Supreme Court Rules in 
Jones v. Harris

The Supreme Court today rejected the Seventh Circuit’s opinion in Jones v. Harris Associates, L.P. and ruled that “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.” The Supreme Court also clarified that while there is no “categorical rule regarding comparisons of the fees charged [to] different types of clients,” courts should be “wary of inapt comparisons.” The differences in fees charged by advisers to different types of clients may be attributable to significant variations in the level and types of services provided to such clients – boards should be sensitive to this possibility and rely on only relevant comparisons in their review of advisory fees.

This case garnered much attention in the industry because it carried with it the potential to overturn the standard of review of advisory fees under Section 36(b) of the Investment Company Action of 1940 (1940 Act) set by the Second Circuit in Gartenberg v. Merrill Lynch Asset Management over 25 years ago. Section 36(b) of the 1940 Act provides that an investment company’s advisers have a fiduciary duty with respect to the receipt of compensation for services and provides an express cause of action against the adviser for recovery of excessive compensation. In accordance with the legislative history of Section 36(b), the Gartenberg court recognized that a court should not “substitute its business judgment for that of a mutual fund’s board of directors in the area of management fees.” Thus, “the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the [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 [adviser] are guilty of a breach of fiduciary duty in violation of [Section] 36(b).” The Gartenberg court, however, went on to state that “even if the trustees of a fund endeavored to act in a responsible fashion, an adviser-manager’s fee could be so disproportionately large as to amount to a breach of fiduciary duty in violation of [Section] 36(b).”

The standard articulated in Gartenberg has guided the industry since 1982 without serious challenge until, in the spring of 2008, the Seventh Circuit issued an opinion rejecting the Gartenberg standard. In so doing, the Seventh Circuit adopted a new standard in which it ruled that an adviser’s full disclosure to investors (so long as they “play no tricks”) is a sufficient basis to assess whether an adviser has met its fiduciary duty under
Section 36(b). The adviser’s compensation is relevant only where it is “so unusual” that it gives rise to an inference “that deceit must have occurred, or that the persons responsible for [the] decision have abdicated.” The new standard set forth by the Seventh Circuit was based on the principle that the market regulates advisers’ fees through competition – investors seek maximum returns, if an adviser sets its fees too high it will drive investors away and the adviser will not profit from the fund.

In today’s opinion, the Supreme Court rejected the Seventh Circuit’s “full disclosure” standard and upheld Gartenberg’s standard that plaintiffs bear the burden of proving that the advisory fee charged was “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 opinion reiterated that the 1940 Act, in recognition of the role of independent directors, “instructs courts to give board approval of an adviser’s compensation ‘such consideration . . . as is deemed appropriate under all the circumstances.’” The opinion also reiterated that “the standard for fiduciary breach under [Section] 36(b) does not call for judicial second guessing of informed board decisions.” While deference to a board’s judgment is appropriate, the measure of such deference “varies depending on the circumstances.” Specifically, the opinion notes that a court’s evaluation of whether fiduciary duties under Section 36(b) are fulfilled “must take into account both procedure and substance.”

With regard to the procedures followed by mutual fund boards in their review of advisory fees, and by advisers in their presentation of information regarding advisory fees, the Supreme Court noted that “robust” reviews and negotiations, in which the board is presented with and considers all relevant factors, should be afforded “considerable weight” by courts, even if courts may have weighed the factors differently. If, however, the board’s review process was flawed or the adviser withheld important information, courts will take a “more rigorous look at the outcome.” Thus, the “adviser’s compliance or noncompliance with its disclosure obligation 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.”

With regard to the substance of a board’s review, the information that is presented to and reviewed by the board is critical. The Supreme Court’s opinion reiterated Gartenberg’s holding that “whether [the board members] are fully informed about all facts bearing on the [investment adviser’s] service and fee” is an important factor to be considered in deciding whether there has been a breach of fiduciary duty in violation of Section 36(b). Because the 1940 Act requires consideration of all relevant factors when reviewing and approving advisory fees, the Supreme Court found that it could not create any categorical rule regarding the comparisons of advisory fees charged to different types of clients. The Supreme Court, however, cautioned courts to reject fee comparison information if the fees are for sufficiently different services such that the comparison is not probative, and went on to state that “the [1940] Act does not necessarily ensure fee parity between mutual funds and institutional clients.” This statement directly rejects arguments made to the Court that advisers should not be able to charge their “controlled” mutual fund clients more than their independent clients. In fact, in response to the argument that comparisons with fees charged to institutional clients will “doom” such funds to trial, the Supreme Court stated that “only where plaintiffs have shown a large disparity in fees that cannot be explained by the different services in addition to other evidence that the fee is outside the arm’s-length range will trial be appropriate.” On the other hand, the Supreme Court
also noted that courts should not “rely too heavily on comparisons with fees charged to mutual funds by other advisers” because such fees may not be the product of arm’s length negotiations. Thus, boards should be sensitive to the possibility that not all fees charged by its adviser to other clients (even mutual fund clients) are necessarily appropriate comparisons and should rely only on what they determine are relevant fee comparisons in their review of advisory fees.

As a result of the Supreme Court’s decision in Jones, the industry can continue to rely on its use of the Gartenberg standard. The Supreme Court’s statements regarding the process and substance of review of advisory fees should serve as useful guidance for board members and advisers to ensure that mutual fund boards are being presented with and reviewing all relevant information in connection with the approval of advisory fees.
Investment Management Group

For more information about the matters discussed in this publication, please contact your regular Drinker Biddle lawyer or any member of our Investment Management Group.

Partners and Counsel

Gary D. Ammon
(215) 988-2981
Gary.Ammon@dbr.com

Jeffrey Blumberg
(312) 569-1106
Jeff.Blumberg@dbr.com

Stephen T. Burdumy
(215) 988-2880
Stephen.Burdumy@dbr.com

Mark F. Costley
(202) 230-5108
Mark.Costley@dbr.com

Joshua B. Deringer
(215) 988-2959
Joshua.Deringer@dbr.com

Glenn F. Ferencz
(312) 569-1246
Glenn.Ferencz@dbr.com

Stephen D.D. Hamilton
(215) 988-1990
Stephen.Hamilton@dbr.com

Veena K. Jain
(312) 569-1167
Veena.Jain@dbr.com

Morgan R. Jones
(215) 988-2792
Morgan.Jones@dbr.com

Michelle M. Lombardo
(215) 988-2867
Michelle.Lombardo@dbr.com

Michael P. Malloy
(215) 988-2978
Michael.Malloy@dbr.com

David M. Matteson
(312) 569-1145
David.Matteson@dbr.com

Diana E. McCarthy
(215) 988-1146
Diana.McCarthy@dbr.com

Nancy P. O’Hara
(215) 988-2699
Nancy.OHara@dbr.com

Mary Jo Reilly
(215) 988-1137
MaryJo.Reilly@dbr.com

Audrey C. Talley
(215) 988-2719
Audrey.Talley@dbr.com