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JUDICIAL DEFERENCE TO MUTUAL FUND BOARDS: LESSONS FROM POST-*JONES* EXCESSIVE FEE LITIGATION

Following on the Supreme Court's Jones *decision, the plaintiffs' bar filed a large wave of actions claiming that mutual funds paid excessive fees to their advisers. The authors analyze this litigation. They focus first on plaintiffs' challenges to the independence and qualifications of independent directors. They then turn to plaintiffs' claims that board processes for reviewing and approving fees were deficient. Although all of plaintiffs' claims have been rejected by the courts, the authors conclude that new fee litigation is "almost certain" and that recent decisions provide valuable insights into current best practices for fund directors.*

By Sean M. Murphy, Robert J. Liubicic, and Ayana Sumiyasu *

Mutual funds are a more than $21 trillion industry, a fact not lost on the plaintiffs' bar.[1] In 1970, Congress enacted Section 15(c) of the Investment Company Act (the "ICA"), the primary federal statute governing mutual funds, which set forth the role of independent directors of mutual funds in reviewing and approving investment advisory contracts and other contracts that establish the fees charged to fund shareholders. At the same time, Congress enacted Section 36(b) of the ICA, which established a fiduciary duty on the part of fund advisers with respect to their receipt of fees, and provided fund shareholders with a private right of action to assert claims for breaches of that duty.[2] Since 1970, the industry has contended with multiple waves of largely attorney-driven Section 36(b) suits based on evolving theories of liability.

In 2010, the Supreme Court held in *Jones v. Harris Associates L.P.* that, to establish liability under Section 36(b), a plaintiff must show that an investment adviser charged a fee "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."[3] In doing so, the Court held that a lower court must consider "all relevant circumstances," including the six-factor framework for assessing Section 36(b) claims set forth in the Second Circuit's 1982 decision in *Gartenberg v. Merrill Lynch Asset Management, Inc.*[4] The "*Gartenberg* factors," which

[1] Investment Company Institute, *2020 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry* (60th Ed.) at 31.

[2] Investment Company Act of 1940, § 36(b), 15 U.S.C.A. § 80a–35(b).

[3] *Jones v. Harris Assocs. L.P.*, 559 U.S. 335, 346 (2010).

[4] *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982).

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FORTHCOMING

- ***REGULATORY EXPECTATIONS FOR CYBERSECURITY AT BROKER-DEALERS***

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were widely adopted by federal courts nationwide in the years prior to *Jones*, require that a court consider:

- the nature and quality of the services provided to the fund and fund shareholders;
- the profitability of the fund to the adviser;
- comparative fee structures — *i.e.*, how the fees the adviser charges the fund compare to the fees charged to comparable investment products;
- economies of scale realized by the investment adviser;
- "fall-out benefits" — *i.e.*, indirect benefits — that accrue to the adviser as a result of its relationship with the fund; and
- the independence and conscientiousness of the fund's independent directors in evaluating adviser compensation.[5]

While all of the *Gartenberg* factors are important and no one factor is dispositive, the independence and conscientiousness of a fund's directors is particularly significant. Independent directors play an important role in ensuring that the fees charged to mutual fund shareholders are fair. The Supreme Court in *Jones* re-emphasized the role of independent directors, noting that the *Gartenberg* standard reflects Congress's decision to "rely largely upon independent director 'watchdogs' to protect shareholder interests."[6] That reliance has major implications for a court's application of the *Gartenberg* factors in a Section 36(b) suit. As the Supreme Court explained, courts must look to the board's decision-making process both to "calibrat[e] the degree of deference that is due a board's decision to approve an adviser's fee" and to assess the "independence and conscientiousness" factor under *Gartenberg*.[7]

Crucially, "if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to *considerable weight, even if a court might weigh the factors differently*."[8] Put somewhat differently, "the standard for fiduciary breach under [Section] 36(b) does not call for judicial second-guessing of informed board decisions."[9] Thus, if a court is satisfied that the fund's independent directors, and the process they followed in approving the fees at issue, pass muster, a plaintiff's burden on the remaining five *Gartenberg* factors is materially heavier. By contrast, "where the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome."[10] For these reasons, the board's review of the challenged fees is subject to intense scrutiny by plaintiffs in Section 36(b) actions and the independent directors of the board are often critical witnesses at trial.

To the surprise of some industry observers, in the years following *Jones,* the plaintiffs' bar filed a large wave of Section 36(b) actions: between 2010 and 2016, more than two dozen such suits were filed. Most of those suits were based on one of two theories. The first, alleging what is known as the "manager-of-managers" theory, claims that where an investment adviser delegates a portion of its investment advisory responsibilities to a third-party subadviser, the portion of the advisory fee retained by the investment adviser is excessive in relation to the services the adviser itself provides. The second, alleging what is known as the "reverse subadviser" theory, claims that the advisory fee charged by an investment adviser for its proprietary funds is excessive when compared to the fees the same adviser charges when it acts as a subadviser to non-proprietary funds.

This post-*Jones* wave of Section 36(b) litigation has taken several years to work its way through the courts; as of today, nearly all cases have been resolved. While some of these suits were settled privately, likely

[5] *Jones v. Harris*, 559 U.S. at 344 & n.5.

[6] *Id.* at 353 (quoting *Burks v. Lasker*, 441 U.S. 471, 485 (1979)).

[7] *Id.* at 352.

[8] *Id.* at 351 (emphasis added).

[9] *Id.* at 352.

[10] *Id.* at 351.

resulting in recoveries for plaintiffs and their counsel, the cases that were litigated fully have been overwhelmingly unsuccessful for plaintiffs. Six cases were resolved at trial between 2016 and 2020, all of them in favor of defendants.[11] Five cases were decided at summary judgment during the same period, all of them in favor of defendants. In every one of these cases, the courts concluded that the independent directors of those funds were independent and conscientious, and that the boards' approvals of the at-issue fees were entitled to deference.

In this article, we examine the attributes of independent directors and boards that courts in post-*Jones* cases have found persuasive when concluding substantial deference was warranted to a board's approval of fund fees. We begin at the individual director level, analyzing how courts have evaluated directors' independence and qualifications. We then move to the board-entity level, examining how courts consider a board's overall process for reviewing and approving fees. Our analysis reveals numerous best practices that directors and boards can follow to most effectively defend the decisions they make from attacks by Section 36(b) plaintiffs.

I. INDEPENDENCE AND QUALIFICATIONS OF INDEPENDENT DIRECTORS

A. Independence

"Supermajorities" of independent directors. Congress's ultimate goal in passing the ICA was to protect shareholders by preventing conflicts of interests between mutual funds and their investment advisers. To that end, the ICA requires that at least 40 percent of a fund board be composed of "disinterested" directors — *i.e.*, directors that are independent of the adviser.[12] While not required, in recent years the percentage of disinterested directors who sit on mutual fund boards has risen well above this mandated 40-percent floor: the Investment Company Institute ("ICI"), a leading source of mutual fund industry guidance, reports that "[b]etween 1996 and 2018, the number of [mutual fund] complexes reporting that independent directors hold 75 percent or more of board seats rose from 46 percent to 84 percent."[13] This trend is also reflected in many recent Section 36(b) decisions; courts frequently note when a board has a "supermajority" of disinterested directors or is otherwise above the ICA's 40-percent floor.[14]

However, even boards with a "supermajority" of independent directors can benefit from input from interested directors — *i.e.*, directors affiliated with the adviser. In its "Practical Guidance for Fund Directors," the Mutual Fund Directors Forum ("MFDF") advises that, "[a]lthough having an independent board is important, inside directors contribute insights into the fund's day-to-day operations and inside industry knowledge not generally available to fund independent directors and can make important contributions to the governance of a fund."[15]

Independent board chairs and lead independent directors. In addition to satisfying the ICA's requirement of statutory independence, many fund boards appoint an independent board chair or lead independent director to promote the board's role as "independent watchdog" of the adviser. Indeed, ICI data

[11] *Sivolella v. AXA Equitable Life Ins. Co.*, No. 11-CV-4194 (PGS)(DEA), 2016 WL 4487857 (D.N.J. Aug. 25, 2016), *aff'd sub nom. Sivolella for use & benefit of EQ/Common Stock Index Portfolio v. AXA Equitable Life Ins. Co.*, 742 F. App'x 604 (3d Cir. 2018); *Kasilag v. Hartford Inv. Fin. Servs., LLC*, No. CV 11-1083 (RMB/KMW), 2017 WL 773880 (D.N.J. Feb. 28, 2017), *aff'd*, 745 F. App'x 452 (3d Cir. 2018); *In re BlackRock Mut. Funds Advisory Fee Litig.*, No. CV-14-1165 (FLW)(TJB), 2019 WL 1387450 (D.N.J. Feb. 8, 2019), *aff'd,* No. 19-1557, 2020 WL 2781413 (3d Cir. May 28, 2020); *Kennis v. Metro. W. Asset Mgmt., LLC*, No. CV 15-8162-GW(FFMX), 2019 WL 4010747 (C.D. Cal. July 9, 2019), *adopted,* No. CV 15-8162-GW-FFMx, 2019 WL 4010363 (C.D. Cal. Aug. 5, 2019); *Chill v. Calamos Advisors LLC*, 417 F. Supp. 3d 208 (S.D.N.Y. 2019); *Obeslo v. Great-West Cap. Mgmt., LLC*, No. 16-CV-00230-CMA-SKC, 2020 WL 4558982 (D. Colo. Aug. 7, 2020).

[12] "'Disinterested' directors are, *inter alia*, those directors who are not 'affiliated' with the fund's investment adviser – *i.e.*, they are not 'controlled' by the investment adviser." *Kennis*, 2019 WL 4010747, at *21 n.41 (citing 15 U.S.C. §§ 80a–2(a)(19) & 80a–2(a)(3)).

[13] ICI, *Overview of Fund Governance Practices, 1994-2018* (hereinafter "ICI Overview") at 1 (Oct. 2019).

[14] *See, e.g.*, *Chill v. Calamos Advisors LLC*, No. 15 Civ. 1014 (ER), 2018 WL 4778912, at *3 (S.D.N.Y. Oct. 3, 2018) (noting that at all relevant times, the board was comprised of a "super-majority" of independent directors); *Sivolella*, 2016 WL 4487857, at *20 (same); *In re BlackRock Mut. Funds Advisory Fee Litig.*, 327 F. Supp. 3d 690, 713 (D.N.J. 2018) (same); *Kennis*, 2019 WL 4010747, at *21 (noting that "[a]t all times relevant, at least 75% of the membership of the entire Board (as well as the chairman of the Board)" was disinterested).

[15] MFDF, *Practical Guidance for Mutual Fund Directors: Board Governance and Review of Investment Advisory Agreements* at 3 (Oct. 2013).

shows that from 2010 to 2018, between 88 and 94 percent of mutual fund boards had an independent chair or lead independent director.[16]

A lead independent director can oversee the many activities of the board that go beyond regular board meetings. In *Sivolella*, for example, the lead independent director managed the board's comprehensive training regimen for new directors, personally assisting with "mini sessions," and setting up additional meetings with the independent directors' legal counsel and relevant personnel of the adviser to answer questions following the board's formal training sessions.[17] A lead director can also chair separate meetings of the independent directors, be responsible for coordinating with independent counsel, and facilitate communication among the directors and with the adviser. A lead independent director can be helpful for the adviser too, as "it can be useful to have a point of contact among the independent directors with whom management can discuss ideas informally."[18]

Plaintiffs have alleged that a board *must* have an independent chair to maintain its independence, but no court has found that an "interested" chair requires less deference to the board. For example, in *Sivolella*, the fund board was comprised of nine disinterested directors (who on that particular board were called "trustees"), including one lead independent director, and one "interested" director who served as CEO of the adviser and chair of the fund board.[19] Despite the board's "supermajority" of disinterested directors — which, the court acknowledged, "compli[ed] with the letter of the law" — the court noted plaintiffs' argument that the interested board chair posed a conflict of interest.[20] Specifically, the court found that the interested chair could be "biased as to the profits" of the adviser and "motivated to ensure that [the adviser] receives higher fees because he serve[d] as the CEO [of the adviser], rather than to protect the interest of investors."[21] This bias could call "into question whether [the interested chair] made accurate statements and presentations to the Board regarding the *Gartenberg* factors."[22] Consequently, the chair's so-called bias required "careful evaluation of the accuracy and quality of the information that [he] relayed to the Board."[23]

Ultimately, the *Sivolella* court concluded that the independent directors had maintained sufficient control over the board's decisions to "adequately address[] any potential conflict" posed by the interested chair.[24] While *Sivolella* is a relative outlier — several recent Section 36(b) decisions did not address the potential bias of an interested board chair[25] — the court's decision illustrates the potential litigation complications, whether deserved or not, that can arise when a board chair is not independent of the adviser. The independent directors should maintain sufficient control over the approval process to mitigate any such conflicts.[26] In many fund complexes with lead independent directors, but not an independent chair, the lead independent director controls the board's approval process, including having input into the agenda and the types of information the board receives. Courts have found this sufficient to establish the independence of the board even if there is an interested chair.

B. Qualifications

Relevant prior experience. It is standard practice for plaintiffs in Section 36(b) cases to paint independent directors as unqualified. Courts in Section 36(b) cases closely review the qualifications of independent directors, often noting with approval prior board and senior executive positions, including experience in the financial services industry.[27] Prior financial industry

[16] ICI Overview at 10.

[17] *Sivolella*, 2016 WL 4487857, at *25.

[18] ICI, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* at 25 (June 24, 1999).

[19] *Sivolella*, 2016 WL 4487857, at *20-21.

[20] *Id.* at *20.

[21] *Id.* at *12-13.

[22] *Id*. at *13.

[23] *Id.*

[24] *Id.* at *21 (finding credible testimony of the lead independent director that, "although [the interested chair] provides the information" considered during the 15(c) process, "it is the independent [directors] that run [the] Board" (citation omitted)).

[25] *Cf. Zehrer v. Harbor Cap. Advisors, Inc*., No. 14 C 00789, 2018 WL 1293230, at *4 (N.D. Ill. Mar. 13, 2018) (discussing testimony of fund board's lead independent director and not addressing potential bias of interested chair); *Chill*, 2018 WL 4778912, at *3 (same).

[26] *See also Kennis*, 2019 WL 4010747, at *21 (noting that "[o]nly Independent Trustees were involved in making the decision as to the . . . adoption of the advisory fee").

[27] *See, e.g., Kasilag v. Hartford Inv. Fin. Servs., LLC,* No. CV 11-1083 (RMB/KMW), 2016 WL 1394347, at *5 (D.N.J. Apr. 7,

experience can be beneficial, allowing independent directors to draw upon this experience to analyze the often voluminous data provided to them by the adviser and assist in fulfilling their duties as independent watchdogs. That financial experience can take many forms. For example, in *Obeslo*, the court found that the independent chair of the board, an attorney, was well-qualified; among other things, the court noted her prior experience as the chair of the board of trustees of a prominent college, which included oversight of the college's billion-dollar endowment.[28]

As the foregoing suggests, direct mutual fund industry experience is certainly not a prerequisite to being qualified to serve on a mutual fund board. Indeed, the court in *In re Blackrock* noted with approval that the board "was comprised of a supermajority of well-qualified individuals . . . hailing from diverse professional backgrounds, including chief executive officers of various corporations, law firm partners, former high-ranking government officials, and a graduate professor at Harvard University's Graduate School of Business Administration."[29] The board in *Kasilag* was similarly diverse: the qualified directors of the Hartford mutual funds board included the former president of a private liberal arts college, the CEO of a residential property management company, and a professor of finance at the University of Maryland.[30] Such diversity of experience is generally considered a positive attribute of a fund board and is encouraged in industry guidance.[31]

Alleged "cozy" relationships with the adviser. When plaintiffs aren't questioning the qualifications of directors who lack direct mutual fund industry experience, they often criticize the directors who *do* have such experience for being too sympathetic to the adviser. A number of Section 36(b) plaintiffs have challenged — largely unsuccessfully — the independence of a fund board based on perceived "cozy" relationships with the adviser and a lack of diversity of experience among the directors. For example, plaintiff in *Zehrer* questioned the independence of the board by pointing to the directors' "deep and extensive ties with investment advisory firms . . . ."[32] Plaintiff did not dispute that the fund board satisfied the ICA's requirement that at least 40 percent of directors be disinterested. Rather, plaintiff argued that the directors' prior mutual fund industry experience made them "predisposed to believ[e] that investment advisers . . . should be rewarded handsomely."[33] Likewise, plaintiffs in *In re Davis* argued on summary judgment that material issues of fact remained concerning the integrity of the board process because the directors had "deep ties to the financial services industry."[34] Similarly, the *Sivolella* court noted the "Wall Street leanings of the Board" and that "all [the directors] come from the same kind of perspective."[35]

The courts in *Zehrer, Davis*, and *Sivolella* ultimately rejected these arguments. As the *Zehrer* court concluded, "[c]oziness may indicate willingness to defer to an interested [director] but, without a financial or personal conflict (such as nepotism), it is not a breach of a fiduciary duty."[36] Still, while "deferring to [the adviser]'s judgment in certain undefined situations is not enough" to compromise a board's independence, directors should be mindful of their roles as "independent watchdogs" of the adviser and guard against potential conflicts, both actual and perceived.[37]

II. THE BOARD'S PROCESS FOR REVIEWING AND APPROVING FEES

While a mutual fund board has little power to prevent a plaintiff from filing a Section 36(b) suit, directors should recognize that the process they follow today for reviewing and approving fund fees will be closely

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2016) (noting that the board was "comprised of business professionals with impressive resumes").

[28] *Obeslo*, 2020 WL 4558982, at *3, *6.

[29] *In re BlackRock*, 327 F. Supp. 3d at 702-03, 713.

[30] *Kasilag*, 2016 WL 1394347, at *5.

[31] ICI, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* at 31 (June 24, 1999); MFDF, *Practical Guidance for Mutual Fund Directors: Board Governance and Review of Investment Advisory Agreements* at 5, 7 (Oct. 2013).

[32] *Zehrer*, 2018 WL 1293230, at *9 (citation omitted).

[33] *Id*. (citation omitted).

[34] *In re Davis N.Y. Venture Fund Fee Litig.*, No. 14 CV 4318-LTS-HBP, 2019 WL 2896415, at *9 (S.D.N.Y. May 30, 2019), *aff'd,* 805 F. App'x 79 (2d Cir. 2020).

[35] *Sivolella*, 2016 WL 4487857, at *22.

[36] *Zehrer*, 2018 WL 1293230, at *9; *see also In re Davis*, 2019 WL 2896415, at *10 ("Plaintiffs' generalized assertion that persons associated with the mutual fund industry cannot function as independent evaluators of mutual fund advisers is conclusory and speculative.").

[37] *Redus-Tarchis v. N.Y. Life Inv. Mgmt. LLC*, No. CV 14-7991, 2018 WL 5307546, at *13 (D.N.J. Oct. 10, 2018).

scrutinized in any future litigation. A robust, well-documented process of reviewing and approving the adviser's compensation — often called the "15(c) review" or "15(c) process"[38] — is crucial.

A. Active Involvement of Independent Directors

Evidence of the directors' active engagement in the 15(c) process can go a long way in demonstrating the robustness of the board's process. Courts have noted with approval the following practices of independent and conscientious boards:

- asking thoughtful and probing questions during board meetings;[39]

- submitting to the adviser — often with assistance of independent counsel — written requests for information pertinent to each *Gartenberg* factor;[40]

- requesting responses to additional follow-up questions prior to approving the adviser's fee;[41]

- updating requests for information "over time to include new topics";[42]

- holding special meetings as needed;[43] and

- meeting in executive session without representatives of the adviser present.[44]

These are just a few examples of the kinds of active involvement acknowledged by Section 36(b) courts. Independent directors must take it upon themselves to consider how they can best engage in the 15(c) process to make informed decisions with respect to their review and approval of the fees charged to the fund.

B. No Duty to "Negotiate" Fees

Courts may also point to evidence of "push and pull" between the board and the adviser — sometimes resulting in a reduction of fees or additional breakpoints — as evidence of a director's active engagement in the 15(c) process.[45] It is important to note, however, that

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[38] Section 15(c) of the ICA mandates that advisory contracts be approved by a majority vote of disinterested directors at an in-person "meeting called for the purpose of voting on such approval." 15 U.S.C. § 80a-15(c).

[39] *See, e.g., In re Davis*, 2019 WL 2896415, at *5 (During board meetings, "the independent directors asked multiple questions of Davis' representatives about topics including the Fund's performance, the Fund's positions in certain securities, fee levels of identified peer funds, Davis staff changes, and Davis' shareholder education initiatives."); *Chill*, 2018 WL 4778912, at *3 ("[I]t is undisputed that the Board engaged Calamos in *some* degree of questioning regarding the Fund's performance, Calamos' investment philosophy, and the structure of Calamos' investment team"); *Kennis*, 2019 WL 4010747, at *22 (prior to the 15(c) meeting, independent directors "have conference calls and/or in-person meetings" where they "get an opportunity to ask questions or seek more information"); *see also Kennis v. Metro. W. Asset Mgmt., LLC*, No. CV 15-8162-GW(FFMX), 2018 WL 8138778, at *9 (C.D. Cal. Oct. 25, 2018) (acknowledging that the board would regularly ask questions and finding that the board employed a "fairly robust" process).

[40] *See, e.g., Chill*, 2018 WL 4778912, at *3 (Prior to the 15(c) meeting, the independent directors, "through their counsel, submit a detailed set of written information requests to [Calamos] on topics pertinent to the Independent [Director]s' annual review . . . ." (internal quotation marks and citation omitted)); *Zehrer*, 2018 WL 1293230, at *5 ("In advance of the 15(c) review meeting," the board, through its independent counsel, "makes a written request to Harbor for information pertinent to what are known as *Gartenberg* factors . . . ."); *In re BlackRock*, 327 F. Supp. 3d at 704 (Prior to the 15(c) meeting, the independent directors and their counsel "submitted to

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BlackRock written questions and requests for additional information and materials.").

[41] *See, e.g.*, *In re Blackrock*, 327 F. Supp. 3d. at 704, 715; *Redus-Tarchis*, 2018 WL 5307546, at *4; *Kasilag*, 2016 WL 1394347, at *6.

[42] *In re Davis*, 2019 WL 2896415, at *4; *see also Kennis*, 2019 WL 4010747, at *8 (noting that the board's questions evolved over time "based on advice from [independent counsel] and changes in the industry").

[43] *See, e.g., Kasilag*, 2016 WL 1394347, at *5 ("[D]uring the relevant time period, the Board met regularly, holding quarterly meetings, annual educational meetings, and special meetings as needed."); *In re BlackRock*, 327 F. Supp. 3d at 703 (board would hold "additional ad-hoc in person or telephonic meetings as necessary").

[44] *See, e.g., In re Davis*, 2019 WL 2896415, at *5 ("Prior to the Board meetings, the independent directors would meet with their counsel and develop topics to discuss at the meeting.").

[45] *See, e.g., Kasilag*, 2016 WL 1394347, at *6 (granting summary judgment as to independence and conscientiousness of the board and acknowledging at least two instances where the board requested follow-up information from and discussion with the adviser, ultimately resulting in fee reductions and breakpoints).

"Section 36(b) does not require negotiation between a board of trustees and [a] fund investment adviser."[46] Therefore, the alleged failure of a board to "negotiate assertively" with the adviser for lower fees is "insufficient to demonstrate that the [b]oard's process was deficient."[47]

Courts consistently reject accusations by plaintiffs that fund boards are not independent and conscientious because they failed to "negotiate" with advisers in the manner one might expect two parties who are strangers to one another to negotiate over the price of an asset in a one-time, zero-sum exchange. For example, in *In re Davis*, the court rejected plaintiffs' argument that there were material issues of fact with respect to the board factor because (among other reasons) the board "did not attempt to negotiate a lower advisory fee" and "did not inquire about issues Plaintiffs contend[ed] were important."[48] As the court explained, "[b]ecause the [ICA] does not impose a duty on a board to negotiate assertively, Plaintiffs' assertion that the Board could have negotiated more aggressively does not provide a basis for a rational finding that the Board's review process was less than robust."[49] Similarly the plaintiff in *Zehrer* argued that the board was not entitled to deference because it had "passively approve[d] [the adviser's fees] year after year," and "fail[ed] to negotiate further fee reductions or additional breakpoints."[50] The court rejected plaintiff's assertion, finding that the board's "failure" to "actively negotiate fees" was insufficient to undermine their process.[51] It is thus clear that while evidence of negotiation may help to show that a board's process was robust, the independent directors have no affirmative duty to negotiate with the adviser, let alone to negotiate for the lowest fee possible.

C. Consideration of Total Expense Ratios

In assessing the information that the independent directors receive and consider, courts also often reject criticisms of the types of information the directors considered and the way in which they chose to weigh that information. For example, the court in *Chill* rejected plaintiffs' assertion that the board's process was deficient because the independent directors considered a comparison of a fund's total expense ratio ("TER") — which represents the total price paid by shareholders — rather than the advisory fee alone.[52] The court agreed with defendant's expert who opined "that to meaningfully compare the costs of different funds, it makes economic sense for a potential investor," and thus the independent directors, "to compare the funds' '*[total] expense ratios*,' which represent the fees that investors pay in exchange for the integrated bundle of services received."[53] The court also noted that, contrary to plaintiffs' claim, the independent directors did not "prioritize" the funds' TER, but rather considered the TER in its "review of *all* relevant data and factors in approving the fee each year."[54] The court in *Kasilag* rejected a similar argument.[55] In *Kasilag*, plaintiffs argued that comparisons of TER were "irrelevant" because plaintiffs were only challenging the adviser's investment management fee. Noting that plaintiffs "ma[d]e this argument even against the backdrop of a *Gartenberg* analysis, which considers 'all relevant circumstances,'" the court concluded that "a board negotiating a fee with an eye toward arm's-length bargaining might well consider the *overall* fee backdrop against which they are negotiating."[56] Most recently, the court in *Obeslo* concluded after an 11-day bench trial that the board "was independent, qualified, and it engaged in a robust process in approving Defendants' fees" that was entitled to substantial deference, despite plaintiffs' argument that the board had "improperly" considered "misleading" comparisons of TER.[57]

D. Treating the 15(c) Review as a Year-Round Process

Courts have looked favorably on boards that engage in a year-long process of reviewing the adviser's fee. Under Section 15(c) of the ICA, advisory fee agreements must be approved by a majority vote of independent

[46] *Chill*, 2018 WL 4778912, at *14.

[47] *In re Davis*, 2019 WL 2896415, at *11.

[48] *Id.* at *9.

[49] *Id.* at *11.

[50] *Zehrer*, 2018 WL 1293230, at *5, *7.

[51] *Id.* ("Even if the Board might have driven a harder bargain, the legal standard does not require that.").

[52] *Chill*, 417 F. Supp. 3d at 261 n.26.

[53] *Id.* (citation omitted).

[54] *Id.*; *see also Jones v. Harris*, 559 U.S. at 352 (Courts may not "supplant the judgment of disinterested directors apprised of all relevant information, without additional evidence that the fee exceeds the arm's-length range.").

[55] *Kasilag*, 2017 WL 773880, at *12 n.28.

[56] *Id.* (emphasis added).

[57] *Obeslo*, 2020 WL 4558982, at *6; Pls.' Proposed Findings of Fact and Conclusions of Law at 22, *Obeslo v. Great-West Cap. Mgmt., LLC*, No. 16-CV-00230-CMA-SKC, 2020 WL 4558982 (D. Colo. Aug. 7, 2020) (No. 37).

directors cast in person at a "meeting called for the purpose of voting on such approval."[58] Other than this annual meeting to review and approve the adviser's compensation — commonly known as the "15(c) meeting" — the ICA does not specifically mandate other meetings of the board.

As recent Section 36(b) decisions show, however, a diligent board's process for reviewing the adviser's compensation almost always extends beyond a single 15(c) meeting. Indeed, the ICI reports that in 2018, 93 percent of complexes held between four and six meetings throughout the year.[59] The ICI also notes that, "[i]n practice, fund directors often meet more frequently than called for by their regular schedule. Additional in-person or telephonic meetings are held, if necessary, to address specific issues."[60]

Courts consistently note with approval a board's "year-round process" for analyzing and approving fees charged to mutual funds. For example, the court in *Sivolella* heard "substantial testimony" at trial regarding the regular practices and procedures of the board. In concluding that the fund board was sufficiently independent and conscientious, the court noted that the board met five times a year, with two-to-three-day meetings for each session.[61] The board also had "pre-Board telephonic meetings" with its independent counsel approximately one month before each quarterly meeting.[62] In virtually all Section 36(b) cases, the independent directors' "annual process of the analysis and consideration of the [adviser's investment management agreement] culminate[d] in the months prior to the annual 15(c) meeting . . ., but the [b]oard review[ed] relevant information and communications during the rest of the year."[63]

E. Thorough and Well-Supplemented Board Materials

As recent decisions make clear, Section 36(b) claims require a fact-intensive analysis. The board's judgment is entitled to "considerable weight" unless the board's process was deficient or it was deprived of material information that would have changed the directors' decision to approve fees charged to the fund.[64] Given this deference to boards' judgment, defendants in Section 36(b) actions heavily rely on board meeting materials and board minutes to demonstrate that a mutual fund board fully considered important issues.

Written board materials — also known as "board books" or "15(c) materials" — are generally the main source of information that independent directors use to prepare for board meetings. The bulk of information contained in the 15(c) materials, which can often be hundreds or even thousands of pages long, comes from the adviser. But 15(c) materials are also frequently supplemented with reports, analysis, and information from independent counsel and other third-party experts. The 15(c) materials should contain most of the information that the independent directors may need to evaluate the *Gartenberg* factors and any other issue that the directors deem relevant.[65] While courts consistently reject criticisms that amount to nothing more than "armchair quarterbacking and captious nit-picking" over the way in which information is presented, it is important for the independent directors to review and comprehend these materials and, when necessary, advocate for additional information or alternative formatting to assist their understanding.[66]

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[58] 15 U.S.C. § 80a-15(c).

[59] ICI Overview at 8.

[60] *Id.*

[61] *Sivolella*, 2016 WL 4487857, at *23.

[62] *Id.* at *24; *see also In re Blackrock*, 327 F. Supp. 3d. at 703 (During the relevant period, "the Board met regularly, holding two-day meetings each quarter, and additional ad-hoc in person or telephonic meetings as necessary."); *Goodman v. J.P. Morgan Inv. Mgmt., Inc.*, 301 F. Supp. 3d 759, 781 (S.D. Ohio 2018), *aff'd,* 954 F.3d 852 (6th Cir. 2020) ("[E]ach year the Board met several times to review information it had requested and received from the Adviser, the Administrator, and independent third parties."); *Zehrer*, 2018 WL 1293230, at *4 (The board met "twice quarterly, typically holding three-hour telephonic meetings, followed a week-to-10 days later by in-person meetings that typically last two days.").

[63] *Kennis,* 2019 WL 4010747, at *21.

[64] *Jones v. Harris,* 559 U.S. at 351.

[65] Directors generally are not expected to read every single page in the 15(c) materials. Rather, the 15(c) materials should be viewed as a resource, containing most of the information the independent directors may need in making their decision. *Cf. Zehrer*, 2018 WL 1293230, at *4 (acknowledging testimony that directors did not read the 15(c) materials "page by page," but nevertheless granting defendant's motion for summary judgment). Moreover, independent counsel can assist the independent directors by providing an opinion as to the sufficiency of the information provided in the 15(c) materials and by flagging new or important information.

[66] *Kasilag*, 2016 WL 1394347, at *14.

F. Information from Multiple Sources

Independent directors should also seek out third-party sources of information. While the adviser is generally best positioned to provide information about the funds the adviser manages, independent directors must keep in mind that they are supposed to be "watchdogs" of the adviser and, therefore, be wary of relying exclusively on information provided by the adviser. Third-party consultants can provide invaluable outside expertise.

Knowledgeable independent counsel. Courts consistently acknowledge the role of independent counsel in facilitating the board's communication with the adviser and providing industry knowledge and expertise. In general, most fund boards retain their own independent counsel or share counsel with the funds.[67] According to an ICI study, 95 percent of responding mutual fund complexes retained counsel separate from the adviser in 2018: 54 percent retained their own dedicated counsel, while 41 percent shared counsel with the funds.[68]

Independent counsel often attends each separate meeting of the independent directors and each board meeting, and plays a pivotal role in facilitating the 15(c) process.[69] Independent counsel can (i) advise the independent directors of their legal obligations and key considerations during the 15(c) process in accordance with *Jones* and *Gartenberg*,[70] (ii) assist with developing and communicating questions to the adviser,[71] (iii) review draft 15(c) materials and coordinate with the adviser to ensure that the information is complete and sufficient for the board to make an informed decision,[72] and (iv) provide expert opinions on new legal developments and keep the directors up to date on emerging issues and changes in the industry.[73]

Use of third-party consultants. Mutual fund boards whose processes were examined in recent Section 36(b) decisions almost universally used third-party experts, such as Broadridge-Lipper, to provide additional information on the funds. For example, the court in *In re Blackrock* noted with approval that, in addition to their independent counsel, the board also engaged at least four outside consultants: (i) Broadridge and Morningstar, which provided independent comparative fee and/or performance data; (ii) PricewaterhouseCoopers, which provided an analysis of the adviser's cost allocation methodology for estimating its profitability; and (iii) Ernst & Young, which provided an analysis of the structure of the advisory fee.[74] In *Kennis*, the independent directors met "with Broadridge representatives to discuss the selection and methodology in regards to peer group comparison studies."[75] The court noted that the information provided by Broadridge gave the board "an additional layer of content as to the marketplace to which the [f]und belongs."[76]

Industry publications and continuing education sessions. Courts also note favorably when independent directors review industry publications and undertake continuing education. In *Sivolella*, the independent directors conducted "general education sessions" with outside industry experts who discussed industry developments and reviewed issues of "particular interest" to the board.[77] The court noted that these sessions were "a chance for the Board to receive and consider input from sources in the industry other than

[67] The ICI advises that "counsel for the independent directors also may serve as fund counsel because, in virtually every situation except possibly litigation, the interest of the fund and its directors are aligned." ICI, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* at 18-19 (June 24, 1999).

[68] ICI Overview at 1, 16-17.

[69] *See, e.g., Sivolella*, 2016 WL 4487857, at *27 (noting the role of the board's independent counsel, who "attends every Board meeting, participates in all of the Board's executive sessions, engages in the 15(c) process, and reviews investment management and administrative contracts").

[70] *See, e.g., Zehrer*, 2018 WL 1293230, at *4 (Independent counsel "advises the independent trustees regarding the legal standards applicable to, and what information should be considered in connection with," the 15(c) review.).

[71] *See, e.g., In re BlackRock*, 327 F. Supp. 3d at 704 (noting that, in connection with the 15(c) process, the board and its independent counsel developed and submitted to the adviser written questions and requests for additional information and materials).

[72] *See, e.g., Chill*, 417 F. Supp. 3d at 225 (Each year, the adviser "sends the draft 15(c) Response materials to Independent [Director]s' Counsel for review and comment" before the materials are circulated to the directors.).

[73] *See, e.g., Kennis,* 2019 WL 4010747, at *8 (The directors' inquiries "would evolve based on advice from [their independent counsel] and changes in the industry.").

[74] *In re BlackRock*, 327 F. Supp. 3d at 703-04.

[75] *Kennis*, 2019 WL 4010747, at *21.

[76] *Id.* at *31.

[77] *Sivolella*, 2016 WL 4487857, at *26.

[the adviser].”[78] Similarly, the independent directors in *Kennis* “relied on a number of sources — such as industry conferences, educational sessions, individual business knowledge and judgment, presentations by Broadridge, communications with [the adviser] plus the latter’s responses to inquiries from the Board, and the knowledge and advice of independent counsel.”[79]

G. Thorough Board Minutes that Demonstrate the Robust Process

Independent directors should not underestimate the important role board minutes play in a Section 36(b) litigation and must be mindful of carefully documenting their review process. A Section 36(b) action can raise questions about board decisions made several years prior, often times by individuals who are no longer even directors.[80] These minutes can provide critical contemporaneous evidence of the factors that the board considered and discussed before voting to approve the fees charged to the fund. Moreover, even outside the litigation context, board minutes can serve as important reminders to the independent directors of issues that require further action or closer scrutiny.

III. CONCLUSION

While the current wave of Section 36(b) litigation has almost run its course, it almost certainly will not be the last. Recent Section 36(b) decisions emphasize the importance of the independence and conscientiousness of the independent directors, and the robustness of the 15(c) review, providing valuable insight into current best practices. ■

[78] *Id.*; *see also Kasilag*, 2016 WL 1394347, at *5 (board held annual educational meetings).

[79] *Kennis*, 2019 WL 4010747, at *21.

[80] Damages in a Section 36(b) action are limited to the “period prior to one year before the action was instituted.” 15 U.S.C. § 80a-35(b)(3).

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