JONES V. HARRIS: A FRESH APPROACH TO THE *GARTENBERG* STANDARD

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ABSTRACT

The Supreme Court, in Jones v. Harris, *broadly affirmed the Second Circuit's* Gartenberg v. Merrill Lynch Asset Management, Inc. *analysis of section 36(b) of the Investment Company Act of 1940, holding that the standard of liability under the statute is whether the fee charged 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." Adding to this narrow holding, the Supreme Court set forth a fresh approach to judicial review of an investment adviser's fiduciary obligation with respect to receipts of compensation for services, or of payments of a material nature.*

Following an examination of the divergent interpretations of Gartenberg *addressed by the Supreme Court in its opinion, the authors interpret the Court's focus on "all relevant circumstances," as opposed to the* Gartenberg *Factors, to be a more nuanced approach to section 36(b) liability. The authors then contend that the Supreme Court adopted a dependent bifurcated analysis that incorporates a sliding scale of substantive scrutiny based on the level of procedural fairness. Finally, the authors argue that the Court's critique of fund fee comparisons prevents their use as evidence to demonstrate that a fee charged is within the range of arm's-length bargaining.*

I. INTRODUCTION

For more than 25 years, federal courts largely relied on the Second Circuit's opinion in *Gartenberg v. Merrill Lynch Asset Management, Inc.*[1] to determine whether an investment adviser has breached the fiduciary duty imposed under section 36(b) of the Investment Company Act of 1940 (ICA) in connection with the receipt of compensation. Under *Gartenberg*, an

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[1] 694 F.2d 923 (2d Cir. 1982).

adviser is not liable unless the fee[2] charged by the adviser 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."[3] In *Gartenberg*, the Second Circuit asserted that courts should evaluate an advisory fee in light of all the facts and circumstances, but specifically noted the relevance of several factors later refined into the oft-cited "*Gartenberg* Factors."[4] Although the standard set by *Gartenberg* was generally considered well-settled law, courts diverged in their application of the *Gartenberg* standard, generating different interpretations of section 36(b).

The Seventh Circuit magnified these interpretive conflicts in May 2008 by explicitly rejecting *Gartenberg* in *Jones v. Harris Associates L.P.*[5] Rather than focusing its analysis on the substantive excessiveness of the compensation, the Seventh Circuit instead concentrated on the actions of the adviser. Whether an adviser breached its fiduciary duty depended on whether it completely disclosed all relevant information to the board and did not play "tricks."[6] Plaintiff-petitioners appealed, and the United States Supreme Court granted certiorari.[7]

In its opinion, the Supreme Court examined the legislative history of section 36(b) and federal common law to understand what Congress intended by the use of the phrase "fiduciary duty."[8]Analogizing to the landmark case of *Pepper v. Litton*,[9] the Court concluded that the fiduciary standard for controlling shareholders claiming compensation against a bankrupt corporation was also applicable to advisers under section 36(b).[10] Unlike *Pepper*, under section 36(b), the Court observed that Congress modified the traditional fiduciary standard by placing the burden of proof on

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[2]Although the advisory fee is used herein as a proxy for the compensation described in section 36(b), compensation has been interpreted more broadly than simply the advisory fee. *See, e.g.*, Green v. Nuveen Advisory Corp., 295 F.3d 738, 742 (7th Cir. 2002).

[3]*Gartenberg*, 694 F.2d at 928.

[4]*Id.* at 929-30; Krinsk v. Fund Asset Mgmt. Inc., 875 F.2d 404, 409 (2d Cir. 1989). The Second Circuit in *Krinsk* enumerated what would become known as the *Gartenberg* Factors: "(a) the nature and quality of services provided to fund shareholders; (b) the profitability of the fund to the adviser-manager; (c) fall-out benefits; (d) economies of scale; (e) comparative fee structures; and (f) the independence and conscientiousness of the trustees." *Krinsk*, 875 F.2d at 409; *see also infra* notes 61-64 and accompanying text (discussing the use in *Krinsk* of the *Gartenberg* Factors).

[5]527 F.3d 627, 632 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418(2010).

[6]*Id.*

[7]Jones v. Harris Assocs. L.P., 129 S. Ct. 1579 (2009) (granting certiorari).

[8]Jones v. Harris Assocs. L.P., 130 S. Ct. 1418, 1427 (2010).

[9]308 U.S. 295 (1939).

[10]*Jones*, 130 S. Ct. at 1427.

the plaintiff to show that the compensation exceeds the range of what could have been negotiated at arm's-length.[11]

In this article, we review the Supreme Court's holding and underlying analysis in the *Jones* case. Incorporating a review of both the legislative history and federal common law, the Court held that *Gartenberg* correctly deduced the appropriate standard of liability,[12] but went further in its analysis and evaluation of an adviser's obligations as set forth in section 36(b).[13] We contend that the Supreme Court further developed the analysis in *Gartenberg* by emphasizing the consideration of all facts and circumstances relevant to the approval of the advisory agreement, including non-fund fee comparisons.[14] We also argue that the Supreme Court adopted a two-part review of all relevant facts and circumstances by analyzing first, the fulsome nature of the advisory fee process, and then second, through that procedural lens, evaluating the substantive application of those facts and circumstances to whether an adviser breached its fiduciary duty under section 36(b). Finally, we contend that the Court provided additional guidance on the relevance of fund fee comparisons by restricting their use in assessing the range of arm's-length bargaining.

As a matter of initial context, in Part II we discuss the structure of investment companies and summarize the more than 15 years of legislative history leading to the passage of section 36(b). Part III provides a brief recount of the Second Circuit's decision in *Gartenberg* and the development of a consensus. In Part IV, we detail the divergence in the application of the *Gartenberg* standard as well as the Seventh Circuit's rejection of *Gartenberg*. We then turn to the Supreme Court opinion in Part V, describing further areas of the opinion analysis that we contend extend beyond that of *Gartenberg* and appear to provide a more fulsome approach to evaluating alleged adviser liability under section 36(b). Finally, Part VI analyzes the *Jones* decision and how the opinion modifies the *Gartenberg* standard.

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[11] *Id.*

[12] *Id.* at 1426.

[13] On its face, the Court concluded that "under § 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." *Id.* As discussed in this article, courts have weighed factors against this standard inconsistently, and we contend that the Supreme Court creates a discrete process to address such inconsistencies.

[14] *Jones*, 130 S. Ct. at 1428.

II. BACKGROUND[15]

A mutual fund has a unique corporate structure.[16] Unlike an operating company, a fund rarely employs its own officers and staff. Instead, an external investment adviser sponsors the fund and provides for its day-to-day management.[17] In exchange, pursuant to a written investment advisory agreement, the adviser earns a percentage of fund assets—an advisory fee.[18]

An adviser's control of a fund creates inherent conflicts of interest between the adviser and fund shareholders. For example, the adviser has control over the initial business structure, often choosing the initial shareholder who, in turn, elects the board of directors.[19] The investment advisory contract is then negotiated; the adviser represents its interest and the recently-appointed board negotiates on behalf of the fund.

In response to widespread abuses, Congress enacted the ICA in 1940 to resolve the conflicts of interest that threatened to undermine the infant industry.[20] Similar to the Securities Act of 1933 and the Securities and Exchange Act of 1934, the ICA increased disclosure by making critical information publicly available.[21] The ICA also established substantive restrictions on funds, from prohibiting pyramidal structures,[22] to limiting the amount of leverage a fund may undertake.[23]

Section 15 is one of the key substantive provisions enacted by Congress to ameliorate conflicts of interest. This provision requires approval of the advisory agreement—and the advisory fee charged to the fund—by a majority of the disinterested directors and a majority of shareholders.[24] Congress intended that, by integrating this requirement, the intervening

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[15] *See generally* Amy Y. Yeung & Kristen J. Freeman, Gartenberg, Jones, *and the Meaning of Fiduciary: A Legislative Investigation of Section 36(b)*, 35 DEL. J. CORP. L. 483 (2010) (discussing the legislative history of section 36 (b)).

[16] *See* Victoria E. Schonfeld & Thomas M.J. Kerwin, *Organization of a Mutual Fund*, 49 BUS. LAW 107, 109-10 (1993) (providing a basic introduction to fund operations). Although "mutual fund" is used herein, section 36(b) applies to all investment companies, including closed-end funds.

[17] SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 46 (1966) [hereinafter PPI].

[18] *Id.*

[19] *Id.* at 130.

[20] H.R. REP. NO. 76-2639, at 7 (1940).

[21] PPI, *supra* note 17, at 63.

[22] 15 U.S.C. § 80a-12(d) (2006) (amended 2010).

[23] 15 U.S.C. § 80a-18(a) (2006).

[24] 15 U.S.C. § 80a-15 (2006).

objective review would mitigate incentives by the adviser to maximize its profits at the expense of shareholders.[25]

The shareholder ratification of section 15, when interpreted in conjunction with state law, had an unintended consequence: shareholders were practically foreclosed from challenging the excessiveness of advisory fees in state courts.[26] For example, in *Saxe v. Brady*,[27] the Court of Chancery of the State of Delaware stated that the shareholder ratification in section 15 relieved the adviser of "the burden of proving the fairness of the transaction."[28] In such cases, the court held that the applicable standard of liability was one of waste, under which a fiduciary would be liable only if a court determines that "no person of ordinary, sound business judgment would deem it worth what the corporation has paid."[29] In sum, due to section 15, plaintiffs were, in effect, precluded from successfully pleading an excessive fee case.

Following an extensive study in the late 1950s by the Wharton School of Business, as well as an additional study in the early 1960s by the U.S. Securities and Exchange Commission (SEC or Commission), the SEC concluded that the state courts' interpretation of section 15 unintentionally prevented shareholders from challenging the reasonableness of the advisory fee in state courts.[30] The Wharton School found that the fees charged by advisers to fund clients, or "fund fees," tended to cluster at a rate substantially higher than the fees charged by advisers to pension funds, private clients, and other "non-fund" clients.[31] This unusual pricing distribution led both the Wharton School and the Commission to question whether boards were able to effectively negotiate on behalf of their funds.[32] Consequently, without judicial review of fees, shareholders lacked effective protection against adviser overreaching.[33]

After extensive hearings, the Senate Committee on Banking and Finance, and the House Subcommittee on Commerce and Finance, concluded that limited arm's-length bargaining existed between an adviser

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[25]PPI, *supra* note 17, at 142.

[26]*Id.*

[27]184 A.2d 602 (Del. Ch. 1962).

[28]*Id.* at 610.

[29]*Id.* at 486.

[30]PPI, *supra* note 17, at 142.

[31]WHARTON SCH. OF FIN. & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274, at 485 (1962) [hereinafter WHARTON]. This differential was attributed in part to the fact that non-fund clients typically negotiate their advisory agreements at arm's-length. *See id.* at 30.

[32]*Id.* at 30. PPI, *supra* note 17, at 130-31.

[33]*See* PPI, *supra* note 17, at 143-44. (discussing the need for a standard of reasonableness to measure the "fairness of compensation paid by investment companies" to investment advisers).

and its funds.[34] Moreover, the Committee determined that existing remedies were insufficient to protect investors.[35] In order to ameliorate these deficiencies, Congress, in 1970, enacted section 36(b) where: "the investment adviser of a [fund] shall be deemed to have a fiduciary duty with respect to the receipt of compensation."[36]

The integration of a fiduciary obligation in section 36(b) represented a compromise between the Commission and fund industry representatives. The SEC initially proposed a "reasonableness" standard, which they believed would allow courts to review advisory fees under the same standard as would have been available but for section 15.[37] Fund industry representatives contended that this reasonableness standard would lead to a burdensome rate-making regime.[38] Following protracted negotiations between the SEC and fund industry representatives, the parties settled on a "fiduciary" standard for the review of compensation arrangements, which, like traditional notions of fiduciary,[39] would prevent adviser overreaching without resorting to rate regulation.[40] In addition, to address industry's concerns that a fiduciary standard would result in a flood of strike suits, Congress integrated a burden-shifting mechanism in section 36(b)(1), placing the burden of proof on the plaintiff.[41] In deference to the pivotal role boards play in controlling conflicts of interest under the ICA, Congress instructed courts to give board approval of the advisory agreement "such consideration...as is deemed appropriate under all the circumstances."[42]

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[34]U.S. SENATE COMM. ON BANKING & CURRENCY, INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. NO. 91-184, at 5 (1969); HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H. R. REP. NO. 91-1382, at 7 (1970).

[35]H. R. REP. NO. 91-1382, at 7.

[36]Investment Company Amendments Act of 1970, Pub. L. No. 91-547, sec. 20, §36 (b), 84 Stat. 1413, 1429 (codified as amended at 15 U.S.C. §80a-35(b) (2006)).

[37]H. R. REP. NO. 91-1382, at 4.

[38]*Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the S. Comm. on Banking and Currency*, 90th Cong. 197 (1967) (statement of Manuel F. Cohen, Chairman, SEC).

[39]*Id.* at 10.

[40]*See Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Fin. of the H. Comm. on Interstate and Foreign Commerce*, 91st Cong. 441 (1969) (letter from Robert L. Augenblick to Chairman Moss).

[41]*See* Investment Company Act of 1940 §36(b), 15 U.S.C. § 80a-35(b)(1) (2006).

[42]*Id.* § 80a-35(b)(2).

III. THE *GARTENBERG* STANDARD

While several courts reviewed cases brought under section 36(b) prior to the Second Circuit's opinion in *Gartenberg*,[43] both the district court's decision and the Second Circuit's affirmation are considered seminal. In its opinion, the district court robustly examined the legislative history of section 36(b) and the meaning of fiduciary under federal common law. In its analysis affirming the district court's opinion, the Second Circuit established a standard of liability under section 36(b) that would guide courts for more than 25 years.

Both the district court[44] and the Second Circuit[45] examined the "tortuous"[46] legislative history of the statute in order to understand the meaning Congress intended for courts to attach to the phrase "fiduciary duty." As the Second Circuit noted, the Senate's conclusion that "'the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy'"[47] prompted Congress to enact the 1970 Amendments. Focusing on Congress' concern over the limited nature of arm's-length bargaining in the fund industry, the Second Circuit interpreted the phrase "fiduciary" to create a judicial inquiry into whether the fees charged by an adviser were "within the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances."[48]

The Second Circuit likened its understanding of "fiduciary" to traditional notions of fiduciary liability under federal common law. As the district court explained, "[t]he net intent of the legislation . . . would seem to leave it to the federal courts to interpret compliance with 'fiduciary duty' in the common law tradition (in this case 'federal common law')."[49] Quoting the Supreme Court's landmark case on federal fiduciary liability, *Pepper v. Litton*, the district court determined "'[t]he essence of the [fiduciary] test is whether or not under all the circumstances the transaction carries the earmarks of an arm's-length bargain.'"[50] Both courts, through legislative history and federal common law, then concluded that the key inquiry into an

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[43]*See, e.g.*, Krasner v. Dreyfus Corp., 500 F. Supp. 36, 37 (S.D.N.Y. 1980).

[44]Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038, 1044-47 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982).

[45]Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928-30 (2d Cir. 1982).

[46]*Id.* at 928.

[47]*Id.*(quoting S. REP. NO. 91-184, at 5 (1969)).

[48]*Id.*

[49]*Gartenberg*, 528 F. Supp. at 1046.

[50]*Id.* at 1047 (quoting Pepper v. Litton, 308 U.S. 295, 306-07 (1939)).

advisor's fiduciary compliance is to determine what arm's-length bargaining would produce.

The courts also identified a burden shift under the language of section 36(b)(1).[51] Under traditional fiduciary principles, the burden rests on the fiduciary to prove the "inherent fairness" of its actions.[52] The language of section 36(b)(1), however, places the onus onto the plaintiff.[53] As the district court noted, Congress recognized that, at common law the burden of proof would be on the fiduciary. Congress nevertheless placed the burden of proof on the plaintiff "'to eliminate nuisance suits designed to harass defendants.'"[54] As a result of this burden shift, the Second Circuit ascertained that rather than the adviser proving the fee is within the range of arm's-length bargaining, the shareholder must prove that the fee charged 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."[55]

To evaluate whether an adviser is liable for a breach of its fiduciary duty under section 36(b), the Second Circuit indicated that courts must consider all pertinent facts. This review of all the facts and circumstances under which the advisory fee is approved is mandated, not only by the legislative history, but also by federal common law principles of fiduciary liability. As the Second Circuit explained, Congress specifically instructed courts to consider "all the facts in connection with the determination and receipt of . . . compensation."[56] Additionally, the district court, quoting *Pepper*, noted that the relevant test was conducted "under all the circumstances."[57]

While the Second Circuit recognized that courts must consider all pertinent facts in determining liability under section 36(b), the court identified a number of factors that would typically be relevant, as they serve as intermediate assessments of arm's-length bargaining. These factors include "the adviser-manager's cost in providing the service, the nature and quality of the service, the extent to which the adviser-manager realizes

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[51] *See* Investment Company Act of 1940 §36 (b), 15 U.S.C. § 80a-35(b)(1) (2006).

[52] *Pepper*, 308 U.S. at 306.

[53] *See* Investment Company Act of 1940 §36 (b), 15 U.S.C. § 80a-35(b)(1) (2006).

[54] *Gartenberg*, 528 F. Supp. at 1044 n.6 (quoting H.R. REP. NO. 91-1382, at 38 (1970)).

[55] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982).

[56] *Id.* at 930 (internal quotation marks omitted).

[57] *Gartenberg*, 528 F. Supp. at 1047 (quoting *Pepper*, 308 U.S. at 306-07) (internal quotation marks omitted).

economies of scale as the fund grows larger, and the volume of orders which must be processed by the manager."[58]

These factors, like the standard itself, were a product of the legislative history. In an early draft of the legislation, Congress included a list of factors that the Commission believed to be relevant to whether an adviser would be liable for excessive fees including:

> The nature and extent of the services to be provided . . . ; [t]he quality of the services . . . rendered . . . ; [t]he extent to which the . . . contract takes into account economies attributable to the growth and size . . . ; [t]he value of all benefits . . . received . . . by the . . . adviser . . . [and] such other factors as are appropriate and material.[59]

While Congress did not include these factors in the final statute, they specifically noted that such factors continued to be relevant in evaluating liability under section 36(b).[60]

In a subsequent excessive fee case, the Second Circuit refined the factors listed in *Gartenberg* into what would become known as the "*Gartenberg* Factors."[61] In *Krinsk v. Fund Asset Management*, the court held that six factors were "to be considered in applying this [*Gartenberg*] standard."[62] Notably absent from the Second Circuit's analysis in *Krinsk* was its earlier observation in *Gartenberg* that courts must consider all the pertinent facts.[63] Instead, the Second Circuit identified six factors, which would be cited by courts, drawn on by regulators, and relied upon by boards: "(a) the nature and quality of services provided to fund shareholders; (b) the profitability of the fund to the adviser-manager; (c) fall-out benefits; (d) economies of scale; (e) comparative fee structures; and (f) the independence and conscientiousness of the trustees."[64]

Following *Gartenberg* and *Krinsk*, a consensus began to emerge.[65] Courts in the Fourth,[66] Eighth,[67] and Ninth[68] Circuits explicitly approved the

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[58]*Gartenberg*, 694 F.2d at 930.

[59]S. 1659, 90th Cong. § 8(d) (1967); H.R. 9510, 90th Cong. § 8(d) (1967).

[60]S. REP. NO. 90-1351, at 5 (1968).

[61]Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404, 409 (2d Cir. 1989); *see, e.g.*, Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 821-22 (8th Cir. 2009), *vacated*, 130 S. Ct. 2340 (2010); Amron v. Morgan Stanley Inv. Advisors, Inc., 464 F.3d 338, 340-41 (2d Cir. 2006).

[62]*Krinsk*, 875 F.2d at 409.

[63]*Id.*

[64]*Id.*

[65]*See* Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and* Gartenberg *at Twenty-Five*, 61 VAND. L. REV. 497, 513-34 (2008) (performing a

Gartenberg standard, while courts in the First,[69] Third,[70] Fifth,[71] and Tenth[72] Circuits cited the decision favorably. In addition, courts often relied on the *Gartenberg* Factors to explicate the standard.[73] In 2004, the Commission further solidified this consensus by incorporating the *Gartenberg* Factors into its disclosure requirements for funds.[74] Under the 2004 rules, the SEC required boards to justify their approval of the advisory agreement using the *Gartenberg* Factors.[75] Thus, prior to the Seventh Circuit's rejection, *Gartenberg* and its factors were considered well-settled law on the liability of advisers under section 36(b).[76]

IV. DIVERGENCE AND DISSENT

While courts largely agreed with the Second Circuit's standard of liability, such consensus did not extend to the application of *Gartenberg*. In particular, courts and some commentators questioned whether liability under section 36(b) requires courts to examine both the procedural and substantive fairness. Although relying extensively on fund fee comparisons, courts viewed non-fund fee comparisons with a more skeptical eye and discounted heavily the similarities in services between fund and non-fund clients.

In *Jones*, the Seventh Circuit magnified this divergence by rejecting the *Gartenberg* standard. In *Jones*, Judge Easterbrook, writing for the panel, eschewed the legislative history, noting that it "contain[s] expressions that seem to support every possible position."[77] No longer relying on a singular legislative directive, the Seventh Circuit then analogized to traditional notions of fiduciary liability in order to infer the appropriate judicial review of adviser liability. Critically, Easterbrook did not apply the fiduciary standard applicable where a transaction involves interested directors or controlling shareholders. Rather, the court looked to the fiduciary principles applicable to trustees in negotiating their compensation: "candor in

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comprehensive review of excessive fee litigation under *Gartenberg*).

[66]Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 327 (4th Cir. 2001).

[67]Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 822 (8th Cir. 2009).

[68]*In re* Am. Mut. Funds Fee Litig., 2009 WL 5215755, at *2-3 (C.D. Cal. Dec. 28, 2009).

[69]Yameen v. Eaton Vance Distribs., Inc., 394 F. Supp. 2d 350, 355 (D. Mass. 2005).

[70]*In re* Dreyfus Mut. Funds Fee Litig., 428 F. Supp.2d 342, 349 (W.D. Pa. 2005).

[71]Lieber v. Invesco Funds Grp., Inc., 371 F. Supp. 2d 852, 855 n.5 (S.D. Tex. 2005).

[72]Sins v. Janus Capital Mgmt., LLC, 2006 WL 3746130, at *2-3 (D. Colo. 2006).

[73]*See, e.g.*, Hunt v. Invesco Funds Grp., Inc., 2006 WL 1581846, at *3 (S.D. Tex. 2006).

[74]*See, e.g.*, 17 C.F.R. § 240.14a-101, Item 22(c)(11)(i) (2009).

[75]*Id.*

[76]*See* Jones v. Harris Assocs. L.P., 537 F.3d 728, 729 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc), *vacated*, 130 S. Ct. 1418(2010).

[77]Jones v. Harris Assocs. L.P., 527 F.3d 627, 633 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010).

negotiation[s]."[78] The court concluded that under section 36(b), an adviser "must play no tricks."[79] In sum, the Seventh Circuit rejected *Gartenberg's* entire fairness understanding of fiduciary in favor of an honesty-in-fact standard.[80]

A. *Procedural vs. Substantive Fairness*

A perceived incongruity in the *Gartenberg* opinion caused courts and academics to question whether the inquiry under section 36(b) is procedural, substantive, or both. In *Gartenberg*, the court indicated that a 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."[81] This phrase implies that the fee charged must exceed the value of the services provided.[82] Said differently, in order to prevail, a shareholder must demonstrate that the fee is, as a substantive matter, excessive.[83]

On the other hand, the *Gartenberg* opinion stated that:

> the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the adviser-manager'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-manager are guilty of a breach of fiduciary duty.[84]

The focus on the procedural fairness in approving the advisory fee demonstrated by this passage has been interpreted to imply that section 36(b) does not require substantive evidence that the amounts charged were

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[78] *Id.* at 632 (citing RESTATEMENT (SECOND) OF TRUSTS § 242).

[79] *Id.*

[80] *See id.*

[81] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982).

[82] *See* Migdal v. Rowe Price-Fleming Int'l Inc., 248 F.3d 321, 328-29 (4th Cir. 2001); *cf.* Green v. Nuveen Advisory Corp., 295 F.3d 738, 743 (7th Cir. 2002) (noting that a compensation scheme providing advisers incentive to keep an investment fund leveraged at a non-optimal level would not, by itself, create a breach of fiduciary duty under section 36 (b)).

[83] John M. Greabe et al., *Moving Beyond* Gartenberg: *A Process-Based and Comparative Approach to § 36(b) of the Investment Company Act of 1940*, 28 REV. BANKING & FIN. L. 133, 147-48 (2009).

[84] *Gartenberg*, 694 F.2d at 930.

excessive; rather, any procedural unfairness would be actionable under section 36(b).[85]

For example, in *Migdal v. Rowe Price-Fleming*, the Fourth Circuit took the former approach arguing that "[s]ection 36(b) is sharply focused on the question of whether the fees themselves were excessive, and not on the status of the directors who approved them."[86] In contrast, the Seventh Circuit in *Jones* held that procedural deficiencies are the sole basis for adviser liability under section 36(b). In the Seventh Circuit's view "[a] fiduciary must make full disclosure and play no tricks," but whether the compensation is excessive is not an appropriate inquiry for the courts.[87] As Judge Easterbrook explained, "trustees (and in the end investors . . .), rather than a judge or jury, determine how much advisory services are worth."[88]

In *Gallus v. Ameriprise*,[89] the Eighth Circuit attempted to resolve these apparent contradictions between how the Fourth and Seventh Circuits evaluated liability under the statute. After reviewing *Gartenberg*, its progeny, and the Seventh Circuit's opinion in *Jones*, the Eighth Circuit determined that both *Gartenberg* and *Jones* identified one way in which shareholders could establish liability under section 36(b).[90] In the Eighth Circuit's view, *Gartenberg*, as interpreted by subsequent courts, has limited a shareholder's ability to prevail on the merits unless the shareholder demonstrates that "the fee *itself* was so high that it violated [section] 36(b)."[91] The *Gallus* court disapproved of this interpretation, concluding instead that the size of the advisory fee is merely "one of the factors to be considered" in evaluating liability.[92] As the court explains, *Jones* provides an alternate "way in which a fund adviser can breach its fiduciary duty."[93] Under the "plain language" of the statute, the court determined that the fiduciary obligation under section 36(b) included "a duty to be honest and transparent throughout the negotiation process."[94] The court concluded "that the proper approach to

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[85]Greabe, *supra* note 83, at 146.

[86]*Migdal*, 248 F.3d at 328. In the Fourth Circuit's view, the "so disproportionately large" standard of *Gartenberg* requires a fee to be substantively excessive. *See id.*

[87]Jones v. Harris Assocs. L.P., 527 F.3d 627, 632 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010).

[88]*Id.* The court acknowledged that a fee may be so unusually large that a court may "infer that deceit must have occurred" however, the amount of the fee demonstrates a lack of candor and not a source of liability. *Id.*

[89]Gallus v. Ameriprise Fin. Inc., 561 F.3d 816 (8th Cir. 2009), *vacated*, 130 S. Ct. 2340 (2010).

[90]*Id.* at 823.

[91]*Id.*

[92]*Id.*

[93]*Gallus*, 561 F.3d at 823.

[94]*Id.* The *Gallus* court acknowledged that this approach was consistent with the *Gartenberg*

[section] 36(b) is one that looks to both the adviser's conduct during negotiation and the end result."[95]

Thus, courts have applied different approaches to evaluating liability under section 36(b) and the application of the *Gartenberg* factors by courts. Some interpreted the statute as solely concerned with the substantive fairness of the fee. Others determined that the inquiry was only into the procedural fairness of the compensation arrangements. Still others believed section 36(b) to require both procedural and substantive fairness. Consequently, judicial review of advisory fees under section 36(b) lacked consistency.

B. *Comparative Fee Structures*

Gartenberg factors include the consideration of comparative fee structures, which potentially include fees charged by advisers to both fund and non-fund clients. As discussed in Part I, historical data collected by the Wharton School reflected that fees charged by funds tended to cluster around a specific rate, and fees charged to fund clients were substantially higher than the fees charged to non-fund clients.[96] Notably, non-fund clients (such as pension funds) negotiate the advisory fee at arm's-length as the investment adviser does not control them. Accordingly, courts have two separate pools of information from which they could conceivably draw relevant comparisons: advisory services provided to funds where advisers perform almost identical services, and advisory services provided to non-funds where advisers perform different but similar services pursuant to an independently negotiated advisory agreement.

Plaintiffs pursuing section 36(b) litigation, therefore, often argue that courts should consider the lower non-fund fees as relevant to a breach of advisory fiduciary duty, citing the lower fees (and discrepancy between the fees) as evidence of arm's-length bargaining.[97] In response, defendants often contend that the pertinent comparison of fees is to other funds, based on the level and nature of the services provided.[98] Generally, courts have sided with defendants, concluding that fund fees are relevant to the evaluation of a section 36(b) breach of fiduciary claim and that non-fund fees are immaterial.[99]

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opinion itself, but not in how it had been subsequently interpreted. *Id.*

[95] *Id.*

[96] *See supra* notes 31-33 and accompanying text.

[97] *See, e.g.*, Hunt v. Invesco Funds Grp., Inc., 2006 WL 1581846, at *3 (S.D. Tex. June 5, 2006).

[98] *Id.* at *6.

[99] *See, e.g.*, Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 930 n.3 (2d Cir. 1982); Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990); *see also* John P.

In *Gartenberg*, the Second Circuit addressed the treatment of both fund and non-fund fees. With respect to fund fees, the court determined that such fees were relevant to determining the range of arm's-length bargaining, but should not be considered the most important factor.[100] In the court's view, competition between advisers for fund business may be "virtually non-existent" therefore "[r]eliance on prevailing industry advisory fees will not satisfy [section] 36(b)."[101]

Similarly, the *Gartenberg* court was skeptical of the probative value of non-fund fee comparisons like fees charged to pension plans. As the court noted, "[t]he nature and extent of the services required by each type of fund differ sharply."[102] For this reason, the court rejected the plaintiff's argument that fees charged to pension plans should be used to determine the range of arm's-length bargaining.[103]

As discussed in more detail below, courts continue to find that the relevant comparison of a mutual fund fee in an alleged section 36(b) case is to other comparative fund fees, resulting uniformly in the holding that an advisory fee is not excessive. While courts have consistently followed *Gartenberg* in excluding non-fund fee comparisons, this approach has drawn fire from the Eighth Circuit and academics who contend that non-fund fees provide valuable insight into the value of advisory services when negotiated at arm's-length.

1. Fund Fee Comparisons

The district court opinion in *Jones* is illustrative of how courts interpreting *Gartneberg* have analyzed comparative fund fee structures. The adviser, Harris, produced evidence that fees charged to its funds "were in line with" fees charged to "other similar funds managed by other companies."[104] The court asserted that these fees established "a range of prices that investors were willing to pay."[105] In the court's view, the fact that the defendant's fee "fell within this range . . . prevent[s] a conclusion that the amount of fees indicates that self-dealing was afoot."[106] The court concluded that, because investors across the fund industry were willing to pay a similar

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Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 651 (2001) (criticizing courts' refusal to consider non-fund fees).

[100] *Gartenberg*, 694 F.2d at 929.

[101] *Id.*

[102] *Id.* at 930 n.3.

[103] *Id.*

[104] Jones v. Harris Assocs. L.P., 2007 WL 627640, at *8 (N.D. Ill. Feb. 27, 2007), *aff'd*, 527 F.3d 627 (7th Cir. 2008), *and vacated*, 130 S. Ct. 1418 (2010).

[105] *Id.*

[106] *Id.*

fee, the defendant's fee could not be a breach of its fiduciary duty.[107]The Seventh Circuit agreed, and further extended such application by disapproving of the Second Circuit's analysis on the basis that *Gartenberg's* underlying assumption of limited competition was flawed.[108]

The differing treatment of fund fee comparisons after *Gartenberg* may be the result of a fundamental disagreement with the premise underlying the Second Circuit's analysis: that competition for fund shares is insufficient to establish arm's-length bargaining for advisory services.[109] Certainly, the rejection of that premise was central to the Seventh Circuit's disapproval of the *Gartenberg* standard. As the court explained, *Gartenberg* "relies too little on markets."[110] In the Seventh Circuit's view, the robust competition for fund shares allows shareholders to "'fire advisers cheaply and easily by moving their money elsewhere" when fees become excessive.[111] Under circumstances such as these, "[m]utual funds come much closer to the model of atomistic competition than do most other markets."[112]

On the other hand, the Eighth Circuit, in *Gallus*, criticized reliance on comparative fund fees and the Seventh Circuit's disapproval of *Gartenberg*,[113]contending that, while comparative fee structures are relevant,[114] the *Gartenberg* standard "should not be construed to create a safe harbor of exorbitance."[115] In the Eighth Circuit's view, if all that is required is for an adviser to "not charge a fee that is egregiously out of line with industry norms," the statute would be "eviscerate[d]."[116] Moreover, the court suggested that the use of fund fees as the critical measure of the range of arm's-length bargaining is responsible for the inability of shareholders to obtain a judgment under section 36(b).[117]

In sum, some courts following *Gartenberg* have relied on fund fee comparisons as determinative of the range of arm's-length bargaining, but the Eighth Circuit has disapproved of this approach. For this reason, prior to

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[107]*Id.* at *9.

[108]Jones v. Harris Assocs. L.P., 527 F.3d 627, 631-34 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010).

[109]*See id.* at 631 (noting the skepticism expressed in *Gartenberg* of "competition's power to constrain investment advisers' fees").

[110]*Id.* at 632.

[111]*Id.* at 634.

[112]*Jones*, 527 F.3d. at 634.

[113]*See* Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 822-23 (8th Cir. 2009), *vacated*, 130 S. Ct. 2340 (2010).

[114]*See id.*

[115]*Id.* at 823.

[116]*Id.*

[117]*Gallus*, 561 F.3d at 823 n.4.

the Supreme Court's opinion in *Jones*, there was uncertainty surrounding the use of fund fee comparisons.

2. Non-Fund Fee Comparisons

Following the Second Circuit's conclusion in *Gartenberg* that the fees charged to pension assets were not relevant to determining liability under section 36(b), courts have frequently excluded evidence of rates charged to trust accounts,[118] institutional investors,[119] and other non-fund clients.[120] In such cases courts have relied on the Second Circuit's analysis that non-fund fee services rendered to non-fund clients "differ sharply" from those provided to the fund.[121]

Academics and practitioners have encouraged the use of non-fund fee structures in section 36(b) litigation. For example, Professors John Freeman and Stewart Brown, and litigation consultant Steve Pomerantz, claim that the Second Circuit erred in excluding non-fund fee structures.[122] According to Freeman et al., "the pricing of investment advisory services . . . provides a legitimate and helpful guidepost for evaluating such services in the fund market."[123] If the appropriate standard for evaluating advisory fees is arm's-length bargaining, then, they contend, evidence of what constitutes arm's-length bargaining "should come from free market transactions," which they maintain non-fund rates are better suited to reflect.[124]

Courts have also acknowledged the premise that non-fund fee structures can be applicable in section 36(b) litigation. In *Jones*, the district court admitted evidence that advisers charged institutional investors lower fees than those charged to the funds,[125] holding that such fees would be used in establishing the low end of the range of arm's-length bargaining.[126] As

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[118] *E.g.*, Taylor v. United Tech. Co., 2009 WL 535779, at *10 (D. Minn. 2007) (stating that the plaintiff failed to show trust accounts are "equivalent investment vehicles" to mutual funds).

[119] *E.g.*, Strougo v. BEA Assocs., 188 F. Supp. 2d 373, 384 (S.D.N.Y. 2002). *But see* Jones v. Harris Assocs. L.P., 2007 WL 627640, at *8 (N.D. Ill. Feb. 27, 2007), *aff'd*, 527 F.3d 627 (7th Cir. 2008), *and vacated*, 130 S. Ct. 1418 (2010) (stating that the court cannot disregard a comparison to fees charged to institutional non-fund clients).

[120] *E.g.*, Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990); Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962, 983 (S.D.N.Y. 1987).

[121] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 930 n.3 (2d Cir. 1982).

[122] John P. Freeman et al., *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 129-30 (2008).

[123] *Id.* at 129.

[124] *Id.* at 140-41.

[125] Jones v. Harris Assocs. L.P., 2007 WL 627640, at *8 (N.D. Ill. Feb. 27, 2007), *aff'd*, 527 F.3d 627 (7th Cir. 2008), *and vacated*, 130 S. Ct. 1418 (2010).

[126] *See id.*; *see also* Freeman, *supra* note 122, at 143 (noting that advisory fees for

discussed above, the court believed such evidence only demonstrated the prices investors were willing to pay.[127]

The Eighth Circuit has also challenged the characterization of non-fund fee structures as non-determinative. Relying on *Gartenberg*, the district court in *Gallus* found that evidence offered by the shareholder that advisers charged institutional investors less than was charged to funds, was not relevant to determining liability under section 36(b).[128] In reaching its conclusion, the court, citing the district court opinion in *Jones*, noted that even if non-fund fee structures were probative, such evidence would only establish the range of prices investors would pay as the result of arm's-length bargaining.[129] On appeal, the Eighth Circuit disagreed,[130] holding that "when there is greater similarity between" the services rendered to the fund and those rendered to the non-fund client, such comparisons would be relevant.[131]

The Eighth Circuit was similarly not persuaded by the argument presented in the district court opinion in *Jones*, which held that the fees charged to non-fund clients were merely demonstrative of "what different investors are willing to pay."[132] The Eighth Circuit explained that "[t]he purpose of an inquiry into the fees paid by institutional, non-fiduciary clients is to determine what the investment advice is worth."[133] Consequently, courts must consider "the similarities and differences between mutual funds and institutional accounts" to determine whether the comparison is "inapt or that the discrepancy is substantively justified."[134]

Thus, courts provided several divergent views surrounding the use of non-fund fee comparisons, as well as the function of such comparisons, assuming they were relevant. Some courts following *Gartenberg* eschewed non-fund fee comparisons altogether, while others accepted such comparisons for the limited purpose of determining the low range of arm's-length bargaining. The Eighth Circuit took a third approach inquiring into whether the non-fund fee structure was sufficiently similar to the fee charged and, if so, whether the difference in price is justified.

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institutional clients fall on the lower end of the pricing spectrum).

[127] *Jones*, 2007 WL 627640, at *8.

[128] Gallus v. Ameriprise Fin., Inc., 497 F. Supp. 2d 974, 982 (D. Minn. 2007), *rev'd* 561 F.3d 816, *and vacated*, 130 S. Ct. 2340 (2010).

[129] *Id.*

[130] Gallus v. Ameriprise Fin., Inc., 561 F.3d 816, 823 (8th Cir. 2009), *vacated*, 130 S. Ct. 2340 (2010). In the court's view, *Gartenberg's* exclusion of pension assets was merely dicta that applied only to the "fundamentally different investment vehicles" at issue in that case. *Id.* at 823-24.

[131] *Id.* at 824.

[132] *Id.*

[133] *Id.*

[134] *Gallus*, 561 F.3d at 824.

V. *JONES V. HARRIS* – THE SUPREME COURT OPINION

In a short and unanimous opinion, the Supreme Court examined section 36(b) to determine the appropriate standard of liability under the statute. The Court looked to both the legislative history and federal common law to interpret the meaning of "fiduciary duty." Based on its understanding of that phrase, the Court concluded that *Gartenberg* was correct in its basic formulation of an adviser's fiduciary liability with respect to compensation. In addition to affirming *Gartenberg*, the Court provided guidance on interpretive conflicts discussed above: focusing the analysis on the totality of the circumstances, defining the procedural and substantive nature of the fiduciary obligation, and limiting the use of fund fee comparisons.

In order to ascertain congressional intent, the Court initially examined the legislative history of section 36(b) and the 1970 Amendments. The Court observed that this legislation, growing out of studies in the 1950s and 1960s, "identified problems relating to the independence of . . .boards and the compensation received by investment advisers."[135] Congress responded to these concerns by strengthening the independence of boards and "impos[ing] upon investment advisers a 'fiduciary duty' with respect to compensation."[136] As the Court noted, the fiduciary standard represented a "delicate compromise" between the existing waste standard, the Commission's proposed reasonableness standard, and industry representatives' concerns over potential rate regulation.[137] In balancing these interests, the Court concluded that Congress intended the phrase "fiduciary duty" to provide a "more favorable" outcome for shareholders, but did not intend courts to inquire into the reasonableness of advisory fees.[138]

With this legislative directive in mind, the Court turned to the traditional notions of fiduciary liability under federal common law. The Court likened the relationship between a fund and its adviser to the relationship between a corporation and its controlling shareholder, a relationship the Court examined in *Pepper*.[139] The Court explained in *Pepper* that a controlling shareholder was a fiduciary "whose 'powers are powers [held] in trust.'"[140] This fiduciary obligation requires that any transaction between a corporation and its controlling shareholder is "subjected to rigorous scrutiny" and when such transactions are challenged

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[135]Jones v. Harris Assocs. L.P., 130 S. Ct. 1418, 1422-23 (2010).
[136]*Id.* at 1423.
[137]*Id.*
[138]*Id.*
[139]*Jones*, 130 S. Ct. at 1427.
[140]*Id.* (quoting Pepper v. Litton, 308 U.S. 295, 306 (1939)).

the burden is on the controlling shareholder to prove both the "good faith" and "inherent fairness" of the transaction.[141] As the Court noted, under *Pepper*, "*[t]he essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's-length bargain.*"[142]

The Court ultimately concluded that this definition of fiduciary provided the appropriate understanding of the obligations created by section 36(b). As the Court stated: "this formulation expresses the meaning of the phrase 'fiduciary duty'" in the statute[143] and affirmed an adviser's fiduciary obligation under section 36(b) to deal in "good faith" and with "inherent fairness" when negotiating compensation with its funds.[144] In reviewing whether an adviser has met this fiduciary obligation, the key inquiry is whether "under all the circumstances" the compensation arrangements bear "the earmarks of an arm's-length bargain."[145]

The Court observed that Congress altered this common law standard of fiduciary. As the Court explained, the statute "modifies this duty in a significant way: it shifts the burden of proof from the fiduciary to the party claiming breach."[146] As a result of this modification, the shareholder must demonstrate that "the fee is outside the range that arm's-length bargaining would produce."[147]

Based on its analysis of the legislative history and federal common law, the Court affirmed the Second Circuit's opinion in *Gartenberg*, concluding that "[t]he *Gartenberg* approach fully incorporates this understanding of the fiduciary duty as set out in *Pepper* and reflects [section] 36(b)(1)'s imposition of the burden on the plaintiff."[148] Notably, the Court emphasized that the Second Circuit "insist[ed] that all relevant circumstances be taken into account" in accordance with the statutory directive in section 36(b)(2).[149] The Court "conclude[d] that *Gartenberg* was correct in its basic formulation of what [section] 36(b) requires."[150] Thus, to have breached its fiduciary duty, "an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the

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[141] *Id.* (quoting *Pepper*, 308 U.S. at 306).
[142] *Id.* (quoting *Pepper*, 308 U.S. at 306-07) (emphasis in original).
[143] *Jones*, 130 S. Ct. at 1427.
[144] *Id.*
[145] *Id.*(quoting *Pepper*, 308 U.S. at 306-07).
[146] *Id.*
[147] *Jones*, 130 S. Ct. at 1427.
[148] *Id.*
[149] *Id.*
[150] *Id.* at 1426.

services rendered and could not have been the product of arm's-length bargaining."[151]

As discussed below, in addition to affirming *Gartenberg*, the Court provided a broader framework for courts to resolve the conflicting approaches that evolved from the *Gartenberg* decision. In particular, the Court endorsed a facts and circumstances analysis, addressed the substantive and procedural nature of a section 36(b) inquiry, and clarified the use of fund fee comparisons.

A. *The Court Endorsed a Facts and Circumstances Analysis*

Consideration of all the facts and circumstances as the criteria by which liability is assessed under the statute is a central theme running throughout the Court's opinion. The Court explicitly stated in its opinion, that the statute "requires consideration of all relevant factors."[152] In addition, the Court identified a fiduciary standard that incorporates a facts and circumstances analysis. Moreover, the Court relied on this facts and circumstances approach as a rationale for both affirming *Gartenberg* and rejecting a categorical rule against the use of non-fund fee structures to determine the range of arm's-length bargaining. Finally, the Second Circuit's assertion that courts must consider all pertinent facts provided a framework for the Court's only discussion of the *Gartenberg* Factors.

The fiduciary standard adopted by the Court requires the finder of fact to consider all the relevant circumstances. The Court derived the test for fiduciary liability from *Pepper's* application of equitable principles, observing that equity will set aside transactions which do not "*under all the circumstances* . . . carr[y] the earmarks of an arm's-length bargain."[153] Hence, deeply rooted in the doctrine of fiduciary liability endorsed by the Court is the notion that the test for fiduciary liability is based on all the facts and circumstances surrounding the advisory fee.

Central to the Court's affirmation of *Gartenberg* was the Second Circuit's assertion that liability under the statute should incorporate all relevant facts and circumstances. The Court approved *Gartenberg*, in part, based on the Second Circuit's "insist[ence] that all the relevant circumstances be taken into account."[154] In the Court's view, "[t]he *Gartenberg* approach fully incorporates [an] understanding of the fiduciary

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[151] *Jones*, 130 S. Ct. at 1426.
[152] *Id.* at 1428.
[153] *Id.* at 1427 (quoting Pepper v. Litton, 308 U.S. 295, 306-07 (1939)) (emphasis added).
[154] *Id.*

duty as set out in *Pepper*."[155] From this, it is evident that the Second Circuit's adoption of the facts and circumstances analysis was critical to the Court's endorsement of *Gartenberg*.

In addition, the foundation of the Court's conclusion that evidence of non-fund fee structures cannot automatically be excluded as irrelevant arose from the mandate that courts consider all the pertinent facts. As the Court explained, "[s]ince the [statute] requires consideration of all relevant factors . . . we do not think that there can be any categorical rule regarding the comparisons of the fees charged different types of clients."[156] Rather, the Court instructed courts to "give such comparisons the weight that they merit in light of the similarities and differences between the services" rendered.[157] The Court noted that such differences may be "significant" and that as a result "courts must be wary of inapt comparisons."[158] The critical question identified by the Court is whether the comparisons are "probative."[159] Such comparisons would be probative where there is "a large disparity in fees that cannot be explained by the different services."[160] Even where non-fund fee comparisons are probative, the Court warned that the statute "does not necessarily ensure fee parity between . . . funds and institutional clients."[161] Accordingly, while the facts and circumstances analysis requires courts to examine non-fund fee structures when probative, the Court recognized that such structures were not an absolute metric of the range of arm's-length bargaining.

Moreover, the facts and circumstances analysis provided the context for the Court's only discussion of the *Gartenberg* Factors. The Court included the *Gartenberg* Factors in its summary of the Second Circuit's opinion as factors mentioned in the context of reviewing "all pertinent facts."[162] Notably, the Court did not include the factors delineated in *Krinsk* or itemized in *Gartenberg*.[163] Instead, it incorporated an amalgamation of both cases in the text of the opinion and in the attached footnote without identifying any of these factors as the *Gartenberg* Factors. In the text of the opinion, the Court quoted three of the four relevant factors specifically

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[155] *Jones*, 130 S. Ct. at 1427.

[156] *Id.* at 1428.

[157] *Id.*

[158] *Id.* at 1428-29.

[159] *Jones*, 130 S. Ct. at 1429.

[160] *Id.* at 1429 n.8.

[161] *Id.* at 1429.

[162] *Id.* at 1425-26 (quoting Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 929 (2d Cir. 1982)).

[163] *See supra* notes 61-76 and accompanying text (explaining the difference between the *Gartenberg* Factors and the factors listed in *Gartenberg* itself).

delineated by the Second Circuit in *Gartenberg*: "the adviser-manager's cost 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."[164] Further, in the footnote accompanying this quotation, the Court listed five of the six *Gartenberg* Factors:

> (1) the nature and quality of the services provided to the fund and shareholders; (2) the profitability of the fund to the adviser; (3) any 'fall-out financial benefits,' . . . (4) comparative fee structure (meaning a comparison of the fees with those paid by similar funds) and (5) the independence, expertise, care and conscientiousness of the board in evaluating adviser compensation.[165]

The Court identified these specific factors as a subset of the relevant considerations to be included in a broader evaluation of all the relevant facts and circumstances.

B. *Section 36(b) Requires both Procedural and Substantive Fairness*

Based on its understanding of fiduciary, the Supreme Court concluded that an inquiry under section 36(b) must consider both the procedural and substantive fairness of the compensation arrangements. This bifurcated inquiry is intrinsic to the federal common law principle of fiduciary liability incorporated into the statute by the Court in *Jones*. As the *Jones* Court explained, the fiduciary obligation is one of both "good faith" and "inherent fairness."[166] In addition, the Court recognized that this bifurcated approach is embedded in the statute itself.[167] Consequently, the Court concluded that an "evaluation of an . . . adviser's fiduciary duty must take into account both procedure and substance."[168]

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[164] *Jones*, 130 S. Ct. at 1425-26 (quoting *Gartenberg*, 694 F.2d at 930) (internal quotation marks omitted). The fourth factor that the Court omitted from this quotation was the "nature and quality of the service" provided. *Gartenberg*, 694 F.2d at 930. This factor is also a *Gartenberg* Factor and was included in footnote five of the Court's opinion.

[165] *Jones*, 130 S. Ct. at 1426 n.5. The sixth factor, economies of scale, was incorporated into the text of the opinion. *Id.* at 1426.

[166] *Id.* at 1427 (quoting Pepper v. Litton, 308 U.S. 295, 306-07 (1939)).

[167] *Id.* at 1429.

[168] *Id.*

While the Court did not explicitly define the nature of the procedural and substantive evaluation, general principles can be derived from the opinion. First, an inquiry into the procedural fairness of the advisory fee questions whether the advisory agreement was approved by an independent expert and a diligent board fully informed by the adviser of all pertinent facts. Second, the substantive fairness analysis requires courts to examine whether the amount of the fee is excessive in relation to the value of the services rendered. In addition, procedural fairness by itself is neither necessary nor sufficient to create liability under the statute. Instead, the level of procedural fairness informs courts as to how rigorously they should examine the transaction for substantive fairness.

Procedural fairness or, in the words of the *Pepper* Court, "good faith," requires courts to examine the process used by the board and the adviser in negotiating the advisory agreement.[169] As the Court explained, where the "disinterested directors considered the relevant factors" and their "process for negotiating and reviewing . . . adviser compensation is robust," the board's approval of any compensation arrangements "is entitled to considerable weight."[170] Conversely, where the process is flawed or where "the adviser withheld important information, the court must take a more rigorous look at the outcome."[171] In such cases, the Court observed, the board may be unable "to function as 'an independent check upon the management.'"[172] The Court's analysis suggests that the procedural inquiry is one in which courts examine whether the board functions as an "independent check" on the adviser.

Substantive fairness, or the "inherent fairness," identified by *Pepper* is an inquiry into whether the amount of the fee is excessive in relation to the services provided. The Court indicated that the level of substantive scrutiny is dependent on the degree of deference to which the board is entitled. Where the transaction is procedurally fair, the appropriate standard of scrutiny is whether "the fee '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.'"[173] "In contrast, where the board's

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[169] *Jones*, 130 S. Ct. at 1427 (quoting *Pepper*, 308 U.S. at 306-07).

[170] *Id.* at 1429. In the Court's view, the board is "the 'cornerstone of the...effort to control conflicts of interest within mutual funds.'" *Id.* at 1427 (quoting Burks v. Lasker, 442 U.S. 471, 482 (1979)). As the Court explained, board approval and judicial review of the advisory agreement are "mutually reinforcing but independent mechanisms for controlling conflicts." *Id.* at 1428.

[171] *Id.* at 1430.

[172] *Id.* at 1430 (quoting *Burks*, 442 U.S. at 484).

[173] *Jones*, 130 S. Ct. at1429-30 (quoting Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982)).

process was deficient ... the court must take a more rigorous look at the outcome."[174] In short, the substantive review requires courts to determine whether the fee exceeds the range of arm's-length bargaining; however, the level of scrutiny required for that determination depends on the degree of procedural fairness.

C. *Fund Fee Comparisons Are "Problematic"*

In addition to adopting a facts and circumstances analysis and endorsing a bifurcated approach, the Court resolved the controversy over the probative value of fund fee comparisons. On this heavily-debated evidentiary issue, the Court advised the lower courts not to "rely too heavily on comparisons with fees charged to . . . funds by other advisers."[175] In the Court's view, such "comparisons are problematic because these fees . . . may not be the product of negotiations conducted at arm's-length."[176] The Court concurred with the *Gartenberg* Court's conclusion that competition for fund shares does not necessarily support the inference that there is competition between advisers.[177] To summarize, while courts should continue to consider fund fees as a relevant factor, they must be mindful of the fact that such fees may not be the product of arm's-length bargaining.

VI. ANALYSIS

Some individuals characterize the Supreme Court opinion in *Jones* as "*Gartenberg*-plus,"[178] a standard similar to *Gartenberg* but additionally requiring courts to examine non-fund fee comparisons.[179] We argue that the opinion is more nuanced than simply integrating the consideration of non-fund fee comparisons. First, we contend that, while the Court affirmed the *Gartenberg* standard, it reframed the analysis as a facts and circumstances inquiry where the *Gartenberg* Factors are merely potentially relevant facts. Second, the Court established a dependent bifurcated review of the facts that require courts to inquire into both the procedural and substantive fairness of

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[174] *Id.* at 1430.

[175] *Id.* at 1429.

[176] *Id.*

[177] *Jones*, 130 S. Ct. at 1429.

[178] *See, e.g.*, William Birdthistle, *Keeping up with* Jones, THE CONGLOMERATE (Mar. 30, 2010), http://www.theconglomerate.org/2010/03/keeping-up-with-jones.html (posted 30 March 2010).

[179] *See* William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61, 104 (2010).

the compensation arrangements. Finally, the Court provided broad guidance on the use of comparable fund fees.

A. *Evaluating Liability Under Section 36(b): All Facts and Circumstances*

In *Jones*, the Supreme Court subtly shifted the focus of section 36(b) litigation from a review of a discrete list of factors, the *Gartenberg* Factors, to a more fulsome review of the context under which the board and the adviser negotiated the compensation arrangements. While this shift may at first glance appear more semantic than substantive, we contend that the Court's facts and circumstances analysis is a significant development in how liability is assessed under the statute.

As discussed in Part III, the Second Circuit in *Gartenberg* insisted that courts reviewing compensation arrangements consider these arrangements in light of all the pertinent facts; however, in order to guide courts, the Second Circuit identified specific factors that were typically relevant.[180] When the Second Circuit in *Krinsk* later refined the factors into the oft-cited *Gartenberg* Factors, the *Gartenberg* Court's emphasis on all the pertinent facts was lost.[181] As a result, litigation under section 36(b) centered on the *Gartenberg* Factors.[182] The Commission further solidified the adoption of the *Gartenberg* Factors by incorporating the factors into the regulatory regime.[183] Thus, prior to the Supreme Court decision in *Jones*, the *Gartenberg* Factors were pivotal to evaluating liability under section 36(b).

The Supreme Court opinion shifted the focus away from the *Gartenberg* Factors to a facts and circumstances analysis. In its opinion, the Court repeatedly underscored the significance of considering all the relevant facts and circumstances. For example, this facts and circumstances analysis was an inherent part of the federal common law standard of fiduciary that the Court incorporated into section 36(b).[184] Moreover, the Court indicated that it affirmed the *Gartenberg* standard due, in part, to the Second Circuit's conclusion that the statute mandated a review of all the facts and

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[180] *See supra* notes 58-59 and accompanying text (discussing the facts and circumstances analysis and its relationship to the factors delineated in *Gartenberg*).

[181] *See supra* notes 61-64 and accompanying text (noting the evolution of the *Gartenberg* Factors).

[182] *See supra* note 73 and accompanying text (explaining how courts often relied on the *Gartenberg* Factors to explicate the standard of liability under section 36(b)).

[183] *See supra* notes 74-75 and accompanying text.

[184] *See supra* note 153 and accompanying text (quoting the standard of liability under *Pepper*).

circumstances.[185] Furthermore, this analysis provided the Court's rationale for rejecting a categorical rule excluding non-fund fee comparisons.[186] More telling was the Supreme Court's failure to include the *Gartenberg* Factors in its holding. Indeed, the Court's only discussion of the Factors described them as examples of relevant facts and circumstances identified by the Second Circuit in *Gartenberg*.[187] At no point did the Court indicate that the *Gartenberg* Factors should remain central to a court's analysis of liability under section 36(b). Rather, the Court focused on the need to consider all pertinent facts.[188]

B. *Incorporating Both Procedure and Substance: A Dependent Bifurcated Review*

The Supreme Court resolved the critical debate that emerged between the circuits over whether the fiduciary obligation created by section 36(b) was procedural or substantive. We contend the Court endorsed a dependent bifurcated review which required courts to consider both procedural and substantive fairness. We argue that this dependent bifurcated review makes the standard of liability applicable to advisers contingent on the level of the "good faith" exhibited by the board and the adviser in negotiating the advisory fee.

As discussed in Part IV, prior to the Court's opinion in *Jones*, the Second, Fourth, Seventh, and Eighth Circuits each developed different approaches to the fiduciary obligation created by section 36(b). In *Migdal*, the Fourth Circuit, in interpreting *Gartenberg*, indicated that the inquiry under the statute was primarily substantive in nature; requiring courts to inquire whether the fee charged was "'so disproportionately large that it . . . could not have been the product of arm's-length bargaining.'"[189] The Seventh Circuit, by contrast, concluded that the fiduciary duty under the statute merely requires procedural fairness on the part of *advisers*, obligating them

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[185] *See supra* notes 154-155 and accompanying text (stating the Court's rationale for affirming *Gartenberg*).

[186] *See supra* note 156 and accompanying text (outlining the Court's rejection of a categorical rule). In the Court's view, such fee comparisons were probative where a large disparity in fees could not be explained by differences in services. *See supra* notes 159-160 and accompanying text.

[187] *See supra* notes 162-165 and accompanying text (explaining the Court's characterization of the *Gartenberg* Factors).

[188] *See supra* note 152 and accompanying text.

[189] Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321,326 (4th Cir. 2001) (quoting Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982); *see also supra* note 86 and accompanying text (explaining the Fourth Circuit's interpretation of *Gartenberg*).

to make full disclosure and "play no tricks."[190] The *Gallus* Court attempted to reconcile these different approaches by incorporating both procedure and substance into its analysis of the fiduciary obligation; however, in their view either procedural or substantive improprieties could independently provide the basis for liability under section 36(b).[191] Essentially, the Eighth Circuit's analysis asks both whether the board properly approved the advisory fee and, separately, whether the fee itself was so disproportionately large. In sum, the Courts of Appeals differed substantially in their interpretation of the fiduciary obligation under section 36(b), with some emphasizing substantive fairness in the form of the "so disproportionately large" standard, others concentrating on the honesty of the adviser, while still others integrated both procedural and substantive fairness.

We contend that the Supreme Court took a different approach from the Courts of Appeals. In the Court's view, the fiduciary obligation of section 36(b) is both procedural and substantive in nature; however, procedural deficiencies alone are not sufficient to establish liability under the statute.[192] Instead, procedural fairness indicates to courts how rigorously they should examine the transaction for substantive fairness.[193] Said differently, the Court endorsed a sliding scale of substantive scrutiny based on the level of procedural fairness.

In the Court's view, if an independent, fully-informed board approves the advisory fee after a robust negotiation and review, then the board's decision is entitled to considerable deference.[194] In such a case, the Court explained that the appropriate level of scrutiny is whether the fee 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."[195] In contrast, where a court finds a failure of process, a court will apply a more rigorous level of scrutiny to whether a fee is "excessive."[196] While the Court did not precisely detail the appropriate level of scrutiny which should apply where the process is deficient, we can discern from the opinion that the level of scrutiny is stricter than the "so disproportionately large" standard that applies where the process is sufficiently rigorous. To

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[190]Jones v. Harris Assocs. L.P., 527 F.3d 627, 632 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010).

[191]*See supra* notes 89-95 and accompanying text (outlining the Eighth Circuit's attempted compromise).

[192]*See supra* Part V.B.

[193]*See supra* Part V.B.

[194]*See supra* Part V.B.

[195]*Jones*, 130 S. Ct. at 1429-30 (quoting Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982)); *see supra* note 173 and accompanying text.

[196]*See supra* note 174 and accompanying text.

summarize, *Jones* created a dependent bifurcated review which applies the "so disproportionately large" standard where the advisory fee is the product of a fair process, but a more rigorous standard where the fee is the product of a deficient process.

C. *Resolving the Evidentiary Debate: Restricting the Application of Fund Fee Comparisons*

We contend that in *Jones*, the Court narrowed the use of fund fee comparisons. Although the Second Circuit in *Gartenberg* expressed concerns about the probative value of fund fee comparisons, its progeny continued to accept such comparisons as a critical component of assessing liability under section 36(b).[197] The district court in *Jones*, for example, argued that such fee structures were conclusive evidence of the range of arm's-length bargaining.[198] The Eighth Circuit in *Gallus* provided a compromise, arguing that fund fee structures were relevant but not determinative.[199]

The Supreme Court held that courts should not necessarily rely on fund fee structures as conclusive evidence of the range of arm's-length bargaining.[200] The Court did not deny the relevance of fund fee structures; instead, it noted that such fees are not necessarily the product of arm's-length negotiations.[201] Concurring with the Second Circuit, the Court reasoned that fund fee structures cannot be used to support an inference that the fee charged is within the range of arm's-length bargaining.[202] Consequently, fund fee comparisons cannot be used as evidence to demonstrate that the fee charged is within the range of arm's-length bargaining. In sum, the Court restricted the application of fund fee comparisons, all but eliminating their use as evidence that a particular fee does not exceed the range of arm's-length bargaining.

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[197] *See supra* notes 104-108 and accompanying text (discussing the opinion of the district court in *Jones* interpreting *Gartenberg*).

[198] *See supra* notes 104-108108 and accompanying text.

[199] *See supra* notes 113-117 and accompanying text (discussing the Eighth Circuit's criticism of *Jones*).

[200] *See supra* notes 153-61 and accompanying text.

[201] *See supra* notes 153-61 and accompanying text.

[202] *See supra* notes 153-61 and accompanying text.

VII. CONCLUSION

The Supreme Court affirmed *Gartenberg*, holding that the standard of liability under the section 36(b) is whether the fee charged is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the products of arm's-length bargaining."[203] In addition, the Court provided a fresh, more nuanced approach to assessing liability under section 36(b). We conclude that the Court shifted the focus of the analysis under the statute from the six *Gartenberg* Factors to all the relevant facts and circumstances. In doing so, the Supreme Court instructed courts to consider non-fund fee structures where a significant disparity in price is not explained by a difference the in the services provided.

Moreover, we maintain that, to evaluate the facts and circumstances, the Court introduced a dependent bifurcated review under which courts employ a sliding scale of substantive scrutiny based on the level of procedural fairness. Critically, the Court indicated that the "so disproportionately large" standard of liability applies only where an independent, fully-informed board approves the advisory fee after a robust negotiation and review. Where there are procedural deficiencies, the Court determined that more rigorous substantive scrutiny is required. Finally, we conclude that the Court proscribed the use of fund fee comparisons as evidence that a fee charged is within the range of arm's-length bargaining.

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[203] *Jones*, 130 S. Ct. at 1429-30 (quoting Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982).