust, consent of all beneficiaries, statute, or the Court. It may now be the common law default rule that a trustee-beneficiary may not participate in decisions regarding discretionary distributions of trust principal to himself or herself. See generally BOGERT & BOGERT, *supra* note 6 at § 129.

114. See, e.g., 15 U.S.C.A. § 80a-10.

115. See 15 U.S.C.A. § 80a-15 (West 2005).

116. See 15 U.S.C.A. § 80a-29 (West 2005).

117. See, e.g., 15 U.S.C.A. § 80a-36 (West 2005) (making it a federal crime to steal or embezzle the moneys, funds, securities, credits, property or assets of any registered investment company).

118. See generally Rounds, *supra* note 11 at 251.

of the investors<sup>119</sup>, a duty that is strikingly similar, if not identical, to that of a common law agent-fiduciary's duty of loyalty to the principal or the common law trustee's equitable duty of loyalty to the beneficiaries. The *Investmentgesetz* also provides that the KAG must exercise the care of a reasonable merchant in managing the underlying asset of the fund, the *Sondervermögen*, on behalf of the investors.<sup>120</sup> The phrase "care of a reasonable merchant" encompasses a variety of duties, e.g., the duty to render proper accounts. In the mutual fund context, it also includes duties such as:

- ◆ the duty not to speculate,
- ◆ the duty to prudently diversify, and
- ◆ the duty to efficiently administer the underlying assets.<sup>121</sup>

Incident to these general duties are a number of specified activities that are off-limits to the KAG, including the following:

- ◆ purchasing for the KAG's own account an asset that should be purchased for the *Sondervermögen*,
- ◆ dumping KAG assets into the *Sondervermögen*,
- ◆ scalping, and
- ◆ churning.

Luxembourg's statutory law applicable to mutual funds provides that the investment manager (*société de gestion*) has a general duty to act solely in the interest of the investors.<sup>122</sup> Specific duties are not listed in the statute, but we can be fairly certain that the duty to act solely interest of the investors encompasses most of the specific fiduciary duties listed above that a German KAG owes to its investors. Moreover, both Lux-

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119. See *Investmentgesetz* [Investment Act], Jan. 1, 2004, at § 9 II (F.R.G.).

120. See *id.* at § 9 I.

121. See generally Frank Schäfer, *Anlegerschutz und die Sorgfalt eines ordentlichen Kaufmanns bei der Anlage der Sondervermögen durch KAGs*, in 17 *STUDIEN ZUM BANK- UND BÖRSENRECHT* (1987).

122. See Law Dated March 30, 1988 Relating to the Undertakings for Collective Investment, art. 13 (1) (Lux.) (providing that the manager shall manage the fund in accordance with the management regulations and in the exclusive interest of the investors).

embourg and Germany are members of the EU and therefore must abide by the same UCITS-Guideline.<sup>123</sup>

ii. Common Law-Like Duties Incident to the Treuhand Relationship

Apart from those duties imposed on the KAG by statute, there also are fiduciary-type duties that are imposed on a KAG acting as the *Treuhänder* of a *Sondervermögen*. As is the case with its common law counterpart, the trustee, the duties and obligations of the *Treuhänder* to the “beneficiary,” e.g., a mutual fund investor, lurk not only in statutes but also in cases and treatises. In other words, there is some common law around the edges and between the cracks of the civil law.<sup>124</sup> The most obvious non-statutory duty of a *Treuhänder* is to segregate the *Sondervermögen* from the *Treuhänder*’s personal assets.<sup>125</sup> The remedies available to a “beneficiary” for actionable harm done to the *Sondervermögen* by the *Treuhänder*, however, are generally contractual<sup>126</sup>, not equitable or quasi-equitable as would be the case with a common law trust. And so we now turn to the German law of obligations.

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123. See Communities of the European Communities, *Green Paper on the Enhancement of the EU Framework on Investment Funds* (2005), available at [http://ec.europa.eu/internal\\_market/securities/docs/ucits/greenpaper\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/ucits/greenpaper_en.pdf): “UCITS (Undertakings for Collective Investment in Transferable Securities) are specially constituted collective investment portfolios exclusively dedicated to the investment of assets raised from investors. Under the UCITS Directive UCITS investment policy and its manager are authorised in accordance with specific requirements. UCITS’ legislation aims to establish a defined level of investor protection. This is achieved through strict investment limits, capital and disclosure requirements, as well as asset safe-keeping and fund oversight provided by an independent depositary. UCITS benefit from a ‘passport’ allowing them, subject to notification, to be offered to retail investors in any EU jurisdiction once authorised in one member State.”

124. See Bundesgerichtshof Neue Juristische Wochenschrift [BGHNJW], 1960, 958 (confirming the *Treuhänder*’s inherent duty to take all actions necessary to protect, secure, and appropriately exploit the subject property).

125. See Hellmut Isele, *Geschäftsbesorgung*, in 75 ARBEITEN ZUM HANDELS-, GEWERBE- UND LANDWIRTSCHAFTSRECHT 135 (1935) (confirming that the *Treuhänder* is not allowed to commingle the “entrusted” property with its own assets).

126. See Roth, *supra* note 86, at 122 (discussing the remedies available to a mutual fund investor should a *Treuhänder* breach one or more of its duties to the investor).

iii. The Contractual Duties of the KAG to the  
“Beneficiary”/Investor

Every contract imposes rights, duties, and obligations on the parties thereto. This is no less the case when one purchases shares of a German mutual fund. The KAG's obligation to abide by the terms of its offering prospectus is contractual. To ensure that the KAG fulfills its end of the bargain, the *Investmentgesetz* allocates to the fund custodian, i.e., the so-called *Depotbank*, the responsibility to see to it that the KAG carries out its contractual obligations to properly administer and invest the *Sondervermögen*.<sup>127</sup> In other words, the *Depotbank* has a “watchdog” function<sup>128</sup> that is similar to, but by no means as intense, proactive, and free-ranging as, that of the independent director-trustee or trustee of an U.S. mutual fund<sup>129</sup> or the fiduciary depository of an U.K. OEIC.<sup>130</sup> Since, under Luxembourg statutory law, the functions of a *dépositaire* are virtually identical to those of a German *Depotbank*, we are confident that the rights, duties, and obligations of the bank depositories are pretty much the same in both countries.

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127. See *Investmentgesetz* [Investment Act], Jan. 1, 2004, at §§ 20 ff. (F.R.G.) (defining the role of the *Depotbank* and outlines its duties).

128. See generally Ohl, *supra* note 82 (describing the special function of a *depotbank* with all of its duties).

129. Under federal law, a majority of the disinterested director-trustees or trustees of an American U.S. mutual fund, for example, must approve all investment advisory contracts their board enters into, including those with the fund sponsor. See 15 U.S.C.A. § 80a-15(c) (West 2005). Courts have actually employed the term “watchdog” in characterizing the oversight function of the independent director-trustees or trustees of an American mutual fund. See, e.g., *Burks v. Lasker*, 441 U.S. 471, 484 (1979). Their primary job is to look after the interests of the investors and only the investors. Under common law principles, however, all mutual director-trustees and trustees, whether or not independent and whether or not disinterested, have a duty of undivided loyalty that runs to the investors and only the investors.

130. Although § 26 of the *Investmentgesetz* provides certain actions by the KAG that need the approval of the custodial bank (*Depotbank*) most of the custodial supervision is to ensure that all investments made comply with the investments guidelines laid out in the prospectus.

B. *What are the Duties that the Sponsor of a Mutual Fund and its Sub-Agents Owe to the Mutual Fund Investors?*

1. *The U.S./U.K. Model*

i. *The Sponsor's Agency Status (Common Law)*

A mutual fund sponsor makes it all happen. It is the entity that commissions the design and erection of the mutual fund's legal structure. It is the entity that handles the branding and promotion. It is also the one with the deep pockets. It is the fund's public face. A mutual fund sponsor is a corporation that is separate and apart from the trustee or incorporated mutual fund that it sponsors. In other words, the sponsor is not the one that holds legal title to the fund's underlying assets. Rather, the typical sponsor legally is an agent of and renders compensated services to the title-holder:

"The Investment Company Act of 1940 (ICA or Act) establishes a scheme designed to regulate one aspect of the management of investment companies that provide so-called 'mutual fund' services. Such funds typically are organized and underwritten by the same firm that serves as the company's 'investment adviser.' The ICA seeks to arrest the potential conflicts of interest inherent in such an arrangement."<sup>131</sup>

In both the U.S. and the U.K., either the sponsor itself or the sponsor acting through its sub-agents renders investment management agency services to the trustees of a trustee mutual fund. In the case of a U.S. mutual fund that has been packaged as a corporation, the sponsor and the investment company sign the investment management contract, although we suggest that in equity it is the directors as trustees and not as representatives of the corporation who are actually contracting with the sponsor. In any case, it is the investment management agency fees paid by the fund's title-holder to the sponsor out of fund assets that makes the mutual fund interesting from a business perspective. Other compensated services rendered by an agent-sponsor and/or its sub-agents to a fund title-holder generally include recordkeeping, asset accounting, and interfacing with shareholders. But those investment advisory fees are where the action is.

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131. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 93 (1991).

As noted, the legal status of the sponsor of the typical U.S. mutual fund is that of agent to the title-holders of the fund's underlying assets. Take Fidelity and Bank of America. Filings with the SEC reveal that the sponsor of Fidelity's mutual funds is Fidelity Management & research Company (FMR). FMR Corp is the ultimate parent company of FMR. FMR Corp is controlled by the Edward C. Johnson 3d family. In the case of Bank of America's mutual funds, filings with the SEC reveal that Columbia Management Advisors, LLC is the sponsor. Columbia Management Advisors, LLC is owned by Columbia Management Groups, LLC, a direct, wholly owned subsidiary of Bank of America. Bank of America hangs from Bank of America Corporation, a financial services holding company that is organized as a Delaware corporation. None of these corporate entities are "investment companies." At the base of their respective food chains are FMR and Columbia Management Advisors. Their business is to render compensated investment management services to the title-holders of the mutual funds that they, the two entities, have sponsored. In the case of Fidelity's and Bank of America's mutual funds, though they are deemed "investment companies" for federal regulatory purposes, they neither operate in corporate form nor themselves sponsor mutual funds. Even mutual funds packaged as corporations are generally not in the business of "sponsoring" mutual funds.

In the U.K., it is common practice for the sponsor/manager - which itself is a corporation - to act as sole director of the OEIC. Recall that an OEIC is an investment company with variable capital. In the case of the OEIC, fiduciary duties and functions are shared by the director-manager and the outside independent bank depository.

## ii. The Sponsor's Duties to the Investor (Common Law)

The typical U.S. mutual fund sponsor, as agent of the title-holder, has certain common law fiduciary duties that run directly to the mutual fund investor. A trustee may prudently delegate fiduciary functions such as investment management to agents, provided there is adequate ongoing supervision by

*the trustee personally* of the agents.<sup>132</sup> The agent of a trustee, however, is in a difficult position in that the agent has some duties that run back to the principal-trustee, e.g., to act within the scope of the agency, and others that run collaterally to the trust beneficiary, e.g., to act solely in the interests of the beneficiary.<sup>133</sup> Moreover, should those duties come in conflict, the interests of the principal-trustee must be subordinated to those of the beneficiary.<sup>134</sup> Even in the case of a trust company, both its internal and external agents have duties that run to the trust beneficiaries, duties that take precedence over the interests of the corporate entity.<sup>135</sup> Neither the trustee nor the trustee's agents, for example, may engage in unauthorized acts of self-dealing or competition with the trust estate, nor aid or abet the other either directly or indirectly, either actively or by forbearance, in doing so. There is one possible common law exception relating to the rendering of legal services by certain agent-fiduciaries, namely attorneys-at-law. In some U.S. common law jurisdictions, a lawyer in the course of representing a trustee has no duties that run to the beneficiary.<sup>136</sup> However, any agent of a trustee who *participates with the trustee in a breach of trust*, and that includes trust counsel, incurs liability, along with the trustee, to the beneficiaries.<sup>137</sup>

The Investment Company Act of 1940 leaves largely undisturbed the matrix of common law duties that agents of a mutual fund title-holder owe the mutual fund investor. It does,

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132. See generally ROUNDS, *supra* note 45 at § 6.1.4 (discussing the trustee's common law duty to give ongoing personal attention to the administration of the trust).

133. RESTATEMENT (SECOND) OF TRUSTS § 326, cmt. a (1934) ("A third person who, although not a transferee of trust property, has notice that the trustee is committing a breach of trust and participates therein is liable to the beneficiary for any loss caused by the breach of trust.").

134. Wolf v. Mitchell, Silberberg & Knupp, 90 Cal. Rptr. 2d 792 (Cal. Ct. App. 1999); Coster v. Crookham, 469 N.W.2d 802, 810 (Iowa 1991); Taylor v. Maile, 127 P.3d 156, 164 (Idaho 2005).

135. See BOGERT & BOGERT, *supra* note 6 at § 901, n.10 and accompanying text; 4 SCOTT & FRATCHER, *supra* note 7, at § 326.3. See, e.g., Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

136. See, e.g., Spinner v. Nutt, 631 N.E.2d 542 (Mass. 1994) (holding that trust counsel's fiduciary duties run to the trustee not to the beneficiaries, assuming there is no conspiracy to breach the trust).

137. See, e.g., Wolf, 90 Cal. Rptr. 2d at 1039 (holding that trust counsel can be held liable to the beneficiaries for conspiring with the trustee to loot the trust).

however, provide some helpful focus, clarity, and certainty when it comes to the issue of whether the sponsor in its capacity as investment advisor to the mutual fund title-holder has a fiduciary duty *to the investor* with respect to the setting of the sponsor-advisor's compensation. This is a critical issue because the source of payment is the fund itself and because the office of mutual fund trustee or director-trustee has been perceived in some quarters, albeit wrongly, as largely a ceremonial one. Not all watch-dogs have teeth, 20-20 vision and are fully engaged. Under common law principles, whether or not the sponsor-advisor has fiduciary or quasi-fiduciary duties with respect to the setting of its own compensation may well hinge on the degree to which the sponsor-advisor actually controls the title-holder and/or has actual or constructive knowledge that the title-holder is in breach of trust with respect to the setting of the sponsor-advisor's compensation. In other words, it could depend upon the particular facts and circumstances of each given situation. Coming to the rescue of the common law, the Act expressly provides that the sponsor-advisor is a fiduciary with respect to the setting of its own compensation.<sup>138</sup>

Vis a vis the investors, the rights, duties and obligations of the sponsor of a U.K. unit trust (or of an OEIC director) and those of the sponsor of a U.S. PTOE mutual fund are pretty much the same. This, again, should come as no surprise, England being the cradle of the common law tradition.

## 2. *The Civil Law Mutual Fund Structural Model*

### i. The Sponsor and its Sub-Agents (Civil Law)

In Germany as well, it is the sponsor of a mutual fund who is actually pulling the strings and receiving the ultimate economic benefit, not the downstream corporate entity, the KAG, which manages the underlying assets. The sponsor of a German mutual fund is typically a full-service bank with the KAG, the corporate entity that manages the fund's underlying assets, being a subsidiary of the sponsor bank. The KAG need not be wholly-owned by the sponsoring bank. It could be owned by a syndicate of banks or insurance companies. The sponsoring bank, however, typically has a controlling interest in its KAG. Unlike a U.S. mutual fund title-holder, however, the KAG does

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138. 15 U.S.C.A. §80a-35(b) (West 2005).

not outsource its investment management function.<sup>139</sup> Moreover, the sponsoring bank has no contractual or other legal relationship with the mutual fund investors, despite the fact that it appoints the members of the KAG's oversight board, the *Aufsichtsrat*, which in turn appoints the members of the KAG's board of managers, the *Vorstand*. Thus, while we have no hard evidence that a German sponsoring bank has ever exercised its control over the personnel of the KAG in a way that is adverse to the mutual fund investors, for example, by subtly pressuring an investment officer to make an imprudent investment in a company with which the sponsoring bank has a loan relationship, the incestuous nature of the matrix of corporate entities ought not to inspire confidence from the investor's perspective, human nature being what it is.

In any case, it would appear that the investor would have little recourse in the face of such acts of self dealing, other than perhaps to petition the BaFin, the SEC's counterpart in Germany. In other words, because the investor would have no legal relationship with the sponsoring bank, there is no private right of action against the sponsoring bank. The absence of private rights of action against mutual fund sponsors, we suggest, is a critical difference between the common law and civil law mutual fund structural paradigms.

We are comfortable in asserting that, under German default law, the sponsoring bank owes no fiduciary duties to those who invest in mutual funds managed by the bank's KAG. That is not to say that the bank could not by contract voluntarily afford investors some protection against the KAG's insolvency by executing a *Patronatserklärung*. A *Patronatserklärung* is a legally binding promise that the sponsoring bank will underwrite all present and future liabilities of its KAG. A *Patronatserklärung*, however, leaves the corporate shield of the sponsoring bank fully intact.

It appears that the liability of the sponsor of a Luxembourg SICAV, SICAF, or FCP to the mutual fund investor is virtually non-existent in the absence of fraud, even if the entity

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139. See Investmentgesetz [Investment Act], Jan 1, 2003, at §16 (F.R.G.) (The KAG has the right to outsource certain duties. But since it has a special banking-license it has to act as a "special bank". This means that it must not outsource its core duties, such as acting as a *Treuhänder* and making the investment decisions).

is a subsidiary of the sponsor and/or the directors are affiliates of the sponsor. In other words, all things being equal, the usual principles of general Luxembourgian corporate law apply. That means that liability begins and ends with the downstream entity, there being neither any direct contractual relationship between the investor and the sponsor nor any equitable-like principle that would make the sponsor a fiduciary vis à vis the investor. In deference to the investor, however, Luxembourg law requires that the FCP manager (*société de gestion*) maintain an adequate line of credit with a bank for the satisfaction of investor claims.<sup>140</sup>

ii. The Sponsor's Duties to the Investor (Civil Law)

As we have seen, there are no duties that a sponsoring bank owes to those who invest in mutual funds managed by its KAG, other than those duties that are indirectly assumed by contract through the execution of a *Patronatserklärung*. And certainly the sponsoring bank owes no direct fiduciary duties to mutual fund investors, if only because Germany, a civil law jurisdiction, does not have a body of background fiduciary law comparable in scope and pervasiveness to that which has evolved in the common law jurisdictions. Thus, the only practical recourse a German mutual fund investor would have in the face of any mischief making on the part of the sponsoring bank is to petition the BaFin, an agency of the German government, and hope that it, in the exercise of its discretionary authority, would investigate the matter and take whatever action it would deem appropriate. There would be no recourse to the German courts as the investor would lack standing to litigate against the sponsoring bank. The investor in a Luxembourgian mutual fund would be in the same boat as his or her German counterpart. If the Luxembourgian financial services regulators could not be persuaded to get involved, under Luxembourg law the investor would likely lack standing to bring a private action against the sponsor. The U.S. mutual fund investor, on the other hand, does have the requisite standing to litigate against the fund's sponsor-advisor. This is because the sponsor-advisor, as we have seen, has fiduciary duties that run directly to the investor.

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140. See Law Dated March 30, 1988 Relating to Undertakings for Collective Investments, art. 6(2)(c) (Lux.).

## VI. CONCLUSION

In the United States and England, the typical open end publicly-traded mutual fund is structured either as a trust or as a corporation that has many of the attributes of a common law trust. In Germany, the typical mutual fund resembles a common law agency where the investors collectively have title to the underlying assets. The KAG manager essentially functions as their investment agent. In the case of a German real estate mutual fund, however, it is the KAG as *Treuhänder*, not the investors, that holds the legal title to the underlying assets. Recall that a *Treuhänder* is a civil law trustee analog. The typical PTOE mutual fund established in Luxembourg operates in corporate form.

It appears that the typical common law PTOE mutual fund and the typical PTOE civil law mutual fund are on a par with one another when it comes to "entity/asset shielding." The *underlying assets* of the typical common law and civil law mutual fund are comparably insulated both from the creditors of the managers and sponsors of the funds and from the creditors of the fund investors themselves.<sup>141</sup> As to the affairs of the fund itself, a mutual fund investor's personal liability under either regime is, as a practical matter, limited to the investor's interest in the fund.<sup>142</sup>

On the other hand, when it comes to limiting the liability of those who sponsor and administer mutual funds, the civil law model appears to be more management friendly while the common law model appears to be more investor friendly. This divergence, we suggest, is not necessarily a function of structure, but of the Anglo-American concept of the fiduciary, which is more elastic and free-ranging than its civil law ana-

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141. The single investor's share of the mutual fund itself can of course be subject to actions taken by the investor's creditors.

142. In a mutual fund operating as a Massachusetts business trust, there is an ultra remote chance that the right of the investors to elect its board of trustees could subject the investors to personal liability for trust obligations. *But see*, Sheldon A. Jones, Laura M. Moret, & James M. Storey, *The Massachusetts Business Trust and Registered Investment Companies*, 13 DEL. J. CORP. L. 421, 443 (1988) (the authors, all experienced mutual fund lawyers, noting that they have no knowledge of a plaintiff ever successfully holding a shareholder personally liable for the obligations of a mutual fund operating as a Massachusetts business trust).

logs. Thus, even if there were no Investment Company Act of 1940, the sponsor of a U.S. open ended publicly traded mutual fund likely would still have common law fiduciary duties that run to the investors. This would be the case even when the U.S. sponsor is not in a contractual relationship with the fund investors, which is typical. (Recall that any contracts involving the sponsor of an open ended publicly traded mutual fund will generally run from the sponsor to the title-holder, which in the U.S. and England is not the investor).

Moreover, in a common law jurisdiction, more of the parties involved in administering a mutual fund are likely to be tagged with fiduciary or fiduciary-like status than would be the case in a civil law jurisdiction. A multi-fiduciary environment brings with it common law co-fiduciary liability which in turn stimulates cross-fiduciary oversight. This adds up to a private system of checks and balances that can only inure to the benefit of the investor and which appears to have no civil law analog.

In a civil law jurisdiction, the absence of a contractual relationship between the sponsoring bank and the mutual fund investors will generally limit investor recourse to the entity with whom the investor has contracted, namely the KAG or the *Investmentaktiengesellschaft* or, in the case of Luxembourg, the SICAV or the manager of the FCP. In the absence of fraud or some other intentional tort committed by the sponsoring bank directly against the investors, the sponsoring bank can be fairly confident that fiduciary liabilities are not going to leak out of the German KAG or the German *Investmentaktiengesellschaft* or the Luxembourgian SICAV or the manager of the Luxembourgian FCP, as the case may be, and make their way upstream; just the economic benefits will do so. Absent special facts, the fiduciary liabilities should remain safely bottled up in the downstream civil law entity.