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Supreme Court Endorses Governing Standard for Mutual Fund Fees Cases Under Investment Company Act: An ERISA Perspective

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On March 30, in *Jones v. Harris Associates L.P.*, No. 08-586, __ U.S. __, 2010 WL 1189560 (Mar. 30, 2010)[1], the U.S. Supreme Court unanimously affirmed the Second Circuit's analysis in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), as the standard by which the fees mutual funds pay to their investment advisers should be evaluated under Section 36(b) of the Investment Company Act of 1940 (the ICA). On March 31, Morgan Lewis's Investment Management Practice issued an analysis of the case from a fund management perspective, "Supreme Court Affirms *Gartenberg* Standard in Unanimous Decision in *Jones v. Harris Associates L.P.*"[2] This LawFlash focuses instead on the implications the *Jones* case may have under the Employee Retirement Income Security Act (ERISA).

Although *Gartenberg* was decided under the ICA, at least one court of appeals has applied its holding to "excessive" fees and expense claims asserted under ERISA.[3] The Second Circuit designated *Young* as nonprecedential, so whether the Supreme Court's analysis actually has implications beyond the ICA is yet to be decided. As this LawFlash explains, *Jones* may prove helpful in defending ERISA-based excessive fees cases.

Jones **Litigation and the Supreme Court's Review**

By way of background, federal courts faced with Section 36(b) cases historically have applied a standard first articulated more than 25 years ago in *Gartenberg*. In that case, the U.S. Court of Appeals for the Second Circuit held that an investment adviser can be liable under Section 36(b) of the ICA only if the 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 arm's-length negotiating."[4]

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1 *Available at* http://www.supremecourt.gov/opinions/09pdf/08-586.pdf.

2 *Available at* http://www.morganlewis.com/pubs/IMFYI_SupremeCourtAffirmsGartenbergInJones-v-Harris_31march10.pdf.

3 *See, for example*, *Young v. General Motors Investment Management Corp*., Civ. No. 08-1532 (2d Cir. May 6, 2009).

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

The district court in *Jones* also followed *Gartenberg*, ultimately concluding that the plaintiffs—shareholders in mutual funds managed by the defendant—had not raised a triable issue of fact. The plaintiffs appealed.

The U.S. Court of Appeals for the Seventh Circuit affirmed the district court's ruling, but in doing so, rejected the district court's application of *Gartenberg*. In an opinion by Chief Judge Easterbrook, the Seventh Circuit held that the fiduciary duty imposed by Section 36(b) was designed to ensure adequate *disclosure* to investors *about the fees* being paid investment advisers, but was not intended to actually impose any cap on investment adviser compensation, except where that compensation was "so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated."

Judge Easterbrook's decision was controversial, including on the Seventh Circuit. On petition for rehearing en banc, Judge Posner took his long-time colleague to task, opining that the Seventh Circuit should continue to follow the *Gartenberg* standard given, among other things, "growing indications that executive compensation in large publicly traded firms is often excessive because of the feeble incentives of boards of directors to police compensation." *Jones v. Harris Associates, L.P.*, 537 F.3d 728, 730 (7th Cir. 2008) (opinion of Posner, J.).

The Seventh Circuit's *Jones* opinion created a circuit split between *Gartenberg* and *Jones* and, thereafter, the Supreme Court granted review.

The Supreme Court vacated the Seventh Circuit's order, ruling that the court relied too heavily on market forces and focused too narrowly on disclosure, and remanded the case for further proceedings. The Court found that *Gartenberg* properly incorporates the meaning of "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." 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 Court confirmed that the ICA requires that directors be furnished with all the information "reasonably . . . necessary to evaluate the terms of the adviser's contract" and instructs courts to give board approval "such consideration . . . as is deemed appropriate under all the circumstances." The Court again endorsed *Gartenberg* because it "heeds these precepts."

The Court acknowledged that although both the plaintiffs and the defendant accepted *Gartenberg* generally, they disagreed on several points that warranted the Court's discussion, such as the weight accorded to comparisons between fees charged by an adviser to its "captive" mutual funds and the fees it charges to its "independent clients."

Comparison of Fees as Between Captive and Independent Clients

The Court stated that, because the ICA requires consideration of *all* relevant factors, there can be no "categorical rule" on the comparison of fees charged to different clients. Further, the Court suggested 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.

Deference to Board's Decision on Adviser Fees

The Court also concluded that two inferences could be drawn from looking at both the language of ICA Section 36(b) and the role of independent directors, acknowledging that a measure of deference to a board's judgment may be appropriate in some instances depending on the circumstances. On one hand, if the board has all the relevant information and its process is robust, its determination should be given "considerable weight." If, on the other hand, the process was deficient or the adviser withheld material information, then the outcome should be given greater scrutiny.

Either way, explained the Court, the standard of fiduciary duty under ICA Section 36(b) does not call for judicial second-guessing. Therefore, "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."[5]

Applicability of *Jones* Decision to ERISA

Because of its recent vintage, it remains to be seen whether *Jones* will be confined to cases brought under the ICA or whether the Court has created a paradigm, at least by analogy, for resolving fee claims brought against 401(k) plans. From the perspective of plan fiduciaries, *Jones* contains analysis that may prove helpful in defending ERISA-based excessive fees cases.

For example, in *Jones*, the Supreme Court warned lower courts not to rely too heavily on comparisons between fees charged to different types of clients, noting that "courts may give such comparisons the weight they merit in light of the similarities and differences between the services that the clients in question require, but a court must be wary of inapt comparisons." In fact, the Court noted that there may be significant differences between the services provided by an investment adviser to, for example, a mutual fund, and those it provides to a pension fund, which are attributable to such factors as (1) the greater frequency of shareholder redemptions in a mutual fund, (2) the higher turnover of mutual fund assets, (3) the more burdensome regulatory and legal obligations, and (4) higher marketing costs. The Court thus cautioned that "[i]f the services rendered are sufficiently different that a comparison is not probative, the courts must reject such a comparison."

This analysis is relevant to a number of existing ERISA fees and expense cases, as plaintiffs often claim that the fees charged by retail mutual fund fees are "excessive" because they may be higher than similar services marketed by the same adviser to institutional clients, like pension plans.

Moreover, the Court appeared to accept market benchmarking as a method of evaluating fund fees, emphasizing that plaintiffs have the burden of establishing the relevance of their comparisons, which "requires courts to assess any disparity in light of the different markets for advisory services." Again,

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[5] The Court's caution against substituting judicial views for those of the board are supported by the ICA's legislative history. "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).

this commentary suggests that, in the ERISA context, would-be plaintiffs will need to do more than identify a disparity; they will have the burden of proving to the court that the fee comparison is an apples-to-apples analysis.

It is not surprising, however, that ERISA plaintiffs are already arguing that *Jones* does not apply to ERISA. Specifically, plaintiffs argue that, unlike the ICA at issue in *Jones*, ERISA already contains a reasonableness requirement in the statute (for example, in Section 403(c), requiring plan assets to be used only for "reasonable expenses of administering the plan"). ERISA's requirement, they claim, is a much higher and, at the very least, an explicit standard. But this narrow response ignores the more fundamental point of *Jones* that the analysis must be a contextual one that takes into account the large variety of factors influencing the level of fees in particular cases—an approach that seems directly applicable in an ERISA case.

Conclusion

In short, the *Jones* analysis may provide an apt analysis for ERISA 401(k) fees cases—but time will tell whether the *Jones* Court has essentially created a new paradigm for resolving them.

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