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REPORT FROM WASHINGTON

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# The Supreme Court Adopts the *Gartenberg* Standard to Determine Whether an Investment Adviser Breached its Fiduciary Duty in Approving Fees

***March 31, 2010***

Under Section 36(b) of the Investment Company Act of 1940 (the "Act"), investment advisers have a "fiduciary duty with respect to the receipt of compensation for services." In *Jones v. Harris Associates L.P.*, No. 08-586, the Supreme Court unanimously held yesterday that an investment adviser breaches this duty where it charges "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."

In the absence of a Supreme Court opinion on the issue, the Second Circuit's decision in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F. 2d 923 (2d Cir. 1982), had been relied upon by most lower courts in evaluating whether an investment adviser breached its fiduciary duty under Section 36(b). This consensus approach, however, was recently challenged by the decision of the Seventh Circuit Court of Appeals in this case. The Seventh Circuit explicitly rejected the *Gartenberg* standard. In its decision, written by Justice Alito, the Supreme Court expressly adopted the *Gartenberg* standard and vacated the Seventh Circuit's decision. The Court did not, however, provide further guidance regarding how the standard should be applied, and in fact recognized that the approach "may lack sharp analytical clarity." Justice Thomas authored a concurring opinion clarifying that the Court's decision does not allow "the free-ranging judicial 'fairness' review of fees that *Gartenberg* could be read to authorize . . . ."

## BACKGROUND

*Jones* was brought by shareholders in several mutual funds formed and advised by Defendant-Respondent Harris Associates L.P. ("Harris"). In 2004, plaintiffs filed suit against Harris, alleging that the company had breached its "fiduciary duty with respect to the receipt of compensation for services" to the shareholders under Section 36(b) of the Act. 15 U.S.C. § 80a-36(b). Specifically, plaintiffs alleged that Harris violated Section 36(b) by charging them twice as much as Harris charged its institutional clients and failing to provide full and accurate disclosure to the funds' board members and shareholders of material facts relating to compensation. Plaintiffs also alleged violations of other structural provisions of the Act relating to public disclosure and board independence.

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Northern District of Illinois Judge Kocoras granted Harris' motion for summary judgment, relying on *Gartenberg*. In that case, the Second Circuit held that a breach of fiduciary duty occurs only when an adviser "charge[s] 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 an arm's-length bargaining." 694 F. 2d at 928. Finding that the fees paid by plaintiffs were fully disclosed and comparable to those paid by other mutual funds, the district court concluded that there was no breach of fiduciary duty under Section 36(b).

On appeal, in an opinion written by Judge Easterbrook, the Seventh Circuit affirmed the district court's decision granting summary judgment, but expressly disapproved of the *Gartenberg* standard for relying "too little on markets." 527 F. 3d 627, 632 (7th Cir. 2008). The Seventh Circuit instead found that the fees were not excessive because they were set by market forces. The court reasoned that the amount of an adviser's compensation should be relevant only if the compensation were "so unusual" as to give rise to an inference "that deceit must have occurred, or that the persons responsible for decision have abdicated." *Id*. According to the court, "[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." *Id*. Recognizing that "[m]utual funds rarely fire their investment advisers," the Seventh Circuit observed that: "investors can and do 'fire' advisers cheaply and easily by moving their money elsewhere." *Id*. at 633. The court found that there was no evidence that Harris "pull[ed] the wool over the eyes" of its shareholders, and therefore there was no need to engage in "judicial price-setting." *Id.* at 635.

The Seventh Circuit denied rehearing *en banc* by a vote of five to five. Dissenting from that decision, Judge Posner stated that the panel opinion was based on "an economic analysis that is ripe for re-examination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation." 537 F. 3d 728, 730 (7th Cir. 2008).

On March 29, 2009, the Supreme Court granted plaintiffs' petition for writ of certiorari. Oral argument was held on November 1, 2009.

## SUMMARY OF THE DECISION

In a unanimous opinion, the Supreme Court vacated the Seventh Circuit's judgment and remanded the case for further proceedings consistent with its opinion.

The Court held that, to breach its fiduciary duty, "an investment adviser 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." The Court expressly adopted the *Gartenberg* standard, reasoning that that the Second Circuit's decision was consistent with two principles embodied in the Act: "First, a measure of deference to a board's judgment may be appropriate in some circumstances. Second, the appropriate measure of deference varies depending on the circumstances."

The Court then addressed the question of whether it is appropriate for a reviewing court to consider comparisons between the fees that an adviser charges a captive mutual fund and the fees that it charges its institutional and other independent clients. According to

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*OPINION OF THE COURT*

the Court, "[s]ince the Act requires consideration of all relevant factors, we do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients." Although reviewing courts should give comparisons the weight that they merit, the Court stated, they should be wary of significant differences in the services provided. The Court noted that services between mutual funds and institutional clients may differ because of the "greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and higher marketing costs." In short, parity was not necessarily required.

The Court also stated that courts "should not rely too heavily on comparisons with fees charged to mutual funds by other advisers. These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm's length."

*"[A] court's evaluation of an investment adviser's fiduciary duty must take into account both procedure and substance."*

*OPINION OF THE COURT*

The Court noted that: "a court's evaluation of an investment adviser's fiduciary duty must take into account both procedure and substance." A reviewing court should afford deference to the outcome of the bargaining process "[w]here a board's process for negotiating and reviewing investment-adviser compensation is robust . . . ." On the other hand, where a board has deficient processes, or the adviser withheld important information, the reviewing court "must take a more rigorous look at the outcome." Although the Court recognized that an adviser's compliance or non-compliance with its disclosure obligations is a factor in considering the degree of deference owed to a board's decision to approve an adviser's fees, the Court held that the Seventh Circuit erred in focusing almost entirely on disclosure.

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*OPINION OF THE COURT*

Finally, the Court stressed that reviewing courts should not substitute their own judgment for that of informed, disinterested directors absent evidence that the fee exceeds the arm's-length range. The Court stated: "the Act does not require courts to engage in a precise calculation of fees representative of arm's-length bargaining." In fact, the Court observed, Congress has recognized that courts are not well suited to make such decisions.

Justice Thomas authored a concurring opinion to clarify the scope of the Court's decision. According to Justice Thomas, "[t]he District Court and Court of Appeals in *Gartenberg* created standard . . . emphasizes fee 'fairness' and proportionality in a manner that could be read to permit the equivalent of the judicial rate regulation the *Gartenberg* opinions disclaim . . . ." Justice Thomas disclaimed the Court's decision as an "affirmation of the '*Gartenberg* standard'" because the decision does not allow "the free-ranging judicial 'fairness' review of fees that *Gartenberg* could be read to authorize . . . ."

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*JUSTICE THOMAS, concurring*

## IMPLICATIONS

In *Jones*, a unanimous Supreme Court expressly adopted the *Gartenberg* standard to evaluate whether an investment adviser breached its fiduciary duty under Section 36(b) of the Act. Under that standard, reviewing courts are to analyze a fee to determine whether 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." Because this is the standard that has been consistently used by reviewing courts for nearly three decades, the impact of the Court's decision on the manner in which fund boards evaluate advisory fees likely will be limited. In evaluating advisory fees and advisory contracts, fund boards should consider factors developed in *Gartenberg*, including (1) the nature, quality and scope of the services and personnel provided by the adviser; (2) the amount of the advisory fees payable to the adviser and advisory fees paid by similar funds; (3) the compensation (in addition to the advisory fees) and other benefits received by the adviser and its affiliates in respect of the fund; (4) the adviser's costs in providing advisory services; (5) the economies of scale realized by the adviser; (6) possible alternatives to the proposed advisory arrangements with the adviser; (7) the operating expenses of the fund; and (8) the policies and practices of the adviser with respect to portfolio transactions of the fund. Boards should also continue to compare fees payable by other clients of the adviser in light of the similarities and differences in the services provided.

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