

4-1-1995

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## Recommended Citation

James G. Smith, *Directors' Guide To Investment Company Advisor Fee Agreements And § 36(b)*, 5 U. Miami Bus. L. Rev. 209 (1995)  
Available at: <http://repository.law.miami.edu/umblr/vol5/iss1/9>

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## **DIRECTORS' GUIDE TO INVESTMENT COMPANY ADVISER FEE AGREEMENTS AND §36(b)**

James G. Smith\*

"The potential for abuse is inherent in the structure of investment companies."<sup>1</sup> Whether this statement is accurate or not is not necessarily important but what is important is the fact that such a statement was made by the United States Supreme Court. Since the enactment of the Investment Company Act of 1940 (hereinafter the "ICA"),<sup>2</sup> the federal law which regulates investment companies, the number of registered investment companies and the amount invested in investment companies has increased dramatically.<sup>3</sup>

The growth in the investment company industry has caused increased discussion on the accountability of investment companies to its shareholders. Much attention has been directed towards the potential conflict of interests between the investment company and its investment adviser about the adviser's compensation. This article looks at one aspect of this potential conflict - how investment company directors should review adviser fee agreements in order to comply with §36(b)<sup>4</sup> of the ICA.

### **I. STRUCTURE OF INVESTMENT COMPANIES AND ADVISER AGREEMENTS**

An investment company is "a pool of assets consisting of securities, belonging to the shareholders of the fund."<sup>5</sup> This "pool" is an entity created under state law and generally subject to the rules of the jurisdiction of the organization. However, investment companies must also comply with the substantive provisions of the ICA. The extent of such compliance depends on whether the investment company must be registered. The ICA requires that all

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<sup>1</sup> *Burks v. Lasker*, 441 U.S. 471, 480, 60 L.Ed.2d 404, 99 S.Ct. 1831 (1979); *See also* *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90, 93, 111 S.Ct. 1711, 114 L.Ed.2d 152 (1991).

<sup>2</sup> 15 U.S.C. §80a-35(b)(1996).

<sup>3</sup> There were 68 investment companies with \$448 million under management in 1940. In 1990, the number of investment companies was over 3,500 with over \$1.2 trillion in assets. Securities Act Rel. 6868; 46 S.E.C. 670, 671 (1990). The amount invested in investment companies has increased to \$2.2 trillion. *Wall Street Journal*, As Mutual Funds Face Growing Competition, 'Wholesalers' Struggle, March 16, 1995, p.1.

<sup>4</sup> 15 U.S.C. §80a-35(b)(1996).

<sup>5</sup> *Zell v. InterCapital Income Securities, Inc.*, 675 F.2d 1041, 1046 (9th Cir. 1982).

investment companies<sup>6</sup> be registered with the Securities and Exchange Commission ("SEC"), unless there is a specific exclusion under the ICA or the SEC grants the investment company an exemption from registration.<sup>7</sup> If the investment company is required to be registered, then most of the substantive law regulating investment companies is derived from the ICA.

Under the ICA, investment companies are divided into three categories: (1) unit investment trusts;<sup>8</sup> (2) face-amount certificate companies; and (3) management companies. The management company, the most common form of investment company, is divided into open-end investment companies, otherwise known as mutual funds, and close-end investment companies.<sup>10</sup> The two most relevant distinctions between an open-end and closed-end investment company are the offering and redemption of shares. Generally, open-end investment companies continually offer shares to investors whereas closed-end investment companies offer a limited number of shares. Open-end funds are obligated to redeem investors' shares and, as such, there are no markets in open-end fund shares. Closed-end funds do not redeem their shares, rather such shares are traded on exchanges or in the over-the counter market.<sup>11</sup>

The organization of an investment company is substantially different than a typical business entity. An investment company is usually formed as a corporation or trust under the laws of a particular state. Unlike most corporations which perform many of the functions with its own employees, an investment company's operations are performed entirely by other entities.

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<sup>6</sup> An investment company is defined as "[A]ny issuer which (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificates outstanding; or (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis; 15 U.S.C. §80a-3(a) (1996).

<sup>7</sup> See ICA §§3 and 6; 15 U.S.C. §§80a-3, 6 (1996).

<sup>8</sup> A unit investment trust is organized under a trust indenture, does not have a board of directors, and issues only redeemable securities. ICA §4(2); 15 U.S.C. § 80a-4(2) (1996). A unit investment trust is subject to the Trust Indenture Act of 1939.

<sup>9</sup> A face-amount certificate company issues securities or obligations which the issuer promises to pay a fixed sum at some determinable date. ICA §4(1); 15 U.S.C. §80a-4(1).

<sup>10</sup> ICA §5(a); 15 U.S.C. §80a-5(a).

<sup>11</sup> However, under ICA Rule 23c-3, closed-end interval funds are permitted to make periodic redemptions. 17 C.F.R. §270.23c-3. For an analysis of closed-end interval funds see, James G. Smith, *Closed-End Interval Funds: Combining the Qualities of Open-End and Closed-End Funds*, Personal Financial Planning, Nov-Dec. 1995, p.26.

These other entities are generally affiliated with the investment company's sponsor.<sup>12</sup> It is this relationship between the investment company and these related entities that the Supreme Court refers to as having the "potential for abuse."<sup>13</sup>

The ICA seeks to restrict the "potential for abuse" arising from the absence of arms-length negotiation of the fee agreement between the investment adviser and the investment company. When originally enacted, the ICA placed the burden of approving advisory fee agreements on the directors of the investment company.<sup>14</sup> However, there was no restriction on the size of that fee.<sup>15</sup> In 1970 Congress amended the ICA, adding §36(b),<sup>16</sup> which states that an investment adviser owes a fiduciary duty to a registered investment company<sup>17</sup> with respect to the adviser's compensation.<sup>18</sup>

<sup>12</sup> SEC Staff Report, *Protecting Investors: A Half Century of Investment Company Regulation*, Fed. Sec. L. Rep. (CCH) Report 1504, Extra Edition, May 29, 1992, p.251, n. 3. (Hereinafter the "SEC Staff Report").

<sup>13</sup> *Burks v. Lasker*, 441 U.S. at 480-1.

<sup>14</sup> ICA §15; 15 U.S.C. §80a-15 (1996); §15 mandates that the investment company's board of directors evaluate and approve the advisory agreement and the adviser's compensation. The advisory agreement must also be approved by the independent directors.

<sup>15</sup> "There is not a single provision in Section 15 [of the ICA] which even remotely assumes to fix what [advisers] should be paid in compensation . . . . We feel that is a question for the stockholders to decide." *SEC Staff Report*, at 257, n. 14, citing *Investment Trusts and Investment Companies: Hearings on S.3580 before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 252 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Section).

<sup>16</sup> For a history of the 1970 amendments, see *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 104 S.Ct. 831, 78 L.Ed.2d 645 (1984).

<sup>17</sup> §36(b) applies to registered investment companies and investment companies which should be registered but are not. *Goldman v. McMahan, Brafman, Morgan & Co.* [Transfer Binder 1987] Fed. Sec. L. Rep. (CCH) ¶93,354 (S.D.N.Y. 1987).

<sup>18</sup> §36(b) reads:

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, 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 investment adviser or person. With respect to any such action the following shall apply:

- (1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

The difficulty in complying with §36(b) is the lack of a definition of "fiduciary." No where in the statute or the legislative history is the adviser's fiduciary duty defined. The little discussion that is provided in the legislative history is of no assistance.<sup>19</sup> Interpreting the adviser's duty under §36(b) has been left to the courts. Therefore, investment company directors are not left without some guidance in meeting the obligations under §36(b). There exist some case law on §36(b) from which basic rules are set forth.<sup>20</sup> From these

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- (2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.
  - (3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.
  - (4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 17 of this Act, or rules, regulations, or orders thereunder, or to sales loads for the acquisition of any security issued by a registered investment company.
  - (5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.
  - (6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of sections 9 and 49 of this Act, section 15 of the Securities Exchange Act of 1934, or section 203 of the investment Advisers Act, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

<sup>19</sup> "§36(b) has been understood in light of its legislative history to put investment advisers on leashes shorter than those of corporate managers generally and to require the federal courts to decide whether the fees charged by investment advisers are 'excessive'" *Kamen v. Kemper Financial Services, Inc.*, 908 F.2d 1338, 1339-40 (7th Cir. 1990), *rev'd and rem'd* 500 U.S. 90.

<sup>20</sup> *Gartenberg v. Merrill Lynch Asset Management, Inc.* (*Gartenberg I*), 528 F.Supp. 1038 (S.D.N.Y. 1981) *aff'd* 694 F.2d 923 (2d Cir. 1982) *cert den.* *Andre v. Merrill Lynch Ready Assets Trust*, 461 U.S. 906 (1983); *Gartenberg v. Merrill Lynch Asset Management, Inc.* (*Gartenberg II*), 573 F.Supp. 1293 (S.D.N.Y. 1983) *aff'd* 740 F.2d 190 (2d Cir. 1984); *Meyer v. Oppenheimer Management Corp.* (*Meyer I*), 609 F.Supp. 380 (S.D.N.Y. 1984) *rev'd* 764 F.2d 76 (2d Cir. 1985); *Meyer v. Oppenheimer Management Corp.* (*Meyer II*), 691 F.Supp. 669 *corrected* 707 F.Supp. 1394 (S.D.N.Y. 1988); *Meyer v. Oppenheimer Management Corp.* (*Meyer III*), 715 F.Supp. 574 (S.D.N.Y. 1989) *aff'd* 895 F.2d 861 (2d Cir. 1990); *Schuyt v. Rowe Prime Reserve Fund, Inc.*, 663 F.Supp. 962 (S.D.N.Y. 1987) *aff'd* 835 F.2d 45 (2d Cir. 1987) *cert den.* 485 U.S. 1034 (1988); *Krinsk v. Fund Asset Management, Inc.*, 715 F.Supp. 472 (S.D.N.Y. 1988) *aff'd* 875 F.2d 404 (2d Cir. 1989) *cert den.* 493 U.S. 919; *Kalish v. Franklin Advisers, Inc.*, 742 F.Supp. 1222 (S.D.N.Y. 1990) *aff'd* 928 F.2d 590 (2d Cir. 1991) *cert den.* 112 S.Ct. 75.

case are derived several factors in determining whether an adviser's compensation is in violation of §36(b). The remainder of this article is devoted to reviewing these factors.

## II. THE GARTENBERG CASE

The first case to confront the fiduciary duty under §36(b) was *Gartenberg v. Merrill Lynch Asset Management* ("*Gartenberg I*").<sup>21</sup> The Gartenbergs were investors in the Merrill Lynch Ready Assets Trust ("MLRAT"), an open-end money market fund. Consistent with many other investment companies, MLRAT's adviser and broker were related entities.<sup>22</sup> The board was comprised of two affiliated directors and six independent directors.

When the fund was formed in 1975, the adviser's fee was a flat 0.50% of assets under management. The following year the fee agreement was revised to reflect a graduated fee schedule. In 1977 and 1978, the fund's assets increased and the fee schedule was revised again to add new graduated fee levels.<sup>23</sup> Under the graduated fee schedule, the incremental rate would decrease as the assets increased. The adviser would receive an increasing total fee as the fund's assets grew but at a declining rate.<sup>24</sup>

The Gartenbergs filed suit alleging that the adviser was paid excessive fees for the years 1980 and 1981 in violation of §36(b). Judge Pollack, ruling in favor of the defendants, reviewed the legislative history of §36(b), rejected a "reasonableness" test, and concluded that the appropriate standard under §36(b) should be based on "fairness."<sup>25</sup> The Second Circuit affirmed the decision but

<sup>21</sup> *Gartenberg I*, 528 F.Supp. 1038 (S.D.N.Y. 1981).

<sup>22</sup> The adviser and manager was Merrill Lynch Asset Management. The broker, which processes about 80% of the purchases and redemptions of shares, was Merrill Lynch, Pierce, Fenner & Smith, Inc. Both the adviser/manager and the broker were wholly owned subsidiaries of Merrill Lynch & Co., Inc.

<sup>23</sup> Like the rest of the money market fund industry, the Fund showed dramatic increases in its assets: 1978 - \$2 billion; 1979 - \$3.5 billion; 1980 - \$9.8 billion; 1981 - \$17 billion.

<sup>24</sup> The fee schedule for 1979 was as follows:

Average Daily Value of Net Assets	Advisory Fee
< \$500 million	0.50%
> \$500 million and < \$750 million	0.425%
> \$750 million and < \$1 billion	0.375%
> \$1 billion and < \$1.5 billion	0.35%
> \$1.5 billion and < \$2 billion	0.325%
> \$2 billion and < \$2.5 billion	0.30%
> \$2.5 billion	0.275%

<sup>25</sup> "It bears repeating that in order to provide relief under Section 36(b), it is not enough for this Court to find that a better bargain was possible. Instead, plaintiffs can prevail only if this Court finds that [the

rejected Judge Pollack's "fairness" standard.<sup>26</sup> The Second Circuit concluded that the test for whether the fiduciary duty under §36(b) had been breached depends on "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," and that §36(b) will be violated if the adviser "charged 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."<sup>27</sup>

Of course, the "unreasonableness" standard is not much more clear than "fiduciary" standard. Nonetheless, *Gartenberg I* and subsequent cases have produced factors from which guide advisers and directors through §36(b). These factors, which are described in detail below, are: (1) the nature and quality of services provided to the fund shareholders; (2) the profitability of the fund to the adviser; (3) fall-out benefits; (4) economies of scale; (5) the independence and conscientiousness of the directors; and (6) comparative fee structures.

### III. §36(b) FACTORS

#### 1. Nature and Quality of Services

The reasonableness of an adviser's fee can only be determined with reference to the services provided by the adviser for the investment company. When conducting the §36(b) analysis, it is important to define what services provided by the adviser are to be included in the total mix of information. In the §36(b) analysis, the courts refer to this as the "nature and quality" of the adviser's services provided to the fund and its shareholders.<sup>28</sup>

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adviser] received compensation under an agreement that was unfair to the Fund and its shareholders." *Gartenberg I*, 528 F.Supp. at 1047.

<sup>26</sup> *Gartenberg I*, 694 F.2d 923 (2d Cir. 1982).

<sup>27</sup> *Gartenberg I*, 694 F.2d at 928. Nor would an investor have a claim based on disparate treatment in assessment of fees among the shareholders. A recent case held that the investor must still show that such fees were unreasonable under the *Gartenberg* standard. *Merine v. Prudential-Bache Utility Fund, Inc.*, 859 F.Supp. 715 (S.D.N.Y. 1994).

<sup>28</sup> The relevant services under the §36(b) analysis include those services provided to the fund or the fund's shareholders. The §36(b) analysis requires that "the court look at all the facts in connection with the determination and receipt of compensation, including all services rendered to the fund or its shareholders and all compensation and payments received, in order to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation." *Gartenberg I*, 695 F.2d at 930 citing *Investment*

(a) *Nature of Services* The types of services provided by advisers to investment companies can be categorized as follows: (1) advisory services, (2) shareholder services, and (3) regulatory compliance. Advisory services include such services as portfolio management, research and analysis, and execution of trades.<sup>29</sup> Shareholder services include opening accounts, redeeming shares, maintaining records, furnishing information, and fund accounting.<sup>30</sup> Marketing services may also be appropriately included under the definition of shareholder services. Investors have argued that marketing efforts do not benefit the shareholder and, therefore, marketing efforts are not services which should be considered in the §36(b) analysis. Fund advisers argued that shareholders benefit from the adviser's increased efficiency when managing a larger fund.<sup>31</sup> The courts have adopted the fund advisers' argument.<sup>32</sup> Finally, the adviser is generally required to ensure that the fund complies with federal and state securities law and to perform the fund accounting.

The types of services discussed in the §36(b) cases are those services which are readily identifiable. However, there are other types of "services" which may be appropriately considered under the certain circumstances. One such abstract service is the adviser's experience and expertise. The §36(b) cases focus on money market funds, which invest in low risk, liquid securities. Other types of investment companies such as geographic funds, product line funds and tax-favorable funds may require an adviser with special expertise. For example, an argument could be made that an adviser of an emerging markets fund provides more "services" than the adviser of a money market fund because an emerging markets adviser must hurdle the cultural, legal and language barriers of the countries in which the fund invests. Another "service" is risk. The §36(b) cases to date confronted advisory fee agreements based on a percentage of assets in the fund. However, other types of compensation to

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Company Amendments Act of 1970, S.Rep. No. 91-184, 91st Cong., 2d Sess. (1970) reprinted U.S. Code Cong. & Ad. News 4897, 4910.

<sup>29</sup> *Kalish*, 742 F.Supp. at 1228; *Schuyt*, 663 F.Supp. at 974-976. The issue of investment research came up with respect to a Franklin Ginnie Mae fund. The investors argued that all of the research was performed by the securities dealer with whom Franklin dealt and that Franklin performed only "back-office" functions. The court disagreed stating that "[t]he fact that trading in Ginnie Mae certificates tends to be long term rather than the hectic pattern of short-term, in and out trading does not diminish the importance of sound investment analysis for long term decisions." *Kalish*, 742 F.Supp. at 1228-9.

<sup>30</sup> *Kalish*, 742 F.Supp. at 1228; *Schuyt*, 663 F.Supp. at 974-976.

<sup>31</sup> *Schuyt*, 663 F.Supp. at 976, n. 44.

<sup>32</sup> *Schuyt*, 663 F.Supp. at 976. However, as discussed below under the economies of scale factor, §36(b) requires that any cost savings arising from the growth of a fund must be shared with the shareholders.



advisers are permissible, such as performance based fees.<sup>33</sup> Courts have not yet confronted a performance-based advisory agreement under §36(b). Yet the risk assumed by an adviser under a performance based agreement must be accounted for somewhere in the analysis of whether the adviser's compensation is "reasonable."

*(b) Quality of Services* The §36(b) cases imply that the higher the quality of the adviser's services, the more likely that an adviser's fees will be deemed reasonable. The most relevant indicia of high quality of an adviser's services is the fund's performance compared to a comparable fund.<sup>34</sup> Although this factor is of significant benefit in the context of litigation where the parties can determine with some objectivity the fund's performance, such a factor is of little use to the fund's directors when determining whether a proposed fee agreement is reasonable. The only remaining choice to the directors is to look at the adviser's past performance.

One issue which one court addressed was whether a fund's performance should be adjusted downwards to account for higher returns generated from riskier investments. In *Krinsk*, the adviser's performance compared favorably with other money market funds. However, based on the standard deviation of the funds weekly yields, the fund's volatility was 25% greater than other money market funds. The plaintiff argued that the fund's returns were due to higher risk investments, and, that when this risk is factored into the calculation, the fund's performance was below average. This "risk-adjusted performance" argument was rejected by the court.<sup>35</sup>

The "risk-adjusted performance" is already built into the analysis in that the fund's performance is to be viewed in the context of *comparable* funds. The intent behind the standard deviation calculation proposed in the *Krinsk* case was correct, but improperly applied. Rather than suggest that the fund's performance be lowered to adjust for risk, the plaintiff should have argued that the performance of different comparable funds be used.

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<sup>33</sup> §205 of the Investment Advisers Act prohibits a registered investment adviser from receiving a fee based on capital gains. 15 U.S.C. §80b-5. §205(b) permits performance based adviser contracts with registered investment companies based on a "fulcrum fee" calculation. 15 U.S.C. §80b-5(b).

<sup>34</sup> *Kalish*, 742 F.Supp. at 1229; *Krinsk*, 875 F.2d at 409.

<sup>35</sup> *Krinsk*, 715 F.Supp. at 487, *aff'd* 875 F.2d at 409.

## 2. *The profitability of the fund to the adviser*

At the heart of the §36(b) analysis is the profitability of the fund to the adviser and the adviser's affiliates.<sup>36</sup> When performing the §36(b) analysis, directors must look at the adviser and its affiliates as a single entity, ignoring the corporate organization boundaries.<sup>37</sup> Although profitability is a simple concept, the practice of calculating it is "an art rather than a science."<sup>38</sup> Because of the difficulty in deriving meaningful profitability figures, the courts have recognized that "calculating an exact profitability figure is impossible."<sup>39</sup> The difficulty with the analysis from a planning position is the predictability of revenues and expenses. The §36(b) cases are based on past events and readily ascertainable data. A director trying to determine whether a proposed advisory fee agreement is reasonable does not have such financial data, but rather, hopefully, has estimates of revenues and costs. Such estimates should certainly be accompanied by an adequate explanation of assumptions used in deriving the estimates.

The §36(b) cases are, however, instructive in explaining what revenues and costs should be included in the calculation and the appropriate method of calculation. The profitability analysis should be divided into three steps: (1) calculate the revenue derived by the adviser and its affiliates; (2) determine the relevant costs of the adviser and its affiliates; and (3) compare the profitability with a relevant index.

(a) *Revenues* The basic principle in this calculation is to include all benefits derived by the adviser and the adviser's affiliates from the investment company.<sup>40</sup> The first step is to calculate the adviser's fees. The §36(b) cases are all based on compensation determined by percentage of assets in the fund. As such, fees fluctuate depending on the growth or contraction of the fund.

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<sup>36</sup> The statutory definition of "affiliated person" includes (1) any person who owns 5% or more of the other person, (2) any person 5% or more owned by the other person, (3) any person directly or indirectly controlling, controlled by, or under common control with the other person, and (4) any officer, director, partner, or employee of the other person. ICA §2(a)(3); 15 U.S.C. §80a-2(a)(3).

<sup>37</sup> "[§36(b)] recognizes that in order to properly assess the fairness of advisory compensation, the courts cannot be strictly bound by corporate structure and ignore closely related entities whose functions intimately impinge on one another. The statute itself speaks of payment for the services of the adviser 'or any affiliated person of such investment adviser' [citation omitted]." *Gartenberg I*, 528 F.Supp. at 1049.

<sup>38</sup> *Krinsk*, 715 F.Supp. at 489.

<sup>39</sup> *Id.*

<sup>40</sup> *Gartenberg II*, 740 F.2d at 194.

Generally, advisory agreements which are based on assets under management are calculated on a graduated, declining scale similar to the fee agreement in *Gartenberg I*.<sup>41</sup> As the fund assets increase, the adviser's percentage declines. These "breakpoint" are generally necessary under the economies of scale factor as discussed below.<sup>42</sup>

The second step is to determine other benefits derived by the adviser or its affiliates. Two such benefits looked at by the courts are free-credit balances and float,<sup>43</sup> which are included in the calculation of an adviser's profitability,<sup>44</sup> even if shareholders could have avoided the float and free credit balances.<sup>45</sup>

An exception to the general rule that all benefits are included in the calculation is Rule 12b-1 payments. This common litigated issue revolves around the relevance of distribution costs, primarily Rule 12b-1 plan fees, paid to the adviser's affiliated broker. Rule 12b-1 permits an open-end management investment company to finance the costs of the distribution of its shares provided the payments comply with §36(b).<sup>46</sup> There have been contradicting decisions from the Second Circuit on the issue of how to treat 12b-1 fees under §36(b). In *Krinsk*, the district court implied that fees paid under Rule 12b-1 should be aggregated with advisory fees to determine if there has been a breach of fiduciary duty under §36(b).<sup>47</sup> However, the Second Circuit rejected this

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<sup>41</sup> See *infra*, note 23.

<sup>42</sup> See *infra* notes 71-80 and accompanying text.

<sup>43</sup> "Float" is the interest income earned by a broker from the time a redemption check is issued by an investment company to the time the check clears. "Free credit balances" are the uninvested funds held for an investor but not yet reinvested. The investment company derives interest from such funds. *Gartenberg II*, 740 F.2d at 192, n. 2.

<sup>44</sup> In *Gartenberg I*, the Second Circuit held that the plaintiff failed to show that the advisory fee agreement was excessive under §36(b), but explicitly held open the possibility that such fee agreement might be excessive by showing "more probative evidence of (1) the Broker's processing costs, (2) the offsetting commission benefits realized by the Broker from non-Fund securities business generated by Fund accounts, and (3) the "float" interest income gained by the Broker . . ." 694 F.2d at 933. The "float" benefits to Merrill Lynch in *Gartenberg II* was estimated between \$14 million and \$26.5 million. 740 F.2d at 192 n. 2.

<sup>45</sup> In *Gartenberg II*, Judge Pollack declined to include benefits derived from "voluntary" float and free credit balances which the shareholder could have avoided. The Second Circuit rejected the "voluntary" exception stating that the fact that float or free credit balances are "voluntary" is irrelevant. 740 F.2d at 194.

<sup>46</sup> Rule 12b-1 reads in part: "A registered open-end management investment company may implement or continue a [12b-1] plan . . . only if the directors who vote to approve such implementation or continuation conclude, in the exercise of reasonable business judgment and in light of their fiduciary duties under state law and section 36(a) and (b) of the [ICA], there is a reasonable likelihood that the plan will benefit the company and its shareholders." Rule 12b-1(e); 17 C.F.R. §270.12b-1.

<sup>47</sup> "To the extent that the 12b-1 fees are excessive for the purpose intended, they should be considered with the advisory fee to determine whether payment of the two, in combination, amounts to a breach of fiduciary duty . . ." *Krinsk*, 715 F.Supp. at 498.

standard in the *Meyer* trilogy making the following conclusions: (1) an investment company may pay distribution expenses to an adviser's affiliate to sell fund shares to its customers; (2) excessive payments made under a 12b-1 plan to an adviser's affiliate is actionable, but only under §36(b); (3) 12b-1 payments are not to be aggregated with an adviser's fee when determining whether the adviser's fee is excessive under §36(b). The rule from *Meyer* is that adviser's fee and the 12b-1 payments are to be tested separately, whether either are excessive independent of each other.<sup>48</sup>

Other "benefits" are also derived by the adviser and the adviser's affiliates. However, such benefits are discussed in another factor in the overall analysis, fall-out benefits.<sup>49</sup>

(b) *Costs* The second analysis is to determine what costs are included in the profitability calculation. The cost determination has been a significant issue in the §36(b) cases. Under basic cost accounting principles, costs can be divided between "direct" costs and "indirect" costs. Direct costs are "identified specifically with one final cost object."<sup>50</sup> For example, the salary of an accountant employed by the adviser whose sole function is to perform the accounting for the fund would be a direct cost. Indirect costs have "two or more final cost objects or at least one intermediate cost object."<sup>51</sup> For example, if the same accountant also performed accounting services with respect to the adviser's individual clients or other funds managed by the adviser, then the accountant's salary would be an indirect cost.

Certainly the adviser's direct costs are included in the determination of costs.<sup>52</sup> The direct costs incurred by the adviser's affiliates are also included in the calculation, such as processing purchases and redemptions.<sup>53</sup> The more

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<sup>48</sup> "The two kinds of payments are for entirely different services, namely advice on the one hand and sales and distribution on the other. If the fee for each service viewed separately is not excessive in relation to the services rendered, then the sum of the two is also permissible." *Meyer III*, 895 F.2d at 866.

<sup>49</sup> See *infra* notes 64-70 and accompanying text.

<sup>50</sup> Michael Chatfield and Denis Neilson, *COST ACCOUNTING*, Harcourt Brace Jovanovich, Inc., 1983, p. 38.

<sup>51</sup> *Id.*

<sup>52</sup> *Gartenberg I*, 528 F.Supp. at 1049.

<sup>53</sup> "Proceeding on the erroneous theory that only the administrative costs incurred by the Manager itself may be considered, appellants ignore the heavy costs incurred by Merrill Lynch affiliates in processing the increase volume of purchases and redemptions of fund shares which were under the Manager's guidance. Since the Manager and Broker were divisions of one economic unit, the district court was entitled to deduct these costs in calculating the Manager's net profits." *Gartenberg I*, 694 F.2d at 931.

contentious issue involves allocation of indirect costs. Most advisers and their affiliates engage in multiple business activities in addition to the services provided for the investment company and incur indirect costs which benefit more than one activity.

Indirect costs pose two questions under §36(b). The first question is should such costs be allocated at all to offset revenues derived from the fund, and, if so, the second question is how should such costs be allocated. The first question, whether indirect costs should be allocated, was answered in the affirmative.<sup>54</sup> The second question, how to allocate the indirect costs, is much more difficult to answer. There are numerous valid procedures for allocating indirect costs, each resulting in different profitability calculations.<sup>55</sup> The §36(b) cases state that once the court determines if the parties' estimates are rational, the court will consider the "true" indirect costs to be somewhere in between the plaintiff's and defendants estimates.<sup>56</sup>

(c) *Comparison* Once all of the relevant revenues and expenses have been determined, the analysis is still not complete until profitability has been measured. Determining the appropriate measurement of profitability is as difficult as determining revenues and expenses. The courts have generally accepted the calculations based on profit as a percent of fee revenue<sup>57</sup> and have rejected the return on equity calculations.<sup>58</sup>

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<sup>54</sup> In *Schuyt*, the plaintiff argued that only direct costs be included in the calculation of the adviser's profits. The court rejected the plaintiff's argument in favor of allocating indirect costs. Although the court stated that it will look at the profitability results using the incremental [direct-only] method, it will "give greater weight to the results" of the calculation using indirect costs. 663 F.Supp. at 977.

<sup>55</sup> See *infra* note 57.

<sup>56</sup> *Krinsk*, 715 F.Supp. at 494.

<sup>57</sup> The wide variation in profitability analysis was demonstrated in *Krinsk*. Two profitability studies, one by the plaintiff's expert and the other by the adviser's outside accountants, estimated the adviser's pretax profitability as follows:

	1986	1985	1984
Plaintiff's Expert	50%	37%	28.5%
Adviser's Accountants	-17.5%	-30.1%	-55.8%

The court eventually concluded that the three-year weighted average of pretax profitability ranges from "a few percentage points greater than 0% to perhaps as much as 33%." 715 F.Supp. at 494. Other §36(b) cases calculated pretax profits of 77% (*Schuyt*), 69.2% (*Gartenberg*), and between 11.6% and 23.2% (*Meyer*). *Meyer III*, 715 F.Supp. at 574.

<sup>58</sup> *Kalish*, 742 F.Supp. at 1237; *Meyer III*, 715 F.Supp. at 576.

Once an appropriate range of profitability is calculated, such figures must be compared to the profitability to advisers to similar funds.<sup>59</sup> This analysis is different from the final factor, comparisons of rates, in that the former is a comparison of profitability and the latter is a comparison of fee rates.<sup>60</sup> Understandably, it is difficult to determine “similar” funds and any comparison is highly subjective.<sup>61</sup> However, the search for similar funds is no more difficult and no less subjective than calculating profitability.<sup>62</sup> The courts have rejected plaintiffs’ attempts to demonstrate advisers’ unreasonable profits using comparisons between the adviser and financial industry firms in general.<sup>63</sup>

### 3. Fall-out Benefits

Related to the profitability analysis is the issue of “fall out benefits.” Fall out benefits can be defined as (1) *quantifiable*, (2) *indirect profits* to the adviser and its affiliates that would not otherwise have occurred (3) *but for* the existence of the investment company.<sup>64</sup>

(a) *Quantifiable* The courts have placed the burden on the party charging that the fee is excessive to quantify the fall-out benefits. In the §36(b) cases, no plaintiff has even undertaken such a task.

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<sup>59</sup> “Under the [§36(b)] cases, to the extent that comparisons are probative at all, a mutual fund adviser-manager must be compared with members of an appropriate universe: adviser-managers of similar funds.” *Kalish*, 742 F.Supp. at 1237.

<sup>60</sup> The comparison of rates factor does not take into account cost savings (or the lack thereof) derived from the adviser’s efficiency (or lack of efficiency). Under a comparison of profitability between similar funds, an adviser’s efficiency in cost savings is a detriment to the adviser under §36(b).

<sup>61</sup> In *Meyer III*, the court did discuss the fund’s expense ratios with funds with comparable objectives listed in Donohue’s Money Fund Report. 715 F.Supp. at 576.

<sup>62</sup> One problem raised by the courts in the comparison analysis is the lack of competition among advisers with respect to certain funds. This position was raised by the courts in *Krinsk* because the fund at issue in this case was the Merrill Lynch’s CMA program, a central asset account, rather than a stand alone fund. The court held that central account funds should be compared to other central account funds but concluded that “such comparisons have limited value due to the lack of competition . . .” *Id.*, at 496-7, even though the court admitted that “many of [Merrill’s] competitors offer similar products.” *Id.*, at 476.

<sup>63</sup> The court in *Kalish* rejected plaintiff’s argument in favor of profitability comparisons between the adviser, Franklin, and “larger broker firms, money center banks, insurance firms, mutual fund sponsors, public broker-dealers, personal loan companies, diversified financial groups, major regional banks, and a compendium of companies taken from Business Week’s “Top 1000.”” 742 F.Supp. at 1237. See also *Meyer III*, 715 F.Supp. at 576.

<sup>64</sup> *Krinsk*, 715 F.Supp. at 494-5.

(b) “*But For*” Advisers and affiliates generally carry on business outside the fund from which benefits to the adviser and affiliates are derived. It is not always easy to determine the exact source of such benefits and the causal relationship between the benefits and the source are not always clearly defined. The courts have taken the approach that only those fall-out benefits are included which “would not have occurred *but for* the existence of the [fund].”<sup>65</sup> An example would be brokerage commissions earned by the adviser’s affiliated broker from other investments sold to the investment company’s shareholders. Under the “but for” test, the plaintiff must show that the investor’s would not have purchased the investments from the adviser’s affiliated broker had the investment company not existed - not an easy task.

(c) *Indirect Profits* The first issue is to determine what are indirect profits. The §36(b) cases state that fall-out benefits include (1) commission profits earned by the adviser’s affiliated broker from trades in the investment company, (2) profits earned by the adviser’s affiliates for other products and services sold to the funds shareholders, (3) margin interest, and (4) management fees derived from related funds.<sup>66</sup>

What makes the fall-out benefits analysis so confusing is that the courts have clearly stated that *all* profits are to be included in the calculation of profitability and then require a separate analysis for “fall-out benefits.” This contradiction can be reconciled by distinguishing between the types of profitability to be included in each of the two factors. The Second Circuit in *Krinsk* makes the distinction based on direct and indirect profits -the former are included in the profitability calculation and the latter are included in the fall-out benefits analysis.<sup>67</sup> The unstated rationale for this manipulation of language is the practical consideration that comparability of *indirect* profits is not feasible. Even with liberalized discovery procedures, obtaining relevant data and calculating indirect profits derived by a defendant adviser is extremely difficult. Add the fact that the plaintiff must also calculate *indirect* profits from comparable investment companies, the probability that a plaintiff could determine fall-out benefits is highly unlikely.

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<sup>65</sup> *Krinsk*, 715 F.Supp at 495.

<sup>66</sup> *Krinsk*, 715 F.Supp. at 494. The court divided fall-out benefits into two categories, primary and secondary, because of the nature of the Merrill Lynch CMA program. Categorizing fall-out benefits, although may possibly assist in identifying such fall-out benefits, does not affect the analysis.

<sup>67</sup> *Krinsk*, 875 F.2d at 411.

The §36(b) cases have held that float and free credit balances are direct profits and therefore are *not* fall-out benefits.<sup>68</sup> It is not easy to reconcile why float benefits are *direct* and broker's commissions are *indirect*. The only rational explanation for this contradiction is found in the original argument supporting division of the profitability and fall-out benefits factors: feasibility of calculation. To the extent the plaintiff can quantify the profitability of benefits derived by an adviser and its affiliates from a fund and can show equivalent figures from comparable funds, the more likely such information will be placed under the profitability factor rather than the fall-out benefits factor. The likelihood of a particular plaintiff showing such quantifiable data is extremely difficult from both aspects of feasibility<sup>69</sup> and cost.<sup>70</sup>

The conclusion to be drawn from the courts' discussion about fall-out benefits is that it is a factor which requires such a herculean undertaking on the part of the party challenging the adviser's fee as to be of little significance in the overall §36(b) analysis. Nonetheless, directors should be aware of the existence of this factor and the interaction of this factor with the much more relevant profitability factor.

#### 4. Economies of Scale

The theory of economies of scale states that, as a mutual fund increases in size, its costs will decrease proportionately. Consistent with the adviser's fiduciary duty, the adviser is expected to share the cost savings associated with economies of scale with the fund shareholders.<sup>71</sup> The §36(b) cases state that the

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<sup>68</sup> "[F]loat benefits and free credit balances are generated directly by the money market fund and cannot be characterized as fall-out revenue." *Krinsk*, 875 F.2d at 411.

<sup>69</sup> The courts have suggested that plaintiffs conduct a survey whether investors would have engaged in particular transactions resulting in fall-out benefits had they not been investors in the fund, and using such information in a regression analysis to demonstrate "but for" causation. *Krinsk*, 715 F.Supp. at 495, n. 46. Such a "customer survey" was previously rejected as being "nothing more than idle speculation and conjecture." *Gartenberg II*, 573 F.Supp. at 1315.

<sup>70</sup> In *Gartenberg II*, the plaintiff argued that Merrill Lynch generated significant brokerage commissions from non-fund transactions with fund investors. Judge Pollack, referring to the plaintiff's choice not to use customer surveys and regression analysis to show this causal relationship, stated that such an undertaking "would amount to nothing more than yet another patently frivolous expenditure of time and funds by both parties." 573 F.Supp. at 1314.

<sup>71</sup> "If a fund realizes economies of scale, its willingness to let the shareholders participate in the resulting benefits becomes a factor in evaluating the reasonableness of the adviser-manager's fees." *Kalish*, 742 F.Supp. at 1237. This sharing component is central to the purpose of §36(b): "The problem to which §36(b) was addressed was that with which the SEC had dealt in pages 125-49, 154 of its REPORT ON PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH (PPI), H.R. REP. NO. 2337, 89TH CONG. 2D SESS.



plaintiff must prove that the increase in the size of the fund directly reduced the fund's costs of processing each transaction and servicing each shareholder.<sup>72</sup> In other words, the per unit cost of performing fund transactions decreased as the number of transactions increased.<sup>73</sup>

As with the profitability and cost analysis, the difficulty is determining how to measure economies of scale. The cases provide little guidance as to how to complete the analysis. All that has been provided is that the plaintiff "must try and create a detailed analysis of each element of a transaction surrounding [the fund], over an extended period of time, over different levels of activity."<sup>74</sup> What is certain is that the plaintiff will not meet this burden by merely showing the ratio of expenses to revenue declined as the fund's volume increased.<sup>75</sup> Nor will the burden be met by demonstrating increasing profit to revenue for the same growth period.<sup>76</sup>

Assuming economies of scale has been demonstrated, the next issue is whether the shareholders participated in the cost savings.<sup>77</sup> The most likely method of sharing economies of scale is through a declining fee schedule by using "appropriately fixed 'break-points'".<sup>78</sup> Another method is by establishing a relatively low initial fee rate which "in effect subsumes economies of scale throughout."<sup>79</sup> Comparable fee arrangements between other advisers and the funds they manage are significant in determining if the cost savings from economies of scale are properly allocated.<sup>80</sup>

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(1966). This was that advisers' fees generally stated as a percentage of the market value of the managed assets, which had been altogether reasonable when a fund was launched, may have become unreasonably high when the fund grew to enormous size." *Fogel v. Chestnutt*, 668 F.2d 100, 111 (2d Cir. 1981) *cert. denied*, 459 U.S. 828 (1982).

<sup>72</sup> *Kalish*, 742 F.Supp. at 1238-9.

<sup>73</sup> *Krinsk*, 875 F.2d at 411; *Gartenberg I*, 528 F.Supp. at 1055; *Kalish*, 742 F.Supp. at 1239.

<sup>74</sup> *Krinsk*, 715 F.Supp. at 496.

<sup>75</sup> *Kalish*, 742 F.Supp. at 1240; *Krinsk*, 715 F.Supp. at 496 *aff'd* 875 F.2d at 411.

<sup>76</sup> *Kalish*, 742 F.Supp. at 1239-40.

<sup>77</sup> *Kalish*, 742 F.Supp. at 1238-9.

<sup>78</sup> *Kalish*, 742 F.Supp. at 1239, *citing Schuyt*, 663 F.Supp. at 970, n. 25.

<sup>79</sup> *Kalish*, 742 F.Supp. at 1239, *citing Schuyt*, 663 F.Supp. at 970, n. 25.

<sup>80</sup> "[W]hile the rates charged by others should not be the standard to test the fairness of the advisory fee, the rates charged by others is nonetheless significant with regard to economies of scale." *Schuyt*, 663 F.Supp. at 972, n. 34, *citing Gartenberg*, 694 F.2d at 929.

### 5. *The Independence and Conscientiousness of the Directors*

The role of the independent directors in the formulation and negotiation of the advisory agreement is a factor in the §36(b) analysis.<sup>81</sup> The first step is to determine which directors are “independent.” Under the ICA, no more than 60 percent of the directors of a registered investment company may be interested persons of the company.<sup>82</sup> §15(c) of the ICA requires that a majority of the independent directors approve the advisory agreement.<sup>83</sup> The relevant portion of the statute states that the advisory agreement must be approved “by the vote of majority of directors, who are not parties to such contract or agreement or interested persons of any such party. . . .” Therefore, to meet the approval requirement under §15(c), the voting director may not be (1) a party to the advisory agreement nor (2) an “interested person” of a party to the agreement.

A director is an “interested person” for purposes of §15(c) if the director (1) is affiliated<sup>84</sup> with the investment company or adviser; (2) is a member of the immediate family<sup>85</sup> of any natural person who is an affiliate of the investment company or adviser; (3) has a beneficial interest in any security issued by the adviser or by any of the adviser’s controlling persons; (4) was a person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of the investment company has acted as legal counsel for such investment company or such investment company’s investment adviser or principal underwriter; (5) is a registered broker-dealer or is affiliated with a registered broker-dealer,<sup>86</sup> or (6) had a material business or professional relationship with the adviser in the last two years as determined by the SEC.

<sup>81</sup> *Gartenberg I*, 694 F.2d at 930. This is probably the most important factor. When the court finds that the directors were qualified, fully informed and acted with care and conscientiousness, “approval of the fee should be weighted heavily.” *Krinsk*, 715 F.Supp. at 502 citing *Schuyt*, 663 F.Supp. at 988.

<sup>82</sup> ICA §10(a); 15 U.S.C. §80a-10(a). Certain no-load mutual funds need have only one director who is not an interested person. ICA §10(d); 15 U.S.C. §80a-10(d).

<sup>83</sup> ICA §15(c); 15 U.S.C. §80a-15(c).

<sup>84</sup> “Affiliate” is defined under ICA §2(a)(3). See *supra* note 36.

<sup>85</sup> A “member of the immediate family” means any parent, spouse of a parent, child, spouse of a child, brother, or sister, and includes step and adoptive relationships. ICA §2(a)(19); 15 U.S.C. §80a-2(a)(19).

<sup>86</sup> Certain registered broker-dealers and affiliates of registered broker-dealers who do not execute any portfolio transactions for the investment company group are deemed not to be interested persons. Rule 2a19-1; 17 C.F.R. §270.2a19-1.

Once the independent directors have been determined, the analysis is divided into three factors: (1) the independent directors' expertise, (2) whether the independent directors were fully informed, and (3) the extent of care and consciousness with which they performed their duties.<sup>87</sup>

(a) *Expertise* The expertise element under §36(b) has been interpreted rather broadly. The courts have not required that the independent directors have any particular expertise in the area of investment management. Instead, the courts have looked almost exclusively at the business education,<sup>88</sup> legal education,<sup>89</sup> and financial services industry experience<sup>90</sup> of the independent directors. Based on the §36(b) cases, it would be difficult not to demonstrate that most independent directors have the requisite expertise.

(b) *Informed* The courts look at three factors whether the independent directors were adequately informed: (1) the type and amount of information from the adviser and fund, (2) the type and amount of information from experts, and (3) the opportunity of the directors to ask questions. First, the type of information provided to the independent directors must be adequate to address the other elements in the §36(b) analysis.<sup>91</sup>

Second, the independent directors need expert information. The independent directors should be represented by independent counsel.<sup>92</sup> Although this rule appears on its face to require that the independent directors' counsel not have had any affiliation with the adviser or fund or represent the adviser or fund, the courts have been very liberal in their construction of the

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<sup>87</sup> *Krinsk*, 875 F.2d at 415; *Gartenberg I*, 694 F.2d at 930.

<sup>88</sup> In *Schuyt*, the court paid particular attention to the directors educational background. The four "exceptionally qualified" independent directors included a Wharton MBA graduate, two Johns Hopkins Ph.D.s, one in economics and one in engineering, and a graduate from Princeton's master's program in international studies. 663 F.Supp. at 980-1.

<sup>89</sup> In *Kalish*, the court looked at three factors: (1) legal education (although it is difficult to reconcile the relationship between the directors' law degrees earned over thirty years ago and the directors' expertise); (2) the directors' legal and business experience; and (3) the number of years each director has held that position with the fund. 742 F.Supp. at 1241-2.

<sup>90</sup> *Krinsk*, 715 F.Supp. at 502.

<sup>91</sup> For example, in *Kalish*, the directors were provided with financial statements of the adviser and affiliates, performance comparisons with other funds, statements of the funds expenses and expense ratios, and expense allocation reports. 742 F.Supp. at 1243. As a reminder, directors have an affirmative duty to request from the investment adviser and to evaluate such information before approving an advisory agreement. ICA §15(c), 15 U.S.C. §80a-15(c).

<sup>92</sup> *Kalish*, 742 F.Supp. at 1242.

term “independent,” permitting the independent counsel to have affiliations with the fund.<sup>93</sup>

In addition to legal advice, directors may also rely on the independent accountant’s information and conclusions.<sup>94</sup> The issue of independence concerning the outside accountants does not raise the degree of inquiry that the issue of counsel’s independence *should* raise. Based on the board’s obligation to select an “independent public accountant” to certify the investment company’s financial statements,<sup>95</sup> the independent directors already have independent accountants from which to draw financial information and conclusions. More important than the accountant’s independence is the scope of the outside accountant’s engagement and the degree of competence and thoroughness of the outside accountant’s examination of the relevant data. Although the courts will review such factors, they have generally deferred to the accountant’s expertise.<sup>96</sup>

Third, independent directors should also have an opportunity to ask questions of the adviser and the affiliates, and to conduct adequate inquiry into the information and conclusions provided by the independent accountants.<sup>97</sup>

(c) *Performance* There is no specific rule as to how the independent directors should conduct themselves in the consideration of a proposed advisory fee agreement. What is certain is that the independent directors should not merely “rubber-stamp” a fee agreement. Some of the §36(b) cases approvingly describe how other directors conducted such review. For example, in one case the directors completed a checklist of the §36(b) factors, each factor being

<sup>93</sup> For example, in *Kalish*, the independent counsel representing the independent directors’ was the fund’s secretary and appeared as an attorney representing the fund in the §36(b) litigation. Nonetheless, the court stated that the independent counsel is not disqualified “automatically from performing the important function of counsel to the independent directors.” 742 F.Supp. at 1242. In *Schuyt*, the definition of independent was stretched to its limit where the independent directors’ independent counsel was the fund’s counsel since the fund was organized and that the independent counsel’s firm represented the fund in the §36(b) litigation. 663 F.Supp. at 965. The court, without discussing the foregoing issues, referred to the independent director’s counsel as “separate and independent.” 663 F.Supp. at 982.

<sup>94</sup> In *Kalish*, the CPA firm, Coopers & Lybrand, after reviewing the fund’s allocation of revenues and expenses, concluded that the allocation was “reasonable under the circumstances.” The court concluded “the independent directors, who bore the responsibility of decision, placed upon Coopers & Lybrand’s certification of reasonableness a wholly justified reliance.” 742 F.Supp. at 1248.

<sup>95</sup> ICA §31, 15 U.S.C. §80a-31.

<sup>96</sup> *Kalish*, 742 F.Supp. at 1248.

<sup>97</sup> In *Kalish*, “[t]he directors did not passively accept the Coopers & Lybrand report.” 742 F.Supp. at 1248.

given appropriate time for discussion and analysis.<sup>98</sup> Such deliberations must be compiled into detailed minutes accompanied by the materials considered by the directors.<sup>99</sup>

#### 6. Comparative Fee Structures

The final factor under §36(b) is the comparison of fee structures between funds. The courts have not viewed this factor as highly relevant.<sup>100</sup> The directors cannot merely rely on prevailing industry advisory fee rates to comply with §36(b).<sup>101</sup>

### IV. LIABILITY FOR BREACH OF §36(b)

A discussion of §36(b) would not be complete without a brief overview of the penalties for breach of the §36(b) fiduciary duty. To enforce the adviser's fiduciary duty, §36(b) specifically allows for derivative and SEC actions against certain persons affiliated with the investment company for violation of this fiduciary duty.<sup>102</sup> The enforcement language in §36(b) on the one hand exposes numerous parties to §36(b)'s reach. However, §36(b) specifically states that no action may be maintained, and no damages may be recoverable from, any person other than the recipient of the advisory compensation. Only under unusual circumstances would any party other than the investment adviser be liable under §36(b). In spite of the prohibition of a breach of fiduciary duty against an investment company's directors, the limitation of actions under §36(b) would appear to immunize the directors from civil liability.<sup>103</sup> There is even authority that §36(b) preempts state law claims of breach of fiduciary duty with respect to excessive advisory fees.<sup>104</sup>

<sup>98</sup> *Krinsk*, 715 F.Supp. at 481, *aff'd* 875 F.2d at 412.

<sup>99</sup> *Gartenberg II*, 573 F.Supp. at 1307.

<sup>100</sup> Comparative rates is the "least probative of [the factors] bearing upon the fairness of the adviser-manager's fee . . ." *Kalish*, 742 F.Supp. at 1249.

<sup>101</sup> "We disagree with the district court's suggestions that the principle factor to be considered in evaluating a fee's fairness is the price charged by other similar advisers to funds managed by them . . . . Reliance on prevailing industry advisory fees will not satisfy §36(b)." *Gartenberg I*, 694 F.2d at 929.

<sup>102</sup> See *supra* note 18.

<sup>103</sup> Nor will a private cause of action lie against the directors for excessive fees under ICA §15(a). 15 U.S.C. §80a-15(a); *Tarlov v. Paine Webber Cashfund, Inc.*, 559 F.Supp. 429, 437 (D.C. Conn. 1983).

<sup>104</sup> *Batra v. Investors Research Corp.* [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,983, n. 3 (W.D. Mo. 1992). At least one §36(b) case has indicated that a violation of state law claims for excessive fees require a breach of the fiduciary duty under §36(b). In *Schuyt*, the court held that there is no waste of

## V. CONCLUSION

By following the outline set forth in this article, investment company directors can reduce the likelihood of challenges to adviser fee agreements under §36(b).

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corporate assets absent a violation of §36(b), 663 F.Supp. at 989, n. 79, and that the information required under §36(b)'s fifth factor, independence and conscientiousness of the directors, satisfied the defendants' fiduciary duty under state law. 663 F.Supp. at 989, n. 81.

