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Chapman Client Alert

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Court Finds Plaintiffs Failed to Demonstrate Breach of Fiduciary Duty in Excessive Fee Litigation for "Manager-of-Managers" Mutual Fund Complex

On August 25, 2016, after approximately five years of litigation concluding with a 25-day bench trial, Judge Peter G. Sheridan issued the opinion of the U.S. District Court for the District of New Jersey in Sivolella v. AXA Equitable Life Ins. Co. (the *"AXA Litigation"*). Plaintiffs alleged that the Board of Trustees (the *"Board"*) of EQ Advisors Trust, a mutual fund complex, breached its fiduciary duty under Section 36(b) of the Investment Company Act of 1940, as amended (the *"1940 Act"*), by approving service contracts that charged excessive management and administrative fees to twelve funds advised by AXA Equitable Funds Management Group, LLC (*"FMG"*). FMG utilized a manager-of-managers structure in which FMG delegated certain of its investment advisory and/or administrative duties to sub-advisers or sub-administrators. Plaintiffs alleged that FMG charged investors exorbitant fees for mutual fund investment and administrative duties and then delegated those same duties to the sub-advisers and sub-administrators for nominal fees. In his 159-page opinion, Judge Sheridan weighed, among other things, the evidence, the credibility of witness testimony (including expert witness testimony), and the legal standard and factors considered in assessing a breach of fiduciary duty under Section 36(b) of the 1940 Act. Ultimately, the Court found that plaintiffs failed to meet their burden in demonstrating a breach of fiduciary duty in violation of Section 36(b).

As the first trial of a "manager-of-managers" theory of liability for breach of fiduciary duty, and perhaps the most closely watched Section 36(b) case since the U.S. Supreme Court's decision in *Jones v. Harris, L.P.*, 559 U.S. 335 (2010), the AXA Litigation may have important ramifications for both the processes employed by boards of fund complexes as well as, more generally, future litigation over excessive fees. However, the Court's intense focus on the particular facts of the AXA Litigation may limit the applicability of its lessons. Indeed, in various parts, the decision reads as a repudiation of unprepared litigants and their experts generally as much as an analysis of Section 36(b) issues specifically.

Fiduciary Duty under Section 36(b) of the 1940 Act

Section 36(b) of the 1940 Act imposes a fiduciary duty on investment advisers with respect to the receipt of compensation for services and provides shareholders with a private right of action to enforce this obligation by seeking judicial review of fees charged by investment advisers under a breach of fiduciary duty standard. Plaintiffs have the burden of proving a breach of fiduciary duty under Section 36(b). The *Jones* decision confirmed the legal standard set forth in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982) for determining whether a breach has occurred. More specifically, the *Jones* and *Gartenberg* decisions taught that a Section 36(b) 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."[1] In *Jones*, the U.S. Supreme Court incorporated the factors articulated in *Gartenberg* for determining whether a breach had occurred. These so-called *Gartenberg* factors include the nature and quality of the services provided by the adviser to the shareholders, the profitability of the mutual fund to the adviser, the economies of scale achieved by the fund and whether such savings are passed on to the shareholders, and the independence of the fund's board.

The "Manager-of-Managers" Structure

In a "manager-of-managers" structure, the sponsor of a fund complex delegates certain investment advisory or administrative responsibilities to sub-advisers or sub-administrators. The sponsor generally retains ultimate responsibility for managing any such third-party sub-adviser or sub-administrator, performs supervisory functions, and

1 *Jones*, 559 U.S. at 346.

continues to be responsible for the ongoing regulatory and business risks associated with sponsoring a fund complex. A sponsor may be inclined to employ such a structure in order to access particular investment advisory expertise or otherwise obtain expert assistance from specialized service providers.

The AXA Litigation was the first case to consider the manager-of-managers structure in assessing a breach of fiduciary duty under Section 36(b) of the 1940 Act.

Key Points from the AXA Litigation

In the AXA Litigation, plaintiffs alleged that FMG's fees were excessive because FMG delegated virtually *all* of its duties to sub-advisers and sub-administrators and retained a disproportionate amount of the total fees paid by the AXA fund complex. However, in his opinion, Judge Sheridan—citing *Jones*—identified the Board's decision-making process, rather than the result of such process, as the key to determining whether a breach of fiduciary duty occurred: "When a court is reviewing investment adviser fees, it should not hone in on the amount of the fees, but focus on whether the Board or the adviser fulfilled their fiduciary duties by acting in a manner consistent with their independent judgment." Ultimately, plaintiffs failed to meet their burden in demonstrating a breach of fiduciary duty in violation of Section 36(b) of the 1940 Act.

High Burden for Proving Breach

The AXA Litigation highlighted the extensive burden faced by plaintiffs in proving a breach of fiduciary duty under Section 36(b), especially because the focus is on the process used to approve fee arrangements rather than the aggregate amounts of such fees. The Court repeatedly found that plaintiffs failed to meet their burden under Section 36(b). On the other hand, the Court did not need to conclude (and did not conclude) that defendants affirmatively demonstrated the reasonableness of either the investment advisory or administrative fees at issue.

Importance of Plaintiff Presence and Expert Credibility

While only one plaintiff testified at or attended the trial, the President and Chief Executive Officer of FMG (who also served as Chair of the Board) attended nearly all twenty-five days of its duration. The Court noted that "this juxtaposition between the parties' respective attendance demonstrates that Plaintiffs may not have had a significant issue at stake." Further undermining plaintiffs' case, the Court overwhelmingly found their experts to lack credibility. For example, plaintiffs' governance expert admitted to his limited review of relevant materials, arguing: "I'm a pretty good skimmer." In addition, the Court noted that while plaintiffs' expert for purposes of discussing various fee calculations holds a Doctorate in Mathematics from the "renowned" institution of the University of California, Berkeley, such expert made errors in his calculations "that would result in FMG returning more money than it received." While such expert acknowledged that he "would have to check the calculations that [he] did" since "it would appear that there's something wrong," the Court nonetheless concluded: "[T]he mathematical error showed a lack of proper prior preparation on a critical point in this case. It undermines his credibility on all issues."

Defendants' experts, on the other hand, generally demonstrated proper preparation and offered reasonable conclusions in the view of the Court. Most notably, the Court cited with approval on multiple occasions the experience and thorough preparation of the Board's lead independent trustee in assessing his credibility. Although not an expert witness, the Court noted that the lead independent trustee had practiced law for 22 years, had led the group at a major law firm that represented mutual funds, independent directors, and investment advisers, and generally provided credible testimony in refutation of plaintiffs' experts.

Expansive View of Contractual Terms

The Court rejected plaintiffs' assertion that analysis of the delegation of investment advisory and administrative services under the "manager-of-managers" structure should be constrained to the plain language of the governing contracts. Instead, the Court looked to the totality of services provided and the actual roles played by FMG, AXA Equitable Insurance Company *("AXA")*, and the third-party sub-advisers and sub-administrators because "the analysis must consider all duties, whether enumerated in a contract or undertaken in a manner to carry out the contractual duties." The Court noted that "trial testimony demonstrated that both FMG and AXA perform a number of services beyond those expressly outlined in the agreements," and therefore concluded that "to adopt Plaintiffs' position would ignore voluminous testimony of credible witnesses." Indeed, the Court found that FMG performed "significant administrative and investment management duties," played an "extensive" role in managing sub-advisers and sub-administrators, and provided the Board with compiled, organized information upon which the Board relied to discharge its fiduciary duty under the 1940 Act.

Independence of the Board

The Court rejected plaintiffs' assertion that the Board did not act with impartiality, diversity, care, and conscientiousness. While the President and Chief Executive Officer of FMG also served as Chair of the Board, the Board had a lead

independent trustee, and none of the eight other Board trustees was employed by FMG or AXA. Although the eight independent trustees came largely from backgrounds in the financial services industry, the Court ultimately found the Board's makeup to be sufficiently diverse and independent. Further, the Board retained independent counsel and accounting services to assist in its duties, held regular two-day meetings that occurred five times per year and participated in various telephonic meetings as needed. With attendance of such meetings at approximately 100%, the Court found that the procedures the Board followed demonstrated that it "robustly reviewed" the contracts and fees put in place under the "manager-of-managers" structure.

Fund Performance

In addition to the *Gartenberg* factors, the Court considered the performance of each of the twelve funds—even as the Court noted that courts have generally been "wary" with respect to "attaching too much significance" to fund performance in determining whether an investment adviser's fee was excessive. However, plaintiffs failed to meet their burden to demonstrate the funds performed poorly, as the Court found that credible testimony established that "the vast majority of the [AXA funds at issue] performed at or above expectations."

Benefits of the AXA Litigation

The Court noted that although the substance of the AXA Litigation "showed little proof" in demonstrating that a breach of fiduciary duty in violation of Section 36(b) of the 1940 Act had occurred, the filing of the lawsuit actually "brought about positive changes to the Board's composition and process." Namely, after the filing of the AXA Litigation, the Board showed heightened focus on managing its expenses, the materials provided for the Board's meetings improved in both volume and substance, and the Board's most experienced independent trustee was elevated to the position of lead independent trustee.

Accounting Treatment of Sub-Advisory Fees

In an analysis of various fee calculations, Judge Sheridan was persuaded that sub-advisory and sub-administrative fees were appropriately categorized as expenses rather than reductions in revenue, which is useful guidance with respect to the calculation of profit margins.

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