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Defendant Investment Advisers Obtain Partial Summary Judgment in Section 36(b) Excessive Fee Suit

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Summary

On June 13, 2018, the U.S. District Court for the District of New Jersey granted in part the defendants' motion for summary judgment in a shareholder action brought under Section 36(b) of the Investment Company Act of 1940 (1940 Act) against BlackRock Advisors, LLC (Adviser), BlackRock Investment Management, LLC (Sub-Adviser) and BlackRock International Limited (collectively, Defendants). The plaintiffs (Plaintiffs), shareholders of two mutual funds managed by the Adviser, BlackRock Global Allocation Fund, Inc. and BlackRock Equity Dividend Fund (together, the Funds), alleged that the Defendants breached their fiduciary duty to the Funds by receiving excessive investment advisory fees. The Plaintiffs claimed that the fees the Adviser received from the Funds violated Section 36(b) because the fees were higher than the fees the Sub-Adviser charges for sub-advisory services provided to other funds. The Defendants filed a motion for summary judgement, seeking a ruling that the decision of the Funds' board to approve the Adviser's investment advisory fees is entitled to substantial deference. The court agreed with the Defendants' contention that the Plaintiffs' complaint failed to allege facts demonstrating that the board's process in approving the Adviser's fees was deficient or that the Adviser withheld material information from the board. The court concluded that because there was "no genuine issue as to any material fact," the Defendants were entitled to summary judgment "as a matter of law." However, the court further held that material factual disputes existed regarding certain other factors to be examined by the court in a Section 36(b) action, including comparative fees, economies of scale and profitability, and, as such, summary judgment with respect to the entirety of the Plaintiffs' claims was not granted.

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Background

Under Section 36(b) of the 1940 Act, investment advisers owe a fiduciary duty with respect to the compensation they receive for providing investment advisory services to registered funds, and fund shareholders have an express private right of action to enforce this duty against investment advisers and their affiliates that receive compensation from funds. In such cases, plaintiffs have the burden of proof to show, by a preponderance of the evidence, that investment advisory fees are excessive, i.e., "that the fees are so disproportionately large that they bear no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."

To determine whether an advisory fee is excessive, courts consider the fee in light of the factors initially set forth in the 1982 decision of the U.S. Court of Appeals for the Second Circuit in Gartenberg v. Merrill Lynch Asset Management, Inc., which were cited with approval by the U.S. Supreme Court in its 2010 decision Jones v. Harris Associates, LP.

The Court's Application of the Gartenberg Factors

Applying the Gartenberg factors, the Court concluded the following:

- **The Board:** Despite the Plaintiffs' argument that the board's decision-making process should be discounted because the Defendants failed to provide complete or accurate information to the board, the Plaintiffs did not provide sufficient evidence to support that assertion. Further, no irregularities or deficiencies were identified in the board's decision-making, and the Plaintiffs failed to provide facts to support the claim that the board did not engage in a good-faith process designed to guard against excessive fees when it reviewed and approved the Adviser's fee.
- **Comparative Fee Structures:** The court stated that the comparability of the fees charged by the Adviser for the advisory services provided to the Funds and those charged by the Sub-Adviser for the sub-advisory services provided to the sub-advised funds raised a genuine issue of material fact as to whether the fees charged are so disproportionately large that they are necessarily outside of the range of what would have been negotiated at arm's length. In this case, the advisory fees charged by the Adviser to the Funds were more than double the sub-advisory fees charged by the Sub-Adviser to the sub-advised funds. Further, the court determined that the question of whether the peer funds identified in the Lipper data report provided by the Adviser to the board set the true arm's-length range of comparability for the Adviser's fees is a dispute that cannot be resolved at the summary judgment phase.
- **Economies of Scale:** The court found that the Plaintiffs had presented sufficient evidence, including information from an expert report, such that a factual dispute exists regarding whether the breakpoints in the Adviser's fee schedules were "appropriately fixed," and thus whether the Adviser adequately shared the benefits of economies of scale with the Funds and their shareholders.
- **Profitability:** The court found that the Plaintiffs had presented sufficient evidence to establish a genuine dispute of material fact as to whether the Adviser's profitability from the Funds is disproportionate to the services provided by the Adviser. In this regard, the Plaintiffs' expert compared the Adviser's profits under the Funds' fee schedules to the profitability that the Adviser would realize using the fee schedules governing the fees charged by the Sub-Adviser to the sub-advised funds, and the court determined that the applicability of this comparison would be dependent on the presentation of additional evidence regarding the comparability of the services the Adviser provides to the Funds to the services the Sub-Adviser provides to the sub-advised funds.

The order granting the motion for summary judgment was issued under the caption In re Blackrock Mutual Funds Advisory Fee Litigation, Case No. 14-1165.