What can mutual fund boards and advisers learn from the AXA trial ruling?

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Abstract

Purpose – *To analyze the August 2016 court decision in Sivolella v. AXA Equitable Life Ins. Co. and its implications for cases concerning mutual fund advisory fees under Section 36(b) of the of the Investment Company Act of 1940.*

Design/methodology/approach – *Discusses Section 36(b), the plaintiffs' arguments and the judge's decision in favor of the mutual fund adviser. Provides insights from the judge's analysis of the advisory fees at issue, including the independence of the mutual fund board and quality of the annual advisory contract renewal process, whether the language of the advisory and subadvisory agreements fully reflects the nature and extent of services provided, the board's reliance on outside experts and advisers when considering the advisers' fees and services, and continuous improvements in the boards' annual advisory contract renewal process.*

Findings – *AXA was a decisive victory for the adviser, and serves as a reminder to boards and advisers alike that a diligent focus on board process and independence can pay twofold after litigation is filed.*

Practical implications – *Boards and advisers should consider AXA's implications, and whether the decision raises issues that should be reviewed by independent counsel with experience advising funds and advisers with respect to the Investment Company Act.*

Originality/value – *Practical guidance from experienced financial services lawyers.*

Keywords *Board of directors, Mutual fund, Investment Company Act of 1940, Excessive fee litigation, Investment management agreement, Section 36(b)*

Paper type *Technical paper*

In the first trial of a recent wave of cases under Section 36(b) of the Investment Company Act of 1940 ("the Investment Company Act"), Judge Peter G. Sheridan of the US District Court for the District of New Jersey ruled in favor of the defendant-adviser, finding that the plaintiffs had failed to prove that the mutual fund advisory fees at issue were excessive. The decision in *Sivolella v. AXA Equitable Life Ins. Co.*, No. 11-cv-4194 (D.N.J. Aug. 25, 2016), spans nearly 150 pages and follows a 25-day bench trial.

Section 36(b) imposes a fiduciary duty on mutual fund advisers with respect their receipt of compensation for the services they render to the funds they manage. To win a Section 36(b) case, a plaintiff must prove that a mutual fund adviser's fee is "so disproportionally large that it bears no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining". In analyzing this standard, courts will consider all relevant factors, including: (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 "fall-out" 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[1].

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Editor's Note: This article was published in the September 12, 2016 issue of Law360: www.law360.com/articles/838099/what-mutual-fund-advisers-can-learn-from-axa-trial-win

In the trial, the plaintiffs – investors in 12 mutual funds managed by AXA Equitable Funds Management Group, LLC (AXA) – claimed that AXA's fees were excessive because it delegated virtually all management responsibilities to subadvisers but kept most of the fees. According to the plaintiffs, any additional fees paid to AXA beyond the amount of the subadvisers' fees were unjustified by the services AXA provided to the funds and therefore were excessive.

Considering the relevant factors with respect to the adviser's fee, Judge Sheridan rejected the plaintiffs' excessive fee theory and also ruled that the plaintiffs failed to establish a workable damages theory.

Here are a few insights from that ruling:

1. Mutual fund boards should continue to focus on both the independence and quality of their annual advisory contract renewal process under Section 15(c) of the Investment Company Act, both of which we expect to continue to have an outsized influence on the outcome of future excessive fee litigation.
2. Although the court in *AXA* considered testimony and evidence beyond the advisory contract language when considering the services provided by the adviser to the mutual funds, advisers should consider, in advance of litigation, whether the language of their advisory and any subadvisory agreements accurately describes and fully reflects the nature and extent of the services they provide.
3. The use of outside experts and advisers to provide guidance with respect to the adviser's fees or services (during the renewal process or otherwise) could be helpful in any subsequent litigation.
4. Boards and advisers should not hesitate to make continuous improvements to their annual advisory contract renewal process, even (and especially) after a Section 36(b) lawsuit is filed, because courts are unlikely to hold these changes against them.

1. A board led by independent directors with independent advisers remains key to defeating Section 36(b) litigation

A thorough and consistent board process led by independent directors with independent advisers will likely be the key factor in defeating Section 36(b) litigation, and will influence the court's analysis of other relevant factors.

In *AXA*, the court determined that the board was "diverse and independent", and had "robustly reviewed" the adviser's compensation. A number of facts supported that finding:

- *The board had appointed a lead independent director, who conducted an "arms-length" process separate from the adviser and the one director affiliated with the adviser.* The court noted that the board consisted of a supermajority of independent directors, and only one director affiliated with the adviser (the Chairman of the Board, who was also the President and CEO of the adviser). The plaintiffs criticized the Chairman's affiliation with the adviser and the court expressed concern that the Chairman "generally controll[ed] the information" in presentations to the board; however, that criticism was insufficient to overcome testimony and evidence reflecting a strong contract approval process led by the lead independent director, not the Chairman[2].
- *The board had broad diversity of expertise on a variety of different subjects, even though it consisted "mainly of individuals with backgrounds in financial services".* The court questioned whether the board had a "regulator type person", but acknowledged that the lead independent director had practiced in front of the Securities and Exchange Commission as a partner at a large law firm, and that the board was assisted by independent counsel with regulatory experience. The court also questioned the

"Wall Street leanings" of the board, but found that it was offset by directors with backgrounds in consulting and public relations.

- *New board members were identified by an executive search firm and benefited from a "comprehensive training regimen".* The court credited testimony that the independent directors were assisted in selecting their replacements by a firm specializing in identifying independent directors. The court also noted that the board's training program was comprehensive, and included presentations and materials from independent counsel in addition to materials provided by the adviser.
- *The board sought and obtained information from multiple sources other than the adviser.* The court rejected the plaintiffs' argument that the board "placed too much faith" in materials provided by the adviser. Rather, the court noted that the board had received advice and information from multiple independent consultants and experts, including Lipper, Morningstar, Strategic Insights, E&Y, the Investment Company Institute, the Independent Directors Council and independent legal counsel.
- *The independent directors participated in preparing and requesting materials regarding the adviser's fee.* The court credited the board's role in developing charts tracking the services provided and fees charged by the adviser as well as the subadvisers. The court also took note of a summary provided to the board regarding significant recent developments facing the funds or adviser. Although the court observed that some of these materials (such as the charts) were created only after the litigation, the court considered the use of the materials to be a positive factor, not evidence of a prior weakness in the board's process[3].

2. Advisers should consider whether the language of their advisory agreements accurately describes and fully reflects the services they render

In litigation, advisers can benefit from clear sources of documentary evidence demonstrating the services provided to the funds in exchange for advisory fees. In *AXA*, the plaintiffs argued that AXA did not provide services to the funds that justified its fees. Although the language of AXA's advisory agreement did not fully describe or reflect AXA's services to the funds, the court rejected the plaintiffs' argument for multiple reasons:

- *Although the plaintiffs were "essentially correct" that the services described in the advisory agreements were largely the same as those described in the subadvisory agreements, the court credited the advisers' additional oversight responsibilities*. The court found that the adviser's responsibilities to oversee the subadvisers and other service providers were not apparent from the "generic and broad" language of the agreements. As one example, the court noted that although the subadvisers were assigned the task of carrying out a fund's investment objectives, they were required to deliver performance data to the adviser for purposes of analysis and reporting. Likewise, although the contracts demonstrated that AXA delegated some administrative services to third-party vendors, it remained responsible for coordinating those service providers, as well as performing other tasks, such as valuation of complex securities, monitoring compliance with securities laws and regulations and creating and organizing materials to be submitted to the funds' board.
- *Testimony and evidence demonstrated that the adviser provided services "beyond those expressly outlined in the agreements*". AXA retained responsibility for developing and implementing the investment strategies associated with each of the funds, conducting initial research in connection with hiring the subadvisers, providing risk management services, operating a shareholder call center, developing investment guidelines and benchmarks and continuously evaluating fund performance and potential restructuring or merger options. Regarding the latter task, the court noted that the adviser had restructured five of the funds at issue during the relevant time period.

- *The court credited testimony and evidence presented by the adviser regarding the risks assumed by the adviser in operating the funds.* The court found that the adviser's fee was justified, in part, by the "litigation and reputational risks" and "operational and business risks" associated with operating the funds. Although the funds had agreed to indemnify the adviser for some risks, the court credited testimony that "notwithstanding the contract language, which is standard in the industry, both the [b]oard and regulators would ultimately hold [the adviser] liable for any issues that impact the Funds or investors".

In sum, AXA could have benefitted from language in the agreements that better reflected the nature and extent of the services it provided to the funds (separate and in addition to the services provided by the subadvisers). However, in the end, the court refused to elevate "form over substance" by limiting its analysis to the language of the contract, and determined that AXA provided significant services beyond those expressly described in the contracts.

3. Outside consultants can demonstrate transparency and credibility in subsequent fee litigation

Throughout the decision, the court credited AXA's use of outside auditors, lawyers and consultants to review its processes and methodologies. For example, the court rejected the plaintiffs' contention that the adviser had improperly classified subadvisory fees as expenses to artificially deflate profitability, and noted that two independent accounting firms had reviewed the arrangement and found it to be within ordinary accounting principles. The court also rejected criticisms of the adviser's methodology for allocating expenses, noting that it also had been reviewed by two independent accounting firms. Similarly, the court rejected the plaintiffs' criticisms regarding the selection of peer groups in the adviser's comparative fee materials, noting testimony by the plaintiffs' expert that Lipper – the organization responsible for preparing the materials – is an "independent and authoritative source for data".

4. Improvements to the board's process after commencement of litigation did not demonstrate prior deficiencies

Although the court found in favor of the defendants, it acknowledged that "the filing of the suit brought about positive changes to the Board's composition and process". For example, the court believed that the lawsuit had resulted "in a more scrupulous and rigorous examination of Board expenses" and the development of additional board materials analyzing AXA's fee. Moreover, the court observed that "the organization of the Board materials, specifically the binders, drastically improved in the years following the lawsuit". However, the court did not find that these improvements during the course of the litigation demonstrated deficiencies in the board's process in prior years. Instead, the court credited the board's efforts to improve its process and materials, implicitly finding that the board's process was sufficient even prior to the filing of the lawsuit.

Conclusion and outlook

AXA was a decisive victory for the adviser, and serves as a reminder to boards and advisers alike that a diligent focus on board process and independence can pay twofold after litigation is filed. Boards and advisers should consider *AXA*'s implications, and whether the decision raises issues that should be reviewed by independent counsel with experience advising funds and advisers with respect to the Investment Company Act.

Further, while *AXA* was the first case to be tried in this wave of Section 36(b) litigation, the cases following behind likewise have an opportunity to shape the landscape. In November 2016, there was a bench trial in a litigation involving the Harford Funds and a decision is pending. A third trial involving Russell Investment Co. is scheduled to begin in March 2017,

and others are in line behind. Although these cases present an opportunity for plaintiffs to "try, try again", pre-trial decisions favorable to the advisers in both *Hartford* and *Russell* may hamstring those efforts. Thus while, *AXA* did not spell the end of the current wave of Section 36(b) litigation, the forthcoming trial decisions in 2017 are likely to determine whether plaintiffs' theory based on subadvisory fees has any viability.

Notes

1. *See Jones v. Harris Associates, L.P.*, 559 US 335 (2010) (citing *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982)).
2. Notably, the Court found that the board's lead independent director provided "credible testimony regarding the Board's composition, training, and decision-making process in analyzing [AXA's] fees". In stark contrast, the Court found all but one of the plaintiffs' witnesses to be less credible, which had a "significant impact on the outcome of the case". For example, the court gave the testimony of the plaintiffs' accounting expert "little weight" because his answers were "evasive" and "often inconsistent" with prior testimony. Likewise, the court discredited the testimony of the plaintiffs' mutual fund expert because of his "inconsistencies, oversimplification, and his sarcastic demeanor", and noted mathematical errors in his work product. The plaintiffs' corporate governance expert "also lacked credibility" because of his admittedly "cursory" review of the documents and unfamiliarity with open-end funds (the type of funds at issue).
3. The Court's finding with respect to the board's independence permeated the Court's consideration of the other relevant factors. For example, regarding economies of scale, the Court noted that the board had frequently discussed the topic, had received relevant information and presentations during its renewal meeting, and had successfully obtained additional management fee breakpoints from the adviser. The Court also discounted evidence from plaintiffs regarding potential fall-out benefits received in connection with the fund (brokerage fees received by an entity affiliated with the adviser's parent) because the benefits had been disclosed to the board and properly considered at renewal meetings. Likewise, the Court rejected the plaintiffs' criticisms of certain comparative fee materials because the board had considered the potential weaknesses in the data and requested additional information where appropriate.

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