Client Alert

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U.S. District Court: Fund Trustees Cannot Rely on Attorney-Client Privilege in Section 36(b) Case

By Jay G. Baris

A federal district court has ordered mutual fund trustees to produce privileged documents to a plaintiff who sued an investment adviser accused of charging excessive investment advisory fees. The November 21, 2016 order may pave the way for plaintiffs in "excessive fee" cases to brush aside the attorney-client privilege and learn what independent trustees discussed with their legal counsel in executive session meetings.

In ordering fund trustees to produce complete, unredacted documents relating to their consideration of investment advisory contracts, the United States District Court for the Western District of Washington relied on a fiduciary exception to the attorney-client privilege. The Court distinguished between legal advice to fund trustees relating to their fiduciary duties in managing the fund, as compared to personal advice given to the trustees.

The case involved a claim under Section 36(b) of the Investment Company Act of 1940 that the adviser breached its fiduciary duty by charging excessive fees and failed to share the economies of scale with the fund.

The plaintiff issued non-party subpoenas to the funds' independent trustees. In response, the independent trustees redacted or withheld more than 200 documents on the basis of attorney-client privilege. The redaction logs indicated that the independent trustees withheld, among other things, communications containing confidential legal advice regarding:

- preparation for, or information received in connection with, board or committee meetings;
- consideration, addition, and/or integration of new independent trustees; and
- the annual review and approval of fund advisory contractions and Rule 12b-1 plans.

The plaintiff argued that a fiduciary exception to the attorney-client privilege should apply. That is, the plaintiff claimed that the attorney-client privilege cannot be a basis for withholding information from the beneficiary of a trust when a trustee seeks or is provided legal advice to "guide the administration of the trust." The fund was organized as a Massachusetts business trust.

The court noted that the communications at issue were provided to the independent trustees "in their role as fiduciaries" of the trust. The court accepted the plaintiff's argument that fund trustees act as representatives for the beneficiaries of the trust (that is, the shareholders), and that the trustees are not the real client in the sense that they are not being personally served by the advice. Moreover, the plaintiff argued, the independent trustees

did not seek advice concerning their own personal protection, nor did they seek advice in anticipation of litigation and that the fund, not the independent trustees individually, paid the counsel fees.

The defendants argued that the court should not extend the fiduciary exception to the mutual fund context, because it is "wholly incompatible with the legal framework governing mutual funds." Citing only two legal precedents, the court rejected this argument.

The court reasoned that while the attorney-client privilege is important, neither the defendant nor the independent trustees could "satisfactorily explain why the independent trustees, acting as fiduciaries to the beneficiaries of the trust, should be able to resist disclosure to those beneficiaries of attorney communications paid for by the trust and for the benefit of the trust."

OUR TAKE

The attorney-client privilege is one of the oldest privileges for confidential communications known to common law. Its purpose is to encourage full and frank communication between attorneys and their clients. To be sure, mutual fund trustees rely on this exemption when they consult with their counsel regarding the approval or continuing advisory contracts as required by Section 15(c) of the 1940 Act. Often this legal advice relates to complex issues that can bear directly to their potential liability. If followed by courts in other jurisdictions, this case could have a chilling effect on the conversations between independent fund trustees and their counsel, especially when they seek independent counsel on matters relating to contract renewals, compliance, compensation and a host of governance issues.

What comes next? Fund trustees should not automatically assume that the attorney-client privilege applies in all situations in the board room. They should be aware that at least one court does not recognize the attorney-client privilege in the context of Section 15(c) reviews, and may want to re-evaluate their review procedures accordingly. Another potential side-effect is that some funds may seek to avoid Massachusetts business trust structures in favor of Maryland corporations. But, it is not certain whether a change of corporate organization would have made a difference in this case.

We hope that the defendants will appeal this unfortunate order because it could have the effect of harming, rather than helping, fund shareholders long term if fund directors cannot seek legal advice without fear that their communications will become part of the public record.

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