10-4-2013

New Wave of Cases Involving Investment Adviser Fees

Francis J. Facciolo
St. John's University School of Law

Leland Solon

New Wave of Cases Involving Investment Adviser Fees

Francis J. Facciolo and Leland Solon

Shareholders challenging fees paid to the advisers of their mutual funds in civil lawsuits under §36(b) of the Investment Company Act face steep substantive and procedural challenges, but a recent decision from the federal district of New Jersey holds promise for private plaintiffs in this area. The central allegation in Kasilag v. Hartford Investment Financial Services[1] was that the defendant investment adviser retained sub-advisers to perform substantially all of the investment management services for the defendant's client mutual funds, and then charged its fund clients much higher investment management fees than what those services actually cost defendant. Based on these allegations, the federal district court denied the investment manager's Rule 12(b)(6) motion to dismiss and allowed the shareholders' lawsuits to proceed.

The victory for the plaintiffs in Kasilag stands in contrast to the defeats of many other prior plaintiff shareholders who could not present convincing evidence that the challenged advisory fees were excessive. Forced to rely on speculative arguments as to what discovery would reveal, these plaintiffs often were unable to survive the crucial pretrial motion to dismiss stage, and, even if they did get past this stage, inevitably lost at either the summary judgment stage or trial. By highlighting the role of the sub-advisers, the plaintiffs in Kasilag were uniquely able to make a plausible showing that the defendant's investment management fees were excessive under the circumstances.

A prior recent case, Curran v. Principal Management, also involved similar but less detailed sub-adviser allegations than Kasilag. Reportedly settled in May 2013, Curran resulted in a 2010 court decision[2] denying defendants' Rule 12(b)(6) motion to dismiss, a decision in which the judge even remarked that the plaintiff shareholders would probably be able to get past a motion for summary judgment.

Standards Over Time

The use of sub-advisers is becoming increasingly widespread in the investment management industry. While approximately 25 percent of funds employed a sub-adviser to manage at least a portion of the fund's portfolio in 2000, that figure had grown to nearly 40 percent by 2010. Although there have been no published court decisions[3] featuring sub-adviser allegations in the §36(b) context until Kasilag and Curran, we can expect more such cases in the future.

---

[1] 2012 WL 6568409 (D. N.J. Dec. 17, 2012).

[2] 2010 WL 2889752 (S.D. Iowa June 8, 2010).

[3] Prior to Kasilag, HIFSCO was the defendant in an action brought by different shareholders who also argued that HIFSCO's fees were excessive in light of their sub-advisory contracts: Southworth v. HIFSCO, No.1:10-cv-00878-RMB (D. Del.). Commenced in the District Court of Delaware in 2010, the Southworth plaintiffs withdrew their action "with prejudice" in November 2011.

For decades, the authoritative court decision interpreting §36(b) and its fiduciary duty provision was Gartenberg v. Merrill Lynch Asset Management.[4] Decided by the Second Circuit in 1982, Gartenberg established the oft-cited precedent that, in order to impose liability on an adviser-manager under §36(b), the plaintiff must show that the fee "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." Gartenberg stressed that all pertinent facts are to be weighed, and set forth a number of factors to be considered by a court in reviewing fees. The Gartenberg analysis, which has become a fixture of subsequent §36(b) decisions, includes consideration of the "nature and quality" of the services provided, the "rates charged" by other advisers, the adviser's "cost," the adviser's "economies of scale," and the conduct of the investment company's board of directors.

By rejecting a "reasonableness" standard for whether an adviser breached its §36(b) fiduciary duties, as urged by the plaintiffs, and instead adopting a standard that a fee is impermissible only if it is "so disproportionately large that it ... could not have been the product of arm's-length bargaining," Gartenberg erected a barrier that has proven virtually impossible to surmount. According to one article, in seven §36(b) cases that had been tried to final judgment by 2010, not a single plaintiff was able to prove that the challenged fees were excessive,[5] although many cases do settle.[6] Proving a violation of §36(b) presents many challenges. Comparisons between the fees charged by investment advisers to funds are usually not "apples to apples": Some provide services that others do not, and different funds have different clients, who may need different services. Moreover, if (as some suspect), the entire investment management industry charges exorbitant fees, there is nothing to be shown by comparisons between advisers.

After a divided 2008 Seventh Circuit panel rejected Gartenberg and ruled that a fiduciary "must make full disclosure and play no tricks but is not subject to a cap on compensation," the Supreme Court in Jones v. Harris Associates[7] reversed and expressly approved Gartenberg's "so disproportionately large" standard and factor analysis. Although the court concluded that Gartenberg was correct, some believe that Jones creates a change in §36(b) cases going forward. Whether that is true remains to be seen, but, if there is any shift, it may be due to the court's comments regarding the investment company's board of directors. According to Jones, when the board's review process was "robust," "commensurate deference to the outcome of the bargaining process" should be afforded, but where the review was "deficient or the adviser withheld important information," the court must take "a more rigorous look" at the fee. In so urging, the court seemed to be applying a variation of the business judgment rule to the Gartenberg analysis, incorporating all the deference to informed board of directors' decisions that comes along with the business judgment rule but placing a particular emphasis on the thoroughness and transparency of the board's process.

[4] 694 F.2d 923 (2d Cir. 1982).
[5] "The SEC's Mutual Fund Fee Initiative: What to Expect," 17 No. 1 WJDER 1.
[6] "The Downside of Judicial Restraint: The (Non-)Effect of Jones v. Harris," 6 Duke J. Const. L. & Pub. Pol'y 58 (reporting "the vast majority of 36(b) cases settle").
[7] 559 U.S. 335, 130 S.Ct. 1418 (2010).

‘Kasilag’

The arguments on the Kasilag defendant’s motion to dismiss occurred post-Jones. The plaintiffs were shareholders in six mutual funds advised by Hartford Investment Financial Services, LLC (HIFSCO). The crux of the plaintiffs’ complaint, which had previously been dismissed in part twice with leave to replead, alleged that HIFSCO paid sub-advisers to perform “substantially all’ of the investment management services that it provides to the Funds at a fraction of the fee” that HIFSCO charged the funds in which the plaintiffs were shareholders. According to the complaint, the management fees HIFSCO charged the Funds are, on average, three and sometimes more than five times “the amount HIFSCO pays its sub- advisors for substantially the same services.” In the year 2010 alone, plaintiffs alleged, this amounted to a profit to HIFSCO of nearly $100 million merely for “overseeing” the sub-advisers and administrative services (for which HIFSCO charged plaintiffs a separate fee).

In denying defendant’s motion to dismiss the excessive fee claim, the Kasilag court evaluated the plaintiffs’ allegations against each of the Gartenberg factors, with the first factor, “Nature and Quality of Services,” being most important. The court stated that the information provided by the plaintiffs in the complaint, which included a comparison of the language in the contracts between HIFSCO and the sub- advisers with the language in the Investment Management Agreements between HIFSCO and the funds, indicated that these contracts were for “essentially the same investment management services,” namely “making investment decisions” and deciding “when to purchase or sell securities.” While HIFSCO countered that it did not delegate “extensive administrative and investment management services” to the sub-advisers, the court rejected these as “merits” arguments which were not appropriate on a Rule 12(b)(6) motion.

After its discussion of the first factor, the court continued its Gartenberg analysis over several pages, discussing several in detail and finding that many weighed in the plaintiffs’ favor. The role of the sub- advisers was the critical point, however, with the court’s opinion even suggesting that the plaintiffs’ allegations regarding the sub-adviser spreads were, by themselves, sufficient to state a claim under §36(b). Concluding its discussion of only the first, and before discussing four other Gartenberg factors, the court held that, “[a]ssuming, as Plaintiffs have alleged, that HIFSCO charged the Funds an average of three times what it cost to provide its investment management services, Plaintiffs have raised a plausible inference that HIFSCO’s fees are excessive under §36(b).”

In addition to playing a key role in the “Nature and Quality of Services” Gartenberg factor, the allegations regarding the sub-advisers in Kasilag were also significant in the court’s evaluation of the other Gartenberg factors. At the heart of the second factor discussed by the court, “Comparative Fee Structures,” was the plaintiffs’ argument that HIFSCO’s fees were excessive compared to competitor Vanguard. Historically, courts have rejected arguments that a defendant’s fee was excessive compared to Vanguard, recognizing Vanguard as a unique, low-cost option in the industry. Going beyond the usually futile argument that the defendant’s fees were excessive merely because Vanguard’s were cheaper, the Kasilag plaintiffs focused on the fact that HIFSCO and Vanguard retained the same sub-adviser to provide similar services for one of their respective funds. Vanguard, the court observed, appeared to pass the sub- adviser's fees on to shareholders near cost, while HIFSCO, according to the complaint, apparently padded its investment and management fee more than 50 basis points for minimal oversight and administrative services. In light of these allegations, the court deemed the Vanguard comparison more apt than in the typical case, and entitled to some weight.

The court also found the "economies of scale" Gartenberg factor weighed in the plaintiffs' favor, also on the strength of Kasilag's unique sub-adviser allegations. Other plaintiffs have argued that defendants do not pass on economies of scale–financial benefits that accrue to the adviser when funds grow but the cost of servicing them remains relatively stable–to shareholders, spacing fee reduction "breakpoints" so far apart that they are barely ever reached, and, in the event that they are, providing only a minimal fee decrease to shareholders. The Kasilag plaintiffs went further: they showed that, while HIFSCO offered only unattainable and immaterial breakpoint fee reductions to plaintiffs, HIFSCO had negotiated contracts "at arm's length" with its sub-advisers for breakpoints that the court characterized as being "much more competitive" and beneficial to HIFSCO, thereby bolstering plaintiffs' argument that HIFSCO's non-arm's length fees with plaintiffs' funds were excessive.

Cases and Reasoning

In its ruling, Kasilag cited another §36(b) decision from an Iowa district court, Curran v. Principal Management. The plaintiffs in Curran, also a post-Jones case, were shareholders in a mutual fund of funds that only invested in other mutual funds in the same family as the defendant investment adviser. Similar to the plaintiffs in Kasilag, the shareholders in Curran also alleged that their funds' investment adviser contracted with sub-advisers to provide "the bulk of investment advice" but charged plaintiffs several times more than what those services actually cost. In denying the defendants' motion to dismiss, the Curran court did not go into as much detail as Kasilag. It held, however, that the totality of plaintiffs' allegations, including that the adviser charged more than the sub-advisers who allegedly provided the bulk of investment advice and did not pass on benefits from economies of scale, and that other institutional clients paid less for the same services, all "more than adequately" stated a claim under §36(b).

Judge Renee Marie Bumb's Kasilag ruling essentially credited the plaintiffs' allegations that the investment management services subcontracted out were the most important and costly to provide, and that the additional services that defendant claimed to provide were, if not negligible, not enough to warrant their price and foreclose judicial scrutiny. In this manner, the Kasilag plaintiffs were able to provide the court with specific facts to support their claim that their excessive fee claim had merit–not an insignificant accomplishment given the high substantive hurdle §36(b) claimants face, and the "plausibility" Rule 12(b)(6) motion to dismiss standard imposed by the Supreme Court in recent years.

The court's comments in Jones regarding the board of directors process was not lost on the defendants in Kasilag or Curran, and both pointed to information regarding their respective board's process in support of their motion to dismiss. In their briefs, the Kasilag defendants claimed that their board undertook a "robust" process in approving the agreement, but the court did not mention these assertions in its decision.

The defendants in Curran pointed to publicly available SEC documents that they claimed specifically outlined the steps the directors took in approving the fees at issue, but the court refused to dismiss on this basis, ruling that the defendants' arguments warranted "a factual inquiry that would be inappropriate in the context of a Rule 12(b) (6) motion."

To the extent that Jones might have changed the 36(b) analysis to afford directors more deference based upon the board's process, it was not helpful at the motion to dismiss stage to either the Kasilag or Curran defendants. If anything, the sub-adviser allegations−which in Kasilag included HIFSCO charging the funds three to five times more for investment management services than what the sub-advisers charged HIFSCO−appear to override anything that the board could have done, i.e., no rational board could approve such an arrangement. Indeed, the Kasilag court cited the sub-adviser spread in its discussion of the "Conscientiousness of the Board" Gartenberg factor, and ultimately found that this factor weighed in plaintiffs' favor because this circumstance, among others, suggested that the board "may not have adequately considered important facts."

Looking Ahead

Given the tendency for plaintiffs' securities class action lawyers to imitate causes of action brought by other plaintiffs' lawyers, we can expect to see more cases involving sub-adviser fees, future cases for which Kasilag will be an important precedent. Ultimately, the resolution of Kasilag may hinge on what additional services HIFSCO provided to plaintiffs' funds, and whether they were enough to justify the enormous disparity between what the sub-advisers−who presumably already built a profit into their investment management rates−charged HIFSCO, and what HIFSCO charged the plaintiffs. Subsequent rulings in Kasilag, including any on the merits, will be ones to watch.[8]

FRANCIS J. FACCIOLO is a professor of legal writing and assistant director of the Securities Arbitration Clinic at St. John's University School of Law. LELAND S. SOLON, an associate at the Law Firm of Gary N. Weintraub, contributed to this article.

[8] The attorneys representing the Kasilag plaintiffs have two other actions pending in the District Court of New Jersey involving sub-adviser allegations, both against the AXA financial group. Sivolella v. AXA Equitable Life Ins., Case 3:11-cv-04194-PGSDEA (filed July 21, 2011); Sanford v. AXA Equitable Funds Management Group, Case 3:13-cv-00312-PGS-DEA (filed Jan. 15, 2013).