THE INVESTMENT LAWYER™
covering legal and regulatory issues of asset management

Aspen Publishers Vol. 17, No. 7 • July 2010

When a Fund is Sued: An Independent Director's Guide to Fund Litigation—Part 1

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Prior to the last decade, most litigation against funds (both open-and closed-end) and their advisers and directors[1] involved claims of excessive fees pursuant to §36(b) under the Investment Company Act of 1940 (ICA) and non-disclosure lawsuits under the Securities Act of 1933 (Securities Act).[2] The collapse of the "dot com" bubble post-2001 left the mutual fund industry under stress, as assets under management for many managers had deflated materially. The aggressive quest for new assets to manage led some managers to adopt or expand marketing practices that became the focus of regulatory inquiries.

Beginning in 2003, the industry saw the beginning of several highly publicized regulatory investigations concerning market timing and improper revenue sharing arrangements. Scores of lawsuits were instigated against advisers, distributors, funds, and, in some cases, a fund's independent directors. While independent directors were named defendants in prior lawsuits—for example, §36(b) excessive fee lawsuits—the scope of litigation that followed 2003 was without precedent both in terms of the number of lawsuits and the number of those suits naming directors as defendants. Moreover, the lawsuits against

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fund directors coincided with an increase in suits against directors of companies outside of the fund industry. Both the number of lawsuits and the scope of litigation reflect the increased scrutiny to which the conduct of fund directors is subject.[3]

With increased litigation came increased costs. Even if fund defendants prevail in a lawsuit, the expense of civil litigation is substantial. The number of law firms and industry experts with experience in representing funds, fund directors, and fund advisers in civil litigation, however, has remained limited. This expertise is reflected in the fees of these firms and experts. Moreover, in addition to the out-of-pocket expenses engendered by civil litigation, the involvement of independent directors in a lawsuit (as witnesses or as defendants) is stressful, time-consuming and, obviously, distracts the directors from focusing on board business.

This article explains what independent fund directors should know about fund litigation. The first section of Part 1 describes the most common types of claims against funds and the roles that independent directors typically play when these claims are brought by a plaintiff. The next section describes the differences between "direct actions" *against* a fund and derivative lawsuits brought *on behalf of* a fund. The differences are important because, among other reasons, independent directors have a particularly important role to play with respect to derivative lawsuits by investors on behalf of the fund. Specifically, as described in the following section, independent directors can form a special litigation committee with respect to a proposed lawsuit to recommend whether the fund should pursue the lawsuit or claim. If handled appropriately, a special litigation committee'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 derivative lawsuit.

Part 2 of this article, which will appear in an upcoming issue of *The Investment Lawyer*, will focus first on the attorney-client privilege, which is critical in fund litigation. Part 2 will then cover the related topics of insurance and indemnification in the context of directors and fund litigation. It will also discuss payment of the settlement costs in fund litigation.

Common Types of Lawsuits and the Director's Role

In this section, fund lawsuits are classified into four categories to simplify the presentation. Lawsuits against funds often involve multiple claims. For example, as discussed in this section, some of the revenue-sharing lawsuits included claims by the plaintiffs that the adviser violated §36(b), and that the fund failed to disclose the revenue sharing in the fund's registration statement.[4] Similarly, disclosure lawsuits against funds often include a claim of fraudulent non-disclosure under the Securities Exchange Act of 1934's (Exchange Act) Rule 10b-5.[5]

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 adviser (or its affiliates) that allegedly received the excessive fees. The "modern era" for these types of lawsuits began in the 1980s, and involved attacks on the nascent money market fund industry, leading up to the *Gartenberg* decision.[6] Following that decision and continuing to the present, no plaintiff in an excessive fee lawsuit has obtained a verdict against an investment adviser.[7]

In the past decade, plaintiffs brought a new wave of lawsuits in the federal courts against fund advisers. One wave of suits were "pure" excessive fee complaints in which the plaintiffs claimed that an adviser received excessive advisory fees for fund management services in breach of the adviser's fiduciary duty under §36(b) of the ICA. Another wave of suits combined excessive fee allegations with other miscellaneous allegations relating to revenue sharing and other alleged misconduct.

Many of these lawsuits focused on comparisons between the fees paid by institutional investors for what were claimed to be the same advisory services. To this extent, these lawsuits were challenges to *Gartenberg* and its progeny because in *Gartenberg*, the federal appeals court rejected comparisons between retail fund advisory fees and institutional clients' advisory fees. Most of these lawsuits were either dropped or dismissed.[8] The most notable exception, of course, is *Jones v. Harris*

Associates L.P.[9] recently decided by the US Supreme Court. The Supreme Court's *Harris Associates* opinion endorses the "traditional" analysis, based on *Gartenberg* and its progeny, on which boards have relied to guide them as to the appropriate factors to consider in their determinations under §15(c) of the ICA whether to approve or to renew an adviser's contract.

Use of the *Gartenberg* factors as an analytical framework for §15(c) determinations had come under attack in recent years. Critics argued that application of the *Gartenberg* factors has not resulted in a §15(c) process that effectively results in the lowest fees. Some courts have voiced similar concerns; in a recent decision dismissing the excessive fee litigation against one fund complex, the district court nonetheless observed:

> Thus, although the directors were represented by counsel and were provided with detailed materials to which they and Defendants can point to and say, "see how thorough and careful we were," the entire process seems less a true negotiation and more an elaborate exercise in checking off boxes and papering the file. Nonetheless, this is what controlling case law and [Securities and Exchange Commission] regulations demand, and is sufficient to immunize Defendants against section 36(b) liability so long as the fees charged are not grossly out of line with the range of fees charged in the industry.[10]

The decision in *Harris Associates* presumably will reduce the exposure of fund advisers to §36(b) claims, although it is reasonable to expect plaintiffs to test that proposition in new or pending actions. However, the naming of independent fund directors as defendants in excessive fee lawsuits should remain the exception because they do not receive the compensation that is at issue in most cases. Nevertheless, independent directors will continue to be critical witnesses in excessive fee lawsuits because §36(b) expressly permits the court to give the fund board's decision regarding the fees in question such weight as is appropriate under all the circumstances—most importantly the board's §15(c) determination. Indeed, in *Harris Associates*, the Supreme Court went out of its way to emphasize the importance of the board's role in excessive fees cases and the deference that a court should give to the board's determination if its §15(c) process was robust. Naturally, then, the independent directors are in the best position to describe the §15(c) process and the considerations that the directors included in reaching their challenged decision.

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. When such drops occur, it is likely that potential plaintiffs will scour the fund's registration statement for any latent ambiguity or less-than-fulsome disclosure, *especially* when that disclosure is viewed in hindsight. Consider these examples:

- Several funds that had substantial exposure during the recent credit crisis to mortgage-backed securities, or derivative instruments related to these securities, are now defending class action disclosure lawsuits.[11] At least one of the lawsuits was dismissed recently based, in part, on plaintiffs' attempt to engage in a misstatement-by-hindsight analysis.[12] In dismissing the complaint, the court noted: "[T]he accuracy of offering documents must be assessed in light of information available at the time they were published. . . . A backward-looking assessment of the infirmities of mortgage-related securities, therefore, cannot help plaintiffs' case."[13]

- In the early 1990s, funds that had substantial losses arising from investments in collateralized mortgage obligations (CMOs) and other synthetic fixed-income instruments were the subject of disclosure class actions.[14]

- After the technology bubble burst in 2000, various Merrill Lynch funds and Morgan Stanley funds were sued in class actions in which plaintiffs alleged that the funds had failed to disclose that they were investing in companies with which an affiliate of the fund's adviser had an investment banking relationship.[15]

- Until the practice was proscribed by the Securities and Exchange Commission (SEC) in 2004, it was common for a fund family to "take into account" the sale of fund shares by a broker as a factor when allocating fund brokerage, assuming the order was not solicited by the broker on that basis and that placement of the order was otherwise consistent with the adviser's duty to seek best price and execution.[16] Separately, fund managers also made cash payments, out of their own resources, to support the broker education process and encourage the sale of fund shares. These payments included expenditures made in response to broker demand for marketing support that came to be known as "shelf-space" (revenue sharing) payments (analogizing to practices in the retail grocery industry). Following a number of SEC enforcement actions against fund managers, beginning in 2004, class actions were filed against funds and investment advisers alleging that, without adequate disclosure, cash payments and directed brokerage had been used improperly to pay broker-dealers to recommend a particular family of funds to their customers.[17] While most of the directed brokerage actions were dismissed, at least two of the actions that were filed as revenue sharing class actions were repleaded as excessive fee cases under §36(b).[18]

- Class action disclosure lawsuits also have resulted when certain fund practices have come to light, including market-timing[19] and the relative economics of B class shares.[20]

The most-recent wave of litigation, involving funds that had substantial exposure during the recent credit crisis to mortgage-backed securities and related derivatives, is likely to lead to decisions that will elaborate further on the scope of disclosure obligations on a host of issues including the risk of derivatives, liquidity, valuation, internal controls, risk management, and the frequency of prospectus amendments. In addition, the courts will be assessing the viability of new theories of disclosure-related liability, such as whether there is a private right of action under §13(a) of the ICA for claims that a fund's portfolio has strayed from its disclosed investment policy.

In disclosure litigation, federal law expressly authorizes independent directors to be named individually as defendants, along with the fund and its executive officers.[21] In fact, naming the independent directors as defendants is not uncommon and may have little to do with the underlying legal claims. Rather, naming independent directors as defendants is a strategy or tactic employed by plaintiffs' counsel to enhance financial and psychological pressure to settle or to settle more favorably.[22] In addition, naming independent directors may facilitate recovery under the applicable Directors and Officers (D&O) insurance policy.

A plaintiff can prevail in a disclosure lawsuit without showing that he relied on a registration statement's misstatements or that there was fault on the part of any defendant with respect to the misstatements.[23] Moreover, even a modest depreciation in a fund's NAV can result in a lawsuit in which plaintiffs claim losses in the tens or hundreds of millions of dollars. Consequently, unless defendants can succeed in having a disclosure lawsuit dismissed at the pretrial stage, defendants will encounter a significant incentive to settle the lawsuit before trial.

All defendants, *except* the fund, may avoid liability through a "due diligence" defense by establishing that, after reasonable investigation, there was no reasonable ground to believe the registration statement contained a material misstatement.[24] However, the burden is on the defendant to establish the defense and doing so prior to trial can be extremely difficult because of the inherent factual issues involved.

All defendants, *including* the fund, also may be able to avoid liability by establishing

that the depreciation in the fund's NAV was not *caused by* the misstatements in the fund's prospectus identified by the plaintiff.[25] Here, again, the burden is on the defendant to establish the defense.

In practical terms, because disclosure lawsuits are almost always settled before trial, the likelihood of personal liability for an independent director is remote. If the lawsuit is dismissed, then defendants owe nothing. In the case of a pretrial settlement, the settlement payment normally is paid by other defendants or insurance or a combination of the two sources.[26]

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.

In general, shareholder proposals to force a closed-end fund to convert to an open-end structure have not succeeded. The corporation laws in most states require an amendment of the fund's articles of incorporation to effect such a conversion. However, this type of amendment may be instigated only by a fund's board. For these reasons, the SEC Staff permits closed-end funds to omit from their proxy materials *mandatory* (that is, binding on the directors) open-ending proposals.[27]

Lawsuits involving closed-end funds typically are instigated by institutional investors that are "in the business" of attempting to cause a closed-end fund to open end.[28] These lawsuits frequently name independent directors as defendants to challenge the board's decision-making. However, the Business Judgment Rule protects directors by providing that directors will not be subject to liability for their decisions as long as their decisions were made in accordance with certain principles. These principles require that directors: (1) act in good faith, (2) be reasonably informed, and (3) reasonably believe that the actions that they take are in the best interests of the fund and its shareholders.[29] Because closed-end fund lawsuits typically do not seek monetary judgments and because the Business Judgment Rule is available, the risk to closed-end fund directors of personal liability is remote.

The recent credit crunch froze the market for so-called auction rate preferred shares, through which closed-end funds derive additional capital to lever their investments. Consequently, various lawsuits were filed against closed-end funds that used this leverage technique and their directors. Plaintiffs in some of these suits allege misleading disclosure, while in other suits, plaintiffs allege breach of fiduciary duty. These cases are still pending, but the discussion, above, concerning disclosure-related suits and the Business Judgment Rule, respectively, should apply to these cases.

Finally, activist investors will sometimes commence proxy fights seeking to replace boards that do not adopt their proposals. Such proxy fights are often accompanied by litigation over the adequacy of proxy disclosures by one or both sides.

Regulatory Investigations and Enforcement Proceedings

The SEC and state regulators[30] investigate and, where deemed appropriate, bring enforcement actions against funds and their advisers. Typically, the fund advisers or distributors are the entities investigated rather than the funds. Nevertheless, the funds may incur substantial defense costs arising from the regulatory investigations. Moreover, if an investigation results in a settlement with a regulator, private lawsuits may follow.[31]

A fund's adviser should apprise a board of any investigation that relates to the adviser's management of the fund. This should include any charges or alleged deficiencies by a regulator that may concern a fund, regardless of whether the adviser contests the charges or allegations.

In addition, directors oversee a fund's Rule 38a-1 compliance program as part of their overall oversight responsibilities. Rule 38a-1 also requires the fund's CCO "no less frequently than annually," to provide a written report including, among other things, any material compliance matters that occurred since the date of the last report. Directors are not expected to be compliance experts. That

said, as part of their oversight responsibilities, Rule 38a-1 mandates that a fund's board must approve the policies and procedures of the fund, the adviser and the principal service providers, based upon a determination that the procedures are reasonably designed to prevent violation of the federal securities laws.

Accordingly, if an investigation reveals that written policies either were not followed or were inadequate, resulting in the problems detected in the investigation, the directors' oversight responsibilities would include overseeing the implementation of new policies and procedures to prevent a reoccurrence. To that end, directors may rely on the CCO, the adviser and their own independent legal counsel to assist them.[32]

If the regulator brings a formal enforcement proceeding against the fund's adviser, in some circumstances, the independent directors may have a role to play in protecting the fund's shareholders and assisting the adviser "to get out ahead" of the enforcement proceeding. There are instances in which independent directors, with the adviser's cooperation, may wish to form a special ad hoc committee (Special Committee) to determine if any harm was incurred by the fund(s) resulting from the alleged violations on the part of the adviser or its affiliates. To this end, the Special Committee can appoint independent counsel and employ independent experts to assist the Special Committee to identify and quantify any harm incurred by the funds. A useful point of reference is the use of independent director committees, discussed in the next section of this article, to investigate and determine whether the fund should instigate litigation against the adviser.

The findings of the Special Committee are not binding on the SEC. Moreover, the principal focus of a Special Committee's investigation is to assess the alleged harm to the fund. Nevertheless, findings by the Special Committee, especially any quantification of harm to the funds that are reimbursed by the adviser along with other remedial measures, may facilitate a resolution of an SEC investigation and possible settlement. Moreover, the Special Committee's findings may preclude a derivative lawsuit by investors or, if such a lawsuit is instigated, prove dispositive in dismissal of the lawsuit.[33]

Direct Lawsuits v. 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 he or she suffered individually as opposed to any injury to the fund that fell upon all shareholders. The suit may be brought by a shareholder against the adviser, distributor, the fund, directors or officers of the fund or any other party who the shareholder believes contributed to their injury.

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 (that is, the suit is "derived" from the fund's right).[34] Derivative suits may require extra procedural steps on the part of the plaintiffs. To avoid the additional procedural requirements that apply to derivative suits, shareholders will often seek to characterize their suit as a direct action.

Direct suits generally pertain to shareholders' structural, financial, liquidity, and voting rights. Disclosure actions are generally brought as direct actions. In contrast, derivative suits generally seek to enforce fiduciary duties owed to the fund or seek redress for alleged wrongs against the fund.

In a direct suit, if there are numerous plaintiffs with similar or identical claims, the suit may be structured as a class action. In a class action suit, a shareholder sues in his or her own capacity, as well as on behalf of other shareholders similarly situated. In effect, the members of a class have banded together through a representative to bring their individual direct actions in one large direct action.[35] Cases may only proceed as class actions if they satisfy a number of procedural requirements intended to protect the interests of absent class members and achieve judicial efficiency.[36]

Section 36(b), uniquely among the provisions of the ICA, explicitly permits shareholders to commence an action for the benefit of the fund against an investment adviser, an affiliated person of an investment adviser and the fund's directors for a breach of fiduciary duty with respect to compensation or payments

paid by a fund to the investment adviser or its affiliates.[37] In addition to the express grant of a right of action under §36(b), courts historically have also implied private direct rights of action from certain other provisions of the ICA, permitting shareholders to seek redress from alleged violations of those provisions.[38] In recent years, however, federal courts have followed a seminal holding by the Supreme Court[39] to deny most claims predicated on such "implied" direct private rights of action.[40]

Separately, §42 of the ICA provides that the SEC has authority to enforce *all* provisions of the ICA.[41]

The Role of 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 derivative state-law claim of breach of fiduciary duty may be appended to a claim under the federal securities laws. This permits the plaintiffs to bring the claim in federal court, rather than in a state court and to pursue alternative theories of seeking recovery for the same or related alleged misconduct.

A demand letter, sent to the fund's board, normally is a prerequisite to a shareholder bringing a derivative lawsuit. Recall that a derivative suit is brought by shareholders on behalf of the fund to enforce the rights of the fund that the fund allegedly has failed to enforce. A demand letter gives the fund board the opportunity to decide whether to pursue a claim directly or make a determination that the lawsuit should proceed. If the board determines not to pursue the claim outlined in the demand letter, then the aggrieved shareholders still may attempt to pursue a derivative suit, although overcoming the board's decision is an additional obstacle.[42]

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. A fund's independent directors may serve on a SLC if they are also deemed independent with respect to the claims being investigated. 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.

The SLC must be independent, unbiased, and act in good faith. Moreover, such a committee must conduct a thorough and careful analysis regarding the claims. When seeking dismissal of a derivative action on the basis of an SLC's determination, the SLC will have the burden of proving that these requirements have been met.[43]

The standard of review of a SLC's decision with respect to derivative suits varies by jurisdiction. In Massachusetts, for example, when a majority of the board is independent, the Business Judgment Rule presumptively applies, with the burden of proof falling on the plaintiffs to deprive the directors of the Business Judgment Rule's protection. When a majority of the board is not independent, the Business Judgment Rule's evidentiary presumption of validity does not apply, and a reasonable/principled review is employed, with the burden of proof falling on the fund.[44]

Regardless of whether the majority of the board of a Massachusetts business trust is independent, the decision to reject a shareholder demand must be determined by:

> (i) A majority vote of independent directors present at a meeting of the board of directors if the independent directors constitute a quorum;
> (ii) A majority vote of a committee consisting of two or more independent directors appointed by a majority vote of independent directors present at a meeting of the board of directors, whether or not the independent directors constituted a quorum; or
> (iii) The vote of the holders of a majority of the outstanding shares entitled

> to vote, not including shares owned by or voted under the control of a shareholder or related person who has or had a beneficial financial interest in the act or omission complained of or other interest therein that would reasonably be expected to exert an influence on that shareholder's or related person's judgment if called upon to vote in the determination.[45]

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.[46]

Finally, it is important to note that the concept of independent directors under the ICA is not synonymous with independence for litigation purposes. Rather, whether a director is independent for derivative litigation purposes will be determined according to applicable state law.

Conclusion

Funds and fund independent directors are now subject to increased scrutiny. Part 2 of this article, to appear in an upcoming issue of *The Investment Lawyer*, will focus first on the attorney-client privilege, which is critical in fund litigation. Part 2 will then cover the related topics of insurance and indemnification in the context of directors and fund litigation. It will also discuss payment of the settlement costs in fund litigation.

Notes

1. For brevity, we use the term "directors" to encompass both directors and trustees.

2. Previous fund litigation includes the brokerage recapture cases (*See, e.g*., Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971); Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975); Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir. 1977); Papilsky v. Berndt, 59 F.R.D. 95 (S.D.N.Y. 1973)), and litigation surrounding the sale of an advisory business (S*ee, e.g*., Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971)). The brokerage recapture cases were laid to rest by the 1973 promulgation of the "Anti-Reciprocal Rule" by the National Association of Securities Dealers (NASD), which prohibited brokers from seeking orders for the execution of fund portfolio transactions, on the basis of sales of fund shares. The Anti-Reciprocal Rule is now codified as Financial Industry Regulatory Authority (FINRA) Rule 2830(k). Litigation concerning the sale of an advisory business (sale of fiduciary office) was effectively eliminated by Congress' 1975 addition of Section 15(f) to the ICA.

3. There are few, if any, civil judgments against independent directors for damages based on a formal finding of liability. However, there are regulatory settlements involving independent directors. *See*, *e.g.*, *In the Matter of Jon D. Hammes*, Rel. No. IC-26290 (Dec. 11, 2003) (no civil penalty, but fund's independent directors consented to an SEC order requiring the directors to cease and desist from violating the Securities Act and the ICA).

4. *See, e.g.,* Siemers v Wells Fargo & Co. 2006 U.S. Dist. LEXIS 60858 (N.D.Cal.); In re Salomon Smith Barney Mutual Fund Fees Litig., 441 F.Supp.2d 579 (S.D.N.Y. 2006).

5. *See, e.g*., In Re Merrill Lynch Inv. Mgmt. Funds Sec. Litig*.,* 434 F.Supp.2d 233 (S.D.N.Y. 2006).

6. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982). Following the decision in *Gartenberg*, in Krinsk v. Fund Asset Mgmt*.*, 875 F.2d 404 (2d Cir. 1990), the federal appeals court endorsed the *Gartenberg* factors, although it recast several of them slightly and provided further amplification of the factors. The same year, the federal appeals court decided Meyer v. Oppenheimer Mgmt. Corporation, 895 F.2d at 867 (2d Cir. 1990). *Meyer* is significant because it applies the fiduciary duty test first developed in *Gartenberg* not only to the compensation received by an adviser, but also to distribution fees (and by extension any other fees) received from the fund by any affiliate of the adviser.

In Kalish v. Franklin Advisers, Inc., 742 F.Supp. 1222 (S.D.N.Y.), *aff'd*, 928 F.2d 590 (2d Cir. 1990), the district court applied the §36(b) test and the various factors developed in *Gartenberg* and its progeny. The court rejected the argument that "excessive profitability" per se should support a finding of a violation of §36(b), in favor of an analysis that took into account all costs and benefits associated with the fund. The court also found that, to the extent comparisons of profitability are "probative" for §36(b) purposes, a mutual fund adviser-manager must be compared with members of adviser-managers of similar funds, rather than other financial services companies, generally. In Yampolsky v. Morgan Stanley, 464 F.3d 338 (2d Cir. 2006), the federal appeals court noted that the plaintiffs had attempted to track the *Gartenberg* standards, but concluded that plaintiffs had failed to allege any facts pertinent to the relationship between fees and services. The *Yampolsky* decision is significant in demonstrating the difficulty plaintiffs have in making a claim under §36(b). Plaintiffs must plead facts specific to the funds at issue in order to survive a motion to dismiss. General observations about performance and fees relative to other funds are not sufficient to establish a cause of action for excessive fees.

7. *See* Lyman Johnson, "A Fresh Look at Director 'Independence': Mutual Fund Fee Litigation and Gartenberg at Twenty-Five," 61 *Vand. L. Rev*. 497, 519 (2008).

8. In Gallus v. Ameriprise Financial, Inc., 561 F.3d 816, 823 (8th Cir. 2009), the federal appeals court found that the trial court properly applied *Gartenberg* for the purpose of establishing that the challenged fee itself did not constitute a breach of fiduciary duty, particularly given that it was undisputed that the fee was within a range of what was charged by peer mutual funds. However, the *Gallus* court departed from *Gartenberg* in holding that the trial court "erred in rejecting a comparison between the fees charged to Ameriprise's institutional clients," observing that "the argument for comparing mutual fund advisory fees with the fees charged to institutional clients [was] particularly strong in this case because the investment advice may have been essentially the same for both accounts." Likewise, the *Gallus* court found that the trial court should have probed the allegation that Ameriprise "purposefully omitted, disguised or obfuscated information that it presented to the board about the fee discrepancy between different types of clients."

9. 559 U.S. ___ (2010), *decided* (March 30, 2010).

10. In re American Mutual Funds Fee Litig., Case No. CV-045593 (C.D.Cal. Dec. 28, 2009).

11. *See, e.g.*, In re Charles Schwab Corp. Sec. Litig., 257 F.R.D. 534 (N.D.Cal. 2009). In a subsequent proceeding, the court held that the Schwab YieldPlus Fund violated §13(a) of the ICA, which provides that a vote of a majority of a fund's outstanding shares must approve any changes to the fund's fundamental policy with respect to concentrating (*i.e.*, investing greater than 25 percent of a fund's total assets) in a particular industry. *See* In re Charles Schwab Corp. Sec. Litig., No. C 08-01510 (N.D. Cal. March 31, 2010). In *Charles Schwab*, the fund's 2001 prospectus stated that the fund deemed mortgage-backed securities issued by private lenders and not guaranteed by US government agencies (MBS) to be within a separate industry for purposes of a fund's concentration policy. The fund's 2006 prospectus reversed this classification by stating that the MBS were not part of any industry for purposes of the fund's concentration policy. Subsequently, the fund invested more than 25 percent of its assets in the MBS. The court held that Section 13(a) required the fund to obtain shareholder approval before investing more than 25 percent of its assets in the MBS. *Id.*

12. Yu v. State Street Corp., Case No. 08 Civ. 8235 (S.D.N.Y., Feb. 22, 2010).

13. *Id.*

14. *See, e.g.*, In re PaineWebber Short Term U.S. Gov't. Income Fund Sec. Litig., 1995 U.S. Dist. LEXIS 12029 (S.D.N.Y.); Shonka v. Piper Funds, Inc. Case No. 3-94-614 (D.Minn. May 19, 1994); Olkey v. Hyperion 1999 Term Trust, 98 F.3d 2 (8th Cir. 1996).

15. *See* In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig. 272 F.Supp.2d 243 (S.D.N.Y. 2003); In re Morgan Stanley Tech. Fund. Sec. Litig. 643 F.Supp.2d 366 (S.D.N.Y. 2009).

16. *See Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Rel. No. IC-26591 (Sept. 2, 2004). At the same time, the NASD (now FINRA) amended its Rule 2830(k) to prohibit brokers from accepting payment, in the form of directed brokerage commissions, from open-end funds for the distribution of the funds' shares. *See Order Approving Proposed Rule Change by NASD, Inc., Relating to Investment Company Portfolio Transactions*, Rel. No. 34-50883 (Dec. 20, 2004) (adding Rule 2830(k)(2) prohibiting any broker-dealer from selling a fund's shares if the broker-dealer "knows or has reason to know" that the fund, its underwriter or its affiliates has an agreement under which the [fund] directs portfolio transactions or any remuneration in consideration for the promotion or sale of shares of the fund).

17. *See, e.g.,* In re Lord Abbett Mutual Funds Fee Litig., 385 F.Supp.2d 471 (D.N.J.), amended and superseded by 407 F.Supp.2d 616 (D.N.J. 2005); In re Dreyfus Mutual Funds Fee Litig., 428 F.Supp.2d 342 (D.Penn. 2005); In re AllianceBernstein Mutual Fund Excessive Fee Litig. 2005 U.S. Dist. LEXIS 24263 (S.D.N.Y.).

18. *See* In re Salomon Smith Barney Mutual Fund Fees Litig., 528 F.Supp.2d 332 (S.D.N.Y. 2007) *app. pend*. Case No. 08-0038-cv (2d Cir. 2009); In re American Funds Fees Litig. 2005 U.S. Dist. LEXIS 41884 (C.D.Ca.).

19. *See, e.g.,* In re Mutual Funds Inv. Litig., 384 F.Supp.2d 845, 864 (D.Md. 2005) (market timing cases); In re Morgan Stanley and Van Kampen Mutual Fund Sec. Litig., 2006 WL 1008233, *35-36 (S.D.N.Y. (2006) (revenue sharing/shelf-space).

20. *See* Benzon v. Morgan Stanley Distribs., 420 F.3d 598 (6th Cir. 2005); Fitzgerald v. Citigroup, Inc., 2007 U.S. Dist. LEXIS 15365 (S.D.N.Y.)

21. *See* Securities Act §11(a).

22. The Private Securities Litigation Reform Act of 1995 (PSLRA) limited each independent director's personal exposure by protecting each independent director from the threat of "joint and several liability," in the absence of proof that the independent director had actual knowledge of the misstatements giving rise to liability. This would ordinarily limit the exposure of each independent director to the proportion of damages found to be attributable to his or her culpable conduct.

23. In stark contrast, in order to succeed in a claim under Rule 10b-5 (which prohibits fraudulent conduct in the sale and purchase of securities), a plaintiff must prove the defendant acted with scienter—an "intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12; 96 S. Ct. 1375 (1976). A plaintiff's inability to present evidence of the defendant's scienter will result in dismissal of a claim under Rule 10b-5. *See, e.g.,* Zavolta v. Lord Abbett & Co. LLC, Case No. 08-CV-04546 (D.N.J. Feb. 24, 2010) (finding that an insufficient inference of scienter where a plaintiff merely claimed that the defendant's fee table, while accurate, failed to report that Class A shares are never the best or preferable investment for investments under $50,000). The judge stated that "[i]t is quite possible that those who compiled the prospectus actively sought to comply with the model provided by the [SEC] and believed that such compliance, and no more, was not only what was

required, but prudent, because any additional information not specifically called for might be mistaken and itself give rise to a lawsuit under the securities laws". Rule 10b-5 was promulgated by the SEC pursuant to §10(b) of the Exchange Act and prohibits fraudulent conduct in the sale and purchase of securities.

24. *See* Securities Act §§11(b) and 12(a)(2). In addition, for purposes of a defendant establishing a due diligence defense under §11(b), Securities Act Rule 176 lists circumstances and factors relevant to the determination of what constitutes a reasonable investigation and a reasonable ground for belief by the defendant (*e.g.*, when the defendant is a director, the presence or absence of another relationship to the issuer).

25. *See* In re Morgan Stanley and Van Kampen Mutual Fund Sec. Litig., 2006 WL 1008233, *35-36 (S.D.N.Y. (2006); In re Van Wagoner Funds, Inc. Sec. Litig., 382 F.Supp.2d 1173, 1188 (D.Cal. 2004). *See generally*, David M. Geffen, "A Shaky Future for Securities Act Claims Against Mutual Funds," 37 *Sec. Reg. L.J.* 20 (Spring 2009). *But see* In re Charles Schwab Corp. Sec. Litig., 257 F.R.D. 534 (N.D.Cal. 2009); In re Evergreen Ultra Short Opportunities Fund Sec. Litig., No. 08-11064 (D. Mass. April 1, 2010).

26. *See* ICI Mutual Insurance Company, "Independent Director Litigation Risk," 14 *The Investment Lawyer* 3 (Jul. 2007); Management Study, "Mutual Fund Prospectus Liability: Understanding and Managing the Risk 17" (Jan. 2010).

27. *See, e.g.*, The First Australia Prime Income Fund, Inc., SEC No-Action Letter (pub. avail. Dec. 18, 1987); Templeton Global Income Fund, Inc., SEC No-Action Letter (pub. avail. Dec. 19, 1996).

28. *See, e.g., http://www.bulldoginvestorstenderoffer.com* (describing the Bulldog Investors group of funds and Mr. Phillip Goldstein's relationship to that group).

29. *See* Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Black v. Fox Hills North Community Assoc., 599 A.2d 1228 (Md. App. 1992).

30. Then-Attorney General Eliott Spitzer first disclosed the mutual fund market-timing abuses. *See* Ari Weinberg, "Eliot Spitzer Finds His Canary," Forbes.com *http://www.forbes.com/2003/09/03/cx_aw_0903spitzer.html* (Sept. 3, 2003).

31. *See* In re Mutual Funds Inv. Litig., 384 F.Supp.2d 845 (D.Md. 2005) (consolidated class action against defendant mutual funds and the mutual funds' advisers relating to market timing and late trading).

32. A board's reliance on the CCO and adviser must have a reasonable basis. The reasonableness of this reliance should be based upon and supported by the board's past experience with the CCO and adviser.

33. *See* Strougo v. Bassini, 112 F.Supp.2d 355 (S.D.N.Y. 2000) (special litigation committee properly recommended dismissal of a shareholder's derivative claims against a mutual fund's investment adviser, its directors, and other defendants associated with a failed rights offering).

34. Pursuant to §33 of the ICA, copies of all shareholder derivative actions filed with a court against a fund or an affiliate thereof must be filed with the SEC.

35. In certain jurisdictions, suits enforcing fiduciary duties have been brought as direct class actions. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (relating to a class action challenging director actions and disclosure in a squeeze-out merger).

36. *See*, *e.g.,* Fed. R. Civ. P. 23 which states, "[o]ne or more members of a class may sue or be sued as representative parties on behalf of all members only if: (1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of law or fact common to the class; (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class; and (4) the representative parties will fairly and adequately protect the interests of the class."

37. As noted above, in excessive fee lawsuits, naming independent fund directors as defendants is the exception. Nevertheless, independent directors will continue to be witnesses in excessive fee lawsuits because §36(b) permits the court to give such weight to the board's approval of the fee or compensation as may be appropriate under all of the circumstances. Independent directors are in the best position to describe the §15(c) process and the considerations that the directors included in reaching the challenged fee.

38. Thomas Lee Hazen, 7 *Law Sec. Reg*. §20.10 (6th ed.).

39. *See* Alexander v. Sandoval, 532 U.S. 275 (2001).

40. *See* Olmsted v. Pruco Life Ins. Co. of N.J., 283 F.3d 429 (2d Cir. 2002). In *Olmsted*, the federal appeals court affirmed the district court's decision holding that there is no private right of action for violations of §§26(f) or 27(i) of the ICA. The appeals court holding was the first time that a federal appeals court refused to find that a provision of the ICA did not have an implied private right of action. *Accord*, White v. Heartland High-Yield Municipal Bond Fund, 237 F.Supp.2d 982 (E.D.Wis. 2002) (denying implied remedy under §§22 and 34(b) in action challenging excessive write-downs of fund's asset value); Bellikoff v. Eaton Vance Corp., 481 F.3d 110 (2d Cir. 2007) ("the text and the structure of the ICA reveal no ambiguity about Congress's intention to preclude private rights of action to enforce §§34(b), 36(a), and 48(a)"). *But see* Northstar Financial Advisors, Inc. v. Schwab Investments, 609 F.Supp.2d 938 (N.D.Cal. 2009) (finding an implied right of action under §13(a) and the first decision since *Olmsted* to find that an implied right of action exists under a provision of the ICA). The *Northstar* decision is now on appeal to the US Court of Appeals for the Ninth Circuit.

41. *See, e.g.,* SEC v. Reserve Mgmt. Co., Case No. 09-CV-4346 (S.D.N.Y. May 5, 2009). In *Reserve Management Co.*, the SEC charged the entities and individuals who operated The Reserve Primary Fund with fraud for failing to provide key material facts to the fund's investors, board of trustees, and ratings agencies after Lehman Brothers filed for bankruptcy protection on September 15, 2008. The Reserve Primary Fund "broke the buck" on September 16, 2008, when its NAV fell below $1.00 per share. The SEC

also alleged that Reserve Management Company, Inc. significantly understated the volume of redemption requests received by the fund and failed to provide the trustees with accurate information concerning the value of Lehman Brothers securities. Because of these misrepresentations and omissions, the fund was unable to strike a meaningful hourly NAV as required by the fund's prospectus. On February 24, 2010, a federal judge ruled that the SEC's charges satisfied the fraud pleading standard, permitting its enforcement action to proceed.

42. While the requirements vary by state, typically state law requires plaintiffs to make a demand on the board to take action or explain why demand on the board would be futile; in some states, demand is absolutely required and may not be excused. Because plaintiffs frequently refuse to make a demand on the board and the pleading standard for demonstrating the futility of demand can be high, courts often dismiss such cases as a matter of law. *See, e.g.*, In re Eaton Vance Mutual Funds Fee Litig., 380 F.Supp.2d 222 (S.D.N.Y. 2005); Benak v. Alliance Capital Mgmt. L.P., No. 01-CV5734, 2005 WL 1285652 (D.N.J. May 23, 2005), *aff'd*, 435 F.3d 396 (3rd Cir. 2006); In re Merrill Lynch Focus Twenty Fund Inv. Co. Act Litig., 218 F.R.D. 377 (E.D.N.Y. 2003; Scalisi v. Fund Asset Mgmt., L.P., 380 F.3d 133 (2d Cir. 2004).

43. Blake v. Friendly Ice Cream Corp*.,* No. 030003, 2006 WL 1579596, at * 10 (Mass. Dist. Ct. May 24, 2006).

44. Mass. Gen. Laws c. 156D §7.44 (2009) at Comment 2. In contrast, New York's *Auerbach* test provides that whatever decision a SLC may make is a matter of business judgment with which a court should not interfere, provided there is sufficient proof that the SLC's investigative procedures and methodologies are reasonably complete and that there has been a good-faith pursuit of inquiry. *See* Auerbach v. Bennett, 47 N.Y.2d 619 (1979). At the opposite extreme is Delaware's *Zapata* test, under which a court performs a two-step analysis (both a procedural and substantive review). The court first scrutinizes the independent, good faith, and procedures of a special litigation committee, and then the court applies its own independent business judgment. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

45. Mass. Gen. Laws c. 156D §7.44(b).

46. *See* Strougo v. Bassini, 112 F.Supp.2d 355 (S.D.N.Y. 2000) (SLC properly recommended dismissal of a shareholder's derivative claims against a mutual fund's investment adviser, its directors, and other defendants associated with a failed rights offering).

Reprinted from *The Investment Lawyer* July 2010, Volume 17, Number 7, pages 3-13,
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1-800-638-8437, www.aspenpublishers.com