No. 08-586

IN THE
# Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
*Petitioners*,
v.

HARRIS ASSOCIATES L.P.,
*Respondent*.

**On Writ of Certiorari**
**to the United States Court of Appeals**
**for the Seventh Circuit**

## BRIEF FOR *AMICI CURIAE*, PROFESSOR DEBORAH A. DeMOTT AND PROFESSOR MARK L. ASCHER, IN SUPPORT OF PETITIONERS

JEROME A. BROADHURST
APPERSON, CRUMP &
MAXWELL, PLC
6000 Poplar Avenue
Suite 400
Memphis, TN 38119
(901) 756-6300

DEBORAH A. DEMOTT
*Counsel of Record*
1542 Hermitage Court
Durham, NC 27707
(919) 489-5366

*Counsel for Amici Curiae*

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## INTERESTS OF THE *AMICI CURIAE*[1]

*Amici*, Deborah A. DeMott and Mark L. Ascher, are law professors who regularly teach and write about fiduciary duty in several contexts. Each has taught for more than 20 years and has written extensively in this field. Further biographical information is included in the appendix.

*Amici* have no stake in the outcome of this case other than their academic interest in the logically coherent development of the law. Because this case implicates fundamental issues of fiduciary duty law, *amici* believe their unique perspectives may assist the Court in its resolution of this case.

## SUMMARY OF THE ARGUMENT

The law imposes fiduciary duties in response to risks of self-interested exploitation that are present in certain relationships in which the structure of the relationship makes one person vulnerable to another. Such relationships are varied, as are the specifics of fiduciary-duty doctrine, but underlying principles provide coherence. The language of § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (2006), which deems an investment adviser to a registered investment company "to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature," should be interpreted in light of well-developed law on the meaning and implementation of fiduciary duties in analogous relationships. The "captive" status of a registered investment company in relation

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[1] No counsel for a party authored this brief in whole or in part, and no person other than *amici* and their counsel made a monetary contribution to fund its preparation or submission. The parties have consented to the filing of this brief.

to its investment adviser, as well as structures and patterns of governance within the mutual fund segment of the financial-services industry, warrant a standard of fiduciary review that encompasses the overall reasonableness of the compensation that the investment company agrees to pay its adviser. Fiduciaries in analogous relationships are subject to duties that encompass the substance of dealings between the fiduciary and the beneficiary of the relationship. Fiduciary doctrine supplies a rich body of accumulated meaning crucial to a correct interpretation of the language of § 36(b).

Moreover, the Act expressly provides in § 36(b)(1) that "it shall not be necessary to allege or prove . . . personal misconduct" on the part of any defendant, and in § 36(b)(2) that approval of payments or compensation to an adviser by a company's independent directors, like ratification or approval by the company's disinterested shareholders, "shall be given such consideration by the court as is deemed appropriate under all of the circumstances." These statutory provisions have counterparts in well-settled bodies of fiduciary-duty law; interpreted in that light they are consistent with judicial assessment of the reasonableness and fairness of compensation paid by the company to its adviser.

The reasoning in the panel opinion below from the United States Court of Appeals for the Seventh Circuit is detached from, and in opposition to, well-established doctrine developed in analogous fiduciary relationships that should inform the interpretation of § 36(b). Moreover, the panel opinion from the Seventh Circuit misstates the law of trusts in a material respect and relies heavily on a pastiche of inapposite examples. Nor does the opinion offer

convincing policy justifications why such a major departure from settled fiduciary doctrine should apply to investment advisers that furnish services to their captive investment companies or why a court is warranted in disregarding statutory language.

## ARGUMENT

### I. Fiduciary duties are the law's response to risks of exploitation that stem from self-interest and that are created by the structure of certain relationships.

In relationships in which the law subjects a party to fiduciary duties, the structure of the relationship makes one party vulnerable to the other. Such vulnerability stems from the relationship, not necessarily from prior ties or dealings between the parties to the relationship, and is present when the fiduciary acts to further its own interests, as in dealings between the fiduciary and the beneficiary once their relationship has been established. Conventional categories of relationships in which actors are subject to fiduciary duties include agent-principal; trustee-beneficiary; corporate director or officer-corporation; lawyer-client; guardian-ward; and controlling shareholder-minority shareholders and corporation. In such relationships, actors subject to fiduciary duties have access to and control over property or resources of others, and, in the case of an agent, the power as a representative to affect the principal's legal position. *See* Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795 (1983); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 Vand. L. Rev. 1399 (2002); *Restatement (Third) of Agency* §§ 1.01 & 8.01 (2006).

At the core of fiduciary doctrine is the requirement that a party subject to fiduciary duties act with loyalty toward the beneficiary of the duty. Loyalty in this context proscribes self-dealing and other forms of self-advantaging conduct undertaken without the beneficiary's consent. Breach of the fiduciary duty of loyalty has long been associated with a distinctive set of remedies that strip profit or benefit from the fiduciary and that require no showing that the fiduciary's breach caused harm to the beneficiary.[2] *See* Deborah A. DeMott, *Disloyal Agents*, 58 Ala. L. Rev. 1049 (2007). Fiduciary doctrine is also distinctive because a fiduciary may breach a duty of loyalty without malign intention or even negligence. Thus, fiduciary doctrine is often characterized as prophylactic, as much geared to discourage breach as to compensate beneficiaries after a breach.[3] Its significance is not limited to after-the-fact litigation because lawyers, as advisers to clients that are subject to fiduciary duties, have professional duties to furnish counsel that is well-grounded in the law.

Fiduciary doctrine is not monolithic in its operation. Thus, the duty of loyalty applicable to some fiduciaries operates with greater stringency. Observed Professor Scott,

> Some fiduciary relationships are undoubtedly more intense than others. The greater the

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[2] *See*, *e.g.*, *Phansalkar v. Anderson Weinroth & Co.*, 344 F.3d 184, 200 (2d Cir. 2003); *Restatement (Third) of Agency* § 8.02 cmt. b.

[3] *See*, *e.g.*, *ABKO Music, Inc. v. Harrisongs Music, Ltd.*, 722 F.2d 988, 995-96 (2d Cir. 1983); *Boyer v. Wilmington Materials, Inc.*, 754 A.2d 881, 908 (Del. Ch. 1999).

> independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty. Thus, a trustee is under a stricter duty of loyalty than is an agent upon whom limited authority is conferred or a corporate director who can act only as a member of the board of directors . . . .

Austin W. Scott, *The Fiduciary Principle*, 37 Cal. L. Rev. 539, 541 (1949).[4] All fiduciary actors nonetheless owe duties of loyalty to their beneficiaries, although their duties differ in relative degrees of "intensity" or stringency. Self-advantaging conduct to which a beneficiary has not consented breaches the duty because it presents the risk that the fiduciary will favor its own interests over those of the beneficiary.

Even when a beneficiary consents to a self-dealing transaction with a fiduciary, the fiduciary must act consistently with fiduciary principles. For example, when an agent obtains its principal's consent to a transaction in which the agent acts on its own behalf, the agent must act in good faith, disclose all material facts to the principal, and otherwise deal fairly with the principal. Likewise, when an agent seeks to act for more than one principal in a transaction between or among them, the agent must deal in good faith

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[4] The categories of fiduciaries identified by Professor Scott also vary in the ease with which they may be ousted by their respective beneficiaries. A principal always has power to terminate an agent's authority, even when the termination breaches terms of a contract between agent and principal. *See Restatement (Third) of Agency* § 3.10. A corporation's shareholders may have power to remove its directors, depending on provisions in the corporation's charter and bylaws and the applicable corporation statute. In contrast, beneficiaries of a trust may not so readily remove a trustee. *See Restatement (Third) of Trusts* § 78 cmt. b (2007).

with each, disclose to each the fact of the multiple representation and material facts concerning the transaction, and deal fairly with each principal. *See Restatement (Third) of Agency* § 8.06(2). A principal's consent in this context is ineffective unless it is specific to a transaction or to transactions of a particular type that could reasonably be expected to occur in the particular agency relationship. *See id.* § 8.06(1)(b). Thus, even the less stringent fiduciary constraints applicable to agents continue to have bite when the agent self-deals or undertakes multiple conflicting representations.

## II. Long-settled bodies of fiduciary doctrine constitute a body of accumulated meaning that should inform the interpretation of § 36(b) of the Investment Company Act.

A general rule that furthers coherence in the law is the inference that, when Congress uses a term with "accumulated settled meaning under either equity or common law," the long-established meaning is intended unless Congress stated otherwise in the statute. *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329 (1981); *see also Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322 (1992). In its enactment of the Act, Congress incorporated state law into the federal common law applicable to investment advisers. *See Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90 (1991); *Burks v. Lasker*, 441 U.S. 471 (1979). A related practice of long standing is development of the law of fiduciary duty through analogy to contexts that have comparable elements.[5]

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[5] For illustrations of this point, see *DiCarlo v. St. Mary Hosp.*, 530 F.3d 255, 268-69 (3d Cir. 2008); *CIC Prop. Owners v. Marsh USA Inc.*, 460 F.3d 670, 673 n. 1 (5th Cir. 2006);

By deeming an investment adviser "to have a fiduciary duty with respect to" its receipt of compensation for services or payments of a material nature, § 36(b) invites analysis in light of well-established fiduciary principle in other contexts. Indeed, § 36(b)(1) explicitly incorporates an element of well-established fiduciary principle by stating that proof or allegations "that any defendant engaged in personal misconduct" are unnecessary to an action for breach of fiduciary duty under the section. Proving that a fiduciary acted with the intention of inflicting an injury on the beneficiary, or that the breach of duty stemmed from negligence, is not required to allege or prove a breach of fiduciary duty.[6] Thus, although breach of fiduciary duty has long been treated as tortious, *Restatement (Second) of Torts* § 874 (1979) situates it within an uncharacterized category of miscellaneous torts, not among the torts designated as intentional or as a specialized instance of negligence.[7]

The relationship between an investment adviser and its captive mutual fund is comparable in basic and relevant respects to the relationships between (1) a trustee and trust beneficiaries, and (2) a controlling shareholder and the controlled corporation and its minority shareholders. The similarity stems from the degree to which the fiduciary actor's position is

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*Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928); *see generally* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 880-82.

[6] *See*, *e.g.*, *In re Baylis*, 313 F.3d 9, 20-21 (1st Cir. 2002).

[7] For analysis of breach of fiduciary duty as a tort, see Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 Ariz. L. Rev. 925, 927-34 (2006).

entrenched, as well as from the relative extent of its power within the relationship. In both contexts, long-established fiduciary doctrine recognizes a principle of fair dealing that requires both full disclosure by the fiduciary and substantive fairness of the terms of any transaction when the fiduciary deals on its own behalf with the beneficiaries or its conduct is otherwise characterized as self-dealing.[8]

In both contexts, the fiduciary enjoys a well-entrenched position. As noted by the Seventh Circuit in the panel opinion in this case, "[m]utual funds rarely fire their investment advisers." *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 634 (7th Cir. 2008). Similarly, beneficiaries of a trust may not easily remove the trustee,[9] and while in office the trustee has the settlor's full title or interest in trust property unless the settlor has manifested a different intention. *See Restatement (Third) of Trusts* § 42 (2003). Likewise, a shareholder that holds sufficient voting power to elect a corporation's directors—typically also sufficient voting power to stymie fundamental transactions that require shareholder approval—is insulated from the voting power held by minority shareholders and is positioned to serve its interests to the detriment or exclusion of theirs. In both instances, as explained below, judicial review of

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[8] *See*, *e.g.*, *Hardy v. Hardy*, 230 S.W.2d 11, 15 (Ark. 1950); *Equitable Trust Co. v. Gallagher*, 102 A.2d 538, 545 (Del. Ch. 1954).

[9] A trustee may be removed in accordance with terms of the trust or by court order. *See Restatement (Third) of Trusts* § 37 (2003). Beneficiaries cannot compel removal unless the terms of the trust so authorize or the beneficiaries have the power by unanimous consent to terminate or modify the trust. *See id.* cmt. b; *id.* § 65 cmt. f.

challenged transactions extends to the substantive reasonableness or fairness of transactions between the fiduciary actor and its beneficiaries.

Thus, well-established fiduciary doctrines applicable to trustees and controlling shareholders are relevant to the interpretation of § 36(b) and furnish the appropriate standard against which to assess compensation agreements between investment advisers and their mutual funds. That standard encompasses the adequacy of disclosure made by the fiduciary to the beneficiary as well as the fairness to the beneficiary of the contested transaction.

### A. Trust law, trustees, and compensation

A trustee's duty of loyalty requires that the trustee "administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purposes," except as otherwise provided in the terms of the trust. *Restatement (Third) of Trusts* § 78(1) (2007). However, express authorization in the terms of the trust may not sweep so broadly as to immunize from liability a trustee who "violates the duty of loyalty to the beneficiaries by acting in bad faith or unfairly," given the fundamentally fiduciary quality of a legally recognized trust relationship. *Id.* cmt. c(2).

The strict prohibition against a trustee engaging in self-dealing transactions or other transactions that stem from or create conflicts between the beneficiaries' interests and those of the trustees is subject to exceptions beyond those expressly created by the terms of the trust. *See id.* § 78(2). These include "the trustee's taking of reasonable compensation for services rendered as a trustee." *Id.* cmt. c(4); *see also id.* § 38(1) ("A trustee is

entitled to reasonable compensation out of the trust estate for services as a trustee, unless the terms of the trust provide otherwise or the trustee agrees to forego compensation."). Thus, although a trustee does not engage in prohibited self-dealing by taking compensation, the exception embraces only compensation that is "reasonable."[10] What is reasonable is not a determination left solely to the trustee to make. Additionally, by dealing directly with trust beneficiaries, the trustee breaches the duty of loyalty unless the dealings are preceded by full disclosure of material facts and are fair to the beneficiaries. *Id.* § 78(3).

*1. Trustee's dealings with beneficiaries*

When a trustee enters into an agreement or otherwise deals with trust beneficiaries, the trustee's dealings are subject to scrutiny under a standard that encompasses both the adequacy of the disclosure made by the trustee to the beneficiaries and the fairness of the dealings themselves. As stated in *Restatement (Second) of Trusts* § 170(2) (1959), "[t]he trustee in dealing with the beneficiary on the trustee's own account is under a duty to the beneficiary to deal fairly with him and to communicate to him all material facts in connection with the transaction which the trustee knows or should know." Likewise, *Restatement (Third) of Trusts* § 78(3) articulates the same standard of full disclosure and fair dealing: "[w]hether acting in a fiduciary or personal capacity, a trustee has a duty in dealing with a beneficiary to act fairly and to

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[10] *Accord Uniform Trust Code* § 802(h)(2) (2000) (duty of loyalty does not preclude, if "fair" to beneficiaries, "payment of reasonable compensation to the trustee").

communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter."

Moreover, the same standard requiring full disclosure by the trustee and fair dealing with the beneficiary applies to agreements between trustee and beneficiary that augment the trustee's compensation beyond the amount to which the trustee would otherwise be entitled. *Restatement (Second) of Trusts* § 242 makes explicit what is implicit in the more general principle stated in § 170(2):

> The amount of compensation to which the trustee would otherwise be entitled may be enlarged or diminished by an agreement between the trustee and the beneficiary. Such an agreement enlarging the trustee's compensation, however, will not bind the beneficiary if he is under an incapacity or if the trustee failed to make disclosure of all circumstances which he knew or should have known or if the agreement is unfair to the beneficiary.[11]

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[11] *Restatement (Second) of Trusts* § 242, cmt. i. To the same effect is *Restatement (Third) of Trusts*: "[n]or will it bind a consenting beneficiary if the trustee failed to disclose all the relevant circumstances that the trustee knew or should have known, or if the agreement is unfair to the beneficiary." *Restatement (Third) of Trusts* § 38 cmt. f. For cases applying this standard, see *Fertel v. Brooks*, 832 So. 2d 297, 304 (La. Ct. App. 2002) (beneficiaries of full age and sound mind may enter into valid agreement with trustee concerning compensation, "provided the trustee displays 'the utmost good faith and fairness in the transaction'") (quoting George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* § 976 (rev'd 2d ed. 1983)); *Bowker v. Pierce*, 130 Mass. 262, 262 (1880) (finding

Thus, even if the trustee makes full disclosure of material facts to a competent beneficiary, the beneficiary's agreement to increase the trustee's compensation is unenforceable if its terms would treat the beneficiary unfairly. The applicable standard encompasses the fairness of the terms to which the beneficiary has agreed, as well as the completeness of disclosure made by the trustee.

*2. Terms of trust and trustee's compensation*

The terms of a trust may address the compensation to be paid to the trustee, for example by providing a formula based on the value of trust assets. That the terms of the trust would yield a particular amount of compensation for the trustee is not dispositive because fiduciary doctrine recognizes that circumstances may make such an amount unreasonable. If so, the court may reduce or augment the compensation due the trustee or permit the trustee to resign. On this point, Illustration 2 to *Restatement (Third) of Trusts* § 38 is informative:

> 2. The terms of a testamentary trust specify that the trustee is to receive annual compensation on a prescribed basis (which has proven to be fair and adequate over the years) and a termination fee set at five percent of the trust principal. The termination fee would produce what amounts to an unreasonably large sum for the circumstances of the trust,

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amount charged by trustee to be less than that contemplated by trust agreement and "clearly not exorbitant or unconscionable"); *Ladd v. Piggott*, 114 S.W. 984, 987 (Mo. 1908) (independent of compensation to which beneficiary agreed, charges by trustee "reasonable" and consistent with amounts allowed to trustees in community for similar services).

> the assets of which now entirely consist of cash equivalents and readily marketable securities worth $50,000,000. This latter figure represents a much greater appreciation in the value of the trust estate than could have been anticipated when the trustee accepted the trusteeship. The court will reduce the termination fee to the extent it concludes that the formula . . . will produc[e] an unreasonably large fee.

Thus, the amount of compensation that a trustee may be paid is subject to a limitation of "reasonableness," although the amount is specified by or derived from the terms of the trust. Nor is a change in circumstances, as in Illustration 2, the only situation in which compensation might be unreasonable.[12]

Many factors are relevant to the court's assessment of reasonableness, including, as in Illustration 2, the character of trust property relative to an amount of compensation. Also relevant are the degrees of difficulty and of risk confronted by the trustee; the trustee's skill and experience and the quality of its performance; and local custom. *See id.* cmt. c(1). Courts also consider whether the settlor may have wished to benefit the person named as trustee by structuring the trustee's compensation in part to confer a gift on the individual so named or

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[12] Illustration 2 concludes: "The court's authority to modify or disregard a compensation provision is not limited to situations involving unanticipated developments (here, the exceptional increase in corpus value) although that factor may be relevant to a court's decision."

compensate him or her for services apart from the trusteeship.[13]

To be sure, the relationship between an investment adviser and the investment company it creates is not identical to the relationship between the settlor of a trust and the trustee. For starters, it is not plausible to assume that investors in an investment company harbor donative impulses toward the company's investment adviser comparable to those a settlor may hold toward a particular individual trustee chosen by the settlor. Moreover, although a trust's settlor may also serve as its trustee or exercise control over the trustee, the starting point for any trust relationship is the settlor, not the trustee. Thus, the settlor's intention often serves as a touchstone in resolving questions that arise in the course of trust administration.[14]

In contrast, a "captive" investment company has no independent originating force comparable to the settlor of a prototypical private trust. Such a settlor is positioned to negotiate the terms of the trust instrument with the trustee on an arm's-length basis. In contrast, in the investment-company context, the beneficiary—the fund, acting through its directors—negotiates compensation with its fiduciary. The absence of an independent settlor eliminates a structural bulwark against overreaching by the fiduciary. Thus, the justification for reviewing an

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[13] *See*, *e.g.*, *Estate of McClenahan v. Biberstein*, 671 N.E.2d 482 (Ind. Ct. App. 1996) (agreeing that fee paid to executor, an attorney, was justified in part because executor received no compensation for preparing estate plan).

[14] *See*, *e.g.*, *Denver Found. v. Wells Fargo Bank, N.A.*, 163 P.3d 1116, 1122 (Colo. 2007); *Pack v. Osborne*, 881 N.E.2d 237, 241 (Ohio 2008).

adviser's compensation against a fiduciary standard of "reasonableness" is stronger than in the prototypical private trust, in which the applicability of the standard is well established.

Moreover, the character of judicial review in the private-trust context is informative. The court's scrutiny encompasses many circumstances. Well-established practice situates the court's application of fiduciary principles as a crucial safeguard against abuse of trust beneficiaries. Although the court may consider "local custom" in determining whether a trustee's compensation is reasonable, custom alone does not determine the answer because the court may also take into account, for example, the degree of risk and difficulty surmounted by the trustee relative to an amount of compensation.[15] Nor is it dispositive, or even relevant, that a given locale may have multiple institutional trustees keen to serve the needs of any particular settlor such that the market for trustee services could be characterized as competitive.

### B. Controlling shareholders and dealings with the corporation

Shareholders that hold sufficient voting power to elect a corporation's directors and defeat proposed fundamental transactions that require shareholder approval are, like investment advisers, both entrenched in place and situated to exploit their position. Corporate law in the United States has long

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[15] *See*, *e.g.*, *In re Will of McDonald*, 138 Misc. 2d 577, 579, 525 N.Y.S.2d 503, 505 (Surr. Ct. 1988) (test of reasonable fairness of compensation for fiduciary requires determination of circumstances of particular trust and services provided; commission schedules established by corporate fiduciaries not binding on court making determination of reasonable compensation).

imposed fiduciary duties on controlling shareholders. Integral to the duties' efficacy is judicial scrutiny of the fairness of a controlling shareholder's dealings with the corporation and the fairness of the price of transactions between the corporation and the shareholder, often phrased as a standard of "intrinsic" or, synonymously, "entire" fairness.[16] A controlling shareholder has the burden under this standard of showing fairness.[17]

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[16] A leading case using the "intrinsic" fairness formulation is *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971). For a leading case using the synonym "entire" fairness, see *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

[17] *See Weinberger*, 457 A.2d at 710 ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts."). If a transaction has been previously approved by the corporation's disinterested shareholders, the party challenging it has the burden of showing that it constitutes a waste of corporate assets. *See Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985). A transaction constitutes a "waste" of corporate assets if the corporation receives no consideration in exchange or receives consideration in an amount so inadequate that no person of ordinary business judgment would deem the consideration worth the corporate assets exchanged through the transaction. *See* American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* § 1:42 (1994); *see also In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009) (plaintiff in derivative suit excused from making demand on corporation's directors for claim stemming from allegations in complaint that created a reasonable doubt that terms of $68 million package to departing CEO, approved by bank's directors, constituted waste of bank's assets). In enacting § 36(b), Congress rejected the application of the waste standard to cases challenging adviser compensation. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 534 n.10, 540 & n.12 (1984); 15 U.S.C. § 80a-35(b)(2) (2006).

As applied to controlling shareholders, the fiduciary standard requires examination of many factors, including those relevant to the fairness to non-controlling shareholders of a transaction's terms. In *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the Delaware Supreme Court formulated its influential application of the entire-fairness doctrine in the context of a merger transaction between a parent corporation and its majority-owned subsidiary that cashed out the subsidiary's minority shareholders. Although the doctrine has two components, fair dealing and fair price, "the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole." *Id.* at 711. Fair price encompasses "economic and financial considerations . . . including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." *Id.*

Fiduciary doctrine in this context differentiates between a controlling shareholder's use of its voting rights and transactions that implicate the corporation itself and advantage the shareholder disproportionately or exclude non-controlling shareholders from participation. Jurisdictions do not identically define the transactions or activities that trigger judicial assessment against the standard of entire fairness. For example, in Delaware, a controlling shareholder has the burden of proving entire fairness only when it engages in self-dealing, defined as causing the controlled corporation to act such that the controlling shareholder receives something from the corporation to the exclusion of

non-controlling shareholders.[18] In other jurisdictions, disproportionate gains to a controlling shareholder are prima facie evidence that it has breached its fiduciary duty although those gains are unaccompanied by detriment to non-controlling shareholders. *See* James D. Cox & Thomas Lee Hazen, *Corporations* 255 (2d ed. 2003).

This fiduciary duty, implemented by the entire fairness standard, applies directly to the controlling shareholder itself. Although a corporation's directors themselves also owe fiduciary duties, well-established doctrine recognizes that the power held by controlling shareholders, like the harm it may inflict on non-controlling shareholders, is not necessarily mitigated by a corporation's directors. They may well be removable from office by the controlling shareholder and, even if nonremovable for their current terms of office, only with the controlling shareholder's support will they be reelected. Moreover, the controlling shareholder itself, but not necessarily the corporation's directors, benefits through the shareholder's unfair dealings. Fiduciary duties would lose meaning were the duty and remedies for breach inapplicable to the controlling shareholder itself.

Although jurisdictions do not define its content identically, the proposition that a controlling shareholder is subject to fiduciary duties is well-

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[18] *See Sinclair Oil*, 280 A.2d at 720 (self-dealing by controlling shareholder encompasses causing controlled corporation not to enforce output contract with controlling shareholder, but not controlled corporation's declaration of dividends in large amounts when corporation pays out same amount per share).

established.[19] Fiduciary doctrine developed in this context is relevant to interpreting the statutory fiduciary duty applicable to an investment company's adviser with respect to its receipt of compensation. Like a corporation's controlling shareholder, an investment company's adviser is well entrenched, while governance patterns in the mutual fund industry make it unlikely that the fund's directors will exercise their power to replace an adviser. *See Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 731 (7th Cir. 2008) (Posner, J. dissenting from denial of rehearing) (describing characteristics of a "captive" mutual fund).

Additionally, the incentives and interests of a controlling shareholder are not necessarily aligned with those of the corporation's non-controlling shareholders. As the merger transaction challenged in *Weinberger* illustrates, a controlling shareholder—supported by the corporation's directors, whom it elected—may be tempted to cash out the equity investment of the corporation's non-controlling shareholders at a price that does not adequately reflect the corporation's value.[20] Likewise, the incentives and interests of an investment company's advisers and its shareholders are not necessarily aligned. Indeed, fees paid to the adviser, charged to

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[19] *See*, *e.g.*, *Moore v. Maine Indus. Servs., Inc.*, 645 A.2d 626, 628 (Me. 1994); *Peters Corp. v. New Mexico Banquest Investors Corp.*, 188 P.3d 1185, 1188 (N.M. 2008); *Kavanaugh v. Kavanaugh Knitting Co.*, 123 N.E. 148, 151-52 (N.Y. 1919).

[20] *See Weinberger*, 457 A.2d at 713-15 (permitting plaintiff to prove that true value of non-controlling shareholders' equity was closer to $26 per share than $21 per share, the consideration paid in merger through which controlling shareholder cashed out non-controlling shareholders' investment).

the company, constitute a substantial portion of, and in some cases the entirety of, the company's material costs of operation. Nor are an investment adviser's interests and incentives necessarily aligned with those of shareholders in its investment company through performance-driven competitive forces; performance accounts for only about 40 percent of aggregate annual growth in the mutual fund industry.[21]

Finally, a corporation with a controlling shareholder may have directors on its board who are by some definition or measure independent of the controlling shareholder, analogous to the statutory independent-director requirements applicable to investment companies.[22] Fiduciary standards and their implementation shape how lawyers advise independent directors concerning dealings with the corporation's controlling shareholder. That *Weinberger* and comparable cases permit judicial scrutiny of the substance of dealings with a controlling shareholder adds a cautionary contour to counsel's advice that would otherwise be lacking.

More importantly, courts do not treat the mere presence of independent directors on a corporation's board as dispositive when determining whether the controlling shareholder dealt fairly with the corporation. At most, isolating dealings with

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[21] *See* Investment Company Institute, *2008 Fact Book* 8 (48th ed. 2008), *at* http://www.ici.org/about_ici/annuals.

[22] *See* 15 U.S.C. § 80a-10(a) (2006) (imposing limit on registered investment companies of 60% of board members who are interested persons of company); *id.* § 80a-15(c) (requiring approval of investment adviser's contract by vote of majority of directors who are not parties to agreement or interested persons.).

the controlling shareholder in a committee of independent directors who have credible power to negotiate, to reject any deal, and to retain their own independent legal and financial advisers shifts the burden on fairness to the party who challenges the transaction.[23] In contrast, provisions in corporation statutes may insulate from attack transactions between a corporation and one or more of its own directors when such self-dealing transactions are approved by disinterested directors who know the material facts and act in good faith.[24] Underlying the difference in treatment are the realities of power and influence when the corporation's directors serve at the behest of the party—the controlling shareholder—that will be the counterparty in transactions that the directors are charged with evaluating.

The specifics of power and influence held by an investment adviser vis-à-vis its investment company are not identical to those present in relationships between controlling shareholders and their corporations. It is the investment company's shareholders, not its adviser, who elect its directors. But the directors are chosen by the adviser or by incumbent directors, making shareholder suffrage more a theoretical than a practical constraint. Moreover, governance patterns

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[23] *See Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997) (controlling shareholder has burden of proving entire fairness unless it can prove an independent committee negotiated an arguably self-dealing transaction, meaning that "the committee . . . function[ed] in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power 'at an arms length'") (quoting *Rabkin v. Olin Corp.*, C.A. No. 7547, 1990 WL 47648 (Del. Ch. Apr. 17, 1990), *aff'd*, 586 A.2d 1202 (Del. 1990)).

[24] *E.g.*, Del. Code Ann. tit. 8, § 144 (1998).

in the mutual fund industry may suggest that softer forms of power and influence could be operative for some directors,[25] ones usefully offset by counsel's advice about the demands of fiduciary duty and by the prospect of substantive judicial assessment of transactions with the company's investment adviser.

Additionally, the Investment Company Act itself treats investment advisers as comparable to controlling shareholders. Section 36(b), by imposing a direct fiduciary duty on advisers with respect to the receipt of compensation and material payments, makes relevant the body of fiduciary principles applicable to controlling shareholders, including the entire fairness standard.

## III. The Seventh Circuit's interpretation of the Act disregards accumulated doctrinal meaning and ignores significant provisions of the Act.

The Seventh Circuit's account of fiduciary duties, minimal at best, is misleading. The panel opinion below ignores well-established bodies of fiduciary doctrine that require judicial assessment of the substance of dealings between fiduciaries and their beneficiaries. The court's assertion that "[j]udicial price-setting does not accompany fiduciary duties"[26] also ignores well-established fiduciary doctrine applicable to contexts similar in relevant respects,

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[25] For example, service by individual directors on multiple funds within the same fund "family" is a common practice. *See Krantz v. Prudential Invs. Fund Mgmt. LLC*, 305 F.3d 140, 143-44 (3d Cir. 2002) (holding that practice is not a basis on which to overcome presumption created by 15 U.S.C. § 80a-2(a)(9) (2006) that a natural person is disinterested).

[26] *Jones*, 527 F.3d at 633.

albeit not identical to, the investment company setting.

### A. General disregard of accumulated doctrinal meaning

The description of fiduciary doctrine earlier in this brief is neither innovative nor controversial. Additionally, the rationales for imposition of fiduciary duties are well-established. The Seventh Circuit's opinion furnishes no general account of fiduciary duty or the rationales that support its imposition. Perhaps for that reason the court's opinion ignores settled and broadly applicable principles that are integral to the meaning of statutory language deeming a party "to have a fiduciary duty." Instead, the court's opinion relies on a series of isolated examples that do not support the conclusion it reaches.

### B. Trust law

#### *1. Inapposite focus*

The Seventh Circuit's treatment of trust law focuses on terms in a trust instrument through which a settlor specifies the trustee's compensation. *See Jones*, 527 F.3d at 632. This focus is inapposite to the mutual fund context because the fund's origin is not traceable to an independent counterpart to a settlor able to negotiate on an arm's-length basis with a prospective fiduciary, as discussed in Part II.A. Instead, the correct analogy within trust doctrine is to a trustee's dealings with its beneficiaries, discussed in Part II.A.1. When dealing with a trust's beneficiaries, the trustee's fiduciary duty requires that it make full disclosure of relevant circumstances and that the terms of the transaction be fair to the beneficiaries. *See Restatement (Second) of*

*Trusts* § 170(2). In particular, an agreement between beneficiaries and the trustee augmenting the trustee's compensation does not bind the beneficiaries if the trustee has dealt unfairly with them by failing to disclose all material circumstances or if the agreement itself is unfair to the beneficiaries. *See id.* § 170 cmt. i; *supra* Part II.A.1.

*2. Inaccuracy*

Additionally, the Seventh Circuit's treatment of trust-law principles is inaccurate. The panel opinion cites *Restatement (Second) of Trusts* § 242 and Comment f for the proposition that "a trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay." *Jones*, 527 F.3d at 632. However, Comment f to § 242, entitled "*The terms of the trust*," says nothing about provisions for trustee compensation that may be challenged as excessively large. Comment f does, however, address the opposite possibility:

> If the amount of compensation provided by the terms of the trust is so inadequate that no duly qualified person would be willing to act as trustee for the compensation so provided, the court may authorize a larger compensation, since otherwise the purposes of the trust would be defeated or substantially impaired.

*Restatement (Second) of Trusts* § 242 cmt. f. Indeed, the black letter principle stated by § 242 itself is only that "the trustee is entitled to compensation out of the trust estate for his services as trustee, unless it is otherwise provided by the terms of the trust or unless he agrees to forego or waives compensation."

This statement does not cover the terrain necessary to ground the Seventh Circuit's assertion. That the intent of § 242's Comment f was limited to trustees who seek compensation in addition to that provided by the terms of the trust is confirmed by *Restatement (Third) of Trusts* § 38, Reporter's Note to Comment c, which observes that *Restatement (Third)*'s provision is "more favorable to such claims" in which trustees seek additional compensation than was Comment f. Indeed, controversy associated with the counterpart provision in the *Uniform Trust Code* (2000) appears to have focused solely on the prospect that the court's power would encompass increasing a trustee's compensation; that the court could decrease unreasonably high compensation was uncontroversial.[27] And, as Part II.A.2 of this brief demonstrates, *Restatement (Third) of Trusts* contemplates circumstances—furnishing a specific illustration—in which fiduciary principles warrant reducing the amount of a trustee's compensation despite its consistency with terms of the trust.

Additionally, the Seventh Circuit's account is uninformed by trusts statutes. Under the *Uniform Trust Code* § 708(b), "[i]f the terms of a trust specify the trustee's compensation, the trustee is entitled to compensation as specified, but the court may allow

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[27] *See* David M. English, *Representing Estate and Trust Beneficiaries and Fiduciaries*, SJ001 ALI-ABA 285 (2003) (commenting on *Uniform Trust Code* § 802 and reporting that "[t]he dispute is not over whether the court should be able to adjust compensation that is unreasonably high" but, "[r]ather, the objection is to the court's authority to adjust compensation that is unreasonably low" and that "[t]hose taking this view concluded that the trustee should be held to its badly made bargain"). Professor English served as the Reporter for the *Uniform Trust Code*.

more or less compensation if . . . (2) the compensation specified by the terms of the trust would be unreasonably high or low." *Uniform Trust Code* § 708. Apart from the Code, to the same effect are statutes in leading jurisdictions.[28]

### C. Inapposite examples

#### *1. Executive compensation*

The Seventh Circuit's opinion also relies on a series of examples that are either inapposite or that fail to support the court's argument in other respects. The court points to compensation practices in business corporations as another instance of the superiority of "[c]ompetitive processes" to a "'just price' system administered by the judiciary." *Jones*, 527 F.3d at 633. As the court describes compensation practices for publicly-traded corporations: "a committee of independent directors sets the top managers' compensation. No court has held that this procedure implies judicial review for 'reasonableness' of the resulting salary, bonus, and stock options." *Id.* Notably, other members of the same court are not so sanguine about public-company compensation practices, the outcomes they produce, and the governance patterns that underlie them.[29]

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[28] *See* Cal. Prob. Code § 15680(b)(2) (2009); Del. Code Ann. tit. 12, § 3560(a) (1989) (Court of Chancery may allow greater or lesser compensation when, *inter alia*, "the compensation in accordance with the terms of the trust would be unreasonably low or high").

[29] *See Jones*, 537 F.3d at 730 (noting the "feeble incentives of boards of directors to police compensation," compensation-related incentives of CEOs who serve as directors of other companies, and conflicted position of compensation consulting firms "which provide cover for generous compensation packages

Flawed (or not) as they may be, public-company compensation practices are not useful as a point of analytic departure for interpreting § 36(b). Congress explicitly deemed investment advisers to have a fiduciary duty in connection with their receipt of compensation and other material payments. No comparable legislative declaration applies to executives' receipt of compensation payments, even in public companies registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934. Additionally, the relative significance of executive compensation pales in contrast to advisers' fees in the investment company context. No publicly traded company's compensation payments, however lavish, amount to such a substantial portion of its cost of carrying on the corporate enterprise, while the compensation that an investment company pays to its adviser is its greatest cost.

The Seventh Circuit's executive-compensation example is also inapposite because it slights the weakness with which corporate executives (individually or as a group) are entrenched in any particular company compared to a mutual fund's investment adviser. Although many senior executives are not employees at will,[30] turnover in executive ranks is a visible phenomenon. Contracts between

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voted by boards of directors" because the firms furnish services apart from compensation consulting to the same clients, for which they are retained by officers on whose compensation packages they advise).

[30] *See* Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 Wash. & Lee L. Rev. 231, 233 (2006).

senior executives and their employers price the cost to the company of effecting an early termination of the relationship without showing cause. In contrast, turnover among investment advisers is acknowledged to be rare. Thus, to the extent the Seventh Circuit's reasoning relies on "competitive processes," on this point of comparison such processes operate without leaving visible traces in the mutual fund context.

*2. Lawyers' fees*

The Seventh Circuit also identifies lawyers as actors who owe fiduciary duties to clients "but are free to negotiate for high hourly wages or compensation from any judgment." *Jones*, 527 F.3d at 633. If a client contests a fee, the question for the court is whether the client's choice was made voluntarily and on an informed basis. *Id.* Judicial fee-setting, in settings where it occurs, follows the market. *Id.* This example, like the court's executive compensation example, again ignores the statutory designation of investment advisers as fiduciaries in relationship to their receipt of compensation and other material payments, a designation without a statutory counterpart applicable to lawyers.

Additionally, in only a purely formal sense would a client owe its existence to its lawyer's entrepreneurial effort. Clients—even business firms originally formed by a lawyer—frequently change counsel. An investment company, in contrast, originates with its investment adviser, and their relationship almost always persists.

Markets for legal services also differ in major ways from the market among mutual funds for investment advice. Lawyers compete on the basis of fees, a form of competition that leads to shifts in

clients' allegiances, both phenomena not observed in relationships between mutual funds and their investment advisers.

Finally, to claim as did the Seventh Circuit that courts merely "follow the market" in making fee determinations slights the complexity of that task. It also ignores the fact that, in some contexts, courts do determine the "reasonableness" of fees. Courts review the reasonableness of fees to be paid to class counsel in class-action litigation and, in the probate setting, the reasonableness of all fees paid to counsel for executors, guardians, and conservators, as well as fees paid to attorneys *ad litem*. In the corporate context, directors and officers who are entitled under corporation statutes to receive indemnification for litigation-related expenses, including attorney's fees, have a claim only for expenses that were "reasonably incurred." *E.g.*, Del. Code Ann. tit. 8, § 145 (2006). In determining whether fees were reasonably incurred, the court may consider whether the particular counsel chosen by the person seeking indemnification—or, more often, enforcement of a right to advancement prior to a final determination of the person's entitlement to indemnification—represented a "reasonable" choice.[31] Justifying some measure of review of reasonableness by the court is the fact that the person seeking indemnification or advancement will, if the quest succeeds, be spending the corporation's money, not his or her own.[32]

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[31] *See Westar Energy, Inc v. Lake*, 552 F.3d 1215, 1227-28 (10th Cir. 2009).

[32] When a corporation has an enforceable obligation to advance the costs of defense to a person pending ultimate determination of the person's entitlement to indemnification, all

Similarly, directors of an investment company use the company's—their shareholders'—assets to pay compensation to the company's investment advisor, a point ignored by the Seventh Circuit. The narrowness of the Seventh Circuit's analytic framework, like the meagerness of its examination of the examples it chose to use, produced a misleading treatment of fiduciary duty, even when discussion is limited to the court's chosen (and inapposite) examples.

## CONCLUSION

The judgment of the United States Court of Appeals for the Seventh Circuit should be reversed.

Respectfully submitted,

DEBORAH A. DEMOTT
*Counsel of Record*
1542 Hermitage Court
Durham, NC 27707
(919) 489-5366

JEROME A. BROADHURST
APPERSON, CRUMP & MAXWELL, PLC
6000 Poplar Avenue
Suite 400
Memphis, TN 38119
(901) 756-6300

*Counsel for Amici Curiae*

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the monies expended may be the corporation's, regardless of the outcome of the ultimate determination.

# APPENDIX

More detailed biographical information about each of the *amici* is as follows:

**Mark L. Ascher** holds the Joseph D. Jamail Centennial Chair at the University of Texas School of Law. He joined the Texas faculty in 2000 and was previously the Ralph W. Bilby Professor at the University of Arizona, James E. Rogers College of Law. He joined Arizona's faculty in 1982. He has taught and written about the law of trusts, the taxation of trusts and estates, as well as taxation more generally. He is the author of *Scott and Ascher on Trusts*, in its fifth edition the successor to *Scott on Trusts*.

**Deborah A. DeMott** is the David F. Cavers Professor of Law at Duke University School of Law, having joined the Duke faculty in 1975. She has taught and written about fiduciary duties in many contexts, including agency and corporate law, partnerships, and other long-term business relationships. She was the sole reporter for the *Restatement (Third) of Agency*, published in final form in 2006.