FUND ALERT

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Seventh Circuit Rejects *Gartenberg* Approach to Determining the Appropriateness of Mutual Fund Management Fees

By Lawrence P. Stadulis, Peter M. Hong and John M. Baker

In a unanimous opinion, the U.S. Court of Appeals for the Seventh Circuit has ruled in the case of *Jones v. Harris Associates* that courts should generally not second-guess the fees payable to mutual fund managers when there has been full disclosure of the fees and approval by the fund's trustees.[1] The court's opinion represents a rejection of the "reasonableness" test applied in *Gartenberg v. Merrill Lynch Asset Management*.[2]

The plaintiff shareholders argued that their funds' investment adviser charged excessive fees in breach of its fiduciary duty under Section 36(b) of the Investment Company Act of 1940. Section 36(b) provides that the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, and that fund shareholders have a private right of action to enforce this fiduciary duty. Although the funds' fees were in line with those paid by other mutual funds, the plaintiffs noted that the adviser charged lower fees to other institutional clients.

In *Gartenberg*, the U.S. Court of Appeals for the Second Circuit applied a "reasonableness" standard in determining whether an adviser's fees were so excessive as to violate Section 36(b). According to the Second Circuit, the test is whether the fee charged is within the range of what would have been negotiated at arm's length in light of all of the surrounding circumstances. Thus, in order to violate Section 36(b), the 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 Seventh Circuit, in an opinion by Chief Judge Easterbrook, rejected the *Gartenberg* test, which the court saw as a form of rate regulation:

> Section 36(b) does not say that fees must be "reasonable" in relation to a judicially created standard. It says instead that the

> adviser has a fiduciary duty. That is a familiar word; to use it is to summon up the law of trusts. And the rule in trust law is straightforward: A trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay.[3]

The Seventh Circuit held that an adviser's fiduciary duty to a fund under Section 36(b) does not mean that the adviser's fees are subject to judicial review for reasonableness. Therefore, while an adviser must make full disclosure of the fees it charges, the court ruled that it is not subject to a cap on compensation.

The court specifically rejected the claim that an adviser's fees should necessarily be challenged because it charges other institutional clients less. It noted that different clients may call for different commitments of time and have lower turnover or less need for liquidity. The court also noted that different clients may share research and other costs, and that in competition those joint costs are apportioned among paying customers according to their elasticity of demand, not according to any rule of equal treatment. The federal securities laws work largely by requiring disclosure and then allowing prices to be set by competition in which investors make their own choices.

While the Seventh Circuit's unanimous rejection of the *Gartenberg* test is not binding on other circuits, Chief Judge Easterbrook's opinion will likely receive serious consideration in other courts as well. Nonetheless, there now unquestionably exists a split in the circuits regarding the application of *Gartenberg*, with *Jones* presenting a clear alternative approach to interpreting Section 36(b). ■

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[1] No. 07-1624 (7th Cir. May 19, 2008).

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

[3] *Jones v. Harris Associates*, slip op. at 8 (citations omitted).

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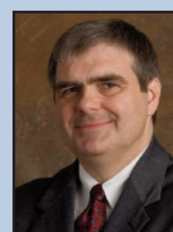

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