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The Harris Associates 36(b) Lawsuit Opinion:

Has the 'Gartenberg Standard' Been Displaced?

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preface

For more than 25 years, the *Gartenberg v. Merrill Lynch Asset Management Inc.* (1982) case ("*Gartenberg*") has served to form the basis for fund advisory contract renewal (15(c)) processes in many boardrooms and its validity in the eyes of the legal system is widely embraced. Many defendants since *Gartenberg* have relied on the approach and factors set down in the judgment for thwarting fund boards of directors' breach of fiduciary duty (36(b)) litigation claims. Several months ago, one of the latest 36(b) cases to emerge resulted in an opinion by Chief Judge Easterbrook that disapproved the '*Gartenberg* standard.' The *Jerry N. Jones, Mary F. Jones, and Arline Winerman v. Harris Associates L.P.* ("Harris") filing did not result in a plaintiff victory, but rather a summary judgment for the defendant. Yet, Easterbrook's rogue opinion may subtly trickle across the country and eventually result in possible dilution of some, if not all, of the *Gartenberg* factors in the judicial system. 15(c) process and boardroom questions clearly emerge from this event. Does or should this case serve to widely displace the '*Gartenberg* standard?' Should directors now focus primarily or more intently on fee benchmarking? Is it wise for a board to relax its 15(c) process standards? Will future cases outside the District in which this case was filed consider and/or try to rely on this *Gartenberg*-unfriendly rationale for support?

Executive Summary

Fund directors and other readers are urged to take away and/or seriously consider the following points contemplated by this white paper:

- Chief Judge Easterbrook's argument that *Gartenberg* is somehow flawed is based primarily on the assumption that <u>free</u> price competition exists and promotes lower advisory fees – this perspective is not necessarily fully valid in that several 'frictions' exist that help to compromise the fluidity of market forces

- His opinion is also based on the belief that *Gartenberg* allegedly relies too little on market forces – while the *Gartenberg* judgment clearly minimized the application of fee benchmarking in the 15(c) process and instead focused on board due diligence, this perspective was based on the pragmatic view that fund advisors simply don't compete directly on price
- Judge Easterbrook also maintains that *Gartenberg* serves to put the judicial system in the rate setting business – KFS does not believe the spirit of the *Gartenberg* decision is such, but rather focused on a solid process that enables boards of directors to adequately apply their business judgment thereby putting courts in the position of primarily analyzing 15(c) process adequacy and not advisory fees relative to benchmarks
- Simply because advisory fee levels of institutional clients for similar products are charged less, this fact does not imply that retail investors are being charged "excessively"
- Given that the Harris opinion was filed in the Seventh Circuit Court of Appeals and is not directly applicable to all future 36(b) cases and – in this author's opinion – did not adequately provide rationale for the full dilution of *Gartenberg*, mutual fund boards should prudently embrace the current advisory contract review standards and ensure an iron-clad 15(c) process
- More weight placed on the fee benchmarking process (by boards) may be advisable during the 15(c) exercise due to the sheer existence of the Easterbrook opinion and the maturation of the fund business since the Gartenberg case was pleaded
- Directors are well-advised to consult with counsel regarding how the Harris case should or may impact the current approaches to upcoming advisory contract renewal cycles, if at all
- Finally, directors are advised to keep current on all pending 36(b) litigation

gartenberg Thumbnail

The landmark *Gartenberg v. Merrill Lynch Asset Management Inc. (1982)* plaintiff's case relied on Section 36(b) of the Investment Company Act of 1940's provision that mutual fund's boards owe a fiduciary duty to shareholders in approving contractual arrangements that involved payments of shareholder assets. The suit claimed that the money market fund shareholders had been charged "excessive fees" and thus, the board had not acted in a fiduciary manner. The plaintiffs were not victorious due to the competitive investment returns realized by the funds, the advisory fees were in proximity to funds of a like nature, and the arguably solid 15(c) process employed by the board. Most importantly, the case effectively laid down a legal foundation for boards of trustees to confidently embrace a 15(c) process that ensured advisory fees were determined to be "fair" and "reasonable." When the process is meticulously followed, some level of 'insulation' is therefore afforded mutual fund directors if excessive advisory fees are claimed by a plaintiff.

The court-sanctioned advisory contract renewal process outlined in the *Gartenberg* case effectively cited – and with support from a few other 36(b) cases – burgeoned into 6 "factors" that should be reviewed and considered as such:

1. The nature and quality of advisory/administrative services provided
2. The cost of the services provided by an advisor and the resulting advisor profitability
3. Economies-of-scale that may be realized through growth of fund assets and how shareholders 'participate' in those economies
4. Advisory fee structures and fees levied for funds of a like type, investment objective and size
5. Any "fall-out benefits" that may result from management of a fund, e.g., ability to promote other investment products, brokerage volume discounts, performance advertising etc.

6. The directors' expertise, the extent to which they are fully informed of the factors surrounding an advisory contract and, perhaps most critical, the care and conscientiousness with which they carry out their duties as "watchdogs"

In the eyes of the courts today and backed by numerous judgments favoring the defendants, in order for an advisory fee to be considered "fair" and "reasonable," all 6 steps have to be comprehensively undertaken with care, a focus on shareholder loyalty, diligence, and appropriate inquiry by a board of directors. And, courts will <u>not</u> substitute their judgment of an advisory fee's fairness and reasonableness for that of a board of directors. It should also be noted that a Court of Appeals reinforced the *Gartenberg* decision and applied the following standard:

> *To be guilty of a violation of 36(b), the advisor/manager 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.*

To boil down and apply this statement, directors <u>could</u> be found liable of breach of fiduciary duty if a fee was determined to be "disproportionately large" even though their process was iron-clad. Thus, beyond diligent processes, careful benchmarking is arguably necessary, albeit within a margin of 'error.'

While the 6 factors are the bedrock upon which many a solid contract renewal process is based, it should be noted that under certain circumstances a board may rightfully (and should) choose to examine additional information as additional business or market condition considerations may impact business judgment. It should also be noted that the factors are not explicitly required by any legislation or regulations, yet have effectively been codified/endorsed by the SEC when the agency mimicked the Gartenberg process in their requirement of boards to publish directors' rationale for renewing advisory contracts in fund annual reports. Finally, boards should seriously consider that while Gartenberg provides a valid structure for applicable subject matter and process, its standards were at least partially based on fund industry conditions many years ago. Consideration should therefore obviously be given to today's business atmosphere and how it differs from that present in 1982.

Bottom line: the widely embraced *Gartenberg* model should rely on the contract review process's integrity, thoroughness and very heavily on directors' business judgment given today's marketplace realities.

Other Factors in the harris case

The Harris case is primarily an excessive fee (36(b)) claim, pointing to the Oakmark Funds Trustees allegedly not upholding their fiduciary duty to shareholders with regard to compensation. In filing the complaint, plaintiffs also contended that *Gartenberg* is flawed in that it relies too much on "market prices" (relative advisory fee levels). The complaint goes on further to state that advisory fee levels charged Harris's institutional clients are the appropriate benchmarks to use when assessing fees' fairness and reasonableness and that economies-of-scale were not appropriately passed on to shareholders. Lastly, the plaintiffs claim that, regardless of the '40 Act's definition of independence with regard to boardmembers, an ex-Harris partner should be deemed interested even though he legally fit the definition of disinterested.

In the opinion of this author, none of these claims were valid (and were dismissed by the court). First, the *Gartenberg* decision rightfully relied much less on market prices and much more on process as have future decisions attached to subsequent excessive fee complaints. Second, participants and observers of the mutual fund business agree, with virtually no exception, that managing a retail mutual fund is not directly comparable business- or cost-wise to an institutional investment account. Thus, the level of advisory fees charged institutional clients does not necessarily imply that similar retail products (with higher fees) are being charged excessively. The issue of economies generated by retail vs. institutional funds/accounts differs as well. Lastly, KFS supports the court's opinion that the status of the ex-Harris Trustee as independent is legally valid and, most importantly, did not hinder the validity of the advisory contract renewal negotiations that transpired.

Chief judge easterbrook's perspective

The *Gartenberg* approach and philosophy is clearly disapproved and gladly disgarded by Chief Judge Easterbrook in the Harris case. What is viewed as an approach that insufficiently relies on market forces morphs into a economic tutorial by Easterbrook. He states that "…holding down costs is vital in competition" and that "…mutual funds have a powerful reason to keep [advisory fees] low." Thus, he concludes that the court reasons "…we are skeptical of *Gartenberg* because is relies too little on markets."

The cornerstone of Easterbrook's opinion is a strong belief in classic trust law that defines fiduciary differently (than *Gartenberg*), i.e., a fiduciary's duty is not to determine fee levels or their reasonableness, but to ensure that no "tricks" are played, full disclosure is practiced, and candor is evident. He believes no artificial cap on compensation should exist – the market determines what will be borne. Easterbrook's perspective may be summed up by "Competitive processes are imperfect but remain superior to a just price system administered by the judiciary." He further reinforces his position with "Judicial price-setting does not accompany fiduciary duties." The Chief Judge cites a Senate Committee report that agrees with his position that a link between fiduciary duty and reasonableness of fees does not exist.

Continuing with his free market argument, Easterbrook claims that "…8,000 funds are enough to put competitive pressure on advisory fees" and "…sophisticated investors put enough pressure on prices to protect the rest." Clearly, underlying his argument is a strong conviction that prices (advisory fee levels) drive demand, investors are free to redeem and reinvest in other funds, competition is wide in the funds business, and that funds which seek to charge investors "excessive fees" will – in time – simply go out of business.

Counterarguments to easterbrook

In the view of KFS, several counterarguments arise when closely examining and picking apart Chief Judge Easterbrook's opinion. His belief in a low intervention economic system is understandable, but arguably only partially applicable to the mutual fund business model.

First, his rationale is very dependent on two primary factors: pressure on advisory fees is based on industry competition and shareholders' acute focus on fee levels. Yet, are advisory fees truly one of the top determinants of fund selection? If they are not, how can price pressure be exerted? One can surely make the case that bottom-line investment returns, service, complex reputation, and containment of volatility typically rise above fee levels in an investor's mind when choosing a mutual fund. Would an investor seriously consider redemption if his/her fund decided to raise advisory fees by, say, 10 basis points if long-term returns and service had been competitive and even if the new fee level is somewhat above perceived industry benchmarks? This reaction is unlikely. One may also point to the lack of widely available advisory fee and (less so) total expense benchmarks with which to compare, thus effectively reducing the prominence of this selection criterion.

One might argue that buffering or holding down fees is only critical if performance rankings are noncompetitive and service is poor. Furthermore, many fund assets are 'sticky' due to being offered in a qualified plan, part of a limited wrap program, or on a 'short list' of intermediary recommended funds. General investor procrastination and reluctance to shift portfolios seen at one time as diversified, well-researched, and rock solid may also promote status quo maintenance.

With regard to competition, if one buys into the notion that advisor/managers do not truly compete against one another for fund business – as expressed in *Gartenberg – and* that many shareholders are 'captive' in some way, then price competition is significant diluted. Aside from the "no reasonable relationship" condition (between services rendered and price), market forces are generally not 100% free to determine mutual fund flows and exert pressure on fees.

Second, 'frictions' exist in the mutual fund business model that impede flows amongst competing funds. One may view them as "understandable disincentives" or "fund companies' enviable way to generate more stable revenues" or "a way to protect investors from their own market timing inadequacies," but they clearly serve to keep investors invested for a reasonable period of time. For an investor to redeem a fund based on unacceptable relative cost, they may have to: 1) pay a redemption fee; 2) pay a load on a new fund; 3) pay an exchange fee; 4) have to conduct research on a replacement fund; and 5) potentially are 'forced' to reallocate their portfolio(s). The process is not simple, may involve expense, and could many times be met with resistance by investors. Frictions may frequently trump allegedly free market forces.

Third, Easterbrook argues that mutual fund advisors have a "…powerful reason to keep [advisory fees] low." This author would argue that fund advisors logically thinking like shrewd businessmen only have a large incentive to keep fee levels low if the market punishes higher-fee funds with little or no cash flows, intermediaries have shown a preference for lower-fee funds, (net) performance rankings are significantly impacted by fee levels, or the fund board has threatened to shop elsewhere for a new advisor if an amicable fee negotiation has not taken place. While Investment Company Institute research has shown that low-fee funds have recently attracted the lion's share of fund flows, this fact does not prove that fees drove the decisions to invest with the likes of Vanguard, Fidelity, American Funds, Dodge & Cox, T. Rowe Price and the like. Solid reputation, service, net returns, and extensive product lines could have easily been as or more persuasive.

As far as financial intermediaries' preference for lower-fee funds, widely diverse flows to funds of all cost levels persist and demonstrate that other factors beyond expense drive investment decisions. Intermediaries must exercise their fiduciary duty by considering fees to be a significant fund selection criterion (and increasingly do so), yet this does not mean that fees truly drive the fund investment decision(s). Frankly, if one still truly believes in an equity fund manager's raw talents, does that not overshadow a seemingly trivial cost issue? With regard to boards throwing down their 'ace in the hole' (ability to not renew the current contract), directors understandably possess trepidation to invoke the 'nuclear option' by firing a fund's advisor and signing a new advisor. Given the turmoil for portfolio management teams (and likely detriment to returns short-term) and service providers, such drastic action is only justified when all other options have been exhausted. For good reason, very rarely has this scenario occurred in the business.

Fourth, turning to the issue of Easterbrook's support of classic fiduciary law versus how *Gartenberg* essentially defined the fiduciary role of mutual fund directors, the waters become murky. The classic definition of fiduciary appears to rest on the assumption that economic forces are free to set prices and thus, high-cost providers will eventually be forced out of business. As argued previously, a truly free market simply does not exist. While classic fiduciary law does and should apply to boards of mutual fund directors, is it fully applicable given the less-than-perfect-competitive market model? For a fiduciary to simply prevent "tricks," fees that are "so unusual," and ensuring full candor of all compensation arrangements hardly seems adequate. Is it not more prudent from an investor advocate and protection standpoint, to account for the market frictions knowledgably and realistically using board-entrusted oversights to ensure prices stay "fair" and "reasonable?" KFS would argue "yes." To get an idea of prices sans independent board oversight, one simply has to look to Europe where painfully interested boards of publicly available pooled investment vehicles routinely charge their fund investors 20-25 bp more for advisory services than in the U.S. (*Source: Lipper Inc.*).

Fifth, a case is also made that sophisticated (presumably institutional) investors drive the demand for lower prices which in turn benefits the 'little guy.' A large proportion of fund investments now reside in qualified retirement plans where other less expensive – but not necessarily more attractive – options in which to switch may not exist. Cost was surely at least a partial determinant of fund selection at the time investment options were chosen. However, costs can shift, plans do not typically modify plan investment options that often, and third party plan administrators may have a limited menu of fund choices. Furthermore, "bundled service providers" may offer limited, and sometimes more expensive, investment options to small plan sponsors (corporations). Couple these facts with the belief that cost may not be the primary determinant of fund selection and the concept of the sophisticated investors' price clout becomes somewhat moot. Furthermore, many large institutions increasingly invest not in retail funds' "I" or "Y" classes where they may be subject to retail pricing, but in an institutionally-designated fund series or separate and commingled accounts.

Lastly, and to Easterbrook's point that the judicial system should not determine advisory fee levels, KFS emphatically agrees. The mutual fund business should have the checks and balances in place to monitor advisory fees and total expenses, examine an advisor's financial condition, and generally protect investors' interests. And, it essentially does! Section 15(c), a board of directors/trustees, and *Gartenberg* dovetail to form a framework inside of which directors create fairness, advocacy, equity, and perpetuate/ensure solid business models. *Gartenberg* also rightfully shied away from rate setting, reinforced that the court would not substitute its judgment for that of a board, and focused on process. Frankly, any defensible 15(c) model should prompt diligent boards to bring to bear any relevant factors viewed as pertinent and apply their business judgment in their determination of a fund advisory contract's fairness and reasonableness.

Implications for 15(c): what's a board to do?

In the opinion of KFS and using the Harris case as the newest addition to the 15(c) landscape, boards should consider the following:

- Be aware of all the circumstances surrounding the Harris case
- Understand that the case is only legally applicable to the Seventh Circuit, yet may be – marginally or seriously – considered by Judges in other circuits henceforth
- Taking a broader, more involved, and prudent stance, continue to apply the *Gartenberg* standard(s) and 6 factors to the 15(c) process
- Consider that fee benchmarking may now be more vital and profitability may be less so
- As necessary, ask for further information and clarity when your board feels it cannot fully apply its business judgment to the 15(c) process
- Consult with board counsel regarding his/her opinion on the validity of the Harris decision, how it should or should not impact the actions that are undertaken by your board, and ripples that may occur from Judge Easterbrook's opinion
- Inquire regularly about new 36(b) complaints that arise

What are some lessons that directors might take away?

- Case history has taught us that *Gartenberg* is a judgment fully embraced by the funds business for over 25 years and has held up under heavy scrutiny
- Yet, the Harris case also teaches us that *Gartenberg* could benefit from some updated interpretations
- Using the *Gartenberg* standard as a defense, no plaintiffs have been successful, yet a number of cases have been understandably settled out of court to avoid potentially bad publicity and unnecessary cost
- The basis of case law decisions may prove to be more literal or 'legal in nature' while complaint resolutions can point to more practical approaches
- The legal landscape shifts as the business matures and promotes constant monitoring
- It is in boards' best interests to be fully aware of the fiduciary duty-based cases that transpire and how they may impact reasonable perspectives on how to carry out one's watchdog responsibilities

Generally, a board or trustee/director that consciously or unconsciously creates a shield from the latest thinking on 15(c) process and fiduciary duty is likely to run some risks.

Concluding remarks

While the Harris case serves to challenge *Gartenberg* and was watched closely by business observers, it has likely neither widely compromised the validity of *Gartenberg* nor significantly minimized its current prominence. However, KFS understands that an appeal was unsuccessful and a Supreme Court hearing may be sought. Many '40 Act law firms providing counsel to boards of directors have publicly indicated that support for *Gartenberg* will continue and the 6 factors will reign supreme as the 15(c) process of choice. Thus, it would appear that boards are well-advised to embrace the belief that reasonable fees should continue to be determined through a combination of carefully crafted inquiries, benchmarking, negotiation, financial considerations, and thorough (documented) due diligence.

What might one expect from 36(b) litigation going forward? The tact taken by plaintiffs to date has possessed common threads and suits continue to surface, yet ‘success’ has been minimal. So, does this mean that a different mode of attack should be expected? Prognosticating a bit, the latest barrage of finance services company failures, government interventions, money market fund defaults, and the mortgage market meltdown may spur new fiduciary duty suits potentially intertwining fiduciary duty, performance and compliance, and claiming inappropriate compensation on more than one level.

While it appears today that the Harris case stance may have little fund business impact, its novel approach has yet to be formally invalidated. If the Supreme Court agrees to review the case and upholds the Harris decision, then far fewer 36(b) cases are likely and defendants have little incentive to settle. While the case breaks joyous ground from the viewpoint of fund companies concerned about excessive fee litigation, is such support for the Harris opinion a positive development for board oversight and ultimately shareholders’ interests? One should surely consider that – given fund business conditions – “excessive fees” can only be determined through careful examination of many factors unique to each advisor’s organization, their financial realities, and their overall capacity to generate shareholder value. Is thorough board due diligence that uncovers business models, streams of revenues, relative fee levels, tertiary benefits, and margins in the 15(c) arena not more desirable than simply relying on questionable market forces and the occasional slapping of a trickster’s wrist by so-called classic fiduciaries?

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