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March 2007 / Special Alert

A legal update from Dechert's White Collar and Securities Litigation Group

Dismissal of Revenue-sharing Class Actions Affirmed

With its March 15, 2007, *per curiam* decision in *Bellikoff v. Eaton Vance Corp.*, the Second Circuit Court of Appeals declined to imply several new private rights of action under the Investment Company Act of 1940 ("1940 Act") and continued its recent pattern of strictly construing the available private right of action under Section 36(b) of that Act.[1] In so doing, the court not only ended the claims of the Eaton Vance plaintiffs, but may have also sounded the death knell for several other similar cases whose appeals were awaiting the outcome in *Eaton Vance*.

The trial court decisions in *Eaton Vance* by U.S. District Judge John G. Koeltl of the Southern District of New York were the first to address the claims asserted by the Milberg Weiss firm in a series of class actions filed against fund complexes nationwide.[2] The plaintiffs in these cases charged that the defendant advisers and boards of trustees were using fund assets to improperly boost advisory fees through a variety of devices, including revenue-sharing, directed brokerage, 12b-1 fees, and soft dollars.[3] This conduct, plaintiffs alleged, violated not only Section 36(b) of the 1940 Act, but also gave rise to causes of action under Sections 34(b), 36(a), and 48(a) of that Act, as well as claims under the Investment Advisers Act, and in some instances, the common law for breach of fiduciary duty.[4]

At least 18 such actions were brought, half against fund complexes in the Second Circuit. Eleven have been dismissed outright by the district court, but the opinion in *Eaton Vance* is the first by a Court of Appeals. The Second Circuit's decision is also the first appellate decision to squarely reject implication of a private right of action under either Section 34(b) or 36(a) of the 1940 Act.

The decision in *Eaton Vance* is the third in a line of recent Second Circuit rulings rejecting efforts to attack excessive advisory fees, following its opinions in *Amron v. Morgan Stanley Investment Advisors, Inc.*, which strongly reaffirmed the critical role of the *Gartenberg* factors in assessing the adequacy of a claim for excessive fees under Section 36(b),[5] and in *Bjurman*, which confirmed that only ultimate recipients of compensation may be potentially liable under Section 36(b).[6]

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1 *Bellikoff v. Eaton Vance Corp.*, — F.3d —, 2007 WL 766209 (2d Cir. 2007) ("*Eaton Vance*").

2 *In re Eaton Vance Mut. Funds Fee Litigation*, 380 F.Supp.2d 222 (S.D.N.Y. 2005); *In re Eaton Vance Mut. Funds Fee Litigation*, 403 F.Supp.2d 310 (S.D.N.Y. 2005).

3 *Eaton Vance*, 380 F.Supp.2d at 226-30; *Eaton Vance*, 403 F.Supp.2d at 311-13.

4 *Id.*

5 *Amron v. Morgan Stanley Investment Advisors, Inc.*, 464 F.3d 338, 340-41 (2d Cir. 2006) ("*Morgan Stanley*") (stating, "To violate § 36(b) an 'adviser-manager 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.' [C]ourts consider six factors in applying this standard. These are: (1) the nature and quality of services provided to fund shareholders; (2) the profitability of the fund to the adviser-manager; (3) fall-out benefits; (4) economies of scale; (5) comparative fee structures; and (6) the independence and conscientiousness of the trustees," internally quoting *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923, 928 (2d Cir. 1982)).

6 *Pfeiffer v. Bjurman, Barry & Assocs.*, 2007 WL 247878 (2d Cir. 2007) ("*Bjurman*").

Lack of Private Rights of Action

The Court of Appeals addressed first the question of whether private rights of action should be implied under Sections 34(b), 36(a), and 48(a) of the 1940 Act.[7]

Section 34(b) is the anti-fraud provision of the 1940 Act, barring persons from making "any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to [this Act]" or "to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading."[8] The *Eaton Vance* plaintiffs alleged that the defendants violated Section 34(b) by, among other things, failing to disclose the use of fund assets in the form of directed brokerage to satisfy revenue-sharing payment obligations, the amount and nature of such payments, and the lack of economy of scale associated with defendants' advisory and 12b-1 fees.[9]

Section 36(a) of the 1940 Act authorizes "the Commission to bring" actions alleging that individual fund fiduciaries, such as officers, directors, and advisers, breached a fiduciary duty involving an act or practice involving personal misconduct.[10] In their complaint, the plaintiffs in *Eaton Vance* had alleged that the individual defendants' misuse of fund assets represented a breach of fiduciary duty violative of this section.[11]

Section 48(b) of the 1940 Act, while labeled a provision dealing with liability of controlling persons, by its terms prohibits a person from doing indirectly through control of another what the act bars him from doing directly.[12]

Plaintiffs hoped to capitalize on both a substantial history in the Second Circuit of acknowledging private rights of action under the 1940 Act, as well as broad language in the legislative history in the 1980 amendments to the Act that encouraged courts to imply private rights of action.[13] The Second Circuit's brief opinion made short shrift of such arguments, focusing instead on the more current standards for determining whether Congress intended to provide a private right of action laid down in the Supreme Court's decision in *Sandoval* and in its own seminal decision in *Olmsted v. Pruco Life Ins. Co.*[14] Applying those standards, the Court of Appeals began with the presumption against implying private rights of action and went on to observe that the express provision of one method of enforcing a substantive rule suggested that Congress intended to preclude others.[15]

Since Section 42 of the 1940 Act explicitly granted authority to the SEC to enforce all provisions of the Act, according to the court, that factor suggested a lack of Congressional intent to provide a private right of action as well.[16] Further, the court held, by providing a private right of action in Section 36(b), it was plain that Congress knew how to mandate such a right when it wanted to.[17] Finally, the court found, the lack of "rights-creating language" in favor of investors in the specific provisions in question cast doubt on the notion that Congress intended to allow such individuals to enforce any such rights.[18]

Excessive Fee Claims

Even more abrupt was the Court of Appeals' rejection of the plaintiffs' claims under Section 36(b). First, the court held, plaintiffs' claims against the investment adviser defendants and the trustee defendants failed because these defendants had not actually received the allegedly excessive fees, thus failing one central element of any Section 36(b) claim: receipt of the fees

7 *Eaton Vance*, 2007 WL 766209 at *2-*4.

8 15 U.S.C. § 80a-33(b).

9 *Eaton Vance*, 380 F.Supp.2d at 228-29.

10 15 U.S.C.A. § 80a-35(a).

11 *Eaton Vance*, 380 F.Supp.2d at 229.

12 15 U.S.C. § 80a-47(a).

13 *Eaton Vance*, 2007 WL 766209 at *4.

14 *Eaton Vance*, 2007 WL 766209 at *2-*4 (citing *Alexander v. Sandoval*, 532 U.S. 275 (2001) and *Olmsted v. Pruco Life Ins. Co.*, 283 F.3d 429 (2d Cir. 2002)).

15 *Id.* at *2-*3.

16 *Id.* at *3.

17 *Id.* The unpublished opinion actually refers here to Section 35(b) but, as that section makes no reference to any private right of action, it is apparent that the court intended to refer to Section 36(b).

18 *Id.*

under scrutiny.[19] Second, the court found that the plaintiffs' central claim—that defendants charged fund investors marketing fees and drew on fund assets in order to generate increased sales and increased advisory fees—was a claim that the fees in question were "improper."[20] That, the court held, did not make out a claim under Section 36(b), which, the Second Circuit reiterated, citing *Gartenberg*, requires that a plaintiff allege that the fees were excessive, "so disproportionately large that they bore no relationship to the services provided."[21]

Implications of *Eaton Vance*

With *Eaton Vance*, the Second Circuit has sharply narrowed the remedies available under the 1940 Act for private claims of excessive fees. Rejecting implied rights of action for the principal provisions outside of Section 36(b) that might support claims for excessive fees, the Court of Appeals has left only Section 36(b) as a viable avenue for redress in such situations. The pleading burden for such claims, however, remain heavy indeed. In both *Eaton Vance* and *Morgan Stanley*, the Second Circuit affirmed dismissals of complaints, citing *Gartenberg*, even though that decision involved affirmance of a decision after trial.

While it may not be necessary that a plaintiff plead all available evidence in order to sustain a Section 36(b) claim, these decisions demonstrate that mere allegations of excessiveness will not suffice, even at the pleading stage. Rather, the recent line of Second Circuit decisions suggest that courts must apply the sort of fine-grained analysis set forth in *Gartenberg* in assessing whether the specific facts set forth in a complaint adequately show that the fee in question is grossly disproportionate to the services rendered. Thus, complaints need more than mere specificity; the allegations must also set forth a coherent explanation of why, applying the *Gartenberg* factors, the services in question do not merit the fees imposed.

Not every court nationwide has applied the rigorous *Gartenberg* standard at the pleading stage, and several such cases are nearing trial as a result. In the Second Circuit, however, the Court of Appeals' recent decisions represent formidable barriers to success on claims brought under Section 36(b) of the 1940 Act.

19 *Id.* at *4.

20 *Id.* at *5.

21 *Id.* (citing *Gartenberg*, 694 F.2d at 928).

Practice group contacts

If you have questions regarding the information in this legal update, please contact one of the attorneys listed, or the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/securities.

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