UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS GRANTS SUMMARY JUDGMENT IN "MANAGER OF MANAGERS" EXCESSIVE FEE CASE

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By: John W. Rotunno, Paul J. Walsen, Molly K. McGinley, Nicole C. Mueller, Stephen J. O'Neil

On March 13, 2018, the United States District Court for the Northern District of Illinois entered summary judgment for Harbor Capital Advisors, Inc. ("Harbor") in consolidated actions brought under Section 36(b) of the Investment Company Act of 1940 (the "ICA"). The ruling marks the first instance in which a court has granted full summary judgment for the defendant in any of the many Section 36(b) actions brought in the last several years against investment advisers employing a "manager-of-managers" structure.

Section 36(b) of the ICA imposes upon investment advisers a fiduciary duty with respect to the receipt of compensation for services rendered to a registered investment company and provides a private right of action for breach of this duty where an adviser charges an "excessive" fee. An investment advisory fee is deemed excessive under the ICA when it 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.

The plaintiffs in the action against Harbor, which was commenced in February 2014, alleged that Harbor violated its fiduciary duty under Section 36(b) by charging what the plaintiffs claimed were excessive advisory fees to two affiliated mutual funds (the "Harbor Funds"). The plaintiffs' theory of liability was predicated on the fact that Harbor, like many investment advisers, employs a "manager-of-managers" business model, utilizing subadvisers selected and paid by Harbor and approved by the Harbor Funds Board (the "Board") to perform day-to-day portfolio management services. In the litigation, the plaintiffs contended that Harbor assertedly delegated to its subadvisers substantially all of Harbor's responsibilities to the Harbor Funds and performed what plaintiffs characterized as only *de minimis* services for the Funds utilizing its own personnel. From this, they claimed that Harbor's advisory fees, net of its subadvisory expense (what plaintiffs called Harbor's "retained fees") ostensibly were excessive in light of the administrative, oversight, compliance, legal, regulatory, tax, and other services performed by Harbor itself. This "retained fee" theory has served as the basis for many of the Section 36(b) cases filed by plaintiffs in recent years.

In its analysis of the plaintiffs' claims under the "so disproportionately large" standard, the District Court addressed each of the factors identified in the Second Circuit's decision in *Gartenberg v. Merrill Lynch Asset Mgmt, Inc.*, an approach endorsed by the Supreme Court in its 2010 decision in *Jones v. Harris Associates L.P.* The *Gartenberg factors* include: (1) the nature and quality of the services provided by the adviser to its funds; (2) the comparability of the at-issue fees to fees paid by other, similar funds; (3) the costs incurred by the adviser in providing services to its funds and the profitability of the funds to the adviser; (4) the extent to which the adviser realizes economies of scale and, if so, whether they are shared with its funds; (5) fall-out benefits realized by the adviser by reason of its relationship with the funds; and (6) the independence, expertise, care, and conscientiousness of the fund's board in reviewing and approving the adviser's compensation.

The District Court began its analysis with the proposition, drawn from the Supreme Court's decision in Jones, that where a disinterested board has considered the relevant factors, their decision to approve a particular fee arrangement "is entitled to considerable weight, even if a court might view the factors differently." The District Court then reviewed in detail the evidence relating to the independence and conscientiousness of the Board. It noted that the qualifications of the independent trustees serving on the Board were undisputed, that the Board was represented by independent, nationally recognized counsel, that a large amount of information (including information reflecting Harbor's profitability both including and excluding its subadvisory expense) was provided to the Board in connection with its annual review and approval of Harbor's advisory fees, and that the independent trustees had engaged in active fee negotiations. Based on these and other facts, the District Court concluded that the decision of the Board to approve the challenged advisory fees was entitled to "substantial deference."

The District Court went on to analyze the remaining Gartenberg factors, ultimately concluding that the plaintiffs had failed to demonstrate the existence of a genuine issue of fact requiring trial. Importantly, in reviewing the nature and quality of the services provided to the Harbor Funds, the District Court rejected the plaintiffs' argument that only those services performed directly by Harbor should be considered to the exclusion of services performed by the subadvisers engaged by Harbor. The District Court thus determined that it should review the combined services performed *both* by Harbor *and* by its subadvisers against the entire amount of the advisory fees paid by the Harbor Funds, because "[b]ut for the agreement between the Funds and [Harbor], the performance of services provided to the Funds by the subadvisers would not have been secured."

Consistent with this, the District Court also rejected the plaintiffs' contention that the subadvisory expense incurred by Harbor should be treated as a "pass through" (that is, as though it were paid directly by the Harbor Funds, rather than as an expense incurred by Harbor) in the computation of the profitability of the funds to Harbor. The District Court noted, moreover, undisputed evidence that the Board received information reflecting Harbor's profitability both with and without subadvisory expenses included, that the Board had considered both metrics, and had "rejected plaintiffs' preferred method as unhelpful or inappropriate." This left plaintiffs in the position of arguing that a genuine issue of fact existed, precluding summary judgment, merely because plaintiffs' retained expert witnesses disagreed with the Board's conclusion. The District Court found this argument untenable in light of the teaching of the opinions in the *Jones* case that Section 36(b) does not contemplate "judicial second-guessing of informed board decisions . . . ." It concluded that "[a]s such, plaintiffs' Monday-morning quarterbacking of the Board's weighing of Harbor's profitability does not create a triable issue of fact."

The opinion is an important—and highly favorable—result for investment advisers, mutual fund boards, investors who benefit from the manager-of-managers business model, and the investment management industry generally.

Harbor was represented in the litigation by John W. Rotunno, Stephen J. O'Neil, Paul J. Walsen, Molly K. McGinley, and Nicole C. Mueller of K&L Gates LLP.

KEY CONTACTS

JOHN W. ROTUNNO
PARTNER

CHICAGO
+1.312.807.4213
JOHN.ROTUNNO@KLGATES.COM

PAUL J. WALSEN
PARTNER

CHICAGO
+1.312.807.4388
PAUL.WALSEN@KLGATES.COM

MOLLY K. MCGINLEY
PARTNER

CHICAGO
+1.312.807.4419
MOLLY.MCGINLEY@KLGATES.COM

NICOLE C. MUELLER
PARTNER

CHICAGO
+1.312.807.4341
NICOLE.MUELLER@KLGATES.COM

