

Endorsing Gartenberg In Jones V. Harris Associates

Law360, New York (April 16, 2010) -- The U.S. Supreme Court recently rejected a controversial lower court decision that would have severely limited investors' ability to sue mutual fund firms over the fees they charge.

In a widely watched case, the court ruled that a lower court went too far in deciding mutual fund managers cannot be held liable for charging excessive fees unless there is fraud involved. What impact will this recent decision have on mutual fund firms?

To answer this question, we first discuss the background facts and lower court's decision, the decision of the appeals court, and the reasoning provided by the Supreme Court for overturning the decision of the appeals court. We will conclude by discussing the potential ramifications of the decision.

The Lower Court Case

In 2004, a group of investors sued Harris Associates LP, adviser to the Oakmark Funds, in the Northern District of Illinois. The investors alleged that Harris Associates breached its fiduciary duty by charging excessive management fees. The plaintiffs claimed that Harris Associates violated Section 36(b) of The Investment Company Act of 1940 by charging fees that were double what Harris Associates charged institutional clients for the same services.

The plaintiffs claimed that the fees were "disproportionate to the services rendered" and "not within the range of what would have been negotiated at arm's length in light of all the surrounding circumstances." Harris contended that its fees were unremarkable, and priced at or slightly above median fees for comparable mutual funds.

The district court granted summary judgment for Harris Associates. Applying the standard adopted in *Gartenberg v. Merrill Lynch Asset Management Inc.*, 694 F. 2d 923 (1982)[1], the court concluded that the investors had failed to raise a triable issue of fact as to "whether the fees charged ... were so disproportionately large that they could not have been the result of arm's-length bargaining."

The district court assumed that a comparison of the challenged fees with those that Harris Associates charged its other clients was relevant. But, in light of those comparisons as well as comparisons with fees charged by other investment advisers to similar mutual funds, the court held that it could not reasonably find that the challenged fees were outside the range that could have been the product of arm's-length bargaining.

Court of Appeals

A panel of the Seventh Circuit affirmed the district court's ruling, but on a different legal theory, "disapprov[ing] the Gartenberg approach." 527 F.3d 627, 632 (2008). Recognizing that "[t]oday thousands of mutual funds compete," the court of appeals concluded that "sophisticated investors" shop for the funds that produce the best

overall results, “mov[e] their money elsewhere” when fees are “excessive in relation to the results,” and thus “create a competitive pressure” that generally keeps fees low. *Id.* at 633-634.

The panel faulted Gartenberg on the ground that it “relies too little on markets.” 527 F.3d at 632. And the court of appeals firmly rejected a comparison between the fees that Harris Associates charged to the funds at issue with the fees that Harris Associates charged other types of clients, observing that “[d]ifferent clients call for different commitments of time” and that costs, such as research, that may benefit several categories of clients “make it hard to draw inferences from fee levels.” *Id.* at 634.

U.S. Supreme Court Decision

In a unanimous opinion written by Justice Samuel Alito, the Supreme Court rejected the Seventh Circuit’s standard, holding that the correct standard was set forth in the Gartenberg decision, which said fees did not violate the law unless “so disproportionately large” they could not have been agreed to in arm’s-length bargaining. The Supreme Court found that the Second Circuit had gone too far and stressed that the law — and not market forces — should decide mutual fund fees.

The court also stated that, under the Investment Company Act of 1940, a fund's board members are charged with acting as the fund's fiduciaries and are therefore responsible for proving that fees were properly negotiated. This, the court stated, should help keep fund fees from becoming excessive.

Potential Ramifications

By endorsing the Gartenberg standard, the court's opinion essentially assures investors that fund directors will be doing their jobs by negotiating for appropriate fees. But it remains to be seen whether the decision will result in more fund fee lawsuits.

At the very least, the Supreme Court’s confirmation of the law — that boards and management of fund companies must prove that fees are appropriate — will bring more publicity to the issue. The Supreme Court stated that fund expenses can vary for different kinds of clients.

Therefore, fund companies are left to explain why higher fees for certain types of accounts are warranted. Not only will this put pressure on boards and managements of funds to defend their fees, but it could also open the door for enterprising lawyers to initiate litigation over the appropriateness of those fees.

All of this means that fund managers would do well to work closely with outside counsel to examine their fee structures in light of the services they provide, to determine if such fees are warranted and whether it is appropriate for one client and/or account to pay more fees than another.

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[1] In Gartenberg, the Second Circuit noted that Congress had not defined what it meant by a “fiduciary duty” with respect to compensation but concluded that “the test is essentially whether the fee schedule represents a charge

within the range of what would have been negotiated at arm's length in the light of all of the surrounding circumstances." 694 F.2d at 928. The Second Circuit elaborated that, "[t]o be guilty of a violation of Section 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." *Id.* "To make this determination," the court stated, "all pertinent facts must be weighed," including "the adviser-manager's costs in providing the service, ... the extent to which the adviser-manager realizes economies of scale as the fund grows larger, and the volume of orders which must be processed by the manager." *Id.* at 929-930.