It's Too Early to Disregard the *Gartenberg* Factors During Advisory Fee Renewals

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Last week the United States Court of Appeals for the Seventh Circuit rejected a claim that advisory fees charged for the Oakmark family of funds were excessive and violated Section 36(b) of the Investment Company Act of 1940. *Jones v. Harris Associates*. The outcome of the case was not surprising, as the district court had reached the same conclusion, after application of the long-standing *Gartenberg* test that Oakmark's advisory fees were "within the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances." The Seventh Circuit decision is, nonetheless, capturing the attention of the investment management industry and the media because, while the appeals court affirmed the district court's decision, it rejected the "*Gartenberg* approach." Which begs the question: What did the Seventh Circuit do in *Harris* and what, if anything, does it portend for boards that are in the process of considering whether to renew an investment company advisory agreement?

The Seventh Circuit's Decision in Harris

The Seventh Circuit pointedly rejected the *Gartenberg* standard and articulated a new test for reviewing advisory fee challenges under Section 36(b). In the first instance, the court stated: "we now disapprove the *Gartenberg* approach." In its stead, the Court stated: "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." In other words, unless an adviser "pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services[,]" courts in the Seventh Circuit will be deferential to the advisory fee negotiated by independent trustees.

The Seventh Circuit's new articulation of Section 36(b) liability now rests on two propositions that were disputed by plaintiffs. First, the court observed that the market for investment company advisory services is competitive. Acknowledging that there are more than 8,000 mutual funds holding more than $6 trillion in assets, the court noted that mutual fund investors "can and do 'fire' advisers cheaply and easily by moving their money elsewhere. Investors do this not when advisers' fees are 'too high' in the abstract, but when they are excessive in relation to the results . . ." The court expressed a policy preference for competitive processes over a "'just price' system administered by the judiciary."

Second, the Court rejected an assertion that has formed the linchpin for many of the current advisory fee litigation challenges (and which was popularized by academics such as John P. Freeman and Steward L. Brown, and former New York Attorney General Eliot Spitzer during his prosecution of market timing abuses); namely, that a lower advisory fee for institutional separate accounts implies that a higher advisory fee for an adviser's mutual funds is "too much." The court reasoned: "Different clients call for different commitments of time. Pension funds have low (and predictable) turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions. That complicates an adviser's task."

The Gartenberg Approach

Now to the "disapprove[d]" *Gartenberg* approach. The landmark holding of that decision is that an investment company advisory fee violates Section 36(b) when it 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." *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). In weighing whether a fee is excessive, courts that follow the *Gartenberg* approach consider all facts and circumstances surrounding the receipt of compensation, with emphasis on six particular factors:

- The nature and quality of the services provided to fund shareholders
- The profitability of the fund to the adviser/manager
- Economies of scale of operating the fund as it grows larger
- Fee structures of comparable funds
- The independence and conscientiousness of the trustees
- Fall-out benefits (i.e., indirect profits to the adviser attributable in some way to the existence of the fund)

The rejection of the *Gartenberg* approach by the Seventh Circuit has led to some speculation within the investment management industry that the varying approaches to Section 36(b) litigation merit review by the Supreme Court.

Should Boards of Directors Now Disregard the Gartenberg Factors?

Over the past week, mutual fund advisers and boards of directors have asked whether they must continue to review the *Gartenberg* factors when considering investment company advisory agreement renewals. That answer is yes. Independent directors should continue to consider the *Gartenberg* factors, without regard to whether the mutual fund's adviser is situated in the Seventh Circuit or elsewhere in the country. The *Gartenberg* approach has shaped how mutual fund boards of directors have conducted so-called 15(c) renewals for almost thirty years and this process-oriented approach has been applied by district courts in the First, Second, Third, Fourth, Fifth, Eighth, Ninth and Tenth Circuits. It continues to be the majority rule and boards of directors can clearly document that they have served as independent watchdogs on the management of investment companies by continuing to review the nature and quality of the services provided to the investment company and its shareholders.

And what about mutual fund advisers located in the Seventh Circuit? Are the *Gartenberg* factors inapplicable to them? It is too early to disregard the factors during Section 15(c) renewals, even in cases in which the adviser is located in the Seventh Circuit. As noted above, some have speculated that the interpretation of Section 36(b) might merit Supreme Court review. Until the time for filing a petition for *certiorari* has lapsed, advisers should be prudent. Moreover, plaintiffs likely will forum shop and elect to file cases outside the Seventh Circuit, where the *Gartenberg* approach continues to apply with full force. If the adviser is unsuccessful in transferring the action to its home forum, the best defense to a Section 36(b) action will continue to be a documented, process-oriented record that an informed board of directors has considered carefully the services provided to the investment company and its shareholders and whether the investment company fee bears a reasonable relationship to the services provided by the mutual fund adviser.

Moreover, SEC disclosure rules contemplate a *Gartenberg* approach to advisory fee renewal. In particular, they require that shareholder reports state whether the board considered the *Gartenberg* factors when it approved the advisory agreements. Any decision to abandon the factors would result in disclosures that the board did not consider the nature and quality of services, or the costs of comparable funds, when it renewed the advisory agreements for a family of funds.

Contact Information

If you would like to discuss the Seventh Circuit's decision, or the impact of the decision on litigation affecting your complex, please contact us or any of members of the firm's Investment Management practice. For a copy of the court's decision in *Jones v. Harris Associates*, please see this attached document.

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