COURT GRANTS SUMMARY JUDGMENT TO DEFENDANT INVESTMENT ADVISER IN SECTION 36(B) EXCESSIVE FEE LAWSUIT

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In a strong opinion, a federal court in the Southern District of New York recently dismissed a suit alleging that the defendant charged "excessive" fees to a mutual fund.[1] In granting summary judgment, the Court held that plaintiffs had not presented enough evidence to allow a rational factfinder to conclude that the fees were excessive under Section 36(b) of the Investment Company Act of 1940 (the "ICA").

Section 36(b) gives a mutual fund shareholder a narrow private right of action against the fund's adviser for breach of a fiduciary duty in connection with the fees it charges for services provided.[2] Under a standard set out by the U.S. Supreme Court in Jones v. Harris Associates, L.P., to prevail on a Section 36(b) claim a plaintiff must prove that the fee charged is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."[3] The fee must be outside "the range of fees that might result from arm's-length bargaining."[4] Courts look at many items, including six "Gartenberg" factors: (1) the nature and quality of services provided to fund shareholders, (2) the profitability of the fund to the adviser, (3) fall-out benefits received by the adviser, (4) economies of scale, (5) comparative fee structures, and (6) the independence and conscientiousness of the board.[5]

The motion before the Southern District of New York involved a theory that the plaintiffs' bar has invoked in several Section 36(b) complaints in recent years. The "subadvisory" or "reverse manager-of-managers" theory attempts to prove that the fees an adviser charges to a mutual fund that it manages are necessarily excessive because they exceed the rates that the adviser charges when it acts as a *sub*adviser to other funds. In granting summary judgment, the Court rejected the theory that these types of comparisons are sufficient on their own to warrant a trial.

In the same order, the Court also granted the investment adviser's motion to exclude certain opinions of plaintiffs' expert witness and provided helpful guidance on the proper and improper scope of expert testimony in Section 36(b) cases.

KEY TAKEAWAYS

When Evaluating Section 36(b) Cases, the Court Acknowledged the Standard Set Out in Jones and the Importance of Board Deference

The Court confirmed that the appropriate standard for evaluating Section 36(b) cases, including on a motion for summary judgment, is the overall standard set out in Jones, as informed by the Gartenberg factors. The Court engaged in a two-step analytical process that first considered the adequacy of the board's process in approving the advisory agreement, to set the proper level of deference, and then went through the remaining Gartenberg factors to determine if the fee arguably was outside the range of what could have been the product of arm's-length negotiation.

Even though the parties offered contrasting arguments or “divergent perspectives” on the facts, the Court found it was not enough to preclude granting summary judgment. Instead, the Court properly looked at whether the plaintiffs put forth sufficient evidence such that a rational factfinder could rule in their favor. In this case, plaintiffs had not done so.

The Board's Process in Reviewing Advisory Agreements Is a Critical Factor, and the Court Rejected Plaintiffs' Efforts to Criticize the Board's Process as Insufficient

The Court concluded that plaintiffs failed to present evidence creating a genuine issue as to whether the board's review process was “sufficiently robust,” and therefore, the board's business decision to approve the fees was entitled to “substantial deference.”

The Court credited the undisputed facts that a majority of the board was disinterested; the adviser compiled an “extensive” book of materials relevant to the Gartenberg factors (commonly known as a “15(c) book”); the directors sent the adviser a questionnaire and informal follow-up requests for additional information; the directors were advised by independent counsel; and the board received information comparing the fee rates and expense ratios of the at-issue Fund, other “peer funds” selected by third parties, and other funds advised or subadvised by the adviser.

The Court rejected plaintiffs' argument that more information should have been provided to the directors about differences in services provided to the at-issue Fund versus subadvised funds, pointing to the 15(c) book and director testimony and explaining that plaintiffs' argument was “ineffective” to frame a genuine disputed fact issue for trial in light of the disclosure of “significant differences” in services that were included in the board materials.

The Court also rejected plaintiffs' argument that a triable issue was created from an absence of changes in the fees during the relevant period or a lack of what plaintiffs styled as “assertive” negotiation between the board and adviser. The Court referenced that the directors “kept abreast of compensation trends in the industry” and previous reductions in advisory fees. The Court also ruled that plaintiffs' arguments that “the board could have negotiated more aggressively” do not provide a basis to conclude that the board's process was “less than robust.”

Plaintiffs' Identification of Lower Fees in Other Contexts Is Insufficient to Create a Triable Issue When Other Fees Are in Line with Those of the At-Issue Fund

The parties disputed the relative scope of services the adviser provided to the at-issue Fund versus the scope of services provided by defendant as subadviser. The Court acknowledged the dispute but concluded that even if plaintiffs had met their burden to show that the rates charged to the subadvised funds were an “apt” comparison, the plaintiffs had not adduced evidence to rebut that the rates the adviser charged other funds were inapt. As a result, because the standard under Jones looks to whether the fee at issue is outside the *range* of fees that could be negotiated at arm's length, merely pointing to some lower fees is insufficient.

The Court noted specifically the fact that the adviser also charged nearly identical rates to two other mutual fund complexes, which themselves had independent boards and previously chose to replace their former advisers with the defendant. Based on these findings, the Court found that plaintiffs did not present evidence to permit a rational trier of fact to exclude these funds' fees from the range that could be generated from an arm's-length transaction, and therefore, they provided "an uncontroverted apt comparison."

The Court Held that Plaintiffs Failed to Show That the Performance of the At-Issue Fund Supported Liability Under Section 36(b)

The Court considered the performance of the at-issue Fund as part of its "holistic analysis under Jones," noting that performance is not a separate Gartenberg factor and, in any event, cannot support a breach of fiduciary duty on its own. The parties presented conflicting evidence on the appropriate measure of performance. Drawing all reasonable inferences in the plaintiffs' favor, the Court accepted their proffer that there was some deviation from the benchmark. Even so, the Court concluded that periods of "below standard" performance do "not strongly favor liability," at least where (like in this case) the underperformance is not "particularly dramatic or unusual." Such an approach would impose upon courts a performance-based fee-setting role that is inconsistent with the statute.

Plaintiffs Failed to Show that Profits Were Disproportional to the Services Rendered

In considering the profitability factor, the Court again recognized that the ICA does not endorse judicial fee-setting and cost-plus billing. Instead, the question is whether the profits, when viewed alongside the other Gartenberg factors, "were out of proportion to the services rendered." The Court concluded that the plaintiffs failed to make a showing on this point. Plaintiffs' central argument, that the adviser could have still made a profit at lower fees, was insufficient to support a breach of fiduciary duty claim where the fees otherwise fell within the range paid by comparable funds. The Court explained that finding a Section 36(b) violation based on this type of evidence "would effectively amount to imposing a billing regime."

Plaintiffs Were Precluded from Using a General "Economics" Expert to Opine on a Number of Issues Central to Their Claim

The defendant moved to preclude the opinions of plaintiffs' expert, an economist and professor, on the grounds that he lacked the necessary qualifications to offer opinions regarding mutual fund operations and accounting, improperly opined on the ultimate legal standard, and failed to provide reliable support for his conclusions regarding mutual fund competition. The Court agreed with these arguments.

With respect to his qualifications, the Court concluded that plaintiffs failed to show how "general" expertise in economics would assist the trier of fact in comparing the services offered to the at-issue Fund versus subadvised funds. Indeed, the Court explained that the expert merely summarized plaintiffs' evidence, which is improper. His economics background similarly did not equip him to provide an accounting-based opinion regarding the potential profits of the adviser under subadvisory fee schedules.

Furthermore, because the expert "couched" his opinions on arm's-length negotiations "in terms of the ultimate legal standard" while also mirroring the legal analysis set forth in Jones, the Court precluded his testimony on the ultimate issue of whether the fees charged to the at-issue Fund were excessive. Lastly, the Court found that the expert did not sufficiently connect general research regarding certain investor behaviors to his conclusions concerning competition in the mutual fund industry, and it excluded this opinion as well.

CONCLUSION

As other cases continue to percolate in the lower courts and courts of appeals, this decision represents a positive result for investment advisers and mutual fund boards. It holds true to the assurance in Jones that not all Section

36(b) defendants will be "doom[ed] to trial." The Court's ruling also provides another reminder of the importance of an independent, well-informed board engaged in a robust advisory contract renewal process. Upon making this determination, the Court afforded deference to the board's business judgment in its review of the remaining Gartenberg factors.

The defendant was represented by K&L Gates LLP.

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[1] In re Davis New York Venture Fund Fee Litig., No. 14 CV 4318-LTS-HBP, 2019 WL 2896415 (S.D.N.Y. May 30, 2019).

[2] 15 U.S.C. § 80a-35(b).

[3] 559 U.S. 335, 346 (2010).

[4] Id. at 347.

[5] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 929–32 (2d Cir. 1982).

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