

## Appeals Court Rejects Mutual Fund Excessive Fee Claims, Adopting New Standard for Evaluation of Fees

In a significant setback for plaintiffs' lawyers taking aim at advisory and distribution fees, the U.S. Court of Appeals for the Seventh Circuit on May 19, 2008, affirmed the grant of summary judgment to Harris Associates – the manager of the Oakmark Family of Funds – on a claim that its fees were excessive in violation of Section 36(b) of the Investment Company Act. In *Jones v. Harris Associates*, the Seventh Circuit rebuffed shareholders' claims of excessiveness, holding that market forces and informed review and approval by independent trustees were the hallmarks of an adviser's compliance with its statutory fiduciary duty. The court refused to engage in an analysis of "reasonableness" or "proportionality," considering it tantamount to after-the-fact judicial rate-making. The Seventh Circuit thus expressly rejected the widely applied *Gartenberg* standard for assessing advisers' liability for excessive fees because that opinion relied "too little on markets" and paid inadequate attention to the approval by independent trustees that the Act contemplates.

The court thus erected a new standard and – at least in the Seventh Circuit – erased nearly 30 years of precedent and practice that focused on *Gartenberg's* "proportionality" test and the "factors" that *Gartenberg* established for measuring compliance with that test. The Seventh Circuit's new standard relies on traditional, common law notions of fiduciary duty: So long as an investment adviser "make[s] full disclosure and plays no tricks," there is no "cap on compensation," and judges will not be in the business of "determin[ing] how much advisory services are worth."

Ropes & Gray represented Harris Associates throughout the case, securing summary judgment in the trial court and successfully arguing the appeal to the Seventh Circuit.

Chief Judge Easterbrook's opinion in *Harris* rejected the plaintiffs' two main contentions that fees charged to the Oakmark Funds were excessive. According to the plaintiffs, a comparison to what other mutual funds charged was inappropriate since "fees are set incestuously" on behalf of "captive" funds that never change advisers, suggesting that the market for mutual fund advisory services is not "competitive," and all mutual fund fees are too high. The court rejected that argument by observing that mutual fund shareholders are mobile: "An adviser can't make money from its captive fund if high fees drive investors away." The "market" that the plaintiffs railed against actually supplies the barometer for measuring compliance with an adviser's duty. According to the court, advisers have a "powerful reason" to keep fees low unless "higher fees are associated with a higher return." In short, said the court, markets work: "[I]nvestors can and do protect their interests by shopping." When markets work, and advisers do not charge fees "so unusual that a court will infer that deceit must have occurred," the advisers do not violate their statutory obligation. The court reasoned that even though the competitive process may be "imperfect" at weeding out pricing anomalies, "the judicial process is worse." According to the Seventh Circuit, "[R]egulating advisory fees through litigation is unlikely to do more good than harm."

The court also disposed of the plaintiffs' second principal argument – that lower fees charged by advisers to institutional clients such as pension funds establish that mutual fund fees are excessive. "Different clients call for different commitments," the court said. Charging one client with one set of demands a lower rate does not imply that an adviser charges

mutual funds too much. According to the court, the costs that an adviser incurs to service different clients should be apportioned according to elasticity of demand, not “any rule of equal treatment.” In short, mutual fund advisers do not breach their fiduciary duty by charging different rates to different clients for different services; they are free to charge what the traffic will bear to each customer category.

These two arguments – that *all* mutual fund advisory fees are too high, and that “rack rate” charges to institutional clients prove excessiveness of fees charged to mutual funds – were the principal contentions advanced by the plaintiffs’ bar in approximately a dozen identical cases that were initiated against fund advisers in the past several years. Two of those cases were voluntarily dropped; two remain pending; and two – this case involving Harris Associates and another brought against Ameriprise Financial – resulted in summary judgment for the defendants. All of the other cases were settled for undisclosed amounts. Ropes & Gray litigators John Donovan and Rob Skinner led the teams that achieved the only two defendant victories.

The immediate consequences of the *Harris* opinion are difficult to predict. In the Seventh Circuit, the decision clearly means that shareholder litigation challenging advisory fees faces a steep uphill battle. Absent specific allegations that an adviser has “pulled the wool over the eyes of disinterested trustees,” or has otherwise “hindered their ability to negotiate a favorable price for advisory services,” producing compensation “so unusual that a court will infer that deceit must have occurred,” Section 36(b) “excessive fee” cases are unlikely to succeed. For advisers and funds in the Seventh Circuit, that holding could influence the periodic fee-approval process between advisers and independent boards. Elsewhere, the effect is less clear. The *Gartenberg* standard and “factors” have been enshrined for nearly 30 years in the minds of advisers, fund trustees and their counsel – and as a result have directly influenced both the mechanics and substance of fee negotiations. Until other courts echo Judge Easterbrook’s reasoning, we doubt that advisers or trustees will endorse a change in their processes or disclosures. Nevertheless, that remains a realistic long-term possibility. The *Harris* decision in the Seventh Circuit poses a real and substantial conflict with the *Gartenberg* standard of the Second Circuit; and the Eighth Circuit will likely be heard from soon in *Ameriprise*. The prospect that the competing decisions will be reconciled by the United States Supreme Court cannot be foreclosed.

For the full text of the court’s decision in *Jones v. Harris Associates*, please [click here](#). For the full text of the July 6, 2007, District of Minnesota decision in *Gallus v. Ameriprise Financial, Inc.* (now on appeal to the Eighth Circuit), please [click here](#).

## Contact Information

If you have any questions or would like to learn more about the issues raised in the court’s decision, please contact the Ropes & Gray lawyer who normally represents you or one of the following Ropes & Gray litigators involved in the case:

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