

MOVING BEYOND *GARTENBERG*: A PROCESS-BASED
AND COMPARATIVE APPROACH TO § 36(b) OF THE
INVESTMENT COMPANY ACT OF 1940

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I. Introduction

As trial lawyers, we regularly place our faith in the judiciary and triers of fact. Experience has taught us, across various fields of law, that juries and judges presiding at bench trials are fully capable of processing complicated evidence to reach commonsense judgments on highly technical matters. It may therefore seem ironic that, in the mutual fund reform litigation that is the subject of this paper, we as representatives of mutual fund shareholders are pitted in a struggle to convince federal judges of the virtues of restraint in the face of industry-sponsored calls for activism. But that is precisely the position in which we find ourselves.

Our dispute with the industry has arisen in recent litigation brought by the shareholders of certain mutual funds challenging fees paid to the funds' advisers under § 36(b) of the Investment Company Act of 1940 ("ICA").² The fundamental question in this litigation is how courts should enforce the "fiduciary duty with respect to the receipt of compensation" imposed on mutual fund advisers and their affiliates by ICA § 36(b).³ Answering this question requires an analysis of whether and how *Gartenberg v. Merrill Lynch Asset*

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² 15 U.S.C. § 80a-35(b) (2006).

³ *Id.*

Management, Inc.,⁴ a 1982 Second Circuit opinion that some lower courts have treated as “seminal” on the meaning of § 36(b),⁵ should inform a court’s approach to shareholder claims under the statute.⁶

An understanding of our approach to § 36(b), and an appreciation of how our reading of the statute differs from the one advocated by the mutual fund industry, requires a basic understanding of the structure of the mutual fund market and of the history and purposes of the ICA. Part II supplies this legal and historical context.⁷ Part III then discusses *Gartenberg* and explains the opinion’s fundamental ambiguity.⁸ Part III also explains how in *Gallus v. Ameriprise Financial, Inc.*⁹ and *Jones v. Harris Associates L.P.*,¹⁰ *Gartenberg*’s ambiguity understandably led the district courts to construe § 36(b) to require federal judges to make substantive economic determinations that they are reluctant to make without judicially administrable liability guideposts.¹¹ This sets the stage for the approach we advance in Part IV, which demonstrates that judges need not be rate-makers to enforce the fiduciary duty created by § 36(b).

⁴ 694 F.2d 923 (2d Cir. 1982).

⁵ See *Gallus v. Ameriprise Fin., Inc.*, 497 F. Supp.2d 974, 979 (D. Minn. 2007).

⁶ As we shall explain below, and as other commentators have noted, *Gartenberg* is ambiguous. See discussion *infra* Part II.A.; see also Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1023 (2005); Lyman Johnson, A *Fresh Look at Director “Independence”: Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 517-18 (2008) (discussing alternate readings of *Gartenberg* and stating that “the court spoke clumsily”).

⁷ See *infra* notes 13-56 and accompanying text.

⁸ See *infra* notes 57-76 and accompanying text.

⁹ 497 F. Supp.2d at 979.

¹⁰ No. 04 C 8305, 2007 WL 627640 (N.D. Ill. Feb. 27, 2007) (memorandum opinion on cross-motions for summary judgment).

¹¹ We focus heavily on *Gallus* and *Jones* because the approaches to § 36(b) taken in these two summary judgment rulings illuminate the legal issues to which we speak.

In Part IV, we present practical answers to the question of how courts should enforce “the fiduciary duty with respect to the receipt of compensation.”¹² In short, federal judges should enforce the fiduciary duty that § 36(b) creates just as they would other fiduciary duties. They should insist at the threshold that fair procedures be used to set mutual fund advisory fees, and they should compare the challenged fees with identifiable benchmarks, such as the fees the adviser charges to its non-mutual fund clients (e.g., pension funds), who bargain at arm’s length for similar services. This process-based and comparative approach to § 36(b) is the appropriate way to conduct the judicial review of fee agreements Congress mandated when it enacted § 36(b). In our view, it is also the analysis intended by *Gartenberg*, notwithstanding Judge Mansfield’s use of some unfortunate language that courts (at the urging of the mutual fund industry) have read to require federal judges to serve as rate makers and to decide by their own lights appropriate fee levels. But even if our proposed approach is thought to conflict with *Gartenberg*, courts entertaining breach-of-fiduciary-duty claims under § 36(b) should adopt it. For unlike the analysis advocated by the industry, ours looks to judicially administrable liability guideposts, draws on settled fiduciary and trust law, and contemplates an appropriate institutional role for the federal courts.

II. Context

A. The Mutual Fund Market and Advisory Fee Agreements

A mutual fund is an open-end, diversified management company registered under and regulated by the ICA.¹³ An open-end fund is one that has no restrictions on the amount of shares that it will issue and buys back its shares at current asset

¹² 15 U.S.C. § 80a-35(b) (2000).

¹³ *Daily Income Fund v. Fox*, 464 U.S. 523, 525 (1984).

value.¹⁴ Congress, the Securities Exchange Commission, and the Supreme Court have identified two related structural phenomena that, in the absence of regulation, are likely to lead to self-dealing between mutual fund investment advisers and the funds they control.

1. Mutual Funds are Captives of their Advisers

The first of these two phenomena is the ‘unseverable’ relationship between a mutual fund and its adviser.¹⁵ The adviser, which establishes the mutual fund, typically populates the fund’s board with directors who have business or personal connections to the adviser or its executives.¹⁶ The adviser then contracts with the board, which as a practical matter it frequently controls, to provide investment management and other services to the fund for fees.¹⁷ Not surprisingly, advisers typically do not negotiate fee agreements by vying against each other to land advisory contracts from mutual funds that are already up and operating. Rather, they create their own mutual fund “clients” by forming, marketing, and managing the funds they advise.¹⁸ Consequently, as the Supreme Court has recognized, “the relationship between investment advisers and mutual funds is fraught with potential conflicts of interest.”¹⁹

In a 1966 report, the SEC elaborated on the effects of this “virtually complete merger of the funds’ management with

¹⁴ BLACK’S LAW DICTIONARY 1045 (8th ed. 2004).

¹⁵ See *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 929 (2nd Cir. 1982).

¹⁶ This was certainly the situation in *Jones*, where members of the board of directors maintained close personal and business relationships with executives and other employees of the adviser. See Brief and Required Short Appendix of Plaintiffs-Appellants at 38–42, *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008) (No. 07-1624), 2007 WL 1582568 at *38–42.

¹⁷ See *Daily Income Fund*, 464 U.S. at 536; *Burks v. Lasker*, 441 U.S. 471, 480-81 (1979).

¹⁸ See *Daily Income Fund*, 464 U.S. at 536; *Burks*, 441 U.S. at 480-81.

¹⁹ *Daily Income Fund*, 464 U.S. at 536 (quoting *Burks*, 441 U.S. at 481).

the advisory organization.”²⁰ The SEC found that “[m]utual funds are unique among large purchasers of investment management services”²¹ in that “neither cost considerations nor other competitive factors influence the funds’ choice of their advisers.”²² Rather, “[m]utual funds are formed by persons who hope to profit from providing management services to them”²³ and who “seldom, if ever, compete with [other investment advisers] for advisory contracts.”²⁴

The SEC also found that competition among funds for shareholders does not result in fee-constraining market forces: “Cost reductions in the form of lower advisory fees or other cost considerations do not figure significantly in the battle for investor favor.”²⁵ In part, this is because the typical advisory fee “may not appear substantial” to shareholders in relation to investment value.²⁶ Moreover, fee rates do not vary substantially from fund to fund, investors are highly susceptible to personalized selling efforts, and sales “loads” (i.e., charges) tend to influence the decisions of cost-conscious individuals far more than advisory fees.²⁷ Recent empirical studies confirm the continuing validity of the SEC’s findings.²⁸

As the Supreme Court has recognized, the net effect of the way mutual funds are created, managed, and advised is that “the forces of arm’s length bargaining do not work in the

²⁰ H.R. REP. NO. 89-2337, at 126-127 (1966), available at www.sechistorical.org/collection/papers/1960/1966_InvestCoGrowth [hereinafter SEC REPORT].

²¹ *Id.* at 126.

²² *Id.*; see also *Burks*, 441 U.S. at 481.

²³ SEC Report, *supra* note 20, at 127.

²⁴ *Id.* at 126.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ See Peter J. Wallison & Robert E. Litan, *Competitive Equity: A Better Way to Organize Mutual Funds* (American Enterprise Institute Press 2007); Langevoort, *supra* note 6, at 1033-36 (collecting authorities and summarizing the recent literature, which suggests that most mutual fund investors do not rationally process cost information when selecting funds); U.S. GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 12, 63 (2000).

mutual fund industry in the same manner as they do in other sectors of the American economy.”²⁹ Thus, “[t]hinking about mutual funds by imagining them simply as a species of ‘corporations’ in a way that is directly informed by contemporary corporate law theory is completely misguided.”³⁰ What is needed, instead, is an appreciation of the *sui generis* nature of mutual funds and the mutual fund market and a willingness to think with an open mind about whether and how traditional market theories might apply in the mutual fund context.³¹

2. The Structure of Fee Agreements and Economies of Scale

The second structural problem that is likely to lead to self-dealing between funds and their advisers if left unregulated is that mutual fund fees are typically calculated as a percentage of a fund’s assets.³² Because the costs of managing a large mutual fund are not significantly higher than the costs of servicing a smaller fund, this calculation method can create an enormous economies-of-scale windfall to the adviser. When fund assets, and thus advisory fees, swell over time, but the adviser does not institute appropriate concomitant fee decreases (called “breakpoints”) to account for diminishing marginal management costs, the adviser pockets these huge sums. The SEC has explained the problem in the following manner:

Beyond a certain point increases in an investment company’s assets do not lead to commensurate increases in the cost of furnishing it with investment advice and other managerial

²⁹ *Burks v. Lasker*, 441 U.S. 471, 481 (1979) (quoting S. Rep. No. 91-184, at 5 (1969), as reprinted in 1970 U.S.C.A.N. 4897, 4901).

³⁰ Langevoort, *supra* note 6, at 1032.

³¹ See *Jones v. Assocs. L.P.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting) (arguing that the basis for the majority’s decision—that market forces will constrain advisory fees—“is ripe for reexamination”).

³² See SEC REPORT, *supra* note 20, at 10, 89.

services. Hence, there are considerable economies of size [or scale] to investment company managers. In large measure these economies reflect the fact that the management of a small security portfolio requires much the same general economic and market forecasting, analyses of various industry groups and evaluations of particular securities—the basic elements of the advisory process—as does the management of a large one.³³

B. The Statutory and Regulatory Regime

1. The Original Act

Congress enacted the ICA in 1940.³⁴ Initially, the ICA sought to compensate for the structural problems described above by, among other things, limiting the number of affiliates of the adviser who could serve on a fund's board of directors and requiring that fees for investment advice and other services be governed by a written contract approved by the board and shareholders.³⁵ The ICA also imposed on the adviser a duty of disclosure to the board and to third parties, including the government,³⁶ and prohibited “gross abuse[s] of trust.”³⁷

In the 1960s, the SEC, and then Congress, determined that the procedural safeguards written into the ICA in 1940 were not adequately constraining advisory fees. The Supreme Court has summarized this history as follows:

In the years following passage of the [ICA], investment companies [i.e., mutual funds] enjoyed enormous growth, prompting a number

³³ *Id.* at 10-11.

³⁴ Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789.

³⁵ *See* *Daily Income Fund v. Fox*, 464 U.S. 523, 536-37 (1984).

³⁶ *See* ICA § 34(b), 15 U.S.C. § 33(b) (repealed 1970) (current version at 18 U.S.C. §§6001 et. seq.).

³⁷ *See* *Daily Income Fund*, 464 U.S. at 540 n.12.

of studies of the effectiveness of the [ICA] in protecting investors. One such report, commissioned by the SEC, found that investment advisers often charged mutual funds higher fees than those charged the advisers' other clients and further determined that the structure of the industry, even as regulated by the [ICA], had proved resistant to efforts to moderate adviser compensation. Wharton School Study of Mutual Funds, H.R. Rep. 2274, 87th Cong., 2d Sess., at 28-30, 34, 66-67 (1962). Specifically, the study concluded that the unaffiliated directors mandated by the [ICA] were 'of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and the investment adviser.' *Id.* at 34. A subsequent report, authored by the SEC itself, noted that investment advisers were generally compensated on the basis of a fixed percentage of the fund's assets, rather than on services rendered or actual expenses. [SEC Report, *supra* note 20, at 89]. The [SEC] determined that, as a fund's assets grew, this form of payment could produce unreasonable fees in light of the economies of scale realized in managing a larger portfolio. *Id.* at 94, 102.³⁸

The advisory fee rates that alarmed the SEC in the 1960s ranged from a median of 0.49% of assets under management in 1960 to 0.44% in 1965,³⁹ while

³⁸ *Id.* at 537.

³⁹ See SEC REPORT, *supra* note 20, at 101. Interestingly, the SEC attributed the 0.05% drop in the median advisory fee between 1960 and 1965 to "pressures generated by the Wharton School Study [*see supra* note 38 and accompanying text] and the pendency of stockholder litigation attacking as excessive the fees paid to investment advisers of many of the larger mutual funds." *Id.* at 102. In reaching this conclusion, the SEC noted that "17 of the

the pretax profit margins for advisory services during the same period ranged from approximately 13% to 69%, with a median of 50.7%.⁴⁰ Notably, these median figures are about half the fee rates and profit margins at issue in the *Jones* litigation and are substantially less than the fees at issue in the *Gallus* litigation.⁴¹

2. The 1970 Amendments to the ICA

As a result of these findings, the SEC proposed a series of legislative adjustments that ultimately led Congress to overhaul the ICA in 1970.⁴² Two statutory amendments were designed to make the mutual fund's board of directors more independent of the adviser and to foster scrutiny of advisory fee contracts under a process replicating an arm's length negotiation. The first imposed a new requirement that at least forty percent of the board of directors not be "interested

20 largest externally managed funds as of June 30, 1965, have had their advisory fee rates change since 1960. For 11 of these 17 funds, the changes were made in whole or part in connection with settlements of stockholder suits Only 2 of these 11 settlements were reached prior to publication of the Wharton Report." *Id.*

⁴⁰ *Id.* at 124-25.

⁴¹ See Brief and Required Short Appendix of Plaintiffs-Appellants at 16-17, *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008) (No. 07-1624), 2007 WL 1582568 at *16-17 (summarizing the defendant's fee rates and profit margins); *Gallus*, 497 F. Supp.2d at 977, 985. As the facts of *Jones* and *Gallus* suggest, mutual fund fee rates have increased significantly since the 1960s even as technological advances have permitted fund advisers to achieve service efficiencies and even as the sizes of the largest funds from which advisers are extracting ever-larger percentages have swelled to tens of *billions* of dollars under management. Compare SEC REPORT, *supra* note 20, at 101 (noting that, on June 30, 1965, only one externally managed mutual fund had over \$2 billion in assets, and only six such funds had over \$1 billion in assets) with Lipper Performance Report, available at www.diansfundfreebies.com/performance/lg25.pdf (noting that, on October 9, 2008, the sixth largest mutual fund in the United States had just under \$70 billion in assets).

⁴² See *Daily Income Fund v. Fox*, 464 U.S. 523, 537-38 (1984).

persons” of the adviser.⁴³ The second required that advisory contracts be approved by a majority vote of the “disinterested” directors cast in person at a special meeting “called for the purpose of voting on such approval.”⁴⁴ It also imposed specific duties of analysis and disclosure on fund directors and the adviser: “It shall be the duty of the directors . . . to request and evaluate, and the duty of an . . . adviser . . . to furnish, such information as may reasonably be necessary to evaluate the terms of any contract”⁴⁵

But the lynchpin of the 1970 legislation was the strengthening of ICA § 36, the shareholder-suit provision that formerly made actionable only gross abuses of trust.⁴⁶ Congress added bite to this provision, currently found in ICA § 36(b),⁴⁷ for two principal reasons. First, lawmakers agreed with the SEC that “lawsuits by security holders challenging the reasonableness of advisory fees had been largely ineffective” under the “gross abuse of trust” standard.⁴⁸ Second, they

⁴³ See ICA § 10(a), 15 U.S.C. § 80a-10(a) (2006). Congress defined this new category of “interested persons” more broadly than the “affiliated” persons who were regulated under the original Act. See *id.* § 80a-2(a)(19)(B). Congress also gave the SEC authority to make “interestedness” determinations based on the adviser’s public disclosures. See *id.* § 80a-2(a)(19)(B)(vi).

⁴⁴ ICA § 15(c), 15 U.S.C. § 80a-15(c). In the mutual fund industry, this meeting is commonly referred to as “the Section 15(c) meeting.”

⁴⁵ *Id.*

⁴⁶ See *supra* note 37 and accompanying text.

⁴⁷ A companion provision, ICA § 36(a), 15 U.S.C. § 80a-35(a), addresses breaches of fiduciary duty not involving an investment adviser’s receipt of compensation under a fee agreement. One key difference between ICA §§ 36(a) and 36(b) is that § 36(a) expressly authorizes actions by the SEC, whereas § 36(b) expressly authorizes actions by the SEC and shareholders.

Originally, courts implied a private right of action under § 36(a) and other ICA provisions. See, e.g., *Fogel v. Chestnutt*, 668 F.2d 100, 110-11 (2d Cir. 1981). In recent years, however, the Supreme Court has restricted implied private rights of action under federal regulatory statutes. See, e.g., *Alexander v. Sandoval*, 532 U.S. 275, 286-87 (2001). This has led to a “lively debate” about whether an implied private right of action remains available under ICA § 36(a). *Langevoort*, *supra* note 6, at 1025.

⁴⁸ See *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 537, 540 n.12 (1984). The prior version of the ICA only permitted stockholders to challenge

concluded in the SEC's conclusion that "approval of adviser contracts by shareholders and independent directors could not alone provide complete protection of the interests of security holders with respect to adviser compensation."⁴⁹ Indeed, contrary to the intended effect, such approvals under the regulatory structure created by the original Act had actually *frustrated* effective court challenges to advisory fees because "the courts had relied on the approval of adviser contracts by security holders or unaffiliated directors to uphold the fees."⁵⁰

ICA § 36(b), the statute under which the recent mutual fund reform litigation was initiated,⁵¹ imposes on the fund's adviser a "fiduciary duty with respect to the receipt of compensation for services."⁵² Section 36(b) also expressly authorizes shareholders to bring suit in the event that this fiduciary duty is breached.⁵³ In such an action, shareholders are entitled to recover actual damages from a period commencing one year prior to the filing of the lawsuit.⁵⁴ To prevail under § 36(b), the plaintiff shareholders need not establish "personal misconduct" on the adviser's part.⁵⁵ Moreover, courts are not to give the fact of board approval of a fee agreement conclusive weight but only "such consideration . . . as is deemed appropriate under all the circumstances."⁵⁶

advisory fees in cases of "gross abuse of trust," and thus can be contrasted with the standard in the reformed statute, which imposes a fiduciary duty on advisers.

⁴⁹ *Id.* at 538 (citing SEC REPORT, *supra* note 20, at 128-31, 144, 146-47).

⁵⁰ *Daily Income Fund, Inc.*, 464 U.S. at 540 (citing SEC REPORT, *supra* note 20, at 132-43).

⁵¹ *See supra* notes 1-4 and accompanying text.

⁵² ICA § 36(b), 15 U.S.C. § 80a-35(b) (2006).

⁵³ *Id.*

⁵⁴ *See id.* § 36(b)(3), 15 U.S.C. § 80a-13(b)(3).

⁵⁵ *See id.* § 36(b)(1), 15 U.S.C. § 80a-35(b)(1).

⁵⁶ *See id.* § 36(b)(2), 15 U.S.C. § 80a-35(b)(2).

III. *The Gartenberg Case*

Gartenberg was the first case in which a federal appeals court engaged in an extensive analysis of § 36(b).⁵⁷ Two shareholders of a money market fund alleged that the fees paid by the fund to its adviser for various services rendered were “so disproportionately large as to constitute a breach of fiduciary duty in violation of § 36(b).”⁵⁸ At trial, the principal legal issue was whether the district court should assess the plaintiffs’ claim of unlawful disproportion by deciding whether the challenged fees were “reasonable” or, rather, by deciding whether the fees were “unfair to the Fund and shareholders” in light of “the nature, quality and extent of the [adviser’s] services to the Fund, the money market fund industry practice and level of management fees, and to a lesser extent the [adviser’s] net earnings as a result of providing the services.”⁵⁹ The district court adopted the latter approach and, “[a]fter reviewing the evidence and appraising the live witnesses who testified, . . . concluded that the compensation paid to the [adviser] was fair.”⁶⁰ An important criterion underlying the court’s judgment was that the fee did not appear unfair in relation to “the fees charged by other advisers to other money market funds”⁶¹

On appeal, the shareholders argued that the district court had “erred in rejecting a ‘reasonableness’ standard for determining whether the [adviser] performed its ‘fiduciary duty’ in compliance with § 36(b)”⁶² and in failing to recognize

⁵⁷ See *supra* note 5 and accompanying text.

⁵⁸ *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 925 (2d Cir. 1982). The fee rates at issue in *Gartenberg* started at 0.50% of the fund’s average daily value of net assets under \$500 million but then graduated downward through a number of intermediate breakpoints to a fee rate of 0.275% of assets in excess of \$2.5 billion. *Id.* at 926. The fund’s effective advisory fee was 0.288%, *id.* and the fund generated a pretax profit margin of up to 38.4%, *id.* at 931.

⁵⁹ *Id.* at 926-27.

⁶⁰ *Id.* at 927.

⁶¹ *Id.*

⁶² *Id.*

that the challenged advisory fees, “which may have been reasonable when the Fund was freshly-launched [had become] unreasonable when the Fund grew to its present huge size.”⁶³ The shareholders also asserted that the court had erred in finding the challenged fees fair by comparing them with those charged by other money market fund advisers, because a fund is a “captive of its [adviser],” from whom “it cannot as a practical matter divorce itself” for another adviser offering lower fees.⁶⁴

In an extended analysis of the reasons why market forces do not constrain advisory fees, the *Gartenberg* panel accepted the shareholders’ argument about the shortcomings of comparing the charged fees against those of other advisers.⁶⁵ In fact, the panel could not have been more explicit in setting forth its conclusions on this point:

We disagree with the district court’s suggestions that the principal factor to be considered in evaluating a fee’s fairness is the price charged by other similar advisers to funds managed by them, that the price charged by advisers to those funds establishes the free and open market level for fiduciary compensation, that the market price . . . serves as a standard to test the fairness of the investment advisory fee, and that a fee is fair if it is in harmony with the broad and prevailing market choice available to the investor.⁶⁶

Nonetheless, the panel rejected the shareholders’ principal appellate argument and affirmed the district court’s judgment that the shareholders had failed to establish a breach of fiduciary duty of § 36(b).⁶⁷

⁶³ *Id.* at 928.

⁶⁴ *Id.* at 927-28.

⁶⁵ *See id.* at 929-30.

⁶⁶ *Id.* at 929 (ellipses in original and internal quotation marks omitted).

⁶⁷ *Id.* at 928-34.

A. The Ambiguity of *Gartenberg*

The ambiguity of *Gartenberg* lies in the panel's explanation of its ruling on the shareholders' principal contention. On one hand, the panel suggested that a shareholder can establish a breach of fiduciary duty under § 36(b) simply by showing an adviser knowingly participated in a materially flawed fee-setting process. This is the implication of the panel's emphasis on the centrality of certain process-oriented considerations to the statutory analysis, particularly the expertise of the board of directors, whether the board has been fully informed about all the facts bearing on the adviser's service and fee, and the care and conscientiousness with which the board performs its duties.⁶⁸ It is also the implication of the panel's statement that a breach of fiduciary duty can still be shown "even if the [directors] of a fund endeavored to act in a responsible fashion"⁶⁹

On the other hand, in discussing the shareholders' argument that advisory fees must be reasonable, the panel also seemed to say that a substantive economic showing of fee excessiveness is a *sine qua non* of liability under the statute. The discussion in question starts with an analysis of § 36(b)'s "tortuous legislative history."⁷⁰ Bills introduced in 1967 and 1968 would have required reviewing courts to conduct a

⁶⁸ See *id.* at 930. Other points of entry to the breach-of-fiduciary-duty analysis discussed by the *Gartenberg* panel include the nature and quality of the services provided to shareholders; the profitability of the adviser; "fall-out" benefits (i.e., incidental benefits that flow to the adviser because of its relationship to the fund); any economies of scale achieved in managing the fund; and comparative fee structures. See *id.* at 928-32. Courts have joined these five criteria with the process-oriented considerations involving the board of directors and labeled the resultant group the six "*Gartenberg* factors." See, e.g., *Amron v. Morgan Stanley Inv. Advisors Inc.*, 464 F.3d 338, 340-41 (2d Cir. 2006); *Forsythe v. Sun Life Fin., Inc.*, 417 F. Supp. 2d 100, 114 (D. Mass. 2006).

⁶⁹ *Gartenberg*, 694 F.2d at 930 (emphasis supplied). The panel then explains that, even in a case where there is no reason to question the integrity of the fee-setting process, an adviser's receipt of a fee that is shown to be excessive still would constitute a breach of its § 36(b) fiduciary duty.

⁷⁰ *Id.* at 928.

“reasonableness” analysis but failed passage.⁷¹ In 1969, a bill was introduced substituting the “fiduciary duty” language eventually enacted, but neither the Senate Report nor the House Committee Report defined the term or explained how it was to be distinguished from the reasonableness formulation contained in earlier bills.⁷² The panel then stated:

In short, the legislative history of § 36(b) indicates that substitution of the term “fiduciary duty” for “reasonable,” while possibly intended to modify the standard somewhat, was a more semantical than substantive compromise, shifting the focus slightly from the fund directors to the conduct of the investment adviser-manager. As the district court and all parties seem to recognize, the test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s length in the light of all of the surrounding circumstances. The Senate recognized that as a practical matter the usual arm’s length bargaining between strangers does not occur between an adviser and the fund, stating: “Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter, sever its relationship with the adviser. Therefore, the forces of arm’s length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.” *To be guilty of a violation of § 36(b), therefore, the adviser-manager must charge a fee that is so disproportionately large*

⁷¹ *Id.*

⁷² *Id.*

*that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining.*⁷³

The italicized passage is confusing for two reasons. First, the use of the word “therefore” suggests that the “so disproportionately large” standard that the panel adopts⁷⁴ follows as a logical consequence from the preceding discussion of § 36(b)’s legislative history. However, no explanation why this is so is either provided or apparent. Second, and more importantly, the panel’s use of the word “must” can be and has been taken to suggest that a shareholder can show a violation of § 36(b) *only* by establishing the excessiveness of the fee as a substantive economic matter. In other words, the passage seems to imply that an adviser’s knowing participation in a materially flawed fee-setting process does not constitute a breach of § 36(b)’s fiduciary duty unless a shareholder can somehow independently convince a court that the resultant fee is too high. But again, this conflicts with the panel’s discussion two pages later, indicating that an adviser’s knowing participation in a materially flawed fee-setting process *does* constitute a § 36(b) violation.⁷⁵ Moreover, as we shall explain below, it is entirely at odds with established trust and fiduciary law.⁷⁶

⁷³ *Id.* (citations omitted and emphasis added).

⁷⁴ Interestingly, the “so disproportionately large” standard that the panel appears to treat as a prerequisite to liability employs the same language that the shareholders used to frame their claim. *See id.* at 929 and accompanying text. This raises the possibility that, in the italicized passage, the panel merely intended to suggest that the case theory that the shareholders pleaded was one of *several* potentially viable ways to prove a § 36(b) violation. We of course agree that, if a shareholder is able to demonstrate fee excessiveness as a substantive economic matter, a statutory violation will have been proved. However, as we argue below, there is no reason to suppose that this is the *only* way to demonstrate a breach of the fiduciary duty that § 36(b) imposes on mutual fund advisers. *See infra* Part IV.C.

⁷⁵ *See infra* notes 81-82 and accompanying text. The Fourth Circuit has suggested that an adviser’s receipt of compensation approved in a fee-setting process that it knows to have been conducted in material violation of procedural requirements, such as those specified in ICA §§ 15(c) and 34(b), is not actionable under § 36(b). *See Migdal v. Rowe Price Fleming Int’l*,

B. Courts Led Astray by *Gartenberg*: *Gallus* and *Jones*

The summary judgment rulings in *Gallus* and *Jones*⁷⁷ illustrate how § 36(b) liability can turn on the way in which a court following *Gartenberg* resolves the ambiguity that we have just discussed. In each case, the shareholders adduced evidence calling into serious question the integrity of the processes in which the challenged advisory fees were approved.⁷⁸ In *Gallus*, there was evidence that the adviser and the board had simply pegged fee rates to those charged by other advisers to similar funds.⁷⁹ There also was evidence that the

Inc., 248 F.3d 321, 326-27 (4th Cir. 2001) (stating in dictum that § 36(b) outlaws only the receipt of excessive advisory fees). This crabbed and counterintuitive reading of the fiduciary duty that § 36(b) creates has been rejected by the Seventh Circuit, *see Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 743 n.8 (7th Cir. 2002) (upholding summary judgment for municipal bond fund advisers in a suit by fund shareholders alleging that advisers breached their fiduciary duty under the ICA by receiving compensation based on percentage of daily net assets of funds), and (at least in the Seventh Circuit's view) the Third Circuit, *see id.* (citing *Green v. Fund Asset Mgmt., L.P.*, 286 F.3d 682, 686 (3d Cir. 2002)). Obviously, the approach to § 36(b) we set forth in Part IV, *infra*, rejects the Fourth Circuit's view as well.

⁷⁶ *See infra* notes 103-3 and accompanying text.

⁷⁷ *See supra* note 11.

⁷⁸ Perhaps because *Gartenberg* led each judge to conclude that the shareholders' evidence of flawed processes was not in and of itself particularly probative of whether the advisers had breached their fiduciary duties, *see infra* at notes 86-88 and accompanying text, the description of the evidence in each summary judgment order is highly general and quite limited. In fact, the shareholders' evidence of defective processes (which is, of course, on file with the authors and in the district court records) was far more voluminous, detailed, and powerful than the summary judgment orders would suggest.

⁷⁹ *See Gallus v. Ameriprise Fin., Inc.*, 497 F. Supp. 2d 974, 983-84 (D. Minn. 2007). Because of the non-competitive nature of the fee-setting market, pegging fee rates to the rates charged to other similar funds, and failing to engage in an arm's length negotiation over the fees to be charged, does not satisfy the fiduciary obligations owed to shareholders under the ICA.

adviser had failed to account for its profits in a transparent manner.⁸⁰ In *Jones*, there was evidence that the board of directors from which the adviser had secured its fees was chaired by a person who was a former executive of the adviser and the former chairman of the adviser's controlling general partner, and who was annually receiving hundreds of thousands of dollars in deferred compensation from the adviser.⁸¹ Nonetheless, this director had falsely declared himself to be "disinterested" in the adviser and had led the deliberations at the ICA § 15(c) meeting⁸² at which the fees were approved.⁸³ There also was evidence that the adviser had violated ICA § 34(b)⁸⁴ by failing to disclose to the SEC and the investing public either this deferred compensation arrangement or a number of other business relationships between fund directors and the adviser's executives and employees, including hundreds of thousands of dollars in joint real estate and investment ventures.⁸⁵

The district courts in *Gallus* and *Jones* struggled to make sense of *Gartenberg's* conflicting signals, so neither opinion is a model of clarity. Nonetheless, both opinions repeatedly suggest that evidence of a materially flawed fee-setting process is inadequate to warrant a trial under

⁸⁰ See *id.* at 980-81.

⁸¹ See Brief and Required Short Appendix of Plaintiffs-Appellants at 21-22, *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008) (No. 07-1624), 2007 WL 1582568 at *21-22.

⁸² See *supra* note 44 and accompanying text. The person at issue was chairman of the fund board both before and after he retired from the adviser. The adviser simply changed the director's designation from "interested" to "disinterested" upon his retirement without disclosing the large financial interest the director continued to hold in the adviser. Brief and Required Short Appendix of Plaintiffs-Appellants at 21-22, 29-31, *Jones*, 527 F.3d (No. 07-1624), 2007 WL 1582568 at *21-22, 29-31.

⁸³ *Jones v. Harris Assocs. L.P.*, No. 04 C 8305, 2007 WL 627640, at *5 (N.D. Ill. Feb. 27, 2007) (mem. opinion on cross-motions for summary judgment).

⁸⁴ See *supra* notes 35-37 and accompanying text.

⁸⁵ See *Jones*, 2007 WL 627640, at *5-6; see also Brief and Required Short Appendix of Plaintiffs-Appellants at 29-31, 38-42, *Jones*, 527 F.3d (No. 07-1624), 2007 WL 1582568 at *29-31, *38-42.

Gartenberg unless such evidence in and of itself also establishes to the satisfaction of the court's untrained eye that the advisory fees charged were excessive as a substantive economic matter.⁸⁶ Thus, both opinions implicitly dismiss *Gartenberg*'s suggestion that a flawed fee-setting process can and should serve as a proxy for an unlawful fee agreement.⁸⁷ As we shall demonstrate below, this interpretation of *Gartenberg* disregards the plain language of § 36(b), ignores settled trust and fiduciary law, and requires courts to serve as rate-makers in evaluating fee agreements that are challenged under the statute. Moreover, it asks courts to ignore identifiable proxies for unlawfully-set fees and to instead conduct analyses they are reluctant to undertake. No wonder then that both the *Gallus* and *Jones* courts heavily weighed the fact that the challenged advisory fees were "in line with" the fees charged to other similar funds⁸⁸ notwithstanding *Gartenberg*'s admonition that they refrain from doing so.⁸⁹ For if a court cannot use other judicially administrable proxies, how else would it determine fee excessiveness as a substantive economic matter?

IV. A More Practical Approach to § 36(b)

For better or for worse, the Second Circuit's analysis in *Gartenberg* has dominated litigation involving ICA § 36(b).⁹⁰

⁸⁶ See *Gallus v. Ameriprise Fin., Inc.*, 497 F. Supp. 2d 974, 979–84 (D. Minn. 2007) (proceeding seriatim through the six *Gartenberg* factors and analyzing whether the evidence as to each established per se that the adviser's fees were too high as a substantive economic matter); *Jones*, 2007 WL 627640, at *5, *6, *7, *9.

⁸⁷ See *Gallus*, 497 F.Supp. 2d at 979-84; *Jones*, 2007 WL 627640 at *5, *6, *7, *9.

⁸⁸ *Jones*, 2007 WL 627640 at *8; see also *Gallus*, 497 F. Supp. 2d at 982–83.

⁸⁹ See *supra* note 66 and accompanying text.

⁹⁰ We hope this changes in the near future. We appealed the summary judgment orders in *Gallus* and *Jones* to the Eighth and Seventh Circuits, respectively. The Seventh Circuit issued an opinion affirming the district court. See *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008). We then petitioned the Seventh Circuit for a rehearing en banc, which the court denied in a 5-5 split decision, with Judge Richard Posner, joined by four

For this reason, we think it important to highlight the strengths and weaknesses of the opinion before we summarize our own position. We reiterate that the opinion is fundamentally ambiguous⁹¹ and that its ambiguity might well be resolved by a reading that is consistent with the more practical approach we set forth here. Regardless, courts should interpret § 36(b) to authorize a process-based and comparative approach to claims that advisers have breached their fiduciary duty with respect to the receipt of compensation. Thus, one way or another, courts must move beyond *Gartenberg*.

A. What *Gartenberg* Got Right: The Actual Meaning of So-Called “Comparative Fee Structures”

As *Gallus* and *Jones* demonstrate, courts that understand *Gartenberg* to *always* require a substantive economic judgment regarding the excessiveness of a challenged fee will be sorely tempted to compare that fee with those charged to similar funds and will declare the fee lawful if it is similar to the comparator fees.⁹² This is hardly surprising, for courts repeatedly have listed “comparative fee structures” as one of the six “*Gartenberg* Factors” that should be used to assess a § 36(b) claim.⁹³ And such an analysis might be reasonable if advisers competed with one another to service mutual funds or if customers were sensitive to advisory fees in

other judges, writing a vigorous dissent. *See Jones v. Harris Assocs. L.P.*, 537 F.3d 728 (7th Cir. 2008) (denying plaintiffs’ petition for a rehearing en banc by a 5–5 split decision). As of this writing, the plaintiffs intend to petition the Supreme Court for a writ of certiorari. The Eighth Circuit has not yet ruled on the appeal in *Gallus*.

⁹¹ *See supra* Part III.A.

⁹² *See supra* notes 86–88 and accompanying text.

⁹³ *See, e.g., Amron v. Morgan Stanley Inv. Advisors Inc.*, 464 F.3d 338, 340–41 (2nd Cir. 2006) (“[The six *Gartenberg* factors] are: (1) the nature and quality of services provided to fund shareholders; (2) the profitability of the fund to the adviser-manager; (3) fall-out benefits; (4) economies of scale; (5) comparative fee structures; and (6) the independence and conscientiousness of the trustees.”).

shopping for funds. But because such market forces do not exist in the mutual fund context, *Gartenberg* warns courts *not* to regard a clustering of rates among competitors as probative of whether the advisers within the cluster are faithfully discharging their fiduciary duties:

Competition between . . . funds for shareholder business does not support an inference that competition must therefore also exist between adviser-managers for fund business. The former may be vigorous even though the latter is virtually non-existent. Each is governed by different forces. Reliance on prevailing industry advisory fees will not satisfy § 36(b).⁹⁴

In this respect, *Gartenberg* is clearly correct. The opinion explains in great detail why the relationship between advisers and the funds they create is “unseverable,”⁹⁵ why “an essential element of arm’s-length bargaining [is] the freedom to terminate the negotiations and to bargain with other parties for the same services,”⁹⁶ and how all of this “tends to weaken the weight to be given to rates charged by advisers of other similar funds.”⁹⁷ We have discussed these points above and need not repeat ourselves here.⁹⁸ For present purposes, it suffices to emphasize that, for very sound reasons, *Gartenberg* does *not* endorse rejecting a § 36(b) claim merely because the challenged fee is similar to fees charged by competitors.

⁹⁴ *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 929 (2nd Cir. 1982).

⁹⁵ *Id.* at 929, n.2 (quoting SEC REPORT, *supra* note 20, at 131) (“In view of the fund’s dependence on its existing adviser and the fact that many shareholders may have invested in the fund on the strength of the adviser’s reputation, few unaffiliated directors would feel justified in replacing the adviser with a new and untested organization simply because of difficulty in obtaining a reduction in long-established fee rates which are customary in the industry.”).

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *See supra* Part II.A.

To be sure, *Gartenberg* does not treat comparative fee structures as irrelevant. In fact, the opinion explicitly states that “to the extent that other managers have tended ‘to reduce their effective charges as the fund grows in size,’ . . . such a reduction represents ‘the best industry practice [which] will provide a guide.’”⁹⁹ However, this suggests not that similar rates charged by a competitor should insulate an adviser from liability, but that serious questions should arise if fund shareholders are not benefiting from a favorable fee structure that is available to others who are similarly situated. The shareholders in *Gallus* and *Jones* adduced precisely such evidence by showing that non-mutual fund clients (e.g., large institutional investors such as pension funds) convinced the defendant-adviser in each case to provide similar management services to funds that were “cloned” from the same mix of investments in their mutual funds *for far lower advisory fees*.¹⁰⁰ What the district courts in *Gallus* and *Jones* failed to appreciate was that such *negotiated* advisory fees for similar services—established in the course of arm’s length bargaining between parties with a vested interest in fee rates—clearly demonstrate what an adviser functioning in a true market might reasonably charge for its services. Thus, such rates are excellent proxies for fees that are lawful within the meaning of § 36(b).¹⁰¹

⁹⁹ *Gartenberg*, 694 F.2d at 929 n.2 (quoting S. REP. NO. 91-184, at 6 (1969), as reprinted in 1970 U.S.C.C.A.N 4897, 4902).

¹⁰⁰ *Gallus v. Ameriprise Fin., Inc.*, 497 F. Supp. 2d 974, 982 (D. Minn. 2007); *Jones v. Harris Assocs. L.P.*, No. 04 C 8305, 2007 WL 627640, at *8 (N.D. Ill. Feb. 27, 2007). In *Jones*, the adviser charged the mutual funds at issue approximately double what it charged other clients for the same services. Brief and Required Short Appendix of Plaintiffs-Appellants at 37-38, *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008) (No. 07-1624), 2007 WL 1582568 at *37-38.

¹⁰¹ Moreover, the failure of a board of directors to insist upon similar fees for the mutual funds they oversee is powerful evidence that the conflicts of interest that spurred enactment of the ICA have fatally compromised the “negotiation” of the challenged fee.

B. What *Gartenberg* Got Wrong: The “So Disproportionately Large” Standard

As explained above, the *Gartenberg* panel rejected the shareholders’ principal appellate argument in a passage that concluded with the following sentence: “To be guilty of a violation of § 36(b), therefore, 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 the product of arm’s-length bargaining.”¹⁰² There are two significant problems with this statement.

First, the statement completely misapprehends the nature of the duties owed by one who assumes a fiduciary obligation. When Congress enacted § 36(b) in 1970, it chose the word “fiduciary” to characterize the new duty it was imposing on mutual fund advisers. At that time, the notion that a fiduciary duty involves significantly heightened obligations to beneficiaries was long established. In the famous words of Chief Judge Cardozo, a fiduciary is required to act with “the punctilio of an honor most sensitive” and must operate at a level higher than that “trodden by the crowd.”¹⁰³ Thus, courts interpreting § 36(b) should start with a presumption that the duties owed to shareholders by mutual fund advisers with respect to their receipt of compensation should track those duties imposed on other fiduciaries by the common law of trusts. For when Congress uses a long-established term such as “fiduciary duty,” courts are to infer that it intended the traditional definition to apply “unless Congress has unequivocally expressed an intent to the contrary.”¹⁰⁴ Nothing in the ICA’s text, structure, or history expresses such a contrary intent. In fact, if anything, the legislative history that the *Gartenberg* panel discussed just before articulating the “so disproportionately large” standard strongly suggests that

¹⁰² *Gartenberg*, 694 F.2d at 928.

¹⁰³ *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

¹⁰⁴ *NLRB v. Amax Coal Co.*, 453 U.S. 322, 330 (1980) (applying the *Meinhard* standard to a federal fiduciary duty).

Congress knew *exactly* what it was doing when it wrote a fiduciary duty into § 36(b).¹⁰⁵

Unfortunately, *Gartenberg*'s "so disproportionately large" language has enabled advisers to argue successfully that the § 36(b) duty is actually quite narrow. For example, the defendant in *Jones* prevailed on a summary judgment motion that invoked *Gartenberg* to contend that, "[a]s a matter of law, the question a Section 36(b) claim raises is *not* whether investment advisory fees were 'reasonable.' Rather, a Section 36(b) case addresses whether the fees were *so unreasonable* that they evince no hint of good faith negotiation."¹⁰⁶ That same motion also asserted that, to establish a § 36(b) violation, shareholders must show that the challenged fees were "grossly unreasonable."¹⁰⁷ Such formulations are, of course, all but indistinguishable from the too-lenient "gross abuse of trust" standard that Congress enacted § 36(b) *to replace*.¹⁰⁸ Moreover, they are in serious tension with ICA § 36(b)(1), which states that shareholders may prevail on a breach of fiduciary duty claim without showing "personal misconduct" on the part of the adviser.¹⁰⁹

There are many ways to articulate what "fiduciary duty" means. In our view, Judge Posner captured the concept as well as anyone when he stated that, "A fiduciary duty is the duty of an agent to treat his principal with the utmost candor, rectitude, care, loyalty, and good faith—in fact to treat the principal as well as the agent would treat himself."¹¹⁰ But regardless of the definition selected, *Gartenberg*'s "so disproportionately large"

¹⁰⁵ See *Gartenberg*, 694 F.2d at 928 (stating that before the bill imposing a "fiduciary duty" standard passed, two prior bills imposing a "reasonableness" standard failed, which suggests that Congress deliberately chose to include a "fiduciary duty" standard).

¹⁰⁶ Memorandum of Law in Support of Defendant Harris Assocs. L.P.'s Motion for Summary Judgment at 1, *Jones v. Harris Assocs. L.P.*, No. 04 C 83052007, 2007 WL 627640 (N.D. Ill. Feb. 27, 2007) (No. 1:04-cv-08305 CPK), 2006 WL 3054110.

¹⁰⁷ *Id.*

¹⁰⁸ See *supra* notes 46-50 and accompanying text.

¹⁰⁹ 15 U.S.C. § 80a-35(b)(1) (2006).

¹¹⁰ *Burdett v. Miller*, 957 F.2d 1375, 1381 (7th Cir. 1992).

language is completely at odds with any established conception of fiduciary duty.

Second, and even more perniciously, *Gartenberg*'s "so disproportionately large" standard is all too easily read to suggest that relief is unavailable under § 36(b) unless a court is convinced as a substantive economic matter that a challenged fee is simply too high, without regard to either the fairness of the fee-setting process or the rates negotiated at arm's length by non-mutual fund clients of the adviser. Once again, the motion for summary judgment filed by the defendant in *Jones* is instructive. The *Jones* defendant interpreted *Gartenberg* to hold that "an investment adviser cannot be liable for breach of its 'fiduciary duty with respect to the receipt of compensation' if *either* its fees are not objectively unreasonable *or* the fees are objectively the result of bargaining at arms' length."¹¹¹ In other words, a plaintiff must prove not only that the fees resulted from an unfair process, but *also* that the fees are patently unreasonable. Therefore, according to the defendant in *Jones*, unless a court is able to say that on its face a given fee is not economically warranted, the court should ignore the structural flaws, including any potential for self-dealing in the mutual fund market,¹¹² any serious procedural irregularities that a plaintiff may identify in the fee-negotiation process, and any evidence that an adviser is providing similar services to non-mutual fund clients for far lower fees. Under this reading, even a shareholder who adduces evidence that an adviser has *bribed* the board to approve a fee would not be entitled to a trial on its breach of fiduciary duty claim unless the shareholder somehow *independently* demonstrates the fee to be "so disproportionately large that it bears no reasonable relationship to the services rendered."¹¹³

Obviously, this understanding of § 36(b) is totally contradicted by the common law of trusts, which requires a

¹¹¹ Memorandum of Law in Support of Defendant Harris Assocs. L.P.'s Motion for Summary Judgment, *supra* note 106, at 1.

¹¹² See *supra* Part II.A.1.

¹¹³ *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2nd Cir. 1982).

fiduciary to act with “the punctilio of an honor most sensitive,”¹¹⁴ obliges a fiduciary to do unto his beneficiary as he would have done unto himself,¹¹⁵ and mandates a searching judicial inquiry of transactions undertaken by a conflicted fiduciary.¹¹⁶ Moreover, such a construction of the statute makes no sense as a jurisprudential matter. Congress enacted § 36(b) to provide judicial oversight of mutual fund advisory fees. Yet a substantive economic judgment that a given advisory fee is too high—made without the use of tools such as the process-based and comparative proxies that we propose—is a judgment courts are reluctant to make. Courts simply lack the expertise and capacity to serve as rate-makers for the mutual fund industry.

Given all of this, readers will not be surprised to learn that *Gartenberg*’s “so disproportionately large” standard has not yet grounded a § 36(b) liability finding in *any* reported case. If, as in *Gallus* and *Jones*, *Gartenberg* is understood to require such a judgment and to render immaterial any evidence of flawed process or far lower advisory fees charged to other clients for similar services, shareholders may *never* prevail under § 36(b). Mutual fund advisers are sophisticated enough to avoid becoming outliers and to charge fees in the same general ballpark as the fees other advisers charge to similar funds in this non-competitive market. And so long as they do, what court will ever eyeball such a fee and say that it is too high?¹¹⁷

¹¹⁴ *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

¹¹⁵ *Burdett*, 957 F.2d at 1381.

¹¹⁶ See *Johnson*, *supra* note 6, at 531.

¹¹⁷ Again, the district court’s analysis in *Jones* is particularly revealing. In *Jones*, the district court held that an advisory fee is lawful if it falls within an acceptable range. *Jones v. Harris Assocs. L.P.*, No. 04 C 8305, 2007 WL 627640, at *7 (N.D. Ill. Feb. 27, 2007). The court defined that range to extend “from a low-end figure below what the [non-mutual fund] clients were paying and a high-end figure *beyond* the fees that other mutual fund clients paid.” *Id.* at *8 (emphasis added). Thus, according to the district court in *Jones*, any fee is lawful as long as it is within striking distance of the highest fee paid by a similar mutual fund.

C. A Process-Based and Comparative Approach to § 36(b) Claims

ICA § 36(b) provides an express right of action to shareholders of a mutual fund when the adviser to the fund breaches its fiduciary duty to the shareholders with respect to its receipt of compensation.¹¹⁸ Recognizing that the competitive market pressures operating elsewhere in corporate markets are absent in the mutual fund industry because “the usual arm’s length bargaining between strangers does not occur between an adviser and the fund,”¹¹⁹ Congress provided for judicial oversight of advisory fee arrangements. At the same time, Congress recognized that federal judges lack the expertise to serve as mutual fund rate-makers.¹²⁰ The ICA thus seeks to ensure the fairness of advisory fee agreements by permitting shareholders to insist *at the threshold* that approved fees be the product of a fair *process*,¹²¹ and then to challenge the fees

¹¹⁸ 15 U.S.C. § 80a-35(b) (2006).

¹¹⁹ *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982).

¹²⁰ *See* S. REP. NO. 91-184, at 6 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897.

¹²¹ Courts are fully capable of examining whether the fee-setting process was fair, that is, whether the fiduciaries were inherently conflicted and whether the resultant agreement was the product of an arm’s-length negotiation between fully informed and conscientious parties who are cognizant of and committed to performing their legal duties. Moreover, skeptical judicial review is a common method for enforcing federal fiduciary duties in circumstances such as those presented here. *Cf., e.g., Werdehausen v. Benicorp Ins. Co.*, 487 F.3d 660, 664-67 (8th Cir. 2007) (explaining that courts should closely review the decision-making processes of an ERISA fiduciary laboring under an inherent conflict of interest); *Martin v. Feilen*, 965 F.2d 660, 670-71 (8th Cir. 1992).

Under state law, the “business-judgment rule” typically gives way to the “entire fairness” standard in situations involving a conflicted fiduciary. *See, e.g., Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). The entire-fairness standard insists on “both fair dealing *and* fair price.” *Cede*, 634 A.2d at 361. Thus, even if it has no basis for saying that a price is unfair, a court applying the entire fairness standard will invalidate a transaction that does not result from a fair process.

substantively by means of comparative evidence. The Act accomplishes these purposes by establishing a series of proxies for fee lawfulness, including deliberation by independent directors (who must negotiate in good faith), disclosure to the public and to the expert agency that oversees the mutual fund market, and comparative benchmarks for compensation set in arm's length transactions in a competitive market.¹²²

The first of these proxies arises from the statutory and regulatory requirements that the disinterested directors of the fund approve any advisory or distribution fee. Section 10(a) of the ICA requires that at least 40% of a fund's board of directors not be "interested persons" with regard to the adviser.¹²³ Furthermore, Section 15(c) of the ICA requires that advisory fee agreements be approved by a majority vote of the disinterested directors cast in person at a special meeting "called for the purpose of voting on such approval" after the disinterested directors have been provided "such information as may reasonably be necessary to evaluate the terms of any contract."¹²⁴ Advisory agreements that the adviser knows to have been made in violation of these structural requirements are void and subject to rescission under § 47(b) of the ICA.¹²⁵ Thus, a court entertaining a § 36(b) claim may determine that a fee has been unlawfully received under § 36(b) if it finds, as a threshold matter, that the adviser knows that the fee was not approved following deliberation by a disinterested board acting

¹²² This is not meant to be an exhaustive list of proxies for fee lawfulness set forth in the ICA, nor is it meant to imply that a court should not consider other evidence that would indicate an adviser has breached its § 36(b) fiduciary duty. Such other proxies or evidence are simply beyond the scope of this article.

¹²³ 15 U.S.C. § 80a-10(a).

¹²⁴ *Id.* § 80a-15(c). This requirement clearly contemplates that the board actually act independently in approving advisory fees and not merely maintain technical disinterestedness. For an in-depth discussion of the role of "independence" in other fiduciary contexts and a proposal that courts incorporate the concept into § 36(b), see Johnson, *supra* note 5. We agree with Professor Johnson and believe that evidence that fund directors did not act independently is another proxy for fee unlawfulness.

¹²⁵ 15 U.S.C. § 80a-46(b).

independently. An example of such a situation was presented in *Jones*, where the adviser knew that the advisory fee was approved by a deeply conflicted board led by director who had falsely declared himself to be disinterested in the adviser.¹²⁶

A second proxy for a breach of duty under § 36(b) is failure to comply with the filing and disclosure requirements of the ICA and its regulations. Section 34(b) of the ICA makes it unlawful for any person to “omit to state” in filings under the ICA “any fact necessary in order to prevent the statements made therein . . . from being materially misleading.”¹²⁷ These disclosures serve two parallel purposes. First, to the extent that prospective purchasers of shares in a fund do pay attention to management fees, full disclosure not only of the fees but also of potential conflicts of interest helps the market function rationally. Second, such disclosures facilitate the SEC’s enforcement of § 36(a) and § 36(b).¹²⁸ Hence, courts also should treat a failure to make the requisite disclosures in connection with the receipt of compensation for advisory services a violation of the adviser’s fiduciary duty under § 36(b).¹²⁹ Again, we see an example of this situation in *Jones*, where the adviser failed to make required disclosures of either the deferred compensation agreement with its former-executive-turned-disinterested-director or the joint investments

¹²⁶ See *Jones v. Harris Assocs. L.P.*, No. 04 C 8305, 2007 WL 627640, at *1-2, *6 (N.D. Ill. Feb. 27, 2007) (recounting that multiple board members had business and social connections with the investment advisor company but finding that, “[t]he evidence the parties have provided indicates that the board as a whole was operating without any conflict that would prevent it from engaging in arm’s length negotiations with Harris.”).

¹²⁷ 15 U.S.C. § 80a-33(b).

¹²⁸ See *supra* note 45. While the SEC is the ostensible front-line enforcer of the ICA and should be particularly well suited to make fine-grained judgments about board independence and fee excessiveness, it has made little, if any, effort to fulfill this function. Nonetheless, courts and private plaintiffs can facilitate the expert agency’s role by insisting on strict enforcement of the ICA’s disclosure requirements.

¹²⁹ Cf. *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 811-12 (2d Cir. 1976) (holding that an adviser breached its fiduciary duty under § 36(b) by failing to make disclosures in connection with its fee to directors and shareholders).

between fund directors and certain of the adviser's executives and employees.¹³⁰

Finally, both Congress and the SEC have recognized that "approval of adviser contracts by shareholders and independent directors [cannot] alone provide complete protection of the interests of security holders with respect to adviser compensation."¹³¹ Section 36(b) thus contemplates not only the threshold procedural review described above, but also a *substantive* review of whether the challenged fee is excessive. Because "the usual arm's length bargaining between strangers does not occur between an adviser and the fund,"¹³² the judicial task is to find a proxy for what arm's length bargaining might have produced. In circumstances such as *Gallus* and *Jones*, where the advisers provided similar advisory services to non-mutual fund clients who bargained at arm's length for their fee rates, judges should use the rates charged to those clients as a proxy for what arm's length bargaining with the fund should have produced. Moreover, if, as in *Gallus* and *Jones*, the discrepancy is substantial, courts should treat the gap as prima facie evidence of a breach of the fiduciary duty under § 36(b) and require the adviser to justify it.¹³³

¹³⁰ See *supra* notes 81-85 and accompanying text.

¹³¹ *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 538 (citing SEC Report, *supra* note 20, at 128-31, 144, 146-47).

¹³² *Gartenberg v. Merrill Lynch Asset Mgmt, Inc.*, 694 F.2d 923, 928 (2d Cir. 1982).

¹³³ See, e.g., *Sins v. Janus Capital Mgmt.*, Nos. 04-cv-01647-WDM-MEH, 04-cv-02395-MSK-CBS, 2006 WL 3746130, at *3-4 (D. Col. Dec. 15, 2006) (denying motion to dismiss § 36(b) claim where plaintiffs alleged that the adviser charged the fund significantly more than it charged institutional investors for equivalent services); *Hunt v. Invesco Funds Group, Inc.*, No. H-04-02555, 2006 WL 1581846, at *3 (S.D. Tex. June 5, 2006); *Strigliabotti v. Franklin Res., Inc.*, No. C 04-00883 SI, 2005 WL 645529, at *3-4 (N.D. Cal. Mar. 7, 2005).

V. *Conclusion*

The nation's mutual fund industry is entrusted with nearly \$12 trillion in retirement and personal savings.¹³⁴ ICA § 36(b) is an essential mechanism for ensuring that the industry does not take advantage of the structural defects in the fee-setting process to extract unreasonable sums of money from the funds it controls. It is therefore critical that federal courts move beyond *Gartenberg* and enforce the fiduciary duty that § 36(b) creates in the same way that they enforce the duties owed by other conflicted fiduciaries: by insisting on both a fair fee-setting process and fair results. By drawing on settled fiduciary and trust law and looking to judicially administrable liability guideposts, the process-based and comparative approach we propose would permit the federal courts to advance the purposes of the ICA in an effective and institutionally appropriate manner.

¹³⁴ Investment Company Institute, Trends in Mutual Fund Investing July 2008, http://www.ici.org/stats/mf/trends_07_08.html.