The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 30624

March 7, 2017

District Judge Rules for Defense in Section 36(b) Case

[30624] March 7, 2017 TO: ICI Members
Investment Company Directors SUBJECTS: Fees and Expenses
Fund Governance
Investment Advisers
Litigation & Enforcement RE: District Judge Rules for Defense in Section 36(b) Case
On February 28, a federal judge ruled in favor of the defense in *Kasilag v. Hartford Inv. Fin. Svcs., LLC*,[1] the second section 36(b) "excessive fees" case to go to trial since the 2010 *Jones v. Harris* decision.[2] (The decision is attached.) The plaintiffs—shareholders of six funds—alleged that the fees retained by the defendants, after delegating advisory work to a sub-adviser, was excessive in relation to the work performed by the defendants. The judge found that the plaintiffs "have not carried their burden of proof" and that judgment in favor of the defendants "is therefore proper."[3]

The judge's opinion focused on the application of the *Gartenberg* factors to the specific facts of the case to determine "the fundamental inquiry"—that is, whether plaintiffs met their burden of establishing that the adviser's fee was "so disproportionate that it does not bear a reasonable relationship to the services the defendant rendered and could not have been negotiated at arm's-length."[4] The crux of the plaintiffs' argument was that the court should look only at the services provided by the defendant and the fees it retained after paying the sub-adviser when considering the *Gartenberg* factors. The judge rejected that approach, however, noting that the fund's advisory agreement with the defendant contemplated the use of a sub-adviser and queried: "[W]hat's the difference to the Funds if the [] Defendants perform the services directly or by way of a sub-adviser?"[5]

- *Independence and conscientiousness of the board*. Before trial, the judge held in a summary judgment opinion, that "the independent director's approval was entitled to substantial weight."[6] The judge noted that the "only factor not genuinely disputed was the independence and conscientiousness of the trustees."[7] The judge did not grant a full summary judgment at that time because of the presence of disputed facts with respect to other factors. Although the board's determination is entitled to "considerable" weight, the judge stated, it is not entitled to "conclusive" weight.[8]
- *Nature of the services.* The judge rejected the plaintiffs' contention that the court should not consider the services of the sub-adviser when evaluating the services rendered to the fund. Defendants put forth testimony that their services to the fund included helping establish a fund's strategy, selecting and monitoring sub-advisers, performing legal services, providing administrative services, and incurring entrepreneurial, reputational, and legal/compliance risks. The judge found that the

plaintiffs "have not carried the burden of showing that the nature of the services indicates the fees were so disproportionate that they could not have been negotiated at arm's length."[9] This is particularly so in light of the risks that were borne by defendants, the judge noted. More problematically, the judge stated, plaintiffs presented little or no evidence on the nature of the services provided by the sub-adviser, and absent evidence showing the nature of these services were suspect or inadequate, plaintiffs have not carried their burden.

- *Quality of the services.* For this factor, the judge considered the performance of each of the six funds. Five of the funds performed—at worst—in the middle of the pack while one of the funds performed below average during the relevant time periods. Thus, the judge determined that, for the five funds, the quality factor does not point in favor of a finding that the fees paid could not have been part of an arm's-length agreement, while for the poorer-performing fund, the factor tips "very mildly" in plaintiffs' favor.[10]
- *Profitability*. Consistent with the judge's ruling with respect to the nature of the services, the judge stated that the profitability consideration is inclusive of the sub-adviser's fees. The court noted that it is not a permissible approach under section 36(b) to argue that the adviser "just plain made too much money."[11] The judge rejected the "cost-plus" method asserted by plaintiffs, and used the methodology employed by the defendants, which treated the sub-adviser's fees as an expense of the adviser. The judge found that the plaintiffs "failed to meet their burden of establishing that the Funds were so profitable that their fee could not have been negotiated at arm's-length."[12]
- *Fall-out benefits*. The plaintiffs did not make any argument with regard to fall-out benefits and, thus, did not carry their burden with regard to this factor.
- *Economies of scale*. The plaintiffs also conceded that they did not address economies of scale at the trial.
- *Comparative fee structures*. The plaintiffs additionally made no effort to present evidence of comparative fee structures at trial and argued in their post-trial brief that this factor is relatively unimportant. The judge found that this factor weighed against a determination that the fees charged to the funds were excessive.

The judge stated that the plaintiffs' failure to present evidence with respect to certain of the *Gartenberg* factors did not "doom" them, because a plaintiff need not triumph with respect to each factor—or any particular factor—to demonstrate that a fee is improper under section 36(b). The judge determined that the select *Gartenberg* factors under consideration—the nature of the services, quality of the services, and defendants' profitability—do not suggest that the fee was so disproportionate that it could not have been negotiated at arm's-length. Thus, the judge declared that a judgment in favor of the defendants was proper.[13]

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Attachment

endnotes

[1] *Kasilag v. Hartford Inv. Fin. Svcs., LLC,* Civil Action No. 11-cv-1083 (RMB/KMW) (D.N.J) (Feb. 28, 2017 ("Opinion").

[2] The first case to go to trial since *Jones v. Harris Assoc. L.P.,* 559 U.S. 335 (2010), was *Sivolella et al. v. AXA Equitable Life Ins. Co., et al.,* Civil Action No. 11-cv-4194 (PGS)(DEA) (D.N.J) (Aug. 25, 2016), and it also resulted in a ruling for the defense. *See* Memorandum No. 30212 for a summary of that case. The plaintiffs have appealed that decision. In a third case that had been scheduled to go to trial, the parties have entered a stipulation of dismissal. *See In Re Russell Inv. Co. Shareholder Litigation*, Lead C.A. No. 1:13-cv-12631-WGY (D. Mass. Mar. 3, 2017) (Stipulation of Dismissal with Prejudice).

[3] Opinion at 70.

[4] *Id*. at 3.

[5] *Id.* at 53.

[6] *Id* at 5.

[7] *Id.* at 6, n. 3.

[8] *Id.* at 5 (quoting summary judgment opinion, which stated that while "the Board's process is entitled to substantial weight, disputed facts permeate the *Gartenberg* factors," and "a grant of summary judgment in favor either party would be improper").

[9] *Id.* at 59.

[10] *Id.* at 63.

[11] *Id.*

[12] *Id.* at 65.

[13] *Id.* at 70.
