

visited 8/8/2008



Alert > Securities Area / Broker-Dealer / Investment Management

Seventh Circuit “Disapproves” Gartenberg, But Is This New Approach Fundamentally Different?

May 27, 2008

On May 19, 2008, the United States Court of Appeals for the Seventh Circuit issued an opinion in the *Harris Associates* case that purports to “disapprove” the standard under which most federal courts have considered whether the advisory fees paid by mutual funds violate Section 36(b) of the Investment Company Act of 1940.¹

The *Harris Associates* opinion suggests that a court need only determine whether the adviser negotiated the advisory fee in a manner consistent with its fiduciary duty to the fund. If, according to the Court of Appeals, a court concludes that the adviser negotiated the fee candidly and without deceit, then it normally need not consider whether that fee was “reasonable.” In other words, according to the *Harris Associates* court, the United States Court of Appeals for the Second Circuit got it wrong in its 1982 *Gartenberg* decision, and other courts following along since then are also wrong.² Before we light a candle for *Gartenberg* and its progeny, however, we would like to make a few observations for your consideration.

The *Gartenberg* Standard

In the *Gartenberg* case, the Court of Appeals stated that, for an adviser to be guilty of violating Section 36(b), its fee must be so disproportionately large that it is not reasonably related to the services provided and could not have resulted from arm’s length bargaining between the adviser and

visited 8/8/2008

the mutual fund. In assessing whether a fee schedule would satisfy that standard, the *Gartenberg* court articulated several factors that might be considered in evaluating an advisory contract. Those factors include:

1. fees charged by other similar advisers to other similar funds;
2. the adviser’s cost in providing services to the fund;
3. the nature and quality of those services;
4. the extent to which the adviser realizes economies of scale in providing those services as the fund grows larger; and
5. the volume of orders or transactions the adviser must process.

Consistent with Section 36(b), the *Gartenberg* court also emphasized that considerable weight should be given to whether a fund’s directors have carefully considered and approved an advisory fee, where those directors performed their duties competently. As a result, courts following *Gartenberg* have tended to evaluate whether mutual fund directors were fully informed about all facts bearing on the adviser’s level of service and its fees, and whether they were careful and conscientious in their deliberations.³

The *Harris Associates* Opinion

In the *Harris Associates* case, the plaintiffs – who were investors in certain mutual funds advised by Harris Associates – alleged that the adviser’s compensation was excessive and that, as a result, the adviser had violated Section 36(b) of the Investment Company Act. On a motion for summary judgment, the District Court dismissed the case. That court analyzed the disputed advisory fee under *Gartenberg* and concluded that it was not excessive.

On appeal, the plaintiffs argued, in part, that *Gartenberg* should not be applied to their Section 36(b) claim because that test “relies too much on

visited 8/8/2008

market prices as a benchmark for reasonable fees” when, in fact, advisory fees are not set by competition.⁴

The Court of Appeals affirmed the order of summary judgment in favor of Harris Associates. In doing so, the court used its response to the plaintiff’s argument as an opportunity to “disapprove” the *Gartenberg* standard. The court’s criticism of *Gartenberg* proceeded on two related tracks:

Section 36(b) Imposes a Fiduciary Standard, Not a Reasonableness Test

The Court of Appeals stated that *Gartenberg* applies a “reasonableness” test that is not found in the statute or the fiduciary principles on which it is based. The court noted that Section 36(b) does not state that fees must be reasonable; instead, Section 36(b) provides that an adviser has a fiduciary duty with respect to the receipt of compensation and other material payments received from a mutual fund or its shareholders.

The court explained that this duty would require an adviser to negotiate candidly with a mutual fund, but it would not preclude the adviser from bargaining “in his own interest and accept[ing] what the settlor or governance institution agrees to pay.”⁵ As the court put it, “[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation.”⁶

The court explained further that, under trust law, a decision by a settlor or the persons charged with a trust’s administration on matters like compensation generally would not be subject to any test for reasonableness. Accordingly, the court rejected the notion that a judge should analyze whether an advisory fee is reasonable.

Market Forces Set Advisory Fees, so the Courts Need Not Intervene

visited 8/8/2008

The court also argued that *Gartenberg* underestimates the degree to which advisers face competitive pressures to reduce their costs. In *Gartenberg*, the court found that mutual funds rarely pressure their advisers to reduce costs. To the contrary, the *Harris Associates* court reasoned that those costs are in fact subject to competitive pressure because investors can easily pull out of a mutual fund when they think its costs are too high relative to the fund’s performance. The court asserted that in this sense, investors “can and do ‘fire’ advisers cheaply and easily by moving their money elsewhere.”⁷

In the court’s view, investors exit a fund when fees “are excessive in relation to the results – and what is ‘excessive’ depends on the results available from other investment vehicles, rather than any absolute level of compensation.”⁸ The court saw no reason for judges to substitute their own notion of reasonableness for the conclusions of investors in a market where more than 8,000 mutual funds compete.

After noting that Section 36(b) “does not make the federal judiciary a rate regulator, after the fashion of the Federal Energy Regulatory Commission,” the court affirmed the order of summary judgment for *Harris Associates*.⁹

Observations

It will be some time before we can assess fully the impact that *Harris Associates* will have on other Section 36(b) cases. In the meantime, we think that the following points are worth considering:

Other Courts May Not Be Persuaded by Harris Associates

It is not clear that courts outside of the Seventh Circuit will be fully persuaded by *Harris Associates*. For one thing, courts may not accept the Court of Appeals’ characterization of *Gartenberg* as a form of federal rate regulation in which judges rely on their own notions of fairness to decide

visited 8/8/2008

whether an advisory fee is reasonable. The decisions in *Gartenberg* and later cases in fact have involved more than an assessment of whether advisory fees are, in the courts’ estimation, reasonable. For example, courts have given considerable weight to director approval of advisory fees where the evidence shows that the board carefully considered the adviser’s performance and other relevant information. Courts have not overruled directors’ approval of advisory fees where a sound rationale for that approval has been articulated and the record reflects due consideration of available information. That courts generally have not substituted their judgment for that of fund directors suggests that *Gartenberg* is not federal rate regulation at all.

Courts may also conclude that in fact what the Court of Appeals has done is merely articulate the *Gartenberg* standard in a different way. The Court of Appeals says that a court should not inquire whether compensation that is “normal” versus peers is excessive, but the court acknowledges that “[i]t is 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”¹⁰ This sounds suspiciously like the *Gartenberg* standard that, to violate Section 36(b), an adviser’s fee must be 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. As a result, *Harris Associates* may be viewed as not living up to its billing as “disapproving” *Gartenberg*.

Another possible outcome is that courts will not view the *Harris Associates* decision as reading enough meaning into the words of Section 36(b), particularly where the statute states that approval of the fees by the directors “shall be given such consideration by the court as is deemed appropriate under all the circumstances.” The Court of Appeals does not comment on this language or discuss how advisers and directors should

visited 8/8/2008

behave in light of its decision. Another court may determine that if in enacting Section 36(b), all Congress had in mind beyond the fiduciary duty standard described by the Court of Appeals was establishing a private right of action, Congress would have done so with far fewer words!

The court in *Harris Associates* places considerable emphasis on the operation of the marketplace, which focuses on fees and performance. It may well be that even if other courts do not fully accept *Harris Associates*, they may take from it, and apply to Section 36(b) cases, more emphasis on relative investment performance and comparative fees than the other factors articulated in *Gartenberg*. Arguably, performance and fees are the factors most germane in determining whether an advisory contract represents an arm’s length bargain.

Directors and Advisers Should Not Abandon Existing Processes for Approval of Advisory Contracts

In our view, it would be premature for directors and advisers to conclude that they should abandon or substantially lessen the processes that they have implemented to satisfy the *Gartenberg* standard. *Harris Associates* was decided under Section 36(b) of the Investment Company Act, and while Section 36(b) is clearly important, fund directors and advisers are subject to other legal obligations in connection with approval of advisory contracts.

For instance, Section 15(c) of the Investment Company Act requires directors to request and evaluate such information as may reasonably be necessary to evaluate the terms of an advisory contract. Under the same provision, advisers have a corresponding duty to furnish that information to the directors. In addition, directors and advisers can be sued by the SEC under Section 36(a) of the Investment Company Act for a breach of fiduciary duty involving personal misconduct. While this provision would

visited 8/8/2008

presumably apply only in extreme cases, it is a reminder that directors and advisers are held to a high standard in their dealings on behalf of funds.

Directors also have fiduciary duties under applicable state law that require them to review an adviser’s performance and compensation carefully. These state laws generally provide that directors must perform their duties in good faith, with reasonable skill and care, and only after reviewing all information reasonably available to them.

These legal obligations suggest that directors should continue to exercise care and diligence in their review of advisory contracts, and a well-accepted way of doing so is to consider the factors articulated in *Gartenberg*. Similarly, advisers should (at least for now) continue to provide the types of information contemplated by *Gartenberg* in seeking approval of their fees, even if – as *Harris Associates* suggests – there is no duty that restrains them from seeking the highest fees that fund directors will agree to pay them. At the very least, by providing this information, advisers may help insulate themselves from any claim that an advisory fee was the product of deceit.

Funds Continue to Be Subject to Disclosure Requirements Relating to Approval of Advisory Contracts

The *Harris Associates* decision also does not relieve funds of their obligations to discuss – in their shareholder reports and proxy statements – the material factors considered and the conclusions reached in approving advisory contracts.¹¹ These discussions are required to include a reasonable amount of detail about the approval process. For example, a fund must disclose whether its board relied upon a comparison of the adviser’s services and fees with those of advisers to other mutual funds. Obviously, boards and advisers will want to ensure that the process followed for reviewing and approving advisory contracts, and the factors

visited 8/8/2008

considered, are consistent with the disclosures made by the fund. Boards may at this point be reluctant to disclose that they are not considering all of the *Gartenberg* factors.

Conclusion

At the end of the day, the *Harris Associates* decision articulates a standard that does not appear to be that different from the *Gartenberg* standard. *Harris Associates* does not tell us what information a board should request and consider or an adviser should provide, but request and provide they must. This would appear to leave us with the *Gartenberg* factors for now, but it is possible that in the long run, courts may be less prescriptive in the types of information they require boards and advisers to have considered and provided, respectively. That remains to be seen, however, and for now, the best course may well be to stay the course.

This alert was authored by Lea Anne Copenhefer, Roger P. Joseph and Joshua B. Sterling. For assistance, please contact the following lawyers:

Lea Anne Copenhefer, Partner, Investment Management
leanne.copenhefer@bingham.com, 617.951.8515

Steven R. Howard, Partner, Investment Management
steven.howard@bingham.com, 212.705.7522

Roger P. Joseph, Practice Group Leader, Investment Management; Co-chair, Securities Area
roger.joseph@bingham.com, 617.951.8247

Neal E. Sullivan, Practice Group Leader, Broker-Dealer; Co-chair, Securities Area
neal.sullivan@bingham.com, 202.373.6159

visited 8/8/2008

ENDNOTES

¹ *Jones v. Harris Assoc.*, No. 07 1624 (7th Cir. May 19, 2008). The opinion in this case was authored by Chief Judge Easterbrook. Last year, Judge Easterbrook wrote an opinion that challenged the prevailing standard for determining whether a company had inadvertently become an “investment company” within the meaning of the Investment Company Act. See *SEC v. National Presto Indus.*, 486 F.3d 305 (7th Cir. 2007).

² *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923 (2d Cir. 1982).

³ See, e.g., *Schuyt v. Rowe Price Prime Reserve Fund*, 663 F. Supp. 962 (S.D.N.Y. 1987), *aff’d*, 835 F.2d 45 (2d Cir. 1987).

⁴ *Harris Assoc.*, slip op. at 6.

⁵ *Id.* at 8.

⁶ *Id.*

⁷ *Id.* at 11.

⁸ *Id.*

⁹ *Id.* at 13, 14.

¹⁰ *Id.* at 9.

¹¹ See, e.g., Item 22(d)(6) of Form N 1A; Item 22(c)(11) of Schedule 14A.

Circular 230 Disclosure: Internal Revenue Service regulations provide that, for the purpose of avoiding certain penalties under the Internal Revenue Code, taxpayers may rely only on opinions of counsel that meet specific requirements set forth in the regulations, including a requirement that such opinions contain extensive factual and legal discussion and analysis. Any tax advice that may be contained herein does not constitute an opinion that meets the requirements of the regulations. Any such tax advice therefore cannot be used, and was not intended or written to be used, for the purpose of avoiding any federal tax penalties that the Internal Revenue Service may attempt to impose.

© 2008 Bingham McCutchen LLP

To communicate with us regarding protection of your personal information or if you

visited 8/8/2008

would like to subscribe or unsubscribe to some or all of Bingham McCutchen LLP's electronic and email notifications, please notify our Privacy Administrator at privacyUS@bingham.com or privacyUK@bingham.com. Our privacy policy is available at www.bingham.com. We can also be reached by mail in the U.S. at One Federal Street, Boston, MA 02110-1726, ATTN: Privacy Administrator, or in the U.K. at 41 Lothbury, London, England EC2R 7HF, ATT: Privacy Administrator.

This communication is being circulated to Bingham McCutchen LLP's clients and friends and may be considered advertising. It is not intended to provide legal advice addressed to a particular situation.

Copyright © 2008 Bingham McCutchen LLP

Attorney Advertising. Prior results do not guarantee a similar outcome.