

## Supreme Court Affirms *Gartenberg* Standard in Unanimous Decision in *Jones v. Harris Associates L.P.*

March 31, 2010

On March 30, the U.S. Supreme Court, in a unanimous decision in *Jones v. Harris Associates L.P.*, affirmed the standard as articulated by the Second Circuit Court of Appeals in 1982 in *Gartenberg v. Merrill Lynch*<sup>1</sup> as the standard upon which mutual fund boards should rely when considering the fees that a mutual fund pays to its investment adviser. Under that standard, an investment adviser will not face liability under Section 36(b) of the Investment Company Act of 1940 (1940 Act) unless 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 affirming the *Gartenberg* standard, which boards have used for many years in assessing the fees mutual funds pay to investment advisers, the Court vacated the judgment of the Seventh Circuit Court of Appeals<sup>2</sup> and remanded the case for further proceedings consistent with the Court's opinion.

As you know from our prior updates, *Jones* was on appeal from a decision by the Seventh Circuit Court of Appeals, which affirmed a district court decision granting summary judgment in favor of a fund adviser in an excessive fee lawsuit brought under Section 36(b) of the 1940 Act. While agreeing with the District Court's factual analysis and conclusion, the Seventh Circuit rejected the *Gartenberg* standard, opining that it "relie[d] too little on markets" and observing that market competition keeps fees in line. The Seventh Circuit said that as long as independent directors were given full disclosure and were not misled, courts should not second-guess a board's decision.

On appeal, the Supreme Court ruled that the Seventh Circuit erred in focusing almost entirely on the element of disclosure. The Court concluded that *Gartenberg* fully incorporates the meaning of the phrase "fiduciary duty" as set forth in prior Supreme Court precedent. "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's-length bargain."<sup>3</sup> Specifically, the Court stated that *Gartenberg* correctly (1) places the burden of proof on the plaintiff, (2) insists all relevant factors be taken into account, and (3) uses the range of fees that might result from arm's-length bargaining as the benchmark for reviewing challenged fees.

In addition, the 1940 Act requires that directors be furnished with all the information "reasonably . . . necessary to evaluate the terms of the adviser's contract"<sup>4</sup> and instructs courts to give board approval "such consideration . . . as is deemed appropriate under all the circumstances."<sup>5</sup> The Court stated in its opinion that *Gartenberg* "heeds these precepts."

The Court acknowledged that while both parties endorsed *Gartenberg* generally, they disagreed on several points that warranted discussion by the Court, such as comparisons between fees charged by an adviser to its "captive"

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

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

3. The Court found *Gartenberg* consistent with its own articulation of fiduciary duty, citing *Pepper v. Litton*, 308 U.S. 295 (1939).

4. Section 15(c).

5. Section 36(b)(2).

mutual fund and the fees it charges to its “independent clients.” The Court stated that because the 1940 Act requires consideration of all relevant factors, there can be no “categorical rule” on the comparison of fees charged to different clients. Further, the Court indicated that lower courts may give such comparisons the weight they merit, keeping in mind the differences in services among clients. The Court also warned that lower courts “must be wary of inapt comparisons.” Noting that the Second Circuit in *Gartenberg* had placed relatively little weight on fees charged to pension plans, the Court stated that “even if the services and fees are relevant, courts should be mindful that the Act does not necessarily ensure fee parity between mutual funds and institutional clients contrary to petitioners’ contentions.” Similarly, the Court also cautioned against relying too heavily on fees charged by other advisers to similar mutual funds as they may not be the result of arm’s-length negotiation.

Another area of disagreement involved the level of deference that courts should give to a board’s decision on adviser fees. The Court concluded that two inferences could be drawn from looking at both the language of Section 36(b) and the role of independent directors. “First, a measure of deference to a board’s judgment may be appropriate in some instances. Second, the appropriate measure of deference varies depending on the circumstances.” If the board has all the relevant information and their process is robust, their determination should be given “considerable weight.” If the process was deficient or the adviser withheld material information, then the outcome should be given greater scrutiny. Regardless, the standard of fiduciary duty under 36(b) does not call for judicial second-guessing. “Thus, if the disinterested directors considered the relevant factors, their decision to approve a particular fee arrangement is entitled to considerable weight, even if a court might weigh the factors differently.”<sup>6</sup> While agreeing with the Court’s decision to affirm the *Gartenberg* approach based upon the text of the 1940 Act and the Court’s “longstanding fiduciary duty precedents,” Justice Thomas clarified in a brief concurring opinion that he did not consider the Court’s decision to “countenance the free-ranging judicial ‘fairness’ review of fees that *Gartenberg* could be read to authorize and that virtually all courts deciding [such cases] have wisely eschewed in the post *Gartenberg* precedents we approve.”<sup>7</sup>

While some industry commenters are viewing the Court’s decision as paving the way for shareholders to bring claims against advisers that charge the fund higher fees than they charge other non-fund clients, we do not see that as a likely outcome—or at least not an outcome that promises much likelihood of success for the plaintiffs. The Court noted in its opinion that lower fees alone are not enough to warrant a trial. Furthermore, the Court discouraged frivolous lawsuits by making clear that a plaintiff must overcome a heavy burden for a Section 36(b) claim to make it to trial. “First, plaintiffs bear the burden in showing that fees are beyond the range of arm’s-length bargaining. § 80a–35(b)(1). Second, a showing of relevance requires courts to assess any disparity in fees in light of the different markets for advisory services. Only 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.”

As a practical matter, we do not anticipate that the Court’s opinion will have anything but an incremental impact on a board’s process for reviewing investment advisory contracts. Consistent with the Court’s opinion and *Gartenberg*, advisers will continue to be asked to provide all reasonably relevant information for the board’s consideration, and boards will continue to examine all relevant factors, with no one factor being dispositive, in deciding whether to approve an adviser’s compensation.

Accordingly, we believe mutual fund boards should take comfort in the Court’s opinion in that so long as the board’s decision to approve a particular fee arrangement is the product of thorough and thoughtful consideration of the relevant facts and circumstances, their decision should be upheld by a court. To that end, boards should continue to request any information they deem relevant to their consideration. Boards should continue to obtain such information far enough in advance to allow for a thoughtful review and the opportunity to ask any questions or request supplemental information. Boards should also continue to be diligent in conducting a thoughtful discussion of the factors they considered and the weight allotted to such factors in coming to their decision, as appropriate. Lastly, boards should be diligent in documenting their reviews.

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6. The parallels between the Court’s opinion and the 1940 Act’s own legislative history are hard to ignore. “This section [36(b)] is not intended to authorize a court to substitute its business judgment for that of the mutual fund’s board of directors in the area of management fees. . . . Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters [advisory fees] and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation.” See S. Rep. No. 1351, 90th Cong., 2d Sess. 30-31 (the legislative history of the 1970 amendments to the 1940 Act).

7. The Court’s opinion is available at <http://www.supremecourt.gov/opinions/09pdf/08-586.pdf>.

The *Jones* decision may also have ramifications for the 401(k) plan “fees” litigation pending in many jurisdictions around the country. Our ERISA Litigation Group will be issuing an FYI this week to clients and friends concerning these possible ramifications. If you would like to receive a copy, please contact Carrie Ryder at [cryder@morganlewis.com](mailto:cryder@morganlewis.com).

Thomas Harman, a partner in Morgan Lewis’s Investment Management Practice, will be participating in a webcast sponsored by Thomson Reuters on April 22 discussing the implications of the Court’s opinion. For information regarding the webcast, please contact Carrie Ryder at [cryder@morganlewis.com](mailto:cryder@morganlewis.com).

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