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THE SO-CALLED "FIDUCIARY EXCEPTION" TO THE ATTORNEY-CLIENT PRIVILEGE IN SECTION 36(B) CASES

A court recently held that the fiduciary exception to the attorney-client privilege applied to communications between independent trustees of a mutual fund and their independent counsel. The authors take issue with the decision. After discussing the background and case law involving the exception, they find that the rationale for applying it in common law trusts is inapplicable, and its effects may be harmful to shareholders, if applied against independent trustees in lawsuits under Section 36(b) of the ICA. They close with suggested steps independent trustees can take in light of uncertainties created by the decision.

By Sean M. Murphy, Robert C. Hora, and Michael E. Mirdamadi *

In *Kenny v. Pacific Investment Management Company*, for the first time in the nearly 50-year history of litigation under Section 36(b) of the Investment Company Act of 1940 (the "ICA"),[1] a federal district court ruled that the independent trustees of a mutual fund board must produce certain privileged communications with their independent legal counsel under the so-called "fiduciary exception" to the attorney-client privilege.[2] In those jurisdictions where it is recognized, the fiduciary exception precludes certain fiduciaries from asserting the attorney-client privilege against beneficiaries who seek disclosure of fiduciary-attorney communications.

Kenny's application of the fiduciary exception against the attorney-client privilege of mutual fund independent trustees is difficult to reconcile with the unambiguous, longstanding endorsement of independent trustees' reliance on independent counsel by courts and the SEC, or with the nuances of independent trustees' fiduciary relationship within the complex statutory framework of the ICA. But, irrespective of the merits of *Kenny*, the decision is important because of its practical consequences. Specifically, because *Kenny* makes it uncertain whether communications between independent trustees and their counsel are privileged, it discourages independent trustees from seeking and obtaining the best possible legal advice to the detriment of millions of

[1] Section 36(b) imposes upon investment advisers of mutual funds "a fiduciary duty with respect to the receipt of compensation" from the fund. 15 U.S.C. § 80a-35(b).

[2] *Kenny v. Pacific Inv. Mgmt. Co.*, No. 14-1987, 2016 WL 6836886 (W.D. Wash. Nov. 21, 2016).

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mutual fund shareholders.[3] In addition, *Kenny* is likely to be seized upon by plaintiffs in other Section 36(b) cases in an effort to gain access to communications that, absent the fiduciary exception, are indisputably subject to the attorney-client privilege. Indeed, though *Kenny* was decided less than six months ago, plaintiffs in two other Section 36(b) cases have filed motions to compel based upon *Kenny*.[4]

This article consists of three parts: (1) background regarding the attorney-client privilege, the fiduciary exception, mutual funds, and the ICA; (2) an analysis of the court's decision in *Kenny*, including why the fiduciary exception should not apply to otherwise privileged communications between mutual fund independent trustees and their independent legal counsel; and (3) a conclusion with practical guidance for independent trustees and their counsel in light of *Kenny*.

I. BACKGROUND

A. The Attorney-Client Privilege

Civil lawsuits in federal court are governed by the Federal Rules of Civil Procedure and the Federal Rules of Evidence. Under Rule 26(b)(1) of the Federal Rules of Civil Procedure, parties generally "may obtain discovery regarding any *non-privileged* matter that is relevant to any party's claim or defense, and proportional to the needs of the case."[5] Under Rule 501 of the Federal Rules of Evidence, evidentiary privileges in federal question cases are generally governed by principles of common law "as interpreted by United States courts in the light of reason and experience."[6]

Federal courts have described the attorney-client privilege as "the oldest," "most sacred," and "most fundamental" of the common law privileges recognized under Rule 501.[7] Under federal common law, the attorney-client privilege generally protects (1) communications, (2) made between attorney and client (or their agents), (3) in confidence, (4) for the purpose of obtaining or providing legal assistance to the client.[8]

The purpose of, and policy behind, the attorney-client privilege is well-established. By assuring confidentiality, the privilege encourages clients to make "full and frank" disclosures to their attorneys, who are then better able to provide "sound legal advice" and

[3] *See, e.g.*, *Hunt v. Blackburn*, 128 U.S. 464, 470 (1888) (recognizing that legal advice "can only be safely and readily availed of when free from the consequences or the apprehension of disclosure"); *United States v. Mett*, 178 F.3d 1058, 1065 (9th Cir. 1999) ("[F]rom a policy perspective, an uncertain attorney-client privilege will likely result in . . . trustees shying away from legal advice regarding the performance of their duties. This outcome ultimately hurts beneficiaries — all else being equal, beneficiaries should prefer well-counseled trustees who clearly understand their duties.").

[4] *Obeslo v. Great-West Capital Mgmt., LLC*, No. 16-230 (D. Colo. Mar. 7, 2017) (order denying motion to compel, without addressing fiduciary exception argument, because document sought was "irrelevant"); *Chill v. Calamos Advisors LLC*, No. 17-1658, 2017 WL 1478123, at *3-5 (N.D. Ill. Apr. 25, 2017) (order denying motion to compel and holding that plaintiffs failed to meet their burden of demonstrating "good cause" to overcome the independent trustees' attorney-client privilege based on the fiduciary exception).

[5] Fed. R. Civ. P. 26(b)(1) (emphasis added).

[6] Fed. R. Evid. 501; *see also Univ. of Pa. v. EEOC*, 493 U.S. 182, 189 (1990) ("Rule 501 manifests a congressional desire . . . to provide the courts with flexibility to develop rules of privilege on a case-by-case basis . . . .").

[7] *See, e.g.*, *United States v. Jicarilla Apache Nation*, 564 U.S. 162, 165 (2011) ("The attorney-client privilege ranks among the oldest and most established evidentiary privileges known to our law."); *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981) ("The attorney-client privilege is the oldest of the privileges for confidential communications known to the common law." (citation omitted)); *In re Grand Jury Investigation*, 810 F.3d 1110, 1113 (9th Cir. 2016) ("[T]he attorney client privilege is arguably most fundamental of the common law privileges recognized under Federal Rule of Evidence 501." (citation and internal quotation marks omitted)); *Mett*, 178 F.3d at 1062 ("The attorney-client privilege is, perhaps, the most sacred of all legally recognized privileges." (citation and alteration omitted)).

[8] *See, e.g.*, Restatement (Third) of the Law Governing Lawyers §§ 68-72 (2000).

effective representation.[9] This, in turn, serves "broader public interests in the observance of law and administration of justice."[10] Ultimately, such benefits outweigh any adverse effect on a party's access to information in litigation.

The Supreme Court has recognized that for the attorney-client privilege to have its intended effect, the attorney and client must be able to predict "with some degree of certainty" at the time they communicate whether the privilege applies.[11] As the Supreme Court explained, "[a]n uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all."[12]

B. The So-Called "Fiduciary Exception" to the Attorney-Client Privilege

The scope of the attorney-client privilege contains a number of well-established limitations and exceptions, primarily designed to ensure that the privilege is applied "only where necessary to achieve its purpose."[13] For example, under the crime-fraud exception, the attorney-client privilege does not apply to communications designed to further a crime or fraud, because protecting such communications, of course, does not promote the administration of justice.[14] Similarly, because the purpose of the privilege is to promote the provision of sound legal advice, the attorney-client privilege generally does not apply to non-legal business advice.[15]

In addition to these exceptions and limitations, many courts have recognized a lesser-established exception — the so-called "fiduciary exception" to the attorney-client privilege. English courts first developed the fiduciary exception as part of the common law of trusts in the 19th century. Specifically, in lawsuits brought by the beneficiary of a private trust against a trustee for trust mismanagement, English courts required the trustee to produce to the beneficiary legal advice that the trustee had received regarding trust administration, the attorney-client privilege notwithstanding.[16]

The fiduciary exception, however, was not adopted by courts in the United States until the 1970s.[17] Indeed, prior to 1970, courts explicitly rejected the notion of a fiduciary exception to the attorney-client privilege.[18] U.S. courts initially adopted the exception in two separate contexts: (1) a shareholder derivative lawsuit against a corporation and (2) an action brought by beneficiaries of a testamentary trust against trustees.[19]

In *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970), the shareholders of an insurance company filed a derivative lawsuit against the company's management. During a deposition, the company's former counsel refused to answer several questions and produce documents concerning legal advice he had provided to the company regarding the issuance and sale of stock and related matters. The Fifth Circuit held that the

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[9] *Upjohn*, 449 U.S. at 389.

[10] *Id.*; *see also Wachtel v. Health Net, Inc.*, 482 F.3d 225, 231 (3d Cir. 2007) ("The policy behind the privilege is . . . well-established: Full and frank communication between attorneys and their clients must be encouraged because the administration of justice in a complex society depends upon the availability of sound legal advice, and in turn, the soundness of legal advice depends upon clients' willingness to present full disclosures to their attorneys." (citation omitted)).

[11] *Upjohn*, 449 U.S. at 393 ("[I]f the purpose of the attorney-client privilege is to be served, the attorney and client must be able to predict with some degree of certainty whether particular discussions will be protected."); *see also Jicarilla*, 564 U.S. at 183 ("[F]or the attorney-client privilege to be effective, it must be predictable." (citations omitted)).

[12] *Upjohn*, 449 U.S. at 393; *see also Wachtel*, 482 F.3d at 237 ("[W]hen dealing with the attorney-client privilege, courts must be particularly careful not to craft rules that cause application of the privilege to turn on the answers to extremely difficult substantive legal questions. . . . We are reluctant to ask lawyers to read tea leaves and predict how courts will resolve the imponderables of ERISA before they can take the most preliminary step of advising their clients as to whether their communications will remain confidential.").

[13] *Fisher v. United States*, 425 U.S. 391, 403 (1976); *see also Wachtel*, 482 F.3d at 231 (describing various exceptions and limitations to attorney-client privilege).

[14] *See, e.g.*, *United States v. Zolin*, 491 U.S. 554, 563 (1989).

[15] *See, e.g.*, *Wachtel*, 482 F.3d at 231.

[16] *Jicarilla*, 564 U.S. at 170; *Wachtel*, 482 F.3d at 231.

[17] *Jicarilla*, 564 U.S. at 171; *Wachtel*, 482 F.3d at 232.

[18] *See, e.g.*, *In re Prudence-Bonds Corp.*, 76 F. Supp. 643, 647 (E.D.N.Y. 1948) (declining to apply the fiduciary exception to the trustee of a bondholding corporation because of the "important right of such a corporate trustee . . . to seek legal advice and nevertheless act in accordance with its own judgment"), *aff'd*, 174 F.2d 288 (2d Cir. 1949); *see also Jicarilla*, 564 U.S. at 170-71 (noting that U.S. courts "seem first to have expressed skepticism" at the notion of a fiduciary exception to the attorney-client privilege).

[19] *Wachtel*, 482 F.3d at 232.

shareholders' ability to overcome the attorney-client privilege depended on their ability to show "good cause" and identified nine non-exclusive factors that courts should consider in assessing whether a shareholder has demonstrated "good cause" to invoke the fiduciary exception in the "particular instance."[20] In so holding, the court found "persuasive" two English common law authorities that treated the relationship between a shareholder and a corporation as analogous to the relationship between beneficiary and trustee.[21] The court also explained that the company's management had no legitimate personal interest in the legal advice it obtained because "management does not manage for itself and . . . the beneficiaries of its action are the stockholders."[22]

In *Riggs National Bank of Washington, D.C. v. Zimmer*,[23] the trustees of a testamentary trust requested and received a memorandum from a law firm regarding potential tax litigation on behalf of the trust against the State of Delaware. Approximately one year later, the beneficiaries of the trust brought a lawsuit to compel the trustees to reimburse the estate for alleged breaches of fiduciary duty related to the potential tax litigation. During discovery, the trustees withheld the memorandum on the basis of attorney-client privilege, and the beneficiaries filed a motion to compel. The Delaware Court of Chancery held that the beneficiaries were entitled to production of the memorandum under the fiduciary exception to the attorney-client privilege and identified two reasons for applying the exception.[24] First, the court found that the "real clients" of the attorney who prepared the memorandum were the beneficiaries, not the trustees whom the court described as "mere representative[s]" of the beneficiaries.[25] Second, the court found that the trustees' fiduciary duty to furnish trust-related information to the beneficiaries outweighed the trustees' interest in the attorney-client privilege.[26] The court based its "real-client" determination on three factors: (1) the trustees had no reason to seek advice in a personal rather than a fiduciary capacity; (2) the legal advice could not have been intended for any purpose other than to benefit the trust; and (3) the legal advice was paid for out of trust assets.[27]

Following *Garner* and *Riggs*, some federal courts have extended the application of the fiduciary exception to other contexts, including against fiduciaries in cases arising under ERISA.[28] Other federal courts, however, have declined to extend the fiduciary exception to other contexts,[29] or, like a number of state courts, have rejected the exception altogether.[30] Both the fiduciary exception generally and efforts to expand its application to other contexts have been criticized by many academics and commentators.[31]

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[20] *Garner*, 430 F.2d at 1103-04.

[21] *Id.* at 1102.

[22] *Id.* at 1101.

[23] 355 A.2d 709 (Del. Ch. 1976).

[24] *Riggs*, 355 A.2d at 711-14; *see also Jicarilla*, 564 U.S. at 172 (noting that *Riggs* "identified two reasons for applying the [fiduciary] exception").

[25] *Riggs*, 355 A.2d at 711-12; *see also Jicarilla*, 564 U.S. at 172.

[26] *Riggs*, 355 A.2d at 714 ("The policy of preserving the full disclosure necessary in the trustee-beneficiary relationship is here ultimately more important than the protection of the

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trustees' confidence in the attorney for the trust."); *see also Jicarilla*, 564 U.S. at 172-73.

[27] *Riggs*, 355 A.2d at 711-12; *see also Jicarilla*, 564 U.S. at 172 (identifying three "real-client" factors in *Riggs*).

[28] *Wachtel*, 482 F.3d at 232-34 (citing various cases and noting that "[i]n the early 1980s, federal courts began extending the principles of *Garner* and *Riggs* to apply against ERISA fiduciaries").

[29] *See, e.g.*, *Jicarilla*, 564 U.S. at 178-87 (finding that the fiduciary exception did not apply to the fiduciary relationship between the federal government and Indian tribes); *Wachtel*, 482 F.3d at 234-38 (holding that the fiduciary exception did not apply to an insurer acting as a fiduciary under an insured ERISA plan).

[30] *See, e.g.*, *Jicarilla*, 564 U.S. at 171 n.3 (noting that courts "differ" on whether the fiduciary exception exists and that "some state courts have altogether rejected the notion that the attorney-client privilege is subject to a fiduciary exception" (citations omitted)); *Shirvani v. Capital Investing Corp.*, 112 F.R.D. 389, 391 (D. Conn. 1986) (rejecting *Garner* and explaining "there seems no sufficient reason to craft such a special exception to attorney-client privilege in order to safeguard appropriate shareholder interests in any event"); *Lefkowitz v. Duquesne Light Co.*, No. 86-1046, 1988 WL 169273, at *6 (W.D. Pa. June 14, 1988) ("We disagree with the reasoning of *Garner*.").

[31] *See, e.g.*, Benjamin Cooper, *An Uncertain Privilege: Reexamining Garner v. Wolfinbarger and Its Effect on Attorney-Client Privilege*, 35 Cardozo L. Rev. 1217, 1221 (2014) (arguing that "much of the ongoing disarray in contemporary *Garner*-related jurisprudence relates to areas of law far afield from the derivative context in which the *Garner*

Against this backdrop, the U.S. Supreme Court considered the fiduciary exception for the first time in *United States v. Jicarilla Apache Nation*.[32] In *Jicarilla*, an Indian tribe initiated an action against the federal government, alleging that the government mismanaged a trust fund established for the benefit of the tribe. During discovery, the tribe sought production of certain legal advice relating to management of the trust, arguing that the fiduciary exception precluded the government from asserting the attorney-client privilege. At the outset of its decision, the Court noted that "courts differ" on whether the attorney-client privilege exists, but "assume[d]" that the exception existed for deciding the case before it because the parties did not dispute its existence.[33] The Court ultimately held that the fiduciary exception did not apply to the fiduciary relationship between the federal government and the tribe.[34] The Court identified several reasons for declining to apply the fiduciary exception, including that: (1) the trust relationship between the government and the tribe was not a private relationship, but rather one established and proscribed by statute;[35] (2) the government was not paid from trust assets;[36] (3) the government had distinctly separate and potentially competing sovereign interests for which it needed to seek legal advice and, therefore, the theory that the tribe was the "real client" of the government failed;[37] and (4) the government did not have the same common law disclosure obligations as a private trustee.[38]

In sum, following *Garner* and *Riggs*, courts have varied widely in determining whether the fiduciary exception may be invoked and, to the extent it can be, what threshold showing a party must make to invoke it. This variation has continued since *Jicarilla*.[39]

C. Mutual Funds and the ICA

To fully understand whether applying the fiduciary exception to mutual fund independent trustees is appropriate, one must understand the unique role of independent trustees under the ICA. A mutual fund is an investment vehicle that pools money from many investors and invests it collectively, usually in publicly traded securities.[40] Although mutual funds are separate legal entities organized as corporations or trusts under the laws of a particular state, they generally have few, if any, direct employees.[41] Instead, the fund contracts with other entities — typically, the investment adviser and its affiliates — to perform the duty of managing and serving the fund and its shareholders.

Under the ICA, mutual funds must be governed by a board of trustees, at least 40% of whom must be independent, meaning that they are not affiliated with the fund's investment adviser or its affiliates.[42] Although independent trustees assume certain duties under state law, they must fulfill those duties in the context of a host of specific additional duties and responsibilities imposed on independent trustees under the ICA and various rules thereunder.[43]

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exception originally arose and that the logic of *Garner* collapses outside of that context"); Mike W. Bartolacci et al., *The Attorney-Client Privilege and the Fiduciary Exception: Why Frank Discussions Between Fiduciaries and Their Attorneys Should Be Protected by the Privilege*, 48 Real Prop. Tr. & Est. L.J. 1, 3, 33 (2013) (arguing that fiduciary exception should be "abolish[ed]" and that cases that have recognized the fiduciary exception "reveal mostly tortured judicial reasoning and fail to provide a convincing rationale as to why a fiduciary should not be entitled to the same privilege afforded any other client"); Jack P. Friedman, *Is the Garner Qualification of the Corporate Attorney-Client Privilege Viable After Jaffee v. Redmond?*, 55 Bus. Law. 243, 281 (1999) ("[T]he *Garner* doctrine is not viable and its utilization by federal courts should cease.").

[32] 564 U.S. 162 (2011).

[33] *Jicarilla*, 564 U.S. at 171 n.3.

[34] *Id.* at 165.

[35] *Id.* at 173-74.

[36] *Id.* at 179.

[37] *Id.* at 181-82.

[38] *Id.* at 183-86.

[39] *See generally Construction and Application of Fiduciary Duty Exception to Attorney-Client Privilege*, 47 A.L.R.6th 255, §§ 2, 8-9 (2009 & Supp.).

[40] *Jones v. Harris Assocs. L.P.*, 559 U.S. 335, 338 (2010).

[41] Clifford E. Kirsch et al., *Mutual Funds and Exchange Traded Funds Regulation*, § 1:2.1 (Practising Law Institute, 3d ed., updated 2016). Although mutual funds are organized under the laws of a number of states, most funds organized in corporate form are organized as Maryland corporations, and most funds organized as trusts are organized as Massachusetts business trusts or Delaware statutory trusts. *Id.*

[42] 15 U.S.C. §§ 80a-2, 80a-10(a).

[43] *Burks v. Lasker*, 441 U.S. 471, 482-83 (1979) ("To these statutorily disinterested directors, the [ICA] assigns a host of special responsibilities, involving supervision of management

Through the ICA, Congress entrusted independent trustees to serve as "independent watchdogs" with respect to the relationship between the mutual fund's shareholders and the investment adviser.[44] As part of that role and pursuant to Section 15(c) of the ICA, the independent trustees must review and approve the fund's advisory contract, and the fees paid thereunder, annually.[45] The statutory Section 15(c) process also requires the independent trustees to "request and evaluate," and the adviser to provide, "such information as may reasonably be necessary to evaluate the terms" of the advisory contract.[46]

In addition to these responsibilities, the ICA and various rules thereunder impose upon independent trustees many obligations of a highly technical and legal nature, including implementation and annual review of fund compliance policies reasonably designed to prevent violations of the federal securities laws; implementation and oversight of fund policies for valuation of portfolio securities; establishing guidelines and standards for determining portfolio liquidity; implementation and oversight of trading practices and procedures; and selection and supervision of the fund's chief compliance officer and independent auditor.[47] Notably, mutual funds are among the most strictly regulated financial products in the world. This expansive regulatory scheme is subject to continual changes and re-interpretation.

To understand and fulfill their obligations, ensure that all regulatory requirements are satisfied, and assist in asking fund management pertinent questions, independent trustees often rely on legal advice of counsel who are also unaffiliated with the adviser. Indeed, the SEC has expressly encouraged such reliance.[48] Likewise, in many Section 36(b) cases decided on the merits, courts have recognized the significance of independent trustees' access to independent counsel.[49] Though not required, independent trustees' retention and reliance upon independent counsel is also consistent with industry best practices.[50] As independent trustees' responsibilities

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and financial auditing."); *see also* Kirsch, *supra* note 39, § 14; *Burks*, 441 U.S. at 479 ("The ICA and [Investment Advisers Act] . . . do not require that federal law displace state laws governing the powers of directors unless the state laws permit action prohibited by the Acts, or unless their application would be inconsistent with the federal policy underlying the cause of action." (citation and internal quotation marks omitted)).

[44] *Jones*, 559 U.S. at 348.

[45] 15 U.S.C. § 80a-15(c); *Jones*, 559 U.S. at 340.

[46] 15 U.S.C. § 80a-15(c); *Jones*, 559 U.S. at 348.

[47] *See generally* Kirsch, *supra* note 41, § 14.

[48] *See, e.g.*, Final Rule: Inv. Co. Governance, Rel. No. IC-26520, 2004 WL 1672374, at *9 n.68 (July 27, 2004) ("One of the

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most useful advisers independent directors should consider engaging is their own counsel."); Final Rule: Role of Indep. Dirs. of Inv. Cos., Rel. No. 7932, 2001 WL 6738, at *6 n.36 (Jan. 2, 2001) (recognizing that "independent directors' access to independent counsel" is "of key importance").

[49] *See, e.g.*, *Sivolella v. AXA Equitable Life Ins. Co.*, No. 11-4194, 2016 WL 4487857, at *27-28 (D.N.J. Aug. 25, 2016) (recognizing the "role" of the board's independent counsel and finding that the board was "careful and conscientious in performing its duties"); *Kasilag v. Hartford Inv. Fin. Servs., LLC*, No. 11-1083, 2016 WL 1394347, at *5, *14 (D.N.J. Apr. 7, 2016) (giving "substantial weight" to board's approval of fees where independent directors "were advised by independent legal counsel"); *In re Am. Mut. Funds Fee Litig*., No. 04-5593, 2009 WL 5215755, at *54 (C.D. Cal. Dec. 28, 2009) (finding that board was "advised at all times by independent counsel who were obligated to ensure that the Unaffiliated Directors were sufficiently independent and well-informed"), *aff'd sub nom. Jelinek v. Capital Research & Mgmt. Co.*, 448 F. App'x 716 (9th Cir. 2011); *Gallus v. Ameriprise Fin., Inc.*, 497 F. Supp. 2d 974, 983 (D. Minn. 2007) (granting summary judgment in favor of adviser where board "sought the advice of independent counsel"); *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1242 (S.D.N.Y. 1990) ("An important element of the independent director's informed state is the advice they received from their independent counsel."), *aff'd*, 928 F.2d 590 (2d Cir. 1991); *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962, 982 (S.D.N.Y. 1987) (noting that directors' "separate and independent legal counsel" was an "important resource"), *aff'd*, 835 F.2d 45 (2d Cir. 1987); *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 528 F. Supp. 1038, 1064 (S.D.N.Y 1981) ("The non-interested Trustees were represented by their own independent counsel at the meetings, who acted to give them conscientious and competent advice."), *aff'd*, 694 F.2d 923 (2d Cir. 1982).

[50] *See, e.g.*, Report of the Mutual Fund Directors Forum, *Practical Guidance for Mutual Fund Directors*, at 8 (Oct. 2013) ("A fund's independent directors should retain knowledgeable counsel to advise and assist them in carrying out their duties."); Report of the Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors*, at 8 (July 2004) ("A fund's independent directors should retain knowledgeable independent legal counsel to advise them on an ongoing basis.").

continue to increase in scope, and areas such as cybersecurity, derivatives, liquidity, fund pricing, and risk management become increasingly complex, the importance of independent trustees' ability to rely on independent counsel will also grow.[51]

II. NOTWITHSTANDING *KENNY*, THE SO-CALLED "FIDUCIARY EXCEPTION" SHOULD NOT APPLY TO COMMUNICATIONS BETWEEN MUTUAL FUND INDEPENDENT TRUSTEES AND THEIR LEGAL COUNSEL

A. A Summary of the Court's Decision in Kenny

In *Kenny*, a shareholder of the PIMCO Total Return Fund alleged that the fund's investment adviser and its affiliate violated Section 36(b) by charging the fund excessive advisory, administrative, and distribution fees. The fund was organized as a Massachusetts business trust. During discovery, in response to plaintiff's document subpoenas, the fund's independent trustees redacted or withheld more than 200 documents on the basis of attorney-client privilege between the independent trustees and their independent counsel.[52] As disclosed in the independent trustees' privilege and redaction logs, the independent trustees withheld, among other things, communications containing confidential legal advice regarding (1) the annual review and approval of the funds' advisory contract and other service agreements; (2) preparation for, or information received in connection with, board and committee meetings; and (3) board governance matters, including the retirement of two independent trustees and the consideration, selection, and integration of four new independent trustees.

The plaintiff did not dispute that the withheld documents met the traditional elements of the attorney-client privilege. Instead, in his motion to compel, the plaintiff argued that the fiduciary exception precluded the independent trustees from asserting the attorney-client privilege. The independent trustees opposed the motion, arguing that no court has ever recognized the fiduciary exception in a Section 36(b) case, and that application of the exception would "destabilize" the mutual fund industry to the detriment of all shareholders.

On November 21, 2016, the court granted the plaintiff's motion, concluding that the independent trustees "failed to meet their burden of showing why" the motion should be denied and ordering the independent trustees to produce the withheld documents under the fiduciary exception to the attorney-client privilege.[53] In doing so, the court noted the parties' inability to cite any precedent extending or barring the application of the fiduciary exception to the context of the case before it and characterized the issue as one of "first impression."[54]

The court explained that the PIMCO Total Return Fund is organized as a "trust,"[55] and that the independent trustees owe a fiduciary duty to fund shareholders such as the plaintiff.[56] The court also explained that "the communications at issue include legal advice for managing the fund, not personal advice" to the independent trustees, and that the communications "were not made in anticipation of this or any other litigation."[57] The court found that these facts were "sufficiently analogous to situations cited by *Jicarilla* and *Mett*, where the fiduciary exception has been applied" to warrant extending the exception to the case before it.[58]

B. The Court's Decision in Kenny *is Misplaced*

Notwithstanding *Kenny*, the fiduciary exception should not apply to otherwise privileged communications between independent trustees and their independent counsel in cases under Section 36(b). Indeed, *Kenny* was wrongly decided for several reasons.

As an initial matter, *Kenny* appears to have placed the burden on the independent trustees to establish that the fiduciary exception applies.[59] But courts, including the

[51] Mary Jo White, Chair, Securities and Exchange Commission, *The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference* (Mar. 29, 2016).

[52] The fund's independent trustees produced to the plaintiff more than 2,000 pages of responsive, non-privileged documents.

[53] *Kenny*, 2016 WL 6836886, at *4-5.

[54] *Id.* at *4.

[55] *Kenny* emphasized the fact that the fund was organized as a "trust" in reaching its decision. It is unclear that the court would have extended the application of the fiduciary exception to funds organized as corporations. *See* Clifford E. Kirsch et al., *Basics of Mutual Funds and Other Registered Investment* Companies, at 55 n.22 (Practising Law Institute 2017) (noting that the *Kenny* decision "may lead sponsors to structure mutual funds as Maryland corporations, as opposed to trusts").

[56] *Kenny*, 2016 WL 6836886, at *4.

[57] *Id.*

[58] *Id.*

[59] *Id.* (concluding that independent trustees "failed to meet their burden of showing why" the plaintiff's motion to compel

Ninth Circuit in *Mett*, have held that the party attempting to invoke the fiduciary exception bears the burden of demonstrating that the exception applies.[60]

In addition, *Kenny* characterized the issue of whether to apply the fiduciary exception to privileged communications between independent trustees and their counsel as one of "first impression."[61] But, prior to *Kenny*, at least one Section 36(b) case addressed the issue and held that the fiduciary exception did not apply.[62] In *Federated*, the plaintiffs alleged that an investment adviser violated Section 36(b) by charging excessive advisory fees to a mutual fund. Like *Kenny*, the fund was organized as a Massachusetts business trust. During discovery, the plaintiffs sought communications between the independent trustees and their independent counsel relating to the retention of Management Practices, Inc. to review the cost allocation methodology used by the adviser in its fund-by-fund profitability analysis. In denying the plaintiffs' motion to compel, the court held that the communications were protected by the attorney-client privilege and that the fiduciary exception did not apply.[63] The court explained that an adviser's continued use of a flawed cost allocation methodology would expose the independent trustees to potential liability in connection with their review and approval of the fund's fees.[64] Accordingly, the court found that "[t]he beneficiaries of the legal advice were the independent trustees" — not "the shareholders or . . . the fund."[65]

Furthermore, *Kenny* relied on two cases — the Supreme Court's decision in *Jicarilla* and the Ninth Circuit's decision in *Mett* — as support for its application of the fiduciary exception against the independent trustees' attorney-client privilege.[66] But both *Jicarilla* and *Mett* concluded that the fiduciary exception did *not* apply on the facts of the case before it.[67] In fact, *Kenny*'s thinly reasoned analysis for applying the fiduciary exception runs contrary to a number of the holdings in *Jicarilla* and *Mett*. For example, in *Kenny*, the court adopted an expansive interpretation of the fiduciary exception that, in essence, communications can be protected from disclosure only if the independent trustees are seeking legal advice solely for their own interest or if the communications relate exclusively to non-fiduciary matters.[68] But, the court in *Mett* rejected such a broad "not one drop" interpretation of the fiduciary exception.[69] Instead, *Mett* excluded from the fiduciary exception "any advice whose goal is to advise the trustee about the legal implications of actions and decisions undertaken while performing its fiduciary obligations."[70] This is precisely what independent counsel does in the context of the mutual

footnote continued from previous page…

should be denied); *id.* at *2 ("Only where the trustee shows that he or she obtained legal advice for his or her own personal protection or independent purpose will the attorney-client privilege survive.").

[60] *See, e.g.*, *Mett*, 178 F.3d at 1064 (party invoking fiduciary exception bears the burden of demonstrating its applicability); *Obeid v. La Mack*, No. 14-6498, 2015 WL 5581577, at *4 (S.D.N.Y. Sept. 16, 2015) ("[T]o the extent that plaintiff seeks to invoke the fiduciary exception, he bears the burden of satisfying the pre-conditions for invocation of that limitation to the privilege." (citations omitted)); *Spear v. Fenkell*, No. 13-2391, 2015 WL 3822138, at *5 (E.D. Pa. June 19, 2015) (party attempting to invoke the fiduciary exception "bears the burden of demonstrating facts that prove the fiduciary exception to the attorney-client privilege should apply"); *Clark v. Unum Life Ins. Co. of Am.*, 799 F. Supp. 2d 527, 537 (D. Md. 2011) (holding that party seeking to invoke the fiduciary exception had the burden "to demonstrate that the documents it seeks concerns subject matter that is covered by the fiduciary exception").

[61] *Kenny*, 2016 WL 6836886, at *4.

[62] *In re Federated Mut. Funds Excessive Fee Litig.*, No. 04-352, slip op. at 12 (W.D. Pa. Mar. 25, 2010).

[63] *Id.* at 1, 10, 12.

[64] *Id.* at 6, 10, 12.

[65] *Id.* at 12.

[66] *Kenny*, 2016 WL 6836886, at *4 ("[T]he only question before the Court is whether to apply the fiduciary exception from *Jicarilla* and *Mett* to the instant matter."); *id.* ("In considering this issue of first impression, the Court looks to the law cited by Plaintiff from *Jicarilla* and *Mett*, the ways those fact patterns differ from the instant matter, and the rationale for the fiduciary exception."); *id.* ("[T]he Court finds the instant matter sufficiently analogous to situations cited by *Jicarilla* and *Mett*.").

[67] *Jicarilla*, 564 U.S. at 178-87 (finding that the fiduciary exception did not apply to the fiduciary relationship between the federal government and Indian tribes); *Mett*, 178 F.3d at 1064-67 (holding that fiduciary exception did not apply to memoranda containing legal advice concerning ERISA plan trustees' potential liability where "[t]rouble was in the air" and trustees had "good reason" to seek legal advice).

[68] *Kenny*, 2016 WL 6836886, at *4.

[69] *Mett*, 178 F.3d at 1065-66.

[70] *Fischel v. Equitable Life Assurance*, 191 F.R.D. 606, 609 (N.D. Cal. 2000).

fund industry — advise independent trustees about the legal implications of actions and decisions undertaken while performing their fiduciary obligations under both state and federal law. Thus, the attorney-client privilege may be appropriately asserted with regard to such communications.

C. The Rationale for Permitting the Fiduciary Exception in the Context of Common Law Trusts is Inapplicable to Mutual Fund Independent Trustees

Kenny also fails to identify which of the "situations cited by *Jicarilla* and *Mett* where the fiduciary exception has been applied" it found "sufficiently analogous" to the case before it.[71] To be sure, both *Jicarilla* and *Mett* discuss application of the fiduciary exception by 19th-century English courts and by the Delaware Court of Chancery in *Riggs*. But, nothing in those cases, or any other, indicates that common law trusts, trustees, and beneficiaries are sufficiently analogous to mutual funds, independent trustees, and mutual fund shareholders for purposes of application of the fiduciary exception. Indeed, Section 36(b) is very distinguishable from common law trusts in a number of respects, such as by shifting the burden of proof from the defendant fiduciary to the party claiming the breach. Courts in Section 36(b) cases have rejected plaintiffs' attempts to import common law trust principles with respect to the investment adviser's fiduciary duty.[72]

Relationships between trustees and beneficiaries of 19th-century English trusts were typically far more intimate than the relationships between mutual fund independent trustees and the thousands of shareholders in a single mutual fund.[73] The trusts of 19th-century England "typically were gratuitous trusts, often established upon the death of the settlor and used to convey the settlor's interest in specified property to distinguished beneficiaries."[74]

In addition, gratuitous trusts of 19th-century England were not subject to the comprehensive, complex regulatory scheme under which mutual funds operate. As the Third Circuit observed in declining to apply the fiduciary exception, "[t]he need for the attorney-client privilege is at its height where the law with which the client seeks to comply is complicated and the penalties for non-compliance are great. . . . An entity's ability to secure confidential legal advice should not be at its lowest when complex legal obligations are at their highest."[75]

Moreover, the two features justifying the fiduciary exception — the beneficiary's status as the "real client" and the common law duty to disclose information about the trust to beneficiaries — are notably absent in the context of mutual fund independent trustees and fund shareholders. Fund shareholders cannot be considered the "real clients" of independent trustees' independent counsel. As the Supreme Court has observed, of "central importance" to the "real-client" determination in "both *Garner* and *Riggs* was the fiduciary's lack of a legitimate personal interest in the legal advice obtained."[76] But mutual fund independent trustees are never in that position. Independent trustees must navigate multiple legal and regulatory obligations that they seek to manage in the interests of an ever-changing and always large number of fund shareholders. And, independent trustees must do so under strict regulatory oversight by the SEC and other regulatory agencies. The SEC, particularly in recent years, has instituted enforcement actions against independent trustees for failing to fulfill their legal obligations.[77] In addition, under Section 36(a) of the ICA, the SEC has authority to bring suit against mutual fund independent trustees for

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[71] *Kenny*, 2016 WL 6836886, at *4.

[72] *See, e.g., Green v. Fund Asset Mgmt., L.P.*, 286 F.3d 682, 685 (3d Cir. 2002) (finding that the fiduciary duty imposed by Section 36(b) is "significantly more circumscribed than common law fiduciary duty doctrines"); *Kasilag v. Hartford Inv. Fin. Servs., LLC*, No. 11-1083, 2017 WL 773880, at *20 (D.N.J. Feb. 28, 2017) (rejecting plaintiffs' "resort to common law fiduciary principles" in Section 36(b) case); *Sivolella*, 2016 WL 4487857, at *3.

[73] *See* John M. Vine, *The Fiduciary Exception*, at 7, Tax Management Compensation Planning Journal (2012).

[74] *Id.*

[75] *Wachtel*, 482 F.3d at 237.

[76] *Jicarilla*, 564 U.S. at 181 (quoting *Wachtel*, 482 F.3d at 232); *see also Wachtel*, 482 F.3d at 232 ("When a legitimate personal interest does emerge — such as when a corporate manager is sued by shareholders — the manager then becomes entitled to legal advice which is not discoverable by the shareholders.").

[77] *See, e.g., In re Commonwealth Capital Mgmt., LLC*, Rel. No. IC-31678 (June 17, 2015) (charging independent directors with failing to satisfy their obligations under Section 15(c) of the ICA after the directors did not receive certain materials they had requested from the investment adviser); *In re J. Kenneth Alderman*, Rel. No. IC-30557 (June 13, 2013) (charging fund directors with causing funds to violate Rule 38a-1 by failing to approve and continuously review fair valuation methodology); *In re N. Lights Compliance Servs.*, Rel. No. IC-30502 (May 2, 2013) (charging independent trustees with violations relating to their obligations under Section 15(c) of the ICA).

"any act or practice constituting a breach of fiduciary duty involving personal misconduct."[78]

As noted above, one of the most important obligations that independent trustees have is to annually review and approve the fund's advisory contract pursuant to Section 15(c) of the ICA. During the Section 15(c) process, independent trustees often seek counsel's advice, for example, on the standards and considerations to apply in approving the fund's advisory contract and the fees paid thereunder, as well as the information that should be requested from the adviser. These are communications for which independent trustees have personal liability under Section 15(c).[79] Given this personal liability, the communications cannot be unbundled, so as to be able to say that the legal advice is only for the benefit of the trust and not the independent trustees' personal benefit. In short, independent trustees — not fund shareholders — are the "real clients" of independent counsel.

Mutual fund independent trustees also do not have the same disclosure obligations to mutual fund shareholders as trustees had with trust beneficiaries at common law. As Mary Jo White, the former chairwoman of the SEC, recently explained, "[o]f course, it is fund directors, not fund investors, who have access to the information and critical participants, like the fund adviser, that makes strong and meaningful [fund] oversight possible."[80] Furthermore, there is no law, regulation, or duty requiring the independent trustees to disclose the legal advice upon which they rely in fulfilling their legal obligations as trustees. In sum, although the general common law duty of disclosure rationale for applying the fiduciary exception may be appropriate in the context of common law trusts, it is not an appropriate basis for negating the well-established attorney-client privilege of mutual fund independent trustees.

D. Kenny *Failed to Consider the Implications of Applying the Fiduciary Exception against the Independent Trustees' Attorney-Client Privilege*

Given the breadth of *Kenny*'s ruling, and the absence of supporting precedent, *Kenny* is notable for its failure to discuss the broader implications of applying the fiduciary exception against the independent trustees' attorney-client privilege. Because the fiduciary exception makes it uncertain whether communications are privileged, the fiduciary exception discourages independent trustees from seeking legal advice regarding their obligations and undermines the attorney-client privilege's purpose of encouraging candid communications to counsel. Furthermore, application of the fiduciary exception may result in some independent trustees refusing to serve on mutual fund boards at all out of fear that counsel will ultimately be used against them.[81] Of course, each of the foregoing results would work to the detriment of mutual fund shareholders who rely on independent trustees to safeguard their interests.

In addition, if communications between independent trustees and their counsel are not privileged, then such communications would be available to the investment adviser and its affiliates. This would defeat the purpose of having independent counsel in the first place. The ICA would not provide for, and in some instances, require, independent counsel if it did not intend the communications to be privileged.[82]

III. CONCLUSION

Courts should not apply the fiduciary exception to otherwise privileged communications between mutual fund independent trustees and their independent counsel in cases under Section 36(b). Notwithstanding, in light of the uncertainty interjected by *Kenny* and plaintiffs' immediate attempts to use *Kenny* to invoke the fiduciary exception in other Section 36(b) cases, some practical guidance for independent trustees and their counsel follows.

First, independent trustees and their counsel should assume that normally privileged communications may be discoverable. In this regard, to avoid an aggressive plaintiff's lawyer taking a communication out of context, independent trustees and their counsel should consider whether certain topics are more appropriately discussed orally instead of via written communication such as e-mail. And, where written communications are used, independent trustees and their counsel should use

[78] 15 U.S.C. § 80a-35(a).

[79] *See, e.g., In re N. Lights Compliance Servs.*, Rel. No. IC-30502 (May 2, 2013) (charging independent trustees with violations relating to their obligations under Section 15(c) of the ICA).

[80] Mary Jo White, *supra* note 51.

[81] *See, e.g., Mett*, 178 F.3d at 1065 ("[A] trustee's fear that her lawyer will be used against her may well translate into either an unwillingness to serve at all, or an insistence on contractual protections aimed at diluting the trustee's accountability. Neither option serves the interest of beneficiaries."); *Fischel*, 191 F.R.D. at 609 ("[A] strong attorney-client privilege minimizes the possibility that a trustee will be dissuaded from serving out of fear that her lawyer will be used against her.").

[82] 17 C.F.R. § 270.0-1(a)(6) (defining "independent legal counsel").

discretion and consider how the communications would appear if taken out of context and later produced in litigation.

Second, counsel for independent trustees should be careful to ensure accurate descriptions of documents withheld on privilege logs and in correspondence with plaintiffs' counsel and, where appropriate, note the personal nature of the legal advice requested or received. Indeed, in *Kenny*, plaintiff's counsel seized on language in a letter from the independent trustees' counsel that the withheld documents do not "concern personal matters unrelated to the Independent Trustees' duties to the Trusts" or "communications in anticipation of litigation."[83]

Third, counsel for independent trustees should consider whether the communications are subject to protection under the work-product doctrine, which is distinct from the attorney-client privilege and provides, in some ways, broader protection.[84] Although there are some outliers, the majority of courts have found that the fiduciary exception does not apply to the work-product doctrine.[85] ■

[83] *See* Pl.'s Mot. to Compel, at 8, *Kenny v. Pacific Inv. Mgmt. Co.*, No. 14-1987 (W.D. Wash. Sept. 22, 2016), ECF No. 100.

[84] *See United States v. Nobles,* 422 U.S. 225, 238 n.11 (1975).

[85] *See, e.g., In re Teleglobe Commc'ns Corp.,* 493 F.3d 345, 385 (3d Cir. 2007) (agreeing with defendant that the fiduciary exception "does not apply to work product"); *In re Int'l Sys. & Controls Corp. Sec. Litig.*, 693 F.2d 1235, 1239 (5th Cir. 1982) (holding that the *Garner* exception "should not be . . . extended" to the work-product doctrine); *Murphy v. Gorman*, 271 F.R.D. 296, 321 (D.N.M. 2010) (agreeing with "the weight of authority that has found that the fiduciary exception does not apply to the work-product doctrine"); *Strougo v. BEA Assocs.*, 199 F.R.D. 515, 524 (S.D.N.Y. 2001) ("[T]he logic of *Garner* does not require the disclosure of material that is protected under the work product doctrine.").