NEWSFLASH / A legal update from Dechert

Federal Court Issues Trial Ruling in Section 36(b) "Manager of Managers" Lawsuit

AXA Investor Fees Held Not To Constitute a Breach of Fiduciary Duty

The U.S. District Court for the District of New Jersey issued its trial ruling on August 25, 2016 in *Sivolella v. AXA Equitable Life Insurance Company*—the first Section 36(b) trial decision since 2009. The Court concluded that plaintiffs failed to meet their burden to show that the defendants breached their fiduciary duty by charging excessive advisory and administrative fees to 12 AXA-sponsored mutual funds. The lengthy, 159-page opinion highlights the heavy burden plaintiffs face in Section 36(b) cases. It also serves as a reminder of the importance of witness expertise and credibility. Finally, as the first Section 36(b) case to go to trial following the Supreme Court's decision in *Jones v. Harris Associates, L.P.*,[1] and the first trial of the "manager of managers" theory of liability, the AXA case has the potential to influence a number of the pending mutual fund "excessive fee" cases around the country.

Section 36(b) of the Investment Company Act of 1940 imposes a fiduciary duty on the adviser to a mutual fund "with respect to the receipt of compensation," and gives mutual fund shareholders a private right of action to enforce that duty. The statute expressly assigns to any such plaintiff the burden of proof, and subsequent case law makes clear that a breach may be shown only where 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."[2] In *Jones*, the Supreme Court cited with approval the use of several commonly-considered factors set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc.*,[3] but emphasized the ultimate "arm's-length bargain" standard.

Prior to the AXA litigation, the Section 36(b) cases that had reached trial had challenged the role of a single investment adviser or administrator (*i.e.*, none had challenged the use of sub-advisers or sub-administrators to provide services to the funds it advised). AXA, however, uses a "manager of managers" model—as do many others in the industry—to engage sub-advisers or sub-administrators to provide certain advisory and administrative services to the funds, while AXA retains ultimate responsibility for such services, performs additional services, and bears attendant regulatory and entrepreneurial risks, among other things. Plaintiffs' challenge to AXA's fees was premised on the notion that AXA had delegated *all* of its responsibilities to the sub-advisers and sub-administrator, and therefore the portion of the fee retained by AXA was inherently unreasonable.

Following a 25-day bench trial, which itself followed extensive fact and expert testimony, the Court concluded that plaintiffs had failed to meet their burden of demonstrating that AXA's fees were excessive. Among the key takeaways from the Court's fact-intensive decision are the following:

- The burden that a Section 36(b) plaintiff faces to prove that a fee received by an investment adviser is excessive cannot be overstated. The Court repeatedly concluded that plaintiffs had failed to meet their

burden, whether on the ultimate liability question or on individual *Gartenberg* factors, as opposed to concluding that defendants had affirmatively demonstrated the reasonableness of the advisory and administrative fees.

- The Court rejected the plaintiffs' assertion that the Court was constrained to review only the services provided by AXA pursuant to the explicit terms of the contracts between AXA and the funds, instead finding that it was more appropriate to review the totality of the advisory and administrative services actually provided by AXA. The Court concluded that the services actually provided were broader than those enunciated in the advisory and administrative agreements.

- The Court rejected the plaintiffs' contention that treating the fees paid to sub-advisers and sub-administrators as expenses to the adviser for purposes of calculating the adviser's profitability in managing the funds was improper, instead crediting the opinion of AXA's expert that such treatment is consistent with ordinary accounting principles.

- The Court found that the plaintiffs' expert witnesses on the whole were not credible, both because of shortcomings in the experts' reports as well as deficiencies and critical inconsistencies in their trial testimony. In contrast, the Court found the defendants' expert witnesses to be credible and their opinions to be reliable.

- The Court also credited the conscientiousness exercised by the funds' Board of Trustees in the 15(c) review and approval of the relevant advisory and administrative agreements. However, the Court did note (in dicta) that the Board apparently made certain enhancements to its governance structure and processes, including its 15(c) process, as a consequence of the filing of the lawsuit against AXA.

An upcoming *Dechert OnPoint* will provide further analysis of the district court's ruling in the AXA case, as well as the potential impact for funds and their boards.

Footnotes

1) 559 U.S. 335 (2010).

2) *Jones*, 559 U.S. at 346.

3) 694 F.2d 923 (2d Cir. 1982).

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