MUTUAL FUND FEES: THE SUPREME COURT ADOPTS THE *GARTENBERG* STANDARD

March 31, 2010

To Our Clients and Friends:

On March 30, 2010, the Supreme Court of the United States issued a unanimous decision in *Jones et al. v. Harris Associates L.P.*[1] The decision reaffirms the long-standing standard set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc.*[2] applicable to challenges to mutual fund management fees under Section 36(b) of the Investment Company Act of 1940 (the "Act"). The Supreme Court's opinion follows the *Gartenberg* rationale fairly closely, and thus does not reflect a significant change in law and should not require a significant departure from the approach that most mutual fund boards take in reviewing investment advisory agreements.

BACKGROUND

The *Harris* plaintiffs, shareholders of mutual funds managed by Harris Associates, filed an action in the Northern District of Illinois in 2007 alleging that Harris Associates had charged fees that violated Section 36(b) of the Act. The plaintiffs argued, among other things, that Harris Associates' mutual fund fees were excessive in light of the lower fees that Harris Associates charged its institutional clients. The District Court granted summary judgment for Harris Associates, concluding that the plaintiffs had failed to raise a triable issue of fact, applying the *Gartenberg* standard. *Gartenberg* held that mutual fund management fees would violate Section 36(b) only if fees were "so disproportionately large that they could not have been the result of arm's-length bargaining." *Gartenberg*, which was decided by the Second Circuit Court of Appeals in 1982, has been widely followed by the federal courts.

The Seventh Circuit Court of Appeals affirmed the District Court's judgment, but, in doing so, explicitly disapproved *Gartenberg* on the grounds that it "relies too little on markets."[3] The Seventh Circuit reasoned that sophisticated investors shop for funds that produce the best overall results and can move their money elsewhere when fees are excessive in relation to the results. The Seventh Circuit adopted a disclosure standard, stating that "[a] fiduciary

1 *559 U.S. __ (2010), available at: http://www.supremecourt.gov/opinions/slipopinions.aspx.*

2 *Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (CA2 1982).*

3 *Jones v. Harris Assocs., L.P., 527 F.3d 627, 632 (7th Cir. 2008).*

must make full disclosure and play no tricks but is not subject to a cap on compensation," based on the notion that if customers knew what they were paying, the competitive marketplace, coupled with a displeased investor's ability to move funds, could be trusted to set fees at acceptable levels. The Court noted that the amount of the fee might be relevant if it were "so unusual" as to give rise to an inference "that deceit must have occurred."[4]

In addition to creating a split in the circuit courts, the Seventh Circuit opinion revealed an interesting split in the Seventh Circuit itself. In a blistering dissent from a denial of a motion for rehearing, Judge Richard Posner argued that the *Harris* court's rejection of *Gartenberg* was based "mainly on an economic analysis that is ripe for reexamination" and expressed concern that Harris Associates charged "its captive funds more than twice what it charges independent funds." Judge Posner's dissent appeared to be designed to encourage the Supreme Court to review the case.

The Supreme Court granted *certiorari* to resolve the split among circuits created by the Seventh Circuit.

THE SUPREME COURT'S DECISION

The Supreme Court, in an opinion written by Justice Alito, concluded that *Gartenberg* was correct in its basic formulation that "[t]o be guilty of a violation of §36(b), . . . the 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." To make this determination, "all relevant circumstances must be taken into account . . . ."[5] The Court vacated the Seventh Circuit's judgment and remanded the case to the District Court for further proceedings consistent with its opinion. Justice Thomas filed a concurring opinion.

The Court acknowledged that "[t]he *Gartenberg* standard . . . may lack sharp analytical clarity, but we believe that it accurately reflects the [legislative] compromise that is embodied in §36(b), and it has provided a workable standard for nearly three decades." Perhaps because of this lack of clarity, the Court reminded lower courts that Section 36(b) does not require them to engage in a "precise calculation of fees representative of arm's-length bargaining" nor call for "judicial second-guessing of informed board decisions." "*Gartenberg's* 'so disproportionately large' standard . . . reflects [a] congressional choice to 'rely largely upon [independent director] "watchdogs" to protect shareholder interests.'" The Court dismissed

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4 *Id.*

5 *Gartenberg at 928-9.*

a debate among the Seventh Circuit judges concerning the economic underpinnings of Section 36(b) as "a matter for Congress, not the courts."

Deference to the Board

Section 36(b) provides that approval of the fee arrangements by a fund board of directors "shall be given such consideration by the court as is deemed appropriate under all the circumstances." In *Harris*, the Supreme Court reaffirmed the important role of independent directors. The Court quoted the *Gartenberg* court's view that "the expertise of the independent trustees . . . whether they are fully informed about all the facts bearing on the service and fee, and the extent of care and conscientiousness with which they perform their duties are important factors to be considered in deciding whether they and the [adviser] are guilty of a breach of fiduciary duty in violation of §36(b)."[6] At the same time, the Court acknowledged that the "appropriate measure of deference varies depending upon the circumstances." The Court discussed the factors that should be considered in assessing the measure of deference that should be given to a board decision:

- *A Robust, Informed Process*: "Where 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."[7] If a board considered the relevant factors, "their decision is entitled to considerable weight, even if a court might weigh the factors differently." A court should not substitute its judgment for that of a board in possession of all relevant information based on evidence that the fee fails the "disproportionately large" standard.

- *Process and Disclosure Failures*: If a board's process was deficient or an adviser withheld important information, the courts must take "a more rigorous look at the outcome." Moreover when an adviser fails to disclose material information to the board, "greater scrutiny [of the adviser's fee] is justified because the withheld information might have hampered the board's ability to function as 'an independent check upon the management.'"[8] Thus, an adviser's compliance or non-compliance with its disclosure obligations "is a factor that must be considered in calibrating the degree of deference that is due to a board's decision . . . ."

6 *Citing Gartenberg at 930.*

7 *Citing Burks v. Lasker, 441 U.S. 471 (1979).*

8 *Quoting Burks at 484.*

The Court made it clear that, even in the event an investment adviser fails to make certain disclosures, the focus of the inquiry must remain on the overall adequacy of the fees. In doing so, the Court appeared to steer clear of a recent Eighth Circuit view that an investment adviser's failure to disclose could itself be actionable under Section 36(b).[9]

The *Gartenberg* Factors

The *Gartenberg* decision cited a number of factors that a board should consider in connection with its review of an investment management agreement.[10] The Court acknowledged these factors, but left the door open to the identification of additional areas of factual inquiry, noting that "the Act requires consideration of all relevant factors."

Fee Comparisons

The formal question presented to the Court was whether a security holder's claim that a mutual fund's investment adviser breached its fiduciary duty by charging an excessive fee—more than twice the fee it charged to clients with which it was not affiliated—is cognizable under Section 36(b). The Court concluded that such a fee comparison, by itself, was not sufficient—since Section 36(b) "requires consideration of all relevant factors" there should not be "any categorical rule regarding the comparisons of the fees charged different types of clients."

The Court did address the considerations that a court should take into account in evaluating fee comparisons. The opinion states that "courts may give comparisons [to institutional fees charged by the same adviser] . . . the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons."

The Court acknowledges that there may be significant differences between the services provided, and thus the fees charged, to institutional and retail funds by the same adviser, and therefore instructs that "[i]f the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison." These issues are factual issues to be considered by the board of directors. In addition, the Court cautioned that even if "the services provided and fees charged to an independent fund are relevant, courts should

9 *See Gallus v. Ameriprise Financial, Inc., 561 F. 3d 816 (CA8 2009).*

10 *The Gartenberg factors include: (i) the adviser's cost in providing the services; (ii) the extent to which the adviser realized economies of scale; (iii) the nature and quality of services provided; (iv) the profitability of the fund to the adviser; (v) fall-out benefits that inure to the adviser; (vi) fees paid to the adviser by similar funds; and (vii) the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation.*

be mindful that the Act does not necessarily ensure fee parity between mutual funds and institutional clients . . . ."

The opinion also sounds a cautionary note with respect to relying too heavily on comparisons with fees charged to mutual funds by other advisers. The opinion observes that such comparisons may be "problematic," because the fees charged by other advisers may not be the product of negotiations conducted at arm's length. In other words, courts and boards of directors should not rely exclusively on industry fee benchmarks.

Impact on Litigation

Defendants hope, in fee litigation, to be able to move for a summary judgment to dismiss the case before trial. To be granted a summary judgment the defendant must show that the plaintiffs have not raised any genuine issue as to any material fact.[11] In actual fact, defendants have been granted summary judgment where they demonstrate overwhelming evidence of well-informed, diligent board action. It remains to be seen whether *Harris* will have a significant impact on the ability of management companies to prevail on motions for summary judgment. The Court stated that Section 36(b) imposes a heavy burden of proof on plaintiffs, noting that "[o]nly where plaintiffs have shown a large disparity in fees that cannot be explained by the different services in addition to other evidence that the fee is outside the arm's-length range will trial be appropriate." Justice Thomas addressed this issue in his concurring opinion, noting that the courts, principally in deciding which Section 36(b) cases may proceed beyond summary judgment, have deferred to "the informed conclusions of disinterested boards" and hold plaintiffs to "their heavy burden of proof in the manner [Section 36(b)] and now the Court's opinion requires."

The Supreme Court's *Harris* decision may do little to change the current state of affairs. Its general language about the need to consider all factors may, however, leave the door open for the discovery by plaintiffs of new lines of inquiry that the board of directors should have, but did not, pursue.

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11 *Summary judgment is proper if the record shows "that there is no genuine issue as to any material fact and that the movant is entitled to judgment as a matter of law." FED. R. CIV. P. 56(c); see also Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986).*

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