Editor-At-Large
Reynolds Holding

THE CLS BLUE SKY BLOG

COLUMBIA LAW SCHOOL'S BLOG ON CORPORATIONS AND THE CAPITAL MARKETS

Editorial Board
John C. Coffee, Jr.
Edward F. Greene
Kathryn Judge

Skadden Discusses BlackRock Win in One of Largest Mutual Fund Cases Ever

By James R. Carroll, Eben P. Colby, Scott D. Musoff, Christopher A. Lisy and Marley Ann Brumme March 1, 2019

Comment

Following an eight-day bench trial, Judge Freda L. Wolfson of the U.S. District Court for the District of New Jersey ruled in favor of certain subsidiaries of BlackRock, Inc. on $1.55 billion in claims brought under Section 36(b) of the Investment Company Act concerning two of BlackRock's largest mutual funds.[1] *In re BlackRock Mut. Funds Adv. Fees Litig.*, No. 3:14-cv-01165-FLW-TJB. The court applied the *Gartenberg* standard, adopted by the U.S. Supreme Court in *Jones v. Harris Associates L.P.*, 559 U.S. 335 (2010), and determined that the shareholder plaintiffs failed to demonstrate at trial that the fee charged by BlackRock was "so disproportionate that it could not be one that was negotiated at arms' length."

BlackRock is the first trial decision on the so-called "subadvisory" or "reverse manager of managers" theory in excessive fee litigation and is one of the largest mutual fund cases ever.[2] Though this theory has now been rejected after consideration on the merits by the court, the *BlackRock* decision further underscores the importance of an independent, conscientious, well-informed fund board, and a robust Section 15(c) process during which information regarding the *Gartenberg* factors is clearly and thoughtfully outlined for the board.

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 this standard, courts may consider relevant factors, but in particular: (i) the independence and conscientiousness of the fund's board of directors charged with approving the adviser's fee; (ii) the nature and quality of the services provided by the adviser (including the fund's performance); (iii) the adviser's profitability; (iv) any fall-out benefits received by the adviser; (v) whether economies of scale in operating the fund were shared with the fund's shareholders; and (vi) comparative fee structures of similar funds.

BlackRock is the first trial decision on the so-called "subadvisory" or "reverse manager of managers" theory in excessive fee litigation and is one of the largest mutual fund cases ever.

The "subadvisory" or "reverse manager of managers" theory posits that the fee an adviser charges to a proprietary (*i.e.*, adviser-sponsored) mutual fund is excessive when it is higher than the fee that it charges to perform subadvisory services to an independent third-party fund. Under this theory, the fee charged to the proprietary fund is excessive because the adviser charges a lower fee for allegedly substantially the same services to third parties for whom it acts as a subadviser. Accordingly, the *BlackRock* trial focused heavily on *Gartenberg*'s comparative fees factor; namely, whether it was apt to compare BlackRock's services and fees charged to the proprietary funds at issue (the Funds) with its services and fees charged to seven subadvised funds sponsored and managed by third-party insurance companies in connection with their variable annuity products (the Subadvised Insurance Funds). The plaintiffs also challenged BlackRock's advisory fees under *Gartenberg*'s economies of scale and profitability factors.[3] In rejecting the plaintiffs' theory, the court's 72-page opinion is insightful both for what it found with respect to BlackRock and for its potential application to currently pending (and any future) Section 36(b) cases in the mutual fund industry.

Key Takeaways

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

In *BlackRock*, the plaintiffs claimed that the adviser provided substantially the same services to both the Funds and Subadvised Insurance Funds.

The court rejected this premise, finding that the plaintiffs' attempted comparison of subadvisory services, on the one hand, to the services provided in sponsoring and managing proprietary mutual funds, on the other, was wholly inapt. While BlackRock did not dispute that its portfolio management services were similar for the funds at issue, the parties vigorously disputed the amount, scope and scale of any so-called "support services." After hearing extensive testimony regarding BlackRock's advisory and subadvisory services, the court found that BlackRock's services to the Subadvised Insurance Funds were not "remotely comparable" to those it provides as adviser to the Funds.

In particular, the court found that BlackRock has "limited support responsibilities" when acting as a subadviser, which are not comparable to the "robust suite of services" it provides as adviser. The court credited BlackRock's fact and expert witness testimony that the services provided by an adviser and subadviser are substantially different, including (but not limited to) with respect to: "(i) compliance; (ii) board administration; (iii) regulatory and financial reporting; (iv) determination and publication of daily NAV; and (v) managing service providers," such as accountants, transfer agents and custodians. The court rejected the plaintiffs' expert's "superficial" and "cursory" analysis and testimony to the contrary.

Additionally, because the plaintiffs' evidence and arguments as to *Gartenberg*'s profitability factor were derivative of, and wholly dependent on, their inapt comparison of advisory to subadvisory services, the court found that this factor, too, weighed in favor of BlackRock.

The Court Recognized That Mutual Funds and Variable Annuity Mutual Funds Are Different Products

The Subadvised Insurance Funds at issue in *BlackRock* were all mutual funds sponsored and managed by various insurance companies and available only for purchase as investment options within those insurers' variable annuity products. Quoting BlackRock's expert, the court acknowledged that "their fees are different, the product is different" and the distribution is different. For example, as the court noted, the Funds have tens of thousands of shareholders, while a variable annuity mutual fund has very few shareholders because investors are serviced at the policyholder level. These differences further rendered the plaintiffs' comparison of the Funds to the Subadvised Insurance Funds inapt under *Jones*.

The Court Acknowledged the Value of an Adviser in Coordinating and Supervising Third-Party Service Providers

In an effort to minimize BlackRock's "robust" services to the Funds to make them seem more comparable to its subadvisory services, the plaintiffs sought to establish that many of the services BlackRock claimed to provide in exchange for the advisory fee are, in fact, performed by third-party service providers for a separate fee and, therefore, must be discounted when viewing the differences in advisory and subadvisory services offered by BlackRock. The court rejected this effort, finding that BlackRock provided substantially more services than any service providers, "even in the areas ostensibly covered by service provider[s]." As the court stated, "that [BlackRock] employs third-party vendors to assist in its work for the funds does not undermine the extensive evidence indicating that the robust services that [BlackRock] offers the funds are reflected in the fees."

Importantly, the court also acknowledged the value of BlackRock's coordination and oversight of the proprietary funds' third-party service providers. The court found that such coordination and oversight requires "substantial effort." Quoting BlackRock's expert, the court noted that:

[A] mutual fund is not just a nexus of contracts of service providers in the sense that you could just contract and go. … The conversations that you have to have and the policies and procedures that you need to have in place to get the fund to operate are substantial. You need experience in the adviser, and the adviser has a day-to-day job of integrating those service providers and causing the right things to happen.

The Court Emphasized the Unique and Significant Risks Borne by the Adviser

In yet another effort to minimize the differences in BlackRock's services to the Funds and the Subadvised Insurance Funds, the plaintiffs argued that BlackRock incurs substantially similar risk for both sets of services. Therefore, according to the plaintiffs, any differences in BlackRock's advisory and subadvisory fees were not justified by the degree of risk borne by BlackRock. The court, however, credited BlackRock's witnesses, who testified that the risk it bears in its capacity as adviser to its proprietary funds is "all-encompassing," entailing risks that it "simply does not face" when acting as a subadviser. In particular, the court noted that there were substantial differences in reputational, regulatory, and financial risk borne by BlackRock with respect to the Funds that are largely absent with respect to its subadvisory services to the Subadvised Insurance Funds.

The Funds' Fees Were in Line With Their Peers'

With the court's rejection of their theory that the funds' fees were excessive when compared to subadvisory fees, the plaintiffs were unable to demonstrate at trial that the advisory fees were out of line with those of their peers. By contrast, the court credited BlackRock's expert's testimony that the advisory fees were in line with their peers under his own analysis and that conducted by Lipper, an independent, widely used organization that maintains a database of all U.S. mutual funds from which it creates fee comparisons between similar funds. As the court noted, "because independent data suggests that [BlackRock's] fees were reasonable" and "squarely in line with their peers," the plaintiffs could not demonstrate that *Gartenberg*'s comparative fees factor in any way indicated that the advisory fees were excessive.

The Bar Remains High for Plaintiffs to Prove Economies of Scale

The plaintiffs could not demonstrate at trial that BlackRock benefited from any economies of scale in managing the funds. Economies of scale are defined as a "decline in a product's per-unit production cost resulting from increased output." The plaintiffs, through their expert, presented evidence that BlackRock's estimated costs for managing the Funds increased at a slower rate than the asset growth in the Funds. According to the plaintiffs, these two data points demonstrated that BlackRock realized economies of scale.

The court, however, found this presentation unpersuasive. Among other reasons, the plaintiffs' expert admitted that he had not performed the required per-unit transaction cost analysis needed to establish the existence of any economies of scale. Further, the court found that the plaintiffs failed to establish that the lower growth rate in BlackRock's costs was caused by the increase in the Funds' size. To that end, the court noted that numerous other factors could have caused these trends, and the plaintiffs thus failed to meet their burden of establishing the existence of any economies of scale.

Conclusion

The *BlackRock* trial demonstrates that yet another plaintiff's theory regarding the mutual fund industry is fundamentally flawed. With the decision in *BlackRock*, courts have now rejected the "reverse manager of managers" theory after hearing a full evidentiary record.

Though the "reverse manager of managers" theory has now been rejected, advisers would be wise to ensure that their fund boards are independent, well-informed and follow a robust process, and that, among other things, the following are clearly outlined and explained to the fund board as part of the advisory contract renewal process pursuant to Section 15(c): (i) the scope of any subadvisory duties the adviser takes on, particularly in comparison to the many advisory duties they handle on a day-to-day basis; (ii) the scope and scale of adviser oversight of the fund's third-party service providers; (iii) the financial, regulatory and reputational risks associated with providing advisory services; and (iv) any pecuniary and nonpecuniary benefits shared with the funds.

ENDNOTES

1 Skadden represented the BlackRock subsidiaries in this case.

2 Two other "reverse manager of managers" cases — *Thomas J. Kennis v. Metropolitan West Asset Management, LLC*, Civ. A. No. 15-08162 (C.D. Cal. Oct. 16, 2015), and *Chill et al v. Calamos Advisors LLC*, Civ. A. No. 15-01014 (S.D.N.Y. Feb. 11, 2015) — were tried after *BlackRock*; no decision has yet been rendered, and post-trial arguments are set for late February 2019. Another case, *Goodman v. J.P. Morgan Investment Management*, 301 F. Supp. 3d 759 (S.D. Ohio 2018), was decided favorably for the adviser on summary judgment in March 2018, only a few months prior to the BlackRock trial. Additionally, two trials were held in "manager of managers" cases in 2016, both of which resulted in favorable findings for the advisers, later upheld on appeal. (See our March 15, 2017, and September 8, 2016, client alerts, "Another Mutual Fund Adviser Prevails at Trial in Excessive Fee Litigation" and "What Can Mutual Fund Boards and Advisers Learn From the *AXA* Trial Ruling?")

3 Before trial, the court granted partial summary judgment to BlackRock, ruling that it was "beyond dispute" that the board's process was robust and that its decision to approve the advisory fees at issue would be entitled to "substantial deference" at trial. That ruling framed the court's decision at trial. In its ruling, consistent with *Jones*, the court noted that Section "36(b) does not call for judicial second-guessing of informed board decisions or supplanting the judgment of disinterested directors apprised of all relevant information." The court then considered the three *Gartenberg* factors at issue under that framework, holding plaintiffs to a "steep" burden on those issues.

This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's memorandum, "Court Rules in BlackRock's Favor in Excessive Fee Trial, One of Largest Mutual Fund Cases Ever," dated February 19, 2019, and available here.

Leave a Reply

Your email address will not be published. Required fields are marked *

Comment

Name *

Email *

Post Comment

© Copyright 2019, The Trustees of Columbia University in the City of New York.