Supreme Court Upholds Gartenberg Standard in Jones v. Harris

On March 30, 2010, the Supreme Court issued its highly anticipated decision in Jones v. Harris Associates, L.P. The decision resolves the Circuit split that was created when the Seventh Circuit Court of Appeals adopted a new, market-based standard for the evaluation of investment advisory fees under Section 36(b) of the Investment Company Act of 1940. In a unanimous opinion, the Court concluded that the Second Circuit’s 1982 decision in Gartenberg “was correct in its basic formulation of what Section 36(b) requires: to face liability under Section 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.”

Background

Section 36(b) imposes a fiduciary duty on mutual fund advisers with respect to their fees and authorizes civil actions by the SEC and shareholders for breach of that duty. In Jones, the plaintiffs alleged that fees the adviser charged to the Oakmark Funds were excessive as compared to fees charged to its institutional clients. The Jones plaintiffs leavened their complaint with allegations that the fee approval process has been tainted by the presence of directors who were not truly “independent.” The district court, applying Gartenberg and finding that the independent directors met required independence standards, granted the defendant adviser’s motion for summary judgment. The plaintiffs appealed, claiming in part that Gartenberg incorrectly interpreted Section 36(b). The Seventh Circuit affirmed the district court’s grant of summary judgment, but disapproved of Gartenberg.

Judicial Split Among Circuits

For over 25 years, Gartenberg served as the predominant framework for judicial and regulatory interpretations of Section 36(b) and functioned as the nucleus of fund boards’ annual review of investment advisory contracts under Section 15(c) of the Act. Departing from this precedent, Chief Judge Frank Easterbrook wrote for the Seventh Circuit in Jones that as long as a fiduciary, such as a fund’s adviser, “make[s] full disclosure and play[s] no tricks,” that fiduciary generally is free to negotiate its compensation in its own interest, like any other market participant. Observing that the fiduciary duty standard in Section 36(b) “differs from rate regulation,” the Seventh Circuit concluded that the statute did not require that advisory fees be “reasonable” in relation to a “judicially created standard” like that articulated in Gartenberg. Although the Seventh Circuit acknowledged that it was “possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for the decision have abdicated” their responsibility, that was not the case where, as in Jones, fees “are roughly the same

1 The Seventh Circuit’s decision in Jones was the subject of an Investment Management Alert in June 2008, and the Supreme Court’s review of Jones was the subject of an Investment Management Alert in November 2009.
...as those that other funds of similar size and investment goals pay their advisers. . .” The Circuit split created by *Jones* caused Judge Richard Posner, in a vigorous dissent from the denial of rehearing by the full Seventh Circuit, to question the substantive standard required by Section 36(b). According to Judge Posner, the “economic analysis” underlying the panel decision’s rejection of *Gartenberg* was “ripe for reexamination” not only because it created a Circuit split but because of the “importance of the issue to the mutual fund industry.” Oral arguments, heard by the Supreme Court in early November 2009, focused on the nature of the fiduciary duty under Section 36(b); the appropriate standard for measuring advisory fees and the appropriateness of institutional versus retail advisory fee comparisons in Section 36(b) inquiries; and the roles of fund boards and courts in Section 36(b) cases.²

**The Supreme Court Weighs In**

In its *Jones* opinion, which vacates the Seventh Circuit’s decision, the Supreme Court embraced the *Gartenberg* standard as the correct approach in the review of challenged advisory fees. The *Gartenberg* framework, Justice Alito wrote for the unanimous Court, accurately reflects the “delicate compromise” between shareholder and adviser interests that Congress “embedded in §36(b).” The Court recognized that “while the standard for an investment adviser’s fiduciary duty has remained an open question in our Court . . . until the Seventh Circuit’s decision below, something of a consensus had developed regarding the standard set forth 25 years ago in *Gartenberg.*” The Court’s opinion also noted that *Gartenberg* “has been adopted by other federal courts, and ‘the SEC’s regulations have recognized, and formalized, *Gartenberg*-like factors.’”

**On Advisers’ Fiduciary Duty**

A significant portion of the Court’s opinion is dedicated to an exploration of the history of Section 36(b), which was adopted by Congress in 1970, with the goal of illuminating the meaning of the statutory statement that an investment adviser “shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services.” Observing that the meaning of Section 36(b) “is hardly pellucid,” the Court affirmed that the *Gartenberg* formulation “was correct.” Citing its 1939 decision in *Pepper v. Litton*, the Supreme Court stated that “the essence of the test [as to whether a fiduciary duty has been violated] is whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain.” According to the Court, “[t]he *Gartenberg* approach fully incorporates this understanding of the fiduciary duty . . . *Gartenberg* insists that all relevant circumstances be taken into account . . . .” The Court also highlighted that “[t]he Investment Company Act shifts the burden of proof from the fiduciary to the party claiming breach,” thus emphasizing that plaintiffs (and not investment advisers) continue to have the burden of proof when bringing suit under Section 36(b), as acknowledged in *Gartenberg*.

**On Comparative Fees**

The Court reviewed extensively the role of comparative fees in the Section 36(b) calculus. Commenting on the usefulness of comparing a mutual fund’s advisory fees to the fees charged by the fund’s adviser to other clients, the Court reasoned that “[s]ince the Act requires consideration of all relevant factors . . . we do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients. Instead, courts 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.” Warning against “inapt comparisons,” the Court noted that:

² Subsequent to the Seventh Circuit’s ruling in *Jones*, and prior to the Supreme Court argument in that case, the Eighth Circuit held in *Gallus v. Ameriprise Financial Inc.*, that it was error for a district court to reject a comparison of the fees charged by an investment adviser to its institutional and retail clients. The *Ameriprise* decision was the subject of an Investment Management Alert in April 2009.
different that a comparison is not probative, then courts must reject such a comparison. Even if the services provided and the 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 contrary to petitioners’ [plaintiffs’] contentions.

The Court also warned, as did the Gartenberg court, against placing too much emphasis on a comparison of one fund’s advisory fees against fees charged to other mutual funds by other advisers. “These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm’s length.” Moreover, the Court cited Gartenberg for the proposition that “competition between . . . funds for shareholder business does not support an inference that competition must therefore also exist between [investment advisers] for fund business. The former may be vigorous even though the latter is virtually non-existent.”

The Court’s reference to marketing costs as a differentiating factor between advisory services charged to mutual funds and institutional investors such as pension funds may affect how directors assess advisory fees in their annual Section 15(c) contract renewal process. This recognition of marketing costs may prove to be especially significant as it could undermine the SEC’s long-held position that the fund directors should not consider such costs in evaluating mutual fund advisory fees.

### On the Role of Independent Directors

The Court’s opinion appears to be a major affirmation of the crucial role of informed and diligent fund directors in overseeing fees and monitoring conflicts of interest. Citing Burks v. Lasker, a case decided by the Court in 1979, the Court observed that “[u]nder the Act, scrutiny of investment adviser compensation by a fully informed mutual fund board is the ‘cornerstone of the . . . effort to control conflicts of interest within mutual funds’ . . . The Act interposes disinterested directors as ‘independent watchdogs’ of the relationship between a mutual fund and its adviser.” The Court also acknowledged that the Act “instructs courts to give board approval of an adviser’s compensation ‘such consideration . . . as is deemed appropriate under all the circumstances.’” The Court noted that from “this formulation, two inferences may be drawn. 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.” According to the Court, “Gartenberg heeds these precepts. 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 . . . .'”

### On the Role of Judicial Review of Board Decisions

The Jones opinion focused on the dangers associated with judicial review of a board’s decision regarding advisory fees. The Court stressed that “where 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. Thus, 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.” The Court also considered the possibility that “a fee may be excessive even if it was negotiated by a board in possession of all relevant information.” In those instances, according to the Court, “a determination [by a court] 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.’” Addressing a scenario in which “the board’s process was deficient or the adviser withheld important information,” the Court stated that judicial review of the board’s decision must be more “rigorous.” In any case, the Court stressed that “Section 36(b) does not call for judicial second-guessing of informed board decisions.”
Conclusion
The Court concluded its opinion by once more endorsing the principles articulated in Gartenberg. Noting that the “Gartenberg standard, which the [Seventh Circuit] panel rejected, may lack sharp analytical clarity,” the Court emphasized that “we believe that it accurately reflects the compromise that is embodied in Section 36(b), and it has provided a workable standard for nearly three decades. The debate between the Seventh Circuit panel and the dissent [in that Circuit] . . . regarding today’s mutual fund market is a matter for Congress, not the courts.”