PAUL D. WEXLER, Individually and Derivatively on Behalf of Holders of Beneficial Interests In the Hudson River Trust, Plaintiff, v. EQUITABLE CAPITAL MANAGEMENT CORPORATION, ALLIANCE CAPITAL MANAGEMENT L.P., THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES and THE HUDSON RIVER TRUST, Defendants.

93 Civ. 3834 (RPP)

UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

1994 U.S. Dist. LEXIS 1651; Fed. Sec. L. Rep. (CCH) P98,118

February 16, 1994, Decided
February 17, 1994, Filed

CASE SUMMARY:

PROCEDURAL POSTURE: Plaintiff, the owner of an individual annuity contract, filed suit against defendants, a trust, a life insurance company, and two investment advisers. He filed individually and derivatively on behalf of holders of beneficial interests in the trust. The owner alleged that defendants had violated §§ 15(f) and 36(b) of the Investment Company Act (ICA), 15 U.S.C.S. § 80a-1 et seq. Defendants filed a motion to dismiss under Fed. R. Civ. P. 12(b)(6).

OVERVIEW: Under § 15(f)(1)(b) of the ICA, 15 U.S.C.S. § 80a-15(f)(1)(b), an investment adviser could receive an amount or benefit in connection with a sale of a fund if the transfer was not an unfair burden upon the investment company. The court stated that the owner had not alleged an unfair burden on the trust. The assertion that the trustees failed to search for less expensive advisers or to negotiate a better fee did not constitute a claim of an unfair burden. The complaint made no allegation that the advisory fee was for other than bona fide investment advisory or other services, and such services were excluded from the definition of "unfair burden" in § 80a-15(f)(2)(b). As for § 36(b) of the ICA, an advisory fee was excessive in violation of this section only if it was so disproportionately large that it bore no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining. The owner did not claim that the fee was disproportionately large. Finally, the owner's failure to make a demand on the trustees required that his claim under § 15(f) of the ICA be dismissed.

OUTCOME: The court dismissed the complaint.

CORE TERMS: advisory, unfair, investment advisor, partnership interests, cause of action, negotiated, excessive, beneficial interests, bona fide, disproportionately, registered, effected, advisor, holders, law firm, business trust, reasonable relationship, fiduciary duty, fail to state, failure to state a claim, conclusions of fact, disinterested, partnership, subsidiary, arm's-length, bargaining, negotiate, non-interested, transferred, negotiating

LexisNexis(R) Headnotes

Civil Procedure > Pleading & Practice > Defenses, Demurrers, & Objections > Failures to State Claims
Civil Procedure > Dismissals > Involuntary Dismissals > Failures to State Claims
[HN1] A complaint should not be dismissed under Fed. R. Civ. P. 12(b)(6) for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim that would entitle him to relief. When passing on a motion to dismiss, the court must accept the allegations in the complaint as true and construe them in favor of the pleader.

Contracts Law > Types of Contracts > Investment Contracts
Securities Law > Investment Companies > Activities
Securities Law > Investment Companies > Transactions With Affiliates
[HN2] Section 15(f) of the Investment Company Act permits an investment advisor to receive any amount or benefit in connection with a sale of securities of, or a sale of any other interest in, such investment advisor which results in an assignment of such investment advisory contract with a company if there is not imposed

an unfair burden on such company as a result of such transaction or any express or implied terms, conditions or understandings applicable thereto. 15 U.S.C.S. § 80a-15(f)(1)(b).

Securities Law > Investment Advisers > Compensation
Securities Law > Investment Companies > Declarations & Findings
[HN3] See 15 U.S.C.S. § 80a-15(f)(2)(b).

Securities Law > Investment Advisers > Compensation
Securities Law > Investment Companies > Declarations & Findings
[HN4] Excluded from the definition of unfair burden under 15 U.S.C.S. § 80a-15(f)(2)(b) is compensation for bona fide investment advisory or other services.

Governments > Fiduciary Responsibilities
Securities Law > Investment Companies > Advisory Contracts
Securities Law > Investment Companies > Declarations & Findings
[HN5] An advisory fee is excessive in violation of § 36(b) of the Investment Company Act only if 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.

Civil Procedure > Pleading & Practice > Defenses, Demurrers, & Objections > Failures to State Claims
Civil Procedure > Pleading & Practice > Pleadings > Complaints > Requirements
Civil Procedure > Pleading & Practice > Pleadings > Rule Application & Interpretation
[HN6] Under Fed. R. Civ. P. 8(a) a party is required to plead the facts upon which its claim is based. On a motion to dismiss under Fed. R. Civ. P. 12(b)(6), the court refers to those facts alleged in the complaint, not to legal conclusions of fact which may be alleged.

Civil Procedure > Pleading & Practice > Defenses, Demurrers, & Objections > Failures to State Claims
Civil Procedure > Dismissals > Involuntary Dismissals > Failures to State Claims
[HN7] Conclusory allegations without more are insufficient to defeat a motion to dismiss for failure to state a claim.

Business & Corporate Law > Corporations > Directors & Officers > Compensation > General Overview
Business & Corporate Law > Corporations > Shareholders > Actions Against Corporations > General Overview
[HN8] Under Massachusetts law, absent allegations of self-interest or showing that a transaction on its face does not benefit the company, the fact that the disinterested directors approved a transaction or were handpicked by principals in the transaction and receive compensation from the company are insufficient to excuse shareholder demand.

COUNSEL: [*1] For Plaintiff Paul D. Wexler: Bragar & Wexler, P.C., New York, NY, By: Raymond A. Bragar, Esq.

For Defendants Equitable Capital Management Corp. and The Equitable Life Assurance Society of the United States: Debevoise & Plimpton, New York, NY, By: Martin Frederic Evans, Esq. For Defendant Alliance Capital Management L.P.: Seward & Kissel, New York, NY, By: Anthony R. Mansfield, Esq. For Defendant The Hudson River Trust: Tofel Berelson & Saxl, P.C., New York, NY, By: H. David Potter, Esq. and Bingham, Dana & Gould, Boston, MA, By: Gordon B. Greer, Esq.

JUDGES: PATTERSON, JR.

OPINION BY: ROBERT P. PATTERSON, JR.

OPINION

OPINION AND ORDER

ROBERT P. PATTERSON, JR., U.S.D.J.

Plaintiff Paul D. Wexler ("Wexler") brings two claims individually and derivatively on behalf of holders of beneficial interests in the Hudson River Trust (the "Trust"), a Massachusetts business trust and registered investment company under the Investment Company Act, 15 U.S.C. 80a-1, *et seq.* ("ICA"). Defendants are the Trust, Equitable Capital Management Corporation ("ECMC"), a New York corporation, The Equitable Life Assurance Society of the United States ("Equitable"), a New York corporation, **[*2]** and Alliance Capital Management L.P. ("Alliance"), a Delaware limited partnership. Plaintiff is an owner of an individual annuity contract issued by Equitable which is invested in portfolios of the Trust. Plaintiff claims defendants have violated Sections 15(f) and 36(b) of the ICA. ECMC, a registered investment advisor, was investment advisor to the Trust and is a wholly owned subsidiary of Equitable. Alliance, a publicly traded limited partnership of which Equitable is a majority owner, is also a registered investment advisor and is now investment advisor to the Trust.

Plaintiff's claims arise out of a Transfer Agreement entered into on February 23, 1993 (the "Transfer Agreement"), pursuant to which substantially all of the assets comprising ECMC's business were transferred in July 1993 to Alliance and certain of its subsidiaries in exchange for newly issued limited partnership interests in Alliance. Plaintiff asserts that in connection with the transfer, certain officers of the Trust and ECMC, after having been employed by Alliance for nine months, will receive rights to buy limited partnership interests in Alliance at "substantially less than fair market value." Compl. P 13.

The **[*3]** first cause of action in the complaint charges that the Trust, a fund of approximately $ 364 million, has been injured by the Transfer Agreement because the sale of ECMC's assets to Alliance, coupled with the transfer of its Investment Advisory Agreement (the "Investment Advisory Agreement") from ECMC to Alliance, represents an "unfair burden" on the Trust within the meaning of Section 15(f) of the ICA in that (a) the non-interested trustees of the Trust, instead of negotiating the same fee structure that the Trust had with ECMC, should have negotiated a lower fee structure for the management of the Trust's funds either with Alliance or another investment advisor; (b) Equitable is using the transfer of the Trust's advisory agreement and future advisory fees as the bulk of the consideration for acquisition of $ 25 million in limited partnership interests in Alliance; and (c) the transaction was effected without reference to its benefit to owners of the Trust. Compl. P 16. As relief for this claim, plaintiff seeks a declaration that the transfer is null and void and termination of the investment advisory contracts.

In its second cause of action, the complaint charges that the advisory **[*4]** fees to be charged by Alliance exceed fair and reasonable investment advisory fees which could have been negotiated with a new investment advisor, and permit ECMC and Alliance to use the Trust's assets to finance the Transfer Agreement from future fees to be paid by the Trust to Alliance, all in violation of Section 36(b) of the ICA. As relief for this cause of action, plaintiff requests that all or part of the $ 25 million in limited partnership's interests in Alliance transferred to ECMC be ordered disgorged to the Trust as an excessive advisory fee and that the value of the options given to certain officers of the Trust and ECMC also be ordered disgorged to the Trust.

The complaint states that no demand is required or has been made on the trustees of the Trust to commence this action and that such demand would be futile, purportedly because the "eight allegedly non-interested trustees" have breached their fiduciary duty to the Trust's beneficiaries by approving the transaction (1) without a proper investigation as to the availability of alternate investment advisors who would perform the same function for lesser compensation, and (2) without negotiating with Alliance and ECMC for **[*5]** a lower advisory fee in lieu of some or all the compensation paid to ECMC for the transfer of the Investment Advisory Agreement.

Defendant Trust moves pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure to dismiss plaintiff's claim under Section 15(f) on the grounds that under Massachusetts law, plaintiff's futility of demand allegations are insufficient. The remaining defendants, joined by the Trust, move to dismiss pursuant to Rule 12(b)(6) on the grounds that plaintiff's allegations fail to state a claim under either Section 15(f) or Section 36(b) of the ICA and on the grounds that plaintiff cannot adequately represent the interests of the Trust or other holders of beneficial interests in the Trust.

DISCUSSION

[HN1] A complaint should not be dismissed under Rule 12(b)(6) for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim that would entitle him to relief. *See Conley v. Gibson,* 355 U.S. 41, 45-46, 2 L. Ed. 2d 80, 78 S. Ct. 99 (1957). When passing on a motion to dismiss, the court must accept the allegations in the complaint as true and construe them in favor of the pleader. *See Scheuer v. Rhodes,* 416 U.S. 232, 236, 40 L. Ed. 2d 90, 94 S. Ct. 1683 (1974); **[*6]** *Cruz v. Beto,* 405 U.S. 319, 322, 31 L. Ed. 2d 263, 92 S. Ct. 1079 (1972).

Section 15(f) of the ICA

Plaintiff's first cause of action is based on the language of Section 15(f) of the ICA which [HN2] permits an investment advisor to

> receive any amount or benefit in connection with a sale of securities of, or a sale of any other interest in, such investment advisor . . . which results in an assignment of such investment advisory contract with such company . . . if--
>
> (A) [75% independent director/trustee requirement not relevant to this case], and
>
> (B) there is not imposed an unfair burden on such company as a result of such transaction or any express or implied terms, conditions or understandings applicable thereto.

15 U.S.C. 80-15(f)(1).

Section 15(f) was enacted by Congress in the wake of *Rosenfeld v. Black,* 445 F.2d 1337 (2d Cir. 1971), *cert. dismissed,* 409 U.S. 802 (1972), to allow investment advisors a profit from the transfer of an investment advisory contract absent two circumstances. *Rosenfeld* had prohibited the sale of an investment advisory position at a profit. **[*7]** Subsequent to the enactment of Section 15(b), the Second Circuit held in *Meyer v. Oppenheimer Management Corp.,* 895 F.2d 861, 865 (2d Cir. 1990), that "in Section 15(f) Congress provided a means by which investment advisors might earn a profit upon the sale of a fund to another advisor subject to two safeguards," *i.e.,* (A) the 75% independent director/trustee requirement, and (B) the no unfair burden requirement.

The plaintiff first claims that the transfer here is an unfair burden because it was effected not for the benefit of the Trust but for the benefit of the investment advisers." Pl. Mem. in Opp. at 1-2. This claim is only an attempt to reassert the law under *Rosenfeld v. Black,* 445 F.2d 1337, which Section 15(f) was enacted to correct. Plaintiff overlooks that that section permits a benefit to the investment advisor and that his allegation in the complaint that the "transaction was effected without reference to its benefit to owners of Trust beneficial interests" (Compl. P 16(c)) does not constitute an allegation of unfair burden on the Trust.

Plaintiff also asserts that the trustees failed to search for less **[*8]** expensive, better advisors, or to negotiate a lower fee from Alliance. Compl. P 16(a); Pl. Mem. in Opp. at 8. At most, this is a claim that a lesser fee might have been negotiated. It does not constitute a claim of an "unfair burden" to the trust in violation of Section 15(f).

Next, plaintiff's memorandum makes reference to the size of the ECMC/Alliance transaction to suggest an "unfair burden" should be presumed from the size of the transaction. Plaintiff fails to articulate in his memorandum of law upon what basis the Court should presume an "unfair burden." Since the Second Circuit in *Meyer v. Oppenheimer Management Corp.,* 895 F.2d 861, did not make such a presumption in a $ 162 million transaction, this Court will not make such a presumption here.

An "unfair burden" is defined by Section 15(f)(2)(b) as: [HN3] "An unfair burden . . . includes any arrangement whereby the investment advisor . . . receives or is entitled to receive any compensation directly or indirectly . . . from such investment company or its security holders for other than bona fide investment advisory or other services." 15 U.S.C. 80a-15(2)(b).

The **[*9]** complaint makes no allegation that the investment advisory fee is "for other than bona fide investment advisory or other services." Indeed it alleges that the payments to Alliance are "advisory fees." Plaintiff argues that the statutory language "in no way limits the meaning of 'unfair burden.'" Pl Mem. in Opp. at 8. The legislative history is to the contrary. [HN4] "Excluded from the definition of unfair burden is . . . compensation for bona fide investment advisory or other services." S. Rep. No. 75, 94th Cong., 1st Sess. 142 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 319.

Lastly, plaintiff's arguments that Alliance is somehow funding the transaction through its advisory fee is rebutted by the complaint's allegations that the consideration flowing from Alliance has already been paid, *i.e.,* the issuance of the Alliance limited partnership interests to ECMC. Compl. P 12. Thus, the advisory fees cannot be "funding the transaction" and could not "fund" limited partnership interests in any event. Further, plaintiff has cited no legal support for its assertion that the use of advisory fees to fund a transaction would create an unfair burden under Section 15(f), which does not, on its **[*10]** face, restrict the use of bona fide investment advisory fees.

Section 36(b) of the ICA

With respect to plaintiff's second cause of action charging a violation of Section 36(b) of the ICA, plaintiff concedes that he has no claim against Equitable. He claims, however, that a claim is asserted against ECMC since it "will receive excessive compensation . . . in that its transfer of control is being paid for by

future fees from the Trust to Alliance." Pl. Mem. in Opp. at 16. As explained above, however, the complaint alleges that Alliance furnished its consideration for the transaction in the form of limited partnership interests in Alliance, not in cash. No further payments by Alliance are to be made according to the allegations of the complaint. Accordingly, plaintiff's argument fails because it is inconsistent with the allegations in the complaint.

With respect to plaintiff's Section 36(b) claim against Alliance, it is based on the sole allegation that the advisory fee, although the same as ECMC's, is "excessive." Complaint PP 19-20. However, [HN5] an advisory fee is excessive in violation of Section 36(b) only if it "is so disproportionately large that it bears no reasonable relationship **[*11]** to the services rendered and could not have been the product of arm's-length bargaining." *Gartenberg v. Merrill Lynch Asset Management, Inc.,* 694 F.2d 923, 928 (2d Cir. 1982), *cert. denied,* 461 U.S. 906 (1983). Plaintiff makes no claim that the fee is disproportionately large but merely argues that the trustees might have negotiated a reduced fee and, by not doing so, violated their fiduciary duty. As such it is a claim of failure to negotiate against the trustees. Absent the complaint containing an allegation of disproportionate fees or facts leading to such a conclusion, plaintiff has failed to set forth the grounds for the relief requested, i.e., that the transaction be set aside. *See also Krinsk v. Fund Asset Management Inc.,* 875 F.2d 404, 409 (2d Cir.) *cert. denied,* 493 U.S. 919 (1989).

[HN6] Under Rule 8(a) of the Federal Rules of Civil Procedure a party is required to plead the facts upon which its claim is based. On a motion to dismiss under Rule 12(b)(6), the Court refers to those facts alleged in the complaint, not to legal conclusions of fact which may be **[*12]** alleged. *Clapp v. Greene,* 743 F. Supp. 273, 276 (S.D.N.Y. 1990), *aff'd,* 930 F.2d 912, *cert. denied,* 116 L. Ed. 2d 157, 112 S. Ct. 197; *Packer v. Yampol,* 630 F. Supp. 1237, 1241 (S.D.N.Y. 1976); *see McCoy v. Goldberg,* 748 F. Supp. 146, 153 (S.D.N.Y. 1990); 5A Wright & Miller, *Federal Practice and Procedure,* § 1357 at 318 (2d ed. 1990). Plaintiff's allegation that the advisory fee is "in excess of fair and reasonable investment advisory fees" is merely a pleading of a conclusion of fact. It does not indicate in any way that the fees are disproportionately large, that they bear no reasonable relationship to the services rendered or that they could not have been the product of arm's-length bargaining. *See Gartenberg,* 641 F.2d at 928. Accordingly, the complaint fails to state a claim under Section 36(b) and must be dismissed. *See McGlinchy v. Shell Chemical Co.,* 845 F.2d 802, 810 (9th Cir. 1988) ([HN7] "conclusory allegations without more are insufficient to defeat a motion to dismiss for failure **[*13]** to state a claim.").

Adequacy of Representation of the Class

Defendants also assert plaintiff cannot fairly and adequately represent the interests of the Trust under Section 36(l) since he is a partner in the two member law firm representing plaintiff in this action. Defendants argue that plaintiff must meet the requirement of Rule 23.1 of the Federal Rules of Civil Procedure, *see Markowitz v. Brody,* 90 F.R.D. 542, 549 (S.D.N.Y. 1981), and that, because plaintiff's primary interest will be in the fee his law firm might recover, his interest in his fee will outweigh his interest as a member of the class. This position is well taken. *See Turoff v. May Co.,* 531 F.2d 1357 (6th Cir. 1976); *Cotchett v. Avis Rent A Car Sys. Inc.,* 56 F.R.D. 549, 554 (S.D.N.Y. 1972); *Kramer v. Scientific Control Corp.,* 534 F.2d 1085, 1092 (3d Cir.), *cert. denied,* 429 U.S. 830 (1976); *Flamm v. Eberstadt,* 72 F.R.D. 187, 188-89 (N.D. Ill. 1976), *aff'd sub nom. Sussman v. Lincoln Am. Corp.,* 561 F.2d 86 (7th Cir. 1977).

[*14]

The Failure to Make Demand on the Trustees

Lastly, plaintiff's failure to make demand on the Trustees requires that his claim under Section 15(f) be dismissed. Since the Trust is incorporated under Massachusetts law, New York courts will apply Massachusetts law. *Daily Income Fund, Inc. v. Fox,* 464 U.S. 523, 78 L. Ed. 2d 645, 104 S. Ct. 831 (1984); *Greenspun v. Lindley,* 36 N.Y.2d 473, 479, 369 N.Y.S.2d 123, 330 N.E.2d 79 (1975); *Skolnik v. Rose,* 55 N.Y.2d 964, 965, 449 N.Y.S.2d 182, 434 N.E.2d 251 (1982).

[HN8] Under Massachusetts law, absent allegations of self interest or showing that a transaction on its face does not benefit the company, the fact that the disinterested directors approved a transaction or were handpicked by principals in the transaction and receive compensation from the company are insufficient to excuse shareholder demand. *In re Kauffman Mutual Fund Actions,* 479 F.2d 257, 264-67 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973). Plaintiff points to no reason why a Massachusetts business trust should be treated any differently.

The complaint here does not allege that the disinterested trustees do not constitute **[*15]** 75% of the board as required by Section 15(f) of the ICA. Thus, there is no allegation of self interest and, since there is also no showing on its face that the transaction does not benefit the Trust, demand on the trustees was required.

CONCLUSION

For the reasons above stated, plaintiff's complaint is dismissed.

IT IS SO ORDERED.

Dated: New York, New York

February 16, 1994

ROBERT P. PATTERSON, JR.

U.S.D.J.