IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

PATRICK J. O'MALLEY and LEATHA S. O'MALLEY, on behalf of themselves and all others similarly situated,	)	
Plaintiffs,	)	Civil Action No. 15735-NC
v.	)	
JAMES R. BORIS, et al.,	)	
Defendants.	)	

<u>MEMORANDUM OPINION</u>

Date Submitted: January 18, 2002
Date Decided: March 18, 2002

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Kevin R. Shannon, Brian C. Ralston, of POTTER, ANDERSON & CORROON LLP, Wilmington, Delaware; OF COUNSEL: Paul Gonson, Jeffrey B. Maletta, Stavroula E. Lambrakopoulos, Christopher E. Dominguez, of KIRKPATRICK & LOCKHART LLP, Washington, D.C., Attorneys for Defendants EVEREN Capital Corporation, EVEREN Securities Holdings, Inc., EVEREN Securities, Inc., EVEREN Clearing Corporation, Wheat First Butcher Singer, Inc., Wheat First Securities, Inc., Mentor Investment Group, Inc., and Mentor Investment Group, L.L.C.

CHANDLER, Chancellor

Named plaintiffs Patrick and Leatha O'Malley have moved for partial summary judgment against. defendant EVEREN Securities, Inc. ("Everen") in this class action lawsuit. Everen, along with EVEREN Capital Corporation ("Everen Capital"), EVEREN Securities Holdings, Inc. ("Everen Holdings"), EVEREN Clearing Corporation ("Everen Clearing"), Wheat First Butcher Singer, Inc. ("WFBS"), Wheat First Securities, Inc. (Wheat Securities"), Mentor Investment Group, Inc. ("Mentor"), and Mentor Investment Group, L.L.C. (the "Joint Venture"), the other defendants in this matter, have cross-moved for summary judgment on all four of the plaintiffs' claims or, in the alternative, for summary judgment on the availability of the constructive trust remedy sought by the plaintiffs. For reasons explained more fully below, I grant summary judgment in favor of the plaintiffs on Counts I and II, the duty of disclosure and duty of loyalty claims. I decline to enter summary judgment with respect to Counts III and IV, the aiding and abetting claims, or with respect to the appropriate remedy for the breach of the duty of loyalty.

I. FACTUAL AND PROCEDURAL HISTORY[1]

The plaintiffs are customers of Everen, a full services brokerage firm. Everen, Everen Clearing, and Everen Holdings were at all relevant times Delaware

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[1] The facts of this case are set forth in the earlier opinions of this Court, *O 'Malley* v. *Boris,* Del. Ch., C.A. No. 15735, mem. op., Chandler, C. (Jan. 19, 1999), and the Supreme Court, *O'Malley* v. *Boris*, 742 A.2d 845 (Del. 1999). They are repeated here only to the extent necessary for this Opinion.

corporations with principal places of business in Chicago, Illinois. Each of them was, until October 1999, wholly owned subsidiaries of Everen Capital. Wheat and Mentor are Virginia corporations and are wholly owned subsidiaries of WFBS, also a Virginia corporation. The Joint Venture was at all relevant times a Virginia Limited Liability Company with its principal place of business in Richmond, Virginia.

Everen offers money market sweep accounts to its customers.* Section 4 of Everen's Client Agreement (the "Sweep Agreement") details the rights and obligations of Everen regarding sweep accounts. The Sweep Agreement indicates that Everen or its affiliates "may select another participating money market fund by providing [a customer] with prior notice and sending [the customer] a copy of the prospectus for such fund," and also that Everen or its affiliates "may terminate the use of a money market fund that is linked to [a customer's] account."[3] Before November 1996, Everen used money market funds sponsored by Zurich Kemper Investments, Inc. for the sweep accounts. Everen's choice of money market funds for the sweep accounts changed, however, after it entered into a joint venture

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[2] Sweep accounts are linked to brokerage accounts. If a customer has a sweep account, any uninvested cash in that customer's brokerage account is periodically "swept" into a money market fund in order to &sure that all funds in the brokerage account earn interest, whether invested in primary securities or hot.

[3] Sweep Agreement § 4(b).

agreement (the "JVA") with WFBS and its affiliates.[4] Under the relevant provisions of the JVA, Mentor was merged into the newly created Joint Venture, which then offered asset management services, including money market funds, mutual funds, and private account management, to the clients of Everen and Everen Clearing. The JVA provided that Everen Holdings would acquire a 20.2% ownership in the Joint Venture, while WFBS would hold the remaining 79.8% interest. Everen Holdings was also to acquire a larger ownership percentage of up to 50% at a second closing, with the exact percentage to be determined based on the amount of customer assets invested in the Joint Venture.

Neither Everen nor Everen Holdings paid any money for the initial 20.2% equity interest received in the Joint Venture.' In connection with the JVA, Everen agreed to facilitate the transfer of its clients' sweep accounts to funds managed by the Joint Venture. Everen also agreed to make the Joint Venture's money market funds its exclusive fund family for sweep accounts and to include the Joint Venture's funds and private account management services on its "preferred" list of mutual funds and private account managers. To initiate the switch, Everen sent its clients letters dated September 23, 1996 (the "Negative Action Letters") notifying

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[4] The JVA was between WFBS, Wheat, and Mentor on the one hand, and Everen, Everen Capital, Everen Holdings, and Everen Clearing on the other.

[5] The transaction was attractive to Everen for precisely this reason. Boris Dep., Defs.' Ex. F, at 34-35. Moreover, WFBS apparently would not have sold the equity interest in the venture for cash from Everen. McGivern Dep., Defs.' Ex. G, at 31-32.

them that, unless they objected, the funds used for their sweep accounts would be replaced by comparable funds owned by the Joint Venture. With the Negative Action Letters, Everen sent each of its clients a prospectus for the funds offered by the Joint Venture (the "Prospectus"). The Negative Action Letters encouraged Everen's clients to read the Prospectus, noting that "the prospectus includes information relating to the EVEREN ownership interest in [the Joint Venture]."[6] The sufficiency of the disclosure in the Prospectus is the central issue remaining in this case and will be discussed in detail below.

On or about November 1, 1996, Everen completed the switch in sweep accounts, transferring roughly $3 billion of its clients assets into money market funds owned by the Joint Venture. Fewer than 10 of Everen's approximately 300,000 customers objected.' The plaintiffs, whose sweep accounts were transferred, originally pursued an array of state and federal claims in connection with the switch. They asserted that (1) Everen and its directors had breached their contract with the plaintiffs and violated their duties of disclosure and loyalty; (2) the other (non-Everen) defendants had aided and abetted these violations;* and (3) the defendants in various combinations had violated federal securities laws,

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[6] Negative Action Letters, Defs.' Ex. J, at 1.
[7] This came as no surprise to the parties to the JVA, who expected that "definitely in excess of 90 per cent" of Everen's customers would consent. McGivern Dep., Defs.' Ex. G, at 141; see *also* Boris Dep., Defs.' Ex. F, at 68.
[8] The plaintiffs contend that all defendants other than Everen aided and abetted the asserted breaches.

specifically sections 11, 12(a)(2), and 15 of the Securities Act of 1933. On January 19, 1999, this Court dismissed all of these claims, concluding that there was no breach of contract and that all material facts had been disclosed in the Prospectus distributed with the Negative Action Letters.[9] The plaintiffs appealed the dismissal of only the state law fiduciary claims and the related aiding and abetting claims, arguing that the way Everen obtained its original 20% interest in the Joint Venture was material and was not disclosed." On December 8, 1999, the Delaware Supreme Court reversed this Court's dismissal of these four state-law claims, holding that the prospectus did not adequately disclose how Everen obtained its 20% interest in the Joint Venture and remanding for a determination, after the development of a more complete factual record, of the materiality of this omission.

Accordingly, the claims before me on remand are that Everen and its directors breached their duty of disclosure and their duty of loyalty (Counts I and II, respectively), and that the other defendants aided and abetted these breaches of duty (Counts III and IV). The parties have moved for summary judgment.

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[9] Realistically, this conclusion controlled all of the remaining claims. Because disclosure was found to be adequate, there was not a valid duty of disclosure claim and any alleged breach of the duty of loyalty would have been ratified by the plaintiffs. There could thus be no claim for aiding and abetting because there was no underlying breach of fiduciary duty. The claims under sections 11 and 12(a)(2) of the Securities Act failed as well, because both of those claims were premised on the existence of material omissions. Finally, the claim for controlling person liability under section 15 of the Securities Act failed because there was no underlying liability.

[10] It is unclear why, in light of the analytical similarity between the claims, the plaintiffs did not also appeal the dismissal of their federal securities claims. Nevertheless, they did not.

II. STANDARD OF REVIEW

Summary judgment under Court of Chancery Rule 56 is appropriate when there are no disputed issues of material fact and the moving party demonstrates an entitlement to judgment as a matter of law.” The Court may deny summary judgment, however, “if it decides that a more thorough development of the record would clarify the law or its application.”[12] The plaintiffs have moved for partial summary judgment on Count II, the duty of loyalty claim, arguing that Everen breached its fiduciary duty of loyalty by obtaining a benefit from a transaction within the scope of its duties that was not remitted to its principals. The plaintiffs contend that this breach was not ratified by Everen’s customers consenting to the switch because Everen failed to disclose fully all of the material facts. The defendants have cross-moved for summary judgment on all four remaining counts, arguing that Everen complied with its fiduciary obligations and that any breaches of fiduciary duty were ratified by Everen’s fully informed clients when they consented to the switch in sweep accounts. In the alternative, the defendants have moved for summary judgment on the availability of the constructive trust remedy sought by the plaintiffs.

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[11] Ct. Ch. R. 56; *see, e.g., Williams v. Geier,* 671 A.2d 1368, 1375 (Del. 1996).
[12] *Continental Ins. Co. v. Rutledge & Co.,* 750 A.2d 1219, 1228 (Del. Ch. 2000).

III. DISCUSSION

A. The Scope of Everen's Fiduciary Duties

A preliminary issue with respect to Count II is whether Everen owed a fiduciary duty of loyalty to its clients. The defendants argue that the scope of Everen's fiduciary duties to its clients was limited by the Sweep Agreement, which granted Everen the right to end sweep accounts altogether or to change the money market funds it made available for the investment of sweep assets. The plaintiffs contend that any waiver of fiduciary duties must be plain and unambiguous to be effective and, relying on the Supreme Court's earlier opinion in this case, that Everen, as an agent, owed fiduciary duties to its clients in connection with its choice of sweep accounts." The defendants' argument is essentially that there could be no breach of duty because Everen complied with the terms of its contracts, which defined the scope of agency.[14] The mere existence of a contract

[13] The Supreme Court explained that "[t]he relationship between a customer and stock broker is that of principal and agent" and noted that agents owe principals "fiduciary duties of good faith, fair dealing, and loyalty [which] are comparable to the fiduciary duties of corporate directors." *O'Malley,* 742 A.2d at 849. "In this case," the Supreme Court explained, "the O'Malleys gave [Everen] little discretionary authority, but the choice of sweep account funds was an investment decision that Everen made for its customers. As such, it is a decision for which Everen is accountable under fiduciary standards.'* *Id.* After development of a more complete factual record, the facts upon which the Supreme Court based its assessment do not appear to have been entirely correct. At the motion to dismiss stage, the Supreme Court was required to assume the truth of the plaintiffs' assertion that the defendants switched the sweep accounts to the Mentor funds. This was not the case, however. The defendants merely recommended the switch, while the plaintiffs ultimately controlled the investment decision. Nevertheless, the defendants still owed the plaintiffs fiduciary duties in connection with the recommendation and in connection with the decision to make the Mentor funds the only funds available for sweep accounts.

[14] As the defendants explain it, "EVEREN and its customers defined the scope of their agency through the Sweep Agreement which gave EVEREN the unilateral and unfettered authority to

authorizing Everen to act with discretion, however, does not absolve it of the responsibility to exercise that discretion in compliance with fiduciary principles." While Everen was free to choose which money market funds would be made available for sweep accounts, it was not free to make that choice in a self-interested manner. Accordingly, Everen owed its clients a fiduciary duty of loyalty.[16]

B. Breach of the Duty of Loyalty

Putting the question of ratification to the side temporarily, I turn now to the plaintiffs' contention that Everen breached its duty of loyalty. As the agent of its customers, Everen must act in its customers' best interests and refrain from self-

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act with respect to the availability of a sweep account and the choice of money market funds for the deposit of the sweep account assets." Defs.' Opening Br. at 34-35.

[15] This is because, as the plaintiffs argue, any waiver of fiduciary duties by contract must be clear and explicit. *See, e.g., Continental Ins. Co.,* 750 A.2d at 1235-37 (refusing to imply that contractual language removed the general prohibition on self-dealing); *Nash v. Schock,* Del. Ch., C.A. No. 14721, mem. op., Steele, V.C., 1997 WL 770706 at *3 (Dec. 3, 1997) ("[I]f a principal intends to waive the fiduciary duties implied by law . . . that intention must be clearly and unambiguously expressed on the face of the document . . . .").

[16] Because the plaintiffs had non-discretionary accounts, this duty was limited in nature. See *O'Malley v. Boris,* Del. Ch., mem. op, Chandler, C., 1999 WL 39548 at *8-*9 (Jan. 19, 1999). Other courts have suggested that duties associated with a non-discretionary account include:

> (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price, and financial prognosis; (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security; (5) the duty not to misrepresent any fact material to the transaction; and (6) the duty to transact business only after receiving prior authorization from the customer.

Patsos v. First Albany Corp., 741 N.E.2d 841, 849 n.15 (Mass. 2001) (citing *Lieb v. Merrill Lynch. Pierce, Fenner & Smith, 'Inc.,* 461 F. Supp. 951, 952 (E.D. Mich. 1978), *aff'd, 647* F.2d 165 (6th Cir. 1981)). It is the fourth of these duties that is arguably implicated in this case.

dealing unless the customers consent.” Before addressing disclosure, materiality, and consent, I must first determine whether Everen engaged in self-dealing. According to the plaintiffs, Everen breached its fiduciary duty by “act[ing] in its own self-interest by exercising its power to choose the money market mutual funds it would use for its customers’ sweep accounts, and agreeing to cause the transfer of its clients’ sweep account assets into such funds in order to obtain for Everen Holding, Inc. a substantial interest in the funds’ investment advisor.“” The defendants make several arguments, described below, to support their position that the transfer of the plaintiffs’ assets to Mentor funds was not a quid pro quo for Everen’s interest in the Joint Venture.

I begin my analysis with the JVA itself. The term “Money Market Conversion” is defined in the JVA as “the investment in the Mentor Money Market Funds of all sweep account assets held at EVEREN Clearing and introduced by EVEREN Securities (except (i) sweep account assets currently invested in money market open-end investment companies for which there is not a comparable Mentor Money Market Fund and (ii) sweep account assets with respect to which the client of such account has not consented to the Money Market Conversion),” and the term “Money Market Conversion Date” is defined as “the date on which

[17] *O 'Malley*, 742 A.2d at 849 (“The broker, as agent, has a duty to carry out the customer’s instructions promptly and accurately. In addition, the broker must act in the customer’s best interests and must refrain from self-dealing unless the customer consents, after full disclosure.“).
[18] Amended Pls.’ Reply Br. at 1.

the Money Market Conversion occurs."[19] The JVA contemplates an initial closing at which "WFBS shall cause the Venture to issue to EVEREN Holdings that amount of Interests representing 20.2% of the outstanding Membership Interest of the Venture; *provided that if the Money Market Conversion Date has not occurred by December 31, 1996, the Venture shall have the right to call the Interests held by EVEREN Holdings at no cost to the Venture*."[20] Read together, these provisions indicate that Everen would have forfeited its interest in the Joint Venture if it did not initiate the switch of its customers' sweep accounts before December 1, 1996. It is difficult to conceive of this arrangement as anything other than a quid pro quo.

The defendants, undaunted by this language in the JVA, contend that the switch was not a quid pro quo because Everen could not guarantee that a specific number of customers would consent to the switch and because the JVA excludes sweep accounts of non-consenting customers from the definition of "Money Market Conversion." These premises are true, but it does not necessarily follow that the transaction is not a quid pro quo. Everen could not guarantee that its customers would all consent to the switch, but Everen could commit to recommend the switch to all its customers, knowing that a vast majority of them would acquiesce when presented with Negative Action Letters,[21] and Everen could also

[19] JVA § 1.1.
[20] I.. § 2.3(c) (emphasis added).
[21] Even though Everen would have retained its interest even if no customers consented to the switch, the parties to the JVA all expected that a vast majority of the customers would consent.

stop offering other sweep account funds altogether. It did all of these things.[22] In exchange for this, Everen retained an equity interest in the Joint Venture. It did not matter how many customers actually consented after the Negative Consent Letters were sent; Everen had already earned its 20% equity interest in the joint venture (or, more accurately, retained its interest by satisfying its condition subsequent) by making the recommendation and then switching the accounts of all customers who did not object. In essence, because Everen could not guarantee that its customers would consent, it was paid for making the recommendation.

The defendants also contend that the transfer of sweep accounts was not a quid pro quo but merely a logical first step in the strategic alliance between Everen and WFBS.[23] It may be true that the parties imposed the condition that Everen's

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Economically speaking, this makes sense; otherwise it presumably would have been an unfavorable transaction for WFBS.

[22] The JVA provides that:

> Following the Initial Closing, (i) EVEREN Securities shall cause the Mentor Money Market Funds to be exclusively utilized for its client sweep accounts (except with respect to sweep account assets which the client desires to invest in money market open-end investment companies of the type offered in EVEREN Securities sweep accounts as of the date of this Agreement for which there is not a comparable Mentor Money Market Fund) and cause the Money Market Conversion to occur and (ii) each of EVEREN Securities and Wheat shall include the Mentor Funds and the Venture Entities' private account management services in its 'preferred' or 'focus group' list of mutual funds and private account managers offered to customers . . . .

JVA § 3.3(a).

[23] The defendants explain this point as follows:

> The transfer of the sweep account assets was selected by the parties as a first step in the Joint Venture because it was easily identifiable, could be accomplished relatively efficiently, and would serve as a milestone to be used by the parties in evaluating the Joint Venture's progress. . . . [T]he parties selected the date of December 3 1, 1996 as the deadline for the Money Market Conversion because

interest would be callable at no cost if the switch was not initiated before December 3 1, 1996 because they wanted to ensure Everen's commitment to the Joint Venture.[24] Nevertheless, the condition imposed is still a condition to Everen getting to keep the equity interest that is the subject of this case. It is ultimately not important why the condition was imposed; the simple fact remains that, as the JVA is structured, if Everen failed to recommend that its customers switch their sweep account funds to the Joint Venture's funds then it would have lost its equity

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> Mentor was concerned that the Joint Venture would be jeopardized in the event that EVEREN placed greater priority and allocated more resources to other matters. Accordingly, the parties agreed to a set deadline for the conversion not *as* a *quid pro quo* for the receipt by EVEREN of its 20.2% interest, but rather as an indication that EVEREN was committed to the Joint Venture. Defs.' Opening Br. at 25-26 (citations omitted).

[24] It may also be the case, however, that the condition was imposed because from an economic standpoint it would make no sense for WFBS to sacrifice 20% of its interest in Mentor without locking in the larger asset base provided by the transfer of sweep account assets. The defendants argue that the Joint Venture was getting access to Everen's network of brokers and potential customers through Everen's designation of the Joint Venture as a "preferred" asset manager and through Everen's commitment to direct its marketing efforts toward funds sponsored by the Joint Venture for primary investments. But as the defendants later note, what WFBS gave Everen in return for this was "the ability to achieve an equal partnership" in the Joint Venture. Defs.' Opening Br. 28. The parties created a sliding scale so that Everen's ownership would vary in direct proportion to its success in selling the funds of the Joint Venture. Absent the condition about the switch, however, Everen could have failed to sell any of the Joint Venture's funds at all-thus contributing no assets whatsoever to the Joint Venture-and still retained its 20% interest.

The defendants also argue in connection with this point that it was not the 20% interest that drove Everen to enter into the JVA, but that Everen was motivated by the opportunity to become equal partners in a venture with WFBS. After listing several valid business reasons for this and describing the benefits Everen would derive from an equal partnership, the defendants note that "[b]y contrast, the revenues that Everen anticipated receiving from the Joint Venture as a result of the transfer of sweep account assets to the [Joint Venture's] funds were relatively minimal." Defs.' Opening Br. at 27. The fact that Everen profited ***at all*** from the transfer of sweep account assets, even relatively minimally, indicates the self-dealing nature of the switch. Agents are prohibited from taking undisclosed compensation from third parties for exercising their agency duties.

interest in the Joint Venture. Giving Everen a valuable interest on the condition that Everen make a recommendation to its customers is not far removed from paying Everen to make the recommendation. It is, in fact, exactly the same as paying Everen to make the recommendation, but with the parties' order of performance reversed. Viewed in this manner, the switch must be considered a quid pro quo. Everen clearly profited through the exercise of its duties as an agent, and in that regard breached its duty of loyalty to its principals. The remaining question is whether that breach of fiduciary duty was ratified by the approval of fully informed principals.

C. Materiality is a Determinative Issue

In this case, the main issue before me on remand is materiality. As the Supreme Court explained, "The question is whether reasonable investors, knowing that Everen stood to profit from the switch in sweep account funds, would consider it important to know what Everen exchanged for its initial share in the venture."[25] If that information is material, then the plaintiffs will prevail on Count I, the duty of disclosure claim, because the Supreme Court has already held that the disclosure of that information was inadequate as a matter of law.[26] My decision on

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[25] *0 'Malley, 742* A.2d at 850.

[26] The Supreme Court reasoned as follows:

> The Court of Chancery found that, from the information that was disclosed, a reasonable investoi could not miss the point that Everen was using its customer base to participate in the venture with Mentor. We think that full disclosure requires more than strong inferences. Investors should not be required to

materiality also controls the outcome of Count II, the duty of loyalty claim, because the only remaining issue on that claim is whether the plaintiffs ratified the defendants' breach after disclosure of all material facts.[27] It is only theoretically possible for the plaintiffs to prevail on Count II and not on Count I.[28] Ultimately, then, the decision on materiality will determine the outcome of both claims.

C. Materiality of the Omitted Information

The Prospectus disclosed Everen's interest in the Joint Venture as follows:

> In addition, it is expected that promptly after that reorganization, EVEREN Securities, Inc. will acquire 20% of the outstanding shares of [the Joint Venture]. EVEREN may thereafter acquire additional shares in [the Joint Venture] (not to exceed an additional 30% of [the Joint Venture's] outstanding shares) depending principally on the amount of assets in investment companies sponsored by [the Joint

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correctly "read between the lines" to learn all of the material facts relating to the transaction at issue. While there may be cases where the disclosures are adequate because the undisclosed information inescapably follows from the disclosed facts, this is not such a case. The disclosures about Everen's interest in Mentor leave open at least two reasonable possibilities as to how Everen acquired its interest— by investing its own money or by transferring its clients' money. Under these circumstances, the information about how Everen acquired its interest in Mentor cannot be deemed to have been disclosed. Id. at 851.

[27] Id. at 851 ("Our decision on the disclosure claim controls all the remaining state law claims. The duty of loyalty claim was dismissed on the theory that the O'Malleys consented to the switch in sweep accounts after full disclosure. If their consent was invalid because it was based on inadequate disclosures, their duty of loyalty claim remains.").

[28] To prevail on Count I, the plaintiffs must prove, by a preponderance of the evidence, that the defendants' nondisclosure was material. To obtain the benefits of ratification and prevail on Count II, the defendants must prove, by a preponderance of the evidence, that the plaintiffs consented to the switch after all material facts were disclosed. ***Cahall** v. **Lofland,*** 114 A. 224, 234 (Del. Ch. 1921) ("One cannot ratify that which he does not know. The burden is on him who relies on a ratification to show that it was made with a full knowledge of all material facts."). If the issue of materiality were precisely in equipoise, neither side would have carried its burden and the defendants would be liable for breaching only their duty of loyalty. This outcome is, however, unlikely from a realistic standpoint, to say the least.

> Venture] or its affiliates (including the Funds [used for sweep accounts]) attributable to shares held by clients of EVEREN.[29]

As discussed above, Everen acquired a 20% equity interest in the Joint Venture in exchange for recommending the switch to its customers, among other things. The Supreme Court has ruled, as a matter of law, that Everen did not adequately disclose how it obtained this original equity interest in the Joint Venture, because it is unclear from the Prospectus whether Everen invested its own capital in the Joint Venture or simply transferred the assets of its clients into funds owned by the Joint Venture.[30] My task now is to determine whether this omission was material. I conclude that it was, even construing any factual disputes in the light most favorable to the defendants as I must at this stage of the case.[31]

The test for materiality is clear and well-settled.

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances,

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[29] Prospectus, Defs.' Ex. K, at 12.

[30] This is the law of the case and is controlling, despite the plaintiffs' testimony, upon reading the disclosure language for the first time, that he understood that Everen "was gaining ownership of the company with [his] money." P. O'Malley Dep., Defs.' Ex. A, at 66; see ***also id.*** at 68 ("It didn't seem fair. . . . It was using somebody else's money for their interest.").

[31] Both parties have moved for summary judgment, but for purposes of this claim I will treat the defendants as the non-moving party. Although the plaintiffs have only moved for summary judgment on Count II, the duty of loyalty claim, my decision on materiality will also control the outcome of Count I, the duty of disclosure claim. For that reason, and because the Court has the authority to enter summary judgment against the moving party ***(i.e.,*** the defendants, for Count I), ***see Bank of Delaware v. Claymont Fire*** Co. No. I, 528 A.2d 1196, 1199 (Del. 1987), I am able to enter summary judgment against the defendants on both of those Counts.

> the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.[32]

For several reasons, I believe that this standard is satisfied here.

Full disclosure of how Everen obtained its original equity interest in the Joint Venture would have affected the decisionmaking process of a reasonable customer in the position of the plaintiffs. A customer would consider his broker's recommendation and the related investment decision differently based on what information was disclosed to him. Disclosure that the broker was paid to make the recommendation and would receive additional compensation if the customer followed his recommendation might well be viewed differently than disclosure that the broker would profit only if the customer followed that same recommendation (*i.e.,* that the broker would receive a commission on the sale or from subsequent management fees). This is essentially the case here. Under the law of the case, Everen disclosed that it owned 20% of the Joint Venture and would own more based on the percentage of customer assets that were deposited into Mentor Funds;[33] that is, Everen disclosed that it would profit from the switch through its original equity ownership and the possibility of increased equity ownership based

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[32] *Rosenblatt v. Getty Oil Co., 493* A.2d 929,944 (Del. 1985).
[33] *O'Malley, 742* A.2d at 850.

on the amount of customer assets switched.[34] But Everen failed to disclose *how* it obtained the original 20% interest, which was in essence paid to Everen in exchange for making the recommendation. To a reasonable investor, the investment decision made in light of that disclosure would be materially different.

It is the information that is disclosed to an investor which is key to the Court's consideration of whether actions taken were consistent with fiduciary obligations. Recommending a switch in sweep account funds that would profit the broker upon switching could be done in good faith if that information was fully disclosed to investors (as it was here). Recommending a switch in sweep account funds in exchange for a substantial payment probably could not be made in good faith unless that information was fully disclosed to investors (which the defendants failed to do in this case). In my opinion, even *with* full disclosure, there would be more reason to trust the broker's recommendation in the first case than in the second. Therefore, it seems likely that additional information concerning the consideration received by the defendants in return for recommending the switch in sweep accounts "would have assumed actual significance" in the deliberations of a reasonable investor in the place of the plaintiffs.

[34] Although it is unclear whether the sweep account funds alone would be sufficient to increase Everen's equity in the Joint Venture above 20%, once that threshold was crossed (as all of the parties to the JVA clearly contemplated it would be) Everen's ownership would depend directly upon, among other things, the number of customers consenting to the switch of sweep accounts.

The economic reality underlying the transaction illustrates this point. The plaintiffs and Everen's other customers pay management fees for the sweep account funds. If Everen put its own capital into the Joint Venture in exchange for the 20% equity interest and then brought customer assets into the fund, its customers would essentially be paying 1/5 of their management fees to their broker. The customers may nevertheless have consented to this, believing that Everen negotiated the best possible deal for its customers and then independently decided to invest in money market sweep account funds.[35] If Everen obtained the 20% equity interest in the Joint Venture in exchange for a commitment to initiate a switch of customer sweep account assets into the funds owned by the Joint Venture (coupled with the generally accepted wisdom that at least 90% of the clients would consent if Everen recommended the switch), however, then any reasonable customer would have known that the assets of the plaintiff class gave Everen significant bargaining power. From that conclusion, it follows inescapably that if Everen were truly faithful to the interests of its customers, it would have used that bargaining power to negotiate a better deal (perhaps in the form of reduced

[35] Alternatively, the customers might infer that the only reason Everen was allowed to buy into the Joint Venture, from an economic perspective, was through a commitment to bring customer assets into the fund so that there was a bigger fee-generating asset base. That way WFBS could give up 20% of the equity in Mentor but still have a more valuable interest overall. While this may have been a reasonable inference for the customers to draw from the disclosure made by Everen, the Supreme Court has indicated that strong inferences of material facts are not suffkient when, as in this case, the undisclosed information does not follow "inescapably" from the disclosed facts. *O'Malley*, 742 A.2d at 85 1.

management fees) for its customers rather than taking an equity interest for itself.[36] This is a separate type of self-dealing, different from and more complex than simply buying an equity interest in a fund recommended to clients. In order to obtain the ratifying effect of customer approval of self-dealing, full and fair disclosure of that self-dealing is unquestionably material. In this case, however, the Supreme Court has held that "[t]he disclosures about Everen's interest in Mentor leave open at least two reasonable possibilities as to how Everen acquired its interest-by investing its own money or by transferring its clients' money."[37]

Finally, and relatedly, settled Delaware law does not allow partial disclosure of material facts to suffice. The disclosure made by Everen constitutes a partial

[36] In other words, if WFBS was willing to give up 20% of its fees in exchange for Everen's commitment to bring $3 billion into the Joint Venture's funds, it probably would have been willing to keep all of the equity but charge Everen's customers a lower management fee. Assume for illustrative purposes (recognizing that this example is oversimplified and that revenue and profits associated with money market funds are "fairly minimal relative to equity funds," see Boris Dep. at 25) that Mentor had assets worth $5 billion under its control before the switch and $8 billion after. If the management fee was 1%, Mentor would be earning $50 million before the switch (0.01 x $5 billion x 100%) and an additional $14 million, or a total of $64 million (0.01 x $8 billion x 80%), after the switch. Everen would be earning nothing before and $16 million (0.01 x $8 billion x 20%) after. Bather than appropriating this benefit for itself, Everen could have negotiated for a management fee of only 0.467% for its customers, thereby creating the same $14 million in additional revenue for Mentor (adding 0.00467 x $3 billion x 100%, or $14 million, after the switch) and saving Everen's customers $16 million.

[37] *O'Malley*, 742 A.2d at 851.

disclosure in that it disclosed part of its interest in the transaction but not all of it. Our law requires full disclosure of all material facts.[38] Everen failed to comply with this obligation. Therefore, I find that Everen's omissions were material, and because the determination of materiality controls the outcomes of the duty of disclosure and duty of loyalty claims, I grant summary judgment in favor of the plaintiffs as to liability on Counts I and II.[39] The remaining question for these two claims is what remedy is appropriate. I turn next to the defendants' argument that the plaintiffs are not entitled to a constructive trust.

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[38] *See, e.g., Arnold v. Soc'y for Savings Bancorp, Inc.,* 650 A.2d 1270, 1280 (Del. 1994) ("[O]nce defendants traveled down the road of partial disclosure of the history leading up to the Merger and used the vague language described, they had an obligation to provide the stockholders with an accurate, full, and fair characterization of those historic events."); *Stroud v. Grace,* 606 A.2d 75, 84 (Del 1992) (recognizing the obligation of fiduciaries to "disclose fully and fairly all material information" when seeking action by principals).

[39] I reject the defendants' argument that the plaintiffs acquiesced in this breach by consenting to the switch or by continuing to be clients of Everen. At the time of the switch, the plaintiffs were not informed of all material facts, and accordingly they cannot be said to have acquiesced. After learning of the breach of fiduciary duty, the plaintiffs were entitled to keep their funds in the only available sweep account offered by Everen. There was no further harm to be done after the accounts were switched, so the plaintiffs were in a situation more analogous to that of minority shareholders in a controlled corporation after the execution of a self-dealing transaction by the controlling shareholder. They can bring suit without ceasing all dealings with the self-dealing fiduciary.

I also reject the defendants' argument that the omitted information was not material because the plaintiffs were concerned only with maintaining interest-earning and check-writing features on their sweep accounts. Just because the amount of self-dealing was quite small for each 'individual customer, it does not mean #at Everen should avoid liability. The O'Malley's were primarily interested in check-writing privileges and earning interest, but Everen should not be allowed to profit to the tune of millions of dollars simply because the transaction was

E. Remedy for These Breaches** of **Fiduciary Duty

The defendants have asked me to rule that a constructive trust is not an appropriate remedy in this case. A constructive trust is generally imposed when a party's "fraudulent, unfair or unconscionable conduct causes him to be unjustly enriched at the expense of another?' The defendants argue that a constructive trust is an extraordinary remedy typically reserved for situations involving manifest injustice and that in order to obtain a constructive trust the plaintiffs must establish that Everen profited at their expense. The defendants also argue that because the Joint Venture's money market funds were comparable to the original sweep account funds, the transaction was entirely fair to the plaintiffs and, essentially, that (as a result) there were no damages suffered by the plaintiffs that would warrant the imposition of a constructive trust. Finally, the defendants note that the plaintiffs never had a claim to operating profits of Everen and that the plaintiffs could not have obtained an equity interest in the Joint Venture themselves.

The plaintiffs contend, to the contrary, that "[i]n Delaware, it remains a fundamental principle that a disloyal fiduciary may not profit from his breach?'

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effectively de *minimis* for each of its roughly 300,000 customers. This is nothing more than the exploitation of a collective action problem faced by the members of the plaintiff class.

[40] *Adams v. Jankouskas, 452* A.2d 148,152 (Del. 1982).

[41] *Continental Ins. Co. v. Rutledge & Co., 750* A.2d 1219, 1239 (Del. Ch. 2000).

Their argument, based on principles of restitution[42] and trust law,[43] is that any personal gain by a fiduciary arising from a breach of fiduciary duty must be disgorged. The plaintiffs also argue that this case presents a sufficiently unjust situation to warrant a constructive trust, citing this Court's decision in *Pike v. Commodore Motel Corp.*[44]

It is not the case, as the plaintiffs allege, that Everen's interest in the Joint Venture, "including the option to gain an additional interest in Mentor, rightfully belonged to the plaintiffs and the Class, as Everen's principals."[45] Any self-dealing in connection with the additional interest in the Joint Venture to be obtained at the second closing was fully disclosed to the plaintiffs,[46] who ratified that self-dealing by consenting to the switch. The material omission in the Prospectus related only to the acquisition of the original 20.2% interest in the Joint

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[42] Restatement of Restitution § 190 (Where a person in a fiduciary relation to another acquires property, and the acquisition or retention of the property is in violation of his duty as a fiduciary, he holds it upon a constructive trust for *the* other."); ***see also Brophy v. Cities Services Co., 70*** A.2d 5, 8 (Del. Ch. 1949); ***Guth v. Loft, 5*** A.2d 503,510 (Del. 1939).

[43] William F. Fratcher, Scott on Trusts § 170.22, at 415 (4th ed. 1987) ("Even though the trustee acts in good faith in receiving a commission on a transaction in the performance of the trust, he is accountable for the commission.").

[44] In ***Pike,*** Vice Chancellor Jacobs held that "[t]he requirement that the wrongdoing be 'unfair' (as distinguished from 'fraudulent' or 'unconscionable') is consistent with the principle that where a fiduciary has breached a duty of loyalty, a constructive trust will be imposed upon any profits received by the fiduciary as a result of the breach." 1986 WL 13007 at *3 (Del. Ch. Nov. 14, 1986).

[45] Amended Pls.' Reply Br. at 30.

[46] ***O'Malley,*** 742 A.2d at 850 (finding that Everen disclosed that it "had a 20.2% interest in the venture at the outset and that Everen's interest would increase with any increase in the amounts that Everen's customers invested in Mentor funds").

Venture. At this stage of the litigation, however, I cannot conclude that a constructive trust for that portion of the equity interest is unavailable to the plaintiffs. Factual disputes as to the feasibility or advisability of that remedy remain. It may be that a constructive trust would be prohibitively difficult to put into effect, or that money damages would be sufficient. A remaining question for trial will be what the proper remedy for Everen's breaches of fiduciary duty should be. The factual dispute underlying this question is what harm the plaintiffs suffered. This portion of the defendants' motion for summary judgment is therefore denied. I turn now to Counts III and IV, the aiding and abetting claims.

F. The Aiding and Abetting Claims (Counts III and IV)

In Counts III and IV of the complaint, plaintiffs assert aiding and abetting claims against the non-Everen defendants. To prevail on their aiding and abetting claims, the plaintiffs must establish that there was a fiduciary duty, that the fiduciary duty was breached, that a non-fiduciary knowingly participated in the breach, and that the plaintiff was damaged thereby.[47] The first two of these elements are established by the earlier portions of this Opinion. At issue in this case is whether the other defendants knowingly participated in Everen's breaches of fiduciary duty, to the detriment of the plaintiffs. These defendants have moved for summary judgment on these claims.

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[47] *See, e.g., In re Santa Fe Pacific Corp. Shareholder Litig.*, 669 A.2d 59, 72 (Del. 1995).

The crux of the plaintiffs' argument is that the WFSB-associated defendants effectively paid Everen to recommend a self-dealing transaction. The plaintiffs also contend that entry of summary judgment would be premature because they have not yet completed discovery relating to these claims. At this point, construing all factual ambiguities in favor of the non-moving party (the plaintiffs in this circumstance), I cannot say with certainty that the other defendants did not aid and abet Everen's breaches of its fiduciary duties. I note that it seems unlikely that the other defendants, particularly those not affiliated with Everen, were involved in Everen's breach of the duty of disclosure. I also note that, as to the duty of loyalty claim, there is not a per se prohibition on self-dealing. Our law only prohibits self-dealing by agents in the absence of fully informed consent by their principals. Thus, even if the other defendants knew that they were helping Everen enter into a self-dealing transaction it may be the case that they expected Everen to disclose all elements of the transaction to its clients, thereby eliminating any potential breach of the duty of loyalty.[48] In any case, although the plaintiffs' burden going forward with these claims will likely be heavy, they must nevertheless be afforded the

[48] This inference is supported by the language of the JVA, which indicates that Everen and Wheat Securities were to include funds and services provided by the Joint Venture in each of their "preferred" or "focus' group" list of mutual funds or private account managers offered to customers *"with a status that reflects WFBS' and EVEREN's proprietary interest in the Venture."* JVA § 3.3(a) (emphasis added).

opportunity to bear that burden. The defendants' motion for summary judgment on Counts III and IV is therefore denied.

IV. CONCLUSION

For the foregoing reasons, I grant summary judgment in favor of plaintiffs on Counts I and II of the complaint. I deny defendants' motion for summary judgment on Counts III and IV of the complaint, as well as defendants' motion for summary judgment on the availability of a constructive trust as a possible remedy in this case.

An Order has been entered in accordance with the rulings set forth in this Opinion.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

PATRICK J. O'MALLEY and LEATHA)
S. O'MALLEY, on behalf of themselves)
and all others similarly situated,)
)
Plaintiffs,) Civil Action No. 15735-NC
)
v.)
)
JAMES R. BORIS, et al.,)
)
Defendants.)

ORDER

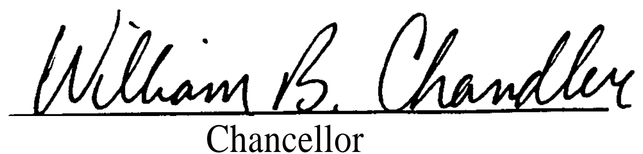
For the reasons set forth in this Court's Opinion entered in this case on this date it is,

ORDERED:

1) Summary judgment is entered in favor of plaintiffs and against defendants with respect to Counts I and II of plaintiffs' complaint;

2) Defendants' motion for summary judgment as to Counts III and IV of plaintiffs' complaint is DENIED;

3) Defendants' motion for summary judgment as to the availability of a constructive trust as a remedy in this case is DENIED.



Chancellor

Dated: March 18th, 2002