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Business Development Company Update: Excessive Fees Lawsuit Against Adviser Dismissed

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A decision issued on Jan. 24, 2017 in the US District Court for the Southern District of New York dismissed a complaint alleging the payment of excessive advisory and administration fees by Prospect Capital Corporation (the Fund), a business development company (BDC) regulated under the Investment Company Act of 1940, as amended (the 1940 Act).[1] The litigation (*Prospect Capital*) involved a claim that fees received by the Fund's investment adviser and the adviser's affiliated administrator constituted a breach of the fiduciary duty established by Section 36(b) of the 1940 Act and sought to recover on behalf of the Fund damages resulting from the breach.

Although there have been numerous Section 36(b) lawsuits relating to registered investment companies, *Prospect Capital* is a rare Section 36(b) action brought against the adviser of a BDC. Moreover, the granting of the defendants' motion to dismiss in *Prospect Capital* stands in contrast to decisions in most other Section 36(b) actions commenced subsequent to the 2008 decision of the US Supreme Court in *Jones v. Harris Assocs.* (*Jones*),[2] in which motions to dismiss were not granted.

What Is Section 36(b)?

In pertinent part, Section 36(b) of the 1940 Act provides that the investment adviser of a 1940 Act registered fund or BDC is deemed to have a fiduciary duty with respect to the receipt of compensation for services paid by the fund or BDC to the adviser or any affiliated person of the adviser.[3] It provides, generally, that an action may be brought for breach of that duty by the Securities and Exchange Commission (SEC), or by a shareholder on behalf of the fund or BDC, against the adviser or its affiliated person. Section 36(b) also provides that, in any action brought pursuant to Section 36(b), approval by the board of directors of a registered fund or BDC of the adviser's compensation, or of a contract providing for such compensation, shall be given such consideration by a court as is deemed appropriate under all of the circumstances.

In this regard, Section 15(a) of the 1940 Act requires that the investment advisory contract of a registered fund or BDC be approved by the board of directors of the company and by the vote of a majority of the outstanding voting securities of the company (a majority shareholder vote). It also requires that, after an initial term of two years from the date of its execution, the contract may continue in effect only so long as its continuance is specifically approved at least annually by the board of directors or by a majority shareholder vote. Section 15(c) of the 1940 Act imposes the additional requirement that an advisory contract and any renewal thereof must be approved by vote of a majority of the directors of the company who are not parties to the contract or interested persons of any such party (independent directors),[4] cast in person at a meeting called for the purpose of voting on such approval. Section 15(c) also provides that, in connection with the approval and renewal of an advisory contract, the directors of a registered fund or BDC have a duty to request and evaluate, and the investment adviser of the company has a duty to furnish, such information as may reasonably be necessary to evaluate the terms of the advisory contract.

Taken together, judicial decisions relating to Section 36(b) and the provisions of Section 15(c) establish the legal framework applicable to approvals of advisory contracts by fund boards and applicable to judicial determinations as to whether the fees received pursuant to such contracts meet the fiduciary standard established by Section 36(b). These standards were enunciated by the US Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.* (*Gartenberg*).[5] In *Gartenberg*, the court stated that an adviser's receipt of an advisory fee will not constitute a breach of the adviser's fiduciary duty if "the fee is in range of what would have been negotiated at arm's length in the light of all of the surrounding circumstances."[6] The court observed that, to violate Section 36(b), an adviser must charge 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."[7] In making this determination with respect to the fee at issue in *Gartenberg*, the Second Circuit explained that "all pertinent facts must be weighed"[8] and noted that specific factors to consider include: (i) the nature and quality of the services provided by the adviser; (ii) the cost to the adviser of providing such services, with special attention to the adviser's profitability and whether the adviser realizes economies of scale; (iii) the direct and indirect benefits received by the adviser from its relationship with the fund (including any fall-out benefits or float the adviser receives from its relationship with the fund); and (iv) the relationship that the amount of the advisory fee bears to the fees paid by other funds of similar size and objectives. In addition, the nature and extent of any non-advisory services provided by the adviser or an affiliated person of the adviser, including any administrative, shareholder accounting, and transfer agent services must also be considered.

In *Jones*, the US Supreme Court for the first time addressed the standard that should be applied in determining whether an advisory fee is consistent with Section 36(b). In its landmark decision in *Jones*, issued on March 30, 2010,[9] the Court unanimously endorsed the *Gartenberg* standard by holding that an investment adviser will not be deemed to be in breach of its fiduciary duty with respect to the receipt of compensation from a mutual fund under Section 36(b) unless it is proven that the adviser's fee 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."[10] The Supreme Court found that the *Gartenberg* approach fully incorporates this understanding of the fiduciary duty standard and thus, "[w]here a board's process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process."[11] Accordingly, the Court determined that if the disinterested directors of a mutual fund have considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently.

In recent years, the fund industry has been subject to lawsuits brought pursuant to Section 36(b)[12] and no court has as yet, in such action, held that the fee at issue violated Section 36(b).[13]

Why Did the Court Dismiss the Complaint in *Prospect Capital*?

The plaintiff's claim in *Prospect Capital* was that the fees paid by the Fund to its adviser and the adviser's affiliate for investment advisory and administrative services were excessive because they substantially exceeded the fees paid by comparable BDCs for comparable services. In this regard, the plaintiff alleged that the fees paid by the Fund exceeded the average fees paid by similar BDCs. The complaint also included allegations addressing the various factors articulated in *Gartenberg*. These included allegations that: (i) the adviser's portfolio selection services were poor based on the fact that the Fund had underperformed its benchmarks; (ii) the adviser's profits were "higher than the norm, and thus excessive;"[14] (iii) the adviser benefited from significant economies of scale that were not shared with the Fund; and (iv) the independent directors were not truly independent because the adviser's website listed them as "members" of the adviser's "team" and they did not actually evaluate the adviser's fees because they did not reject them or negotiate for lower fees.[15]

The plaintiff alleged that the Fund's board had failed to conduct an independent evaluation as required by Section 15(c) and had merely "rubberstamped" the advisory agreement.[16] The plaintiff also argued that the investment adviser's and administrator's fees were "blatantly excessive" in that they were markedly above the average fees charged by peer funds. The court disagreed and gave particular deference to the board's review process, finding that "Section 36(b) does not provide relief where more arduous bargaining could have resulted in lower fees" and that the plaintiff failed to show "that the fees resulted from the purportedly deficient process."[17] In addition, the court noted that, although above average, the fees were still below the highest fees charged by a peer fund and that, regardless of that fact, "charging a fee that is above the industry average does not violate Section 36(b)."[18]

In evaluating the plaintiff's claims as they related to each *Gartenberg* factor, the court stated that: (i) the claims regarding the nature and quality of the adviser's services were insufficient because the plaintiff did not allege that the Fund has underperformed with respect to comparable funds; (ii) the claims regarding the adviser's profitability were insufficient because they were based on "unsupported speculation" that the adviser's costs were equal to the "average fee rate paid by internally-managed BDCs;" (iii) the claims regarding economies of scale were insufficient because the decrease in fees received by the adviser from 2009 to 2015 "indicate[d] some sharing of economies of scale" with the Fund;[19] (iv) the claims regarding the board's independence and conscientiousness were insufficient because the adviser's website's characterization of the independent directors as "members" of the adviser's "team" was too vague "to overcome the heavy statutory presumption"[20] that the directors are in fact disinterested.

In considering the complaint and determining whether, assuming the truth of the facts asserted therein, it stated a claim upon which relief could be granted, the court concluded that the plaintiff failed to plead facts creating a plausible inference that the defendants were liable. Among other things, the court noted that the plaintiff had failed to meet its burden of showing that the fees paid by the Fund were outside the range that would have been produced by arm's length bargaining. In this regard, the court observed that charging a fee that is above "industry average" does not violate Section 36(b) and concluded that, because the effective fee rate was within the range of fees paid by other BDCs, the Fund's fee was not outside of the "outer bounds of arm's length bargaining."[21]

To prevail on a motion to dismiss, a defendant must show that the plaintiff's complaint fails to state a claim upon which relief can be granted.[22] In this regard, the court in *Prospect Capital* determined that the plaintiff's complaint did not allege sufficient facts indicating a plausible basis for concluding that the fee at issue was not comparable to what would have been negotiated at arm's length.

What Are the Implications of *Prospect Capital?*

As previously noted, *Prospect Capital* stands in contrast to most other recent Section 36(b) lawsuits in which motions to dismiss have not been granted. However, those other lawsuits have involved either:

(i) a "manager of managers" situation, where a fund's adviser had delegated portfolio management responsibilities to one or more sub-advisers and the plaintiff claimed that the portion of advisory fees retained by the adviser was excessive given the limited scope of services required to be provided by the adviser; or (ii) a situation where a fund's adviser received a higher level of compensation from the fund as compared to the compensation that the adviser received for providing similar services as sub-adviser to a non-proprietary fund. In comparison, the adviser in *Prospect Capital* did not retain a sub-adviser and did not provide advisory services to any clients other than the Fund. Thus, the *Prospect Capital* decision may reflect the high bar a plaintiff must overcome post-*Jones* in fashioning a Section 36(b) complaint that will survive a motion to dismiss, absent facts providing strong support for an excessive fee claim.

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NOTES

1 Paskowitz v. Prospect Capital Management L.P. et al., No. 16-cv-2990 (S.D.N.Y. 2017).

2 Jones v. Harris Associates L.P., 559 U.S. 335 (2010).

3 Section 59 of the 1940 Act makes various sections of the 1940 Act, including Section 36(b), applicable to BDCs.

4 In order to qualify as an independent director under Section 2(a)(19) of the 1940 Act, an independent director generally cannot currently have, or at any time during the previous two years have had, a significant business relationship with the fund's adviser, principal underwriter or affiliates.

5 694 F.2d 923 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983).

6 *Id*. at 928.

7 *Id*.

8 *Id*. at 929.

9 Jones v. Harris Associates L.P., 559 U.S. 335 (2010).

10 *Id*. at 9. Several other federal courts also have interpreted Section 36(b) to determine whether advisory fees were excessive, and have reiterated the "so disproportionately large"/"no reasonable relationship" principle established in Gartenberg. Strougo v. BEA Associates, 188 F.Supp.2d 373 (S.D.N.Y. 2002) (finding that the fee at issue was not unreasonable based on the nature and quality of the services, the profit and fall-out benefits received by the adviser, the economies of scale, the comparative fee structures and the directors' care in approving the fee); Migdal v. Rowe Price-Fleming International, Inc., et al., 248 F.3d 321 (4th Cir. 2001) (stating that plaintiffs failed to state a claim because they did not address the relationship between the fees received and the services provided by the adviser and, as a result of that omission, the court was unable to conclude that the fee was excessive); and In re Franklin Mutual Funds Fee Litigation 04-CV-982 (WJM) (D.Ct. N.J. 2007) (fund underperformance, coupled with the payment of above-market fees, is not sufficient to state a Section 36(b) claim).

11 *Id*. at 15.

12 "Section 36(b) Litigation Since Jones v. Harris: An Overview for Investment Advisers and Fund Independent Directors," ICI Mutual, July 2016 at 1.

13 ICI Mutual at 1.

14 *Prospect Capital* at 15 quoting complaint.

15 *Id.* at 20.

16 *Id.* at 15 quoting complaint.

17 *Id.* at 20-21.

18 *Id*. at 12.

19 *Id.* at 18.

20 *Id.* at 20.

21 *Id.* at 6 quoting *Jones*.

22 *Id.* at 5.