THE DOWNSIDE OF JUDICIAL RESTRAINT: THE (NON-)EFFECT OF *JONES V. HARRIS*

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In 1970, Congress added section 36(b) to the Investment Company Act of 1940 ("ICA").[1] Section 36(b) imposes a fiduciary duty on investment advisers of mutual funds "with respect to the receipt of compensation"[2] and creates a private right of action to enforce this duty. In *Gartenberg v. Merrill Lynch Asset Management*,[3] the Second Circuit outlined what would become the generally accepted test of whether the adviser fees were in an acceptable range. *Gartenberg* set out a number of non-exclusive factors to be considered: the nature and quality of the services provided; the profitability to the adviser of providing services to the fund; realized economies of scale; fee structures of comparable funds; the independence and conscientiousness of trustees; and fall-out benefits.[4] Recently, the Seventh Circuit specifically disavowed *Gartenberg* in *Jones v. Harris*,[5] emphasizing the candor of the adviser to the board as the primary consideration in determining whether the adviser's compensation was lawful under the ICA.[6] Based on its view that the mutual fund markets are sufficiently competitive, the Seventh Circuit held that absent extreme circumstances the only cause of action under section 36(b) is for a failure of the adviser to make full disclosure. The Supreme Court, in a unanimous decision, reversed the Seventh Circuit decision and instead adopted the *Gartenberg* test with minor adjustments.[7] This short article will assess the likely impact of *Jones*

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1. 15 U.S.C.A. § 80a-35(b) (West 2009).
2. *Id*.
3. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982).
4. *Id.* at 928.
5. Jones v. Harris Assocs., L.P., 527 F.3d 627 (7th Cir. 2008).
6. *Id.* at 632.
7. *See* Jones v. Harris Assocs., 130 S. Ct. 1418 (2010).

and evaluate the Supreme Court's decision to exercise what would commonly be called "judicial restraint" in its analysis.

Little has changed from the pre-*Jones v. Harris*[8] legal environment. True, section 36(b) cases will move through the courts a bit differently from now on. Lower courts will not be able to dismiss cases solely on the basis that a given fee is within industry norms and they will be required to consider evidence comparing a fee with fees charged by the same advisor to institutional funds or other institutional clients. The Supreme Court's refusal to rule out any particular set of arguably relevant facts for purposes of section 36(b) analysis, or to establish any bright-line rules establishing how plaintiffs might conclusively demonstrate that a fee is excessive,[9] means that fewer cases are likely to be decided on a motion for summary judgment.

Nevertheless, federal trial court judges had enormous discretion prior to *Jones* and continue to have enormous discretion to award damages, or not, under section 36(b). Since the Supreme Court chose to give little additional meaningful guidance to lower courts on what factors to use, beyond slight modifications to the *Gartenberg* factors,[10] the probability of liability after trial will continue to depend on the judge to which each case is assigned. If future cases are based not on what the judge had for breakfast,[11] then they will certainly be based on the judge's prior (and not necessarily known) beliefs about how strong competitive market forces are in restraining fees. Since judge assignments are not known prior to a case being filed, the outcome of cases will be unpredictable, as in the past. Relatively few cases will be brought, as in the past.[12] Both plaintiffs—effectively controlled by

8. Jones v. Harris Assocs., 130 S. Ct. 1418 (2010).

9. *Id*. at 1428.

10. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 930 (2d Cir. 1982) (providing six factors to consider in weighing whether the mutual fund investment advisor breached a fiduciary duty through charging excessive fees: nature and quality of services provided; the profitability of the fund to the advisor; economies of scale operating as the fund grows larger; fee structures of comparable funds; the independence and conscientiousness of trustees; and fall-out benefits).

11. *See* Charles M. Yablon, *Justifying the Judges' Hunch: An Essay on Discretion*, 41 HASTINGS L.J. 231, 235 n.16 (1990) (discussing Ronald Dworkin's critique of legal realism, but noting that the closest published phrase used by a realist, or a contemporary interlocutor of a realist, was Roscoe Pound's reference to "cadi" justice administered "at the city gate by the light of nature tempered by the state of his digestion." *See* Roscoe Pound, *The Decadency of Equity*, 5 COLUM. L. REV. 20, 21 (1905)).

12. With the assistance of lawyers and experts (both defense and plaintiff) involved in pending section 36(b) cases, to whom I extend thanks, I have been gathering data on section 36(b) cases. So far, I have identified fewer than twenty discrete fund complexes that were

plaintiff attorneys, who are averse to the risk of losing the time and effort they invest bringing a case—and defendants—effectively controlled by in-house attorneys and managers of fund advisory firms, who are averse to the risk of a losing a high-profile case with potential for both large money damages and reputational harm—will be likely to settle cases before a trial on the merits.

I. THE IMMEDIATE BENEFICIARIES OF *JONES*

Thus, the primary beneficiaries post-*Jones* are lawyers. Plaintiff attorneys will continue to bring fee cases and to extract fees from settlements in some cases. Defense attorneys will still have to be paid to defend all cases, good or bad, and fund and fund advisor corporate counsel will have to be paid to advise and manage a time-intensive fee review process in the shadow of potential fee litigation. Fund directors, who are not typically paid by the hour but receive fixed fees, will need to expend time and effort to go through a fee review and approval process, with lengthy documentation, and will face the risk of depositions, all without regard to whether the fees in question are clearly competitive or not. In the end, of course, shareholders—fund investors—have to pay for all of those attorney hours: plaintiffs' attorney fees come out of settlements; defense litigator fees are paid by advisors in the first instance, but ultimately by fund investors in the form of higher fees; and defense corporate counsel are paid directly by funds and indirectly through fund advisor fees.

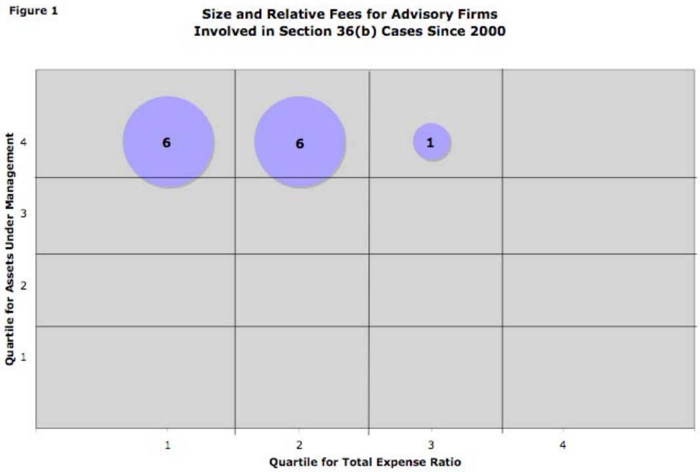
II. WILL THE POST-*JONES* LEGAL FRAMEWORK FOR SECTION 36(B) BENEFIT SHAREHOLDERS OF FUNDS?

Shareholders will only benefit from all of this lawyer expense if cases are in fact brought against funds charging higher-than-competitive fees and if the resulting settlements involve fee reductions. Evidence from an ongoing research project suggests that such cases will be rare. To date, litigants have sued, almost exclusively, advisors charging fees that are below the median for funds of a similar type, advising funds that are in the top quartile of assets under

targets of "pure" 36(b) litigation in the past ten years. "Pure" 36(b) section cases are those in which 36(b) claims were based on excessive fees on their own, rather than piggy-backed on claims involving allegations of advisory complicity in late trading, market timing, or other practices not directly related to fees. I list the "pure" cases in Appendix A. (If readers are aware of any additional cases, please contact me with the citations.) By contrast, in 2007, there were over 600 advisory complexes.

management.[13] In other words, plaintiff attorneys have been targeting advisors of relatively large funds charging relatively low fees. As depicted in Figure 1, of the relatively few pure section 36(b) cases[14] brought since 2000 that I have been able to identify, all have primarily targeted advisors in quadrants (1, 4) and (2, 4), where the first number indicates the quartile for expenses (the x-axis on Figure 1), and the second number indicates the quartile for fund size—and not against funds being charged relatively high fees, which would be in quadrants (3, y) or (4, y). Based on my analysis, not a single case has been brought against an advisor to an equity fund ranked below the top quartile in size.

Figure 1



Why would plaintiffs' attorneys target those advisors, rather than advisors charging relatively high fees? The answer is simple: the highest fees tend to be charged to the smallest funds, and because the prospective relief under 36(b) is based on the absolute size of excess

13. This is true of each of the cases listed in Appendix A, based on data on assets under management and total expense ratios for over 600 advisors for equity funds from Simfund for 2007. Simfund is a database providing information on mutual funds, funds-of-funds, and ETFs.

14. *See supra* note 12 for a discussion of how I identify "pure" 36(b) cases.

fees, rather than on their relative size.[15] Thus, prospective damages are greatest when the target is large. But wouldn't a damage award be most likely when the fees are relatively high? Not necessarily. A damage award would be most likely if, but only if, courts consider comparable fees in reaching liability determinations, –something that *Gartenberg*[16] and *Jones*[17] permit, but a baseline on which both courts cast some doubt.

Moreover, as noted above, the parties have powerful interests to settle, and the vast majority of 36(b) cases settle.[18] Even if settlements are correlated with expected liability, settlements are likely to be much more sensitive to differences in damage awards caused by differences in fund size, and not as sensitive to differences in the expected probability of liability caused by differences in relative fee levels. This is because expected damage awards rise very quickly as one moves from the smallest to the largest funds—indeed, the largest funds are now much larger than the smallest funds. The variation in expected return due to variation in fund size is not subject to significant judicial discretion: fees are a fixed percentage of fund assets, and legal fees are a relatively fixed fraction of fee overcharges. By contrast, trial courts have enormous discretion in deciding whether liability exists in 36(b) cases, and that discretion will be used differently by different judges (based, among other things, on their prior beliefs about how strong competition is as a restraining force on fund fees). Since both *Gartenberg* and *Jones* questioned the significance of fee comparisons—the expected liability for complaint attacking a relatively high fee will often be only slightly higher than the expected liability for attacking a relatively low fee.

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15. 15 U.S.C.A. § 80(a)-35(b)(3) (West 2009).

16. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 929 (2d Cir. 1982) (noting that the fee charged by advisors is a factor to be considered, but not the "principal" factor).

17. Jones v. Harris Assocs., 130 S. Ct. 1418, 1426 (2010) (noting that the fees charged by other advisors should not be the principal consideration, but that this does not absolutely preclude their consideration).

18. Of the cases listed in Appendix A, 80 percent of those that had been resolved as of this writing were settled. *See also* Mark S. Van Broek, *The Demand Requirement In Investment Company Act Shareholder Actions*, 50 U. CHI. L. REV. 1500, 1528 n.158 (1983) (noting that, as of 1982, most section 36(b) cases have settled).

III. THE DOWNSIDE OF JUDICIAL RESTRAINT

Judicial restraint has long been touted as a virtue by political conservatives[19] who viewed the expansion of civil rights and civil liberties under the Warren Court as turning courts into unelected legislators. Chief Justice John Roberts, before joining the Supreme Court, advocated judicial restraint, and was touted by conservatives as a "model of judicial restraint."[20] More recently, political liberals have rediscovered the virtues of judicial restraint,[21] as the conservative majority on the Supreme Court has radically rewritten whole sections of Constitutional law in favor of political activists at the National Rifle Association,[22] the U.S. Chamber of Commerce,[23] companies engaged in price-fixing,[24] mass tortfeasors,[25] and employers charged with discrimination.[26] All of these decisions were written or joined by Chief Justice Roberts. Despite the evident activism of these decisions, however, the Roberts Court is capable of restraining itself—as in cases like *Jones v. Harris*—in technical cases that grab few headlines and offer no talking points for political fundraisers.

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19. *See e.g.*, ROBERT H. BORK, THE TEMPTING OF AMERICA: THE POLITICAL SEDUCTION OF THE LAW 69–100 (The Free Press 1990) (criticizing the Warren Court); ALEXANDER M. BICKEL, THE LEAST DANGEROUS BRANCH: THE SUPREME COURT AT THE BAR OF POLITICS 16–23 (1962) (same); *see also* LEARNED HAND, THE BILL OF RIGHTS: THE OLIVER WENDELL HOLMES LECTURES 66–75 (Harvard University Press 1958) (criticizing judicial restraint broadly); MARK TUSHNET, THE WARREN COURT IN HISTORICAL AND POLITICAL PERSPECTIVE 38–42 (University Press of Virginia 1993) (characterizing the Warren Court as political rather than legal).

20. Edward Whelan, Op-Ed, *A Model of Judicial Restraint, Not Activism*, L.A. TIMES (Sept. 6, 2005), http://articles.latimes.com/2005/sep/06/opinion/oe-whelan6.

21. *See* LARRY D. KRAMER, THE PEOPLE THEMSELVES: POPULAR CONSTITUTIONALISM AND JUDICIAL REVIEW 225 (2004) (maintaining that the Rehnquist Court "carried the theory of judicial power developed by its predecessors to its logical conclusion").

22. *See* District of Columbia v. Heller, 128 S. Ct. 2783, 2821–22 (2008) (striking down a handgun law on Second Amendment grounds); McDonald v. City of Chicago, 130 S. Ct. 3020, 3025 (2010) (same, and incorporating the Second Amendment into the Fourteenth Amendment).

23. Citizens United v. Fed. Election Comm'n 130 S. Ct. 876, 886 (2010) (overturning several precedents and utilizing the First Amendment to strike down a 50-year old federal statute barring corporations and unions from making independent political expenditures in federal elections).

24. Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 882 (2007) (overturning a ninety-seven-year-old precedent to hold that vertical price-fixing schemes are not *per se* illegal under Section 1 of the Sherman Act).

25. Williams v. Philip Morris Inc., 549 U.S. 346, 349 (2007) (deeming a jury award of damages designed to punish the defendant for harm to persons not before the court as a "taking" of property without due process).

26. Ledbetter v. Goodyear Tire & Rubber Co., 550 U.S. 618, 621 (2007) (interpreting Title VII of the Civil Rights Act to bar claims based on decisions made more than 180 days prior), *superseded by statute,* Lilly Ledbetter Fair Pay Act of 2009, Pub. L. No. 111-2, 123 Stat. 5.

Unfortunately, sometimes-judicial activism is precisely what a statute needs. Sometimes, judicial "activism" is simply another name for the conventional evolution of the law in a fashion familiar to all lawyers from first-year common law courses—a process the most legally conservative jurists (whether politically liberal or conservative) would embrace. In enacting section 36(b), Congress gave the federal courts an unappetizing job: to discern limits based on a vaguely stated standard on compensation in what is clearly both a conflicted but also competitive context. That job necessarily involves exercise of judicial discretion. For an appellate court to attempt to put some order on the chaos invited by the statutory standard is precisely what courts have long attempted to do. Courts create order in an iterative fashion by coupling decisions with written opinions, explaining their reasoning, which become precedent to be distinguished or followed based on further reasons, and so on. In *Jones v. Harris*, the Court squashed the nascent effort by the Seventh Circuit to begin this process—not by disagreeing with what the Seventh Circuit had decided and announcing its own interpretative reasoning, but by punting the entire shapeless mess of section 36(b) back to the federal district courts. An apparent adherence to the "rule of law"—rejecting a contestable interpretation of a statute—becomes instead its very opposite, rejecting by implication any effort by the federal circuit courts to organize or shape litigation under section 36(b).

APPENDIX A LIST OF "PURE" SECTION 36(B) CASES FILED SINCE JAN. 1, 2003

Case, Court	**Docket No.**
Hunt v. INVESCO Funds Group, Inc., S.D. Texas	04-2555
Baker v. Am. Century Inv. Mgmt., Inc., W.D. Missouri	04-4039
Gallus v. Ameriprise Fin., Inc., D. Minnesota	04-4498
Reaves v. Federated Investors, Inc., W.D. Pennsylvania	05-201
Bennett v. Fid. Mgmt. & Research Co., D. Massachusetts	04-11651
Strigliabotti v. Franklin Resources, Inc., N.D. California	04-883
Sins v. Janus Capital Mgmt. LLC, D. Colorado	04-1647
Dumond v. Mass. Fin. Servs. Co., D. Massachusetts	04-11458
Amron v. Morgan Stanley Inv. Advisers Inc., S.D. New York	03-5896
Krueger v. Neuberger Berman Mgmt., Inc., S.D. New York	05-1316
Jones v. Harris Assocs., L.P., N.D. Illinois	04-8305
Vaughn v. Putnam Inv. Mgmt. LLC, D. Massachusetts	04-10988
Williams v. Waddell & Reed Inv. Mgmt. Co., D. Kansas	04-2561