Supreme Court Endorses *Gartenberg*, But It's Not the Same Old Standard

2010-04-05

In May 2008, the United States Court of Appeals for the Seventh Circuit created significant uncertainty as to the legal obligations of investment company boards and investment advisers in the negotiation of investment advisory agreements for funds registered under the Investment Company Act of 1940. After 25 years of virtual consensus regarding the factors detailed in Gartenberg v. Merrill Lynch Asset Management,[1] the Seventh Circuit expressly departed from *Gartenberg*, and concluded that an investment adviser has not violated Section 36(b) of the Investment Company Act 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."[2] Last week, a unanimous Supreme Court rejected the Seventh Circuit's standard under Section 36(b) and held that the 25-year-old *Gartenberg* formulation was correct: namely, liability under Section 36(b) requires that "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."[3] Importantly, the Court emphasized that "the standard for fiduciary breach under §36(b) does not call for judicial second-guessing of informed board decisions" and that courts should not "engage in a precise calculation of fees representative of arm's-length bargaining."[4]

This alert discusses the Supreme Court's interpretation of the fiduciary duty that advisers owe to mutual fund investors under Section 36(b), the relevance of institutional separate account advisory fees to that assessment, and the potential impact that alleged process violations in the provision of information to boards may have on the deference that courts may extend to boards in Section 36(b) litigation.

I. Fiduciary Duty with Respect to the Receipt of Compensation

Section 36(b) creates a private right of action for breach of "fiduciary duty with respect to the receipt of compensation for services" paid by the investment company to the adviser or its affiliates. The Investment Company Act does not define this fiduciary duty and the lower courts, beginning with *Gartenberg*, sought to construct the contours of the duty according to factors that Judge Pollack, the author of the district court's opinion in *Gartenberg*, had identified in the legislative history for Section 36(b), which Congress enacted in 1970. In weighing whether a fee is excessive, the lower courts that followed *Gartenberg* considered 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 boards
- Fall-out benefits (*i.e.*, indirect profits to the adviser attributable in some way to the existence of the fund)

The Court quotes the *Gartenberg* factors with approval.[5] The Court did not, however, suggest a priority consideration of the factors, or the extent to which any of the factors would be dispositive in Section 36(b) litigation. Academic literature suggests that some of these factors may not be relevant to assessing whether an advisory fee is excessive for fund investors. Commentators, for example, have written that the profitability of the fund to an investment adviser measures the adviser's efficiencies in providing an advisory service and not whether investors could obtain the same performance and services for a lower price at a competitor.[6] The Court neither acknowledges this debate, nor suggests how the lower courts should assess fund profitability in investment advisory challenges. There are few judicial pronouncements about fund profitability, which in turn provide scant guidance to boards seeking to adhere to the *Gartenberg* formulation in reviewing investment advisory agreements.

II. Unanswered Questions: Institutional Separate Account Fees, Fees for Like Funds, and Allegations of Process-Based Failures in Reports to the Independent Trustees

Petitioner sought Supreme Court review on whether the Seventh Circuit erroneously held that a shareholder's claim that the fund's investment adviser charged an excessive fee—more than twice the fee it charged to funds with which it was not affiliated—is not cognizable under Section 36(b), unless the shareholder can show that the adviser misled the fund's directors who approved the fee. The Court's opinion primarily focuses on the relevance of institutional separate account fees to a review of mutual fund fees under Section 36(b) and does not provide much elaboration of the other *Gartenberg* factors. Even as to the *Gartenberg* consideration of the fee structures of comparable funds, however, the decision leaves much unanswered. Three issues will be of particular interest to independent trustees charged with the review of an advisory agreement – and subsequently, to district courts reviewing an advisory agreement in response to a challenge under Section 36(b): 1) Do lower institutional separate account fees mean that a mutual fund advisory fee is *per se* excessive under Section 36(b)? 2) Is the fee structure of a comparable mutual fund an appropriate standard for boards and district courts to consider in a review of a mutual fund advisory agreement? 3) Is it possible to have liability under Section 36(b) through process failure in the provision of material information to the independent trustees, even in circumstances in which the advisory fee is not excessive? The significance of the Court's assessments of these issues is discussed below.

First, the Court avoided adopting a categorical rule regarding the relevance of institutional separate account fees. Since 2003, when then-New York Attorney General Eliot Spitzer criticized the mutual fund industry for setting mutual fund advisory fees at higher levels than advisers charged unaffiliated institutional separate accounts, most Section 36(b) litigation has been premised on the assertion that the investment adviser breached its fiduciary duty as to the receipt of compensation for advisory services because its fee exceeded that which the adviser charged its unaffiliated separate accounts for advisory services. The Supreme Court's decision in *Jones v. Harris* does not provide clarity regarding the vitality of this argument, or the circumstances in which advisory fees for institutional separate accounts should be given greater weight.

Some *amici* urged the Court to hold that separate accounts are *never* relevant in assessing the reasonableness of mutual fund fees. Petitioner took the opposition approach – urging the Court to find that separate account fees are the *only* relevant consideration in judging the reasonableness of an adviser's fees. The Court resisted both invitations to make "any categorical rule regarding the comparison of the fees charged different types of clients."[7] While acknowledging that the Investment Company Act "does not necessarily ensure fee parity between mutual funds and institutional clients[,]"[8] the Court left determinations about the relevance of the institutional separate account fees in particular cases to the lower courts. The Court stated:

> [C]ourts 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. As the panel below noted, there may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable 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.[9]

Second, the Court's decision introduces new uncertainty into Section 36(b) litigation by casting some doubt on the relevance of fees for comparable mutual funds managed by competitors.[10] The relevance of fees of like funds, of similar size and comparable methods of distribution, has become industry standard and is now a common comparison in third party reports provided to boards during 15(c) advisory renewal meetings. With respect to the relevance of a competitor's mutual fund fees, however, the Court speculated that mutual fund fees of competitive advisers "may not be the product of negotiations conducted at arm's length."[11] How boards are supposed to assess whether a competitor's advisory fee – and thus, the fee that the fund might arguably obtain in a market – are the products of arm's length negotiation (and a proper comparison for assessing whether to renew an advisory agreement under Section 15(c)) is nowhere specified in the opinion. Moreover, there is significant economic research tending to show that the mutual fund industry is, in fact, competitive.[12] It is unclear from the opinion whether an investment adviser or third party services must provide boards with some information about market competition to justify an advisory fee in comparison to fee levels at competitive firms.

Third, the Court's decision does not directly address the relevance of alleged process-based failures such as those referenced by the United States Court of Appeals for the Eighth Circuit in *Gallus v. Ameriprise*. In *Ameriprise*, as in *Jones*, plaintiff argued that the adviser breached its fiduciary duty to mutual fund investors by charging an advisory fee that exceeded the advisory fee for institutional separate accounts. The district court concluded that institutional separate account fees were not a valid comparison because the nature and quality of services provided to the two sets of clients were dramatically different and ultimately dismissed the action. The Eighth Circuit reversed, noting that the district court had erred "in rejecting a comparison between the fees charged to Ameriprise's institutional clients and its mutual fund clients."[13]

The Eighth Circuit further stated, however, that plaintiff had challenged the truthfulness and completeness of the competitive fee information and that the adviser had misled the independent trustees. On this claim, the Eighth Circuit noted that "[u]nscrupulous behavior with respect to either can constitute a breach of fiduciary duty."[14] The focus on behavior, rather than actual fee levels, is a controversial aspect of the Eighth Circuit's decision, suggesting the possibility that a low fee could nonetheless result in litigation because of some process failure in the negotiations. The adviser has petitioned for *certiorari* in *Ameriprise* and several amicus briefs in *Jones v. Harris* referenced the Eighth Circuit's decision.

To the extent that the Court acknowledges the debate as to whether process-based disputes are sufficient to plead a violation of Section 36(b), it appears to suggest that the process-based failure is not an independent violation of Section 36(b), but may undercut the deference to which an informed board decision would be entitled. As support for this interpretation, the Court emphasized that Section 36(b) is directed to fee levels: "Section 36(b) is sharply focused on the question of whether the fees themselves were excessive."[15] Given the focus on whether a fee is excessive, a pure process-based challenge to negotiation of a fee should not result in a violation of Section 36(b). A process-based failure, however, may result in less deference to the board; although the significance of the process-based failure, and how it might be material, is nowhere discussed in the opinion. For some unspecified category of process-based failure, the Court states that "where a board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome. When an investment adviser fails to disclose material information to the board, greater scrutiny is justified because the withheld information might have hampered the board's ability to function as 'an independent check upon the management.'"[16] The failure to provide information to the board – which could, in fact, be unintentional – is not dispositive on whether there is a breach of fiduciary duty. Rather, the Court notes, "an adviser's compliance or non-compliance 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."[17]

III. Conclusion

The Court's adoption of the *Gartenberg* factors, and its express recognition that courts are not institutionally suited to set advisory fees, restored much needed stability to the process by which investment advisers and boards negotiate advisory fees. The *Gartenberg* factors have created a structure that assists advisers in the provision of information to boards relevant to a fee determination and has shaped boards' expectations about the kinds of information that they should consider in setting advisory fees. The Court's decision nonetheless has created uncertainty about an important factor in the analysis – *i.e.*, the fee structures of comparable funds – and that uncertainty may require reconsideration of comparability in the course of 15(c) renewals.

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[1] 694 F.2d 923 (2d Cir. 1982).

[2] *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 635 (7th Cir. 2008).

[3] *Jones v. Harris Assocs. L.P.*, No. 08-856, slip op. at 9 (U.S. Mar. 30, 2010).

[4] *Id.* at 16.

[5] *Id.* at 12-13 ("*Gartenberg* advises that 'the expertise of the independent trustees 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 §36(b)").

[6] John C. Coates IV and R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 3 J. Corp. L. 151, 185 (2007).

[7] *Jones v. Harris*, slip op. at 13.

[8] *Id.* at 14.

[9] Notwithstanding the Court's reference to the difference between marketing costs, Rule 12b-1 under the Investment Company Act may limit

the extent to which boards may consider marketing expenses in their evaluation of the reasonableness of investment advisory agreements. *See* 17 C.F.R. § 270.12b-1 (2009).

[10] *Strougo v. BEA Assocs.*, 188 F. Supp. 2d 373, 384 (S.D.N.Y. 2002) (holding that the "relevant comparison must be to other mutual funds, not to non-mutual fund institutional clients); *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990) (to the extent comparative fees are probative in a Section 36(b) case, "a mutual fund adviser-manager must be compared with members of an appropriate universe: adviser-managers of similar funds"); and *Gallus v. Ameriprise Fin., Inc.*, 497 F. Supp. 2d 974, 982 (D. Minn. 2007) ("Since *Gartenberg*, courts have held that other mutual funds provide the relevant comparison for measuring fees – *not non-mutual fund institutional clients*") (emphasis added), *rev'd on relevance of institutional fees*, 561 F.3d 816 (8th Cir. 2009), *petition for cert. filed* (U.S. Aug. 6, 2009) (No. 09-163).

[11] *Jones v. Harris*, slip op. at 14.

[12] Investment Company Institute, *Investment Company Fact Book* (49th ed. 2009), *available here*. Moreover, unlike comparisons to fees of institutional separate accounts, comparisons to fee levels of competitor funds generally do not suffer from differences in types of services.

[13] *Id.* at 823.

[14] *Id.*

[15] *Jones v. Harris*, slip op. at 16 (quoting *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F. 3d 321, 328 (4th Cir. 2001)); *see also* 15 U. S. C. §80a–35(b) (imposing

a "fiduciary duty with respect to the *receipt of compensation* for services, or of payments of a material nature" (emphasis added)).

[16] *Id.* at 15-16.

[17] *Id.* at 16.

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