Directors of Mutual Funds: Special Problems

By MARTIN LIPTON*

IN THE investment company and mutual fund area we have a separate body of statutory and case law that is significant for the analogies that can be drawn to the general company area. Mutual funds over the past ten years have attracted a great deal of derivative and class action litigation challenging the judgments of the outside directors and the external management companies.

The director of a mutual fund, and particularly the outside independent director, or to use the statutory term, the "disinterested" director, has a special problem that arises from the external management arrangement of most mutual funds. There is a continuing conflict between the interest of the shareholders of the mutual fund and the interest of the management company. The Investment Company Act of 1940 makes the independent director the special guardian of the shareholders interest.

I will focus on two particular problems of outside directors of mutual funds. First, what the outside directors must consider when making the fundamental decision as to the advisory, and in some cases brokerage arrangements, between the fund and the management company. Second, the important role played by counsel and committees of independent directors in assuring that the board fulfills its duty, and of equal or maybe even greater importance, assuring that the board is able later to prove that it has fulfilled this duty when hindsight reveals that indeed there was an alternative course of action that would have been more favorable to the fund.

Recent cases in the area of recapture of brokerage commissions by funds best illustrate the point. Before May 1 of this year when brokerage commissions were fixed it was possible for mutual funds—through the use of various devices that I will not go into—to recapture for the benefit of the fund a portion of fixed brokerage commissions. Some mutual fund management companies created elaborate structures in order to achieve that recapture and thereby reduce the advisory expenses of the funds that they managed. Other management companies did not recapture for the benefit of their funds.

In some cases brokerage commissions were used by the management companies to promote the sale of fund shares or to obtain research that was used in connection with the investment management of the fund. There is an obvious self-interest in a management company using brokerage commissions for the promotion of the sale of shares of a fund or to obtain research that otherwise would have to be supplied by the management company itself. It might be expected that the use of mutual fund brokerage commissions

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and the recapture question would be litigated on behalf of the shareholders of mutual funds. The first case was *Moses* v. *Burgin*.[1]

In *Moses* v. *Burgin* the management company had not set up a structure for the recapture of brokerage commissions by the funds that it managed and, in fact, the testimony was that the outside directors of the fund were not aware of the ability to recapture. The court held that the management company and the management company affiliated directors had violated their duties to the fund in not having disclosed to the outside directors the ability to recapture and in not having had the outside directors consider and pass on the issue.

What is most interesting about the decision is that, after having found that the inside directors and the management company, violated the act, the court said, "the unaffiliated directors were not shown to have had any knowledge of the possibility of recapture. Nor did they have any personal conflicting interest which should have sharpened their attention. The plaintiff did not show that the unaffiliated directors violated any duty to discover and explore the issue on their own; recapture was a new problem, and they were entitled to rely on the management defendants, who devoted full time to the investment industry, to advise them of its emergence. While the unaffiliated directors are not free of all obligations to consider matters on their own, we see no basis for holding them in this case."

Notwithstanding the decision in *Moses* v. *Burgin*, one would not want to say that nothing need be done by the outside directors in the absence of information from the inside directors of management. *Tannenbaum* v. *Zeller*[2] illustrates my point.

The *Tannenbaum* v. *Zeller* case illustrates just what should be done in a mutual fund conflict situation such as brokerage recapture. I think it is as applicable to general business corporations as it is to mutual funds.

There were a number of things that the court found significant in holding that not just the outside directors but the management directors and the management company had fulfilled their duties. The basic facts were exactly the same as *Moses* v. *Burgin*: No brokerage recapture arrangement had been instituted, and the brokerage commissions were used to compensate brokers for supplying research and selling shares of the fund.

The first thing the court mentioned was that there was indeed full disclosure by the management company and the management directors to the outside directors.

Second, the management company had a good reason for not being involved in recapture. The management company had determined that there was a conflict in acting as both broker and advisor for a fund and it did not want to have that conflict and be involved in the brokerage business.

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1. 445 F.2d 369 (1st Cir.), *cert. denied* 404 U.S. 991 (1971).
2. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 92,257 (S.D.N.Y. 1975).

Third, and most significant, there was periodic review by the board of directors. The court referred to periodic reviews—which it characterizes as extensive—and the physical documentation of such reviews. There were minutes and memoranda that reflected what the board had considered.

The court notes that the board was regularly supplied with the latest information about developments in the field of recapture. For a number of years, there were continuing developments. Cases were being decided, pronouncements were being made by the SEC, rules were being proposed, and so on. Each time that there was a significant development in the recapture area the management informed the outside directors and the outside directors considered the new development and documented such consideration. Because of the conflict situation such consideration was undertaken by a sub-committee of outside directors so that no management directors were involved in the direct consideration. The sub-committee did not rely solely on the information supplied by management. It sought the advice of outside counsel.

The court said: "On the basis of this record, it is clear over the years that the board's unaffiliated directors have given careful consideration to the issues raised by the plaintiff. The board has examined the practices each year, noted what methods were available for the fund to recapture excess brokerage commissions but each time has concluded that it should not do so." Then finally the court said, "What is involved here is the exercise of a good faith business judgment. On the facts developed before me, I have no basis for finding that the board failed to exercise such care and diligence in respect of the matters in controversy that careful and prudent men could reasonably be expected to exercise under similar circumstances. When questions arose the board sought and relied upon the advice of counsel which alone is sufficient to free them of liability."

The lesson to be learned from *Moses* v. *Burgin* and *Tannenbaum* v. *Zeller* is that careful advance preparation, documentation, resort to advice of counsel, and use of committees of independent directors can indeed establish that directors have completely fulfilled their duties.

The next question is what does a board of directors consider when passing on the advisory contract between the fund and the management company? You can't just find a more cogent example of conflict than the advisory contract. How should a board approach the problem?

Section 15 of the 1940 Act sets forth that the independent directors of the fund must request and evaluate such information as may reasonably be necessary to evaluate the terms of any such arrangement. In practical effect this is no more than a codification of the directors' duty of care with respect to any significant matter.

A short checklist of the things that might be considered by a board in passing on the advisory arrangements are: the actual amount of all compensation paid to the advisor; the expenses incurred by the advisor attributable to the fund and the general profitability to the advisor of its services to the fund (frequently a list of the employees and services performed and a basis for the allocation of costs is presented as part of the profitability information); a comparison of the advisory fee arrangements that other investment advisors have with funds with similar objectives and investment techniques and a comparison of the operating expenses of those funds with the fund in question; information with respect to the degree to which advisory services required by the fund are actually performed by the advisor rather than by other firms in exchange for the allocation of brokerage; information as to the receipt by the advisor of any indirect forms of compensation, such as brokerage commissions in those cases where the advisor acts as a broker for the fund; information with respect to the performance of the fund including comparative performance with other funds; and finally, information with respect to how the advisor allocates investment opportunities between the fund in question and any other accounts that the advisor may manage. That is not an exhaustive list. It's an illustrative list of the kinds of things that should be considered by the board of directors.

I'd like to turn at this point to the role played by counsel and special committees. I believe that mutual funds should have separate counsel. Either the independent directors of a fund should have separate counsel or the fund itself should have separate counsel. That is, separate counsel from counsel for the management company. Independent counsel plays a very important role.

I think this role is best illustrated by *Lasker* v. *Burks*.[3] In that case the directors and the management company were being sued in a derivative action which alleged violations of the Investment Company Act and the Investment Advisers Act, for bad portfolio investments that the management company had made for the fund. In connection with the suit, the board of directors created a special committee consisting only of disinterested directors who were not defendants in the action. That committee retained special independent counsel who then advised that there had been no violation of the Acts and the committee determined that continued prosecution of the action was not in the best interests of the shareholder of the fund. The court said:

> This court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the board has no power to exercise its business judgment because of the strong public policies behind those Acts.
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> Unlike Section 16(b) of the Securities Exchange Act, which allows shareholders to bring suit if the directors decline a demand, Congress

3. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,297 (S.D.N.Y. 1975).

> has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Acts.
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> It is true that causes of action under those Acts are implied rights of action . . . It does not necessarily follow that because the right is implied, a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue.
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> This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is "implied," the directors of a corporation should be given the chance to perform their duties in running the business of the corporation, including whether to prosecute a cause of action.
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> If they have exercised their business judgment in good faith, then a decision not to sue should be final.

There is a very important lesson to be learned from *Lasker* v. *Burks*. Frequently, derivative actions will terrorize a board of directors and frequently they will be strike suits. Often they are settled in order to avoid expensive litigation or exposure to the possibility of very large damages. I think that *Lasker* v. *Burks* points out a method that can be used, not just with respect to mutual funds, but any corporation that's faced with a suit that the directors believe to be without merit. The creation of a committee of independent directors who are not involved in the suit and the advice to such a committee of counsel or, in an appropriate case involving a different issue, other advisors have generally been accepted by the courts as a proper exercise of business judgment which will not be second-guessed.

I think that *Lasker* v. *Burks* clearly points up the desirability of special committees for special situations and the general committees that Sam Harris mentioned before and the role that can be played by independent counsel as illustrated by *Tannenbaum* v. *Zeller*.