Trio of 36(b) rulings a blow to post-Jones legal theories

Three recent decisions give new depth to pending, future excessive fee cases

--By Keith Dutill, partner, Stradley Ronon

Nearly 50 years have passed since Congress amended the Investment Company Act of 1940 to add Section 36(b) and confer on fund shareholders an express right to sue investment advisers for charging allegedly excessive fees. During that time, more than 100 excessive fee cases have been brought against advisers. While many of those cases have settled, some have progressed through the courts to judgment, where adviser defendants have prevailed without exception. Nine cases have advanced through a full trial on the merits, and advisers have won them all.

Despite this record, plaintiffs have continued to file new 36(b) cases. Since 2010, when the Supreme Court handed down its landmark 36(b) decision in *Jones v. Harris,* 28 new excessive fee cases have been filed. While there may be no historical basis to believe that the number or frequency of 36(b) cases will change moving forward, a trio of very recent rulings from district courts across the country give new depth to the 36(b) landscape for both pending and future excessive fee cases.

In a span of less than thirty days in early 2018, three different courts issued significant decisions in 36(b) cases. First, on Feb. 14, the US District Court for the Southern District of New York granted JPMorgan's motion to dismiss in *Pirundini v. JPMorgan Investment Management.* To prevail on a motion to dismiss, a defendant is required to demonstrate that even if all of the facts pled in the complaint are true and the plaintiff is given the benefit of every reasonable inference from those alleged facts, the complaint is insufficient to state a claim under the law. Because of this standard, courts have been reluctant to dismiss 36(b) cases at this preliminary stage of the litigation. Indeed, *Pirundini* is only the second case dismissed at this preliminary stage since *Jones* was decided in 2010.

Perhaps more importantly, the *Pirundini* court carefully applied the *Jones* standard in conjunction with the federal pleading standard established by a pair of Supreme Court decisions known as *Iqbal* and *Twombly*. Those cases held that in order to survive a motion to dismiss, a plaintiff must plead a claim that has facial plausibility that would allow the court to "draw the reasonable inference that the defendant is liable for the misconduct alleged." The court then applied this facial plausibility pleading standard in combination with the standard for liability under Section 36(b) established in *Jones v. Harris*, which requires a plaintiff to show that an "investment adviser [has charged] a fee that 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." Examining the facts as alleged against these two legal standards in combination, the court found the complaint insufficient and dismissed the claims.

Pirundini is significant for at least one other reason. The plaintiff in *Pirundini* advanced the sub-advised funds theory of liability under 36(b), contending that the fees charged by the adviser were excessive because they were substantially higher than the fees charged by the adviser when acting as a sub-adviser to outside funds. The sub-advised funds theory is one of the two primary theories relied on by plaintiffs in the post-*Jones* era. The court's dismissal of the case at the motion to dismiss stage will provide courts considering the same theory of liability in both pending and future cases with a fresh outline for summary dismissal.

The second major 36(b) decision was issued on March 9 by the US District Court for the Southern District of Ohio. In *Goodman v. JPMorgan Investment Management*, the plaintiff shareholders again argued the sub-advised funds theory, contending that the arms-length bargaining range described in *Jones v. Harris* was "unequivocally established" by the fees that the adviser charged sub-advised funds and that no further analysis was necessary. Unlike *Pirundini,* the *Goodman* case progressed through both fact discovery and expert discovery and was decided at the summary judgment stage. To prevail on summary judgment, a defendant is required to prove that there is "no genuine issue of material fact," and that the defendant is "entitled to judgment as a matter of law." The *Goodman* court found that JPMorgan met this standard, marking the first time a 36(b) defendant has prevailed at the summary judgment stage since *Jones* was decided in 2010.

Goodman has significant implications for future 36(b) litigation for other reasons as well. Most notably, in rejecting the sub-advised funds comparison, the court in *Goodman* relied on the Supreme Court's instruction in *Jones* that "if the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison." In the most thorough treatment to date of the sub-advised funds theory, the *Goodman* court focused on the differential in scale of services as well as the distinct risks associated with the roles of adviser and sub-adviser. With respect to services, the court highlighted both fact and expert testimony regarding the scale and scope of services rendered by the adviser, including compliance and shareholder services not provided by sub-advisers. Regarding the substantial additional risks assumed by advisers, the court cited at length from a report of JPMorgan's expert. Specifically, the court described the liquidity risks, business risks, operational risks, pricing risks, litigation risks, regulatory risks, and reputational risks that advisers confront that are vastly different in both type and magnitude from the risks faced by sub-advisers. The *Goodman* court's detailed and careful analysis of the relative risks assumed by advisers and sub-advisers goes well beyond any prior consideration of this issue by courts and should provide a useful roadmap in the remaining cases where plaintiffs advance the same sub-advised funds theory.

Just four days later, the US District Court for the Northern District of Illinois granted summary judgment to **Harbor Capital** in a 36(b) case rejecting the second, equally prominent theory advanced by recent 36(b) plaintiffs. In *Zehrer v. Harbor Capital Advisors*, the court confronted the so-called manager-of-managers theory, wherein the plaintiff contends that the advisory fees are excessive in light of the adviser's delegation of investment decisions to a sub-adviser. The court began with a review of the standard established in *Jones v. Harris*, summarized by the Seventh Circuit on remand: "The Supreme Court's approach does not allow a Court to assess the fairness or reasonableness of adviser's fees; the goal is to identify the outer balance of arms-length bargaining and not engage in rate regulation." The

court then reviewed carefully the facts respecting the 15(c) process of the board, finding that plaintiff's challenge to the board process constituted "armchair quarterbacking and captious nit-picking."

The *Harbor Capital* court then specifically addressed the manager-of-managers theory at the heart of plaintiff's case. Plaintiff's principal contention was that only those advisory services directly performed by Harbor Capital should be considered in determining whether its fees were excessive, and those provided by the sub-advisers retained by Harbor Capital should be excluded. Here the court readily agreed with the conclusion of the New Jersey District Court in *Kasilag v. Hartford Investment Financial Services* that "the combined services should be considered against the entire advisory fee." Citing *Kasilag*, the court held that disregarding the services rendered by the sub-adviser "solely because [the adviser] made the permissible business decision that they were better or more efficiently (or even more inexpensively) performed by [sub-advisers] is nonsensical."

Fourteen 36(b) cases remain pending as of this writing. More certainly will be filed, perhaps advancing new theories or variations on the old. These recent successive rulings add considerable substance to the evaluation of the two theories relied on most heavily by plaintiff since *Jones v. Harris,* while preserving the successful record of adviser defendants in 36(b) cases that have progressed to judgment.