

Judge's Ruling Questions Attorney-Client Privilege for Mutual Fund Trustees

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Independent mutual fund trustees will likely think twice before they say anything incriminating to their external legal counsel about how they administer mutual funds.

The rights of mutual fund investors to fair advisory fees trump the rights of independent mutual fund trustees to attorney-client confidentiality, says a Washington State federal district court judge in a recent ruling involving Pacific Investment Management Company (Pimco). Independent trustees to Pimco's Total Return Fund must now fork over two hundred pages of privileged communications Pimco's independent trustees had with their legal counsel about the advisory fees Pimco earned .

Those fees are at the heart of a lawsuit filed by a disgruntled investor against Newport Beach, California-based Pimco in late 2014. Robert Kenny of Clinton Island, Washington State, alleges that Pimco's Total Return Fund earned excessive advisory fees because the fund's investment adviser didn't act in the best interests of investors. He claims that the advisory fees far exceeded the value of the services rendered and only served to bolster the excessive compensation of C-level executives. They include former chief investment officer Bill Gross who earned more than \$200 million in compensation in 2013. That is the year Pimco was paid a total of US\$1.2 billion in advisory fees, alleges Kenny, while its Total Return Fund suffered its worst performance since 1994. It lost 1.92 percent in value. Gross, who launched the fund in May 1987, left the following year to join Janus Capital Group.

Although independent trustees weren't party to the lawsuit against Pimco, the judge's decision has generated plenty of angst in the mutual fund industry where independent trustees rely on external legal advice on how to administer mutual funds. "Often such cases [involving excessive fees] have been settled out of court with the investment adviser agreeing to reduce its advisory fees," says David Mahaffey, co-chair of the investment management practice at the law firm of Sullivan & Worcester in Washington DC.

The stakes in Pimco's case are even higher. Should Kenny win his case, he and other shareholders of Pimco's Total Return Fund could receive all or part of the advisory fees paid. Investors in other lawsuits cases involving excessive fees could also capitalize on the recent ruling to obtain otherwise confidential information. Such disclosure could even be extended beyond just excessive fees.

"Fund trustees should not automatically assume the attorney-client privilege applies in all situations in the boardroom," says Jay Baris, a partner at Morrison & Foerster, who chairs the law firm's investment management practice. "If followed by other courts, this case could have a chilling effect on the conversations between independent fund trustees and their counsel, especially when they seek independent counsel on matters related to contract renewals, compliance, compensation and a host of governance issues."

Kenny's case, still in the discovery phase, rests largely on 200 pages of documentation representing emails and other communications made by the fund's independent trustees. The independent trustees have good reason not to want to surrender any information on their discussions with legal counsel. Judge Ricardo Martinez will be evaluating the process used by the board to approve Pimco's advisory fees and the written notes of a former independent trustee could prove incriminating. "If Pimco was overpaid so outrageously then we the trustees must be authorizing payments/fees to Pimco that were too high," says William Popejoy who complained about Gross' compensation at a February 2014 board meeting. Popejoy subsequently alleged he was ousted from the board because of his stance.

Judge Martinez disagreed with the decision of the independent trustees not to produce the documentation on the grounds that their communications with external counsel was protected by attorney-client privilege. He ruled that because Pimco's Total Return Fund was organized as a business trust in Massachusetts, the independent trustees are acting as fiduciaries on behalf of shareholders. It is the shareholders who are the true clients of the external legal counsel. Therefore, any communications between the independent trustees and legal counsel should be made available to shareholders. "Only where the trustee shows that he or she obtained legal advice for his or her personal protection or independent personal purpose will the client privilege survive," says the judge in his ruling. That legal advice would be protected in the case of pending litigation against the trustee.

“The judge’s ruling isn’t the first time the fiduciary exception to attorney-client privilege has been applied. However, it is the first time that it has been applied to a mutual fund trustee,” explains Niels Holch, director of the Washington, D.C. based Coalition of Mutual Fund Investors, which tracks investor litigation against mutual funds. Until now, the exception has only been applied in cases involving employers offering pension plans governed under ERISA or simple trusts.

Judge Martinez says there should be no distinction between mutual funds and pension plans, but some legal experts disagree. “Mutual funds are created as trusts, but that doesn’t mean that the independent trustees should be treated like trustees of an ordinary trust,” says Mahaffey. “The judge’s ruling misinterprets the structure of the mutual fund and the role of trustees who are the equivalent of a corporate board of directors. Other states, besides Maryland have similar corporate structures available for organizing mutual funds.”

So far, the US Securities and Exchange Commission has not issued any guidance on what specific metrics should be used to determine fair advisory fees. Legal experts say that it is unlikely it will do so but they hope the SEC will issue further clarifications on the obligations of independent trustees and more importantly the status of their communications with external counsel.