Chancery Finds Lack of Personal Jurisdiction, Failure to Demonstrate Demand Futility in Suit Over Investment in Online Gambling

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On June 15, the Delaware Court of Chancery dismissed with prejudice a derivative and direct action brought against the board of trustees and the investment management firms that oversaw investments of mutual funds. The shareholders argued that the trustees and advisers' actions constitute a violation of their fiduciary duties, negligence and waste because some of the investments involved illegal foreign online gambling businesses that violated 18 U.S.C. § 1955, which makes it a crime to "own" any part of an illegal gambling business. The case is captioned *Hartsel v. The Vanguard Group Inc.*

The introductory part of the opinion describes in great detail the rather complex organizational structure of the various mutual fund families involved, as well as the overlapping board of trustees and other related entities that provide advisory services. Vanguard is one of the largest mutual funds in the business and the description from a corporate law point of view of the various types of entities and organizational structures of the related mutual funds is illuminating for those interested in how one of the largest mutual fund families is governed.

Interestingly, the different mutual funds held by the nominal defendants are not separate legal entities, rather they are separate mutual funds that form part of a series of mutual funds that are held by each of the nominal defendants. Thus, investors in each of the mutual funds within a specific nominal defendant hold different series of shares in the same legal entity. The nominal defendants are part of a larger mutual fund complex in which there are 34 other separate registered investment companies like them. The two nominal defendants are Delaware statutory trusts based in Wayne, Pa. Each of the trusts contains multiple mutual funds, for each of which a separate class of stock is offered to public investors. The investment companies within the mutual fund complex all share a single board of trustees.

The defendant, the Vanguard Group Inc., is an investment management company organized under the laws of and headquartered in Pennsylvania. It is owned by the investment companies it manages and, importantly, the same board of trustees that oversees each separate mutual fund series in the mutual fund complex also serves as the board of directors for Vanguard. Vanguard provides advisory services to the nominal defendants through one of the principals of Vanguard, who is one of the individual defendants. Additional defendant-entities also provided investment advisory services. Although the intricate organizational structure that binds the defendants is necessary to understand the opinion, based on the space provided for this overview, the details are necessarily limited.

LACK OF PERSONAL JURISDICTION

None of the individual defendants were residents of Delaware and all of them objected to the exercise of personal jurisdiction by the Delaware Court of Chancery, arguing that there was no basis for such jurisdiction under Delaware's long-arm statute or the Due Process Clause of the Fourteenth Amendment. Plaintiffs disagreed and asserted that jurisdiction was appropriate under both the long-arm statute and the conspiracy theory of jurisdiction, as well as, for defendants Frashure, Chisholm and Wolahan, because they consented to jurisdiction under 6 Del. C. Section 18-109(a).

TWO-STEP APPROACH

The court applied a two-step analysis to determine whether the exercise of personal jurisdiction over a nonresident defendant is appropriate in the context of a motion to dismiss for lack of personal jurisdiction under Rule 12(b)(2). First, the court determines whether there is a basis for personal jurisdiction under the Delaware long-arm statute. Second, if a statutory basis for jurisdiction exists, the court must determine "whether subjecting the nonresident to jurisdiction in Delaware violates the Due Process Clause of the Fourteenth Amendment." The plaintiff has the burden to prove that both steps are satisfied as to each of the defendants.

IMPLIED CONSENT STATUTE

The court also examined the implied consent statute of Section 18-109(a) of the Delaware Limited Liability Company Act because three of the defendants served as officers of a Delaware LLC that was named as a defendant. The determinative phrase in that statute that was in dispute allows claims against a manager of an LLC in actions "involving or relating to a business of the limited liability company." The issue is whether that phrase allows a manager to be sued in Delaware in an action that relates the business of the LLC if the allegations in the complaint focus on the rights, duties and obligations the manager owes to his organization and not to external entities, such as the stockholders of a client mutual fund.

The defendants argued successfully that the consent statute did not apply here because the action concerned breaches of duties that allegedly were owed to parties who were not affiliated with the LLC. The court explained that regardless of a literal reading of Section 18-109(a), the wording of the statute had to be limited by the constitutional prerequisites that prohibited the exercise of personal jurisdiction in situations which would "offend traditional notions of fair play and substantial justice." Due process would not be offended however, if the plaintiffs could show the following three factors: (1) The allegations against the defendant-managers focus centrally on rights, duties and obligations as a manager of a Delaware LLC; (2) The resolution of the matter is inextricably bound up in Delaware law; and (3) Delaware has a strong interest in providing a forum for the resolution of a dispute relating to the managers' ability to discharge their managerial functions. The allegations in this case did not focus on the duties and obligations the managers owed to the LLC and in that sense, did not relate to the internal business of the LLC as required by both the statute and the Due Process Clause.

CONSPIRACY THEORY OF PERSONAL JURISDICTION

The court explained that this theory of personal jurisdiction is not an independent basis for subjecting a nonresident to personal jurisdiction. Rather, it rests upon the notion that when the conduct of a defendant that occurred in Delaware or had a substantial effect in Delaware such that it would make one subject to personal jurisdiction in Delaware, that activity may be attributed to another defendant who would not otherwise be amenable to jurisdiction in Delaware if that defendant is a co-conspirator. The court also noted the general rule that a corporation cannot conspire with itself any more than a private individual can. Although the acts of the agent are generally considered to be the acts of the corporation, there is an exception to this rule when an agent acts pursuant to personal motives instead of in his role as an agent of the corporation. Generally, agents of a corporation are not subject to civil liability for conspiring among themselves and with their own corporation. In this case, the plaintiffs did not satisfy the basic elements of a civil conspiracy.

LONG-ARM STATUTE

The court discussed Section 3104(c)(2) of Title 10 of the Delaware Code relating to contracting to supply services or things in Delaware. This basis was not sufficient to establish jurisdiction because a business relationship between an out-of-state defendant's employer and a company located in Delaware does not provide the necessary contacts to satisfy the Delaware long-arm statute. Next, Section 3014(c)(4) relating to an injury and act or omission outside of Delaware was not helpful to the plaintiffs. That section applies when a defendant has had contacts with Delaware that are so extensive and continuing that it is fair and consistent with state policy to require that the defendant appear here and defend a claim even when that claim arose outside of this state and causes injury outside of this state. Plaintiffs cited to no case law or other authority to support their argument that a receipt by an employee of a salary based on services rendered to a company that derives substantial revenue from its activities in Delaware, is a sufficient basis to confer personal jurisdiction over the defendant.

Finally, the court found that plaintiff failed to satisfy Section 3104(c)(3), which requires a plaintiff to demonstrate that the nonresident defendant caused a tortious injury in Delaware and that such injury was due to an act or omission by the defendant in Delaware.

DUE PROCESS

The court did not reach this analysis, which must be satisfied in addition to the statutory analysis, because the court concluded that there was no statutory basis on which to assert personal jurisdiction. Nonetheless the court provided a hypothetical analysis for why the Due Process Clause would not be satisfied even if there were a statutory basis for jurisdiction.

JURISDICTIONAL DISCOVERY

The court denied the request for jurisdictional discovery for several reasons. First, discovery was never stayed and the court noted that for over two months the plaintiffs had the opportunity to conduct discovery, but they did not do so. In addition, the court determined that the facts on which the jurisdictional issues were based were not in dispute.

The court also conducted a very extensive presuit demand analysis, which the space allotted for this overview did not allow us to cover, but which provides the latest Delaware jurisprudence on the distinction between direct and derivative claims, as well as the procedural presuit demand futility prerequisite for pursuing derivative claims.

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