

## Seventh Circuit “Disapproves” of *Gartenberg* Factors

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The Seventh Circuit Court of Appeals recently cast some uncertainty over the long-standing factors that fund directors use to determine the proper level of an adviser’s fees as set forth in *Gartenberg v. Merrill Lynch*. The court affirmed the lower court’s dismissal of a complaint against Harris Associates, the adviser to the Oakmark family of mutual funds. In support of a claim under Section 36(b) of the Investment Company Act of 1940, the plaintiffs argued that, because the funds paid a higher fee than the adviser’s institutional accounts for allegedly similar services, the funds’ fees could not have been the result of arm’s-length bargaining. While the Seventh Circuit agreed with the lower court’s dismissal of this claim, it is unclear how this decision will affect the treatment of *Gartenberg* by other courts.

### Lower Court Decision

In February 2007, the lower court dismissed a complaint against Harris Associates in *Jones v. Harris Associates*. The plaintiffs argued that the funds’ advisory fees should not have been compared to those of other comparable mutual funds in the industry, but to the fees for the adviser’s similarly managed institutional separate accounts.

The lower court disagreed with the plaintiffs’ argument that, because the funds paid a higher fee than the institutional accounts for allegedly similar services, the funds’ fees could not have been the result of arm’s-length bargaining. The lower court noted that Section 36(b) does not create a duty that advisers receive the lowest possible fees for the services they provide. Rather, what matters is whether there is a fundamental disconnect between what the funds paid and what the services were worth.

### Seventh Circuit Decision

On May 19, 2008, a three-judge panel of the Seventh Circuit affirmed the lower court’s dismissal in an opinion written by Chief Judge Easterbrook. In it, the Seventh Circuit noted that the lower court followed *Gartenberg v. Merrill Lynch* in its analysis. *Gartenberg* is the 1982 Second Circuit case that, among other things, sets forth the factors that mutual fund directors use to determine the proper level of an adviser’s fees. In its opinion, the Seventh Circuit stated that “we now disapprove the *Gartenberg* approach.”

The court took note of the plaintiffs’ skepticism of *Gartenberg* because it “relies too heavily on markets,” but stated that the court itself was skeptical about *Gartenberg* because it “relies too little on markets.” The Seventh Circuit disagreed with *Gartenberg*’s analysis that competition between funds for shareholder business does not necessarily mean that there is competition between advisers. The opinion noted that mutual funds rarely fire their investment advisers, but investors can and do “fire” advisers cheaply and easily by moving their money elsewhere. It stated that fund directors and investors, who vote with their feet and dollars—rather than a judge or jury—should determine how much advisory services are worth.

In *Gartenberg*, the court discussed the legislative history of Section 36(b), noting that the imposition of fiduciary duty contained in Section 36(b) would, in effect, require a standard of reasonableness. The *Gartenberg* court further noted that the substitution of the term “fiduciary duty” for “reasonable,” while possibly intended to modify the Section 36(b) standard somewhat, was a “more semantical than substantive compromise.”

The Seventh Circuit, in turn, stated that Section 36(b) does not say that fees must be "reasonable" in relation to a judicially created standard, but instead that the adviser has a fiduciary duty. In this regard, the decision characterizes the rule in trust law as "straightforward," allowing a fiduciary to negotiate its compensation subject only to "an obligation of candor in negotiation, and honesty in performance." It stated that judicial price-setting does not accompany fiduciary duties, and Section 36(b) does not call for a departure from this norm. It stated that competitive processes are "imperfect" but "superior to a 'just price' system administered by the judiciary." Consistent with the general trend in securities cases, the court discounted the legislative history in favor of the "text" enacted by Congress.

## Conclusion

It is unclear how this decision will affect the treatment of *Gartenberg* by the courts in the Seventh Circuit, much less by the courts in other circuits. This decision clearly asserts that the judiciary should take a less activist role than that articulated by *Gartenberg* and challenges certain *Gartenberg* advisory fee analysis factors. However, the court, despite its apparent emphasis on statutory language, does not address the actual wording of Section 36(b). That section does not simply incorporate general fiduciary principles. Instead, it creates a unique federal fiduciary duty relating specifically to investment adviser compensation. Accordingly, it is unclear that directors could use the Seventh Circuit opinion, and its suggestion of greater reliance on disclosure and allowing fees to be set by competition, as a replacement for the *Gartenberg* analysis.

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