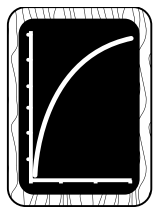

LEARNING CURVE®

When A Fund Is Sued: An Independent Director's Guide To Fund Litigation

By **Robert W. Helm** & **David M. Geffen***

Both the number of lawsuits and the scope of litigation involving funds reflect the increased scrutiny to which the conduct of fund directors is subject. This article outlines the major issues concerning fund independent directors and fund litigation.

I. Common Types of Lawsuits and the Director's Role

A. Excessive Fee Litigation

Excessive fee lawsuits are normally commenced as a class action by fund investors although, technically, the nominal plaintiffs are suing on behalf of the fund against the advisor (or its affiliates) that allegedly received the excessive fees. To date, no plaintiff in an excessive fee lawsuit has obtained a verdict against an investment advisor. In its March 2010 decision in *Jones v. Harris Associates L.P*. the U.S. Supreme Court endorsed the "traditional" *Gartenberg* analysis on which boards have relied to guide them as to the appropriate factors to consider in their determinations under § 15(c) of the Investment Company Act (ICA) whether to approve or to renew an adviser's contract.

B. Disclosure Litigation

Independent directors and the funds they oversee will continue to see class action lawsuits in which investors contend that a fund's registration statement contained material misstatements or failed to disclose material facts. Not surprisingly, such lawsuits occur when a fund's net asset value (NAV) has decreased significantly.

C. Closed-End Fund Litigation

Closed-end funds face additional litigation challenges. Instead of seeking monetary damages for shareholders, most lawsuits involving closed-end funds are instigated to challenge decisions reached by the fund's board in order to force the fund to become an open-end fund or to take some other action designed to mitigate a share price/NAV discount.

D. Regulatory Investigations and Enforcement Proceedings

The SEC and state regulators investigate and, where deemed appropriate, bring enforcement actions against funds and their advisors. Typically, the fund advisors or distributors are the entities investigated rather than the funds. Nevertheless, the funds may incur substantial defense costs arising from the regulatory investigations.

II. Direct Lawsuits & Derivative Lawsuits

A *direct* lawsuit is one in which a shareholder sues in his or her personal capacity to enforce rights arising from his or her share ownership, typically for harm they suffered individually as opposed to any injury to the fund that fell upon all shareholders.

A *derivative* lawsuit is brought on behalf of the fund, rather than on behalf of individual shareholders or classes of shareholders, to enforce the rights of the fund that the fund allegedly has failed to enforce (*i.e*., the suit is "derived" from the fund's right). Derivative suits may require extra procedural steps on the part of the plaintiffs.

III. Special Litigation Committees in Derivative Actions

Derivative actions frequently allege a state-law claim of breach of fiduciary duty owed to the fund on the part of a fund's directors or officers, such as failure to exercise due care or loyalty in the performance of one's responsibilities. A challenge of a closed-end fund board's decision not to reorganize the fund as an open-end fund is an example. A demand letter, sent

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to fund's board, normally is a prerequisite to a shareholder bringing a derivative lawsuit. Following a board's receipt of a written demand letter that it pursue claims against persons alleged to have harmed the fund, a board may vote to create a special litigation committee (SLC) to investigate, review and analyze the facts and circumstances underlying both the demand letter and any related investigations. The SLC analyzes the veracity of the claims of the aggrieved shareholders and makes a reasonable business determination as to whether it is in the best interest of the fund that the proposed lawsuit should proceed. If handled appropriately, an SLC's decision not to recommend that the proposed lawsuit or claim be pursued may deter a derivative lawsuit by investors or, if such a lawsuit is pursued, prove dispositive in dismissal of the lawsuit.

IV. Attorney-Client Privilege in Fund Litigation

A. What is the Privilege?

The attorney-client privilege is a legal rule of evidence that protects the confidentiality of communications between an attorney and a client. The attorney-client privilege requires at least four elements: (1) a communication; (2) with an attorney or his or her subordinate; (3) in confidence; (4) for the primary purpose of securing an opinion of law, legal services or assistance in a legal proceeding.

The independent directors, interested directors, fund, SLC or advisor may hire counsel to assist in fulfillment of their respective duties. If the requisite elements are met, the attorney-client privilege may be asserted by the independent directors, interested directors, fund, SLC or advisor to protect communications with their respective counsel.

As a general matter, to the extent that any board materials or communications with one's counsel meet the requisite four elements, the fund or board may assert the privilege against outsiders, including the advisor. Communications between the board and the counsel to the advisor generally are not privileged unless, as described below, they are subject to the common interest/joint defense exception.

B. The Common Interest Doctrine and the Attorney-Client Privilege

The common interest doctrine, also known as the joint defense privilege, is a rule of evidence that permits parties to share privileged information without a waiver of confidentiality protections where they have common interests in defending against a pending or anticipated proceeding. The doctrine is an exception to the rule that no attorney-client privilege attaches to communications between a client and an attorney in the presence of a third person. In general, communications between a fund's directors and the fund's adviser where there is a common interest/joint defense, should be deemed to be privileged against third parties.

V. Insurance and Indemnification

A. Insurance

Funds normally purchase directors' and officers' liability insurance policies (D&O policies), which indemnify their directors and officers for claims made *against them* for their designated acts, errors or omissions. Funds also normally purchase "errors and omissions" insurance (E&O policies), which typically covers the fund for claims made *against the fund* for designated acts, errors or omissions by the fund or its representatives (*e.g.*, its directors and officers). Both forms of insurance protect against losses resulting from claims made against an insured for a wrongful act, including any actual or alleged error, misstatement, misleading statement, act, omission, neglect or breach of duty.

B. Indemnification

Under state indemnification statutes, funds are typically *required* to indemnify directors in certain circumstances, and are *permitted* to indemnify fund directors in other circumstances. While there are variations by state, state laws commonly provide, for a director who has been fully exonerated, mandatory indemnification of the director for legal fees and expenses the director incurred. State law also commonly permits, but does not require, a corporation or business trust to include provisions in its organic documents of organization, which provide for director indemnification of defense costs and of amounts paid

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in judgment or settlement, provided the director acted in good faith.

Provisions in fund governing documents typically grant directors the broadest indemnification rights available under applicable law. Directors' indemnification rights are constrained by, among other things, the securities laws and SEC Staff interpretations. Section 17(h) of the ICA prohibits indemnification of a fund director where the director engaged in disabling conduct, which includes willful malfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of office.

VI. Payment of Settlement Costs

The majority of fund lawsuits that are not dismissed are resolved by a settlement. Generally, when a settlement is reached, it will be submitted for approval to the court in which the lawsuit is pending. Any settlement or compromise in a class action or shareholder derivative action settlement requires court approval.

Some, if not all, of a director's costs associated with a settlement will typically be covered by insurance and/or indemnification. The extent of coverage will vary.

VII. Conclusion

While independent directors were named defendants in prior lawsuits, the scope of litigation that followed 2003 was without precedent in terms of the number of lawsuits and the number of those suits naming directors as defendants.

This article summarizes a lengthier article that appeared in the July and August editions of The Investment Lawyer *(co-written by* ***Dechert LLP*** *attorneys* ***William K. Dodds****,* ***Jeanette Wingler*** *and the authors).*

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