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Section 36(b) Plaintiffs' 'Retained Fee' Theory Rejected in *Kasilag* Verdict for Defendants

Echoing last year's opinion in *Sivolella,*[1] finding no liability for allegedly excessive fees charged by Axa advisers to mutual fund investors (see September 2016 *Fund Alert,* http://www.stradley.com/insights/publications/2016/09/fund-alert-september-2016), the District of New Jersey again ruled in favor of adviser defendants, this time Hartford Investment Financial Services LLC and Hartford Funds Management Company LLP ("Hartford").[2] After a four-day bench trial, the *Kasilag* court rejected plaintiffs' "retained fee" theory and found no breach of fiduciary duty under Section 36(b)[3] for investment advisory fees charged in relation to services rendered to six Hartford mutual funds. Continuing to reinforce the "high bar" of Section 36(b), *Kasilag* joins the unbroken line of fully-tried 36(b) cases resulting in judgments in favor of investment advisers who delegate a portion of mutual fund duties to subadvisers.

The backdrop of *Kasilag* is similar to many other 36(b) cases: The plaintiffs claimed that Hartford's fees were disproportionate and excessive relative to the duties directly performed by Hartford under the investment management agreements ("IMAs") between Hartford and the funds as compared to the duties delegated to and performed by subadvisers. Before trial, the Court determined that approval of the advisers' fees by the undisputedly independent trustees of the funds' boards warranted considerable weight under *Jones v. Harris Associates*.[4] Thus, the Court intended for the trial to focus on the remaining *Gartenberg*[5] factors: (1) the nature and quality of services provided by the adviser, (2) the profitability of the mutual fund to the adviser, (3) "fall out" benefits, (4) the economies of scale realized by the adviser, and (5) comparative fee structures of similar funds. Notably, at trial, the plaintiffs never challenged factors 3 through 5. Still, the Court considered all of these factors to analyze the ultimate guidepost of liability under 36(b): whether the investment adviser's fee is so disproportionate that it does not bear a reasonable relationship to the services rendered by defendant and could not have been negotiated at arm's length. In ruling for Hartford, the Court applied the established standard set by Section 36(b), which "raises the bar for Plaintiffs" by shifting the burden of proof from the defendant fiduciary to the party claiming breach.

Kasilag is significant for rejecting the "retained fee" theory, the "crux of Plaintiffs' case." Specifically, plaintiffs argued that the Court should consider the services performed by the adviser as separate and apart from those performed by subadvisers. The Court found that the theory ignored the practical realities of how and why advisers hire and pay subadvisers, crediting Hartford in its explanations of the role and risks it faced under the IMAs and the contractual delegation of certain duties to subadvisers as specifically contemplated under the funds' IMAs. Moreover, the Court found that Hartford paid the subadvisers from Hartford's assets (not fund assets) and therefore properly treated those payments as expenses to the adviser, consistent with generally accepted accounting principles. Accordingly, the Court considered <u>all</u> services provided under the IMAs in exchange for the fees paid to Hartford, whether Hartford performed the services or hired others to fulfill those obligations. This ruling reinforces the argument that the comparison of profit margins of an adviser versus those of a subadviser is irrelevant.

Other rulings by the Court vindicated industry data on performance and rejected plaintiffs' unsupported measures of profitability. Over plaintiffs' strong objections, the Court found that Lipper performance data was reliable and admissible to assess funds' performance, both directly for peer comparison and as used by Hartford's expert. The Court rebuffed plaintiffs' suggested comparison of fund performance against its respective benchmark, explaining that failure to hit a benchmark is not a strong indicator of poor performance because benchmarks, unlike funds, do not have to account for operating costs. The Court also summarily denied plaintiffs' profitability model because it advocated a cost-plus approach, emphasizing that 36(b) has never required a cost-plus method of analyzing adviser profits, and reiterating the long-standing view that a 36(b) claim cannot be premised on the argument that the adviser "just plain made too much money."

For investment advisers, *Kasilag* reinforces the argument that fiduciary duties under Section 36(b) are more circumscribed and particularized than those under common law. Section 36(b)'s fiduciary obligation can thus be deemed to attach to all compensation approved and paid for services provided under a fund's IMA, whether performed by the adviser or subcontracted to another. Accordingly, with the rejection of the "retained fee" theory, there are strong arguments that a 36(b) analysis should continue to be guided by all of the *Gartenberg* factors, evaluating all of the services rendered and the total amount of fees paid, rather than on a piecemeal basis. Relatedly, *Kasilag* affirms that a sound 15(c) process undertaken by a disinterested board should carry significant weight when analyzing fees for 36(b) purposes.

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[1] *Sivolella v. AXA Equitable Life Insurance Company,* Civil Action No. 11-cv-4194 (PGS)(DEA), 2016 WL 4487857 (D.N.J. Aug. 25, 2016)

[2] *Kasilag v. Hartford Investment Financial Services, LLC*, Civil Action No. 11-cv-1083 (RMB/KMW), ECF No. 262 (D.N.J. Feb. 28, 2017).

[3] Section 36(b) of the Investment Company Act of 1940 provides that the investment adviser of a registered fund has a fiduciary duty with respect to the receipt of compensation for services, and provides shareholders with a derivative right of action against a fund adviser that receives excessive compensation.

[4] *Jones v. Harris Associates, L.P.*, 559 U.S. 335 (2010).

[5] *Gartenberg v. Merrill Lynch Asset Management Inc.*, 694 F.2d 923 (2d Cir. 1982).

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