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The Inapplicability of the Demand Requirement of Rule 23.1 to Mutual Fund Shareholder Suits Under Section 36(b)

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THE INAPPLICABILITY OF THE DEMAND REQUIREMENT OF RULE 23.1 TO MUTUAL FUND SHAREHOLDER SUITS UNDER SECTION 36(b)

INTRODUCTION

The portfolio of an open-end investment company, or mutual fund, is usually managed by a company external to the fund itself. For its services, this managing company, otherwise known as an investment adviser, receives a fee normally calculated as a percentage of the net assets of the fund. Reacting to an enormous growth in the

1. Securities and Exchange Commission (SEC), Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 43 (1966) [hereinafter cited as PPI]. The primary business of an investment ("management") company is investing and reinvesting in securities of other companies. The investment company issues shares of its own stock to the public, the value of which fluctuates with the value of the securities in its portfolio. The significant feature of an open-end, as opposed to a closed-end, investment company is that the securities issued to the public are redeemable and therefore entitled the holder to receive, on demand, the approximate proportionate share of the issuer's net assets or their cash equivalent represented by the share tendered for redemption. 1 L. Loss, Securities Regulation 144-46 (2d ed. 1961); Note, The Mutual Fund Industry: A Legal Survey, 44 Notre Dame Law. 732, 740-43 (1969) [hereinafter cited as Survey]; see 15 U.S.C. § 80a-5(a) (1976).


5. Id.; PPI, supra note 1, at 46. The advisory fee fluctuates with the value of the fund's portfolio. 1969 Senate Report, supra note 2, at 5, reprinted in 1970 U.S. Code Cong. & Ad. News at 4901. It is usually an average of the net assets throughout the year, PPI, supra note 1, at 46, calculated as average daily net assets. See Gartenberg v. Merrill Lynch Asset Mgm't, Inc., 694 F.2d 923, 925 (2d Cir. 1982), petition for cert. filed, 51 U.S.L.W. 3686 (U.S. Mar. 3, 1983) (No. 82-1483); Dreyfus Liquid
mutual fund industry and the accompanying increase in advisory fees, Congress in 1970 extensively amended the Investment Company Act of 1940 (ICA). As part of that amendment, Congress added section 36(b) to impose a fiduciary duty on an investment adviser with respect to receipt of advisory fees. That section expressly pro-


7. See Rottenberg, supra note 2, at 310. As the fund grows, certain economies of scale develop with respect to management of the fund. In many instances, however, these economies are not passed on to the fund's shareholders by a reduction in fees. See Investment Company Act Amendments of 1967: Hearings on H.R. 9510, 9511 Before the Subcomm. of Commerce and Finance of the House Comm. on Interstate and Foreign Commerce [pt. 1], 90th Cong., 1st Sess. 35 (1967) (statement of Manuel Cohen, Chairman SEC) [hereinafter cited as 1967 House Hearings]; Wharton Report, supra note 3, at 492.


The 1970 amendments were preceded by extensive study which began eight years earlier when the SEC, as authorized by the 1940 Act, commissioned the securities research unit of the Wharton School of Finance and Commerce at the University of Pennsylvania to study the investment company industry. The resulting Wharton Report was submitted to Congress in 1962. Wharton Report, supra note 3. This was followed by a study conducted by the SEC, which included recommendations to amend the ICA and was presented to Congress in 1966. PPI, supra note 1. Numerous bills were proposed, accompanied by extensive hearings and reports. See infra notes 47-53 and accompanying text. For a general discussion of the legislative history culminating in the 1970 amendments, with an emphasis on advisory fee provisions, see Rottenberg, supra note 2, passim.


10. 15 U.S.C. § 80a-35(b) (1976). The Senate Report accompanying the enacted bill makes it clear that "as a matter of Federal law, the investment adviser or mutual fund management company has a fiduciary duty with respect to mutual fund shareholders." 1969 Senate Report, supra note 2, at 2, reprinted in 1970 U.S. Code Cong. & Ad. News at 4898. The fiduciary standard was a substitute for the standard in earlier bills that fees be reasonable. Id. at 5-6, reprinted in 1970 U.S. Code Cong. & Ad. News at 4902. The legislative history is somewhat ambiguous as to the meaning to be given the term "fiduciary duty." The Senate Report states that the fiduciary duty standard "is in accordance with the traditional function of the courts to enforce such fiduciary duties in similar type relationships." Id. at 6, reprinted in 1970 U.S. Code Cong. & Ad. News at 4902. The SEC expressed its view that "the failure of fiduciaries to deal fairly or reasonably with those to whom they are so obligated is a breach of fiduciary duty. It is also a breach of fiduciary duty to charge excessive or unreasonable fees." Mutual Fund Amendments: Hearings on H.R. 11,995, S. 2224, H.R. 13,754 and H.R. 14,737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce [pt. 1], 91st Cong., 1st Sess. 190 (1969) (memorandum of SEC to Chairman Moss) [hereinafter cited as 1969 House Hearings].
vides that the shareholders of a mutual fund have the right to bring an action to recover excessive fees paid within one year prior to the institution of suit.\(^\text{11}\)

The express authorization of a private right of action under section 36(b) clothes shareholder suits with a unique, hybrid quality—the recovery reverts to the fund as it would in a typical shareholder derivative suit,\(^\text{12}\) but the right of action flows from an express statutory grant\(^\text{13}\) rather than from the fund's own cause of action.\(^\text{14}\) Indeed, the fund may not even have its own cause of action; the statute provides no express right of action under section 36(b),\(^\text{15}\) and courts disagree whether the fund has an implied right of action under that section.\(^\text{16}\) The effect of this disagreement has been debate among the circuits regarding the applicability to section 36(b) shareholder actions of Federal Rule of Civil Procedure 23.1,\(^\text{17}\) particularly that Rule's demand requirement.\(^\text{18}\) Rule 23.1 must be complied with if the

action is one that is brought derivatively by a shareholder of a corporation or association and "may properly be asserted by" the corporation or association. Consequently, if the fund itself may not exercise a section 36(b) action, the section is not within the purview of Rule 23.1.

A number of courts either state or assume that an implied right of action exists for the fund under section 36(b). Accordingly, these courts reason that Rule 23.1 applies and that pursuant to the Rule, tors of fund to be prerequisite to § 36(b) suit) with Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928, 936-37 (3d Cir. 1982) (holding that demand requirement fully consonant with purposes of ICA), petition for cert. filed, 51 U.S.L.W. 3721 (U.S. Mar. 26, 1983) (No. 82-1592) and Grossman v. Johnson, 674 F.2d 115, 120-23 (1st Cir.) (same), cert. denied, 103 S. Ct. 85 (1982).

The demand requirement of Rule 23.1 states:

The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort.

Fed. R. Civ. P. 23.1. This procedural rule governs actions in federal courts. 13 W. Fletcher, supra note 12, § 5943, at 367. Federal law governs the demand on director requirement. Whether a demand on shareholders is necessary, however, is governed by the law of the forum. E.g., Oldfield v. Alston, 77 F.R.D. 735, 739 (N.D. Ga. 1978); see 13 W. Fletcher, supra note 12, § 5970, at 425. Discussion of the applicability to § 36(b) suits of this latter requirement is beyond the scope of this Note.


demand must be made on the fund's directors prior to the suit unless the plaintiff can prove that demand would have been futile.\textsuperscript{24}
On the other hand, one court has concluded that a mutual fund has no right of action under section 36(b). In Fox v. Reich & Tang, Inc., the Court of Appeals for the Second Circuit held that the shareholders' right of action is independent of, and not derived from, the fund's right to sue. The court refused to hold that a right of action for the fund could be implied from section 36(b), stating that the advisory fee problem which the 1970 amendments sought to cure was "basically incompatible with a corporate right of action as an effective solution." In dictum, the court considered the futility of demand under Rule 23.1. Noting that the ICA, as interpreted by the Supreme Court in Burks v. Lasker, precludes the board of directors from terminating a shareholder suit under section 36(b), that the fund's directors may not institute a section 36(b) suit, and that they are unlikely to take other action, the Fox court concluded that demand would be futile.

Because section 36(b) is silent with respect to a fund's right of action, this Note applies the implication doctrine set forth in recent Supreme Court cases and contends that a fund does not have a right of action under that section. Rule 23.1 therefore does not apply to section 36(b) shareholder actions because such actions may not "properly be asserted by" the fund. This Note further argues that even if the


26. Id. at 255. The court held that the words contained in the statute—on behalf of—"signify only that [the SEC or shareholder bringing] an action under § 36(b) must do so to seek return of excessive management fees to the company treasury and not to individual or governmental coffers." Id. The shareholders sue not derivatively, but as "'private attorneys general' to assist in the enforcement of a duty imposed by the statute on investment advisers." Id.

27. Id. at 259. The court said that "it defies logic to conclude [that the directors'] contemplated role included suing their advisers." Id.


29. 692 F.2d at 261 (construing Burks v. Lasker, 441 U.S. 471, 484 (1979)).

30. See 692 F.2d at 261.


implication doctrine supports a fund's right of action under section 36(b), application of the demand requirement to a shareholder suit would subvert Congress' intent in giving mutual fund shareholders an express right of action.

I. THE IMPLICATION DOCTRINE AND SECTION 36(b)

A. The Mutual Fund Industry and the 1970 Amendments

Because of the unique structure of the mutual fund industry, a conflict of interest is inherent in the relationship between a fund and its investment adviser, particularly with respect to advisory fees. A fund's directors have a duty to maximize the fund's assets by paying as small a fee as possible, yet they are wholly dependent for the fund's daily operations upon the adviser, which wants to maximize its own profits. Advisers face little or no competition for their services, a circumstance that gives them tremendous bargaining power with respect to fees. Moreover, because investors base their purchase of mutual fund shares upon the adviser's expertise, and the fund cannot exist without continuous management, the directors lack an essential


34. See 1967 House Hearings [pt. 1], supra note 7, at 31-32, 40-41 (statement of Manuel Cohen, Chairman SEC) (unaffiliated directors unable to combat excessive fees); PPI, supra note 1, at 131 (same); 114 Cong. Rec. 23,532 (1968) (statement of Sen. Proxmire) (The hearings "demonstrated beyond any doubt that the independent directors have not been able to act effectively to reduce management fees."); 1969 Senate Report, supra note 2, at 2, reprinted in 1970 U.S. Code Cong. & Ad. News at 4898.

35. 1967 House Hearings [pt. 1], supra note 7, at 34. This problem is particularly acute when the adviser is a publicly owned corporation because the adviser then owes to its shareholders the additional duty to maximize its own profits. Id.; see 1967 Senate Hearings [pt. 1], supra note 33, at 10 (statement of Manuel Cohen, Chairman SEC).

36. See 1967 House Hearings [pt. 1], supra note 7, at 40, 101, 129. One reason for the lack of competition is that advisory fees have so small an impact on the individual shareholder that cost reductions are not a significant consideration in the battle for investor favor. PPI, supra note 1, at 126. Naturally, the industry contends that competition exists. 1969 Senate Hearings, supra note 33, at 89 (statement of Robert Augenblick, President Inv. Co. Inst.); 1967 House Hearings [pt. 2], supra note 7, at 780 (statement of Harold Bache, Bache & Co.).
bargaining tool—the ability to threaten termination of the fee contract. The situation is aggravated even further by the affiliation that many of the fund's directors have with the adviser, and because the prevalent practice in the industry is to choose directors who are friendly to the adviser. Even a director sincere in his efforts to reduce fees is hampered by inadequate or non-existent research staffs, a problem compounded by dependence upon the adviser for financial and other information.

For many years, mutual fund shareholders, faced with excessive fees and directors unable to cope with them, had instituted actions against directors and advisers under either state corporation law, which required them to prove "corporate waste" of assets, or former ICA section 36, which required the plaintiff to show a "gross abuse

37. See 1969 House Hearings [pt. 2], supra note 10, at 788 (statement of Abraham Pomerantz, Esq.) (No adviser has ever been fired.); 1967 House Hearings [pt. 1], supra note 7, at 40-41 (statement of Manuel Cohen, Chairman SEC) (fee negotiations lack essential element of arm's-length bargaining—threat of contract termination); 1967 Senate Hearings [pt. 1], supra note 33, at 19 (statement of Manuel Cohen, Chairman SEC) (contract termination not possible due to dependence of fund upon adviser and lack of competition among advisers); 1969 Senate Report, supra note 2, at 5 (mutual fund, as a practical matter, not able to sever relationship with adviser), reprinted in 1970 U.S. Code Cong. & Ad. News at 4901.

38. See 1967 Senate Hearings [pt. 1], supra note 33, at 10 (statement of Manuel Cohen, Chairman SEC); PPI, supra note 1, at 131.

39. 1967 House Hearings [pt. 1], supra note 7, at 40 (statement of Manuel Cohen, Chairman SEC) (unaffiliated directors selected by management or affiliated directors); id. [pt. 2] at 635 (statement of Richard Jennings, Professor of Law University of California, Berkeley) (same); 114 Cong. Rec. 23,532 (1968) (statement of Sen. Proxmire) (unaffiliated directors hand-picked by adviser).

40. 1967 House Hearings [pt. 1], supra note 7, at 104 (statement of Manuel Cohen, Chairman SEC). The independent director usually has another occupation and cannot spend much time on his directorship. Id.; PPI supra note 1, at 130. Moreover, social pressures prevent independent directors from bargaining with affiliated directors. 1967 Senate Hearings [pt. 2], supra note 33, at 699 (statement of Abraham Pomerantz); see 1967 House Hearings [pt. 1], supra note 7, at 93 (memorandum of SEC) (independent directors disinclined to engage in active bargaining with colleagues on board).

41. PPI, supra note 1, at 130-31. The inability of unaffiliated directors to deal with advisory fee problems is demonstrated by the testimony of various directors taken in connection with the SEC's PPI report. See 114 Cong. Rec. 23,541-43 (1968), reprinted in 1969 Senate Hearings, supra note 33, at 110-15.

42. 1969 Senate Report, supra note 2, at 5, reprinted in 1970 U.S. Code Cong. & Ad. News at 4901; see PPI, supra note 1, at 142. Most cases were brought in state courts and relied on state law. 1967 Senate Hearings [pt. 1], supra note 33, at 84 (statement of Philip Loomis, General Counsel SEC).

of trust." These actions were uniformly unsuccessful, largely because the courts deferred to prior director and shareholder approval of the advisory contracts.

Concern with the inability of fund directors or shareholders to control advisory fees was an overriding factor in Congress' decision to amend the ICA. The industry's fear of strike suits and rate-making by the SEC or the judiciary led initially to a bevy of proposed bills which, in comparison to section 36(b) as enacted, would have given

44. Investment Company Act of 1940, ch. 686, § 36, 54 Stat. 789, 841 (currently codified as amended at 15 U.S.C. § 80a-35(a) (1976)); see Brown v. Bullock, 194 F. Supp. 207, 213, 215 (S.D.N.Y.) (action brought under state law and sections of the ICA, including § 36), aff'd on other grounds, 294 F.2d 415 (2d Cir. 1961). Although theoretically possible as a right of action, the SEC recognized that the "harshness of the sanction [imposed for violations of § 36, which is a prohibition against advisers and underwriters serving in those capacities for a period deemed appropriate by the court] impairs its usefulness in modifying advisory fee rates." PPI, supra note 1, at 143; see Survey, supra note 1, at 937-38.

45. Only three, Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963); Saxe v. Brady, 40 Del. Ch. 474, 164 A.2d 602 (1962); Meiselman v. Eberstadt, 39 Del. Ch. 563, 170 A.2d 720 (1961), of the "50 or so" lawsuits were fully litigated. 1967 House Hearings [pt. 1], supra note 7, at 42-43 & nn.10-12 (statement of Manuel Cohen, Chairman SEC); id. at 273-74, 277-78 (letter from Inv. Co. Inst. to Rep. Keith). Even though two courts questioned the fees, judgment for the defendants was granted in all three cases. Id. at 43. As the Chairman of the SEC noted, the 1940 Act's requirement of shareholder and unaffiliated director approval of fees, intended to protect shareholders, had precisely the opposite result. Id. Most of the remaining lawsuits were settled, resulting in some reduction of fees. In light of the magnitude of the overall problem, however, the effect of the reductions was insignificant. Id.

46. See 1967 House Hearings [pt. 1], supra note 7, at 29 (statement of Manuel Cohen, Chairman SEC) (management and sales charges major problems to be addressed by the legislation).


47. 1969 House Hearings [pt. 2], supra note 10, at 688 (statement of Milton Mound, President First Multifund of America, Inc.) ("[S]trike suits would be greatly encouraged by the bill as it is now drawn."); 1969 Senate Hearings, supra note 33, at 7 (statement of Hugh Owens, Commissioner SEC) (safeguards against shareholder suits added at request of industry); id. at 89-90 (statement of Robert L. Augenblick, President Inv. Co. Inst.) (industry concerned with need for protection against strike suits); see Grossman v. Johnson, 674 F.2d 115, 122 (1st Cir.) (stating that legislative history demonstrates concern over unjustified derivative suits), cert. denied, 103 S. Ct. 85 (1982).

48. 1967 House Hearings [pt. 1], supra note 7, at 242 (statement of John Haire, Chairman-Elect Inv. Co. Inst. ("SEC . . . proposes a true ratemaking statute."); id. at 262 (statement of Ralph Demmler, former Chairman SEC, on behalf of Inv. Co. Inst.) (noting that bill has "fee fixing provisions [that] go beyond the rate regulation of public utilities").
the shareholders far less ability to bring an excessive fee suit, enhanced
the deference to be accorded the directors' actions, or both.\textsuperscript{49} Representative of these proposals were bills that allowed shareholder suits
only if brought by a bona fide shareholder with justifiable cause\textsuperscript{50} or
after a fruitless demand on the SEC;\textsuperscript{51} that instructed the court to give
"substantial weight" to prior director approval of the advisory fee
contract;\textsuperscript{52} or that authorized an action by the fund itself.\textsuperscript{53}

Congress rejected these proposals and their underlying rationale,\textsuperscript{54}

\textsuperscript{49} H.R. 14,737, 91st Cong., 1st Sess. § 19, \textit{reprinted in 1969 House Hearings [pt. 1]}, supra note 10, at 113 (reduced shareholder ability to bring suit); S. 296, 91st Cong., 1st Sess. § 8(d), \textit{reprinted in 1967 Senate Hearings, supra note 33, at 314-17 (reduced shareholder ability to bring suit, increased deference to director actions)}; S. 34, 91st Cong., 1st Sess. § 8(d), \textit{reprinted in 1969 Senate Hearings, supra note 33, at 241 (deference to director decisions)}; S. 3724, 90th Cong., 2nd Sess. § 8(d), 114 Cong. Rec. 23,546-47 (1968) (same).


\textsuperscript{51} S. 296, 91st Cong., 1st Sess. § 8(d), \textit{reprinted in 1969 Senate Hearings, supra note 33, at 317}; S. 3724, 90th Cong., 2nd Sess. § 8(d), 114 Cong. Rec. 23,547 (1968). The demand requirement was "intended to reduce the possibility of a multiplicity of suits involving the same management compensation." S. Rep. No. 1351, 90th Cong., 2nd Sess. 6 (1968). Other restrictions were favored by the industry. \textit{See 1969 Senate Hearings, supra note 33, at 90 (statement of Robert Augenblick, President Inv. Co. Inst.) (amendment barring suit if fee contract approved by certain percentage of shareholders and independent directors); id. at 12, 30 (statement and letter of Hugh Owens, Commissioner SEC) (proposal to restrict suits to shareholders owning certain percentage of outstanding shares).

\textsuperscript{52} S. 3724, 90th Cong., 2nd Sess. § 8(d), 114 Cong. Rec. 23,546 (1968). In addition, the bill created certain presumptions of reasonableness which were based on director approval. \textit{Id. at 23,546-47. S. 296 contained similar provisions. S. 296, 91st Cong., 1st Sess. § 8(d), reprinted in 1967 Senate Hearings, supra note 33, at 314-17. Other deferences to director judgment were proposed by the industry. 1967 Senate Hearings [pt. 1], supra note 7, at 100-01.}

\textsuperscript{53} Several bills gave the SEC the power to intervene in an excessive fee suit "brought by or on behalf of a registered investment company." S. 296, 91st Cong., 1st Sess. § 22 (emphasis added), \textit{reprinted in 1969 Senate Hearings, supra note 33, at 337}; S. 34, 91st Cong., 1st Sess. § 22 (emphasis added), \textit{reprinted in 1969 Senate Hearings, supra note 33, at 266}; S. 1659, 90th Cong., 1st Sess. § 23 (emphasis added), \textit{reprinted in 1967 Senate Hearings [pt. 2], supra note 33, at 945. In addition, S. 34 and S. 296 termed the shareholder actions as derivative or representative. S. 296, 91st Cong., 1st Sess. § 8(d), \textit{reprinted in 1969 Senate Hearings, supra note 33, at 317}; S. 34, 91st Cong., 1st Sess. § 8(d), \textit{reprinted in 1969 Senate Hearings, supra note 33, at 241.}

\textsuperscript{54} Congress' rejection of the proposed bills reflects its perception that the threat of strike suits is illusory and that the shareholders need access to the courts. 1969 \textit{House Hearings [pt. 1], supra note 10, at 163 (memorandum report of SEC) (shareholders need access to courts); id. at 202 (SEC response to questionnaire) ("The
substituting a carefully balanced,55 two-level regulatory system. At the first level of this regulatory scheme, Congress sought to solve the advisory fee problem by increasing director ability to negotiate reasonable fees.56 The 1970 amendments to the ICA ensured that a fund's outside directors would be disinterested by expanding the category of persons deemed "interested" in the fund.57 In addition to those persons designated as "affiliated" under the 1940 Act,58 the amendments' definition of "interested person" includes persons having close family, financial or professional relationships with the fund, its adviser, or its underwriter.59

After having increased the requisite level of disinterest in the disinterested director, the 1970 amendments proceeded to make those same directors the "watchdogs" over all the mutual fund's operations.60 Certain duties are specified, such as approval of underwriting con-

specter of shareholder actions flooding the courts with harassing law suits is a much overworked bogeyman . . . . [T]he realities have never borne out the dire predictions.""); id. at 440 (statement of Chairman Moss) (specter of strike suits raised often but rarely happens); id. [pt. 2] at 881 (letter from SEC Commissioner Owens to Chairman Sparkman) (shareholders should not have to meet procedural hurdles): 1967 House Hearings [pt. 2], supra note 7, at 614 (statement of Judge Friendly) ("Plaintiff's lawyers will not wish to spend years litigating against well financed defendants unless there are real prospects of financial reward . . . ."); 116 Cong. Rec. 39,345 (1970) (statement of Rep. Springer) (final bill reflects Congress' "willing-ness to rely on the general fairness and the ability of our courts [to provide] adequate protection to fund managers and security holders as well"); see 114 Cong. Rec. 23,532 (1968) (statement of Sen. Proxmire) (amendment proposing to reduce possibility of strike suits jeopardizes the solution to the excessive fee problem, which is the threat of impartial judicial examination).


57. See Burks v. Lasker, 441 U.S. 471, 482-83 (1979). The ICA requires that 40% of a mutual fund's board be composed of independent outside directors. Prior to the 1970 amendments, these independent directors could not be "affiliated" as defined in the ICA. The 1970 amendments strengthened this definition so that the independent directors could not be "interested." Id. at 482. This Note uses the term "disinterested" to encompass both definitions.


tracts and selection of the fund’s accountants. The disinterested director also serves as an independent check on management by monitoring all of the investment company’s affairs. With specific reference to advisory fees, independent directors have a duty to request from the adviser and to evaluate such information as necessary to approve the fee contract. In addition, a majority of this class of directors must approve the contract.

Congress realized, however, that because the amendments were unable to eliminate the unique conflict of interest inherent in the adviser-director relationship, the expanded role given the directors was insufficient to enable them to negotiate effectively a reasonable advisory fee. Congress therefore sought to supplement the role of


64. The legislative history reveals that the tightening of the definition of what constitutes an independent director was regarded as a relatively minor recommendation [which] ... will be helpful in strengthening the ability of unaffiliated directors to provide in certain other areas the independent check on management which the Act intends, but ... unaffiliated directors cannot effectively deal with problems in the advisory fee area. [The proposal to tighten the unaffiliated director definition], standing alone, would perpetuate the unsatisfactory situation which exists today and, indeed, would confirm the present unwarranted belief of some courts that the business judgment of the directors as to management fees cannot be questioned so long as the statutory procedures for approval are followed. 1967 House Hearings [pt. 1], supra note 7, at 46 (statement of Manuel Cohen, Chairman SEC) (emphasis added); accord id. at 93 (SEC Memorandum); 1967 Senate Hearings [pt. 1], supra note 33, at 96 (SEC answers to questionnaire).


66. Id.

67. 1967 House Hearings [pt. 1], supra note 7, at 44; see 1969 Senate Report, supra note 2, at 5, reprinted in 1970 U.S. Code Cong. & Ad. News at 4901 (unique structure of mutual fund industry not conducive to arm’s-length bargaining). Suggestions were made in the legislative hearings that the conflict of interest problem could be solved by mandating an “‘internalization’ of the management function,” rather than by allowing separately owned investment advisers to manage the fund. This suggestion was rejected because of the drastic effect it would have had on existing management companies. 1967 House Hearings [pt. 1], supra note 7, at 94. Evidence suggests that in addition to the conflict of interest problem, directors still face the same problems they experienced prior to the 1970 amendments. See infra note 180.

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disinterested directors by adding a second, fallback level of regulation. For the first time, Congress expressly authorized a right of action in favor of mutual fund shareholders to recover excessive fees.

Section 36(b) as enacted is the exact antithesis of the proposed bills—shareholders are provided an unconditional cause of action, and director involvement in the shareholder action is greatly circumscribed. The procedural hurdles contained in the proposed bills are not present to block the shareholders' right to sue the adviser for breach of fiduciary duty respecting fees. Moreover, as a consequence of section 36(b), the courts, not fund directors, are now the ultimate judges whether a breach of this duty has occurred. Director approval of fees is to be accorded only such weight as the court deems proper.

Finally, the mechanics of the action are carefully detailed. Recovery is allowed only of actual damages, defined as excessive fees paid within one year prior to the initiation of the suit. Burden of proof, potential defendants, jurisdiction and the relationship between violations of section 36(b) and other statutory provisions are also specified.

These extensive amendments, however, did not include a provision authorizing a right of action under section 36(b) for the mutual fund

Reich & Tang, Inc., 692 F.2d 250, 259 (2d Cir. 1982) (provisions “cannot seriously be expected to induce arm’s-length bargaining”), cert. granted sub nom. Daily Income Fund v. Fox, 51 U.S.L.W. 3649 (U.S. Mar. 7, 1983) (No. 82-1200). The PPI study by the SEC stated: “[E]ven a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company’s adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation.” PPI, supra note 1, at 148.

69. Advisory Fee Suits, supra note 55, at 627 n.131, 628.
74. See Advisory Fee Suits, supra note 55, at 628.
76. Id. § 80a-35(b)(1).
77. Id. § 80a-35(b)(3).
78. Id. § 80a-35(b)(5).
79. Id. § 80a-35(b)(6).
itself. This absence, coupled with a lack of definitive congressional intent, poses the question whether such a right may be implied under current Supreme Court analysis.

B. The Supreme Court Standard For Implied Rights of Action

In Cort v. Ash, the Supreme Court enunciated four factors to be considered in determining whether a private right of action should be implied from a statute that does not expressly so provide. The first two Cort factors are whether the plaintiff is a member of the class "for whose especial benefit the statute was enacted," and whether there is any "legislative intent, explicit or implicit, either to create or deny" a federal remedy for that class. Recent decisions of the Court have emphasized the importance of congressional intent, as ascertained from statutory language and legislative history, in determining whether a private federal right of action exists for the class of which the plaintiff is a member.

Under the Court's general implication standard, statutory language evinces a congressional intent to create a right if, rather than generally proscribing activities or creating duties, it "unmistakably focus[es] on [a] particular class of beneficiaries" that includes the plaintiff.

81. Id. at 78.
82. Id. (quoting Texas & Pac. Ry. v. Rigsby, 241 U.S. 33, 39 (1916) (emphasis deleted)).
83. 422 U.S. at 78. The other two factors are whether implying the right is consistent with the legislative scheme and whether "the cause of action [is] one traditionally relegated to state law . . . so that it would be inappropriate to infer a cause of action based solely on federal law." Id.
86. California v. Sierra Club, 451 U.S. 287, 294 (1981). For example, § 901 of Title IX of the Education Amendments of 1972 has been held to have this focus. Cannon v. University of Chicago, 441 U.S. 677, 690-93, 717 (1979). The language of Title IX expressly identifies a class of beneficiaries: "No person in the United States shall, on the basis of sex, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any education program or activity receiving Federal financial assistance." 20 U.S.C. § 1681(a) (1976).
seeking the implied right. The absence of such focus, accompanied by congressional silence or indications of disapproval of the right, creates a presumption against implication. If the statute contains a “comprehensive legislative scheme including an integrated system of procedures for enforcement,” the presumption approaches conclusiveness.

The presumption against implication shifts, however, when the doctrine is applied to certain amended statutes. In the recent case of Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, the Court noted that if courts had uniformly recognized an implied right at the time Congress amended a statute, the amendment's legislative history must be examined to determine whether Congress intended to preserve that right. In this inquiry, congressional silence weighs in favor of, rather than against, implication.

C. Application of the Implication Doctrine to the 1970 Amendments

After applying the general implication standard used by the Court, including that propounded in Merrill Lynch for an amended


88. Two recent cases have given no weight to this factor of the implication analysis, focusing solely on the factors of comprehensiveness of the legislative scheme and the legislative history. See Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n, 453 U.S. 1, 13-18 (1981) (enforcement provision so detailed that Congress could not have implied additional remedies); Texas Indus. v. Radcliff Materials, Inc., 451 U.S. 630, 639-40 (1981) (relied on legislative history in holding plaintiff was member of class Congress intended to regulate, not benefit).


93. Id. at 378-82.

94. See id. at 381-82 (“[T]he fact that a comprehensive reexamination and significant amendment of [the statute] left intact the statutory provisions under which the federal courts had implied a cause of action is itself evidence that Congress affirmatively intended to preserve that remedy.”); The Supreme Court, 1981 Term, 96 Harv. L. Rev. 62, 238 (1982) (Court regards congressional silence as dispositive). But see 456 U.S. at 398 (Powell, J., dissenting) (majority's reliance upon congressional inaction is “novel legal theory”).

95. See supra notes 80-91 and accompanying text.
The inescapable conclusion is that section 36(b) does not contain an implied action for mutual funds against their advisers. Nevertheless, two recent decisions, Weiss v. Temporary Investment Fund, Inc., and Markowitz v. Brody, have applied the implication doctrine specifically to section 36(b) suits, with both finding a right of action for the fund. These courts relied primarily, however, on the factors enunciated in Cort v. Ash rather than on more recent Supreme Court analysis.

In their discussions of the first Cort factor, both courts failed to incorporate the gloss put on that factor by Cannon v. University of Chicago. In Cannon, the Supreme Court held that a plaintiff falls into the class for whom a right may be implied if the statutory language "expressly identifies the class Congress intended to benefit." The Weiss and Markowitz courts simply concluded that because the fund is the ultimate beneficiary of the fiduciary duty created by section 36(b), the fund is a member of the especial class for whose benefit that section was enacted. Yet neither court discussed the statutory language of section 36(b). Nowhere in that section does the language expressly identify the fund as a beneficiary of its provisions; rather it is entirely directed at the adviser's conduct.

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96. See supra notes 92-94 and accompanying text.
97. See Fox v. Reich & Tang, Inc., 692 F.2d 250, 261 (2d Cir. 1982), cert. granted sub nom. Daily Income Fund v. Fox, 51 U.S.L.W. 3649 (U.S. Mar. 7, 1983) (No. 82-1200) (finding no legislative intent to create right for fund). The Fox court did not specifically apply the implication doctrine as delineated in either Cort or Merrill Lynch, but did examine the most important factors of the doctrine—the statutory language and legislative history—to find that the fund had no right of action. Id. at 254-61.
100. 692 F.2d at 934-35; 90 F.R.D. at 557 n.12.
101. 692 F.2d at 936; 90 F.R.D. at 557 n.12.
103. 692 F.2d at 934-36; 90 F.R.D. at 557 n.12.
105. Id. at 690. The Court held that "[t]here would be far less reason to infer a private remedy in favor of individual persons if Congress, instead of drafting [the statute] with an unmistakable focus on the benefited class, had written it simply as a ban on . . . conduct . . . ." Id. at 690-92.
106. 692 F.2d at 935-36; 90 F.R.D. at 557 n.12.
107. See 15 U.S.C. § 80a-35(b) (1976); cf. California v. Sierra Club, 451 U.S. 287, 294 (1981). The Court in Sierra Club noted that the statute in question contained "no more than a general proscription of certain activities; it [did] not unmistakably focus on any particular class of beneficiaries whose welfare Congress intended to further. Such language does not indicate an intent to provide for private rights of action." Id.
108. 15 U.S.C. § 80a-35(b) (1976) ("The investment adviser . . . shall be deemed to have a fiduciary duty with respect to the receipt of compensation."). See supra note 10 and accompanying text.
tion 36(b) therefore lacks the type of language necessary to meet the special benefit criterion in *Cannon*.

Even assuming, however, that section 36(b) did meet the *Cannon* criterion, that is not sufficient to support a finding of a right of action for the fund. As the Supreme Court stated in *Transamerica Mortgage Advisors v. Lewis*, "the mere fact that [section 36(b)] was designed to protect [the fund and its shareholders] does not require the implication of a private cause of action for damages [in a fund-instituted action]. The dispositive question remains whether Congress intended to create any such remedy." In considering this second *Cort* factor of legislative intent, both the *Weiss* and *Markowitz* courts relied in their conclusions on the finding that the legislative history of section 36(b) reveals no intent to deny the fund a right of action. In so relying, the courts ignored the recent Supreme Court admonition that absent "strong indicia of a contrary congressional intent, [a court is] compelled to conclude that Congress provided precisely the remedies it considered appropriate."

The legislative history of the 1970 amendments reveals no congressional intent to confer a right of action on the fund. Indeed, Congress' rejection of proposals that would have accorded greater deference to director judgment, and its deletion from proposed amendments of language upon which an implied action could clearly

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111. *Id.* at 24 (citations omitted). *Transamerica* was an action brought against a real estate investment trust adviser under the Investment Advisers Act of 1940, enacted as companion legislation to the ICA. *Id.* at 13 & n.1, 20. The Court pointed out that Congress' inclusion of express private rights of action under the ICA and other securities statutes was evidence that when Congress wanted to provide private rights of action it did so explicitly. *Id.* at 20-21.


have been based, indicate the contrary. These congressional actions, in conjunction with the legislative scheme in the 1970 amendments, which provides for comprehensive regulation of all aspects of advisory fees, from contract negotiation to detailed enforcement procedures, are presumptive evidence that Congress' omission of an express right of action for the fund was deliberate. By giving express rights of action to the SEC and the shareholders, Congress included only those remedies it deemed appropriate. That section 36(b) was an amendment to the ICA does not alter this conclusion. Under the Merrill Lynch analysis, a fund's right of action could be implied only if there had been uniform judicial acceptance of

115. Compare S. 34, 91st Cong., 1st Sess. § 22 (words "brought by or on behalf of" included), reprinted in 1969 Senate Hearings, supra note 33, at 266 with 15 U.S.C. § 80a-43 (1976) (SEC may intervene in § 36(b) action; words "brought by or on behalf of" omitted); compare S. 34, 91st Cong., 1st Sess. § 8 (security holder may bring an action "in a derivative or representative capacity"), reprinted in 1969 Senate Hearings, supra note 33, at 241 with 15 U.S.C. § 80a-35(b) (1976) (security holder may bring action; not characterized as representative or derivative). See supra note 53 and accompanying text.

116. See Transamerica Mtge. Advisors v. Lewis, 444 U.S. 11, 22 (1979) (deletion of language that would have indicated private right of action is evidence Congress did not intend to authorize the cause of action); Burks v. Lasker, 441 U.S. 471, 484-85 (1979) (attention must be paid to what Congress did not do in enacting ICA); 2A C. Sands, Sutherland's Statutes and Statutory Construction § 45.10 (4th ed. 1973) (defeated legislative proposals can give meaning to legislative intent of statutes).

117. See supra notes 65-70, 74-79 and accompanying text.


119. In recent decisions, the Supreme Court has applied the maxim expressio unius est exclusio alterius, 2A C. Sands, supra note 116, § 47.23, at 123 ("[A]ll omissions should be understood as exclusions.")., holding that "when Congress wished to provide a private damages remedy, it knew how to do so and did so expressly." Touche Ross & Co. v. Redington, 442 U.S. 560, 572 (1979); accord Universities Research Ass'n v. Coutu, 450 U.S. 754, 773 (1981); Transamerica Mtge. Advisors v. Lewis, 444 U.S. 11, 19-20 (1979); see Fox v. Reich & Tang, Inc., 692 F.2d 250, 256 (2d Cir. 1982), cert. granted sub nom. Daily Income Fund v. Fox, 51 U.S.L.W. 3649 (U.S. Mar. 7, 1983) (No. 82-1200).

An example of Congress' express authorization of a right of action to both a corporation and its shareholders in the securities area is § 16(b) of the Securities and Exchange Act of 1934. 15 U.S.C. § 78p(b)(1976). That section also expressly incorporates a demand on directors requirement. Id.
the right prior to 1970. Because not all courts had recognized the right, the Merrill Lynch analysis reinforces the conclusion that section 36(b) does not yield a private right of action for a mutual fund. Although the Weiss court did refer generally to Merrill Lynch in its discussion of the implication doctrine, the court failed to consider specifically, as required by Merrill Lynch, whether the fund's right of action was uniformly recognized at the time of the amendments. In


Although the majority of pre-amendment cases did recognize an implied right of action under the ICA, and the one decision to the contrary, Brouk, was questioned in its own circuit by a later case, see Greater Iowa Corp. v. McLendon, 378 F.2d 783, 793 (8th Cir. 1967), what is important in a Merrill Lynch analysis is Congress' perception of the law that it was shaping or reshaping.

... "Whether that understanding of Congress was in some ultimate sense incorrect is not what is important. ... For the relevant inquiry is not whether Congress correctly perceived the then state of the law, but rather what its perception of the state of the law was."

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 378 & n.61 (1982) (quoting Brown v. GSA, 425 U.S. 820, 828 (1976)). The legislative history reveals that Congress perceived a split whether a right of action could be implied under the ICA prior to the 1970 amendments, and that no distinction was made between decisions that dealt with advisory fees and those that did not. 1969 Senate Hearings, supra note 33, at 30 (letter from Commissioner of SEC to Chairman of House Committee) (courts have generally implied right of action under ICA); 1967 House Hearings [pt. 2], supra note 7, at 636 (statement of Richard Jennings, Professor of Law, University of California, Berkeley) (questioning whether private right of action exists under ICA).


addition, Weiss looked at state common law at the time of the amendments to determine whether a fund had a right of action at that time. As Judge Gibbons pointed out in his dissent, however, common-law causes of action are not implied from a federal statute, but rather exist independently as a matter of state law. Supreme Court implication analysis seeks to determine legislative intent to provide a federal remedy, not whether some remedy exists which can be applied through the vehicle of a federal statute.

Weiss found no congressional intent to deprive a mutual fund of the implied right it enjoyed at the time of the 1970 amendments. Even assuming that partial judicial acceptance may be deemed to satisfy the criterion of uniformity, congressional action with respect to proposed bills and Congress' failure to leave intact the pre-amendment provisions under which the right had been implied strongly indicate congressional intent not to preserve any existing right. Thus, Merrill Lynch provides no foundation for inferring a private right of action for a mutual fund under section 36(b).

Notwithstanding the evidence to the contrary, many courts have either assumed or stated that a right of action exists for a mutual fund under section 36(b). Because the existence of such a right of action on the part of the fund would automatically bring any shareholder action within the purview of Rule 23.1 generally, these courts have concluded, although erroneously, that the shareholders must make a demand on the fund's directors pursuant to Rule 23.1 before instituting suit. Even assuming a cause of action can be implied for the

124. See 692 F.2d at 935-36.
125. Id. at 953 (Gibbons, J., dissenting).
127. 692 F.2d at 935.
128. See supra notes 47-69 and accompanying text.
130. See 456 U.S. at 381-82. Congress not only failed to leave intact former § 36, but restructured it specifically to make a shareholder action alleging excessive fees more effective than the actions brought under the unamended section or state law. See Fox v. Reich & Tang, Inc., 692 F.2d 250, 258-61 (2d Cir. 1982), cert. granted sub nom. Daily Income Fund v. Fox, 51 U.S.L.W. 3649 (U.S. Mar. 7, 1983) (No. 82-1200). The amended § 36(b), expressly providing only for an action by the SEC and the shareholder, demonstrates that Congress did not consider that a right of action for the fund would solve this problem. See id.
131. See supra notes 21-22 and accompanying text.
132. See supra note 24 and accompanying text.
fund under the Cort-Merrill Lynch analysis, examination of the demand requirement reveals that it serves no purpose in a section 36(b) action by shareholders.

II. APPLICATION OF RULE 23.1

A. Director Involvement in Section 36(b) Suits

Rule 23.1 is designed to prevent suits that are not in the best interest of a corporation. This objective is achieved in part by the Rule's demand requirement, which mandates that before commencing derivative litigation, a shareholder must demand that the corporation's board of directors redress the shareholder's grievance. If the plain-

133. Note, The Demand and Standing Requirements in Stockholder Derivative Actions, 44 U. Chi. L. Rev. 168, 168-69 (1976) [hereinafter cited as Standing Requirements]; see H. Henn, supra note 14, § 358, at 752. The derivative suit has potential for abuse and can be very expensive and time consuming. Standing Requirements, supra, at 168-69. A particular target of the Rule is the strike suit. H. Henn, supra note 14, § 358, at 752. Originally strike suits were those brought to force an out-of-court settlement which would enrich the plaintiff. Because any recovery from a derivative suit or its settlement must today go to the corporation, this definition of a strike suit is obsolete. The modern motivation to bring a strike suit is to enrich the plaintiff's attorney rather than the plaintiff himself. Id. at 752 n.22; see Dent, The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?, 75 Nw. U.L. Rev. 96, 137-38 (1980).

134. There are several devices by which Rule 23.1 protects against suits that are not in the best interests of the corporation. In addition to the demand requirement, three provisions are directed against strike suits: 1) the verification requirement, 13 W. Fletcher, supra note 12, § 5943, at 367 n.2; but see 7A C. Wright & A. Miller, Federal Practice and Procedure: Civil § 1827, at 335 (1972) (pointing out that the verification requirement's purpose of encouraging truthfulness may not be effective), 2) the contemporaneous ownership requirement, 13 W. Fletcher, supra note 12, § 5981, at 467; 3B J. Moore & J. Kennedy, Federal Practice ¶ 23.1.15[2], at 23.1-15 to -16 (2d ed. 1982); 7A C. Wright & A. Miller, supra, § 1828, at 341-42, and 3) the requirement that suits will not be dismissed or compromised without judicial approval, H. Henn, supra note 14, § 375, at 790; 7A C. Wright & A. Miller, supra, § 1839, at 427-28; Dent, supra note 133, at 138. This third provision is one factor that has prompted questioning whether strike suits now exist to any significant degree. Dent, supra note 133, at 137-39. Moreover, because an attorney usually serves in derivative actions on a contingent fee basis and is therefore unlikely to be paid unless the suit is successful or favorably settled, he will carefully weigh the merits of the suit before undertaking it. Kon Sik Kim, The Demand on Directors Requirement and the Business Judgment Rule in the Shareholder Derivative Suit: An Alternative Framework, 6 J. Corp. L. 511, 521 & n.56 (1981).

An additional protection provided for the corporation in Rule 23.1 is the requirement that the shareholders bringing derivative suits fairly and adequately represent the interests of other shareholders. 13 W. Fletcher, supra note 12, § 5981.1. This tends to reduce the number of suits that can be brought. Kon Sik Kim, supra, at 523-26. One commentator recommends that this requirement be utilized more often by courts as a means of preventing lawsuits not in the interests of the corporation. Id.

135. Fed. R. Civ. P. 23.1 ("The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors
tiff can show that making a demand would have been futile, however, his failure to make the demand will be excused.\textsuperscript{136} Demand affords the board an opportunity to act in its role as manager of corporate affairs\textsuperscript{137} by determining the claim's merits and what action, if any, should be taken on behalf of the corporation.\textsuperscript{138} If the board decides that the claim has merit, the corporation may either take over the suit or take measures toward settlement.\textsuperscript{139} Alternately, if the board determines that the claim is meritless, it traditionally has the power to decline to pursue the action in court, thus terminating the shareholder's cause of action.\textsuperscript{140} The traditional standard of review or comparable authority... and the reasons for his failure to obtain the action or for not making the effort.\textsuperscript{136}


In Hawes v. Oakland, 104 U.S. 450 (1881), the Supreme Court set out an early formulation of the demand requirement, stating that the plaintiff must exhaust intracorporate remedies before conducting litigation in his own name; he must make an earnest effort "to induce remedial action" on the part of the managing body of the corporation. Id. at 460-61. This early formulation was incorporated into various predecessors of Rule 23.1, such as Equity Rule 94. 104 U.S. at ix-x; see Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928, 940 n.14 (3d Cir. 1982), petition for cert. filed, 51 U.S.L.W. 3721 (U.S. Mar. 26, 1983) (No. 82-1592).

138. 13 W. Fletcher, supra note 12, § 5963, at 398; Standing Requirements, supra note 133, at 171-72.


140. Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982) ("[D]irectors' decision will be conclusive unless bad faith is proven."); see Auerbach v. Bennett, 47 N.Y.2d 619,
for such a decision by the board of directors is the common-law business judgment rule. That rule limits judicial scrutiny of a given corporate decision to its procedural aspects: whether the directors made a good faith determination while following procedures suitable to a thorough investigation of the matter in question. The substance of the corporate decision—such as the factors considered by the directors and the relative weight accorded them—is barred from judicial review.\(^{141}\)

A number of factors indicate that Congress did not intend demand on directors to be a prerequisite to a shareholder suit under section 36(b) for receipt of excessive advisory fees. Rather, Congress intended to confine director involvement in the control of fees to the initial stage of contract negotiation.\(^{142}\) First, Congress specifically abrogated

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\(^{142}\) Courts finding demand to be necessary in a § 36(b) action have relied in part on language in the Senate report accompanying the enacted bill:

[Section 36(b)] is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees. It does, however, authorize the court to determine whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee.

... Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section 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.

When read in the context of the entire report and the legislative history, however, it is clear that this language refers only to the initial stages of negotiating the contract. *Advisory Fee Suits*, supra note 55, at 627. The report makes clear that the court has the ultimate authority to determine if the adviser has breached its fiduciary duty. 1969 Senate Report, supra note 2, at 2, *reprinted in* 1970 U.S. Code Cong. & Ad. News at 4898 (provides effective enforcement method whereby courts can determine whether duty has been breached); *id.* at 6, *reprinted in* 1970 U.S. Code Cong. & Ad. News at 4903 (initial responsibility of approval with directors; ultimate responsibility with court); *id.* at 15, *reprinted in* 1970 U.S. Code Cong. & Ad. News at 4910 (directors have initial responsibility for approving fees, but judicial remedy exists for breach of fiduciary duty). The report's focus on the conduct of the advisers, rather than on that of the directors, reflects the shift from the reasonable fee standard in earlier bills to an adviser's fiduciary duty standard in the enactment. The change was made at the request of the industry so that the director's conduct would not be put on trial; rather the focus of the litigation would be shifted from the directors of the fund to the adviser. 1969 House Hearings [pt. 1], *supra* note 10, at 187-90 (SEC memorandum); *id.* at 441 (letter from Robert L. Augenblick, President, Inv. Co. Inst. to Rep. Moss); see Gartenberg v. Merrill Lynch Asset Mgm't, Inc., 694 F.2d 923, 928 (2d Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3686 (U.S. Mar. 3, 1983) (No. 82-1483). The SEC's acquiescence to this request demonstrates its belief that it is unfair to put the directors on trial when they are unable to exercise their business judgment freely in the area of advisory fees. See 1967 House Hearings [pt. 1], *supra* note 7, at 46; 1967 Senate Hearings [pt. 1], *supra* note 33, at 96.

The argument might be made that directors were intended to have a role when excessive fees are litigated because if they do not respond properly to a demand prior to a § 36(b) suit, they could be sued under § 36(a). See Note, *Termination of Section 36(b) Actions By Mutual Fund Directors: Are the Watchdogs Still the Shareholders' Best Friends?*, 50 Fordham L. Rev. 720, 737 (1982) (Section 36(a) provides incentives for disinterested directors to make unbiased decision regarding termination of § 36(b) actions.). Section 36(a) allows the SEC to bring an action against directors and others for a breach of fiduciary duty involving personal misconduct and imposes strong sanctions for such a breach. 15 U.S.C. § 80a-35(a) (1976). The Senate Report indicates Congress' intent that rights of action be implied under this section. 1969 Senate Report, *supra* note 2, at 16, *reprinted in* 1970 U.S. Code Cong. & Ad. News at 4911. Given, however, that the standard for § 36(b) actions was changed to avoid subjecting the conduct of directors to trial with respect to advisory fees, it is unlikely this intent can be circumvented by a § 36(a) action against those directors. Actions brought under § 36(a) for reasons other than excessive fees illustrate that courts feel bound by the business judgment rule in § 36(a) actions and therefore defer to director decisions. Tannenbaum v. Zeller, 552 F.2d 402, 427-29 (2d Cir.) (directors' decision not to recapture brokerage commissions proper exercise of business judgment), *cert. denied*, 434 U.S. 934 (1977); Herzog v. Russell, 483 F. Supp. 1346, 1350 (E.D.N.Y. 1979) (same); cf. Cambridge Fund, Inc. v. Abella, 501 F. Supp. 598, 623, 627 (S.D.N.Y. 1980) (director did not breach fiduciary duty on indemnification claim because adviser failed to make full disclosure); *Advisory Fee Suits*, supra note 55, at 621 n.105 (shareholder bringing action under § 36(a) "run[s] squarely into the business judgment rule"). Because a plaintiff is not hampered by the business judgment rule under a § 36(b) action, see *infra* pt. II(A)(1) and accompanying text, the two actions do not compare in enforcement potential. Finally, the existence of an implied right to sue under § 36(a) for breach of duty regarding fees is questionable, because courts differ whether § 36(b) is the exclusive remedy for breaches of fiduciary duty concerning advisory fees. Compare Jerozal v. Cash Reserve Mgm't, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 99,019, at 94,824 (S.D.N.Y. Aug. 10, 1982) (implied cause of action against adviser and administrator of fund under § 15) *with* Halligan
the business judgment rule with respect to judicial scrutiny of director decisions regarding advisory fees.\textsuperscript{143} Second, directors have no right to terminate section 36(b) suits for excessive fees, thus giving the shareholder an unhampered right to sue.\textsuperscript{144}

1. Removal of the Business Judgment Rule

In direct contrast to the limitation on independent judicial discretion imposed by the business judgment rule, courts scrutinizing claims under section 36(b) are instructed to "look at all the facts in connection with the determination and receipt of [advisory fees]."\textsuperscript{145} In considering director approval of fees the court "might wish to evaluate whether the deliberations of the directors were a matter of substance or a mere formality,"\textsuperscript{146} but the scope of permissible judicial inquiry is not confined to this consideration. Thus, section 36(b)(2) reverses the normal rule in determining the propriety of corporate decisions—the court, not the directors, is the ultimate arbiter of the reasonableness of advisory fees.\textsuperscript{147} Director approval of the fees is not accorded the deference usually given under the business judgment rule, and does not control the determination whether the adviser breached its fiduciary duty under section 36(b).\textsuperscript{148}

2. Director Inability to Terminate Suits Under Section 36(b)

Implicit in any decision by mutual fund directors not to pursue a shareholder claim under section 36(b) is their approval of the reason-

\textsuperscript{143} See infra pt. II(A)(1).

\textsuperscript{144} See infra pt. II(A)(2).

\textsuperscript{145} 1969 Senate Report, supra note 2, at 15, reprinted in 1970 U.S. Code Cong. & Ad. News at 4910. The Senate report accompanying the enacted bill is quite specific as to the type of factors the court should consider in determining whether the adviser breached his fiduciary duty. These factors include all services rendered by the adviser to the fund and comparisons to services and fees of other funds. Id.

\textsuperscript{146} Id.


ablness of advisory fees. A consequence of removing the business judgment rule in this context, however, is that no reason exists for allowing directors to terminate a section 36(b) action. The Supreme Court apparently recognized this in *Burks v. Lasker* in which the Court addressed the issue whether disinterested directors of a mutual fund could properly terminate a shareholder derivative suit brought pursuant to the unamended version of section 36. The Court held that director termination of suits under the ICA generally was permissible only to the extent it was allowed both by state law and by the federal policy underlying the appropriate section of the ICA. Central to the *Burks* holding was the distinction between section 36(b) as amended and the section of the ICA under which the *Burks* suit had been brought. As the Court noted, when Congress intended not to allow director termination of shareholder suits "it said so expressly. Section 36(b)[(2)] ... performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees."  

149. 441 U.S. 471 (1979).
150. *Id.* at 473. Violations of other sections of the ICA were also alleged in the complaint. *Id.* & n.1. The plaintiffs' cause of action accrued prior to the effective date of the 1970 amendments. *See id.*
151. *Id.* at 486.

Judge Gibbons found that the holding of *Burks* put the Court's position as to termination of § 36(b) suits in context. Termination of a § 36(b) suit is inconsistent with the policy of that section and therefore is impermissible under the analysis required by the Court in *Burks*. Weiss v. Temporary Inv. Fund, Inc. 692 F.2d 928, 952 (3d Cir. 1982) (Gibbons, J., dissenting), *petition for cert. filed*, 51 U.S.L.W. 3721 (U.S. Mar. 26, 1983) (No. 82-1592).

As one commentator has noted: "[I]t would be anomalous to place [the] ultimate responsibility in the judiciary to determine whether disinterested directors were successful in preventing the adviser from setting an excessive fee while giving the judiciary a passive role once a litigation committee decided to terminate a suit challenging the fee." *Advisory Fee Suits*, supra note 55, at 618 (footnote omitted). To
Because directors are unable to terminate section 36(b) actions, shareholders have "an absolute, indefeasible right to maintain [an] action." Therefore, even if directors take action on a shareholder demand under section 36(b) by instituting suit or negotiating a settlement with the adviser, they are unable to defeat the shareholder's standing to sue.

Director inability to terminate section 36(b) suits removes the principal justification for the demand requirement of Rule 23.1. Meritless suits can be prevented both by other provisions of the Rule and by the limited recovery under section 36(b), which has a chilling effect on the incentive of attorneys to encourage suits for their own pecuniary gain. As Judge Gibbons recognized, any intrusion upon the directors' responsibility to manage the fund as conferred by state law is minimized by the circumscribed nature of the section 36(b) suit.
Moreover, directors have authority to negotiate during litigation, with court approval, a settlement that will resolve the shareholder claims.\textsuperscript{159}

**B. Effects on Shareholders of Requiring Demand**

In section 36(b) suits, whereas the absence of a demand requirement does not detract from the purposes of Rule 23.1, its presence could gravely undermine the purposes of section 36(b). The legislative history of the 1970 amendments reveals that Congress viewed recovery of fees to be an incentive to bring suit and for that reason rejected proposals that would have restricted section 36(b) to a prospective reduction in fees only.\textsuperscript{161} Requiring demand, however, removes the incentive to sue by creating the potential that the recovery period finally employed will be one in which the fees paid were not excessive. Section 36(b)(3) allows the recovery of only those excessive fees paid within one year prior to institution of the suit.\textsuperscript{162} Requiring demand delays the shareholder’s suit, and hence the beginning of the recovery period, while his demand is being considered.\textsuperscript{163} Indeed, while the shareholder waits for board response, sufficient time may elapse that the allegedly excessive fees which prompted the demand will no longer be recoverable.\textsuperscript{164} Thus, the recovery will be subject to the vicissitudes of the financial market and the corporate machinery.\textsuperscript{165} As

\textsuperscript{159} Fed. R. Civ. P. 23.1 (“The action shall not be dismissed or compromised without the approval of the court . . .”).

\textsuperscript{160} Blatt v. Dean Witter Reynolds Intercapital Inc., 528 F. Supp. 1152, 1156 (S.D.N.Y. 1982). A forced out-of-court settlement has been condemned as one of the evils of strike suits. See supra note 133 and accompanying text. The provision of Rule 23.1 requiring judicial approval of such settlements, however, eliminates the risk that a settlement will be unfair. See supra note 134 and accompanying text. Settlement has the advantage of avoiding costly litigation. H. Henn, supra note 14, § 374, at 789. A number of § 36(b) suits have been settled. E.g., Markowitz v. Moneymart Assets Inc., [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,360, at 92,208 (S.D.N.Y. Nov. 20, 1981); Krasner v. Dreyfus Corp., 90 F.R.D. 665, 676 (S.D.N.Y. 1981); Boyko v. Reserve Fund, Inc., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,165, at 92,281 (S.D.N.Y. Sept. 8, 1977). Should the directors decide that the shareholder’s § 36(b) suit has no merit, the directors may litigate on the merits. The one case that has been fully litigated was decided for defendants. See Gartenberg v. Merrill Lynch Asset Mgm’t, Inc., 694 F.2d 923 (2d Cir. 1982), petition for cert. filed, 51 U.S.L.W. 3686 (U.S. Mar. 3, 1983) (No. 82-1483).

\textsuperscript{161} 1969 House Hearings [pt.1], supra note 10, at 203.


\textsuperscript{164} See id. at 261-62.

\textsuperscript{165} See Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928, 951 (3d Cir. 1982) (Gibbons, J., dissenting) (“normal delays incident to corporate decision-making are
a result, the damage award may be smaller than it would have been if the shareholder had been able to sue without making a demand.\footnote{\text{166}}

Several scenarios are possible. As noted by the court in Fox v. Reich \& Tang, Inc.,\footnote{\text{167}} any special one-time payment made outside the one-year period may not be recovered.\footnote{\text{168}} Moreover, Judge Gibbons recognized in Weiss that while considering the demand, the directors could negotiate a prospective reduction in fees, which would yield a recovery smaller than what is due the fund.\footnote{\text{169}} Regardless of any such prospective reduction, if the fund's assets declined,\footnote{\text{170}} even temporar-
ily, while the demand was being reviewed, any subsequent recovery would correspondingly decline because the fee paid is based on a percentage of average net assets. The courts in Weiss and in Grossman v. Johnson countered this concern with the cursory statement that any delay would probably not result in a reduced recovery, apparently a reference to increases in mutual fund assets over past years. In doing so the courts ignored the effect that a temporary drop could have on a section 36(b) recovery and Congress' intention to encourage shareholder suits by enacting that section.

Furthermore, even assuming the assets of mutual funds on an industry-wide basis remain constant or increase, the dynamics of the securities market add another perspective to the matter. Although the industry's assets may have remained constant or increased over a given period of time, a particular fund's assets may have decreased, resulting in a reduced recovery for shareholders of that fund who bring a section 36(b) action.

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171. See supra note 5 and accompanying text.
172. 674 F.2d 115 (1st Cir.), cert. denied, 103 S. Ct. 85 (1982).
173. Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928, 938 (3d Cir. 1982), petition for cert. filed, 51 U.S.L.W. 3721 (U.S. Mar. 26, 1983) (No. 82-1592); Grossman v. Johnson, 674 F.2d 115, 122 (1st Cir.), cert. denied, 103 S. Ct. 85 (1982). The Weiss court seemed to retreat from its statement later in the opinion. 692 F.2d at 943 (application of rule of not allowing demand to be made after suit is filed may seem costly due to one year recovery limitation).
174. See Zuckerman, supra note 165, at 4, col. 5.
175. Because the fee is based on the average net assets, a temporary drop the size of that recently experienced in the money market funds might significantly impair recovery. See supra notes 5, 161 and accompanying text.
176. Zuckerman, supra note 165, at 4, col. 5.
177. As interest rates decline, investors are prone to withdraw their money from money market funds, see G. Christie & J. Clendenin, Introduction to Investments 582 (8th ed. 1982), and transfer it to other types of funds. Similar shifts may occur as the stock market rises and falls. See Scholl, Mutual Funds' Success: A Remembrance of Things Past, Barron's, Feb. 21, 1983, at 37. This phenomenon has been cited as one of the reasons for the recent decline in money market fund assets. Bennett, The Money Funds' Decline, N.Y. Times, Feb. 17, 1983, at D1, col. 3. In fact, money market funds were an outgrowth of the decline of the stock market in the early 1970's. D. Bellemore, H. Phillips, & J. Ritchie, Investment Analysis and Portfolio Selection: An Integrated Approach 605-06 (1979). Because most funds today are "no-load" funds that do not make a sales charge when selling shares, investors are not faced with the disincentives to redeeming shares and purchasing new ones that existed in the past. See Advance Notice and Request for Comment on Whether the Commission Should Propose Rules or Recommend Legislation to Enable All or Certain Types of Open-End Investment Companies to Be Organized and Operated Without Shareholder Voting, or Without Either Shareholder Voting or Boards of Directors, Investment Company Act Release No. 12,888, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,303, at 85,620-22 (Dec. 10, 1982).
Assuming that fees have been excessive from the initial accrual of a cause of action, the fund is foreclosed from recovering fees paid more than one year prior to the suit. Not requiring demand, however, may result in an earlier suit and recovery of those fees,¹⁷⁸ as well as in a prospective reduction in fees to avoid future suits. Given Congress' belief that directors are ill-equipped to negotiate reasonable fees,¹⁸⁰


¹⁸⁰. See supra notes 33-41, 67-68 and accompanying text. There are some indications that directors face the same problems they experienced prior to the 1970 amendments. The court in Gartenberg v. Merrill Lynch Asset Mgm't, Inc., 694 F.2d 923 (2d Cir. 1982), petition for cert. filed, 51 U.S.L.W. 3686 (U.S. Mar. 3, 1983) (No. 82-1483), found that while money market funds may have competed with each other for shareholder business, such competition did not lead to competition between advisers for fund business because the advisory fee is a relatively insignificant cost to each individual investor. Id. at 928-29.


Two noted commentators differ on the effectiveness of the disinterested director concept. Compare Brudney, The Independent Director—Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597, 617-20 & n.59 (1982) (mutual fund disinterested director has played an "essentially passive role") with Phillips, Deregulation Under the Investment Company Act—A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors, 37 Bus. Law. 903, 910-11 (1982) (disinterested directors have become increasingly sophisticated and serve as a check on advisers). Other commentators have discussed the social forces which prevent an independent director in any corporation from being truly independent. E.g., Elfin, An Evaluation of a New Trend in Corporate Law: Dismissal of Derivative Suits By Minority Board Committees, 20 Am. Bus. L.J. 179, 197 (1982) (entire board of any corporation bound by various relationships so that special litigation committee is not independent); Hamilton, Commentary, 60 Wash. U.L.Q. 345, 348 (1982) (corporate independent directors are "too old, too trusting, too cautious, not very intelligent, or so eager to stay on the board that they will accept management's explanation for practically anything").
and the constraints Congress put on the directors' ability to respond to section 36(b) suits, it is unlikely that Congress thought directors would overcome their handicaps to take such action as negotiating a settlement upon receipt of demand. Equally unlikely is that Congress intended the incentive of recovery to be subject to the uncertainties precipitated by a demand requirement.

CONCLUSION

Rule 23.1 is applicable to shareholder actions under section 36(b) of the ICA only if the right of action may also be exercised by the mutual fund itself. Section 36(b) gives no express right of action to the fund, nor can one be implied under the implication doctrine of recent Supreme Court cases.

Even if a right of action could be implied for the fund so as to make section 36(b) actions subject to Rule 23.1, enforcement of its demand requirement would be contrary to congressional intent. Shareholder suits under section 36(b) were authorized because of Congress' belief that fund directors are ineffective protectors against excessive advisory fees. To increase shareholder effectiveness in section 36(b) suits, available director responses to a shareholder demand were limited severely. Congress could not have intended to free shareholder suits under section 36(b) from the pitfalls normally associated with share-
holder suits, only to have full recovery under the section jeopardized while demand was being considered.

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bills, was seen as having the potential drawback of reducing recovery. _1969 Senate Hearings_, _supra_ note 33, at 163 (statement of Ernest Folk, III, Professor of Law University of Virginia).