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Supreme Court Emphasizes Role of Deference to Independent Directors in Mutual Fund Fee Litigation

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On Tuesday, March 30, 2010, the United States Supreme Court issued its opinion in *Jones v. Harris Associates, L.P.* ("*Harris*"), unanimously holding that the Second Circuit's opinion in *Gartenberg v. Merrill Lynch Asset Management, Inc.* [694 F.2d 923 (2d Cir. 1982), *cert*. denied, 461 U.S. 906 (1983) ("*Gartenberg* ")] applied the correct standard for determining a claim made under Section 36(b) of the Investment Company Act of 1940. Justice Alito delivered the opinion of the Court, stressing that judicial review of a plaintiff's claim under Section 36(b) "must take into account both [the] procedure and substance" of a board's deliberations and concluding that the decisions of a fund's disinterested directors are "entitled to considerable weight" where the board's process for negotiating and reviewing investment adviser compensation is "robust." Importantly, the Court emphasized that the standard for fiduciary breach under Section 36(b) does not call for judicial second-guessing of informed board decisions. NCLC filed an *amicus curiae* brief in the case.

Background

The plaintiffs in *Harris* were shareholders in certain of the mutual funds in the Oakmark family of funds for which Harris Associates served as investment adviser. Their complaint alleged that Harris Associates breached its fiduciary duty with respect to the management fees it received from the funds for its services, and thereby violated Section 36(b) of the Investment Company Act. Among other alleged misdeeds, plaintiffs claimed that Harris Associates did not provide complete information to the fund boards during the fee negotiation process and charged the funds higher fees than Harris Associates charged to institutional clients.

In 2007, the district court granted summary judgment for Harris Associates, applying the standard laid out by the Second Circuit in *Gartenberg*. Finding that the fees charged to the Oakmark funds were not "so disproportionately large that they could not have been the result of arm's-length bargaining between Harris and the [fund's] board," the

court dismissed the case. Plaintiffs appealed.

The Seventh Circuit affirmed the judgment for Harris Associates, holding that an adviser has a fiduciary duty to make full disclosure to a fund's board of directors and "play no tricks," but that the adviser is not subject to a court-imposed cap on its compensation. Instead, it is the role of the fund's directors, who approve the fees, and investors, who are free to move their money elsewhere, to determine the proper value of the advisory services rendered.

Following the Seventh Circuit's decision, plaintiffs moved for a rehearing of their appeal *en banc*. This motion was denied over a strongly-worded dissent from Judge Posner, who wrote that marketplace competition cannot be trusted to police compensation levels. The Supreme Court granted *certiorari* to resolve a perceived split among the circuit courts as to the proper standard for assessing claims that fund advisers breached their fiduciary duties with respect to the receipt of compensation for their services.

The *Harris* Decision

The Court's decision in *Harris* endorses the *Gartenberg* standard of review. Accordingly, under *Harris*, an investment adviser may charge a fee within a range that is not 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.

Primarily at issue in *Harris* was the meaning of "fiduciary duty" under Section 36 (b). The Court rejected the Seventh Circuit's conclusion that full and proper disclosure of all relevant facts in the negotiation of its fee satisfied an adviser's fiduciary obligations under Section 36(b). Rather, the Court applied its standard in *Pepper v. Litton* that "the essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." The Court went on to explain that the Investment Company Act modifies this duty in a significant way because it "shifts the burden of proof from the fiduciary to the party claiming breach...to show that the fee is outside the range that arm's-length bargaining would produce." The Court found that the *Gartenberg* approach fully incorporates the understanding of fiduciary duty stated in *Pepper* and reflects Section 36(b)'s imposition of the burden on the plaintiff.

The Court emphasized the fact that the *Gartenberg* standard preserves the substantial role of disinterested directors under the Investment Company Act. In this regard, the Court provided a framework from which the judiciary may delineate the degree of deference that should be afforded the decisions of the disinterested directors as required by Section 36(b)(2) of the Investment Company Act. The Court stressed the importance of both the procedure and substance of a board's review of an investment adviser's fee. The Court noted that *Gartenberg* advises that the expertise of the disinterested directors of a fund, whether they are fully informed about all facts bearing on the investment adviser's service and fee, and the extent of care and conscientiousness with which they perform their duties, are important factors to be considered in deciding whether they and the investment adviser are guilty of a breach of fiduciary duty in

violation of Section 36(b). The Court concluded 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." Moreover, the Court stated that "if 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." Thus, if a fee was negotiated by a board in possession of all relevant information, it could be considered excessive only if the plaintiff's evidence proved 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. In contrast, the Court stated that "where the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome." Indeed, the Court decided that an adviser's compliance or noncompliance with its disclosure obligations is a factor that must be considered in calibrating the degree of deference that is due a board's decision to approve an adviser's fees.

In establishing a framework for judicial review of a claim brought under Section 36(b), the Court noted with approval that the *Gartenberg* standard insists that all relevant circumstances be taken into account and that a "range" of fees that might result from arm's-length bargaining would not be actionable. The Court also cited, presumably with approval, the factors expressed in *Gartenberg* for making this determination.

The Court also addressed two types of comparisons often made in advisory fee litigation. The Court first addressed comparisons between the fees that an adviser charges a captive mutual fund and the fees that it charges its independent clients, noting that the *Gartenberg* court rejected a comparison between the fees that the adviser in that case charged a money market fund and the fees that it charged a pension fund. Because the Investment Company Act requires consideration of all relevant factors, the Court concluded that there can be no categorical rule regarding the comparisons of the fees charged different types of clients. Rather, the Court noted that a court reviewing a claim under Section 36(b) "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." In this regard, the Court acknowledged that there may be significant differences between the services an adviser provides to its mutual funds and its institutional accounts and 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...." The Court went on to state that "[i]f the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison." The Court concluded that, "[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."

The Court also addressed comparisons of fees charged to mutual funds by other advisers. Here, the Court stated that "courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers." The Court stated "[t]hese comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm's length." The Court's decision raises a question as to how much deference a court reviewing a claim under Section 36(b) will

assign to a director's conclusions that are principally based on comparisons to fees charged to other mutual funds. In light of this, fund boards may wish to document that approval of an advisory arrangement was not disproportionately dependent on the single fact of the comparison to other fees currently charged in the industry.

Conclusion

The practical implications of the Court's decision are centered around the process and substance of a board's review of a proposed advisory fee. The *Harris* decision affords substantial deference to the decision of the fund's disinterested directors where those directors are well informed regarding a proposed advisory fee arrangement and where the investment adviser has made disclosure of the material facts relevant to the board's review of the fee. Under these circumstances, plaintiffs cannot second-guess the conclusions of the disinterested directors when the fee charged is within a range that is not 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.

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The National Chamber Litigation Center (NCLC) is the leading voice of business in the courts. NCLC and its co-counsel, Willkie Farr & Gallagher LLP, filed an *amicus* brief in *Jones v. Harris Associates*.

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