EIGHTH CIRCUIT PROVIDES FOR A REVISED STANDARD FOR REVIEW OF MUTUAL FUND ADVISORY FEES

On April 8, 2009, the U.S. Court of Appeals for the Eighth Circuit decided Gallus v. Ameriprise Financial, Inc.,[1] the latest significant case under Section 36(b) of the Investment Company Act of 1940 (the "1940 Act"). In Gallus, the Eighth Circuit reversed the District Court's grant of summary judgment for the investment adviser and remanded the case for further consideration in a case involving potentially excessive advisory fees. This opinion was the first appellate opinion to address Section 36(b) since the Seventh Circuit, in Jones v. Harris Associates,[2] rejected the standard articulated by the Second Circuit in Gartenberg v. Merrill Lynch Asset Management, Inc.,[3] over twenty-five years ago. Gallus articulated a different standard for judicial review of fee cases under the fiduciary duty standards of Section 36(b) than the standards provided by either Gartenberg or Jones.

While Gallus reaffirmed the Gartenberg standard for assessing the amount of an advisory fee and a fund board of director's review of the fee, Gallus expanded on the Gartenberg standard in two significant ways. First, the Court in Gallus emphasized that a violation of Section 36(b) could arise from either (i) improprieties by the adviser during the fee negotiation process or (ii) an excessive fee. Thus, the Court in Gallus concluded that the appropriate standard of review under Section 36(b) includes an evaluation of an adviser's conduct throughout a negotiation for advisory fees, in addition to reviewing the final result of the negotiation. Second, the Gallus Court concluded that a Section 36(b) review should consider a comparison of fees charged by the adviser to mutual fund clients and institutional clients with similar investment programs. Applying that standard, the Eighth Circuit held that the District Court erred in failing to assess the reasonableness of fees charged by the adviser to mutual fund clients and those charged to institutional clients.

Background of Section 36(b)

A. Investment Company Amendments Act of 1970

Section 36(b) of the 1940 Act imposes a "fiduciary duty" upon an investment company adviser with respect to its compensation and authorizes derivative actions by a fund's shareholders against an adviser for breach of this duty. Since its enactment under the Investment Company Amendments Act of 1970, there has been significant litigation under Section 36(b) concerning advisers' fiduciary duties and the appropriate process for board of director review of registered investment company fees.

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1 No. 07-2945 (8th Cir. Apr. 8, 2009).

2 527 F.3d 627 (7th Cir. 2008), *cert. granted*, (U.S. Mar. 9, 2009) (No. 08-586).

3 694 F.2d 923 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983).

B. Gartenberg

In the widely followed Gartenberg decision, the Second Circuit concluded that "to be guilty of a violation of § 36(b)…the [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 Gartenberg standard of review has been applied in the Second Circuit[5] and has been adopted by both district and appellate courts in other circuits as well.[6]

Gartenberg and its progeny set forth the factors that courts should consider in determining whether a fund's board of directors and its investment adviser have breached their fiduciary duty under Section 36(b). In general, these factors include: (1) the nature and quality of the advisory services; (2) the profitability of a fund to the adviser; (3) the payments received by the adviser and its affiliates from all sources involving the fund, including any "fall-out" benefits received; (4) the sharing of economies of scale as the fund increases in size; and (5) the relationship that the amount of the advisory fee bears to the fees paid by other funds of similar size and objective.[7] The Securities and Exchange Commission implicitly endorsed the Gartenberg approach in its 2004 amendments of the forms governing registered fund shareholder reports (and certain proxy statements).[8]

C. Jones

Recently, however, the Seventh Circuit rejected the Gartenberg standard. In Jones, the Court held that the fiduciary duty imposed by Section 36(b) does not permit judicial review for reasonableness or make the federal judiciary a "rate regulator." Rather, the Court opined that the fiduciary standards of trust law apply and that the appropriate test is whether the adviser's client

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4 Gartenberg, 694 F.2d at 928.

5 See, e.g., Wexler v. Equitable Capital Management Corp., No. 93 CIV 3834, 1994 WL 48807 (S.D.N.Y. Feb. 17, 1994) (not reported in F. Supp.); Olesh v. Dreyfus Corp., No. 94 CIV 1664, 1995 WL 500491 (E.D.N.Y. Aug. 8, 1995) (not reported in F. Supp.); In re TCW/DW North American Government Income Trust Securities Litigation, 941 F. Supp. 326 (S.D.N.Y. 1996); Strougo v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783 (S.D.N.Y. 1997); Strougo v. BEA Associates, 188 F. Supp. 2d 373 (S.D.N.Y. 2002); In re Eaton Vance Mutual Fund Fees Litigation, 380 F. Supp. 2d 222 (S.D.N.Y. 2005); In re Goldman Sachs Mutual Fund Fees Litigation, No. 04 CIV 2567, 2006 WL 126772 (S.D.N.Y. Jan. 17, 2006) (not reported in F. Supp.); In re Evergreen Mutual Fund Fees Litigation, 423 F. Supp. 2d 249 (S.D.N.Y. 2006); and In re Salomon Smith Barney Mutual Fund Fees Litigation, 528 F. Supp. 2d 332 (S.D.N.Y. 2007).

6 See, e.g., Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321 (4th Cir. 2001); Batra v. Investors Research Corp., et al., 1991 U.S. Dist. LEXIS 14773 (W.D. Mo. Oct. 4, 1991); Barrett v. Van Kampen Merritt Inc., et al., 1993 U.S. Dist. LEXIS 3936 (N.D. Ill. Mar. 26, 1993); and Krantz v. Fidelity Mgmt. & Research, Co., 98 F. Supp. 2d 150 (D. Mass. 2000) (Krantz was settled before it could be decided on the merits).

7 See generally, Gartenberg, 694 F.2d at 929-930.

8 Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act No. 33-8433 (June 23, 2004).

made a voluntary choice with the benefit of adequate information. The Court stated that an investment adviser is held to an "obligation of candor in negotiation, and honesty in performance, but may negotiate in [its] own interest and accept what the…governance institution agrees to pay."[9] Notably, in analogizing to other exercises of fiduciary duty, the Court said that when "the persons charged with the trust's administration make a decision [regarding compensation], it is conclusive."[10] Emphasizing its position that judges should not regulate advisory fees, the Court concluded that so long as an investment adviser "make[s] full disclosure and play[s] no tricks,"[11] judges will not be in the business of "determin[ing] how much advisory services are worth."[12]

The Eighth Circuit's Decision in Gallus

In partially adopting the Gartenberg standard, the Eighth Circuit noted that the District Court had properly utilized the Gartenberg factors in its determination that the fee charged did not constitute a breach of Section 36(b). Although the Court approved of the approach taken in Gartenberg, stating "that the Gartenberg factors provide a useful framework for resolving claims of excessive fees…,"[13] the Court warned that the standard created by the Gartenberg test does not create a blanket "safe harbor" for advisory fees that are consistent with industry norms but may be exorbitant in the context of the particular fund.

Nevertheless, the Gallus Court expanded upon the Gartenberg standards stating, "We believe that the proper approach to Section 36(b) is one that looks to both the adviser's conduct during negotiation and the end result."[14] For the end result (the amount of the advisory fees), the Gallus Court generally was satisfied with the Gartenberg standard. However, the Court provided an additional standard for review, stating that the adviser has a duty to be honest and transparent during the negotiation process and that "unscrupulous behavior with respect to either [the negotiation or the end result] can constitute a breach of fiduciary duty."[15] The Eighth Circuit noted that plaintiffs accused the adviser of, among other things, misleading the fund's Board of Directors about certain fee arrangements with non-fiduciary clients and the creation of a report for the Board of Directors that may have "purposefully omitted, disguised or obfuscated" information that, if accurately presented to the Board of Directors, might have impacted the Board's decision to approve the advisory fee. The Gallus Court remanded the case to the District

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9 Jones at 11.

10 *Id.*

11 *Id.* at 10-11.

12 *Id.* at 11.

13 Gallus at 11.

14 *Id.*

15 *Id.*

Court to determine whether the adviser's behavior during the negotiation was a breach of its fiduciary duty under Section 36(b).

The Gallus Court also stated that the application of the Gartenberg factors by the District Court was too limited in scope because the lower court failed to consider evidence that the adviser offered comparable advisory services to institutional clients at a substantially lower fee than it charged to its mutual fund clients. The District Court's decision to reject the comparison data was grounded in dicta of Gartenberg, in which the Court refused to compare the adviser's fees for "fundamentally different investment vehicles - money market funds and equity pension funds."[16] The Eighth Circuit, however, distinguished Gartenberg, concluding that when there is a greater similarity between the institutional funds and mutual funds, a court should consider the comparison between fees. Comparing fees of institutional and mutual fund clients was particularly relevant in this case, the Court noted, "because the investment advice may have been essentially the same for both accounts."[17] This approach of comparing fees paid by institutional clients and mutual fund clients deviates from numerous district court holdings and Jones, in which the Seventh Circuit refused to consider in its Section 36(b) analysis the difference in fees of non-institutional clients versus institutional clients due to the varying degrees of effort required on the part of the subadviser.[18]

Impact of Gallus Decision

The Gallus opinion's emphasis on the process by which fees are set could lead to increased litigation under Section 36(b) and may make it more difficult for defendants in such cases to secure dismissal on the pleadings. Under the Gallus standard, plaintiffs will claim to be entitled to discovery of all materials concerning the fee review process and may, for example, attempt to exploit any variations between draft materials and final materials to bolster their claims and avoid dismissal before trial. Further, Gallus gives new life to plaintiffs' arguments that differences between institutional fees and mutual fund fees are central to a board of director's consideration of advisory contracts under Section 15(c). The Gallus Court, however, reemphasized that the burden of proof belongs to the plaintiffs on both the existence of a breach of fiduciary duty and on showing financial harm resulting from the breach.

Supreme Court Review of Judicial Standards for Section 36(b) Cases

On March 9, 2009, the United States Supreme Court granted the plaintiffs' petition for a writ of certiorari in the Jones case. The Supreme Court will hear the case during its next term, which

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16 *Id.*

17 *Id.* at 13.

18 Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962 (S.D.N.Y. 1987); Miller v. Mitchell Hutchins Asset Mgmt., 2002 U.S. Dist. LEXIS 27675 (S.D. Ill. Mar. 12, 2002); Strougo v. Bea Assocs., 188 F. Supp. 2d 373, 384 (S.D.N.Y. 2002); In re AllianceBernstein Mut. Fund Excessive Fee Litig., 2005 U.S. Dist. LEXIS 24263 (S.D.N.Y. Oct. 19, 2005); and In re Evergreen Mut. Funds Fee Litig., 240 F.R.D. 115 (S.D.N.Y. 2007).

begins on October 5, 2009. However, until the Supreme Court sets a standard of review for claims brought under Section 36(b) (whether that standard is the one articulated in Jones, Gartenberg, Gallus or something else), we believe it is advisable for fund boards to continue to consider advisory fees using the standard promulgated by Gartenberg. We also caution advisers to be mindful of Gallus when deciding the information to be presented to a fund board during the contract review process.

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If you have any questions concerning the foregoing or would like additional information, please contact Rose F. DiMartino (212-728-8215, rdimartino@willkie.com), Benjamin J. Haskin (202-303-1124, bhaskin@willkie.com), Mary Eaton (212-728-8626, meaton@willkie.com), or the attorney with whom you regularly work.

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