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Supreme Court Upholds *Gartenberg* Standard

MARGERY K. NEALE AND P. JAY SPINOLA

The authors of this article discuss a unanimous U.S. Supreme Court decision, Jones v. Harris Associates L.P., which upheld the Gartenberg standard for determining whether an investment adviser has breached its fiduciary duty with respect to compensation received from a mutual fund under Section 36(b) of the Investment Company Act of 1940.

In a unanimous decision in *Jones v. Harris Associates L.P.*,¹ the U.S. Supreme Court upheld the *Gartenberg*² standard for determining whether an investment adviser has breached its fiduciary duty with respect to compensation received from a mutual fund under Section 36(b) of the Investment Company Act of 1940.³ Justice Alito delivered the opinion of the Court, which concluded that *Gartenberg* was correct in its basic formulation of what the Investment Company Act requires: “[T]o 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.”⁴ The Court indicated that judicial review of a breach of fiduciary duty claim under Section 36(b) “must take into account both [the] procedure and substance” of a board’s deliberations and that the decisions of an

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investment company's disinterested directors are "entitled to considerable weight" where the board's process for negotiating and reviewing investment adviser compensation is "robust."⁵

The Supreme Court's affirmation of the *Gartenberg* standard, albeit with important clarifications, was generally anticipated within the mutual fund industry; however, there was uncertainty as to how the Court would address the issue of what weight a mutual fund board should give to any differences between the fees advisers charge to mutual funds and to their other clients. On that question, the Court declined to establish a "categorical rule."⁶ The Court stated, however, that the weight attributed to any such comparisons will depend on the similarities and differences between the clients and cautioned against "inapt comparisons."⁷ The Court confirmed that the Investment Company Act "does not necessarily ensure fee parity" between mutual funds and other clients.⁸ The Court also cautioned that, in assessing a Section 36(b) claim, "courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers," because they may not be the product of arm's length negotiation.⁹

The Court's opinion in *Harris* has obvious implications for both fund directors and investment advisers, including:

- The Court's emphasis on the significance of both the procedure and substance of a board's review of advisory fees, and recognition of the role played by disinterested directors under the Investment Company Act, highlight the importance of both the information a board requests during the fee review process and the care and conscientiousness with which the directors perform their duties.
- Because the Court found that a "more rigorous look at the outcome" is required by a court when an adviser withholds or fails to disclose material information to the board, advisers should consider whether there is any other material information that ought to be provided to the directors in addition to responding to specific requests.
- The Court's discussion of the relative importance of fee comparisons, both between those charged by advisers to their mutual fund and institutional clients and those charged by third party advisers to other mutual funds, underscores the need for a fund board to consider care-

fully the weight it assigns to the information it receives in making and recording its determinations.

- Because the Court affords substantial deference to the conclusions of the disinterested directors when the board’s deliberations and process for negotiating and reviewing adviser compensation are “robust,” the substance and extent of the record of the fee approval process are of considerable importance.

In short, the Court’s opinion is a significant pronouncement on the fundamental role that informed and conscientious fund directors play in the advisory fee approval process and the amount of deference that should be granted directors by the courts when reviewing a claim made under Section 36(b).

HISTORY OF THE CASE

The plaintiffs in *Harris* were shareholders of 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.

In 2007, the district court granted summary judgment for Harris Associates, applying the standard established by the Second Circuit in *Gartenberg*.¹⁰ Finding that the plaintiffs had not raised a triable issue of fact as to whether fees charged to the Oakmark funds were so disproportionately large that they could not have been the result of arm’s length bargaining between Harris Associates and the funds’ board, the district court granted summary judgment for Harris Associates. The plaintiffs appealed.

The Seventh Circuit affirmed the judgment for Harris Associates.¹¹ In doing so, however, the court rejected the *Gartenberg* approach and instead looked to the meaning of fiduciary duty under trust law. As a fiduciary, the circuit court reasoned, an adviser has a duty of “candor in negotiation” with a fund’s board of directors and must “play no tricks,” but “may negotiate in his own interest” for compensation.¹² As such, an adviser is

not subject to a cap on compensation, and the amount of an adviser's compensation would be relevant only if the compensation were "so unusual" as to give rise to an inference "that deceit must have occurred, or that the persons responsible for [the] decision have abdicated."¹³ The circuit court noted that this approach was consistent with market forces, as investors, who are free to move their money elsewhere, effectively determine the proper value of the advisory services rendered.

Following the Seventh Circuit's decision, the 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 in the mutual fund industry.¹⁴ The Supreme Court granted *certiorari* to resolve a split among the Courts of Appeal 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 SUPREME COURT'S DECISION IN *HARRIS*

The Supreme Court's decision in *Harris* largely 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.

At issue in *Harris* was the meaning of "fiduciary duty" under Section 36(b). The Second Circuit, in its decision in *Gartenberg*, concluded that "the test [under Section 36(b)] 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."¹⁵ The Seventh Circuit, in contrast, found that the phrase "fiduciary duty" invokes the law of trusts and concluded that the appropriate test is whether the investment adviser's client (*i.e.*, the fund) made a voluntary choice with the benefit of full disclosure by the investment adviser of all relevant information. The Court rejected the Seventh Circuit's conclusion that full and proper disclosure of all relevant facts in the fee negotiation process is sufficient to satisfy an adviser's fiduciary obligations under Section 36(b).

Rather, the Court applied the fiduciary standard it set out in *Pepper v. Litton*,¹⁶ the “essence” of which is “whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain.”¹⁷ The Court stated 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 articulated in *Pepper* and reflects Section 36(b)’s imposition of the burden on the plaintiff.

The Court noted with approval that the *Gartenberg* standard requires that “all relevant circumstances” be taken into account in reviewing a claim brought under Section 36(b) and that the range of fees that might result from arm’s length bargaining is established as the benchmark for reviewing challenged fees.¹⁸ The Court cited in the text certain factors expressed in *Gartenberg* for making this determination, including the adviser-manager’s cost in providing the service, the extent to which the adviser-manager realizes economies of scale as the fund grows larger, and the volume of orders which must be processed by the manager. The Court also noted the additional *Gartenberg* factors, namely:

- The nature and quality of the services provided to the fund and shareholders;
- The profitability of the fund to the adviser;
- Any collateral benefits (*i.e.*, “fall-out” benefits) that accrue to the adviser because of its relationship with the mutual fund;
- Comparative fee structure (*i.e.*, a comparison of the fees with those paid by similar funds);¹⁹ and
- The independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation.

THE ROLE OF DISINTERESTED DIRECTORS AND THE PROCEDURE AND SUBSTANCE OF ADVISORY FEE APPROVALS

The Court recognized the role of a mutual fund's disinterested directors as the "cornerstone of the...effort to control conflicts of interest within mutual funds," including, specifically, conflicts related to adviser compensation.²⁰ Based on Section 36(b)(2) of the Investment Company Act, which instructs courts to give board approval of an adviser's compensation "such consideration...as is deemed appropriate under all the circumstances,"²¹ the Court drew two inferences, both of which are embodied in the *Gartenberg* standard. First, a measure of deference to a board's judgment may be appropriate in some instances. Second, the appropriate measure of deference varies depending on the circumstances.²²

The Court emphasized the importance of both the procedure and substance of a board's review of an investment adviser's fee. The Court noted that, under *Gartenberg*, 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 the investment adviser has breached its fiduciary duty under 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."²³ 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."²⁴ Conversely, "where the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome."²⁵

The decision highlights the importance of the requirements under Section 15(c) of the Investment Company Act²⁶ that a board request and evaluate, and that the investment adviser furnish, all information as may reasonably be necessary for the board to evaluate the terms of an advisory contract. As emphasized by the Court, "the standard for fiduciary breach under §36(b)

does not call for judicial second-guessing of *informed* board decisions.”²⁷ Accordingly, a record that can demonstrate that the board engaged in a robust process of requesting and evaluating relevant information regarding a proposed fee arrangement can help defend against a breach of fiduciary duty claim under Section 36(b). Moreover, an investment adviser that fails to disclose material information to the board, even if not specifically requested by the board, risks heightened scrutiny of its fee in an action under Section 36(b) as the degree of deference that is granted by a court to the board approving the fee may be reduced. Indeed, the Court stated 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.”²⁸

FEE COMPARISONS

A point of disagreement between the parties in *Harris* related to the importance of fee comparisons. The Court first addressed comparisons between the fees that an adviser charges its mutual fund and the fees that it charges its independent clients, noting that the *Gartenberg* court rejected a comparison between the fees the adviser in that case charged a money market fund and the fees it charged a pension fund client. Because the Investment Company Act requires consideration of all relevant factors, the Court in *Harris* concluded that there can be no categorical rule regarding the comparisons of the fees charged to different types of clients. Rather, the Court noted that a judge 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.”²⁹ The Court acknowledged that there may be significant differences between the services an adviser provides to its mutual funds and its institutional clients attributable, for example, 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.³⁰ The Court stated 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....”³¹ The Court also stated that “[i]f the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison.”³²

In light of the Investment Company Act’s requirement that the directors of a fund request and evaluate such information as may reasonably be necessary to evaluate the terms of an advisory contract, it appears appropriate in the post-*Harris* world for disinterested directors to request information regarding the fees charged to other accounts managed by the investment adviser and, depending on the similarities and differences between those accounts and the fund in question, assign this information such weight as is appropriate under the circumstances in the business judgment of the directors. Notwithstanding the Court’s explicit recognition that fees charged to institutional clients may be relevant to a board’s deliberations, the practical effect of *Harris* with respect to this issue may be to limit a plaintiff’s ability to obtain relief under Section 36(b) simply because an adviser charges different fees to different types of clients. Indeed, the Court stated 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.”³³ It is notable that the Court included “higher marketing costs” in its list of potential differences between services provided to a mutual fund and other types of clients.

The Court also addressed comparisons of fees charged to mutual funds by other advisers. Here, the Court stated, “courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers.”³⁴ The Court viewed these comparisons as “problematic because these fees... may not be the product of negotiations conducted at arm’s length.”³⁵ It has become common practice in the industry for fund boards reviewing a proposed advisory fee to review fees charged by third party advisers to a peer group of funds. If disinterested directors continue to find data regarding fees charged to third party funds informative in evaluating an adviser’s proposed compensation, this information should continue to be requested and evaluated. The Court’s decision, however, raises a question as to how much deference a court reviewing a claim under Section 36(b) will assign

to directors' conclusions that are principally based on comparisons to fees charged to other mutual funds.

CONCLUSION

The Court's decision in *Harris* endorses the *Gartenberg* standard of review that, with the exception of the Seventh Circuit's decision, generally has been consistently applied by courts for nearly 30 years. 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 Court emphasized the importance of the procedure followed by fund directors in evaluating an advisory fee and the substance of the information considered in reaching their conclusion. 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 full disclosure of the material facts relevant to the board's review of the fee. Under these circumstances, courts are admonished not to second guess the conclusions of the disinterested directors unless the fee charged 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.

NOTES

¹ No. 08-586, slip op., 559 U.S. ____ (2010) ("*Harris*"). *Harris* vacates the judgment of the Court of Appeals for the Seventh Circuit and remands the case for further proceedings.

² *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983) ("*Gartenberg*").

³ Section 36(b) of the Investment Company Act provides, in relevant part: "[T]he 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...to such investment adviser or any affiliated person of such investment adviser." 15 U.S.C. §80a-35(b).

⁴ *Harris*, slip op. at 9. In a concurring opinion, Justice Thomas emphasized

that the Court’s ruling in *Harris* does not support the free-ranging judicial “fairness” review that *Gartenberg* could be read to authorize.

⁵ *Id.* at 15.

⁶ *Id.* at 13.

⁷ *Id.*

⁸ *Id.* at 14.

⁹ *Id.*

¹⁰ *Jones v. Harris Assocs.*, 04-8305, 2007 U.S. Dist. LEXIS 13352 (N.D. Ill., Feb. 27, 2007).

¹¹ *Jones v. Harris Assocs.*, 527 F.3d 627 (7th Cir. 2008).

¹² *Id.* at 632.

¹³ *Id.*

¹⁴ *Jones v. Harris Assocs.*, 537 F.3d 728 (7th Cir. 2008).

¹⁵ *Gartenberg*, 694 F.2d at 928.

¹⁶ 308 U.S. 295 (1939) (“*Pepper*”).

¹⁷ *Id.* at 306-307.

¹⁸ *Harris*, slip op. at 11.

¹⁹ As further discussed below, the Court specifically addressed the utility of fee comparisons.

²⁰ *Harris*, slip op. at 11 (internal quotation marks omitted) (citing *Burks v. Lasker*, 441 U.S. 471, 482 (1979)). The Court indicated that the Investment Company Act also vests in fund shareholders a separate, independent check on advisory fees: “Board scrutiny of adviser compensation and shareholder suits under [Section 36(b)] are mutually reinforcing but independent mechanisms for controlling conflicts.” *Id.* at 12.

²¹ *Harris*, slip op. at 12 (internal quotation marks omitted) (quoting §80a-35(b)(2)).

²² *Id.*

²³ *Id.* at 15.

²⁴ *Id.* The Court cautioned that even if a fee were negotiated by a board in possession of all relevant information the fee still may be considered excessive. Such a determination, however, 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.

²⁵ *Id.*

²⁶ 15 U.S.C. §80a-15(c).

²⁷ *Harris*, slip op. at 16 (emphasis added).

²⁸ *Id.* (emphasis added).

²⁹ *Id.* at 13.

³⁰ *Id.* at 13-14.

³¹ *Id.* at 14.

³² *Id.*

³³ *Id.* at 14, n.8 (emphasis added).

³⁴ *Id.* at 14.

³⁵ *Id.*