

# SCARED STRAIGHT: AN ARGUMENT FOR A NEW CAUSE OF ACTION TO ENFORCE MUTUAL FUND DIRECTOR INDEPENDENCE

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## I. INTRODUCTION

In recent months, the focus of governmental reform in the wake of the post-dot-com-bubble wave of corporate scandal has been fixed on the financial services industry.<sup>2</sup> Regulatory and enforcement activism at both the federal and state levels has shed an unprecedented amount of light on an entire industry, the management of which seems, in hindsight, to have long operated in the shadows, or at least off the radar screen, of most legislators and the investing public. While recent Securities and Exchange Commission (“SEC”) rulemaking and activism by state attorney generals have sought to produce some improvements in the management of investment companies and their usefulness to investors, these measures have received substantial criticism, ranging from claims that regulatory changes are useless to claims that politicians are ruining perfectly good investment companies for their own political gain.<sup>3</sup> The following article proposes an altogether

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<sup>2</sup> See Amy Borrus, *How's Donaldson Doing?*, BUS. WK., Feb. 23, 2004, at 100. See generally John C. Coffee, Jr., *SEC Pursues Indirect Disclosure Strategy in Response to Mutual Fund Scandal*, 175 N.J.L.J. 477 (Feb. 9, 2004).

<sup>3</sup> New York Attorney General Eliot Spitzer has described the SEC's approach to regulating the mutual fund industry as a “culture of accommodation,” implying that the agency does not propose meaningful regulations if they meet with much resistance from the agency. This dim view of the SEC appears to be widely shared by securities experts. See John C. Coffee, Jr., *SEC Pursues Indirect Disclosure Strategy in Response to Mutual Fund Scandal*, 175 N.J.L.J. 477 (Feb. 9, 2004); Faith Arner, *The SEC Wrist-Slaps Another Fund*, BUS. WK., Feb. 6, 2004. On the other hand, the unprecedented litigation that Spitzer has initiated against the industry poses what some call an unnecessarily aggressive executive action that has more to do with Spitzer's political ambitions than realizing justice. See *Let There Be But One Spitzer*, ROCKY MTN. NEWS, Feb. 8, 2004, at 7E; Bill Arthur & Robert Schmidt, *Spitzer: Make All Fees the Same; N.Y. Attorney General at Odds With SEC Over Charges to Investors*, CHAR. OBS., Jan. 28, 2004, at 3D.

unique change in the law that should more effectively target the specific abuses that seem to plague the investment company industry, particularly mutual funds.

Among those who observe the mutual fund industry, there appears to be agreement that directors of mutual funds are too beholden to the advisors and managers of the funds to direct effectively. Directors sit on the boards of too many mutual funds, do not possess enough financial sophistication to competently serve as directors, and are too dependent on director salaries to effectively oversee their funds. Some commentators go so far as to argue that had mutual fund directors more diligently overseen their companies' investments, they could have prevented the recent financial crises that have plagued the United States.<sup>4</sup>

In an interesting coincidence, some mutual fund shareholders have sued the directors of their funds in recent years, alleging breaches of fiduciary duties imposed by the Investment Company Act of 1940 (hereinafter, "Investment Company Act" or "Act"), seeking relief from the lack of independence that commentators have identified.<sup>5</sup> However, these plaintiffs have found little or no success. In order to ensure director independence, as encouraged by several commentators, Congress should legislatively create a new cause of action that empowers mutual fund shareholders with a private enforcement action.

Directors of mutual fund companies have somewhat different duties than their counterparts in traditional corporations due to the unique structure of mutual funds. Mutual funds typically do not have any employees of their own.<sup>6</sup> Basically, advisory companies run most mutual funds as independent contractors of the funds.<sup>7</sup> Often the advisor or manager of a mutual fund is the individual or entity that created the fund and remains closely identified with it despite the fact the advisor or manager is, in theory, in an arm's-length relationship with the fund.<sup>8</sup> Director independence maintains the arm's-length nature of the relationship between a fund and its advisor.

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<sup>4</sup> See generally *Mutual Fund Regulation in the Next Millennium Symposium Panel*, 44 N.Y.L. SCH. L. REV. 431 (2001) [hereinafter, the "*Symposium Panel*"].

<sup>5</sup> 15 U.S.C. § 80a (1997).

<sup>6</sup> Jane E. Willis, *Banks and Mutual Funds: A Functional Approach to Reform*, 1995 COLUM. BUS. L. REV. 221, 230-31.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

Congress should promulgate a more useful statutory standard of independence and ensure its maintenance by expanding the private enforcement incentives that exist under the Act. Following this introductory Part I of this article, Part II introduces a novel cause of action that allows mutual fund shareholders to privately enforce director independence. Part III of this article considers the benefits, costs, and alternative methods of improving independence. Finally, Part IV concludes by summarizing and consolidating these determinations.

## II. A NEW “INDEPENDENCE” CAUSE OF ACTION

Congress, when it established mutual fund shareholders’ right of action against their directors under the original Act, intended to empower shareholders with a cause of action through which they could remedy the perceived lack of arm’s-length bargaining between mutual fund directors and advisors. However, as the observations of commentators indicate, a sufficient amount of director independence simply does not exist.<sup>9</sup> Therefore, Congress should amend (or more accurately, expand) the shareholder right of action available under the Act, which is currently limited to suits for a breach of fiduciary duty involving excessive fees, and allow shareholders recourse in the courts when they perceive that their directors are not acting independently.

“Director independence,” for purposes of this article, means that a director is free to act in a manner that benefits shareholders without regard for whether such action adversely affects a fund’s advisor or other affiliated persons or directors.<sup>10</sup> In creating a new cause of action, Congress should add the following language to the Act:

An action may be brought under this Act by the Commission or a security holder of the registered company against any director of the registered company for an act or omission, the overall consideration of which indicates that directors have acted unfairly to shareholders

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<sup>9</sup> *Symposium Panel, supra* note 4, at 432; *See generally* Statement of John C. Bogle Before the U.S. House of Representatives Sub-Committee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Hearing: *Mutual Fund Industry Practices and their Effect on Individual Investors* (Mar. 12, 2003) available at <http://financialservices.house.gov/media/pdf/031203jb.pdf> (last visited May 12, 2004); BERKSHIRE HATHAWAY, INC., 2002 ANNUAL REPORT 17 (2002) available at <http://www.berkshirehathaway.com/2002ar/2002ar.pdf> (last visited May 12, 2004).

<sup>10</sup> *See infra* note 46.

by affording the interests of himself or herself or an affiliated person a greater priority than the interests of shareholders.

This articulation accomplishes two tasks. First, it adopts a meaningful notion of independence (which Part II(A) below explains in greater detail). Second, it incorporates the “intermediate” standard of review involved in state law corporate director’s breach of the duty of care claims. The remainder of this part explains the formulation of the new cause of action.

For additional clarity of this new cause of action, judges and scholars should retrospectively scrutinize the conduct of mutual fund directors. Additionally, in order to avoid “reinventing the wheel,” we should incorporate the common law of Delaware governing director breaches of fiduciary duty as a compass to guide construction of this new cause. Delaware’s substantial judicial precedent associated with the judicial review of directors’ activities would prove extremely helpful in defining the parameters of the new cause of action.<sup>11</sup> Furthermore, a large body of scholarly thought and years of judge-made law has been devoted to creating the optimal standard of review regime to govern directorial breaches of fiduciary duty.<sup>12</sup>

Delaware law divides the fiduciary duties of corporate directors into two broad categories: the duty of loyalty and the duty of care.<sup>13</sup> If a shareholder alleges that a director engaged in some type of self-dealing at the shareholders’ expense, courts would apply a duty of loyalty analysis.<sup>14</sup> The standard of review that governs a duty of loyalty claim is one of “entire fairness,” which means that the court broadly considers all aspects of the allegedly self-dealing transaction to determine if the director breached his duty of loyalty.<sup>15</sup> This standard of review establishes a

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<sup>11</sup> William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1288-90 (2001). Throughout this discussion, the author relies primarily on this article for support regarding the standards of review governing director breaches of fiduciary duty rather than attempting to recreate the work of this article by reviewing the myriad of Delaware cases it discusses. This article is even better authority than case law because it represents the work of three eminent Delaware judges and corporate law scholars as they offer an ideal standard of review regime and point out the flaws in the existing law.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 1290-91.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

presumption that a self-dealing transaction is a breach of the duty of loyalty, and a defendant must overcome this presumption to prevail.<sup>16</sup>

The second category of fiduciary duty existing in Delaware common law is the duty of care. Cases in which a plaintiff alleges that directors failed to exercise appropriate judgment in their governance activities implicate the duty of care.<sup>17</sup> The standard of review in these cases, known as the “Business Judgment Rule,” establishes the presumption that directors acted in a reasonable, prudent, and independent manner and constitutes a significant burden that plaintiffs must overcome.<sup>18</sup>

An intermediate standard of review exists to govern duty of care cases in which a plaintiff alleges that directors took actions that were not in the interests of shareholders in an effort to entrench themselves in their board positions.<sup>19</sup> The intermediate standard of review allows courts to exercise judgment without the imposition of any presumptions.<sup>20</sup> Thus far, courts have limited this intermediate standard to cases involving corporate takeovers.<sup>21</sup>

The policy tension underlying these varying standards of review is simple. On one hand, the law seeks to protect shareholders’ ownership rights by arming them with a cause of action when their representatives, the directors, act unjustly toward them.<sup>22</sup> On the other hand, the law is reluctant to find liability based on a judge’s non-expert *ex post* inquiry into directors’ business decisions.<sup>23</sup> As the standards of review indicate, Delaware’s common law applies an adjusted degree of judicial scrutiny based on the extent that outwardly objective circumstances (*e.g.*, a

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 1290.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 1298-99.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 1289-90.

<sup>23</sup> *Id.* at 1298.

self-dealing transaction by a director) indicate a breach of fiduciary duty.<sup>24</sup> The challenge this article faces is to determine which level of review, if any, is most useful as a tool for governing the various policy considerations underlying a cause of action that enforces mutual fund director independence.

The conflict between the shareholders' ability to exercise ownership power and judicial second-guessing of business decisions also exists in the mutual fund context. The specific problem of independence appears most like director entrenchment, subject to intermediate review.

The following paradigm provides an example. Mutual fund directors decide not to remove an underperforming fund's advisor. Assume further that some evidence of a lack of independence exists (*e.g.*, the director relies on his directorship for more than half of his income, he is a long-time friend of the advisor, and he was elected a director at the advisor's urging). This situation does not offer an obvious self-dealing transaction in that a self-dealing transaction involves a very specific and concrete conflict of interest. On the other hand, if we presume that the director in this example exercised "independent" judgment when he refused to remove the advisor, then the business judgment rule analysis would substantially deprive a mutual fund shareholder of his ownership rights by making it essentially impossible for him to seek redress from this directorial decision. However, to be fair to the director, the plaintiff should bear some burden of proving that there was reason to believe that the director should have removed the advisor. In other words, it does not seem appropriate that the mere allegation that a fund director is not independent should be sufficient for a shareholder to prevail. The cause of action must demand some proof, such as underperformance, that the director should have removed the advisor. Therefore, the intermediate standard of review, free from any presumptions that restrict the court's inquiry, is appropriate to govern a new cause of action to enforce independence.

Furthermore, consider the nature of the inquiry. The new cause of action invites a fact-finder to question whether, under the circumstances surrounding a mutual fund director's decision making, the director would have felt free to act independently. Although this inquiry involves some analysis of a business decision, it primarily demands that the fact-finder engage in a "reasonable person" analysis

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<sup>24</sup> *Id.*

found throughout the law;<sup>25</sup> the fact-finder asks, “would an average person with the same compensation structure, friend and family relationships, etc., as the director being sued have felt independent?” The proposed cause of action invites judges and juries to contemplate matters that involve more of a layman’s analysis as opposed to a technical business application of reasonableness. Thus, the proposed cause of action will be useful because it directly targets what commentators agree is a serious problem, director independence. Further, this analysis fits within a fact-finding structure, the intermediate review of the Business Judgment Rule, that is well within the grasp of judges and juries.

### III. DEFENDING THE NEW CAUSE

#### *A. The Notion of Independence that the New Cause Embraces*

The proposed cause of action adopts a more meaningful notion of “independence” than the Act currently contemplates. There are a number of sources from which one can glean the meanings of this term as used in the mutual fund director context. First, the Act imposes standards of independence on directors. Second, the SEC has amplified the Act’s instructions with further proposals to ensure that directors are independent. Finally, commentators have offered their understandings of independence, often pointing out the shortcomings of the directorial status quo. This section sets out these various understandings of independence, suggests the “best understanding” of independence, and explains the shortcoming of the current statutory regime.

The Act imposes a number of standards of independence on mutual fund directors. The Act demands that at least 40 percent of the board members of a mutual fund not be “interested persons” or, to put it another way, must be independent directors.<sup>26</sup> Most mutual funds employ a majority of independent directors.<sup>27</sup> An “interested person” is basically one who is an advisor,<sup>28</sup> an officer of an advisory company, or anyone with an immediate familial or business relationship with the mutual fund, the advisor, or an employee or legal counsel of the advisory

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<sup>25</sup> For an explanation of the notion of “reasonable person,” see RESTATEMENT (THIRD) OF TORTS § 2 (2001).

<sup>26</sup> 15 U.S.C. § 80a-10(a) (1997).

<sup>27</sup> *Symposium Panel, supra* note 4, at 448.

<sup>28</sup> An advisor of a mutual fund company is the person or company that manages the fund.

company.<sup>29</sup> Additionally, directors, and persons who are affiliated with them,<sup>30</sup> may not underwrite or broker any securities that the mutual fund purchases.<sup>31</sup> Finally, the Act also stipulates that a director may not acquire a stake in an underwriter of the mutual fund.<sup>32</sup> Thus, the Act appears most concerned with opportunistic directors who invest mutual fund monies in enterprises in which they had a stake, rather than investing to maximize the shareholders' welfare. The Act's independence requirements attempt to limit director incentives for such dealings.

Recently, the SEC implemented a number of measures targeted at improving the information used by investment products customers in their decision-making. According to an SEC press release, these measures "are designed to encourage mutual fund advertisements that convey more balanced information to prospective investors, particularly with respect to past performance."<sup>33</sup> For example, the new regulations require that mutual fund advertisements: (1) direct attention to investment objectives, risks, and charges; (2) make more prominent disclosures of certain information related to the timing of past performance (to prevent the exaggeration of brief moments of excellent performance); and (3) reemphasize that fund advertisements are subject to antifraud provisions of federal securities laws.<sup>34</sup> Through these regulations, the SEC is attempting to improve the mutual fund market by limiting mutual fund advertisement to the underlying economics of a particular transaction.

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<sup>29</sup> 15 U.S.C. § 80a-2(19) (1997). This provision actually sets out a much more specific and intricate definition of "interested person" than the one the text describes. The definition in the text has been simplified to capture the thrust of the Investment Company Act's definition of "interested person" while allowing the text to remain readable.

<sup>30</sup> See 15 U.S.C. § 80a-2(3) (1997) (providing the Act's definition of affiliated persons).

<sup>31</sup> 15 U.S.C. § 80a-10(b)(1) & (2) (1997). There is an exception to both of these requirements, however, for instances where a majority of the board of directors is composed of people who are not brokers or underwriters. *Id.*

<sup>32</sup> 15 U.S.C. § 80a-10(f) (1997).

<sup>33</sup> Stephen E. Roth & Elisabeth M. Grano, *The Impact of New Form N-6 and Amendments to Form N-4 on Underlying Mutual Fund Disclosure*, in A SEMINAR FOR '40 ACT LAWYERS 501 (2003); Coffee, *supra* note 2.

<sup>34</sup> *Id.*



These new regulations expand the Act's definition of "material business or professional relationship" by preventing any individual deemed to be "interested" under the Act within the last two years from serving as an independent director.<sup>35</sup> Essentially, the Act dictates that independent directors may neither be "interested persons" nor have been an "interested person" within two years of becoming a director. The SEC's interpretation applies this two-year prohibition to the Act's requirement that an independent director may not engage in "material transactions" that would have made him an "interested person" (such as providing services to the fund's advisor).<sup>36</sup> The SEC's interpretation goes on to endorse directors' indemnification insurance if it only indemnifies directors from liability for good faith efforts in fulfilling their duties.<sup>37</sup> Likewise, the SEC's interpretation endorses directors' purchasing of shares of the funds that they direct in order to better align their interests with those of the shareholders.<sup>38</sup> Thus, the SEC extends the Act's independence requirements. However, commentators argue that mutual fund directors lack independence in ways that neither the Act nor the SEC appear to contemplate.

Several commentators embrace a "real world" understanding of independence, approaching independence from the perspective of the director, rather than focusing, as the Act does, on external indicators of impropriety. While the Act addresses very clear conflicts of interest, commentators take into account more subtle pressures and incentives that might induce independent directors to use less than their best judgment. For example, Mark Sargent, Dean of Villanova School of Law, states that mutual fund directors are "damned if they do ... act independently of the fund managers, and damned if they do not."<sup>39</sup> Sargent expresses that "there have been notorious situations in which independent directors who exercised their authority to remove fund managers under the appropriate circumstances have, as a result, faced proxy battles to remove them from office."<sup>40</sup>

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<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Symposium Panel, supra* note 4, at 431-32.

<sup>40</sup> *Id.* at 433.

Several commentators argue for regulation of independent directors to eliminate this dilemma.

Commentators most often cite the process by which mutual funds select independent directors as creating an inherent conflict of interest. For example, most independent directors are selected as a favor or reward for being a friend or trusted colleague of the entrepreneur or company that started the mutual fund.<sup>41</sup> This phenomenon results in boards made up of independent directors who are grateful for receiving their well-compensated positions and do not wish to make decisions that may be unpopular with fund managers or fellow directors. Steve Howard, a partner at the New York law firm of Paul Weiss with considerable experience counseling mutual funds and their directors, has proposed what he believes is an ideal approach for maintaining independence.<sup>42</sup> Howard argues that a national, perhaps governmental, overseeing body should appoint directors to mutual funds from a national pool of qualified directors, with directors rotating to different funds every few years.<sup>43</sup> For a veteran of the mutual fund industry to suggest the severing of the relationship between a mutual fund's advisors and managers and its directors reveals the difficult task of attaining appropriate directorial independence. Howard indicates that informal relationships between directors and fund advisors are better suited for truly independent directors, as opposed to the "material business or professional relationships" that saturate the industry and inhibit truly independent director behavior.

The second strand of commentators' "independence" regards the "house director," or the director that sits on the boards of numerous funds within a fund family.<sup>44</sup> It is a conventional practice in the industry to use one board of directors to

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<sup>41</sup> *Id.* at 435 (stating that "[a] method of selection may be used that is haphazard and not systematic, and thus not designed to identify truly independent individuals."). The Act demands that a majority of existing independent directors elect subsequently-appointed directors, but there is little reason to think that the pressure not to upset the fund manager and advisor would be any less pervasive in this decision than in any other.

<sup>42</sup> *Id.* at 454-55.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 435.

oversee a number of mutual funds within the same family.<sup>45</sup> These directors derive a modest income from each fund, but often receive considerable total compensation from the fund family.<sup>46</sup> For example, each of the seven independent directors of the Merrill Lynch Developing Capital Markets Fund received between \$6,000 and \$8,000 for serving on the board of that fund in 2002.<sup>47</sup> However, each of these directors received total compensation ranging from \$234,567 to \$293,400 for their service on the boards of a number of Merrill Lynch funds.<sup>48</sup> This is particularly shocking considering the average compensation for directors of industrial corporations was \$154,016 in 2002.<sup>49</sup> This “house director” structure provides an obvious disincentive for a director to raise concerns with the advisor over any one fund and put his entire compensation from that fund family at risk.

Proponents of these arrangements argue that such boards provide enormous economies of scale to shareholders by attracting highly qualified directors at a relatively low cost to any particular fund.<sup>50</sup> In fact, some argue that these boards actually possess much more leverage to negotiate advisory contracts with terms that are favorable to shareholders due to the fact that the board controls a great deal of the advisor’s ability to extract fees from numerous funds.<sup>51</sup> However, these justifications are usually rooted in propaganda efforts of interest groups who lobby on behalf of fund advisors and directors with an interest in maintaining the status quo.<sup>52</sup>

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<sup>45</sup> U.S. Securities and Exchange Commission, *Transcript of the Conference on the Role of Independent Investment Company Directors*, Feb. 23 & 24, 1999, available at <http://www.sec.gov/divisions/investment/roundtable/iicdrndt2.htm#enhan> (last visited May 12, 2004).

<sup>46</sup> Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1464 (2002).

<sup>47</sup> See Prospectus of the Merrill Lynch Developing Capital Markets Fund, Inc., Oct. 10, 2002, available at <http://www.sec.gov/Archives/edgar/data/849402/000095010902005028/d485bpos.htm> (last visited May 12, 2004).

<sup>48</sup> *Id.*

<sup>49</sup> PEARL MEYER & PARTNERS, 2002 DIRECTOR COMPENSATION: COMPANY LISTINGS 2 (2002).

<sup>50</sup> Palmiter, *supra* note 46, at 1465.

<sup>51</sup> *Id.*

<sup>52</sup> See Palmiter, *supra* note 46, at 1469. For example, when the SEC recently promulgated rules demanding that mutual funds disclose their boards’ voting in order to improve the information

Thus, the understandings of independence vary between the Investment Company Act, the SEC, and commentators because of the amount of information each considers. The following statement, incorporated into the new cause of action articulated in the preceding section, captures the notion of independence that each of the three sources of meaning embrace: a director is independent if he acts, or at least feels free to act, in a manner that benefits shareholders without regard for whether such action adversely affects himself or the fund's advisor. The manner in which the Act seeks to accomplish this is by prohibiting specific relationships where the conflicts of interest facing the independent director are so great as to impermissibly interfere with the director's ability to act adversely to the advisor. However, commentators agree that even when directors meet the criteria of independence under the Act and the SEC's interpretation, their disincentives to act adversely to advisors impermissibly interfere with their decision-making.<sup>53</sup> One approach to solving this problem might be to impose new standards of independence. This approach could include whether directors had *any* relationship to advisors, not just a material business or professional relationship, or the percentage of yearly income that directors derive from any single family of funds. However, the establishment of these safe harbors could easily be avoided by the use of clever compensation arrangements or the careful selection of directors who fit the statutory definition of "independent" yet remain beholden to advisors for their positions. Therefore, the Act should embrace a general understanding of independence and expand the private rights of action under the Act to include challenges to director independence.

### *B. Current Remedies are Insufficient*

The Investment Company Act creates several rights of action, for both the SEC and shareholders, against mutual fund directors. These include suits seeking relief for unreasonable director or advisor compensation and breaches of fiduciary duty by directors. In recent years, mutual fund shareholders have brought a number

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available to shareholders, the Investment Company Institute, a lobbying group that typically represents the interests of mutual fund advisors, mounted a massive lobbying campaign to prevent the SEC from adopting the new requirements. See Kathleen Day, *SEC Wants Funds to Disclose Votes; Rules Proposed on Proxy Records*, WASHINGTON POST, Sept. 20, 2002, at E3; Kevin Burke, *Proxy Bout Enters Final Round*, MUTUAL FUND MARKET NEWS (Mar. 10, 2003).

<sup>53</sup> *Id.*

of lawsuits against directors seeking relief for a lack of director independence.<sup>54</sup> Courts have summarily dismissed most of these cases, interpreting the causes of action available under the Act very narrowly in the process. This section describes the statutorily created causes of action that are available under the Act and then discusses courts' treatments of these claims. Ultimately, this section concludes that the current treatment of shareholder claims effectively precludes shareholders from enforcing the meaningful independence that the preceding section describes.

The Investment Company Act provides several judicial remedies for shareholders and the SEC who wish to ensure that directors fulfill their duties. First, Section 36(a) of the Act authorizes the SEC to bring an action in federal court against a fund director alleging that he or she "has engaged ... or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any investment company."<sup>55</sup> Additionally, courts have read an implied right of action into Section 36(a) that authorizes shareholders to bring derivative actions alleging breaches of fiduciary duties for self-dealing against mutual fund directors.<sup>56</sup> Next, Section 36(b) of the Act authorizes shareholders to bring actions against directors alleging breaches of fiduciary duty with respect to compensatory arrangements between funds and their advisors.<sup>57</sup> Section 36(b) explicitly authorizes private citizens to bring suits against mutual fund directors.<sup>58</sup> Congress enacted Section 36(b) in 1970 upon realizing that directors and advisors throughout the mutual fund industry were not negotiating at arms-length when determining advisory fees.<sup>59</sup> Thus, the Act's history includes precedent with which to arm shareholders when alleging insufficiency of director independence.

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<sup>54</sup> See James N. Benedict, et al., *Recent Developments in Litigation Under the Investment Company Act of 1940*, PRACTICING LAW INSTITUTE CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 238 (2000) (offering a comprehensive summary of litigation under the Investment Company Act).

<sup>55</sup> 15 U.S.C. § 80a-35(a) (1997); ROBERT A. ROBERTSON, FUND GOVERNANCE: LEGAL DUTIES OF INVESTMENT COMPANY DIRECTORS § 9.01 (2001).

<sup>56</sup> *Id.* at § 9.01[2]. This implied right of action is not addressed in detail in this article because courts have generally held that it is limited to claims involving self-dealing by directors, advisors, or other affiliated persons named in § 36(a). Benedict, et al., *supra* note 41, at 259-63. Though § 36(a) seems more broad than § 36(b), in practice it presents an even more difficult standard under which to enforce independence. *Id.*

<sup>57</sup> 15 U.S.C. § 80a-35(b) (1997).

<sup>58</sup> Robertson, *supra* note 55, at § 9.01.

<sup>59</sup> *Id.*

The courts' treatment of shareholder actions, while consistent with the Act in its current form, prevent shareholders from holding directors to standards of meaningful independence.<sup>60</sup> The leading case interpreting Section 36(b) allows suits for breaches of "fiduciary duty" only in cases involving "excessive fees." Furthermore, the shareholder must prove that the fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."<sup>61</sup> The court, by limiting its focus to the arm's-length relationship between directors and advisors in negotiating advisory fees, appears to have adopted such a high standard to ensure that Section 36(b) actions do not devolve into suits regarding the performance of fund advisors. However, some shareholders have attempted to use recent Section 36(b) actions to enforce independence.

First, in *Green v. Fund Asset Management*, mutual fund shareholders brought a Section 36(b) action alleging that fund advisors breached their fiduciary duties by approving a fee structure under which the fund's advisor had an incentive to fully leverage the fund (an action that would ostensibly be contrary to the interests of shareholders in many circumstances) in order to maximize its fees.<sup>62</sup> The plaintiffs in the case also alleged that the advisors failed to properly disclose the fee arrangement, thereby further breaching their fiduciary duty to shareholders.<sup>63</sup> The Third Circuit reasoned that the advisors did not breach their fiduciary duties, because such fee arrangements were common in the mutual fund industry, and the Act does not treat the mere existence of an incentive to act against the interests of shareholders as a breach of fiduciary duty.<sup>64</sup> In arriving at this conclusion, the court mentioned that the "fiduciary duty" contemplated in Section 36(b) is much more circumscribed than traditional state law notions of "fiduciary duty."<sup>65</sup> Although this case did not involve a suit against directors specifically, the shareholders attempted to seek judicial relief

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<sup>60</sup> "Meaningful independence" refers to the understanding offered by Section III of this article.

<sup>61</sup> *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982).

<sup>62</sup> *Green v. Fund Asset Mgmt.*, 286 F.3d 682, 684 (3d Cir. 2002).

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 684-85.

<sup>65</sup> *Id.* at 685.

from a fee arrangement that was not in their best interest. If shareholders<sup>66</sup> found this fee arrangement so undesirable that they were willing to sue the advisor, it seems likely that they might sue the independent fund directors who did not fulfill the fiduciary duty imposed by the Act when they negotiated the advisory fee contract. *Green* is significant because the court upheld summary judgment for the advisor even with the possibility of a factual dispute that the advisory and director did not negotiate at arm's-length.<sup>67</sup>

In a similar case, the Seventh Circuit upheld summary judgment against mutual fund shareholders who alleged that an advisory fee arrangement based on a percentage of the net assets of the fund created an impermissibly powerful incentive for the advisor to breach his fiduciary duties to shareholders.<sup>68</sup> In *Green v. Nuveen Advisory Corp.*, the court offered further clarification that was absent in the Third Circuit case. The *Nuveen* court noted the distinction between a plaintiff alleging that an impermissible temptation existed and one in which an advisor had actually acted on this incentive.<sup>69</sup> The former situation, the court held, could not constitute a breach of fiduciary duty, while the latter could.<sup>70</sup> Thus, the *Nuveen* case provides another example of a court refusing to find a potential breach of fiduciary duty where plaintiffs allege that the arm's-length relationship between fund directors and advisors broke down.

The purpose of discussing the *Green* and *Nuveen* cases is not to criticize the courts' reasoning, but rather to illustrate the limitations of the private right of action by shareholders against directors created by Section 36(b). The courts essentially limit these actions to instances involving excessive fees, neglecting other instances where director independence appears to have failed.

In an inspired attempt to enforce mutual fund shareholders' rights, a shareholder filed suit against the Investment Company Institute ("ICI"), the primary

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<sup>66</sup> Actually, it seems more likely that a handful of activist shareholders and a plaintiff's attorney probably thought that, perhaps, the legal claim involved in this case was worth pursuing.

<sup>67</sup> *Green v. Fund Asset Mgmt.*, 286 F.3d at 683.

<sup>68</sup> *Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 739-40 (7th Cir. 2002).

<sup>69</sup> *Id.* at 742.

<sup>70</sup> *Id.*

trade group and a powerful lobbying force for the mutual fund industry.<sup>71</sup> The plaintiff-shareholder alleged that the membership dues collected by ICI from its members, one of which was a mutual fund in which she was a shareholder, made the ICI an “affiliated person” accountable to shareholders for breaches of fiduciary duties under Section 36(b).<sup>72</sup> Furthermore, the plaintiff argued, the ICI engaged in activities that served the interests of fund advisors to the detriment of shareholders’ interests.<sup>73</sup> The court dismissed the plaintiff’s claim on the grounds that membership dues did not make the ICI an “affiliated person.”<sup>74</sup> Additionally, the court examined the legislative history of the Act and concluded that Section 36(b) was only meant to apply to actions against directors and advisors for excessive advisory fees, despite the fact that its language purports to cover any breach of a fiduciary duty.<sup>75</sup> The court reached this conclusion even though ICI probably acted in the interests of mutual fund advisors to the detriment of its members’ shareholders.<sup>76</sup> Thus, judicial interpretation of the Act prevented another check on the activities of mutual fund advisors when it appeared that directors failed to adequately police their activities.

The final case representing the current state of shareholder litigation under the Act is *Migdal v. Rowe-Price Fleming International, Inc.*<sup>77</sup> In *Migdal*, shareholders sued a mutual fund advisor under Section 36(b) alleging that the advisor’s fees were excessive and bolstered their argument by complaining that the directors of the fund were not “independent” because the directors served on numerous boards within one fund family.<sup>78</sup> The Fourth Circuit upheld the district court’s dismissal of this

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<sup>71</sup> Rohrbaugh v. Inv. Co. Inst., No. 00-1237, July 2, 2002, 2002 U.S. Dist. LEXIS 13401, \*2-3 (D.D.C. 2002).

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at \*20.

<sup>75</sup> *Id.* at \*28-29.

<sup>76</sup> Palmiter, *supra* note 46.

<sup>77</sup> *Migdal v. Rowe-Price Fleming Int’l, Inc.*, 248 F.3d 321 (4th Cir. 2001). Incidentally, one of the plaintiffs in this case was Linda Rohrbaugh of the *Rohrbaugh* case; *see supra* note 71.

<sup>78</sup> *Id.* at 325.



case reasoning that the plaintiffs failed to state a claim.<sup>79</sup> First, the court explained that the plaintiffs had not provided a meaningful explanation of why the fees the advisors had secured from the fund were “excessive,” even though the plaintiffs asserted that several similar funds offered lower rates.<sup>80</sup> Second, the court explained that director independence, as it relates to sitting on numerous boards, is irrelevant for the purposes of a Section 36(b) excessive fee analysis.<sup>81</sup> Nevertheless, the court discussed the possibility that the fee arrangement between the fund and the defendant was not the result of arm’s-length bargaining.<sup>82</sup> The court further stated that since the plaintiffs had not proven, or even alleged facts that would, if true, prove, that the advisor somehow controlled the independent directors, the issue of independence did not matter in the case at hand.<sup>83</sup> Finally, the court provided illuminating commentary on its narrow interpretation of Section 36(b): “The Investment Company Act balances the tension between protecting mutual fund investors from overly generous charges by investment advisers, and shielding fund management from an outbreak of harassing lawsuits. Any change in this balance will have to come from Congress.”<sup>84</sup>

These representative cases indicate that shareholders are essentially powerless to combat the lack of director independence in their mutual funds, despite the fact that Congress enacted a private cause of action designed to ensure that arm’s-length bargaining occurs between mutual fund directors and advisors.<sup>85</sup> Each discussed case involved a situation where plaintiffs alleged that directors failed to act independently, and in every case, plaintiffs were left without recourse.

Section III(A) of this article posits that commentators, the SEC, and the Investment Company Act appear to embrace the idea that true “independence” allows a director to feel free to act in a manner that benefits shareholders without regard for whether such action adversely affects a fund’s advisor. The situations that

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<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at 327.

<sup>81</sup> *Id.* at 329-30.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> *Id.* at 331.

<sup>85</sup> *See supra* note 54.

these cases present, including advisory fees based on a percentage of a fund's net assets, payments to the ICI, and directors who sit on numerous boards, all demonstrate some indication that the directors involved do not meet this notion of "independence."

Mutual fund shareholders do not appear to have the power to enforce director independence in state courts. Additionally, at least one federal court has concluded that Congress intended the Section 36(b) right of action to pre-empt state actions.<sup>86</sup> The court noted that existing remedies were inadequate and the Act's actions differed from state actions in scope, parties, and relief, generating impermissible conflicts between the Act and state law. On the other hand, an Illinois appellate court held that a district court improperly dismissed a common law breach of fiduciary duty claim that mutual fund shareholders brought against the directors and advisors of a mutual fund.<sup>87</sup> However, there appears to be no further litigation on this issue particularly when the plaintiffs' claims for self-dealing by insiders of mutual fund directors could have survived summary judgment.

One Delaware court declared that "non-affiliated directors ha[ve] the same responsibility as that of the ordinary directors of a Delaware corporation. Their non-affiliated status is a creation of the Investment Company Act, but it does not lessen their obligations."<sup>88</sup> However, this forty-year-old decision addressed the "grossly negligent" behavior of certain mutual fund directors, and it provides little guidance regarding a shareholder's current prospects for seeking judicial redress for lack of director independence, particularly considering that ordinary directors are substantially insulated by the Business Judgment Rule in Delaware.<sup>89</sup> Finally, another Delaware case from the 1960's involved a shareholder who directly argued that mutual fund directors acted in a manner that no independent director would rationally act and, therefore, violated the Act rather than state corporate law.<sup>90</sup> The *Coran* court held that since the "non-independent" action alleged by the plaintiff did

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<sup>86</sup> *Green v. Fund Asset Mgmt., L.P.*, 53 F. Supp. 2d 723 (D.N.J. 1999) (*overruled on other grounds by* 245 F.3d 214 (3rd Cir. 2001)).

<sup>87</sup> *Mann v. Kemper Fin. Co.*, 618 N.E.2d 317, 327 (Ill. App. Ct. 1993).

<sup>88</sup> *Lutz v. Boas*, 171 A.2d 381, 395 (Del. Ch. 1961).

<sup>89</sup> *Id.*

<sup>90</sup> *Coran v. Thorpe*, 203 A.2d 620, 624 (Del. Ch. 1964).

not, itself, violate the Act, the plaintiff failed to state a claim.<sup>91</sup> Because this case only involved the Act and not state corporate law, it is presumed that state remedy was available. Thus, there appears to be no state law alternative to Section 36(b) for shareholders who wish to enforce director independence in state courts.

All told, the current private enforcement mechanism existing under the Act does not afford mutual fund shareholders the opportunity to hold their directors to meaningful standards of independence, despite the fact that Congress sought to ensure an arm's-length relationship between directors and advisors under Section 36(b).

*C. Economic Forces Will Not Improve Independence on Their Own*

If a lack of director independence is such a rampant problem throughout the mutual fund industry, then it follows that shareholders would “vote with their feet,” or sell their shares in funds in which they perceive an impermissible lack of independence. We could draw two conclusions from the phenomenon that shareholders do not seem particularly bothered by this syndrome of coziness between directors and advisors: (1) they are not aware that it exists, or (2) shareholders simply do not care about director independence. If the former is true, then perhaps we need stronger disclosure requirements or a more robust notion of what constitutes an “affiliated person” under the Act, rather than a new cause of action. If the latter is true, and independence has no bearing on anything that is important to consumers, then it seems wasteful for Congress to intercede with a novel cause of action. This position seems persuasive, but it relies on the assumption that if there is a defect in fund governance, then the market will correct it as mutual fund shareholders sell or refuse to purchase shares of those funds with directors perceived as lacking independence. There are at least two reasons to reject this assumption.

First, the existence of the Act itself is a monumental acknowledgement that we cannot rely on market forces to weed out impermissible practices in the management of investment companies. Second, commentators appear to agree that an impermissible lack of director independence pervades the mutual fund industry, despite the fact that shareholders are, and have for a long time been, free to vote with their feet. Assuming that commentators' observations are a reasonable proxy for the way that mutual fund shareholders would vote if they acted in an economically rational way, it appears that shareholders' retention due to a perceived

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<sup>91</sup> *Id.*

lack of director independence does not reflect a conscious statement that shareholders do not care about director independence.<sup>92</sup> Rather, it seems more likely that shareholders are not aware of the mutual fund independence conflict. Although there is no empirical support for this proposition, the lack of activist institutional investor shareholders in the mutual fund context probably accounts for this phenomenon.

Additionally, ordinary shareholders will not frequently enforce their rights under the new cause of action. Activist shareholders and enterprising plaintiffs' attorneys will more likely present litigation that should precipitate increased independence and, subsequently, improved governance. Additionally, this new cause of action should precipitate some change in fund governance; hopefully the threat of litigation will remain a threat and not become a flurry of litigation. However, at this point it is necessary to contemplate the reality of the policy choice of creating a new cause of action.

One criticism of this article's approach is that it would function to line the pockets of class-action plaintiffs' lawyers who specialize in securities. Critics may argue that the risk of a blizzard of frivolous lawsuits will cripple otherwise profitable investment companies outweighs any potential benefits of a new cause of action. Furthermore, the threat of litigation could work more to extort settlement money from directors than to improve directorial practices. Given the well-documented eagerness of plaintiffs' lawyers in the field of securities, these risks are certainly real.<sup>93</sup> However, these weaknesses merely identify an inherent drawback to the regulatory choice of private enforcement.<sup>94</sup>

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<sup>92</sup> See Palmiter *supra* note 46, at 1426-27 (setting out mutual fund ownership statistics demonstrating that an enormous number of individuals in the United States own shares in mutual funds). Since so many people own stakes in mutual funds and a lack of director independence is apparently rampant in the industry, it is reasonably safe to conclude that shareholders either are not aware of the problem or do not care about it.

<sup>93</sup> The substantial effect that plaintiffs' lawyers can have on the overall market is well-documented. See *e.g.*, Peter Elkind, *Score One for the Snake*, FORTUNE, Mar. 5, 2001, at 44.

<sup>94</sup> See SIDNEY A. SHAPIRO & JOSEPH P. TOMAIN, REGULATORY LAW AND POLICY 392-95 (2003) (describing the relative positive and negative aspects of a litigation-based regulation versus other types of regulation).

The cost of litigation is the greatest negative result of private enforcement, whereas the benefits of private enforcement include superior *ex post* fact-finding, direct compensation of injured parties, and a precise attribution of liability to particular parties.<sup>95</sup> Traditional regulation, on the other hand, allows an agency to promulgate rules and enforce them. This method provides more predictability via *ex ante* rulemaking and an opportunity to appoint true experts to promulgate regulations, as opposed to forcing judges to parse similar issues in fields where they might not have expertise. Individuals that agencies employ, on the other hand, often have a greater incentive to ensure the existence and longevity of the agency. A regulator does not want to carry out his mission too well, or the need for the agency might become obsolete.<sup>96</sup> For example, some critics have expressed the view that recent SEC regulations governing the mutual fund industry are largely ineffective and blame the cozy relationship that apparently developed between the government and the private sector.<sup>97</sup>

Thus, it is important to recognize that, in a sense, one must “pick her poison” when selecting a method of regulation. In other words, any approach that one chooses necessarily involves certain inherent weaknesses, and the risk of costly litigation is certainly a weakness from which the regulatory approach of private enforcement suffers.

Congress should have already decided to take the regulatory approach of private enforcement in the area of investment company director relationships with shareholders. Further, a modest extension of that choice would improve the extent to which the choice effectuates Congress’ goals. Five or ten years from now, we might look back on the recent reaction to perceived abuses in the investment company industry, particularly the SEC’s recent regulations and the historic lawsuit that state attorneys general are currently attempting against some of the nation’s largest mutual fund companies, and conclude that these measures adequately “cleaned up” the industry. However, by modifying the Act to arm shareholders with a robust cause of action, Congress will better address the condition that seems most to blame for mutual fund company abuses, directors’ coziness with advisors, regardless of the extent to which regulators and executive officials’ priorities may shift over time.

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<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> Coffee, *supra* note 2.

The important role that private enforcement activities play in the governance of traditional corporations has been well-documented<sup>98</sup> and, despite the distaste many people undoubtedly harbor for litigation and the plaintiffs' bar, private enforcement has a useful role to play in the mutual fund context. This article merely argues that, if we already have private enforcement for mutual fund shareholders, let us make it optimal.

*D. Why Expand the Current Cause of Action Beyond Cases Involving Excessive Fees? Isn't the Negotiation of Advisory Fees the Only Director Activity in Which Independence Really Matters?*

Negotiating the advisor's fee is perhaps the most important duty of the mutual fund director.<sup>99</sup> As the preceding discussion of case law explains, the Act already creates a private right of action for shareholders to combat "excessive fees."<sup>100</sup> Therefore, it seems that an additional cause of action would address a non-existent problem. However, there are two reasons to reject this notion. First, despite the existence of this well-established cause of action, commentators still suggest that an impermissible lack of independence exists.<sup>101</sup> Though this problem may involve the issue of advisory fees in the vast majority of cases, some new or additional enforcement appears necessary to achieve a desirable level of independence. Second, some circumstances present an independence problem that does not involve advisory fees. The *Robrbaugh* case, involving the membership fees that a fund paid to the ICI, discussed such an instance.<sup>102</sup>

Likewise, as discussed in Part II, the decision to remove or not to remove the fund's advisor presents, the paradigmatic instance in which director independence is vital even though it does not involve advisory fees. For example, in the notorious

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<sup>98</sup> See Robert B. Thompson & Randall S. Thomas, *Shareholder Litigation: Reexamining the Balance Between Litigation Agency Costs and Management Agency Costs*, at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=336162](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=336162) (last visited May 12, 2004).

<sup>99</sup> *Symposium Panel*, *supra* note 4, at 433 (stating that "[t]he principal duty [of the mutual fund independent director] is hiring and, theoretically, firing fund managers and other service providers).

<sup>100</sup> See *supra* note 45.

<sup>101</sup> *Symposium Panel*, *supra* note 4, at 432, and *supra* note 9.

<sup>102</sup> See *supra* note 71.

*Navellier* case, independent directors voted to remove a mutual fund's advisor.<sup>103</sup> An affiliated director and advisor, Navellier, threatened to abandon the fund unless the independent directors reinstated the advisor and resigned.<sup>104</sup> After the independent directors submitted to Navellier's demands, Navellier sued for breach of fiduciary duty under the Act. The case went to trial, though the independent directors ultimately prevailed.<sup>105</sup> The *Navellier* case presents an especially extreme example of the importance of the decision to remove the advisor and its implications for independence. Therefore, the counter-argument that the only important director independence issues involve excessive fees is not a persuasive reason to abandon an "independence-specific" cause of action because other equally important decisions the board must make, especially whether to remove an advisor, implicate independence as well.

#### IV. Conclusion

Those who observe the mutual fund industry seem to agree that director independence does not exist.<sup>106</sup> The current statutory regime neither captures a meaningful notion of independence nor allows shareholders to pursue the private enforcement of breakdowns in the arm's-length relationship that is supposed to exist between directors and advisors. To remedy this problem, Congress should promulgate a private right of action that specifically allows shareholders to enforce independence. The value of this solution is that it would allow the enforcement of a meaningful notion of independence without sacrificing the benefits that the current board structures and director selection processes seem to present.<sup>107</sup> The weakness of this new cause of action is that its broadness has the potential to precipitate a landslide of lawsuits that lack merit, but capitalize on the ambiguities inherent in a broadly articulated cause of action. This would force judges to make *ex post* evaluations of business decision-making. Hence, this article adopts the Delaware Corporate law "intermediate" standard of review as a useful guide for balancing this tension. A new cause of action that allows shareholders to enforce a meaningful

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<sup>103</sup> *Navellier v. Sletten*, 262 F.3d 923 (9th Cir. 2001).

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> *Symposium Panel*, *supra* note 4, at 432, and *supra* note 9.

<sup>107</sup> The benefits are the economies of scale and low expense that the "house director" board structure presents. Ostensibly, the more robust the search for qualified independent directors, the greater expense this creates for shareholders.

notion of director independence constitutes one useful approach to correcting a rampant problem in the mutual fund industry.