

Plaintiffs Face Uphill Battle In Excessive-Fee Litigation

Law360, New York (March 16, 2017, 9:53 AM EDT) -- Following a four-day bench trial, Judge Renee Marie Bumb of the U.S. District Court for the District of New Jersey ruled in favor of an adviser on claims brought under Section 36(b) of the Investment Company Act by investors in six mutual funds managed by the adviser. *Kasilag v. Hartford Investment Financial Services LLC*, No. 1:11-cv-01083 (Feb. 28, 2017). The court applied the Gartenberg standard, adopted by the U.S. Supreme Court in *Jones v. Harris Associates LP*, 559 U.S. 335 (2010), and determined that the plaintiffs had failed to demonstrate at trial that the fee charged by the adviser was “so disproportionate that it could not be one that was negotiated at arms’ length.”



Eben P. Colby

Hartford is the second case to be decided at trial in the current wave of so-called “excessive-fee litigation” against mutual fund advisers. The first was decided in August 2016, when AXA emerged victorious after a 25-day trial on similar claims. (See our earlier article, “What Mutual Fund Advisers Can Learn From AXA Trial Win”)



Seth M. Schwartz

To prevail in a Section 36(b) case, a plaintiff must prove that a mutual fund adviser’s fee is “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining.” Under the Gartenberg standard, courts may consider all relevant factors, but in particular:

1. the independence and conscientiousness of the fund’s board of directors charged with approving the adviser’s fee;
2. the nature and quality of the services provided by the adviser (which may include the fund’s performance);
3. the adviser’s profitability;
4. any fallout benefits received by the adviser;
5. whether economies of scale in operating the fund were shared with the fund’s shareholders; and
6. comparative fee structures of other similar funds.



Kenneth E. Burdon

Judge Bumb's 70-page opinion is insightful both for what it found with respect to Hartford and for its potential application to the more than 20 other pending Section 36(b) cases in the mutual fund industry. Key takeaways are as follows.

The Court's Deference to the Board Was Influential

Before trial, Judge Bumb granted partial summary judgment in favor of Hartford, ruling that the board's process had been sound and that its decision regarding the advisory fees at issue would be entitled to deference at trial. The court stated that the plaintiffs' criticisms amounted to "no more than nit-picking the Board's process."

That ruling framed the court's decision at trial. Consistent with *Jones*, Judge Bumb stated that "Section 36(b) does not call for judicial second-guessing of informed board decisions," and that "a determination of an informed and disinterested Board is entitled to considerable, but not conclusive weight." (Opinion at 4-5.) The court considered the remaining Gartenberg factors under that framework, creating an uphill battle for plaintiffs on those issues.

The Court Rejected the Fundamentally Flawed Premise That Advisory Services and Subadvisory Services are the Same

The current wave of Section 36(b) litigation generally relies on the theory that the investment adviser to a mutual fund renders few, if any, services of value to the fund whenever a subadviser has been retained to invest the fund's assets. In *Hartford*, the plaintiffs claimed that the adviser's fee was excessive because it delegated virtually all of its management responsibilities to subadvisers but kept most of the fees paid by the funds. Plaintiffs argued that the fees retained by Hartford were excessive because they were not proportional to the services provided (nearly all of which were purportedly delegated to subadvisers for a lower fee).

The court rejected that premise. It noted that the advisory and subadvisory "businesses are different" and subadvisers have "a different role and different risks, among other differences." (Opinion at 15, n. 13, 64, n. 40.) Indeed, the court found that the adviser provided several services separate and in addition to the services provided by the subadviser. For example, the adviser was responsible for "managing the full line of mutual funds," including establishing fund strategy, constantly re-evaluating strategies, and selecting and overseeing subadvisers and portfolio managers. The court found that the adviser's oversight function included "multiple levels," including continuous quantitative analysis of performance and in-person meetings with portfolio managers. The court also found that the adviser provided a range of legal services to the funds and oversaw the funds' and subadvisers' compliance programs.

The Court Rejected Plaintiffs' "Retained Fee" Theory

Throughout the trial, the plaintiffs sought to isolate the services provided by the adviser from those provided by the subadviser. In an effort to demonstrate a greater disparity between the services provided and the fees received by the adviser, the plaintiffs offered a comparison of the adviser's so-called "retained fee" (the total advisory fee minus subadvisory fees) against the adviser's "in-house" operating costs. The plaintiffs argued that the adviser's expenses excluding subadvisory costs were relatively small in comparison to its retained fee, reflected by the fact that "less than one full-time employee was devoted to working on each fund." (Order at 38.)

The court rejected the plaintiffs' efforts to exclude subadvisory costs from the equation, stating that it would not "divide the unitary fees pursuant to the IMAs into components earmarked for Defendants or the sub-advisers." (Order at 15, n. 12.) Among other

reasons, the plaintiffs' expert admitted on cross-examination that under generally accepted accounting principles (GAAP) rules, subadvisory fees are "treated as an expense of the adviser, just as Defendants have asked the Court to treat them." (Opinion at 43.) In addition, the court noted the plaintiffs' expert had served on a board that had approved a retained fee in an amount "nearly identical" as one of the funds at issue, and that the expert testified that he "hadn't ever thought about these issues" before this case. (Opinion at 43-44 (internal quotation marks and alterations removed))

The court likewise rejected expert testimony that the adviser's fee could not have resulted from a competitive market because "nobody expects to pay a profit 70 times the provider's cost."

The court held that it is "well-established" that Section 36(b) is not a rate regulation statute and does "not require cost-plus profit for advisers," as the expert's testimony suggested. (Opinion at 65.) Rather, an adviser is entitled to negotiate at arm's length for the best deal, and the plaintiffs' expert admitted on direct examination that one of the fees at issue was "a little high, but could have resulted from an arm's length bargain." (Opinion at 65.)

Instead, the court adopted the defendants' more traditional profitability analysis — considering the total advisory fees and subadvisory expenses — and held that there was "little evidence before it with which to determine whether these profit margins [which ranged between 52 percent and 80 percent for the different funds during the time period] are so great that they could not have been achieved at arm's-length." (Opinion at 64.)

The Court Acknowledged the Unique Risks Borne by the Adviser

The court also credited testimony that as the sponsor of its proprietary mutual funds, the adviser assumes entrepreneurial, reputational and legal/regulatory risks in managing its funds that are not shared by the subadvisers it retains to invest fund assets. The court acknowledged testimony from the plaintiffs' expert that indemnification clauses in the relevant investment management agreements limited liability risk, to some extent, but the court noted that the testimony failed to address "the types of risk, such as entrepreneurial risk or reputational risk, which Defendants view to be important." (Order at 20.) This evidence of the risks borne by the adviser was particularly informative when the court considered the services provided by the adviser. The court held that the adviser's fee was not disproportionate, in part, "in light of the risks that were also borne by Defendants." (Order at 59.)

The Plaintiffs Failed to Show That the Funds' Fees or Performance Were Out of Line With Peers

The plaintiffs could not demonstrate at trial that the advisory fees and performance of the funds at issue were subpar in comparison with those of their peer funds. The court noted that certain comparative analyses prepared by Lipper and the defense expert's testimony demonstrated that all funds except for one had "outperformed the majority of their peers in the vast majority of 10-year reporting periods." As for the worst-performing fund, the court found its "generally weak performance tips very mildly in Plaintiffs' favor," but that this factor was "softened" by testimony explaining that performance had been challenged as a result of a management "shakeup" at the time. (Opinion at 63.)

The court rejected the plaintiffs' argument that the "performance of the Funds was poor based on their near-universal failure to exceed the performance of their selected benchmarks." The plaintiffs had "presented little evidence that the failure to hit a benchmark is a strong indication of poor performance," and the court credited testimony from the defendants' expert that benchmarks "are a metric that analyzes performance in a vacuum, because fees are not involved" (i.e., deducted from the benchmarks). (Opinion at

62.)

With respect to comparative fees, the plaintiffs set forth even less evidence. The court stated that the plaintiffs “made no effort to present evidence of comparative fee structures at trial.”

Conclusion

The past year has seen the momentum turn in favor of mutual fund advisers in the current wave of excessive-fee litigation. While over 20 Section 36(b) cases have been filed since 2011, 10 of those cases have been dismissed by the court or by agreement over the past year. Aside from AXA, which went to trial, three other cases were dismissed at the pleading stage or at summary judgment, and five others were dismissed by stipulation (including one case in which the stipulation states that the dismissal “is not the result of a settlement or compromise”). Although these developments do not necessarily spell the end for the more than a dozen still-pending cases, the Hartford decision will likely cause plaintiffs to rethink the current theory of these cases, which has been clearly rejected by courts in the first two trials.

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