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Supreme Court Upholds *Gartenberg* Standards

On March 30, 2010, the U.S. Supreme Court in *Jones v. Harris Associates* [1] reaffirmed the *Gartenberg v. Merrill Lynch Asset Management, Inc.* [2] *("Gartenberg")* standard as the correct formulation of what § 36(b) of the Investment Company Act of 1940 (the "1940 Act") requires for evaluating excessive advisory fee claims by mutual fund shareholders. Under this standard, an investment adviser will be liable under § 36(b) only if it charges an advisory 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." [3] Procedurally, the Court vacated the Seventh Circuit's decision in *Jones v. Harris Associates*,[4] rejecting that court's new market and disclosure based standard. Instead, the Court chose not to disturb the *Gartenberg* standard, observing that the standard had proved "workable for nearly three decades." [5]

Procedural History

Mutual fund shareholders sued Harris Associates L.P. ("Harris Associates") in the District Court of the Northern District of Illinois alleging that the advisory firm had violated §36(b) by charging fees to the mutual funds that were "disproportionate to the services rendered" and "not within the range of what would have been negotiated at arm's length in light of all the surrounding circumstances." Applying the *Gartenberg* standard, the District Court granted summary judgment in favor of Harris Associates.

The shareholder plaintiffs appealed the District Court's summary judgment order to the Court of Appeals for the Seventh Circuit, setting the stage for a show down between two judges on that court -- Judge Frank Easterbrook and Judge Richard Posner. Judge Easterbrook, writing for a three-judge panel of the Seventh Circuit that overturned the District Court's decision, opined that the *Gartenberg* "reasonableness" standard requires a form of judicial rate regulation that is neither mandated by the statute nor an effective means for protecting investors. Instead, Judge Easterbrook's opinion instructed that, when evaluating a § 36(b) claim, a court should ask "whether the client made a voluntary choice *ex ante* with the benefit of adequate information."[6] The Court of Appeals held that, while there should be proper disclosure, the level of fees should be regulated by the market and not the courts.[7]

Subsequently, the shareholder plaintiffs submitted a petition to the Court of Appeals for a rehearing, which was denied. At the same time, another judge on the Court of Appeals suggested a rehearing *en banc*, which was denied by an equally divided vote. Judge Posner, who did not participate in the initial decision, and four other judges dissented from the denial. The dissent cited the overwhelming authority supporting the *Gartenberg* approach for considering excessive fee claims and questioned the prudence of contradicting that authority.

The Supreme Court granted *certiorari* to resolve the split among the Courts of Appeals caused by the *Harris* decision and heard oral arguments on the case in November 2009.

Preservation of the *Gartenberg* Standard

The Supreme Court upheld the *Gartenberg* standard. The Court recognized that, with the exception of the Seventh Circuit's decision in *Harris*, the courts and the Securities and Exchange Commission had reached a consensus that the *Gartenberg* standard should be used when reviewing advisory fees.

The Court began its opinion by discussing the meaning of "fiduciary" for purposes of § 36(b), noting that it incorporates a standard taken from the law of trusts. Instead of trying to identify the precise trust-law standard, the Court referenced a non-investment company case, *Pepper v. Litton*, 308 U.S. 295 (1939), and stated that the following formulation expresses the meaning of "fiduciary duty" for purposes of § 36(b):

The essence of the test is whether or not under all circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside.[8]

In particular, the Court noted that:

- *Gartenberg* insists that all relevant circumstances be taken into account;
- *Gartenberg* uses the range of fees that might result from arm's length bargaining as the benchmark for reviewing challenged fees; and
- The party claiming the breach of § 36(b) has the burden of proof to show that the fee is outside the range that arm's length bargaining would produce.[9]

Comparison of Mutual Fund and Other Institutional Client Fees

The Court did not review each *Gartenberg* factor or other factors subsequently developed by other courts. However, the Court addressed the relevance of a comparison of fees charged by the adviser to the mutual fund and other types of adviser clients, a key factor in the lower courts' decisions. The Court stated that "courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require."[10] The Court specifically noted, however, that there may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension plan. If the differences are too great, the Court warned that such a comparison will not be probative. Even if the services are similar, "courts should be mindful that the [1940] Act does not necessarily ensure fee parity between mutual funds and institutional clients . . ."[11]

Comparison of Mutual Fund and Unaffiliated Mutual Fund Fees

The Court, in dictum, also addressed the significance of a mutual fund's fee compared to fees charged in other fund complexes. It stated that "[c]ourts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers."[12] Competiveness between unaffiliated funds in terms of advisory fees in the Court's view did not necessarily mean that those fees satisfied the adviser's duty under § 36(b) to charge a reasonable, arm's length fee.[13]

Board Process and a Court's Deference to the Board's Judgment

The Court set forth a sliding scale dependent upon board process with respect to the extent to which a reviewing court should defer to the Board's business judgment regarding the appropriateness of the advisory fee. Citing *Burks v. Lasker*, 441 U.S. 471, 484 (1979), the Court stated that "[w]here a board's procedures for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process."[14] On the other hand, a deficient board process or the withholding by the adviser of important information will necessitate "a more rigorous look at the outcome."[15]

Practical Implications

The Supreme Court's decision in *Jones v. Harris* will require independent directors to review and possibly strengthen, instead of overhaul, their 15(c) investment advisory contract review process. The decision certainly reminds independent directors that they are the "independent watchdogs" of the relationship between the mutual fund and its adviser and with that role comes significant responsibilities, including the 15(c) process. Many fund boards undoubtedly will have to improve this process so that it rises to the "robust" review envisioned by the Supreme Court.

One notable shift may be a de-emphasis of competing funds' fees and an increased emphasis on the costs of the investment adviser to provide its advisory services to the mutual funds. While the Court chose not to elevate the significance of the fees charged to non-mutual fund clients, it nevertheless stressed the importance of the board having information about the costs of advisory services. Consequently, investment advisers may find it useful to describe to boards in more detail than is customarily provided currently the differences between the advisory services provided to mutual fund clients and those provided to other clients when the advisory fees charged to mutual funds are significantly higher than those charged to the other clients.

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[1] 559 U.S. ___ (2010).
[2] 694 F.2d 923 (2d Cir. 1982).
[3] 559 U.S. ___ (2010) (slip op., at 9).
[4] 527 F.3d 627 (7th Cir. 2008).
[5] 559 U.S. ___ (2010) (slip op., at 17).
[6] 527 F.3d 627 at 633.
[7] *Id.* at 635.
[8] 559 U.S. __ (2010) (slip op., at 2) (citing *Pepper v. Litton*, 308 U.S. 295, 306-307 (1939)).
[9] 559 U.S. __ (2010) (slip op., at 11).
[10] *Id.* at 13.
[11] *Id.* at 14.
[12] *Id.*
[13] *Id.*
[14] *Id.* at 15.
[15] *Id.*