A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and *Gartenberg* at Twenty-Five

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INTRODUCTION

Today, the concept of the "independent" director is widely, if not universally, regarded as critical to the healthy governance of public corporations.[1] The concept remains fiercely contested, however, in the governance of investment companies, including mutual funds.[2] This resistance appears on two fronts, one of which is quite visible, while the other is often overlooked. The more obvious battle over director independence has occurred in response to the Securities and Exchange Commission's ("SEC's") rulemaking effort to alter the standard for granting certain regulatory privileges under the Investment Company Act (the "Act").[3] The SEC, among its other reforms, sought to limit privileges under the Act to companies where at least seventy-five percent of the directors and the board chairman are independent.[4] Those rulemaking efforts have been struck down twice on procedural grounds.[5] In late 2006, the SEC resolicited public comment on two studies addressing the costs and benefits of the proposals.[6]

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1. *E.g.*, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

2. Judith Burns, *SEC to Revisit Independence Rule*, WALL ST. J., Dec. 12, 2006, at C13 (noting opposition of the U. S. Chamber of Commerce and the Investment Company Institute to a proposed SEC rule requiring an independent chair of mutual fund boards).

3. Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,380-81 (Aug. 2, 2004) (promulgating rules conditioning exemptions from the Act's requirements for mutual funds with an independent chair and with at least seventy-five percent of the fund's directors being independent of the fund's investment adviser). The proposed rule was adopted by a 3-2 vote of the SEC Commissioners. *Id.* at 46,390-93 (dissenting opinion).

4. *Id.* The SEC also proposed conditioning exemptions on independent directors holding quarterly "executive sessions" separate from the full board and having authority to hire staff (including legal counsel) to support them in discharging their responsibilities. *Id.* at 46,384-85.

5. Chamber of Commerce v. SEC, 443 F.3d 890, 908 (D.C. Cir. 2006) (holding that SEC's re-adoption of the rule violated the Administrative Procedures Act by failing to afford opportunity for public comment on certain data used in estimating costs of complying with proposed rule); Chamber of Commerce v. SEC, 412 F.3d 133, 143-45 (D.C. Cir. 2005) (holding that SEC violated Administrative Procedures Act by failing to determine costs of its proposed conditions and by failing to address a proposed alternative to the independent chair proposal).

6. Request for Additional Comment, Investment Company Act Release No. 27,600, 71 Fed. Reg. 76,618, 76,618 (Dec. 21, 2006) (permitting public comment until March 2, 2007, on two papers prepared by the SEC's Office of Economic Analysis addressing the costs of complying with the conditions in the proposed rule). The December 2006 action by the SEC reopened the comment period that was first opened in June 2006. *Id.*; Investment Company Governance, Request for Additional Comment, Investment Company Act Release No. 27,395, 71 Fed. Reg. 35,366, 35,366 (June 19, 2006).

On February 5, 2007, the U.S. Chamber of Commerce filed a Freedom of Information Act petition seeking information pertaining to the studies, including information concerning the decision to undertake the studies, the methodologies used in the studies, and data pertaining to

Mutual fund fee litigation is the second area in investment company governance where, in striking contrast to the trend in corporate governance generally, the concept of director independence remains undeveloped. Section 36(b) of the Act deems an investment adviser of an investment company to owe a fiduciary duty with respect to the receipt of compensation for advisory services (i.e., management compensation).[7] That section also creates an express, private right of action permitting a security holder, acting on behalf of the investment company, to sue the investment adviser or its affiliates for breach of that duty.[8] The seminal section 36(b) case, decided twenty-five years ago, is *Gartenberg v. Merrill Lynch Asset Management, Inc.*[9] The Second Circuit affirmed the district court's dismissal of the complaint[10] and articulated six factors ("*Gartenberg* factors") to guide the determination whether an investment adviser's fee is excessive.[11] One factor is the independence of fund directors.[12] The independence factor, however, has not played a meaningful role in judicial analysis of advisory fees under the Act.[13] As to scope, it has been regarded, unlike developments in corporate law, as essentially equivalent to a director falling outside the narrow statutory definition of "interestedness" found in section 2(a)(19) of the Act.[14] Moreover, of 150

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earlier drafts or edits of the two papers. Kara Scannell, *Chamber Wants Data Behind SEC Studies*, WALL ST. J., Feb. 12, 2007, at C7.

As of February 21, 2008, the SEC has not yet reissued a rule on independence.

7. Investment Company Amendments Act of 1970 § 36, 15 U.S.C. § 80a-35(b) (2000). Compensation paid to the investment adviser is analogous to the "executive compensation" paid to officers by corporations. This is because mutual funds do not have "internal" management; instead, they "contract" with an external adviser for such services. *See infra* notes 34-35 and accompanying text.

8. 15 U.S.C. § 80a-35(b). The SEC may also bring an action. *Id. See generally* 4 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 34.03 (2d ed. 2004) (discussing case law under section 36(b)).

9. 694 F.2d 923 (2d Cir. 1982).

10. *Id.* at 925.

11. *Id.* at 929-30; *accord* Amron v. Morgan Stanley Inv. Advisors, Inc., 464 F.3d 338, 340-41 (2d Cir. 2006).

12. *Id.*

13. *See infra* Part III.C.

14. *Id.*; *see also* Investment Company Act of 1940 § 2(a)(9), 15 U.S.C. § 80a-2(a)(19) (defining "interested person"); Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 170 (2006) ("The definition of 'interested person' makes it relatively easy to seat outside directors sympathetic to management firm interests."). For a critique of mutual fund director independence focusing on the failure to consider the relevance of professional relationships, see Larry D. Barnett, *When is a Mutual Fund Director Independent? The Unexplored Role of Professional Relationships Under Section 2(a)(19) of the Investment Company Act*, 4 DEPAUL BUS. & COMM. L.J. 155 (2006). For a description of how "independence" both has been broadened in scope and has become central to Delaware's analytical approach to fiduciary duty issues, see *infra* Part IV.

reported cases citing *Gartenberg* since 1982, only thirty mention the narrowed notion of director independence, with few according it much significance.[15] Not surprisingly, then, in the twenty-five years since *Gartenberg*, no plaintiff ever has obtained a reported judgment under section 36(b).[16]

In contrast, over the last quarter of a century, the concept of director independence has traced a very different path in the larger world of corporate governance.[17] Here the concept has expanded, flourished, and generally taken hold as a critical component of fiduciary analysis. This is not to say the judiciary's actual handling of the independence issue in particular factual settings is always commendable.[18] Rather, the point is that director independence is accepted as an indispensable element of good governance in corporate law, and the concept is open textured and fluid.[19] In the area of mutual fund fee litigation, on the other hand, the concept has remained cramped in scope and marginal in significance.

This Article takes a fresh look at director independence in the mutual fund fee context and offers a proposal for reinvigorating it. Part I briefly identifies the central agency conflict between mutual fund investors and investment advisers and highlights the economic significance of mutual fund fees. Part II summarizes strategies to

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15. *See infra* Part III.C.

16. James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 923 (2005) ("[P]laintiffs are still seeking to achieve their first victory under section 36(b)."). *See generally* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609 (2001) (reviewing litigation under section 36(b)).

17. *See infra* Part IV.

18. For recent critiques of how Delaware courts have interpreted the independence factor in specific contexts, see J. Robert Brown, Jr., *Disloyalty Without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53 (2006); Harvey Gelb, *Corporate Governance and the Independence Myth*, 6 WYO. L. REV. 129 (2006). For other good discussions of recent developments in independence in Delaware law, see Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73 (2007); Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381 (2005); E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399 (2005).

19. *See* Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375, 1376 n.4 (describing Delaware's corporate law definition of independence as "more nuanced"). Independence has not been without its critics, it should be noted. Professor Victor Brudney made a strong critique in 1982, and others subsequently have echoed his opinion. Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 617-19 (1982); *see* Palmiter, *supra* note 14, at 202-03 (proposing regulatory options to replace a board-centered approach); Wallace Wen Yen Wang, *Corporate Versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 WASH. L. REV. 927, 1008 (1994) ("[B]ecause directors are not truly independent, they are vulnerable to coalition politics.").

minimize the adverse effects of these conflicts. One such strategy, competition, suffers from weaknesses aptly noted by Professor Donald Langevoort,[20] such as a lack of activist institutional investors exercising influence through voting rights as typically seen in the corporate arena. The second strategy, regulation, essentially has failed on the section 36(b) litigation front.

Part III begins by summarizing the emerging and somewhat inconclusive empirical evidence on the relationship between mutual fund director independence and mutual fund advisory fees. It suggests that an exceedingly narrow definition of "independence" is to blame for the failure to identify a strong connection between director independence and the size of advisory fees. When the independence inquiry is broadened beyond the Act's statutory definition to examine past or present business relationships between mutual fund directors and advisers or subadvisers, Professor Camelia Kuhnen's recent study finds that such relationships correlate with higher fees.[21] In short, fiduciary discourse in the mutual fund industry is hobbled (to the advantage of investment advisers) by a flawed vocabulary. Language matters, and insiders, with regulatory acquiescence, have captured the terms of the debate, linguistically deploying what this Article calls "ostensible independence" as a counterfeit for genuine independence. Part III then takes a critical look at *Gartenberg* as a prelude to the reinterpretation of section 36(b) that is offered in Part V. Part III also summarizes salient empirical data on outcomes in mutual fund fee litigation under section 36(b) since *Gartenberg* and highlights the scant dispositive role played by director independence in judicial analysis. To provide a reference point for assessing this path dependent status of independence in the mutual fund industry, Part IV chronicles the dramatic expansion of director independence in corporate law generally over the same twenty-five year period.

Finally, Part V offers a proposal for according director independence a more prominent role in section 36(b) fee litigation. The proposal does not necessitate congressional action—although a more robust definition of genuine independence would clarify matters. Instead, it offers a new way to understand the text of section 36(b) that is informed by the quite different trajectories traced by the notion of independence in the mutual fund and corporate governance areas

20. Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017 (2005).

21. Camelia M. Kuhnen, Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry 18-28 (Mar. 1, 2007) (unpublished manuscript, on file with Vanderbilt Law Review), *available at* http://ssrn.com/abstract=849705.

since 1982. The proposed reading builds on and seeks to implement Professor Langevoort's and Professor Frankel's calls for a stronger norm of fiduciary responsibility in adviser fee litigation and contract negotiation under the Act.[22] Langevoort argues for a strengthened fiduciary norm because he finds analogizing mutual fund governance to market-based approaches to corporate governance to be inapt for various reasons.[23] The proposal advanced in Part V of this Article argues, ironically, that to rectify what Langevoort rightly considers inappropriate mutual fund "borrowing" from corporate law as a strategy to resist tighter oversight, judges should borrow even *more* from corporate law in section 36(b) fee litigation—specifically, they should borrow an enriched notion of director independence with real procedural significance, thereby bolstering section 36(b) as a credible sanction for excessive fees. This Article concludes with some reflections on the mutual fund industry's resistance to independence and on the role of private litigation as a key ingredient in any regulatory strategy for mutual funds.

I. CONFLICTS BETWEEN MUTUAL FUND INVESTORS AND INVESTMENT ADVISERS

Late trading,[24] market timing,[25] and other abusive practices in the mutual fund industry have attracted widespread attention.[26] These practices have engendered various proposals for reform and reignited debate about how best, or whether,[27] to regulate further the

22. Tamar Frankel, *How Did We Get into this Mess?*, 1 J. BUS. & TECH. L. 133 (2006); Langevoort, *supra* note 20.

23. Langevoort, *supra* note 20.

24. For a description of this practice, see William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1458-60 (2006).

25. For a description of this practice, see *id.* at 1453-56. For an in-depth analysis, see Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing*, 25 ANN. REV. BANKING & FIN. L. 235 (2006).

26. For a full description of various regulatory responses to the mutual fund scandals, see Laurin B. Kleiman & Carla G. Teodoro, *Forming, Organizing and Operating a Mutual Fund: Legal and Practical Considerations*, *in* THE ABCS OF MUTUAL FUNDS 11, 49-56 (PLI Corp. Law & Practice Course Handbook Series No. 8455, 2006), WL 1550 PLI/Corp. 11. *See generally* Conference, *The $7 Trillion Question: Mutual Funds & Investor Welfare*, 1 J. BUS. & TECH. L. 1 (2006) (providing transcripts of discussions and essays from a conference on late trading, market timing, front running, and related topics held at the University of Maryland School of Law through the Business Law Program).

27. Some commentators do not favor increased regulation. *See, e.g.*, Paul Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161, 179-80 (2004); Larry E. Ribstein, *Do the Mutuals Need More Law?*, 27 REGULATION 14 (2004).

mutual fund industry.[28] While the exposed practices are significant and disturbing, they did not cost investors nearly as much as substantial, ongoing management fees.[29] As noted by financial commentators, payments for management services "are the largest expenses of most funds."[30] The SEC's Office of Economic Analysis ("OEA") recently observed that lower advisory fees are a "critical determinant of long-term fund performance"[31] and cited a study showing that differences in expenses and transaction costs explain most of the difference in average and risk-adjusted returns across mutual funds over time.[32] In short, fees paid to investment advisers are quite large in absolute dollar terms and can affect dramatically overall rates of return.

The management structure of investment companies inherently creates a significant conflict between investor and adviser interests,[33] presenting a classic agency problem with respect to mutual fund fees. The investment company obtains funds from investors (and issues securities in return) and has a board of directors, much like other companies. Management of investment company assets, however, is not provided internally but by an external investment adviser pursuant to an advisory contract negotiated and approved by the fund's board of directors.[34] Frequently, the adviser establishes and "sponsors" the investment company and provides all necessary personnel, facilities, and expertise. The company essentially is a pool of portfolio securities, options, futures, loans, cash, or cash

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28. *E.g.*, Mercer E. Bullard, *The Mutual Fund As a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 HOUS. L. REV. 1271 (2006); Thomas R. Hurst, *The Unfinished Business of Mutual Fund Reform*, 26 PACE L. REV. 133 (2005); Donna M. Nagy, *Regulating the Mutual Fund Industry*, 1 BROOK. J. CORP. FIN. & COM. L. 11 (2006).

29. *See* Langevoort, *supra* note 20, at 1018-19 ("The broader issues involve fiduciary responsibility across a wide range of matters including management fees, distribution expenses, brokerage commissions, and the like.").

30. Diane Del Guercio et al., *Governance and Boards of Directors in Closed-End Investment Companies*, 69 J. FIN. ECON. 111, 112 (2003).

31. Memorandum from Chester Spatt, Chief Economist, Office of Economic Analysis, SEC, to Inv. Co. File S7-03-04, at 10 (Dec. 29, 2006) [hereinafter OEA Study] (providing a review of literature on mutual fund governance), *available at* http://www.sec.gov/rules/proposed/s70304/oeamemo122906-litreview.pdf.

32. *Id.* (citing M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 57-82 (1997)).

33. Burks v. Lasker, 441 U.S. 471, 480 (1979) (recognizing "the potential for abuse inherent in the structure of investment companies").

34. Section 15(c) of the Investment Company Amendments Act of 1970 requires that the advisory contract be approved annually by a majority of the directors on the fund's board and by a majority of the "noninterested" directors. 15 U.S.C. § 80a-15(c) (2000).

equivalents.[35] This arrangement has led some, including former SEC Chairman Harvey Pitt, to describe mutual funds as "products," not companies.[36] For the most part, the investment adviser runs the company and, for a variety of reasons, stands in a dominant and controlling position with respect to the fund.[37] Notwithstanding the adviser's strong position, directors of the company are supposed to negotiate the advisory contract on behalf of investor interests and, in the words of the Supreme Court, serve as ongoing "watchdogs" over all adviser activities.[38]

The advisory contract typically charges a fee based on a percentage of assets managed and not on fund performance.[39] Investors benefit from a lower percentage while the adviser obviously prefers a higher percentage. Moreover, advisers have an incentive to maximize assets under management because that raises the aggregate fee even when the performance of the fund falters. Investors gain only by enhanced fund performance—i.e., higher returns, lower expenses, or both.

Academic literature has identified several conflicts between mutual fund investors and advisers. These include differences in financial incentives, differences in investor and adviser risk tolerances, and cross-subsidization of funds in a fund complex.[40] A simple illustration of the first, drawn from the recent OEA study, highlights the problem:

> New mutual fund investments are highly sensitive to published reports of annual performance. Because greater performance implies greater net fund inflows and greater net inflows imply greater management fees, managers may alter the risk of the fund to

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35. Zell v. InterCapital Income Sec., Inc., 675 F.2d 1041, 1046 (9th Cir. 1982); Birdthistle, *supra* note 24, at 1409-10.

36. Harvey L. Pitt, *Over-Lawyered at the SEC*, WALL ST. J., July 26, 2006, at A15 ("[The Act] treats mutual funds as companies when the economic reality is that they are products."). For a critique of such a viewpoint, see Langevoort, *supra* note 20, at 1037 ("Once the mutual fund is viewed as a product to be marketed . . . then any notion that the producer is a 'fiduciary' is awkward and disorienting.").

37. The SEC has expressed its concern that "many boards continue to be dominated by their management companies." Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,381 (July 27, 2004).

38. *Burks*, 441 U.S. at 485 (stating that disinterested directors are to serve as "'watchdogs' to protect shareholder interests"). Perhaps the court chose the wrong canine metaphor, as noted in an old Chancery decision, *In re* Kingston Cotton Mill Co. (No. 2), [1896] 2 Ch. 279, 280, 287 (Ct. App.) (appeal taken from Ch.D.) (describing a watchdog's role as requiring a reaction only when there is something to "arouse [its] suspicion"). In contrast, a bloodhound's role is that of "approach[ing] [its] work with suspicion or with a foregone conclusion that there is something wrong." Steven Schwarcz, *Financial Information Failure and Lawyer Responsibility*, 31 J. CORP. L. 1097, 1119 n.148 (2006).

39. OEA Study, *supra* note 31, at 5.

40. *Id.* at 5-7 (describing conflicts and academic literature).

> indirectly maximize their own compensation. If a fund is ahead of expectations halfway into the reporting period, managers may "pull back" from the strategy preferred by investors and reduce the risk of the portfolio in order to lock-in the present level of returns, attract more assets and maximize fees from investors. Conversely, if the fund is underperforming during the year, managers may be tempted to "gamble" and increase the risk of the portfolio to try and catch up to the market so they can minimize the impact on fees.[41]

The structural-financial conflict illustrated above is exacerbated by another common feature of investment companies: officers and employees of the investment adviser frequently serve on the investment company's board of directors. As members of the investment company board, they owe a duty of loyalty to fund investors. As decisionmakers for the adviser, however, they both personally benefit from and are in a position to influence a contract that is good for the adviser but adverse to the interests of investors. This evident conflict of interest is compounded by investors' inability to observe directly or influence the adviser.

II. STRATEGIES TO MINIMIZE ADVERSE EFFECTS OF CONFLICTS

A. Competition

Certain factors, as a theoretical matter, might serve to align investor and adviser interests without regulatory (or at least without additional regulatory) intervention. For example, the mutual fund industry is said to be competitive with more than 8,600 funds in existence at the end of 2004.[42] Advisers seeking to preserve and enhance their reputations to attract greater fund inflows and facilitate their own advancement in the adviser labor market have an incentive to perform well on behalf of investors.[43] Investors' ability to redeem mutual fund shares at net asset value also may impose discipline on fund managers because investors can exit the fund without dampening the price of fund shares.[44] These factors lead some, such as

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41. *Id.* at 5 (citing literature); *see also* Jeff D. Opdyke, *Mutual Funds Avoid Risk to Lift Ratings*, WALL ST. J., Feb. 28, 2007, at D2 (describing Goldman Sachs study indicating that large-company equity mutual funds sidestep risk to reduce price volatility and gain higher Morningstar ratings so as to attract and retain assets under management).

42. INV. CO. INST., INVESTMENT COMPANY FACT BOOK 3 (45th ed. 2005); John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 157 (2007) ("In 2006, there were over 8,000 mutual funds . . . .").

43. Coates & Hubbard, *supra* note 42, at 210; OEA Study, *supra* note 31, at 7.

44. Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV. 1021 (2007) (finding that investors who made significant withdrawals from mutual funds and mutual fund families found that fund managers had engaged in wrongdoing); Coates &

Professor Paul Mahoney and Professors John Coates and Glenn Hubbard,[45] to argue for a strategy of enhancing competition as a means for reducing the adverse effects of investor-adviser conflicts.

As noted in the recent OEA study, however, several constraints may inhibit the effectiveness of competitive forces in mitigating conflicts between investors and advisers.[46] These include lack of investor knowledge about management and how to assess managerial skill; high search and switching costs in fund selection; tax considerations on selling shares; and reliance on reputation, trends, and recommendations. These constraints demonstrate substantial shortcomings in a strategy relying only on market forces to align investor and adviser interests.[47] For example, one study found that Morningstar rankings are inaccurate predictors of future fund performance.[48] Moreover, Professor Langevoort has identified several other ways in which market forces, possibly at work to some degree in corporate law, are lacking in the mutual fund industry.[49] Salient differences include the lack of stock or stock option grants to align investor and management interests, the absence of active institutional investors advocating governance reforms, the absence (at least in mutual funds, though not in closed-end funds) of a market for corporate control (i.e., no hostile takeovers), and manager compensation based on the value of assets (i.e., size, not performance).[50] Overall, these features may lead to mutual fund assets being "sticky," rather than mobile, as market theory posits.[51]

Hubbard, *supra* note 42, at 162; OEA Study, *supra* note 31, at 8. This discipline does not operate on managers of closed-end funds.

45. Mahoney, *supra* note 27; Coates & Hubbard, *supra* note 42.

46. OEA Study, *supra* note 31, at 8-10.

47. *Id.*; *see also* Freeman & Brown, *supra* note 16, at 651 ("[A]dvisers refuse to compete against each other for advisory business . . . .").

48. Christopher R. Blake & Matthew R. Morey, *Morningstar Ratings and Mutual Fund Performance*, 35 J. FIN. & QUANTITATIVE ANALYSIS 451 (2000) (noting exceptions for low-rated funds); *see* Remarks of Professor Alan Palmiter, Conference, *The $7 Trillion Question: Mutual Funds & Investor Welfare*, 1 J. BUS. & TECH. L. 23, 26 (2006) ("[T]he [Morningstar] rating is a very powerful predictor of future performance—but negatively!"); *see also supra* note 41 and accompanying text.

49. Langevoort, *supra* note 20, at 1031-32.

50. *Id.*

51. OEA Study, *supra* note 31, at 9. Coates and Hubbard recently have sought to rebut certain of these claims that competition is lacking in the mutual fund industry. Coates & Hubbard, *supra* note 42. They note:

> [Much of our] evidence on competition is general—we present evidence on market structure and investor sensitivity for the overall fund industry, and for general investment styles, but we do not attempt to present the multiple, extensive, detailed analyses that would be needed to investigate every subsector and competitively distinct niche within the mutual fund industry.

B. Regulation

Since the adoption of the Act in 1940, regulation has been a key strategy in addressing investor-adviser conflicts in the mutual fund industry.[52] The Act, unlike state corporate law, substantively regulates several aspects of investment company governance. The statutory provisions are designed to supplement, rather than preempt, state law, at least "to the extent such law is consistent with the policies of the [Investment Company Act]."[53] For example, state law fiduciary duties of care and loyalty continue to govern fund directors. The mutual fund board of directors is the governance centerpiece of the federal regulatory strategy. The board must negotiate and approve the critical advisory contract,[54] and, in theory, the board oversees all fund affairs to ensure that its adviser complies with the Act's various provisions.

Two key sections of the Act designed to safeguard investor interests in relation to advisers are sections 15(c) and 36(b),[55] the latter having been added in 1970.[56] Section 15(c) requires approval of the terms of the advisory contract, initially or as renewed, by the vote, cast in person, of a majority of directors who are not parties to the contract or "interested persons" of any such party.[57] The term "interested person" is defined in section 2(a)(19) of the Act.[58]

Id. at 206. They go on to acknowledge the continuing importance of section 36(b). *Id.*

52. Regulation is not a purely market-based policy approach. For a good overview, see Palmiter, *supra* note 14, at 167-71.

53. Burks v. Lasker, 441 U.S. 471, 486 (1979). Mutual funds typically are organized as corporations, often under Maryland law, or as business trusts, often under Massachusetts law. FED. REGULATION OF SEC. COMM., AM. BAR ASS'N, FUND DIRECTOR'S GUIDEBOOK 4 (3d ed. 2006). State law principles continue to apply, subject to preemption where they are inconsistent with the policies of the Act. *Id.*

54. Investment Company Act of 1940 § 15, 15 U.S.C. § 80a-15 (2000).

55. *Id.* §§ 80a-15(c), -35(b).

56. Investment Company Amendments Act of 1970 § 36, 15 U.S.C. § 80a-35(b).

57. *Id.* § 80a-15(c). Prior to the 1970 amendments, rather than the term "interested person," the Act used the term "affiliated" person. Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 538 (1984).

58. 15 U.S.C. § 80a-2(a)(19) provides as follows:

> "Interested person" of another person means . . .
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> (B) when used with respect to an investment adviser of or principal underwriter for any investment company—
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> (i) any affiliated person of such investment adviser or principal underwriter,
>
> (ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,
>
> (iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security

In mutual fund parlance, a director who is not an "interested person," as defined in section 2(a)(19) of the Act, typically is described as "independent."[59] This deeply ingrained rhetorical practice began in

issued either by such investment adviser or principal underwriter or by a controlling person of such investment adviser or principal underwriter,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,

(v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, engaged in any principal transactions with, or distributed shares for—

(I) any investment company for which the investment adviser or principal underwriter serves as such;

(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or

(III) any account over which the investment adviser has brokerage placement discretion,

(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to—

(I) any investment company for which the investment adviser or principal underwriter serves as such;

(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or

(III) any account for which the investment adviser has borrowing authority,

(vii) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purposes of this paragraph (19), "member of the immediate family" means any parent, spouse of a parent, child, spouse of a child, spouse, brother, or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vii) of subparagraph (A) or (B) of this paragraph whenever it finds that such order is no longer consistent with the facts. No order issued pursuant to clause (vii) of subparagraph (A) or (B) of this paragraph shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this subchapter or for any other purpose for any period prior to the effective date of such order.

59. *See* Lasker v. Burks, 567 F.2d 1208, 1210 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979) ("[S]tatutorily disinterested directors, [are] usually referred to as 'independent directors' . . . ."); Kleiman & Teodoro, *supra* note 26, at 28 ("Registered funds are required to have a board of directors, a majority of whom must be 'disinterested' or 'independent.'").

Some states, also conflating the distinction, have enacted laws providing that a person who is not an "interested person" under the Act shall be presumed to be "independent" under state law. *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 2-405.3 (LexisNexis 2007); MASS. GEN. LAWS ANN. ch. 182, § 2B (West Supp. 2007). No doubt, such semantic alchemy increases the number of

1940 and is evidenced by a statement of the Chief Counsel of the SEC's Investment Trust Study:

> The bill as originally introduced . . . required that a majority of the board be independent of the management. However, . . . it was urged that if a person [the investor] is buying management of a particular person and if the majority of the board can repudiate his advice, then in effect, you are depriving the stockholders of that person's advice . . . . [T]hat is why the provision for 40 percent of independents was inserted.[60]

The Supreme Court continued to equate uncritically the concepts of disinterestedness and independence in 1979 when it described the central role of disinterested directors under the Act: "Congress consciously chose to address the conflict-of-interest problem through the Act's independent director section, rather than through more drastic remedies such as complete disaffiliation of the companies from their advisers or compulsory internalization of the management function."[61] Even the SEC has adopted this unfortunate convention.[62]

In response to market timing, late trading, and related scandals in 2003,[63] the SEC sought by rulemaking to bolster the independence requirement.[64] It did not do so by requiring directors to be *more independent*, but by requiring that a greater *percentage* of directors fall outside the Act's existing definition of "interested person." In 2004, the SEC conditioned certain regulatory exemptions on what it called the independence of at least seventy-five percent of a mutual fund's board and the independence of its chairman.[65] "Independent" means, as it always has in this context, not "interested" under the Act.[66] The SEC also required enhanced disclosure to investors of the material factors and conclusions pertaining to the

"independent" mutual fund directors who can consider, under state law principles, whether to comply with a mutual fund investor's demand that a derivative action be commenced. This is an ironic move because, as seen in Part IV, *infra*, state corporate law principles increasingly differentiate between those two notions.

60. Martin E. Lybecker, *Enhanced Corporate Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration*, 83 WASH. U. L.Q. 1045, 1051 (2005) (citing statement of David Schenker, Chief Counsel of the SEC's Investment Trust Study).

61. Burks v. Lasker, 441 U.S. 471, 483 (1979).

62. In 2004, the SEC stated: "In this Release we are using 'independent director' to refer to a director who is not an 'interested person' of the fund, as defined in the Act." Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,381 n.23 (Aug. 2, 2004).

63. *See* sources cited *supra* notes 24-26 and accompanying text.

64. *See supra* notes 3-4 and accompanying text.

65. Investment Company Governance, 69 Fed. Reg. at 46,381.

66. *See id.* at 46,381 n.23.

board's approval of the most recent advisory contract.[67] The SEC emphasized the importance of an independent mutual fund board, stating: "[A] fund board must be an independent force in fund affairs rather than a passive affiliate of management."[68] Although these rule changes are mired in litigation on procedural grounds,[69] many funds have implemented them voluntarily.[70]

Structural reform of the sort adopted by the SEC to regulate the advisory contract through fund directors is useful but inadequate for several reasons. First, the SEC's conception of independence is too narrow because it is equated with a lack of "interestedness" as defined in the Act. The definition does not exclude, for example, persons with strong personal or business connections to the adviser's or subadviser's officers, or persons who provide direct or indirect services to the funds, or even certain adviser or subadviser family members. Nor does the definition address whether directors *function* independently and effectively. Second, neither investors nor the SEC are able to monitor closely thousands of advisory contracts ex ante; other safeguards are needed if directors and advisers fail to protect investor interests. Third, as Professor Langevoort and others have argued,[71] in the mutual fund industry, market discipline may not work for the good of investors as robustly as analogies to market forces in corporate governance suggest. Congress recognized this argument in 1970, stating: "But in the mutual fund industry . . . these marketplace forces are not likely to operate as effectively."[72] Finally, in 1970, both the SEC and Congress were uneasy about independent boards as a sufficient check on excessive fees. As the Supreme Court noted in 1984, "Congress decided not to rely solely on the fund's directors to assure reasonable fees, notwithstanding the increased disinterestedness of the board."[73] As a regulatory strategy, therefore, director approval of advisory contracts under section 15(c) must be

67. Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26,486, 69 Fed. Reg. 39,798 (June 30, 2004).

68. Investment Company Governance, 69 Fed. Reg. at 46,380.

69. *See* cases cited *supra* note 5 and accompanying text.

70. Kara Scannell & Tom Lauricella, *SEC Considers Fund-Board Compromise*, WALL ST. J., Feb. 15, 2007, at C13 (reporting that eighty percent of mutual funds have boards with seventy-five percent of its members from outside the industry, according to the Investment Company Institute).

71. *See supra* notes 49-51 and accompanying text.

72. S. REP. NO. 91-184, 5 (1970), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901; *see also* Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 534 n.10 (1984).

73. *Fox*, 464 U.S. at 540; Burks v. Lasker, 441 U. S. 471, 481 n.10, 484 (1979).

supplemented by viable private litigation with respect to excessive fees.

Congress provided such an express right of action in 1970 by adding section 36(b). That section took on greater significance when courts ruled that neither section 15(a)[74] nor 15(c)[75] supports implied private rights of action for excessive fees. Moreover, courts also have begun to abandon the longstanding view that section 36(a) supports a private right of action.[76] Consequently, the one undoubted litigation vehicle for protecting investors against conflicts of interest surfacing in the form of excessive advisory fees is section 36(b). Given the growing uncertainty as to whether other sections of the Act support private rights of action, one important interpretive issue under section 36(b) is the scope of conduct for which the Act provides redress. This Article, however, focuses specifically on management fees paid to the adviser pursuant to the advisory contract, a matter undoubtedly within the coverage of section 36(b).

Section 36(b) specifies that an investment adviser of a registered investment company "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services."[77] The section provides that the SEC or a security holder of the company, but not the company itself, may bring an action on behalf of the company against the adviser or any affiliated person "for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such adviser or person."[78] Strictly speaking, the action is not a "derivative" action because the company itself cannot initiate a lawsuit.[79] This frees an investor from any need to make a demand on the board of directors before beginning the suit.[80] Section 36(b)(1) mandates that the plaintiff "shall have the burden of proving a breach

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74. Tarlov v. Paine Weber Cashfund, Inc., 559 F. Supp. 429 (D. Conn. 1983). Section 15(a), however, has been interpreted to provide a right of action against an investment adviser accused of self-dealing. Fogel v. Chestnutt, 668 F.2d 100 (2d Cir. 1981).

75. Halligan v. Standard & Poor's/Intercapital, Inc., 434 F. Supp. 1082, 1084 (E.D.N.Y. 1977).

76. *See* Langevoort, *supra* note 20, at 1025 (collecting authority); Palmiter, *supra* note 14, at 181 n.73 (same). Palmiter argues that a refusal to imply a private action under section 36(a) "flies in the face of legislative urgings." Palmiter, *supra* note 14, at 181 n.73. *See generally* William K. Sjostrom, *Tapping the Reservoir: Mutual Fund Litigation Under Section 36(a) of the Investment Company Act of 1940*, 54 U. KAN. L. REV. 251 (2006).

77. Investment Company Amendments Act of 1970 § 36(b), 15 U.S.C. § 80a-35(b) (2000).

78. *Id.*

79. *Id.*; Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984).

80. *Fox*, 464 U.S. at 527-28.

of fiduciary duty."[81] Personal misconduct, however, is not an element of the claim.[82] No action may be brought against a person who is not the recipient of compensation, and any award of damages against such recipient is limited to actual damages resulting from the breach of fiduciary duty; punitive damages may not be recovered.[83] Damages cannot be recovered for any period prior to one year before the action is commenced.[84] Federal courts have exclusive jurisdiction,[85] and there is no right to a jury trial.[86]

In sum, as noted by the Supreme Court,[87] Congress adopted a two-fold regulatory approach to adviser conflicts. This strategy relied in part on "the structural requirement" of disinterested director negotiation with the investment adviser under section 15, and in part on meaningful private fiduciary duty litigation initiated by investors under section 36(b).[88] The court described this as a "policy choice" to provide "independent checks on excessive fees."[89] The dual director approval and investor litigation approaches to regulation are not as unrelated as Congress thought in 1970 or as the Supreme Court might have suggested in *Fox*. The vital connection between independent directors and fiduciary duty litigation becomes clear in a profoundly negative way when reviewing case law under section 36(b) over the last twenty-five years. A survey reveals that the arrested state of development of section 36(b) jurisprudence stands in marked contrast to the ongoing development of fiduciary duty litigation in corporate law, where the concepts of director independence and fiduciary duty are linked. Part III traces the short arc of independence in mutual fund fiduciary duty litigation over the last quarter-century, and Part IV traces the larger arc in corporate law over the same period.

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81. 15 U.S.C. § 80a-35(b)(1).
82. *Id.*
83. *Id.* § 80a-35(b)(3).
84. *Id.*
85. *Id.* § 80a-35(b)(5).
86. Krinsk v. Fund Asset Management, Inc., 875 F.2d 404 (2d Cir. 1989).
87. Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 538-41 (1984).
88. *Id.*
89. *Id.* at 541.

III. EMPIRICAL DATA ON MUTUAL FUND FEE LITIGATION SINCE *GARTENBERG*

A. Does Independence Matter For Adviser Fees?

The OEA recently reviewed the rather undeveloped finance literature addressing the relationship between board structure and fees in the mutual fund industry.[90] Some studies find that funds with smaller boards and a larger percentage of independent directors tend to negotiate and approve lower fees.[91] Also, independent directors are more likely to authorize share repurchases,[92] initiate fund mergers, and make decisions designed to benefit investors, such as replacing poorly performing managers.[93] This led the OEA to conclude tentatively that "boards with a greater proportion of independent directors are more likely to make decisions such as negotiating lower adviser fees that may potentially lead to higher returns."[94] The study cautions, however, that due to insufficient data and certain methodological factors, there is "no consistent evidence that chair or board independence is associated with lower fees and/or higher returns for fund shareholders in the cross-section."[95]

Yet, a key assumption in the OEA's mixed findings—like that of discourse generally in the mutual fund culture[96]—is that someone who is not an "interested person" as defined in the Act is an independent director.[97] However, in an unpublished March 2007 study,[98] Professor Camelia Kuhnen employed a richer understanding of independence and examined the effect on investor welfare of past business dealings between mutual fund directors and advisers (or subadvisers) in advisory contracts for all U.S. mutual funds during 1993-2002. These kinds of repeated dealings, although not encompassed in the definition of "interestedness" (and, hence,

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90. OEA Study, *supra* note 31.

91. Peter Tufano & Matthew Sevick, *Board Structure and Fee-Setting in the U.S. Mutual Fund Industry*, 46 J. FIN. ECON. 321 (1997); *see also* Del Guerico et al., *supra* note 30, at 148.

92. *See* Del Guerico et al., *supra* note 30, at 148.

93. OEA Study, *supra* note 31 at 13.

94. *Id.* at 23.

95. *Id.* at 24.

96. *See supra* notes 59-62 and accompanying text.

97. In fact, the OEA used a definition of independence that assumed all "outside" directors were independent. OEA Study, *supra* note 31, at 2 n.1. That definition, if in fact used, could characterize as "independent" certain directors who would be considered "interested persons" under the Act.

98. Kuhnen, *supra* note 21.

"independence") under the Act, are precisely the sort of interactions that raise concerns about director independence in corporate law.

Professor Kuhnen found that business connections—specifically the number of times fund directors have sat on boards of any other funds managed by the adviser and a related measure of connectivity between the adviser and a potential new subadviser—foster favoritism in dealings between fund directors and advisers to the detriment of investors.[99] She found that when mutual funds select subadvisory firms to help the primary adviser manage the fund, the greater the connection between such firms and fund directors through past business relationships, the more likely they are to win the management contract.[100] Moreover, the more connected subadvisers and fund directors are, the lower the net and risk-adjusted rates of return.[101] Past business connections also play a role in an adviser's selection of directors to serve on new funds sponsored by the adviser.[102] In addition, Professor Kuhnen found that business connections are positive predictors of expense ratios and advisory fees.[103] She also concluded that all measures of business connections are significant negative predictors of the amount of expenses the advisor reimburses to the fund.[104] For the entire sample, a similar increase in measures of director to adviser connections corresponded to a 1.5% increase in the advisory fee, which results in an aggregate fee increase of $1 billion transferred from funds to advisers each year.[105] The data, Professor Kuhnen cautions, establishes a correlation and does not test for causality between business connections and performance.[106] The data does tend to rule out information asymmetries, ease of monitoring, and reduced search costs as plausible reasons for directors hiring advisers whom they have dealt with in the past. Overall, the findings strongly suggest that a richer conception of independence, designed to identify the variety of relationships between fund directors and persons associated with advisers and subadvisers, may be useful in identifying funds where fees warrant special judicial scrutiny under section 36(b).

99. *Id.* at 4-6, 24.
100. *Id.* at 21-22.
101. *Id.* at 20.
102. *Id.* at 22-23.
103. *Id.* at 24-25.
104. *Id.* at 26.
105. *Id.* at 25.
106. *Id.* at 6.

B. The Gartenberg *Decision*

How important of a role has director independence (using the Act's narrow definition) actually played in section 36(b) fee litigation? The leading case under section 36(b) is *Gartenberg v. Merrill Lynch Asset Management Inc.*, a 1982 decision of the Second Circuit.[107] In *Gartenberg*, the plaintiff challenged advisory fees charged by Merrill Lynch Asset Management, Inc. on a money market fund that in four years had grown from $428 million to more than $19 billion. Although the fee as a percentage of net assets declined gradually from 0.5% to 0.275% for assets in excess of $2.5 billion, the plaintiff argued that the fee as a percentage of assets should be even lower due to significant economies of scale.[108] Six of the eight trustees on the fund board that had approved the contract were "noninterested" as then defined in the Act.[109]

In the district court, Judge Milton Pollack scoured the legislative history of section 36(b) for guidance in interpreting the fiduciary duty language in the statute. He observed that Congress "was not precise in delineating the test for compliance with the fiduciary standard."[110] The net effect, he concluded, "would seem to leave it to the federal courts to interpret compliance with 'fiduciary duty' in the common law tradition (. . . really federal equity jurisprudence)."[111] The Second Circuit, after its own review of the legislative history, likewise concluded that Congress had made "no attempt to set forth a definitive test by which observance or breach of fiduciary duty was to be determined."[112] It found that the adoption of the fiduciary duty standard in section 36(b), instead of the reasonableness test used in earlier failed bills, was more of a "semantical than substantive compromise."[113]

107. 694 F.2d 923 (2d Cir. 1982).

108. *Id.* at 926. See Cox & Payne, *supra* note 16, at 923-25, for further details of the case.

109. *Gartenberg*, 694 F.2d at 926.

110. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1045 (S.D.N.Y. 1981).

111. *Id.* at 1046.

112. *Gartenberg*, 694 F.2d at 928.

113. *Id.* As the Supreme Court's review of legislative history two years after *Gartenberg* made clear, the dispute between the SEC and the mutual fund industry in the late 1960s apparently was not so much a disagreement about the substantive standard proposed in earlier bills—"reasonableness"—as it was disagreement over who could bring an action. Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 538-40 (1984). The SEC, in an earlier proposal, sought to have Congress empower it to bring actions enforcing the "reasonableness" standard and to intervene in any action brought by or on behalf of the company. *Id.* at 538. The mutual fund industry expressed concern about the SEC enforcing a provision as, in essence, granting the SEC rate-making authority. *Id.* As an alternative, the Investment Company Institute proposed an

In *Gartenberg*, the Second Circuit phrased the test under section 36(b) in two quite different ways. In a famous passage, the court seemed to adopt a two-prong approach, stating that to violate section 36(b) an investment adviser must charge a fee that is "so disproportionately large that it bears no reasonable relationship to the services rendered *and* could not have been the product of arm's length bargaining."[114] In the preceding paragraph, however, the court described a singular focus and asserted that "the test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's length in the light of all the surrounding circumstances."[115] Nothing like the "so disproportionately large" language appears in this earlier rendition of the test.

Between its two formulations of the test, the court noted the Senate's appreciation that the structure of a mutual fund did not lend itself to the workings of the usual market forces: "The Senate recognized that as a practical matter the usual arm's length bargaining between strangers does not occur between an adviser and the fund."[116] Thus, the court effectively conceded that the second, process-oriented half of the two-prong formulation—i.e., arm's length bargaining—rarely will exist, which makes it an odd element of the test. Moreover, the court illogically framed the first prong in a way that deviates from "reasonableness" and seemed to require extremeness—"so disproportionately large," not just "disproportionately large," and "no reasonable relationship," not just "unreasonable."

Moreover, the "so disproportionately large" language seems better suited to capture *one* way a fee might constitute a breach of an adviser's fiduciary duty, but not the *only* way. This is seen in a portion of the legislative history cited by Judge Pollack, but not by the Second Circuit. Judge Pollack noted:

> [Some] members of Congress left open the possibility that in certain limited circumstances the fee, *considered by itself*, might be enough to prove a breach of the

alternative to the SEC bill under which only the company or a security holder could bring an action. *Id.* The proposed industry alternative, however, retained the "reasonableness" standard. The provision ultimately enacted by Congress rejected the industry proposal that the company itself be authorized to bring suit in favor of permitting either the SEC or an investor acting on behalf of the company to initiate an action. The "fiduciary duty" standard also was substituted for the earlier "reasonableness" language, but not, apparently, because the industry found the earlier language objectionable. *Id.* at 539.

114. 694 F.2d at 928 (emphasis added); *see* Richard M. Phillips, *Mutual Fund Independent Directors: A Model for Corporate America?*, INVESTMENT COMPANY INST. PERSP., Aug. 2003, at 1, 10.

115. *Gartenberg*, 694 F.2d at 928; *see* Phillips, *supra* note 114, at 10.

116. *Gartenberg*, 694 F.2d at 928.

> section 36(b) standard. Senator Bennett, in his remarks on the bill, stated that the section authorized lawsuits "in the event that the fee received is claimed to be so excessive as to constitute a breach of fiduciary duty."[117]

By analogy, in corporate fiduciary doctrine, it is accepted that a court may infer a breach of fiduciary duty from an egregious substantive outcome. As the Delaware Supreme Court has noted, a business decision may be substantively "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[118] An egregious outcome is thus one way to demonstrate bad faith; however, it is neither the only way, nor an exhaustive definition of bad faith.[119]

The Second Circuit, in an effort to elaborate its test, delineated several factors related to the manner in which the fund's directors conduct the fee negotiations that are "important" to determine whether the adviser violated its fiduciary duty under section 36(b).[120] Notably, however, the court stated that even if the trustees endeavored to act responsibly, a fee nonetheless could be "so disproportionately large as to amount to a breach of fiduciary duty in violation of section 36(b)."[121] In other words, the court conceded that the test is not solely whether the fee is "so disproportionately large," but that a disproportionate fee is one way for a court to infer that an adviser breached its fiduciary duty. Conversely, the court's language also clearly indicates that the behavior of the fund's trustees is a consideration that bears on the adviser's compliance with its fiduciary duty. Thus, if independent fund directors act properly, a disproportionate fee still may indicate a breach of fiduciary duty. By the court's own reasoning, however, if fund directors do *not* behave properly, then that improper behavior is an important consideration as to whether the adviser breached its duty.

Furthermore, given the court's clear acknowledgement that a reasonableness standard is appropriate, its phrase "so disproportionately large that it bears no reasonable relationship to the services rendered" is either a verbose way to express a reasonableness requirement or it wrongly introduces a stricter requirement that contradicts the very reasonableness standard that the court seemingly

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117. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1045-46 (S.D.N.Y. 1981) (emphasis added).

118. Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1246 (Del. 1999).

119. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006) (noting non-exhaustive examples of conduct that would establish a lack of good faith).

120. *Gartenberg*, 694 F.2d at 930.

121. *Id.*

endorsed.[122] The reading more consistent with legislative history and the rest of the opinion is that the court spoke clumsily. Certain important conclusions follow from this analysis. For example, the waste standard has no application whatsoever, a point that the Supreme Court underscored two years later.[123] Moreover, the deferential business judgment standard of review has no place under a "reasonableness" standard, as corporate fiduciary duty jurisprudence makes clear,[124] particularly when the genuine independence of fund directors is not established. Finally, the *Gartenberg* court ultimately concluded that the fees in that case were not unfair and evaluated the adviser's conduct pursuant to the fairness test applied by Judge Pollack[125] and referred to several times by the court.[126] Thus, fairness is the applicable standard for judicially reviewing advisory fees. It is a strikingly odd feature of the *Gartenberg* case that Judge Pollack and the Second Circuit initially questioned a "reasonableness" standard,[127] but then acknowledged that section 36(b) triggered judicial review of adviser conduct by "rigorous scrutiny," which required "utmost fairness."[128] In corporate fiduciary duty law, it is well known that the fairness standard of review requires "even more exacting scrutiny" than judicial review for reasonableness.[129] Under a fairness standard of review, courts closely scrutinize both the conduct of a self-dealing fiduciary and the substance of the deal struck.[130] Thus, by substituting

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122. *See* Phillips, *supra* note 114, at 9 ("[T]he directors . . . [have] the duty to satisfy themselves on an annual basis that the investment adviser satisfied its fiduciary duty to have a reasonable fee.").

123. Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 534 n.10 (1984) ("The new right created by § 36(b) is not only formally distinct from that asserted in a state claim of corporate waste; it is substantively different as well. Indeed, an important reason for the enactment of § 36(b) was Congress's belief that the standards applied in corporate waste actions were inadequate to ensure reasonable adviser fees."). Thus, Judge Pollack is simply wrong to assert that Congress "did not indicate that the common law standard of 'corporate waste,' which had previously been available to challenge advisory fees, was to be disregarded as an element of the Court's inquiry." Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1046 (S.D.N.Y. 1981).

124. *See, e.g.*, Paramount Commc'ns, Inc. v. QVC Network, 637 A.2d 34, 42 (Del. 1994) (noting situations mandating that a court take a more direct and active role in overseeing decisions of directors and subjecting directors' conduct "to enhanced scrutiny to ensure that it is reasonable").

125. 528 F. Supp. at 1045, 1047, 1049, 1055.

126. *Gartenberg*, 694 F.2d at 926-27, 930.

127. *Id.* at 926-27; 528 F. Supp. at 1045.

128. *See Gartenberg*, 528 F. Supp. at 1045, 1047, 1049, 1055.

129. *QVC Network*, 637 A.2d at 42 n.9. Coates & Hubbard, *supra* note 42, at 204-05, puzzlingly finds "fairness" a more congenial standard for section 36(b) than a "reasonableness" standard, but they do not note the stricter scrutiny brought to bear by a court under the former standard.

130. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

a fiduciary duty standard for the earlier proposed reasonableness standard, Congress did not shift the analytical focus away from the *substance* (amount) of the management fee but *heightened* the judicial standard for reviewing the totality of adviser conduct.

The *Gartenberg* court articulated several considerations that bear on the section 36(b) fiduciary duty analysis, and later decisions distilled these into six factors called the "*Gartenberg* factors."[131] These factors are: (1) the nature and quality of services provided to fund shareholders, (2) the profitability of the fund to the adviser-manager, (3) fall-out benefits, (4) economies of scale, (5) comparative fee structure, and (6) the independence and conscientiousness of the trustees. After considering these factors, the *Gartenberg* court affirmed the dismissal of the complaint.[132]

C. The Aftermath of Gartenberg

The most remarkable statistic under section 36(b) is that, thirty-seven years after its enactment and twenty-five years after *Gartenberg*, no investor has obtained a verdict against an investment adviser.[133] Either no adviser has breached its fiduciary duty by charging an excessive fee or something is amiss under section 36(b). Another telling statistic is that advisory fees do not change significantly over time, and advisers rarely are fired.[134] As observers revisit the Act in the wake of several recent mutual fund scandals,[135] scholars are criticizing *Gartenberg* and its progeny severely and justifiably.[136] Scholars raise the question whether, in light of no investor victories, section 36(b) is working as intended—i.e., as an "independent check" on excessive fees.[137]

In the aftermath of *Gartenberg*, however, two additional statistics have not been highlighted.[138] The first is that of 150 decisions citing *Gartenberg*, only thirty mention its independence

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131. *See supra* note 11 and accompanying text.

132. 694 F.2d at 934.

133. *See supra* note 16 and accompanying text.

134. *See* Camelia M. Kuhnen, Dynamic Contracting in the Mutual Fund Industry 15-16 (Feb. 15, 2005) (unpublished manuscript, on file with Vanderbilt Law Review), *available at* http://ssrn.com/abstract=687530 (noting that only about ten percent of all mutual funds renegotiate the management fee or change the subadviser in any given year, and that there are only a handful of cases where a primary adviser was fired).

135. *See* notes 24-26 and accompanying text.

136. *See* Langevoort, *supra* note 20, at 1023-24; Palmiter, *supra* note 14, at 179-82.

137. *See* Daily Income Fund, Inc., v. Fox, 464 U.S. 523, 541 (1984) (noting actions under section 36(b) intended by Congress to serve as "independent checks" on excessive fees).

138. For an analysis of these two statistics, see *infra* Appendix A, pp. 537-42.

factor.[139] Of those thirty cases, sixteen involved motions to dismiss that were granted, six involved motions to dismiss that were granted in part and denied in part, one involved a motion to dismiss that was denied, three involved motions for summary judgment that were granted, one was a decision on the merits for the defendant, one granted a motion to reconsider, and three involved motions to dismiss that were affirmed on appeal.[140] All thirty cases that mention the independence factor also include the troubling "substantially disproportionate" language analyzed *supra*,[141] and forty-nine additional cases mentioned that language without discussing independence.[142] The independence factor, which has been contested so hotly in the SEC's rulemaking efforts,[143] does not play an important role in very many section 36(b) cases and does not help investors in these cases. Moreover, the concept has not evolved over the decades and is equated, too simplistically, with a lack of "interest" as defined under the Act.

The second statistic relates to a breakdown of post-*Gartenberg* cases by circuit. Many of the section 36(b) cases are from the Second Circuit, where *Gartenberg* was decided.[144] The Sixth and Eleventh Circuits have no reported decisions under section 36(b), and the D.C. Circuit has only one.[145] The Fourth, Eighth, and Ninth Circuits are the only other circuits that have adopted *Gartenberg*,[146] although decisions in the First, Third, Fifth, Seventh, and Tenth Circuits clearly refer to the decision.[147]

These statistics suggest that some circuits might be open to an alternative approach for interpreting section 36(b). Even as to those circuits that have adopted, or at least refer to, *Gartenberg*, renewed attention to the crucial but neglected concept of independence offers a promising method for injecting greater investor protection into the

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139. *See infra* Appendix A, pp. 537-38. This suggests that the assertion by Coates & Hubbard, *supra* note 42, at 210, that "[in] most subsequent opinions, the courts appropriately spend a substantial amount of time evaluating the credibility, credentials, and reasonableness of fund directors in their evaluation of fees," is not, with respect to the *Gartenberg* independence factor, supported by the evidence. Moreover, Coates and Hubbard predominantly use the term "disinterested" director without addressing how a different conception of "independence" under section 36(b) might alter judicial review. *Id.*

140. *See infra* Appendix A, pp. 537-38.

141. *See supra* notes 115-119 and accompanying text; *infra* Appendix A, pp. 537-38.

142. *See infra* Appendix A, pp. 539-41.

143. *See supra* notes 3-6 and accompanying text.

144. *See infra* Appendix A, pp. 537-41.

145. *See infra* Appendix A, p. 541.

146. *See infra* Appendix A, p. 541.

147. *See infra* Appendix A, pp. 541-42.

fiduciary duty standard adopted in section 36(b*)*. Examining the trajectory traced by independence in corporate law over the twenty-five years since *Gartenberg* reveals why focusing on the concept of independence can increase protection for mutual fund investors.

IV. THE RISE OF INDEPENDENCE IN CORPORATE LAW SINCE *GARTENBERG*

If both the contours and the role of independence have languished in mutual fund fee litigation in the last twenty-five years, they have flourished in corporate fiduciary litigation. Professor Jeffrey Gordon has compiled empirical data showing a steady increase in the representation of independent directors on corporate boards from approximately twenty percent in 1950 to approximately seventy-five percent in 2005.[148] Bearing in mind that there are different definitions of "independence"—a central point of this Article—the trend is impressive.

Understandings of independence in corporate law have been enriched from several sources and have broadened considerably over the last twenty-five years. The New York Stock Exchange ("NYSE"),[149] Nasdaq,[150] state fiduciary duty law,[151] and prestigious bodies such as the American Law Institute and the American Bar Association Committee on Corporate Law have contributed valuable perspectives on the importance and meaning of "independence" in corporate law.[152] Since the passage of the Sarbanes-Oxley Act in 2002, Congress and the SEC have spoken more fully to the independence issue.[153] Some

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148. *See* Gordon, *supra* note 1, at 1565 tbl.1. A recent survey by Shearman & Sterling found that, among the hundred largest public companies, independent directors continue to comprise seventy-five percent or more of the boards for the majority of them. TheCorporateCounsel.net Blog, http://www.thecorporatecounsel.net/blog/archive/001321.html (Mar. 1, 2007, 5:46 EST) (on file with Vanderbilt Law Review) (summarizing Shearman & Sterling's 4th Annual Corporate Governance Survey). The role of independent directors in corporate governance has been extensively addressed. *See* Sale, *supra* note 19, at 1381 n.32 (collecting commentary).

149. The independence requirements for directors of companies listed on the New York Stock Exchange are described in Lyman Johnson & Mark Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1159-68 (2004). For an argument that the Sarbanes-Oxley Act and NYSE standards may lead "independent" directors to become "public" directors whose chief function is risk management, see Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817 (2007).

150. Johnson & Sides, *supra* note 149, at 1168-75 (describing Nasdaq independence requirements).

151. *See infra* notes 157-185 and accompanying text.

152. *See* Gordon, *supra* note 1, at 1481 nn.46-47, 1490 n.93.

153. *See* Johnson & Sides, *supra* note 149, at 1159-74; *see also* Executive Compensation and Related Person Disclosure, Securities Act Release. No. 8732A, Exchange Act Release No. 54,302A, Investment Company Act Release No. 27,444A, 71 Fed. Reg. 53,158, 53,254-59 (Sept. 8,

sources, notably the NYSE and Nasdaq, adopted a rules-based approach to the concept of independence after the passage of the Sarbanes-Oxley Act, just as section 2(a)(19) of the Act has done for mutual funds. The NYSE prudently has cautioned, however, that it is "not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company."[154] The NYSE also rightly resisted taking the position "as a categorical matter that any director who passes the bright line tests [under the listing standards] is per se independent."[155]

The influential Delaware courts have taken a more open-textured standards approach to independence in preference to a specific rules approach.[156] These courts, which are called on repeatedly to delineate the equitable limitations on the exercise of legal powers by those owing fiduciary duties, such as directors and controlling shareholders, have deployed independence as a core component of fiduciary duty analysis over the last three decades. Proceeding by the common law method of adjudication, the Delaware courts have shaped the notion of independence in a way that is more subtle and efficient than what legislation or administrative agency rules alone can do.

An initial endorsement of independence from the Delaware Chancery Court appears as early as 1971 in *Puma v. Marriott*.[157] Independence in corporate law had not yet been separated fully from the related concept of the outside director, and, therefore, the Court spoke of "outside, independent directors whose sole interest was the furtherance of the corporate enterprise."[158] In 1984, the Delaware Supreme Court elaborated a broad, philosophical definition of "independence" that, in substance, harkened (without citation) back to

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2006) (adopting new item 407 of Reg. S-K and Reg. S-B requiring narrative explanation of independence status of directors under a company's director independence policies).

154. *See* NYSE, Inc., Listed Company Manual § 303A02 cmt. (2004).

155. *See* NYSE Listed Company Manual Section 303A, Corporate Governance Listing Standards, Frequently Asked Questions 8 (last updated Feb. 13, 2004), *available at* http://www.nyse.com/pdfs/section303Afaqs.pdf.

156. *See infra* notes 157-185 and accompanying text. For another well-developed assessment of how Delaware's approach to the independence issue differs from that taken by the Sarbanes-Oxley Act, the NYSE, and Nasdaq, see Usha Rodriguez, *The Fetishization of Independence* (Univ. of Ga. Sch. of Law Research Paper Series, Paper No. 07-007, 2007), *available at* http://ssrn.com/abstract=968513.

157. 283 A.2d 693 (Del. Ch. 1971).

158. *Id.* at 696. See Gordon, *supra* note 1, at 1478 for a discussion of the era of the "outside" director, a concept that preceded the notions of "disinterested" and "independent" in corporate discourse.

Puma's more cryptic statement.[159] In *Aronson v. Lewis*, the Supreme Court stated:

> Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences . . . . It is the care, attention and sense of individual responsibility to the performance of one's duties . . . that generally touches on independence.[160]

Vice Chancellor Leo Strine later summarized the independence inquiry as asking, broadly, whether "a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind."[161]

Many observers question whether genuine independence of the sort so loftily described above has been attained, or is attainable, in corporate law.[162] Other commentators have not faulted so much the seemingly broad conceptual definition of "independence," as they have criticized how Delaware courts have resolved the independence issue in particular factual settings, especially as courts sometimes may underemphasize personal and social connections among directors.[163] The point here is not to contend that Delaware courts always have handled the concept of director independence properly in fiduciary analyses, but rather to explore the broader meaning and reach of the concept as contrasted to mutual fund fee litigation under section 36(b) of the Act.

At a doctrinal level, the conceptual breadth of independence articulated in *Aronson* repeatedly has been reaffirmed.[164] Moreover, the centrality of the concept in fiduciary duty analysis has been underscored, thereby enabling the concept to grow in several ways. First, in several contexts, the independence of directors is now a pivotal inquiry that goes beyond examining the mere structural or putative composition of the board.[165] It is significant in director conflict-of-interest transactions,[166] in reviewing defensive measures

159. Aronson v. Lewis, 473 A.2d 805 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

160. *Id.* at 816.

161. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003).

162. *See, e.g.*, Brudney, *supra* note 19.

163. *See* Brown, *supra* note 18, at 70; Gelb, *supra* note 18, at 135; Rachel Fink, Note, *Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate "Rubber Stamping" Boards*, 79 S. CAL. L. REV. 455 (2006).

164. *See, e.g.*, Kahn v. Lynch Commc'n Sys., 638 A.2d 1110 (Del. 1994); Rales v. Blasband, 634 A.2d 927 (Del. 1993); *In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ.A. 16415, 2004 WL 1305745 (Del. Ch. May 3, 2004); Orman v. Cullman, 794 A.2d 5 (Del. Ch. 2002).

165. *See supra* note 148 and accompanying text.

166. *See, e.g.*, Teachers' Ret. Sys. of La. v. Aidinoff, 900 A.2d 654, 669 nn.19-20 (Del. Ch. 2006).

relating to hostile takeovers,[167] in determining whether demand on the board is excused in derivative litigation,[168] in reviewing the conduct of special litigation committees in demand-excused derivative litigation,[169] and in reviewing the performance of special negotiating committees dealing with controlling shareholders on major transactions.[170] Second, the Delaware Supreme Court, invoking *Aronson*'s broad language on independence,[171] has emphasized that the independence inquiry is not limited to an examination of interrelationships between board or committee members and a corporate actor owing a fiduciary duty, but also entails examining whether such members actually "functioned independently."[172] In other words, independence has both a structural and a process dimension, the latter often being overlooked.

Finally, the broad philosophical framing of independence found in *Puma* and *Aronson* enabled the concept to break free of the narrower notion of interestedness with which it often was (and still is) confused. In 2002, Chancellor William Chandler wrote that although "interest and independence are two separate and distinct issues, these two attributes are sometimes confused by parties."[173] Vice Chancellor Strine, lauding Chandler's analysis of independence as "searching and sophisticated,"[174] summed up the difference between the two attributes this way:

> A director is interested if he receives something from the transaction that is different than that received by the corporation or its other stockholders. A director is not independent if his relationship to a director interested in the decision at hand makes him unable to fulfill his duties to the corporation impartially.[175]

167. *See, e.g.*, Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

168. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); *Rales*, 634 A. 2d 927; *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563 (Del. Ch. 2007).

169. *See, e.g.*, Zapata v. Maldonado, 430 A.2d 779 (Del. 1981); *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

170. Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997); Gesoff v. IIC Indus., 902 A.2d 1130 (Del. Ch. 2006).

171. *See supra* note 160.

172. *Kahn*, 694 A.2d at 429-30; *see also In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ.A. 16415, 2004 WL 1305745, at *33 (Del. Ch. May 3, 2004).

173. Orman v. Cullman, 794 A.2d 5, 25 n.50 (Del. Ch. 2002). The Chancellor then goes on at length to describe the differences. *Id.*; *see also* MODEL BUS. CORP. ACT § 8.01 official cmt. (1984) (noting that the Model Business Corporation Act does not attempt to define independent director, unlike stock exchange listing standards, and stating that "disinterestedness" is not identical to "independence").

174. Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1380 n.32 (2002).

175. *Id.* at 1377 n.16.

Strine also observed that whether a director can "act independently" is "inherently situational."[176] This captures the fact-sensitive, context-laden approach to the subject of independence as an equitable standard rather than a bright-line, legal rule. The state law approach does not displace and it is not displaced by Sarbanes-Oxley or applicable to NYSE or Nasdaq listing standards.[177] Rather, each supplements the other by taking different regulatory approaches.

A director may lack independence on a matter, in the sense described by Chancellor Chandler, if he is "beholden" to another officer, director, or controlling shareholder proposing a transaction with the corporation.[178] Such a state exists if the other party has the direct or indirect power to

> decide whether the challenged director continues to receive a benefit, financial or otherwise, upon which the challenged director is so dependent or is of such subjective material importance to him that the threatened loss of that benefit might create a reason to question whether the controlled director is able to consider the corporate merits of the challenged transaction objectively.[179]

The reason for concern in these settings was noted cogently by French philosopher René Descartes: "A man is incapable of comprehending any argument that interferes with his revenue."[180] Alternatively, a director may lack independence because of a "close personal or familial relationship or through force of will."[181]

Notably, the focus is not simply whether a director whose independence is at issue has a relationship to the *company*, as is the case under Sarbanes-Oxley and NYSE and Nasdaq listing standards,[182] but whether that director has a connection to the particular *fiduciary* (director, officer, controlling shareholder) who is dealing with the company on a transaction.[183] The Delaware "duty" approach of examining relationships with particular persons as the crux of the independence inquiry reinforces the underlying thrust of the "rules" approach because there, too, the ultimate "concern is independence from management."[184] Under Delaware's approach, there are numerous cases in which, at particular procedural stages of

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176. *Id.*; *see also* Beam v. Stewart, 845 A.2d 1040, 1049 (Del. 2004) ("Independence is a fact-specific determination made in the context of a particular case.").

177. *See* Johnson & Sides, *supra* note 149.

178. *Orman*, 794 A.2d at 25 n.50.

179. *Id.*; *see also In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563 (Del. Ch. 2007).

180. DANIEL YANKELOVICH, PROFIT WITH HONOR 140 (2006) (quoting Descartes).

181. Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002); *Orman*, 794 A.2d at 25 n.50.

182. *See* Johnson & Sides, *supra* note 149, at 1213.

183. *See* Rodriguez, *supra* note 156, at 53.

184. NYSE, Inc., Listed Company Manual § 303A.02 cmt. (2004).

litigation, the independence of one or more directors was found lacking or questionable.[185]

Many of these instances involved directors who, in the mutual fund context, would not be considered "interested" under the Act.[186] For example, a mutual fund director who is a brother-in-law, son-in-law, or grandson of the investment adviser's CEO is not interested statutorily but should not be considered independent either.[187] Likewise, a fund director who has significant, non-fund-related financial dealings with such a CEO or any other senior officer of, or principal in, the investment adviser should not be considered independent. A director who is, or has a family member who is, a partner, co-investor, or party otherwise financially involved with an officer or principal of the adviser may not be independent. Concern for their own or their family's well-being may prevent the director from placing the company's interests first.[188] Such close personal, financial, and, in some settings, social connections[189] raise substantial doubts

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185. *See, e.g.*, *Telxon*, 802 A.2d 257; *In re* InfoUSA, Inc. S'holders Litig., No. Civ.A. 1956-CC, 2007 WL 2419611, at *16 (Del. Ch. Aug. 13, 2007); *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563 (Del. Ch. 2007); Ryan v. Gifford, 918 A.2d 341, 356, 361 (Del. Ch. 2007); *In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ.A. 16415, 2004 WL 1305745 (Del. Ch. May 3, 2004); *see also* Brown, *supra* note 18, at 72 nn.93-94, 73 nn.98-101 (collecting additional authority); Strine, *supra* note 174 (collecting authority).

186. *Cf.* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 266 (2002) (noting the possibility that "some directors who are classified as independent are not truly independent of management because they are beholden to the company or its current CEO in ways too subtle to be captured in customary definitions of independence").

187. *See In re Emerging Commc'ns, Inc.*, 2004 WL 1305745, at *34 (citing family relationships found to raise a concern about director independence); Strine, *supra* note 174 (same).

188. Section 2(a)(19)(B)(vii) of the Investment Company Act includes within the definition of "interested person":

> [Any] natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or . . . with the principal executive officer or any controlling person of such investment adviser.

Investment Company Act of 1940 § 2(a)(19)(B)(vii), 15 U.S.C. § 80a-2(a)(19)(B)(vii) (2000). The provision, by its terms, requires an SEC order before such a person is considered "interested." Such a determination is not retroactive. *See* Barnett, *supra* note 14, at 166-68. Thus, close connections between senior officers of an adviser and fund directors are unlikely to make such directors "interested" for purposes of section 36(b) litigation. Under Delaware law, by way of contrast, concerns about independence would arise in that situation.

189. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003) (finding members of special litigation committee not independent); *see also* Beam v. Stewart, 845 A.2d 1040, 1050-52, 1054-56 (Del. 2004) (noting that some social connections can raise serious concern as to director independence and contrasting independence inquiries in pre-suit demand and demand-excused contexts).

about director independence. But, with respect to a mutual fund company, such persons are not considered "interested" under the Act and, therefore, automatically are considered "independent." Finally, a director who has other directorships with funds managed (or sub-managed) by the adviser (or subadviser) may not be a trustworthy person to act only in the interests of the fund and its investors.[190]

The aim here is not to recount exhaustively the myriad ways in which a director may lack independence. Rather, by looking to corporate law for guidance, we see that in the mutual fund arena it is wrong and simplistic to equate the independence factor under the *Gartenberg* analysis with the Act's narrow statutory definition of "interestedness." How might mutual fund fee litigation under section 36(b) draw on corporate law's more sophisticated understanding of "independence" to increase investor protection?

V. A PROPOSAL FOR BORROWING "INDEPENDENCE" FROM CORPORATE LAW TO IMPROVE MUTUAL FUND FEE LITIGATION

One response to the stunning lack of investor success under *Gartenberg* and its progeny would be for Congress to amend section 36(b) to better advance investor welfare. This might be done by expanding the category of "interested persons" under section 2(a)(19), perhaps by removing from subsection (vii) the requirement of a prior Commission order.[191] Another possibility is to specify more fully and precisely the duties of fund directors.[192] Perhaps, too, some modest exposure to liability on the part of fund directors themselves, of the kind suggested in the American Law Institute's Principles of Corporate Governance,[193] might lead to greater vigilance in negotiating the advisory contract. Another response would be to rethink the existing "fiduciary duty" standard in a way that provides more meaningful protection for investors. This Article favors the last approach.

In two respects, the independence factor from *Gartenberg* should play a more prominent role in mutual fund fee litigation under section 36(b). First, as has occurred in corporate law discourse over

190. *See supra* notes 98-106 and accompanying text.

191. *See supra* note 188 (noting the necessity of an SEC order determining that certain persons come within the statutory definition of "interested person").

192. *See* Hurst, *supra* note 28, at 152-53 (calling for statutory strengthening of fiduciary duties).

193. 2 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.19 (1994) (permitting stockholders to limit director or officer liability, but only to the amount of annual compensation).

the past twenty-five years, the concept of independence must be more sharply distinguished from the related, but distinct and narrower, notion of interestedness. Although the term "independence" entered the vocabulary earlier in the mutual fund industry,[194] it continues to be a shrunken conception that is equated simplistically with a lack of "interestedness."[195] It is perhaps more, not less, important to have a robust conception of independence in the mutual fund industry given that investors in funds have, overall, less influence over fund affairs than shareholders have over corporate affairs. Second, the concept of independence must assume greater procedural significance in section 36(b) litigation.

The enactment of section 36(b) reveals a policy decision to transform the very nature of the investment advisory agreement from a mere contractual interaction between the adviser and the fund into a fiduciary relationship. By deeming the adviser to owe a fiduciary duty, the statute effectively considers the advisory contract to represent self-dealing by the adviser in relationship to the fund. A core requirement of fiduciary duty is an obligation of loyalty prohibiting self-dealing by a fiduciary except under strict conditions.[196] Moreover, the adviser might be characterized as an agent of the mutual fund, thereby owing the array of duties, including loyalty, owed by an agent to its principal. This applies to subadvisers and portfolio managers as well; as subagents they, too, owe an ultimate duty of loyalty to fund investors.[197] Traditionally, as the Second Circuit recognizes,[198] a fiduciary who deals with a company to whom a duty is owed must carry the burden of proving that the transaction is in the best interests of the company and is fair.[199] Moreover, judicial review of such matters is close and searching, not deferential.[200] Courts review both process and substance in making this overall

194. *See supra* text accompanying note 60 (considering the requirement that forty percent of the board of a mutual fund be independent); cases cited *supra* notes 157-161 and accompanying text (describing an "independent" director as one who carries out his duties solely in the interest of the corporate enterprise without any extraneous considerations or influences).

195. *See supra* notes 59, 61-62 and accompanying text (explaining that both the Supreme Court and the SEC have equated the ideas of independence and disinterestedness).

196. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986) (reiterating that a corporate director owes a fiduciary duty of loyalty to the corporation); RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006) (explaining that an agent owes a fiduciary duty of loyalty to the principal).

197. *See* RESTATEMENT (THIRD) OF AGENCY § 3.15(i) & cmt. d (defining subagent and imposing upon subagents a duty of loyalty to the principal).

198. Lewis v. S.L. & E., Inc., 629 F.2d 764, 768 (2d Cir. 1980).

199. *Id.*

200. *Id.* at 769; Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

"fairness" determination.[201] If disinterested, independent directors carefully approve a self-dealing transaction with a director, for example, courts will accord greater deference to that decision because they have greater assurance that a "neutral decisionmaker" appropriately has approved the matter.[202]

Where a special negotiating committee of disinterested, independent directors approves a self-dealing transaction with a controlling shareholder, however, the directors also must *function* independently; they must bargain freely at arm's length and make a well-advised decision not dictated by the shareholder.[203] Even if those exacting requirements are met, the court will still review closely the matter under a fairness standard but will place the burden of proof on the plaintiff.[204] The reason for retaining the demanding fairness standard (which requires not simply the best price, but also a "fair price") is to address a basic policy concern that arises when a controlling shareholder engages in self-dealing. Due to shareholder control, directors or minority investors might perceive that their disapproval will lead to retaliation by the controlling shareholder; such a perception never can be eliminated fully and may taint the approval process.[205] Therefore, the court, despite various procedural precautions, substantively reviews transactions with a controlling shareholder under a more stringent fairness standard.[206]

Except for the explicit requirement of section 36(b) that the plaintiff rather than the defendant shall carry the burden of proof, all other typical fiduciary safeguards should be construed as falling within the statutory "fiduciary duty" standard. Fiduciary standards in business governance, being equitable in nature as Judge Pollack recognized in *Gartenberg*,[207] are not abstract and fixed principles, but rather exist in particular historical and institutional settings and must continually be informed by "evolving standards" of expected conduct.[208] This means that the enhancements in fiduciary duty

201. *Weinberger*, 457 A.2d at 711.

202. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1170 & n.25 (Del. 1995).

203. *See* cases cited *supra* note 172 and accompanying text (discussing the Delaware Supreme Court's emphasis on the functional independence of directors).

204. Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1116 (Del. 1994); *In re* Cysire, Inc. S'holders Litig., 836 A.2d 531, 548 (Del. Ch. 2003).

205. *Kahn*, 638 A.2d at 1116; *In re Cysive, Inc.*, 836 A.2d at 548.

206. *Kahn*, 638 A.2d at 1116; *In re Cysive, Inc.*, 836 A.2d at 548.

207. *See supra* notes 110-111 and accompanying text (quoting Judge Milton Pollack's description of the proper interpretation of the statutory fiduciary duty language).

208. It is worth recalling a comment about the duty of care made by the ALI PRINCIPLES OF CORPORATE GOVERNANCE: "[T]he 'duty' . . . component[] of duty of care provisions [is] . . . flexible and dynamic . . . . [O]bligations may change over time to reflect new conditions or revised

protections for investors that have been developed in corporate law over the last twenty-five years should be transplanted into section 36(b) litigation as a matter of federal law. One of these developments is the more far-reaching and fluid definition of "independence" used in corporate law.

The *Gartenberg* independence factor, cited just thirty times in the last twenty-five years,[209] must become far more prominent in mutual fund fee litigation. The beginning point is to appreciate that, under the *equitable* fiduciary duty standard of section 36(b), the independence requirement goes well beyond the Act's *statutory* requirement that fund directors approving the advisory contract under section 15(c) not be "interested." In effect, the nature of fiduciary discourse in the mutual fund industry needs to mature and "catch up" with the parallel discourse in corporate law. The SEC came close to recognizing this but still missed the mark when it stated that "[w]e recognize that 'legal' lack of interestedness does not equate with 'real' independence."[210] That is a true observation, but it lacks legal "bite." What the SEC should have said is that "legal" lack of interestedness under section 2(a)(19) and section 15(c) of the Act does not equate automatically to genuine independence under section 36(b)'s statutory requirement that an *equitable* fiduciary duty standard of independence be met. Correctly understanding the relationship between "interestedness" and "independence" permits the fiduciary duty standard of section 36(b) to be interpreted as *legally* requiring "real" independence.

Beyond the need for a broader conception of independence—with respect to both the structure and actual functioning of the mutual fund board—section 36(b)(2) offers a way to alter the procedural obligations of each party on the independence issue. Section 36(b)(2) provides, in essence, that approval of the advisory contract by the mutual fund board "shall be given such consideration

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business practices or mores. Duty of care provisions should be interpreted in light of contemporary conditions." 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. b (1994); *see also* Paul H. Dawes, Caremark *and the Duty of Care*, *in* SECURITIES LITIGATION 2000, at 219, 225 (PLI Corp. Law & Practice Course Handbook Series No. B-1199, 2000) ("That directors owe their organizations a duty of care is a venerated standard of business law, widely if not universally accepted by the legal and financial community. The understanding of what that duty entails, however, *has changed significantly* over time." (emphasis added)). The same sensitivity to change applies with respect to the duty of loyalty and to our understanding of independence.

209. *See supra* note 139 and accompanying text (arguing that the evidence does not support the assertion that "the courts appropriately spend a substantial amount of time evaluating the credibility, credentials, and reasonableness of fund directors in their evaluation of fees").

210. Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,380 (July 27, 2004).

by the court as is deemed appropriate under all the circumstances."[211] We know from corporate fiduciary law that courts treat fully informed decisions by independent directors differently than those made by non-independent directors.[212] Given the longstanding and quite significant concerns about whether fund boards continue to be dominated by investment advisers,[213] there is no reason to presume that an independent fund board approved the advisory contract; corporate law does not make that presumption with respect to controlling shareholders. If advisers want significance attached to director approval, they should establish the independence (broadly understood) of a majority of the directors on the fund board.[214] This goes not only to structural independence; just as Delaware courts ask whether directors were fully informed and "functioned" independently, courts under section 36(b) must ask whether fund directors acted with "care and conscientiousness" in how they were informed and actually functioned. Then, if such independence is established, "appropriate" consideration should lead a court to substitute a somewhat more deferential "reasonableness" standard for the more searching "fairness" standard.[215] If, however, the adviser does not establish the independence of a majority of the fund board's directors, then the "consideration" that is "appropriate" with respect to approval of the advisory contract is markedly heightened judicial skepticism, along with continued application of the exacting fairness standard.[216]

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211. Investment Company Amendments Act of 1970 § 36(b)(2), 15 U.S.C. § 80a-35(b)(2) (2000).

212. *See supra* notes 164-169 and accompanying text (listing several contexts in which courts consider the independence of directors).

213. *See* Birdthistle, *supra* note 24, at 1442 (asserting that the market for investment advisers is not fluid).

214. There are two settings in corporate law where the defendant bears the burden of establishing independence. The first is in the demand-excused derivative litigation setting where the special litigation committee bears the burden of proving its independence. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 937 (Del. Ch. 2003). The second setting involves transactions between the company and controlling shareholders. Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997).

215. *See supra* note 129 and accompanying text (noting that the fairness standard requires "even more exacting scrutiny" than the reasonableness standard).

216. Vice Chancellor Stephen Lamb recently described how economic fairness will have a narrower range when a fiduciary self-deals with non-independent persons by means of a faulty process:

> [W]here the pricing terms of a transaction that is the product of an unfair process cannot be justified by reference to reliable markets or by comparison to substantial and dependable precedent transactions, the burden of persuading the court of the fairness of the terms will be exceptionally difficult. Relatedly, where an entire fairness review is required in such a case of pricing terms that, if negotiated and approved at arm's-length, would involve a broad exercise of discretion or judgment by the directors, common sense suggests that proof of fair price will generally require a

This approach gives the oft-overlooked section 36(b)(2) a dignity equal to the more commonly cited section 36(b)(1), which places the burden of proving a breach of fiduciary duty on the plaintiff.[217] Under the approach outlined above, the plaintiff retains the ultimate burden of proof throughout. The adviser, however, has a choice. If the adviser elects not to establish the independence of fund directors, or seeks to do so but fails, then section 36(b)(2) mandates that no (or even negative) consideration or weight be given to director approvals, and the plaintiff then must address the other *Gartenberg* factors with the court reviewing for fairness. If the adviser elects to establish, and succeeds in establishing, the independence of fund directors, the plaintiff must address the other *Gartenberg* factors with the court reviewing the advisory contract under a lesser standard of reasonableness. Alternatively, a court might rule that a plaintiff proves a breach of fiduciary duty by showing that the defendant-adviser obtained the contract without the approval of truly independent directors. Notwithstanding the breach, the defendant could be given the opportunity to avoid liability by establishing the fairness of the contract. This system mirrors the practice in corporate law, where a proven breach of the duty of care by the plaintiff does not lead to liability per se, but shifts the burden of proving fairness to the defendant.[218] Under either approach, a court should be exceedingly reluctant to dismiss, before trial, an action involving an advisory contract where the genuine independence of the fund board has not been established clearly.[219]

This approach to reviewing the advisory contract corresponds to the approach corporate law takes in reviewing significant transactions between controlling shareholders and the companies that they control. Delaware courts have described these matters as "inherently coercive,"[220] the precise structural concern that both Congress and the courts have identified in the mutual fund advisory

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> showing that the terms of the transaction fit comfortably within the narrow range of that discretion, not at its outer boundaries.

Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 748-49 (Del. Ch. 2007).

217. Investment Company Amendments Act of 1970 § 36(b)(1), 15 U.S.C. § 80a-35(b)(1) (2000).

218. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1163 (Del. 1995).

219. *See* Emerald Partners v. Berlin, 726 A.2d 1215, 1223-24 (Del. 1999) (noting that close judicial scrutiny under the demanding *Lynch* doctrine often precludes dismissal); *Kahn*, 694 A.2d at 428 (same).

220. *In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ.A. 16415, 2004 WL 1305745, at *32 (Del. Ch. May 3, 2004).

relationship.[221] It also parallels the approach taken by Delaware courts in derivative litigation where demand has been excused as futile but a special litigation committee thereafter seeks dismissal. The committee's independence in that setting is not presumed; it must be established.[222] The concerns that underlie section 36(b)—indeed, the concerns pervading the entire Act—similarly warrant special judicial vigilance on the independence issue.

The remedy under section 36(b) is restitutionary in nature, although in principle a breach of fiduciary duty need not be so limited.[223] The remedy is that the adviser returns that portion of the fee that is excessive.[224] Such a sanction may not prevent adviser overreaching because the only penalty for a successful investor lawsuit is the restoration of ill-gotten gain, which may not prove to be a behavioral deterrent. At the same time, such a remedy forecloses those policy concerns that sometimes are raised about damage awards against corporate directors deterring service by qualified persons or inducing suboptimal risk-averse behavior.[225] A credible monetary sanction clearly reinforces the statutory requirement that "noninterested" directors must be the key decisionmakers for mutual fund matters, including the advisory contract.

In this way, mutual fund fee litigation complements the policy aims sought by the stalled SEC rules on director independence.[226] Risk of liability under section 36(b)—even if that risk is only marginally heightened and only occasionally realized because some directors no longer are considered "independent" under the broader reach of that term advocated here—likely will induce advisers to ensure more zealously that directors who approve the advisory contract truly are both disinterested and independent. This is especially true if an adviser suffering an adverse verdict under section 36(b) were required to disclose that fact prominently in communications to investors for, say, the next year or so. That rule introduces reputational considerations into adviser conduct. Greater risk of an adverse outcome for the adviser should serve investor interests better by

221. *See supra* notes 33, 37 and accompanying text (noting the dominant and controlling position of most investment advisers and the potential for conflicts between investor and adviser interests).

222. *See supra* note 214.

223. *See* Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049, 1056-61 (2007) (describing various remedies for an agent's breach of duty).

224. Investment Company Amendments Act of 1970 § 36(b)(3), 15 U.S.C. § 80a-35(b)(3) (2000).

225. *See* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 455-56 (2005) (discussing concerns).

226. *See supra* notes 3-5 and accompanying text.

eventually inculcating a stronger norm of fiduciary obligation on both the advisers' and fund directors' parts. To alter institutional norms in the mutual fund industry may require an occasional legal "nudge" from the judiciary—i.e., an investor victory. Healthy norms often are undergirded and nourished by sound regulation;[227] at least the two cannot be at odds, as they seem to be today. A heightened norm and culture of loyalty to investor interests may lead to real bargaining for lower fees of the kind at least modestly seen, for example, with the AIM Funds.[228] Some greater evidence of genuine bargaining over advisory fees may instill greater public confidence and, at some point, lead to another twenty-five years with no investor victories under section 36(b), but for the quite different reason that such wins finally are not needed anymore.

CONCLUSION

Fiduciary duty discourse has traced a "path dependent" course in the cabined world of mutual fund fee litigation. As a result, the "fiduciary duty" regulatory approach to advisory fees adopted in section 36(b) has failed to provide meaningful investor protection. One reason is that courts continue to be guided by *Gartenberg*, a 1982 case that articulated a faulty test for assessing fiduciary conduct and spelled out six factors, one of which—independence—is stalled where it was twenty-five years ago. Meanwhile, over that same period, fiduciary duty analysis generally, and the independence inquiry specifically, have matured and become more nuanced in corporate law. This is not to say such change always has served investor interests, and this Article does not make that claim for corporate decisional law.

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227. YANKELOVICH, *supra* note 180, at 137; Lauren B. Edelman & Mark C. Suchman, *The Legal Environments of Organizations*, 23 ANN. REV. SOC. 479, 479 (1997). The proposed approach of heightened judicial attention to the independence factor under section 36(b) is fully consistent with the findings of Coates & Hubbard, *supra* note 42, at 205-06, as to the "overall" competitiveness of the mutual fund industry. Their legal and economic analysis leads them to conclude that courts under Section 36(b) should continue to assess the role and effectiveness of fee approvals by disinterested directors. *Id.* at 55-56. The thesis of this article is that, in doing so, courts must be more vigilant in ensuring that directors are genuinely independent.

228. Tom Lauricella, *Independent Directors Strike Back*, WALL ST. J., July 5, 2006, at R1 (describing fund director success in bargaining with advisers for lower fees). Mutual fund culture may currently be changing in another respect, as well—the increased willingness of mutual funds to be more "activist" investors, just as public pension funds and other institutional investors have been doing for some time on various corporate governance issues. *See* JoAnn S. Lublin & Phred Dvorak, *The Insiders: How Five New Players Aid Movement to Limit CEO Pay*, WALL ST. J., Mar. 13, 2007, at A1 (describing increase in assertiveness on governance issues by Putnam fund trustees); Kaja Whitehouse, *The Activist Game: It's Not Just for Hedgies*, WALL ST. J., Mar. 14, 2007, at C15 (describing increase in mutual fund activism).

Rather, it is to say that fiduciary analysis in corporate law remains open textured and adaptive, and, therefore, it has grown and retained significance over the years. Delaware courts, in short, *attend* to fiduciary duty as their unique and valuable contribution to corporate law. Federal courts address fiduciary duty issues infrequently, and therefore, they have little practice or expertise with respect to fiduciary analysis. Moreover, unlike Delaware courts, they receive little reputational payoff for expertise in the area, and they do not need to "compete" with other lawmaking jurisdictions. Accordingly, they appear content in section 36(b) cases to recite woodenly an approach long abandoned in corporate law. The result is that the all-important concept of "fiduciary duty" in mutual fund fee litigation is frozen in 1982, where courts seem happy to leave it. This might not matter if other market-based forces brought discipline to advisory fees or if institutional investors pressed directors for tighter scrutiny of management compensation, as in the corporate world. The absence of these influences in the mutual fund industry means that regulation, including both agency rulemaking and fiduciary duty litigation, must be a more potent disciplinary mechanism.

Although the industry never has been defeated in a section 36(b) case, it nonetheless resists proposed rules requiring an independent chair and a seventy-five percent majority of independent directors. Of course, "independence" in the mutual fund lexicon means something narrower than it does in corporate law. It means "ostensible independence." But that difference makes the resistance more puzzling. Perhaps industry insiders believe that ostensible independence is an acceptable regulatory outcome but that genuine independence is not. Genuine independence looks beyond a mere lack of "interestedness" as defined in the Act and explores business and other connections between fund directors and advisory and subadvisory personnel, much as in contemporary corporate law. Moreover, as Professor Kuhnen concludes genuine independence may result in lower advisory fees.

Ostensible independence is a social convention that does not demonstrably lower fees. Consequently, the fund industry can live with ostensible independence for now. A strategy that resists a policy initiative aimed at increasing the *number* of ostensibly independent directors is a strategy that, even if it loses, successfully can resist direct government regulation of fees and preserve vast autonomy over compensation. What really matters, and what the new numerical rules on independence only approximate, is genuine independence, a concept that cannot be legislated categorically but only can be examined—as Delaware corporate law so clearly reveals—on a case-by-case basis in particular contexts. Therefore, a political strategy of resisting the new rules, but then acquiescing or compromising, provides good cover while still preserving fees.

Investors in mutual funds, following the lead of shareholders in public corporations,[229] could seek to amend fund bylaws to adopt a stricter definition of "independence." With respect to section 36(b), however, only courts can demand genuine independence, rather than its appearance, from fund directors. By looking to modern corporate fiduciary discourse for guidance, courts may conclude that some "disinterested" directors under the Act are not really "independent." By refashioning independence—which is, after all, a *Gartenberg* factor—to be more contemporary and central to their analysis, courts are unlikely to open the floodgates of litigation. They probably will disqualify some fund directors from the "independent" category. Perhaps that will give investors a few victories under section 36(b), thereby making derivative litigation a more "serviceable mechanism" for attaining accountability.[230] More importantly, that first win or two may motivate both advisers and fund directors to adopt a stricter, more appropriate definition of independence for director selection purposes. That, in turn, may begin to inculcate a healthier norm and culture of genuine independence in the mutual fund industry, to the good of investors.

229. Lublin & Dvorak, *supra* note 228 (describing bylaw amendments as one technique for increased investor voice on governance issues).

230. Langevoort, *supra* note 20, at 1043.

Appendix A

The thirty decisions citing the *Gartenberg* independence factor, all of which also cite the "substantially disproportionate" language, are as follows:

Amron v. Morgan Stanley Inv. Advisors, Inc., 464 F.3d 338 (2d Cir. 2006); Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321 (4th Cir. 2001); Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404 (2d Cir. 1989); *In re* Scudder Mut. Funds Fee Litig., No. 04 Civ. 1921 (DAB), 2007 U.S. Dist. LEXIS 59643 (D.N.Y. Aug. 14, 2007); Gallus v. Ameriprise Fin., 497 F. Supp. 2d 974 (D. Minn. 2007); Jones v. Harris Assocs. L.P., No. 04 C 8305, 2007 U.S. Dist. LEXIS 13352 (D. Ill. Feb. 27, 2007); *In re* Evergreen Mut. Funds Fee Litig., 240 F.R.D. 115 (D.N.Y. 2007); Sins v. Janus Capital Mgmt., LLC, Civ. A. No. 04-cv-01647-WDM-MEH, 2006 U.S. Dist. LEXIS 90673 (D. Colo. Dec. 15, 2006); Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2006 U.S. Dist. LEXIS 60858 (D. Cal. Aug. 14, 2006); Hunt v. Invesco Funds Group, Civ. A. No. H-04-02555, 2006 U.S. Dist. LEXIS 40944 (D. Tex. June 5, 2006); *In re* AllianceBernstein Mut. Fund Excessive Fee Litig., No. 04 Civ. 4885 (SWK), 2006 U.S. Dist. LEXIS 939 (D.N.Y. Jan. 11, 2006); *In re* AllianceBernstein Mut. Fund Excessive Fee Litig., No. 04 Civ. 4885 (SWK), 2005 U.S. Dist. LEXIS 24263 (D.N.Y. Oct. 19, 2005); *In re* Columbia Entities Litig., Civ. A. No. 04-11704-REK, 2005 U.S. Dist. LEXIS 33439 (D. Mass. Nov. 30, 2005); Yameen v. Eaton Vance Distribs., 394 F. Supp. 2d 350 (D. Mass. 2005); *In re* Dreyfus Mut. Funds Fee Litig., 428 F. Supp. 2d 342 (D. Pa. 2005); Gallus v. Am. Express Fin. Corp., 370 F. Supp. 2d 862 (D. Minn. 2005); Pfeiffer v. Bjurman, Barry & Assocs., No. 03 Civ. 9741 (DLC), 2004 U.S. Dist. LEXIS 16924 (D.N.Y. Aug. 26, 2004); Benak v. Alliance Capital Mgmt. L.P., Civ. A. No. 01-5734, 2004 U.S. Dist. LEXIS 12231 (D.N.J. Feb. 9, 2004); Miller v. Mitchell Hutchins Asset Mgmt., Inc., No. 01-CV-0192-DRH, 2002 U.S. Dist. LEXIS 27675 (D. Ill. Mar. 12, 2002); Strougo v. Bea Assocs., 188 F. Supp. 2d 373 (D.N.Y. 2002); Green v. Nuveen Advisory Corp., No. 97 C 5255, 2001 U.S. Dist. LEXIS 14047 (D. Ill. Sept. 6, 2001); Krantz v. Fidelity Mgmt. & Research, Co., 98 F. Supp. 2d 150 (D. Mass. 2000); Migdal v. Migdal v. Rowe Price-Fleming Int'l, Inc., Civ. No. AMD 98-2162, 2000 U.S. Dist. LEXIS 22853 (D. Md. Mar. 20, 2000); Krantz v. Prudential Invs. Fund Mgmt. L.L.C., 77 F. Supp. 2d 559 (D.N.J. 1999); Verkouteren v. Blackrock Fin. Mgmt., Inc., No. 98 Civ. 4673 (WK), 1999 U.S. Dist. LEXIS 10892 (D.N.Y. July 16, 1999); Verkouteren v. Blackrock Fin. Mgmt., Inc., 37 F. Supp. 2d 256 (D.N.Y. 1999); Strougo *ex rel.* Brazil Fund v. Scudder, Stevens &

Clark, Inc., 964 F. Supp. 783 (D.N.Y. 1997); Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (D.N.Y. 1990); Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472 (D.N.Y. 1988); Schuyt v. Rowe Price Prime Reserve Fund, 663 F. Supp. 962 (D.N.Y. 1987).

The sixteen decisions involving motions to dismiss that were granted are as follows:

In re Scudder Mut. Funds Fee Litig., No. 04 Civ. 1921 (DAB), 2007 U.S. Dist. LEXIS 59643 (D.N.Y. Aug. 14, 2007); *In re* Evergreen Mut. Funds Fee Litig., 240 F.R.D. 115 (D.N.Y. 2007); Sins v. Janus Capital Mgmt., LLC, Civ. A. No. 04-cv-01647-WDM-MEH, 2006 U.S. Dist. LEXIS 90673 (D. Colo. Dec. 15, 2006); *In re* AllianceBernstein Mut. Fund Excessive Fee Litig., No. 04 Civ. 4885 (SWK), 2006 U.S. Dist. LEXIS 939 (D.N.Y. Jan. 11, 2006); *In re* Columbia Entities Litig., Civ. A. No. 04-11704-REK, 2005 U.S. Dist. LEXIS 33439 (D. Mass. Nov. 30, 2005); Yameen v. Eaton Vance Distribs., 394 F. Supp. 2d 350 (D. Mass. 2005); Benak v. Alliance Capital Mgmt. L.P., Civ. A. No. 01-5734, 2004 U.S. Dist. LEXIS 12231 (D.N.J. Feb. 9, 2004); Miller v. Mitchell Hutchins Asset Mgmt., Inc., No. 01-CV-0192-DRH, 2002 U.S. Dist. LEXIS 27675 (D. Ill. Mar. 12, 2002); Strougo v. Bea Assocs., 188 F. Supp. 2d 373 (D.N.Y. 2002); Migdal v. Rowe Price-Fleming Int'l, Inc., Civ. No. AMD 98-2162, 2000 U.S. Dist. LEXIS 22853 (D. Md. Mar. 20, 2000); Krantz v. Prudential Invs. Fund Mgmt. L.L.C., 77 F. Supp. 2d 559 (D.N.J. 1999); Verkouteren v. Blackrock Fin. Mgmt., Inc., No. 98 Civ. 4673 (WK), 1999 U.S. Dist. LEXIS 10892 (D.N.Y. July 16, 1999); Verkouteren v. Blackrock Fin. Mgmt., Inc., 37 F. Supp. 2d 256 (D.N.Y. 1999); Strougo *ex rel.* Brazil Fund v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783 (D.N.Y. 1997); Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (D.N.Y. 1990); Krinsk v. Fund Asset Mgmt., Inc., 715 F. Supp. 472 (D.N.Y. 1988).

The six decisions involving motions to dismiss that were granted in part and denied in part are as follows:

Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2006 U.S. Dist. LEXIS 60858 (D. Cal. Aug. 14, 2006); *In re* AllianceBernstein Mut. Fund Excessive Fee Litig., No. 04 Civ. 4885 (SWK), 2005 U.S. Dist. LEXIS 24263 (D.N.Y. Oct. 19, 2005); *In re* Dreyfus Mut. Funds Fee Litig., 428 F. Supp. 2d 342 (D. Pa. 2005); Gallus v. Am. Express Fin. Corp., 370 F. Supp. 2d 862 (D. Minn. 2005); Pfeiffer v. Bjurman, Barry & Assocs., No. 03 Civ. 9741 (DLC), 2004 U.S. Dist. LEXIS 16924 (D.N.Y. Aug. 26, 2004); Krantz v. Fidelity Mgmt. & Research, Co., 98 F. Supp. 2d 150 (D. Mass. 2000).

The single decision denying a motion to dismiss was Hunt v. Invesco Funds Group, Civ. A. No. H-04-02555, 2006 U.S. Dist. LEXIS 40944 (D. Tex. June 5, 2006).

The three decisions granting motions for summary judgment are as follows:

Gallus v. Ameriprise Fin., 497 F. Supp. 2d 974 (D. Minn. 2007); Jones v. Harris Assocs. L.P., No. 04 C 8305, 2007 U.S. Dist. LEXIS 13352 (D. Ill. Feb. 27, 2007); Green v. Nuveen Advisory Corp., No. 97 C 5255, 2001 U.S. Dist. LEXIS 14047 (D. Ill. Sept. 6, 2001).

The single decision on the merits for the defendant was Schuyt v. Rowe Price Prime Reserve Fund, 663 F. Supp. 962 (D.N.Y. 1987).

The single decision granting a motion to reconsider was *In re* AllianceBernstein Mut. Fund Excessive Fee Litig., No. 04 Civ. 4885 (SWK), 2006 U.S. Dist. LEXIS 939 (D.N.Y. Jan. 11, 2006).

The three decisions involving motions to dismiss that were affirmed on appeal are as follows:

Amron v. Morgan Stanley Inv. Advisors, Inc., 464 F.3d 338 (2d Cir. 2006); Migdal v. Rowe Price-Fleming Int'l, 248 F.3d 321 (4th Cir. 2001); Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404 (2d Cir. 1989).

The forty-nine decisions mentioning the "substantially disproportionate" language but not discussing independence are as follows:

Bellikoff v. Eaton Vance Corp., 481 F.3d 110 (2d Cir. 2007); Verkouteren v. Blackrock Fin. Mgmt., Inc., No. 99-9005, 2000 U.S. App. LEXIS 4487 (2d Cir. Mar. 21, 2000); Levy v. Alliance Capital Mgmt. L.P., No. 98-9528, 1999 U.S. App. LEXIS 20213 (2d Cir. Aug. 20, 1999); Meyer v. Oppenheimer Management Corp., 895 F.2d 861 (2d Cir. 1990); Meyer v. Oppenheimer Management Corp., 764 F.2d 76 (2d Cir. 1985); Alexander v. Member Cases Allianz Dresdner Asset Mgmt. of Amer. Holding, Inc., 509 F. Supp. 2d 190 (D. Conn. 2007); *In re* Franklin Mut. Funds Fee Litig., 478 F. Supp. 2d 677 (D.N.J. 2007); Fitzgerald v. Citigroup, Inc., No. 03 Civ. 4305 (DAB), 2007 U.S. Dist. LEXIS 15365 (D.N.Y. Feb. 22, 2007); Mintz v. Baron, No. 05 Civ. 4904 (LTS)(HBP), 2006 U.S. Dist. LEXIS 66867 (D.N.Y. Sept. 18, 2006); Everett v. Bozic, No. 05 Civ. 00296 (DAB), 2006 U.S. Dist. LEXIS 55824 (D.N.Y. Aug. 2, 2006); *In re* Salomon Smith Barney Mut. Fund Fees Litig., 441 F. Supp. 2d 579 (D.N.Y. 2006); *In re* Merrill Lynch Inv. Mgmt. Funds Sec. Litig., 434 F. Supp. 2d 233 (D.N.Y. 2006); *In re*

Mut. Funds Inv. Litig. v. Deutsche Bank AG, 437 F. Supp. 2d 449 (D. Md. 2006); *In re* Morgan Stanley & Van Kampen Mut. Fund Sec. Litig., No. 03 Civ. 8208 (RO), 2006 U.S. Dist. LEXIS 20758 (D.N.Y. Apr. 14, 2006); *In re* Oppenheimer Funds Fees Litig., 426 F. Supp. 2d 157 (D.N.Y. 2006); *In re* Evergreen Mut. Funds Fee Litig., 423 F. Supp. 2d 249 (D.N.Y. 2006); Dumond v. Mass. Fin. Servs. Co., Civ. A. No. 04-11458-GAO, 2006 U.S. Dist. LEXIS 1933 (D. Mass. Jan. 19, 2006); Forsythe v. Sun Life Fin., Inc., 417 F. Supp. 2d 100 (D. Mass. 2006); *In re* Goldman Sachs Mut. Funds Fee Litig., No. 04 Civ. 2567 (NRB), 2006 U.S. Dist. LEXIS 1542 (D.N.Y. Jan. 13, 2006); *In re* Eaton Vance Mut. Funds Fee Litig., 403 F. Supp. 2d 310 (D.N.Y. 2005); Brever v. Federated Equity Mgmt. Co., 233 F.R.D. 429 (D. Pa. 2005); Stegall v. Ladner, 394 F. Supp. 2d 358 (D. Mass. 2005); *In re* Davis Selected Mut. Funds Litig., No. 04 Civ. 4186 (MGC), 2005 U.S. Dist. LEXIS 23203 (D.N.Y. Oct. 11, 2005); *In re* Eaton Vance Mut. Funds Fee Litig., 380 F. Supp. 2d 222 (D.N.Y. 2005); ING Principal Prot. Funds Derivative Litig., 369 F. Supp. 2d 163 (D. Mass. 2005); Gilliam v. Fid. Mgmt. & Research Co., Civ. A. No. 04-11600-NG, 2005 U.S. Dist. LEXIS 10478 (D. Mass. 2005); Jones v. Harris Assocs., L.P., No. 04 C 8305, 2005 U.S. Dist. LEXIS 39560 (D. Ill. Apr. 7, 2005); Wicks v. Putnam Inv. Mgmt.. LLP, Civ. A. No. 04-10988-GAO, 2005 U.S. Dist. LEXIS 4892 (D. Mass. Mar. 28, 2005); Strigliabotti v. Franklin Res., Inc., No. C 04-00883 SI, 2005 U.S. Dist. LEXIS 9625 (D. Cal. Mar. 7, 2005); Lieber v. Invesco Funds Group, Inc., 371 F. Supp. 2d 852 (D. Tex. 2005); Zucker v. Aim Advisors, Inc., 371 F. Supp. 2d 845 (D. Tex. 2005); Yampolsky v. Morgan Stanley Inv. Advisers Inc., No. 03 Civ. 5710 (RO), 2004 U.S. Dist. LEXIS 8573 (D.N.Y. May 11, 2004); Millenco L.P. v. meVC Advisors, Inc., Civ. A. No. 02-142-JJF, 2002 U.S. Dist. LEXIS 19512 (D. Del. Aug. 21, 2002); Rohrbaugh v. Inv. Co. Inst., Civ. A. No. 00-1237, 2002 U.S. Dist. LEXIS 13401 (D.D.C. July 2, 2002); Green v. Fund Asset Mgmt., L.P., 147 F. Supp. 2d 318 (D.N.J. 2001); Strougo v. BEA Assocs., No. 98 Civ. 3725 (RWS), 2000 U.S. Dist. LEXIS 346 (D.N.Y. Jan. 19, 2000); Strougo v. BEA Assocs., No. 98 Civ. 3725 (RWS), 1999 U.S. Dist. LEXIS 3021 (D.N.Y. Mar. 11, 1999); Migdal v. Rowe Price-Fleming, Case No. AMD 98-2162, 1999 U.S. Dist. LEXIS 22001 (D. Md. Jan. 20, 1999); Levy v. Alliance Capital Mgmt. L.P., No. 97 Civ. 4672 (DC), 1998 U.S. Dist. LEXIS 16749 (D.N.Y. Oct. 26, 1998); Green v. Fund Asset Mgmt., L.P., 19 F. Supp. 2d 227 (D.N.J. 1998); King v. Douglass, 973 F. Supp. 707 (D. Tex. 1996); *In re* TCW/DW N. Am. Gov't Income Trust Sec. Litig., 941 F. Supp. 326 (D.N.Y. 1996); Langner v. Brown, 913 F. Supp. 260 (D.N.Y. 1996); Olesh v. Dreyfus Corp., No. CV-94-1664 (CPS), 1995 U.S. Dist. LEXIS 21421 (D.N.Y. Aug. 8, 1995); Wexler v. Equitable

Capital Mgmt. Corp., No. 93 Civ. 3834 (RPP), 1994 U.S. Dist. LEXIS 1651 (D.N.Y. Feb. 16, 1994); Meyer v. Oppenheimer Mgmt. Corp., 715 F. Supp. 574 (D.N.Y. 1989); Meyer for Meyer v. Oppenheimer Mgmt. Corp., 707 F. Supp. 1394 (D.N.Y. 1988); Meyer v. Oppenheimer Mgmt. Corp., 691 F. Supp. 669 (D.N.Y. 1988); Kamen v. Kemper Fin. Servs., Inc., 659 F. Supp. 1153 (D. Ill. 1987).

The only section 36(b) decision from the D. C. Circuit is Rohrbaugh v. Inv. Co. Inst., Civ. A. No. 00-1237, 2002 U.S. Dist. LEXIS 13401 (D.D.C. July 2, 2002).

The decisions in the Fourth, Eighth, and Ninth Circuits that follow *Gartenberg* are as follows:

Migdal v. Rowe Price-Fleming Int'l, 248 F.3d 321 (4th Cir. 2001); Gallus v. Ameriprise Fin., 497 F. Supp. 2d 974 (D. Minn. 2007); Siemers v. Wells Fargo & Co., No. C 05-04518 WHA, 2007 U.S. Dist. LEXIS 21935 (D. Cal. Mar. 9, 2007); *In re* Am. Mut. Funds Fee Litig., Case No. CV-04-5593 GAF (RNBx), 2007 U.S. Dist. LEXIS 8276 (D. Cal. Jan. 17, 2007); Gallus v. Am. Express Fin. Corp., 370 F. Supp. 2d 862 (D. Minn. 2005); Strigliabotti v. Franklin Res., Inc., No. C 04-00883 SI, 2005 U.S. Dist. LEXIS 9625 (D. Cal. Mar.7, 2005); Migdal v. Rowe Price-Fleming Int'l, Inc., Civ. No. AMD 98-2162, 2000 U.S. Dist. LEXIS 22853 (D. Md. Mar. 20, 2000); Batra v. Investors Research Corp., 144 F.R.D. 97 (D. Mo. 1992).

The decisions in the First, Third, Fifth, Seventh, and Tenth Circuits that refer to *Gartenberg* are as follows:

Green v. Nuveen Advisory Corp., 295 F.3d 738 (7th Cir. 2002); Green v. Fund Asset Mgmt., L.P., 286 F.3d 682 (3d Cir. 2002); Romano v. Merrill Lynch, Pierce, Fenner & Smith, 834 F.2d 523 (5th Cir. 1987); *In re* Franklin Mut. Funds Fee Litig., 478 F. Supp. 2d 677 (D.N.J. 2007); Jones v. Harris Assocs. L.P., No. 04 C 8305, 2007 U.S. Dist. LEXIS 13352 (D. Ill. Feb. 27, 2007); Sins v. Janus Capital Mgmt., LLC, Civ. A. No. 04-cv-01647-WDM-MEH, 2006 U.S. Dist. LEXIS 90673 (D. Colo. Dec. 15, 2006); Hunt v. Invesco Funds Group, Civ. A. No. H-04-02555, 2006 U.S. Dist. LEXIS 40944 (D. Tex. June 5, 2006); Dumond v. Mass. Fin. Servs. Co., Civ. A. No. 04-11458-GAO, 2006 U.S. Dist. LEXIS 1933 (D. Mass. Jan. 19, 2006); Forsythe v. Sun Life Fin., Inc., 417 F. Supp. 2d 100 (D. Mass. 2006); *In re* Columbia Entities Litig., Civ. A. No. 04-11704-REK, 2005 U.S. Dist. LEXIS 33439 (D. Mass. Nov. 30, 2005); Stegall v. Ladner, 394 F. Supp. 2d 358 (D. Mass. 2005); Yameen v. Eaton Vance Distribs., 394 F. Supp. 2d 350 (D. Mass. 2005); *In re* Dreyfus Mut. Funds Fee Litig., 428 F. Supp.

2d 342 (D. Pa. 2005); Jacobs v. Bremner, 378 F. Supp. 2d 861 (D. Ill. 2005); ING Principal Prot. Funds Derivative Litig., 369 F. Supp. 2d 163 (D. Mass. 2005); Gilliam v. Fid. Mgmt. & Research Co., Civ. A. No. 04-11600-NG, 2005 U.S. Dist. LEXIS 10478 (D. Mass. May 3, 2005); Jones v. Harris Assocs., L.P., No. 04 C 8305, 2005 U.S. Dist. LEXIS 39560 (D. Ill. Apr. 7, 2005); Wicks v. Putnam Inv. Mgmt. LLP, Civ. A. No. 04-10988-GAO, 2005 U.S. Dist. LEXIS 4892 (D. Mass. Mar. 28, 2005); Lieber v. Invesco Funds Group, Inc., 371 F. Supp. 2d 852 (D. Tex. 2005); Zucker v. Aim Advisors, Inc., 371 F. Supp. 2d 845 (D. Tex. 2005); Benak v. Alliance Capital Mgmt. L.P., Civ. A. No. 01-5734, 2004 U.S. Dist. LEXIS 12231 (D.N.J. Feb. 9, 2004); Millenco L.P. v. meVC Advisors, Inc., Civ. A. No. 02-142-JJF, 2002 U.S. Dist. LEXIS 19512 (D. Del. Aug. 21, 2002); Miller v. Mitchell Hutchins Asset Mgmt., Inc., No. 01-CV-0192-DRH, 2002 U.S. Dist. LEXIS 27675 (D. Ill. Mar. 12, 2002); Green v. Nuveen Advisory Corp., No. 97 C 5255, 2001 U.S. Dist. LEXIS 14047 (D. Ill. Sept. 6, 2001); Green v. Fund Asset Mgmt., L.P., 147 F. Supp. 2d 318 (D.N.J. 2001); Krantz v. Fidelity Mgmt. & Research, Co., 98 F. Supp. 2d 150 (D. Mass. 2000); Krantz v. Prudential Invs. Fund Mgmt. L.L.C., 77 F. Supp. 2d 559 (D.N.J. 1999); Green v. Fund Asset Mgmt., L.P., 19 F. Supp. 2d 227 (D.N.J. 1998); King v. Douglass, 973 F. Supp. 707 (D. Tex. 1996); *In re* Nuveen Fund Litig., Case No. 94 C 360, 1996 U.S. Dist. LEXIS 8071 (D. Ill. June 5, 1996); Kamen v. Kemper Financial Servs., Inc., 659 F. Supp. 1153 (D. Ill. 1987).