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Court Rules for Defendants in Excessive Fee Case After Full Trial

Following a 25-day bench trial, a federal court has ruled that AXA Equitable Life Insurance Co. and AXA Equitable Funds Management Group (collectively, "AXA") have no liability for purportedly excessive fees charged to mutual fund investors.[1] The case was brought under Section 36(b) of the Investment Company Act of 1940, which 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. This is the first Section 36(b) case to go to trial in several years;[2] all fully tried 36(b) cases have resulted in judgments for defendants, although there have been some cases that have resulted in settlements.

The plaintiffs in the current case claimed that AXA charged investors excessive fees for mutual fund investment and administrative duties, and then delegated those same duties to subadvisers and subadministrators for nominal fees. This is one of a number of cases in which plaintiffs have alleged that a fund adviser relies upon subadvisers to provide the bulk of the services for which it is responsible, but retains what plaintiffs contend is a disproportionately large amount of the total compensation. Courts in some of these cases have ruled that this allegation presents a factual question that is unsuitable for resolution at the motion to dismiss stage.[3]

Federal Judge Peter Sheridan of the District of New Jersey concluded that the plaintiffs in this case failed to meet their burden to demonstrate that the defendants breached their fiduciary duty in violation of Section 36(b), and also failed to show any actual damages. In reaching this conclusion, the court performed a detailed factual analysis, applying the factors used in *Gartenberg v. Merrill Lynch Asset Management*[4] and approved by the Supreme Court in *Jones v. Harris Associates*:[5]

Board's Independence and Conscientiousness: The court found that the makeup of the mutual funds' board is sufficiently diverse and independent, and the procedures the board followed demonstrate that it robustly reviewed AXA's compensation. Although the court inquired at trial about the role of the chairman of the board, who is also the chief executive officer of AXA Equitable Funds Management Group, the court found that credible testimony from the funds' lead independent trustee adequately addressed any potential conflict posed by this role.

Nature and Quality of the Services Provided: The plaintiffs alleged that AXA delegated almost all of its duties to subadvisers and subadministrators, yet retained an excessive fee. The plaintiffs relied particularly on the language of the subadvisory agreements, which described the subadvisers' services in quite similar terms to that in AXA's own advisory agreement. The court ruled that looking only to the contractual language would be "elevating form over substance" and that its analysis must consider all duties, whether enumerated in a contract or undertaken in a manner to carry out the contractual duties. It found that AXA continued to perform significant administrative and investment management

duties, despite the fact that some duties were delegated to subadvisers and subadministrators, and its services warrant compensation through a fee. The court also recognized the enterprise risk to which AXA was subject, including "litigation and reputational risks, operational and business risks, and the risk that [AXA] and the Funds may have to pay the sub-advisers in the event of legal action."

Profitability: The plaintiffs disputed AXA's calculation of its profitability, which it provided to the funds' board annually. The court ruled that the plaintiffs failed to demonstrate that AXA's accounting methodologies were improper. In particular, the plaintiffs failed to establish that it was improper for AXA to treat subadvisory and subadministration fees as an expense and to use revenue to allocate costs. In this regard, as in others, the plaintiffs faced a significant disadvantage because the court did not find their experts to be credible, while it did find the AXA experts to be credible. Helpfully, the court included AXA's cost allocation method in an appendix to its opinion.

Economies of Scale: The court found that AXA shared potential benefits it received from economies of scale with the mutual funds, and it also found that the board received information regarding economies of scale to prepare it for fee negotiation. The greater credibility given to AXA's experts again proved important, as the court found that the plaintiffs' experts had not provided adequate support for their conclusions. The court also found that AXA used other cost-saving methodologies in addition to breakpoints in order to pass on savings to investors, including expense limitation agreements and product cap reimbursements. Expense limitation agreements are agreements that reduce fees for particular funds, while product cap reimbursements function as waivers at the shareholder level for investors who invest through a certain type of annuity contract.

Fall-out Benefits: Fall-out benefits are collateral benefits that accrue to the adviser because of its relationship with the mutual fund. The plaintiffs' experts were unable to show that AXA received fall-out benefits that were not adequately disclosed to and considered by the funds' board.

Comparative Fees: Again giving greater credibility to AXA's experts, the court found that the board compared the fees on each fund against reliable sources and determined they were reasonable in the industry.

With each factor inclining in favor of the defendants, the court had no difficulty in finding for AXA. The court also ruled that the plaintiffs had failed to show damages, even if there had been a breach of fiduciary duty. The plaintiffs attempted to address damages in post-trial charts, but the court ruled that these were inadmissible and that they lacked credibility in any case.

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Although the court found that the plaintiffs failed to meet their burden of proof, it observed that the filing of the lawsuit, as opposed to the substance of the proofs, has been the impetus to improve the quality of the board's decision-making, facilitating enhancements to the board materials and changes in the board's composition. For example, the board named a new lead independent trustee, there was a more scrupulous and rigorous examination of board expenses, the board received charts providing a breakdown of AXA's fees, and board materials were reorganized and improved. The court noted that although the substance of the lawsuit showed little proof, the filing of the suit brought about positive changes to the board's composition and process.

Taken as a whole, the court's ruling shows the fact-driven nature of these cases and the importance of the role of the independent trustees. Fund complexes will be well-advised to study carefully the court's evaluation of AXA's fee approval process and consider whether any improvements are warranted to their own fee approval processes. ■

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[1] *Sivolella v. AXA Equitable Life Insurance Co.*, No. 3:11-cv-4194 (D.N.J. Aug. 25, 2016), available at http://www.stradley.com/~/media/Files/Publications/2016/SivolellavAXAEquitableLifeInsCo.pdf.

[2] The most recent such case was tried in 2009. *In re American Mutual Funds Fee Litigation*, 2009 WL 5215755 (C.D. Cal. Dec. 28, 2009), *aff'd mem. sub nom. Jelinek v. Capital Research & Management Co.*, 448 F. App'x 716 (9th Cir. 2011).

[3] *See North Valley GI Medical Group v. Prudential Investments*, 2016 WL 4447037 (D. Md. Aug. 23, 2016); *Redus-Tarchis v. New York Life Investment Management*, 2015 WL 6525894 (D.N.J. Oct. 28, 2015); *Curd v. SEI Investments Management Corp.*, 2015 WL 4243495 (E.D. Pa. July 14, 2015); *Zehrer v. Harbor Capital Advisors*, 2014 WL 6478054 (N.D. Ill. Nov. 18, 2014); *American Chemicals & Equipment, Inc. 401(k) Retirement Plan v. Principal Management Corp.*, 2014 WL 5426908 (S.D. Iowa Sept. 10, 2014); *Kasilag v. Hartford Investment Financial Services*, 2012 WL 6568409 (D.N.J. Dec. 17, 2012); *Curran v. Principal Management Corp*., 2010 WL 2889752 (S.D. Iowa June 8, 2010).

[4] 694 F.2d 923 (2d Cir. 1982).

[5] 559 U.S. 335 (2010).