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Supreme Court Unanimously Reinforces *Gartenberg* Approach in Investment Company Adviser Fee Cases

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On March 30, 2010, the United States Supreme Court, in a unanimous decision, standardized the law for determining whether investment adviser fees are excessive for purposes of the adviser's fiduciary duty under Section 36(b) of the Investment Company Act of 1940 (the "Act"), 15 U.S.C. §80a-35(b). In a case closely watched by shareholders, investment advisers, and investment company boards alike, the Supreme Court in *Jones v. Harris Associates L.P.*, 559 U.S. __, --- S. Ct. --- (2010), vacated the Seventh Circuit's novel approach to excessive fee cases and adopted the standard which has been relied upon across the investment management industry for over a quarter of a century, *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982). In an opinion authored by Justice Alito, *Jones* resoundingly affirms the vitality of the *Gartenberg* approach. The opinion also clearly confirms the factors that an investment company board must consider in determining whether the directors have satisfied their duties under Section 15(c) in evaluating an adviser's compensation.

The *Gartenberg* Standard

In *Gartenberg*, the Second Circuit recognized that the relationship between an investment company and its investment adviser is such that the market forces of arm's-length bargaining operate differently in the mutual fund industry than in other sectors of the American economy. The Second Circuit held that under Section 36(b), "the test [for excessive fees] is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances." The Second Circuit further stated that "[t]o be guilty of a violation of §36(b), therefore, 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. . . . To make this determination," the Second Circuit explained, "all pertinent facts must be weighed."

The *Gartenberg* test had been largely unchallenged for twenty-five years, and had been utilized by courts, the Securities and Exchange Commission, mutual fund boards, and investment advisers in analyzing an adviser's fiduciary obligations under Section 36(b). The Seventh Circuit changed this when it rejected *Gartenberg* and held that so long as the fee is adequately disclosed and no deception is involved, the directors' decision as to whether the adviser's fee is appropriate will not be disturbed. 527 F.3d 627, 632-35 (7th Cir. 2008).

The Supreme Court in *Jones* embraced *Gartenberg,* echoing its precepts and establishing *Gartenberg* as the law in all jurisdictions. The Supreme Court in *Jones* held that "*Gartenberg* was correct in its basic formulation of what §36(b) requires: to face liability 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." In so holding, the Supreme Court vacated the Seventh Circuit's decision below and remanded for further proceedings. *Jones* is a strong affirmation of the *Gartenberg* standard; it settles industry concerns that the Supreme Court might have been inclined to follow the Seventh Circuit and create a new and untested standard.

The Supreme Court Clarifies Important Aspects of the *Gartenberg* Approach

While both parties in *Jones* had actually endorsed the basic *Gartenberg* approach in evaluating an adviser's fiduciary duty under Section 36(b), they disagreed on how that approach should be applied. One disputed issue concerned whether, in determining excessiveness, the fees an adviser charges its captive funds could be compared to the fees it charges its independent clients. The Supreme Court refused to create any "categorical rule regarding the comparisons of the fees charged different types of clients" and provided that "[i]nstead, courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require, but courts must be wary of inapt comparisons."

For example, as in *Gartenberg,* the Supreme Court in *Jones* cautioned that "courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers[,]" which "may not be the product of negotiations conducted at arm's length."

By the same token, comparisons to fees charged to institutional clients such as pension funds are not necessarily apt. "If the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison." And even where a seemingly relevant comparison may exist, courts "should be mindful that the Act does not necessarily ensure fee parity between mutual funds and institutional clients[.]"

Thus, the excessiveness inquiry must focus not on the types of clients being advised, but on the factual realities of providing services to the particular clients that are being compared, such as whether there might be higher marketing costs for one client versus another, or whether one client might be subject to more burdensome regulatory and legal obligations than the other. As with *Gartenberg*, the Act requires consideration of more than whether the challenged fees are in line with fees charged by other funds. The totality of the circumstances must be evaluated.

A Court's Deference Will Depend on the Circumstances, and Informed Decisions Are Entitled to "Considerable Weight"

Jones also provided guidance on when a court should defer to a board's decision to approve the compensation paid to a fund adviser, noting that the court in such case should consider both the procedural and substantive aspects of the board's decision. The substantive aspect will be governed by the "disproportionately large" standard. And the procedural aspect will involve a consideration of the board's process and the information it used in making its decision. A decision that was achieved through a procedurally deficient process, such as when important information is withheld from the board, will invite "a more rigorous look at the outcome" by the courts. In contrast, 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." And "if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight" since "the standard for fiduciary breach under §36(b) does not call for judicial second-guessing of informed board decisions."

In practice, application of the Supreme Court's guidance to lower courts in evaluating the appropriateness of the fee should be no different from the *Gartenberg* approach in which several factors were balanced to determine whether the fee represented a breach of fiduciary duty under Section 36(b). While under *Jones* it is possible that "a fee may be excessive even if it was negotiated by a board in possession of all relevant information," this seems unlikely so long as the evidence shows the fee reflects the reasonable range of outcomes that could have been achieved based on arm's-length bargaining. And while the Supreme Court hinted that a board has a duty to negotiate fees, this does not necessarily translate into a duty to achieve lower fees, so long as the basis for the fee is appropriately reviewed and considered.

Jones Confirms That Plaintiffs Bear the Burden of Proof; Trial is Inappropriate Unless Fee Disparity Cannot be Explained and the Fee is Outside Arm's-Length Range

While *Jones* did not announce any new standard of fiduciary duty under Section 36(b), it did remind plaintiffs of their burden to prove breach of fiduciary duty consistent with the Act. Indeed, in his concurrence, Justice Thomas opined that *Jones* "holds plaintiffs to their heavy burden of proof in the manner the Act, and now the Supreme Court's opinion, requires."

The Supreme Court's statement that a trial will be appropriate "[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" should be particularly beneficial for advisers and boards defending against allegations of excessive fees. While *Jones* essentially adopted the *Gartenberg* standard as a *substantive* matter, *Jones* moved further *procedurally* by expressly stating that unless there is some reason to believe the higher fees did not correspond to higher, more costly service levels, and the fees were beyond the range of arm's length bargaining, or were otherwise "disproportionately large," the plaintiff will be unable to reach trial. Although plaintiffs can be expected to read the vacating of the Seventh Circuit's decision as a victory, the bottom line is that the industry (and reviewing courts) are now equipped with clearer, more standardized rules and processes for determining compliance with Section 36(b).

Next Steps

Jones may result in some refinement of the process that fund boards use in evaluating the appropriateness of an adviser's fee. Boards will continue to be diligent in ensuring that they have been provided, and have carefully considered, all the information relevant to any fee arrangement. Nevertheless, to the extent that boards and advisers previously relied upon the *Gartenberg* standard, *Jones* reinforces the validity of that approach.

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