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ALERT

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Court Rejects Excessive Fee Claims Following Trial on Mutual Fund "Manager of Managers" Theory

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On August 25, a federal court in the District of New Jersey issued a much-anticipated decision, finding after a lengthy trial that shareholder plaintiffs failed to prove claims that AXA entities had charged excessive mutual fund management fees in violation of Section 36(b) of the 1940 Act. In the first case to proceed to trial since the U.S. Supreme Court established the legal standard for these claims in its landmark 2010 decision in *Jones v. Harris Associates L.P.*, the New Jersey trial court held in the defendants' favor on all claims relating to twelve mutual funds operating in a "manager of managers" structure. The plaintiffs' central theory of liability – mirrored in several other pending cases across the industry – is that AXA improperly retained a significant portion of the management fees despite delegating virtually all of the management responsibilities to external sub-advisers. Based on review of extensive documents and testimony, Judge Peter G. Sheridan rejected the premise of this theory, finding that there was ample evidence that AXA retained responsibility for a range of management services and bore significant risks in its role as fund sponsor and adviser.

The case of *Sivolella v. AXA Equitable Life Insurance Co.*, originally filed in 2011, was one of the earliest of the current wave of more than two dozen Section 36(b) cases filed since *Jones*. The funds at issue in the case all serve as investment vehicles underlying variable annuity products offered by AXA. The defendants initially moved to dismiss the claims, arguing that the plaintiffs did not have standing under Section 36(b) as "security holders" of the funds since they do not own the fund shares directly – but only owned units in the variable annuity separate accounts that, in turn, owned the funds. Judge Sheridan denied this motion in 2012, and the parties proceeded to discovery. After completion of discovery in 2014, AXA moved for summary judgment. The court denied this motion in 2015, ruling orally from the bench that there were disputed issues of fact regarding the respective services provided by the adviser and sub-advisers (among other issues) that required a trial. A 25-day bench trial before Judge Sheridan commenced on January 11, 2016, culminating in closing arguments on June 1.

Judge Sheridan's August 25 opinion spans over 150 pages, and is closely focused on the competing evidence offered by the parties at trial under the "*Gartenberg* factors" – the non-exhaustive list of factors that courts may consider in deciding Section 36(b) claims, first set forth by the Second Circuit Court of Appeals in *Gartenberg v. Merrill Lynch Asset Management, Inc.* in 1982. The decision gives relatively little attention to the actual standard of liability articulated in *Gartenberg* and later enshrined by the Supreme Court in *Jones*: that an adviser only violates Section 36(b) if it charges a fee that 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. Instead, the decision essentially treats the *Gartenberg*factors as though they are the standard, and also suggests – inconsistently with the language of Section 36(b) – that the fiduciary duties of the funds' independent trustees (rather than those of the adviser) were at issue in the trial.

On the central issue of the services respectively provided by AXA and its sub-advisers, the judge rejected the plaintiffs' effort to focus exclusively on the contractual language of the investment management and sub-advisory agreements. Although the court acknowledged that the "broad and vague" language in the "fairly boilerplate" agreements might suggest that most of the adviser's duties are delegated, "voluminous testimony of credible witnesses" demonstrated that the adviser, in fact, bears an array of significant responsibilities that are not delegated to the sub-advisers. The judge concluded it would elevate "form over substance" to look only at the contractual language. Instead, "the analysis must consider all duties, whether enumerated in a contract or undertaken in a manner to carry out the contractual duties." Similarly, the court found that, as sponsor of the funds, the adviser bears "a large amount of enterprise risk," including "litigation and reputational risks, operational and business risks, and the risk that [the adviser] and the Funds may have to pay the sub-advisers in the event of legal action." Such risks "would justify a portion of the fees charged to investors."

More generally, the court found AXA's fact witnesses and experts to be credible, while questioning the credibility of the plaintiff's proffered experts. The judge pointed, in particular, to the "credible and reliable" testimony provided by the funds' lead independent trustee, that the court described as "generally consistent, thorough, and accurate." By contrast, plaintiffs' expert Dr. Steven Pomerantz – a "professional expert witness" who has testified in several Section 36(b) cases – was heavily criticized in the opinion: the court gave "little weight to his testimony due to inconsistencies, oversimplifications, and his sarcastic demeanor." In considering the plaintiffs' various arguments under the *Gartenberg* factors, the court was unpersuaded by the plaintiffs' critiques of AXA's profitability methodology, concluding, for example, that allocating costs on the basis of revenue was consistent with accounting principles. The judge credited the defendants' evidence on economies of scale, demonstrating that both break-points and other cost-saving devices had been used to share economies with shareholders. Regarding the comparison of the funds' fees to those of other funds, the judge rejected the plaintiffs' attempt to discredit the reliability of the Lipper comparative data relied upon by the board and found the trustees' reference to comparative fees to be "reasonable." Regarding the makeup and actions of the fund board, the court held that its members were impartial, diverse and independent. While the judge appeared to give some credence to the plaintiffs' critique that the board chair was not independent, he also seemed comforted by the presence of an active "lead" independent trustee.

Given the fact-intensive nature of much of the court's findings and reasoning, it is unclear how significantly the *Sivolella* opinion will impact other Section 36(b) cases. The court's recognition of the fact that boilerplate language in industry-standard management and sub-advisory agreements does not tell the whole story about the services provided and responsibilities and risks borne by fund advisers should give other courts pause when assessing allegations in complaints that point to nothing more than the contract language. What is certain, however, is that this court's decision provides further confirmation that the stringent standard of Section 36(b) liability imposed by Congress in framing the 1940 Act and later embraced by the Supreme Court in *Jones* erects a high hurdle for plaintiffs attempting to impose liability for ostensibly "excessive" fees.

Ropes & Gray's litigators are actively involved in defending advisers in Section 36(b) litigation, and are closely monitoring developments in the case law. For further information, please contact John Donovan, Robert Skinner or Amy Roy.