ICI MUTUAL **Expert Roundtable Report**

Trends in Fee Litigation

Actions Brought under Section 36(b) and ERISA

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Trends in Fee Litigation

Introduction

Over the years, the plaintiffs' bar has often challenged fees charged to mutual funds by investment advisers and other service providers. Such challenges—sometimes referred to as "excessive fee" or "section 36(b)" lawsuits—have typically alleged violations by investment advisers (and/or certain of their affiliates) of section 36(b) of the Investment Company Act of 1940 (1940 Act). Section 36(b) establishes a "fiduciary duty" on the part of advisers "with respect to the receipt of compensation for services," and expressly provides shareholders with the right to bring lawsuits to enforce this duty. Over the past eighteen months, 15 separate section 36(b) lawsuits have been filed, bringing to 20 the number of section 36(b) lawsuits filed since the Supreme Court's 2010 ruling in Jones v. Harris Associates, L.P.[1]

In recent years, the plaintiffs' bar has also initiated challenges to fees and compensation received directly or indirectly by retirement plan service providers (including fund advisers and their affiliates). Such lawsuits have typically alleged violations of various provisions of the Employee Retirement Income Security Act of 1974 (ERISA), a federal statute that imposes complex obligations and prohibitions on a broad array of entities and individuals associated with retirement plans and retirement assets.

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Recently, ICI Mutual invited two highly regarded legal experts to participate in a roundtable discussion on trends in section 36(b) and ERISA fee litigation. Discussion ranged from the basic legal frameworks, to the fund industry's experience in such litigation, to predictions for the future. What follows are highlights from the roundtable discussion.* Panelist bios are included in the Appendix.

Roundtable Participants

Panelists:

- James O. Fleckner, Partner, Goodwin Procter LLP
- Sean M. Murphy, Partner, Milbank, Tweed, Hadley & McCloy LLP

Moderator:

- Julia S. Ulstrup, Vice President and General Counsel, ICI Mutual Insurance Company, RRG

* Editor's note: The content of this discussion was edited to make the information more concise and readable for a printed format. The views expressed are those of the panelists and do not necessarily represent the views of Goodwin Procter LLP, Milbank, Tweed, Hadley & McCloy LLP, or ICI Mutual Insurance Company, RRG, or any of their respective clients.

Overview: Applicable Laws

Ulstrup: *Jamie and Sean, it is a pleasure to have you participate in this roundtable discussion of trends in fee litigation affecting the mutual fund industry. As you know, we will be focusing specifically on litigation brought under section 36(b) of the 1940 Act and under relevant provisions of ERISA. By way of background, I think it would be helpful to begin with a relatively high-level overview of the applicable laws. Perhaps you could start by discussing the history of ERISA and section 36(b) as well as their distinct legal frameworks?*

Fleckner: ERISA is a statute that was enacted in 1974. It was intended to govern private employer-sponsored employee benefit plans, such as retirement plans, which today include 401(k) plans. It also applies to private employer-sponsored health or welfare plans.

As a federal statute, ERISA was designed to provide a uniform standard for governing these matters across the country. It was also intended to provide a baseline of security for employees and retirees. The statute was passed after the Studebaker Company collapsed and a number of the Studebaker employees found themselves without protection for their pensions.

In drafting the statute, Congress consciously drew on "fiduciary" standards derived from trust law, including ERISA's so-called "prudent person" standard. Basically, a plan should be administered in a way that a prudent person, under like circumstances, would manage a like enterprise. It is a standard that does not build in precise contours. Forty years after the statute was adopted, the Supreme Court had not addressed the substance of the prudent person standard under ERISA until its *Fifth Third v. Dudenhoeffer* decision earlier this summer.[2] When you look to trust law more broadly, there are cases going back to the 1920s, including cases written by Justice (then Judge) Cardozo, that are bandied about by plaintiffs' lawyers today in referring to the fiduciary standard as the "highest duty known to law."

Ulstrup: *Why are we seeing fee-based litigation being brought under ERISA and why now?*

Fleckner: Well, for starters, you have a confluence of (1) a significant amount of money in these retirement plans, (2) a lower pleading hurdle, relative to certain other types of lawsuits, for plaintiffs' lawyers to meet when it comes to crafting their complaints, and (3) duties that have been described as the highest known to law. Also fueling the rise in fee-based ERISA litigation are the facts that (1) ERISA is very broad and general when it comes to the duties that are applicable to those who manage 401(k) plans, and (2) ERISA case law is still in its infancy in addressing the kinds of fee challenges that we've been seeing of late. Even though the statute has been around for 40 years, until the last six or seven years there had not been many fee challenges like the wholesale attacks we're seeing now on very common fee structures (e.g., the use of mutual funds, revenue sharing practices, 12b-1 fees). The lack of a developed body of case law, along with plaintiffs' lawyers who are newer to the space and are just getting their feet underneath them, has led to a lot of different outcomes and different challenges for those of us who represent defendants.

Murphy: Section 36(b) was added to the Investment Company Act of 1940 as an amendment in 1970. The statute imposes a fiduciary duty on fund investment advisers with respect to the "receipt of compensation." That's not exactly a model of clarity, and there was a lot of debate for a number of years as the statute was going through Congress to try to determine what that really means.

Essentially, the courts have said that you can have a breach of fiduciary duty with respect to the receipt of compensation when a fee is so disproportionate to the services rendered that it could not have been the product of arm's-length bargaining.

Historically, if you went back over the last 40 years, you'd see plaintiffs trying to use section 36(b) to try to attack certain conduct of the adviser, like market timing or revenue sharing. But the Supreme Court has now limited the reach of the statute to fees that are excessive—to fees that are disproportionate to the services that are rendered. I should note that challenges by plaintiffs are not limited to advisory fees, and that you sometimes see the statute used to challenge other fees (e.g., administrative fees, 12b-1 fees) as well.

The legislative history suggests that in assessing whether a fee is so disproportionate to the services rendered as to violate section 36(b), you should look at the total fee involved. Even so, the plaintiffs' bar often tries to break fees apart and isolate individual fees in relation to individual sets of services. But whether it's the total fee or an individual fee, the courts have given us a number of factors to look at in assessing whether a fee is disproportionate. They came out of a case called *Gartenberg* decided in 1981.[3] Those factors are:

- Nature and quality of services (with performance being the most important)
- Comparative fees
    - How do the fund's fees compare to fees of other similar funds in the industry?
- Fund profitability
    - How profitable is the fund to the adviser?
- Economies of scale
    - Has the adviser achieved economies of scale?
    - If so, has the adviser equitably shared those economies with fund shareholders?
- Fallout benefits
    - Have benefits accrued to the adviser that it would otherwise not have received but for the existence of the fund?
- Independence and conscientiousness of the independent directors (who by statute are required to approve the fee on an annual basis)
    - Did they get comprehensive materials?
    - Were they diligent?
    - Did they have independent counsel advising them?

This last factor, independence and conscientiousness, in my opinion, is by far the most important factor, because the legislative history suggests that a court should not substitute its business judgment for that of a fully informed fund board.

One could ask the question, why do we even need section 36(b)? I would argue that, certainly over time, the marketplace has become very competitive for mutual funds, as it has for any number of investment products. Section 36(b) is a unique statutory provision. It has no analogue in the hedge fund space or with respect to any other investment product. If it were up to me, I would say let the market dictate fees, and I know that there are people in the fund industry who would no doubt agree. But Congress saw fit in 1970 to enact this provision, and thereby to create this fiduciary duty with respect to the receipt of fees and to permit fund shareholders to sue to enforce it. It's a litigation area that has a lot of people scratching their heads.

Who Sues Whom?

Ulstrup: *Let's turn to how ERISA-based and section 36(b)-based lawsuits play out on the ground, and take a look at their similarities and differences at various stages of the litigation process. Let's start with a basic question: just who is suing whom?*

Fleckner: We've seen two types of plaintiffs in ERISA-based fee litigation. One group constitutes participants or beneficiaries, the employees who are covered by a particular employee benefit plan; and, for purposes of this discussion, I'm going to focus on 401(k) plan suits because they seem to be, right now, the most prevalent in the ERISA-based fee litigation space. The other type of plaintiff, comprising a somewhat smaller group, includes the trustees or the named fiduciaries of smaller plans suing on behalf of their plans, bringing suit against the service providers.

The first type of suit, brought by participants or beneficiaries, is typically brought against the employer who sponsors the 401(k) plan and/or a plan service provider (e.g., the trustee record keeper or the investment manager). In the second type of suit, brought by trustees of 401(k) plans, the defendants are typically only the service providers of the plan. Now, in each of these types of suits you see the claims brought on behalf of classes. So, in the first type of suit, the putative class consists of all participants in a particular 401(k) plan, or sometimes all participants of all plans that are serviced by a particular service provider. In the second type of suit, the putative class usually consists of all plans serviced by the same defendant service provider.

Ulstrup: *How do fund affiliates end up as defendants in these lawsuits?*

Fleckner: Often times, a mutual fund adviser affiliate who serves as a directed trustee and/or provides recordkeeping services to 401(k) plans can be among the defendants in these cases. Other times, you'll see the investment adviser to a fund itself named as a defendant in the litigation, particularly when the litigation focuses directly on the advisory fee. We've even seen a third category where distributors of funds are added as defendants, where the distributor is the entity that receives 12b-1 fees; 12b-1 fees are oftentimes an issue in ERISA fee cases.

In enacting ERISA, Congress generally decided not to impose ERISA's obligations on fund advisers on top of the obligations that were already imposed on them under the 1940 Act and under the Investment Advisers Act of 1940. There are exceptions in the statute, such as where the adviser affirmatively assumes ERISA fiduciary status by other actions. Plaintiffs have pursued different theories against fund advisers in ERISA litigation. For example, advisers are often included in lawsuits either as so-called "parties in interest" or for purposes of securing "complete relief" on behalf of the plaintiffs.

Plaintiffs' lawyers can be very creative in trying to get investment advisers included as defendants. In the usual case, I don't think a fund adviser is a proper party given the operation of the provisions within ERISA that exempt mutual fund assets from being ERISA plan assets. However, plaintiffs' lawyers often feel that there is a tactical benefit to having more defendants in a lawsuit rather than fewer. As a result, they will likely continue to try and find ways to assert claims against advisers.

Ulstrup: *And, presumably, you can also have an adviser or other fund affiliate sued in their capacity as an employer sponsor of a plan for their own employees?*

Fleckner: That's correct. Recently, we've seen a fair number of lawsuits in which employees of a financial services company sue on behalf of a putative class consisting of all other participants of that financial services company's plan.

Ulstrup: *Sean, what about on the 36(b) side; who is suing whom over there?*

Murphy: Well, unlike ERISA, there's not much variation on either side of the caption. Under the 1940 Act, a shareholder of the mutual fund can sue derivatively on behalf of the mutual fund. So it's always shareholders of funds who sue. But it gets interesting when you look at which shareholders of which funds tend to bring these lawsuits.

The shareholders serving as plaintiffs in these lawsuits tend to be shareholders of the largest funds out there, and that fact brings some insight into the realities of section 36(b) litigation. Generally speaking, these cases are not being filed or driven by aggrieved shareholders who happen to wake up one day and decide they're being overcharged. What tends to happen is that a set of entrepreneurial plaintiffs' lawyers come up with a theory to sue a fund adviser for excessive fees, and they often then advertise for shareholders in funds or a fund complex they're specifically targeting. So, the targets tend to be advisers of large funds to justify the investment of time, effort and money that these lawsuits require of the plaintiffs' lawyers.

These are expensive cases, both for the plaintiffs' firms to prosecute and for fund advisers to defend. As a plaintiffs' firm, you prefer to target the adviser of a large fund in order to justify the financial investment that you'll need to make in the litigation. In the past, plaintiffs' firms have tried to use a single shareholder in a fund complex to stand as the named plaintiff in a section 36(b) lawsuit attacking fees charged to multiple funds within the complex. But the courts have said "no," you have to have an actual shareholder for each fund whose fees are being challenged. That's another reason why you don't tend to see smaller funds being targeted very often, because there are obviously fewer shareholders in the smaller funds and the plaintiffs' firms need to find a shareholder who is willing to stand in as a plaintiff. So that's who's suing.

As for who is being sued, under the express terms of the statute, only recipients of compensation can be sued. At the end of the day, this means that the defendant is basically the entity getting the fee. But this also means, most importantly, that the independent directors of the fund who approve a fee cannot be defendants in a section 36(b) case brought by plaintiffs' lawyers. In civil claims under section 36(b), there is no aiding and abetting liability for charging excessive fees, and so plaintiffs' lawyers can't try to claim that independent directors facilitated an adviser in the charging of excessive fees. There's no liability for that.

Ulstrup: *Although independent directors are not themselves defendants in these suits, I have heard defense counsel say that sometimes the independent directors can certainly feel as though they're defendants, because they end up as non-party witnesses whose actions are closely scrutinized. So, independent directors can be brought into the litigation process, even though they're not themselves defendants.*

Murphy: Correct. Fund independent directors won't be in the caption in these lawsuits – they won't be defendants. They won't pay any recovery. But, independent directors are not only witnesses, they are the key witnesses. It's a certainty that in every section 36(b) case that goes forward, some of the independent directors are going to be deposed. It tends to be a time-consuming effort, because independent directors get subpoenaed for documents, they sit for a full day of deposition testimony, and, if the case actually goes to trial, they would usually be called upon to testify at trial—so it is a significant burden. But it's not a financial burden, in the sense that independent directors would not be called upon to pay for any monetary recovery should the plaintiffs prevail in the case.

Ulstrup: *Before we leave this topic of who sues whom, let's spend some time talking about the role of the plaintiffs' bar in fee litigation. Who are they, this entrepreneurial group of lawyers who bring these suits? Do they tend to specialize in one type of fee case or do you see crossover between the lawyers and law firms who bring section 36(b) and ERISA lawsuits?*

Fleckner: In the ERISA space, similar to the 36(b) space, most, if not all, of these cases are brought – are really instigated—by plaintiffs' lawyers and not by an aggrieved individual plan participant who wakes up one day and feels that his or her fees are too high. We see similar advertising to that in the 36(b) space, and the costs of bringing and defending these ERISA class actions are also very high.

There is some crossover of plaintiffs' firms involved in ERISA fee suits and section 36(b) fee suits. In fact, there is one case now where a class action brought by plaintiffs' lawyers included claims under both statutes. While there is some crossover, I also see some plaintiffs' lawyers who focus singularly on ERISA class action litigation and have not, at least to date, brought section 36(b) litigation.

One other area of overlap that I see involves the experts used by the plaintiffs' lawyers. There are experts used in the ERISA fee space who are also used as experts in section 36(b) fee litigation. Most notably, there are economists who will talk about appropriateness of fees and, in looking at economic theory, will try to debunk the competitive market analysis that Sean mentioned, which is a defense that we use in ERISA fee litigation as well. I think many of the arguments about why a mutual fund operates in a competitive environment can also be utilized to explain 401(k) plan fees. 401(k) service providers also operate in competitive environments.

Murphy: I totally agree that there is crossover in the ERISA and section 36(b) spaces. In fact, you are starting to see theories as well as experts overlap.

To give you some sense of who the plaintiffs' counsel are in section 36(b) cases, in 2004 there were three or four firms that brought a dozen or so excessive fee cases. Those cases were litigated over five, six, seven years. But the plaintiffs' firms that brought those suits have entirely disappeared from the scene. They haven't filed a new case in the last three or four years. Almost all of the recent section 36(b) cases have been filed by three law firms that are new to the section 36(b) scene, and that are just getting into this space. I don't know whether this is going to turn into a regular habit for them or this is going to be a series of cases that's one-and-done. It is probably going to be driven by the results, by how successful they are in pursuing these cases. But, it's a whole new frontier for 36(b) suits because all of these firms are new.

For What are Defendants Sued?

Ulstrup: *Let's turn now to a second set of questions. For what are defendants sued? What are the nature of the fee allegations and how, if at all, have they changed over time?*

Murphy: Ten years ago, during the last big wave of section 36(b) lawsuits, the plaintiffs' bar brought a dozen or so cases and they all had very similar theories. Those lawsuits basically focused on the largest equity funds in the marketplace. The primary allegations in those cases generally fell into two buckets: (1) allegations that advisers charged lower fees for institutional products like separate accounts or sub-advised mandates than they did for retail mutual funds, even though the advisers were allegedly providing essentially similar services; and (2) allegations that these large funds, some of which had 10 to 20 billion dollars in assets, had grown to such an extent that their advisers were allegedly realizing massive economies of scale and that any breakpoints in the funds' fee structures were not adequate to equitably pass along the benefits of those economies of scale to shareholders. Some of those cases settled, two cases (*Gallus* and *Jones*) resolved at summary judgment,[4] and there was one trial. Both of the summary judgments and the trial ended in the defendant adviser's favor. We saw those cases stop after a period, and for the rest of the decade, we didn't really see any new filings.

Many of the section 36(b) lawsuits in the most recent wave, starting in around 2010, have involved a "manager of managers" theory. In these cases, the plaintiffs' bar is essentially alleging that funds with some form of sub-advisory arrangement are being charged excessive fees because their advisers (as the manager of managers) are collecting advisory fees and keeping the bulk of those fees, but allegedly delegating virtually all of the real advisory work to sub-advisers. These are a brand new series of cases. I think that the plaintiffs' bar is greatly underestimating the amount of work that goes into managing mutual funds, which are one of the most heavily regulated products in the world.

But clearly, the plaintiffs' bar thinks this is a theory with merit, and so they have duplicated that theory numerous times in the last couple of years in different lawsuits, that have come in different varieties. The plaintiffs' bar has sued insurance companies that use sub-advisers in various contexts, such as the variable annuity space. They have sued advisers in fund-of-funds relationships. They have sued managers of managers, and by that I mean fund advisers that, for example, hire ten sub-advisers in a single fund. They've sued the advisers of garden variety retail mutual funds who utilize a single sub-adviser. Basically, if there's a sub-adviser somewhere in your mutual fund product, the plaintiffs' bar has been looking at the arrangement.

In addition, there were recently a number of section 36(b) cases filed where the plaintiffs' bar—again the new set of plaintiffs' lawyers—has rekindled some of the old theories used in the 2003-2004 wave of cases. In these recent cases, the allegations are essentially that the adviser is basically charging more for a retail fund than it does for other managed products, such as institutional products. It is a bit of déjà vu.

Ulstrup: *Jamie, what are the types of allegations that you see on the ERISA side at the moment?*

Fleckner: There are various types of allegations that we're seeing at the moment. You see lawsuits attacking the fee structures of funds offered as investments under retirement plans. One recent lawsuit, for example, has attacked use of an R share fund (which is designed specifically for the retirement distribution channel), because the fee structure includes revenue sharing with the record keeper and therefore, claim the plaintiffs' lawyers, the fund's fees are excessive. A more typical attack alleges that mutual funds with fee structures designed for retail investors are not appropriate vehicles for large 401(k) plans, given that such plans may have hundreds of millions or billions of dollars of so-called purchasing power in selecting investments to include in their menus.

You also see attacks on bundled service arrangements. If funds have 12b-1 fees, sub-transfer agency arrangements, or other types of servicing fee arrangements—where the mutual fund adviser, distributor, or fund complex has an arrangement in place with record keepers to share some of the revenues—we've seen litigation challenging those revenue streams as allegedly excessive compensation being paid to the record keeper. I see a number of problems with all of these lines of plaintiffs' arguments, which ignore the economics of 401(k) plans and the competitive nature of the market. But those are some of the challenges out there.

Until recently, we were also seeing challenges to disclosure of fees, but we're seeing less of that now, following the promulgation by the Department of Labor of new regulations (effective in 2012) relating to the disclosure of certain compensation arrangements for service providers to 401(k) plans.

What are the Key Stages in the Litigation?

Ulstrup: *What are the key stages in the litigation process in these section 36(b) and ERISA lawsuits, and are there critical turning points?*

Murphy: The first key stage in a section 36(b) case involves assessing whether, as a defendant, you're going to try to get the case resolved at the early, motion to dismiss stage of the litigation process. In a section 36(b) case, for purposes of a motion to dismiss, you have to assume that the well pled factual allegations made by the plaintiffs' lawyers in their complaint are true. If you look at the numbers, some motions to dismiss have been granted and some have been denied. It is a critical stage of the section 36(b) litigation process, and advisers should carefully consider the pros and cons of making a motion to dismiss. However, there is a hurdle that advisers face in that a court will assume the allegations in the complaint are true for purposes of the motion.

The next big stage is fact and expert discovery. It's interesting, albeit frustrating, that an adviser must often wait until the expert discovery stage of the litigation process to see the plaintiff's real theories. Counsel for the defendant advisers, as a practical matter, don't have an opportunity to take much discovery of the plaintiffs in these cases, other than discovery of the fund shareholder who is the plaintiff in the lawsuit. Often, these plaintiff shareholders are not exactly sure what they are even alleging. So, until expert discovery is underway, an adviser and its defense counsel may not really understand the plaintiff's theories of the case beyond whatever has been set forth in the plaintiff's original complaint.

The next big stage is summary judgment. In the first 20 years of section 36(b)'s existence, there were very few summary judgment motions decided under section 36(b). But with the Supreme Court's recent pronouncements in *Jones*, and with a summary judgment motion having been granted to the defendant advisers in the *Gallus* and *Jones* cases, the door to summary judgment has really opened up. This being said, there haven't been a lot of new summary judgment motions filed by advisers in section 36(b) cases since these decisions. So, we may need to wait and see what happens in this recent wave of section 36(b) cases before we can really assess how available summary judgments may be for defendant advisers.

The final big stage, of course, is trial. These trials don't happen often, but in the last section 36(b) lawsuit that reached trial—the *American Funds* lawsuit in 2009—the adviser prevailed.[5] I should note that in section 36(b) lawsuits, you have bench trials before judges, and not jury trials. The plaintiffs' bar has been contending that they should be able to have jury trials in these cases, and many of their recent complaints have jury demands. But the case law is pretty well laid out that these are bench trials, if the lawsuits get that far.

Ulstrup: *How long does an average 36(b) case last – two years, five years, longer?*

Murphy: These cases are pretty slow moving. Some judges have tried to put their section 36(b) case on a "rocket docket," meaning that two years might elapse from initial filing to trial. But, I'm not sure that any of them will actually move that quickly. More often, a case lasts many years. Timing is often determined by what motions are filed. If the defendant adviser foregoes a motion to dismiss and neither party files a motion for summary judgment, a case is going to go much quicker. A motion to dismiss or a transfer motion at the outset of a lawsuit can set you back six months to a year, or even more.

Looking back at the 2003-2004 wave of section 36(b) cases, many of them lasted five years or more. The *Jones* case,[6] that eventually went to the Supreme Court and was then remanded back to the Seventh Circuit Court of Appeals, is still not finally concluded. We're a decade out, and it is still not over. That gives you a sense as to how some of these cases tend to be very slow moving creatures.

Ulstrup: *Is class certification ever an issue under section 36(b)?*

Murphy: No. Section 36(b) provides an express private right of action for a shareholder to bring a claim to sue on behalf of the fund. As a technical matter, the claim is brought on behalf of the fund so any recovery goes back to the fund. Basically, a shareholder is able to challenge all of the fees charged to the fund and, therefore, the plaintiffs don't have to worry about a class action or a class certification.

Ulstrup: *Sean, before we move on, could you briefly touch on how the fees at issue under section 36(b) are calculated? What is the relevant time period?*

Murphy: The statute limits recovery to the fees received for the one-year period prior to the filing of the complaint. There have been disputes over whether the statute allows for a so-called "continuing wrong" theory, such that damages could continue to mount while the lawsuits are in progress (keeping in mind that it can take many years to get a case to trial). Most courts have subscribed to this theory, but others have not. In the end, the plaintiffs' lawyers typically try to moot the issue. They generally call defense counsel and say: "Will you stipulate that the damages continue to run every year? And if you won't stipulate to that, I will file an anniversary complaint (which is a new complaint every year involving the same funds), making the same allegations and each complaint will then be consolidated and I'll achieve the same effect." Either way, in many cases, you are basically talking about the fees at issue mounting up over many years, which is how the plaintiffs' lawyers get to the bigger dollar numbers that they allege are recoverable.

Ulstrup: *Turning to the ERISA side, Jamie, what are the key stages in the litigation? And how long do these ERISA fee cases last?*

Fleckner: Many of the key stages are the same as in the section 36(b) context. One notable difference is that ERISA cases are typically brought as putative class action cases, so there is frequently a class certification stage in ERISA litigation if the claims survive an initial motion to dismiss. As a technical matter, a suit could be brought derivatively on behalf of a plan by plaintiffs without the need to seek to have a class certified, but, as a practical matter, nearly all of the cases today are brought as class actions and so class certification is a critical stage in this type of fee litigation.

I'd also note that when looking at the defendant service providers to a plan, the motion to dismiss stage is a critical stage for the defendants because it is sometimes possible to argue at that stage that the service providers are not relevant fiduciaries—that they shouldn't be proper parties to the lawsuit. Sometimes those arguments are successful and sometimes they are not. In any event, the motion to dismiss can be an important stage because, if successful, it may be possible for defendants to avoid the significant costs of the subsequent discovery stage of the litigation process, as well as any potential recoveries by plaintiffs. Note in this regard that, while there's no automatic stay of discovery under ERISA, when a motion to dismiss is pending typically a court will allow a stay of discovery when there's a dispositive legal issue. So, the motion to dismiss mechanism is important. Summary judgment is likewise an important stage in these ERISA cases.

As in the section 36(b) cases, counsel for defendants do learn quite a bit about a plaintiff's case through discovery of their experts. Some of the plaintiffs' firms who are bringing suits in the ERISA space will amend their complaints, three or four or maybe even five times in the course of litigation. Through the discovery process, new theories may emerge that weren't articulated when the case was first filed, theories that the plaintiffs' counsel might try to adopt as the case goes forward.

At trial, ERISA cases are not typically tried to a jury, but to a judge. I should mention, however, that there's been some erosion of that principle. In fact, in one of the cases that was tried late last year, the first judge who heard the case actually allowed a jury, but the case was transferred to another judge who ended up holding a bench trial.

Ulstrup: *So, if these section 36(b) and ERISA lawsuits survive motion to dismiss, and it sounds like they often do, what should defendants expect during the discovery stage of the litigation?*

Murphy: I mentioned at the outset, as background, that section 36(b) lawsuits involve examination of the various *Gartenberg* factors. Many of these factors involve economic concepts, like economies of scale and fund profitability and so-called “fallout benefits.” These cases are largely driven by those economic factors and by the fund board’s annual process for approving advisory fees, what we call the “15(c) process.” As a result, section 36(b) lawsuits tend to be very fact-intensive, document-intensive cases. There are typically depositions of key personnel at the adviser, including potentially the individuals managing the money (e.g., the portfolio managers), the individuals handling the 15(c) process, and some senior executives at the adviser. As I mentioned, some independent directors will typically be deposed, and third parties that touch the board process as consultants may also be deposed. Keep in mind that thousands of pages of materials may be produced and provided to fund directors each year in connection with the 15(c) process. So fact discovery in these cases may often go on for lengthy periods, sometimes years.

And when you turn from fact discovery to expert discovery, you see much the same thing. Because the *Gartenberg* factors are very economically oriented, you tend to have experts on each factor. It’s not unusual for each side to have four or five experts. Having more experts adds to time and expense. So these are long and, unfortunately, expensive cases for both sides.

Ulstrup: *Jamie, what happens during discovery in an ERISA fee case? What is the main focus? Is there a Gartenberg-like test?*

Fleckner: There is no *Gartenberg*-like test under ERISA, so the applicable standard is more open-ended. While section 36(b) litigation, as Sean described, tends to include a focus on the care and conscientiousness of fund independent directors, ERISA lawsuits tend to focus on the conduct of the defendants alleged to be “fiduciaries” of a plan, including both named fiduciaries who clearly have been allocated fiduciary status and others who are alleged to be fiduciaries based on their actions.

You do see both sides having to make the same type of significant investment in experts. It is not uncommon to see plaintiffs identifying three or four different experts on their end, and then defendants will need to counter. So all the same costs that Sean identified for section 36(b) litigation apply in ERISA cases as well. There’s a lot of work that defendants and defense counsel need to undertake in order to prepare the case both for discovery and then ultimately for trial, which entails expense. The Supreme Court has recognized this problem more broadly by tightening up the pleading standards applicable to most types of civil cases. For example, in the Supreme Court’s decision in *Twombly*,[7] a decision that governs almost all motion to dismiss practice in federal courts, the Supreme Court noted the asymmetrical costs of discovery in large litigation where all of the facts are basically held in the defendants’ possession. This increases the burden on defendants in litigation and, as a result, the Supreme Court said that plaintiffs should be required to make a higher showing to survive motions to dismiss than maybe was required of them in a previous era, when litigation was not as routinely expensive and complex as it often can be today.

Ulstrup: *Do ERISA fee suits go on for years? Like section 36(b) litigation, is it a fairly lengthy process?*

Fleckner: Yes, unfortunately. The timeframes, I think, are very similar to what you might see in section 36(b) cases. So for example, of those dozen or so ERISA fee lawsuits that started the current wave, lawsuits that were initiated back in 2006 and 2007, at least three or four are still being litigated today. Moreover, if the appellate courts overturn various decisions reached in the district courts, these cases could conceivably continue to go on for many years to come. There's even a case that's still going on now, involving an insurance company in Connecticut, that was filed 12 or 13 years ago. I think the Second Circuit has been called to address this lawsuit perhaps four times already now.

How is the Litigation Ultimately Resolved?

Ulstrup: *So, at the end of the day, how are these fee cases, brought under section 36(b) or under ERISA, ultimately resolved?*

Murphy: Well, there have been perhaps 100 cases or so filed under section 36(b) over the past 40 years. Of these, seven have actually made it to trial. So, as you can see, most section 36(b) lawsuits don't make it as far as trial. Of those that went to trial, all seven were won by the adviser defendants. So if you can make it to trial, history suggests that you're probably in good shape, and you'll have a very good chance of winning. No adviser has ever lost one of these cases at trial. I mentioned earlier that only a handful of cases have been decided at the summary judgment stage, and that many survive motions to dismiss. So, if you're just looking at the pure numbers, it appears that many section 36(b) lawsuits over the years have settled. These resolutions have tended to be confidential, at least over the last ten years. If you look back far enough, you saw some public settlements where plaintiffs went to court and asked the court to approve the settlements as fair and reasonable, but that has not been the trend of late. So the terms of the most recent settlements are confidential.

I think the general message to take away from these resolutions is this. If you are an adviser who is sued in a section 36(b) litigation, there's a good chance that the case will reach the discovery stage, and there's going to be a significant expense and distraction and burden. If you are willing to hang in there and go the distance, you have a good chance, a very good chance, of winning the case at summary judgment or at trial. But I would say, if you look at the numbers, many of these cases do not go the distance. Defendants may decide to settle. And that's exactly what the plaintiffs' bar is banking on. They are banking on the fact that, with the significant time expense and distraction of these cases, an adviser will at some point throw up its hands and say, "You know, perhaps we should just pay the plaintiffs something to go away. We're confident of our facts here and we're confident that if we go the distance we would ultimately prevail at trial, but there is always going to be some risk, however modest, that we could lose. So perhaps a settlement needs to be considered."

Ulstrup: *What about resolutions on the ERISA side?*

Fleckner: Well, I'd like to say the actual success rate at trial has been as strong for defendants as it has in section 36(b) litigation. But, unfortunately, it hasn't been. A majority, a vast majority, of the cases that are brought under ERISA are either settled, or are disposed of in defendants' favor (e.g., on a motion to dismiss or summary judgment.) But there have been a few that have gone to trial; in those cases, the outcomes have been more mixed.

Ulstrup: *Are the settlements in the ERISA fee lawsuits confidential?*

Fleckner: No, they're not. This is the result of ERISA fee lawsuits being brought as class actions under the generally applicable class action rules. In federal courts, judges ultimately have to opine on whether resolutions of class action lawsuits are fair and reasonable to the absent class members. As a result, these settlements are a matter of public record. From public settlements, you can see that settlements in fee cases in the ERISA space have ranged from approximately $12 million to $35 million. These are cases that have been settled in the past three or four years.

In addition to the monetary payments to class members, the plaintiffs' lawyers are going to want to be compensated in an ERISA class action settlement. The plaintiffs' lawyers can get compensated in one of two ways. First, ERISA has a statutory provision allowing for attorneys' fees to be recovered. Second, under the class action rules, you can have the class attorneys' fees paid out of the settlement fund. So, in either event, the plaintiffs' lawyers are typically going to get their own recovery as part of those settlements.

In addition to the monetary terms, you also see in many of these settlements some non-monetary terms. An employer might agree to different disclosure practices, for example, or perhaps agree to put plan services out to bid. In some cases, an employer may agree to eliminate a certain type of fund from a plan's lineup for a period of years. So you've seen varying non-monetary terms included in the ERISA fee settlements that have been signed to date.

Ulstrup: *Do you have any risk management advice for fund advisers and/or their affiliates with regard to fee litigation? Any tips for things they might do now that could prove helpful if and as they ever face such litigation?*

Murphy: Unfortunately, there's very little that an adviser can do to avoid being sued in section 36(b) litigation. I don't think the plaintiffs' bar is doing such an extensive amount of research that they are differentiating very much between the practices of one adviser versus another. In fact, if you take the cases that have been filed historically, the plaintiffs' bar often has sued advisers of funds with the lowest fees, which clearly shows that someone has not focused on the merits. As I mentioned, plaintiffs' firms have other reasons they want to sue advisers of large funds, and I don't think any adviser would start shedding assets in order to protect itself against the possibility of a future lawsuit.

But an adviser can increase the chances that it will be successful, at summary judgment or at trial, by encouraging fund boards and their independent directors to implement and employ processes that are very sound. We know the standard (i.e., *Gartenberg*) by which advisers are going to be judged in these cases. Courts are not going to substitute their judgment for the business judgment made by a good independent fund board that is fully informed and that has a record of being diligent, of focusing on fees, of reviewing the 15(c) materials, and of pushing back on management as appropriate. As an adviser, you can't necessarily do much about whether or not you get sued, but you should do everything you can to make sure that you win that case, if a case is filed.

Fleckner: My advice is very similar to Sean's. You know it is hard to predict under ERISA when you might get sued and, as Sean mentioned, process can provide a formidable defense.

There are other very feasible defenses to an ERISA suit, including the substantive outcome. For those service providers who aren't affirmatively accepting fiduciary status, I would add that one of the things that you would want to show in litigation is that you, in fact, did not function as a fiduciary. The more that you've made clear in your dealings with the plan and with the named fiduciary of the plan that you're not accepting fiduciary status, and that you are disclosing the limited nature of your activities, the more receptive a court is likely to be at an earlier stage in litigation to your defense that you're not a fiduciary subject to an ERISA fee suit.

The Future of Section 36(b) and ERISA Fee Litigation

Ulstrup: *What is on the horizon for section 36(b) and ERISA fee litigation? Any predictions for the future?*

Murphy: Well, I'm watching the most recent section 36(b) filings that I mentioned earlier, the lawsuits that target the advisers of large funds with allegations of fee disparities between their retail and institutional clients. As I mentioned, this was a theory that was used in 2004 and now has been dusted off and put out there again. I will be curious to see if these are a one-off or if we get more of these types of cases. Interestingly, multiple sets of law firms filed these cases, so there are several firms out there that are again pursuing this theory. As opposed to section 36(b) lawsuits involving "managers of managers," for which there is a finite universe of investment advisers, the theory underlying this more recent filing could be applied to most mutual fund advisers. There are far more potential targets to attack.

I would like to think that these plaintiffs' firms, which tend to be very small law firms, are at capacity and that they can't file a lot more of these lawsuits, at least at present. I hope that we won't be seeing many more cases filed in the near future, simply because these plaintiffs' firms may not be able to handle that many more. But once these cases, the current wave of cases, get resolved, I think their resolutions may dictate whether or not the industry sees a new wave. The plaintiffs' firms have initiated these new lawsuits as a business endeavor. Like any investments, they will need to see whether they pay off. If these lawsuits settle and the plaintiffs' firms get significant enough payments of attorney's fees, they may obviously file more. If these plaintiffs' firms are unsuccessful and don't obtain significant settlements, they may decide to find someone else to sue, or try to develop new and different theories of recovery. So, the first couple of cases in this wave may well dictate what happens down the road.

Fleckner: Unfortunately, I see more uncertainty. There is an evolution underway in these suits, making it hard to predict what will happen in the future. Given the legal uncertainties, coupled with the large dollar amounts that are held in 401(k) plans today, these fee cases might remain sufficiently attractive for plaintiffs' lawyers to try and pursue additional suits.

Ultimately, though, I think the real economic dynamic is the same for ERISA suits as for section 36(b) suits. Are the plaintiffs' lawyers, who are required to invest a tremendous amount of money to bring and maintain these suits, seeing a return on their investment that is sufficient to incent them to bring more lawsuits?

Depending how some of these ERISA lawsuits turn out in the courts, it may be that plaintiffs' lawyers will decide they see additional opportunities for litigation in the 401(k) space.

Ulstrup: *On behalf of ICI Mutual and its insureds, I want to thank you, Jamie and Sean, for your time today and for a most interesting discussion.*

Endnotes

[1] In 2010, the U.S. Supreme Court, in Jones v. Harris Associates, L.P., affirmed use of the longtime "*Gartenberg* standard" for assessing the liability of fund advisers in "excessive fee" lawsuits brought under section 36(b) of the 1940 Act. Jones v. Harris Assocs. L.P., 559 U.S. 355 (2010). Note that a number of the post-*Jones* lawsuits referenced above have been consolidated.

[2] Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459 (June 25, 2014).

[3] The standard was first articulated by the appellate court in Gartenberg v. Merrill Lynch Asset Mgmt., Inc. 694 F.2d 923 (2d Cir. 1982).

[4] *Jones*, 559 U.S. 355; Gallus v. Am. Express Fin. Corp., 2010 U.S. Dist. LEXIS 131264 (D. Minn. Dec. 10, 2010).

[5] In re Am. Mut. Funds Fee Litig., 2009 U.S. Dist. LEXIS 120597 (C.D. Cal. Dec. 28, 2009).

[6] Jones v. Harris Assocs. L.P., 537 F.3d 728 (7th Cir. 2008), *vacated*, 559 U.S. 355 (2010), *remanded to* No. 07-1624 (7th Cir. filed Mar. 20, 2007).

[7] Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007).

Panelist Bios

JAMES O. FLECKNER

Jamie Fleckner is a partner in Goodwin Procter's Litigation Department and heads the firm's ERISA Litigation Practice. Mr. Fleckner is a nationally recognized leader in the field of ERISA litigation. His practice also involves a wide array of complex commercial litigation and securities law. He also focuses on regulatory investigations and governmental proceedings, and has appeared before the U.S. Department of Labor, Securities and Exchange Commission, Department of Justice, Pension Benefit Guaranty Corporation and state authorities.

Mr. Fleckner's work in successfully defending his clients in litigation involving cutting edge legal issues has been profiled in The American Lawyer, Big Suits. According to The Legal 500 United States publication, Mr. Fleckner "is particularly strong, and is fast becoming a leader in ERISA fiduciary litigation involving financial products."

His matters include representation of numerous companies and individual officers in class actions, regulatory investigations and bankruptcy proceedings regarding the discharge of ERISA and other fiduciary duties. Currently, he is representing numerous clients in so-called "excessive fee" ERISA and Investment Company Act litigation, and other ERISA litigation challenging the discharge of fiduciary obligations.

Mr. Fleckner is a nationally recognized lecturer and author on ERISA and related litigation topics. He has presented at over 40 conferences across the United States to lawyer and non-legal audiences, including conferences sponsored by ALI-CLE, American Conference Institute, Fiduciary Investment Risk Management Association, Institutional Investor, Law Seminars International, MCLE, Pensions & Investments, PlanAdviser, PlanSponsor, SIFMA, Strafford Publications and WestLegalEd Center (Thomson Reuters). Mr. Fleckner also has been quoted in numerous publications, including *Ignites, Pensions & Investments*, *Pension & Benefits Daily*, *The United States Law Week*, *PlanSponsor.com*, *California Lawyer*, *The New York Law Journal*, *The Washington Post* and *The Boston Globe*.

Mr. Fleckner is listed in the nationwide ERISA Litigation category in Chambers USA: America's Leading Lawyers for Business, where clients praise his "knowledge of the ERISA area and ability to distill concepts into practical strategic advice." In 2013, he was recognized as a national leader in ERISA litigation by The Legal 500 United States. From 2011-2014, Mr. Fleckner has been recognized as a New England Super Lawyer by Law & Politics and Boston magazine. He was recognized in 2008 as a Massachusetts Super Lawyer "Rising Star" by the same publication.

SEAN M. MURPHY

Sean M. Murphy is a partner in the New York office of Milbank, Tweed, Hadley & McCloy and a member of the firm's Litigation & Arbitration Group. Prior to joining Milbank in 2004, Mr. Murphy was a partner in the New York office of Clifford Chance LLP, where he was a member of that firm's Securities Litigation practice group.

Mr. Murphy's practice focuses on complex securities matters. He has defended dozens of companies and financial institutions in multi-jurisdictional class action and derivative litigation under state and federal securities laws, including claims under the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940. He has extensive experience representing investment advisers in class and derivative litigation involving management fees, revenue sharing, conflicts of interest, prospectus disclosure, distribution and trading, portfolio mismanagement, Rule 12b-1, board oversight and fiduciary duty litigation.

Mr. Murphy has represented some of the largest financial institutions in the country in complex securities cases, including Citibank, Merrill Lynch, Fidelity, Capital Group, AllianceBernstein, American Century, Dreyfus, Federated Investors, First Trust Advisers, Legg Mason, Neuberger Berman, Prudential, Putnam, Royal Bank of Canada, Salomon Smith Barney and Waddell & Reed.

Mr. Murphy has been recognized as a leading litigator by a number of publications, including: the American Lawyer's "Fab Fifty" list of the top 50 litigators in the country under the age of 45; he was selected as one of the top 500 lawyers in the country in Lawdragon's 500 Leading Lawyers in America; and Legal 500 described him as "one of the best young lawyers for securities shareholder litigation, anywhere in the country." Lawdragon also elected Mr. Murphy to its list of "100 Lawyers You Need to Know in Securities Litigation," and profiled him as a "rising star" in "The Lawdragon 500 New Stars, New Worlds." Mr. Murphy also has been consistently recognized as a leading securities lawyer in Chambers USA, Benchmark Litigation and New York Super Lawyers.

Mr. Murphy has spoken on a number of panels about complex litigation issues, and has written a number of articles, including "The Trial of a Securities Case" (1996), "Litigation Under the Private Securities Litigation Reform Act" (1997), "Recent Developments in Litigation Under the Investment Company Act of 1940" (2004), "Mutual Funds Under Scrutiny" (2005), "Securities Plaintiffs Turn to Class Actions Under ERISA" (2008), "Court Finds Implied Private Right of Action Under the Investment Company Act" (2009), "The SEC's Mutual Fund Fee Initiative: What to Expect" (2010), and "Fund Profitability in Mutual Fund Fee Litigation" (2012). Recently, he also co-authored a chapter of a textbook titled Litigating Securities Class Actions (2011).

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**1401 H Street NW, Suite 1000
Washington, DC 20005**

**800.643.4246
info@icimutual.com
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