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"Everything Old Is New Again": Supreme Court Affirms *Gartenberg* Standard in Unanimous Decision in *Jones v. Harris Associates L.P.*

by Patrick D. Conner, Thomas S. Harman, Kathleen M. Long, Christopher D. Menconi and Christian J. Mixter

In a greatly anticipated opinion, the US Supreme Court unanimously vindicated industry practice by affirming the standard long used by mutual fund boards and advisers in reviewing investment advisory agreements.[1] Under that standard, as first articulated by the Second Circuit Court of Appeals in 1982 in *Gartenberg v. Merrill Lynch*[2] and now endorsed by the Supreme Court, 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." Although conceding that the *Gartenberg* standard may "lack sharp analytical clarity," the Court declared

Messrs. Conner and Mixter are partners in the litigation practice group of Morgan Lewis & Bockius LLP in Washington, DC. Mr. Harman is a partner, Ms. Long is an associate and Mr. Menconi is Of Counsel, in the investment management practice group of Morgan Lewis & Bockius LLP in Washington, DC.

that the standard reflects the appropriate method of testing investment adviser compensation and "it has provided a workable standard for nearly three decades."[3] The Court's ruling strongly reaffirms the integral role of boards and the deference their decisions typically should be accorded. While the Court addressed many questions surrounding the *Gartenberg* standard, it left a few issues unresolved.

Background and Court's Findings

Jones was on appeal from a decision by the Seventh Circuit Court of Appeals,[4] 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.[5] 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. Interestingly, both plaintiffs and defendants thoroughly criticized the Seventh Circuit's holding during oral arguments before the Supreme Court.

On appeal, the Supreme Court ruled that the Seventh Circuit erred in focusing almost entirely on the element of disclosure, which put too little emphasis on directors' fiduciary duties. The Court concluded that *Gartenberg* fully incorporates the meaning of the phrase "fiduciary duty" as set forth in prior Supreme Court precedent.[6] In determining whether directors have met their fiduciary obligations, "the essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's-length bargain."[7] Specifically, the Court stated that *Gartenberg* correctly:

(1) Places the burden of proof on the plaintiff;
(2) Insists all relevant circumstances 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 noted that the 1940 Act requires that directors be furnished with all the information "reasonably . . . necessary to evaluate the terms of the [adviser's] contract"[8] and instructs courts to give board approval of advisory fees "such consideration . . . as is deemed appropriate under all the circumstances."[9] The Court stated in its opinion that *Gartenberg* "heeds these precepts."[10]

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."[11]

Fee Comparisons

The Court acknowledged that while both parties endorsed *Gartenberg* generally, they disagreed on several points that warranted further discussion, such as comparisons between fees charged by an adviser to its "captive" mutual fund and the fees it charges to its "independent clients."[12] In recent years, plaintiffs have brought a number of lawsuits alleging excessive advisory fees and comparing the mutual fund fees in question with fees charged by the same investment adviser to its institutional clients. In 2006, in a lawsuit filed against a prominent mutual fund adviser, the court held that evidence about the advisory fees paid by the adviser's institutional account clients was irrelevant and, therefore, inadmissible.[13] In *Jones*, 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.[14] 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" between differing services.[15] As noted by the Court in its opinion, the difference in services an adviser provides to a mutual fund client and those it provides to a pension fund client may be attributable to "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."[16]

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." Thus, while the Court left the door open to compare retail fund fees to institutional account fees, it did so while making clear that such comparisons should be carefully scrutinized, as their relevance may be modest. From a practical standpoint, it will be difficult for plaintiffs to make use of differences in fees charged to institutional accounts because the services that advisers perform for those accounts will often differ in a number of significant ways from the services advisers provide to their retail clients. Although the Court highlighted "marketing costs" as a factor differentiating mutual funds from an adviser's institutional accounts, fund boards and advisers should be very careful. Absent a 12b-1 plan, fund assets cannot be used directly or indirectly to finance the distribution of fund shares.[17] Of course, a fund adviser can pay fund marketing costs from its "legitimate profits," but if any part of the advisory fee were earmarked to cover such costs that could be viewed as an unlawful, indirect use of fund assets to finance distribution.[18]

The Court also cautioned against relying too heavily on fees charged by other advisers to similar mutual funds, as those fees may not be the result of arm's-length negotiation. Many mutual funds have outsourced to third-party providers responsibility for compiling peer fund fee information for Section 15(c) review purposes. Typically, boards are presented with both a large group of funds representing generally the universe of funds that are similar to the fund at issue as well as a select few (typically four to six depending on how unique the fund is—the fewer similar funds there are overall, the smaller the subset) believed to most closely resemble the fund at issue.[19] It is unclear whether these third-party providers will attempt to incorporate the Court's guidance on these comparisons by somehow analyzing whether the fees in the comparison funds reflect the result of arm's-length negotiation. While we would agree that fees charged by other mutual fund advisers should not be relied upon too heavily, our conclusion is based on the fact that this is just one of the *Gartenberg* factors and that some funds may have a thin peer group such that the "law of large numbers" cautions against too much reliance. Despite the Supreme Court's cautionary language, we believe that boards should continue to look at this information because peer fund data may be the most objective of any of the information gathered as part of the 15(c) process.

Deference to Board's Decision and Impact of Deficient Fee Approval Process

Another area of disagreement between the parties in *Jones* 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."[20] If the board has all of the relevant information and their fee approval process is robust, their determination should be given "considerable weight."[21] If the process was deficient or the adviser withheld material information, then the outcome should be given greater scrutiny. Nonetheless, the Court's opinion suggests that a deficiency in the board's process alone will not result in a violation of Section 36(b), as the plaintiffs continue to bear the burden of showing that the disputed fees are beyond the range of arm's-length bargaining.[22] Regardless, the opinion is clear that 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 agreement is entitled to considerable weight, even if a court might weigh the factors differently."[23]

Impact on Board's 15(c) Review Process

As a practical matter, the Court's opinion does not appear to 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 likely 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. One trend advisers and fund service providers might begin seeing is directors asking for a broader range of information for their consideration based on the Court's directive to consider "all of the relevant factors" when deciding whether to approve a particular fee arrangement and looking at issues and factors beyond *Gartenberg*.[24] Boards may embrace this opportunity to examine more closely any unique circumstances relating to their fund or its adviser that might warrant consideration outside of the more typical *Gartenberg* factors. The Court's opinion has made it clear that directors not only have permission to request such information, but it is their obligation to do so.

One oft-debated *Gartenberg* factor the Court acknowledged but did not discuss with specificity[25] is that of the adviser's profitability. Boards have wrestled for years over issues relating to profitability, such as how it should be calculated and how much weight it should be accorded. These issues remain unanswered by the Court's opinion.[26] The industry is taking comfort in the Court's opinion in that so long as a board's decision to approve a particular fee arrangement is the product of thorough and thoughtful consideration of the relevant facts and circumstances, its decision should be upheld by a court. Lower courts will likely continue to defer to boards, because *Jones* recognizes that such deference is appropriate and because *Jones* also recognizes that "courts are not well suited to make such precise calculations."[27] To that end, boards should continue to request any information they deem relevant to their consideration, weigh that information following the guidance provided in *Jones,* and appropriately document their views.

Impact on 36(b) Litigation

While some industry commenters are viewing the Court's decision as paving the way for shareholders to bring claims against advisers that charge their retail funds higher fees than they charge other non-fund clients,[28] many do not see that as a likely outcome—or at least not an outcome that promises much likelihood of success for 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. 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.[29]

Now that the relevance of institutional account fees has been conditionally reconfirmed, advisers may need to provide additional information to boards in the annual review process. Many boards already have been requesting and routinely evaluating this type of information. Even so, advisers and boards would be well-served by taking a fresh look at the information requested and information provided to make sure that they take into account the nuanced views of the Court on institutional accounts. For some boards, this may require revising their current 15(c) information request to include institutional account fees and an explanation for any difference in fees. Nonetheless, the Court's ruling makes clear the statute's burden of proof is upon the plaintiff. The Court also emphasized that plaintiff's burden is a heavy one, so while the decision does not preclude litigation it will without a doubt cause some current and potential plaintiffs to reconsider their course of action if their claim is based largely on institutional fee comparisons.

Conclusion

Although a few questions regarding advisory fee approval remain unanswered after *Jones,* the Court clarified a number of issues, such as the comparison of various fees being charged to institutional clients and by other mutual funds that may require some additional review by boards in evaluating their fee approval processes. At the same time, however, the Court made clear that plaintiffs will bear a heavy burden in proving a Section 36(b) claim based solely on a fee differential. Most important, by reconfirming *Gartenberg* as the standard upon which mutual fund boards should rely when considering the fees that a mutual fund pays to its adviser the decision in *Jones* will allow many boards to continue with their current fee approval processes without significant change.

Notes

1. Jones v. Harris Associates L.P., 599 U.S. ___ (2010), No. 08-586, 2010 WL 1189560, (Mar. 30, 2010). is available at *http://www.supremecourt.gov/opinions/09pdf/08-586.pdf*.

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

3. *Jones*, 2010 WL 1189560, at *3.

4. In affirming the *Gartenberg* standard, the Supreme Court vacated the judgment of the Seventh Circuit Court of Appeals in Jones v. Harris Associates L.P., 527 F.3d 627 (7th Cir. 2008), and remanded the case for further proceedings consistent with the Court's opinion.

5. *Jones*, 527 F.3d at 632.

6. *Jones*, 2010 WL 1189560, at *8.

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

8. 15 U.S.C. § 80a-15(c).

9. 15 U.S.C. § 80a-36(b)(2).

10. *Jones*, 2010 WL 1189560, at *9.

11. *Id.* at *12.

12. *Id.* at *9.

13. Baker v. American Century Investment Management, Inc., No. 04-4039 CV-S-ODS (W.D. Mo., July 18 2006).

14. *Jones*, 2010 WL 1189560, at *9.

15. *Id.* at *14.

16. *Id.*

17. *See* 15 U.S.C. § 80a-12(b) and 17 C.F.R. § 270.12b-1.

18. *See* Roye, Paul F., Director, Division of Investment Management, Remarks Before the American Law Institute/American Bar Association Investment Company Regulation and Compliance Conference (June 19, 2003), also available at *http://www.sec.gov/news/speech/spch061903pfr.htm*. ("We also have concerns as to the use of so-called revenue sharing arrangements where a fund's adviser makes payments out of its own resources to finance the distribution of the fund's shares. One issue raised by a fund investment adviser's revenue-sharing payments is whether the payments are an indirect use of the fund's assets to finance the distribution of its shares and therefore must be made in accordance with the requirements of rule 12b-1. In our view, a fund indirectly finances the distribution of its shares within the meaning of rule 12b-1 if any allowance is made in the fund's investment advisory fee to provide money to finance the distribution of the fund's shares. In that case, the investment advisory fee essentially serves as a conduit for the indirect use of the fund's assets for distribution, and the portion of the advisory fee that is used to finance the distribution of the fund's shares must be paid in compliance with the requirements of the rule. In this regard, a fund's board of directors, particularly its disinterested directors, is primarily responsible for determining whether revenue-sharing payments are an indirect use of the fund's assets for distribution or whether they are paid out of the 'legitimate profits' from the investment adviser's contract with the fund. If the fund's board of directors determines that the payments are an indirect use of the fund's assets for distribution, it must ensure that the payments are made in accordance with the requirements of rule 12b-1."). *See also, Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Release No. 11,414, [1980 Transfer binder] Fed.Sec.L.Rep. (CCH) p 82,678, at 83,723 (Oct. 28, 1980) (discussing an investment adviser's "legitimate profits").

19. The third-party provider works with the adviser to create this sub-set of peer funds. When deciding which peer funds most closely resemble the fund at issue, the parties might look at factors such as overall fee structure, investment strategy, target investor group and marketing plan.

20. *Jones*, 2010 WL 1189560, at *9.

21. *Id.* at *10.

22. Prior to the decision in *Jones*, the Eighth Circuit had held that "the proper approach to § 36(b) is one that looks to both the adviser's conduct during negotiation and the end result. . . . Unscrupulous behavior with respect to either can constitute a breach of fiduciary duty." Gallus v. Ameriprise Financial, 561 F.3d 816, 823 (8th Cir. 2009) (citations omitted). After *Jones*, the Supreme Court vacated the Eighth Circuit's decision in *Gallus* and remanded the case for further proceedings consistent with the *Jones* opinion. Ameriprise Financial v. Gallus, __ S.Ct.__, No. 09-163, 2010 WL 1265857 (April 5, 2010).

23. *Id.* 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. 184, 91st Cong., 2d Sess. (1970) (the legislative history of the 1970 amendments to the 1940 Act); 1969 WL 4981, at *4902-03.

24. *Jones*, 2010 WL 1189560, at *1.

25. As recited by the Supreme Court, the Second Circuit called for review of such factors as "the nature and quality of the services provided to the fund and shareholders, the profitability of the fund to the adviser, collateral benefits that accrue to the adviser because of its relationship with the mutual fund, comparison of the fees [at issue] with those paid by similar funds, and the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation." *Id.* at *6 n. 5.

26. Subsequent to oral argument but before the issuance of the opinion in *Jones*, the court in American Mutual Funds Fee Litigation, Case No. CV 04-5593 GAF (RNBx) (C.D. Cal., Dec. 28, 2009), analyzed profitability and noted that the independent directors were never provided with data showing aggregate or specific compensation paid to the investment adviser's employees. Given that the adviser paid 35 percent of the operating revenues remaining after the payment of salaries, bonuses, benefits and all other operating expenses to an employee profit sharing pool, the judge expressed concern that such a fact should have led to inquiry of some sort by the independent directors. We are aware that some boards already request this type of information on an aggregate basis, perhaps because they agree with the Supreme Court that the *Gartenberg* standard "may lack sharp analytical clarity" and "insists that all relevant circumstances be taken into account."

27. *Id.* at *10.

28. Mercer Bullard, founder of Fund Democracy, a shareholder advocacy group, and a University of Mississippi securities law professor, was credited in the New York Times on April 1, 2010 with saying excessive fee claims are now more likely to succeed as a result of this decision.

29. *Jones*, 2010 WL 1189560, at *9 n. 8.

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