Seventh Circuit Court of Appeals Rejects *Gartenberg*

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The U.S. Court of Appeals for the Seventh Circuit issued a unanimous opinion on May 19, 2008, rejecting the *Gartenberg* standard by which courts have judged the "reasonableness" of mutual fund investment advisers' fees for nearly 30 years. The court, in the case of *Jones v. Harris Associates L.P.*, stated that market forces and investor decisions were better suited than a court to regulate an adviser's fees, so long as the adviser "make[s] full disclosure [to investors] and play[s] no tricks." As long as an adviser meets this basic fiduciary obligation, the court said that there is no cap on its compensation.

Since it was decided by the U.S. Court of Appeals for the Second Circuit in 1982, *Gartenberg v. Merrill Lynch Asset Management* has guided a number of court decisions in judging an adviser's compliance with Section 36(b) of the Investment Company Act of 1940. That section provides that an investment company's adviser has a fiduciary duty with respect to the receipt of compensation for services. The *Gartenberg* court applied a "reasonableness" or "proportionality" standard to determine whether an adviser had met its fiduciary duty: "[t]o be guilty of a violation of §36(b), . . . the adviser-manager 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."

The *Harris* court dismissed the *Gartenberg* standard because it relied too little on market forces. The new *Harris* standard contemplates that the market regulates advisers' fees through competition. The court noted that investors seek maximum returns and that if high fees drive investors away, an adviser will not profit from a fund. The opinion distinguishes between an adviser's fiduciary duty under Section 36(b) and what it perceives as *Gartenberg*'s dated standard allowing judicial rate regulation: "A fiduciary duty differs from rate regulation. . . . [T]he 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." The opinion pointed out that Section 36(b) does not indicate a judicial standard by which to judge reasonableness of fees.

The *Harris* opinion made comparisons to the fiduciary duties of trustees and lawyers to demonstrate the normal expectation that a person or an institution in a fiduciary position owes a duty of "candor in negotiation, and honesty in performance," but otherwise is free to "negotiate in his own interest" as to compensation. According to the court, if compensation is set too high, shareholders will look elsewhere and the adviser will be induced to lower fees in order to encourage investment. The court stated that this process is "imperfect but remain[s] superior to a 'just price' system administered by the judiciary."

The new Seventh Circuit standard conflicts with the *Gartenberg* standard of the Second Circuit. The consequences of this conflict are currently unclear. At the very least, plaintiffs in Seventh Circuit excessive advisory fee litigation will need to show that the fees are "so unusual that a court [should] infer that deceit must have occurred." In the Seventh Circuit (which includes Illinois, Indiana and Wisconsin), this standard may influence the advisory fee approval processes that the independent directors of funds consider periodically.

The implications of *Harris* are less clear outside of the Seventh Circuit, where the *Gartenberg* standard has long influenced courts and the independent directors of funds in considering and reviewing advisory fees. Another excessive fee case, *Gallus v. Ameriprise Financial, Inc.*, is currently on appeal in the Eighth Circuit, and the court there could accept the new *Harris* standard. Until the *Harris* standard is adopted by other jurisdictions, the competing decisions are settled in the U.S. Supreme Court, or Congress acts, it is unlikely that funds or advisers outside the Seventh Circuit will change their policies with respect to the advisory fee approval process.

For the full text of the decision in *Jones v. Harris Associates*, please click here. For more information, please contact your regular Drinker Biddle Investment Management Group contact.

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