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DERIVATIVE SUITS: DIRECTOR DEMAND UNDER RULE 23.1 AND SECTION 36(b) OF THE INVESTMENT COMPANY ACT

I. Introduction

In 1882, the Supreme Court first established[1] the conditions precedent to an ordinary derivative action[2] by the shareholders of a corporation.[3] Now, after over nine decades of common law development, the present conditions are embodied in Rule 23.1 of the Federal Rules of Civil Procedure.[4] Of relatively recent interest, however, is the relationship between that Rule and section 36(b)[5] of the Investment Act of 1940 (Act),[6] which authorizes a derivative action by the shareholders of a registered investment company.[7] This Note will focus on one aspect of that relationship—the requirement that a plaintiff make a demand upon the corporation's directors before he institutes his action.

Rule 23.1's requirement[8] of a director demand has been the source

1. *See* Hawes v. Oakland, 104 U.S. 450 (1882).

2. A derivative suit is an action brought by stockholders to enforce a corporate claim. In a sense it is both a representative and a class action. *See* Ross v. Bernhard, 396 U.S. 531, 534-35 (1970).

3. The derivative or secondary suit may be distinguished from the direct action by a corporation in its own behalf against a third party, and from the individual shareholder suit against the corporation, in that although the derivative plaintiff is a stockholder, the potential benefit runs to the corporation. *See* H. HENN, LAW OF CORPORATIONS 360 (3d ed. 1970). *See also* Swanson v. Traer, 354 U.S. 114, 116-17 (1957); W. CARY, CORPORATIONS: CASES AND MATERIALS 733-37 (4th ed. abr. 1970).

4. FED. R. CIV. P. 23.1. This Rule is the cumulation of three previous efforts to regulate the institution of derivative suits in federal courts. The Supreme Court, immediately after its decision in Hawes v. Oakland, 104 U.S. 450 (1882), adopted Equity R. 94 as an attempt to state in definite form the holding of that case. 104 U.S. ix (1882). The Supreme Court modified the rule slightly when it promulgated Equity R. 27, 226 U.S. 657 (1912), which added the phrase "or the reasons for not making such effort." Equity R. 27 applied only to "corporations." Former Fed. R. Civ. P. 23(b), 308 U.S. 28 (1939) made some changes which enlarged its scope to all associations, incorporated or unincorporated. Rule 23.1 substantially restates the principles of Rule 23(b). *See* Tasner v. Billera, 379 F. Supp. 821, 825 n.4 (N.D. Ill. 1974).

5. 15 U.S.C. § 80a-35(b) (1970).

6. *Id.* §§ 80a-1 to 80b-21 (1970) [hereinafter cited as Act].

7. *Id.* § 5(a)(1). This section defines "investment companies."

8. Rule 23.1 provides that in an action brought by a shareholder to enforce a right of the corporation: "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and the reasons for his failure to obtain the action or for not making the effort." FED. R. CIV. P. 23.1.

of much controversy.[9] One particularly controversial issue is whether the demand should be presumed futile, and therefore excused, when the complaint alleges that: (1) a corporate board was controlled and dominated by a minority of the directors; and (2) the majority of the directors approved the corporate wrongdoing of this minority.[10] When the board members so accused are the directors of a mutual fund,[11] there is the additional question of whether the traditional case law on excuse of director demand should apply to derivative actions involving investment companies organized under the Act.

In 1973, the First Circuit addressed this issue in *In re Kauffman Mutual Fund Actions.*[12] There, plaintiff brought suit as a shareholder in four mutual funds and also as a representative of shareholders of other funds.[13] He alleged that certain fund directors, who were also directors of the fund's advisory firms, conspired with the other funds and their advisers to set schedules of excessive, noncompetitive management fees, based solely on the average net assets of the funds rather than on the managerial services performed by the advisers.[14] Plaintiff made no demand on the directors because, he alleged, any demand would have been futile due to the nature of the allegations.[15]

The district court dismissed the derivative action for failure of plaintiff to satisfy the Rule 23.1 demand requirement.[16] The court of appeals affirmed. It held that plaintiff's allegations—that the affiliated directors and the funds had "acquiesced, encouraged, cooperated, and assisted in the effectuation" of the conspiracy—failed

9. Rule 23.1 does not per se require a demand on the directors. If no such effort is made, however, the rule requires an explanation. Of the two alternatives—making the demand or explaining its absence—courts seem to favor the former. *See* 8 SUFFOLK L. REV. 287, 291 (1974). Demand gives the corporation's management an opportunity to examine the merits of the stockholder's claim of wrongdoing and determine if it can be resolved without litigation. *Id.*

10. *See* sections II. B, C *infra.*

11. "Mutual Fund" is a common term denoting open-end investment companies. Mutual funds are companies that offer securities representing a proportionate share of their investment portfolios and will redeem outstanding shares at current net asset value. For more detailed descriptions of the structure and nature of investment securities, see 1 L. Loss, SECURITIES REGULATION 144-47 (2d ed. 1961).

12. 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973).

13. *Id.* at 261.

14. *Id.* at 262.

15. *Id.*

16. *Id.* at 264.

to establish that the majority, unaffiliated directors participated in the transactions. Thus, the allegations were not sufficient to satisfy Rule 23.1.[17]

Kauffman subsequently became the leading mutual fund case on excuse of director demand in situations involving allegations of domination and control of a board by a wrongdoing minority. Courts in a number of other circuits have either followed[18] *Kauffman* or attempted to distinguish[19] it on the facts. However, in a recent case involving allegations similar to those in *Kauffman,* the District Court for the Southern District of New York, in *Boyko v. The Reserve Fund, Inc.,*[20] ruled that the *Kauffman* reasoning no longer applied to mutual fund derivative actions.

Plaintiff in *Boyko* was a shareholder in a mutual fund. The defendants were the fund (nominally) and its external investment adviser. Plaintiff alleged that the management fee schedule, again based solely on a percentage of the net assets of the fund, was excessive and unreasonable in light of the growth in fund assets and volume of managerial services required from the investment adviser.[21] He further alleged that no demand was made upon the fund's directors because they were designees, nominees, and persons controlled by the defendant adviser. Moreover, since these fund directors had allegedly "participated and acquiesced in the wrongs complained of," turning the suit over to the fund would "place prosecution of this action in the hands of persons friendly to the defendant [adviser]."[22]

The basic issue in *Boyko* was essentially the same as in *Kauffman:* whether mere allegations of bias and control would serve to excuse demand.[23] The *Boyko* court agreed with the First Circuit that ordinarily they would not be sufficient. However, in contrast

17. *Id.* at 267 (Coffin, C.J., concurring).

18. *See, e.g.,* Kusner v. First Pa. Corp., 395 F. Supp. 276 (E.D. Pa. 1975); Royston v. Eastern Empire Corp., 393 F. Supp. 1010 (E.D. Pa. 1975); Tasner v. Billera, 379 F. Supp. 815 (N.D. Ill. 1974).

19. *See, e.g.,* Nussbacher v. Continental Ill. Nat'l Bank & Trust Co., 518 F.2d 873 (7th Cir. 1975); Abbe v. Goss, CCH FED. SEC. L. REP. ¶ 95,319 (S.D.N.Y. 1975); Penn Central Sec. Litigation v. Pennsylvania Co., 367 F. Supp. 1158 (E.D. Pa. 1973).

20. CCH FED. SEC. L. REP. ¶ 95,304 (S.D.N.Y. 1975).

21. *Id.* at 98,538.

22. *Id.*

23. *Id.*

to *Kauffman*, the *Boyko* court concluded that in a derivative action brought under section 36(b) of the Act, the demand requirement of Rule 23.1 was met by an allegation that there was at least one interested person on the board of directors of the mutual fund.[24] In such cases, the demand would be presumed futile.

II. Prior Law & Rule 23.1

A. The Three Views

Traditional case law on mutual fund derivative actions has been ambiguous at best.[25] Judicial construction of the Rule 23.1 director demand requirement has, however, followed three general approaches.

One view essentially presumes fidelity and diligence on the part of the corporate directors.[26] An opposite view presumes that demand on the directors would be futile under certain conditions.[27] A third view prefers the use of "sound discretion" to presumptions.[28]

Varying interpretations of the Rule 23.1 demand requirement have arisen in several different classes of cases. One such class includes cases in which the wrongdoers constitute a majority of the board at the time the action reaches the court.[29] Another such class

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24. *Id.* at 98,540.

25. *See* section II. B, C, D *infra*.

26. It has been suggested that, in a given case, the construction given the demand requirement is a function of the court's public policy views on the desirability of the derivative remedy. Pomerantz v. Clark, 101 F. Supp. 341, 346 (D. Mass. 1951). One respected jurist has observed that in jurisdictions, such as Massachusetts, where the narrow view is prevalent, "[t]he emphasis is on precedent and adherence to the older ways, not on creating new causes of action or encouraging the use of novel judicial remedies that have sprung up in less conservative communities." *Id.* For a comparison of the "Massachusetts view" and the "New York view," see Greenspun v. Lindley, 36 N.Y.2d 473, 479, 330 N.E.2d 79, 82, 369 N.Y.S.2d 123, 127-28 (1975).

27. The demand requirement is less stringent, and demand therefore often excused, where the "useful gadfly" philosophy prevails, *see, e.g.*, Pomerantz v. Clark, 101 F. Supp. 341, 346 (D. Mass. 1951), and the derivative suitor's role as a "corporate policeman" is viewed with favor, *cf.* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949). *See also* Brendle v. Smith, 46 Supp. 522, 525 (S.D.N.Y. 1942), in which the court notes a number of positive achievements for derivative actions.

28. The centrist, or sound discretion, approach seems to have gained increased favor with both the courts and the commentators. *See, e.g.*, Jannes v. Microwave Communications, 57 F.R.D. 18, 21 (N.D. Ill. 1972) ("Recent cases have made clear, if the question was ever in doubt, that . . . whether an excuse is sufficient is within the sound discretion of the court."); 3B J. MOORE & J. LUCAS, MOORE'S FEDERAL PRACTICE ¶ 23.1 19, at 23.1-254 (2d ed. 1975) ("it lies within the sound discretion of the court to determine the necessity for demand").

29. *See, e.g.*, Nusbacher v. Continental Ill. Nat'l Bank & Trust Co., 518 F.2d 873 (7th

involves situations in which some or all of the allegedly wrongdoing directors have been replaced, so that active wrongdoers no longer constitute a majority of the board.[30] While there has been something less than judicial unanimity vis-à-vis these classes of cases, there is probably the greatest divergence of views when allegations of minority control, or passive acquiescence by the majority, are the basis of the plaintiff's failure to make the demand.[31]

B. Presumptive Director Fidelity and Diligence

The rationale for this view lies in the business judgment rule.[32] The basic premise is that "[t]he directors represent all the stockholders and are presumed to act honestly and according to their best judgment for . . . all."[33] Therefore, the directors "have no reason to protect an outside wrongdoer at the corporation's expense."[34] Consequently, the decision whether or not to sue the alleged wrongdoer is a matter of internal management, and stockholders should not be allowed to force the corporation to sue, if the directors "have exercised their business judgment in good faith . . . ."[35]

These courts assume that the directors are loyal to the corporate entity and would diligently prosecute any wrong done to it. As a result they generally tend to be unreceptive to allegations of board control by a wrongdoing minority: "If by plaintiff's merely alleging error, the directors are to be presumed incapable of exercising sound business judgment, Rule 23.1 would become virtually meaningless . . . ."[36]

An illustration of the presumption of director fidelity and dili-

Cir. 1975); Abrams v. Mayflower Investors, Inc., 62 F.R.D. 361 (N.D. Ill. 1974); *In re* Caesars Palace Sec. Litigation, 360 F. Supp. 371 (S.D.N.Y. 1973).

30. *See, e.g.*, Brody v. Chemical Bank, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973); Nelson v. Pacific Southwest Airlines, 399 F. Supp. 1025, 1030 (S.D. Cal. 1975); Independent Investors Protective League v. Saunders, 64 F.R.D. 564, 571 (E.D. Pa. 1974).

31. *See* section III.A, B *infra*.

32. Under the business judgment rule rationale, if the directors decide that no suit is warranted, a shareholder's suit should be precluded if it appears that the board's decision was a legitimate exercise of business judgment consistent with its fiduciary duty to the corporation and its shareholders. *See* Note, *Shareholders' Derivative Suits in Minnesota: Function and Operation of the Control Requirements*, 54 MINN. L. REV. 978, 988 (1968).

33. Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903).

34. Ash v. IBM, Inc., 236 F. Supp. 218, 220 (E.D. Pa. 1964).

35. Lasker v. Burks, 404 F. Supp. 1172, 1180 (S.D.N.Y. 1975).

36. Tasner v. Billera, 379 F.Supp. 815, 826 (N.D. Ill. 1974).

gence is found in *Lerman v. ITB Management Corp.*[37] Plaintiff was a shareholder in a mutual fund which switched from internal to external investment management. Four of the fund's trustees (directors) were also directors of the proposed investment adviser. Upon approval of the investment advisory contract, two of these "double directors" resigned from the fund's board, leaving a minority of two affiliated directors on the fund's five man board. At the time of the suit, only one of the fund's trustees was affiliated with the investment adviser.[38]

Plaintiff alleged fraud and self-dealing. He also asserted that because of the overlap between the directorates of the fund and the adviser, annual reapproval of the investment advisory contract was assured. Moreover, he charged that the wrongdoers controlled the fund and would prevent diligent prosecution of any action.[39]

The court held that mere allegations of control over the nonaffiliated majority were insufficient to meet Rule 23.1's requirement that the complaint allege with particularity the nature of the demand made.[40] Thus, the complaint was dismissed. The court stated that since only one current trustee had participated in the approval of the original advisory contract, "it cannot be reasonably presumed that a majority of the trustees were involved in the alleged wrongdoing . . . ."[41] Moreover, the court refused to presume that the majority was committed to the course of action initiated by its predecessors, or that it would be futile to propose an alternative course, which would be more beneficial to the fund and its shareholders.[42]

C. Presumptive Futility

Courts espousing this view are likely to consider director demand futile in a broad range of situations.[43] They question whether a

37. 58 F.R.D. 153 (D. Mass. 1973).
38. *Id.* at 156-57.
39. *Id.* at 156.
40. *Id.* at 159.
41. *Id.* at 157.
42. *Id.*
43. Examples of the language typically used by the courts in sanctioning non-demand, include that the directors are "antagonistic toward the plaintiff," or that the demand would be "unavailing," "useless," "an idle ceremony," or "farcical." For listings of cases employing such language in excusing demand, see 3B J. MOORE & J. LUCAS, MOORES FEDERAL PRACTICE ¶ 23.1.19 (2d ed. 1975). *See also* 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE: CIVIL § 1831, at 378-80 (1972).

"theoretically disinterested majority of the board can be 'expected to weigh impartially a charge against their accused colleagues . . . .' "[44]

If the wrongdoers picked the outside directors, a court may be skeptical that any "meaningful action" would be forthcoming, even where each member of the affiliated majority has expressly deposed that he is not dominated by the accused wrongdoing minority, he would investigate the shareholders' complaint, and he would take appropriate action.[45] In such a situation, one court stated that while the outside directors might not be wholly dominated, the majority would not "be likely to undertake the difficult and demanding task of prosecuting a lawsuit for fraud against those who elected them."[46] Consequently, the court concluded that demand on the directors would have been a "futile and useless gesture."[47]

An illustration of this view in a mutual fund situation is *Papilsky v. Berndt*.[48] Plaintiffs were shareholders in a fund whose adviser was also its underwriter. They alleged that certain practices, *i.e.*, reciprocal brokerage, give-ups, and interpositioning, redounded to the benefit of the adviser instead of the fund, and that the fund could have recaptured some of its commissions had its directors not "participated in or acquiesced in" the challenged transactions.[49] The defendants argued for dismissal on the grounds that plaintiff's allegations of dominion and control of the unaffiliated directors by the minority affiliated directors were not sufficient to excuse director demand under Rule 23.1.[50]

The court held that more than mere control was alleged due to the "strategic positions of the affiliated directors on the board of the Fund."[51] It further observed that *all* of the fund's directors participated in or acquiesced in the challenged transactions, and thus the

44. *See* Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 754 (1960), *quoting* Pomerantz v. Clark, 101 F. Supp. 341, 344 (D. Mass. 1951).

45. *See* de Hass v. Empire Petroleum Co., 286 F. Supp. 809 (D. Colo. 1968), *aff'd in part*, 435 F.2d 1223 (10th Cir. 1970).

46. *Id.* at 814.

47. *Id.* at 815.

48. 59 F.R.D. 95 (S.D.N.Y. 1973).

49. *Id.* at 96.

50. *Id.*

51. *Id.* at 97.

case was distinguishable from *Lerman*.[52] Finally it noted the Second Circuit rule that where the directors were "*involved in the transaction attacked*, a demand on them is presumptively futile and need not be made."[53]

D. The Sound Discretion Approach

Overtones of this view, which emphasizes the use of sound judicial discretion rather than presumptions, were heard in an early Supreme Court case where it was said that Equity Rule 94 (an early predecessor of Rule 23.1) should be "given such play as to fit the conditions of different cases."[54]

An illustration of this approach in a mutual fund situation is *Phillips v. Bradford*,[55] where three separate mutual funds all had the same directors and a common adviser. The adviser gained information concerning the impending collapse of a stock (Penn Central) owned by all three funds. Plaintiff sued the directors, the adviser, and all three funds, alleging that the advisers and directors caused one fund (Mutual) to delay sale of its Penn Central shares until the other two funds had sold 100 percent of their Penn Central shares. As a result, the average price received by Mutual for its Penn Central shares was only one-half that received by the other two funds.[56] Plaintiff also asserted that she was excused from making demand since it would have been a futile gesture.[57]

The court first rejected the presumption of futility, stating that "merely naming the directors does not establish that a demand would have been futile."[58] It then rejected the rationale that courts should not interfere with business decisions by businessmen.[59] Instead, the court based its decision on the facts of the instant case,

52. *Id.*

53. *Id.*, *quoting* Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 88 (2d Cir. 1955).

54. Delaware & Hudson Co. v. Albany Sus. R.R., 213 U.S. 435, 452 (1909).

55. 62 F.R.D. 681 (S.D.N.Y. 1974).

56. *Id.* at 684.

57. *Id.*

58. *Id.* at 688; *accord*, Kusner v. First Pa. Corp., 395 F. Supp. 276 (E.D. Pa. 1975); Jones v. Equitable Life Assurance Soc'y, CCH FED. SEC. L. REP. ¶ 94,986, at 97,404 (S.D.N.Y. 1975).

59. *See, e.g.*, Ash v. IBM, Inc., 236 F. Supp. 218, 220 (E.D. Pa. 1964). "Most courts respect the directors' business judgment and will not interfere with decisions concerning business matters, regardless of whether the directors' judgment proves correct." Note, *supra* note 32, at 988.

which indicated that a conflict of interest was apparent and that demand would have been futile.[60]

III. Section 36(b) and The New Derivative Action

A. The *Boyko* and *Kauffman* Decisions

While the demand provisions of Rule 23.1 have been subject to many and varied judicial interpretations, what must be alleged in a section 36(b) complaint is an issue which had not been addressed by the courts prior to *Boyko*.[61]

Faced with a question of first impression, the *Boyko* court might have decided the case by simply adopting one of the three views and thereby extending the traditional common law rules on director demand to section 36(b) actions. Instead, it analyzed the complaint in terms of the most demanding of the traditional standards, *i.e.*, the *Kauffman* view, and used this analysis to bring out the inappropriateness of the common law rules for the new derivative action.[62]

Boyko and *Kauffman* both involved mutual fund shareholders suing derivatively on behalf of the funds and alleging excessive management fee schedules.[63] The *Boyko* court noted that two of the reasons pleaded for not making a demand upon the directors in *Kauffman* were also similar to those alleged in *Boyko:* (1) the fund's directors were "controlled" by the adviser, and (2) the fund's directors "participated and acquiesced" in the wrongdoing.[64]

With regard to the first reason, the *Kauffman* view was that mere allegations of domination and control were insufficient to satisfy Rule 23.1. The court reasoned that if there had been a majority of self-interested defendant directors, then a conclusion of control might properly follow.[65] But since the directors affiliated with the adviser constituted less than a majority of the fund's board, conclusory pleading was not enough.[66] The First Circuit's standard for sufficiency of allegations of control was that "[p]laintiff must al-

60. Phillips v. Bradford, 62 F.R.D. 681, 688 (S.D.N.Y. 1974).

61. CCH FED. SEC. L. REP. ¶ 95,304 (S.D.N.Y. 1975).

62. *Id.* at 98,540.

63. *See* text accompanying notes 16, 23 *supra.*

64. CCH FED. SEC. L. REP. ¶ 95,304, at 98,538.

65. This view reflects the so called "ratification theory," which requires a demand on directors unless the wrongdoers constitute a majority of the board of the allegedly injured corporation. *See* Note, *supra* note 44, at 747.

66. 479 F.2d at 264.

lege specific facts demonstrating the unmistakable link between the inaffiliated majority and the affiliated and allegedly wrongdoing minority."[67]

With regard to the second excuse, the *Kauffman* court also held that mere allegations of approval of suspect contracts were insufficient to excuse demand:[68]

> Where mere approval of the corporate action, absent self-interest or other indication of bias, is the sole basis for establishing the directors' "wrongdoing" . . . plaintiff's suit should ordinarily be dismissed.

Further, the court refused to create an exception in the case of unaffiliated directors of a mutual fund simply because a stockholder alleged a corporate injury stemming from the adviser-fund relationship.[69] The rationale advanced for this refusal was that while self-dealing by any corporate director is usually suspect, "Congress recognized . . . that a certain type of self-dealing is endemic in a mutual fund, and must be permitted."[70] Moreover, the court reasoned that Congress had adequately compensated for the endemic self-dealing by requiring that all mutual fund boards must contain a minimum number of "watchdog"[71] directors not affiliated with the advisers. The First Circuit concluded that these watchdog mutual fund directors were subject to the same fiduciary obligation as a disinterested[72] director "in any other corporate venture."[73] The court therefore declined to adopt a presumption of futility, and (in the

67. *Id.*

68. *Id.* at 265.

69. *Id.* at 266.

70. *Id.*

71. *See* Comment, *Duties of the Independent Director In Open-End Mutual Funds*, 70 MICH. L. REV. 696, 701 (1972) where it was noted that "the men who need to be watched pick the watchdogs to watch them." Further, the adviser is not likely to choose an independent director who will be hard on it, or for that matter to even take the job seriously. It has also been suggested that independent directors are reluctant to vigorously exercise the little power they have, because it would be unpleasant to countermand people that they like, respect, and have worked with for years, and that this is probably the only reason they were put on the board in the first place. *Id.* at 701-02.

72. 479 F.2d at 266-67. At the time of the commencement of the *Kauffman* action, the Act required that at least 40 percent of a fund's directors not be "affiliated" with the fund's adviser. The Act was amended in 1970 to require that not more than 60 percent of the directors be "interested persons," a broader category. 15 U.S.C. § 80a-2(a)(19) (1970).

73. 479 F.2d at 266.

words of the *Boyko* court) "adhered to the traditional pleading requirements."[74]

After noting the similarity between the two complaints, the *Boyko* court observed that "under the traditional pleading requirements of Rule 23.1 as set forth in the *Kauffman* opinion, the pertinent allegations of the instant complaint would be insufficient to excuse prior demand . . . ."[75] However, the court found it worthy of note that the *Kauffman* rules were "applicable to derivative actions in general and not peculiar to actions brought on behalf of mutual funds against their investment advisors for excessive compensation."[76]

The court observed that the two actions differed in at least one significant respect. The *Kauffman* action was commenced prior to the effective date of the recent amendments to the Investment Company Act. The *Boyko* plaintiff, however, brought his action pursuant to section 36(b) of the Act, which became effective in June, 1972.[77]

B. The New Fiduciary Duty

When it enacted section 36(b), Congress created an explicit fiduciary duty on the part of the investment adviser.[78] In so doing, "Congress recognized the unusual relationship between the investment company and its advisor,"[79] and the unique structure[80] of the

74. CCH FED. SEC. L. REP. ¶ 95,304, at 98,539.

75. *Id.*

76. *Id.*

77. *Id.*

78. 15 U.S.C. § 80a-35-(b) (1970) provides that:

> [T]he investment advisor 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, or by the security holders thereof, to such investment advisor or any affiliated person of such investment advisor.

79. CCH FED. SEC. L. REP. ¶ 95,304, at 98,539.

80. The uniqueness of the investment company industry structure may be traced to the organizational history of most trust funds. Generally, an investment adviser, either in the form of a corporation or a partnership, nominates its board of directors. The board then approves an advisory contract with the investment adviser. Thus, while still under the control of its creators the fund enters into a management and research contract with these creators. *See* Note, *Mutual Funds and Their Advisors: Strengthening Disclosure and Shareholder Control* 83 YALE L.J. 1475. *See also* Simpson, *1(b), or not 1(b). . . . ? Recognition of Legislative Intent in Judicial Interpretation of Investment Company Act of 1940,* 40 GEO. WASH. L. REV. 890 (1972).

mutual fund industry where "the forces of arm's length bargaining do not work in the . . . same manner as they do in the other sectors of the American economy."[81]

Moreover, the creation of the fiduciary duty evidenced another Congressional recognition with regard to cases like *Kauffman* and *Boyko*:[82]

> [T]hat the directors of the investment company would be antagonistic toward, and unlikely to prosecute, an action against the fund's advisors for breach of fiduciary duty with respect to the receipt of compensation.

The court further observed that the fund in *Boyko* admitted its opposition to the lawsuit and argued that a decision of its board not to prosecute would preclude a shareholder from asserting the claims derivatively.[83] It added that "while this rule might be appropriate in other kinds of derivative actions, its application in this context would clearly thwart the purpose of Congress in enacting Section 36(b) . . . ."[84]

The court's rationale for this conclusion was that a majority of the board of an investment company is rarely composed of "interested persons."[85] Thus, mutual fund derivative suitors would not normally be able to meet the *Kauffman* requirements.[86]

The *Boyko* court noted that the *Kauffman* case has been cited by the Second Circuit[87] with approval.[88] In the face of this apparent

81. 1970 U.S. CODE CONG. & ADMIN. NEWS 4897, 4901.

82. CCH FED. SEC. L. REP. ¶ 95,304, at 98,540.

83. *Id.*

84. *Id.*

85. *Id.*

86. *See* section III.A. *supra.*

87. CCH FED. SEC. L. REP. ¶ 95,304, at 98,539. The *Boyko* court was here referring to the Second Circuit's comments on *Kauffman* in Brody v. Chemical Bank, 482 F.2d 1111, 1114 (2d Cir. 1973). However, *Brody* was more concerned with the "new director" aspect than the "minority control" aspect of the director demand issue. The new director aspect was also present in *Kauffman* and was the reason why Chief Judge Coffin concurred with the majority. 479 F.2d at 267.

88. In Papilisky v. Berndt, 503 F.2d 554 (2d Cir. 1974) (per curiam) the Second Circuit had an opportunity—subsequent to both the district court decision in *Papilsky* and the First Circuit decision in *Kauffman*—to state its position on the issue in question, but chose not to do so. There the Second Circuit panel noted that the district judge, in a "reasoned" opinion, had excused demand based on allegations that the unaffiliated directors, and that all the directors had participated or acquiesced in the challenged transactions. However, the opinion did not reach the merits, and the appeal was dismissed on other grounds. *Id.* at 555. Therefore it may be questioned whether the Second Circuit's citation to *Kauffman* was "with approval."

authority from two Courts of Appeals, the court found it inappropriate to decide the first section 36(b) director demand case on the basis of traditional "common law rules."[89] Instead, it based its holding on the premise that, in enacting section 36(b), Congress created "a new type of derivative action."[90]

C. The New Derivative Action

The court in *Boyko* observed that "strict application of the common law rules designed to enforce the particularity requirement of Rule 23.1 would doubtless mandate the dismissal of most, if not all, derivative actions commenced under Rule 36(b)."[91] General allegations of bias and control would ordinarily not suffice to excuse demand, if the *Kauffman* approach were followed.[92] This, the court opined, would not be in keeping with the legislative recognition of the unique mutual fund industry structure as reflected by section 36(b).[93]

> [Rather,] the derivative action designed expressly to enforce the specific fiduciary duty created by Rule 36(b) should not be rendered meaningless by an application of the more general provisions of Rule 23.1 and the case law generally applicable to derivative actions.

While the common law standards developed over the years were sound, the court found that Congress had created a new type of derivative action to keep in check certain unique problems[94] and abuses[95] which have developed in a relatively new industry.[96] The typical management fee arrangement[97] between the fund and its adviser, which was the gravamen of the complaint in both *Boyko* and *Kauffman*, is probably the most significant problem.[98]

89. CCH FED. SEC. L. REP. ¶ 95,304 at 98, 540.
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.*
94. *See generally* Modesitt, *The Mutual Fund—A Corporate Anomaly*, 14 U.C.L.A.L. REV. 1252 (1967).
95. *See generally* Note, *The Mutual Fund and Its Management Company: An Analysis of Business Incest*, 71 YALE L.J. 137 (1961).
96. CCH FED. SEC. L. REP. ¶ 95,304, at 98,540.
97. *See* Rottenberg, *Developing Limits on Compensation of Mutual Fund Advisors*, 7 HARV. J. LEGIS. 309, 312-14 (1970). The adviser in fact sometimes wears *four* hats. *Id.* at 312 n.17. In *Boyko*, the annual fee paid to the adviser was a flat .5 percent of the fund's total assets. CCH FED. SEC. L. REP. ¶ 95,304, at 98,538.
98. The management fees are usually calculated as a flat percentage of the fund's total

Prior to section 36(b), over fifty suits were instituted challenging the propriety of compensation arrangements between funds and their advisers.[99] However, the common law strictures were such that there was never a successfully litigated suit[100] prior to the 1970 amendments to the Act.[101]

Galfand v. Chestnutt,[102] another section 36(b) case, recognized the burden on plaintiffs alleging excessive management fees. It posited that one of the purposes of section 36(b) was to overrule existing case law which subjected plaintiffs to an untenable burden (of proving mismanagement and waste) if the "advisory contracts were . . . approved by a vote of disinterested directors . . . ."[103] It noted that in the mutual fund industry, where the fund and its adviser were closely related, such a common law rule was "unduly restrictive."[104]

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assets under the advisers' managment. While it may be simplistic to say "it costs no more in research effort to buy 100 shares than 1000 shares," the cost of managing a fund does increase proportionately with its assets, and significant economies of scale do exist in mutual fund management. Thus, as assets grow, advisers' profit margins grow at a much faster rate, and in large funds the profits can become immense. *See* Sterrett, *Reward For Mutual Fund Sponsor Entrepreneurial Risk,* 58 CORNELL L. REV. 195, 203-04 (1973).

99. *See* Sterrett, *supra* note 98, at 204. The impropriety of the enormous fees may be particularly gross in the case of "money market" funds such as the fund in *Boyko.* Money market funds experienced tremendous growth during the "tight money" high interest rate periods of the early 1970's. They primarily invest in "cash equivalents" and short-term securities, such as treasury bills, certificates of deposit, and commercial paper, rather than stocks and corporate bonds. Their return on investment is essentially tied to the prime rate, the Federal Reserve Bank's monetary policy, and the economy as a whole, rather than to the earnings prospects of dividend paying ability of particular corporations. As a result, the number of investment decisions and volume of advice, required from the adviser to keep assets invested in money market instruments, is relatively low. CCH FED. SEC. L. REP. ¶ 95,304, at 98,538.

100. *See* Note, *Mutual Fund Advisory Fees And The New Standard of Fiduciary Duty—Interpreting The 1970 Mutual Fund Act,* 56 CORNELL L. REV. 627 (1971). Most of the suits ended in settlement. *Id.* at 636. Only three major advisory feee cases were fully litigated. *See* Kurach v. Weisman, 49 F.R.D. 304, 305-06 (S.D.N.Y. 1970). *See also* 60 Geo. L.J. 1594, 1601 (1972).

101. *See* Manages, *The Investment Company Amendments Act of 1970—An Analysis and Appraisal After Two Years,* 14 B.C. IND. & COM. L. REV. 387, 392-93 (1973).

102. 402 F. Supp. 1318 (S.D.N.Y. 1975). The initial decision in *Galfand* was prior to *Boyko.* However, the "Supplemental Findings and Conclusions" were subsequent to *Boyko.*

103. *Id.* at 1325.

104. *Id.* The *Galfand* court further noted that in post-amendment management fee cases, one of the factors the court may wish to consider in determining whether the advisor has fulfilled his fiduciary duty is whether the deliberations of the directors were a matter of substance or a "mere formality." *Id.* at 1326.

However, while the *Galfand* and *Boyko* courts both held that demand would have been futile in their respective section 36(b) actions, they did so on very different bases. The *Galfand* court adopted traditional[105] common law rules, albeit the broader rules of *Papilsky,* rather than those of *Kauffman.*

On the other hand, the *Boyko* court moved away from the traditional common law rules, and created significant new law. The *Boyko* court noted that the common law rules on demand requirements "are not to be blindly applied to newly created derivative actions."[106] It therefore held that if it is alleged that at least one interested person sits on the board of the mutual fund, "the requirement of Rule 23.1 is met in a section 36(b) action,"[107] and the "futility of making a demand" on the entire board will be presumed.[108]

IV. Conclusion

The strict standard of pleading adopted by the First Circuit in *Kauffman* may well have placed an overly burdensome obstacle in the derivative plaintiff's path.[109] The new standard adopted by the district court in *Boyko* clearly lessened this burden for mutual fund derivative suitors.

Boyko is of course still subject to appellate scrutiny. And, in recent cases such as *Eisen v. Carlisle & Jacquelin,*[110] the Supreme Court has shown a tendency to tighten pleading requirements in non-derivative class actions. If, however, the principle of *Boyko* withstands appellate review, it may well help open the doors of the judicial forum to other types of quasi-public plaintiffs. Conceivably, various other types of private attorneys general—*i.e.,* in other types of class actions, consumer actions, environmental actions, etc.—may ultimately stand to benefit from the *Boyko* departure from the traditional common law pleading strictures.

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105. *Id.* at 1331.
106. CCH FED. SEC. L. REP. ¶ 95,304, at 98,540.
107. *Id.*
108. *Id.*
109. *See* 8 SUFFOLK L. REV. 287, 303 (1974).
110. Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974).