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**INVESTMENT MANAGEMENT
UPDATE****Seventh Circuit Rejects *Gartenberg* Standard in Adviser Fee Case and Fashions New Test**

The U.S. Court of Appeals for the Seventh Circuit affirmed a grant of summary judgment in favor of an investment adviser to a mutual fund in a suit alleging that advisory fees charged by the adviser were excessive in violation of the fiduciary duty owed by the adviser to the fund and its shareholders under Section 36(b) of the Investment Company Act.¹ In reaching its decision, the Court “disapproved” the reasonableness test articulated by the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*,² in favor of reliance upon full disclosure by the adviser of its fees and price competition created by free market forces.

BACKGROUND: *GARTENBERG* FACTORS

For over two decades, *Gartenberg* has stood for the proposition that Section 36(b) liability for breach of fiduciary duty based on a claim of excessive investment advisory fees will not be found unless the fee 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 Subsequent to the original *Gartenberg* case, the Second Circuit enumerated five factors that may be used to inform this test. Specifically, the Second Circuit suggested that the reasonableness of an investment advisory fee is the product of:

- The nature and quality of services provided to fund shareholders by the adviser;
- The profitability of the fund to the adviser;
- The fall-out benefits enjoyed by the adviser;
- The existence of economies of scale; and
- The independence and conscientiousness of the trustees.⁴

Provided that a review of these factors indicated that an adviser’s fee was within the range of what could be negotiated at arm’s-length, courts generally have been unwilling to find a breach of fiduciary duty.⁵

SEVENTH CIRCUIT’S REASONING***Rejection of Gartenberg Factors***

The Seventh Circuit reasoned that while Section 36(b) creates a fiduciary duty, it does not require that advisory fees be “reasonable.” The Court held that because the existence of a fiduciary duty



does not imply judicial review for reasonableness, the standard for contesting fees is whether the shareholder made a voluntary choice with the benefit of adequate information. The Court further noted that there is no express command in Section 36(b) that would “... make the federal judiciary a rate regulator, after the fashion of the Federal Energy Regulatory Commission ...”⁶ The Court stated that competition, not litigation, determines the fee. In short, the Court suggested that investors do not need judicial protection because, armed with full disclosure regarding the level of advisory fees, they will avoid or sell high-cost funds, in effect voting with their dollars if they find fund fees excessive.

Harris Test

In rejecting *Gartenberg*, the Court fashioned a new test for compliance with Section 36(b) by looking to traditional notions of fiduciary duty found in the law of trust as supplemented by competitive market theory. Specifically, the Court found that an adviser complies with its fiduciary duty if it:

- makes full disclosure of fees; and
- is truthful in its disclosures.⁷

The Court noted that, once armed with transparent fee disclosures, the mutual fund industry is economically self-policing because even though “[m]utual funds rarely fire their investment advisers, [...] investors can and do “fire” advisers cheaply and easily by moving their money elsewhere.”⁸

In formulating its new test, the Court also rejected the plaintiffs’ assertion that “reasonable” fees should be measured by comparison to fees paid by non-mutual fund institutional clients, such as pension funds.⁹ It reasoned that mutual funds and other institutional clients are too dissimilar in their demands on an adviser’s resources and time to be directly comparable.¹⁰

OUTLOOK

The Court’s decision suggests that shareholder litigation over excessive fees is both less likely to be initiated and, if initiated, less likely to prevail.

However, while the Seventh Circuit’s opinion presents an alternative approach to evaluating advisory fees, the Securities and Exchange Commission continues to require that shareholder reports disclose a board’s conclusions with respect to each of the *Gartenberg* factors. Consequently, it is unlikely that the type of information requested by boards and supplied by advisers when approving or renewing advisory contracts will change any time soon.





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¹ *Jones v. Harris Associates L.P.*, No. 07-1624 (7th Cir. May 19, 2008) (announcing new test for breach of fiduciary duty by investment advisers to mutual funds when they charge excessive fees).

² *Harris*, No. 07-1624 at 8.

³ *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2nd Cir 1982), cert. denied, 461 U.S. 906 (1983) (Gartenberg I) (announcing test of breach of fiduciary duty without enumerating factors which might inform the test).

⁴ *Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404, 409 (2nd Cir. 1989).

⁵ See e.g., *Midgal v. Rowe Price-Fleming Int'l*, 248 F.3d 321 (4th Cir 2001); *Yampolsky v. Morgan Stanley Asset Management, Inc.*, 464 F.3d 338 (2nd Cir 2006).

⁶ *Harris*, No. 07-1624 at 13-14.

⁷ *Id.* at 8 (the Court states that “[a] fiduciary must make full disclosure and play no tricks ...” *Id.*).

⁸ *Id.* at 11.

⁹ *Id.* at 6.

¹⁰ *Id.* at 13.