Director Dismissal of Shareholder Derivative Suits Under the Investment Company Act: *Burks v. Lasker*

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**INTRODUCTION**

When a federal cause of action is brought in the federal courts and Congress has not enacted a statute directly governing the issue, the federal courts have sometimes adopted state law to fill the gap.¹ This approach was taken in *Burks v. Lasker,*² where the Supreme Court held that state law should be used to define the authority of a disinterested director of an investment company³ to terminate a shareholder derivative suit brought against other directors under the Investment Company Act of 1940 ("ICA").⁴ This note will describe the elements generally considered in the determination of whether to adopt state law or to fashion a federal rule and, in relation to those elements, will examine the Investment Company Act of 1940 and its recent amendments. The Supreme Court opinion will then be discussed and criticized. Finally, an alternative approach will be suggested which, in light of the policies behind the Investment Company Act, calls for the development of a federal rule as opposed to the adoption of state law.

3. The Investment Company Act of 1940, 15 U.S.C. § 80a-3 (1976) [hereinafter "ICA"], provides in part:
   
   (a) When used in this title, "investment company" means any issuer which—
   (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percentum of the value of such issuer's total assets . . . on an unconsolidated basis.
Federal Adoption of State Law

Generally

If a cause of action is created by a federal statute, it is well settled that the *Erie* doctrine does not apply and state law will not operate of its own force. However, when a federal statute does not adequately address a particular issue, ambiguities are created. To fill the gap, a court must decide whether state law should apply or whether a federal rule should be developed. In this situation, some courts have "fashion[ed] the governing rule of law according to their own standards." Indeed, with respect to providing adequate relief to those denied a federally created right, federal courts "may use any available remedy to make good the wrong done." Yet courts are also reluctant to disregard state law where Congress has not mandated such a result. Thus, the remedy chosen by a court

5. The *Erie* doctrine dictates that state substantive law must be applied in federal courts on state causes of action. *Erie R. R. v. Tompkins*, 304 U.S. 64 (1938). This doctrine has been well received and has led one commentator to remark:

The complimentary concepts—that federal courts must follow state decisions on matters of substantive law appropriately cognizable by the states whereas state courts must follow federal decisions on subjects within national legislative power where Congress has so directed—seem so beautifully simple, and so simply beautiful, that we must wonder why a century and a half were needed to discover them, and must wonder even more why anyone should want to shy away once the discovery was made.


7. Ambiguities are especially likely to arise in conjunction with suits brought under the Investment Company Act. Although the ICA is a federal legislation, investment companies that fall under its regulation must incorporate under state incorporation statutes.


is occasionally the adoption of state law.  

When a federal court considers adoption of a state rule, it examines three critical factors: a need for consistency; a need for uniformity; and the congressional intent in enacting the federal statute. Since a federal program is at issue, a rule may not be adopted that would contravene the purpose of that program. Therefore, if a state law is not in accord with the federal program, two options are available to a court. First, the state law could be completely rejected for federal purposes, but remain in effect for state matters. Second, the court could reject the law of a particular state and fashion a federal rule for that state in its stead. However, this latter choice might have the anomalous result of state law being adopted for some states, while a federal rule is in effect in other states. Obviously, then the benefits of consistency are lost.

The need for uniformity also plays an important role in the decision to adopt a state rule or to develop a federal rule. Where it appears that the federal program must be uniform throughout the nation, the necessity for the formulation of a single federal rule becomes clear. Conversely, where the federal program does not require a nationally uniform rule of law, state law may be adopted. Although this "uniformity argument" is considered by the courts, some commentators believe the factor is inappropriate.

13. Mishkin, supra note 6, at 805-806.
14. When the court rejects the rule of a particular state and adopts the rule of another state, the rule of the first state continues to operate as to state matters. Moreover, any state law that is adopted is, in effect, absorbed into the federal scheme and is not an independent source for private rights. Textile Workers Union v. Lincoln Mills, 353 U.S. 448, 457 (1957); Mishkin, supra note 6, at 806.
They suggest that the increasing reliance on centralized government diminishes the importance of the states and harms the fundamental nature of federalism.\(^{17}\) Other commentators have noted that the Supreme Court lacks the time and resources to develop detailed substantive rules that uniformity requires.\(^ {18}\)

The overriding factor used to determine whether to adopt a state rule has been congressional intent.\(^ {19}\) The court must examine not only whom and in what manner the statute seeks to protect, but also the specific congressional activity in enacting the law and the historical background of the legislative scheme.\(^ {20}\) Once legislative intent is formulated, the effect of applying the state law to it must be ascertained.\(^ {21}\) Only then can the court effectively decide whether or not to adopt the state rule.

**Securities Law**

Federal securities regulation has had a great impact on what previously was considered to be exclusively state corporation law.\(^ {22}\)

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17. Since our government is based on federalism, national action is, for the most part, an "exceptional" occurrence in our policy. As one commentator observes: "Indeed, with all the centralizing growth throughout the years, federal law is still largely an interstitial product, rarely occupying any field completely, building normally upon legal relationships established by the states." Wechsler, The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government, 54 Colum. L. Rev. 543, 544-45 (1954).

18. Mishkin, supra note 6, at 813-14.


20. Cort v. Ash, 422 U.S. 66, 82 (1975) (the court uses factors such as "a clearly articulated federal right in the plaintiff . . . , or a pervasive legislative scheme," in determining whether to imply a private cause of action); Wallis v. Pan American Petroleum Corp., 384 U.S. 63, 69 (1966) (here, the court notes that any federal statute is "a prime repository of federal policy and a starting point for federal common law."); Textile Workers Union v. Lincoln Mills, 353 U.S. 448, 456-57 (1957) (the court looked at the "policy of our national labor laws" to determine whether to enforce an arbitration clause in a labor contract); United States v. Standard Oil of California, 332 U.S. 301, 309 (1947) (this court employed a theory of consent to the application of state law by congressional silence on a matter); Dietrick v. Greaney, 309 U.S. 190, 200-201 (1940) (the remedy is to be derived from the federal statute, even where it remains silent on an issue, by looking at its policy).


22. Federal securities laws have to a great extent generated a "wholly new and far-reaching body of Federal corporation law." In the matter of Cady, Roberts & Co., 40 S.E.C. 907,
Yet the federal law is only pervasive, not exclusive. Essentially, securities laws have been directed at specific practices or problems such as proxy regulation and disclosure requirements. These types of regulation do not pre-empt state corporation laws, which are enacted for other reasons. However, state corporation law has not been readily adopted by the federal courts and it "is not uncommon for federal courts to fashion federal law where federal rights are concerned."

In determining whether to adopt state law with respect to the Investment Company Act, the ICA has been distinguished from previous securities acts. Unlike the other acts, "the 1940 Act operates as a corporation law for investment companies" in many respects. Cognizant of this broad scope of the ICA, courts have specifically rejected the state imposed requirements of demand and security for expenses in shareholder derivative suits brought under the statute. The reluctance of courts to adopt state law can best be understood in light of the historical development of the ICA.

The development of investment companies began in the early
Against the background of the stock market boom, the public sought to invest their money in these investment companies and investment trusts. In the period between 1927 and 1929, almost 600 investment companies were organized. Assets of these companies reached a height of more than $8 billion before the market crash in 1929.

In the wake of the stock market crash, total assets of the industry dropped to a low of $2 billion in 1932. Some of the losses were due to unrealized depreciation on portfolio securities and general business decline. However, substantial losses were the direct result of fund mismanagement and organizer self-dealing. Fund securi-

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28. Promoters of these investing organizations were attracted by the fact that no large personal outlay of cash was necessary to establish an investment company. An even more appealing factor was that governmental supervision was lax and that there were no specific statutory restraints on investment companies. SEC Report on Investment Trusts and Investment Companies, pursuant to § 30 of the Public Utility Holding Co. Act of 1935, part III, ch. 1, 3 (1940) [hereinafter cited as Report]. These promoters advertised expert management of funds and a lower risk of loss through the ability to purchase and maintain diversified portfolios. Report, Part III, ch. 1, 36-37. However, the advertised advantages of investment companies never materialized. The investment company funds performed no better than the common stock index. The failure to achieve such benefits resulted from abuses in the management of the funds by those in control. Report, Part II, Appendix J, 904-06 and supplement V, p. 933 et seq. (H.R. Doc. No. 70, 76th Cong.).


30. Report, supra note 28, Part III, ch. 1, 3; Part II, ch. 2, Table 16, 111 (H.R. Doc. No. 70, 76th Cong.). The 600 investment companies mentioned represented one-half of the investment companies, whose dates of organization were known to the Commission, that were in existence in 1929. The peak of this accelerated expansion was reached in 1929 when "investment companies were literally being formed at the rate of almost one each business day." Yearly sales increased from almost $400 million in 1927 to over $3 billion in 1929. Report, supra note 28, Part III, ch. 1, 3; Part II, ch. 2, Table 16, 111 (H.R. Doc. No. 70, 76th Cong.).


32. Report, supra note 28, Part III, ch. 1, 17; Part II, ch. 2, 32 (H.R. Doc. No. 70, 76th Cong.).

33. The SEC revealed that control people, such as managers, officers, directors and sponsors, often effected transactions on their own behalf. Such transactions took the forms of selling personally acquired, unmarketable securities to their investment companies, encouraging the company to take over interests in which they were obligated, or causing the company to extend financing to clients of these insiders. Other forms of mismanagement of funds surfaced as excessive profits to organizers, failure to diversify portfolios and creation of investment companies for ulterior purposes. Report, supra note 28, Part III, ch. 1, 22 and 47-48. For a detailed description of prevalent abuses, see Tolins, The Investment Company Act of 1940, 26 Cornell L.Q. 77 (1940).

To restore some faith in the companies and overcome strong sales resistance by the public, promoters developed the fixed and semi-fixed trusts. These trusts limited management involvement and offered an interest in the fund which could be redeemed at any time for a proportion of the net assets of the company. Report, supra note 28, Part III, ch. 1, 26-28.
ties were sold at considerable discounts and investment company management became widely disfavored by the public.

Although the popularity of investment companies declined, it was estimated that in 1940, “one out of ten investors in the country”\(^34\) was a participant in an investment company or trust. Because these investors were typically composed of “widely scattered small security holders,”\(^35\) it was virtually impossible to make a concerted effort to control the various abuses that were occurring. Congress realized that earlier securities statutes were inadequate to deter the abuses and unscrupulous practices prevalent in investment companies.\(^36\) Thus, the Investment Company Act of 1940 was enacted as another in a series of investor-protection statutes.\(^37\)

The ICA is perceived as a broad, comprehensive regulatory scheme which approaches a corporation law for investment companies.\(^38\) Its scope has been likened to that of federal regulation in

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34. Report, supra note 28, Part III, ch. 1, 31-32; Part II, ch. 5, 369-71 (H.R. Doc. No. 70, 76th Cong.).


37. Congress states in § 1 of the ICA that:

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.


the banking and insurance industries, and has been contrasted with the much narrower reach of the Securities Act of 1933 and the Securities Exchange Act of 1934. It is by far the most complex of the federal securities acts. In *Burks v. Lasker*, however, the Supreme Court was presented an issue not specifically governed by the ICA.

**Burks v. Lasker**

*The Factual Background*

On February 5, 1973, two shareholders of Fundamental Investors, Inc., ("Fundamental" or the "Fund"), an investment company registered under the Investment Company Act of 1940 and...
incorporated pursuant to Delaware law, brought a derivative suit against the Fund's investment adviser, Anchor Corporation ("Anchor") and several former and present members of the Fund's board of directors. The dispute arose over Anchor's recommendations to buy and Fundamental's purchase of $20 million of Penn Central 270-day notes from Goldman, Sachs & Co. in 1969. Seven months after the purchase, Penn Central filed for reorganization under the Bankruptcy Act and consequently the notes were not paid on maturity.

The plaintiffs alleged that the Fund's board members and investment adviser failed to make an independent investigation of the quality and safety of the notes that had been purchased. The defendant directors were charged with violating sections 13(a)(3) and 36 of the ICA for relying solely on the representations of Goldman, Sachs & Co. Anchor was charged with violation of section 206 of the Investment Advisers Act, and breach of the investment advisers contract. Additionally, all defendants were charged

45. Id. at 1174. The Fund purchased the 270-day notes on four separate dates: November 26, December 2, 4 and 8, 1969. Each transaction represented the purchase of $5 million of Penn Central commercial paper.
46. Id. The petition for reorganization was filed pursuant to § 77 of the Bankruptcy Act, 11 U.S.C. § 1 et seq. (1976).
50. Section 206 describes prohibited transactions by investment advisers. 15 U.S.C. § 80b-206 (1976). This article will concentrate on the Investment Company Act as opposed to the Investment Advisers Act (IAA) due to the recent Supreme Court decision which precludes a private cause of action under § 206 of the IAA. Transamerica Mortgage Advisers, Inc. v. Lewis, 48 U.S.L.W. 4001 (October 9, 1979) (The Court held that a private cause of action was not warranted by the language or purposes of the IAA. They also opined that to allow a private cause of action would undermine well-reasoned limitations on federal court
with breach of common-law fiduciary duties.\textsuperscript{51}

Fundamental's board of directors met to discuss the pending derivative suit. They determined that of the eleven board members, five directors should act as a quorum of "disinterested directors."\textsuperscript{52}

\textsuperscript{51} Lasker v. Burks, 404 F. Supp. at 1175.

\textsuperscript{52} Brief for Petitioner at 7, Burks v. Lasker, 441 U.S. 471 (1979). The remaining directors were named defendants to the action or affiliated with Anchor. The statutory definition of "interested person" can be found at 15 U.S.C. § 80a-2(a)(1976). The ICA adopted the "unaffiliated director" as its primary safeguard against overreaching by managers and advisers. Conference on Mutual Funds, 115 U. Pa. L. Rev. 669, 739 (1967) (comment by A. Pomerantz). At least 40% of the board of directors of an investment company could not be officers or employees of the company or affiliated with its investment adviser. Investment Company Act of 1940, § 10, 54 Stat. 80 (current version at 15 U.S.C. § 80a-10 (1976)). Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir. 1977), cert. denied, 434 U.S. 934 (1977). Such directors were to act as "watchdogs," ensuring that stated investment policies were being carried out and providing an independent check on management. Conference on Mutual Funds, supra, at 739. It soon became apparent that the classification of "unaffiliated" person was too narrow. Adequate protection of shareholder interests was not being provided since one who was not an officer or employee of the investment company but who, nonetheless, had close ties with a company adviser could be classified as an "independent" director. S. Rep. No. 184, 91st Cong., 1st Sess. 32 (1969), reprinted in, [1970] U.S. Code Cong. & Ad. News 4897, 4927; Public Policy Report, supra note 36, at 333. Although technically unaffiliated, the director would be partial to the adviser and would hesitate to take any action against him. S. Rep. No. 184, 91st Cong., 1st Sess. 32, reprinted in, [1970] U.S. Code Cong. & Ad. News 4897, 4927. Such occurrences prompted the observation that: The affiliated men pick the unaffiliated men. The men who need to be watched pick the watchdogs to watch them . . . But obviously, you know and I know that if you are choosing an unaffiliated director or an independent director you are not going to choose anybody who is going to be too hard on you. Conference on Mutual Funds, 115 U. Pa. L. Rev. 669, 739 (1967) (comment by A. Pomerantz).

In 1970, Congress amended the ICA and strengthened the independent director safeguard. Section 2(a)(19), defining the term "interested persons", was added as a substitute for the deficient term "affiliated person." This term was not, however, used to widen the scope of sections 10(f) and 17 of the Act. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 15 U.S.C. §§ 80a-10, 17 (1976). The new term encompasses family members of affiliated persons as well as those who have beneficial or legal interests in securities issued by the investment adviser, principal underwriter and their controlling persons. Such "interested" individuals are now precluded from occupying the status of independent director. See also, Goldberg, Disinterested Directors, Independent Directors and the Investment Company Act of 1940, 9 Loy. Chi. L.J. 565 (1978). Congress also expanded the relief available for managerial abuse. Former § 36 of the ICA, forbidding "gross abuse of trust," was amended to forbid "breach of fiduciary duty involving personal misconduct." Investment Company Amendments Act of 1970, supra, at § 36(a). In addition, a private right of action under § 36 of the ICA was created for breach of fiduciary duty in setting advisory fees. Congress added § 36 to make it clear to the court that fund advisers had a fiduciary duty to the funds they advise. Prior to the enactment of this section, courts required shareholders to prove mismanagement and waste of corporate assets before recovery could be had for excessive management fees. Galfand v. Chestnutt, 402 F. Supp. 1318, 1325 (1975), aff'd, 545 F.2d 807 (2d Cir. 1976). Thus, shareholders, as well as the SEC, have been provided with a vehi-
to decide the Fund's proper course of action. These five were not affiliated in any way with Anchor, had not been directors at the time of the events complained of, and were not defendants in the suit. After retaining outside counsel and reviewing alternative means of proceeding, the disinterested directors moved to dismiss the suit as an exercise of their business judgment.


54. Wickers, an officer of both the Fund and Anchor, ascertained that Stanley H. Fuld, former chief justice of the New York Court of Appeals, would be available to serve as special counsel to the disinterested director group. The disinterested board members agreed to retain Judge Fuld.

Judge Fuld prepared a memorandum which outlined three alternatives that the board might pursue: (1) to seek realignment to gain control of the action; (2) move to have the suit dismissed; (3) maintain a neutral position and allow the suit to proceed. Lasker v. Burks, 404 F. Supp. 1172, 1176 (S.D.N.Y. 1975).

55. Lasker v. Burks, 426 F. Supp. 844 (1977). The directors gave ten reasons for their decision to dismiss the suit: (1) little likelihood of success; (2) likely inability for the Fund to attract and maintain personnel during the pendency of the trial; (3) the necessity of removing Anchor as investment adviser which would cause delay and uncertainty in management; (4) Anchor had acted in good faith in suggesting the purchase of Penn Central notes; (5) Anchor had acted prudently in following the general belief that commercial paper was like cash; (6) other financial institutions had also purchased the Penn Central notes; (7) some affirmative action should be taken by the Board; (8) Judge Fuld's analysis that Anchor was not at fault since they are not to be held as insurers; (9) unnecessary litigation costs to the Fund; and (10) maximum recovery possible was too small to risk the damage to the Fund's shareholders which the suit may produce. Lasker v. Burks, 404 F. Supp. 1172, 1176-77 (S.D.N.Y. 1975).


Generally, the choice of whether to enforce a corporate cause of action is considered to be a matter of internal management and falls within the limitations of the business judgment rule. Ashwander v. Tennessee Valley Authority, 297 U.S. 288, 320 (1936); United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 263 (1917); Hausman v. Buckley, 299 F.2d 696, 702 (2d Cir. 1962).
Upon consideration of the motion to dismiss, the District Court for the Southern District of New York initially held that the minority directors had the power to seek dismissal of the derivative suit as long as they were "truly disinterested and independent." The court then permitted further discovery on this point and allowed the directors to renew their motion to dismiss. Upon rehearing, the court held that the plaintiffs had failed to sustain the burden of proving that the directors were not truly disinterested. Thus, the motion to dismiss was granted based upon the business judgment rule, which presumes that the directors acted in good faith.

Plaintiffs appealed this decision on the ground that, under the ICA, minority directors have no authority to dismiss a nonfrivolous derivative suit against the fund's majority directors and investment adviser. The Court of Appeals for the Second Circuit recognized this as a case of first impression. The court reasoned that although the ICA was designed to interpose statutorily disinterested directors as a check on majority directors, Congress did not intend these disinterested directors to have the final word in determining whether the best interests of the fund would be served by pressing claims against co-directors and advisers. Accordingly, the Second Circuit reversed the district court and held that dismissal by minority directors is against congressional policies and cannot be sustained. The Supreme Court granted certiorari on this issue.

The Supreme Court Decision

The question confronting the Supreme Court in Burks v. Lasker was whether the disinterested directors of an investment company may terminate a stockholder's derivative suit brought

59. Id. at 852.
60. Id. at 853. See note 56 supra for a discussion of the business judgment rule.
62. Id. at 1211.
63. Id. at 1210.
64. Id. at 1208. To form the basis of its opinion, the court focused on the policy behind the enactment of the Investment Company Act and the practical reality that board members can never be truly "disinterested" as to the actions of their colleagues.
against other directors under the Investment Company Act.\textsuperscript{67} Writing for the Court, Justice Brennan first considered the issue of whether federal common law or state law governs the authority of a director to dismiss such a suit.\textsuperscript{68} The ICA is silent on this point.

Recognizing that the suit was brought pursuant to a federal cause of action, the Court cited \textit{J.I. Case Co. v. Borak}\textsuperscript{69} for the proposition that where a federal statute is controlling, the courts need not adopt state law.\textsuperscript{70} He further acknowledged that in certain areas, federal statutes authorize federal courts to create a complete body of federal common law.\textsuperscript{71} Justice Brennan reasoned, however, that the above principles do not make state law irrelevant and he concluded that corporation law is one area where federal courts should not develop a federal common law.\textsuperscript{72}

Supporting this conclusion, Justice Brennan noted that federal corporation law regarding directoral power is largely regulatory and prohibitory in nature and enacted only tangentially to state law.\textsuperscript{73} In this respect, he reasoned that the regulation of mutual funds is no different than that of conventional corporations, because "[m]utual funds, like other corporations, are incorporated pursuant to state, not federal law."\textsuperscript{74} Therefore, Justice Brennan held that the ICA did not displace state law.\textsuperscript{75}

Although permitting state law to govern might lead to inconsistencies, to Justice Brennan uniformity was not of paramount importance in the area of director dismissal of derivative suits.\textsuperscript{76} Rather, the critical requirement is that the state law meet the standards necessary to insure that the policies of the Act will be carried out. To guarantee that the standards are met, Justice

\textsuperscript{68} 441 U.S. at 476. The Supreme Court assumed, without deciding, that implied causes of actions existed and that a derivative action was appropriate as a means for seeking relief.
\textsuperscript{69} 377 U.S. 426 (1964), cited at, 441 U.S. at 477.
\textsuperscript{70} \textit{J. I. Case Co. v. Borak}, 377 U.S. 426, 434 (1964) (shareholder derivative suit alleging violation of pre-emptive rights and violation of the Securities Exchange Act of 1934 § 14(a) for effecting a merger with a false and misleading proxy statement).
\textsuperscript{71} 441 U.S. at 477.
\textsuperscript{72} Id.
\textsuperscript{73} Id. at 478.
\textsuperscript{74} Id.
\textsuperscript{75} Id. at 479. Justice Brennan stated that "it is state law which is the font of corporate director's powers," and that Congress has never indicated an intention to completely replace state law whenever a federal cause of action is asserted. As to the mutual fund industry, Justice Brennan noted that the ICA does not create managerial powers, but rather, seeks to restrict and control internal management.
\textsuperscript{76} Id. at 479 n.6.
Brennan adopted the "consistency test" which mandates that only state rules consistent with federal policies may be adopted for federal purposes.\(^{77}\)

To determine whether a state law permitting director dismissal of derivative suits is contrary to federal policy, Justice Brennan next considered the purpose and structure of the ICA.\(^{78}\) Congress had been concerned with potential abuse inherent in the structure of investment companies and Justice Brennan acknowledged that the relationship between investment advisers and mutual funds had been plagued with conflicts of interests.\(^{79}\) To control these conflicts of interest, Congress had provided that at least forty percent of a fund's board of directors must be disinterested.\(^{80}\) In reviewing this provision, Justice Brennan emphasized that Congress intended these independent directors to act as a check on management and to provide a means for the representation of shareholder interests. He also noted that Congress did not expressly prohibit board action from cutting off derivative suits as it had in other sections of the Act.\(^{81}\) Justice Brennan further reasoned that there may be instances where director dismissal of a derivative suit would be in the best interest of the company.\(^{82}\) In such cases, dismissal would not contravene the investor-protection policies of the Act and could be allowed.

Thus, Justice Brennan's holding was twofold. First, Congress did not intend to absolutely prohibit director termination of all non-frivolous derivative suits. Second, federal courts should apply state law to determine the authority of independent directors to terminate nonfrivolous derivative suits "to the extent such law is consistent with the policies of the Investment Company Act."\(^{83}\) Since the district court had not considered whether the "business judgment rule" and the "presumption of good faith" were consistent with the

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77. Id. at 479-80; See notes 12-14 supra and accompanying text.
78. 441 U.S. at 480-484.
79. Id. at 481. Justice Brennan recognized that such conflicts of interests may justify some restraints even on disinterested directors but rejected the approach of the appellate court which stated that directors may never terminate a nonfrivolous suit.
80. See note 52 supra.
81. 441 U.S. at 482-83. Justice Brennan determined legislative intent, in part, by what Congress did not adopt in the 1970 amendments to the ICA. He noted that Congress did not require judicial approval before settling claims against insiders, nor did they expressly cut off directors' power to terminate derivative suits, as they have done in the past.
82. Id. at 481-82.
83. Id. at 486.
ICA, the case was remanded.84

**C**RITICISM OF THE **S**UPREME **C**OURT **D**ECISION

The Supreme Court's decision that state law should be used to determine the authority of an independent director to dismiss derivative suits, as long as it is not inconsistent with the policies of the ICA, is flawed in several respects. Most fundamentally, it is inappropriate to treat mutual funds and corporations alike simply because both are created under state law. In addition, the analysis of the congressional policy behind the ICA and of the needs for uniformity and consistency should lead to the conclusion that federal common law is necessary.

**M**utual **F**unds and **C**orporations **D**istinguished

Justice Brennan did not consider the unique pervasiveness of the ICA when he concluded that the federal statute does not displace state law. Instead, he emphasized the fact that mutual funds, like other corporations, are incorporated under state law.85 Mutual funds, however, are not like other corporations,86 their corporate structure is unique in several ways.

First, mutual funds are permitted, under the ICA, to market their shares continuously and they must be prepared to redeem outstanding shares at any time.87 A second feature of mutual funds is that their assets are composed of cash and securities only.88 These assets are readily negotiable and afford a greater opportunity for mismanagement and misuse than would be possible in industrial corporations whose assets are largely plants, fixtures and bulk goods.89 Third, and perhaps the most striking distinction between mutual funds and conventional corporations, almost all mu-

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85. Id. at 478.
86. A mutual fund has been described as a mere “shell” which holds a pool of assets belonging to several investors who, in turn, hold shares in the fund. Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir. 1977), cert. denied, 434 U.S. 934 (1977); Fogel v. Chesnutt, 533 F.2d 731, 734-35 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976).
Mutual funds are externally managed by investment advisers, while the typical corporation is internally managed.90 Because of the external management, the interests of shareholder and management are not always aligned.91 This unique structure is fraught with conflicts of interests,92 which is the reason Congress separated investment companies from other corporations by enacting the ICA.93

**Congressional Policy**

Additional support for not using state law to define the authority of directors is derived from the congressional policy found in the provisions of the ICA itself. The ICA imposes substantial obligations upon the directors of investment companies that are greater than the duties imposed upon directors of conventional corporations.94 Because of the external management of mutual funds, a fund's independent director seldom has effective control over individual investment decisions.95 Despite this lack of control, one of the most important duties imposed upon directors is to make sure that such investments are made within the limitations set forth in the company's registration statement.96 Moreover, un-
like in general corporate law, even if the director feels that a fund objective is unprofitable, he must obtain shareholder approval to invoke a change in policy.

The shareholder approval for changes in investment policy is a critical check on management in light of the observation that, generally, the people who organize the funds also act as investment advisers and are often elected to the board of directors. Reinforcing the importance of this provision, in 1970, Congress strengthened the shareholder's check by providing a private cause of action against directors for breach of fiduciary duty to the fund. Consequently, the ICA imposes a more "fundamental and pervasive" fiduciary duty upon mutual fund directors than directors of conventional corporations usually bear. Thus, by requiring more from investment company directors than from directors of conventional corporations, Congress and the courts have indicated a reluctance to allow state standards to dictate directoral responsibilities.

to make certain that these operations are carried out competently and within the scope of applicable limitations both governmental and self-imposed.


This high standard of fiduciary duty is matched by an equally stringent requirement of disclosure. Because even independent directors are dependent upon the adviser and affiliated directors for statistical and accounting information, courts have imposed a higher duty of disclosure upon investment company directors than upon directors of conventional corporations. Moses v. Burgin, 445 F.2d 369, 376 (1st Cir. 1971), cert. denied, 404 U.S. 994 (1971); Note, Private Rights of Action Against Mutual Fund Investment Advisers: Amended Section 36 of the 1940 Act, 120 U. Pa. L. Rev. 143, 145-46 (1971).

ties of mutual funds.

**Uniformity and Consistency**

In enacting the ICA, Congress specifically declared that, "the activities of [investment] companies, extending over many States . . . make difficult, if not impossible . . . effective State regulation of such companies in the interest of investors. . . ." Justice Brennan acknowledged this congressional declaration but gave it only cursory treatment in a footnote to his opinion. Considering the uniformity and consistency factors together, he determined that the enforcement problem expressed by Congress would be obviated by the availability of private causes of action in federal courts combined with the requirement that the state law used by the court be consistent with the policies of the ICA. Any state law that failed to meet the standards set forth in the ICA would be precluded from use by the federal courts.

This rationale of adopting state law only if it is consistent with the policy of the ICA is, in effect, the long road to fashioning a federal common law rule. If, for example, it is determined that the policy of the ICA dictates that director dismissal should be allowed where the interest of the company will be benefited, those states whose laws prohibit dismissal will be inconsistent with the policy of the Act. Their laws, thus, will not be applied by the federal courts. A federal rule that allows director dismissal will have to be created and used instead. In addition, even the states that permit director dismissal might allow it in a situation inconsistent with the ICA. Then, the state law would have to be modified. This approach not only creates the problem of determining which law applies, but the eventual outcome will be that one rule, allowing termination of the suit, is created as a "federal" rule.

In light of the foregoing discussion, it seems clear that the Court's directive to apply state law is both inappropriate and ineffective. In determining whether a disinterested director should be allowed to terminate a derivative suit brought against other directors under the Investment Company Act, a federal rule is necessary.

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105. *Id.*
106. *Id.*
AN ALTERNATIVE APPROACH

The Supreme Court should have taken a more direct approach, fashioning a federal rule to resolve the issue of director dismissal of derivative suits. A combination of two suggested approaches to this issue would produce an effective resolution to the problem.

One commentator suggested that the Supreme Court should employ a two-prong test: "(1) whether the independent directors' decision was a reasonable exercise of their business judgment," and (2) whether the directors were actually independent. The failure to satisfy either of these factors would preclude director dismissal of the suit.

The first factor is similar to the business judgment rule. The test is whether prudent, independent directors would terminate the derivative suit "under the circumstances prevailing at the time of the decision." In determining reasonableness, adequate disclosure of the facts to the independent directors would be crucial. Where it could be shown that relevant information was not made available, a rebuttable presumption of unreasonableness would be raised.

The second factor, independence, focuses on whether the independent directors comprised a majority or minority of the board. Where the independent directors constituted only a minority, a presumption of non-independence would be raised. In that situation, the burden of proof would be borne by the party seeking dismissal.

Under this suggested test, the decision to terminate the derivative suit in *Burks* seems to have been reasonable. Not only was

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107. Note, *Mutual Fund Independent Directors, Putting a Leash On the Watchdogs*, 47 FORDHAM L. REV. 568, 580 (1979) [hereinafter cited as *Mutual Fund Directors*]. This approach was suggested as a means to reconcile the deficiencies of the district court and appellate court decisions.

108. See note 60 supra and accompanying text for a discussion of the business judgment rule.


110. Id. at 581-82. See also note 101 supra.

111. Id. The factor of independence would additionally delve into the relationships of the directors in question to the investment adviser and other directors of the fund. The district court inquired into the independence of the directors and determined that their affiliations with other boards managed by the same adviser was insufficient to disqualify them as independent directors. *Burks v. Lasker*, 426 F. Supp. 844, 849 (S.D.N.Y. 1977).

112. *Mutual Fund Directors*, supra note 107, at 580. Such a presumption is raised because a group comprised of a minority of a board of directors is often susceptible to control by majority members of the board.

113. Id.
there disclosure of all pertinent information, but outside counsel was retained as an impartial source of advice. Moreover, it was determined that the potential gain from the litigation did not outweigh the possible detriment to the Fund. Thus, the termination of the pending suit seemed a prudent business decision.

Notwithstanding the apparent reasonableness of the directors decision, dismissal of the derivative suit would be denied. Because the independent directors comprised only a minority of the board, a presumption of non-independence automatically would arise. This presumption would not be rebutted since it was the defendant directors who screened potential nominees for the board and who selected new board members after having been notified of the derivative suit. Thus, it is likely that the interested directors exerted some influence over the disinterested directors such that impartial judgment might have been impaired. Since the directors were not independent, the safeguards provided to shareholders by the ICA broke down. Therefore, the shareholder derivative action was the only means for the shareholders to protect their interests and the suit should not have been dismissed.

A second approach to the director dismissal issue was recently

114. See note 54 supra.
115. See note 55 supra.
116. Burks v. Lasker, 441 U.S. 471 (1979). Petitioners claimed that the testimony on this point showed that none of the five "disinterested directors" were related to any of the defendants by blood or marriage; that none knew more than two of the eleven directors at the time that they joined the Board, and that none had a personal stake in the outcome of their deliberations. Brief for Petitioner at 15, Id.

However, Respondent countered with persuasive evidence that:

1. the so-called quorum was made-up of a minority of the Board who were defendants in the pending litigation;
2. the five directors selected to Fundamental's board were simultaneously selected as directors of five other funds managed by Anchor;
3. the directors selected had longstanding business and social relationships with one or more of the defendants;
4. Anchor supplied office space and equipment to the Fund at no charge as well as paid all of the salaries of the Fund's officers, executives and administrative personnel;
5. Anchor held all key executive positions; and
6. defendants, as a majority of the Board, controlled the Fund's proxy machinery. Since no shareholder owned more than one percent of the Fund's stock, it was not feasible for the minority to commence a proxy contest to assert control.

Brief for Respondent at 8-9, Burks v. Lasker, 441 U.S. 474 (1979); Mutual Fund Directors, supra note 107, at 583 (citing Petitioner's Brief at 64-66, 66-68).

117. Id.
118. See note 27 supra.
used by a Delaware Court of Chancery in *Maldonado v. Flynn*.\textsuperscript{119} The opinion was a response to the surge of cases,\textsuperscript{120} after *Burks*, brought by directors of corporations seeking the dismissal of derivative suits pending against them. The Delaware court held that where wrongdoing by defendant directors is charged, a committee of independent non-party directors, appointed by the defendant directors after the commencement of a suit, may not terminate the litigation by use of the business judgment rule.\textsuperscript{121} The business judgment rule, the court reasoned, is only a defensive rule which directors use as a shield to oppose shareholder attacks on the directors’ decisions.\textsuperscript{122} Nothing in the rule creates an independent affirmative power that permits directors to terminate a shareholder derivative suit.\textsuperscript{123} The court also mentioned, in dicta, that even if the business judgment rule were relevant to the dismissal issue presented, the concepts of “fairness and fiduciary duty” mandate that the defendant directors bear the burden of proving the independence of their select committee.\textsuperscript{124}

The two-prong test suggested as an alternative to *Burks* would be more effective if the Delaware court’s dicta concerning the satisfaction of the directors fiduciary duty\textsuperscript{120} were added as an element to be considered with the reasonable business judgment portion of the test. Since the standard of duty is higher for the mutual fund director than for the director of a conventional corporation,\textsuperscript{126} it would seem reasonable to afford it greater weight than the test implies. If fiduciary duty is considered an element of reasonableness, the burden of proof would be on the director to show that his actions were proper.\textsuperscript{127} Only upon showing of propriety of director

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\textsuperscript{119} SEC. REG. & L. REP. (BNA) K-1 (March 18, 1980).


\textsuperscript{121} Maldonado v. Flynn, SEC. REG. & L. REP. (BNA) K-1, K-5 (March 18, 1980).

\textsuperscript{122} Id. at K-2.

\textsuperscript{123} Id. at K-3.

\textsuperscript{124} Id. at K-6.

\textsuperscript{125} See notes 100-01 supra and accompanying text.

\textsuperscript{126} Id.

\textsuperscript{127} Such a shift of the burden of proof would be extremely helpful to the shareholder because under the business judgment rule the shareholder would have to prove bad faith on
action could the business judgment rule come into play.

In *Burks v. Lasker*, it is not likely that the directors would sustain the burden of proving the propriety of their actions. Not only was no independent investigation of the Penn Central notes undertaken, but the directors also failed to obtain the shareholder approval necessary to change the investment policy of the Fund. Thus, the directors effectively purchased the 270-day notes in contravention of the protections set forth in the ICA.

This addition of a fiduciary duty element may be the edge needed to offset the presumption of reasonableness of director action inherent in the business judgment rule. This approach would be very effective because it allows the freedom necessary for truly independent directors to manage efficiently a mutual fund, while it also incorporates the protection of the Investment Company Act.

**CONCLUSION**

The effect of the Supreme Court decision in *Burks v. Lasker* is likely to be twofold. Despite the stated objective to adopt state law, the outcome will be the emergence of one "federal" rule of law defining the authority of disinterested directors of investment companies to terminate a shareholder derivative suit as an exercise of their business judgment. Yet the initial deference to state law may adversely affect the development of strong federal protections intended by the enactment of the Investment Company Act.

Second, when shareholders bring a derivative suit against some
of the directors of an investment company, the defendant directors can establish a committee of "independent directors" who may then apply their business judgment and rely upon Lasker for dismissal of the suit. The result will be that shareholders will either begin to sue all of the directors on the board or risk dismissal of their suit by the director or directors not named as defendants. Without stronger guidelines set by the federal courts to safeguard the policies of the Investment Company Act, abuses of the power to terminate nonfrivolous derivative suits might become yet another one of the many abuses already recognized as prevalent in the investment company industry.

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