ICI MUTUAL **RISK MANAGEMENT**

Independent Director

Litigation Risk

A Practical Guide to Understanding and Reducing Risk to Fund Independent Directors in Civil Litigation

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Introduction and Executive Summary

In 2003 and 2004, in the wake of highly publicized investigations by federal and state regulators into market timing and other fund industry issues and practices, hundreds of civil lawsuits were initiated against investment advisers, distributors, funds, and, in some cases, fund independent directors and independent trustees (hereafter, "independent directors").[1] Independent directors have been the subject of civil litigation in the past. However, the unprecedented developments of 2003 – 2004, coupled with highly publicized results in several recent lawsuits against corporate directors outside the fund industry, have resulted in a renewed focus by independent directors on the litigation risk associated with their service on fund boards.

Given the growth of the fund industry over the past twenty-five years, the high visibility of the industry in the country's economic and political landscape, and the emergence of the industry as an attractive target for a highly sophisticated plaintiffs' bar, civil litigation is likely to present a real risk to the fund industry for the indefinite future. Although fund advisers, other service providers, and funds themselves are expected to remain the primary focus of such industry litigation, independent directors are not immune from litigation risk, and independent directors undoubtedly will continue to be individually named from time to time as defendants in fund industry lawsuits.

The risk to independent directors of personal liability in fund industry lawsuits has historically been small, and it is likely to remain so. Nevertheless, some degree of litigation risk is inherent in board service. Moreover, civil lawsuits that involve independent directors can divert board attention from ongoing fund business, and are often a time-consuming and stressful distraction for affected individuals. Such lawsuits can also generate substantial financial expense in the form of litigation defense costs (which typically are borne directly or indirectly by funds themselves). Accordingly, from both a business and financial perspective, it is appropriate for independent directors — in the interest of the funds they oversee, in the interest of fund shareholders, and in their own interest — to *understand* the nature of their litigation risk, and to take appropriate steps to *manage* such risk.

This Study is designed to assist independent directors in this effort. Towards this end, the Study is divided into three sections:

- *Understanding Independent Director Litigation Risk*. The first section of this Study describes the nature of litigation risk faced by independent directors, both within the historical context of fund industry litigation and within the broader context of corporate litigation generally. It also examines the potential bases for independent director liability in civil litigation, as well as the practical risk of such liability.

- *Management of Front-End Litigation Risk*. The second section of this Study reviews management of "front-end" independent director litigation risk. Efforts to manage "front-end" risk are directed towards preventing civil litigation against independent directors in the first instance, or, if civil litigation cannot be prevented, towards ensuring that any such litigation is resolved favorably to independent directors. The particulars of these efforts may vary, but they share a focus on three underlying principles — preparation, process, and documentation.

- *Management of Back-End Litigation Risk*. The third section of this Study reviews management of "back-end" independent director litigation risk. Efforts to manage "back-end" risk are directed towards reducing both the direct and indirect financial impact of civil litigation on independent directors and their funds. Efforts to reduce the *direct* financial impact of civil litigation commonly focus on indemnification and insurance. Efforts to reduce the *indirect* financial impact of civil litigation commonly focus on management of litigation defense costs, which are typically the most significant financial exposure for independent directors.

This Study is designed to address risk to independent directors in private civil litigation. While the issues and observations in this Study may bear on risk faced by independent directors in other adversarial contexts (e.g., regulatory lawsuits, proceedings, and investigations) and on risk faced by other fund industry personnel (e.g., fund inside directors and fund officers), neither of these risks is the focus of this Study.

The issues and observations in this Study are derived from ICI Mutual's discussions with independent directors and outside legal counsel to independent directors, from analysis of claims reported to ICI Mutual over its nineteen-year history, and from ICI Mutual's review of publicly available information on fund litigation and related issues. This Study is not intended to, and does not, suggest any single approach or set of "best practices" for use by independent directors in addressing litigation risk. Given the diversity of fund groups, it is neither practical nor advisable to seek a one-size-fits-all standard for behavior in this area. Moreover, nothing contained in this Study is to be considered legal advice; rather, independent directors should look to their counsel for such advice.

Understanding Independent Director Litigation Risk

The legal standards to which independent directors are subject — and therefore the legal violations for which they may be held liable — are derived from both state and federal law. Appendix A to this Study summarizes these legal standards. As a practical matter, whatever legal standards are applied, fund directors should face little risk of personal liability (other than for their defense costs, as discussed below) where they act with due care and independence (i.e., without conflicts of interest), and devote appropriate time, attention, and oversight to reaching considered judgments on fund issues and concerns.

Historical experience supports this conclusion. Over the long history of the fund industry, there appear to be few, if any, examples of civil judgments for damages (i.e., formal court determinations of liability) against independent directors. Similarly, there appear to be few, if any, known instances of independent directors being individually responsible for amounts paid in civil settlements (i.e., resolutions of litigation by the parties, without a formal determination of liability by the court).[2]

Why, then, is there a common perception that independent directors in today's environment are at increased risk of personal liability in civil litigation? In part, this perception can be traced to the extraordinary increase in civil litigation against the fund industry in recent years. In particular, beginning in 2003, following highly publicized investigations by federal and state regulators into market timing, revenue sharing, and other fund industry issues and practices, independent directors were among many defendants sued in "follow-on" civil lawsuits.[3] Yet the fact that independent directors were initially sued as defendants in these lawsuits does not mean that they were found personally liable. To the contrary, as these follow-on civil lawsuits have been defended and litigated, independent directors have generally been dismissed or dropped as defendants, even where the lawsuits have otherwise survived.[4]

The perception that independent directors are at increased risk of personal liability can also be traced, in part, to several high-profile settlements of civil litigation involving directors outside the fund industry. In general, personal liability for corporate directors has been a rare occurrence.[5] However, in recent well-publicized settlements of civil litigation involving WorldCom and Enron, the lead plaintiffs demanded that independent directors of these two companies personally contribute towards the settlements. These highly unusual settlements were concluded in the context of facts that formed a "perfect storm" for director personal liability: insolvency of the companies, expected damages exceeding the applicable insurance limits, the political environment at the time of the settlement negotiations, allegations of fraud in the offering of securities, press reports criticizing the WorldCom and Enron directors, and the egregious facts underlying these scandals, including the number of "undisclosed related-party transactions" (i.e., undisclosed transactions involving management and the companies). A number of observers view these two settlements as aberrations that do not signal any significant increase in personal liability risk for corporate directors generally, let alone for mutual fund directors.[6]

Despite their low risk for personal liability, independent directors have become, and will likely remain, potentially attractive defendants in fund industry litigation. The naming of fund directors as defendants may have little to do with the underlying facts. It does, however, reflect a strategic or tactical decision on the part of the plaintiffs' attorneys initiating the particular litigation. Thus, for example, plaintiffs' attorneys may include independent directors as defendants in civil litigation (1) to increase financial and psychological pressure on fund groups to settle litigation more quickly and/or at a higher sum than might otherwise be the case, (2) to obtain a "bargaining chip" for use with defendants' counsel at a subsequent stage of the litigation, (3) to seek to ensure the availability of insurance proceeds for any settlement that may ultimately be reached in the litigation, and/or (4) to drive a wedge between independent directors and other defendants (for example, the fund adviser or distributor), so as to undercut efforts by defendants to present a unified defense in the litigation.

In the future, as in the past, independent directors are most likely to find themselves personally involved in particular types of civil lawsuits. From the perspective of independent directors and the funds they oversee, perhaps the most serious of these types is shareholder litigation challenging the accuracy or completeness of disclosure in fund prospectuses.[7] Federal law expressly authorizes independent directors to be individually sued in disclosure lawsuits, in addition to funds themselves and certain fund service providers (such as distributors and accountants). Disclosure lawsuits tend to be most common where a fund's net asset value (NAV) has declined significantly, and the NAV decline can potentially be linked to particular risks or practices for which prospectus disclosure is arguably misleading or incomplete.[8]

From an economic perspective, disclosure lawsuits appeal to attorneys who specialize in representing shareholders in securities litigation because the potential return on their effort can be enormous. Indeed, for funds of any significant size, even a modest decline in NAV can frequently result in claimed "losses" for fund shareholders in the tens or hundreds of millions of dollars. As a result, to the extent that a disclosure lawsuit survives pretrial legal and factual challenges, defendants can find themselves faced with a difficult choice between (1) proceeding to trial and taking the risk (however low) that a court will award damages in an amount at or near that claimed by plaintiffs, and (2) settling the lawsuit before trial. Faced with such a choice, defendants typically opt to settle the lawsuit for a fraction of the damages claimed by plaintiffs — albeit a fraction that may still, as an absolute matter, run into the millions, or even tens of millions, of dollars.

Independent directors who are defendants in disclosure lawsuits are potentially at risk of incurring personal liability. As a legal matter, independent directors may avoid such liability through a "due diligence defense."[9] Although the strength of a due diligence defense will necessarily depend upon the particular facts and circumstances involved, counsel consulted for this Study suggest that independent directors can promote such a defense through their (1) appropriate and periodic consideration, review, and questioning of their funds' actual prospectus disclosure, and (2) demonstrable attention to, and understanding and oversight of, the process by which prospectus disclosure is formulated, vetted, and finalized by their fund group. Federal legislation enacted in 1995 has further curtailed the potential legal risk to independent directors in certain disclosure lawsuits, by protecting independent directors from the threat of "joint and several liability," absent proof of independent directors' actual knowledge of the prospectus misstatements or omissions at issue.[10]

As a practical matter, independent directors should remain at low risk of personal liability in disclosure lawsuits. Disclosure lawsuits are nearly always resolved prior to trial, whether through pretrial dismissals or pretrial settlements. In pretrial dismissals, no amount is paid by any defendant. In pretrial settlements, the settlements are typically funded by other defendants, by insurance, or by some combination of the two.

A second type of civil litigation in which independent directors may find themselves involved is litigation challenging their conduct as "fiduciaries."[11] Independent directors are required under the laws of most states to act with due care and loyalty in the performance of their responsibilities. Lawsuits of this type typically allege breaches of one or both of these state law duties, but are often appended to lawsuits brought in federal courts under federal law (such as prospectus disclosure lawsuits as discussed above, and fee lawsuits as discussed below).

As a practical matter, independent directors should remain at low risk of personal financial liability in breach of duty lawsuits. Such lawsuits are typically structured as "derivative actions," meaning that the lawsuit is brought on behalf of the fund itself rather than on behalf of individual shareholders or classes of shareholders. State law almost always requires that the plaintiff, in order to proceed with a derivative action, first make a demand on the board to take action or else to explain why demand on the board would be futile. Since plaintiffs rarely make such a demand on the board, and courts likewise rarely excuse the demand requirement as futile, courts often dismiss such cases as a matter of law.[12] Even in those instances in which a demand is made, applicable law generally requires that the fund itself — through appropriate fund representatives, such as a committee of directors whose conduct is not at issue — make a determination as to whether the lawsuit should proceed. In many instances, the representatives reach a judgment that prosecution of the lawsuit is not in the best interests of the fund and the lawsuit is terminated; courts are typically reluctant to second-guess such judgments.

Moreover, even if breach of duty lawsuits proceed to trial, the judgments of fund directors, like those of other corporate directors, will typically be accorded broad deference by courts under a long-standing legal doctrine known as the "business judgment rule." Under this doctrine, directors are presumed to have exercised their judgment in good faith and in a rational belief that their action was taken in the best interest of the fund.[13]

A third type of civil litigation in which fund directors may find themselves involved is litigation challenging the payment of fees by funds to advisers or other service providers. Under the federal statute governing these lawsuits, the principal risk of financial liability rests with the service provider that received the fees. Nevertheless, plaintiffs in fee-based lawsuits have sometimes sought to include independent directors as defendants. To date, courts have generally rejected these efforts (although some of these court decisions are now under appeal). Still, independent directors will continue to be witnesses in fee-based lawsuits, since their testimony might give more details about the process they followed in considering the documents in the record.

A fourth type of civil litigation in which independent directors may find themselves involved is litigation challenging the structure or governance of closed-end funds. Although lawsuits of this type often challenge decisions reached and judgments made by fund boards, and may even seek to hold fund directors personally liable for their alleged violations of law, these lawsuits are frequently designed to force "open-ending" or other structural or governance changes in closed-end funds, rather than to obtain monetary awards for shareholders. As a result, there is often little practical risk of personal financial liability for independent directors.

As the foregoing discussion suggests, independent directors should remain at low risk of personal liability from judgments or settlements in civil litigation. However, the cost to fund directors of civil litigation itself — including the cost of legal and expert representation — is often substantial. There are a limited number of law firms and industry experts with experience in representing funds, fund directors, and fund advisers in civil litigation. The fees charged by these firms and experts reflect both their experience and their relative scarcity. For this reason and others discussed in another ICI Mutual study (Managing Defense Costs: A Study of Trends and Management Strategies (December 2004)), the cost to the fund industry of defending civil litigation has increased dramatically in recent years.

However remote the risk of personal liability for independent directors, civil litigation that involves them, whether as defendants or key witnesses, is disruptive to fund business, and invariably constitutes a time-consuming and stressful distraction for the directors involved. Moreover, the cost of representing independent directors in civil litigation is typically borne, directly or indirectly, by funds themselves, and thus ultimately by fund shareholders. Accordingly, it is appropriate for independent directors to take steps to manage their litigation risk, in furtherance of the interests of the funds they oversee, fund shareholders, and themselves. The following two parts of this Study address management of independent director litigation risk.

Management of Front-End Litigation Risk

Efforts to manage "front-end" litigation risk are directed towards (1) reducing the risk of civil litigation being initiated in the first instance, and (2) increasing the likelihood that litigation, if brought, will be resolved favorably for independent directors. While they may vary in their particulars, effective efforts to manage "front-end" litigation risk all tend to reflect three fundamental principles — preparation, process, and documentation.

As discussed in the first section of this Study, fund directors should face little risk of personal liability in civil litigation if they have acted with due care and independence (i.e., without conflicts of interest), and if they have devoted appropriate time, attention, and oversight to reaching considered judgments on fund issues and concerns. Attention to these three principles — preparation, process, and documentation — can help directors to satisfy this standard of conduct in fulfilling their board responsibilities, thereby reducing the overall risk of litigation in the first instance. Attention to these three principles can also help directors, in the event of litigation, to establish that they have, in fact, met this standard of conduct, so as to increase the probability of a favorable litigation result.

Preparation refers to the readiness of independent directors to exercise their responsibilities as board members. A focus on preparation reflects that directors take their responsibilities seriously and that they are devoting the necessary time and effort to permit them to make informed and reasoned decisions on fund affairs. Appropriate attention to preparation also evidences directors' due care and good faith in the fulfillment of their responsibilities.

Process refers to the practices and procedures adopted and followed by independent directors and fund boards in identifying, considering, and deciding issues relevant to fund affairs. A focus on process helps to ensure that matters of importance are evaluated fully and in the best interests of the fund, and that board decisions are made and implemented in a timely and considered manner. As with preparation, appropriate attention to process also evidences directors' due care and good faith in the fulfillment of their responsibilities.

Documentation refers to the appropriate recordation of board preparation and process for reaching decisions, of actual board decisions, and of board oversight in the implementation of those decisions. Documentation plays a critical role in the event of civil litigation. By its very nature, civil litigation involves an examination of past events and judgments. As such, in reconstructing and assessing directors' past conduct and decisions, plaintiffs' attorneys, as well as judges and juries, will necessarily rely on two broad types of evidence: (a) contemporaneous writings (such as board minutes, board meeting materials, individual e-mails, and individual notes), and (b) after-the-fact recollections and explanations by defendants and witnesses, as elicited through sworn testimony during the course of litigation. Such testimony may not take place until months or even years after the challenged events or judgments, and memories of defendants and witnesses may fade in the interim. A focus on properly constructed documentation helps to ensure the existence of a contemporaneous, accurate, and unambiguous record, in the event that board deliberations, judgments, or actions become subject to subsequent legal challenge.

Techniques for promoting these three principles will vary among fund groups, individual boards, and even individual directors. Indeed, particular approaches to the management of front-end litigation risk may differ widely, depending on such factors as a fund group's size, board structure, business operations, and director background and experience. By way of practical and commonsense guidance, however, independent directors may wish to consider the following suggestions, among others. Note that references below to "you" and "your" are to independent directors.

Focus on Board Materials

Focus carefully on board materials, and make your expectations regarding board materials known to management and counsel.

Written meeting materials are generally the primary source used by independent directors in preparing for board meetings. These materials typically take the form of "board books" prepared by the fund adviser or administrator. Board books also frequently incorporate, or are supplemented by, memoranda, reports, and other information provided by counsel and other experts. Meeting materials are of greatest value to you — from both a practical and a litigation risk management perspective — if the materials are thoughtful and comprehensive, and if you are in a position to review and consider them carefully for a reasonable period of time before board issues are discussed and decided. Accordingly, you may find it helpful (perhaps as part of your board's annual self-assessment) to formulate your expectations with regard to meeting materials, and to discuss these expectations with management and counsel. In this regard, you may wish to consider the following questions, among others:

- How far in advance of the meeting do you expect to receive board materials?
- Under what circumstances, if any, will your board accept materials distributed at the board meeting itself?
- To what extent would use of particular conventions in the materials (for example, executive summaries which state the purpose of the proposed action and the anticipated benefit to the fund) prove helpful?
- To what extent does your board expect to be involved in setting or approving agendas?
- To what extent does your board expect to consult with fund management and counsel regarding agenda issues prior to board meetings?

Enhance your Effectiveness

Consider ways to enhance your effectiveness as an independent director.

Many independent directors come from distinguished backgrounds outside the fund industry. The outside perspective of such independent directors offers many important benefits to funds and fund shareholders. However, if you have limited past experience in the fund industry — and, indeed, even if you have extensive fund industry experience — you may find that you can enhance your effectiveness as an independent director, and the effectiveness of your board as a whole, by exploring broader issues and developments affecting the fund industry.

There are numerous resources to assist in such efforts. The Bibliography to this Study lists a number of publications that may be of special interest to independent directors. Some independent directors may also find it useful periodically to commission educational sessions or background briefs from management or counsel on particular matters, or to invite in-person presentations by providers with unique perspectives on fund industry issues and concerns (such as auditors, ICI Mutual, the Investment Company Institute, and the Independent Directors Council). Some independent directors attend industry seminars and conferences sponsored by the Investment Company Institute and other organizations. There are also various events designed specifically for independent directors, including events sponsored by the Independent Directors Council.

The Decision-making Process

Pay close attention to the decision-making process.

Independent directors are responsible for exercising their judgment in the best interests of their funds. By paying close attention to the integrity of the decision-making process, you can help to ensure the integrity of the individual and collective judgments that are reached by you and your fellow directors on issues requiring board attention. You can also help to reduce the risk that your judgments will be successfully second-guessed in the event of future litigation.

The decision-making process of a board may vary, depending on the particular issue at hand and other factors. Thus, for example, on some issues, the integrity of the process may be best served through dissemination of comprehensive background materials, followed by a pre-meeting consultation between independent directors and counsel, directors' extensive questioning of management, a full debate by the board, and, as necessary, a referral of the issue to a board subcommittee or experts for review. By contrast, other issues may appropriately be addressed through, for example, a written consent of the board.

In the context of considering your board's overall approach to addressing and resolving issues affecting the fund and fund shareholders, you may find it helpful to look to guidance from your outside counsel and other service providers, and to recommendations included in the Investment Company Institute's 1999 Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness.[14]

In the context of arriving at specific decisions in your role as independent director, you may further wish to consider the following questions, among others:

- Have you been provided with adequate background information to understand the issue presented, and its relative importance to the fund and fund shareholders?
- Do you want independent advice on the issue from counsel or other experts (such as consultants or industry analysts)?
- Do you believe there would be a benefit to creating/hearing the views of a board subcommittee, or to discussing the issue in "executive session" with other independent directors?[15]
- Have you asked management or other parties who may have a personal or institutional interest in the issue as many questions as you believe necessary in order to understand the issue, recognize the nature of their personal or institutional interest, and come to your own reasoned conclusion?
- Is the issue one that you believe should be fully debated by the full board?

Maintaining Minutes

Don't underestimate the importance of maintaining carefully written and accurate minutes of board and committee meetings.

At each board and board committee meeting, directors are typically called on to adopt a resolution approving minutes of their prior meeting. Once approved by directors, minutes constitute an official written record of the proceedings of the prior meeting, and are retained permanently with the fund's other corporate records.[16] As a contemporaneous written record, and as a document whose fundamental accuracy is attested to by directors (through their approval resolution), minutes can play an important role in subsequent civil litigation, by providing tangible evidence of the issues, judgments, and processes that may be referenced therein.

Minutes are designed to summarize proceedings and not to transcribe them. As such, minutes are necessarily selective in their contents and in the level of generality or detail with which they describe particular decisions, events, and discussions. Care must also be taken by the author to avoid inaccuracies or ambiguities. Accordingly, minutes can be challenging to write. Yet the preparation of draft minutes is often viewed as a tedious assignment and is therefore sometimes relegated to relatively junior personnel. Similarly, the review and approval of draft minutes should not be viewed as a perfunctory exercise. Given the potential role of minutes in the litigation context, independent directors should not underestimate the importance of maintaining carefully written and accurate minutes of board and committee meetings.

In light of the foregoing, you may wish to give attention to the drafting and approval process for board and committee minutes. In this regard, you may wish to solicit the views of counsel and management as to the following questions, among others:

- Are decisions reached and other matters before the board or committee described in the minutes at an appropriate level of detail or generality?

- Are the minutes reflecting, to the extent appropriate, information provided to directors, the deliberations of the directors, the general nature of their debate, and the occurrence of question-and-answer sessions?

- Does the length of the minutes on a particular issue bear an appropriate relationship to the time devoted to that issue at the meeting?

- If board or committee meetings relate to multiple funds, do the minutes identify considerations and issues relevant to particular funds, as appropriate?

- Are minutes drafted and circulated for review to appropriate individuals in a timely fashion?

- Should draft minutes be reviewed for the purpose of identifying language that may be misunderstood or misinterpreted in a litigation context?

Personal Notes and E-mails

Be very careful with personal notes and e-mails.

Some independent directors believe that personal notes and the use of e-mail assist them in fulfilling their board responsibilities. Indeed, taking notes may enhance the ability of some directors to understand, review, and make inquiries into issues before them, and communication via e-mail has become ubiquitous in today's business climate. At the same time, personal notes and e-mails tend to be highly informal, are typically prepared hurriedly, and usually reflect only "snippets" of their authors' thinking. Moreover, unlike meeting minutes, personal notes and e-mails are rarely scrutinized or reviewed either by their authors or by third parties. Accordingly, personal notes and e-mails frequently contain inaccuracies, ambiguities, or omissions, and may fail to accurately reflect their authors' actual views or concerns.

As contemporaneous written documents created by directors themselves, personal notes and e-mails may be given credence in a litigation context. Accordingly, you should expect that, in the event of litigation, plaintiffs' attorneys will seek discovery of any potentially relevant personal notes or e-mails created or received by you. You should also expect that plaintiffs' attorneys will seek to use such notes and e-mails as a basis for questioning during your sworn deposition testimony. Unfortunately, your personal notes and e-mails may inadvertently create a misleading or inaccurate impression of your past views or actions.

Because handwritten notes rarely serve a long-term personal or corporate purpose, you should consider whether notes — if taken at all — should ordinarily be taken on separate pads of paper and routinely discarded after the immediate project for which they were created is completed. Any use of electronic notes and e-mail communications should be approached with special care, as such materials, once recorded, may remain retrievable for use as evidence in the event of future litigation, even if they have seemingly been previously deleted. In light of the foregoing, you may wish to consult with counsel regarding whether and when to take notes or use e-mail communications for fund-related affairs. In particular, attention should be given to spoliation issues — the destruction or alteration of materials once a lawsuit (or regulatory investigation or proceeding) is initiated or reasonably foreseeable — and to any relevant regulatory or other legal prohibitions on your disposal of personal notes or e-mails, once created.

Reevaluate Your Commitment

Periodically reevaluate your commitment to board service.

Service on a mutual fund board requires a substantial commitment on the part of individuals who may frequently have significant other professional and personal responsibilities. In the highly regulated world of the fund industry, you are expected to act as an attentive "watchdog" for the interests of fund shareholders.[17] From the economic perspective of those individuals who will judge your conduct and actions in the event of civil litigation, you will most likely be perceived to be well compensated for your services. If you are unable or unwilling to devote adequate time and attention to your role, you may be placing yourself, your fellow directors, and the funds you oversee at increased risk in the event of civil litigation.

Accordingly, before accepting a board position, and periodically thereafter as your personal and professional circumstances change, you may wish to assess carefully whether you are in a position to devote an appropriate amount of time and energy to board service, given your other obligations, interests, and general health. The commitment that will actually be required of you as an independent director may depend on a number of factors — including, among others, your individual background and experience, the number and types of funds subject to your oversight, the extent of your participation on board committees, the frequency of your board and committee meetings, and the relative complexity of the legal and business issues facing your funds and their affiliated advisers and service providers.

One means of facilitating this type of periodic reassessment may be through your board's annual evaluation of its performance, which is now required by new rules of the Securities and Exchange Commission ("SEC").[18] In adopting this new requirement, the SEC said that it is intended, among other things, to strengthen directors' understanding of their role.[19] Although such a review is designed to focus on the board's performance as a whole, it can also help to enhance the commitment and contributions by individual directors. Some observers have suggested that peer assessments, while beyond the scope of the new SEC rules, may also be helpful in evaluating and enhancing each director's individual commitment and capacity for ongoing board service.

Management of Back-End Litigation Risk

Efforts to manage "back-end" litigation risk are directed towards taking, generally in advance of any litigation, steps to reduce the direct and indirect financial impact of civil litigation on independent directors and their funds. Efforts to reduce the direct financial impact of civil litigation commonly focus on (1) arranging for appropriate indemnification of independent directors for their financial exposure in civil litigation, and (2) securing adequate professional liability insurance coverage for such financial exposure. Efforts to reduce the indirect financial impact of civil litigation commonly focus on management of independent director defense costs.

Indemnification affords a strong first line of protection to independent directors against the direct financial impact of civil litigation. Indemnification allows independent directors to be reimbursed, from fund assets, for liabilities (including legal expenses) incurred by them as defendants[20] and witnesses[21] in fund-related civil litigation. Indemnification also allows independent directors to receive "advances" to cover their legal and associated expenses as those expenses are incurred by them during the course of litigation.[22] Because funds typically have minimal risk of insolvency, indemnification generally affords even stronger protection to independent directors of funds than to directors of operating companies.

Under state indemnification statutes, funds are typically required to indemnify directors in certain circumstances (so-called "mandatory indemnification"), and are permitted — but not required — to indemnify fund directors in other circumstances (so-called "permissive indemnification").[23] Provisions in fund charters and bylaws typically grant independent directors the broadest indemnification rights available under applicable law, thus effectively converting permissive indemnification into mandatory indemnification.[24]

Indemnification rights remain subject to certain restrictions under state and federal law. Thus, for example, the Investment Company Act of 1940 prohibits indemnification of a fund director for liability that he or she may have to the fund or fund shareholders where the director engaged in "disabling conduct."[25] Courts and the SEC have also generally taken the position that indemnification against liabilities under the Securities Act of 1933 is contrary to public policy and is therefore unenforceable.[26] Historically, however, these legal and regulatory restrictions on indemnification have rarely left independent directors at personal financial risk in civil litigation.[27]

Insurance affords a second line of protection against the direct financial impact of civil litigation. While there is no legal requirement that they do so, most funds arrange to purchase professional liability insurance, commonly referred to as directors and officers ("D&O") insurance.[28] D&O insurance typically provides coverage for liabilities resulting from negligence or breach of duty by fund directors or officers in performance of their duties (though not for liabilities resulting from their fraud, dishonesty, or similar misconduct). As with indemnification, D&O insurance allows independent directors to be reimbursed for liabilities, including legal expenses, incurred by them in fund-related civil litigation. As with indemnification, D&O insurance also typically allows independent directors to receive "advances" to cover their legal and associated expenses, as those expenses are incurred by them during the course of litigation. Of course, unlike indemnification, liabilities and advancements covered by D&O insurance are paid by a third-party insurer, rather than directly out of the assets of the fund itself.

The most important role of D&O insurance is to provide direct financial protection for funds themselves. More specifically, through what is commonly referred to as "company reimbursement" coverage, D&O insurance allows funds to be reimbursed from insurance for indemnification amounts payable by funds to their independent directors in connection with civil litigation in which the directors are involved. The nature and scope of the insurer's reimbursement obligations are governed by the terms and conditions of the D&O insurance policy itself, which constitutes an enforceable agreement between the funds and the insurer. The insurer's maximum potential financial obligation under the company reimbursement coverage is set forth in the policy's limit of liability; funds are typically responsible for retaining a portion of their risk through a pre-established deductible (or "retention") that is applied on a per-claim basis.

Because indemnification amounts paid by a fund to its independent directors are a fund expense, and because D&O

insurance compensates the fund for the indemnification it pays, D&O insurance serves to eliminate the immediate impact on fund assets (and, therefore, the immediate impact on fund shareholders) of indemnifiable liabilities that may be incurred by independent directors in civil litigation. Instead, the impact on fund assets is absorbed over time through the fund's payment of annual premiums for D&O insurance. Looked at another way, premiums paid for D&O insurance serve, in a sense, to hedge the fund's risk of a sudden and substantial reduction in fund assets as a result of the fund's own "indemnification risk."

A separate, functionally less important role of D&O insurance is to provide "backup" direct financial protection for independent directors where indemnification may otherwise be unavailable. Thus, for example, D&O insurance may provide financial protection to independent directors for certain liabilities for which indemnification is prohibited, or where indemnification cannot be obtained in the unlikely event of a fund's financial insolvency. This "backup" protection is commonly referred to as "direct" D&O coverage. The insurer's maximum potential financial obligation for direct coverage is set forth in the policy's limit of liability (which limit of liability is typically shared with the company reimbursement coverage); independent directors typically retain little or no financial exposure of their own in the form of deductibles.

Over the mid-to-long term, D&O insurance premiums and scope of coverage will necessarily adjust to reflect the losses paid by the insurer. Given the effect of insurable losses on premiums paid over time by funds for D&O insurance, it is appropriate for independent directors to seek means to limit these losses. Defense costs are typically the most significant financial exposure for independent directors in civil litigation; these costs are typically indemnifiable by funds and covered under D&O insurance. As a result, efforts to manage the financial impact of civil litigation frequently focus on managing the defense costs of independent directors.

Approaches to indemnification, insurance, and defense cost management may vary among fund groups and individual boards, depending on such factors as a fund group's size, risk profile, and litigation experience. By way of practical and commonsense guidance, however, independent directors may wish to consider the following suggestions, among others:

Understand Your Rights

Understand your indemnification rights.

Since state statutes vary and fund governing documents vary among fund groups (and may even vary among the funds in a fund group), independent directors should understand their own indemnification rights — in particular, whether they are fully indemnified to the extent permitted by applicable law. If your fund does not provide full indemnification to its directors, you may wish to consult your counsel for ways to enhance your indemnification — for example, by amending governing documents.[29] You should also understand if you are entitled to advances of expenses, and, if so, how you exercise this right.[30]

D&O Insurance

Recognize that D&O insurance is not all the same.

D&O insurance policies can be structured in a number of different ways. Most commonly, fund groups purchase policies that combine D&O insurance with "errors and omissions" ("E&O") insurance. Unlike D&O insurance, which covers the individual liability of fund directors and officers, E&O insurance covers the entity liability that funds may themselves incur in civil litigation.

A fund's insurance policy is typically structured to cover both D&O and E&O exposures of multiple funds within a fund group. A fund's insurance policy may also be structured to extend coverage to both D&O and E&O exposures of the funds' adviser(s) and other affiliated service providers.[31] Such "joint" policies are often the most cost-effective approach to purchasing insurance and frequently permit individual funds (and their directors and officers) to secure more aggregate coverage at lower overall premiums than would otherwise be feasible for them. A joint policy with the funds' adviser(s) and other affiliated service providers may also lessen the risk of coverage disputes with and among insurers, which may occur if the parties are covered under different policies or with different insurers. For these reasons, joint policies are the most common insurance structure used by fund groups for D&O insurance. On the other hand, joint policies add complexities (such as how to allocate premiums and/or recoveries) and erosion risk (see Special Protection below), and, therefore, some fund groups choose stand-alone "funds-only" policies.

Whether policies are structured as joint or stand-alone, they can differ as to premiums, deductibles, and limits of liability. D&O policies may also offer different scopes of coverage. In that regard, D&O policies may have different exclusions, either in the policies themselves or added by endorsements to the policies, that may alter their respective scopes of coverage for independent directors. Moreover, insurers themselves differ as to their claims-handling reputations, their responsiveness, and the services they provide to insureds. These differences among policies and insurers warrant careful attention and balancing by independent directors as they assess their insurance options. Fund directors may seek guidance in this assessment from counsel or professional insurance intermediaries. Fund directors may also seek guidance from ICI Mutual, whose professional staff regularly provides both insured and noninsured fund groups with customized policy comparisons, peer profiles, and other individualized assistance in structuring and evaluating their insurance programs.

In light of the foregoing, as you assess your D&O insurance options, you may wish to consider the following questions, among others:

- Would you and the funds benefit from purchasing a joint policy in conjunction with other funds and/or fund service providers? If so, how are insurance premiums and/or recoveries to be allocated among insureds?

- What overall limit of insurance is being purchased, and what deductible amounts will be applied? Are the overall limit and deductible amounts generally consistent with limits and deductibles secured by fund groups of similar size? If not, what is the rationale for the differences?

- What is the insurer's reputation for claims handling, claims payments, and general client service?

- With respect to any insurance option under consideration, what is and is not covered by such option? If more than one insurance option is under consideration, are there key differences in policy terms and conditions among the different options? If so, which of these differences are likely to be most important in the event of an actual claim?

Special Protection

Consider whether to supplement your fund's basic D&O insurance with special protection for independent directors.

D&O insurance policies include an aggregate limit on the amount payable by the insurer for any and all insurance claims made by any and all insureds. Because of this feature, a joint insurance structure, while cost-effective and administratively efficient, necessarily exposes each insured to the risk that the limit of liability of the joint policy may be eroded or exhausted by insurance claims of other insureds. Some fund groups address this issue through internal agreements, under which each insured is guaranteed some minimum amount of coverage and coverage is preallocated among insureds in the event losses exceed the policy limit.

Other fund groups address this issue through D&O insurance that provides special protection to independent directors by its own terms (rather than through internal agreements). Such supplementary protection for independent directors may be provided by a "reserved limit," under which a portion of the joint policy limit is predesignated, under the terms of the joint policy itself, for the sole use of independent directors. Alternatively, such protection may take the form of a stand-alone D&O policy for independent directors — commonly referred to as an independent directors' liability ("IDL") policy — under which coverage becomes available if the underlying joint policy is first exhausted through claim payments, or upon the occurrence of other relatively uncommon events (for example, termination of the underlying joint policy by the adviser, or cancellation or rescission of the underlying joint policy by the insurer). Under some IDL policies, coverage may also become available if coverage is excluded under the terms of the underlying joint policy. For example, IDL policies may provide coverage for market timing and late trading losses, which are now frequently excluded by D&O policies.

Over the past two years, IDL policies have become increasingly popular among fund groups, and IDL policies are now available from ICI Mutual and from a number of commercial insurers. Some IDL policies, including those offered by ICI Mutual, provide both "nonindemnifiable loss" coverage (which insures directors and officers in situations where the fund cannot or does not provide indemnification) and "indemnifiable loss" coverage (which reimburses the independent directors for losses where indemnification is available), and thus functionally protect funds against their indemnification risk. By contrast, most IDL policies offered by commercial insurers provide only "nonindemnifiable" loss coverage for independent directors.

In light of the foregoing, as you consider whether to supplement your fund's basic D&O insurance with special protection for independent directors, you may wish to consider the following questions, among others:

- Is special protection for independent directors necessary or advisable, in light of the amount and scope of coverage already provided under the fund's underlying D&O insurance program?
- Is an appropriate level of special protection for independent directors best secured through "reserved limits," an internal agreement, or a stand-alone IDL policy?
- If an IDL policy is under active consideration, does the IDL policy provide both "indemnifiable loss" and "nonindemnifiable" loss coverage? Under what circumstances will coverage under the IDL policy potentially be available?

Manage Defense Costs

Pay close attention to managing defense costs.

Fund groups commonly retain one or more outside law firms to represent the interests of fund group defendants in civil litigation. Depending on the nature and perceived severity of the particular lawsuit, and on the actual or potential conflicts raised by joint legal representation of multiple defendants by a single law firm, different law firms may be retained to represent the interests of different defendants or groups of defendants. Thus, for example, in some lawsuits, a single law firm may be retained to represent jointly all defendants, including independent directors; in other lawsuits, different law firms may be retained to represent the interests of the fund's adviser or other service providers, the fund's independent directors, and even the fund itself.

Use of multiple defense firms can afford both advantages and disadvantages to fund groups in litigation. Use of different defense firms for different defendants or groups of defendants (such as use of different defense firms for the adviser and fund directors, or for different boards or board "clusters") can sometimes help to ensure that appropriate legal attention is given to the separate interests of these defendants or groups of defendants in the course of litigation. At the same time, use of multiple firms can muddle the overall litigation strategy for all defendants. Use of multiple firms also creates substantial additional expense, and often invites significant inefficiencies in the delivery of legal services. Independent directors should weigh these advantages and disadvantages carefully in the context of the particular litigation before making decisions as to retention of defense firms.

As a practical matter, the primary focus of attention in most fund-related lawsuits is on the conduct of the adviser. In such cases, independent directors, even where named separately as defendants, would not typically expect to face liability risk of their own unless the conduct of the adviser is first determined to be wanting. Accordingly, it is common — as both a matter of litigation strategy and cost-effectiveness — for the adviser's counsel to take the lead in defense of the litigation, with counsel for the directors (if separate counsel is retained) taking a limited role that is carefully tailored to avoid efforts that overlap or duplicate defense services being provided by the adviser's counsel.

Defense cost payments have constituted a substantial percentage of claim payments made by liability insurers in recent years.[32] ICI Mutual's own experience is consistent with that of the liability insurance industry generally. In recognition of these increased costs, and of the importance of managing defense costs effectively and reducing them when appropriate, many fund groups have devoted substantial time and attention to developing and implementing strategies and techniques designed to promote robust, efficient and cost-effective defense of civil litigation. (These various issues — including the reasons for growth in defense costs, and particulars on defense management strategies and techniques — are the subject of the previously cited ICI Mutual study titled Managing Defense Costs: A Survey of Trends and Management Strategies. Copies are available to ICI Mutual insureds upon request.)

When named as defendants, independent directors should recognize that the retention of separate defense counsel will complicate the effective management of defense costs. Since in-house personnel with responsibility for litigation management at the fund group may have a very limited ability to influence the nature and scope of resources devoted by directors' counsel to the defense effort, it is incumbent on independent directors themselves to pay particular attention to, and participate actively in, the management of the civil litigation in which they are involved, so as to ensure a defense effort that is not only vigorous, but cost-efficient.

Conclusion

Despite an extraordinary increase in civil litigation against the fund industry in recent years and several recent well-publicized settlements involving independent directors outside the fund industry, the risk to independent directors of personal liability in fund industry lawsuits has been, and is likely to remain, small. Nevertheless, some degree of litigation risk is inherent in board service. Civil lawsuits that involve independent directors can divert board attention from ongoing fund concerns, and generate substantial financial expense in the form of litigation defense costs. It is thus appropriate for independent directors to take steps to manage their litigation risk, so as to reduce the likelihood of litigation against them, to enhance the odds of achieving a favorable resolution in any litigation that may be brought, and to reduce the direct and indirect financial impact of litigation on independent directors and their funds.

Appendix A: State And Federal Law Duties And Liabilities

State Law

Fund directors, like directors of public operating companies, generally have two basic duties under state law: the duty of care and the duty of loyalty.

THE DUTY OF CARE

The duty of care requires directors to act with reasonable care and skill in light of their actual knowledge and any knowledge they should have obtained in functioning as directors. Breach of the duty of care need not necessarily involve an affirmative act; in some circumstances, waiting to take action or make decisions may in itself constitute a breach of this duty.[33] Yet directors are not generally held to be "insurers," and will not be found liable for errors of judgment where reasonable care and diligence and ordinary skill have been exercised. Reasonable reliance on others, including counsel, accountants, or other experts, is permissible.

THE DUTY OF LOYALTY

In addition to the duty of care, directors owe a duty of loyalty to the fund. This means that directors owe a duty to protect the interests of their fund and neither pursue interests of their own that are contrary to the interests of the fund nor place their own interests ahead of the interests of the fund. While courts have been hesitant to second-guess the reasonable business judgments of directors under the duty of care standard, they generally apply a more rigorous test in evaluating whether or not the duty of loyalty has been violated.

THE BUSINESS JUDGMENT RULE

In litigation, the usual standard for court review of a board decision is whether the decision resulted from the exercise of reasonable business judgment. This standard is commonly referred to as the "business judgment rule." In other words, if a decision of the board is a result of the board's exercise of reasonable business judgment, then a court should not upset or reverse the board's decision or judgment, or impose liability on the directors, even if that decision or judgment later proves to have been erroneous. Under the business judgment rule, directors will be presumed to have exercised their judgment in good faith and in a rational belief that their action was taken in the best interest of the fund.[34] However, a plaintiff may rebut this presumption, and directors who have a conflict of interest, or who act too quickly and without sufficient information, may not always be able to rely on the business judgment rule.[35]

Federal Law

Fund directors, like directors of public operating companies, are subject to potential civil liability under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act"). There is also some additional, but limited, potential for civil liability under the Investment Company Act of 1940 (the "1940 Act").

LIABILITIES UNDER THE 1933 ACT

Section 11 of the 1933 Act

Section 11 of the 1933 Act imposes liability on certain categories of people, including directors, for a registration statement that contains an untrue statement or omits to state a material fact required to be stated or necessary to make the statement not misleading.[36] Section 11 provides for strict liability, which means there is no requirement for the plaintiff investor to prove that a director had the intent to defraud or some other intentional wrongdoing by the director.[37] However, directors may avoid Section 11 liability by proving that, after reasonable investigation, they had reasonable grounds to believe, and did believe, that the statements in the registration statement were correct and not misleading (the "due diligence" defense).[38] The kind of investigation necessary to satisfy the standard of due diligence varies, based on the individual's degree of involvement, expertise and access to pertinent information and data. For example, a director who is also the chief executive officer will be expected to have a higher degree of familiarity than an outside director, and thus is likely to be held accountable for a more careful kind of investigation than is an outside director.[39] Nevertheless, the mere absence of knowledge of a material misstatement or omission is not an adequate defense for any of the persons who may be subject to liability.[40]

The Private Securities Litigation Reform Act of 1995 (the "PSLRA") protects outside directors[41] from joint and several liability under Section 11 absent proof that the outside director had actual knowledge that the issuer had made an intentionally false or misleading statement to the investing public.[42]

Section 12(a)(2) of the 1933 Act

Under Section 12(a)(2) of the 1933 Act, a purchaser of a registered security may recover losses from any person who sold the security to the purchaser by means of a prospectus that included an untrue statement of a material fact or omitted to state a material fact necessary to make the statements, in light of the circumstances under which they were made, not misleading. This liability will only be found where the purchaser did not know of the untruth or omission. Although directors sign the registration statement, of which the prospectus is a part, these actions alone cannot typically subject directors to potential liability under Section 12(a)(2).[43] In order for a director to be liable under Section 12(a)(2), the director must be more directly involved in the sales process, such as soliciting sales, or initiating or participating in sales negotiations.[44] Similar to the Section 11 due diligence defense, a director may defeat a claim under Section 12(a)(2) by showing that he or she did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

Statute of Limitations under the 1933 Act

No action may be brought to enforce any of the 1933 Act liabilities discussed above unless brought within the earlier of (i) one year after the discovery of the untrue statement or omission, or after such discovery should have been made by the exercise of reasonable diligence, or (ii) three years after the security was bona fide offered to the public or three years after the sale for Sections 11 and 12(a)(2), respectively.

LIABILITIES UNDER THE 1934 ACT

Section 10(b) of the 1934 Act and Rule 10b-5 thereunder

Section 10(b) of the 1934 Act and Rule 10b-5 thereunder are the most relevant provisions of the 1934 Act from the perspective of independent directors because they are the paramount antifraud provisions in the federal securities laws. Investors may sue directors for fraud under Section 10(b) and Rule 10b-5 "in connection with the purchase or sale of a security." Unlike Sections 11 and 12(a)(2) of the 1933 Act, to succeed under Section 10(b) and Rule 10b-5, an investor plaintiff must prove that the director engaged in intentional or reckless misconduct and must show that the investor suffered harm as a result. Plaintiffs must also prove the fact and extent of their financial harm — i.e., actual damages. Because of these heightened requirements imposed on plaintiffs, claims under the 1934 Act pose less of a practical threat of liability to directors than claims under the 1933 Act.

Statute of Limitations under the 1934 Act

No action may be brought to enforce a Section 10(b) or Rule 10b-5 claim unless brought within the earlier of (i) two years after the discovery of the facts constituting the violation, or (ii) five years after the violation.

LIABILITIES UNDER THE 1940 ACT

Section 36(b) is the only provision of the 1940 Act that expressly provides individuals (as opposed to regulators) with a right to bring civil litigation. Litigation under Section 36(b) has historically focused on breaches of fiduciary duty involving the receipt of advisory compensation or other payments by an investment adviser (or its affiliate). Attempts have been made in recent years to expand the scope of Section 36(b) lawsuits,[45] although efforts to pursue independent directors as defendants in Section 36(b) lawsuits have generally been unsuccessful.

Section 36(a) of the 1940 Act expressly authorizes the SEC to bring an action against, among others, directors for "breach of fiduciary duty involving personal misconduct in respect of any registered investment company."[46] By its terms, Section 36(a) is limited to actions by the SEC. However, plaintiffs have, in the past, brought civil actions of their own against fund directors under Section 36(a), on the theory that Section 36(a) permitted "implied" private rights of action against fund directors for breach of their fiduciary duties. In the past, plaintiffs have also pursued fund industry lawsuits under other provisions of the 1940 Act, based on similar theories of "implied" private rights of action.

Recently, there has been a notable reversal of a prior trend by courts towards permitting "implied" rights of action under Section 36(a) and other provisions of the 1940 Act. Over the past twelve months, in connection with a number of revenue sharing and market timing cases, various lower federal courts have consistently rejected lawsuits based on such implied private rights of action.[47] A number of these recent decisions are now on appeal.

Appendix B: Bibliography

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National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Director Liability: Myths, Realities, and Prevention* (2005).

Robert A. Robertson, *Fund Governance: Legal Duties of Investment Company Directors* (2001).

James M. Storey & Thomas M. Clyde, *The Uneasy Chaperone: A Resource for Independent Directors of Mutual Funds* (2000).

Endnotes

[1] As used in this Study, the term "independent directors" refers to those directors (and trustees) who are not "interested persons" of a fund as defined in Section 2(a)(19) of the Investment Company Act of 1940 (the "1940 Act")

[2] There have, however, been regulatory settlements involving independent directors. *See, e.g., In the Matter of Jon D. Hammes et al.*, SEC Rel. No. IC-26290 (Dec. 11, 2003) (While no monetary payment was involved, independent directors of an investment company consented to an SEC order requiring them to cease and desist from committing or causing certain violations of the Securities Act of 1933 and the 1940 Act.).

[3] *See, e.g., In re Salomon/Smith Barney Mut. Funds Fee Litig.*, No. 04-4055 (S.D.N.Y. filed May 28, 2004) ("shelf space" litigation); *Emblad v. Austin*, No. 1:05-CV-10055 (D. Mass. filed Jan. 10, 2005) (litigation regarding participation in class action settlements); *Potter v. Janus Inv. Fund*, No. 03-692 (S.D. Ill. filed Oct. 23, 2003) ("fair value" litigation); *In re Franklin Mut. Funds Fee Litig.*, 388 F. Supp. 2d 451 (D. N.J. 2004) (fee litigation); *In re Mut. Funds Inv. Litig.*, 437 F. Supp. 2d 444 (D. Md. filed Apr. 9, 2004) (market timing litigation).

[4] *See, e.g., In re Dreyfus Mut. Funds Fee Litig.*, No. 04-0128 (W.D. Pa. 2004) (order dismissing independent directors from fee litigation); *In re Franklin Mut. Funds Fee Litig.*, 388 F. Supp. 2d 451 (D. N.J. 2004) (order dismissing independent directors from fee litigation); *In re Mut. Funds Inv. Litig.*, 437 F. Supp. 2d 444 (D. Md. filed Apr. 9, 2004) (order dismissing independent directors from market timing litigation).

[5] *See* Bernard Black et al., *Outside Director Liability*, 58 Stan. L. Rev. 1055 (2006). The authors identified only nine settlements since 1980, other than the WorldCom, Enron, and Tyco settlements, in which outside directors made out-of-pocket payments. Most of these settlements involved allegations of oversight failure by outside directors, with a few of the settlements involving breaches of the directors' duty of loyalty to their corporations. *See id.* at 1074.

In part, the perception that fund independent directors are at increased risk of personal liability may also be traced to a 2004 decision by the Delaware Chancery Court, which ruled that officers and directors with "specialized expertise or knowledge" can be held to a higher standard than other directors. *See In re Emerging Communications, Inc. S'holders Litig.*, No. 16415, 2004 WL 1305745 (Del. Ch. May 3, 2004). Although this ruling is the first Delaware decision to hold directors with "specialized expertise or knowledge" to a higher standard, many legal commentators, including retired Delaware Supreme Court Chief Justice E. Norman Veasey, believe the ruling will not be broadly construed because of its specific set of facts. *See* E. Norman Veasey, Musings From the Center of the Corporate Universe, Remarks Before the Section of Business Law Luncheon at the Annual Meeting of the American Bar Association, at 13 (Aug. 9, 2004), *available at* http://www.abanet.org/buslaw/newsletter/0027/materials/speech.pdf.

[6] *See, e.g.*, Black, *supra* note 5, at 1056 ("Absent facts that fit or approach this 'perfect-storm' scenario, directors with state-of-the-art insurance policies face little out-of-pocket liability risk, and even in a perfect storm they may not face out-of-pocket liability. The principal threats to outside directors who perform poorly are the time, aggravation, and potential harm of reputation that a lawsuit can entail, not direct financial loss.").

[7] A fund's prospectus typically incorporates by reference the fund's statement of additional information ("SAI"). Thus, shareholder litigation may also challenge the accuracy or completeness of disclosure in fund SAIs. *See White v. Melton*, 757 F. Supp. 267, 271 (S.D.N.Y. 1991) (citing the SEC's statements that "SAIs incorporated by reference are deemed 'a part of the prospectus as a matter of law'").

[8] *See, e.g., Abrams v. Van Kampen Funds, Inc.*, No. 01-C-7538, 2006 U.S. Dist. LEXIS 2129 (N.D. Ill. Jan. 18, 2006) (decline in NAV of floating rate fund alleged to result from undisclosed use of improper valuation methods); *In re Merrill Lynch & Co. Research Reports Secs. Litig.*, 272 F. Supp. 2d 243 (S.D.N.Y. 2003) (decline in NAV of technology fund alleged to be linked to undisclosed conflicts of interest), *appeal docketed*, No. 03-7978 (2d Cir. Sept. 19, 2003); *In re Alliance N. Am. Gov't Income Trust, Inc. Sec. Litig.*, No. 95 Civ. 330 (S.D.N.Y. filed Jan. 17, 1995) (decline in NAV of government income fund alleged to result from fund's failure to follow its disclosed investment strategies and techniques).

[9] *See* Appendix A for a discussion of the due diligence defense.

[10] *See* Appendix A for a discussion of the Private Securities Litigation Reform Act of 1995 ("PSLRA").

[11] Some commentators have questioned whether the standard of conduct for directors is that of fiduciary. *See, e.g.,* James J. Hanks, Jr., *Maryland Corporation Law* § 6.6[b] (Supp. 2005) (noting that the provisions of the Model Business Corporation Act and the Maryland General Corporation Law, which define the general standard for conduct of directors, omit "any reference to 'fiduciary' 'because that term could be confused with the unique attributes and obligations of a fiduciary imposed by the law of trusts, some of which are not appropriate for directors of a corporation"' (citing Model Bus. Corp. Act § 8.30, com. at ¶ 1 (1998))).

[12] *See, e.g., In re Eaton Vance Mutual Funds Fee Litig.,* 380 F. Supp. 2d 222 (S.D.N.Y. 2005), *appeal docketed*, No. 05-6957 (2d Cir. Dec. 22, 2005); *Benak v. Alliance Capital Mgmt. L.P.*, No. 01-CV-5734, 2005 WL 1285652 (D.N.J. May 23, 2005), *aff'd*, 435 F.3d 396 (3d. Cir. 2006); *In re Merrill Lynch Focus Twenty Fund Inv. Co. Act Litig.*, 218 F.R.D. 377 (E.D.N.Y. 2003), *aff'd sub. nom. Scalisi v. Fund Asset Mgmt., L.P.,* 380 F.3d 133 (2d Cir. 2004).

[13] See Appendix A for additional information on the business judgment rule.

[14] Recognizing that "best practices" are merely that — best practices and not legal requirements — independent directors' counsel consulted for this Study do not believe that funds and their boards must adopt or follow each and every best practice recommendation. However, as noted in a recent, well-publicized decision by the Delaware Chancery Court, while failure to comply with "aspirational" best practices does not create liability (nor do best practices define the standards of liability), following best practices may help directors avoid liability — in other words, following evolving industry best practices may be the best way a director can be "unremittingly faithful to his or her charge." *See In re Disney Co. Derivative Litig.*, No. 15452, 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005), *aff'd*, No. 411, 2006 Del. LEXIS 307 (June 8, 2006).

[15] Rule 0-1(a)(7)(vi) under the 1940 Act requires independent directors of investment companies that rely on one or more of certain exemptive rules to meet at least quarterly in executive session at which no interested directors are present.

[16] Rule 31a-2(a)(1) under the 1940 Act requires a fund to maintain permanently (and in an easily accessible place for the first two years) minutes of the fund's board meetings as well as meeting minutes of the committees thereof.

[17] *See Burks v. Lasker*, 441 U.S. 471, 484 (1970) (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1979)); *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the House Subcomm. on Interstate and Foreign Commerce*, 76th Cong. 109 (1940) (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC).

[18] Rule 0-1(a)(7)(v) under the 1940 Act requires the board of directors of funds relying on certain exemptive rules to evaluate at least annually the performance of the board of directors and the committees of the board of directors.

[19] *See* SEC Release No. IC-26520 (July 27, 2004).

[20] While variations exist among state indemnification statutes, many state laws:

- require indemnification for attorneys' fees and expenses of a director who has been fully exonerated.

- permit a corporation or business trust to include provisions in its charter/bylaws or trust documents to permit indemnification of defense costs and of amounts paid in judgment or settlement where the director acted in good faith.

- do not permit indemnity for conduct that involves bad faith, willful misfeasance, or reckless disregard of duty or that resulted from active and deliberate dishonesty or improper personal benefit or, in a criminal proceeding, where the director knew or had reasonable basis to know that his conduct was unlawful.

- provide a mechanism so that a fund can make a determination as to whether indemnity is proper.

The statutes commonly provide that the determination can be made by a majority vote of the board of directors or by a committee of directors not involved in the proceeding, by special legal counsel selected by the board or committee of the board to make the determination, or by the shareholders. *See generally* James Hamilton & Ted Trautmann, *Responsibilities of Corporate Officers and Directors under Federal Securities Law* ¶ 1402 (1999); William E. Knepper & Dan A. Bailey*, Liability of Corporate Officers and Directors* § 22-11 (6th ed. 1998).

[21] Independent directors are often called as witnesses in fund-related civil litigation. Depending on applicable state law and the fund's governing documents, indemnification may also be available to directors for expenses incurred as witnesses.

[22] Usually, advances are conditioned upon an undertaking by the director to repay the amounts advanced if it is ultimately determined that the director is not entitled to indemnification.

[23] As an example of mandatory indemnification, see § 2-418(d)(1) of the Maryland Corporations and Associations Code ("A director who has been successful, on the merits or otherwise, in the defense of any proceeding . . . shall be indemnified against reasonable expenses incurred by the director in connection with the proceeding."); as an example of permissive indemnification, see § 2-418(b)(1) ("A corporation may indemnify any director made a party to any proceeding" unless it is "established" that the director engaged in certain disqualifying conduct as defined in the statute).

[24] In some situations, separate indemnification agreements between independent directors and their funds may further assist fund directors in augmenting or preserving their indemnification rights. Such agreements are sometimes considered, for example, when a fund's governing documents do not in fact grant independent directors the broadest indemnification rights available under applicable law, or as a "belt and suspenders" supplement to the indemnification rights contained in the fund's governing documents.

[25] Section 17(h) of the 1940 Act provides: "neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office." This is often referred to as "disabling conduct."

The SEC staff also requires that indemnification provisions set forth reasonable and fair means for determining whether indemnification shall be made. In the staff's view, "reasonable and fair means" would include:

- a final decision on the merits by a court or other body before whom the proceeding was brought that the person to be indemnified was not liable by reason of "disabling conduct"; or

- in the absence of such a decision, a reasonable determination, based upon a review of the facts, that the indemnitee was not liable by reason of "disabling conduct" by:

    - the vote of a majority of a quorum of directors who are neither "interested persons" of the fund nor parties to the proceeding ("disinterested, non-party directors") or

- an independent legal counsel in a written opinion.

See Interpretation: Matters Concerning Independent Directors of Investment Companies, SEC Release Nos. IC-11330 (Sept. 4, 1980) and IC-24083 (Oct. 14, 1999).

[26] Under the 1933 Act, a registrant must describe in its prospectus the provisions relating to indemnification of its directors, officers, and controlling persons against liability under the 1933 Act, and include a statement similar to the following:

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers [or controlling persons], the registrant has been informed that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is therefore unenforceable. . . .

See, e.g., 17 C.F.R. §§ 228.510, 228.512(e), 230.484(b); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969).

[27] As noted above, Section 17(h) of the 1940 Act prohibits a fund from indemnifying its directors in certain circumstances. Independent directors should recognize that if a fund independent director has liability for which indemnification is prohibited by Section 17(h) of the 1940 Act, it may also be that the director's liability will not be covered by insurance. Thus, for example, D&O policies typically exclude coverage for fraudulent or dishonest acts and for intentional violations of law — conduct which, as a practical matter, constitutes a substantial subset of the "disabling conduct" for which indemnification is prohibited.

Independent directors should also recognize that the SEC staff has stated its belief that Section 17(h) of the 1940 Act also precludes a fund from use of insurance to indirectly indemnify directors for "disabling conduct." (See Item 19 of the Guidelines for the preparation of Form N-8B-1 registration statement for open-end funds (the predecessor to current Form N-1A)) issued by the SEC staff, which provides:

It is the Staff's position that Section 17(h) does not prohibit the [fund] from paying for insurance which protects the directors against liabilities arising from action not involving willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of their offices. The Staff would regard insurance paid for by the [fund] covering any of the enumerated categories as involving a violation of Section 17(h) unless it merely provided for payment to the [fund] of any damages caused by a director or officer, and also provided that the insurance company would be subrogated to the rights of the [fund] to recover from the director or officer. It is therefore the staff's position that when 17(h) prohibits a fund from directly indemnifying a director, it also precludes the fund from indirectly indemnifying him by means of D&O insurance.

The SEC staff has indicated, however, that directors may obtain insurance to cover "disabling conduct" if they pay for it themselves. *See* SEC Release No. IC-10891 (Oct. 4, 1979). The SEC staff's view is more restrictive than most state laws, which allow insurance for conduct that would not be indemnifiable, subject to certain limitations. *See, e.g.,* Md. Code Ann., Corps. & Ass'ns § 2-418(k) (LEXIS through 2005 Reg. Sess.); Mass. Gen. Laws ch. 156B § 67 (LEXIS through Act 176 of 2006 Leg. Sess.); John F. Olson & Josian O. Hatch, *Director and Officer Liability* (1998). No significant court has decided whether the SEC staff is correct in its view of the 1940 Act's limitation on insurance.

[28] In the fund industry, D&O insurance is usually combined in a single policy with "errors and omissions" ("E&O") coverage, resulting in combined "D&O/E&O" coverage. D&O coverage typically covers *directors* (and officers) of a fund for claims made against them for their designated acts, errors, or omissions. By contrast, E&O coverage typically covers *the fund* for claims made against the fund itself for designated acts, errors, or omissions of the fund or its representatives (e.g., its directors and officers).

[29] Another option may include separate indemnification agreements between funds and their independent directors.

[30] The SEC staff has advised that, in its view, one of the three following circumstances must exist in order for directors to obtain advancement of expenses in accordance with Section 17(h) of the 1940 Act:

- the director provides security for his undertaking to repay the advance; or

- the fund is insured against losses arising out of any such advances; or

- a determination is made based upon a review of readily available facts (as opposed to a full trial-type inquiry) that there is a reason to believe that the director ultimately will be found entitled to indemnification by either:

  - a majority of independent directors acting on the matter; or

  - independent legal counsel in a written opinion.

See SEC Release No. IC-11330 (Sept. 4, 1980).

[31] Joint policies are permissible under Rule 17d-1(d)(7) under the 1940 Act provided that:

- the fund's participation in the joint policy is in the best interest of the fund;

- the proposed premium for the joint insurance policy to be allocated to the fund, based upon the proportionate share of the sum of the premiums that would have been paid if such insurance coverage were purchased separately by the insured parties, is fair and reasonable to the fund;

- the board of directors of the fund, including a majority of the directors who are not interested persons with respect thereto, determine at least annually (even if the policy is a multi-year policy) that the standards described above have been satisfied;

- the joint insurance policy does not exclude coverage for bona fide claims made against any director who is not an interested person of the fund, or against the fund if it is a co-defendant in the claim with the disinterested director, by another person insured under the joint insurance policy; and

- The board of directors of the fund satisfies the fund governance standards defined in Rule 0-1(a)(7) under the 1940 Act.

[32] *See* Susan Randall, *Litigation Cost Controls and the Professional Obligations of Insurance Defense Lawyers*, 60 Ala. Law. 336 (1999).

[33] As stated by one court, in addressing the duty of care owed by a director, "'If the director does not exercise sufficient care and sound personal judgment in his duties, he will be subject to personal liability for mismanagement or negligence.'" *In re Dehon, Inc.,* 334 B.R. 55, 66 (Bankr. D. Mass, 2005) (*citing* 13A *Massachusetts Practice* § 465, at 207 (1971)). Quoting an earlier case, the court stated that "affirmative malfeasance by a director is not necessary in order to constitute a breach of duty; mere passivity can rise to the level of negligence if the director does not 'exercise the degree of care which a prudent person ordinarily would use as a director.'" *Id.* at 67 (citing *Hathaway v. Huntley*, 188 N.E. 616, 618 (Mass 1933)).

[34] *See Navellier v. Sletten*, 262 F.3d 923 (9th Cir. 2001).

[35] *See Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

[36] Under Section 11 of the 1933 Act, if the registration statement, when it becomes effective, contains an untrue statement of a material fact or omits to state a material fact required to be stated or necessary to make the statement not misleading, civil liability may be imposed on:

- the fund;
- any director of the fund (whether or not the director signed the registration statement);
- any person who signs the registration statement;
- every person who, with such person's consent, is named in the registration statement as being or about to become a director, irrespective or whether such person signs the registration statement;

- every accountant (or any person whose profession gives authority to a statement made by such person), who has with such person's consent been named as having prepared or certified any report used in connection with the registration statement, with respect to such report; and
- every underwriter.

[37] The extent of liability under Section 11 is, in general, the difference between the amount paid for the security (not exceeding the public offering price) and (i) the market price as of the time suit is brought, or (ii) the price at which the security was disposed of in the market before suit. Section 11 also contains a "negative causation" defense, which may reduce damages to the extent the issuer proves that the decline in the price of the security represents other than depreciation in value resulting from the misstatement or omission. In addition, there is no liability if the purchaser's knowledge of the misleading statement or omission at the time of purchase is established.

[38] To the extent that parts of the registration statement are certified by experts, such as accountants, or are a copy of or extracted from a public or official document, the directors need not prove reasonable investigation; instead, they must prove only that they had no reasonable ground to believe and did not believe that such parts of the registration statement were untrue or omitted to state a material fact required to be stated or necessary to make such parts not misleading.

[39] In the final rules implementing Section 407 of the Sarbanes-Oxley Act of 2002 relating to the disclosure of "audit committee financial experts," the SEC provided a safe harbor for "audit committee financial experts" from being deemed an "expert" for any purpose, including for purposes of Section 11. Because the "audit committee financial expert" is not an "expert" for purposes of Section 11, he or she would not be subject to a higher level of due diligence with respect to any portion of the registration statement as a result of his or her designation or identification in the Form N-CSR as an "audit committee financial expert." *See* SEC Release No. 34-47262 (Jan. 27, 2003).

[40] For another frame of reference, albeit outside the specific context of Section 11, directors may want to review the W.R. Grace Report, in which the SEC emphasized "the affirmative responsibilities of corporate officers and directors to ensure . . . accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions." In that report, the SEC warned that:

[o]fficers and directors who review, approve, or sign their company's proxy statements or periodic reports must take steps to ensure the accuracy and completeness of the statements contained therein, especially as they concern those matters within their particular knowledge or expertise. To fulfill this responsibility, officers and directors must be vigilant in exercising their authority throughout the disclosure process.

According to the SEC, "[a]n officer or director may rely upon the company's procedures for determining what disclosure is required only if he or she has a reasonable basis for believing that those procedures have resulted in full consideration of those issues." According to the SEC, such procedures are effective "only if individuals in positions to affect the disclosure process are vigilant in exercising their responsibilities." *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W. R. Grace & Co., SEC Release No. 34-39157 (Sept. 30, 1997).

[41] The PSLRA provides that "the term 'outside director' shall have the meaning given such term by rule or regulation of the [SEC]." To date, the SEC has not promulgated any rule or regulation defining the term "outside director." However, it appears likely that directors who are considered to be independent under the stringent requirements of the 1940 Act would likewise be considered to be "outside directors" for purposes of the PSLRA.

[42] Congress enacted the PSLRA to address, among other concerns, the fact that securities litigation often deterred individuals from serving as directors of public companies. In an effort to "protect[] outside directors and others who may be sued" from what Congress deemed "baseless and extortionate securities lawsuits," the PSLRA established a heightened standard for pleading securities fraud. The PSLRA also established that outside directors who are sued in cases asserting liability under Section 11 of the 1933 Act cannot be held jointly and severally liable for such a violation absent proof that the outside director had *actual knowledge* that the issuer made a materially false or misleadingly incomplete statement to the investing public. Congress noted that "by relieving outside directors of the specter of joint and several liability under Section 11 for non-knowing conduct, [this provision] will reduce the pressure placed by meritless litigation on the willingness of capable outsiders to serve on corporate boards."

[43] *See* Louis Loss & Joel Seligman, *Securities Regulation* 4,235-37 (3rd ed. 2005) (discussing director liability under Section 12(a)(2)).

[44] *See id.* (discussing cases involving director and other collateral participant liability under Section 12(a)(2)); *Capri v. Murphy*, 856 F.2d 473 (2d Cir. 1988) (holding that partners in a coal mining venture who personally prepared and circulated prospectuses were liable under Section 12(a)(2)).

[45] In recent years, for example, lawsuits have been brought under Section 36(b) alleging that (i) receipt of advisory compensation based on the total assets of closed-end funds, including assets acquired through leverage, created an improper and undisclosed conflict of interest, *see Green v. Fund Asset Mgmt., L.P.*, 147 F. Supp. 2d 318 (D.N.J. 2001), *aff'd*, 286 F.3d 682 (3d Cir. 2002); *Green v. Nuveen Advisory Corp.*, No. 97 C 5255, 2001 WL 1035652 (N.D. Ill. Sept. 10, 2001), *aff'd*, 295 F.3d 738 (7th Cir. 2002); (ii) defendants used improper means to acquire "shelf space" at brokerage firms by using fund assets to pay expensive commissions and make payments to brokerage firms and their brokers for selling the funds to investors, *see, e.g., In re Eaton Vance Mut. Funds Fee Litig.*, 380 F. Supp. 2d 222 (S.D.N.Y. 2005), *appeal docketed*, No. 05-6957 (2d Cir. Dec. 22, 2005); and (iii) funds improperly continued to pay Rule 12b-1 fees after the funds were closed to new investors, *see, e.g., Zucker v. AIM Advisors*, 371 F. Supp. 2d 845 (S.D. Tex. 2005); *Leiber v. INVESCO Funds Group, Inc.*, 371 F. Supp. 2d 852 (S.D. Tex. 2005).

[46] Section 42 of the 1940 Act also gives authority to the SEC for enforcement of all provisions of the 1940 Act. Section 42 does not give shareholders any rights to sue.

[47] *See, e.g., In re Oppenheimer Funds Fee Litig.*, 419 F. Supp. 2d 593 (S.D.N.Y. 2006), *appeal docketed* (2d Cir. May 12, 2006); *In re Davis Selected Mut. Funds Litig.*, No. 04-4186, 2005 U.S. Dist. LEXIS 23203 (S.D.N.Y. Oct. 11, 2005), *appeal docketed*, No. 05-6396 (2d Cir. Dec. 23, 2005); *In re Franklin Mut. Funds Excessive Fee Litig.*, 388 F. Supp. 2d 451 (D.N.J. 2005); *In re Lord Abbett Mut. Funds Fee Litig.*, 385 F. Supp. 2d 471 (D.N.J. 2005); *In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d 845 (D. Md. 2005); *In re Eaton Vance Mut. Funds Fee Litig.*, 380 F. Supp. 2d 222 (S.D.N.Y. 2005), *appeal docketed*, No. 05-6957 (2d Cir. Dec. 22, 2005); *Hamilton v. Allen*, 396 F. Supp. 2d 545 (E.D. Pa. 2005). As noted, a number of these decisions have been appealed.

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