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Mutual Fund Independent Directors: Putting a Leash on the Watchdogs

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NOTES

MUTUAL FUND INDEPENDENT DIRECTORS: PUTTING A LEASH ON THE WATCHDOGS

INTRODUCTION

Mutual funds are organizations into which individuals pool their money for the purpose of having it invested by professional managers in a diversified portfolio.[1] Mutual funds have traditionally been "fraught with potential conflicts of interest."[2] These problems stem largely from the fact that mutual funds are typically organized and managed externally by a distinct corporation, generally referred to as the "investment adviser." The adviser, since it appoints the fund's first board of directors, is able to place some of its own members and affiliates on the board, thereby ensuring itself strong presence, if not virtual domination, for the future.[3] This practice places those directors who are members or affiliates of the adviser between the conflicting interests of the adviser in maximizing its fees and the shareholders in attaining a high return on their investments.[4] As a result of the temptation for affiliated directors to favor the adviser's interests, mutual fund shareholders have resorted to derivative suits in order to preserve and protect their rights.

In view of the important function served by mutual fund derivative suits, attention has recently been focused on the issue of whether a mutual fund's

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1. Mutual funds are one type of investment company. Investment companies are organizations that sell shares to the public and use the funds received to invest in the securities of corporations and governmental bodies. There are three types of investment companies: management companies, face-amount certificate companies, and unit investment trusts. Mutual funds are a subclass of management companies. A mutual fund shareholder owns a proportionate amount of the fund's pool of securities. Face-amount certificate companies sell unsecured, nonvoting debentures on an installment plan. Unit investment trusts sell interests in a fixed group of securities held by a trustee. R. Pozen, Financial Institutions: Investment Management 187 (1978). For a detailed description of investment companies, see Securities & Exchange Commission, Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 39-45 (1966) [hereinafter cited as Public Policy Report].

Mutual funds can be either open-end or closed-end. Open-end funds offer securities to the public on a continuing basis and are under a legal duty to repurchase their shares at approximately current net asset value. Investment Company Act § 5, 15 U.S.C. § 80a-5 (1976). Closed-end companies, on the other hand, generally do not offer securities after the initial capitalization and are not legally obligated to redeem their own shares. Public Policy Report, *supra*, at 42.

2. Galfand v. Chestnutt Corp., 545 F.2d 807, 808 (2d Cir. 1976), *cert. denied*, 435 U.S. 943 (1978).

3. Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 66-69 (1962) [hereinafter cited as Wharton Report]; R. Jennings & H. Marsh, Securities Regulation 1393-94 (4th ed. 1977). "The investment adviser usually is well represented on the fund's board of directors and maintains effective control over the fund." *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 10 (1967) (statement of M. Cohen, Chairman, Securities and Exchange Commission).

4. *See* R. Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. Pa. L. Rev. 1058, 1059-60 (1967).

independent board members can unilaterally terminate a shareholder derivative action brought against their co-directors and the fund's investment adviser.[5] Two approaches to this issue have been taken in *Lasker v. Burks.*[6] In that case, a derivative suit commenced by two shareholders on behalf of Fundamental Investors, Inc. (Fundamental) charged that the adviser and several of its present and former board members had engaged in practices constituting "gross misconduct and a gross abuse of trust"[7] when they failed to make an independent investigation of Penn Central's financial condition before purchasing $20 million of that company's commercial paper.[8] Since a majority of Fundamental's directors were either named defendants or affiliated with the adviser, the board appointed a committee composed of the minority independent directors to investigate and decide the fate of the action.[9] On the basis of outside counsel's recommendations and their own investigation,[10] the directors concluded that the continuation of the litigation would not be in the best interests of the fund and, therefore, moved to dismiss the action.[11]

The district court in *Lasker* proffered the first approach to this issue by holding that the minority members of the board had the authority to move for dismissal of derivative litigation.[12] In addition, the court stated that, pursuant to the business judgment rule's policy of noninterference with business

5. It has been noted that the outcome of the controversy may reshape the securities laws, N.Y. Times, Dec. 18, 1978, § D, at 1, col. 5, and that the resolution may "make it much harder for stockholders to call managements to account." N.Y.L.J., Jan. 18, 1979, at 28, col. 1.

6. 404 F. Supp. 1172 (S.D.N.Y. 1975), *motion to dismiss granted,* 426 F. Supp. 844 (S.D.N.Y. 1977), *rev'd,* 567 F.2d 1208 (2d Cir.), *cert. granted,* 99 S. Ct. 75 (1978) (No. 77-1724).

7. 404 F. Supp. at 1174. Plaintiffs claimed that this conduct violated § 36 of the Investment Company Act of 1940, ch. 686, 54 Stat. 739 (current version at 15 U.S.C. § 80a-35 (1976)). Plaintiffs also alleged violations of the common law, § 206 of the Investment Advisers Act, 15 U.S.C. § 80b-6 (1976), and breach of the advisory contract between the fund and the adviser. 404 F. Supp. at 1174.

8. 404 F. Supp. at 1174-75. In June of 1970, after Fundamental had bought the commercial paper, Penn Central filed a petition for reorganization. As a result of Penn Central's default on the commercial paper, Fundamental and a group of other investors instituted a suit against the seller, Goldman, Sachs & Co., seeking rescission of their purchases of Penn Central notes. Welch Foods Inc. v. Goldman, Sachs & Co., 398 F. Supp. 1393 (S.D.N.Y. 1974). Since the *Welch* litigation was still in progress when the *Lasker* action was commenced, all defendants in *Lasker* moved for and were granted a stay pending resolution in *Welch.* In 1974, Fundamental settled its claims in the *Welch* action when Goldman, Sachs & Co. agreed to take back the notes and pay Fundamental $5.25 million in cash and assign to the fund a 73.75% interest in the proceeds of the notes in the bankruptcy proceedings. Shortly after the settlement, the board of directors of Fundamental met to determine what position the fund should take in the *Lasker* suit. 404 F. Supp. at 1175.

9. 404 F. Supp. at 1175. For an explanation of the policy behind allowing a board of directors to decide the fate of such an action, see notes 62-65 *infra* and accompanying text.

10. The director's retained the assistance of outside counsel, Stanley Fuld, former Chief Judge of the New York Court of Appeals. He concluded that neither the adviser nor the directors were liable. 404 F. Supp. at 1175. The disinterested directors also met with litigation counsel for Fundamental and with three defendants in *Lasker*—the chairman and chief executive of the adviser, and two unaffiliated directors of Fundamental. *Id.* at 1176.

11. *Id.* at 1176.

12. *Id.* at 1179.

decisions of the board, such a motion should be granted in the absence of bad faith, fraud, or corruption.[13] The business judgment rule, in effect, makes the independent directors' decision almost inviolable.

The second approach, utilized by the Second Circuit in its reversal of the district court, concluded that the independent directors of a mutual fund generally do not have the power to terminate derivative suits[14] in light of the policy of the Investment Company Act of 1940 (ICA),[15] the federal regulatory statute for mutual funds. The policy of the ICA, the court noted, clearly intended that the independent directors check management and protect the interests of mutual fund shareholders; it did not envision that the independent minority would be used to approve majority action and thereby preclude shareholder derivative suits.[16] Under this approach, the independent directors are powerless to terminate nonfrivolous suits,[17] even if dismissal of such a suit would be in the best interests of the shareholders.

The extreme approaches taken by these courts provide unsatisfactory solutions to the issue. Instead, as this Note will contend, this issue should be resolved by a more balanced approach which recognizes both the purpose of the ICA and the merit of the business judgment rule's "hands-off" policy toward board decisions. In Part I this Note will explore the uniqueness of the mutual fund industry and will discuss the relevant portions of the ICA. Part II will then examine the two approaches taken in resolving the issue in *Lasker*. Finally, in Part III, this Note will suggest a new approach to the issue. This approach takes two factors into account: whether the directors were actually independent and whether they exercised reasonable business judgment in view of their protective function under the ICA.

I. The Mutual Fund Industry and the ICA

Mutual funds are incorporated under state law; the federal statute, the ICA, provides a regulatory rather than a chartering scheme.[18] These funds are typically organized by investment management companies, which are corporations that specialize in providing professional investment advice.[19] By pooling the assets of small investors, mutual funds are able to provide the benefits of a professionally managed and diversified portfolio to a wide range of investors.[20]

As organizer of the fund, the investment management company appoints

13. *Id.* at 1180.

14. 567 F.2d at 1212.

15. 15 U.S.C. §§ 80a-1 to -52 (1976).

16. 567 F.2d at 1211.

17. *See* notes 75-76 *infra* and accompanying text.

18. United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 704-05 & n.13 (1975); Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977); Brown v. Bullock, 194 F. Supp. 207, 217 (S.D.N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961); *see The Mutual Fund Industry: A Legal Survey,* 44 Notre Dame Law. 732, 794-95 (1969). The ICA acknowledges that state regulation of the industry is almost impossible. Investment Company Act § 1(a)(5), 15 U.S.C. § 80a-1(a)(5) (1976).

19. Public Policy Report, *supra* note 1, at 46-47; *The Mutual Fund Industry: A Legal Survey,* 44 Notre Dame Law. 732, 740-41 (1969).

20. Galfand v. Chestnutt Corp., 545 F.2d 807, 809-10 (2d Cir. 1976), *cert. denied,* 435 U.S. 943 (1978).

the first board of directors.[21] In turn, the board enters into a contract with the investment management company to manage the mutual fund's assets and to provide a full range of clerical services and office space for the fund.[22] Since nearly all of their management and service functions are conducted externally, mutual funds have been characterized as mere corporate "shells."[23]

In addition to its duties as manager of the fund's assets, the investment management company often performs two additional functions. First, the adviser may act as underwriter to the fund when its shares are offered to the public.[24] When performing this task, the adviser generally offers the shares through designated brokers.[25] Second, the adviser may act as broker for the fund's portfolio transactions.[26] Thus, by organizing a mutual fund, an investment adviser is potentially entitled to three forms of remuneration. As compensation for its managerial services it receives either a fixed or declining percentage of the fund's net assets.[27] In its underwriting capacity, the adviser is entitled to its underwriting fee. Finally, as broker for the fund, it collects commissions for handling the fund's portfolio transactions.

The fusion of some or all of these functions in the investment management company provides a fertile ground for conflicts of interest. For one, an "incestuous relationship" exists between the fund and the adviser, stemming from the adviser's strong presence on and control of the fund's board.[28] As a result of this relationship, many board members negotiating the advisory contract and fees for the adviser are caught between the competing interests of the shareholders and the investment adviser.[29] Moreover, when the adviser

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21. *See* note 3 *supra* and accompanying text.

22. The ICA requires that a written contract exist between the adviser and the mutual fund. Investment Company Act § 15(a), 15 U.S.C. § 80a-15(a) (1976). That contract must "precisely" describe the adviser's compensation and must allow the fund the right to revoke without penalty on sixty days written notice. *Id.* § 15(a)(1), (3), 15 U.S.C. § 80a-15(a)(1), (3) (1976). In addition, any contract with a term of more than two years must be approved yearly by the board or shareholders. *Id.* § 15(a)(2), 15 U.S.C. § 80a-15(a)(2) (1976). By requiring yearly approval, Congress intended to provide the fund with the opportunity to evaluate the performance of the adviser and, if that performance is deemed unsatisfactory, to terminate the contract. Taussig v. Wellington Fund, Inc., 187 F. Supp. 179 (D. Del. 1960), *aff'd,* 313 F.2d 472 (10th Cir. 1963), *cert. denied,* 374 U.S. 806 (1965).

23. Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977).

24. Public Policy Report, *supra* note 1, at 54. "The sale of fund shares to new investors is generally the responsibility of a 'principal underwriter' who is usually the adviser itself or a close affiliate." Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977).

25. Some advisers, however, eschew designated brokers and instead offer the shares exclusively through their own sales forces. *See* Moses v. Burgin, 445 F.2d 369, 374 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971).

26. Public Policy Report, *supra* note 1, at 163.

27. The vast majority of advisory contracts provide for fees based on the market value of the fund's average net assets. Traditionally, a fixed rate of one-half of one percent has been used. *Id.* at 89. After the Wharton Report was published in 1962, however, the industry began to employ a rate which declines as the size of the fund's assets increases. *Id.*

28. One commentator has noted that "nothing—but nothing—approaches the open end mutual fund for incestuous relationships." *Conference on Mutual Funds,* 115 U. Pa. L. Rev. 663, 739 (1967) (remarks of A. Pomerantz).

29. R. Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds,* 115 U. Pa. L. Rev. 1058, 1059-60 (1967).

is also the fund's broker, a conflict exists between its managerial duty to strive for a high return on the fund's investments and its interest, as broker, to earn commissions by handling portfolio transactions.[30] Finally, when the adviser also functions as the underwriter, a similar conflict arises because, through its control of the fund's board, the adviser has substantial influence on the setting of underwriting fees.

In the 1920's and 1930's, mutual funds were plagued with abuses resulting from these conflicts of interest.[31] For example, the adviser's selection of the initial board frequently resulted in the inclusion of exculpatory clauses in the advisory contract to shield the adviser from claims of mismanagement and in the payment of excessive fees to the investment adviser.[32] These abuses did not end once the appointed board's term of office ended. Through its control of the proxy machinery and the use of staggered elections,[33] the adviser was able to perpetuate these abuses by maintaining its dominant position on the board.

In response to these and other pervasive abuses, Congress enacted the Investment Company Act of 1940.[34] This legislation was designed to regulate the mutual fund industry and to minimize its inherent conflicts of interest.[35] As a regulatory statute, the ICA requires full disclosure of all material information to mutual fund investors.[36] Prior to offering its shares to the public, the fund must file with the Securities and Exchange Commission (SEC) a detailed registration statement, including a description of its fundamental investment policies.[37] Reports must also be sent periodically to share-

30. The SEC has noted that "such affiliations could possibly lead investment company managers to adopt investment policies that call for high portfolio turnover rates for the purpose of increasing the amount of brokerage commissions obtainable through their relationships with [the broker]." Public Policy Report, *supra* note 1, at 189.

31. *Hearings on S. 3580 Before a Subcomm. of the Committee on Banking and Currency*, 76th Cong., 3d Sess. 37-38 (1940) (statement of R. Healy, Commissioner, Securities and Exchange Commission). For a detailed discussion of these abuses, see *The Mutual Fund Industry: A Legal Survey*, 44 Notre Dame Law. 732, 787-92 (1969).

32. Note, *The Investment Company Act of 1940*, 41 Colum. L. Rev. 269, 273 nn.34 & 37 (1941).

33. S. Rep. No. 1775, 76th Cong., 3d Sess. 7 (1940); Note, *The Investment Company Act of 1940*, 41 Colum. L. Rev. 269, 273 n.36 (1941).

34. Investment Company Act of 1940, ch. 686, 54 Stat. 789 (current version at 15 U.S.C. §§ 80a-1 to -52 (1976)). Congress also passed the Investment Advisers Act of 1940, ch. 686, 54 Stat. 847 (current version at 15 U.S.C. § 80b-1 to -21 (1976)) in response to these abuses. This Act, however, was primarily a disclosure statute and was a much weaker regulation than the ICA. R. Pozen, Financial Institutions: Investment Management 193 (1978). This weakness is apparent in the Act's express exclusion from its coverage of many investment advisers, such as banks, lawyers or brokers whose investment advice is incidental to their profession, publishers of newsletters or financial periodicals with regular circulation, or persons whose advice concerns only securities issued or guaranteed by the United States. Investment Advisers Act of 1940, § 202(a)(11) (codified at 15 U.S.C. § 80b-2(a)(11) (1976)).

35. S. Rep. No. 1775, 76th Cong., 3d Sess. 11-12 (1940); H.R. Rep. No. 2639, 76th Cong., 3d Sess. 9-10 (1940); *see* Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977).

36. Investment Company Act § 8, 15 U.S.C. § 80a-8 (1976).

37. *Id.*

holders and the SEC.[38] In addition to requiring full disclosure, the ICA also provides the SEC with certain regulatory and enforcement powers. For example, the SEC must approve any offer by a mutual fund to exchange its shares at other than net asset value[39] and may obtain injunctions against directors and advisers, among others, for breach of their fiduciary duties to the fund.[40]

To minimize the conflicts of interest pervasive in the mutual fund industry before 1940, the ICA contained two principal provisions.[41] First, in an effort to diminish self-dealing, the ICA prohibited certain transactions between mutual funds and affiliated persons, including the fund's principal underwriter, unless prior SEC approval was received.[42] For example, a mutual fund could not lend money, sell property to, or buy property from, affiliated persons in the absence of SEC approval.[43] Second, and more importantly, the ICA provided that a portion of the fund's board must be independent, that is, not directly or indirectly "affiliated"[44] with its investment adviser or principal underwriter. This provision was designed to check the adviser's control over the fund by providing shareholders with adequate representation on the fund's board.[45] At the minimum, forty percent of the board had to be composed of unaffiliated directors.[46] When the potential for abuse was enhanced, however, such as when the adviser acted as, or was affiliated with, the fund's broker, investment banker, or principal underwriter, the ICA mandated that a majority of the board be unaffiliated.[47] To effectuate this purpose of protecting shareholder interests, unaffiliated directors were given certain specific powers. Thus, for instance, the ICA provided that a majority of such

38. *Id.* § 30, 15 U.S.C. § 80a-29 (1976).

39. *Id.* § 11, 15 U.S.C. § 80a-11 (1976). Moreover, the ICA prohibits an investment company from making any public offering of its securities unless it has a net worth of at least $100,000, *id.* § 14, 15 U.S.C. § 80a-14 (1976), and severely restricts the issuance of senior securities by such companies. *Id.* § 18, 15 U.S.C. § 80a-18 (1976).

40. *Id.* § 36, 15 U.S.C. § 80a-35(a) (1976).

41. The final form of the ICA was a compromise. Some people had suggested that management be completely internalized or that it be at least separated from underwriting and brokerage functions. The industry, however, strongly protested these proposals. As enacted, the ICA regulates but does not eliminate the external management structure. R. Pozen, Financial Institutions: Investment Management 190-91 (1978).

42. Investment Company Act of 1940, ch. 686, § 17, 54 Stat. 789 (current version at 15 U.S.C. § 80a-17 (1976)).

43. *Id.* § 17(a)(1), (2), (3) (current version at 15 U.S.C. § 80a-17(a)(1), (2), (3) (1976)).

44. The ICA described an affiliated person as anyone who directly or indirectly owns or controls five percent or more of the outstanding voting securities and any officer, director, partner, co-partner, or employee of an affiliated person. The investment adviser and any member of an investment company's advisory board were considered affiliated persons. *Id.* § 2(a)(3) (current version at 15 U.S.C. § 80a-2(a)(3) (1976)).

45. *See* Lasker v. Burks, 567 F.2d at 1211; Tannenbaum v. Zeller, 552 F.2d 402, 418 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977).

46. Investment Company Act of 1940, ch. 686, § 10(a), 54 Stat. 789 (current version at 15 U.S.C. § 80a-10(a) (1976)).

47. *Id.* § 10(b) (current version at 15 U.S.C. § 80a-10(b) (1976)).

directors must approve the renewal of the advisory contract and fees[48] and must select the fund's public accountants.[49]

In the years following the enactment of the ICA, it became readily apparent that the independent director safeguard had failed to achieve its goal of preventing abuses[50] in the rapidly expanding mutual fund industry.[51] For one, the definition of "affiliated" directors had been too narrowly drafted. Under this definition, close friends and relatives of the managers, and shareholders of less than five percent of the adviser's outstanding shares were not "affiliated" and could thereby qualify as independent directors.[52] Moreover, persons qualifying as independent directors, even if they were not related to or financially affiliated with management, were often morally obligated to the adviser. Through its initial appointments, the adviser controlled the board and the nominations for future elections of directors. By controlling the nominations, the adviser could perpetuate its control of the board because, although management's nominees could always be challenged, these nominees were, as a practical matter, routinely elected by the shareholders.[53] As a result of this process, whereby "[t]he men who need to be watched pick the watchdogs to watch them,"[54] the independent directors that were elected were likely to feel indebted or at least sympathetic to the adviser. Thus, it was natural for independent directors to undertake reluctantly any action adverse to the adviser's interests.[55]

In 1970, Congress responded to these deficiencies in the independent director safeguard by amending the ICA in two major ways. First, the amendments imposed a stricter standard of care on the independent directors. Under the 1940 Act, directors were subject to SEC actions enjoining them from serving in their capacity only if they had engaged in practices constituting "gross

48. *Id.* § 15(c) (current version at 15 U.S.C. § 80a-15(c) (1976)).

49. *Id.* § 32(a) (current version at 15 U.S.C. § 80a-31(a) (1976)).

50. S. Rep. No. 184, 91st Cong., 1st Sess. 32-34 (1969), *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4927-29. The Wharton Report concluded that "the independent director requirement may be of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser." Wharton Report, *supra* note 3, at 34. As reasons for its conclusion, the report noted the control that management had over the board, the inadequacy of the definition of "affiliated," and the minor role that directors play in mutual fund affairs. *Id.*

51. S. Rep. No. 184, 91st Cong., 1st Sess. 3-4 (1969), *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4899-901. During the period of 1936-1952, the assets of open-end companies increased from $506 million to approximately $4 billion, or almost 800%; between December 1952 and September 1958 those assets tripled. Wharton Report, *supra* note 3, at 39.

52. S. Rep. No. 184, 91st Cong., 1st Sess. 32 (1969), *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4927; Public Policy Report, *supra* note 1, at 67-68; Wharton Report, *supra* note 3, at 34.

53. Public Policy Report, *supra* note 1, at 130.

54. *Conference on Mutual Funds,* 115 U. Pa. L. Rev. 663, 739 (1967) (remarks of A. Pomerantz).

55. One commentator noted: "[The independent director] only has some power. He is probably reluctant to exercise that in a vigorous way, because, after all, it's unpleasant to [reprimand] the people that he has worked with for years and likes and respects—and probably that's the only reason that he's on the board; he wouldn't accept the job if he didn't like and respect them . . . ." *Id.* at 759 (remarks of P. Loomis).

misconduct" or "gross abuse of trust."[56] By virtue of the 1970 amendments, directors became subject to such actions for any act amounting to "a breach of fiduciary duty involving personal misconduct."[57] Second, the 1970 amendments narrowed the definition of independent directors. The new definition provides that all "interested" persons, as opposed to all "affiliated" persons under the 1940 version, do not qualify as independent directors.[58] "Interested" persons include those with close family ties, substantial financial or

56. Investment Company Act of 1940, ch. 686, § 36, 54 Stat. 789 (current version at 15 U.S.C. § 80a-35 (1976)).

57. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1413 (codified at 15 U.S.C. § 80a-35(a) (1976)). Although this section, before it was amended in 1970, granted the SEC a cause of action, it did not provide an express right of action for shareholders. Nevertheless, courts traditionally implied a shareholder cause of action under the original § 36. Moses v. Burgin, 445 F.2d 369, 373 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971); Herpich v. Wallace, 430 F.2d 792, 815 (5th Cir. 1970); Epslin v. Hirschi, 402 F.2d 94, 103 (10th Cir. 1968), *cert. denied,* 394 U.S. 928 (1969); Taussig v. Wellington Fund, Inc., 313 F.2d 472, 476 (3d Cir.), *cert. denied,* 374 U.S. 806 (1963); Brown v. Bullock, 194 F. Supp. 207, 222-28 (S.D.N.Y.), *aff'd,* 294 F.2d 415, 420-21 (2d Cir. 1961). The Eighth Circuit, however, reasoning that the failure to provide a private remedy in the ICA was a deliberate omission, has refused to imply a shareholder cause of action under § 36. Brouk v. Managed Funds, Inc., 286 F.2d 901 (8th Cir.), *vacated per curiam as moot,* 369 U.S. 424 (1962). *But see* Greater Iowa Corp. v. McLendon, 378 F.2d 783, 793 (8th Cir. 1967) ("[T]he strong indications are, that if given the opportunity, the Supreme Court would also find an implied civil liability in the Investment Company Act and thereby overrule our opinion in *Brouk.*").

The 1970 amendments also added § 36(b), which expressly provides for a shareholder derivative action against the adviser for excessive management fees. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1413 (codified at 15 U.S.C. § 80a-35(b) (1976)). The creation of an express cause of action in § 36(b) suggests an argument that Congress intended to abrogate the case law implying a private action under the original section. Such an argument, however, is unsupported by the legislative history of the amendments. The purpose in adding subsection (b) was to ameliorate the "unduly restrictive" standard of "corporate waste" which shareholders had been required to prove in implied derivative actions for excessive fees under the original § 36. S. Rep. No. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4901; *see* Galfand v. Chestnutt Corp., 545 F.2d 807, 812 n.12 (2d Cir. 1976), *cert. denied,* 435 U.S. 943 (1978). The section was not intended to abrogate by implication subsection (a) and its case law. *See* S. Rep. No. 184, 91st Cong., 1st Sess. 16 (1969), *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4911 ("[T]he fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a)."). Consistent with this intention, Congress eased the standard of liability in § 36(a) from "gross misconduct" to a "breach of fiduciary duty involving personal misconduct." The argument that § 36(b) was intended to abrogate implied actions under subsection (a) has been rejected by the courts. Tannenbaum v. Zeller, 552 F.2d 402, 417 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977) (by providing an express cause of action in § 36(b) Congress did not intend to abrogate private action under § 36(a) previously recognized by the courts); Moses v. Burgin, 445 F.2d 369, 373 n.7 (1st Cir.) (protection of shareholders was intended by § 36, and, although amended to grant certain express causes of action, this can best be effectuated by allowing private causes of action), *cert. denied,* 404 U.S. 994 (1971). *Contra,* Monheit v. Carter, 376 F. Supp. 334, 342 (S.D.N.Y. 1974).

58. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 5(a), 84 Stat. 1413 at 15 U.S.C. § 80a-10(a) (1976)). The 1970 amendments, however, did not adopt the definition of "interested" in place of "affiliated" for the purposes of §§ 10(f) and 17, 15 U.S.C. §§ 80a-10(f), -17 (1976), which deal with insider transactions.

professional relationships with the adviser or underwriter, and those with beneficial or legal interests as fiduciaries in securities issued by the adviser or underwriter.[59]

Although this definition excludes individuals manifestly interested in the fund or its adviser, it will not be a panacea for mutual fund abuses. The subtle influences, almost impervious to proof,[60] that come to bear upon a director in the board's conference room are a reality which cannot be totally eradicated by any statutorily mandated percentage of independent directors. This reality should be acknowledged and its effects should not be ignored.

II. THE TWO APPROACHES

As a result of the unique structure, organization, and regulation of mutual funds, the question of whether independent directors of a fund can terminate derivative litigation has arisen. In the absence of any explicit guidance from the ICA or its legislative history,[61] the federal courts have developed two approaches to the resolution of the issue.

The first approach, adopted by the district court in *Lasker*, provides that the independent directors of a mutual fund have the power to decide whether a derivative suit should be terminated or allowed to proceed and that, under the business judgment rule, such a decision is not reviewable by the courts unless bad faith, fraud, corruption, or a similar impropriety is shown.[62] This reliance on the business judgment rule reflects the court's unwillingness to substitute its own judgment for that of the directors.[63]

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59. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 2(a)(3), 84 Stat. 1413 (codified at 15 U.S.C. § 80a-2(a)(19) (1976)). Any registered brokers, dealers or their affiliated persons and anyone who has acted as legal counsel for the investment company within the last two fiscal years are also considered "interested." *Id.*

Congress also addressed the independent directors' inadequacy as a check on management in the area of management fees. This inadequacy resulted from the lack of arm's length bargaining between the adviser and the fund's directors in fee negotiations. For one, the adviser usually had strong representation on the fund's board. Second, the adviser sometimes possessed all the fund's business records and therefore could hamper any attempts by the independent directors to obtain them. Third, if they chose to bargain with another adviser, the independent directors would subject the fund to the uncertainty of relying on the untested performance of a new organization. Finally, the independent faction of the board might not have the power to obtain a new adviser. Public Policy Report, *supra* note 1, at 130. Thus, the independent director safeguard in this area was termed a "myth." *Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737, Before the Subcomm. on Commerce and Finance of the Committee on Interstate and Foreign Commerce,* 91st Cong., 1st Sess. 769 (1969) (statement of A. Pomerantz). In response to this inadequacy Congress added § 36(b) to the ICA. This section serves to curb excessive fees by placing a specific fiduciary duty on investment advisers with respect to their compensation and by providing an express cause of action for both the shareholders and the SEC.

60. One court has noted that "tangible indications of bias on the part of the unaffiliated [directors] are rarely present . . . . [C]ontrol of a mutual fund by its advisor is the result of intangible factors arising out of the unique structure of the industry." Boyko v. Reserve Fund Inc., 68 F.R.D. 692, 696 (S.D.N.Y. 1975).

61. Although some specific duties of independent directors are spelled out in the Act, neither the ICA nor its legislative history makes reference to the role of these directors when a derivative suit is commenced against their co-directors and the fund's adviser.

62. 404 F. Supp. at 1179.

63. The business judgment rule originated in the late nineteenth century. *See, e.g.,* Hawes v. Oakland, 104 U.S. 450 (1881); Witters v. Sowles, 31 F. 1, 2 (C.C.D. Vt. 1887); Spering's Appeal,

Within the context of board decisions concerning derivative suits, the principal purpose behind the application of the rule has traditionally been to provide the directors, who are empowered to run the corporation's business, with the liberty to decide whether it is in the best interest of their company to allow the derivative action to proceed.[64] This deference to the board's business judgment permits the directors not only to terminate meritless actions, but also to squelch meritorious claims when the merit of and potential recovery under the claim are outweighed by the costs of litigation and the adverse effect the action may have on the business relationship between the corporation and the potential defendant.[65]

The *Lasker* district court did not find that the disinterested directors' duty to safeguard shareholder interests warranted a modification in the business judgment rule.[66] It did observe, however, that the actual independence of the disinterested directors affected the issue of bad faith.[67] Accordingly, the court permitted further discovery on the issue of independence.[68] After considering a myriad of factors on remand, such as the directors' remuneration for service

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71 Pa. 11, 24 (1872). The policy behind the rule is to permit management to run the business of the company without fear of liability resulting from mere errors in judgment. The rule is applied only if the directors acted within their authority, in good faith and without bias, and in the honest belief that the corporation's best interests were served by their decision. *See* H. Henn, Handbook of the Law of Corporations § 242, at 482-83 (1970).

The rule has been applied to actions brought by shareholders against corporate directors. *E.g.*, Polin v. Conductron Corp., 552 F.2d 797, 809 (8th Cir.) (directors' decision to merge with another corporation did not involve improper motives or self-dealing and would not be reviewed by the court), *cert. denied*, 434 U.S. 857 (1977); Schein v. Caeser's World, Inc., 491 F.2d 17, 18 (5th Cir.) (directors incur no liability to the corporation for exercise of their business judgment in executing a compromise agreement regarding the purchase of corporate stock), *cert. denied*, 419 U.S. 838 (1974); Berman v. Gerber Prods. Co., 454 F. Supp. 1310, 1319 (W.D. Mich. 1978) (management is not liable for good faith business decision to bring action to resist tender offer).

The rule has also been applied to prevent shareholders from forcing the corporation to prosecute claims against third parties. *E.g.*, United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917) (enforcement of a corporate cause of action is, like other business questions, a matter ordinarily left to the discretion of the directors); Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903) (directors presumably act in the best interests of all and, when they elect not to pursue a cause of action, dissenting shareholders may not always call on the courts to enforce such corporate rights); Ash v. IBM, 353 F.2d 491, 493 (3d Cir. 1965) (unless bad faith or bias are shown, shareholder lacks standing to sue derivatively), *cert. denied*, 384 U.S. 927 (1966); Bernstein v. Mediobanca di Credito Finanziario—S.p.A., 69 F.R.D. 592, 595 (S.D.N.Y. 1974) (unless something worse than unsound business judgment is shown, derivative suits may not be maintained).

64. Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 274 (3d Cir. 1978); Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 518 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); *see* 3B Moore's Federal Practice ¶ 23.1.19 (2d ed. 1978).

65. Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978); *see* Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 168 (1976).

66. The court felt that the policy behind the ICA does not preclude a board of directors' exercise of business judgment. 404 F. Supp. at 1179.

67. *Id.* at 1180.

68. Procedurally, the district court denied defendants' motion to dismiss with leave to renew upon completion of discovery. *Id.*

on boards of other mutual funds managed by the same adviser, the directors' relationship to other board members at the time of their nomination, and the fact that the relationship between mutual funds and advisers may raise an inference of nonindependence or control, the court concluded that the unaffiliated directors were truly independent and granted the defendants' motion for dismissal.[69]

The second approach was adopted by the Second Circuit on appeal of *Lasker*. It provides that mutual fund independent directors do not have the power to terminate a nonfrivolous derivative action brought against majority directors for breach of their fiduciary duties.[70] This approach, unlike the district court's, is based primarily on the ICA's policy of protecting shareholders of mutual funds. In its decision, the Second Circuit noted that the statutorily mandated independent directors were intended by Congress to act as a check on management and its representatives and affiliates on the board.[71] To effectuate this purpose, the ICA granted independent directors certain specific powers.[72] This "watchdog" authority, however, did not include any explicit power to terminate derivative suits.[73] Moreover, the court decided that the implication of such a power would be inconsistent with the ICA's policy of protecting shareholders because the independent directors' moral obligation to the adviser inevitably precludes the objectivity necessary for exercising impartial judgment.[74] Accordingly, since these directors cannot be expected to make an objective decision regarding their colleagues, the court concluded that independent directors are simply without the power to terminate derivative suits.[75] The court did, however, recognize one possible exception when it noted in dictum that independent directors might have the power to terminate frivolous suits.[76]

III. A New Approach

Neither the district court nor the circuit court approach to the issue of the power of independent directors to terminate a shareholder derivative suit is wholly satisfactory. The district court approach fails to incorporate the policy of the ICA, while the circuit court, by misinterpreting that policy, unduly limits the independent directors' power to participate in running the business of a mutual fund. A more appropriate approach to this question would

69. 426 F. Supp. at 853.

70. 567 F.2d at 1212.

71. *Id.* at 1211.

72. *See* notes 48-49 *supra* and accompanying text.

73. 567 F.2d at 1211.

74. "It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned. . . . [I]t cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires." *Id.* at 1212. (footnote omitted).

75. *Id.*

76. *Id.* Although the court left no guidelines, frivolous suits presumably are claims without merit.

incorporate both the merits of the business judgment rule's "hands-off" policy toward board decisions and the policy of the ICA to protect shareholders from the conflicts of interest and other abuses that have traditionally plagued the mutual fund industry.

The district court's business judgment approach was satisfactory in part because it recognized the fact that independent directors possess the powers generally available to directors of ordinary corporations. Support for this conclusion is found in the legislative history of the 1970 amendments to the ICA. To explain the intended effect of section 36(b), which grants shareholders an express cause of action against the adviser for excessive management fees,[77] the Senate Report states that the provision

is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the [independent] directors to deal with these matters . . . . [It] is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.[78]

Additional support for this conclusion exists in court decisions which have recognized that, in order to carry out effectively their watchdog function, independent directors must be empowered with substantially the same authority available to ordinary directors.[79] One power available to directors of ordinary corporations is the ability to terminate a derivative action when such a suit would not be in the best interest of their company.[80] Accordingly, since independent directors possess the same powers as ordinary directors, they should be able to decide the fate of derivative litigation.

Nonetheless, the district court approach is deficient since it fails to recognize that the policy of the ICA places constraints on the independent directors' exercise of this power to terminate shareholder suits. Under the ICA, these directors are intended to champion shareholder interests.[81] The specific powers granted them, such as the authority to approve the investment adviser's contract and to review portfolio transactions, are all consistent with this watchdog function. It is submitted that the independent directors' exercise of general directorial powers, such as the power to terminate derivative suits, should similarly comport with the ICA's policy. The district court did not conclude that this policy constrained the employment of general powers; instead, that approach placed only one limitation on the exercise of

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77. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1413 (codified at 15 U.S.C. § 80a-35(b) (1976)).

78. S. Rep. No. 184, 91st Cong., 1st Sess. 7 (1969), *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4903.

79. Unless limited by the ICA or its legislative history, independent directors are empowered with the authority available to directors of ordinary corporations. Tannenbaum v. Zeller, 552 F.2d 402, 417 (2d Cir.) (decision to recapture brokerage commissions is within directors' power), *cert. denied*, 434 U.S. 934 (1977); *see In re* Kaufman Mutual Fund Actions, 479 F.2d 257, 266-67 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973).

80. *See* notes 64-65 *supra* and accompanying text.

81. The independent director is "to provide a means for the representation of shareholder interests in investment company affairs." S. Rep. No. 184, 91st Cong., 1st Sess. 32, *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4927.

these powers—independence of the directors.[82] This approach is unsatisfactory since it may result in the exercise of the power to terminate in situations where the ICA's policy of protecting the best interests of the shareholders would be served by allowing the suit to proceed.

The Second Circuit's approach, on the other hand, is satisfactory in part since it recognizes that the ICA places constraints on the exercise by independent directors of general directorial powers. That court, however, misinterpreted the ICA's policy to mean that, with the exception of frivolous cases, the independent directors cannot exercise this power to terminate. The policy of the ICA does not so narrowly circumscribe the power to terminate. The ICA's purpose is to protect the best interests of shareholders. This purpose can sometimes be better served by allowing directors to terminate even a nonfrivolous action, such as a suit that will yield an inadequate recovery or will disrupt the fund's business.

A better approach to this issue recognizes that independent directors are empowered by the ICA to terminate derivative suits, but that the exercise of that power must be consistent with their function under the ICA of protecting shareholder interests. In order to determine whether the exercise of their power was consistent with the ICA's policy, a court must examine two factors: (1) whether the independent directors were actually independent; and (2) whether their decision was a reasonable exercise of their business judgment. If either of these factors is not satisfied, then the directors should not be permitted to terminate the shareholder derivative suit.

The first factor, independence, requires an examination of the directors' relationship with the adviser, their relations to other members of the board, and the percentage of the board which is disinterested. These factors were examined by the district court in *Lasker* when it conducted a similar inquiry into the actual independence of the directors.[83] In one respect, however, the suggested approach goes beyond the district court's inquiry. This approach places more weight on the question of whether the independent directors comprise a minority or majority of the board. When the disinterested faction makes up only a minority of the board,[84] there is a dangerous possibility that they are subject to the whims of the majority and cannot act independently. For example, the fact that they were nominated by a committee controlled by the majority, as was alleged in *Lasker*,[85] may indicate that they "were [not] selected . . . to protect the interests of the minority stockholders and to assure

82. *See* note 67 *supra* and accompanying text.

83. The court noted that each of the independent directors had served on the board of other funds managed by the same adviser and had received compensation for his services. Moreover, the court considered the fact that each of the independent directors knew one or more of the defendants before they were elected to the board. Nonetheless, the court concluded that such relationships were not enough to create an inference of nonindependence. 426 F. Supp. at 849.

84. In *Lasker*, the independent directors were a minority of the board. 404 F. Supp. at 1175. Typically, however, these directors comprise a majority of the board. Section 10(b) of the ICA, 15 U.S.C. § 80a-10(b) (1976), requires a majority of independent directors if the fund's investment adviser is affiliated with a broker or underwriter. This is often the case. Public Policy Report, *supra* note 1, at 162; L. Modesitt, *The Mutual Fund-A Corporate Anomaly*, 14 U.C.L.A. L. Rev. 1251, 1257 n.18 (1967).

85. Appellants' Brief at 64, Lasker v. Burks, 567 F.2d 1208 (2d Cir. 1978).

a vigorous prosecution of effective litigation against the offending majority."[86] Accordingly, whenever the disinterested directors comprise a minority, a presumption of nonindependence should be made and the burden of proof on this issue should be borne by the party seeking dismissal.

The second part of the suggested approach requires that the decision to terminate derivative litigation be reasonable in view of the independent directors' watchdog function.[87] This inquiry focuses on the reasonableness of the decision at the time and under the circumstances it was made and not on its correctness in retrospect.[88] This test would be satisfied if prudent independent directors, fully aware of their responsibilities to the shareholders, would decide to terminate the derivative suit under the circumstances prevailing at the time of the decision. Simply put, a reasonable director would decide to terminate if the adverse business effects and the cost of litigation outweighed the possible recovery from the action.

In determining reasonableness, the question of whether the independent directors were aware of all facts relevant to the case should be weighted

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86. Cohen v. Industrial Fin. Corp., 44 F. Supp. 491, 494 (S.D.N.Y. 1942).

87. A test of reasonableness was recently used to review the decision of mutual fund independent directors not to recapture commissions from brokers who had executed the fund's portfolio transactions. Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir. 1976), *cert. denied*, 434 U.S. 934 (1977). In that case, a shareholder of Chemical Fund, Inc., a mutual fund, brought a derivative suit against the fund's investment adviser, the adviser's parent company, and an affiliated director of the fund, alleging that these defendants had breached their fiduciary duty under § 36 of the ICA. *Id.* at 416. In her suit, the shareholder contended that it was a common practice in the mutual fund industry for executing brokers to "give-up" a portion of their commissions. This practice provided the fund's directors with the option to direct these excess commissions to other brokers who had compiled outstanding records selling the fund's shares or to recapture them for the fund by, for example, directing the commissions to an affiliate of the adviser to be set off against the adviser's management fee. *Id.* at 412. Plaintiff argued that the defendants breached their fiduciary duty to the fund and its shareholders when they persuaded the independent directors to forego recapture of the excess commissions in order to allocate them to other brokers. *Id.* at 413.

The *Tannenbaum* court concluded that the ICA permits the independent directors to exercise their discretion and decide whether it is in the best interest of the fund to recapture. *Id.* at 417. Noting, however, that "such discretion is by no means unrestrained," *id.* the court proceeded to review the reasonableness of the directors' decision. *Id.* at 427-28.

The *Tannenbaum* court's test of reasonableness required a "careful investigation of the possibilities [to recapture] with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons." *Id.* at 418 (quoting Fogel v. Chestnutt, 533 F.2d 731, 749-50 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976)).

Courts have also employed a test of reasonableness to review proposed derivative suit settlements between a corporation's directors and shareholders. *E.g.*, Schusselberg v. Colonial Mgmt. Assocs., Inc., 389 F. Supp. 733, 735 (D. Mass. 1974); *see* 3B Moore's Federal Practice ¶ 23.1.24[2], at 23.1-137 to -139 (2d ed. 1978). Such a test has also been applied to review the settlement of a derivative action brought by mutual fund shareholders against the fund's adviser. West Virginia v. Charles Pfizer & Co., 314 F. Supp. 710, 740 (S.D.N.Y. 1970) ("Approval should be given if the settlement offered is fair, reasonable, and adequate."), *aff'd*, 440 F.2d 1079 (2d Cir.), *cert. denied*, 404 U.S. 871 (1971).

88. This distinction was emphasized in Tannenbaum v. Zeller, 552 F.2d 402, 428 (2d Cir. 1976), *cert. denied*, 434 U.S. 934 (1977), *discussed at* note 87 *supra*.

heavily because, unless these directors are fully informed, they will be unable to "exercise the independent judgment that Congress clearly intended."[89] Accordingly, if the court finds that the independent directors were unaware of some of the relevant facts, it should make a presumption of unreasonableness. This presumption can be rebutted if the court finds that the additional facts were supportive of the directors' decision or, if not supportive, that the independent directors would have nevertheless reached the same decision.

This approach is distinguishable from the approaches of the two *Lasker* courts. The Second Circuit found the independent directors powerless to terminate nonfrivolous derivative suits.[90] In contrast, the suggested approach acknowledges that independent directors have the power to decide the fate of these suits. The district court, on the other hand, found that the independent directors possess the power to decide the fate of derivative suits but held that, absent a showing of nonindependence, the business judgment rule precludes any judicial review of their decision.[91] The suggested approach, however, mandates a review of the reasonableness of the directors' decision regardless of independence.[92]

When applied to the facts of *Lasker*, the suggested approach would find that the "disinterested" directors were not truly independent. Initially, a presumption of nonindependence would be made because of the disinterested directors' minority status on the board.[93] This presumption would not appear to be rebutted under the facts of the case. For example, the qualifications

89. Moses v. Burgin, 445 F.2d 369, 377 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971); *accord,* Imperial Fin. Servs., Inc., 42 S.E.C. 717 (1965). "The Investment Company Act's requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser itself, to insure that unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company." *Id.* at 730.

In Moses v. Burgin, 445 F.2d 369 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971), the court followed this directive from the SEC and held that the ICA imposes a duty of full disclosure to the independent directors on the adviser and affiliated directors. The court noted that the independent directors may not always be familiar with the "special and often technical problems of fund operation[s]" and that this should be considered when deciding whether the information supplied to them is adequate. *Id.* at 377. This requirement of full disclosure was subsequently applied in Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976). In that case, the court found that adequate disclosure to the unaffiliated directors had not been made when one of the directors affiliated with the adviser sent a copy of a relevant SEC release to the unaffiliated directors but did not discuss with them the particular application it might have had on the matter they were considering. *Id.* at 746-49. Finally, the Second Circuit in Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977), required the independent directors to be fully informed. There, the court found the disclosure adequate when the independent directors were furnished with all relevant administrative, judicial, and legislative developments and were made aware of the possibility of recapture and the procedure that would have to be followed to effectuate it. *Id.* at 427.

90. *See* notes 75-76 *supra* and accompanying text.

91. *See* notes 62-63 *supra* and accompanying text.

92. In a recent case not arising under the ICA, the court noted that there is some support for the judiciary to review the reasonableness of the directors' decision that a derivative suit is not in the best interests of their corporation. Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 274-75 (3d Cir. 1978) (dictum).

93. *See* text following note 86 *supra.*

committee that screened potential nominees for the board and the nominating committee itself were both dominated by the defendants.[94] These circumstances suggest that the majority may have had a degree of influence over the disinterested directors that would in all likelihood impair their ability to exercise impartial judgment. Moreover, it appears that the independent directors were elected to the board after the defendants had been made aware of the possibility that some legal action might be taken against them by the fund.[95] This fact suggests the possibility that the selection of these disinterested directors may have been dependent upon their attitude towards "vigorous prosecution of . . . litigation against the offending majority."[96]

Despite their apparent nonindependence, the "disinterested" directors seem to have made a reasonable business decision. For one, on the basis of the facts recited in the opinions of the district court and the circuit court, it appears that the independent directors were fully informed. This information was primarily supplied by outside counsel's report, which was the product of an extensive review of the relevant files of the fund and its adviser.[97] In addition, the independent directors questioned outside counsel and both the fund's and adviser's officers and directors about the "merits of the derivative action and the alternatives open to the Fund's Board."[98] Thus, since these directors were fully informed, no presumption of unreasonableness should be made.

Second, the decision to terminate the derivative suit is reasonable since the adverse effects of the litigation seem to outweigh the potential recovery for the fund.[99] The directors concluded that if the action were allowed to proceed, the fund's business would be adversely affected since the relationship between the adviser and the fund would be severely strained. As a result, the directors believed that this would require the hiring of a new adviser, thereby causing delay, uncertainty, and lapse in the management of the fund's affairs.[100] On

94. Appellant's Brief at 64-66, Lasker v. Burks, 567 F.2d 1208 (2d Cir. 1978).

95. *Id.* at 66-68.

96. Cohen v. Industrial Fin. Corp., 44 F. Supp. 491, 494 (S.D.N.Y. 1942).

97. The report suggested three possible courses of action for the directors: (1) prosecution of the claim by the fund; (2) termination; or (3) adoption of a neutral position, thus allowing the derivative suit to proceed. 404 F. Supp. at 1176. The report concluded that neither the adviser nor the directors had breached any statutory, common law, or contractual obligation to the fund. *Id.* at 1175-76.

If the independent directors had been unaware of the various options available, or if the adviser's files had been withheld from their view, a finding that the directors were not fully informed might be warranted. *Cf.* Fogel v. Chestnutt, 533 F.2d 731, 749 (2d Cir. 1975) (directors were not fully informed when they were merely provided with a copy of an SEC release relevant to the issue of recapture and some "causal advice from a lawyer having a personal stake adverse to the shareholders"), *cert. denied*, 429 U.S. 824 (1976).

98. 404 F. Supp. at 1176.

99. The directors felt that, given Judge Fuld's opinion, the expenses and risks involved in prosecuting the action simply outweighed any possible recovery. *Id.* at 1177. The directors also concluded that defendants' investment in Penn Central was prudent at the time of the purchase. This conclusion seems questionable in light of the ample warnings of Penn Central's troublesome financial situation that appeared in the press before the fund began purchasing the company's securities in December of 1969. *See* University Hill Foundation v. Goldman, Sachs & Co., 422 F. Supp. 879, 889 (S.D.N.Y. 1976) ($40.2 million loss for first three quarters of 1969 reported on October 20, 1969).

100. 404 F. Supp. at 1176.

the other hand, the potential recovery for the fund did not seem promising. This assessment was based primarily on outside counsel's conclusion that the suit lacked merit.[101]

Notwithstanding the reasonableness of the director's decision, the application of the suggested approach to the facts of *Lasker* dictates the denial of defendants' motion to dismiss because the decisionmakers were not truly independent. This result is consistent with the policy of the ICA. As has been noted, that policy seeks to guarantee adequate representation of shareholder interests. Congress believed that the independent director safeguard would be sufficient to ensure such representation. When the disinterested directors are not truly independent, however, the congressional mechanism for providing representation breaks down. In such a case derivative suits become the only device through which shareholders can protect their interests. Thus, when the disinterested directors do not satisfy the truly independent test, it is appropriate to allow the derivative suit to proceed.

Conclusion

The unique structure of mutual funds dictates that somewhat unorthodox methods be used to ensure the protection of those who entrust their money to these institutions. Congress has chosen the independent director check as a means to achieve this goal. This choice, however, has left the courts with the difficult task of accurately defining the exact role of these directors in running the affairs of a mutual fund. In deciding whether independent directors can terminate derivative suits, the courts have adopted two extreme approaches. As an alternative, this Note has suggested an approach which recognizes the independent directors' function "to provide a means for the representation of shareholder interests"[102] and supplies the tools with which a court can scrutinize the decisions of independent directors in order to ensure that these interests have been emphasized.

Ezio Scaldaferri

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101. *Id.* The hiring of outside counsel in *Lasker* was evidently intended to comply with the suggestion made in Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976), that it would be preferable to "have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors." *Id.* at 750 (footnote omitted).

The decision to terminate would have been unreasonable if, for example, outside counsel had concluded that the defendants were most likely, or at least probably, liable. In such a case, the adverse effects on the relationship between the fund and the adviser would be outweighed by the likelihood of gains. Indeed, notwithstanding the prosecution of the derivative suit, a finding that the adviser was probably liable would seem to suggest inferior performance on the adviser's part and indicate that a change in management might be advisable.

102. S. Rep. No. 184, 91st Cong., 1st Sess. 32, *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4927.