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Fiduciary Duties of Directors of Registered Investment Companies

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I. Introduction

The standards of conduct applicable to investment professionals under federal law have been under scrutiny in recent years. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 empowered the Securities and Exchange Commission (SEC) to review the effectiveness of existing legal and regulatory standards of care for brokers, dealers, and investment advisers and to adopt a uniform fiduciary standard for broker-dealers. Last year, the Department of Labor adopted a fiduciary rule under the Employee Retirement Income Security Act (ERISA) for broker-dealers and others who provide advice to retirement investors. While the standards of care under the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, and ERISA have been much debated, the fiduciary duties applicable to directors and trustees (directors) of registered investment companies (funds) under state law and the Investment Company Act of 1940 (1940 Act or Act) have remained largely the same. Although the standard of care has not changed, fund directors have seen increased responsibilities in light of SEC rulemaking, enforcement actions, and shareholder litigation. In this article, we will examine the fiduciary duties of fund directors under state and federal law as well as risk mitigation considerations.

II. Fiduciary Duties of Fund Directors under State Law

A. Duty of Care, Duty of Loyalty and the Business Judgment Rule

The concept of fiduciary dates back to the Latin word *fidere,* which means "to trust."[1] The word is also closely associated with the word *fides* (faith).[2] Because funds are organized under state law, directors of funds, like directors of any company, are subject to fiduciary duties arising from applicable state laws and general common law fiduciary principles.[3] Most state statutes dealing with the fiduciary duties of directors are relatively vague, with no specific guidance provided regarding the scope of directors' responsibilities. As a result, the development of specific standards has been left to the courts. The obligations of directors as developed in case law can be grouped into two broad categories: the duty of care and the duty of loyalty.

In general, the duty of care requires directors to act in good faith, in a manner the director reasonably believes to be in the best interests of the fund and its shareholders, and with the degree of care which an ordinarily prudent person in a like position would exercise under similar circumstances.[4] Under this duty, directors must inform themselves with all material information reasonably available to them prior to making a business decision. This can be done by attending directors' meetings, requesting pertinent information, and then carefully evaluating the information provided.[5] Depending on the matter being acted upon, such information may include, among other things, materials relating to fund performance, compliance reports, and any interests of affiliated persons in the action. In certain circumstances, the 1940 Act requires the board to request information relevant to its decision making.[6] In discharging their duty of care, directors are typically entitled to rely on the fund's records and on information, reports, and records prepared by or under the direction of the fund's investment adviser, counsel, public accountants, or other persons as to matters that the directors reasonably believe to be within such person's expertise. However, directors' reliance on such data must be reasonable, which means they must be attentive to detail, engaged, and, when necessary, critical.[7]

Like the duty of care, the duty of loyalty also requires directors to act in good faith and in a manner the director reasonably believes to be in the best interests of the fund and its shareholders. In addition, the duty of loyalty prohibits directors from appropriating, for their own advantage, an opportunity that rightly belongs to the fund and from otherwise engaging in self-dealing.[8] The duty of loyalty has been construed by some state courts to require that directors be disinterested, so that they neither appear on both sides of a transaction nor expect to derive any personal benefit from it, as well as independent, so that their decisions are based on the merits of the subject matter rather than extraneous considerations.[9]

In assessing the actions of directors, courts will apply the business judgment rule, which is a rebuttable presumption that insulates a director from liability for a business decision provided (1) the decision is made in good faith, and (2) the director (a) does not have a personal interest in the subject matter of the decision, (b) is sufficiently informed, and (c) reasonably believes the decision is in the best interests of the fund and its shareholders.[10] The business judgment rule will not be applied where directors have violated their duty of loyalty. Likewise, the rule will not be applied in situations where directors have abdicated their responsibility to act on the basis of their informed business judgment. This latter situation has been likened to acting with gross negligence.[11]

B. Delaware Statutory Trusts

For funds organized as Delaware statutory trusts, the Delaware Statutory Trust Act (DSTA), like many other state corporate statutes, does not define the fiduciary duties of trustees. But, unlike other state corporate statutes, the DSTA provides that unless the governing instrument provides otherwise, the laws of the state pertaining to common law trusts, including as they relate to the fiduciary duties of common law trustees, apply.[12] Because the Delaware default fiduciary standard for common law trustees is a negligence standard,[13] if the governing instrument is silent on this issue, a court could refuse to apply the business judgment rule as being incompatible with the common law standard.

Fortunately, in August 2016, legislation went into effect adding new Section 3806(l) to the DSTA, which provides that a trustee of a statutory trust that is registered as an investment company under the 1940 Act has the same fiduciary duties as directors of a for-profit corporation organized under the Delaware General Corporation Law, unless the governing instrument provides otherwise. This amendment makes applicable to trustees of registered investment companies organized under the DSTA the business judgment rule and its presumption that decision-makers act in good faith, on a fully-informed basis and in the best interests of the organization for whom they act.

C. Massachusetts Business Trusts

For funds organized as Massachusetts business trusts, although there is no question that the business judgment rule is available to protect the decisions of trustees of such funds,[14] a recent federal district court decision has left trustees of such funds nervous not about the business decisions they make, but rather about the communications they have with counsel in connection with fulfilling their duties to the funds and shareholders they serve.

In *Kenny v. Pacific Investment Management Company*, a shareholder of the PIMCO Total Return Fund, a series of a Massachusetts business trust, sued the fund's investment adviser and distributor for breaching their fiduciary duties by allegedly charging the fund excessive fees and failing to pass on economies of scale.[15] As part of the lawsuit, the shareholder issued subpoenas to the independent trustees, who were not parties, for documents pertaining to the case. The independent trustees provided some documents, but withheld over 200 documents containing legal advice about the fund. The shareholder sought a court order to compel the trustees to produce the withheld documents.

Even though the parties agreed that the documents fell within the attorney-client privilege,[16] the shareholder argued that the so-called "fiduciary exception" applied because the trustees were seeking legal advice to guide the administration of the fund, and not legal advice for their own personal matters.[17] The shareholder further argued that the attorney-client privilege in this case belonged to the trust's beneficiaries—that is, the shareholders—rather than to the trustees.

The independent trustees and the fund's investment adviser responded that requiring the production of such documents would have a chilling effect on the communications between trustees and their counsel, and could have a destabilizing effect on the fund industry.

Ruling in the shareholder's favor, the US District Court for the Western District of Washington observed that the independent trustees owed fiduciary duties to the fund's shareholders that required disclosure of the documents. The court reasoned that the documents at issue contained legal advice for managing the fund and were not sought in anticipation of any litigation. The court further noted that the fund paid legal counsel's fees and that legal advice concerning the fund was ultimately for the shareholders' benefit. Therefore, the independent trustees and the defendants failed to show why the shareholder was not entitled to the documents he requested.

While an appeal of this decision is not likely,[18] it is unclear whether the *Kenny* decision will apply more broadly to funds organized under other state laws.[19] Regardless of where the fund is organized, this case serves as an important reminder to all directors not to assume that their communications with counsel are privileged.

III. Fiduciary Duties of Fund Directors under the 1940 Act

The fiduciary standard has been part of the 1940 Act since its adoption. During the Senate hearings in 1940, SEC Commissioner Robert E. Healy cited malpractice in the investment management industry, noting that "Too often sponsors and managers and insiders disregarded their basic fiduciary obligations to their investors."[20] As stated by the SEC Staff in 1999, the 1940 Act "places substantial responsibilities on the independent directors of investment companies to protect the interests of fund shareholders by policing potential conflicts of interest. These responsibilities are in addition to the general duties of loyalty and care imposed on directors under state law."[21] Although the standard of care applicable to directors under the 1940 Act is higher than what is required under state law, courts have struggled with defining what type of conduct constitutes a breach of a director's fiduciary duty under the Act.

A. Section 36 of the 1940 Act

As originally adopted on August 22, 1940, Section 36 of the 1940 Act, which was titled "Injunctions Against Gross Abuse," was shorter than the current iteration of that section and read as follows *(emphasis added)*:

> **Injunctions Against Gross Abuse**
> *The Commission is authorized to bring an action* in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, *alleging that a person serving or acting in one or more of the following capacities has been guilty*, after the enactment of this title and within five years of the commencement of the action, *of gross misconduct or gross abuse of trust* in respect of any registered investment company for which such person so serves or acts:
>
> **(1)** as officer, *director*, member of an advisory board, investment adviser, or depositor; or
>
> **(2)** as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.
>
> If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

In the years following passage of the 1940 Act, Congress sought to give courts greater flexibility in enforcing breaches of fiduciary duty under Section 36, finding that the reference to "gross abuse of trust" or "gross misconduct" created a stigma and tended to limit cases that could be brought under that section.[22] Accordingly, Congress amended the statute in 1970 when it added Section 36(b), which imposes a fiduciary duty on investment advisers and their affiliates with respect to advisory compensation. Existing Section 36 was redesignated as Section 36(a) and the "gross abuse" standard was changed to "breach of fiduciary duty involving personal misconduct." As currently enacted, Section 36(a) reads as follows *(emphasis added)*:

> **Civil actions by Commission; jurisdiction; allegations; injunctive or other relief**
> *The Commission is authorized to bring an action* in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, *alleging that a person who is, or at the time of the alleged misconduct was, serving or acting in one or more of the following capacities has engaged* within five years of the commencement of the action or is about to engage *in any act or practice constituting a breach of fiduciary duty involving personal misconduct* in respect of any registered investment company for which such person so serves or acts, or at the time of the alleged misconduct, so served or acted—
>
> **(1)** as officer, *director*, member of any advisory board, investment adviser, or depositor; or
>
> **(2)** as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

Section 36(b) is a frequent subject of shareholder litigation whereas Section 36(a) has only infrequently been used by the SEC and is not available to private litigants, as discussed in Section IV, below. Section 36(a) has been described by one court as a "reservoir of fiduciary obligations imposed upon affiliated persons to prevent gross misconduct or gross abuse of trust not otherwise specifically dealt with in the Act."[23]

B. Specific Duties of Directors under the 1940 Act

In addition to the general fiduciary duty set forth in Section 36(a), fund directors have numerous other duties set forth in the 1940 Act and the regulations thereunder, including approval of the investment advisory and underwriting agreements, appointment of independent auditors, review of 12b-1 fees, approval of affiliated transactions, and approval of the methodology for the fair valuation of securities. These duties can thus be "read into" the fiduciary duties set forth in Section 36, as a fund's independent directors in particular are expected to act on behalf of the shareholders in approving contracts and arrangements that could present an opportunity for overreaching by the investment adviser. Moreover, Rule 12b-1 specifically cites the fiduciary duties of the board in connection with the required board approval of a distribution plan. Rule 12b-1 provides in relevant part as follows *(emphasis added)*:

> (e) A registered open-end management investment company may implement or continue a plan pursuant to paragraph (b) of this section only if the directors who vote to approve such implementation or continuation conclude, in the exercise of reasonable business judgment and *in light of their fiduciary duties under state law and under sections 36(a) and (b) of the Act*, that there is a reasonable likelihood that the plan will benefit the company and its shareholders.

The reference to Section 36(b) in Rule 12b-1 is confusing given the requirement that Rule 12b-1 plans be approved by the independent directors, who do not have a fiduciary duty under Section 36(b). However, the reference may be emphasizing that interested directors (who are often picked up under Section 36(b)[24] have a heightened duty when voting to approve a Rule 12b-1 plan. In the adopting release for Rule 12b-1, the SEC noted that it adopted this standard of care in implementing a distribution plan as originally proposed.[25] In that release, the SEC stated that it "intentionally did not define the relationship between a 'reasonable business judgment' and 'fiduciary duties' under state law and sections 36(a) and (b) of the Act, nor did it define those director activities that would be consistent with each concept. The Commission did this in recognition that the concepts are constantly evolving and, particularly, that there have been no comprehensive or definitive interpretations of the various fiduciary duty requirements of section 36."[26]

The specific duties of fund directors have continued to increase in recent years to include, among others, appointment of the fund's chief compliance officer and oversight of compliance policies and procedures, anti-money laundering programs, cybersecurity, sub-transfer agent fees, and, beginning in 2018, liquidity risk management programs.

IV. Actions Against the Board for Breach of Fiduciary Duty under the 1940 Act

A. Private Actions

Only the SEC can bring charges against directors under Section 36(a), although private litigants continue to try. For example, in *Tannenbaum v. Zeller*,[27] the Second Circuit found that the original form of Section 36 authorized private actions by investors, a right that was not eliminated by the 1970 amendment that added Section 36(b). In that case, the court stated that:

> Congress did not intend this modification to abrogate the private action already recognized under the Act for other types of breach of fiduciary duty. We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the brokerage generated by portfolio transactions from the informed discretion of the independent members of a mutual fund's board of directors.... While we thus conclude that the Investment Company Act did not remove the recapture decision from the discretion of the Fund's board of directors, such discretion is by no means unrestrained. As previously mentioned, independent directors can

> perform their function under the Act only when they exercise informed discretion, and the responsibility for keeping the independent directors informed lies with the management, i.e., the investment adviser and interested directors.[28]

Since 2005, however, courts have generally held that Section 36(a) does not authorize private right of actions.[29] In *Bellikoff*, the court found that the text and structure of the 1940 Act "reveal no ambiguity about Congress's intention to preclude private rights of action to enforce" Section 36(a).[30] While only the SEC can bring cases under Section 36(a), the responsibility for its enforcement is vested in the courts, not the SEC.[31]

Despite this general agreement regarding who may bring an action under Section 36(a), courts disagree in how broadly to interpret the "personal misconduct" standard of Section 36(a). For example, in *Young v. Nationwide Life Insurance*, the court found that the statute could apply to "any nonfeasance of duty or abdication of responsibility"—that is, a general breach of fiduciary duty without self-dealing or conflicts of interest.[32] On the other hand, in *Prescott v. Allstate Life Insurance*, the court stated that "personal misconduct" refers to "misconduct that involves self-dealing by investment company or other insiders," noting that the 1940 Act was adopted to address self-dealing in the investment company industry.[33] The SEC has acknowledged the lack of definitive guidance regarding the meaning of fiduciary duty under Section 36[34] while at the same time asserting that these responsibilities are in addition to the general duties of loyalty and care imposed on directors under state law.[35]

Most private actions for breach of fiduciary duty under Section 36 are made against investment advisers under Section 36(b) because, as noted above, since 2005, courts have held that no private right of action exists under Section 36(a). Nonetheless, litigants have alleged a breach of fiduciary duty against fund directors under both Section 36(a) and Section 36(b) in a variety of contexts under the 1940 Act, including recapture of brokerage commissions,[36] Rule 12b-1 payments,[37] securities lending,[38] participation in securities class action cases,[39] and Rule 38a-1 compliance programs.[40] The plaintiffs in these cases were unsuccessful because the courts generally found that there is neither an explicit nor implicit private right of action under Section 36(a).[41]

B. SEC Actions

The SEC has not brought many cases alleging breach of fiduciary duty against fund directors under Section 36(a) and its predecessor.

In *Aldred Investment Trust*, an early case interpreting the original version of Section 36, the First Circuit Court of Appeals upheld the district court's finding in favor of the SEC that the defendants had been guilty of "gross abuse of trust" as officers and trustees of the investment company within the meaning of Section 36.[42] Newly-elected trustees and officers of the trust caused the trust to purchase a horse-racing track and then elected themselves as directors of the racetrack with large salaries. In addition, the trust invested 30 percent of its assets in the horse-racing business, a deviation from its diversification policy which required shareholder approval. The court stated, "[t]he findings of the District Court, amply supported by the evidence, reveal a course of conduct that was motivated by self-interest and personal advantage and the calculated denial of fiduciary obligations . . . . In our opinion the court below properly found them guilty of 'gross abuse of trust' within the meaning of § 36 of the Act."[43] The self-dealing aspects of this case support the conclusion that the trustees violated their duty of loyalty to the trust and its shareholders in keeping with the early wording of Section 36, which required an abuse of trust.

In a case involving the current iteration of Section 36, the SEC alleged violations of Section 36 because of transactions between a fund and affiliated companies of two interested directors of the fund.[44] Although the Seventh Circuit in *Advance*

Growth Capital found that the trial court's decision not to appoint a receiver under Section 36 was not manifestly incorrect, it also noted that the 1940 Act imposes fiduciary obligations of the "highest order" upon persons who control investment companies.[45] This finding suggests that the fiduciary standard under the 1940 Act is higher than and/or in addition to the comparable state law standard, which is consistent with the SEC's statements on the subject.

In 2004, following the Canary Capital Partners (Canary) market timing scandal, the SEC brought an action against an interested trustee and another officer of various PIMCO funds. The SEC alleged that the defendants' activities in allowing Canary to have special market timing privileges while at the same time deterring market timing through public disclosures violated their fiduciary duties under Section 36(a), among other violations. The court in that case held that to state a claim under Section 36(a), the SEC need not allege fraud or self-dealing, rather "it must demonstrate an accepted breach of fiduciary duty via affirmative acts or 'in appropriate cases, nonfeasance of duty or abdication of responsibility'."[46] This court noted that courts are divided over what it means for a breach of fiduciary duty to involve personal misconduct under Section 36(a). After reviewing the legislative history leading up to the 1970 amendments, the court found that Congress inserted "involving personal misconduct" to limit the SEC's ability to undertake a "general revision of the practices or structures of the investment company industry," not to limit the reach of the provision to those involving self-dealing, fraud, or conflicts of interest.[47] As a result, the court held that factual questions existed about whether the interested trustee informed himself about the Canary arrangement (a duty to investigate), made appropriate disclosures to the fund board regarding the arrangement, and placed the interests of one shareholder (Canary) above the interests of other fund shareholders. Based on the foregoing, it is clear that the court in this case believes the duties under Section 36(a) extend beyond the duty of loyalty to encompass nonfeasance or abdication of duty. These actions may constitute a breach of fiduciary duty under Section 36(a) even if there was no self-dealing.

V. Limitations on Liability of Fund Directors

A. State Law Protections

Most state statutes permit the governing instrument of a fund to limit and, in some cases, eliminate, personal liability of directors under state law for monetary damages for breach of fiduciary duty. For example, the DSTA permits a governing instrument to provide for the "limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a trustee … to a statutory trust or to another trustee or beneficial owner or to another person that is a party to or is otherwise bound by a governing instrument; provided, that a governing instrument may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing."[48] Comparable provisions exist under Maryland and Massachusetts law for funds organized as Maryland corporations and Massachusetts business trusts.[49]

In contrast to other state statutes, however, the DSTA takes this approach one step further by permitting a governing instrument to restrict or eliminate a trustee's fiduciary duties under state law altogether. Specifically, the DSTA provides that to the extent that at law or in equity a trustee "has duties (including the fiduciary duties) to a statutory trust or to another trustee or beneficial owner or to another person that is a party to or is otherwise bound by a governing instrument, the trustee's … duties may be expanded or restricted or eliminated by provisions in the governing instrument; provided that the governing instrument may not eliminate the implied contractual covenant of good faith and fair dealing."[50]

Accordingly, the DSTA distinguishes between fiduciary duties and liability for breaches of fiduciary duty, and permits the two concepts to be independently addressed in the fund's governing instrument. Under this authority, a fund organized under the DSTA could choose to eliminate both fiduciary duties and liabilities to the fullest extent permitted by Delaware law.[51] Although there are still certain duties (and liabilities) that cannot be eliminated under the 1940 Act, as discussed elsewhere in this article, these sorts of provisions in a fund's governing instrument, coupled with standard indemnification provisions, indemnification agreements and/or third-party insurance, provide broad protection to persons serving on fund boards, particularly funds organized as Delaware statutory trusts.[52]

B. 1940 Act Constraints

Section 17(h) of the 1940 Act prohibits a fund from including in its governing instrument, or in any other instrument pursuant to which such fund is organized or administered, any provision that protects or purports to protect any director against liability to the fund or its shareholders for "willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his [or her] office." Section 17(h) is intended to balance the need to ensure that funds have the ability to indemnify directors for liability arising out of actions that they took in good faith with the need for funds and their shareholders to be able to hold fund directors personally accountable for their actions as directors. The Staff of the SEC has interpreted Section 17(h) as a substantive restriction on a fund's ability to indemnify, as well as advance expenses to, its directors. Although Section 17(h) establishes a minimum standard of conduct for fund directors, it is not a particularly high standard, given that indemnification for negligence is permitted.

The SEC Staff has taken the position that an indemnification provision is acceptable under Section 17(h) if it (1) precludes indemnification for any liability arising by reason of a director's willful misfeasance, bad faith, gross negligence, or reckless disregard of duties as described in Section 17(h) (disabling conduct), and (2) sets forth "reasonable and fair means" for determining whether indemnification shall be made.[53] In the Staff's view, "reasonable and fair means" include (a) a final decision on the merits by a court or other body before whom the proceeding was brought that the director to be indemnified was not liable by reason of disabling conduct, or (b) a reasonable determination, based upon a review of the facts, that the director was not liable by reason of disabling conduct, by (1) the vote of a majority of a quorum of the fund's independent directors who are not parties to the proceeding, or (2) independent legal counsel in a written opinion.[54] However, the Staff has stated that an indemnification provision that requires or permits indemnification *except* when the person to be indemnified has been adjudged by a court to be liable by reason of disabling conduct violates Section 17(h) since it would, for example, protect a person whose conduct constitutes disabling conduct but who avoids judgment by settlement.[55]

The SEC Staff has also indicated that an indemnification provision that permits advances for attorneys' fees and similar expenses is generally permissible under Section 17(h) provided that (1) the director undertakes to repay the advance unless it is ultimately determined that the director is entitled to indemnification, and (2) either (a) the director provides security for the undertaking, (b) the fund is insured against losses arising by reason of any such advances, or (c) a majority of a quorum of the independent, non-party directors, or an independent legal counsel in a written opinion, determines, based on a review of readily available facts, that there is reason to believe that the director ultimately will be found entitled to indemnification.[56]

A fund may purchase liability insurance to protect itself and its directors against liability, or it may obtain a joint liability insurance policy with its affiliated persons (for example, its investment adviser) to provide such protection, provided that, with respect to the latter, the requirements of Rule 17d-1(d)(7) under the 1940 Act must be satisfied.[57] However, the SEC Staff has stated that a fund may not pay for any such insurance that protects directors against liabilities arising from disabling conduct, unless (1) the insurance merely provides for payment to the fund of any damages caused by the director and (2) the insurer is subrogated to the rights of the fund to recover from the director.

Section 17(h), then, prohibits a fund from directly indemnifying a director for disabling conduct and precludes the fund from indirectly indemnifying the director for such conduct through insurance or, presumably, other means, such as a separate indemnification agreement. However, the Staff has stated that directors might be permitted to obtain insurance against such misconduct if they pay for it themselves.[58]

VI. Conclusion

While the fiduciary duties of fund directors under state law are fairly well defined by statute and/or common law, the same is not true with respect to a fund director's fiduciary obligations under Section 36 of the 1940 Act. It is clear the standard of care under the 1940 Act is higher than what is required under state law; however, courts disagree regarding exactly what action (or inaction) constitutes "personal misconduct" under Section 36(a). This coupled with the increasing responsibilities of fund boards under the 1940 Act and the specter of SEC enforcement or shareholder litigation makes it imperative for directors to consider ways in which to perform their board functions in good faith, with due care, and with the best interests of shareholders in mind while at the same time seeking to minimize their liability to the extent possible through careful drafting of governing instruments.

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NOTES

1 *See, e.g.*, *Random House Dictionary of the English Language Unabridged* 528 (1966); *Webster's Third New Int'l Dictionary of the English Language Unabridged* 845 (1981); *Am. Heritage Dictionary of the English Language* 656 (4th ed. 2006).

2 *Black's Law Dictionary* 743 (10th ed. 2014).

3 Funds are commonly organized as statutory trusts under Delaware law, corporations under Maryland law, or business trusts under Massachusetts law. Regardless of the form of organization, the state law fiduciary concepts discussed here apply to all fund directors, except as otherwise noted.

4 3A William Meade Fletcher *et al.*, *Fletcher Cyclopedia of the Law of Corporations*, § 1032 (perm. ed., rev. vol. 2011). *See also* Robert A. Robertson, "Fund Governance: Legal Duties of Investment Company Directors" § 2.04 (2017) [hereinafter Robertson].

5 Edward Brodsky & M. Patricia Adamski, *Law of Corporate Officers and Directors – Rights, Duties and Liabilities,* § 2:1 (2017) [hereinafter Brodsky & Adamski].

6 *See, e.g.,* Section 15(c) of the 1940 Act, which provides in relevant part, that "[i]t shall be the duty of the directors of a registered investment company to request and evaluate … such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser." *See also* Rule 12b-1(d) under the 1940 Act, which contains similar language as it relates to the directors' decision to implement and/or continue a Rule 12b-1 plan.

7 Thomas J. Dougherty, *The Directors' Handbook,* § 1.1.1 (2016) [hereinafter Dougherty].

8 Brodsky & Adamski, *supra* n.5, at § 3:1. *See also* Robertson, *supra* n.4, at § 2.05.

9 Dougherty, *supra* n.7, at § 1.1.2.

10 The business judgment rule does not, however, absolve directors in all circumstances. *See* discussion regarding Section 17(h) of the 1940 Act in Section V(B).

11 Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (under the business judgment rule, director liability is predicated upon concepts of gross negligence).

12 12 Del. Code § 3801 (2017).

13 12 Del. Code § 3302(a). *See also* Lockwood v. OFB Corp., 305 A.2d 636 (Del. Ch. 1973).

14 *See, e.g.,* Evangelist v. Fidelity Management & Research Co., 554 F. Supp. 87 (D. Mass. 1982).

15 Kenny v. Pac. Inv. Mgmt. Co., No. 14-1987, 2016 WL 6836886 (W.D. Wash. Nov. 21, 2016).

16 Generally speaking, the attorney-client privilege protects confidential disclosures made by a client to an attorney in order to obtain legal advice, as well as an attorney's advice in response to such disclosures and communications made between an attorney and client in anticipation of litigation. *See, e.g.*, Colton v. United States, 306 F.2d 633, 637 (2d Cir. 1962).

17 In those jurisdictions where it is recognized, the "fiduciary exception" precludes a fiduciary from asserting the attorney-client privilege against beneficiaries who seek disclosure of fiduciary-attorney communications. Essentially, application of the fiduciary exception to the attorney-client privilege requires disclosure of such communications to beneficiaries where the fiduciary sought the legal advice in exercising the fiduciary's duties and responsibilities on the theory that the fiduciary's duty to administer the trust solely for the benefit of the beneficiaries takes priority over the attorney-client privilege. *See e.g.,* United States v. Jicarilla Apache Nation, 564 US 162 (2011).

18 In fact, a recent court filing shows that the fund's independent trustees have decided not to appeal the district court's decision. Instead, the trustees reached an agreement with plaintiff's attorneys that establishes a framework for sharing and reviewing the emails and other documents at issue. Kenny v. Pac. Inv. Mgmt. Co., No. 14-1987 (W.D. Wash. Feb. 22, 2017) (stipulation and order re: independent trustee discovery).

19 For a number of reasons, our view is that the *Kenny* decision will not have broad applicability. First, given that the decision was a "written" but not "published" decision, we believe it is less likely that it will be formally relied upon by other courts as precedent. Further, we do not believe the decision is good law. No other court has ever recognized a fiduciary exception to the attorney-client privilege in the context of the fund industry with respect to communications between independent directors and their independent counsel. Additionally, the precedent case on which the *Kenny* court relied concerned a common law trust, which is critically different from a fund organized as a business or statutory trust. Common law trusts were originally developed by courts in order to allow property to be divided such that a fiduciary would hold legal title to property on behalf of another who held equitable title. *See* Carly Howard, "Trust Funds in Common Law and Civil Law Systems: A Comparative Analysis," *13 U. Miami Int'l & Comp. L. Rev*. 343, 345 (2006). By contrast, business or statutory trusts are created and governed pursuant to a statutory framework, and are often used as legal entities for the conduct of business.

20 Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the S. Comm. On Banking and Currency, 76th Cong. 37 (1940) (statement of Hon. Robert E. Healy, Commissioner, Securities and Exchange Commission).

21 *Interpretive Matters Concerning Independent Directors of Investment Companies*, Release No. IC-24083, at n.55 (Oct. 14, 1999).

22 Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and H.R. 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce, 90th Cong. 75 (1967) (statement of Hon. Manuel F. Cohen, Chairman, Securities and Exchange Commission).

23 Steadman v. SEC, 603 F.2d 1126, 1141-42 (5th Cir. 1979) (quoting Brown v. Bullock, 194 F. Supp. 207, 238-39 n.1 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961)).

24 As discussed previously, Section 36(b) provides that an investment adviser to a fund has a fiduciary duty with respect to the receipt of compensation for services or other payments of a material nature paid by the fund to the adviser or an "affiliated person" of the adviser. Interested directors are often affiliated persons of the investment adviser.

25 *Bearing of Distribution Expenses by Mutual Funds*, Release No. 33-6254 (Oct. 28, 1980).

26 *Id.*

27 Tannenbaum v. Zeller, 552 F.2d 402, 416 (2d Cir. 1977).

28 *Id.* at 417-18.

29 *See, e.g.*, Forsythe v. Sun Life Fin., Inc., 417 F. Supp. 2d 100 (D. Mass. 2006).

30 Bellikoff v. Eaton Vance Corp., 481 F.3d 110 (2d Cir. 2007). *See also* 4 Tamar Frankel & Arthur B. Laby, "The Regulation of Money Managers" § 35.03[C] (3d ed. 2015) ("Several pre-2005 decisions reflected that section 36 affords a private right of action if breach of fiduciary duty is based on a violation of other sections of the 1940 Act. If a general breach of fiduciary duty is alleged, however, one court observed that a private suit should 'more properly be brought in state court' ").

31 *Steadman, supra* n.23.

32 Young v. Nationwide Life Ins. Co., 2 F. Supp. 2d 914, 927 (S.D. Tex. 1998) (citation omitted).

33 Prescott v. Allstate Life Ins. Co., 341 F. Supp. 2d 1023, 1029 (N.D. Ill. 2004).

34 *See* text accompanying n.26.

35 *See* text accompanying n.21.

36 *Tannenbaum supra* n.27.

37 In re Franklin Mut. Funds Fee Litig., 478 F. Supp. 2d 677 (D.N.J. 2007) (in which fund shareholders alleged that directors failed to exercise due care when approving Rule 12b-1 fees paid to the fund's distributor and adviser and failed to obtain the information necessary to evaluate the use of Rule 12b-1 fees).

38 Laborers' Local 265 Pension Fund v. iShares Trust, 769 F.3d 399 (6th Cir. 2014).

39 Hamilton v. Allen, 396 F. Supp. 2d 545 (E.D. Pa. 2005).

40 Smith v. Oppenheimer Funds Distrib., 824 F. Supp. 2d 511 (S.D.N.Y. 2011) (in which the plaintiff alleged fund trustees had a duty to ensure broker-dealers were paid only in transactional commissions).

41 While our focus is on actions brought against the board under the 1940 Act for breach of fiduciary duty, private litigants are always free to bring similar actions against the board under state law. A relatively recent ruling by the Ninth Circuit Court of Appeals makes it easier for private litigants to do just that, permitting direct actions against directors because, in the court's view, the process for bringing derivative actions is inapt in the mutual fund setting. *See* Northstar Fin. Advisors Inc. v. Schwab Investments, 779 F.3d 1036 (9th Cir. 2015).

42 Aldred Inv. Trust v. SEC, 151 F.2d 254, 260 (1st Cir. 1945).

43 *Id.*

44 SEC v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972).

45 *Id.* at 55 n.21.

46 SEC v. Treadway, 430 F. Supp. 2d 293, 341 (S.D.N.Y. 2006).

47 *Id.* at 342.

48 Section 3806(e) of the DSTA (12 Del. Code § 3806(e)). Under Delaware law, every contract has an obligation of good faith and fair dealing, which is implied into the agreement by law. As such, each party to a contract makes an implied covenant to act reasonably to fulfill the intent of the parties to the agreement. This implied covenant was created to promote the spirit of the agreement and to protect against one side using underhanded tactics to deny the other side of the fruits of the parties' bargain. Chamison v. Healthtrust, Inc., 735 A.2d 912, 920 (Del. Ch. 1999), *aff'd*, 748 A.2d 407 (Del. 2000). Although this implied covenant has been addressed by the Delaware courts many times, rather than attempting to articulate an all-encompassing definition of the term to guide parties in the future, courts have applied the doctrine in a fact-intensive, case-by-case fashion. Nevertheless, the common principle that flows throughout these interpretations is that the covenant implies terms into a contract to protect and fulfill each party's reasonable expectations. *See, e.g.*, Mohsen Manesh, "Express Contract Terms and the Implied Contractual Covenant of Delaware Law," *38 Del. J. Corp. L.* 1 (2013). As a result, there appears to be a relatively low bar for assessing whether directors' conduct has met this standard under Delaware law. In the case of a fund organized under the DSTA, the primary contract at issue is the fund's governing instrument (*i.e.,* the agreement and declaration

of trust). However, at least as it relates to funds organized as Massachusetts business trusts, one court has concluded that a contract exists between trustees and shareholders in the form of the fund's registration statement (including its prospectus). *See* Northstar Fin. Advisors Inc. v. Schwab Investments, *supra* n.41 (the fund's deviation from the disclosures contained in its registration statement could form the basis for a breach of contract claim), *cert. denied*, 136 S. Ct. 240 (2015).

49 *See* e.g., §§ 2-405.1 and 2-405.2 of the Maryland General Corporate and Associations Law. There is no statutory limitation of liability applicable to Massachusetts business trusts; however, Massachusetts courts have permitted liability limiting provisions to be included in the trust instrument. For a general discussion of the Massachusetts business trust, *see* Charles E. Rounds, Jr. & Andreas Dehio, "Publicly-Traded Open-End Mutual Funds in Common Law and Civil Law Jurisdictions: A Comparison of Legal Structures," 3 *N.Y.U J.L. & Bus*. 473 (2007).

50 Section 3806(c) of the DSTA.

51 For a detailed discussion of this topic, *see* J. Weston Peterson, "Investment Companies Organized as Delaware Statutory Trusts: Practical Considerations for Drafting Governing Instruments," *The Investment Lawyer*, (Jan. 2008) at 1.

52 To address the 1940 Act constraints, a fund organized under the DSTA could eliminate state law fiduciary duties and liabilities, while including a savings clause subjecting such provision to the requirements of the 1940 Act, as applicable.

53 *Indemnification by Investment Companies*, Release No. IC-11330 (Sept. 4, 1980).

54 *Id.* The SEC Staff's view on indemnification (and advancement of expenses, discussed in text accompanying note 56) is generally consistent with state indemnification statutes. *See, e.g.,* Section 3817 of the DSTA; Md. Code, Corps. & Ass'ns § 2-418.

55 *Indemnification by Investment Companies*, *supra* n.53.

56 *Id.* In this same release, the Staff stated that an improper indemnification payment or advance of legal expenses could constitute a breach of fiduciary duty involving personal misconduct under Section 36 of the 1940 Act or an unlawful and willful conversion of fund assets under Section 37 of that Act. Separately, the SEC Staff, in a no-action letter, said that independent counsel could proceed to issue an opinion permitting advancement of expenses under a rebuttable presumption that the directors in question did not engage in disabling conduct. *See The Yacktman Funds, Inc.*, SEC No-Action Letter, 1998 WL 895653 (Dec. 18, 1998). Such a presumption could be rebutted by evidence that the directors had engaged in such conduct. Following the *Yacktman* no-action letter, the SEC Staff extended this rebuttable presumption to situations where the disinterested, non-party directors make the reasonable belief determination. *See Interpretive Matters Concerning Independent Directors of Investment Companies*, Release No. IC-24083 (Oct. 14, 1999). The SEC Staff also stated its view that disinterested, non-party directors or independent legal counsel must make a reasonable belief determination *prior to* each advance of legal fees to fund directors.

57 Rule 17d-1(d)(7) under the 1940 Act provides that a joint liability policy is permissible provided that (1) the fund's participation in the policy is in the best interests of the fund; (2) the proposed premium for the policy to be allocated to the fund, based upon its proportionate share of the sum of the premiums that would have been paid if such insurance coverage were purchased separately by the insured parties, is fair and reasonable to the fund; (3) the policy does not exclude coverage for bona fide claims made against any director who is not an interested person of the fund, or against the fund if it is a co-defendant in the claim with the disinterested director, by another person insured under the joint liability insurance policy; (4) the board, including a majority of the directors who are not interested persons, determine no less frequently than annually that the standards described in clauses (1) and (2) above have been satisfied; and (5) the board satisfies the fund governance standards defined in Rule 0-1(a)(7) under the 1940 Act.

58 *See Exemption of Certain Joint Purchases of Liability Insurance Policies*, Release No. IC-10891 (Oct. 4, 1979).