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The Demand Requirement And Mutual Fund Advisory Fee Suits: An Incompatible Combination ?

THE DEMAND REQUIREMENT AND MUTUAL FUND ADVISORY FEE SUITS: AN INCOMPATIBLE COMBINATION ?

Congress passed the Investment Company Act of 1940 (ICA)[1] to correct adverse conditions within the investment company industry.[2] At the time of the ICA's enactment, however, Congress was not concerned with the level of compensation that investment companies paid to investment advisers.[3] Investment advisers normally receive compensation for their services at rates based on the size of investment company assets.[4] Following the enactment of the ICA, investment advisory fee rates remained at a fixed percentage of investment company assets[5] while spectacular

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[1] Investment Company Act of 1940, ch. 686, 54 Stat. 789 (current version at 15 U.S.C. §§ 80a-1 to -64 (1976 & Supp. V 1981)).

[2] *See* 15 U.S.C. § 80a-1(b) (1976). Congress enacted the Investment Company Act (ICA) in 1940 to correct adverse conditions within the investment company industry including lack of adequate information disclosure to fund shareholders, management structures creating conflicts of interest between directors and shareholders, discriminatory practices in the issuance of securities, unsound accounting principles, changes in fund investment policy without shareholder consent, excessive borrowing that increased investment risk, and operation of investment companies without sufficient assets. *See id.* The primary means by which the ICA sought to control these adverse conditions was through a requirement that not more than 60% of a fund's board consist of directors affiliated with an investment adviser. Investment Company Act of 1940, ch. 686 § 2(a)(3), 54 Stat. 789; *see* Burks v. Lasker, 441 U.S. 471, 482 (1979). The 1970 amendment to the ICA strengthened this requirement by changing "affiliated" to not "interested." *See* 15 U.S.C. §§ 80a-10(a), 80a-2(a)(19) (1976); *infra* note 24 (definitions of affiliated and interested persons); *see also infra* note 9 and accompanying text (1970 amendment to ICA).

Investment companies are corporations or trusts that sell shares to the public and reinvest the proceeds in a wide variety of funds that consist of relatively low-risk, diversified portfolios of market securities. *See* Fabozzi & Groppelli, *Investment Companies*, in HANDBOOK OF FINANCIAL MARKETS: SECURITIES, OPTIONS, FUTURES 507 (F. Fabozzi & F. Zarb eds. 1981) [hereinafter cited as *Investment Companies*]. Investment company stockholders share in the returns that the company realizes through the efforts of market analysts who develop portfolios, and administrators who manage fund assets. *See id.* at 507-08.

[3] *See* Phillips & Powell, *Controls over Management Compensation Under the Investment Company Act*, in THE INVESTMENT COMPANY ACT OF 1940 481 (PLI 1981) [hereinafter cited as *Management Compensation*]; *infra* note 23 and accompanying text (function of investment advisers).

[4] *See* SECURITIES AND EXCHANGE COMMISSION, REPORT ON PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH; H. REP. NO. 2337, 89th Cong., 2d Sess. 88 (1966) [hereinafter cited as PPI]; 2 T. FRANKEL, THE REGULATION OF MONEY MANAGERS 255 (1978). Compensation rates for investment advisers generally are about .5% of fund assets and the rates normally decline as the size of the fund increases. *Investment Companies, supra* note 2, at 517; *see, e.g., infra* note 85 (describing compensation rate of investment advisers in Weiss v. Temporary Investment Fund, 692 F.2d 928, 931 (3d Cir. 1982)). The payments some advisers receive fluctuate with the performance of the fund. *See Investment Companies, supra* note 2, at 517.

[5] *See* WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R.

growth occurred in the assets of mutual fund investment companies.[6] Due to economies of scale in the performance of mutual fund advisory services,[7] the compensation of investment advisers grew at a greater rate than their expenses.[8] Consequently, in amending the ICA in 1970, Congress added a new provision, section 36(b),[9] in an effort to control excessive investment advisory fees.[10] Section 36(b) grants the Securities and Exchange Commission (SEC) and investment company shareholders an express cause of action to recover excessive compensation that investment companies pay to investment advisers.[11]

REP. No. 2247, 87th Cong., 2d Sess. 29 (1962). In 1960, mutual funds generally paid advisory fees at an average fixed rate of .5% of average net assets. *See id.* at 28, 480.

[6] *See* H.R. REP. No. 1382, 91st Cong., 2d Sess. 2 (1970). Between 1941 and 1970 the net assets of investment companies increased dramatically. *Id.* In particular, the size of mutual fund investment company assets burgeoned from $450 million to $53 billion during that period. *Id.* A mutual fund is a type of investment company that continuously offers new shares for public sale and will redeem outstanding shares at market value. 15 U.S.C. § 80a-5 (1976); *see Investment Companies, supra* note 2, at 508. Also called open-end investment companies, mutual funds are the most dominant and dynamic components of the investment company industry. *See* PPI, *supra* note 4, at 42-45. The other type of investment company, called the closed-end investment company, does not offer to buy or sell its own shares on a continual basis. *See Investment Companies, supra* note 2, at 508. Closed-end investment companies sell their shares in the same manner as other publicly traded companies, and trading in the securities markets determines the value of closed-end company shares. *See id.* at 508, 510.

Many variations of mutual funds exist. *See* INVESTMENT COMPANY INSTITUTE, 1982 MUTUAL FUND FACT BOOK 22-24 (1982) [hereinafter cited as MUTUAL FUND FACT BOOK]. Traditional mutual funds invest in common stocks, preferred stocks, and bonds, the quantities, combinations, and characteristics of which differ depending upon the fund objective. *See id.* at 15, 21. Money market and municipal bond funds are more recent additions to the mutual fund industry. *See id.* at 22. Money market funds purchase high-yield money market instruments including United States government securities, bank certificates of deposit and commercial paper. *See id.* at 15. Municipal bond funds, also called Tax-Exempt Money Market Funds, invest in municipal securities with relatively short maturities. *See id.*

[7] *See* S. REP. No. 184, 91st Cong., 2d Sess. 5, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4902 (economies of scale attributable to dramatic growth of mutual fund industry).

[8] *See Proposed Amendments to the Investment Company Act: Hearings on H.R. 9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate Commerce,* 90th Cong., 1st Sess. 34-35 (1967) (statement of M. Cohen, Chairman, Securities and Exchange Commission (SEC)). One investment adviser received an anual fee that increased by almost 200% between 1961 and 1964 while the same adviser's operating expenses increased by only 80% during the same period. *See id.*

[9] 15 U.S.C. § 80a-35(b) (1976).

[10] Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970) (amending 15 U.S.C. §§ 80a-1 to -52 (1964)). In addition to creating a provision to control investment company advisory fees, the 1970 amendments to the ICA sought to regulate mutual fund sales commissions, to permit banks and savings and loan associations to operate accounts in competition with mutual funds, and generally to update and improve the ICA and the Investment Advisers Act of 1940. *See* S. REP. No. 184, 91st Cong., 2d Sess. 2, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4898.

[11] *See* 15 U.S.C. § 80a-35(b) (1976).

As a result of the continued expansion of mutual fund assets,[12] fund shareholders have instituted numerous suits alleging that the growth of the funds has produced excessive advisory fees in violation of section 36(b).[13] Rule 23.1 of the Federal Rules of Civil Procedure ordinarily requires shareholders instituting derivative actions to make a demand on directors prior to bringing suit.[14] Shareholder plaintiffs have asserted, however, that application of the demand requirement in section 36(b) actions is contrary to Congress' intent to create an effective means to obtain judicial review of investment advisory compensation.[15] Congress enacted section 36(b) with an awareness that the interests of mutual fund directors regarding advisory compensation generally conflict with the objectives of fund shareholders.[16] Section 36(b) plaintiffs consequently have argued that a demand on directors would be futile in mutual fund advisory fee suits.[17] The failure of plaintiffs to make a demand on investment company directors has resulted in the dismissal of many section 36(b) actions,[18] and in several cases courts have not allowed plaintiffs to amend their complaints to reflect a subsequent demand on directors.[19] In recent decisions,

[12] *See* 1 SEC. REG. GUIDE (P-H) ¶ 1.5 (Jan. 12, 1983) (sales of mutual funds in 1982 largest ever). In a relatively short period of time, mutual funds have become the fourth largest type of financial institution in the United States, behind commercial banks, savings and loan associations, and insurance companies. *See* MUTUAL FUND FACT BOOK, *supra* note 6, at 15; *see also* Hudson, *Mutual Funds Urged to Start Inspection Unit*, Wall St. J., Feb. 11, 1983, at 4, col. 1 (mutual fund industry major force in national economy).

[13] *See infra* notes 30-54 and accompanying text (shareholder § 36(b) suits since 1970 amendment).

[14] *See* FED. R. CIV. P. 23.1 (requiring shareholder derivative action complaints to allege efforts, or reasons for failing to make efforts, to obtain desired action from directors).

[15] *See* Petition for Writ of Certiorari at 6, Grossman v. Johnson, 674 F.2d 115 (1982), *petition for cert. filed sub nom.*, Grossman v. Fidelity Municipal Bond Fund, 51 U.S.L.W. 3027 (U.S. June 25, 1982) (No. 81-2361) (arguing demand requirement undercuts congressional intent of creating effective means for shareholders to obtain judicial review of advisory compensation), *cert. denied*, 103 S. Ct. 85 (1982).

[16] *See* S. REP. No. 184, 91st Cong., 2d Sess. 2, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4898 (recognizing potential conflicts of interest in setting of advisory fees).

[17] *See e.g.*, Blatt v. Dean Witter Reynolds Intercapital, Inc., 528 F. Supp. 1152, 1154 (S.D.N.Y. 1982) (§ 36(b) suit in which plaintiffs argued demand was empty formality); Markowitze v. Brody, 90 F.R.D. 542, 554-55 (S.D.N.Y. 1981) (plaintiff argued demand should be excused as futile in § 36(b) suit).

[18] *See* Weiss v. Temporary Inv. Fund, 692 F.2d 928, 943-44 (3d Cir. 1982) (affirming dismissal of § 36(b) suit for failure to make demand); Grossman v. Johnson, 674 F.2d 115, 118, 126 (1st Cir.) (same), *cert. denied*, 103 S. Ct. 85 (1982); Jerozal v. Cash Reserve Management, Inc. [Current] FED. SEC. L. REP. (CCH) ¶ 99,019, at 94,822 (S.D.N.Y. 1982) (dismissing § 36(b) action for failing to make demand); Markowitz v. Brody, 90 F.R.D. 542, 562-63 (S.D.N.Y. 1982) (same).

[19] *See, e.g.*, Weiss v. Temporary Inv. Fund, 692 F.2d 928, 943 (3d Cir. 1982) (rejecting plaintiff's request for leave to amend complaint after making demand on investment company directors); Grossman v. Johnson, 674 F.2d 115, 125-26 (1st Cir.) (plaintiff's demand after filing complaint did not rectify initial failure to make demand before bringing suit), *cert. denied*, 103 S. Ct. 85 (1982).

several United States circuit courts of appeals have reached discordant conclusions on whether shareholders must make a demand on investment company directors prior to instituting a section 36(b) claim.[20]

Mutual funds are investment companies that continuously offer new shares for public sale and will redeem outstanding shares at market value.[21] The mutual fund industry is characterized by an external management structure.[22] A separate legal entity, the investment adviser, typically creates the mutual fund and appoints the fund's directors.[23] In most cases, chief executives or employees of the investment adviser serve on the fund's board of directors.[24] After the fund's creation, the board enters into a con-

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[20] *See* Weiss v. Temporary Inv. Fund, 692 F.2d 928, 943-44 (3d Cir. 1982) (affirming dismissal of § 36(b) suit for failure to make demand); Fox v. Reich & Tang, Inc., 692 F.2d 250, 261-62 (2d Cir. 1982) (finding demand requirement inapplicable in § 36(b) suit), *cert. granted sub nom.* Daily Income Fund, Inc. v. Fox, 51 U.S.L.W. 3646 (U.S. Mar. 7, 1983) (No. 82-1200); Grossman v. Johnson, 674 F.2d 115, 118, 126 (1st Cir.) (affirming dismissal of § 36(b) suit for failure to make demand), *cert. denied,* 103 S. Ct. 85 (1982); *infra* notes 53-98 and accompanying text (discussing *Weiss, Fox* and *Grossman*).

[21] *See supra* note 6 (describing mutual funds).

[22] *See* Burks v. Lasker, 441 U.S. 471, 480-81 (1979); Weiss v. Temporary Inv. Fund, 692 F.2d 928, 932 (3d Cir. 1982); S. REP. No. 184, 91st Cong., 2d Sess. 5, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4901. Mutual fund management differs from the management of closed-end investment companies. *See Investment Companies, supra* note 2, at 517; *supra* note 6 (describing mutual funds and closed-end investment companies). Officers of a brokerage or investment banking firm usually manage closed-end companies while a mutual fund generally hires an investment adviser to provide research and management services. *See Investment Companies, supra* note 2, at 517. Courts and commentators have described mutual funds as shell corporations that merely contain a pool of liquid assets. *See* Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977); Galfand v. Chestnutt Corp., 545 F.2d 807, 808 (2d Cir. 1976); Randall, *Fiduciary Duties of Investment Company Directors and Management Companies Under the Investment Company Act of 1940,* 31 OKLA. L. REV. 635, 636 (1978) [hereinafter cited as *Fiduciary Duties*].

[23] *See* Weiss v. Temporary Inv. Fund, 692 F.2d 928, 933 (3d Cir. 1982); *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency,* 90th Cong., 1st Sess. 10 (1967) (statement of M. Cohen, Chairman, SEC). Investment advisers develop and manage the portfolios of investment companies while analyzing the economy, securities markets, and particular industries. *See* 1 T. FRANKEL, *supra* note 4, at 20. Investment advisers also may provide investment companies with brokerage and administrative services in addition to supplying office space, salaries and compensation to officers and directors, payments for legal and custodian fees, and clerical, bookkeeping, auditing and accounting services. *See id.* at 20-21.

[24] *See* PPI, *supra* note 4, at 46; Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds,* 115 U. PA. L. REV. 1058, 1059-60 (1967) [hereinafter cited as *Unaffiliated Directors*]. The ICA requires at least 40% of the directors of a mutual fund to be disinterested. 15 U.S.C. § 80a-10(a) (1976). If the adviser is also the mutual fund's principle underwriter, 50% of the fund directors must be disinterested. *Id.* § 80a-10(b)(1); *see* T. FRANKEL, *supra* note 4, at 42-56. A director is interested with respect to an investment adviser if he has an ownership interest in, is on the board of directors of, or has close ties to the investment adviser, or if he is affiliated or related to persons affiliated with the investment adviser. 15 U.S.C. § 80a-2(a)(19) (1976). A person affiliated with an investment adviser is one who controls 5% of the outstanding voting securities of the adviser, controls the adviser, or is an officer, director or employee of the adviser. *Id.* § 80a-2(a)(3).

tract with the investment adviser and agrees to pay the adviser a commission in exchange for management and investment services.[25] Since the investment adviser creates and controls the mutual fund,[26] the fees that the adviser charges to the fund are not the product of arm's length bargaining.[27] By imposing a fiduciary obligation on investment advisers with respect to their compensation, section 36(b) seeks to minimize the potential conflicts arising out of the external management structure of the mutual fund industry.[28]

Shareholders have filed several section 36(b) actions since the provision became effective in 1972,[29] but most of the ensuing litigation has focused on procedural issues.[30] Until a recent Second Circuit decision in

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[25] *See* S. REP. No. 184, 91st Cong., 2d Sess. 4, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4901. Investment advisory contracts must specify all compensation the fund will pay pursuant to the agreement. 15 U.S.C. § 80a-15(a)(1) (1976). Advisory contracts generally describe the calculation of fees and the method of valuing assets, as well as the investment objectives of the fund and any restrictions on investment policy. *See* Carlson, *Opening Accounts, Suitability, Discretionary Accounts and Investment Advisory Contracts* in COUNSELING THE INVESTMENT ADVISER, 385, 398-400 (PLI 1975). Advisory contracts usually are renewable yearly and either party may cancel on 30 days notice. *See Investment Companies, supra* note 2, at 517. The investment adviser often guarantees to pay expenses that the fund incurs in excess of a certain limit as insurance that the adviser will not exceed an appropriate expense margin. *See* 2 T. FRANKEL, *supra* note 4, at 246.

[26] *See Fiduciary Duties, supra* note 22, at 636. Unlike the conventional corporation that directly pays company officers, who generally have a substantial equity investment in the corporation, the mutual fund is dependent on its investment adviser, which primarily is interested in maximizing its own profits. *See* Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977). Mutual fund directors usually receive a nominal salary or none at all. *See Unaffiliated Directors, supra* note 24, at 1060. Mutual fund directors that are affiliated, however, receive significant compensation from investment advisers, or from affiliated brokers or underwriters. *See id.*; *supra* note 24 (describing affiliated directors).

[27] *See* S. REP. No. 184, 91st Cong., 2d Sess. 4, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4901. Competition between investment advisers for advisory contracts rarely, if ever, exists. PPI, *supra* note 4, at 126-27.

[28] *See* 15 U.S.C. § 80a-35(b) (1976); S. REP. No. 184, 91st Cong., 2d Sess. 2, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4898.

[29] *See* 15 U.S.C. § 80a-52 (1976) (§ 36(b) effective as of June 14, 1972, eighteen months after enactment).

[30] *See, e.g.,* Fogel v. Chestnutt, 668 F.2d 100, 112 (2d Cir. 1981) (§ 36(b) not applicable in suit alleging adviser and affiliated fund directors failed to recapture brokerage commissions), *cert. denied,* 103 S. Ct. 65 (1982); *In re* Gartenberg, 636 F.2d 16, 17-18 (2d Cir. 1980) (shareholder § 36(b) suit not entitled to jury trial), *cert. denied,* 451 U.S. 910 (1981); Lerner v. Reserve Management Co., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,036, at 91,366-68 (S.D.N.Y. 1981) (§ 36(b) suit barred by res judicata since prior suit involving same parties and issues settled, and settlement agreement still effective); Halligan v. Standard & Poor's/Intercapital, Inc., 434 F. Supp. 1082, 1085 (E.D.N.Y. 1977) (denying motion to dismiss § 36(b) claim for failure to state claim); Frankel v. Hyde, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,486, at 95,710-12 (S.D.N.Y. 1974) (shareholder action alleging officers and directors of adviser to closed-end investment company failed to capture brokerage commissions stated cause of action under § 36(b)); *see also infra* notes 37-98 and accompanying text (§ 36(b) cases considering demand requirement application).

Gartenberg v. Merrill Lynch Asset Management,[31] no court had considered the measure of advisory fees that constitutes a violation of fiduciary duty under section 36(b).[32] In *Gartenberg*, the Second Circuit sought to define a standard of fiduciary obligation under section 36(b) that would take into account the absence of competition between investment advisers for mutual fund business.[33] The *Gartenberg* court stated that if advisory compensation is so disproportionately high that the fee is not related reasonably to the services the adviser renders and could not have been negotiated at arm's length, then the adviser has breached its fiduciary obligation under section 36(b).[34] In *Gartenberg*, the Second Circuit affirmed the district court's dismissal of two consolidated section 36(b) suits, but did not hold that the disputed advisory fee contract was fair and reasonable.[35] The *Gartenberg* court concluded instead that the plaintiffs had failed to present enough evidence to prove a breach of fiduciary duty under section 36(b).[36]

With the exception of the *Gartenberg* decision and a few court-approved

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[31] 694 F.2d 923 (2d Cir. 1982).

[32] *See* Krasner v. Dreyfus Corp., 90 F.R.D. 665, 668 (S.D.N.Y. 1981) (to court's knowledge no § 36(b) suit recovered on merits); Note, *Mutual Fund Advisory Fees—Too Much for Too Little?*, 48 FORDHAM L. REV. 530, 531-41 (1980) (no § 36(b) suit recovered on merits) [hereinafter cited as 48 FORDHAM NOTE]; *but cf. infra* note 37 (determination of advisory fee fairness in court-approved settlement).

[33] *See* 694 F.2d at 933. In *Gartenberg*, shareholders of the Merrill Lynch Ready Assets Trust (ML Fund) charged that Merrill Lynch Asset Management, Inc. (ML Management), the adviser and manager of ML Fund, violated § 36(b) by accepting an unreasonably high fee that was disproportionate to the costs of the services rendered to ML Fund. *Id.* at 924-25; Gartenberg v. Merrill Lynch Asset Management, 528 F. Supp. 1038, 1043 (S.D.N.Y. 1981) (district court opinion). ML Fund paid the challenged fees to ML Management for various services, including investment advice and processing of fund shareholder daily orders. 694 F.2d at 925. ML Management also manages all of the operations of ML Fund and provides all of the office space and facilities, administrative staff, and equipment necessary to conduct ML Fund's operations. *Id.* The fee charged by ML Management is based on a percentage of the average daily value of ML Fund's net assets. *Id.* As ML Fund's total assets increase in value the fee rate declines. *Id.* at 926.

[34] *See* 694 F.2d at 928. To apply the arms-length bargaining test properly, the *Gartenberg* court emphasized that Congress intended the courts to consider all of the facts that are relevant to a determination of whether the amount of compensation constituted an observance or a breach of the adviser's fiduciary duty. *See id.* at 930 (citing S. REP. NO. 184, 91st Cong., 2d Sess. 13, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4910). The *Gartenberg* court recognized a number of factors that are important in evaluating the fiduciary obligation under § 36(b), including the cost of providing the advisory service, the nature and quality of the service, the extent to which the adviser realizes economies of scale, and the volume of the orders that the adviser must process. *See id.* The *Gartenberg* court rejected, however, the district court's suggestion that a comparison of the level of advisory fees charged to other funds should be a primary consideration in the evaluation of a fee's fairness. *See id.* at 928-29.

[35] *See* 694 F.2d at 933. In contrast to the Second Circuit's holding in *Gartenberg*, the district court found the advisory fee contract to be fair and reasonable. *See* Gartenberg v. Merrill Lynch Asset Management, 528 F. Supp. at 1055.

[36] *See* 694 F.2d at 933.

settlements,[37] section 36(b) litigation primarily has focused on the issue of whether the demand requirement imposed by rule 23.1 of the Federal Rules of Civil Procedure[38] applies to section 36(b) claims.[39] Rule 23.1 requires shareholder derivative action complaints to allege the plaintiff's effort to obtain the desired action from the corporation's directors or, if the plaintiff does not make such an effort, the reason for failing to do so.[40] The earliest recorded decision on the issue of whether the demand requirement applies in section 36(b) suits is *Boyko v. Reserve Fund, Inc.*[41] In *Boyko*, the District Court for the Southern District of New York denied a motion to dismiss a shareholder section 36(b) claim on the grounds that the plaintiff shareholder failed to comply with the rule 23.1 demand requirement.[42] The *Boyko* court stated that the demand requirement would thwart Congress' purpose in enacting section 36(b) because fund directors would seek to terminate any shareholder action brought against the fund's advisor for receipt of excessive compensation.[43] The *Boyko* court

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[37] *See, e.g.*, Lewis v. Oppenheimer Management Corp., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,966, at 90,978-79 (E.D.N.Y. 1981) (settlement approved in derivative action charging payment of excessive advisory fees); Korenstein v. Dreyfus Corp. [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,238, at 96,703 (S.D.N.Y. 1980) (opinion summary). In one of the earliest § 36(b) actions, the parties reached a settlement agreement after the court denied defendant's motion to dismiss. *See* Boyko v. Reserve Fund, Inc., 68 F.R.D. 692, 696 (S.D.N.Y. 1975) (denying motion to dismiss under rule 23.1 of Federal Rules of Civil Procedure); Lerner v. Reserve Management Co., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,036, at 91,367 (S.D.N.Y. 1981) (describing court approval of settlement agreement of parties in Boyko v. Reserve Fund, Inc., 68 F.R.D. 692 (S.D.N.Y. 1975)). In *Krasner v. Dreyfus Corp.*, the District Court for the Southern District of New York approved perhaps the largest settlement in a § 36(b) action. *See* 90 F.R.D. 665, 667-73 (S.D.N.Y. 1981). In *Dreyfus*, the court acknowledged that no judicial precedent existed for determining the fairness of advisory fees. *See id.* at 668. The court stated, however, that a settlement determination only requires the court to make a general assessment of whether the advisory fee is fair within the meaning of the ICA, and also to determine whether the terms of the settlement are fair and reasonable in light of the plaintiff's probability of success after a trial on the merits. *See id.* Under the settlement agreement in *Dreyfus*, the adviser, Dreyfus Corporation, will pay the fund, Dreyfus Liquid Assets, Inc., $2.82 million by 1986. *See id.* at 672. Additionally, the parties agreed to change the advisory fee schedule from a fixed percentage rate of fund assets to a declining scale rate. *Id.* at 673.

[38] FED. R. CIV. P. 23.1.

[39] *See* Weiss v. Temporary Inv. Fund, 692 F.2d 928 (3d Cir. 1982); Fox v. Reich & Tang, Inc., 692 F.2d 250 (2d Cir. 1982), *cert. granted sub nom.* Daily Income Fund, Inc. v. Fox, 51 U.S.L.W. 3646 (U.S. Mar. 7, 1983) (No. 82-1200); Grossman v. Johnson, 674 F.2d 115 (1st Cir.), *cert. denied*, 103 S. Ct. 85 (1982); Untermeyer v. Fidelity Daily Income Trust, 580 F.2d 22 (1st Cir. 1978); Jerozal v. Cash Reserve Management, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 99,019 (S.D.N.Y. 1982); Blatt v. Dean Witter Reynolds Intercapital, Inc., 528 F. Supp. 1152 (S.D.N.Y. 1982); Markowitz v. Brody, 90 F.R.D. 542 (S.D.N.Y. 1981); Wolfson v. Cooper, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,634 (S.D.N.Y. 1976); Boyko v. Reserve Fund, Inc., 68 F.R.D. 692 (S.D.N.Y. 1975).

[40] FED. R. CIV. P. 23.1. Rule 23.1 requires shareholder derivative action complaints to allege that the plaintiff was a shareholder at the time of the complained of transaction, and to allege that the action was not collusive to confer federal jurisdiction. *Id.*

[41] 68 F.R.D. 692 (S.D.N.Y. 1975).

[42] *See id.* at 696.

[43] *See id.* The *Boyko* court stated that since the mutual fund is controlled by its ad-

concluded that demand is futile in a section 36(b) action whenever at least one affiliated or interested director sits on the board of the mutual fund.[44]

In other early decisions, courts also did not dismiss shareholder section 36(b) suits for failing to satisfy the rule 23.1 demand requirement.[45] In 1981, however, the Southern District Court of New York in *Markowitz v. Brody*[46] dismissed two section 36(b) shareholder claims for failing to make a demand.[47] The *Markowitz* court rejected one plaintiff's argument that the demand requirement does not apply to section 36(b),[48] and stated that the rule 23.1 demand requirement is excused only when fifty percent or more of the mutual fund's directors are interested.[49] Shortly after the *Markowitz* decision, however, another federal district court in the same district decided in *Blatt v. Dean Witter Reynolds Intercapital, Inc.*[50] that the demand requirement is inherently futile in section 36(b) suits.[51] In more recent decisions, the Southern District of New York has contradicted itself again by holding that section 36(b) suits are not exempt from the rule 23.1 demand requirement.[52]

Three recent United States circuit court of appeals decisions have increased the judicial discord regarding the application of the demand re-

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viser, the requirement of demand would result in the dismissal of most, if not all, shareholder § 36(b) actions. *See id.*

[44] *See id.*; *supra* note 24 (definitions of affiliated directors and interested directors). The *Boyko* court stressed that the court's decision was not a holding that § 36(b) has abrogated rule 23.1. *See* 68 F.R.D. at 696.

[45] *See, e.g.*, Untermeyer v. Fidelity Daily Income Trust, 580 F.2d 22, 23-24 (1st Cir. 1978) (vacating lower court's judgment dismissing § 36(b) action for failing to allege adequate excuse for not making demand); Wolfson v. Cooper, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,634, at 90,152-54 (S.D.N.Y. 1976) (demand requirement satisfied by demonstration of futility, but judgment for defendants because excessiveness of fees unproven); Galfand v. Chestnutt, 402 F. Supp. 1318, 1331 (S.D.N.Y. 1975) (demand excused in § 36(b) suit when demand would have been fruitless), *cert. denied*, 435 U.S. 943 (1978).

[46] 90 F.R.D. 542 (S.D.N.Y. 1981).

[47] *See id.* at 549, 554-61, 563.

[48] *See id.* at 555. The *Markowitz* court decided that the demand requirement is applicable to § 36(b) suits because an investment company has a cause of action under § 36(b). *See id.* at 557 n.12, 560 n.18.

[49] *See id.* at 559. The *Markowitz* court held that the board of directors of a mutual fund may not terminate a § 36(b) action. *See id.* at 562. The court stated, however, that by providing a means by which the fund directors can voice approval of the challenged fee, the demand requirement serves as a means by which the board can influence the court and thereby protect the investment adviser from strike suits. *See id.*

[50] 528 F. Supp. 1152 (S.D.N.Y. 1982).

[51] *See id.* at 1156. The *Blatt* court held that investment company directors may not terminate § 36(b) suits and that § 36(b) does not provide the directors with the right to institute a suit. *See id.* at 1155. The *Blatt* court concluded, therefore, that the basis of the demand requirement in the ordinary derivative suit does not apply in a § 36(b) action. *See id.*

[52] *See* Jerozal v. Cash Reserve Management, Inc. [Current] FED. SEC. L. REP. (CCH) ¶ 99,019, at 94,822 (S.D.N.Y. 1982) (section 36(b) action not exempt from rule 23.1 demand requirement); Fox v. Reich & Tang, Inc., 90 F.R.D. 94, 95, 96-98 (S.D.N.Y. 1982) (demand required in § 36(b) suit), *rev'd*, 692 F.2d 250 (2d Cir. 1982), *cert. granted*, 51 U.S.L.W. 3646 (U.S. Mar. 7, 1983) (No. 82-1200).

quirement in section 36(b) suits by reaching contradictory conclusions on the issue.[53] The First Circuit, in *Grossman v. Johnson*,[54] held that the rule 23.1 demand requirement is applicable to section 36(b) suits.[55] The plaintiff in *Grossman*, a shareholder of Fidelity Municipal Bond Fund, Inc. (FMB Fund), brought suit against FMB Fund's investment adviser, Fidelity Management & Research Company (FMR), for receiving allegedly excessive advisory fees in violation of section 36(b).[56] The plaintiff asserted that FMR's compensation was disproportionate to the cost of performing advisory and management services because FMR's fee rate had remained based on a fixed percentage of FMB Fund net assets during a period in which the assets had increased substantially.[57] Because the plaintiff did not make a demand on FMB Fund directors prior to filing suit, the defendants moved to dismiss the complaint on the grounds that the plaintiff had failed to comply with rule 23.1.[58]

In *Grossman*, the First Circuit rejected the plaintiff's argument that Congress did not intend the rule 23.1 demand requirement to apply in section 36(b) suits.[59] The First Circuit decided that even if investment com-

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[53] *See supra* note 22 (circuit courts with conflicting decisions on applicability of demand requirement in § 36(b) suits).

[54] 674 F.2d 115 (1st Cir.), *cert. denied*, 103 S. Ct. 85 (1982).

[55] *See id.* at 119-23.

[56] *Id.* at 117-18.

[57] 89 F.R.D. 656, 658 n.2 (district court opinion). The *Grossman* plaintiff alleged that FMR received about 10% of FMB Fund's income as compensation while other funds of the same type pay well-qualified advisers as little as .15% of fund income. *See id.*; Comment, *Director Termination of Mutual Fund Advisory Fee Suits:* Grossman v. Johnson, 62 B.U.L. REV. 601, 604 n.21 [hereinafter cited as *Director Termination*] (describing growth of FMB Fund's assets as asserted in *Grossman* plaintiff's brief).

[58] 674 F.2d at 118. The district court in *Grossman* allowed the plaintiff to send a demand letter to the directors and to amend the complaint. *Id.* In response, the FMB Fund formed a litigation committee to investigate the plaintiff's demand. *Id.* After six months, the litigation committee concluded that the suit was not in the best interests of FMB Fund. 89 F.R.D. at 658-59. The district court dismissed the amended complaint for failure to file a timely demand, and, alternatively, granted summary judgment based on the litigation committee's business judgment recommendation to terminate the suit. *See* 674 F.2d at 118; *Director Termination, supra* note 57, at 604-06 (analysis of *Grossman* district court's decision to allow director termination of plaintiff's § 36(b) claim); *infra* note 60 (defining director termination).

[59] *See* 674 F.2d at 119-25. The First Circuit in *Grossman* interpreted the language of § 36(b), which states that any shareholder recovery is on behalf of the investment company, as signifying that a § 36(b) action is derivative. *See id.* at 120. The *Grossman* court stated that the legislative history of § 36(b) is ambiguous on the issue of whether Congress intended the demand requirement to apply in § 36(b) suits. *See id.* at 121. The court recognized Congress' concern over the prior ineffectiveness of independent directors in correcting excessive advisory fees and Congress' intent to give the courts a significant role in determining whether advisory fees are excessive. *See id.* The court stated, however, that Congress placed an equal emphasis on the authority and responsibility of the directors. *See id.* The *Grossman* court held that the Federal Rules of Civil Procedure are presumed to apply unless congressional intent clearly suggests otherwise, and therefore held that the rule 23.1 demand requirement applies in § 36(b) suits. *See id.* at 122-23; FED. R. CIV. P. 23.1.

pany directors may not exercise their business judgment to terminate shareholder section 36(b) suits,[60] the demand requirement is useful in providing directors with the opportunity to decide whether to accede to the views of the complaining shareholders.[61] The *Grossman* court, therefore, dismissed the plaintiff's suit for failing to comply with rule 23.1, and decided that a ruling was not necessary on the district court's summary judgment granting director termination of the suit.[62]

After the First Circuit's decision in *Grossman*, the Second Circuit in *Fox v. Reich & Tang, Inc.*[63] held that shareholders instituting section 36(b) suits do not have to make a demand on the investment company's board of directors.[64] In *Fox*, a shareholder of Daily Income Fund, Inc. (DI Fund) alleged that DI Fund paid excessive fees to its adviser, Reich & Tang, Inc.[65] Prior to filing suit, the plaintiff in *Fox* did not make a demand on

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[60] *See id.* at 121. The *Grossman* court was aware that the United States Supreme Court had suggested that directors may not terminate shareholder § 36(b) actions. *Id.* (citing Burks v. Lasker, 441 U.S. 471, 484 (dictum) (1979)). The *Grossman* court reasoned that although the Supreme Court's statement in *Burks* may have been dictum, the statement formed an integral part of the Court's holding. *See* 674 F.2d at 121 n.12.

Director termination occurs when a court dismisses a shareholder derivative action after finding that the board of directors exercised proper business judgment when the board concludes that the suit would not be in the best interests of the corporation. *See* 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 5822, 5969 (rev. perm. ed. 1980). In addition to making a demand on directors, therefore, shareholders instituting a traditional derivative suit must demonstrate that the court should not respect the directors' decision against bringing suit. *See* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 191 (1976) [hereinafter cited as *Demand Requirement*]; *infra* note 150 (director termination not available in § 36(b) suits).

[61] *See* 674 F.2d at 121. The *Grossman* court stated that the one-year limitation period on damages under § 36(b) is not a sufficient reason for excluding the rule 23.1 demand requirement in § 36(b) actions. *See id.* at 122; *infra* notes 157-59 and accompanying text (one-year limitation period on damages under § 36(b)). The *Grossman* court stated that if the requirement of demand delayed a § 36(b) suit and forced the plaintiff to assert a later one-year period of excessive advisory fee payments, the amount of excessive fees recoverable would probably not decrease. *See id.* The court postulated that in the unusual case in which the recoverable amount might decrease, a district court could allow the suit to proceed without awaiting the directors' response to demand. *See id.* In *Weiss v. Temporary Investment Fund*, the Third Circuit noted this postulation by the *Grossman* court, but the Third Circuit chose not to reinforce it. *See* 692 F.2d 928, 938 n.10 (3d Cir. 1982).

[62] *See* 674 F.2d at 126; *supra* note 58 (*Grossman* district court termination of § 36(b) action); *infra* note 150 (director termination not available in § 36(b) suits).

[63] 692 F.2d 250 (2d Cir. 1982), *cert. granted sub nom.* Daily Income Fund, Inc. v. Fox, 51 U.S.L.W. 3646 (U.S. Mar. 7, 1983) (No. 82-1200).

[64] *See id.* at 253, 262. The *Fox* court recognized that the case presented an issue of first impression to the Second Circuit. *See id.* at 252.

[65] *Id.* In *Fox*, DI Fund paid Reich & Tang, Inc. at a set rate of .5% of the DI Fund's net assets. *Id.* at 253. The fixed rate fee structure is unlike those of many mutual funds that pay at downward-scaled rates. *See supra* note 4 (mutual fund fee schedules). During a period of less than three years, the assets of DI Fund increased enormously, and as a result, Reich & Tang, Inc's advisory fees increased from about $375,000 in 1978 to more than $2 million in 1980. 692 F.2d at 252-53. The plaintiff in *Fox* alleged that the extraordinary rise in advisory fees was unjustified since Reich & Tang, Inc.'s management of DI

DI Fund's board of directors.[66] The plaintiff asserted instead that section 36(b) actions are exempt from the demand requirement of rule 23.1.[67] The district court in *Fox* concluded that a rule 23.1 demand is required in suits brought under section 36(b), and therefore dismissed the plaintiff's claim for failure to make a demand on DI Fund's directors before filing suit.[68]

In analyzing whether shareholders must make a demand on directors as a prerequisite to filing a section 36(b) suit, the Second Circuit initially established that rule 23.1 would operate only if the court found that the shareholders' action was derivative. The *Fox* court maintained that to conclude that shareholder section 36(b) suits are derivative, the court must find that investment companies have an independent private right of action under section 36(b).[70] As the *Fox* court observed, however, the statutory language of section 36(b) expressly authorizes only the SEC or fund shareholders to bring suit for excessive advisory fees.[71] Referring to recent United States Supreme Court policy regarding the implication of private statutory rights of action, the *Fox* court declared that courts should not assume casually that Congress intended to create additional remedies by implication under a statute that specifically provides express rights of action.[72] The court examined the legislative history of section

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Fund was not sophisticated and did not require highly paid securities analysts. *Id.* at 253. The plaintiff asserted that the managerial function of Reich & Tang, Inc. was simply a process of "turning over" money market instruments with a few institutions. *Id.*

[66] 692 F.2d at 253.

[67] *Id.*

[68] *Id.*; *see* 90 F.R.D. 94, 95, 96-98 (S.D.N.Y. 1982) (district court opinion in *Fox*). The district court in *Fox* agreed with the plaintiff's argument that a fund's board of directors may not terminate a § 36(b) suit. *See* 90 F.R.D. at 96 (citing Burks v. Lasker, 441 U.S. 471, 484 (1979)). The district court ruled, however, that the demand requirement was still necessary to provide fund directors with an opportunity either to avoid a lawsuit by remedying the plaintiff's grievance, or possibly to litigate the issue themselves. *See id.*; *see also id.* at n.2 (recognizing judicial dispute over whether investment company right of action exists under § 36(b)).

[69] *See* 692 F.2d at 253-54 (citing FED. R. CIV. P. 23.1). In *Fox*, DI Fund argued that even if the court ruled that investment funds cannot institute § 36(b) actions, the demand requirement still is necessary in order to make use of informal methods of recovering excessive advisory fees. *See id* at 254 & n.7. DI Fund suggested that the availability of informal means of director control, such as negotiation with advisers for refunds and termination of advisory contracts, should be sufficient to require shareholder plaintiffs to make demands on directors. *See id.* at 254 n.7. The *Fox* court doubted that the informal methods of director control suggested by DI Fund would have a positive effect and held that, in any case, rule 23.1 would require demand on fund directors only if the fund itself had a private right of action. *See id.* at 254 & n.7.

[70] *See id.* at 254 & n.7.

[71] *See id.* at 254; 15 U.S.C. § 80a-35(b) (1976).

[72] *See* 692 F.2d at 255 (citing Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n, 453 U.S. 1, 13-15 (1981)). The *Fox* court criticized, as being inconsistent with congressional policy, the *Grossman* court's argument that Congress could have believed that Congress did not need to expressly specify that investment funds have a right of action under § 36(b). *See id.* at 256 (citing Grossman v. Johnson, 674 F.2d 115, 120 (1st Cir.), *cert. denied*, 103 S. Ct. 85 (1982)).

36(b) in search of persuasive evidence of congressional intent contrary to the statute's exclusion of a cause of action for investment companies.[73] Finding that Congress promulgated section 36(b) so that courts effectively could counteract the inherent conflicting interests of fund directors in the setting of advisory fees,[74] the *Fox* court maintained that Congress could not have contemplated that fund directors would assume the role of suing their advisers.[75] The *Fox* court concluded, therefore, that investment funds do not have a right of action under section 36(b), and consequently shareholder section 36(b) suits are not derivative and do not invoke the rule 23.1 demand requirement.[76]

Although concluding that the rule 23.1 demand requirement does not apply in section 36(b) suits, the *Fox* court also briefly examined the policy of requiring demand in shareholder suits in light of the distinctiveness of the section 36(b) right of action.[77] The *Fox* court noted that fund directors do not have power to terminate section 36(b) suits, and therefore the traditional justification for the demand requirement does not exist.[78] Furthermore, because section 36(b) limits recovery to the adviser's receipt of excessive compensation within one year prior to commencement of the suit,[79] the court declared that the delay caused by the directors' review of the shareholder grievance would preclude full recovery in many cases.[80] The *Fox* court suggested that Congress was aware of this hazard, and therefore Congress would not have developed the one-year limitation on recovery if the demand requirement was to apply in section 36(b) litigation.[81] The *Fox* court recognized the value of the demand requirement in standard shareholder derivative suits, but concluded that because of the unique nature of a section 36(b) lawsuit, the requirement of shareholder demand on fund directors would be a futile exercise.[82]

In *Weiss v. Temporary Investment Fund, Inc.*,[83] the most recent appellate court decision on the section 36(b) demand requirement issue, the Third Circuit held that a shareholder section 36(b) action is a derivative

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[73] *See* 692 F.2d at 256-61.

[74] *See id.* at 259 (citing S. REP. No. 184, 91st Cong., 2d Sess. 1, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4898).

[75] *See id.* Although the *Fox* court recognized that Congress desired disinterested fund directors to watch over the management of investment funds, the court suggested that by referring to the powers of disinterested directors Congress merely intended to declare that directors have obligations to conduct business in a responsible manner. *See id.* at 260.

[76] *See id.* at 261.

[77] *See id.* at 261-62.

[78] *See id.* at 261 (citing Burks v. Lasker, 441 U.S. at 483-86)).

[79] *See* 15 U.S.C. § 80a-35(b)(3) (1976).

[80] *See* 692 F.2d at 261-62; *infra* note 157-58 and accompanying text (burden of one-year limitation period under § 36(b)).

[81] *See id.* at 262.

[82] *See id.*

[83] 692 F.2d 928 (3d Cir. 1982).

suit subject to the rule 23.1 demand requirement.[84] The plaintiff in *Weiss*, a shareholder of Temporary Investment Fund (TI Fund), alleged that Provident Institutional Management Corporation (Provident Management), the adviser and manager of TI Fund, and Shearson Loeb Rhodes, Inc. (Shearson), the underwriter and a partial administrator for TI Fund, breached their fiduciary duties under section 36(b) by receiving excessive compensation from TI Fund.[85] In bringing suit to require Provident Management and Shearson to repay all excessive fees to TI Fund, the plaintiff acknowledged in his complaint that he had not made a demand on TI Fund directors.[86] The plaintiff asserted, however, that demand is not a prerequisite to section 36(b) suits.[87]

The *Weiss* court initially discussed the plaintiff's argument that a shareholder suit under section 36(b) is not a derivative action, and therefore is no subject to the rule 23.1 demand requirement.[88] The Third Circuit relied on a test that the Supreme Court developed in *Cort v. Ash*[89] to determine whether a federal statute implicitly contains a private right of action.[90] Concluding that the *Cort* requirements do not preclude the implication of an investment company remedy under section 36(b), the *Weiss* court held that the investment company has a right of action, and therefore the shareholder section 36(b) action is derivative.[91]

[84] *See id.* at 933-42.

[85] 692 F.2d at 931. In *Weiss*, TI Fund paid Provident Management and Shearson advisory fees based on a declining-scale percentage rate of TI Fund's assets. *Id.* Provident Management and Shearson each received .175% of the first $300 million in TI Fund's assets, .15% of the next $300 million, .125% of the third $300 million, and .1% of average assets in excess of $900 million. *Id.* The surge in the popularity of money market funds led to a dramatic increase in TI Fund's assets, producing a proportionate rise in the amount of advisory compensation that TI Fund paid to Provident Management and Shearson. *See id.*

[86] *Id.*

[87] *Id.* The district court in *Weiss* determined that shareholders must make a demand on directors before filing § 36(b) claims. *Id.* at 932; *see* 516 F. Supp. 665, 668-70 (D. Del. 1981). Finding that the plaintiff's demand on TI Fund's directors would not have been futile, the district court refused to excuse demand and dismissed the plaintiff's complaint. *See* 692 F.2d at 932; 516 F. Supp. at 671-73.

[88] *See* 692 F.2d at 934-36.

[89] 422 U.S. 66, 78 (1975).

[90] *See* 692 F.2d at 934-36.

[91] *See id.* at 936. The *Weiss* court held that because the investment company is the intended beneficiary of § 36(b), the implication of a § 36(b) right of action for investment companies conforms to the first factor of the four-part *Cort v. Ash* test. *See id.* at 935. In evaluating the second *Cort* factor, the Weiss court did not find that Congress made an explicit expression that the investment company has a right of action under § 36(b). *See id.* The *Weiss* court decided, however, that Congress presumably knew of the implication of investment company rights of action at common law and under ICA provisions existing prior to the 1970 amendments. *See id.* at 935-36. The court concluded, therefore, that Congress implicitly approved of the incorporation of the investment company's right to sue under § 36(b). *See id.* The Weiss court also held that an implied § 36(b) cause of action for investment companies conforms to the third factor of the *Cort* test because an investment company right of action provides another method of recovering excessive advisory fees,

The *Weiss* court next considered the plaintiff's argument that the legislative history and statutory scheme of section 36(b) manifest Congress' intent to excuse shareholder section 36(b) suits from the rule 23.1 demand requirement.[92] The *Weiss* court decided that the excerpts of legislative history cited by the plaintiff did not demonstrate direct congressional intent to eliminate the demand requirement,[93] and the court referred instead to passages reflecting Congress' intent to preserve the role of management.[94] In discussing the one-year limitation period on damages under section 36(b), the *Weiss* court declared that the provision would not reduce the allowable recovery in most suits, and therefore was not an indication that Congress intended to eliminate the demand requirement.[95] The *Weiss* court also decided that even if directors may not terminate section 36(b) suits,[96] the demand requirement provides directors with the opportunity to resolve shareholder grievances without resorting to litigation.[97] The Third Circuit concluded, therefore, that the rule

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and therefore is consistent with the underlying purposes of the statute. *See id.* at 936. Finally, the *Weiss* court found that the implication of an investment company right of action under § 36(b) satisfies the fourth and final *Cort* requirement by not creating any interference with traditional state law coverage. *See id.*

[92] *See id.* The *Weiss* court established at the outset that a presumption exists that rule 23.1, like all Federal Rules of Civil Procedure, applies in any civil suit brought in federal district court unless inconsistent with a congressional enactment. *Id.* (citing FED. R. CIV. P. 1 and 28 U.S.C. § 2071 (1976)).

[93] *See* 692 F.2d at 937. In support of his argument, the plaintiff in *Weiss* cited excerpts from the legislative history of § 36(b) that suggest Congress' awareness that unaffiliated directors have been unable to obtain alterations in the level of advisory compensation, and Congress' intention to establish an effective means by which shareholders and courts could enforce the fiduciary obligations of investment advisers. *See id.* (citing H.R. REP. No. 2337, 89th Cong., 2d Sess. 131, 143, 146 (1966), and S. REP. No. 184, 91st Cong., 1st Sess. 2, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4898).

[94] *See id.* (citing S. REP. No. 184, 91st Cong., 1st Sess. 5, 6, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4902-03). The *Weiss* court cited a statement from the congressional hearings on the proposed ICA amendments in which then SEC Chairman Hamer Budge suggested that a shareholder cause of action would not encourage nuisance suits because of safe-guards within the Federal Rules of Civil Procedure. *See id.* at 938 (citing *Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. of Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess. 201 (1969)). The *Weiss* court interpreted the statement as referring to the rule 23.1 demand requirement. *See id.*

[95] *See* 692 F.2d at 938; 15 U.S.C. § 80a-35(b) (1976); *infra* notes 157-59 and accompanying text (describing one-year limitation period on damages under § 36(b)). The *Weiss* court recognized that at least one court has identified the § 36(b) limitation period as a basis for suggesting that the demand requirement should not apply to section 36(b) suits. 692 F.2d at 938 (citing Blatt v. Dean Witter Reynolds Intercapital, Inc., 528 F. Supp. 1152, 1155 (S.D.N.Y. 1982)). The *Weiss* court stated, however, that shareholders could make a demand promptly and directors could consider the demand in an expeditious manner. *See id.*

[96] *See* 692 F.2d at 939. The *Weiss* court conceded that the Supreme Court has suggested strongly that directors may not terminate § 36(b) suits, but the court maintained that the impact of the Supreme Court's message was unclear. *See id.*; *infra* note 150 (director termination not applicable to § 36(b) suits).

[97] *See* 692 F.2d at 942.

23.1 demand requirement applies to section 36(b) actions because depriving directors of the opportunity to respond to shareholder grievances would frustrate the ICA's objective of strengthening investment company management through its independent directors.[98]

The *Weiss*, *Fox*, and *Grossman* courts recognized that the rule 23.1 demand requirement will apply to section 36(b) shareholder actions only if the suits are derivative.[99] In contrast to a direct shareholder action, a derivative suit is an action shareholders institute on behalf of the corporation, rather than for the direct benefit of the individual shareholders.[100] In direct actions, the shareholder plaintiff generally is the recipient of the award, while in derivative actions the recovery returns to the corporation's treasury.[101] Since shareholders bring section 36(b) suits to recover excessive advisory fees on behalf of the investment company,[102] the section 36(b) action resembles a traditional derivative suit.[103] Perhaps because of this outward similarity, the Supreme Court has described the shareholder section 36(b) suit as a derivative action.[104] A prerequisite to a derivative action, however, is that the corporation must have the right of action that the shareholders seek to assert.[105] The corporation must have a cause of action in derivative suits because the corporation is the true party in interest and the shareholders are merely nominal plaintiffs.[106]

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[98] *See id.* One of the *Weiss* judges filed a lengthy dissent to the majority's holding on § 36(b). *See id.* at 944-53 (Gibbons, J., dissenting) (concluding demand requirement inapplicable to § 36(b) suits).

[99] *See Weiss*, 692 F.2d at 933-34; *Fox*, 692 F.2d at 253-54; *Grossman*, 674 F.2d at 120; *see also* FED. R. CIV. P. 23.1 (applying only to derivative actions by shareholders).

[100] *See* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND BUSINESS ENTERPRISES 756 (2d ed. 1970); 13 W. FLETCHER, *supra* note 60, at § 5939. A shareholder action is direct, rather than derivative, when the corporation does not suffer the alleged injury, and the plaintiff claims injury as an individual shareholder. *See* 13 W. FLETCHER, *supra* note 60, at § 5911. Examples of direct shareholder actions include claims alleging fraud directly affecting the plaintiff, alleging violation of a right belonging severally to the plaintiff, or alleging the plaintiff's involvement in a contractual dispute. *See id.*

[101] *See* Note, *Derivative Actions: Policy Considerations Leading to Choice of Derivative Form*, 40 CALIF. L. REV. 127, 127 (1952).

[102] *See* 15 U.S.C. § 80a-35(b) (1976) (authorizing shareholder action to sue adviser on behalf of investment company for breach of fiduciary duty with respect to compensation); *Weiss*, 692 F.2d at 935 (recovery in shareholder § 36(b) suit reverts to investment company and not to plaintiff); *Fox*, 692 F.2d at 255 (same).

[103] *See Grossman*, 674 F.2d at 120 (shareholder suits on behalf of company normally derivative). A shareholder suit ordinarily is derivative when the action seeks to recover corporate assets or is based on a contract between the corporation and a third party. 13 W. FLETCHER, *supra* note 60, §§ 5926-5927.

[104] *See* Burks v. Lasker, 441 U.S. 471, 484 (1979) (dictum).

[105] *See* 13 W. FLETCHER, *supra* note 60, § 5947; N. LATTIN, THE LAW OF CORPORATIONS 349 (1959).

[106] *See* 13 W. FLETHCER, *supra* note 60, § 5939. Derivative suits seek to enforce rights belonging to a corporation when the corporation fails to act in its own behalf. *See* N. LATTIN, *supra* note 110, at 349; 3B MOORE'S FEDERAL PRACTICE ¶ 23.1 .16[1] (2d ed. 1982). The derivative suit, therefore, is subject to any limitations affecting the corporate right of ac-

The rule 23.1 demand requirement, therefore, is applicable only to shareholder derivative actions brought to enforce a right that the corporation itself may assert.[107] Because section 36(b) does not provide an express right of action in favor of the investment company,[108] an implied corporate right of action must exist for the rule 23.1 demand requirement to apply.[109]

A determination of whether an implied right of action exists for the investment company under section 36(b) necessarily involves consideration of the Supreme Court's policy regarding the implication of private remedies from federal statutes.[110] In establishing a pattern of restricting the implication of statutory remedies in recent decisions,[111] the Supreme

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tion since the shareholders derive their right of action from the corporation. 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1834 (1972).

[107] *See* FED. R. CIV. P. 23.1 (applies only when shareholder's corporation fails to enforce right corporation properly may assert).

[108] *See* 15 U.S.C. § 80a-35(b) (1976) (providing express action only for SEC and shareholders of investment companies); *Weiss*, 692 F.2d at 934 (recognizing that express language of § 36(b) does not authorize right of action for investment company); *Fox*, 692 F.2d at 254-55 (same).

[109] *See Fox*, 692 F.2d at 254 (demand not required if investment company may not bring suit under § 36(b)).

[110] *See Weiss*, 692 F.2d at 934-36 (citing Supreme Court policy as authority for finding implied investment company right of action under § 36(b)); *Fox*, 692 F.2d at 254-61 (citing Supreme Court policy as authority for determination that no implied investment company right exists under § 36(b)); *see also infra* note 111 (evolution of Supreme Court policy on implied causes of action).

[111] *See* Merrill Lynch, Pierce, Fenner & Smith v. Curran, 102 S. Ct. 1825, 1837-39 (1982) (in recent decisions Supreme Court has modified approach to implication of remedies from federal statutes). The Supreme Court first recognized the existence of an implied private cause of action arising from a federal statute in *Texas & Pacific Ry. Co. v. Rigsby*. *See* 241 U.S. 33, 39-41 (1916) (railroad employee granted personal injury action based upon federal statute prescribing railroad equipment standards). Later, in *J.I. Case Co. v. Borak*, the Court held that courts could imply a right of action from a federal statute if the implied remedy effectuated the purposes for which Congress enacted the statute. *See* 377 U.S. 426, 431-34 (1964) (holding cause of action implied under § 14(a) of the Securities Exchange Act of 1934). In *Cort v. Ash*, the Court established four factors relevant to the determination of whether an implied cause of action arises from a federal statute. *See* 422 U.S. 66, 78 (1975) (finding no implied remedy under Federal Election Campaign Act Amendments of 1974). The relevant factors include whether the language of the statute indicates that the plaintiff is a member of the class for whose benefit Congress enacted the statute, whether evidence exists of legislative intent to create or deny a private remedy, whether the implication of such a remedy is consistent with the underlying objectives of the legislation, and whether the remedy is traditionally a concern of state law. *Id.* In *Cannon v. University of Chicago*, the Court applied the *Cort* test again but warned that in the future the Court would imply remedies under federal statutes only in limited situations. *See* 441 U.S. 677, 717 (1979). Later, in *Touche Ross & Co. v. Reddington*, the Court applied only the first two factors of the *Cort* test. *See* 442 U.S. 560, 576 (1979) (finding no cause of action implied under § 17(a) of the Securities Exchange Act of 1934). The Supreme Court continued its restriction of the statutory implication doctrine in *Transamerica Mortgage Advisers, Inc. v. Lewis*. *See* 444 U.S. 11, 18-24 (1979) (holding implied remedy exists under § 215 but not under § 206 of the Investment Advisers Act of 1940). The *Transamerica* Court decided that no implied cause of action exists when a statute expressly provides alternative remedies, since Congress' creation

Court has stated that the process for determining whether Congress implicitly intended to create a particular private right of action is first to evaluate the statutory language, and then to interpret the statute in light of its legislative history.[112] The statutory language of section 36(b), while specifically creating rights of action only in favor of the SEC and investment company shareholders, states that the authorized plaintiffs sue "on behalf" of the fund.[113] In *Grossman*, the First Circuit interpreted the "on behalf of" language to denote that shareholder section 36(b) suits are derivative.[114] As the Second Circuit recognized in *Fox*, however, the language indicating that plaintiffs institute section 36(b) suits on behalf of the fund merely signifies that the plaintiffs, whether the SEC or investment company shareholders, seek to recover excessive advisory fees and return them to the fund treasury.[115] The section 36(b) action thus resembles a derivative suit when shareholders are the plaintiffs,[116] but the statutory language of the section does not imply that investment companies have a right of action against investment advisers for excessive fees.[117]

In examining the legislative history of section 36(b), the Third Circuit in *Weiss* relied partly on precedent the Supreme Court established in *Merrill Lynch, Pierce, Fenner & Smith v. Curran*.[118] In *Curran*, the Supreme

of certain remedies suggests that it was capable of providing others but chose not to. *See id.* at 19-21. In recent decisions, the Supreme Court has reinforced the approach it applied in *Touche Ross* and *Transamerica* by emphasizing that the critical determination is the intent of Congress when Congress enacted the statute as reflected by the statute's language and legislative history. *See, e.g.*, Jackson Transit Auth. v. Amalgamated Transit Union, 102 S. Ct. 2202, 2207-10 (1982) (finding no cause of action implied under § 13(c) of the Urban Mass Transportation Act of 1964); Merrill Lynch, Pierce, Fenner & Smith v. Curran, 102 S. Ct. 1825, 1837-48 (1982) (holding private right of action exists under Commodity Exchange Act); Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n, 453 U.S. 1, 11-21 (1981) (finding no implied right of action under Federal Water Pollution Control Act and Marine Protection, Research, and Sanctuaries Act of 1972); California v. Sierra Club, 451 U.S. 287, 292-98 (1981) (finding no implied right of action under § 10 of Rivers and Harbors Appropriation Act of 1899). *See generally*, Maher, *Implied Private Rights of Action and the Federal Securities Laws: A Historical Perspective*, 37 WASH. & LEE L. REV. 783 (1980); Note, *The Implication Doctrine After* Touche Ross *and* Transamerica: *The State of Implied Causes of Action in Federal Regulatory Statutes*, 26 VILL. L. REV. 433 (1981).

[112] *See* Middlesex County Sewerage Auth. v. National Sea Clammers Ass'n, 453 U.S. 1, 13 (1980).

[113] *See* 15 U.S.C. § 80a-35(b) (1976).

[114] *See Grossman*, 674 F.2d at 120; *supra* note 59 (*Grossman* interpretation of § 36(b) "on behalf of" language).

[115] *See Fox*, 692 F.2d at 255.

[116] *See supra* notes 100-03 and accompanying text (shareholder suits to benefit corporation are normally derivative).

[117] *See Fox*, 692 F.2d at 255.

[118] *See Weiss*, 692 F.2d at 935-36; *see also* Merrill Lynch, Pierce, Fenner & Smith v. Curran, 102 S. Ct. 1825 (1982). To support its finding that an implied investment company right of action exists under § 36(b), the *Weiss* court relied heavily on the test that the Supreme Court enunciated in *Cort v. Ash*. *See Weiss*, 692 F.2d at 934-36; *see also* Cort v. Ash, 422 U.S. 66, 78 (1975); *supra* note 91 (*Weiss* application of *Cort* test); *supra* note 111 (describing

Court considered the focus of the implied action analysis in situations in which Congress enacts amending legislation within a federal statutory scheme for which courts already have recognized an implied remedy.[119] The *Curran* Court held that in such situations the inquiry is not whether Congress implicitly intended to create a new remedy, but whether Congress intended to preserve the pre-existing judicially implied remedy.[120] Applying the *Curran* analysis, the *Weiss* court concluded that Congress assumed that an implied investment company right of action exists under section 36(b) because, prior to the section's enactment, courts had implied shareholder remedies under former section 36 and described them as derivative actions.[121] In suits prior to the 1970 amendment, however, judicial decisions that described implied shareholder actions as derivative did not reflect any understanding that the investment company had an

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Cort test). As the *Weiss* dissent recognized, however, recent Supreme Court decisions have modified greatly the significance of the *Cort* test. *See* 692 F.2d at 953 (Gibbons, J., dissenting); *supra* note 111 (evolution of Supreme Court policy on implied causes of action). In *Merrill Lynch, Pierce, Fenner, & Smith v. Curran*, the Court suggested that the *Cort* test is useful only as a secondary inquiry when direct evidence of congressional intent does not lead to a conclusive determination that a federal statute implies a private right of action. *See* 102 S. Ct. at 1844; *The Supreme Court, 1981 Term*, 96 HARV. L. REV. 62, 239 (1982) (analysis of *Merrill Lynch, Pierce, Fenner & Smith v. Curran*). A strict reliance on the *Cort* factors could mislead the implied action analysis under § 36(b) so that, for example, a finding that the investment company is the intended beneficiary of § 36(b) would satisfy the first *Cort* factor but would not take into consideration the potential inability of fund directors to represent properly the investment company's interests. *See Weiss*, 692 F.2d at 935 (finding first *Cort* factor satisfied since investment company is intended beneficiary of § 36(b)); *see also infra* text accompanying notes 135 & 136 (Congress probably did not believe fund directors would sue advisors under § 36(b) although investment company might benefit from suit).

Although the First Circuit in *Grossman* found an implied investment company right of action under § 36(b), the *Grossman* court did not evaluate the legislative history of § 36(b) to reach that determination. *See Grossman*, 674 F.2d at 120. The *Grossman* court simply stated that the § 36(b) language indicating that plaintiffs bring suit on behalf of the fund suggests that Congress believed that Congress was not required to specify that the investment company had a right of action. *See id.*; *supra* notes 114 & 115 and accompanying text (contrasting interpretations of § 36(b) "on behalf of" language by *Grossman* and *Fox* courts).

[119] *See* 102 S. Ct. at 1839.

[120] *See id.* The *Curran* Court held that an implied right of action exists under the Commodity and Exchange Act (CEA) after finding that courts had implied the remedy prior to congressional amendments to the CEA, and that the legislative history of the amendments indicated Congress intended to preserve the implied remedy. *Id.* at 1837-48.

[121] *See Weiss*, 692 F.2d at 935-36. Because courts generally had described shareholder common-law actions alleging excessive advisory fees as derivative actions, the *Weiss* court cited the *Curran* analysis as authority for the court's conclusion that Congress expected the § 36(b) action to be derivative. *See* 692 F.2d at 935 n.9. Under the *Curran* holding, however, the implied action analysis focuses on whether Congress intended to preserve a pre-existing implied remedy only when courts imply the pre-existing remedy under a federal statute that Congress subsequently amended. *See* 102 S. Ct. at 1839. The *Curran* analysis, therefore, does not apply to common-law actions since they exist as a matter of state law and courts do not imply them from federal statutes. *See* 692 F.2d at 953 (Gibbons, J., dissenting).

implied right of action.[122] The remedy that courts implied under former sections 36(b), furthermore, is codified presently under section 36(a) of the ICA, which is a substantially different provision than section 36(b).[123] Because an implied investment company remedy did not precede section 36(b), therefore, the *Curran* rationale is not relevant to the determination of whether Congress intended to create an implied investment company right of action.[124] The examination of the legislative history of section 36(b) consequently is not focused on whether Congress intended to preserve a pre-existing remedy, but rather whether Congress intended to create a new investment company right of action under section 36(b).[125]

To support a finding that Congress did not intend to create an investment company right of action under section 36(b), the Second Circuit in *Fox* relied on the Supreme Court's analysis in *Middlesex County Sewerage Authority v. National Sea Clammers Association.*[126] The *Middlesex* Court determined that when a statute expressly provides specific enforcement mechanisms, courts should not assume in the absence of strong evidence of contrary legislative intent that Congress sought to authorize implied rights of action.[127] Section 36(b) explicitly authorizes a right of action for the SEC and investment company shareholders, but the provision does

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[122] *See* Moses v. Burgin, 445 F.2d 369, 371-85 (1st Cir.) (shareholder action under former ICA provision in which court did not mention right of investment company to sue), *cert. denied,* 404 U.S. 994 (1971); Levitt v. Johnson, 334 F.2d 815, 816-20 (1st Cir. 1964) (same), *cert. denied,* 379 U.S. 961 (1965); Chabot v. Empire Trust Co., 301 F.2d 458, 459-62 (2d Cir. 1962) (same); Brown v. Bullock, 294 F.2d 415, 417-22 (2d Cir. 1961) (same).

[123] *Compare* 15 U.S.C. § 80a-35(a) (1976) (authorizing SEC to bring action against investment company directors or advisers for breach of fiduciary duty involving personal misconduct and empowering courts to enjoin violators) *with id.* § 80a-35(b) (authorizing shareholders or SEC to sue investment adviser on behalf of investment company for breach of fiduciary duty with respect to compensation). *See Weiss,* 692 F.2d at 935 (shareholder action under former § 36 now § 36(a) action). Although § 36(a) does not provide an express cause of action for shareholders, courts have implied a remedy for shareholders under the provision. *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, 728 n.72 (1982) [hereinafter cited as *Termination of Section 36(b) Actions*] (citing cases inferring shareholder right to bring § 36(a) suit); Note, *Implied Private Rights of Action Under the Investment Company Act of 1940,* 40 Wash. & Lee L. Rev. 1069, 1087-88 (1983) (concluding implied cause of action for shareholders exists under § 36(a)).

[124] *See Weiss,* 692 F.2d at 953 (Gibbons, J., dissenting).

[125] *See Curran,* 102 S. Ct. at 1839 (when Congress enacts legislation in statutory scheme in which no implied remedy previously existed, focus of inquiry is congressional intent to create impliedly new remedy).

[126] 453 U.S. 1 (1981); *see Fox,* 692 F.2d at 255 (citing *Middlesex* decision).

[127] *See* 453 U.S. at 13-15. In *Middlesex,* the Supreme Court held that implied rights of action do not exist under the Federal Water Pollution Control Act and the Marine Protection, Research, and Sanctuaries Act of 1972 after finding that the enactments expressly provide elaborate enforcement mechanisms. *See id.* The *Middlesex* Court reasoned that, without strong evidence of contrary congressional intent, Congress' creation of specific express causes of action is conclusive evidence that Congress provided the precise remedies it considered appropriate. *See id.* at 15.

not state that the investment company itself may sue under section 36(b).[128] In the absence of a decisive finding of contrary congressional intent, therefore, the *Middlesex* rationale suggests that an implied remedy in favor of the investment company does not exist under section 36(b).[129]

The legislative history of section 36(b) is ambiguous on the issue of whether Congress intended to create a right of action for investment companies.[130] While Congress enacted section 36(b) to create a more effective mechanism by which shareholders and the SEC could recover payments of excessive advisory fees,[131] Congress expressed a desire that independent investment company directors also play a significant role in determining advisory compensation.[132] By strengthening the role of independent directors, however, Congress sought not to establish an investment company right of action under section 36(b), but rather to create a means of providing more responsible and effective management of the investment company industry.[133] The central purpose of enacting section 36(b) clearly was to control the potential conflicts of interest confronting investment company directors in the setting of advisory fees.[134] Congress, therefore, probably did not contemplate that fund directors actually would

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[128] *See* 15 U.S.C. § 80a-35(b); *supra* note 108 and accompanying text (§ 36(b) does not provide express right of action for investment company).

[129] *See Fox*, 692 F.2d at 255.

[130] *See Weiss*, 692 F.2d at 935 (legislative history of § 36(b) contains no explicit congressional intent either to foreclose or to create investment company remedy); *Fox*, 692 F.2d at 258 (legislative history of § 36(b) neither approves nor disapproves of investment company suits); *Grossman*, 674 F.2d at 121 (debate on legislative history of § 36(b) is close); *c.f.*, Fogel v. Chestnutt, 668 F.2d 100, 112 (2d Cir. 1981) (§ 36(b) language ambiguous) (quoting JENNINGS & MARSH, SECURITIES REGULATION: CASES AND MATERIALS 1396-97 (4th ed. 1977)), *cert. denied*, 103 S. Ct. 65 (1982).

[131] *See* S. REP. NO. 184, 91st Cong., 2d Sess. 4, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4901 (§ 36(b) enacted to ease standard of determining excessiveness of advisory fees).

[132] *See id.* at 4903 (courts should not ignore directors' responsible determination of advisory fee).

[133] *See* Burks v. Lasker, 441 U.S. 471, 482-83 (1979) (in strengthening role of independent directors, ICA assigns to them multiplicity of responsibilities including management supervision and financial auditing); *Fox*, 692 F.2d at 260 (congressional intent to strengthen role of independent directors is merely imposition of managerial responsibility). While emphasizing the strengthened role of independent directors, the Senate report introducing § 36(b) only specified that either the SEC or shareholders may sue under the provision. *See* S. REP. NO. 184, 91st Cong., 2d Sess. 6, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4903.

[134] *See* Burks v. Lasker, 441 U.S. 471, 480-81 (1979) (in enacting ICA, Congress concerned about abuse potential inherent in investment company structure); *Fox*, 692 F.2d at 258-59 (Congress recognized source of excessive advisory fee problem was potential conflicts of interest in investment company structure); Markowitz v. Brody, 90 F.R.D. 542, 552-53 (S.D.N.Y. 1981) (Congress enacted § 36(b) out of concern that mutual fund industry structure prevented arm's-length bargaining over advisory fee); S. REP. NO. 184, 91st Cong., 2d Sess. 4, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4901 (forces of arm's-length bargaining not present in investment company industry as in other sectors of economy).

sue their advisers,[135] even though the investment company would benefit by recovering excessive advisory fees.[136] Strong evidence of congressional intent to imply an investment company right of action does not exist, therefore, to override the presumption that Congress intended to provide the SEC and investment company shareholders with the sole means to enforce section 36(b).[137] Since the investment company may not assert an enforceable right under section 36(b), shareholder section 36(b) suits are not derivative and the rule 23.1 demand requirement does not apply.[138]

Even assuming a judicial determination that shareholder section 36(b) suits are derivative,[139] the distinctive nature of section 36(b) strongly suggests that Congress did not intend the rule 23.1 demand requirement to apply in mutual fund advisory fee litigation.[140] The section 36(b) suit, due to the many restrictions of the provision, differs from the traditional shareholder derivative suit.[141] Under section 36(b), the plaintiff has the burden of proving a breach of fiduciary duty and may bring suit only against the recipient of the allegedly excessive compensation, and not against the investment company itself.[142] In addition, the section 36(b) plaintiff may not recover excessive fees that the fund paid to the adviser prior to one year before the institution of the suit, and damage awards may not exceed actual damages nor the amount of compensation the adviser has received.[143] The section 36(b) restrictions imply, therefore, that the purpose of the provision is to deter the payment of excessive advisory fees while not subjecting the investment adviser to exorbitant and debilitating damage judgments.[144] The procedural limitations of the section 36(b) action also signify that shareholders sue not to gain large personal judgments, but rather to assist in the enforcement of the statute

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[135] *See Fox*, 692 F.2d at 259 (a conclusion that role of independent directors includes suing advisers defies logic).

[136] *See Weiss*, 692 F.2d at 935 (investment company is intended beneficiary of § 36(b)); *supra* note 115 and accompanying text (fees recovered in § 36(b) return to fund).

[137] *See supra* text accompanying note 129 (*Middlesex* analysis mandates that no implied remedy exists when statute provides specific enforcement mechanisms without strong evidence of contrary congressional intent).

[138] *See supra* note 107 and accompanying text (rule 23.1 demand requirement applies only to shareholder actions seeking to enforce right of action corporation may assert).

[139] *See Weiss*, 692 F.2d at 936 (concluding § 36(b) action is derivative); *Grossman*, 674 F.2d at 120 (same).

[140] *See Fox*, 692 F.2d at 261-62 (finding distinctiveness of § 36(b) suit precludes demand).

[141] *See id.* at 262 (§ 36(b) suit unlike typical shareholder derivative suit); Blatt v. Dean Witter Reynolds Intercapital, Inc., 528 F. Supp. 1152, 1155 (S.D.N.Y. 1982) (§ 36(b) suit distinguished from ordinary derivative suit); *infra* text accompanying notes 143-45 (characteristic differences between § 36(b) suits and traditional derivative suits).

[142] *See* 15 U.S.C. § 80a-35(b)(1), (3) (1976).

[143] *See id.* § 80a-35(b)(3).

[144] *See id.* (limiting recoverable damages to compensation in excess of reasonable advisory fees); *Director Termination, supra* note 57, at 628 (procedural provisions of § 36(b) limit potential recovery while deterring adviser from breaching fiduciary duty).

as "private attorneys general".[145] Shareholder section 36(b) suits, therefore, should be outside investment company control.[146]

Despite the restrictive nature of section 36(b) suits, some courts have held that the demand requirement is necessary to exhaust intracorporate remedies properly.[147] Other courts, however, have held that the demand requirement does not have a legitimate purpose in section 36(b) litigation because investment company directors may not terminate shareholder suits.[148] In shareholder derivative suits, the demand requirement generally serves both to require exhaustion of intracorporate remedies and to allow directors to terminate suits that are harmful to the corporation's best interests.[149] Although conceding that directors may not terminate section 36(b) suits,[150] the *Weiss* court declared that shareholders must make a

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[145] *See Fox*, 692 F.2d at 255 (shareholders bring § 36(b) suits as "private attorneys general" to assist in enforcement of statute). In § 36(b) suits, the investment company treasury, not the plaintiff, receives any monetary recovery that the court awards. *See supra* note 102 and accompanying text. Section 36(b) suits, however, clearly benefit shareholders as a whole since a reduction in excessive advisory compensation will increase the value of fund shares. *See* Markowitz v. Brody, 90 F.R.D. 542, 553 (S.D.N.Y. 1981) (advisory fee abuses potentially affect shareholders since excessive payments reduce value distributed to shareholders). Although the 36(b) plaintiff personally will not benefit greatly because recovery in shareholder suits is normally minimal on a per share basis, the suit has the meaningful effect of deterring future abuses. *See* Coffee & Swartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 304-05 (1981) (aggregated effect of shareholder derivative action is deterrence although typical recovery is minimal on per share basis). Because individual shareholders do not receive compensation for bringing a § 36(b) action, the plaintiff's attorney is the driving force behind the lawsuit. *See id.* at 316.

[146] *See Weiss*, 692 F.2d at 950 (Gibbons, J., dissenting) (shareholder § 36(b) suit is type of private attorney general action outside control of directors).

[147] *See Weiss*, 692 F.2d at 942 (demand requirement gives management opportunity to pursue alternative remedies); *Markowitz v. Brody*, 90 F.R.D. 542, 561 (S.D.N.Y. 1981) (demand gives mutual fund opportunity to engage in informal negotiation); *Demand Requirement*, *supra* note 60, at 171 (original purpose of demand was to prevent judicial interference until intra-corporate remedies exhausted).

[148] *See Fox*, 692 F.2d at 261 (traditional reason for demand requirement not applicable partially because directors may not terminate § 36(b) suit); Blatt v. Dean Witter Reynolds Intercapital, Inc., 528 F. Supp. 1152, 1155 (S.D.N.Y. 1982) (demand requirement not applicable in § 36(b) suit since directors may not terminate plaintiff's suit nor bring suit themselves); *see also supra* note 60 (director termination of derivative suits); *infra* note 150 (directors may not terminate § 36(b) suits).

[149] *See Demand Requirement*, *supra* note 60, at 169 (director termination of derivative suits).

[150] See *Weiss*, 692 F.2d at 939 (acceding to strong signal from Supreme Court that directors may not terminate § 36(b) suits). In *Burks v. Lasker*, the Supreme Court stated in dictum that Congress did not intend investment company directors to have the power to terminate § 36(b) suits. *See* 441 U.S. 471, 484 (1979). Recognizing that the statement, although dictum, was an integral part of the Court's holding in *Burks*, lower courts have interpreted the *Burks* statement as a strong indication that directors may not terminate § 36(b) suits. *See Weiss*, 692 F.2d at 939; *Fox*, 692 F.2d at 261 (citing *Burks* for holding that directors may not terminate § 36(b) suit); *c.f. Grossman*, 674 F.2d at 121 & n.12 (assuming arguendo that directors may not terminate § 36(b) suits since *Burks* dictum formed integral part of

demand so that directors informally may resolve shareholder grievances and thereby avoid unnecessary lawsuits.[151] As the *Fox* court recognized, however, investment company directors are unlikely to engage in effective negotiations with the adviser to recover allegedly excessive fees since the directors necessarily approved payment of the advisory compensation originally.[152] In the unlikely circumstance that directors are able to negotiate effectively with the investment adviser, the negotiation could occur during the pretrial stages of the litigation.[153] In section 36(b) litigation, therefore, the elimination of the demand requirement will not affect

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Court's holding). The *Grossman* district court held that directors may terminate § 36(b) suits. *See* Grossman v. Johnson, 89 F.R.D. 656, 664 (D. Mass. 1981); *see also supra* note 58 (*Grossman* district court holding). The First Circuit in *Grossman* chose not to rule on the district court's summary judgment that granted director termination of the suit. *See* 674 F.2d at 126; *see also supra* text accompanying note 62 (*Grossman* holding). Citing *Grossman* as authority, however, a district court in the First Circuit recently chose not to dismiss a shareholder § 36(b) action on the recommendation of a litigation committee of disinterested directors exercising business judgment. *See* Evangelist v. Fidelity Management & Research Co., [Current] FED. SEC. L. REP. (CCH) ¶ 99,094, at 95,226 (1982); *see also Director Termination, supra* note 57, at 614-31 (criticizing *Grossman* district court opinion and concluding director termination of § 36(b) suits contrary to legislative intent). *But see Termination of § 36(b) Actions, supra* note 123, at 733-43 (relying on *Grossman* district court opinion to conclude director termination appropriate in § 36(b) suits).

[151] *See Weiss*, 692 F.2d at 942 (demand especially important if directors may not terminate § 36(b) suits since demand provides opportunity to resolve grievances without litigation). The *Grossman* court suggested that one of the purposes of applying the rule 23.1 demand requirement in § 36(b) cases is to discourage unjustified shareholder suits. *See Grossman*, 674 F.2d at 122. According to some critics, corrupt attorneys may initiate strike suits to coerce settlements from corporations that seek to avoid litigation. *See* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit*, 75 NW. U.L. REV. 96, 137 (1980) (critics claim derivative suits are subject to abuse by unscrupulous attorneys seeking to extort corporate settlements). Commentators have suggested, however, that the beneficial deterrent effect on corporate management, caused by the threat of possible strike suits, outweighs the potential harm strike suits might cause. *See* N. LATTIN, *supra* note 105 at 140 (cleansing effect of threat outweighs possible strike suit abuse). The trial judge, moreover, may dissuade potential absues of derivative suits. *See* Weinstein, *Some Reflections on the "Abusiveness" of Class Actions*, 58 F.R.D. 299, 302 (1973) (discretion of trial judge may reduce effect of possible abuse).

[152] *See Fox*, 692 F.2d at 254 n.7; Blatt v. Dean Witter Reynolds Intercapital, Inc., 528 F. Supp. 1152, 1156 (S.D.N.Y. 1982) (speculative at best that directors will satisfy shareholder objectives since directors approved challenged fees). Rule 23.1 allows derivative suit plaintiffs to allege an excuse for not making a demand on directors. *See* FED. R. CIV. P. 23.1. Courts generally excuse demand when the plaintiff demonstrates that a demand would meet rejection by the directors. *See* 1 MOORE'S MANUAL, FED. PRAC. & PROCEDURE 14.07[8] (1982) (courts dispense with demand when directors clearly would reject). The *Fox* court suggested that investment company directors are always "interested," so that courts inevitably will excuse demand in § 36(b) suits. *See Fox*, 692 F.2d at 261 n.13.

[153] *See* Blatt v. Dean Witter Reynolds Intercapital, Inc., 528 F. Supp. 1152, 1156 (S.D.N.Y. 1982) (nothing prevents directors from negotiating after commencement of suit and thereby mooting plaintiffs' claims); *c.f.* Evangelist v. Fidelity Management & Research Co., [Current] FED. SEC. L. REP. (CCH) ¶ 99,094, at 95,224 (1982) (investment company negotiated reduction in advisory fees after receiving demand but plaintiff claimed fees remained excessive).

the proper roles of investment company directors.[154]

While the demand requirement is not necessary to maintain effective investment company management, its application frustrates the adjudication of shareholder section 36(b) suits.[155] The plaintiff's task of making a demand on directors in shareholder suits is not burdensome in itself.[156] The section 36(b) one-year limitation period, however, may obviate full recovery of excessive advisory fee payments if directors choose to prevent the plaintiffs from promptly filing suit.[157] Investment company directors could utilize the demand requirement to adjust advisory fees prospectively while delaying their response to shareholder demand, and consequently cause a significant reduction in the plaintiffs' potential recovery.[158] As several courts have recognized, Congress would not have developed intentionally a method by which directors could circumvent Congress' express intention that section 36(b) provide an effective means for shareholders to sue for the recovery of excessive advisory fees.[159] The distinctiveness of the provisions of section 36(b), therefore, clearly suggests that Congress did not intend the demand requirement to apply to mutual fund advisory fee suits.[160]

Congress established section 36(b) in 1970 to create an effective means by which investment company shareholders and the SEC could control the potential conflicts of interest involved in the setting of mutual fund advisory fees.[161] Since the provision became effective, courts have dismissed shareholder section 36(b) actions for failing to make a demand on direc-

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[154] *See Weiss*, 692 F.2d at 951 (Gibbons, J., dissenting) (restrictive provisions in § 36(b) minimize intrusion on director responsibility); *see also supra* note 133 (responsibilities of investment company directors under ICA).

[155] *See Weiss*, 692 F.2d at 943-44 (affirming dismissal of § 36(b) suit for failure to make demand); *Grossman*, 674 F.2d at 115, 126 (same); Jerozal v. Cash Reserve Management, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 99,019, at 94,822 (S.D.N.Y. 1982) (dismissing § 36(b) action for failure to make demand); Markowitz v. Brody, 90 F.R.D. 542, 562-63 (same).

[156] *See Weiss*, 692 F.2d at 938 (demand is simple procedure not burdensome to shareholders); *Demand Requirement*, *supra* note 60, at 172 (shareholders satisfy demand simply by mailing complaint to directors and threatening to bring suit unless corporation enforces rights).

[157] *See* 15 U.S.C. § 80a-35(b)(3) (1976); *supra* text accompanying note 143 (§ 36(b) plaintiff may not recover excessive fees paid adviser prior to one year before institution of suit); *Fox*, 692 F.2d at 261-62 (delay in director response to demand would preclude full recovery in some cases by preventing plaintiffs from promptly filing suit); Blatt v. Dean Witter Reynolds Intercapital, Inc., 528 F. Supp. 1152, 1156 (S.D.N.Y. 1982) (same).

[158] *See Weiss*, 692 F.2d at 951 (Gibbons, J., dissenting). *But see Grossman*, 674 F.2d at 122 (district court could allow suit to proceed without awaiting director response).

[159] *See Fox*, 692 F.2d at 262 (Congress was aware of problem resulting from § 36(b) one-year limitation period on damages); Blatt v. Dean Witter Reynolds Intercapital, Inc., 528 F. Supp. 1152, 1156 (S.D.N.Y. 1982) (same); *c.f. Weiss*, 692 F.2d at 951 (Gibbons, J., dissenting) (Congress must have discounted director involvement because delays incident to corporate decision-making incompatible with one-year limitation period).

[160] *See supra* notes 140-45 and accompanying text (distinctiveness of § 36(b)).

[161] 15 U.S.C. § 80a-35(b) (1976); *see supra* note 134 and accompanying text.

tors in compliance with rule 23.1 of the Federal Rules of Civil Procedure.[162] In 1982, three United States circuit courts of appeals reached contradictory conclusions in deciding whether shareholder plaintiffs must make a demand on investment company directors prior to instituting a section 36(b) action.[163] The rule 23.1 demand requirement applies only to shareholder suits that are derivative.[164] A shareholder suit is derivative rather than direct only when the corporation has the right of action that the shareholders seek to assert.[165] Section 36(b), however, provides an express right of action only for the SEC and investment company shareholders,[166] and the legislative history of section 36(b) does not reflect congressional intent to create by implication an investment company right of action.[167] Since the investment company has no right to bring suit under section 36(b),[168] shareholder section 36(b) suits are not derivative, and the rule 23.1 demand requirement should not apply.[169] The conclusion that the demand requirement is not applicable to mutual fund advisory fee litigation is consistent with Congress' creation of several restrictive provisions within section 36(b).[170] The distinctive nature of section 36(b) reflects Congress' intention that investment company shareholders bring suit independent of director control.[171] Since mutual fund directors may not sue investment advisers nor terminate shareholder suits,[172] and since the filing of a shareholder action will not render ineffective subsequent director negotiations with investment advisers,[173] the rule 23.1 demand requirement serves no beneficial purpose in section 36(b) litigation.

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[162] *See supra* note 155 (§ 36(b) actions dismissed for failure to make demand).

[163] *See supra* notes 53-98 and accompanying text (discussing *Weiss, Fox* and *Grossman* decisions).

[164] FED. R. CIV. P. 23.1 (applying only to derivative actions by shareholders).

[165] *See supra* note 105 and accompanying text.

[166] *See* 15 U.S.C. § 80a-35(b) (1976) (providing express action only for SEC and shareholders of investment companies).

[167] *See supra* notes 118-37 and accompanying text.

[168] *See supra* notes 107-09 and accompanying text (investment company must have implied right of action for rule 23.1 demand requirement to apply).

[169] *See Fox*, 692 F.2d at 261 (concluding investment company does not have right to action under § 36(b) and rule 23.1 does not apply).

[170] *See supra* notes 140 & 160 and accompanying text (distinctive nature of § 36(b) strongly suggests that Congress did not intend rule 23.1 demand requirement to apply).

[171] *See supra* note 146 and accompanying text.

[172] *See supra* notes 130-37 and accompanying text (investment company has no § 36(b) right of action); *supra* note 155 (directors may not terminate § 36(b) suits).

[173] *See supra* notes 152 & 153 and accompanying text (effective director negotiation with adviser unlikely and not precluded by shareholder initiation of § 36(b) suit).