SDNY Rules in Favor of Mutual Fund Adviser, Dismisses Excessive Fee Claim

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In an opinion unsealed on July 3, 2019, Judge Laura Taylor Swain of the U.S. District Court for the Southern District of New York granted summary judgment to a mutual fund adviser and dismissed an excessive fee claim brought under Section 36(b) of the Investment Company Act (ICA). *In re Davis New York Venture Fund Fee Litig.*, No. 14-04318 (S.D.N.Y. 2019).

Davis New York is the latest in a string of decisions rejecting the so-called "subadvisory" or "reverse manager of managers" theory in excessive fee litigation. Prior cases were resolved in favor of the advisers at the summary judgment and motion to dismiss stages. *Goodman v. J.P. Morgan Inv. Mgmt., Inc.*, No. 14-00414 (S. D. Ohio 2018); *Pirundini v. J.P. Morgan Inv. Mgmt. Inc.*, No. 17-03070 (S.D.N.Y. 2018). Notably, Judge Freda L. Wolfson of the U.S. District Court for the District of New Jersey repudiated the theory after an eight-day bench trial in one of the largest mutual fund cases ever litigated. *In re BlackRock Mut. Funds Adv. Fees Litig.*, No. 14-01165-FLW-TJB (D.N.J. 2019).[1]

The court's opinion in *Davis New York* reinforces three key lessons from the most recent wave of Section 36(b) litigation.

First, the opinion is yet another nail in the coffin of the subadvisory theory in excessive fee liability. Specifically, the opinion supports the conclusion reached in prior Section 36(b) decisions that peer funds are a more apt benchmark than subadvised funds for evaluating fees. However, this case, together with another recent Section 36(b) case, *Pirundini*, focused on a different type of comparison than most recent Section 36(b) litigation. Most litigation in the last two waves of cases rejected comparisons between retail funds and other products such as subadvised or institutional funds in favor of comparisons, compiled by third parties, to groups of funds managed by other advisers. *See*, *e.g.*, *BlackRock* and *Goodman*. Instead, *Davis New York* and *Pirundini* focus on comparisons between two or more retail funds managed by the same adviser. In *Davis New York*, the adviser used such a comparison defensively to show that the management fee was not excessive, and in *Pirundini* the plaintiffs used such a comparison offensively to claim that the management fee was excessive. Both courts found the comparison apt — although the *Pirundini* court ultimately held that the fee differential did not demonstrate that the management fee was outside the range of an arm's length negotiation and granted the adviser's motion to dismiss.

In *Davis New York*, the plaintiffs alleged that the lower management fees the adviser charged several subadvised funds could not be explained by any substantial difference in advisory versus subadvisory services. The court rejected the plaintiffs' argument and concluded that two other retail funds that had replaced their prior advisers with the defendant-adviser provided better comparators than the subadvised funds. *Id*. at 27. Those peer funds had "nearly identical" fee structures to that of the at-issue fund, and their relationship with the adviser was indisputably the result of arm's length bargaining, as indicated by their willingness to "remove their adviser only a few years earlier." *Id*. at 27-28. In conclusion, the court held that the peer funds provided "an uncontroverted apt comparison, establishing that the range of arm's length fees encompasses those paid by the Fund to [the adviser], even if the Subadvised Funds could be found to be probative as to the lower end of this range." *Id*. at 29-30.

[1] See our February 19, 2019, client alert, "Court Rules in BlackRock's Favor in Excessive Fee Trial, One of Largest Mutual Fund Cases Ever."

Second, the opinion reaffirms the crucial importance of an independent, well-informed board that conducts a robust contract renewal process pursuant to Section 15(c) of the ICA. The opinion serves as a reminder to advisers to provide sufficient information so that the board can appropriately inform itself about the scope of advisory and subadvisory services, and consider whether a comparison is apt.

In *Davis New York*, the plaintiffs alleged that the adviser withheld important information during the Section 15(c) process related to subadvisory and third-party fees and services. Specifically, they alleged that the adviser withheld "(1) an accurate description of the services [the adviser] provided to the sub-advised funds, (2) an explanation of the services that are provided under the [investment advisory agreement] as opposed to separate contracts with the Board, and (3) an estimation of the level of profits [the adviser] would have attained on its Fund advisory services had it been paid at the fee rates charged to the Subadvised Funds." Op. at 22. The court quoted another Section 36(b) case, *Kasilag v. Hartford Inv. Fin. Servs., LLC*, No. 11-01083 (D.N.J. 2017) and rejected the plaintiffs' attempt to survive summary judgment through "armchair quarterbacking and captious nitpicking."[2] Specifically, the court held that the adviser (i) provided the board with — and the board conscientiously reviewed — substantial materials on the differences in scope, scale and risk of advisory versus subadvisory services; (ii) disclosed to the board services provided pursuant to contracts other than the investment advisory agreement; and (iii) provided sufficient information to the board on advisory and subadvisory profit margins. *Id*. at 10, 22-23. Consequently, the court held that "the Board's review process was sufficiently robust to warrant a significant degree of deference to the Board's decision to approve [the adviser's] advisory fee." *Id*. at 25.

Third, the opinion reaffirms that periods of underperformance and profit margins as high as 81% are not alone sufficient for excessive fee plaintiffs to survive a motion for summary judgment.

After granting deference to the board and finding for the adviser on comparative fees, the court summarily rejected the plaintiffs' performance and profitability arguments. With regard to performance, the court held that although the plaintiffs "proffered sufficient facts to enable a rational factfinder to conclude that [the fund's] performance was below standard to at least some degree," they failed to proffer "evidence that the Fund's deviation from its benchmark or negative Alpha was particularly dramatic or unusual, and this factor does not strongly favor liability even when all reasonable inferences are drawn in Plaintiffs' favor." *Id*. at 31. With regard to profitability, the court held that the plaintiffs failed to proffer "evidence to demonstrate that, when viewed holistically in the context of the other *Gartenberg* factors, [the adviser's] profits [of 73-81%] were out of proportion to the services rendered." *Id*. at 32.

Conclusion

The past three years have seen the momentum turn unequivocally in favor of mutual fund advisers in the current wave of excessive fee litigation. *Davis New York* is the sixth case since 2016 to be dismissed on the merits. Building on the prior cases, *Davis New York* reaffirms the rejection of the fundamentally flawed subadvisory theory of excessive fee liability and the importance of a robust contract review process by a conscientious board.

[2] See our March 15, 2017, client alert, "Another Mutual Fund Adviser Prevails at Trial in Excessive Fee Litigation."

Associate **Isaac N. Saidel-Goley** assisted in the preparation of this alert.