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REAFFIRMING *GARTENBERG*: THE SUPREME COURT UPHOLDS THE LONG-STANDING FRAMEWORK FOR EVALUATING MUTUAL FUND FEES

On March 30, 2010, the Supreme Court unanimously reversed and remanded the Seventh Circuit's denial of an appeal of summary judgment by plaintiffs alleging that a mutual fund's investment adviser charged excessive advisory fees.[1] Justice Samuel Alito's decision reaffirmed the Gartenberg[2] standard, which has been used for almost three decades to determine whether investment advisers to mutual funds have complied with their statutory fiduciary duty.

BACKGROUND

Section 36(b) of the Investment Company Act of 1940 (the "1940 Act")[3] deems the investment adviser of a registered investment company to have a fiduciary duty with respect to the fees it charges its clients and gives the Securities and Exchange Commission (the "SEC") and private securityholders a right of action against investment advisers who have breached that fiduciary duty.

The *Jones* lawsuit was brought by investors in the Oakmark Funds, a family of open-ended mutual funds advised by investment adviser Harris Associates L.P., who claimed that Harris Associates breached its fiduciary duty by charging advisory fees that were unreasonably high in light of the fact that, among other things, the fund's investment adviser charged institutional clients only half of the fees that it charged mutual fund clients. The *Gartenberg* standard for determining whether an investment adviser fulfilled its fiduciary duty is 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,"[4] and a thorough evaluation of the propriety of mutual fund fees would include the following considerations:

- the adviser-manager's cost in providing the service;

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- the extent to which the adviser-manager realizes economies of scale as the fund grows larger;
- the volume of orders that must be processed by the manager;
- the nature and quality of the services provided to the fund and shareholders;
- the profitability of the fund to the adviser;
- any "fall-out financial benefits," collateral benefits that accrue to the adviser because of its relationship with the mutual fund;
- comparative fee structure (meaning a comparison of the fees with those paid by similar funds); and
- the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation.[5]

Courts evaluating the propriety of mutual fund fees have determined that an investment adviser has or has not fulfilled its fiduciary duty by considering the factors listed in *Gartenberg*, reviewing the negotiations between the board of directors and the investment adviser, and then comparing the actual fees assessed to the fees that would result from arm's-length bargaining.

THE SEVENTH CIRCUIT REJECTS *GARTENBERG*

The Seventh Circuit heard *Jones* on appeal after the Northern District of Illinois granted summary judgment to Harris Associates on the basis that the fees Harris Associates charged were consistent with the fees that other fund advisers charged for other similar financial products, including products and services offered to both institutional investors and mutual fund clients. The district court applied the *Gartenberg* standard and rejected the plaintiffs' claims that conflicts of interest inherent in the relationships between the board of directors and the investment adviser rendered the Oakmark Funds' boards unable to effectively negotiate on behalf of the funds' shareholders.

After losing in the district court, the plaintiffs appealed to the Seventh Circuit, which upheld the lower court's decision but rejected the *Gartenberg* standard.[6] Rather than apply the *Gartenberg* standard, the Seventh Circuit used the law of trusts as the benchmark to determine what "fiduciary duty" meant in the context of §36(b): "A trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay."[7]

The Seventh Circuit held that the Second Circuit both misinterpreted the "fiduciary duty" language in §36(b) and that the market—not the courts—should determine appropriate investment advisory fees. "A fiduciary duty differs from 'rate regulation.' A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth."[8]

The court continued on to state that comparing industry fee standards may be an imperfect method to determine the exactly appropriate fees, but they remain superior to a fee system imposed by and subject to judicial review, which was appropriate only when investment advisers inadequately disclosed pertinent facts to the board of directors or when fees were so "unusual that a court will infer that deceit must have occurred or that the persons responsible for decision … abdicated"[9] their responsibilities.

THE SUPREME COURT REVERSES THE SEVENTH CIRCUIT AND RESOLVES A CIRCUIT SPLIT

The Supreme Court held that while *Gartenberg* was an imperfect framework for determining the reasonableness of mutual fund fees, the Seventh Circuit put undue weight on the element of disclosure by advisers and that competitive pricing does not necessarily indicate that boards of directors and advisers have negotiated a fair fee. The Court quoted *Gartenberg*: "Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between [investment advisers] for fund business. The former may be vigorous even though the latter is virtually non-existent."[10]

Courts must apply the *Gartenberg* test by appropriately weighing those factors that are most prominent and applicable in a certain fee structure. Depending on the circumstances and the similarities and differences between various other investment vehicles, comparisons of services provided to mutual funds and institutional investors may or may not be appropriate. And while reviewing courts must give substantial deference to the outcome of fair and robust negotiations between investment advisers and boards of directors, the resulting fees may still be excessive. Courts should also continue to evaluate investment advisers' compliance with their duties of full and thorough disclosure, but that should be one of several considerations, not the only consideration, and should also be weighted based on the "care and conscientiousness"[11] with which the board performs its duties.

On April 5, 2010, the Supreme Court vacated and remanded an Eighth Circuit decision, *Gallus v. Ameriprise Financial, Inc.*, that held that courts should use the *Gartenberg* test to determine if mutual fund fees were merely excessive and not "disproportionately large."[12] The Eighth Circuit decision also suggested that *Gartenberg* should be used to evaluate other aspects of the investment adviser's fiduciary role, in addition to its responsibility to fair dealing and not setting "disproportionately large" advisory fees. The Eighth Circuit noted that *Gartenberg* neither addressed nor reversed a 1976 Second Circuit decision that held that an investment adviser violated its fiduciary duty by "acquiring from the mutual fund, without full disclosure to the [board of directors], a patently onesided revision of the advisory contract."[13] The Supreme Court's decision in *Gallus* seems to indicate that the question as to whether an investment adviser has breached its fiduciary duty under §36(b) requires a two-pronged analysis: The fees must be "disproportionately large" *and* violate the *Gartenberg* factors that are most appropriate to consider in the particular instance.

THE FUTURE OF MUTUAL FUND FEE LITIGATION

The Supreme Court's reversal of *Gallus* and *Jones* reflects its interest in solidifying *Gartenberg* as the standard for determining investment advisers' compliance with §36(b). The decisions, however, have different implications for investors and investment advisers. *Jones* favors investors by requiring courts to use the entirety of the *Gartenberg* test to determine the reasonableness of a particular fee structure. But *Gallus* favors investment advisers because it restricts courts to using *Gartenberg*'s "disproportionately large" fee metric as the basis of litigation under §36(b)—courts may not use the *Gartenberg* factors to reduce a fee if that fee is merely excessive and not "disproportionately large."

It is important to keep in mind, and the decision in *Jones* states, that plaintiffs have never used *Gartenberg* to win a court-ordered reduction in mutual fund fees. Still, boards of directors should be aware that their dealings with their funds' investment advisers will be a critical element of any analysis of the propriety of their advisers' fees. Boards should require that advisers disclose all material facts during negotiations and should also be sure to use all relevant industry comparisons, such as the fees charged to similarly structured funds advised by other investment advisers, as well as the fees charged to other clients of the adviser, when benchmarking their own funds' fees.

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ENDNOTES

1. *Jones et al v. Harris Associates L.P.*, No. 08-586, U.S. LEXIS 2962 (U.S. Mar. 30, 2010).

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

3. 15 U.S.C. § 80a-35(b) (2010).

4. *Gartenberg*, 694 F.2d at 928.

5. *Gartenberg*, 694 F.2d at 929-32.

6. *Jones v. Harris Associates L.P.*, 527 F.3d 627 (7th Cir. 2008). In an ironic twist, the plaintiffs asked the Seventh Circuit to reject the application of the *Gartenberg* standard because the *Gartenberg* court relied too heavily on a comparison of other mutual fund fees. The plaintiffs argued that, due to the lack of real competition between funds and the inherent conflicts of interest between funds' boards of directors and investment advisers, the mutual fund industry had an "incestuous" fee climate. Even an apparently thorough negotiation would be tainted by the too-close relationship between the funds' boards and the investment advisers and the lack of a truly competitive market. Almost all of a particular fund's physical and intellectual infrastructure was supported by the investment management company. Plaintiffs also claimed that the fees charged to mutual funds should mirror the fees charged to institutional investors, who received the same products and services. The Seventh Circuit did indeed reject *Gartenberg* but still also firmly rejected the plaintiffs' reasoning.

7. *Id.* at 632.

8. *Id.*

9. *Id.*

10. *Jones et al v. Harris Associates L.P.*, No. 08-586, U.S. LEXIS 2962, at *27 (U.S. Mar. 30, 2010) (citing *Gartenberg*, 694 F.2d at 929).

11. *Gartenberg*, 694 F.2d at 930.

12. *Gallus v. Ameriprise Financial, Inc.*, 561 F.3d 816, 821 (8th Cir. 2009).

13. *Id.* at 823 n.3 (citing *Galfand v. Chestnutt Corp.*, 545 F.2d 807 (2d Cir. 1976)).

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