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Jones V. Harris Associates, L.P.: The Unconflicted Fiduciary

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Jones v. Harris Associates, L.P.: The Unconflicted Fiduciary

COLLEEN DEL CASINO*

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A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

—Chief Judge Cardozo¹

I. INTRODUCTION

Roughly half of American households invest in mutual funds,² making the mutual fund industry both highly lucrative³ and subject to

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1. *Meinhard v. Salmon*, 164 N.E. 545, 536 (N.Y. 1928) (citations omitted).

2. John P. Freeman et al., *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Test*, 61 OKLA. L. REV. 83, 83 (2008) (citing INV. CO. INST., 2006 INVESTMENT COMPANY FACT BOOK (46th ed. 2006)). "According to one industry insider, most of the money saved by Americans from 1999–2001 was used to purchase mutual fund shares." *Id.* at 83 n.2.

3. *Id.* at 89 (noting that two of the top three best performing American stocks over the last twenty-five years were mutual fund sponsors); *id.* at 90–91 ("Compound average annual returns

considerable debate over just how lucrative it *ought* to be.⁴ This debate is as much ethical as it is economic and stems, in part, from the fact that mutual funds have been successfully marketed as an everyman's investment tool, while employing a unique corporate structure that is "fraught with potential conflicts of interest"⁵ and encourages self-dealing to the detriment of unsophisticated investors.⁶

Simply put, mutual funds are "created and managed by a pre-existing external organization known as an investment adviser which generally supervises the daily operation of the fund and often selects affiliated persons to serve on the company's board of directors."⁷ Industry critics argue that because of the tightly intertwined arrangement between a fund and its adviser, mutual fund boards cannot, "as a practical matter, terminate their relationships with their advisers."⁸ Thus, advisers, free from competitive pressures, are able to charge their aptly named "captive funds" fees for advisory services⁹ that are well above market value.¹⁰ Moreover, because the advisory fee structure is usually set up as a percentage of assets under management, as the fund grows, so does the possibility that fees will become excessive.¹¹

The Supreme Court has twice recognized that it was Congress's concern over the "potential for abuse inherent in the structure of investment companies[,]"¹² that prompted it to enact the Investment Company

for the five largest publically traded fund sponsors were more than double returns on the S&P 500 market index over corresponding periods.").

4. Compare John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 154-60 (2007) with Freeman et al., *supra* note 2.

5. Brief for United States as Amicus Curiae Supporting Petitioners at 2, *Jones v. Harris Assocs. L.P.*, No. 08-586 (U.S. June 15, 2009) [hereinafter Brief for United States] (quoting *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984)).

6. See Coates & Hubbard, *supra* note 4 (summarizing criticisms of the mutual fund industry).

7. Brief for United States, *supra* note 5, at 2 (quoting *Daily Income Fund*, 464 U.S. at 536 (internal quotations omitted)).

8. *Id.* at 3 (citing SEC. EXCH. COMM'N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 148 (1966)).

9. Although the investment adviser often provides some other managerial services to the fund, the adviser's primary duty is research and stock selection. See Freeman et al., *supra* note 2, at 1-2.

10. See generally *id.* (comparing captive mutual fund advisory fees to advisory fees paid by other investors who purchase portfolio management services on the open market and finding that captive funds paid at least double for equivalent services).

11. *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 820-21 (8th Cir. 2009). See generally Freeman et al., *supra* note 2 (discussing how economies of scale lead to excessive advisory fees). But see Coates & Hubbard, *supra* note 4 (arguing that economies of scale are relatively modest and do not create windfall profits for advisers as the fund grows).

12. *Daily Income Fund*, 464 U.S. at 536 (quoting *Burks v. Lasker*, 441 U.S. 471, 480 (1979)).

Act of 1940,¹³ a regulatory scheme designed to increase board independence and improve disclosure and transparency.¹⁴ In response to claims that the ICA hadn't gone far enough to protect investors,¹⁵ the ICA was amended in 1970 to include, *inter alia*, section 36(b), which imposes a "fiduciary duty with respect to the receipt of compensation for services" on investment advisers.¹⁶

In *Jones v. Harris Associates L.P.*,¹⁷ mutual fund investors alleged that their adviser had breached this statutory fiduciary duty by charging its captive fund roughly double what it charged its independent institutional clients, such as pension funds, for similar services.¹⁸ In an opinion authored by Chief Judge Easterbrook, the Seventh Circuit affirmed summary judgment in favor of the adviser, holding "[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation."¹⁹ In doing so, the Seventh Circuit: (1) continued the nearly thirty-year streak of adviser victories in mutual fund fee cases;²⁰ (2) explicitly rejected the long standing *Gartenberg* standard for evaluating section 36(b) claims;²¹ and (3) prompted the Supreme Court to grant

13. 15 U.S.C. § 80a-1 *et seq.* The Investment Company Act will be referred to textually as the "ICA."

14. See *Daily Income Fund*, 464 U.S. at 536–37; Brief for United States, *supra* note 5, at 2.

15. See S. REP. NO. 91-184 (1969), reprinted in 1970 U.S.C.C.A.N. 9847; see also *Daily Income Fund*, 464 U.S. at 537–38; *Burks*, 441 U.S. at 482.

16. Section 36(b) of the Investment Company Act states in relevant part:

[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser . . . for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company . . . to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances.

15 U.S.C. § 80a-35(b) (2006).

17. *Jones v. Harris Assocs., L.P. (Jones II)*, 527 F.3d 627 (7th Cir. 2008), vacated, 130 S. Ct. 1418 (2010).

18. *Id.* at 631.

19. *Id.* at 632.

20. See *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 823 n.4 (8th Cir. 2009) (noting that no investor has obtained a verdict against an investment adviser in the twenty-five years since *Gartenberg*) (citation omitted); Sam Mamudi, *Ruling Over Fees Raises the Stakes*, WALL ST. J., Apr. 15, 2009, at C11.

21. The widely accepted standard rejected by *Jones* was established in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982). *Jones v. Harris Assocs., L.P. (Jones III)*,

certiorari to resolve the circuit split.²²

This note argues that by misconstruing (if not purposefully circumventing) the fiduciary duty imposed by section 36(b), *Jones* created a standard that is blatantly unfaithful to the ICA's language and purpose. However, this note further argues that the Supreme Court need not have granted certiorari to disapprove of Judge Easterbrook's standard because although it *appears* to be a radical departure, an analysis under *Jones* is the functional equivalent of an analysis under *Gartenberg*.

Part I of this note analyzes the relevant law leading up to *Jones*, specifically focusing on the *Gartenberg* standard and the confusion that developed with regard to the parameters of the fiduciary duty under 36(b).

Part II briefly discusses the facts and procedural posture of *Jones* including Judge Easterbrook's panel opinion and Judge Posner's dissent from the Seventh Circuit's decision to deny rehearing *en banc*. Additionally, Part II analyzes Judge Easterbrook's interpretation of the fiduciary duty imposed by section 36(b) and argues that the standard he advances is of little practical significance in terms of affecting the outcome of section 36(b) claims.

Part III explains the various approaches proposed by the parties on appeal to the Supreme Court and also explores some of the scholarly debate that developed in the wake of the Seventh Circuit's decision. This section briefly addresses the Supreme Court's opinion vacating *Jones*; however, because the opinion is primarily a reaffirmation of the *Gartenberg* standard, it is not the focus of this article. Rather, this section argues that no judicially created standard adequately protects investors. Real reform in this area has to come from Congress because no court can fix the underlying problem with section 36(b)—its allocation of the burden of proof to plaintiffs. Finally, this section explores the implications of a burden of proof properly allocated to defendants.

II: A HISTORY IGNORED: THE ICA, THE *GARTENBERG* STANDARD, AND THE FIDUCIARY DUTY IN PRACTICE

Prior to the Investment Company Amendments Act of 1970,²³ courts evaluated claims challenging advisory fees under the corporate waste standard.²⁴ Under this standard, "an unreasonable or unfair fee

537 F.3d 728, 729 (7th Cir. 2008) (denying rehearing *en banc*) (Posner, J., dissenting); see discussion *infra* Part III.

22. *Jones v. Harris Assocs., L.P.*, 129 S. Ct. 1579 (2009) (granting certiorari).

23. Pub. L. No. 91-547, 84 Stat. 1413.

24. Daniel D. Birk, Note, *A Hermeneutics of Suspicion: Jones v. Harris Associates, L.P. and the Limits of Public Choice Textualism*, 104 Nw. U. L. Rev. (forthcoming 2010), available at

might be approved unless the court deemed it ‘unconscionable’ or ‘shocking.’”²⁵ Not surprisingly, lawsuits under this lenient standard were largely ineffective at curbing perceived fee abuses by advisers.²⁶ In response to mounting concerns over the rapidly expanding mutual fund industry,²⁷ the ICA was amended to include section 36(b), which imposes on advisers a “fiduciary duty with respect to the receipt of compensation”²⁸ and gives investors an apparent remedy—a private right of action against an adviser who breaches this duty.²⁹

Although the ICA places the burden of proving a breach of fiduciary duty on the plaintiff, the act makes clear that it is not necessary for the plaintiff “to allege or prove that any defendant engaged in personal misconduct.”³⁰ In addition, section 36(b) requires that “approval by the board of directors . . . of such compensation . . . be given such consideration by the court as deemed appropriate under the circumstances.”³¹

Notably, section 36(b) does not specify what constitutes a breach of the adviser’s fiduciary duty as to compensation.³² Thus, the sizeable task of developing a workable standard that was consistent with the legislature’s intent was left to the courts.³³

A. *The Rise of the Gartenberg Standard*

In *Gartenberg v. Merrill Lynch Asset Management*,³⁴ the Second Circuit attempted to carry out this task, and in doing so “created the framework that has served as the starting point for interpreting a fund adviser’s fiduciary duty”³⁵ for the last twenty-eight years. In *Gartenberg*, mutual fund investors alleged, “because of their fund’s exponential growth, the adviser’s fee had become so disproportionately large that it constituted a breach of fiduciary duty.”³⁶ After a bench trial,

<http://ssrn.com/abstract=1392562> (citing *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 541 n.12 (1984)).

25. *Id.* (quoting *Daily Income Fund*, 464 U.S. at 541 n.12 (1984)).

26. *Id.*

27. Brief for United States, *supra* note 5, at 3 (citing *Daily Income Fund, Inc.*, 464 U.S. at 537–41); S. REP. NO. 91-184, at 6 (1969), *reprinted in* 1970 U.S.C.C.A.N. 9847.

28. 15 U.S.C. § 80a-35(b) (2006). *See text supra* note 16.

29. § 80a-35(b).

30. *Id.*

31. *Id.*

32. *Jones v. Harris Assocs., L.P. (Jones I)*, No. 04 C 8305, 2007 WL 627640, at *4 (N.D. Ill. Feb. 27, 2007), *aff’d*, 527 F.3d 627 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010) (“The statute does not delineate the specific boundaries of the fiduciary duty it imposes on investment advisers . . .”).

33. *See id.*

34. 694 F.2d 923 (2d Cir. 1982).

35. *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 821 (8th Cir. 2009).

36. *Id.*

the district court found that the fees “were comparable to those charged to other money market funds,” and on that basis, ruled in favor of Merrill Lynch.³⁷ On appeal, the Second Circuit refused to find the mere comparability of fees dispositive. The court noted that section 36(b) was enacted for the purpose of mitigating the competitive deficiencies inherent in the mutual fund market,³⁸ and held that in order to breach its fiduciary duty “the adviser-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 a product of arms-length bargaining.”³⁹

The Second Circuit then listed a number of non-exclusive factors “bearing upon whether an adviser’s compensation was within the range that could be expected to result from an arms-length bargain[]. . . .”⁴⁰ Namely, the quality of the services provided by the adviser; the profitability of the fund to the adviser; fall-out benefits (i.e., “non-fund securities business generated by fund customers and interest income on funds (known as the ‘float’)”);⁴¹ economies of scale; the fee structure of comparable funds; and the independence, expertise, and the care and conscientiousness of the board of directors.⁴²

In short, the *Gartenberg* standard established that the fees charged to comparable funds should be one aspect of the analysis, while acknowledging that this one factor could not provide a complete picture. Because of the insulated nature of the mutual fund market, the court reasoned, mere “reliance on prevailing industry advisory fees will not satisfy § 36(b).”⁴³ Moreover, the court specifically noted that while candor and proper disclosure during the negotiation process were relevant to the 36(b) analysis, alone they could not insulate the adviser from breaching its fiduciary duty where the fee charged was “disproportionately large” in relation to the services rendered.⁴⁴ By requiring an analysis of “all pertinent facts,”⁴⁵ that is, both *process* (at least to some degree) and *price* in relation to value, *Gartenberg* properly gave effect to the lan-

37. *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff’d*, 694 F.2d at 928 (2d Cir. 1982).

38. *Gallus*, 561 F.3d at 821.

39. *Gartenberg*, 694 F.2d at 928 (emphasis added).

40. *Jones I*, No. 04 C 8305, 2007 WL 627640, at *6 (N.D. Ill. Feb. 27, 2007), *aff’d*, 527 F.3d 627 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010).

41. *Gartenberg*, 694 F.2d at 932.

42. *Id.* at 928–31.

43. *Id.* at 929.

44. *Id.* at 930. (“[E]ven if the trustees of a fund endeavored to act in a responsible fashion, and adviser-manager’s fee could be so disproportionately large as to amount to a breach of fiduciary duty in violation of § 36(b).”).

45. *Id.* at 929.

guage in section 36(b) requiring that a reviewing court give the board's approval of an adviser's compensation appropriate consideration "under all the circumstances."⁴⁶

Ultimately however, the standard, which on its face appeared to be a success for plaintiffs, proved too difficult to meet. The Second Circuit affirmed the district court's dismissal, reasoning that plaintiffs had failed to meet their burden of showing that the fees were "so excessive or unfair as to amount to a breach of fiduciary duty within the meaning of 36(b)."⁴⁷ Specifically, the court pointed to the fact that fund investors had "enjoyed a better-than-average return"⁴⁸ while rejecting plaintiffs' economies of scale and fall out benefits arguments for lack of proof.⁴⁹ *Gartenberg* would prove to be the first in a long line of cases to come to this result.

B. *Parameters of the Fiduciary Duty Under Section 36(b): A Comparative Analysis*

Although the *Gartenberg* standard was widely accepted,⁵⁰ the language of section 36(b) is exceedingly vague. (In fact, during oral argument, with regard to the 36(b)(2) provision requiring the Court to give the board of director's approval of the fee "such consideration . . . as is deemed appropriate under all the circumstances[,]” Justice Scalia sarcastically quipped, “That’s a wonderfully clear command, isn’t it?”⁵¹) As a result, even where *Gartenberg* was embraced, the Circuits differed substantially as to the weight to be given the factors.

Creating a more troublesome issue, various sections of the ICA impose requirements on investment companies with regard to board composition, director independence, and disclosure.⁵² In addition, section 36(a) of the ICA prohibits any “practice constituting a breach of

46. 15 U.S.C. 80a-35(b)(2) (2006).

47. *Gartenberg*, 694 F.2d at 930.

48. *Id.*

49. *Id.* at 930–32.

50. See *Jones III*, 537 F.3d 728, 729 (7th Cir. 2008) (providing an extensive list of cases favorably citing *Gartenberg*).

51. Transcript of Oral Argument at 30, *Jones v. Harris Assocs., L.P.*, 130 S. Ct. 1418 (2010) (No. 08-586).

52. *Migdal v. Rowe Price–Fleming Int’l, Inc.*, 248 F.3d 321, 328 (4th Cir. 2001) (citing 15 U.S.C. §§ 80a-10(a), 80a-15(c)). U.S.C. § 80a-10(a) provides that at least 40% of the board's directors must not be “interested persons” as defined by 15 U.S.C. § 80a-2. The debate over director independence has been brewing for some time in both this arena and in corporate law. In short, the argument is that definitions of “independent” are too lenient and directors are often closer to executives, or in this case, fund advisers, than is ideal. See Lyman Johnson, *A Fresh Look at Director “Independence”: Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 521 (2008), for an interesting discussion of this issue. See also discussion *infra* Part III.B.

fiduciary duty involving personal misconduct” by directors and advisers.⁵³ However, unlike section 36(b), these sections do not give investors a private right of action. Thus, after *Gartenberg* it remained unclear whether breaches of fiduciary duty involving “personal misconduct” or failures to comply with ICA mandates could be considered in an analysis of a section 36(b) breach of fiduciary duty *as to compensation*. On this issue, the federal courts reached differing results.⁵⁴

For instance, in *Migdal v. Rowe Price-Fleming International, Inc.*,⁵⁵ the Fourth Circuit rejected plaintiffs’ argument that section 36(b)’s private right of action included claims for breach of fiduciary duty in *negotiating fees*.⁵⁶ The *Migdal* plaintiffs alleged that the fund advisers breached their fiduciary duty because (1) the fees they received were excessive; and (2) their fund’s purportedly “‘independent’ directors were not actually disinterested parties as required by the ICA . . . [because they served on the boards of multiple funds] within the T. Rowe Price Fund Complex.”⁵⁷ Accordingly, they argued, their investment advisers⁵⁸ had breached their fiduciary duties under section 36(b) by failing to negotiate their advisory agreements at arms-length.⁵⁹

The court disagreed, finding, “[s]ection 36(b) is sharply focused on the question of *whether the fees themselves were excessive*, and not on the status of the directors who approved them.”⁶⁰ Consequently, the court held claims for general breaches of fiduciary duty were outside the scope of section 36(b) and would have to be brought under some other section of the ICA or under state law.⁶¹

The Third Circuit took a slightly broader view of the duty imposed by section 36(b) than the Fourth Circuit did in *Migdal*. In *Green v. Fund Asset Management, L.P.*,⁶² “[p]laintiffs, shareholders in seven closed-

53. 15 U.S.C. § 80a-35(a) (2006) (authorizing the SEC to bring an action alleging that a person acting as an “officer, director, member of any advisory board, investment adviser or depositor . . . has engaged . . . or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct”).

54. Compare *Migdal*, 248 F.3d at 321 with *Green v. Fund Asset Mgmt., L.P.*, 286 F.3d 682 (3d Cir. 2002), discussed *infra* part II.

55. 248 F.3d at 321.

56. *Id.* at 328.

57. *Id.* at 325. The *Migdal* Court noted that “[u]nder the ICA, at least forty percent of a fund’s directors must be ‘disinterested’—i.e., independent of the investment adviser.” *Id.* at 324.

58. In *Migdal*, plaintiffs were investors in two separate funds that were part of the T. Rowe Price Fund Complex. Two T. Rowe Price Affiliates served as investment advisers of plaintiffs’ respective funds. *Id.* at 325.

59. *Id.*

60. *Id.* (emphasis added).

61. *Id.* at 329. Of course, this construction is problematic because the other sections of the ICA, including section 36(a), do not provide a private right of action.

62. 286 F.3d 682 (3d Cir. 2002).

end,⁶³ publicly traded municipal investment funds,” brought suit against their investment advisers under section 36(b).⁶⁴ Interestingly, the plaintiffs in *Green* did not allege the fees charged were excessive. Rather, they contended that a fee structure incentivizing the adviser to keep the fund fully leveraged created an actual conflict of interest which “amount[ed] to a *per se* breach of fiduciary duty under 36(b).”⁶⁵ In addition, plaintiffs argued that by failing to disclose this conflict in the Funds’ prospectus, the advisers committed a “separate actionable breach of fiduciary duty.”⁶⁶

The Third Circuit held that the mere existence of a *potential* conflict of interest in a fee arrangement was not a *per se* breach of the adviser’s fiduciary duty as to compensation.⁶⁷ However, the Third Circuit did go on to consider plaintiff’s disclosure argument. The court ultimately dismissed the claim on the grounds that the defendant had adequately disclosed the method by which fees would be calculated.⁶⁸ In considering the merits of the claim, however, the court seemingly indicated that adviser behavior and statutory compliance was part of the section 36(b) “fiduciary duty with respect to fees” analysis—a significant departure from the Fourth Circuit’s interpretation.

Yet, just five months after *Green*, the Third Circuit heard another advisor fee case and narrowed its interpretation of section 36(b). In *Krantz v. Prudential Investments Fund Management, LLC*,⁶⁹ the Third Circuit likened the plaintiffs’ claims to those made by the plaintiffs in *Migdal*. Adopting the reasoning of the Fourth Circuit, the *Krantz* Court rejected the argument that advisers could breach their section 36(b) fiduciary duty by accepting a fee negotiated by directors who were not “disinterested.” First, the court held that plaintiffs must allege “facts indicating that the fees received were disproportionate to services rendered”⁷⁰ in order to survive a motion to dismiss.⁷¹ Additionally, the

63. Closed-end funds differ from open-end funds in that they have “fixed capitalization and may sell only the number of shares of its own stock as it originally authorized. . . . [Additionally,] securities are not redeemed at the shareholder’s option and shares are traded on a secondary market.” *Jones I*, No. 04 C 8305, 2007 WL 627640, at *4 (N.D. Ill. Feb. 27, 2007), *aff’d*, 527 F.3d 627 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010) (quoting *Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 740 (7th Cir. 2002)).

64. *Green*, 286 F.3d at 683.

65. *Id.* at 684.

66. *Id.*

67. *Green*, 286 F.3d at 685. Plaintiffs were unable to point to any instance during the ICA’s one-year limitation period where the advisers actually failed to de-leverage the Funds in order to maximize their fees where it would have been in the investors best interest to do so. *Id.* at 686.

68. *Id.* at 686.

69. 305 F.3d 140 (3d Cir. 2002).

70. *Id.* at 143.

71. The court further concluded that *Krantz* had failed to do so. *Id.*

court rejected plaintiffs' claim that the directors were "interested" within the meaning section 10(a) of the Act⁷² by virtue of the fact that they participated on multiple boards.⁷³

One of two things may be deduced from this holding. First, the court may have been dismissing the argument that directors could somehow be "interested" even when they do not fall strictly within the section 2(a)(19)⁷⁴ definition of an "interested person." Alternatively, and more likely in light of the court's endorsement of *Migdal*, the holding stands for the proposition that even if the directors were "interested" as defined by the Act, this would not, in and of itself, constitute a breach of section 36(b) so long as the fees negotiated by the interested directors were not disproportionately large.

Thus, both the Fourth and Third Circuits ultimately seemed to agree that it is acceptance of a disproportionately large fee, and *not* the process by which the fee is negotiated that is the linchpin of the section 36(b) analysis. Under this interpretation, the ICA necessarily does *not* give investors a private right of action against advisers simply because they fail to comply with procedural requirements in negotiating fees.

Interestingly, in 2009, the Eighth Circuit breathed new life into the broad reading of the fiduciary duty imposed by section 36(b). In *Gallus v. Ameriprise Financial, Inc.*,⁷⁵ plaintiffs alleged that their adviser, Ameriprise, breached its fiduciary duty not only by charging an excessive fee relative to the fees charged to its institutional clients, but also by actively misleading the board of directors into accepting this fee.⁷⁶ Ameriprise, on the other hand, argued that it did not mislead the board, and that in any event, the fees charged to institutional clients were irrelevant for the purpose of determining if a fee was disproportionately large. An adviser, they argued, cannot be liable for breach of fiduciary duty under section 36(b) so long as its fees are in line with the fees paid by other mutual funds.⁷⁷

Adopting an enhanced standard resembling the "entire fairness" standard found in corporate law (albeit, with a reversed burden of proof),⁷⁸ the Eighth Circuit rejected defendant's arguments. Reversing a summary judgment in Ameriprise's favor, the *Gallus* Court found that

72. 15 U.S.C. §80a-10(a) (2006).

73. *Krantz*, 305 F.3d at 142.

74. 15 U.S.C. § 80a-2 (2006).

75. 561 F.3d 816 (8th Cir. 2009), *vacated*, 130 S. Ct. 2340 (2010) (mem.).

76. *Id.* at 818. Plaintiffs cited the "San Diego Office Report," which Ameriprise had provided at the board's request. The report purported to compare the fees paid by Ameriprise's mutual funds with those of its institutional investors. Plaintiffs' experts testified that the report omitted information in order to make the fee discrepancy seem smaller than it was. *Id.*

77. *Id.* at 820.

78. See discussion *infra* Part III.C.

Gartenberg “provided a useful framework for resolving claims of excessive fees”⁷⁹ but that the fiduciary duty contemplated by section 36(b) *also* includes an analysis of the adviser’s conduct during negotiation:

We believe that the proper approach to § 36(b) is one that looks to both the adviser’s conduct during negotiation and the end result. . . . Unscrupulous behavior with respect to *either* can constitute a breach of fiduciary duty. . . . The district court should not have engaged in so limited a scope of review. Ameriprise’s *conduct must be evaluated independent from the result of the negotiation*. The district court concluded that Ameriprise did not breach its fiduciary duty in one way (by setting a fee that was exorbitant relative to that of other advisers), but it should have also considered other possible violations of § 36(b). Specifically, the court should have determined whether Ameriprise purposefully omitted, disguised, or obfuscated information that it presented to the Board about the fee discrepancy between different types of clients. The record indicates that there are material questions of fact on this issue.⁸⁰

However, even the *Gallus* Court went on to recognize that “Congress allocated the *burden of proof to plaintiffs*, both with respect to establishing the existence of a breach of fiduciary duty . . . as well as demonstrating the existence of a cognizable financial harm resulting from that breach.”⁸¹ Which begs the questions: If the fees received are not “exorbitant” or “disproportionately large,” how could one prove that the adviser’s “other possible violations” caused any damages at all? And, if one cannot, what is the purpose of this second inquiry?

As to the issue of evaluating excessiveness, the court held that under *Gartenberg*, comparisons with the fees charged to other institutional investors, such as pension funds, for similar financial advising services are relevant and appropriate in determining whether fees are disproportionate.⁸² Echoing the sentiments of Professors Freeman, Brown, and Pomeranz⁸³ the court reasoned: “We are also unpersuaded by the assertion that the fee disparity simply reflects what different investors are willing to pay. The purpose of an inquiry into the fees paid by institutional, non-fiduciary clients is to determine what the investment advice is worth.”⁸⁴

While the *Gallus* decision arguably marked a victory for investors (as well as scholars in favor of more comprehensive review of adviser

79. *Gallus*, 561 F.3d at 822.

80. *Id.* at 823–24 (emphasis added).

81. *Id.* at 823 (emphasis added).

82. *Id.* at 824.

83. See Freeman et al., *supra* note 2; see also *supra* note 10 and accompanying text.

84. *Gallus*, 561 F.3d at 824.

fees), the plaintiffs' fate remains uncertain. The judgment was vacated and the case remanded for further consideration in light of the Supreme Court's ruling in *Jones*—the black sheep out of the Seventh Circuit.⁸⁵

III. OVERVIEW: *JONES V. HARRIS ASSOCIATES, L.P.*

Significantly, prior to *Jones*, the section 36(b) debate surrounded the relevance of adviser conduct during negotiation (i.e., fairness of process) in analyzing whether a 36(b) breach of fiduciary duty occurred. That the amount of the fee (i.e., whether it was “so disproportionately large that it [could] bear[] no reasonable relationship to the services rendered,”⁸⁶) was relevant to the 36(b) analysis went relatively unquestioned. And although it was unclear exactly what type of exorbitance might meet this standard, given that the statute imposes a “fiduciary duty as to the receipt of compensation” it seemed unlikely that the amount of the compensation could be irrelevant. Yet, the Seventh Circuit decided exactly that.

The plaintiffs in *Jones* were investors in the Oakmark Funds, a complex of three mutual funds created and managed by their investment adviser, Harris Associates.⁸⁷ Much like their predecessors, the *Jones* plaintiffs alleged that their fund adviser had breached its fiduciary duty under section 36(b) by charging the Oakmark Funds excessive fees.⁸⁸ Specifically, the Oakmark Funds' fees were roughly double⁸⁹ those paid by Harris's institutional investors, such as pension funds, for similar advisory services.⁹⁰ According to the plaintiffs, this disparity was clear evidence that the fees were disproportionate to the value of the services provided.⁹¹

In addition, plaintiffs alleged that Harris “impermissively retained savings it realized from economies of scale as the Funds grew”⁹² Further, like the plaintiffs in *Migdal* and *Krantz*, they argued that certain directors on Oakmark's board were not “disinterested” within the meaning of the ICA because they were so closely affiliated with Harris,⁹³ and

85. *Ameriprise Fin., Inc. v. Gallus*, 130 S. Ct. 2340 (2010) (mem.).

86. *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982).

87. *Jones I*, No. 04 C 8305, 2007 WL 627640, at *1 (N.D. Ill. Feb. 27, 2007).

88. *Id.* at *2.

89. *Id.*

90. *Id.* at *6–7.

91. *See id.* at *3.

92. *Id.* Although the fee structure consisted of a graduated pay scale whereby Harris received smaller percentages of assets under management as the fund grew, Plaintiffs argued that the break points were so high that little of the savings realized from economies of scale were passed on to shareholders. *Id.* at *7.

93. Plaintiffs took particular issue with the fact that one of the board's “disinterested” directors was a former partner of Harris Associates. His partnership had been bought out with a

that Harris breached its fiduciary duty by failing to disclose the nature of its relationships with the directors.⁹⁴

In its motion for summary judgment, Harris countered that the advisory fees it charged the Oakmark funds “were in line with those charged by . . . other similar funds managed by other companies,” and urged the court to disregard comparisons to the fees paid by institutional clients.⁹⁵ Harris also stressed the fact that the board of directors had engaged in an informed negotiation over the fee and had approved the price structure.⁹⁶

The District Court for the Northern District of Illinois refused to disregard comparisons to the fees paid by Harris’s institutional clients.⁹⁷ However, the court, applying *Gartenberg*,⁹⁸ found that to the extent the fees paid by the institutional clients were relevant, they merely established a lower limit in a wide range of prices investors were willing to pay.⁹⁹ Thus, the trial court granted defendant’s motion for summary judgment, holding that plaintiff’s failed to set forth an issue of fact as to “whether there [was] a fundamental disconnect between what the funds paid and what the services were worth.”¹⁰⁰

Interestingly, in coming to this conclusion, the district court rejected dicta from an earlier Seventh Circuit case, *Green v. Nuveen Advisory Corp.*¹⁰¹ In *Nuveen*, plaintiff’s asserted a claim similar to that made by the plaintiffs in the Third Circuit’s *Green v. Fund Asset Management, L.P.* Essentially, they argued that the fee structure itself (a percentage of assets under management) created a conflict of interest and that the advisers had breached their fiduciary duty by accepting it.¹⁰² In a footnote later relied upon by Judge Easterbrook in his *Jones* opinion,¹⁰³ the *Nuveen* court endorsed a “slightly more broad[]” reading of the 36(b) fiduciary duty.¹⁰⁴ *Nuveen* suggested that in a proper case (which it characterized as “improbable”) a plaintiff might be able to survive summary judgment if it could point to a conflict of interest that

series of deferrable payments, contingent on Harris’s performance in a given year. Plaintiff’s argued this was a form of profit sharing, making the director a security holder, and thus, an interested person under 15 U.S.C. § 80 a-2(a)(19)(B)(iii). *Jones II*, 527 F.3d 627, 629 (7th Cir. 2008).

94. *Id.*

95. *Jones I*, 2007 WL 627640, at *6–7.

96. *Id.* at *6.

97. *Id.* at *7.

98. *Id.* at *6.

99. *Id.* at *7.

100. *Id.*

101. 295 F.3d 738 (7th Cir. 2002).

102. *Id.* at 742.

103. *Jones II*, 527 F.3d 627, 632 (7th Cir. 2008).

104. *Nuveen*, 295 F.3d at 743 n.9.

actually caused shareholders to lose current income. But, the court noted, even then, damages under the statute would be limited to the amount of compensation received.¹⁰⁵ Nevertheless, the district court refused to take the Seventh Circuit up on its invitation to employ this broader approach, instead opting for a narrow, but not unusual¹⁰⁶ reading of the provision, stating:

Plaintiffs do not explain how the disclosure of [a board member's] deferred compensation in a filing to the SEC relates to the § 36(b) fiduciary duty with respect to compensation received by Harris. There is no evidence that any failure to disclose impacted the amount of fees Harris was paid. To sweep this conduct into the ambit of § 36(b) would directly contradict the universal view that the fiduciary duty it sets out is both *narrow and limited*.¹⁰⁷

Stating what seemed to be obvious, the court added, “the different nature of the claim involved in [*Nuveen*] counsels against a conclusion that the Seventh Circuit would not apply the *Gartenberg* standard in an excessive fees case such as this one.”¹⁰⁸ Surely, most would have agreed.

A. Judge Easterbrook's Panel Opinion: A Duty Defined

On appeal, the Seventh Circuit affirmed.¹⁰⁹ However, in an opinion authored by Chief Judge Easterbrook, the court expressly “disapprove[d] the *Gartenberg* approach.”¹¹⁰ The panel reasoned that *Gartenberg*'s factor-oriented test, which compares price to value, gave too little deference to free-markets.¹¹¹ According to the court, the economic suppositions underlying the ICA and *Gartenberg*—namely, the widespread belief that adviser fees are insulated from competitive forces¹¹²—are no longer applicable.¹¹³ To support its conclusion, the panel noted that “[t]oday thousands of mutual funds compete[,]”¹¹⁴ and “competitive processes are imperfect but remain superior to a ‘just price’ system

105. *Id.*

106. See *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321 (4th Cir. 2001).

107. *Jones I*, No. 04 C 8305, 2007 WL 627640, at *5 (N.D. Ill. Feb. 27, 2007) (citing *Nuveen*, 295 F.3d at 743 n.8; *Green v. Fund Asset Mgmt., L.P.*, 286 F.3d 682, 684–85 (3d Cir. 2002); *Migdal*, 248 F.3d at 329). It is worth noting that although the Third Circuit *Green* opinion did contain language that supports the cited proposition, this article argues that ultimately its holding was somewhat broader than the *Jones I* court seemed to suggest.

108. *Id.* at *6.

109. *Jones II*, 527 F.3d at 635.

110. *Id.* at 632.

111. *Id.*

112. *Id.*

113. *Id.* at 633.

114. *Id.*

administered by the judiciary.”¹¹⁵ Moreover, while funds may rarely fire their advisers, “investors can and do ‘fire’ advisers cheaply and easily by moving their money elsewhere.”¹¹⁶

Easterbrook analogized the fiduciary duty imposed by section 36(b) on an adviser to that imposed by the law of trusts on a trustee: It requires a fiduciary to “make full disclosure and play no tricks” but does not impose “a cap on compensation.”¹¹⁷ In other words, Judge Easterbrook’s standard is disclosure dispositive. Assuming the process by which the fee is approved is “fair,” it is almost impossible for an adviser to breach its fiduciary duty by imposing it. The court did provide one caveat, noting that “[i]t is *possible to imagine* compensation *so unusual* that a court will infer that deceit must have occurred or that the persons responsible for the decision have abdicated.”¹¹⁸

Easterbrook relied on the Third Circuit’s *Green* case for further support of his reading of 36(b) and pointed to the footnote in *Nuveen* to support his contention that the Seventh Circuit had previously indicated that *Gartenberg* was “wanting.”¹¹⁹ Fascinatingly, he made no attempt to square the fact that both of those cases had endorsed a broader view of section 36(b) which *included* a review of the fee negotiation and approval process, but neither had made that analysis dispositive, or even suggested that it should be a predominate factor. However, applying its new standard the court held that the plaintiffs’ claim necessarily failed because they did not argue that “Harris Associates pulled the wool over the eyes of the disinterested trustees. . . .”¹²⁰

B. Judge Posner’s Dissent: A Word of Caution

The Seventh Circuit denied a petition for rehearing *en banc* with five judges dissenting.¹²¹ In an opinion by Judge Posner, the dissenters primarily took issue with the panel’s rejection of *Gartenberg*, pointing out that none of the case law cited in the panel opinion actually supported Easterbrook’s claim that the Seventh Circuit had previously indicated that the *Gartenberg* approach was “wanting.”¹²² Judge Posner disagreed with the panel’s blind faith in the power of the market to con-

115. *Id.*

116. *Id.* at 634.

117. *Id.* at 632 (citing RESTATEMENT (SECOND) OF TRUSTS § 242 & cmt. f).

118. *Id.*

119. *Id.*

120. *Id.* at 635.

121. *Jones III*, 537 F.3d 728 (7th Cir. 2008) (denying rehearing *en banc*).

122. *Id.* at 729 (Posner, J., dissenting) (noting that *Green v. Nuveen Advisory Corp.*, 295 F.3d 738 (7th Cir. 2002) was not an excessive fee case and did not disapprove of *Gartenberg*). See discussion *supra* part II; see *Jones I*, No. 04 C 8305, 2007 WL 627640, at *4 (N.D. Ill. Feb. 27, 2007).

trol advisory fees, citing both the legislative history of the ICA and recent economic analysis indicating that the sheer volume of mutual funds had not cured the anti-competitive nature of the industry.¹²³

The dissent was also far more reluctant to dismiss the evidence of comparable fees proffered by plaintiffs, commenting: “A particular concern in this case is the adviser’s charging its captive funds more than twice what it charges independent funds.”¹²⁴ Moreover, the dissent found that the panel’s conclusion that fees charged by other funds were not comparable was nothing more than “airy speculation.”¹²⁵ According to Posner, the panel’s new “disclosure dispositive” fiduciary duty “misse[d] the point—which is that unreasonable compensation can be evidence of a breach of fiduciary duty.”¹²⁶

C. *The Standard Applied: How Jones Nullifies Section 36(b)*

Judge Easterbrook was correct in his assertion that “section 36(b) does not say that fees must be ‘reasonable’ in relation to a judicially created standard.”¹²⁷ However, he incorrectly assumed that this fact renders the amount of the fee irrelevant in a section 36(b) analysis, despite clear statutory language to the contrary. Under Easterbrook’s standard, the actual amount of the fee charged is only relevant in *exceptional* circumstances.¹²⁸ The more appropriate inquiry, according to the court, is whether the board made a “voluntary choice *ex ante* with the benefit of adequate information.”¹²⁹ In coming to this conclusion, the *Jones* panel relied too heavily on common law notions of fiduciary duty while ignoring the fact that section 36(b) specifically modifies this duty by adding the words “with respect to *receipt* of compensation.”¹³⁰ Conspicuously missing from section 36(b) is any reference to a fiduciary duty with respect to *negotiation* of compensation. In fact, section 36(b)(1) specifically states that it *shall not* be necessary to allege or prove that any defendant engaged in personal misconduct.¹³¹ And that is no surprise. Under the common law and certainly under the 1940 version of the ICA, advisers were already obligated to negotiate truthfully with disinterested

123. *Jones III*, 537 F.3d at 731–32 (citing John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 634 (2001)).

124. *Id.* at 731.

125. *Id.* at 732.

126. *Id.* (emphasis added).

127. *Jones II*, 527 F.3d 627, 632 (7th Cir. 2008).

128. *Id.* (“It is possible to imagine compensation so unusual that a court will infer that deceit must have occurred . . .”).

129. *Id.* at 633.

130. 15 U.S.C. 80a-35(b) (2006) (emphasis added).

131. *Id.* (emphasis added).

directors.¹³² The *Jones* Court's attempt to make the two duties synonymous renders 36(b) superfluous. Had encouraging truthful negotiation been Congress's goal, it would not have needed to amend the Act to do so. Moreover, the legislative history makes clear that the concern was not that advisers would be deceitful in negotiating their fees, it was that they would not *have to be*, because the funds are captive and the directors would approve their fees regardless of whether they were a "good deal."¹³³ Thus, the only way to curb this problem was to make the advisers themselves responsible for accepting a fee that they knew was unfair or disproportionately large.

Ironically, nowhere is the fallacy of the court's process-based standard more obvious than in its own opinion. The *Jones* plaintiffs *did* allege that that Harris Associates failed to disclose financial links between itself and the fund's directors.¹³⁴ Yet the *Jones* court "makes short work of these" claims,¹³⁵ dismissing them at the outset because "although 36(b) creates a private right of action, the other sections we have mentioned do not."¹³⁶ (These "other sections" included section 10(a), requiring 40% of trustees (directors) to be "disinterested";¹³⁷ section 15(c), requiring approval of the adviser's fee by a majority of disinterested directors;¹³⁸ and section 33(b), requiring disclosure of financial links between the directors and the advisers).¹³⁹ In essence, all process-based breaches of fiduciary duty fall within "other" provisions of the ICA,¹⁴⁰ and none of them provide a private right of action.¹⁴¹ If the section 36(b) private right of action is only triggered by process-based breaches of fiduciary duty, and allegations of process-based breaches necessarily involve allegations of violating other provisions of the ICA that may be "easily dispensed with" because they do not provide private right of action, what is left of 36(b)? Apparently, the answer is only

132. See RESTATEMENT (SECOND) OF TRUSTS, § 243 (1959) ("If the trustee commits a breach of trust, the court may in its discretion deny him all compensation . . ."); see also *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 328 (4th Cir. 2001) (explaining an adviser's duties under 15 U.S.C. §§ 80a-10(a) and 80a-15(c)).

133. See *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 820 (8th Cir. 2009) (discussing lack of arm-length bargaining as reason for congressional regulation in the mutual fund industry).

134. *Jones II*, 527 F.3d at 629.

135. *Id.*

136. *Id.*

137. See 15 U.S.C. § 80a-10(a) (2006).

138. See 15 U.S.C. § 80a-15(c) (2006).

139. See 15 U.S.C. § 80a-33(b) (2006).

140. See discussion *supra* notes 53–54 and accompanying text.

141. See *Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110, 116 (2d Cir. 2002) (referring specifically to the ICA: "Congress's explicit provision of a private right of action to enforce one section of a statute suggests that omission of any explicit private right to enforce other sections was intentional.") (quoting *Olmstad v. Pruco Life Ins. Co.*, 283 F.3d 429 (2d Cir. 2002)).

the hypothetical fee that is *so unusual* that misconduct can be *inferred*, but does not fall within any of the already statutorily prohibited conduct.

Remarkably, this isn't even the biggest problem with the *Jones* standard. Even assuming that such a remarkable case came along, section 36(b)(1) specifically states that "plaintiff shall have the burden of proving breach of fiduciary duty"¹⁴² and 36(b)(2) limits damages to "actual damages resulting from the breach of fiduciary duty."¹⁴³ Therefore, even if there was misconduct, and even if there were an implied private right of action, plaintiffs would end up in the exact same place they started; i.e., unable to prove damages except by reference to the fees charged to other mutual funds, which ostensibly suffer from the same process deficiencies. It becomes clear that the fiduciary duty created by *Jones* is a mere illusion. Thus, so long as all mutual funds continue to charge exorbitant fees, there can be no successful 36(b) claim.

IV. WHAT TO DO ABOUT 36(B)?

If we assume, as we should, that Congress intended the section 36(b) amendment to be more than mere surplusage, then the question becomes, how can section 36(b) be implemented to have effect?

A. *The Parties' Arguments*

Both the investor-plaintiffs and the adviser-defendant in *Jones* argued to the Supreme Court that the Seventh Circuit's formulation should not be adopted.¹⁴⁴ Predictably, the plaintiffs argued that the fiduciary duty imposed by section 36(b) requires both fairness of price and fairness of process: "First, the adviser must fully and accurately disclose all material facts relating to its compensation. Second, the compensation must be fair to the fund, meaning that it comports with what would be bargained for in an arm's-length transaction."¹⁴⁵ Interestingly, at the trial level, plaintiffs had argued that *Gartenberg* should not apply because it was too narrow in this regard.¹⁴⁶ However, in petitioners' appellate brief to the Supreme Court, they argued that this two-part analysis is what the *Gartenberg* Court intended, but that subsequent courts perverted its holding to stand for a pure fairness of price analysis, narrowly limited to comparisons with fees charged to other captive funds.¹⁴⁷ In fact, they argued, *Gartenberg* was not so limited. On its

142. 15 U.S.C. § 80a-35(b)(1) (2006).

143. 15 U.S.C. § 80a-35(b)(2) (2006).

144. See Brief for Petitioners, *Jones v. Harris Assocs., L.P.*, 130 S. Ct. 1418 (2010) (No. 08-586); Brief for Respondent, *Jones v. Harris Assocs., L.P.*, 130 S. Ct. 1418 (2010) (No. 08-586).

145. Brief for Petitioner, *supra* note 144, at 17.

146. *Jones I*, 2007 WL 627640, at *6.

147. Brief for Petitioner, *supra* note 144, at 29.

facts, *Gartenberg* refused to draw comparisons between money market funds and pension funds because they were not sufficiently similar, but “[t]he [*Gartenberg*] court did not suggest that a comparison of fees charged for like services provided to different clients (*e.g.*, a mutual fund and an institutional client with the same investment objective) would be irrelevant.”¹⁴⁸ In essence, the plaintiffs advanced the same test set out by the Eighth Circuit in *Gallus*, but suggested that it was a clarification of *Gartenberg* rather than a new standard.

Perhaps more intriguingly, Harris Associates also urged the Supreme Court to reject the *Jones* standard, but in favor of a more circumscribed reading of *Gartenberg*.¹⁴⁹ (Perhaps this is because the *Gartenberg* standard has proved to be such a winner for adviser-defendants.) In any event, Harris suggested that other Circuits were correct in their interpretations—*Gartenberg* does not provide for any “fair process” review because such review is not supported by the text or legislative history of the Act.¹⁵⁰ Moreover, comparisons to institutional clients can only be supported if the “adviser provides comparable services” to those clients, and according to Harris, this is simply not the case:

Petitioners’ claims that the institutional-client comparison is “highly probative” and “highly pertinent,” . . . cannot apply in all cases, or even most. Section 36(b) provides no mandate for courts to demand that mutual fund fees match some institutional fee. And the “most-favored-pricing” rule that petitioners seek to impose ignores the substantial differences that exist between mutual funds and other accounts. To be sure, an investment adviser provides portfolio management services for both types of accounts, including security selection, research, trading and asset allocation. But the similarities largely end there.¹⁵¹

Thus, Harris asserted, a mutual fund adviser’s fees should only be compared to other mutual fund adviser’s fees, and if the fees are “neither ‘so disproportionate’ nor ‘so unusual’ [in relation to each other] to support a conclusion of fiduciary breach[.]”¹⁵² the analysis should end there.

Ultimately, the Supreme Court attempted to strike a balance. The unanimous Court vacated the Seventh Circuit’s opinion, reaffirming *Gartenberg* and clarifying some of the issues that had been plaguing lower courts.¹⁵³ First, the Court acknowledged that fair process should play at least somewhat of a role in a 36(b) analysis:

148. *Id.* at 30.

149. Brief for Respondent, *supra* note 144, at 25–32.

150. *Id.* at 33.

151. *Id.* at 40 (internal citations omitted).

152. *Id.* at 55.

153. *Jones v. Harris Assocs., L.P.*, 130 S. Ct. 1418 (2010).

[A] court's evaluation of an investment adviser's fiduciary duty must take into account both procedure and substance Thus, if the disinterested directors considered the relevant factors, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently In contrast, where the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome. When an investment adviser fails to disclose material information to the board, greater scrutiny is justified because the withheld information might have hampered the board's ability to function as "an independent check upon the management."¹⁵⁴

Second, the Court held that in determining whether the fee is proportionate, lower courts could look at the fees charged to institutional clients, but noted that these fees may not always provide a reliable comparison. The Court cautioned lower courts only to "give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require," and was quick to point out that "the Act does not necessarily ensure fee parity between mutual funds and institutional clients contrary to petitioners' contentions."¹⁵⁵ In light of the fact that courts have generally understood this to be the rule yet have routinely declined to make such comparisons because of perceived incomparability between the services rendered, it is unlikely that the Supreme Court's holding will have a significant impact on the outcome of section 36(b) claims in the future.

Justice Thomas wrote a short concurrence for the purpose of noting that although the Court characterized its own opinion as a reaffirmation of "the *Gartenberg* standard," in fact, the Court's analysis is actually (and properly, in his opinion) more circumscribed than *Gartenberg*'s multi-factor fairness review.¹⁵⁶ In short, Thomas underscored the point made by the majority—"the standard for fiduciary breach under § 36(b) does not call for judicial second-guessing of informed board decisions."¹⁵⁷

Although the *Jones* plaintiffs got much of what they asked for from the Supreme Court, it seems unlikely in light of *Gartenberg*'s long history that the Court's opinion, which essentially restored the status quo, will work in their favor.

B. *Scholarly Solutions*

There is disagreement about whether *Gartenberg* is broken. Never-

154. *Id.* at 1429–30.

155. *Id.* at 1429.

156. *Id.* at 1431 (Thomas, J., concurring).

157. *Id.* (quoting *id.* at 1430 (majority opinion)).

theless, unless the competitive deficiencies perceived by Congress when enacting 36(b) were merely a figment of its imagination, it seems apparent that *Gartenberg* has done little to remedy the problem. The majority of scholars who have written on this topic agree. However, they disagree on how it should be remedied. One of the dominant themes in these recent publications has been a call for comparisons with fees paid by institutional investors. For instance, Professors Freeman, Brown, and Pomeranz advance a test that parallels the framework set out by the Supreme Court in *McDonald Douglas Corp. v. Green*,¹⁵⁸ for “analyzing disparate treatment cases relying on circumstantial evidence of discrimination.”¹⁵⁹ In brief, their test would require plaintiffs to make a prima facie showing of “disparate treatment” (i.e., significantly higher fees for captive funds than institutional funds). Then, “the defendant must produce evidence to rebut the presumption of discrimination,”¹⁶⁰ which might include evidence that the services provided are substantively different and justify the fee disparity.¹⁶¹ Ultimately however, the burden would remain on the plaintiff to show that the differences do not explain the disparity and thus acceptance of the fee constitutes a breach of fiduciary duty.¹⁶² Of course, underlying Freeman’s test is his own (seemingly well-evidenced) assumption that the services provided to institutional investors are not in fact substantially different than those provided to captive funds.¹⁶³

Additionally, in a recent article appropriately titled, *Moving Beyond Gartenberg: A Process Based and Comparative Approach to §36(b) of the Investment Company Act*,¹⁶⁴ the authors (who just so happen to be counsel of record for the *Jones* plaintiffs)¹⁶⁵ argue for the same dual prong standard they argued for in front of the Supreme Court: an insistence upon fair procedures as well as a fair price. Fair price, they contend, should be determined based on comparisons with the fees the adviser charges its non-captive funds (e.g., pension funds).¹⁶⁶ Essentially, they argue for the *Gallus* standard.

The problem with both of these formulations is that they can be effective only if courts are willing to accept that the fees charged to institutional investors are an appropriate benchmark for fair price. If

158. 411 U.S. 792 (1973).

159. Freeman et al., *supra* note 2, at 144.

160. *Id.* at 145.

161. *Id.*

162. *Id.*

163. *See id.*

164. John M. Greabe et al., *Moving Beyond Gartenberg: A Process Based and Comparative Approach to §36(b) of the Investment Company Act*, 28 REV. BANKING & FIN. L. 133 (2009).

165. *See* Brief for Petitioner, *supra* note 144.

166. Greabe et al., *supra* note 164, at 135.

they are not, we are back to square one—comparing mutual funds to mutual funds, which, as we have seen, is a futile exercise.

A second important theme has been reassessment of director independence under the Act. After all, the Seventh Circuit *Jones* Court was able to quickly dismiss allegations of process-based breaches because according to Easterbrook's analysis, the directors and advisers had in fact complied with the Act's rules. Professor Lyman Johnson argues that the years since *Gartenberg* have yielded significant changes in the law governing corporate fiduciaries and that mutual funds should benefit from the trend toward increased director independence.¹⁶⁷ He suggests that Congress should "expand[] the category of interested persons under section 2(a)(19)"¹⁶⁸ and advocates a standard that gives director independence "greater procedural significance in section 36(b) litigation."¹⁶⁹ Specifically, under Johnson's proposed standard (derived by analogy to corporate law), if the board's directors are established to be "independent," a reviewing court should apply a deferential standard in reviewing the fees. However, if the advisers fail to establish that the board is independent or choose not to do so, then under section 36(b)(2), no consideration should be given to the board's approval of the fee.¹⁷⁰ Notably, "the plaintiff retains the ultimate burden of proof throughout."¹⁷¹ Johnson argues that this approach gives section 36(b)(2), which provides that the board's approval of the fee be given "such consideration by the court as is deemed appropriate under the circumstances," "equal dignity" to section 36(b)(1), which places the burden of proof on plaintiffs.¹⁷²

Most intriguing of all is Johnson's submission that damages under section 36(b) should no longer be limited to restitution. Johnson convincingly makes the case that restitution alone provides little deterrence and argues that a more effective solution might be to force advisers to prominently disclose adverse 36(b) verdicts in all of their investor communications for a period of time.¹⁷³ If nothing else, the threat of this embarrassment could encourage good behavior.

Professor Johnson's call for reform of the ICA's independence rules is undoubtedly a necessary step in the right direction.¹⁷⁴ Moreover, his proposed standard properly draws attention to the fundamental

167. Johnson, *supra* note 52.

168. *Id.* at 527.

169. *Id.* at 528.

170. *Id.* at 531.

171. *Id.* at 532.

172. *Id.*

173. *Id.* at 533.

174. As Johnson notes, even the Securities and Exchange Commission has advanced rulemaking efforts that would limit certain "regulatory privileges under the [ICA] . . . to companies where at least seventy-five percent of the directors and the board chairman are

disconnect between the development of fiduciary duty law in the corporate context and the lack of development in the mutual fund context. However Professor Johnson's standard does not go far enough. More sweeping reform of section 36(b) is necessary if it is to provide a realistic remedy for investors.

C. *An Entirely Fair Solution: Importing the Law of Corporate Fiduciary Duties in Conflict Transactions*

As previously mentioned, the problem with the comparative approach is that it presupposes that the fees charged to institutional clients can serve as a reliable benchmark for fair price.¹⁷⁵ However, not all scholars agree with this assessment¹⁷⁶ and as alluded to by the Supreme Court in *Jones*, it is not clear that the lower courts will either. Moreover, assuming that Congress was correct in its determination that the mutual fund market suffers from competitive deficiencies, the fees other advisers charge their captive funds provide a worthless comparison. Just because the fees are similar to each other does not mean that they are meaningfully related to value. Thus, a standard that includes a review of procedural fairness is necessary. As we have seen though, process-based approaches become seriously problematic under the framework of section 36(b). Recall the quote from *Gallus*: "Congress allocated the *burden of proof to plaintiffs*, both with respect to establishing the existence of a breach of fiduciary duty, . . . as well as demonstrating the existence of a *cognizable financial harm* resulting from that breach."¹⁷⁷ Hence, even Easterbrook's disclosure dispositive standard, if met, leaves plaintiffs with the burden of proving to what extent the process failure adversely impacted the fee, if at all.

It is this exact problem that has led Delaware courts to apply the entire fairness standard in conflict transactions, particularly so-called "interested-party" mergers wherein a controlling majority shareholder who owes fiduciary duties to the minority shareholders is on both sides of the transaction.¹⁷⁸ Under entire fairness review, a plaintiff must first allege "some basis for invoking the fairness obligation."¹⁷⁹ Thereafter,

independent." *Id.* at 498 (citing Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,380-81 (Aug. 2, 2004)).

175. See discussion *supra* Part II.B.

176. See *e.g.*, Coates & Hubbard, *supra* note 4.

177. *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 823 (8th Cir. 2009) (emphasis added); see discussion *supra* Part I.A.

178. See generally Nelson Ferebee Taylor, *Evolution of Corporate Combination Law: Policy Issues and Constitutional Questions*, 76 N.C. L. REV. 687 (1998) (explaining the application of entire fairness review in interested-party mergers); see also *Weinberg v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

179. *Weinberg*, 457 A.2d at 703.

“the ultimate burden of proof is on the [*defendant*] to show by a preponderance of the evidence that the transaction is fair.”¹⁸⁰ This requires a showing of both fair price and fair process.¹⁸¹ “However, the test for fairness is not a bifurcated one All aspects of the issue must be examined as a whole since the question is one of *entire* fairness.”¹⁸² Where the transaction has been approved by an informed vote of either disinterested directors or minority shareholders, the burden shifts back to the plaintiff to show that the transaction was in fact *unfair*.¹⁸³ However, even then, “the burden clearly remains on those relying on the vote to show that they completely disclosed all material facts relevant to the transaction.”¹⁸⁴

The rationale behind entire fairness review, according to several former and current Chancellors and Vice Chancellors of the Delaware Court of Chancery, is two-fold. First, “where . . . a majority of the board is conflicted, i.e., where a majority have personal interests in the transaction that are adverse to the interest of the shareholders, it cannot be presumed that the board will be motivated to achieve the [best] transaction price the market will permit.”¹⁸⁵ Second, and more importantly, is “the difficulty of ascertaining, in non-arms-length transactions, the price at which the deal would have been effected in the market.”¹⁸⁶ This is the same difficulty that has plagued section 36(b) plaintiffs for years and the rationale for applying it to mutual fund advisers who, like corporate boards of directors and majority shareholders, must act as fiduciaries is the same.

The “shifting burden” framework of the entire fairness standard is more plaintiff friendly than Professor Johnson’s proposed standard because it formally allocates the burden of proof to defendants until they show approval of the transaction by an independent board. Moreover, as Professor Johnson accurately notes,¹⁸⁷ courts applying entire fairness review specifically recognize that in certain situations the burden *does not* shift to plaintiffs, even if defendants can show approval by a formally “disinterested” committee. First articulated in *Rabkin v. Olin Corp.*,¹⁸⁸ and re-approved of by the Delaware Supreme Court in *Kahn v.*

180. *Id.*

181. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporate Law*, 26 DEL. J. CORP. L. 859, 873 (2001).

182. *Weinberg*, 457 A.2d at 711.

183. *Id.*

184. *Id.*

185. Allen et al., *supra* note 181, at 876.

186. *Id.*

187. Johnson, *supra* note 52, at 531.

188. No. 7547, 1990 WL 47648 (Del. Ch. Apr. 17, 1990), *aff'd*, 586 A.2d 1202 (Del. 1990).

Lynch Communication Systems, Inc.,¹⁸⁹ there is a two-prong test for determining whether the burden should shift back to plaintiffs:

The mere existence of an independent special committee . . . does not itself shift the burden. At least two factors are required. First, the majority shareholder must not *dictate the terms* of the merger Second, the special committee must have *real bargaining power* that it can exercise with the majority shareholder on an arms length basis.¹⁹⁰

Although the test is framed with the backdrop of cash-out mergers in mind, the principle is equally applicable to mutual fund fee negotiations. In deciding whether the burden should shift to plaintiffs, “[p]articular consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the *freedom to negotiate at arm’s length*.”¹⁹¹ In other words, the approving body must not only be “disinterested” in the formalistic sense mandated by section 10 of the Act,¹⁹² it must also perform independently. A strict application of the entire fairness test ensures that if the approving body, in this case the board of directors, is “acutely aware”¹⁹³ that it has no real bargaining power, the burden remains on defendants. If an adviser fails to meet its burden of proving that the fees approved by the board are entirely fair, then the court should find a breach of fiduciary duty with respect to receipt of that compensation.

Notably, the entire fairness framework contemplates a second alternative for a fiduciary to shift the burden to plaintiffs—approval of the transaction by a majority of disinterested, fully informed shareholders.¹⁹⁴ Although Delaware corporate law requires that the transaction actually be contingent upon approval by the shareholders in order to shift the burden,¹⁹⁵ such a drastic rule is probably unnecessary in this context. Rather, similar to the non-binding votes on executive compensation advanced by proposed “say-on-pay” legislation,¹⁹⁶ a non-binding

189. 638 A.2d 1110 (Del. 1994).

190. *Id.* at 1117 (quoting *Rabkin*, 1990 WL 47648 at *6) (emphasis added); *see also* *Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997) (“To obtain the benefit of burden shifting, the controlling shareholder must do more than establish a perfunctory special committee of outside directors.”).

191. *Id.* at 1120–21 (emphasis added).

192. 15 U.S.C. §§ 80a-10 (2006).

193. *Kahn*, 638 A.2d at 1117 n.6 (quoting *Rabkin*, 1990 WL 47648 at *13).

194. *Id.* at 1117.

195. *Rabkin*, 1990 WL 47648, at *6 (explaining that in the context of interested mergers, a non-binding vote by minority shareholders is not sufficient because it is “virtually ceremonial in light of the foregone conclusion . . . that the merger would be approved by way of [defendants] control of a majority of [the corporation’s] stock”).

196. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009); Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. § 3 (2009).

investor vote on adviser compensation could serve as an alternative burden shifting mechanism.

Advisers hoping to limit their exposure to 36(b) claims would have an incentive to urge the board to put compensation agreements to a vote. And, like say-on-pay, the mere existence of the vote, while not determinative of or binding on the fee negotiations, would increase transparency and accountability¹⁹⁷ and lend credibility to the argument advanced by Judge Easterbrook that investors “vote with their feet and dollars” to “determine how much advisory services are worth.”¹⁹⁸

Placing the burden of proof on advisers in section 36(b) claims would give the provision effect, and would be consistent with modern fiduciary duty analysis in conflict transactions. Of course, this change must come from Congress, as it is impossible for a court to circumvent the burden on plaintiffs imposed by section 36(b)(1). If section 36(b) is to provide a meaningful check on adviser fees, the burden on plaintiffs must be abandoned.

V. CONCLUSION

In sum, there can be no doubt that *Jones* leaves mutual fund investors in the same position they were in under *Gartenberg*, and even in the same position they were in before section 36(b) was enacted. As has been shown, courts have widely refused to accept institutional investor fees as reliable benchmarks, leaving mutual fund plaintiffs with the near impossible burden of proving what fee would have been negotiated in the market if not for the anti-competitive nature of the industry. Unfortunately, no judicially formulated standard can help plaintiffs if the burden remains on them to prove defendant’s breach under section 36(b). If Congress is firm in its conviction that the mutual fund industry is insulated from competitive forces and concludes that, as a result, investors are paying too much, then it must be equally firm in crafting a remedy that does more than pay lip service to those investor’s claims.

197. See generally U.S. DEP’T OF THE TREASURY, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, 29–30, 73 (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf; U.S. DEP’T OF THE TREASURY, FACT SHEET: ENSURING INVESTORS HAVE A “SAY ON PAY”, available at http://www.treas.gov/press/releases/reports/fact_sheet_say%20on%20pay.pdf (explaining that the goal of say-on-pay is to “improve board accountability and better align compensation with long term value creation for shareholders”).

198. *Jones II*, 527 F.3d 627, 632 (7th Cir. 2008).