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The Future of Gartenberg*: A New Approach in Evaluating Investment Adviser Fees*

BY GRACE CARTER & KATHARINE CHAO

For more than 25 years, the "*Gartenberg* factors" have served as the prevailing standard for a court to determine whether investment adviser fees are excessive under Section 36(b) of the Investment Company Act of 1940. Taken from the Second Circuit decision in *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923 (2d Cir. 1982), the multi-factor test has been routinely applied by courts across the country to determine the reasonableness of such fees.

On May 19, 2008, in a departure from *Gartenberg,* Chief Judge Easterbrook of the Seventh Circuit, joined by Judges Kanne and Evans, decided *Jones v. Harris Associates L.P.*, No. 07-1624 (7th Cir. 2008). The *Jones* decision affirmed the district court's granting of summary judgment in favor of the defendant investment adviser, Harris Associates, who had been sued for breach of fiduciary duty pursuant to Section 36(b). Most significantly, *Jones* held that whether or not an adviser's fee is excessive does not depend on the reasonableness of the fee according to judicially created factors as set forth in *Gartenberg*. Rather, as long as the fee is adequately disclosed and no deception is involved, the trustees' decision as to whether the adviser's fee is appropriate will not be disturbed. Market forces – as reflected in the trustees' decision-making and ultimately that of investors who "vote with their feet and dollars" – will be determinative.

While *Jones* arguably removes the obligation to show the reasonableness of adviser fees under *Gartenberg*, at least in the Seventh Circuit – a result favorable to Section 36(b) defendants – whether other courts follow suit remains to be seen. While it clearly rejected the *Gartenberg* standard, the *Jones* court did not clarify whether any other standard will replace the factors set forth in *Gartenberg*; it would therefore be an aggressive, and possibly premature, interpretation of *Jones* to conclude that boards of investment companies need no longer consider the *Gartenberg* factors. Furthermore, until other courts have ruled on the issue, *Gartenberg* remains controlling authority in the Second Circuit and other circuits that have adopted its multi-factor balancing test.

The Backdrop

Prior to *Jones*, the seminal case on excessiveness was *Gartenberg*. In *Gartenberg*, the Second Circuit 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." 694 F.2d at 928. The *Gartenberg* court expressly disagreed with the notion that "the principal factor to be considered in evaluating a fee's fairness is the price charged by other similar advisers to funds managed by them" on the open market. *Id.* at 929. Instead, whether an

adviser's fee was excessive, and therefore a breach of fiduciary duty under Section 36(b), depended on six factors: (1) the nature and quality of the services provided; (2) the profitability of the mutual fund to the adviser-manager; (3) any "fall-out" benefits to the adviser; (4) economies of scale; (5) how the fee structure compares with those of other similar funds; and (6) the independence and conscientiousness of the fund's independent directors. *Gartenberg* therefore required the court to use its own judgment, considering several factors of which the market price was only one, to determine excessiveness. The *Gartenberg* factors have enjoyed continuing force for more than a quarter-century in excessive fee litigation under Section 36(b).

For fund trustees, *Gartenberg* provided a clear roadmap as to how trustees could satisfy their fiduciary duties to investors in evaluating fees of advisers. The road ahead under *Jones*, however, is somewhat less clear.

The *Jones* Decision

In *Jones,* Judge Easterbrook, writing for the three-judge panel, expressly disapproved of *Gartenberg* "because it relies too little on markets. And this is not the first time we have suggested that *Gartenberg* is wanting." Op. at 7-8, *citing Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 743 n.8 (7th Cir. 2002). Judge Easterbrook explained that "[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." Op. at 8. Analogizing to the setting of compensation for corporate officers, and to the rates charged by law firms, the *Jones* court found that competitive forces should prevail for investment advisers as well, stating: "Competitive processes are imperfect but remain superior to a 'just price' system administered by the judiciary. However weak competition may be at weeding out errors, the judicial process is worse – for judges can't be turned out of office or have their salaries cut if they display poor business judgment." Op. at 9.[1]

Noting that the federal securities laws, of which the Investment Company Act is one component, "work largely by requiring disclosure and then allowing price to be set by competition in which investors make their own choices," the *Jones* court applied this rule to the adviser's fees and found no violation of Section 36(b). "Plaintiffs do not contend that Harris Associates pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services. The fees are not hidden from investors – and the Oakmark funds' net return has attracted new investment rather than driving investors away." Op. at 13. Under these broad, market-driven parameters, the court concluded that, since the federal judiciary was not designed to be a rate regulator "after the fashion of the Federal Energy Commission," the judgment of the district court that the fees were not excessive must be affirmed.

The Future

The potential impact of the *Jones* decision is significant, partially because the court's understanding of the current mutual fund market is impressive. Noting that today's market for mutual funds is robust, with thousands of mutual funds competing, the court stated that the fairness of adviser fees will necessarily be checked by investors' ability to walk away from funds that charge excessive fees. "Mutual funds rarely fire their investment advisers, but investors can and do 'fire' advisers cheaply and easily by moving their money elsewhere." Op. at 11. Even if a majority of investors are unsophisticated, "[t]he sophisticated investors who do shop create a competitive pressure that protects the rest." Op. at 12. As the court noted, sophisticated investors such as hedge funds "regularly pay their advisers more than 1% of the pool's asset value, plus a substantial portion of any gains from successful strategies" and "[w]hen persons who have the most to invest, and who act through professional advisers, place their assets in pools

whose managers receive more" than the fees at issue, the court could not find the fees charged by Harris Associates excessive. Op. at 12-13.

Nor was the court concerned by Harris Associates' charging of higher fees for some funds than for others. In the court's view, structuring fees in this manner was reasonable since some funds are more complicated to manage than others. Furthermore, joint costs, such as those incurred for research, valuation and portfolio design, benefit multiple clients. Yet, these costs are not apportioned equally, but rather through elasticity of demand. Op. at 13.

It remains to be seen whether, and to what extent, other courts will adopt the reasoning of the *Jones* decision. *Jones* is controlling authority for cases filed in the Seventh Circuit only, which includes Illinois, Indiana and Wisconsin. Judge Easterbrook is an influential jurist, but his opinion reflects a heavy reliance on the self-correcting power of free markets – a philosophy that is not shared by a number of judges in other circuit courts. If other courts do follow *Jones*, the Seventh Circuit's approach will create greater protection for advisers against excessive fees claims when their fees are in line with the market. Because defense counsel will no doubt rely on *Jones* with regularity, we can expect a great deal of analysis from courts across the country as to whether *Gartenberg* will maintain its force in Section 36(b) litigation.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Michael Glazer
213-683-6207
michaelglazer@paulhastings.com

Joshua G. Hamilton
213-683-6186
joshuahamilton@paulhastings.com

William F. Sullivan
213-683-6252
williamsullivan@paulhastings.com

Art Zwickel
213-683-6161
artzwickel@paulhastings.com

New York

Domenick Pugliese
212-318-6295
domenickpugliese@paulhastings.com

Michael R. Rosella
212-318-6800
mikerosella@paulhastings.com

Orange County

Jay C. Gandhi
714-668-6242
jaygandhi@paulhastings.com

San Francisco

Julie Allecta
415-856-7006
julieallecta@paulhastings.com

Grace A. Carter
415-856-7015
gracecarter@paulhastings.com

David A. Hearth
415-856-7007
davidhearth@paulhastings.com

Mitchell E. Nichter
415-856-7009
mitchellnichter@paulhastings.com

[1] Although the Seventh Circuit recognized that in an imagined case the fee could be so large as to trigger suspicion that "deceit must have occurred," it opined that no court would find excessiveness where the fee charged was consistent with those charged by other advisers in similar circumstances. Op. at 9.