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A legal update from Dechert's Financial Services Group

The United States Supreme Court Upholds the Gartenberg Standard for Claims Alleging Excessive Advisory Fees

Introduction

On March 30, 2010, the Supreme Court handed down its long-awaited decision in *Jones v. Harris Associates L.P.,*[1] the Supreme Court's first decision interpreting section 36(b) of the Investment Company Act of 1940, as amended (the "1940 Act") in roughly a quarter century.[2] In a unanimous opinion written by Justice Samuel Alito, the Court held that the correct standard in determining whether a fund's investment adviser has breached its fiduciary duty with respect to the receipt of compensation was the standard applied by the Second Circuit Court of Appeals in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*[3] The Court noted that *Gartenberg* has provided a "workable standard" for nearly three decades.[4] The Supreme Court vacated the decision of the Seventh Circuit Court of Appeals, which had rejected the *Gartenberg* standard in favor of a market competition-based approach, and remanded the case to the Seventh Circuit for further proceedings consistent with the Court's decision.

Discussion

The Gartenberg Standard

Section 36(b) of the 1940 Act provides in part that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser."[5]

In *Gartenberg,* the Second Circuit Court of Appeals held that "[t]o be guilty of a violation of §36(b) . . . the adviser-manager must charge 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."[6] The *Jones* petitioners (the plaintiff shareholders who lost the case in the lower courts on summary judgment) urged the Supreme Court

1 No. 08-586, 2010 WL 1189560 (U.S. Mar. 30, 2010).

2 Before *Jones*, the last Supreme Court decision on section 36(b) was *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984). Interestingly, while serving as Assistant to the Solicitor General, Department of Justice, Justice Alito, who authored the *Jones* opinion, helped draft the Securities and Exchange Commission's *amicus curiae* brief in *Daily Income Fund*.

3 964 F.2d 923, 928 (2d Cir. 1982).

4 *Jones*, 2010 WL 1189560, at * 11. Justice Thomas wrote a concurring opinion, stating that he agreed with the Court's approach – which defers to the informed conclusions of disinterested boards and holds plaintiffs to their heavy burden of proof in the manner the 1940 Act requires – but did not agree that this approach endorses the *Gartenberg* standard, which could be viewed as authorizing a "free-ranging judicial 'fairness' review of fees."

5 84 Stat. 1429 (codified at 15 U. S. C. §80a–35(b)).

6 *Gartenberg,* 964 F.2d at 928.

to adopt the "arm's-length bargaining result" element of the test, but to reject the "disproportionately large" element as setting a higher burden than intended by Congress for claims of excessive fees.[7]

The high court declined to do so. Under the *Gartenberg* standard, as articulated by the Supreme Court, "to face liability [due to a breach of fiduciary duty] under §36(b), an investment adviser must charge 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."[8]

Fiduciary Duty

For purposes of section 36(b), the Supreme Court held that "fiduciary duty" means what the Court said it meant in 1939, when the Supreme Court stated, in an analogous context, "*the essence of the test is whether under all the circumstances the transaction carries the earmarks of an arm's length bargain*."[9] According to the Supreme Court, *Gartenberg* incorporates this meaning of fiduciary duty as set out in 1939 by using the range of fees that could result from an arm's-length negotiation as the benchmark for reviewing challenged fees.[10] The Supreme Court noted, however, that section 36(b) departed from this concept "in a significant way" by shifting the burden of proof from the fiduciary to the investor claiming a breach.[11]

In arriving at the meaning of "fiduciary duty" for purposes of section 36(b), the Supreme Court expressly recognized that Congress rejected a "reasonableness" standard.[12] In doing so, the Court found, Congress recognized "that courts are not well-suited to make such precise calculations."[13] Rather, the Court said, "*Gartenberg*'s 'so disproportionately large' standard . . . reflects this congressional choice" to rely on independent directors to act as "watchdogs" to protect investors' interests.[14]

Role of the Board of Directors

Consistent with this view, the Supreme Court emphasized the role of the board of directors in a court's determination of whether an investment adviser has breached its fiduciary duty in regard to receipt of compensation. It stated that "[w]here a board's process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process."[15] "[I]f 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."[16]

That is not to say, however, that a well informed board's decision is dispositive. The Court noted that "a fee may be excessive even if it was negotiated by a board in possession of all relevant information, but such a determination must be based on evidence that the fee 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."[17]

The Court stated: "it would have been paradoxical for Congress to have been willing to rely largely upon [boards of directors as] 'watchdogs' to protect shareholder interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled."[18] Notwithstanding the importance of that role, the Court declined to adopt petitioners' argument that a defective process alone might give rise to a breach of fiduciary duty claim under section 36(b),[19] as the Eighth

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7 The petitioners stated, "[A]lthough the *Gartenberg* court correctly identified the 'test' as whether the fee is comparable to an 'arm's-length' deal, it added the erroneous additional concept that, '[t]o be guilty of a violation of § 36(b),' the adviser 'must charge 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.'" Brief of Petitioner, 2009 WL 1640018, at * 31, *Jones v. Harris Associates L.P.* No. 08-586, 2010 WL 1189560 (U.S. Mar. 30, 2010).

8 *Jones*, 2010 WL 1189560, at * 7.

9 *Id.* at *8 (emphasis added by the Supreme Court) (citing to *Pepper* v. *Litton*, 308 U. S. 295, 306-307 (1939)).

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

11 *Id.*

12 *Id.* at * 10.

13 *Id.*

14 *Id.*

15 *Id.*

16 *Id.*

17 *Id.* (emphasis supplied).

18 *Id.* at *8 (citing *Burks v. Lasker*, 441 U.S. 471, 485 (1979)).

19 Brief of Petitioner, 2009 WL 1640018, at * 3, *Jones v. Harris Associates L.P.* No. 08-586, 2010 WL 1189560 (U.S. Mar. 30, 2010).

Circuit had ruled in *Gallus v. Ameriprise Fin., Inc.*[20] Rather, the Court said, where "the board's process was deficient or the adviser withheld important information, [a reviewing] court must take a more rigorous look at the outcome" of the bargaining process.[21]

Fee Comparisons

A major component of the petitioners' claim rested on their contention that the lower fees charged to institutional clients was critical evidence that the higher fees assessed against retail investors were excessive. The respondent (the defendant adviser) disagreed. The Supreme Court steered a middle course, declining to adopt a categorical rule regarding the comparisons of the fees charged to different types of clients.

The Court held that comparisons between fees charged by an investment adviser to its mutual funds versus the fees charged to its independent or institutional clients may be appropriate and should be given "the weight that they merit in light of the similarities and differences between the services that the clients in question require."[22] The Court warned, however, that a reviewing court must be "wary of inapt comparisons"[23] and that where services provided to clients are "sufficiently different that a comparison is not probative" the reviewing court must reject the comparison.[24]

The Court commented that "there may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are 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."[25]

Underscoring the limited utility of fee comparisons, the Supreme Court noted that "[e]ven if the services provided and fees charged to an independent fund 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."[26]

Addressing industry concerns that permitting claims premised on fee comparisons would prolong burdensome fee litigation, the Court commented that "[c]omparisons with fees charged to institutional clients . . . will not doom any fund to trial."[27] Elaborating, the Court stated that to go to trial for a breach of fiduciary duty under section 36(b): "[f]irst, 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."[28] Thus, "[o]nly 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] In reaching to set the bar high for a plaintiff to avoid summary judgment in an excessive fee case, *Jones* leaves less certain what impact its standard will have at the motion to dismiss stage or on the scope of proper discovery in cases that survive such motions.

Finally, the Court expressed some skepticism on the value of comparisons of fees that an investment adviser charges to its mutual funds compared with fees charged by other investment advisers to their mutual funds. Consistent with the views articulated by the Second Circuit in *Gartenberg,* it commented that "[c]ourts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers" as they "may not be the product of negotiations conducted at arm's length."[30] This skepticism does not suggest that such comparisons would be inappropriate for a board to consider in the

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20 561 F.3d 816 (8th Cir. 2009). In *Gallus*, the Eighth Circuit Court of Appeals held that a proper analysis of section 36(b) has two separate and independent elements, each of which alone constitutes a breach of fiduciary duty. Under this standard, a court properly "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 under Section 36(b)." *Id.* at 823. As a result, the Eighth Circuit held that the plaintiffs could state a claim under section 36(b) based on the adviser's alleged misconduct during the contract approval process, even where the resulting fee was not excessive and thus "passed muster under the *Gartenberg* standard." *Id.*

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

22 *Id.* at *9.

23 *Id.*

24 *Id.*

25 *Id.*

26 *Id.*

27 *Id.* at *9 n.8.

28 *Id.*

29 *Id.*

30 *Id.* at *9.

15(c) process but does encourage a deeper and fuller assessment of the fees relative to the services provided to the funds that the board oversees.

Impact

This case has important implications both for the future of fund fee litigation and the conduct of the contract approval process under section 15(c) of the 1940 Act. While it is difficult to predict the long-term effect on the number and success of section 36(b) cases that may be brought, generally the Court's opinion appears to discourage rather than encourage such complaints, by reinforcing—and perhaps even raising—the bar for alleging and proving these cases. As to the impact on the section 15(c) process, this will depend on the practices currently engaged in by individual boards. Where the process is robust and a board receives and considers information on all of the *Gartenberg* factors, as well as fees paid to other clients of the adviser and the services provided, the opinion may have little impact. However, by emphasizing the importance of the board's process, both in protecting fund investors and in determining how much deference courts should give a board's decision, the opinion may well encourage both advisers and boards to strengthen and further document that process. Under the Court's approach, the adviser's provision and the board's robust consideration of all material information could reduce the scrutiny courts will apply to the board's decision. The Court's discussion of the factors and the relevant considerations may also affect certain aspects of fund disclosures of the board process and factors considered in the contract approval process.

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