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A legal update from Dechert's Financial Services Group

# Eighth Circuit Fees Decision Accepts *Gartenberg* Standard But Enhances Process Focus, While Seventh Circuit Rejects *Gartenberg* Standard in Favor of Fiduciary Standards of Trust Law

In its long-awaited decision in *Gallus v. Ameriprise Financial, Inc.*,[1] the United States Court of Appeals for the Eighth Circuit adhered to the established standard for claims for breach of fiduciary duty under Section 36(b) of the Investment Company Act of 1940 set in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*,[2] but with important departures that could encourage more investor litigation pursuant to that often-tried but never successful cause of action. Whether it does encourage more Section 36(b) litigation, however, is likely to turn on the outcome of the Supreme Court's review next term of the Seventh Circuit's controversial decision in *Jones v. Harris Associates*.[3]

In *Jones*, the Seventh Circuit upheld a mutual fund "excessive fee" summary judgment in favor of Harris Associates, the management company for Oakmark Funds, and rejected the *Gartenberg* standard, taking issue with *Gartenberg* as the controlling authority in "excessive fee" suits. The *Jones* Court held that Section 36(b) does not impose a fiduciary duty that in effect makes the federal judiciary a "rate regulator." The Court said that, instead, the fiduciary standards of trust law should apply, and that the appropriate test is whether the adviser's client made a voluntary choice after having the benefit of adequate information. The Court said, "[W]e are skeptical about *Gartenberg* because it relies too little on markets ... Having had another chance to study this question, we now disapprove the *Gartenberg* approach. A fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth."[4] Harris Associates were originally granted summary judgment in the U.S. District Court for the Northern District of Illinois, Eastern Division and the U.S. Supreme Court will hear the case in the fall of 2009.

In *Gallus*, the Eighth Circuit declined to follow the market-oriented approach applied by the divided Seventh Circuit in *Jones*, hewing closer

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[1] 561 F.3d 816 (8th Cir. April 17, 2009).

[2] 694 F.2d 923 (2d Cir. 1982).

[3] 527 F.3d 627 (7th Cir. 2008).

[4] *Id.* at 10-11.

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to the now-familiar *Gartenberg* analysis – albeit with important distinctions. Reversing the District Court's grant of summary judgment to the defendants, the Eighth Circuit held that the lower court was correct to apply the non-exclusive factors identified in *Gartenberg* for assessment as to whether an advisory fee violated Section 36(b), but the District Court gave too limited a reading to the fiduciary duty standard laid down by Congress. *Gartenberg*, the Court held, related to one way in which a fund adviser can breach its fiduciary duty – through the receipt of excessive fees – but this is not the only way. A tainted process, in which an adviser does not satisfy its duty of honesty and transparency, could also constitute a breach of fiduciary duty. In addition, the Eight Circuit found that the District Court erred in rejecting evidence that fees charged to institutional investors were lower than those borne by retail mutual fund investors. Finally, the Court determined that the damages limitation of Section 36(b) was retrospective only and did not necessarily foreclose losses incurred by plaintiffs after the filing of the claim.

The plaintiffs had challenged fees charged by eleven Ameriprise mutual funds as excessive and in breach of the adviser's fiduciary duties under Section 36(b), making three core charges. First, the plaintiffs alleged, the fee negotiation was driven by a comparison of the proposed fee with the fees charged by peer group funds rather than by a full spectrum of factors including profitability and the actual costs associated with managing the funds. Ameriprise acknowledged that its pricing strategy was to put its funds in the middle of a group of comparably situated funds.

Second, the plaintiffs contended that Ameriprise charged institutional clients far less, for what the plaintiffs asserted was essentially the same investment advice, than charged to the mutual fund investors to whom the adviser also owed a fiduciary obligation. Finally, the plaintiffs argued that Ameriprise misled the Board regarding the reasons for the differing fees charged to institutional and retail investors, through a distorted report that the Board relied on in approving the excessive fees. Ameriprise sharply contested the attack on the veracity of the report, and asserted that differences between the cost of services provided to institutional accounts and retail accounts made comparisons between the two inappropriate. Although it had earlier denied the defendants' motion to dismiss, after reviewing the evidence as to the various *Gartenberg* factors presented in their motion for summary judgment, the District Court granted the defendants' motion, setting up the Eighth Circuit's April 2009 decision.

Although the Eighth Circuit found that "the *Gartenberg* factors provide a useful framework for resolving claims of excessive fees," the Court continued that the decision "demonstrates one way in which a fund adviser can breach its fiduciary duty; but it is not the only way."[5] Citing *Jones*, which it otherwise declined to follow, the Court "read the plain language of § 36(b) to impose on advisers a duty to be honest and transparent throughout the negotiation process."[6] This, the Court said, meant that "the proper approach to § 36(b) is one that looks to both the adviser's conduct during negotiation and the end result."[7]

Accordingly, it held that the District Court erred in holding that plaintiffs had not made out a Section 36(b) claim since they had not satisfied the *Gartenberg* standard. The District Court held that plaintiffs had not demonstrated that the services provided to institutional accounts and funds are comparable. Nevertheless, the Eighth Circuit was unpersuaded that no comparison could properly be made between the fees charged to institutional accounts and those charged to retail investors. It went on to find that, given the process-oriented dimension of the fiduciary duty imposed under Section 36(b), the District Court should have considered whether the Board had been misled with respect to the asserted discrepancy between fees charged to different types of investors.

Finally, the Eighth Circuit declined to limit a plaintiff's damages under Section 36(b) to those incurred in the one year prior to filing of an action, holding that the statutory damages limitation was retrospective only and did not prohibit proof that investors continued to be harmed by the breach of fiduciary duty following commencement of the action.

The Eighth Circuit's decision could be seen as an important departure from *Gartenberg*, potentially leading the way for claims that stem more from concerns over the process followed in fee negotiations than from the excessiveness of the fees themselves. The Court, however, made a number of observations that may suggest that such theories could prove difficult. It noted that the plaintiff bore the burden of proving that the breach of fiduciary duty resulted in "cognizable financial

[5] 561 F.3d 816 at 823.

[6] *Id.*

[7] *Id.*

harm."[8] Whether such harm can be identified and quantified when the fee has not been shown to be excessive under *Gartenberg* is uncertain at best. In addition, despite its emphasis on an open and honest negotiation, it acknowledged that the court's role was not to substitute its business judgment for that of a fund's board of directors and that "[c]andid, transparent negotiation does not require discussion of every issue that a plaintiff might find relevant; and it does not require the adoption of a particular negotiation strategy."[9] Lastly, while the Court found that comparisons between institutional and retail investor fees were appropriate to consider, it did no more than remand for further exploration of these issues, and did not foreclose a resolution in favor of the defendant manager.

[8] *Id.*

[9] *Id.* at 824.

The longevity of *Gallus* is unclear given the likelihood that the Supreme Court will make a definitive ruling in the pending *Harris* appeal in the term commencing in October 2009. For the present, the decision may encourage claims predicated as much on process as on outcome, and a renewed focus by fund critics and plaintiffs on any perceived discrepancies between fees charged to institutional and retail fund investors.

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