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INVESTMENT COMPANY ACT OF 1940—STOCKHOLDER DERIVATIVE ACTIONS—*Daily Income Fund, Inc. v. Fox* — In *Daily Income Fund, Inc. v. Fox*,[1] the Supreme Court held that the demand requirement of Federal Rule of Civil Procedure 23.1,[2] governing derivative actions,[3] does not apply to an action brought by an investment company shareholder under section 36(b) of the Investment Company Act of 1940 ("ICA").[4]

[1] 464 U.S. 523 (1984).

[2] Rule 23.1 provides:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. 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. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

FED. R. CIV. P. 23.1.

[3] A derivative action is a suit by a shareholder of a corporation "founded on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff." Hawes v. City of Oakland, 104 U.S. 450, 460 (1882).

[4] Section 36(b) of the Investment Company Act of 1940 states:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. *An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company*, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such reg-

This decision has resolved a conflict among courts of appeals.

The Court of Appeals for the Second Circuit, in *Fox v. Reich & Tang, Inc.*,[5] the instant case below, had held that the demand requirement of rule 23.1 does not apply to actions brought under section 36(b) because rule 23.1 applies only to derivative actions,[6] and an action brought pursuant to section 36(b) is not derivative.[7] Furthermore, the circuit court believed that the nature of section 36(b) actions renders the demand requirement futile.[8] Adopting the opposite position, the Court of Appeals for the First Circuit, in *Grossman v. Johnson*,[9] and the Court of Appeals for the Third Circuit, in *Weiss v. Temporary Investment Fund, Inc.*,[10] had found that the demand requirement was

> istered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:
>
> (1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.
>
> (2) In any such action, approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.
>
> (3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payment received from such investment company, or the security holders thereof, by such recipient.

15 U.S.C. § 80a-35(bl) to (b3) (1982) (emphasis added).

[5] 692 F.2d 250 (2d Cir. 1982), *rev'd sub nom.* Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984).

[6] *Id.* at 253.

[7] *Id.* at 255. The court noted that the suit was not derivative because it did not involve the assertion by a shareholder of a right properly asserted by the corporation. The court instead found that the suit resulted from a statutory provision allowing individual security holders tn assist in enforcing the fiduciary duty imposed on investment advisors. *Id.*

[8] *Id.* at 262. The demand requirement implies a reasonable amount of time for directors to consider the merits of the stockholder's demand, while § 36(b) imposes a one-year limit on the period for which recovery will be allowed. Thus, imposing the demand requirement in § 36(b) actions could have "the untoward result of precluding full recovery of excessive fees." *Id.*

[9] 674 F.2d 115 (1st Cir.), *cert. denied,* 459 U.S. 838 (1982). For a discussion of *Grossman*, see *infra* notes 53-58 and accompanying text.

[10] 692 F.2d 928 (3d Cir. 1982), *vacated and remanded,* 465 U.S. 1001 (1984). On

applicable to section 36(b) actions.

In *Daily Income Fund, Inc. v. Fox,* the Supreme Court affirmed the judgment of the Second Circuit, holding that a plaintiff in a shareholder action brought under section 36(b) of the ICA is not required to first make a demand on the investment company's board of directors.[11] The Court's decision has important ramifications for shareholders of both investment companies and other publicly owned companies. Had the Court found the demand requirement of rule 23.1 applicable, investment company shareholders would constantly face the prospect of having their actions delayed by the process of making a demand on the board of directors.[12] Because section 36(b) limits recovery to actual damages incurred within a period of one year prior to suit,[13] this delay would result in a less effective law.[14] Since the Supreme Court has expressly limited its ruling to actions brought under section 36(b), however, there is a strong likelihood that future decisions will continue to uphold the demand requirement of rule 23.1 in other types of shareholder actions.[15]

The demand requirement is of common law origin. Prior to 1882, federal courts exercised their equity powers to allow suits by minority stockholders seeking to enforce corporate rights when the corporation had failed to do so on its own behalf.[16] In *Hawes v. Oakland,*[17] the Supreme Court emphasized the importance of such suits, but noted the

remand, the court of appeals found that "[i]n view of the Supreme Court's ruling [in *Daily Income Fund, Inc.*], the judgment of the district court must be reversed and the case remanded for further proceedings consistent with the Supreme Court's opinion." Weiss v. Temporary Inv. Fund, Inc., 730 F.2d 939, 940 (3d Cir. 1984).

[11] 464 U.S. at 542.

[12] *Id.* at 546 (Stevens, J., concurring).

[13] 15 U.S.C. § 80a-35(b)(3) (1982). For the text of the statute, see *supra* note 4.

[14] *See* 464 U.S. at 546 (Stevens, J., concurring) (the longer the delay, the more excessive the fees paid to the advisors, a result "squarely at odds with the purposes of the Act and hence congressional intent").

[15] *See, e.g.,* Allison on Behalf of General Motors Corp. v. General Motors Corp., 604 F. Supp. 1106 (D. Del. 1985) (stockholder's derivative action dismissed because complaint was deemed premature when filed two-and-a-half months after demand was made upon board of directors); Kaufman v. Safeguard Scientifics, Inc., 587 F. Supp. 486 (E.D. Pa. 1984) (stockholder's derivative action dismissed for failure to comply with rule 23.1 and failure to demonstrate that making the required demand upon corporate directors would be futile).

[16] *See, e.g.,* Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855) (a court of equity will give relief when there has been a breach of trust, but not when the directors' action results from error or negligence); Peabody v. Flint, 88 Mass. (6 Allen) 52 (1863) (stockholders of a corporation may sue the directors on behalf of the corporation where the directors are guilty of fraud); March v. Eastern R.R., 40 N.H. 548 (1860) (stockholders have a remedy in chancery against directors and the corporation to prevent misuse of assets that might reduce dividends).

[17] 104 U.S. 450 (1882).

risk of abuse inherent in this "equitable device." One such possible abuse was the undermining of the basic principle that the decisions of a corporation should be made by the directors or a majority of stockholders.[18] To avoid this problem, the *Hawes* Court established the requirement that a stockholder make a demand for action upon the corporation itself before bringing a derivative suit. The Court ruled that such stockholder "must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court."[19] This requirement was designed to limit the use of stockholder derivative actions to situations in which the corporation failed to act on its own behalf.[20] The demand requirement set forth in *Hawes*, albeit with some changes, has been incorporated into rule 23.1,[21] which requires the

[18] *Compare id.* at 458 (quoting *Dodge*, 58 U.S. at 343) ("in a corporation, when acting within the scope of . . . its constitution, the will of the majority, clearly expressed, must govern") *with* Burks v. Lasker, 441 U.S. 471, 484 (1974). In *Burks*, the Supreme Court indicated, in dicta, that Congress intended that § 36(b) shareholder suits could not be terminated by the independent directors of investment companies under the "business judgment" rule. *See id.*; *see also infra* note 111. The "business judgment" rule provides that

> [i]f in the course of management, directors arrive at a decision, within the corporation's powers (*intra vires*) and their authority, for which there is a reasonable basis, and they act in good faith, as the result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be the best interests of the corporation, a court will not interfere with internal management and substitute its judgment for that of the directors to enjoin or set aside the transaction or to surcharge the directors for any resulting loss.

H. Henn & J. Alexander, Laws of Corporations and Other Business Enterprises § 242, at 661 (3d ed. 1983) (footnotes omitted).

Director termination refers to the action of a court dismissing a derivative suit if, when acting upon a shareholder's demand, the board of directors of a corporation exercises its good-faith business judgment and refuses to sue or actively opposes the suit. *See* Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982), *cert. denied sub nom.* Citytrust v. Joy, 460 U.S. 1051 (1983). In such a situation, the shareholder has the burden of proving that the directors' decision was not made in good faith, in order for the action to proceed. *Id.* at 892.

The Court's dicta in *Burks* has been accepted by the lower courts. *See, e.g.*, Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928, 939 (3d Cir. 1982), *vacated and remanded*, 465 U.S. 1001 (1984); Grossman v. Johnson, 674 F.2d 115, 121 (1st Cir.), *cert. denied*, 459 U.S. 838 (1982).

[19] 104 U.S. at 461.

[20] *See id.* at 460-61 ("[B]eforè the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should [have] . . . exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances . . . .").

[21] The demand requirement was originally enacted into § b of rule 23. Under the 1966 revision of rule 23 the provisions of § b were carried forward without substantive change into rule 23.1. 3B J. Moore, W. Taggart & J. Wicker, Moore's Federal Prac-

complaint to "allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . . and the reasons for his failure to obtain the action or for not making the effort."[22] Courts have usually interpreted this to mean that a demand must be made.[23]

The purpose of the demand requirement is to give effect to the principle that corporations, through their boards of directors, have the right to control their own affairs: a right that includes the decision whether or not to engage in litigation.[24] Courts are usually reluctant to interfere with the directors' business judgment.[25] Thus, a decision not to litigate, or to terminate a stockholder derivative action,[26] is often

TICE ¶¶ 23.1.15-23.1.23 (2d ed. 1976).

[22] FED. R. CIV. P. 23.1. For the text of rule 23.1, see *supra* note 2.

[23] Rule 23.1, read plainly, seems to say that if the shareholder does not demand action by the directors or try in some other way to get the directors to act, he must explain his failure to do so. The rule does not expressly state that if a demand is not made the action will be barred. *See Daily Income Fund, Inc.*, 464 U.S. at 543 (Stevens, J., concurring). For the text of rule 23.1, see *supra* note 2. Despite the absence of any mention of the demand requirement in the committee hearings, courts have traditionally interpreted the rule to require a demand. *See, e.g.*, Shlensky v. Dorsey, 574 F.2d 131, 141 (3d Cir. 1978) (plaintiff must specifically demand that directors bring suit against a known or specified defendant); Brody v. Chemical Bank, 517 F.2d 932, 934 (2d Cir. 1975) (finding of insufficiency grounded in failure of plaintiff to actually present demands to current directors); Halprin v. Babbitt, 303 F.2d 138, 141 (1st Cir. 1963) (plaintiff must make a specific demand on the directors, and such demand will not be excused unless it would be futile).

Courts have often ruled on the sufficiency of such demand. The standards employed in determining the sufficiency of a demand are unclear and vary among the circuits. In *Hawes v. City of Oakland*, the Court stated that "[t]he efforts to induce such action as complainant desires on the part of the directors . . . and the cause of failure in these efforts should be stated with particularity . . . ." 104 U.S. at 461. This standard has been followed with varying degrees of stringency. *See, e.g.*, Long v. Stites, 88 F.2d 554 (6th Cir.), *cert. denied*, 301 U.S. 706 (1937). Although the complaint described the plaintiff's efforts to demand action by the corporation's president and directors, it was dismissed for failure to show that demand was also made to the stockholders. *Id.* at 557. In Fleishhacker v. Blum, 109 F.2d 543 (9th Cir.), *cert. denied*, 311 U.S. 665 (1940), the complaint was upheld even though it merely alleged that the plaintiff had demanded action only from the directors. *Id.* at 547.

[24] *See, e.g.*, Delaware & Hudson Co. v. Albany & Susquehanna R.R., 213 U.S. 435 (1909). The Court found that the rule was intended to recognize the right of the corporate directorate to control the corporation, including the decision to assert or protect its rights through litigation. *Id.* at 446; *see also Hawes*, 104 U.S. 450 (1882). This requirement is a recognition of the numerous concerns that a corporation must address when deciding whether or not to initiate litigation. *Id.* at 457.

[25] *See supra* note 18.

[26] Disinterested directors may terminate an action alleging violations of the ICA when state law permits, so long as the state rule is consistent with the federal policy behind ICA. Burks v. Lasker, 441 U.S. 471, 486 (1979). In dicta, however, the Court noted that § 36(b) was designed by Congress to stiffen the requirement that the directors act independently. *Id.* at 484; *see also supra* note 18.

upheld in the absence of "gross abuse of trust."[27]

Investment companies are regulated by the Investment Company Act of 1940.[28] A major purpose of the ICA is to protect investment company shareholders from possible abuse by the company's directors and investment advisors.[29] The ICA was intended to eliminate, as far as possible, those conditions that "adversely affect the national public interest and the interest of investors."[30] One common abuse is the payment of inflated fees to the company's investment advisor.[31] In an effort to combat this abuse, the ICA originally provided that at least forty percent of the directors of an investment company must be persons other than officers or employees of such company, or persons affiliated[32] with the company's advisor,[33] in order to "furnish an indepen-

[27] *See, e.g.*, Acampora v. Birkland, 220 F. Supp. 527, 550 (D. Colo. 1963) (liability of directors rests on standard of "gross negligence" or at least "bad faith"); Saxe v. Brady, 40 Del. Ch. 474, 487, 184 A.2d 602, 610 (Del. Ch. 1962) (courts often defer to decisions of directors or stockholders unless it is clear both in law and fact that the actions can be construed as "unconscionable"); Meiselman v. Eberstadt, 39 Del. Ch. 563, 568, 170 A.2d 720, 723 (Del. Ch. 1961) (for plaintiff to prevail, he must show that the compensation paid by the fund was "excessive"); Brown v. Bullock, 194 F. Supp. 207, 237 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961) (a cause of action can be maintained against a defendant management company when the totality of its acts constitute "gross misconduct and gross abuse of trust").

[28] 15 U.S.C. §§ 80a-1 to 80a-64 (1982).

[29] *See* Burks v. Lasker, 441 U.S. 471, 482 (1979) (noting that the purpose of the ICA was to control conflicts of interest within mutual funds). For the definition of investment advisor, see *infra* note 46 and accompanying text. *See also Hearings on S.1659 before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 130 (1967) (statement of SEC Chairman M. Cohen):

> It is important to remember, however, that with respect to the fixing of investment advisory or management fees and, in many cases, the charges for sales of fund shares to the public, an obvious conflict of interest exists between fund managers who staff and control the fund and whose representatives sit on the board of the fund, on the one hand, and the shareholders of the investment company, on the other.

Id.

[30] 15 U.S.C. § 80a-1(b) (1982). The statute addresses situations in which an investment company: (1) discloses inadequate information concerning securities it issues; (2) is organized and managed for the advantage of a select group; (3) issues securities containing inequitable and discriminatory provisions; (4) unduly concentrates control of the organization; (5) uses misleading accounting methods; (6) changes the internal structure of the company without shareholder approval; (7) incurs excessive debt through the use of senior debt instruments to the detriment of junior securities; or (8) operates without adequate capital reserves. *Id.*

[31] For an explanation of why inflated fees become an issue, see *infra* notes 36-46 and accompanying text.

[32] "Affiliated person" under the ICA is defined as:

> (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by

[33] Footnote 33 appears on page 173.

dent check upon the management" of investment companies.[34] In addition, a majority of either the unaffiliated directors or the holders of the outstanding shares were required to approve an advisory fee contract.[35]

Concern over the dramatic growth of mutual funds in the 1950's and 1960's[36] prompted the Securities and Exchange Commission to authorize two studies on the investment company industry.[37] The first study resulted in the Wharton Report,[38] presented before Congress in 1962, which found that advisory fees were usually based on a percentage of the assets managed, rather than on services rendered or actual expenses incurred.[39] The report also noted that investment companies, due to their dependence on the very advisors controlling them, had almost no bargaining power in the determination of advisory fees.[40] The SEC's own report,[41] issued in 1966, found that shareholder suits

> such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, an investment advisor thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

15 U.S.C. § 80a-2(a)(3) (1982).

[33] Section 10(a) provides: "No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company." 15 U.S.C. § 80a-10(a) (1982). "Interested person" is defined at 15 U.S.C. § 80a-2(19) (1982).

[34] *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce,* 76th Cong., 3d Sess. 109 (1940).

[35] 15 U.S.C. § 80a-15(a) (1982).

[36] The net asset value of mutual funds was less than $500 million in 1940 when ICA was enacted. By 1961 that amount had risen to over $17 billion. *See* Eisenberg & Phillips, *Mutual Fund Litigation—New Frontiers For The Investment Company Act,* 62 COLUM. L. REV. 73, 74 (1962).

[37] In the original Act, Congress had authorized the Securities and Exchange Commission to conduct studies if it found that further growth of investment companies should "create any problem involving the protection of investors or the public interest." 15 U.S.C. § 80a-14(b) (1982).

[38] WHARTON SCHOOL STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2774, 87th Cong., 2d Sess. (1962) [hereinafter cited as WHARTON STUDY].

[39] As found by the WHARTON STUDY, *supra* note 38, three of five investment advisors supervising $600 million or more of mutual fund assets and 22 of 40 advisors managing assets of $50 million or more "charged an effective fee rate of approximately one-half of one percent." *Id.* at 29.

[40] "[T]he special structural characteristics of this industry, with an external advisor closely affiliated with the management of the mutual fund, tend to weaken the bargaining position of the fund in the establishment of advisory fee rates." *Id.* at 30.

[41] SECURITIES AND EXCHANGE COMMISSION REPORT ON PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as 1966 SEC REPORT].

challenging these fees were largely unsuccessful due to the court-imposed requirement that litigants prove a waste of corporate assets in situations where the contracts had been approved by shareholders or unaffiliated directors.[42]

In an effort to curb these abuses, the SEC submitted a number of proposals to Congress that led to the 1970 amendments to the ICA. One of these amendments[43] was section 36(b), which imposes a fiduciary duty on the investment advisor with respect to compensation from the investment company. Accordingly, section 36(b) grants shareholders of an investment company, as well as the Securities and Exchange Commission,[44] the right to sue investment advisors in order to recover excessive fees.[45]

Section 36(b) was enacted by Congress because of the realization that investment companies are by nature particularly vulnerable to

[42] *Id.* at 128. *See, e.g.,* Acampora v. Birkland, 220 F. Supp. 527, 548 (D. Colo. 1963) (in determining the value of a service, the court will defer to the judgment of directors or stockholders, unless the payments are "shocking" or "unconscionable"); Saxe v. Brady, 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (Del. Ch. 1962) (to prove corporate waste a plaintiff must show that no reasonable business person would judge the value of the services received to be worth what the corporation has paid); Meiselman v. Eberstadt, 39 Del. Ch. 563, 568, 170 A.2d 720, 723 (Del. Ch. 1961) (although the fiduciaries paid themselves more than the average pay in the industry, this cannot be considered excessive where non-affiliated directors approved the compensation contract).

[43] Other amendments included the adoption of § 10(a) and § 15(c). Section 10(a) prohibited any registered investment company from having a board of directors more than 60% of which were "interested persons" as defined in § 80a-2(a)(19). 15 U.S.C. § 80a-10(a) (1982). Section 15(c) requires that a majority of independent directors approve advisory contracts. 15 U.S.C. § 80a-15(c) (1982).

[44] Congress has given the Securities and Exchange Commission authority to enforce the federal securities laws. The statute states, in pertinent part:

> The Commission is authorized in its discretion, to publish information concerning any such violations [i.e., violations of federal securities laws, rules of national securities exchanges or of a registered securities association, rules of a registered clearing agency, or the rules of the Municipal Securities Rulemaking Board], and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of such provisions, in the prescribing of rules and regulations under this chapter, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this chapter relates.

15 U.S.C. § 78(u) (1982).

[45] *Id.* § 80a-35(b). The statute, however, limits the amount of damages that can be awarded:

> No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient [of compensation for services as an investment advisor] shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

Id. § 80a-35(b)(3).

abuses by their investment advisors.[46] An investment company, unlike most corporations, is created and managed by its investment advisor: an external organization that often selects affiliated persons to serve on the company's board of directors.[47] Because an investment company is organized and managed by its investment advisor, "a mutual fund cannot, as a practical matter, sever its relationship with the advisor."[48] Section 36(b) provides for an action to be brought against an investment advisor or its affiliates[49] "by the Commission or by a security holder of such registered investment company on behalf of such company"[50] for breach of fiduciary duty. In contrast to cases decided before 1970,[51] the statute provides that approval of the advisory fee contract by the directors or shareholders shall only "be given such consideration by the court as is deemed appropriate under all the circumstances,"[52] in effect eliminating the requirement that plaintiffs prove corporate waste.

Daily Income Fund resolved a conflict between the Second Circuit and the First and Third Circuits. In *Grossman v. Johnson*,[53] a share-

[46] *See* 464 U.S. at 536. In its REPORT ON THE STUDY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 279, pt. 3, 76th Cong., 1st Sess. (1939), the Securities and Exchange Commission identified these abuses as including self-dealing, larceny, and embezzlement by investment company management. *Id.* at 39-49.

[47] *See* 464 U.S. at 536; WHARTON STUDY, *supra* note 38. This structure makes the fund's directors especially prone to a conflict of interest in negotiating the fee of the investment advisor. The advisor, who appointed the directors, wants a large fee, while the shareholders want him to have a small fee. *But see* Burks v. Lasker, 441 U.S. 471, 481-82 (1979) (noting that "while these potential conflicts may justify some restraints upon . . . mutual fund directors," Congress, in enacting § 36(b), did not intend to create a rule that directors may never terminate non-frivolous derivative actions involving codirectors).

[48] S. REP. No. 184, 91st Cong., 2d Sess. 3, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4901.

[49] A fiduciary duty is also imposed on any officer, director, advisory board member, depositor, or principal underwriter of the investment company. 15 U.S.C. § 80a-35(a)-(c) (1982).

[50] *Id.* Representatives of the investment company industry proposed an alternative amendment under which only the company itself or "a security holder on its behalf" could bring such an action. 464 U.S. at 539. *Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., pt. 1, at 101 (1967) [hereinafter cited as *Mutual Fund Legislation of 1967*]. The Senate version of the bill rejected this proposal in favor of requiring that a shareholder make a demand on the Securities and Exchange Commission before bringing suit. S. 3724, 90th Cong., 2d Sess. § 8(d)(6) (1968). "After further consideration this requirement was deleted. Thus, it cannot be said that Congress was unaware of the demand concept, yet it decided not to impose it even with respect to the SEC." 464 U.S. at 546 (Stevens, J., concurring).

[51] For a discussion of cases decided before 1970, see *supra* note 42 and accompanying text.

[52] 15 U.S.C. § 80a-35(b)(2) (1982).

[53] 674 F.2d 115 (1st Cir.), *cert. denied*, 459 U.S. 838 (1982).

holder of an investment fund brought a derivative action[54] without making a prior demand on the board. The plaintiff charged that the directors had breached their fiduciary duty to the fund "with respect to the allegedly excessive amount of advisory fees" and "by failing to recapture . . . excessive underwriting commissions."[55] The First Circuit held that Congress, in adding the 1970 amendments to the ICA, neither repealed nor limited the demand provision of rule 23.1.[56] The court also stated that Congress intended for investment companies to be able to bring an action under section 36(b),[57] and that a suit "on behalf of such company" is a derivative action that the company itself could bring.[58]

Weiss v. Temporary Investment Fund, Inc.[59] was a Third Circuit case in which a shareholder brought suit under section 36(b) of the ICA without making a prior demand on the board. The court disagreed with the plaintiff's contention that the ICA's legislative history was inconsistent with the purposes of the demand requirement.[60] The court held that the demand requirement contributed significantly to efficient corporate governance,[61] and, therefore, application of rule 23.1 to section 36(b) actions was mandated.[62]

These two decisions conflicted with the Second Circuit's decision in *Fox v. Reich & Tang, Inc.*[63] Martin Fox was a minority shareholder of Daily Income Fund, Inc. ("Fund"), an open end investment com-

[54] The defendants in the action were the fund's investment advisor, the fund's affiliated directors and most of its unaffiliated directors. *Id.* at 117.

[55] *Id.* at 118.

[56] *Id.* at 122.

[57] *Id.* at 120.

[58] The court rejected appellant's claim that § 36(b) does not permit an action by the investment company itself, stating:

> We cannot believe, however, that, for example, a new and independent board of directors, intent on recovering excessive fees from the investment adviser, would be precluded from suing under section 36(b). That section is explicit that recovery by a shareholder is to be on behalf of the investment company and that his suit must be brought on the same behalf. With those clear requirements, Congress could well have believed that . . . it was unnecessary to say with particularity that the company also [had a statutory cause of action under § 36(b)].

Id. at 120 (footnote and citation omitted).

[59] 692 F.2d 928 (3d Cir. 1982), *vacated and remanded,* 465 U.S. 1001 (1984).

[60] *Id.* at 936-38.

[61] The term "corporate governance" is a generic phrase referring to certain propositions that are widely accepted as the basis for a system of rules regarding the governance of publicly held corporations. One of these propositions is that independent directors have the ability and potential to monitor the actions of management more efficiently than shareholders. *See* Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project,* 70 CORNELL L. REV. 1, 5 (1984).

[62] 692 F.2d at 942.

[63] 692 F.2d 250 (2d Cir. 1982), *rev'd sub nom.* Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984).

pany.[64] Reich & Tang, Inc. ("R&T"), were investment advisors who provided the Fund with investment advice and management services for the standard fee[65] of one-half of one percent of the Fund's net assets.[66] Between 1978 and 1981 the Fund's assets increased dramatically, thereby increasing R&T's annual fee from $375,000 to $3,875,000.[67] Fox brought suit in federal district court against the Fund[68] and R&T to recover the allegedly excessive fees paid to R&T,[69] charging that R&T had received this substantial increase in payment for an amount of work that was basically unchanged.[70] This, Fox charged, violated the fiduciary obligation that advisors owe their investment companies under section 36(b) of the ICA.[71] The Fund moved to dismiss for Fox's failure to plead that a demand had been made on the Fund's board of directors prior to the suit,[72] as required by rule 23.1. Fox contended that actions brought under section 36(b) of the ICA do not require such a demand,[73] and that even if the demand requirement of rule 23.1 did apply, a demand was excused because the Fund's directors would be hostile to the suit.[74]

The trial judge granted defendant's motion to dismiss[75] and denied Fox leave to file an amended complaint.[76] On appeal, the Second

[64] *Id.* at 252. An "open end" investment company is a mutual fund in which persons may purchase shares representing pro rata portions of the fund's average net assets. The fund engages in a continuous offering of its shares, and shareholders have the right to redeem their shares at their current average net asset value. *See* 15 U.S.C. § 80a-5 (1982); 12 C.F.R. § 222.125(c) (1985).

[65] *See* 1966 SEC REPORT, *supra* note 41, at 131. The Commission found that advisors' fee rates were generally uniform throughout the industry, *id.* at 89, 131, and that directors had little chance to secure a different rate. *Id.* at 131.

[66] 692 F.2d at 253.

[67] *Id.*

[68] In a derivative action, the corporation itself (in this case the Fund) is usually named as a nominal defendant. The shareholder is seeking the enforcement of an obligation owed the shareholders by the corporation by asserting legal rights against directors, management, other shareholders or third persons who have caused damage to the corporate entity. The derivative action is really two battles, one between the shareholder and management, the second between the corporation and the offending third party. *See* R.J. MAGNUSON, SHAREHOLDER LITIGATION § 8.01 (1984).

[69] 94 F.R.D. 94, 95 (S.D.N.Y.), *rev'd,* 692 F.2d 250 (2d Cir. 1982), *aff'd,* 464 U.S. 523 (1984).

[70] 692 F.2d at 253.

[71] 94 F.R.D. at 95.

[72] *Id.*

[73] Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 526-27 (1984).

[74] *Id.*

[75] 94 F.R.D. at 99.

[76] *Id.* The plaintiff had requested leave to amend his complaint in the event that the court ruled unfavorably on the 36(b) issue. *Id.* at 98. The trial judge reasoned that the plaintiff should not be allowed to file an amended complaint because granting such leave would be prejudicial to the directors of the defendant corporation. *Id.* at 98-99.

Circuit reversed the trial court's decision.[77] The Supreme Court affirmed the decision of the Court of Appeals.[78]

The Supreme Court held that rule 23.1 does not govern actions brought under section 36(b) of the ICA because rule 23.1 applies only to those situations in which a corporation would have the right to bring the action itself.[79] The Court found that investment companies have no right, express or implied, to bring an action under section 36(b) of the ICA.[80] Since there was no direct precedent guiding these propositions, Justice Brennan, writing for the Court, based his decision on the language and legislative histories of rule 23.1 and the ICA.

Justice Brennan stated that rule 23.1 "applies in terms only to a 'derivative action brought by one or more shareholders or members to enforce a right of a corporation [when] the corporation [has] *failed to enforce a right which may properly be asserted by it.*' "[81] This means that an action is derivative when the right asserted by the plaintiff

The court observed that "one of the purposes of Rule 23.1 is to allow the directors to respond to plaintiff's claim prior to the initiation of a lawsuit. Allowing plaintiff to now file an amended complaint would make a mockery of the demand requirement." *Id.* at 99. The potential for prejudice flows from the underlying purpose of the demand requirement. The requirement is meant to afford directors the opportunity to decide what action should be taken prior to the initiation of a suit; once a suit has been filed, directors are deprived of that opportunity. *See* Weiss v. Temporary Inv. Fund, Inc., 692 F.2d at 943 ("[a] demand after suit is filed would usurp [the directors'] prerogative" to determine what action, if any, should be taken). Justice Stevens rebuts this argument in his concurrence in *Daily Income Fund.* 464 U.S. at 542. The Justice observed that since directors have no power to terminate a § 36(b) action, "the only effect of a demand requirement would be to delay commencement of the suit." *Id.; accord* Burks v. Lasker, 441 U.S. at 484. For a discussion of the *Burks* decision, see *supra* note 18. *See also* Grossman v. Johnson, 674 F.2d 115 (1st Cir.), *cert. denied,* 459 U.S. 838 (1982), in which plaintiff's action in sending a demand letter to the directors after the suit had commenced was held not sufficient to satisfy rule 23.1 because the directors were not afforded "the opportunity to occupy their normal status." *Id.* at 125 (quoting *In re* Kauffman Mutual Fund Actions, 479 F.2d 257, 263 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973)). For a discussion of *Grossman,* see *supra* notes 53-58 and accompanying text.

[77] 692 F.2d at 253. Writing for a unanimous court, Judge Kaufman held that Congress did not intend to provide investment companies with a right of action under the ICA, and therefore shareholders' suits brought pursuant to § 36(b) were not derivative in nature. *Id.* at 260-61. Thus, a shareholder of an investment company did not need to comply with the demand requirement of rule 23.1 prior to filing suit to challenge the company's advisory contract. *Id.* at 262.

[78] 464 U.S. at 525.

[79] *Id.* at 533-34.

[80] *Id.* at 534-41. Section 36(b) of the ICA imposes a fiduciary duty on investment company advisors with respect to fees paid by the company, and provides that "[a]n action may be brought under this subsection by the [Securities and Exchange] Commission, or by a security holder of such registered investment company on behalf of such company." 15 U.S.C. § 80a-35(b) (1982). For the full text of the statute, see *supra* note 4.

[81] 464 U.S. at 528 (quoting FED. R. CIV. P. 23.1).

shareholder is a right that the corporation could have asserted itself.[82] Justice Brennan supported this interpretation with definitions of the term "derivative action," culled from a number of prior Supreme Court decisions.[83]

The demand requirement serves the function of giving "the directors an opportunity to exercise their reasonable business judgment."[84] In this way, the directors have the option of either waiving "a legal right vested in the corporation in the belief that its best interest will be promoted by not insisting on such right,"[85] or putting "the resources of the corporation, including its information, personnel, funds, and counsel, behind the suit."[86] Since these options assume that a board of directors has control over the suit, Justice Brennan surmised that the language of the rule means that such a rule "only governs [a] suit 'to enforce a right of a corporation' when the corporation itself has 'failed to enforce a right which may be properly asserted by it.' "[87]

Justice Brennan also discussed the origin and purposes of rule 23.1 to support his interpretation.[88] The Court, in *Hawes v. City of Oak-*

[82] 464 U.S. at 528-29. Justice Brennan explained the application of rule 23.1:

> This qualifying language suggests that the type of derivative action governed by the Rule is one in which a shareholder claims a right that could have been, but was not, "asserted" by the corporation in court. The "right" [referred to in the Rule], which cannot sensibly mean any right without limitation, is most naturally understood as referring to the same right, or at least its substantial equivalent, as the one asserted by the plaintiff shareholder. And, in the context of a rule of judicial procedure, the reference to the corporation's "failure to enforce a right which may properly be asserted by it" obviously presupposes that the right in question could be enforced by the corporation in court.

Id. at 528. This meaning, of course, reflects the very logic behind a demand: The shareholder is demanding that the corporation take an action against an alleged wrongdoer to the corporation. It would be pointless to require a stockholder to demand that a corporation take an action that it is not legally able to take.

[83] *Id.* at 528-29; *see, e.g.*, Ross v. Bernhard, 396 U.S. 531, 534 (1970) (describing a derivative action as "a suit to enforce a *corporate* cause of action"); Cohen v. Beneficial Loan Corp., 337 U.S. 541, 548-49 (1949) (stating that a derivative action allows a stockholder "to step into the corporation's shoes" and bring "suit on a cause of action derived from the corporation"); *Hawes*, 104 U.S. at 460 (describing a derivative action as "founded on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff"). For further discussions of *Hawes*, see *supra* notes 17-21 and *infra* notes 89-92, and accompanying text.

[84] 464 U.S. at 532-33.

[85] *Id.* (quoting Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903)).

[86] 464 U.S. at 533 (quoting Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 172 (1976) (footnote omitted)).

[87] 464 U.S. at 533-34 (quoting rule 23.1).

[88] 464 U.S. at 529. Justice Brennan stated:

> [T]he origin and purposes of Rule 23.1 support this understanding of its scope. The Rule's provisions derive from this Court's decision in *Hawes v. City of Oakland* . . . . Prior to *Hawes*, federal courts exercising their equity powers had

land,[89] first established the demand requirement as a prerequisite to the bringing of a derivative suit in the federal courts. The *Hawes* Court, seeking to reconcile the importance of allowing derivative suits with the basic policy that the decisions of a corporation are properly left to the directors,[90] imposed the requirement that a shareholder make a demand upon the corporation itself before filing a derivative suit.[91] This requirement eventually evolved into rule 23.1.[92] This, according to Justice Brennan, confirmed his finding that the rule governs only suits to enforce a right that a corporation possesses and could itself assert.[93]

Justice Brennan concluded that the language of the statute distinguishes a section 36(b) action from a derivative action because section 36(b) expressly provides that only the SEC or a security holder may bring such an action.[94] Consequently, there is no corporate right from which a shareholder's right to sue may be derived.[95]

Relying on legislative history, Justice Brennan dismissed the argument that the section 36(b) phrase "on behalf of such company" implies a corporate right of action.[96] Section 36(b) is a part of the 1970 amendments to the ICA, enacted because advisor's fees had risen dramatically in the 1950's and 1960's,[97] and stockholder suits challenging these fees were usually ineffective.[98] Justice Brennan relied on two specifics to prove this premise. First, an SEC report[99] had determined that security holders were not afforded much protection by the ICA re-

> commonly entertained suits by minority stockholders to enforce corporate rights in circumstances where the corporation had failed to sue on its own behalf.

Id. (citation omitted). For a further discussion of the origin and purposes of rule 23.1, see *supra* notes 16-27.

[89] 104 U.S. at 450.

[90] *Id.* at 460-61. For further discussion of the reconciliation of these interests, see *supra* note 18.

[91] 104 U.S. at 460-61.

[92] 464 U.S. at 530. For a further discussion of this evolution, see *supra* note 21.

[93] 464 U.S. at 533-34.

[94] *Id.* at 535. "By its terms, then, the unusual cause of action created by § 36(b) differs significantly from those traditionally asserted in shareholder derivative suits." *Id.*

[95] *Id.* "Instead of establishing a corporate action from which a shareholder's right to sue derivatively may be inferred, § 36(b) expressly provides only that the new corporate right it creates may be enforced by the Securities and Exchange Commission . . . and security holders of the company." *Id.*

[96] *Id.* at 535-36. Justice Brennan noted that "these factors plainly demonstrated that Congress intended the unique right created by § 36(b) to be enforced solely by the SEC and security holders of the investment company." *Id.*

[97] WHARTON STUDY, *supra* note 38, at 28-30.

[98] 464 U.S. at 537. The Court noted that the Securities and Exchange Commission found "lawsuits by security holders challenging the reasonableness of advisor fees had been largely ineffective due to the standards employed by courts to judge the fees." *Id.*

[99] 1966 SEC REPORT, *supra* note 41, at 89.

quirement that shareholders and independent directors approve advisor contracts and compensation.[100] Second, the Senate had rejected the investment company industry's proposed bill, which would have provided that only the company, or a security holder on its behalf, could bring an action to enforce the reasonableness standard.[101] This, Justice Brennan stated, "strongly suggests that, in adopting § 36(b), Congress did not intend to create an implied right of action in favor of the investment company."[102]

Justice Stevens, in his concurring opinion, stated that it was unnecessary to decide whether an investment company itself could maintain an action under section 36(b). Rather, the language of rule 23.1 itself makes clear that "the rule does not require a demand, it only requires that the complaint allege with particularity what demand if any has been made on the corporation."[103] Since rule 23.1 allows an adequate excuse for' not making a demand, that is sufficient to show that there are situations in which a demand is not required. Justice Stevens explained that this is one of those situations, as evidenced by the statutory language and the legislative history of the ICA. First, the statute never mentions a demand requirement.[104] Second, the policy behind the demand requirement is respect for the managerial judgment of the directors. Section 36(b), however, provides that the directors' position shall be given only the significance that a court deems appropriate.[105] In Justice Stevens' opinion, this demonstrates that Congress had laid out its own test for consideration of the directors' position, and did not intend to rely on a demand requirement.[106] Congress' rejection of a prior version of section 36(b), which required that a security holder make a demand on the SEC before bringing an action, illustrated its awareness of the demand concept.[107]

[100] *Id.* at 128-31, 144, 146-47.

[101] *Mutual Fund Legislation of 1967, supra* note 50, at 100-01.

[102] 464 U.S. at 539.

[103] *Id.* at 543 (Stevens, J., concurring).

[104] The rule merely requires that the complaint allege with particularity what demand if any has been made on the corporation. The rule provides that: "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 . . . ." FED. R. CIV. P. 23.1.

[105] "In any such action approval by the board of directors . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b) (1982).

[106] 464 U.S. at 545 (Stevens, J., concurring).

[107] The earlier Senate version stated that an action "may be maintained by a security holder of a registered investment company acting in a derivative or representative capacity, if the [Securities and Exchange] Commission refuses or fails within six months to bring such action upon the written request of such security holder." 114 CONG. REC. 23,544 (1968).

Justice Stevens further explained that rule 23.1 did not create a demand requirement; that had been done by the Court's decision in *Hawes v. City of Oakland.*[108] What the rule did, in consonance with the Rules Enabling Act,[109] was to concern itself with the adequacy of pleadings, not with any substantive rights. In Justice Stevens' opinion, because the plaintiff had pleaded that no demand had been made, he had complied with rule 23.1.[110]

Justice Stevens concluded that a demand requirement would be futile and inefficient. The directors would have already approved the contract, and would therefore be unlikely to agree to an action. Moreover, since the directors could not terminate the suit,[111] the only effect of the requirement would be to delay the suit.[112]

Justice Stevens' approach contains much to recommend it. Undoubtedly, the demand requirement serves an important function in the operation of corporate governance; it allows the corporation to avoid spending time and money on a suit that the directors feel is frivolous or without merit. But rule 23.1 is not the basis of this substantive demand requirement, only of a procedural pleadings requirement. The substantive demand requirement was judicially created by the *Hawes* decision and can be applied only in the absence of contrary congressional intent. Congress clearly intended that the *Hawes* demand requirement not be applied to actions brought under section 36(b).

The likely result of the decision in *Fox* is that lower courts will continue to hold that rule 23.1 requires that a demand be made on the board of directors in all actions except those brought under section 36(b) and other statutes showing a similar congressional intent. Justice Stevens' approach would leave open the possibility of a less mechanical application of the demand requirement. Courts would have greater freedom to inquire whether the nature of a pending action truly re-

[108] 104 U.S. at 450. For further discussion of the *Hawes* decision, see *supra* notes 17-21 and accompanying text.

[109] 28 U.S.C. § 2072 (1982).

[110] 464 U.S. at 544 (Stevens, J., concurring).

[111] *See Burks*, 441 U.S. at 471. The Supreme Court in *Burks* held that disinterested directors of investment companies could terminate a suit brought under another section of the ICA if consistent with state law and the policy of the particular section of the ICA under which the suit was brought. In dicta, however, the Court indicated that a § 36(b) action could not be terminated in that manner because Congress intended to prevent board action from cutting off derivative suits in this area, as evidenced by the express language of § 36(b). *Id.* at 471.

[112] 464 U.S. at 546 (Stevens, J., concurring). A delay in filing the suit could lead to serious consequences for shareholders because the statute of limitations on recovery under § 36(b)(3) is limited to one year. 15 U.S.C. § 80a-35(b)(3) (1982).

quires a demand on a corporate board of directors. This is surely a preferable application of the demand requirement.

D. Kathleen Berbig