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Seventh Circuit Decision in Jones v. Harris Associates L.P.: "Judicial price-setting does not accompany fiduciary duties" under Section 36(b) of the Investment Company Act

On May 19, 2008, the United States Court of Appeals for the Seventh Circuit affirmed the granting of summary judgment in favor of Harris Associates, a registered investment adviser, finding that the fees charged by Harris Associates to open-end mutual funds were sufficiently constrained by market forces and competition, and that no inquiry needed to be made as to the fees' reasonableness under Section 36(b) of the Investment Company Act of 1940, as amended (the "Act").[1]

The plaintiffs in *Harris Associates* brought suit under, *inter alia*, Section 36(b) of the Act, alleging that the defendant had breached its fiduciary duty by charging excessively high fees to the Oakmark complex of open-end mutual funds ("Oakmark").[2] Section 36(b) provides that an "investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the compensation for services . . . paid by such registered investment company," and it creates a private right of action for security holders of the investment company on the company's behalf.[3]

In reaching its holding, the Court criticized the 1982 *Gartenberg* decision,[4] claiming that the Second Circuit's approach for determining excessive fees under Section 36(b)—measuring fees against a "normal range" as determined by a jury or a court—did not rely heavily enough on the market and thus was unacceptable judicial price-setting. The Seventh Circuit bluntly stated, "[j]udicial price-setting does not accompany fiduciary duties."

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1 *Jones v. Harris Associate L.P.*, No. 07-1624, slip op. at 10 (7th Cir. May 19, 2008) (hereinafter *Harris Associates*).

2 *See id.* at 1-2.

3 15 U.S.C. §80a–35(b).

4 *Gartenberg v. Merrill Lynch Asset Management*, 694 F.2d 923 (2d Cir. 1982).

Discussion

In *Harris Associates*, plaintiffs who were investors in several Oakmark mutual funds managed by Harris Associates, brought suit alleging that the advisory fees charged were excessive and in violation of Harris Associates' Section 36(b) fiduciary duty to the funds. The district court granted Harris Associates' motion for summary judgment relying on *Gartenberg*. In that decision, the Second Circuit held that the test for determining excessive fees in light of Section 36(b)'s fiduciary obligations is whether the fee schedule is within the "range of what would have been negotiated at arm's length in the light of all of the surrounding circumstances"[5] and that Section 36(b) is only violated when 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."[6]

The plaintiffs argued that *Gartenberg* was wrong because it inappropriately relied on market forces and competition to set investment adviser fees. The plaintiffs claimed that true competition does not exist because of the close relationships between boards of trustees of mutual funds and their investment advisers, and that if market prices are used as a benchmark, the benchmark market should be limited to fully independent investment advisers instead of to the standards of the industry as a whole.

Following its own trend in *Green v. Nuveen Advisory*[7] and the Third Circuit's decision in *Green v. Fund Asset Management*,[8] the Seventh Circuit found that *Gartenberg* was wrong -- not for relying too much on markets forces as plaintiffs asserted, but for not relying heavily enough on markets. The court explained that "[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth."[9] While Section 36(b) creates a fiduciary duty, it "does not say that fees must be 'reasonable' in relation to a judicially created standard."[10] The court held that "[j]udicial price-setting does not accompany fiduciary duties," noting that "Section 36(b) does not create a rate-regulation mechanism...."[11] The court presented three analogies in support of its holding:

First, the court drew on the law of trusts, where the concept of fiduciary duties originates, to explain that 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 . . . agrees to pay."[12] Although compensation can conceivably be so vastly disproportionate that the court can infer wrongdoing, in general—and especially where the compensation is in the normal range—when the settlor has determined the trustee's compensation, that decision stands.

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5 *Id.* at 928.

6 *Id.*

7 295 F.3d 738, 743 n.8 (7th Cir. 2002) (criticizing *Gartenberg* in a closed-end fund context).

8 286 F.3d 682 (3d Cir. 2002).

9 *Harris Associates*, at 8.

10 *Id.*

11 *Id.* at 10 - 11.

12 *Id.* at 8.

Second, the court looked to the law of corporations, another context where fiduciary duty applies, and concluded that while directors owe fiduciary duties to investors, they are not prevented from "demanding substantial compensation and bargaining hard to get it."[13] When determining salaries for upper management, publicly traded corporations are subject to many of the same constraints as mutual funds are subject to when setting compensation for investment advisers, but courts do not normally engage in judicial review of reasonableness of corporate salaries.

Third, the court points out that lawyers owe a fiduciary duty to their clients, but are still allowed to set their fees as high as they choose, as long as their client agrees and has sufficient information to make the decision.

The court admitted that competition-based market forces are not a perfect measure for setting fees, but insisted nevertheless that they are superior to judicially administered pricing: "[h]owever weak competition may be at weeding out errors, the judicial process is worse — for judges can't be turned out of office or have their salaries cut if they display poor business judgment."[14] The court expressed confidence that sufficient competition exists in the mutual fund industry for market forces to constrain excessive investment adviser fees: higher fees mean higher expenses, and a commensurately lower investment return for a mutual fund's investors. Thousands of competing mutual funds are available, some mutual funds — for example, those that track market indexes — do not use investment advisers at all, and the court noted that transaction costs of finding and investing in mutual funds over the Internet are low. When advisers' fees are too high in relation to the fund's results — not to some absolute level of reasonableness — investors can easily take their money elsewhere.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Charles Gilman at (212) 701-3403 or cgilman@cahill.com; or Jon Mark at (212) 701-3100 or jmark@cahill.com.

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13 *Id.*

14 *Id.* at 9.