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THE POWER STRUGGLE BETWEEN SHAREHOLDERS AND DIRECTORS: THE DEMAND REQUIREMENT IN DERIVATIVE SUITS

Tamar Frankel & Wayne M. Barsky***

This article examines the demand shareholders must make on a corporation's board of directors prior to bringing a derivative suit. The article is divided into two parts. The first part analyzes the nature of the demand requirement and its implications generally. The second part evaluates the demand requirement in a narrow federal statutory context: section 36(b) of the Investment Company Act of 1940.¹

We chose this topic and its specific application for two reasons. First, the subject involves important issues relating to corporate power structure. Second, judicial analysis, especially in the federal appellate courts, has been consistent only in its persistent confusion. Consequently, cases are conflicting and provide little guidance for practitioners and the courts alike.

Specifically, this article evaluates judicial decisions on the demand requirement and offers a clearer approach to the subject. Part I of this article, concerning demand generally, is divided into four sections. Section A describes rules of procedure and substance regarding demand and analyzes their effects. Section B examines the diverse and conflicting outcomes of applicable cases. Section C specifies the issues raised by the demand requirement and demonstrates how the cases differ depending on the issues chosen. Section D proposes general principles which should guide the development of the law in the demand area.

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

Part II of this article examines the demand requirement in connection with claims under section 36(b) of the Investment Company Act.

I. THE DEMAND REQUIREMENT

A. *Demand: Procedure and Substance*

Rule 23.1 of the Federal Rules of Civil Procedure² and many state procedural rules³ require that a shareholder plaintiff suing derivatively allege with particularity: (1) the efforts, if any, which he made to obtain the action he desired from the corporate directors, and (2) the reasons for his failure to obtain the action he desired, or the reasons for not making the effort.

These rules are not purely procedural. Clearly, rule 23.1⁴ has been given a substantive component, presumably in accordance with the applicable state law or federal law.⁵ The courts have insisted that the plaintiff not only describe his efforts—or reasons chosen for not making such efforts—to obtain a specific action from the directors, but have further prescribed the legal sufficiency required in these efforts and the basis on which the courts then determine whether the plaintiff may proceed to litigate.⁶ The effect of these procedural rules is to make it mandatory for the plaintiff to bring before the court the issues of his standing to sue derivatively and the directors' power to prevent him from pursuing the litigation. Because of the nebulous distinction between simple pleading requirements and substantive law, the exact issues posed by the pleadings have varied with different cases. The issues seem to stem from related sources which are difficult to isolate. This difficulty is compounded by the different approaches which courts have taken when confronted with a derivative suit. Some courts apply the "business judgment rule,"⁷ while others

2. FED. R. CIV. P. 23.1.

3. *See, e.g.*, CAL. CORP. CODE § 834 (West Supp. 1977); COLO. REV. STAT. § 23.1 (1973); *cf.* N.Y. BUS. CORP. LAW § 626(c) (McKinney 1963).

4. FED. R. CIV. P. 23.1.

5. When a federal statute is involved, the courts determine which law is applicable and to what extent federal law supersedes state law in the case of conflict. *See, e.g.*, *Burks v. Lasker*, 441 U.S. 471 (1979).

6. *See* Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 170, 193-98 (1976). For an analysis of similar treatment in the courts of equity, see *Hawes v. Oakland*, 104 U.S. 450 (1881). *See generally* Buxbaum, *Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 CALIF. L. REV. 1122 (1980) (proposed standards to aid courts in determining when directors' refusal to sue should terminate a shareholder's derivative suit).

7. *E.g.*, *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920

evaluate the underlying corporate claim on the merits.⁸ Still other courts consider the benefits accruing to the corporation from the derivative suit.⁹ As a result of these foregoing considerations, confusion reigns.

B. *Judicial Decisions and Issues*

The decisions regarding the demand requirement will be treated briefly since so much has already been written about them.¹⁰ We have chosen to describe recent cases by listing some of the issues as the various courts have posed them and the divergent results which these courts have reached.

1. *The "Effort."*—Since the rules require the plaintiff to state the efforts he has made to seek the directors' compliance with his wishes or the reason for failing to make such efforts,¹¹ most courts start the inquiry at this point. Courts, however, define the "efforts" in different ways and often vary as to what constitutes an adequate effort.¹²

If the directors are substantially implicated as defendants, demand on them, in some cases, is held to be "futile."¹³ The extent to which the directors are "substantially implicated" may depend on the severity of the derivative claim and the extent to which the directors are the principal defendants involved in the alleged wrongdoing.¹⁴ Thus, at the outset, it appears that the courts evaluate the

(1979).

8. See *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. Sup. Ct. 1981).

9. E.g., *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983).

10. E.g., Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U.L. REV. 96 (1980); Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981); Comment, *supra* note 6.

11. See, e.g., FED. R. CIV. P. 23.1; N.Y. BUS. CORP. LAW § 626(c) (McKinney 1963) ("In any such action, the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reasons for not making such effort.").

12. E.g., *Hawes v. Oakland*, 104 U.S. 450, 460-61 (1881); *Long v. Stites*, 88 F.2d 554, 556 (6th Cir.), cert. denied, 301 U.S. 706 (1937); *Gunn v. Voss*, 154 F. Supp. 345, 347-48 (D. Wyo. 1957).

13. See, e.g., *Delaware & Hudson Co. v. Albany & Susquehanna R.R.*, 213 U.S. 435, 451 (1909); cf. *Abbe v. Goss*, 411 F. Supp. 923 (S.D.N.Y. 1975) (defendant shareholders' control of corporation was sufficient to excuse demand on Board of Directors).

14. Compare *In re Kaufman Mutual Fund Actions*, 479 F.2d 257 (1st Cir. 1973) (conduct alleged not undirected to a legitimate corporate purpose, and therefore, approval by directors of action alleged to be injurious to corporation not sufficient to excuse demand by shareholder on the directors), cert. denied, 414 U.S. 857 (1974), with *Galfand v. Chestnutt*, 402 F. Supp. 1318 (S.D.N.Y. 1975) (fact that directors adamantly and effectively resisted stock-

merits of the derivative claim and the extent of the directors' conflict of interest to determine whether demand is required. When demand is deemed futile, courts usually uphold the shareholder's right to pursue the derivative action.¹⁵ If the demand is not futile, courts may either dismiss the action or allow the plaintiff to make a demand after the institution of the action.

2. *The Reasons for the Directors' Failure to Comply with the Plaintiff's Demands.*—If the shareholder plaintiff shows that he has made adequate demand on the directors, but they refused to conduct the litigation on behalf of the corporation, or to comply with the plaintiff's other wishes, the courts will examine the reasons for the directors' refusal.¹⁶ Once again the directors' conflict of interest becomes an issue. That conflict is evaluated in light of the severity of the allegations and the extent of the directors' implication in the wrongdoing.¹⁷ If the directors are tainted, their recommendations that the action be dismissed may carry little weight. If the directors are not tainted, or if a disinterested group of directors makes the recommendation to dismiss the action, some courts have given that recommendation the force of a "business judgment."¹⁸ Other courts have not given as much deference to such a recommendation.¹⁹

Three cases illustrate the disagreement among the courts and the different treatment of the issues.

In *Burks v. Lasker*,²⁰ Justice Brennan, writing for the majority in a case involving a derivative claim based in part on federal law, stated the issue as "whether the disinterested directors of an investment company may terminate a stockholders' derivative suit

holder's attempt to enjoin meeting on new investment agreement warranted finding demand would be futile), *aff'd and modified on other grounds*, 545 F.2d 807 (2d Cir. 1976).

15. See, e.g., *Clark v. Lomas & Nettleton Fin. Corp.*, 625 F.2d 49 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981).

16. See *Auerbach v. Bennett*, 47 N.Y.2d 619, 623-24, 393 N.E.2d 994, 996, 419 N.Y.S.2d 920, 922 (1979) ("the court may inquire as to the disinterested independence of the members . . . and as to the appropriateness and sufficiency of the investigative procedures chosen and pursued . . ."); see also *Koral v. Savory, Inc.*, 276 N.Y. 215, 217, 220, 11 N.E.2d 883, 885-86 (1937) (whether there was an "unprejudiced exercise of judgment").

17. See, e.g., *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

18. See, e.g., *id.* For a general discussion of the factors to be considered by the directors in exercising their business judgment and the courts' review of the disinterested nature of the directors involved, see *id.* at 631-35, 393 N.E.2d at 1000-02, 419 N.Y.S.2d at 927-29 (1979).

19. E.g., *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. Sup. Ct. 1981).

20. 441 U.S. 471 (1979), *rev'g* 567 F.2d 1208 (2d Cir. 1978), *rev'g* 426 F. Supp. 844 (S.D.N.Y. 1977).

. . . .”²¹ The district court had held that “under the so-called ‘business judgment rule,’ a quorum of truly disinterested and independent directors has authority to terminate a derivative suit which they in good faith conclude is contrary to the company’s best interests.”²² Since the district court found the directors had acted independently and in good faith in terminating the suit, summary judgment was granted.²³ The court of appeals reversed and held that “disinterested directors of an investment company do not have the power to foreclose the continuation of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties.”²⁴

Concurring with Justice Brennan’s reversal and remand,²⁵ Justices Stewart and Powell characterized the directors’ decision to terminate a derivative action as a business decision “no different from any other corporate decision to be made in the collective discretion of the disinterested directors.”²⁶

The New York Court of Appeals in *Auerbach v. Bennett*,²⁷ which dismissed a derivative suit alleging management’s violations of the Foreign Corrupt Practices Act, arrived at a similar rationale to that of Justices Stewart and Powell. The court of appeals phrased the issue thusly:

As all parties and both courts below recognize, the disposition of this case on the merits turns on the proper application of the business judgment doctrine, in particular to the decision of a specially appointed committee of disinterested directors acting on behalf of the board to terminate a shareholder[’s] derivative action.²⁸

In *Zapata Corp. v. Maldonado*,²⁹ the Supreme Court of Delaware rejected the deferential approach taken in *Auerbach*. Presented

21. *Id.* at 473.

22. *Id.* at 474-75 (citing 404 F. Supp. 1172 (S.D.N.Y. 1975) (company’s motion to dismiss denied without prejudice)).

23. 426 F. Supp. 844.

24. 567 F.2d at 1212.

25. The Supreme Court held that “federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the ICA [Investment Company Act] and IAA [Investment Advisers Act].” 441 U.S. at 486. The case was remanded on the question of state law. *Id.*

26. *Id.* at 487 (Stewart, J., concurring and Powell, J., joining) (citations omitted).

27. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

28. *Id.* at 629, 393 N.E.2d at 999-1000, 419 N.Y.S.2d at 926. *But see generally* Dent, *supra* note 10 (questioning a broad application of the business judgment rule in derivative suits).

29. 430 A.2d 779 (Del. Sup. Ct. 1981).

with the question of whether the court would give effect to a decision of a committee of disinterested directors to terminate a shareholder derivative suit alleging directors' breach of fiduciary duties, the court ruled that even if the special committee was truly disinterested and independent, "[t]he Court should determine, *applying its own independent business judgment*, whether the [corporation's] motion [to dismiss the derivative action] should be granted."³⁰

The Second Circuit adopted a similar position, applying Connecticut law, in *Joy v. North*.³¹ The court refused to give effect to a special litigation committee's decision to terminate a shareholder's suit. The court focused on what it considered to be the main issue, namely, the extent to which the action would benefit the corporation, and articulated a standard which the lower court should follow in resolving the issue.³² Following a standard similar to the one mentioned in dictum by Justice Brennan in *Burks v. Lasker*,³³ the *Joy* court held that "[w]here the court determines that the likely recoverable damages discounted by the probability of a finding of liability are less than the costs to the corporation in continuing the action, it should dismiss the case."³⁴

These cases illustrate the different approaches the courts have taken. Some courts have adopted a deferential approach to the directors' opinion, while others have reviewed the situation closely and have reached an independent decision on the merits. The ultimately dispositive issues are stated differently and result in the application of different rules. The courts have had a variety of views of what the demand requirements should achieve and of what their own role in the conflict between the plaintiff shareholder and the corporate directors should be.

C. Analysis

1. *Specifying the Issues and Their Sequence.*—It is useful at this point in our analysis to list what we consider to be the major questions addressed by the demand requirement and the sequence in which these questions should be addressed:

30. *Id.* at 789 (emphasis added).

31. 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983).

32. *Id.* at 892.

33. 441 U.S. at 485.

34. 692 F.2d at 892. If the potential net gain is not substantial, the costs to the corporation in terms of management and employee time, and potential adverse impact on the corporation's reputation may then be taken into account. *Id.*

(1) The main question involved in the demand requirement is whether the suit would benefit the corporation. The procedural and statutory scheme is aimed at bringing this question before the courts.

(2) Since the corporation must act through its agents, the second question is who should make the determination of whether the suit is beneficial to the corporation. Generally, the directors, as the statutory agents of the corporation, would decide this issue. Derivative suits, however, are peculiar because they are aimed at testing the loyalty, skill, and diligence with which the directors act. For this reason, shareholders have been granted equitable and statutory rights to bring the action and represent the corporation in court. The question at this point is who is more *suitable* to make the decision on whether or not to bring the action on the corporation's behalf.

(3) Since both the derivatively suing shareholders and the directors are fiduciaries, their decision should be subject to judicial review. The third question at this stage of the analysis is what is the courts' role in the process of review, and to what extent should the courts defer either to the directors' or to the shareholders' decision of whether the particular suit is or is not in the corporation's best interest.

(4) If the courts do not defer to the decision of the shareholders or directors, but rather, determine the question on the merits, the next issue must center on the legal standards which the courts should apply on resolving whether or not the litigation benefits the corporation.

The cases illustrate the various issues on which the courts have chosen to focus. In *Burks v. Lasker*,³⁵ the Supreme Court posed the question as to whether the directors can terminate a derivative suit.³⁶ The Court therefore focused on the power of the directors, as opposed to the power of the shareholders, to evaluate and determine whether the action is in the corporation's interest. Justices Stewart and Powell, in their concurrence, suggested that the business judgment rule applies,³⁷ classifying the issue of the benefit to the corporation as a business decision,³⁸ and applying the standard rules of judicial review of such a decision—rules that usually require the courts to defer to the directors' determination.³⁹ The Justices there-

35. 441 U.S. 471 (1979).

36. *Id.* at 473.

37. *See id.* at 487.

38. *See id.*

39. *See id.*

fore focused on the standard of judicial review.

Implicit in the cases which hold that demand is futile,⁴⁰ is the assumption that the directors are disqualified from making the decision on behalf of the corporation, and, therefore, the plaintiff shareholder is the *only* qualified agent for the corporation in this limited instance. Furthermore, these decisions imply that the courts should defer *fully* to the shareholder's decision.⁴¹ The courts focused in these cases both on the allocation of power to the shareholders and on the standard of judicial review.

Cases like *Zapata*⁴² and *Joy*⁴³ allocate to the courts an active review, on the merits, of whether the action benefits the corporation and design the standards for judicial evaluation of the issue. The varying starting points and the resulting substantive applicable rules cause the courts to reach different conclusions.

2. *The Diverse Nature of Derivative Claims.*—No analysis of the demand issue can be coherent without an understanding of the dual nature and the history of derivative suits. One component of every derivative claim implicitly or explicitly charges the corporate directors and officers with breach of their fiduciary duties.⁴⁴ This component of the derivative action is aimed at bringing corporate fiduciaries to account for their actions and for the harm they caused to the corporation. Viewed thusly, the derivative suit is in fact a shareholder's personal action.

In order to avoid a multitude of suits and to prevent the plaintiff shareholders from collecting individually what is due to the aggregate of shareholders, the action by any particular shareholder is considered derivative.⁴⁵ The source of the perception of derivative suits as personal actions against corporate fiduciaries is historical. These

40. See, e.g., *Delaware & Hudson Co. v. Albany & Susquehanna R.R.*, 213 U.S. 435 (1909).

41. See, e.g., *id.*

42. 430 A.2d 779.

43. 692 F.2d 880.

44. Indeed, this feature permeates the entire basis from which derivative claims arose. As the Supreme Court in *Ross v. Bernhard*, 396 U.S. 531 (1970), noted:

The remedy made available in equity was the derivative suit, viewed in this country as a suit to enforce a *corporate* cause of action against officers, directors, and third parties. As elaborated in the cases, one precondition for the suit was a valid claim on which the corporation could have sued; another was that the corporation itself had refused to proceed after suitable demand, unless excused by extraordinary conditions.

Id. at 534 (emphasis in original).

45. See *Watson v. Button*, 235 F.2d 235 (9th Cir. 1956) (where appellee cites these reasons as justification for derivative suits).

suits were conceived of as equitable actions to enforce the rights of beneficiaries against their trustees.⁴⁶ “[T]he equitable right of the shareholder to call his trustees to account . . . belonged to the shareholders and to them alone, although they could exercise it collectively through the corporation”⁴⁷ The plaintiff shareholder was not in court to enforce corporate rights of action indirectly. Rather, he was in court to enforce his own equitable rights directly. There is little that is secondary or derivative in such an action. Thus, this view of a derivative suit emphasizes the breach of fiduciary duties which the plaintiff shareholder can assert as a matter of personal right and bases the requirement that the claim be brought on behalf of all shareholders—namely, on behalf of the corporation—on grounds of efficiency.⁴⁸

A second perspective of a derivative suit focuses upon the nature of the alleged wrongs to the corporation. The more the activities complained of are part of the operation of the corporate enterprise, the more pronounced the truly derivative nature of the claim becomes. Furthermore, the process which is designed to pool personal claims for efficiency purposes takes on a life of its own. The derivative component of the suit is based on the shareholder’s ability to bring a claim on behalf of the corporation. If the suit is viewed in such a manner, then the shareholder can bring *any* action on behalf of the corporation, including, for example, actions against third parties for damages on breach of contract. Such an action asserts corporate rights against an outsider and has less of the features of a beneficiary’s personal action against his trustee. The latter is merely implicit in the complaint that the directors wrongfully failed to bring the claim in the corporation’s behalf. Historically, the derivative view of shareholders’ suits came later when the rights of the shareholders were extended to suits against third parties on behalf of the corporation.⁴⁹ Although a breach of fiduciary duties is implicit in all derivative actions, when the shareholder sues a third party derivatively, the underlying cause of action is essentially a claim by the corporation against the third party. In contrast, in the “purer” class

46. *Ross v. Bernhard*, 396 U.S. 531, 545 (1970) (Stewart, J., dissenting with Burger, C.J., and Harlan, J., joining); Prunty, *The Shareholders’ Derivative Suit: Notes on its Derivation*, 32 N.Y.U. L. Rev. 980, 994 (1957).

47. Prunty, *supra* note 46 and accompanying text.

48. See *supra* note 45 and accompanying text.

49. *Ross v. Bernhard*, 396 U.S. 531, 545 (1970) (Stewart, J., dissenting with Burger, C.J. and Harlan, J., joining); see Prunty, *supra* note 46, at 994.

action type of derivative claim, the action against the directors for breach of fiduciary duties *is* the underlying cause of action.

In sum, derivative actions encompass two aspects. The first aspect focuses on the allegation of breach of duties by corporate fiduciaries, from which follows the shareholder's personal right to bring disloyal or negligent corporate fiduciaries to account. The second aspect concerns the right of the corporation to bring an action against its disloyal managers or others, from which follows the right of shareholders to bring a claim *on behalf* of the corporation.

The results of these twin features of a derivative action is twofold. First, the action enables shareholders to control valuable litigation on behalf of the corporation and to benefit personally from this litigation at the corporation's expense. Second, it enables plaintiff shareholders to encroach upon the statutory functions of directors to manage the corporation by allowing the shareholders to bring suits directly on behalf of the corporation against third parties; thereby enabling shareholders to test in court all activities of corporate fiduciaries in managing the corporation.

The problem presented is therefore dialectical: How should the law governing derivative suits be designed to make directors accountable before the courts, while simultaneously still prevent shareholders from misappropriating corporate benefits, creating a nuisance value from the litigation by "strike suits," and interfering in the management of the corporation on the other.

3. *How Rules of Procedure and Substantive State Law Attempt to Resolve the Problem.*—The purpose of the demand rule has traditionally been to require the plaintiff shareholder to seek initial redress for his complaints directly from the corporate fiduciaries responsible for corporate governance.⁵⁰ Presumably, upon receipt of the demand, corporate fiduciaries could: (1) convince the plaintiff that he erred; or (2)—being convinced that the plaintiff is right—either accede to his claims by compensating the corporation for injury done to it, or follow the course of action which the plaintiff advocates.⁵¹ In most circumstances, however, the shareholder plaintiff and corporate fiduciaries disagree, either on the merits of the underlying corporate claim or on the wisdom of bringing it, even as-

50. See Comment, *supra* note 6, at 171; see also *Hawes v. Oakland*, 104 U.S. 450, 460-61 (1881).

51. If the plaintiff is satisfied, no action will be brought. If he is not, and he sues derivatively, the court will determine whether his cause of action was in fact satisfied by the directors' reaction to his complaint.

suming the claim was meritorious. In these cases, the demand rules and substantive law force the plaintiff to bring the corporate fiduciaries into court on the issue of whether the corporation will benefit from the litigation.

4. *The Model: The Business Judgment Rule and Directors' Self-Dealing.*—The recent decisions that apply the business judgment rule to the question of whether the derivative claim is in the corporation's best interest, start with the assumption that bringing actions on behalf of the corporation is the function of the directors. In other words, the derivative nature, rather than the personal feature of the suit, is the pervasive aspect of the claim. That classification naturally leads to the choice of the business judgment rule.

The business judgment rule is based on the principle that directors should not be liable for honest mistakes in managing the corporate business.⁵² Unlike trustees, directors are and should be given incentives to take calculated business risks as entrepreneurs. Furthermore, the corporate business should be managed by the directors, not the courts or the shareholders. The corollary of these principles is that if a decision involves a "business judgment" and if the directors are "honest," the courts will adopt a "hands-off" attitude, decline to scrutinize the decision, and leave the market and election processes to discipline unsuccessful entrepreneurial activities of the board.⁵³

The view of a derivative action as a conglomeration of personal claims against directors for breach of fiduciary duties would lead to a different judicial review process, namely, judicial review on self-dealing. Since some derivative actions assert egregious breach of loyalty and duty of care, the decision whether such suits benefit the corporation is better reviewed in the same fashion as the claims themselves. The starting point of these rules is diametrically opposed to that of the business judgment rule.

Transactions between the corporate fiduciaries and the corpora-

52. *Financial Indus. Fund, Inc., v. McDonnell Douglas Corp.*, 474 F.2d 514, 518 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973).

53. The rule may be justified on various grounds: The courts may loathe to intervene in the day to day operational decisions of a large organization for fear of tampering with efficient operation; the courts may not have the expertise to pass judgment on such activities; judicial interference may give incentives to increasing strike suits; alternative controls of the market for shares and for corporate managers may effectively discipline ineffective managers; the courts have no on-going supervisory powers over directors; the courts' decisions are conditioned on plaintiffs' actions which, in fact, may be brought for reasons other than correcting managerial errors.

tion were historically *prohibited*,⁵⁴ except with the consent of the shareholders. More recently, both courts and legislatures have permitted self-dealing, presumably to allow the corporation to benefit from fair deals, but have subjected the transaction to procedural and substantive judicial review.⁵⁵ The extent of that review, in turn, depends on the degree to which effective internal institutional independent review is available. If the board consists of independent and disinterested directors, they (or the majority of the shareholders) can approve the deal.⁵⁶ In many states, an additional judicial finding of fairness is required.⁵⁷ Implicit in the design of the law regarding self-dealing is the principle that the directors have the authority to determine whether the corporation will engage in the transaction—which decision is, in fact, a business judgment—and that the courts will review management's decision when the management is tainted with conflicts of interest. When the courts determine that such taint does not exist, the courts will defer to the management's business judgment if it is reached with care. The evaluation of management's disinterestedness and, in its absence, the fairness of the self-dealing transaction is within the realm of judicial review.⁵⁸ The question of whether a qualified transaction should be adopted is left to the directors exclusively. They have the freedom to choose between two qualified transactions.

The results of applying the business judgment rule and the rule against self-dealing may be similar, but the basic assumptions, starting points, and extent of judicial interference are different.

As boards of directors began to appoint disinterested and independent directors to determine the issue, the range of cases which could be terminated on the rationale of the business judgment rule

54. See *Wardell v. Railroad Co.*, 103 U.S. 651, 658 (1880); Marsh, *Are Directors Trustees?*, 22 BUS. LAW 35, 36 (1966). Subsequently, the "Trust Model" generally allowed the director to self-deal with the corporation if he disclosed that the contract was fair. *Id.* at 40.

55. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. Sup. Ct. 1971); *Schreiber v. Bryan*, 396 A.2d 512 (Del. Ch. 1978); CAL. CORP. CODE § 310 (West 1977); DEL. CODE ANN. tit. 8, § 144(a)(1) (1975); N.Y. BUS. CORP. LAW § 713(a)(1) (McKinney Supp. 1982-83). For an elaboration of this theme, see generally Buxbaum, *supra* note 6.

56. See generally Marsh, *supra* note 54, at 43-50.

57. E.g., *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788-89 n.17 (Del. Sup. Ct. 1981) ("[T]he Delaware approach to 'interested director transactions' . . . [requires] the directors, once the transaction is attacked, . . . [to carry] the burden of establishing its 'intrinsic fairness' to a court's careful scrutiny.") (citation omitted); see, e.g., DEL. CODE ANN. tit. 8, § 144(a)(3) (1975).

58. Marsh, *supra* note 54, at 43.

covered almost all potential claims including those alleging severe breaches of fiduciary duties.⁵⁹ Thus, since the application of the rule depends on classifying the decision as a business decision, the courts applying the rule classified all actions the board was authorized to undertake as business decisions. Justices Stewart and Powell, in *Burks v. Lasker*,⁶⁰ reasoned that since the directors are vested with the authority to bring actions on behalf of the corporation, they can bring *all* actions on behalf of the corporation.⁶¹ Therefore, the directors' decision that any claim brought derivatively should be terminated, regardless of the cause of action, should be given effect by the court, provided the directors are disinterested.⁶² If this view is adopted, every action brought derivatively is a business decision that can be terminated by disinterested directors, including new directors appointed for the purpose of determining the fate of the suit.

This rigid syllogism is overbroad. First, as mentioned previously, the "business judgment" rule is necessary to shield directors from liability for their honest (even if mistaken) business decisions. The rule is defensive, not allocative,⁶³ in that "[i]t is generally used as a defense to an attack on the decision's soundness,"⁶⁴ and not as giving directors additional or "stronger" powers. Second, derivative actions may involve activities which have no corporate business components, such as insiders' trading.⁶⁵ These suits are not and should not be within the directors' exclusive domain.⁶⁶ Furthermore, the evaluation of the potential success of litigation is not within the director's expertise.

Third, with the creation of new directorships, every claim of self-dealing and breach of fiduciary duty would be placed outside

59. *E.g.*, *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. Sup. Ct. 1981) (derivative action against officers and directors for alleged breach of fiduciary duty).

60. 441 U.S. 471, 487 (1979) (Stewart, J., concurring and Powell, J., joining).

61. *See id.*

62. *See id.* ("A decision whether or not a corporation will sue an alleged wrongdoer is no different from any other corporate decision to be made in the collective discretion of the disinterested directors.") (citations omitted).

63. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. Sup. Ct. 1981).

64. *Id.*

65. *See, e.g.*, *Abbe v. Goss*, 411 F. Supp. 923 (S.D.N.Y. 1975).

66. Although trustees have a duty to bring action against their co-trustees who violate their fiduciary duties, this duty does not preclude the beneficiary from doing the same. Similarly, a shareholder has a right to bring his fiduciary to account before the court. The shareholder's right is qualified only because he himself is a fiduciary appearing on behalf of all shareholders and thus, the derivatively suing shareholder must be an adequate representative. Therefore, suits against the directors for breach of fiduciary duties are not exclusively within the director's domain.

judicial review if disinterested directors determine that the decision to litigate is not in the corporation's best interest. This rule on demand thus changes the substantive law of the duty of loyalty and care, shifting the judicial power of review on the merits of the transaction to a group within the institution, namely to "litigation committees." The court's function becomes limited to testing litigation committee members' disinterestedness. Yet, the law contemplated judicial review on the merits of self-dealing, not on litigation committee's review. The business judgment rule was to apply only to the disinterestedness of the directors who made the decision of which the plaintiff complains and not to the disinterestedness of the directors who evaluated the prudence of bringing the case to court.

Some suggestions were made to permit litigation committees to determine the prudence of actions based on a breach of duty of care, but not on a breach of duty of loyalty. A distinction, however, between allegations of breach of duty of care and loyalty is not helpful, because some duties of care—especially in the case of specialized institutions such as banks—are important to protect the corporation as well as its shareholders and creditors from serious financial losses. Additionally, the distinction between the duty of care and loyalty is not clearly delineated. It has been argued, and we believe persuasively, that the courts may resort to a duty of care when they suspect, but have found no proof of, self-dealing.⁶⁷ Furthermore, a plaintiff shareholder who bases his derivative claim on a breach of a duty of care will, in most cases, also be able to allege a breach of the duty of loyalty.

We conclude, therefore, that the business judgment rule is unsuitable as applied to the demand requirement and results in the current state of confusion.

5. *Allocating the Power to Make the Initial Decision.*—The problem of determining when to permit a derivative suit can be analyzed by examining the two contending decisionmakers and evaluating who is more suitable for the task of making the initial decision—the directors or the shareholders. Both shareholders and directors are fiduciaries.⁶⁸ The directors are fiduciaries vested with the authority to manage the corporation. The plaintiff shareholder represents the corporation in order to ensure the director's accountability. In all but exceptional cases, the plaintiff shareholder owns

67. See Phillips, *Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine*, 32 RUT. L. REV. 184, 208-09 (1979).

68. See Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795 (1983).

only a few shares and is not entitled to the full benefits of the claim. Therefore, his powers to bring, litigate, and settle the action are powers held as a fiduciary for the corporation. The plaintiff-shareholder is not a "pure" fiduciary. His right to sue is also grounded in his proprietary right in the corporation's shares. In the past fifty years, however, the emphasis on the shareholder's right to sue has shifted to his fiduciary capacity, that of a beneficiary suing on behalf of others as a fiduciary. Thus, although he has no duty to sue, once he does, both the justification for bringing the suit and the maintenance of the suit should be subject to judicial review.

How do the shareholders and directors, competing for the power over initiating claims on behalf of the corporation, fare against each other? One factor which may influence the choice of an appropriate corporate agent is expertise in evaluating the potential success of the claim. This expertise depends on, first, the legal talent at one's disposal, and second, on the information which one can discover in or out of the courtroom. With respect to legal talent, shareholders and corporate fiduciaries are equal. With respect to access to information, however, the directors may have the upper hand. Expert evaluation of the potential benefits of a derivative suit may also involve the impact of the litigation on the day-to-day operation of the corporation's business. This assessment is within the corporate fiduciaries' expertise if the claim is closely related to the business, such as a claim against a business associate. The directors can also better determine the burdens of time and effort required of corporate management and employees in pursuing the claim, and to a lesser extent, the impact of the litigation on the corporation's reputation and credit.⁶⁹

Another factor affecting the choice of an appropriate initial decision maker is the extent to which his interests conflict with those of the corporation. If conflict is present, his expertise is valueless to the corporation because he might refrain from using it to benefit the corporation.⁷⁰ The corporate fiduciaries' conflicts of interest are directly related to the nature of the derivative claim and their exposure to

69. Similarly, corporate fiduciaries can better evaluate the impact of the litigation on the relation between the corporation and the defendant's fiduciaries. Such a balancing of factors, however, must be open to judicial scrutiny. *See Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. Sup. Ct. 1981).

70. Such expertise will not be valuable since "the [initial decision maker is] under an influence that sterilizes discretion." *McKee v. Rogers*, 18 Del. Ch. 81, 86, 156 A. 191, 193 (1931).

that claim. Even litigation committees, composed of new directors who are not defendants in the case, may have personal conflicts. After all, the members of these committees have been chosen by the defendant directors, and in many cases, these members have joined the boards with the understanding that they will serve on these committees. In sum, in very few cases do the disinterested directors or the committees possess the incentives to act for the corporation's sole interest. Furthermore, unlike independent directors, who usually have the free choice to approve or disapprove a self-dealing transaction (and if they disapprove their colleagues may merely lose potential profits), the decision to bring a derivative suit is not completely in their hands. The shareholder plaintiff has initiated the action on behalf of the corporation. Consequently, the pressure on the committee to decide against bringing suit is greater than the pressure on disinterested directors to approve a self-dealing transaction.

Shareholder plaintiffs, however, are not free from conflicts of interest either. Their attorney is generally the interested party, taking the risk of the litigation for the purpose of collecting fees.⁷¹ We may assume that these fees play an important role in the shareholder's decision to sue and in his conduct of the litigation.⁷²

It can be concluded, therefore, that both shareholder plaintiffs and management have substantial conflicts of interest in determining whether a derivative claim is in the best interest of the corporation. Consequently, neither should be entrusted with the ultimate power to determine this question.

E. *Proposal*

We conclude that the courts should determine whether a derivative suit serves the corporation's best interests. The judiciary has expertise in evaluating the potential success of litigation and, as discussed previously, they examine the merits of the litigation to determine the extent of the conflicts of interest that directors may have concerning it. To make that decision, not as reviewers of the directors' determination, but as decision makers on the merits, the courts should be assisted by both the shareholder plaintiff and the board. Therefore, demand should be generally required, and only in very exceptional cases should it be deemed "futile." Our conclusion

71. See *Joy v. North*, 692 F.2d 880, 887 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983).

72. "The real incentive to bring derivative actions is usually not the hope of return to the corporation but the hope of handsome fees to be recovered by plaintiffs' counsel." *Id.*

follows the principle enunciated in *Zapata v. Maldonado*⁷³ and *Joy v. North*.⁷⁴ We believe, however, that the guiding standards for the courts should be broader than those set forth by Judge Winter in *Joy*.

In *Burks v. Lasker*,⁷⁵ Justice Brennan alluded to one standard, applicable to claims under the Investment Company Act.⁷⁶ Justice Brennan suggested that “[t]here may well be situations in which the independent directors could reasonably believe that the best interests of the shareholders call for a decision not to sue—as, for example, where the costs of litigation to the corporation outweigh any potential recovery.”⁷⁷ The test which Justice Brennan applied to the directors’ decision could be applied by the courts in evaluating the claim on the merits. A similar approach was followed by Judge Winter, applying Connecticut law, in *Joy*.⁷⁸ The standard requires the court to evaluate the potential net benefits inuring to the corporation discounted by the probability of liability, and deducting from the expected amount of recovery the likely costs of the litigation, including attorney’s fees.⁷⁹

We submit that this formula is too narrow. There are nonquantifiable but crucial factors that must also be included in the decisional calculus. The protection of a corporation from fiduciaries’ abuse and the efficiency of the markets depend on the information as to how the corporation is managed. A derivative suit is one of the means for conducting a thorough investigation of corporate management. Furthermore, even though shareholders may sell their shares when dissatisfied with management’s performance, the sale does not make corporate fiduciaries accountable, except through takeovers.

Arguably, the reputation and credit of a corporation may suffer

73. 430 A.2d 779 (Del. Sup. Ct. 1981); see *supra* text accompanying note 30.

74. 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983); see *supra* notes 23-25 and accompanying text.

75. 441 U.S. 471 (1979).

76. *Id.* at 485 (citation omitted). Justice Brennan further wrote that “Congress [in passing the Investment Company Act and Investment Advisers Act] did not require that States, or federal courts, absolutely forbid director termination of all nonfrivolous actions.” *Id.* at 486.

77. *Id.* at 485.

78. 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1498 (1983). Other factors mentioned by the *Joy* court that might be taken into account when “a likely net return to the corporation . . . is not substantial in relation to shareholder equity,” are “the impact of distraction of key personnel by continued litigation . . . [and] potential lost profits which may result from the publicity of a trial.” *Id.* at 892.

79. *Id.* The court listed other factors not reiterated here. *Id.* at 892-93. The court limited its formula to cases where the underlying cause of action allegedly resulted in direct monetary harm to the corporation. *Id.* at 892.

from such litigation and disclosure, as the defendants contended in *Joy*.⁸⁰ The court rejected this argument summarily. The court noted that if the argument were, in fact, legally valid, it would follow that the more egregious the corporate manager's behavior, the more secret such behavior should be kept.⁸¹ This issue merits further discussion. The damage to the corporation's reputation and credit is not caused by disclosure of mismanagement, but by the mismanagement itself. The more offensive it is, the more injurious it is to the corporation. The disclosure hurts the shareholders in the sense that the market value of their shares will incorporate the information regarding management and will reflect the judgment of the market in the price. The current shareholders, however, are not entitled to a price which is not representative of the current value of their shares. Shareholders do not have a right to keep secret adverse information of corporate mismanagement from potential buyers.

The benefits of judicial investigation and disclosure of mismanagement also accrue to shareholders by the deterrent effect on the present management and by the potential change in their management through voluntary or involuntary departure of corporate fiduciaries. Furthermore, the public will benefit from such derivative actions by the deterrent effects of such claims on other managements.

The test should contain these nonquantifiable benefits resulting from the litigation. Thus, even where the potential net gain from the litigation is not substantial, these benefits may militate against dismissal. The converse is also true: If the violations alleged are substantial but inadvertent, if they have been rectified prospectively, or if the claims may result in the loss of valuable and honest personnel, these factors ought to be weighed in assessing the benefits of the claims to the corporation and the public. The objection to adding nonquantifiable factors because they are speculative is readily answered. The seemingly quantifiable factors mentioned in *Joy* are in fact speculative too, so as to make little difference between them and the additional proposed factors.

80. The defendants offered this argument in order to keep the special committee's report under seal. *Id.* at 894.

81. *Id.* The court concluded that "foreclosing public scrutiny . . . [was] wholly unjustifiable." *Id.*

F. Conclusion

The question which rule 23.1,⁸² and similar state rules of procedure,⁸³ as well as corporate laws⁸⁴ pose by requiring specific pleadings in a derivative suit, is whether the action benefits the corporation. Some courts have answered this question by allocating the initial decision to the directors and reviewing the decisions along the lines of judicial review under the business judgment rule. The results are incoherent and unjustifiable. Instead of the current format, the courts should determine the issue on the merits, taking into consideration the parties' arguments in light of the parties' position as to expertise and conflicts. The courts should follow the standards stated in *Joy v. North*,⁸⁵ expanded to include intangible benefits to the corporation and the securities markets.

To broaden the discussion, we have chosen to focus our analysis on a specific context, a claim arising under section 36(b) of the Investment Company Act of 1940 (ICA).⁸⁶ This variation on the general theme was chosen not only because it raises additional questions involving the distinction between a derivative and personal claim as well as the applicability of state corporate law to a federal claim, but also because, again, judicial results conflict and provide little guidance for the future.

II. THE DEMAND REQUIREMENT AND SECTION 36 OF THE INVESTMENT COMPANY ACT

There is presently a split among the federal circuit courts on the issue of whether a shareholder suing to recover excessive adviser fees pursuant to section 36(b) of the Investment Company Act⁸⁷ must comply with the demand requirement embodied in rule 23.1.⁸⁸ During 1982, three circuit courts of appeals examined this precise issue. The First and Third Circuits, in *Grossman v. Johnson*⁸⁹ and *Weiss v. Temporary Investment Fund, Inc.*,⁹⁰ respectively, held that a de-

82. FED. R. CIV. P. 23.1.

83. See, e.g., COLO. REV. STAT. § 23.1 (1973).

84. See, e.g., CAL. CORP. CODE § 834 (West Supp. 1977); N.Y. BUS. CORP. LAW § 626(c) (McKinney 1963).

85. 692 F.2d 880, 887 (2d Cir. 1982), cert. denied, 103 S. Ct. 1498 (1983).

86. 15 U.S.C. §§ 80a-1 to 80a-64 (1982).

87. *Id.*

88. FED. R. CIV. P. 23.1.

89. 674 F.2d 115 (1st Cir. 1982), cert. denied, 103 S. Ct. 85 (1982).

90. 692 F.2d 928 (3d Cir. 1982), petition for cert. filed, 51 U.S.L.W. 3814 (U.S. Mar. 26, 1983) (No. 82-1592).

mand upon an investment company's directors is required as a prerequisite to maintaining a section 36(b) action.⁹¹ The Second Circuit, however, in *Fox v. Reich & Tang, Inc.*,⁹² ruled that a shareholder demand is *not* required under similar circumstances.⁹³ The Supreme Court granted certiorari in the *Fox* case in March of 1983⁹⁴ and will presumably resolve this issue during the 1983 Term. The resolution of this issue requires a difficult balancing of an express statutory right to sue, on the one hand, with an express qualification of that right, applicable to all derivative actions, on the other. Section 36(b) expressly authorizes shareholders of investment companies to bring suits for the recovery of excessive adviser fees.⁹⁵ On its face, the section seems to provide for an unqualified right. Yet, two circuit courts have concluded that the shareholder must satisfy the demand requirement of rule 23.1 as a condition for maintaining the lawsuit. Since rule 23.1 applies only to derivative suits,⁹⁶ the federal courts sought to resolve this issue by categorizing section 36(b) actions as either derivative or personal in nature.⁹⁷ These courts have largely eschewed a policy-based analysis as a means of determining the extent to which rule 23.1 is compatible with a section 36(b) claim. It is precisely this analysis which we endeavor to undertake.

A. *The History of Section 36(b) Claims*

Conflicts of interest are inherent in the management of an investment company.⁹⁸ The company's portfolio is managed not by its board of directors, but by an investment adviser serving under a contract with the company.⁹⁹ The adviser creates the fund, manages its assets, and effectively controls the board of directors.¹⁰⁰ One com-

91. *Grossman*, 674 F.2d at 122; *Weiss*, 692 F.2d at 942.

92. 692 F.2d 250 (2d Cir.), *cert. granted sub nom.* *Daily Income Fund, Inc. v. Fox*, 103 S. Ct. 1271 (1983).

93. 692 F.2d at 262.

94. 103 S. Ct. 1271 (1983).

95. 15 U.S.C. § 80a-35(b) (1982).

96. Compare FED. R. CIV. P. 23 (class actions) with FED. R. CIV. P. 23.1 (derivative actions by shareholders).

97. See *Weiss*, 692 F.2d at 933-36; *Fox*, 692 F.2d at 254-61; *Grossman*, 674 F.2d at 120.

98. For an explanation of how such conflict results, see *Weiss*, 692 F.2d at 933.

99. *Id.*

100. See *id.*; see also *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976) ("The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects its portfolio and administers its daily business."). See generally 1 T. FRANKEL, *THE REGULATION OF MONEY MANAGERS* B§ 4, at 8-15 (1978); 2 T. FRANKEL, *supra*, B§ 7, at 408-09; Wharton School of Finance and Commerce, A Study

mentator has described the relationship between an investment advisor and a mutual fund as "incestuous."¹⁰¹

Recognizing the potential for managerial self-dealing, Congress enacted the ICA,¹⁰² which requires, inter alia, that at least forty percent of the investment company's board of directors be "disinterested" and independent of the company's investment adviser.¹⁰³ As part of the independent director's "watchdog" function,¹⁰⁴ Congress made it unlawful for an investment adviser's contract to be executed or renewed without the approval of a majority of the disinterested directors.¹⁰⁵

Investment adviser fees, typically calculated as a fixed percentage of the total assets managed by the company, increase in direct proportion with the company's assets.¹⁰⁶ Given the economies of size associated with managing an investment portfolio, however, the adviser's expenses do not generally increase proportionately.¹⁰⁷ As the size of mutual fund portfolios grew during the 1950's, the independent directors mechanism proved unequal to the task of ensuring the reasonableness of the adviser's burgeoning fees.¹⁰⁸ Nonetheless, when fees were challenged during this period, courts refused to set aside or modify adviser's fees unless the fees were so unconscionable that they constituted "waste."¹⁰⁹ The rationale for the decisions was generally based on the approval of the adviser's contract by the independent directors and the shareholders.¹¹⁰

Congress reacted to the inadequacy of the disinterested directors mechanism in curbing excessive adviser fees¹¹¹ by passing sec-

of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 1, 6 (1962).

101. *The Mutual Fund Management Fee*, 115 U. PA. L. REV. 726, 739 (1967) (remarks of A. Pomerantz).

102. See S. Rep. No. 91-184, 91st Cong., 2d. Sess. 1, reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4897, 4899, 4901 (1970).

103. 15 U.S.C. § 80a-10 (1982). The Act also prohibits certain sale transactions between the fund and its investment adviser. 15 U.S.C. § 80a-17 (1982).

104. See *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977) cert. denied, 434 U.S. 934 (1978).

105. 15 U.S.C. § 80a-15(a), (c) (1982).

106. See *Fox*, 692 F.2d at 257.

107. See *id.*

108. See *id.*

109. *E.g.*, *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (1962) (shareholder required to prove gross abuse of trust under old § 36 of the Investment Company Act of 1940).

110. *E.g.*, *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (1962) (where adviser contract almost unanimously approved by shareholders, the plaintiffs were required to show "actual waste" or "unconscionable fee").

111. See *Fox*, 692 F.2d at 258-60.

tion 36(b) as an amendment to the ICA in 1970.¹¹² Congress imposed a fiduciary duty on investment advisers "with respect to the receipt of compensation for services,"¹¹³ disavowed the notion that adviser fees must constitute "waste" to be set aside, and made it clear that henceforth the fees would be evaluated under a test applicable to fees of fiduciaries.¹¹⁴ Congress expressly empowered investment company shareholders, as well as the Securities and Exchange Commission, to bring an action against the investment adviser to recoup excessive fees received in breach of the adviser's statutory fiduciary duty to the investment company.¹¹⁵ Congress explicitly directed the courts to consider board and shareholder approval when evaluating the adviser fees.¹¹⁶

As shareholders started to bring suits under section 36(b) in the late 1970's—a period characterized by a significant growth of money market funds—¹¹⁷federal courts were faced with the question of whether and to what extent the procedural and substantive requirements of rule 23.1 applied to section 36(b) shareholder actions. As noted previously, federal circuit courts disagree on the answer to this question.¹¹⁸ The disagreement does not, however, result from conflicting approaches to this difficult problem. On the contrary, the federal courts have reached divergent conclusions by way of analytically indistinguishable methodologies.

B. *The Nature of Section 36(b) Actions: The Derivative-Personal Dichotomy*

By its express terms, rule 23.1 applies only to derivative suits.¹¹⁹ It is, therefore, not surprising that, as an initial matter, the federal courts sought to classify section 36(b) shareholder actions as either

112. Act of Dec. 14, 1970, Pub. L. No. 91-547, § 36, 84 Stat. 1413, 1428-29.

113. ICA § 36(b), 15 U.S.C. § 80a-35(b) (1982).

114. *Id.*; see *Fox*, 692 F.2d at 259-60.

115. ICA § 36(b), 15 U.S.C. § 80a-35(b) (1982); Benedict & Rogers, *Money Market Fund Management Fees: How Much is Too Much?*, 57 N.Y.U. L. REV. 1059 (1982); see also T. FRANKEL, *supra* note 100, B§ 4 at 262-74.

116. Section 36(b)(2), 15 U.S.C. § 80a-35(b)(2), provides that approval of the adviser's fee contract by the board of directors and ratification or approval by the shareholder, "shall be given such consideration by the court as is deemed appropriate under all circumstances."

117. 4 T. FRANKEL, *supra* note 100, § 15, at 308 (Supp. 1982) (The June 1982 assets of money market funds exceeded \$200 billion).

118. See *supra* notes 89-94 and accompanying text.

119. The rule requires, in pertinent part: "In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it. . . ." FED. R. CIV. P. 23.1.

derivative or personal.¹²⁰ Yet, in order for a section 36(b) action properly to be called derivative, the courts had to resolve a legally requisite, and analytically precedent, question: Does section 36(b) establish a cause of action which the investment company could properly assert on its own behalf?¹²¹ Since section 36(b) expressly grants a right of action to recoup excessive adviser fees only to the Securities and Exchange Commission and the investment company shareholder, the federal courts inquired whether section 36(b) grants an implied right of action to the company.¹²²

In *Grossman*, the First Circuit held that section 36(b) grants an implied right of action to the investment company.¹²³ The court reasoned that since any action brought pursuant to section 36(b) must be "on behalf" of the investment company, Congress may not have felt compelled to specify that the company had a right of action.¹²⁴ The court speculated that in some circumstances, such as when a new board of directors takes office, the company may wish to bring suit pursuant to the section.¹²⁵ The First Circuit concluded that a shareholder's section 36(b) action is therefore derivative and, consequently, the demand requirement embodied in rule 23.1 is fully applicable.¹²⁶ Following *Grossman*, the Third Circuit ruled in *Weiss* that, while the analysis in *Grossman* was correct, it did not go far enough.¹²⁷ Instead, the *Weiss* court analyzed section 36(b) in terms of the test enunciated by the Supreme Court in *Cort v. Ash*¹²⁸ for determining whether a statute creates an implied private right of action.¹²⁹ Finding that the four-pronged test had been satisfied, the *Weiss* court held that the investment company has a private right of action.¹³⁰

In *Fox*, the Second Circuit stated that the words in section 36(b) setting out the right of shareholders of the investment com-

120. See *supra* notes 89-94 and accompanying text.

121. This is essentially the threshold question which determines whether a shareholder action is in fact "derivative," since the shareholder's claim would then "derive" from the ability of the corporate entity to assert the claim on its own behalf.

122. See, e.g., *Weiss*, 692 F.2d at 934; *Fox*, 692 F.2d at 261; *Grossman*, 674 F.2d at 120.

123. 674 F.2d at 120.

124. *Id.*

125. *Id.*

126. *Id.* at 122-23.

127. 692 F.2d at 934.

128. 422 U.S. 66, 78 (1975).

129. 692 F.2d at 934-36.

130. *Id.* at 936.

pany to sue on behalf of the investment company “do not create by implication a statutory right of the company itself to sue, from which the stockholder’s right may be said to be ‘derivative.’”¹³¹ According to the court, the language simply meant that the recovery of excessive fees must be returned to the company’s treasury.¹³² The Second Circuit viewed section 36(b) as empowering the Securities and Exchange Commission and the shareholder as, respectively, public and private “attorneys general” to enforce a statutory duty imposed on the investment adviser by the ICA.¹³³ Rejecting as unsupported the rationale offered by the First Circuit in *Grossman*, the Second Circuit reasoned that if Congress had intended to provide the investment company with a cause of action, it would have done so expressly.¹³⁴ In the court’s view, the solution to the problem of excessive adviser fees was incompatible with a grant of a corporate right of action.¹³⁵ The court concluded that since the investment company lacked a right of action under the statute, the shareholder suing pursuant to a section 36(b) claim was not suing derivatively and, therefore, was not subject to the rule 23.1 demand requirement.¹³⁶ The Second Circuit in *Fox*, reinforced this conclusion by noting that the traditional reasons for requiring demand were absent, since, in its view, the company could neither terminate the shareholder’s suit nor institute its own suit to recover excessive fees under section 36(b).¹³⁷

All federal courts that have considered the matter have deemed the issue of whether a shareholder claim brought pursuant to section 36(b) is derivative or personal as dispositive of whether the rule 23.1 demand requirement applies. We conclude that this generic approach, of adopting and perpetuating a rigid personal-derivative dichotomy, cannot yield a satisfactory answer.¹³⁸

131. *Fox*, 692 F.2d at 255.

132. *Id.*

133. *Id.*

134. *Id.* at 255-56.

135. *Id.* at 256.

136. *Id.* at 255, 262. A number of federal district courts have reached similar conclusions by a similar analysis. Compare *Blatt v. Dean Witter Reynolds Intercapital, Inc.*, 528 F. Supp. 1152, 1155 (S.D.N.Y. 1982) (demand not a prerequisite to shareholder suit under section 36(b)) with *Markowitz v. Brody*, 90 F.R.D. 542, 562 (S.D.N.Y. 1981) (demand required, but excused when 50% of mutual fund’s directors are “interested persons”) and *Boyko v. Reserve Fund, Inc.*, 68 F.R.D. 692, 695-96 (S.D.N.Y. 1975) (demand requirement satisfied where plaintiff alleges at least one “interested” director sits on investment company board).

137. 692 F.2d at 261. Indeed, whether or not the Second Circuit was correct in its legal analysis, our research indicates that at no time has an investment company utilized § 36(b) to attempt to recoup excessive advisory fees.

138. When the federal courts reach the conclusion that § 36(b) gives rise to a personal

A section 36(b) shareholder action has elements of both a derivative and a personal claim. On one hand, Congress has given the shareholder an express, personal right to sue an investment adviser for recovery of excessive fees.¹³⁹ On the other hand, the language of section 36(b) makes it abundantly clear that the investment company, not the shareholder, has the exclusive right to recovery.¹⁴⁰ Conversely, a section 36(b) shareholder action has elements which are inconsistent with both derivative and personal rights of action. The courts which hold that section 36(b) creates a derivative right of action have been forced to minimize the significance of the express statutory language vesting the right to sue in the shareholder—not the investment company. The courts which hold that section 36(b) gives rise to a personal right of action largely ignore the express statutory language which vests the right to recovery in the investment company—not the shareholder.

We submit that the federal courts have struggled unnecessarily with the apparent duality of a section 36(b) action. A corporation cannot act except through its agents. Section 36(b), in effect, establishes an express corporate right of action—the right to collect excessive fees from the adviser—but appoints the Securities and Exchange Commission and the shareholder as the statutory enforcers of this corporate right of action. This appointment of the shareholders as agents for the corporation does not change the essential nature of the claim as a corporate claim.

Section 36(b) does not make it clear whether it substitutes or merely adds agents to the investment company. We tend to conclude that addition rather than substitution was intended. The directors' duties differ from those of the shareholders and the Securities and Exchange Commission. Directors do not have a right to sue on their company's behalf. They have a duty to do so.¹⁴¹ The company's shareholders and the Securities and Exchange Commission have discretion to bring a section 36(b) action on the company's behalf.¹⁴²

claim they are forced to hold that rule 23.1 is wholly inapplicable. *See, e.g., Fox*, 692 F.2d at 261. Logically, this means that not only the portion of the rule pertaining to the demand requirement is inapplicable, but the provisions of rule 23.1 governing the qualifications of the shareholder to bring suit—such as contemporaneous ownership and “fair and adequate representation” of other shareholders—are similarly inapplicable.

139. ICA § 36(b), 15 U.S.C. § 80a-35(b) (1982).

140. *Id.*; *see Fox*, 692 at 255.

141. *Cf. Prunty, supra* note 46, at 991.

142. Section 36(b) states: “An action *may* be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such

They have no duty to do so. Presumably, Congress relied on the incentives given to both these parties to be alert to excessive adviser's fees and recoup these fees, if necessary. Since section 36(b) was designed to protect both the public interest and the interest of investors,¹⁴³ it seems more reasonable to interpret the section as adding agents to the company for the purpose of bringing suit, rather than substituting them for corporate agents i.e., the board of directors. Besides, a converse conclusion does not affect the derivative nature of a section 36(b) claim, but merely the identity of those who can bring it on behalf of the investment company.

In view of the fact that the directors of the investment company, including the disinterested directors, have approved the contested fees, and that research fails to disclose a single case in which directors of an investment company sued the adviser for excessive fees, the appointment of public and private "attorneys general"¹⁴⁴ for the company comports with the legislative intent of Congress in passing the 1970 amendment which added section 36(b) to the ICA.¹⁴⁵

We conclude that section 36(b) grants an express right of action to the corporation for which the shareholder has been named statutory agent. It follows that a shareholder suit to recover excessive fees pursuant to section 36(b) is a derivative suit to which rule 23.1 applies.¹⁴⁶

company. . . ." § 36(b), 15 U.S.C. § 80a-35(b) (1982) (emphasis added).

143. See *Fox*, 692 F.2d at 257; ICA § 1(b), 15 U.S.C. § 80a-1(b) (1982) (statement of findings and declaration of policy).

144. *Fox*, 692 F.2d at 255.

145. Act of Dec. 14, 1970, Pub. L. No. 91-547, § 36, 84 Stat. 1413, 1428-29.

146. It is true that in a conventional derivative action the shareholders' right to sue on behalf of the corporation stems or "derives" from a legal claim which the corporate management could otherwise assert on behalf of the company. A conventional derivative claim, however, is solely a creature of equity. See 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE, § 1821 (1972). For application of equitable principles in a shareholder derivative action, see *Koster v. (American) Lumbermens Mut. Casualty Co.*, 330 U.S. 518 (1947); *Liken v. Shaffer*, 64 F. Supp. 432 (N.D. Iowa 1946).

Section 36(b) is a creature of Congress, so to speak. The shareholder's right to sue to recoup excessive fees stems not from a pre-existing corporate claim, but rather from an affirmative congressional grant of power. To the extent that a § 36(b) action does not "derive" from a pre-existing corporate claim, it is conceded that the shareholder's action is not "derivative" in the strict, parochial sense of the word. Yet, the dispositive factor seems to be that, like any other derivative action, the corporation has a legal claim—granted by Congress—to the proceeds of the shareholder's § 36(b) action. While Congress has tinkered with the corporation's right to bring an action *through its management* to collect excessive fees, it seems misguided to import principles designed for claims sounding in equity—i.e., a conventional or equitable derivative claim—to a "statutory" derivative claim created by Congress. This type of sui

C. *Choice of Law and Statutory Construction*

Having reached the conclusion that a shareholder's section 36(b) action is derivative, this does not end our inquiry. The question remains which law applies to whether demand is required, and if demand is required, what are its attendant results.

As to the choice of law, the Supreme Court held in *Burks v. Lasker*¹⁴⁷ that the question of whether demand is required should be resolved by the applicable state law, provided that the law does not conflict with the policies of the ICA.¹⁴⁸ The power of Congress to modify or supersede procedural rules promulgated by the Supreme Court of otherwise applicable state law seems fairly clear.¹⁴⁹

The difficult issues are, therefore, whether section 36(b) conflicts with *any* demand requirement and, if not, whether the section conflicts with some types of demand requirements, in particular, with those state laws which apply the business judgment rule. If such conflict exists, the last inquiry is what are the federal policies on the demand question regarding the decision makers, judicial review, and standards for that review.

We begin the inquiry with the language of section 36(b). Arguably, section 36(b) excuses demand by a plaintiff shareholder because it expressly and unqualifiedly grants to the shareholders of investment companies a right to bring suit.¹⁵⁰ Moreover, investment company shareholders had a right to bring derivative actions to recoup excessive fees prior to the passage of section 36(b).¹⁵¹ If section 36(b) is to have meaning, it should be interpreted as granting the plaintiff shareholder something more than he had under prior law. In response, it can be said that section 36(b) did not increase shareholders' power to bring derivative actions, but instead was aimed at creating a cause of action for recouping excessive fees

generis treatment for statutory derivative claims seems essential if the regulatory scheme established by Congress in the ICA is to be given its desired and intended effect.

147. 441 U.S. 471 (1979).

148. *Id.* at 486. It is interesting that neither the *Fox*, *Weiss*, nor *Grossman* courts focused attention on state law conflicts with ICA policies. Attention was drawn instead to the relation between ICA and rule 23.1. As the court in *Fox* stated in dictum, even if it is concluded that a shareholder's § 36(b) action is derivative—bringing it within the terms of rule 23.1—it is beyond cavil that the ICA policies supersede the policies underlying the requirement of shareholder demand. 692 F.2d at 261-62.

149. 7 J. MOORE & J. LUCAS, *MOORE'S FEDERAL PRACTICE* ¶ 86.04[4] (1982 ed.); 4 C. WRIGHT & A. MILLER, *supra* note 146, § 1001, at 30-31 (1969).

150. *See supra* note 142.

151. *See, e.g., Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (1962).

which those shareholders, who qualify under rule 23.1 and state law, can pursue. There is no clear resolution to these arguments.

Congressional silence can also be explored, but not fruitfully. Arguably, if Congress wished to eliminate demand as a requirement to bringing section 36(b) actions by shareholders it would have done so expressly. By analogy, section 16(b) of the Securities Exchange Act of 1934,¹⁵² which allows shareholders to claim on behalf of their corporations "short swing" profits of insiders,¹⁵³ expressly modifies the demand requirement by allowing the shareholders to sue "if the issuer . . . fail[s] or refuse[s] to bring such suit within sixty days after request"¹⁵⁴ In response, it can be said that, by this same analogy, shareholders who bring suit under section 16(b) are judicially relieved of the contemporaneous ownership requirement of rule 23.1 even though section 16(b) does not address this issue.¹⁵⁵

It cannot be said that Congress, in enacting section 36(b), failed to consider the procedural posture of actions brought under it. In fact, Congress paid attention to procedural details. Section 36(b), inter alia, limits the class of potential defendants to recipients of compensation¹⁵⁶ and limits the award of damages to one year prior to the institution of the action.¹⁵⁷ Despite coming to contrary conclusions as to the applicability of rule 23.1 demand, both the *Fox* and *Grossman* courts concluded that "debate over the legislative history 'end[s] in a draw.'"¹⁵⁸ This leaves us with nowhere to go but to the policies of the ICA and to test which interpretation comports more closely with the policies.

It has been argued that the one year damages limitation militates against requiring demand, since normally demand implies a reasonable period of time for the corporation to respond.¹⁵⁹ If the corporation delays its response in section 36(b) actions, the one year damages limitation would operate to insulate a significant amount of

152. 15 U.S.C. § 78p(b) (1982).

153. Section 16(b) provides that "any profit realized by [an insider] from any purchase and sale, or any sale and purchase, of any equity security . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer. . . ." 15 U.S.C. § 78p(b) (1982).

154. 15 U.S.C. § 78p(b) (1982).

155. See, e.g., *Blau v. Mission Corp.*, 212 F.2d 77, 79 (2d Cir.), cert. denied, 347 U.S. 1016 (1954).

156. ICA § 36(b)(3), 15 U.S.C. § 80a-35(b)(3) (1982).

157. *Id.*

158. *Fox*, 692 F.2d at 261 n.12 (quoting *Grossman*, 674 F.2d at 121).

159. *Id.* at 261-62; see also *Weiss*, 692 F.2d at 951 (Gibbons, J., dissenting).

excessive fees from recovery.¹⁶⁰ While this is perhaps true, the simple answer is that federal courts can prevent such delays in section 36(b) actions and there exists ample justifications for so doing. Common law derivative actions, sounding in equity, have no firm and fast limitations on recovery. It was these actions in which the "reasonable response time" doctrine was developed.¹⁶¹ We believe that federal policies authorize federal courts to distinguish section 36(b) actions on the basis of its damages limitation and limit applicable state law by allowing the shareholder action to proceed unless a corporate response is obtained within a reasonably short time.¹⁶²

It may be argued that requiring the shareholder to make demand upon investment company directors does no more than force the shareholder to engage in futile fencing with the same directors whose ineffectiveness Congress found to be at the very root of the excessive fee problem.¹⁶³ In response, it can be said that the fact that Congress found it necessary to supplement prior legislation by amending the ICA to include section 36(b) cannot serve as a justification for disregarding or circumventing the earlier statutory provisions. Requiring a shareholder to make demand on the disinterested directors reaffirms and strengthens their role as corporate "watchdogs." Congress has determined, as a matter of federal policy, that disinterested directors are to have a role on the investment company's board and that they are to oversee and approve the advisory fees.¹⁶⁴ While it is true, as Congress recognized when it created sec-

160. See *Weiss*, 692 F.2d at 943; *Fox*, 692 F.2d at 261-62.

161. See 7A C. WRIGHT & A. MILLER, *supra* note 146, § 1831, at 377; see also *Hawes v. Oakland*, 104 U.S. 450, 460-61 (1881).

162. The courts could do so, consistent with rule 23.1 and state law, by sustaining shareholders complaints which allege that: (1) a copy of such complaint was mailed to the board of directors, together with a letter demanding corporate action to recoup excessive fees; (2) no response, or an inadequate response, was received by the shareholder; and (3) a reasonable period of time has passed between the mailing of the demand and the filing of the complaint. As to the last requirement, we believe that 15 days is a more adequate time for the corporation to respond in some manner to the shareholder.

We do not think that this scenario simply converts the demand into an empty notice requirement. By requiring the passage of a minimum period of time in which no response has been received, the statutory role of the independent directors is affirmed. If the independent directors do in fact wish to respond to the shareholder with other than a rejection, this formulation leaves them adequate time to do so.

If the directors reject the shareholders' demand, we believe the burden is upon the directors to persuade the court that the shareholders' claim is harmful to the investment company.

163. See *Fox*, 692 F.2d at 261.

164. ICA § 10, 15 U.S.C. § 80a-10 (1982) (requiring that investment company board be comprised of at least 40% disinterested directors).

tion 36(b), that the disinterested directors mechanism is an insufficient safeguard against excessive adviser fees,¹⁶⁵ it does not follow that Congress intended shareholders to bypass that mechanism completely. By requiring shareholders to make a demand on the disinterested directors prior to instituting a section 36(b) action, federal courts recognize the "watchdog" role accorded to the independent directors by Congress.¹⁶⁶

Two arguments can be advanced for requiring demand in section 36(b) actions. The first argument is that if federal policies are not affected, federal law should be interpreted so as to coexist with and not supersede state law and rule 23.1. The second argument is that demand, per se, would bring before the courts the issue of the desirability of the action, protecting the investment company and its shareholders from "strike suits," i.e., from injurious litigation. On balance, we conclude that there is no conflict between the policies of section 36(b) and the ICA as a whole, and the *mere* requirement for demand.

The last issue to be resolved is whether some state laws, through rule 23.1, may conflict with federal policies. As discussed previously, some state courts apply the business judgment rule, thereby deferring to the directors' opinion that a derivative suit is not in the company's best interests.¹⁶⁷ Would federal policies as set out in the ICA conflict with such state laws?

On this question, we have conflicting signals from the Supreme Court. In *Burks* while not dealing with demand in a section 36(b) action, the majority implied that federal policies as enumerated in the ICA would not conflict with state laws which require judicial review of the merits of the desirability of a derivative action.¹⁶⁸ The court set forth a hypothetical situation when independent directors may justifiably terminate a derivative suit: where the expected litigation costs would outweigh the potential recovery.¹⁶⁹ The majority's statement implies that, consistent with federal policies, a court may

165. See S. REP. No. 184, 91st Cong., 2d Sess. 1, reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4897, 4898 (1970) ("in view of the potential conflicts of interest involved in the setting of [adviser] fees, there should be effective means for the courts to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty."); see also *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977), cert. denied, 434 U.S. 934 (1978).

166. See *Fox*, 692 F.2d at 259.

167. E.g., *Auerbach v. Bennett*, 47 N.Y.2d 619, 623, 393 N.E.2d 994, 996, 419 N.Y.S.2d 920, 922 (1979).

168. 441 U.S. at 477-80.

169. *Id.* at 485.

terminate a derivative suit based on the ICA if this standard is not met.¹⁷⁰ There is also dictum that investment company directors have no power to terminate a section 36(b) action.¹⁷¹ It is not clear, however, whether this dictum implies that a *court* cannot do so, in spite of the language of section 36(b). After all, section 36(b) was designed to benefit the investment company and its shareholders, not permit a shareholder to act to their detriment.¹⁷²

Justices Stewart and Powell, on the other hand, suggest that the courts should always defer to the disinterested directors' opinion by applying the business judgment rule as a matter of federal policy.¹⁷³ Their suggestion would preclude judicial review if the directors are independent and would include litigation committees among the class of independent directors.

We submit that federal policies underlying section 36(b) conflict with the application of the business judgment rule to the demand requirement, even if, as we assert, the requirement should apply. This interpretation does not conflict with our previous conclusion. It does not follow that, because the demand requirement applies, the ultimate power over the claim should be placed in the hands of the investment company directors. Unlike a derivative suit brought in a jurisdiction where the *Auerbach v. Bennett* "doctrine of deference"¹⁷⁴ is utilized, Congress has expressly granted the shareholders of investment companies the right to bring section 36(b) actions on behalf of the company.¹⁷⁵ Section 36(b) may be read as vesting the decision regarding the prudence of the claim to the shareholder. Therefore, the directors' judgment as to the propriety of bringing the claim should not be dispositive. Although the courts may not defer to the directors by terminating the shareholder action, the directors may, nevertheless, respond to the shareholder demand in other ways. Demand puts them on notice that a law suit is imminent.¹⁷⁶ In addition, requiring demand brings management's exper-

170. *Id.*

171. "And when Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b) . . . performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees." 441 U.S. at 484 (footnote omitted).

172. See *supra* note 143 and accompanying text.

173. 441 U.S. at 487 (Stewart, J., concurring and Powell, J., joining).

174. 47 N.Y.2d 619, 623, 393 N.E.2d 994, 996, 419 N.Y.S.2d 920, 922 (1979).

175. 15 U.S.C. § 80a-35(b) ("An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company. . . .").

176. For example, the directors may recognize that the claim is meritorious and negoti-

tive before the court on the issue of desirability of the action.

We conclude that courts should apply the demand requirement in state law and rule 23.1 to a section 36(b) suit. If state law, however, requires the courts to defer to the disinterested directors to terminate a section 36(b) action under the business judgment rule, the courts should refrain from doing so in light of the federal policies established in section 36(b). However, if it is shown that the action is harmful to the investment company, for example, if the recovery expected is less than the cost of the litigation, courts may terminate the action as against federal policy as expressed in section 36(b).

III. CONCLUSION

In general, the demand question will be better understood and resolved if it is viewed as a device through which the courts can determine whether an action by a shareholder on behalf of the corporation is prudent, namely, whether it is beneficial to the corporation. Since courts cannot generally interfere, absent a conflict between litigants, the rule 23.1 and state law demand requirement is an ingenious way in which to create such a conflict to pose before the courts the issue of the prudence of bringing the derivative action. In all cases, the courts should review the issue on its merits, in accordance with legal standards, because neither the directors, nor the shareholders, are reliable fiduciaries to be entrusted with the decision. In the course of this resolution, courts should allow the directors or the plaintiff shareholder to present their views, giving these views credence depending upon the nature of the claim, the expertise of the parties, and the relative absence of conflict of interest between each of the two contenders and the corporation.

In a derivative suit based on an express federal statutory grant of power to the plaintiff shareholder, such as section 36(b) of the ICA, rule 23.1, and state law must be interpreted in light of this statutory grant. Investment company shareholders should be required, as a prerequisite to instituting a section 36(b) action, to make demand on the investment company board of directors to recoup the alleged excessive adviser fees. Courts administering the demand requirement must make it clear that excessive delays in the corporation's response to demand will not be permitted in the con-

ate a settlement with the investment adviser, avoiding costly and unnecessary litigation. Alternatively, the directors may convince the shareholder that his claim is not meritorious, again avoiding litigation. See *Weiss*, 692 F.2d at 942 (citing *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979)).

text of section 36(b) claims.

Federal policy points to vesting in the courts the final decision on the merits of bringing the claim and to a rule similar to that suggested in the first part of this article: The prudence of the litigation should come before the courts by imposing a demand requirement. The standards by which the courts would evaluate the benefit to the company should encompass potential net gain both in dollars and cents as well as in broader terms of enforcing managements' fiduciary duties. This formula may help effectuate congressional mandate, prevent strike suits, and keep intact managements' authority and the independent directors' role.

POSTSCRIPT

On January 18, 1984, after this article went to press, the Supreme Court in a unanimous opinion (Justice Stevens concurring), upheld the Second Circuit's decision in *Daily Income Fund, Inc. v. Fox*.¹⁷⁷ The Court held that a shareholder suing under section 36(b) of the ICA need not make a demand on the investment company's directors before initiating the suit, for the following reasons: (1) Rule 23.1 applies only to those derivative suits which the corporation can properly assert itself (presumably, through its board of directors);¹⁷⁸ and (2) section 36(b) of the ICA does not grant the investment company the right to assert a claim under that section.¹⁷⁹ Therefore, rule 23.1 is inapplicable to shareholders' suit under section 36(b) and the plaintiff may proceed to litigate.¹⁸⁰

Justice Stevens took a different route to reach the same result. He concluded that: (1) Rule 23.1 is a mere pleading rule; (2) the plaintiff *complied* with the rule by stating that he did not make demand on the directors; (3) the substantive standards applicable to the demand requirement are to be found in section 36(b) of the ICA, which created the cause of action; and (4) the language and history of the section do not indicate that Congress contemplated a demand by the shareholders which would result in directors' termination of the action.¹⁸¹ Therefore, even though rule 23.1 *does* apply to this case, the plaintiff complied with it and may proceed to litigate, regardless of how the directors view the action.

The Court construed rule 23.1 to be a codification of judicially created standards regarding the demand requirement—a standard designed to ensure that the directors control corporate litigation and exercise their business judgment in so doing.¹⁸²

The holding of the decision is neither particularly disturbing nor

177. 52 U.S.L.W. 4119 (U.S. Jan. 18, 1984), *aff'g sub nom. Fox v. Reich & Tang, Inc.*, 692 F.2d 250 (2d Cir. 1983).

178. *Id.* at 4120.

179. *Id.* at 4123.

180. *Id.* at 4124.

181. *Id.* at 4125 (Stevens, J., concurring).

182. *Id.* at 4121 ("The Rule's provisions derive from the Court's decision in *Hawes* . . ."). Justice Stevens viewed rule 23.1 as a pleading rule, devoid of substantive underpinnings, and derived the substantive standards with respect to the demand requirement from the section on which the claim was based and, perhaps, also from the *Hawes* decision. *See id.* at 4125 (Stevens, J., concurring). He seems to have deviated from the ruling in *Burks v. Lasker*, 441 U.S. 471 (1979), that the source of standards on the demand requirement is the law of incorporation of the investment company, subject to the policies of the ICA.

surprising. It is clear that congressional disappointment with the independent directors' supervision of advisory fees led Congress to grant shareholders the power to sue the adviser for excessive fees.¹⁸³ The decision, therefore, implements congressional intent and policy. The rationale of both opinions, however, raises problems regarding section 36(b) suits, and the Court's opinion has far reaching consequences to parties in derivative actions in general.

With respect to section 36(b) actions, if, as the Court stated, rule 23.1 is inapplicable in its entirety, then the other provisions of the rule are inapplicable to these suits as well. These provisions require that settlements in derivative suits be approved by the courts; that plaintiffs represent the companies on whose behalf they sue adequately; and that plaintiffs own shares in the company at the time the wrong was committed.¹⁸⁴ If the courts are to assert the power to disqualify plaintiffs and disapprove settlements of claims under section 36(b), the courts must find a source of power to do so outside of rule 23.1. Such authority could implicitly be found in the ICA. However, there is little in the ICA that would indicate congressional intent on the subject. Using the *Burks v. Lasker*¹⁸⁵ analysis, the Court's approach may lead to finding judicial authority in the applicable state incorporation laws.¹⁸⁶ If these laws are to apply, however, they must differ from the provisions of rule 23.1 in that they must cover derivative suits which the corporation *cannot* assert itself. Yet, most state rules follow the language of this federal rule¹⁸⁷ and, therefore, would be inapplicable to a section 36(b) action, unless the state courts interpret their own rules differently from the interpretation of rule 23.1 by the Supreme Court.¹⁸⁸ In sum, the Court's opinion creates problems in the settlement and adequate representation areas with respect to section 36(b) actions. In future cases, courts could, however, classify section 36(b) actions as class actions to which rule 23 would apply. That rule contains similar provisions to those of rule

183. See 2 T. FRANKEL, *THE REGULATION OF MONEY MANAGERS* §§ 15, 16 (1978).

184. FED. R. CIV. P. 23.1.

185. 441 U.S. 471 (1979).

186. These state laws are subject to conflicting federal policies of the ICA. Arguably, there is nothing in the ICA which would conflict with state laws requiring court approval of settlements or supervision of plaintiffs' qualifications.

187. See, e.g., COLO. REV. STAT. § 23.1 (1973).

188. The problem arises, in a different way, in the case of Justice Steven's opinion. If rule 23.1 is a pure pleading rule, the standards applicable to settlement approval and disqualification of plaintiffs must be found elsewhere. These requirements in the rule would be, at the very least, subject to attack as extending beyond the realm of pleading and, therefore, having no place in the rule.

23.1 as to adequacy of representation and court approval of settlements.¹⁸⁹

The most far-reaching part of the Court's opinion is found, I believe, at the end of footnote 8. The implications of that footnote extend beyond section 36(b) actions to derivative suits before federal courts both in diversity and federal question jurisdiction. The Court states that:

Because we conclude that a suit brought under § 36(b) of the Investment Company Act is not a 'derivative action' for purposes of Rule 23.1, . . . we need not decide whether the Rule itself, as a matter of federal procedure, makes demand on directors the predicate to a proper derivative suit in federal courts or whether any such obligation must instead be found in applicable substantive law.¹⁹⁰

This statement opens the door to a determination that the rule—although procedural for the purposes of the *Erie* doctrine and hence, binding on federal courts—can apply not only to pleading requirements, but can also be a source of power for the federal courts to develop standards as to the consequences of these pleadings, e.g., the fate of derivative suits which the directors oppose because, in their opinion, the suits are not in the corporation's best interests.

There are indications in the Court's opinion that rule 23.1 may indeed be destined to be a source of federal common law power and that such an interpretation of the rule is in the offing. As Justice Stevens noted, the view of the rule as a source of substantive federal common law presents thorny problems and is fraught with difficulties.¹⁹¹ If this is the route the Supreme Court will choose to take, it raises very important and difficult questions concerning the relations between federal and state law as well as policy issues as to the direc-

189. FED. R. CIV. P. 23.

190. *Daily Income*, 52 U.S.L.W. at 4122 n.8.

191. *Id.* at 4125 n.2 (Stevens, J., concurring).

This construction of the rule [that it is concerned solely with the adequacy of the pleadings] is consistent with the Rules Enabling Act, which states that the federal "rules shall not abridge, enlarge or modify any substantive right," 28 U.S.C. § 2072. . . . It cannot be doubted that this type of [demand] requirement, designed to improve corporate governance, is one of substantive law. . . . Ely, *The Irrepressible Myth of Erie*, 87 HARV. L. REV. 693 (1974). Therefore, there is substantial doubt whether the rule could create such a requirement consistently with the Rules Enabling Act. . . . Since the rule does not clearly create such a substantive requirement by its express terms, it should not be lightly construed to do so and thereby alter substantive rights.

Id. (citations omitted).

tors' powers to terminate claims based on the breach of these directors' fiduciary duties. This postscript is not the place to develop these questions, but I may have occasion to do so in the future, if my reading of the case is correct.

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