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EMPLOYEE BENEFITS

Employee Retirement Income Security Act

Supreme Court Ruling on Excessive Fee Claim Against Mutual Fund Investment Advisor May Have Implications for ERISA Excessive Fee Cases

BY SUSAN PETERS SCHAEFER, MICHAEL T. GRAHAM, AND BRIAN J. TIEMANN

The U.S. Supreme Court recently ruled in *Jones v. Harris Associates LP*,[1] that fees paid to a mutual fund's investment advisor will not violate the advisor's fiduciary duty under the Investment Company Act of 1940 (the Act), unless the fees are so disproportionately large that they could not have been the product of arm's-length bargaining. This decision is expected to have a substantial impact for plans and fiduciaries defending the rash of pending litigation under the Employee Retirement Income Security Act of 1974, as amended (ERISA), involving allegations of excessive fees charged by service providers under 401(k) plans.

[1] 78 U.S.L.W. 4229 (U.S. 2010).

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Background

U.S. Congress enacted the Act to create protections for mutual funds and their shareholders against potential abuses by the mutual funds' investment advisors. Among other requirements, under Section 36(b) of the Act, an investment advisor is subject to a fiduciary duty with respect to the fees it charges the fund for its services. The Act also requires that a board of trustees be appointed to oversee the fund annual review and approve the contract with the advisor as well as the amount of the advisor's compensation from the fund.

The plaintiffs in *Jones*, shareholders in mutual funds managed by the defendant investment advisor, filed suit derivatively on behalf of the funds, claiming that the defendant breached its fiduciary duty under the Act with respect to the amount of compensation it charged the fund.

Although the defendant charged fees comparable to the fees that other investment advisors charged similar mutual funds, the fees were nearly twice the amount that the advisor charged institutional clients for similar services.

Reviewing cross motions for summary judgment, the U.S. District Court for the Northern District of Illinois concluded that the proper standard for adjudicating an investment advisor's breach of fiduciary duty under the

Act was set forth by the U.S. Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management*.[2]

Under the *Gartenberg* standard, an investment advisor breaches the advisor's fiduciary duty under the Act if the fee it charges the fund 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 in light of all of the surrounding circumstances.

After reviewing the fees that the defendant received from the funds, the fees that the defendant charged to other clients and the fees that other investment advisors charged similar mutual funds, the district court concluded that the amount of fees at issue did not raise a triable issue under the *Gartenberg* standard and granted summary judgment for the investment advisor.

On appeal, the Seventh Circuit affirmed the district court's judgment in favor of the investment advisor, but rejected *Gartenberg* as the standard under which such breach of fiduciary duty claims should be adjudicated.[3] Instead, the

Seventh Circuit concluded that an investment advisor breaches the advisor's fiduciary duty under the Act only if the advisor fails to fully disclose the facts relevant to its fees to the fund's board of trustees. An analysis of the advisor's compensation from the fund is only relevant under the Seventh Circuit's standard if it is so unusual that it raises an inference that deceit must have occurred or that the fund's board of trustees failed to engage in an arm's-length negotiation of the fees.

Supreme Court's Decision

Writing on behalf of a unanimous court, Justice Alito rejected the Seventh Circuit's standard of full disclosure and instead embraced *Gartenberg* as the correct standard for adjudicating whether an investment advisor breached the advisor's fiduciary duty to mutual fund shareholders under the Act. In doing so, the Supreme Court noted that *Gartenberg* has been the workable standard that a majority of the lower courts have followed in such cases for nearly 30 years.

The court concluded that the *Gartenberg* decision accurately reflects the compromise that is embodied in Section 36(b) of the Act between protecting mutual fund shareholders from fee arrangements that are not negotiated at arm's length while simultaneously shifting the burden of proving that the investment advisor breached the advisor's fiduciary duty to the party alleging the breach. Typically in actions for a breach of fiduciary duty, the fiduciary bears the burden of proving that it did not breach its duty. However, Section 36(b) of the Act shifts this burden away from the investment advisor and requires the plaintiff to prove that the fees the advisor charged to the fund were so excessive that the advisor breached the fiduciary duty.

In evaluating an investment advisor's compliance with the fiduciary duty under the Act, the court noted that the Act does not require the courts to engage in a precise calculation of the fees that would result from arm's-length negotiations between the advisor and the mutual fund's board of trustees. Comparisons between the amount of the challenged advisor's fees from the fund and the fees that the advisor charges other clients for investment advisory services may be relevant, provided that such comparisons consider the similarities and differences between the services the advisor provides to the mutual fund and those it provides other clients. In addition, the court concluded that comparisons with the fees that other investment advisors charge similar mutual funds for advisory services are not probative because there is no evidence that such fee arrangements are the product of arm's-length negotiations.

The court also concluded that any assessment of the reasonableness of the investment advisor's fees must take into account the procedural safeguards of Section 36(b) of the Act, which require the fund's board of trustees to annually review and approve the fund's contract with the advisor and the amount of the advisor's compensation.

Justice Alito cautioned that courts should not second guess the informed decisions of a mutual fund's board of trustees.

Rather, courts should defer to the decisions of the board of trustees if the decisions are the result of a ''robust'' process for reviewing and approving the amount of the advisor's compensation from the fund. If the board of trustees considered the relevant factors in agreeing to the fee arrangement, the court should give its decisions considerable weight, even if the court may weigh the factors differently. Closer judicial scrutiny of the fee arrangement is only required if a court concludes that the board's process was deficient or if the advisor failed to disclose relevant information to the board, such that the board was unable to make an informed decision regardless of the process by which the decision was made.

In light of its adoption of *Gartenberg* as the standard by which an investment advisor's compliance with its fiduciary duty under the Act should be adjudicated, Justice Alito vacated the ruling of the Seventh Circuit and remanded *Jones* for further consideration by the lower courts.

Impact on Plan Sponsors and Fiduciaries

Although the court's ruling in *Jones* is limited to claims of an investment advisor's breach of fiduciary duty under the Act with respect to the fees it charges to a mutual fund for its services, the decision may lend support for courts to apply the *Gartenberg* standard to excessive fees cases brought under ERISA. The Second Circuit has already concluded that *Gartenberg* is the correct standard for adjudicating a breach of fiduciary duty claim with respect to excessive fees under ERISA in *Young v. General Motors*.[4]

In light of the court's ruling in *Jones*, more courts may be willing to follow the Second Circuit's lead in applying the *Gartenberg* standard in the ERISA context, which will lead to greater deference to fee arrangements made by plan sponsors and fiduciaries provided they engage in a robust process to ensure such fees are negotiated at arm's length.

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

[3] 527 F.3d 627 (7th Cir. 2008).

[4] 46 Employee Benefits Cas. (BNA) 2278 (2d Cir. 2009).

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