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LEGAL ALERT

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Supreme Court to Hear Investment Adviser Fee Case

On March 9, 2009, the U.S. Supreme Court granted certiorari in *Jones v. Harris Associates*,[1] a Seventh Circuit case that rejected the "reasonableness" standard, as articulated in *Gartenberg v. Merrill Lynch Asset Management, Inc.*,[2] and set forth a new market and disclosure based standard for evaluating excessive fee claims under § 36(b) of the Investment Company Act of 1940 ("1940 Act").

The Second Circuit held in *Gartenberg* that a § 36(b) violation occurs when the adviser "charge[s] a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered" and the fee is outside "the range of what would have been negotiated at arm's-length in light of all the surrounding circumstances."[3] Judge Easterbrook, writing for a three-judge panel of the Seventh Circuit, opined that the *Gartenberg* "reasonableness" standard requires a form of judicial rate regulation that is neither mandated by the statute nor an effective means for protecting investors. Instead, the *Harris* decision instructed that, when evaluating a § 36(b) claim, a court should ask "whether the client made a voluntary choice *ex ante* with the benefit of adequate information."[4] The Court held that, while there should be proper disclosure, the level of fees should be regulated by the market and not the courts.[5] Please see Sutherland's legal alert on the *Harris* decision for more detail.

The *Harris* panel denied requests for rehearing and rehearing en banc.[6] Judge Posner, who did not serve on the *Harris* panel, published a dissent to the denial of rehearing *en banc*. The dissent cited the overwhelming authority supporting the *Gartenberg* approach for calculating excessive fee claims and questioned the prudence of contradicting that authority without review by the full Seventh Circuit.[7] Judge Posner further opined that "[c]ompetition in product and capital markets can't be counted on to solve the problem [of excessive fees] because the same structure of incentives operates on all large corporations and similar entities, including mutual funds. Mutual funds are a component of the financial services industry, where abuses have been rampant."[8]

The Supreme Court will hear the case in its October 2009 term and likely resolve the split in the circuits on the appropriate standard for reviewing excessive fee claims. *Gartenberg* focuses a court's inquiry on the reasonableness of the fee charged and whether the fund's board of directors conducted a proper inquiry into the reasonableness of the fee; whereas, *Harris* focuses on the sufficiency of an adviser's

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[1] *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008).

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

[3] *Id.* at 929-32.

[4] *Harris*, 527 F.3d at 633.

[5] "Federal securities laws … work largely by requiring disclosure and then allowing price to be set by competition in which investors make their own choices … §36(b) does not make the federal judiciary a rate regulator, after the fashion of the Federal Energy Regulatory Commission …" *Harris*, 527 F.3d at 635.

[6] *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 729 (7th Cir. 2008) (dissent) (hereinafter "*Harris* (denial of rehearing)").

[7] *Id.* at 729.

[8] *Id.* at 730.

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disclosure. However, even under the *Harris* standard, it is within a court's discretion to determine that the fee charged is unreasonably high.[9]

Despite the differences in the *Gartenberg* and *Harris* approaches, the effect of the Supreme Court adopting one over the other may not be significant in practice. The *Harris* standard poses a greater hurdle for plaintiffs than does *Gartenberg* since *Harris* requires plaintiffs to prove that the adviser's disclosure was deceptive, inadequate or "otherwise hindered their ability to negotiate a favorable price for advisory services."[10] But, even under the more easily satisfied *Gartenberg* standard, no plaintiff has succeeded on a § 36(b) claim against a fund advisor.[11] Furthermore, fund boards are likely to continue using the factors for review articulated in *Gartenberg* as part of their advisory contract renewal process regardless of the Supreme Court's decision. This is because the Securities and Exchange Commission requires fund boards to disclose information in shareholder reports that essentially follows these *Gartenberg* factors.[12] Fund boards also often rely on the *Gartenberg* factors to meet their state law obligations to exercise a duty of care.[13]

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[9] The *Harris* court remarked 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 decision have abdicated." *Harris*, 527 F.3d at 632.

[10] *Id.* at 635.

[11] Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 Vand. L. Rev. 497, 519 (2008). "[U]nder Section 36(b) … thirty-seven years after its enactment and twenty-five years after Gartenberg, no investor has obtained a verdict against an investment adviser." *Id.*

[12] *See* Item 22(d)(6) of Form N-1A; Item 24(6)(e) of Form N-2; Item 22(c)(11) of Schedule 14A.

[13] Steven B. Boehm and Marguerite C. Bateman, *New Path, Same Destination: The Effect of Jones v. Harris Associates on 36(b) Litigation*, Investment Lawyer Magazine, Vol. 15, No. 8 (Aug. 2008).

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