Litigation

April 5, 2010

U.S. Supreme Court Adopts *Gartenberg* Standard for Mutual Fund Advisers' Fees

High Court Clarifies When Advisers May be Liable to Investors for Excessive Fees Under Section 36(b) of the Investment Company Act of 1940

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On March 30, 2010, the Supreme Court resolved a split among the courts of appeals regarding the standard for liability under Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. Section 80a-35(b), which imposes on mutual fund investment advisers a "fiduciary duty with respect to the receipt of compensation for services" and provides mutual fund investors with a private cause of action if advisers breach that fiduciary duty by charging excessive fees. Jones v. Harris Associates, L.P.*, No. 08-586 (Mar. 30, 2010).*

In *Jones*, the Supreme Court held that an investment adviser is not liable under Section 36(b) unless it "charge[s] a fee that is so disproportionately large that it bears no relationship to the services rendered and could not have been the product of arm's length bargaining." The Court adopted the standard for liability under Section 36(b) first articulated in *Gartenberg v. Merrill Lynch Asset Management*, 694 F.2d 923 (2d Cir. 1982), and provided guidance regarding how the *Gartenberg* standard should be applied in future cases. In particular, the Court held that courts should defer to and not second-guess the compensation decisions made by a mutual fund board so long as the board has followed a "robust process" and considered all relevant information.

Mutual Funds and the Investment Company Act of 1940

The promoter of a new mutual fund typically organizes it as a Massachusetts business trust, a Delaware business trust or a corporate entity, and then files a notification of registration pursuant to Section 8 of the Investment Company Act of 1940 (the "1940 Act"). The promoter or its affiliate is typically the entity that will become the investment adviser to the mutual fund; most mutual funds have no employees themselves. During the registration process, the promoter typically appoints the board of directors or trustees of the mutual fund. For a mutual fund that is distributed by a "principal underwriter," as most mutual funds are, a majority of the board must be people who are not "interested persons" of the investment adviser. The definition of an "interested person" is much broader than simply an affiliation, but nonetheless typically the promoter chooses board members with whom the promoter has a substantial relationship and often the new directors or trustees are former business colleagues of the promoter's principals.

A majority of the "disinterested" directors or trustees must approve the investment advisory contract between the mutual fund and the investment adviser for an initial two-year period and annually thereafter. Once such a contract has been approved and the new mutual fund's registration statement becomes effective, the investment adviser manages the mutual fund's investment portfolio and provides the other services necessary to operate the mutual fund. The fees provided for by the investment advisory contract are disclosed in the prospectus and other marketing materials of the mutual fund.

The disinterested directors or trustees often are business and personal colleagues of the investment adviser, who are appointed by the investment adviser and who make fees themselves for acting in the capacity as a director or trustee. Also, the fees of the directors or trustees are paid from the assets of the mutual fund, not from the fees of the adviser. Therefore, as a practical matter the mutual fund cannot easily terminate its relationship with the investment adviser and such terminations are rare. Since 1940, there have been only two cases where the disinterested directors or trustees did not reapprove an investment advisory contract with the then existing investment adviser, and neither one of those cases ended well for either the disinterested directors or the shareholders of the mutual fund.[1] These circumstances have raised concerns about the independence of mutual fund boards and the compensation received by investment advisers.

To address these and other concerns regarding mutual funds and other types of investment companies, Congress adopted and later, in 1970, amended the 1940 Act, 15 U.S.C. Section 80a-1 *et seq*. Under the Act, no more than 60 percent of a mutual fund's directors may be "interested persons," meaning they have an interest in or affiliation with the investment adviser. 15 U.S.C. Sections 80a-10(a), 80a-2(a)(19). Investment adviser compensation must be approved by a majority of the board members who are *not* "interested persons." In addition, Section 36(b) of the Act (added in 1970) imposes a "fiduciary duty" on investment advisers with respect to their compensation and grants individual investors a private right of action against the investment adviser for breach of that duty. 15 U.S.C. Section 80a-35(b).

The *Gartenberg* Standard and the Seventh Circuit's Decision in *Jones*

In *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), the Second Circuit held that an investment adviser can be liable under Section 36(b) of the Act 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." 694 F.2d at 928. The court held that "all pertinent facts must be weighed" to make this determination, and cited a number of relevant factors to be considered. *Id.* at 929-32.

[1] In the cases of the Yacktman Fund (*See* Verified Complaint, *In the Matter of Yacktman v. Carlson*, No. 98278117 (Cir. Ct. Md. 1998) and the Navellier Series Fund (*See McLachlan, et al., v. Simon, et al.*, 31 F.Supp. 731, 734-36 (N.D. Cal. 1998),, where "disinterested" directors or trustees did not reapprove an investment advisory contract with the existing investment adviser, the parties ended up in heated proxy battles and costly litigation initiated by the investment adviser. *See* David A. Sturms, *Enhancing the Effectiveness of Independent Directors: Is the System Broken, Creaking or Working?* 1 Vill. J.L. & Inv. Mgmt. 103 (1999).

Federal courts deciding Section 36(b) cases have generally applied the *Gartenberg* standard.[2] In *Jones*, however, the Seventh Circuit applied a different standard and expressly "disapprove[d] of the *Gartenberg* approach." 527 F.3d 627, 632 (7th Cir. 2008). The Seventh Circuit held, in an opinion by Chief Judge Easterbrook, 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 impose a substantive "cap" on investment adviser compensation. *Id*. Rather, the court held that amount of investment adviser compensation should be set freely based on market forces, and a Section 36(b) violation should be found only in cases of inadequate disclosure, or if the investment adviser's compensation was "so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated." *Id.*

In dissenting from the Seventh Circuit's denial of rehearing *en banc*, Judge Posner argued that the Seventh Circuit should continue to follow the *Gartenberg* standard. In Judge Posner's view, the *Jones* panel based its rejection of the *Gartenberg* standard "mainly on an economic analysis that is ripe for reexamination on the basis of 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.). In this regard, Judge Posner found it particularly noteworthy that the investment adviser in *Jones* "was charging its captive funds more than twice what it charges independent funds." *Id.* at 731. (The Easterbrook-Posner split interested many commentators, as the two judges both are closely identified with the "Chicago School" of law and economics analysis and have often agreed on issues over the years.)

The Supreme Court granted certiorari to resolve the split among the circuits created by the Seventh Circuit's decision in *Jones*.

The Supreme Court's Decision

Reversing the Seventh Circuit's decision, the Supreme Court held that *Gartenberg* was correct in holding that "to face liability under Section 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." Slip op. at 9. The Court also held that, as required by the language of Section 36(b), the burden of proof is on the investor to show that the investment adviser's fee is outside the range that arm's-length bargaining would produce. *Id.* at 11.

In discussing the scope of liability under Section 36(b), the Court emphasized the deference owed to the decisions of disinterested directors, and that Section 36(b) was not intended as a vehicle by which courts could second-guess director's compensation decisions. "Where 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." Slip op. at 15. The amount of deference given a board's compensation decisions varies depending on the circumstances. *Id.* at 12. "[If] 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." *Id.* at 15. However, courts must take a "more rigorous look" at fee agreements when the board's process was deficient or the adviser withheld important information. Nonetheless, the Court was clear that Section 36(b) does not call for "judicial second-guessing

[2] *E.g.*, *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321 (4th Cir. 2001); *Gallus v. Ameriprise Financial, Inc.*, 561 F.3d 816 (8th Cir. 2009); *Siemers v. Wells Fargo & Co.*, 2006 WL 2355411 (N.D. Cal. Aug. 14, 2006); *Hunt v. Invesco Funds Group, Inc.*, 2006 WL 1581846 (S.D. Tex. June 5, 2006).

of informed board decisions" and that courts should not "engage in a precise calculation of fees representative of arm's-length bargaining."

The Court also endorsed the approach of *Gartenberg* that "the range of fees that might result from arm's-length bargaining [is] the benchmark for reviewing challenged fees." Slip op. at 11. In response to the concern raised by Judge Posner below, the Court held that differences between the fees that an adviser charges a captive mutual fund and the fees that it charges its independent clients may be considered, but such differences are to be given the weight that they merit "in light of the similarities and differences between the services that the client in question requires." *Id.* at 13. The Court cautioned, moreover, that this could lead to "inapt comparisons" and courts must reject such comparisons where the services rendered are sufficiently different that a comparison is not probative. *Id.* "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." *Id.* at 14 n.8.

Justice Thomas issued a concurrence noting that the Court's opinion does not affirm *Gartenberg* to the extent that *Gartenberg* can be read to authorize a free-ranging judicial "fairness" review of fees. Justice Thomas emphasized that the Court's opinion affirmed an approach "that defers to the informed conclusions of disinterested boards and holds plaintiffs to their heavy burden of proof [,]" as required by Section 36(b).

Conclusion

The decision in *Jones* provides important guidance to investment advisers and mutual fund boards regarding how to set fees and limit investment advisers' potential liability under Section 36(b). In particular, if boards continue to follow the rigorous and robust process that developed after *Gartenberg* with respect to negotiating and reviewing investment adviser compensation, including the maintenance of a record demonstrating that all relevant information was provided and reviewed, their compensation decisions will be accorded considerable deference by the courts, and a Section 36(b) claim is likely to fail (as, indeed, most have failed over the years).

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the attorneys below.

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